Financial Crisis - Some Old Questions and Maybe Some New Answers[1]

- **Duvvuri Subbarao**

It would be a privilege for anyone to deliver this lecture to honour the memory of Sir Chintaman D. Deshmukh. The privilege is particularly special for a serving Governor of the Reserve Bank of India. Everyday, as I go to work, I bask in the glory of serving a public institution that is held in such high esteem.

2. I am deeply conscious that this high esteem owes a lot to the competence and professionalism of the Reserve Bank's staff, its institutional values and culture, and importantly, the outstanding leadership of former Governors. As the Governor of the Reserve Bank in these exciting times, I am deeply humbled by the intellectual reputation of the lineage of the Reserve Bank's Governors. Sir Chintaman stands out among them not only because he was the first Indian Governor of the Reserve Bank, but because he laid the ethical and intellectual foundations of central banking in India, and all of us, his successors have stood on his giant shoulders.

3. A couple of months ago, I happened to visit the Reserve Bank's Archives in Pune, and there I came across a letter from Prime Minister Nehru to Governor

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[1] Tenth C.D. Deshmukh Memorial Lecture delivered by Dr. Duvvuri Subbarao, Governor, Reserve Bank of India at the Council for Social Development, Southern Regional Centre, Hyderabad on August 5, 2010.

Deshmukh in 1948 expressing concern over the country's deteriorating economic situation and asking for his analysis and guidance. That letter is a reflection not only of the intellectual stature of Sir Chintaman but also evidence of his lasting legacy to the office of the Governor of the Reserve Bank that has sustained the confidence and respect of successive Prime Ministers for the Reserve Bank.

4. We owe a deep debt of gratitude to several of our early post independence leaders – politicians, civil servants, public intellectuals, corporate heads and social activists – who all contributed to building the institutional structure of independent India. Given the gigantic scale of our democracy, the aspirations of Pandit Nehru for the country, and the low literacy and awareness levels, this was by all accounts a formidable challenge. Sir Chintaman, whose public career spanned over three decades, was a doyen among those early leaders. Not just the Reserve Bank, but several of our institutions today are a testimony to Sir Chintaman's commitment to the idea of India as a modern economy and an inclusive society.

5. As Governor of the Reserve Bank during 1943-49, Sir Chintaman's intellectual values, progressive outlook, meticulous planning and his ability to think outside the box played a critical role in steering the economy through turbulent waters. I know from personal experience that the job of a Governor, more than most other positions, involves managing the tension between doing what is expedient in the short-term and what is good in the medium to long run. By his actions, Sir Chintaman demonstrated that the *dharma* of a central banker is always to defend long term sustainability against short term compulsions.

6. I struggled to determine how best to pay a tribute to a person of the intellectual stature and social commitment of Sir Chintaman. As I read about him, I realized that he was among those who believed in building a modern India based on reevaluating conventional wisdom and finding fresh approaches to old problems, and new answers to old questions.

7. That has a resonance with the situation today as the world is trying to grasp the aftermath of the most devastating financial crisis of our time. The global crisis has challenged many of our ideas and reopened questions that we thought have been settled. In the spirit of paying tribute to the memory of Shri Deshmukh and his remarkable intellectual traits, I want to raise five old questions and see how the crisis has possibly thrown up new answers. The five questions are:

(i) Have emerging market economies (EMEs) decoupled from the advanced economies?

(ii) Should central banks persist with pure inflation targeting?

(iii) Should financial stability be an explicit mandate of central banks?

(iv) Are controls an appropriate mechanism for managing the capital account?

(v) Has fiscal dominance of monetary policy ended?

Question 1: Have emerging market economies (EMEs) decoupled from the advanced economies?

8. The answer before the crisis was an increasingly assertive 'yes'. The decoupling hypothesis held that even if advanced economies went into a downturn, EMEs would not be affected because of their improved policy framework, robust external reserves and resilient financial sectors. It is difficult to trace the precise origins of the decoupling hypothesis but it would be fair to surmise that it was inspired by the superior growth performance of EMEs as compared to advanced economies.

9. Clearly, differential growth performance by itself is not conclusive confirmation of the decoupling hypothesis. But the decoupling hypothesis failed the first test which came during the recent crisis. The banking sectors of the EMEs had relatively marginal exposure to toxic assets and their off-balance sheet activities were limited. So, if decoupling worked, EMEs should have been spared the crisis. Yet all EMEs were affected by the crisis, although to different extents, as the crisis spread through finance, confidence and trade channels.

10. Notwithstanding our sound banking system and relatively robust financial markets, India felt the tremors of the tectonic shocks in the global financial system. The first round effects came through the finance channel by way of sudden stop and then reversal of capital flows consequent upon the global deleveraging process. This jolted our foreign exchange markets as well as our equity markets. Almost simultaneously, our credit markets came under pressure as corporates found that

their external sources of funding had dried up suddenly and turned to domestic bank and non-bank sources for funds.

11. By far the most contagious route for crisis transmission was the confidence channel. For weeks after the Lehman collapse in mid-September 2008, everyday there was news of yet another storied institution crashing. In this global scenario of uncertainty, the lack of confidence in advanced country markets transmitted as hiccups to our markets too. The net result was that all our financial markets - equity, debt, money, foreign exchange and the government securities markets - came under varying degrees of pressure. Finally, the transmission of the crisis through the real channel was quite straightforward as the global recession that followed the financial crash resulted in a sharp decline in export demand for our goods and services.

12. I have sketched the Indian situation in some detail but what we had experienced here was typical of most EMEs, save for some differences in the degree of impact. The short point is that the crisis resulted in a dissipation of the euphoria over decoupling.

13. So, have EMEs decoupled from the advanced economies? The new answer to this old question is quite nuanced. It is that 'strong' decoupling does not work. In a globalized world, no country can be an island and what happens around the world affects every economy, even as the extent of impact depends on the nature and depth of integration of the economy. However, 'soft' decoupling works. It is possible for economies to insulate themselves against an external crisis, but to be

able to do so, they need to diversify their drivers of growth, institute automatic stabilizers and develop the fiscal space to accommodate those stabilizers, regulate their financial systems effectively, and be swift and nimble in economic management.

Question 2: Should central banks persist with pure inflation targeting?

14. The answer before the crisis was an increasingly confident 'yes'.

15. The years before the crisis saw a powerful intellectual consensus building around inflation targetting. A growing number of central banks, starting with New Zealand in the late 1980s and currently numbering over twenty, embraced the principle of gearing monetary policy almost exclusively to stabilizing inflation. Even where central banks did not target a precise inflation rate, their policy objectives were informed, if not dominated, by price stability. This approach seemed successful. There was an extended period of price stability accompanied by stable growth and low unemployment. In the world that existed before the crisis, central bankers were a triumphant lot. They had discovered the holy grail.

16. The unravelling of the Great Moderation during the crisis has diluted, if not dissolved, the consensus around the minimalist formula of inflation targetting. The mainstream view before the crisis was that price stability and financial stability reinforce each other. The crisis has proved that wrong. We have seen that price stability does not necessarily ensure financial stability. Indeed there is an even stronger assertion - that there is a trade-off between price stability and financial

stability, and that the more successful a central bank is with price stability, the more likely it is to imperil financial stability.

17. Where do we in India stand on this? The Reserve Bank is not an inflation targetter. However, there is an influential view that our economy will be better served if the Reserve Bank becomes a pure inflation targetter. The argument is that inflation hurts much more in a country like India with hundreds of millions of poor people and that the Reserve Bank will be more effective in combating inflation if it is not burdened with other objectives.

18. This argument is contestable. Inflation targetting is neither desirable nor practical in India, and for several reasons.

(i) In an emerging economy like ours, it is not practical for the central bank to focus exclusively on inflation oblivious of the larger development context. The Reserve Bank needs to balance between growth, price stability and financial stability.

(ii) More often than not, the drivers of inflation in India emanate from the supply side. Food items have a weight of 46 to 70 per cent in various CPIs and are notoriously subject to supply shocks which are normally beyond the pale of monetary policy. This dilutes our potential effectiveness as inflation targetters.

(iii) Which inflation index do we target? Our headline inflation index is the WPI and that does not, by definition, reflect the consumer price situation. Getting a single representative inflation rate for a large economy with 1.2 billion people, fragmented markets and diverse geography is a formidable challenge.

(iv) A necessary condition for inflation targetting to work is effective monetary transmission. Our monetary transmission mechanism is improving but is yet to reach robust standards. It remains impeded because of administered interest rates, the asymmetric contractual relationship between banks and their depositors, illiquid bond markets and large government borrowings. These impediments to monetary transmission diminish our effectiveness as inflation targetters.

(v) Finally, large and volatile capital flows will continue to be an important feature of our external sector. Managing these flows will mean managing what has come to be called 'the impossible trinity' - balancing between the objectives of a fixed exchange rate, open capital account and independent monetary policy. Inflation targetting is clearly not possible in an impossible trinity situation.

19. The burden of my argument is that the Reserve Bank cannot be, and indeed should not be, a pure inflation targetter. Post-crisis, the dominant view around the world is shaped by the "new environment hypothesis" which says that flexible inflation targetting, rather than pure inflation targeting, is more efficient. According to this hypothesis, if inflation is way off target, a central bank's first call is to bring it within acceptable range, and if inflation is within the range, the central bank should focus on other objectives.

20. To summarize, the answer to the old question, 'should central banks be pure inflation targetters?' has shifted from an increasingly confident 'yes' to an increasingly qualified 'yes'.

Question 3: Should financial stability be an explicit mandate of central banks?

21. Before the crisis, there was no answer to this question - not because there was an intellectual vacuum but because no one really asked the question so pointedly.

22. Post-crisis, financial stability has come centre stage. One of the big lessons of this crisis is that financial stability can be jeopardized even in an environment of price stability and macroeconomic stability. It is even possible to make a stronger argument, based on the experience of this crisis, that extended periods of price stability and macroeconomic stability may indeed blindside policy makers to financial instability brewing in the underbelly. These lessons from the crisis have triggered a vigorous debate on whether financial stability should be made an explicit mandate of central banks.

23. There are powerful arguments for why central banks should be in the centre of the financial stability function. Let me list a few important ones.

(i) Generally, monetary policy and financial stability are mutually supportive. This inter-dependency between the two dimensions suggests that the central bank, with inherent responsibility for monetary policy, should also be the systemic regulator in charge of financial stability so that it can take a holistic view of policy options by factoring in costs and benefits in both dimensions.

(ii) The responsibility of central banks for monetary policy is unquestioned. Because banks are the conduits through which

monetary policy decisions are transmitted to the real economy, it is synergistic to entrust responsibility for prudential regulation of banks also to the central bank. And if the central bank is the prudential regulator, there is a strong case for it to be the systemic regulator.

(iii) By far the strongest argument in favour of entrusting the financial stability responsibility to the central bank is that it is unquestionably the lender of last resort (LOLR) for the financial system. A central bank can discharge its LOLR function more efficiently if its mandate extends beyond merely monitoring financial institutions to taking preventive action. This becomes possible if the central bank is also the systemic regulator.

24. Developments around the world over the last few months reflect two clear trends. – first, a decisive shift towards giving increased responsibility for both systemic oversight and prudential regulation to central banks; and second, institutionalisation of collegial arrangements involving the central bank, other regulators and the government, with the primary responsibility of identifying threats to financial stability. The councils can make recommendations for heightened prudential standards in the interest of the safety of the financial system, but notably, not for forbearance or relaxations. The two seemingly paradoxical trends make eminent sense and supplement each other.

25. A brief review of the situation around the world will be instructive in this regard. In the US, the proposed Financial Stability Oversight Council is to be headed by the Treasury Secretary and comprises the heads of the central bank and all the regulatory agencies. However, the Act entrusts the Federal Reserve with

powers of supervision over all bank holding companies as well as any non-bank financial entity that can be a threat to financial stability regardless of whether they are bank holding companies or not, and to oversee the payment, clearing and settlement system. In Europe, recognizing the need for a specific body responsible for macroprudential supervision across the EU financial system, it is proposed to constitute a European Systemic Risk Council (ESRC) chaired by the President of the ECB with central bank governors of the 27 member states, chairpersons of the three European Supervisory authorities, and a member of the European Commission. The chairperson of the Economic and Financial Committee (EFC) representing the finance ministries will participate as an observer.

26. In the UK, there is a paradigm shift underway in terms of the institutional arrangements for microprudential as well as macroprudential regulation. The new Government has announced plans to: (i) shift the responsibility for prudential oversight from the Financial Services Authority (FSA) to a new Prudential Regulation Authority (PRA) under the Bank of England; and (ii) to set up a Financial Policy Committee within the Bank of England to 'monitor macro issues that may threaten economic and financial stability'. The Committee will comprise a representative of the Treasury, other regulators and external members appointed by the Treasury. The Treasury will, however, lead coordination of action in a crisis.

27. The above trends recognise that while all financial sector regulators and indeed the sovereign have a role in maintaining financial stability, from an effectiveness and accountability perspective and for preventing as well as managing

a crisis, it is imperative to enjoin the executive responsibility for financial stability to a single entity and that the central bank is best positioned to be that single entity. The participation of and indeed coordination by the finance ministries underlines their role in crisis management and resolution.

28. Where do we in India stand on this issue of financial stability? Historically, the Reserve Bank has played a central role in preserving financial stability. As central banks go, the Reserve Bank is a full service central bank. In addition to being the monetary authority, we are the regulator and supervisor of banks, non-bank finance companies and of important segments of the financial markets. We also regulate the payment and settlement system.

29. This unique combination of responsibilities for macroprudential regulation and microprudential supervision together with an implicit mandate for systemic oversight has allowed the Reserve Bank to exploit the synergies across various dimensions. The micro-level information coming from supervision of individual institutions has been a valuable input for shaping the macro perspective. Vice versa, the broad understanding from macroprudential regulation has been effective in instituting prudential safeguards at the micro institution level. The micro and macro level oversight has helped address systemic risk by providing an insight into: (i) firm level risk and the collective behaviour of financial institutions as well as interconnectedness in the financial system through the direct links between financial institutions and the indirect links created through the financial markets;

and (ii) the close links of the financial system with the real economy and the potential for strong feedback effects.

30. This is a system that has served us well. Just to give one example, in the years before the crisis, sensing an unusual build-up of credit in certain sectors such as commercial real estate, consumer credit and capital market exposure, the Reserve Bank, to use a phrase that is now commonplace, 'leaned against the wind' and tightened the flow of credit to these sectors by raising the provisioning norms and risk weights. This is one of the important factors that shielded us from the worst impact of the crisis. Again, as the crisis set in, and reflecting the need to revive the flow of credit, these norms were reversed to normal levels. What we did in India is a classic case of deployment of macroprudential tools to preserve financial stability, action made possible by the Reserve Bank's broad mandate and the host of instruments at its command. It is interesting, although not surprising, therefore that increasingly the reformed regulatory models around the world are moving towards resembling our model.

31. After all this exposition, let me return to the original question: "should financial stability be an explicit mandate of the central banks?". Pre-crisis, as I said, there was no answer; post-crisis, the answer is mostly 'yes'.

Question 4: Are controls an appropriate mechanism for managing the capital account?

32. Pre-crisis, the question was usually posed in the context of the problems encountered by emerging market economies in managing the adverse impact of

large and volatile capital flows. The answer, flowing from the free market paradigm, was largely ‘no’.

33. Critics maintain that capital controls are distortionary, largely ineffective, difficult to implement, easy to evade and that they entail negative externalities. Furthermore, the costs of imposing capital controls far exceed the potential benefits because financial markets always outsmart policy makers. On the other hand, supporters of capital controls have argued that controls are desirable because they preserve monetary policy autonomy, save sterilization costs and tilt the composition of foreign liabilities toward long-term maturities and ensure macroeconomic and financial stability. Pro-controllers also contest the argument about the ease of evading controls; they contend that the cost-benefit calculus is not all that decisive since efforts to evade controls and move funds in and out of a country entail additional costs which is precisely what controls aim to achieve.

34. The debate on capital controls resurfaced after the Asian crisis of the mid-1990s especially as the root cause of the crisis was traced to the open capital accounts of the East Asian economies. Even so, the intellectual orthodoxy continued to denounce controls on capital flows as being inefficient and ineffective. The debate on capital controls was not pursued to a logical closure as the Asian economies recovered in quick order, regained their export competitiveness and started building up external reserves for self-insurance.

35. The recent crisis has, however, been a clear turning point in the worldview on capital controls. Evidence coming in is that emerging economies which have

been more open have been affected more than those which were less open demonstrating that premature opening hurts more than it helps. This has prompted a review of the earlier dominant view that capital controls are inadvisable - always and everywhere. Notably, the IMF[2] put out a policy note in February 2010 that reversed its long held orthodoxy. The note has referred to certain '*circumstances in which capital controls can be a legitimate component of the policy response to surges in capital flows*'. The World Bank[3] has noted that 'capital restrictions might be unavoidable as a last resort to prevent a crisis or mitigate its effects, should one arise. The Asian Development Bank Outlook - 2010 observed that 'carefully designed capital controls can help guard against disruptive short term capital flows and prevent extreme volatility in exchange rates'.

36. So, what does all this rethinking suggest? It suggests that wisdom lies in *festina lente*, as the Romans used to say - *make haste slowly*. Open up your capital accounts but calibrate the opening to your domestic and external circumstances. In the context of this lecture, the answer to the question, "are capital controls an appropriate mechanism for managing the capital account?" has shifted from a qualified 'no' pre-crisis to a qualified 'yes' post-crisis.

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[2] Ostry, Jonathan D. and Others (2010), "Capital Inflows: The Role of Controls", IMF Staff Position Note, SPN/10/04, February 19, 2010.

[3] World Bank: Global Monitoring Report 2009: A Development Emergency. Washington DC

Question 5: Has fiscal dominance of monetary policy ended?

37. The answer before the crisis was 'hopefully'. That judgement is being revisited amidst apprehensions that the extraordinary fiscal expansion by the advanced economies to combat the crisis is actually mutating into structural fiscal deficits and that monetary policy will have no choice but to accommodate continued elevated government borrowing into the medium term. Most recently, we have all seen how the European Central Bank has had to show unusual accommodation in resolving the sovereign debt crisis in some European countries. Many fear that this is just the beginning of a trend whereby fiscal policies will once again start dictating monetary stances.

38. The history of fiscal dominance of monetary policy is quite interesting. The eighty odd years since the Great Depression saw a famous rivalry between monetary and fiscal policy for influence. For at least three decades after the Great Depression, Keynes' intellectual heritage ruled; governments borrowed as much as they wanted and at the price they wanted without worrying about the implications of debt build-up, and central banks had willy-nilly acquiesced in this profligacy.

39. This trend began to reverse as a result of very influential work during the 1960s by Milton Friedman and others arguing that inflation is always and everywhere a monetary phenomenon and that output gains from debt financed public expenditure will not only be temporary, but also eventually inflationary. Supportive evidence for this came from the repeated episodes of stagflation during the 1970, which saw a baffling combination of unemployment and inflation. The

belief that continued fiscal deficits are clearly not sustainable gained ground during the 1980s especially as countries integrated into the global system, and fiscally irresponsible economies realized that the world capital markets penalized them by demanding higher premia.

40. The trend since the mid-1990s has been for a growing number of countries to adopt fiscal rules placing limits on deficits and/or debt and also prohibiting primary financing of debt by the central banks. One of the broad outcomes of this effort has been that central banks found themselves relatively free to conduct independent monetary policy, not only free of fiscal compulsions but also in a predictable fiscal framework. The environment of price stability coupled with steady growth that characterized the Great Moderation came to be seen as a vindication of the merits of freeing monetary policy from fiscal dominance.

41. That happy state of affairs ended in the aftermath of the crisis, and fears about fiscal dominance of monetary policy have resurfaced. There are widely shared concerns about the extraordinary fiscal expansion necessitated by the crisis, and when and how long it will take to reverse that. But, by far the larger concern is not about the crisis related cyclical deficits but about the structural fiscal deficits looming large in most advanced economies. Current estimates are that rich countries will see a rapid increase in their social security payment obligations because of ageing populations and shrinking workforces, and that they will need to raise significant amount of debt year-on-year to finance these commitments. If that

be the case, monetary independence will remain circumscribed by fiscal compulsions into the medium term.

42. The sovereign debt crisis in Europe over the past few months has turned out to be yet another arena where the tensions between fiscal and monetary policies played out. What characterizes monetary unions like the euro system is that member countries pursue independent fiscal policies but do not have recourse to exchange rate or monetary policy levers to make the adjustment needed. This underscores the importance of sound and credible fiscal policies by member countries to ensure the independence and credibility of their collective monetary policy. Absent that, monetary policy will become hostage to fiscal excesses of individual members.

43. Where do we in India stand on this? It will be fair to say that we followed the global trends, indeed more so. During the 1970s, and much of the 1980s, monetary policy was almost totally hostage to fiscal policies. However, again following trends around the world, there has been a gradual abatement of fiscal dominance of monetary policy starting the 1990s.

44. The easing of fiscal pressures on monetary policy has been a continuous process but two discrete events marked significant milestones. The first was the agreement between the Reserve Bank and the Government to completely phase out ad-hoc treasury bills from April 1997, a move that saw the termination of the egregious practice of automatic monetization by the central bank of the government's fiscal deficit. The second was the enactment of the Fiscal

Responsibility and Budget Management (FRBM) Act which, among other things, prohibited the Reserve Bank from financing government debt in the primary market with effect from April 2006.

45. Like in most countries, in India too, fiscal stimulus was part of the crisis response and monetary policy had to acquiesce in elevated government borrowing. Going forward, the challenge for the Government is to continue the fiscal consolidation that started with this year's budget and for the Reserve Bank to regain the space to conduct monetary policy free of fiscal compulsions.

46. What this broad review of the global and the Indian scenarios shows is that the jury is still out on the issue of fiscal dominance of monetary policy. But it will be less than honest not to acknowledge that the autonomy of monetary policy from fiscal compulsions is once again under threat, and resolving that threat requires credible efforts by both governments and central banks.

47. So, in the format of this lecture, the new answer to the question, has fiscal dominance of monetary policy ended, is the same as the old one. 'Hopefully'.

Conclusion

48. That brings me to the conclusion of old questions and new answers. As I sign off, I want to say that this crisis has been a reminder, if one was required, of the need to question conventional wisdom and approaches. Like Sir Chintaman, who presided over a time when the world, as well as the national, political, economic and financial order was undergoing radical transformation, we too stand

on the cusp of what may be a significant turning point in the international financial architecture. The best tribute we can pay to Sir Chintaman Deshmukh is to remember that we can make progress only if we are willing to accept new answers to old questions when circumstances change.