

Dilemmas in Central Banking

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Dilemmas in Central Banking

- **During the crisis – how accommodative is accommodative enough?**
- After the crisis – how to calibrate exit from the accommodative monetary stance?
- Can/should RBI be an inflation targetter?
- Capital Account – how best can we manage the ‘impossible trinity’?
- How to manage the balance between the costs and benefits of regulation?

First Dilemma

During the Crisis

How Accommodative is Accommodative Enough?

- Why was India hit by crisis?
- How was India hit by the crisis?
- How did we respond to the crisis?

Why Was India Hit by the Crisis? (1)

Dismay on two counts that India was hit by the crisis

First

- Indian banking system had no exposure to tainted assets or stressed institutions.
- Indian financial sector has only limited off-balance sheet activities or securitised assets.

Second

- India's growth emanates from domestic demand and domestic investment .
- India's exports are less than 15% of GDP.

Why Was India Hit by the Crisis? (2)

Because

- More closely integrated with the rest of the world
- Financial integration as deep as trade integration

Why Was India Hit by the Crisis? (3)

India's Global Integration

(Percentage)

	1998-99	2008-09
(Export+Import)/GDP	19.6	40.7
Two-way (capital+ current) flows/ GDP	44.1	111.9

How was India Hit by the Crisis?

- Finance Channel
- Real Channel
- Confidence Channel

How Did We Respond to the Crisis? (1)

RBI's monetary policy response guided by three objectives:

- Ample rupee liquidity
- Comfortable foreign exchange liquidity
- Credit flow to productive sectors

How Did We Respond to the Crisis?(2)

Reserve Bank of India

Conventional measures

- Reduction in policy rates
- Reduction in Cash Reserve Ratio
- Relaxed norms for external borrowings
- Raised interest rate ceilings on NRI deposits

Unconventional measures

- Rupee-dollar swap facility for Indian banks
- SPV + refinance window for NBFCs
- Refinance window for specific sectors

First Dilemma

During the Crisis

How Accommodative is Accommodative Enough?

- Criticism from both sides
- Origins of crisis common across countries
- Evolution of crisis different across countries
 - Advanced economies – financial to real sector
 - Emerging economies – real to financial sector
- Response to crisis – country specific?

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Second Dilemma

After the Crisis How to Calibrate Exit from the Accommodative Stance?

- India's unique growth-inflation dynamics
- Managing expectations on exit plans
- Exit sooner rather than later – arguments for and arguments against

Second Dilemma

After the Crisis

How to Calibrate Exit from the Accommodative Stance?

- Evolution of inflation – from supply constraints to demand pressures
- No template for monetary tightening
- Keep an eye on global situation
- Behind the curve?

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Third Dilemma

Can/Should RBI Be an Inflation Targetter?

- Inflation targetting gained credibility in the years before the crisis
- Arguments in support of RBI being an inflation targetter

Third Dilemma

Why RBI Cannot Be an Inflation Targetter?

- Other objectives apart from price stability
- Inflation due largely to supply shocks
- Which inflation index do we target?
- Ineffective monetary transmission
- Capital flows and 'impossible trinity'

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Fourth Dilemma

How Best Can We Manage the Impossible Trinity?

- Capital flows to sustain excess of investment over savings
- But capital flows are volatile and complicate macroeconomic management

Challenge of Globalization

India's External Sector

	2007-08	2008-09	2009-10
CAD (% of GDP)	1.3	2.4	2.9
Net capital flows (% of GDP)	8.7	0.6	4.1
Capital flows in excess of CAD (\$ billion)	92	(-) 20	13
Rupee appreciation (+) / depreciation (-) vis-à-vis US\$ during the year	9	(-) 21	13

Fourth Dilemma

How Best Can We Manage the Impossible Trinity?

India's Policy on Capital Account

- Gradual approach to capital account convertibility
- Prudent use of capital controls
- Stable policy on capital account
- Agnostic on the choice of instruments
- Exchange rate policy – flexible and pragmatic
- Reserve build-up yes, but not as self-insurance

Fourth Dilemma

How Best Can We Manage the Impossible Trinity?

Every option is costly

- Don't intervene in forex market
- Intervene in forex market but don't sterilize
- Intervene in forex market and sterilize

Fourth Dilemma

How Best Can We Manage the Impossible Trinity?

Managing Capital Flows

- Law of capital flows
- *Festina Lente* – Make haste slowly

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- **How to manage the balance between the costs and benefits of regulation?**

Fifth Dilemma

How to Manage the Balance Between the Costs and Benefits of Regulation

- Crisis caused by loose regulation?
- Post-crisis regulatory reforms
- Basel III package – costs and benefits
- Macroeconomic impact of Basel – III
- When to tighten regulation, how and by how much is the real dilemma