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Changing Contours of Central Banking

EMERGING ECONOMIES' PERSPECTIVE

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I. **Outline**

II. **Concept and Context**

III. **Principles and Practices**

IV. **Managing Crisis and Recovery**

V. **Towards a redefined normal**

VI. **What lies ahead?**

VII. **New Directions towards New Normal**

II. Concept and Context

A. Main objectives of central banking at a conceptual level generally are:
   - Price Stability
   - Financial Sector Development and Stability
   - Supporting economic growth / employment.
   - Supporting financing needs of government when needed but restraining misuse of borrowing power when appropriate and possible.

B. Pre-1970's, since Great Depression, Central Banks were full service banks, and overall subservient to Government.

C. Subsequently, around 1980, market ideology dominated, and finance took the lead. Primary focus on Price Stability and independence of Central banks consequent upon high inflation in 1970s. (This was more relevant for market-based financial system, namely, the Anglo-Saxon tradition of the UK and the US and not necessarily for a country like Germany, or Canada. But, Anglo-Saxon thoughts dominated the global financial system.

II. **Concept and Context**

D. Central banking was then equated with monetary policy till Global Financial Crises (GFC). Also described as North Atlantic Financial Crisis or Great Financial Crisis.

E. Global Financial Crisis (GFC) brought the stability objective into focus.

F. To sum up, what Central Bank does in practice depends on the context and keeps changing over time.

G. The question is: Is supporting fiscal needs (public debt management) the next step for central banks? Is "full service" central banking inevitable?

III. **Principles and Practices**

A. On the run-up-to-crisis, some "principles" (elevated to the level of science by some central bankers) dominated central banking. These are: importance of price stability; independence of central bank, leadership role to finance; markets should be allowed to connect excesses;

B. In practice, many Emerging Economies (EEs) did not fully adopt the "principles"; just as a few Advanced Economies (AEs) also did not.

C. For example in India, RBI continued as full service bank with multiple objectives. The Governing Board of RBI provides for broad representation from Agriculture, NGOs, industry, Science and Economics. Operational autonomy was exercised but policies were harmonised and coordination on structural changes practiced.

III. **Principles and Practices**

D. In general, in EEs, banks dominated and financial sector was still developing. Data was inadequate. In any case, structural transformation was taking precedence.

E. During GFC and after, pragmatism gained respectability over the 'science' of monetary policy in AEs also.

F. The question is: Is it time to recognise importance of diversity among countries in approaches to central banking? If so, how to reconcile it with coordination at global level?

IV. **Managing Crisis and Recovery**

A. GFC warranted management of global coordination involving both AEs and EEs; though epicenters of crisis were AEs. This was done via rejuvenation of G-20 by upgrading to Heads of Government level.

B. Distinction between givers and takers of liquidity blurred. Later IMF had a programme to support Ireland, Greece and Portugal in Europe (AEs).

C. There was huge bail-out program of financial conglomerates in AEs.

D. In parallel, the Financial Inclusion and inequalities became part of global agenda (of G20).

E. Financial sectors in EEs less affected. However, some stimulus became essential due to the spillover affect. In India, in pursuit of global coordination, perhaps, excess of fiscal stimulus, monetary stimulus, and of regulatory forbearance was observed for a couple of years.

IV. **Managing Crisis and Recovery**

F. Due to divergence in initial conditions, recovery was uneven and, in any case, swifter in EEs.

G. The size of Public Debt becomes a concern for AEs also – so far restricted to EEs. (Now, AE debt / GDP ratio is higher than EEs?).

H. In AEs, "Whatever it takes" becomes common, but fundamental issues remain. EEs become important engines of global growth led by China, and to some extent, by India.

I. Financial crisis turns slowly into economic, social and political crisis mainly in AEs.

V. Towards a redefined normal

A. Currently, Global economy has strengthened. Growth is nearing long term average. Unemployment remains a concern except in USA, and inflation is creeping slowly towards long-term average. AE are close to normal in near term.

B. But, monetary policy remains accommodative and real interest rates remain low. Central banking in AEs is facing new challenges namely, secular stagnation, liquidity traps, addiction to easy monetary conditions, etc. Some reforms in regulation have been taken in AEs, but they seem to have peaked.

C. In EEs, changes in monetary and financial sector are less discernible and, perhaps, changes were not warranted. In India, however, movement is in the direction of "principles" – but with safeguards. The monetary policy framework is closer to the redefined central banking. EEs will have to continue with structural changes.

V. Towards a redefined normal

D. They have to reorient their reform goals and reform path of financial sector to be in tune with redefined role of central banks in AEs.

E. Arguably, the principles of central banking have been modified after GFC to strengthen role of public policies vis-a-vis markets, coordination with other policies and emphasis on financial stability mainly in AEs.

F. Mandate in AEs is getting wider, beyond price stability, and hence focus of redefining will be wide; possibly under-mining capacity to be independent.

G. Operationally, this may mean almost equal weight to all three traditional functions, namely, price stability, economic growth with equity considerations, financial stability and supporting or restraining government in its public debt management, as needed.

H. This may also redefine governance, or procedural changes with more of political or accountability factors in practice.

V. Towards a redefined normal

I. The era of independence from governments with dependence on financial markets may be replaced by little less independence from government and more intensive regulation of financial institutions / market. However, financial institutions and markets are fighting back. (The swinging door syndrome [whereby a market player today is a regulator tomorrow and a market player day after] could have helped them. Also for the AEs, finance is a key component of their comparative advantage)

J. Relationship between bank regulator and monetary activity could be closer, unless regulation and supervision are part of central banks functions.

K. For effectiveness, depending on the macro economic situation, coordination of monetary policy with other policies may be critical (namely, fiscal policy, public debt management, and system vide risk oversight, including macro-prudential).

V. Towards a redefined normal

L. Despite dangers of dilution of focus, the central bank has to accept the overall responsibility for maintaining trust in the Currency in the financial system, and in the fairness of revolving around societal concerns such inequalities.

M. M. Challenges to balance sheet management, especially managing assets of central banks, especially choices of reserve currencies, safe assets and gold. For example, China is diversifying into physical assets.

N. Redefined central banking will face two TRILEMMAS. One, the impossible trinity – independent monetary policy; open capital account and fixed exchange rate. Second, financial stability, national level independent regulation, and global integration of financial sector.

V. Towards a redefined normal

O. Exit from unconventional monetary policy and restoring normalcy to central bank balance sheets in AEs may warrant a consolidated view of the consolidated public sector balance sheet comprising government and central bank balance sheets. It is possible to undertake intra public sector transactions especially relating to debt obligation, with a view to strengthen public policy effectiveness. Both, debt of government and of central bank are part of public sector debt in the broadest sense. For example, in India we understood such transactions on two occasions, namely, to normalise huge stock of adhoc treasury bills with the balance sheet of the central bank in late 90s. Secondly, in introducing Market Stabilisation Scheme in 2004 to shift the excessive burden of capital account management to the government. (Recently, post-demonitisation, the MSS was used to handle the temporary flush of liquidity with the banking system).

VI. **What lies ahead?**

A. Simultaneous rebalancing on several fronts characterises the future and hence central banking will also be rebalanced.

B. National governments are seeking greater policy-space to address concerns of their citizens: thus, redefining the role of national policies in the global economy.

C. Redefining the roles of state and markets due to inequalities, environmental concerns, etc.

D. Redefining risks and rewards of globalisation of finance.

E. Addressing the expectations from and role of central banking in financial inclusion.

F. Disconnect between <u>financial markets, especially stock markets</u> and real activity such as output and employment.

VI. **What lies ahead?**

G. Disconnect between Titanic changes in demography especially China / Japan / Europe will influence macros (Savings, consumptions, etc.).

H. Varied impacts of technology and migration on macro balances and public policies across the global economy and independence.

I. Globally, economic activity is shifting from West to East. Real activity may shift but finance may take long time. (Disputes can be settled only in West because of the legal frameworks and stipulation in the contracts). However, this imbalance will need new rules of the game.

J. The growing diversity in the structures and relative positions of AEs and EEs. Blurring of distinction between AEs and EEs.

K. In brief, while GFC warranted changes in functioning of central banks. Are there developments in the big picture since crisis, which warrant more fundamental changes than we imagined in all Central banks – AEs, EEs, large and small economies?

VII. **New Directions towards New Normal**

A. Towards Full Service central banking with greater focus on governance representing society as a whole.

B. Towards Tobin Tax on a comprehensive basis as a tool for getting information that is relevant for fiscal, monetary and financial sector policies.

C. Towards separation of lending and surveillance in IMF. Global surveillance functions of IMF to be outsourced to an agency akin to global central bank to be created by IMF. The agency will have no weighted voting. Functions in the nature of lender of last resort to remain with IMF with weighted voting.

D. Towards a genuine multipolar world recognizing that (a) a few decades ago we had predefined two distinct ideological economic blocks; and (b) what lies ahead is a different type of bipolar world – heavily interdependent, but arguably one representing AEs and the other EEs.