Diversity to combat groupthink

No one size fits all for world central banking

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History suggests that there is no constancy in the practice of central banking. We have to keep changing central banking functions as the need changes. Central bankers around the world, and those who oversee them, need to acknowledge this and act accordingly. We need different horses for different courses.

This principle applies to a large number of issues ranging from policing financial stability to managing reserve assets. Emerging market economies (EMEs) and developed countries have very different preoccupations and these need to be borne in mind when devising strategies for their functioning. This is especially so as the EMEs have generally emerged from the trans-Atlantic financial crisis in better shape than the established industrial nations: their precepts and experience should therefore be heeded more in future than hitherto.

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What are the lessons from what went on? The costs of this economic crisis are consistent with those suffered by other countries in the past, but this time the fall-out has been concentrated on the core of the world economy in the US and Europe. Poor countries or EMEs like India can ill-afford the severe consequences that typically emanate from the eruption of systemic financial instability. Thus, for EMEs, the maintenance of financial stability assumes greater significance in the ordering economic policy objectives.

All this has an impact on central banks' real or perceived independence, but we need a proper debate on this. We shouldn't see the independence of central banks as an objective in itself, but much more as a means toward some end. The addition of various new responsibilities, particularly related to financial stability, is seen as a problem because it could erode the perceived independence of central banks. However, the subject is more complicated than this and needs more discussion and clarification.

As one example, it is clear now that a great deal of financial innovation in the West was misguided, and central bankers should have developed the tools to keep this under control. Loose monetary policy and very low interest rates were responsible for the search for yields that led to a great deal of innovation that has been neither economically nor socially useful.

There was rare academic unanimity on the neatness of inflation targeting and light-touch financial regulation over the 15 years preceding the crisis. Much of this view came from a belief in the rationality of financial markets that we now know (and some of us knew all along) was wholly misplaced.

The experience of the Reserve Bank of India (RBI) is noteworthy and worthy of emulation. In the years before the trans-Atlantic financial crisis, the RBI followed a course of active policy intervention, both in monetary policy and in active and intrusive financial regulation. This went against the received wisdom of the time and was viewed critically by many foreign observers, but this policy has now largely been vindicated.

In contrast to the prevailing approach of laisser-faire liberalisation, the RBI demonstrated the value of independent thinking in the face of the groupthink that was characteristic of monetary policy and financial regulation around the world. Such an eclectic approach has a long tradition. Pragmatism in the interest of maintaining financial stability has been the RBI's hallmark, with the former governor, Y. Venugopal Reddy, playing an invaluable role in the pre-crisis period.

Not surprisingly, rethinking is now under way on what is best practice in macroeconomic management, encompassing fiscal, monetary, and financial policies. The narrow monetary policy fixation on consumer price index-based inflation targeting is being questioned, as is the phenomenon of the Great Moderation itself. This was a period of massive credit expansion along with an eventually unsustainable asset price boom.

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Not only is the wisdom of light-touch financial sector regulation being questioned but, as a result of the huge fiscal expansion worldwide, fiscal policy is back at the centre of economic policy-making. We have been in an extended era of zero interest rates. This policy has been instituted to stimulate lending so that economic growth can be revived. However, is it possible that interest rates below a certain level actually lead to lower lending? The huge expansion of central bank balance sheets, accompanied by near zero interest rates has so far not led to expansion in lending. Below a certain level, there is no incentive for banks to take the risk that lending implies. It is better for them to buy so-called risk free treasury bonds and central bank deposits, especially if they are interest-bearing.

Partly as a result of this, quantitative easing in the US, the UK and in continental Europe has brought attention back to the symbiosis between national treasuries and central banks, shifting the previous trend towards 'purity' of independent monetary policymaking. The European Central Bank has had to abandon its declared policy of no bail-outs for sovereign debt in order to preserve European financial stability. Additionally, the orthodox doctrine of free cross-border capital flows is being reconsidered in the light of global imbalances. Inflation differentials between developed countries and EMEs have persisted. This implies a corresponding nominal interest rate differential, leading to arbitrage capital flows that then put further upward pressure exchange rates. Is there any alternative for EMEs than to practise regular foreign exchange intervention and capital account management?

Reserve accumulation in EMEs is often perceived as resulting only from precautionary motives. We must see the need for expansion of central bank balance sheets in the presence of 7%-plus real GDP annual growth (nominal growth of 12-15%) in some significant EMEs over a sustained period. Base money, and hence central bank assets, need to grow at a similar rate. If the EME is practising prudent fiscal policy, the supply of domestic securities may not be adequate for expanding the central bank balance sheet: hence the demand for foreign securities and foreign exchange reserves. When this happens with a large economy like China, the whole world feels the consequences. More needs to be done to expand the supply of risk-free foreign assets for central bank needs. As large EMEs like India and Indonesia, among others, join China in such a growth mode over the next couple of decades, the demand for such assets can only expand.

We must consider the background of the resilience exhibited by Asian and Latin American EMEs, and India in particular, in the light of the impact of the crisis on these economies during 2008-10. First, there was a sudden reversal of capital flows, which had been unprecedented in magnitude. This reversal had significant impact on the these countries' capital and foreign exchange markets. Second, the fall in global trade far exceeded the contraction in global GDP. In spite of these setbacks no significant banks or financial institutions in these countries exhibited substantial stress: few, if any, required a bail-out. The EMEs are now clearly on a strong recovery path that is pulling up the rest of the world.

Evidently, these countries have been doing something right since the various Latin American crises of the 1980s and 1990s, and the Asian crisis of the late 1990s. While much of the world increasingly insulated the central bank from financial sector and banking regulation, the RBI consciously viewed regulation as an integral tool of monetary policy-making, broadly interpreted, which also focused on financial stability. We viewed the barrage of financial innovations, ostensibly to aid risk management, with caution. Opening of the capital account was pursued with great circumspection, though much professional economic advice was to the contrary.

The consequence was that India escaped the worst consequences of this international crisis, as it had also done during the Asian crisis. It had been able to resume its pre-crisis growth path relatively quickly, and at relatively low fiscal cost, though some storm clouds have indeed appeared recently, primarily due to excessive continued fiscal expansion. Prior to the crisis, this cautious approach had merely been seen as one being pursued by non-modern, inadequately-informed, conservative policymakers.

The Indian approach is no longer an outlier. A cautious but consistent line on liberalisation seems to bring greater financial stability as well as economic growth. These are lessons to which the world should pay greater attention if it is to return to growth and prosperity.