Globalisation and Monetary Policy : Some Emerging Issues*

Professor Radhakrishna, Professor Eichenbaun, Professor Rebelo, Professor Christiano, Professor Nachane, Dr. Rakesh Mohan and friends,

Happy New Year to all of you. For Dr. Rakesh Mohan, it is a holiday issue, as he described. For me, it is a festival issue also, since I am a Telugu. So, my address will be in the form of sharing of the festive mood also. As you may be aware, today is a festival celebrated as New Year by the State of Maharashtra, and is called Gudipadwa by the Marathi-speaking people, who number about 70 million. It is also celebrated by about 65 million Kannada-speaking people as “Ugadi”. We, the 80 million Telugu-speaking also celebrate the festival as Ugadi.

The festival marks the New Year day for people who follow the southern Indian lunar calendar. This calendar reckons dates based on the Salivahana era (Salivahana Saka), which begins its count from the supposed date of the founding of the Empire by the legendary hero Shalivahana. The Satavahana king Shalivahana (also identified as Gautamiputra Satakarni) is credited with the initiation of this era known as Shalivahana. The Shalivahana era begins its count of years from the year corresponding to 78 AD of the Gregorian calendar. Thus, the year 2000 AD corresponds to the year 1922 of the Salivahana Era. In the terminology used by this lunar calendar, Ugadi falls on *Chaitra Sudhdha Paadyami* or the first day of the bright half of the Hindu month of Chaitra.

The Telugu and Kannada people celebrate the festival with great fanfare; gatherings of the extended family and a sumptuous feast are *de rigueur*. The day, however, begins with ritual showers followed by prayers, and then the eating of a specific mixture of Neem Buds/Flowers for *Bitterness,* Jaggery for *Sweetness,* Raw Mango for *Vagaru* , Tamarind Juice for *sour.* This mixture, called "Ugadi Pachhadi" in Telugu and "Bevu-Bella" in Kannada, symbolizes the fact that life is a mixture of pleasure and pain, which should be accepted together and with equanimity.

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* Inaugural address by Dr. Y V Reddy, Governor, Reserve Bank of India on March 19, 2007 at Hotel Taj President, Mumbai at the conference on ‘Advances in Open Economy Macroeconomics’ organised by the Center for Economics and Development, Northwestern University, USA and the Indira Gandhi Institute of Development Research, Mumbai.

People traditionally gather to listen to the recitation of the religious almanac (Panchangam) of the coming year, and to the general forecast of the year to come. This is the *Panchanga Sravanam*, an informal social function where an elderly and respected person opens the new almanac pertaining to the coming year and makes a general benediction to all present. The advent of radio and television has changed this routine somewhat, especially in the cities. Nowadays, people turn on the radio or TV to watch the recitation.

Ugadi celebrations are also marked by literary discussions, poetry recitations and recognition of authors of literary works through awards and cultural programmes. Recitals of classical carnatic music and dance are held in the evenings.

In Maharashtra, it is customary to erect 'Gudis' on the first day (Padwa) of the Marathi New Year. 'Gudi' is a bamboo staff with a colored silk cloth and a garlanded goblet atop it, which symbolizes victory or achievement. Hence, this day is known as "Gudipadwa" in Maharashtra. The New Year is ushered in with the worship of the "Gudi" and the distribution of a specific "Prasadam" comprising tender neem leaves, gram-pulse and jaggery. The symbolism of tastes is the same as that of Ugadi.

It is believed that the creator of the Hindu pantheon Lord Brahma started creation on this day – Chaitra suddha padhyami or the Ugadi day. Also, the great Indian Mathematician Bhaskaracharya's calculations proclaimed the Ugadi day from the sunrise on as the beginning of the New Year, new month and new day.

Let me confess that I am not able to predict for the next year, the future of monetary policy in the open economies in general or opening economies like India, since I am yet to hear "Panchang Sravanam" for the New Year named as "Sarvajeet". There is an interesting reason why I could not hear the authentic Panchang Sravanam. There is a difference of opinion among the top pundits in Andhra Pradesh as to whether Panchang Sravanam should be on the 19th or the 20th March, 2007, and a leading light insisted that it should really be on 20th since "Surya-Grahanam" (solar eclipse) on the 19th bars "Panchang Sravanam" on that day. So, the Panchang Sravanam is slated for the 20th March at 11 am on Saptagiri official TV channel. So, I understand that the Government of Andhra Pradesh has declared that in addition to today being a holiday, the 20th March would be an optional holiday for those who would choose tomorrow for their festivities.

Friends, the Indians may be argumentative but the Telugus are not only argumentative but love freedom to choose – even their Ugadi festival day, even when based on a reading of celestial stars.

In the festive mood that lasts for two days this year for the Telugus, let me wish the deliberations of the conference on "Advances in Open Economy Macroeconomics" a very productive and pleasant time. I recognise that a number of eminent economists from the North Western University and other US universities are participating in the conference and I would like to extend a hearty welcome to them. I congratulate the economists from the IGIDR, the RBI and other Indian universities for their contributions to this conference. Let me extend a personal warm welcome to our guests from other countries – we believe in "Atithi devo bhava".

I would like to take this opportunity to share a few thoughts on a possible rethink that may be occurring in regard to globalisation that could affect how the open economies would choose to be - to the extent the public policy has choices. That would lead me to share some of the challenges for conduct of monetary policy, in a world currently less certain of the costs or benefits of globalisation. I am afraid, I may be repeating what I had said in some other fora recently but, I hope to contextualise the presentation.

In the recent period, a reassessment of the costs and benefits associated with globalisation seems to be taking place. Domestic structural reforms in the emerging economies are unlocking the pent-up domestic demand and, in turn, enabling a greater realisation of the huge potential for growth. So, what is causing the rethink in both – the developed and the emerging economies?

Firstly, the traditional postulate that the capital flows from the capital-surplus or developed countries to the capital-scarce or developing countries, seems to have been disproved in recent years. The world's largest economy, the United States, currently runs a current account deficit, financed to a substantial extent by capital exports from the emerging market economies. Of course, it can be argued that the so-called 'global imbalances' are a reflection of incomplete globalisation. But the fact remains that as long as globalization happens to be incomplete, public policy has to manage the consequential "imbalances".

Secondly, in a globalising world, the context in which monetary policy is set, often leads to a confrontation with the impossible trinity – independent monetary policy,

open capital account and managed exchange rate. The theory holds that at best, only two out of the three would be feasible. In practice, however, there is a shift in preference away from the corner solution with respect to financial imbalances. Currently, intermediate solutions, which were earlier regarded as 'fuzzy', are now becoming increasingly relevant. Moreover, in recognition of the differences between trade and financial integration – first pointed out by Jagdish Bhagwati – there is less certainty today about the corner solutions than in the past.

Thirdly, at a practical level, the recent experience seems to indicate that globalisation may have had accentuated potential conflicts that can impact the fabric of our societies, particularly, in view of rising corporate profits coupled with a reduction in share of remuneration for the labour. In this regard, I was struck by what Mr. John Micklethwait, Editor-in-Chief of The Economist is reported to have said in an interview, as mentioned in a leading daily yesterday (March 18, 2007). He said this in the context of the process of globalisation:

> *"But as far as globalisation goes, I am worried about one thing: if you look at inequality, particularly in America, the rich have got even richer and the median income has barely budged. What is interesting is that just in the last couple of quarters, you began to see a sign of the wages beginning to rise. What if you have seen in the last ten years is the returns to capital increasing dramatically and returns to labour proportionately going down? What is happening now is that if you have the prospect of a downturn, then inequality will become much bigger issue in the American elections. Around the world it is already a much bigger issue, including in places like Japan. The corporate boss in Japan now is paid 35 times what the median worker is paid. In America, it is 411 times."*

Fourthly, there are wide-spread concerns about the gaps in international trade rules and regulations, the impasse in multilateral trade negotiations and consequently, a rising number of regional and bilateral trade arrangements.

Fifthly, the rapid pace of globalisation in monetary and financial relationships has not been accompanied by an improvement in the international financial architecture. Managing financial crisis remains largely a national responsibility. As the UNCTAD's *Trade and Development Report, 2006* has noted: ''*The bulk of adjustment in case of external imbalances is often concentrated on a group of developing and transition*

economies, despite the fact that the source of such imbalances may occur in the developed world" (Overview, p. 38-39).

In the wake of these developments, there is a growing expression of heightened sensitivity to the costs associated with globalisation. It is recognised that in the ultimate analysis, public policy has important role in managing the costs and benefits of globalisation. To quote Chairman Bernanke: *"Further progress in global economic integration should not be taken for granted…as in the past, the social and political opposition to openness can be strong… much of it arises because changes in the patterns of production are likely to threaten the livelihoods of some workers and the profits of some firms…The natural reaction of those so affected is to resist change, for example, by seeking the passage of protectionist measures"* (Jackson Hole, 2006).

In brief, the unfolding path of global economic integration and consequently, preferences for open economies are beset with unknown uncertainties. In this broader setting, let us look at the emerging challenges to monetary policy.

First, considerations relating to maximising output and employment weigh as much upon monetary authorities as maintaining price stability, particularly in the developing countries. The twin-objective is often enshrined in the legal provisions except where inflation targeting is mandated. However, domestic inflation has increasingly become less sensitive to the domestic output gap and potentially more sensitive to the world output gap. Each country may, therefore, take a holistic approach to the trinity of free flows of capital, fixed or managed exchange rates and independent monetary policy. The impossible trinity has to be often managed in the emerging economies and this is ensured by close coordination between monetary and other public policies.

Second, the central banks are often concerned with the stability / variability of inflation rather than the level of prices. However, inflation processes have become highly unclear, amidst these uncertainties; central banks are faced with the need to recognise the importance of inflation perceptions and inflation expectations also, as distinct from inflation indicators. The distinction between inflationary expectations and current inflation perceptions in the context of inflation policy is also worth bearing in mind. Furthermore, often than not, the expected change rather than the actual change in real interest rate, following a change in the policy rate, often drives the actions of the economic agents. In this context, credible communication and creative

engagement with the market and economic agents has emerged as the critical channel of monetary transmission. The existence of administered prices in commodities critical to inflation expectations, perceptions or indicators complicates the relationship between prices and monetary policy transmission, though the outcome may be socially desirable.

Third, the presence of administered interest rates, even in segments of a financial system, could hold back appropriate adjustments in real rates as a sequel to changes in the policy rates. The administered interest rates do occur in different forms, instruments and magnitudes but these could be, to some extent, monitored. What is surprising, however, is that the financial market rates could also display somewhat inexplicable impervious behaviour and thereby, act as the source of nominal rigidities in the economy. Sometimes, it is described as a conundrum, or might I say "I do not know"?

Fourth, the central banks are now taking baby steps – sometimes more frequent steps and at other times after a long gap, and in both directions – to respond to, what appear to be, ripples rather than huge waves in the sea of economic activity. Further, while what is considered as a 'neutral rate' of interest, in the present period, appears to be much lower compared to several years before, the issue is whether the neutral rate in respect of the emerging market economies, which has been coming down in tandem with global rates, will tend to be distinctly higher than in the developed economies.

Fifth, if the domestic inflation rate of an economy, however low it may be, is higher than the average inflation rate of its trading partners, it puts pressure on the exchange rate. In this context, the question of simultaneous balance of the internal and external sectors becomes a major issue if the flexibilities in the economy are less than adequate. The conduct of monetary policy inevitably involves a careful judgment on the relative weights assigned to the domestic and the global factors and constant reassessment and rebalancing of these in response to evolving circumstances.

Sixth, since external capital flows to emerging economies cannot be easily predicted and can also reverse even in the presence of sound fundamentals, monetary authorities often have to, in consultation with the government, make choices in regard to exchange rate and monetary management.

Seventh, financial stability considerations may require the use of monetary policy measures, in conjunction with other prudential measures. Some times, there could be even a trade-off between raising the short-term interest rate and tightening of prudential norms, if the risks are perceived to originate from certain segments of the market. The highly leveraged lending operations in the backdrop of asset-price bubbles might require adjustments in the lending margins and risk-based capital requirements.

Eighth, in terms of financial stability, some new challenges are emerging. The international financial markets are currently dominated by private equity funds like hedge funds, which are largely operating outside the ‘Know-your-customer’/ ‘Know-your-investor’ (KYC/KYI) norms. Hedge funds have long used arrangements that allow them to execute trades with several dealers but there is now an increasing tendency on their part to consolidate the clearing and settlement of their trades at a single firm, the 'prime broker'. Prime brokerage poses some unique challenges for the management of counterparty credit and operational risk. Recent events have reinforced the possible adverse impact of their risks. Further, it is commonly observed at the global level that hedge funds are 'opaque' – that is, information about their portfolios is typically limited and infrequently provided. From a policy perspective, transparency to investors is largely an issue of investor protection, but the need for counterparties to have adequate information is a risk-management issue.

Finally, there are some uncertainties associated with the settling of trades in newer types of over-the-counter (OTC) derivatives, particularly credit derivatives. As part of recent financial innovations, the credit-derivative and structured-credit markets have grown rapidly during the past few years, allowing dispersion of credit risk by financial players. As we are aware, the impact of instability in the emerging economies in times of crisis appears to be borne by the home or domestic public sector also, along with the global private sector. Avoiding crisis is ultimately a national responsibility. In such a milieu, the policy makers are often confronted with competing positions and make choices in the face of daunting dilemmas.

Concluding Remarks

Before concluding, it will be remiss of me not to address the relationship between the real and the financial sectors in the context of globalisation, open economies and macro finance.

Economists have for long recognised the strong complementarities between the real and the financial sectors. Financial development contributes to growth in either a supply-leading or a demand-following sequence; that is, either the financial sector development creates the conditions for growth or the growth generates demand for the financial services. It is important to recognise that the financial sector in India is no longer a constraint on growth and its strength and resilience are acknowledged, though further improvements need to take place. On the other hand, without the real sector development in terms of the physical infrastructure and improvement in supply elasticities, the financial sector can even misallocate resources, potentially generate bubbles and possibly amplify the risks. Hence, public policy may have a crucial role to play in ensuring balanced reforms in both the real and the financial sectors. The criticality for the policy makers is not only to ensure that there are no financial sector constraints on the real sector activity but also to assure that the financial sector reforms have complementarity with the pace and process of reforms in the real sector in India, along with, no doubt, fiscal empowerment – as consistently emphasised by the Reserve Bank.

Let me conclude by complimenting all those who have devoted their energies to bring to fruition this innovative collaborative academic activity with policy significance for the Reserve Bank of India. I am thankful to the organizers, specially Prof. Nachane for giving me this opportunity to be with you.

We, in the RBI, look forward to the benefit of discussions in this conference. Let me wish the conference all success, and, with success, hopefully many happy returns.

Thank you.