

Monetary Policy across Developed and developing Countries

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Overview

- Economic Policy
- Macroeconomic Policy: Fiscal, Monetary
- Central Banking
- Global Financial Crisis and Monetary Policy
- Indian Monetary Policy

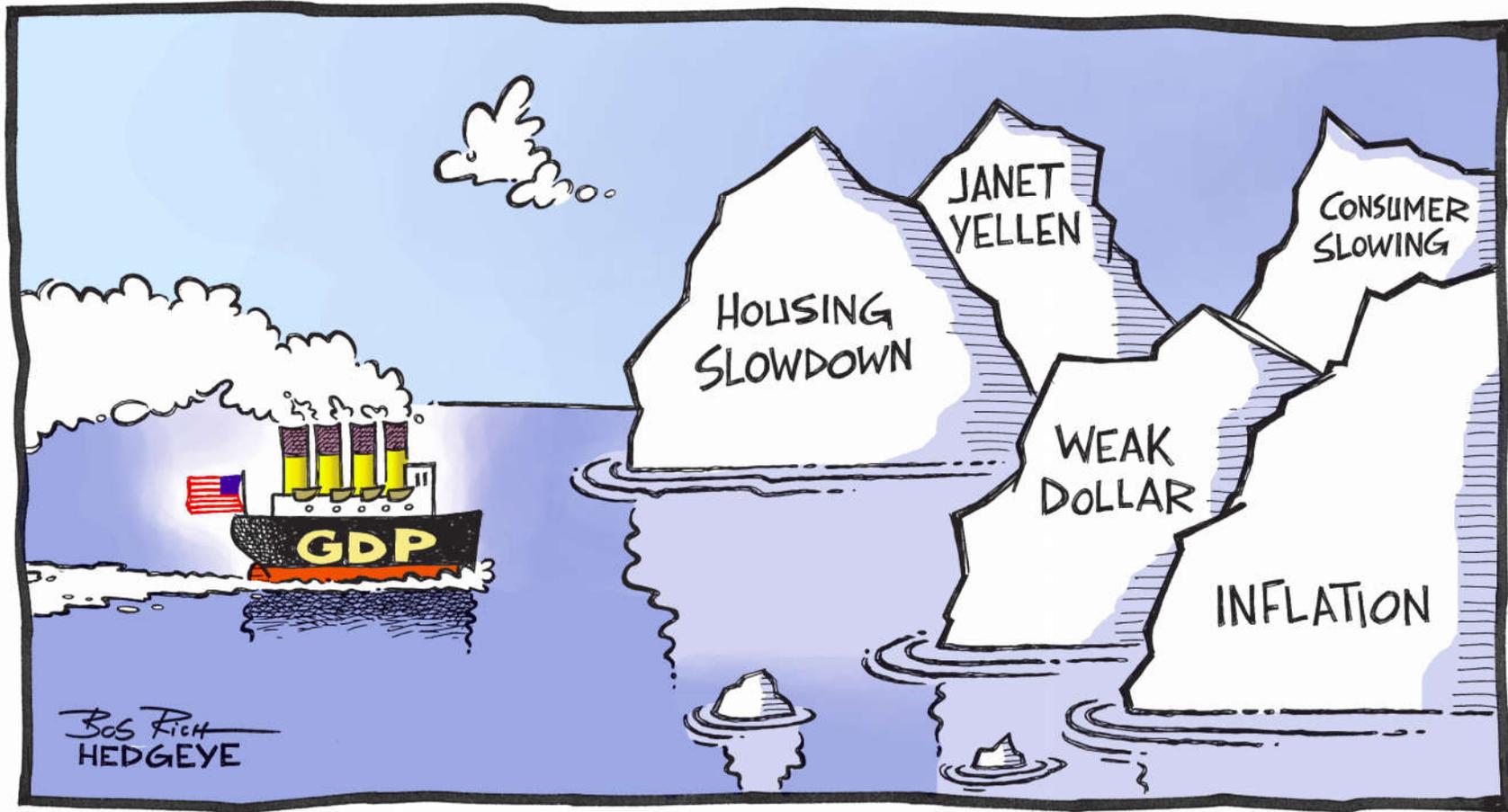


ECONOMIC POLICY

Objectives of Economic Policy

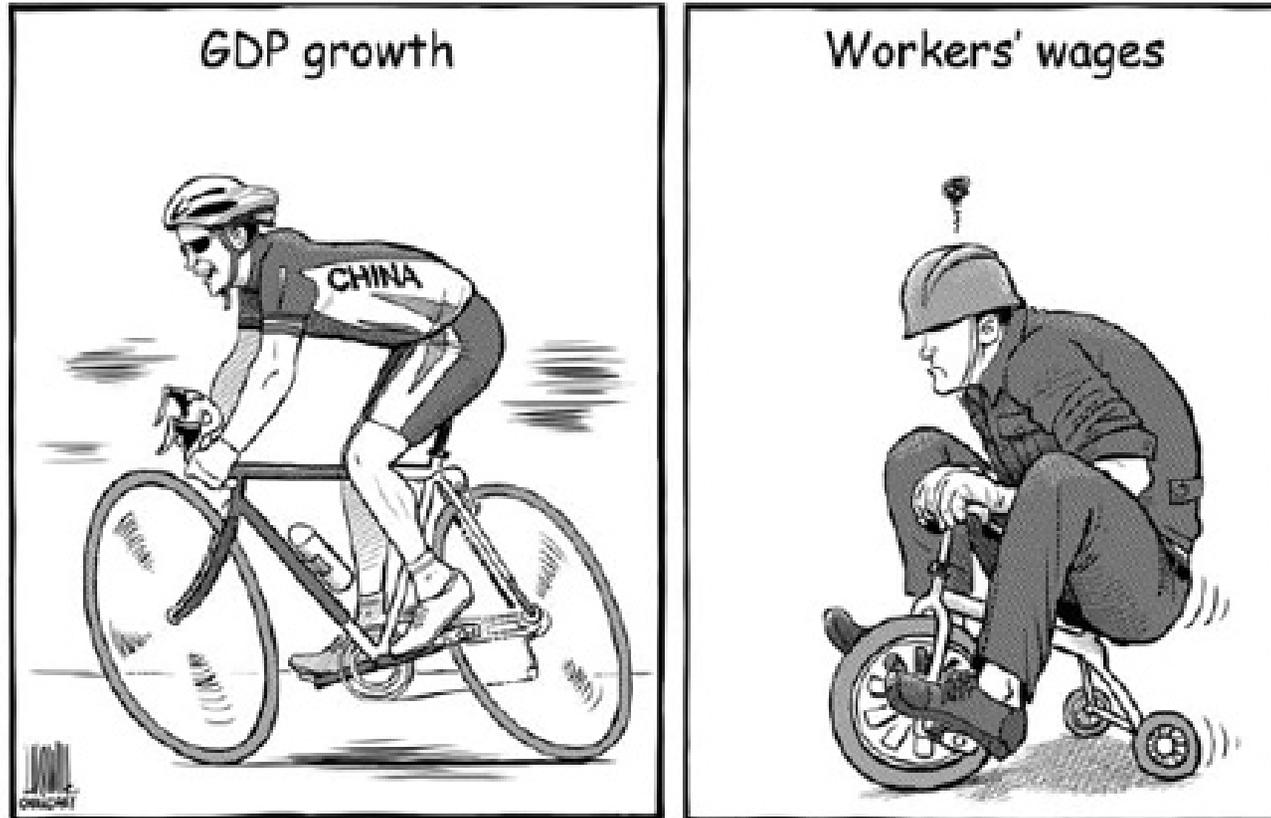
- Improve overall well-being of society through
 - Maximizing Growth: increase GDP
 - Increase investment
 - Increase consumption
 - $\text{GDP} = \text{Investment} + \text{consumption} + (\text{exports} - \text{imports})$
 $Y = C + I - (X - M)$
 - Redistribution to ensure inclusive growth
 - Tax policies
 - Expenditure policies
 - Regulatory policies
 - GDP per capita the best single proxy for well being

Single best indicator of wellbeing



.....Single Best Indicator

LUO JIE



Economic Policies

- Structural: To raise growth potential/trend through economic reforms – labour policies, improving infrastructure, productivity, market reform, tax policies, etc. Inflation also has structural, non-monetary roots (eg. food inflation in India)
- Macro-economic: To stabilize real economic growth around the current trend/potential



MACROECONOMIC POLICY

Macroeconomic Policy

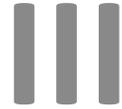
- Rose to prominence with the Keynesian Revolution in the wake of the Great Depression of the 1930s.
- Objective: To stabilize real growth around potential/trend:
 - Below trend: stimulate
 - Above trend: reduce overheating
- Two separate instruments:
 - Fiscal – domain of the treasury/finance department
 - Monetary – domain of the central bank

Choice of macro policy: Fiscal

- Fiscal
 - Transmission channel through government expenditure
 - Government single largest investor and consumer
 - Crowding In and Crowding out of private investment & consumption
 - Discredited because it is too political: easy entry, difficult exit:
 - Increases budget deficits and public debt
 - Following inflationary 1970s advanced economies
 - Relegated fiscal policy to second line of defence
 - Discretionary policies gave way to automatic stabilizers: automatic exit
 - Monetary policy by 'independent central banks' became first line of defence
 - Developing countries continued to rely on fiscal policies because their financial markets were undeveloped and interest rates not market determined.
 - Corollary: In a liquidity trap fiscal policy may become instrument of choice even where financial markets are developed.

Choice of macro policy: Monetary

- Non political provided the central bank is left 'independent'
 - Formal independence: arms length from government
 - Litmus test: relative weight to growth and inflation
 - Effective independence: fiscal dominance (zero bound?)
- First line of macroeconomic defence in advanced economies.
- Lower interest rate stimulates investment through the money multiplier leading to higher output. increase in income. Rise in interest rate brings down inflation by curtailing demand.
- Transmission through financial markets:
 - Influencing the yield curve indirectly by defending the overnight policy rate
 - Influencing the yield curve directly through purchase of long term securities – quantitative and qualitative easing
 - Helicopter drop of money?
 - Influencing money supply through changing reserve requirements. (SLR and CRR in India). More relevant where interest rate transmission through financial markets is weak.



CENTRAL BANKING

Centralbankspeak



“ I hate these bird analogies hawkish dovish etc, I would just say it is a realistic assessment of the data that have come in, there are potential disinflationary pressures, there are also potential inflationary pressures.
— **Raghuram Rajan**, RBI Governor

“ The tone of the policy is fairly balanced, pragmatic and continues to re-emphasise that the policy continues to be in accommodative cycle. Capital infusion will be the key going forward to support credit growth

— **Arundhati Bhattacharya**,
Chairman, SBI



“ RBI's continued commitment to an accommodative policy stance and the assurance of moving towards a neutral liquidity framework is positive. This should continue to support transmission of RBI's policy stance

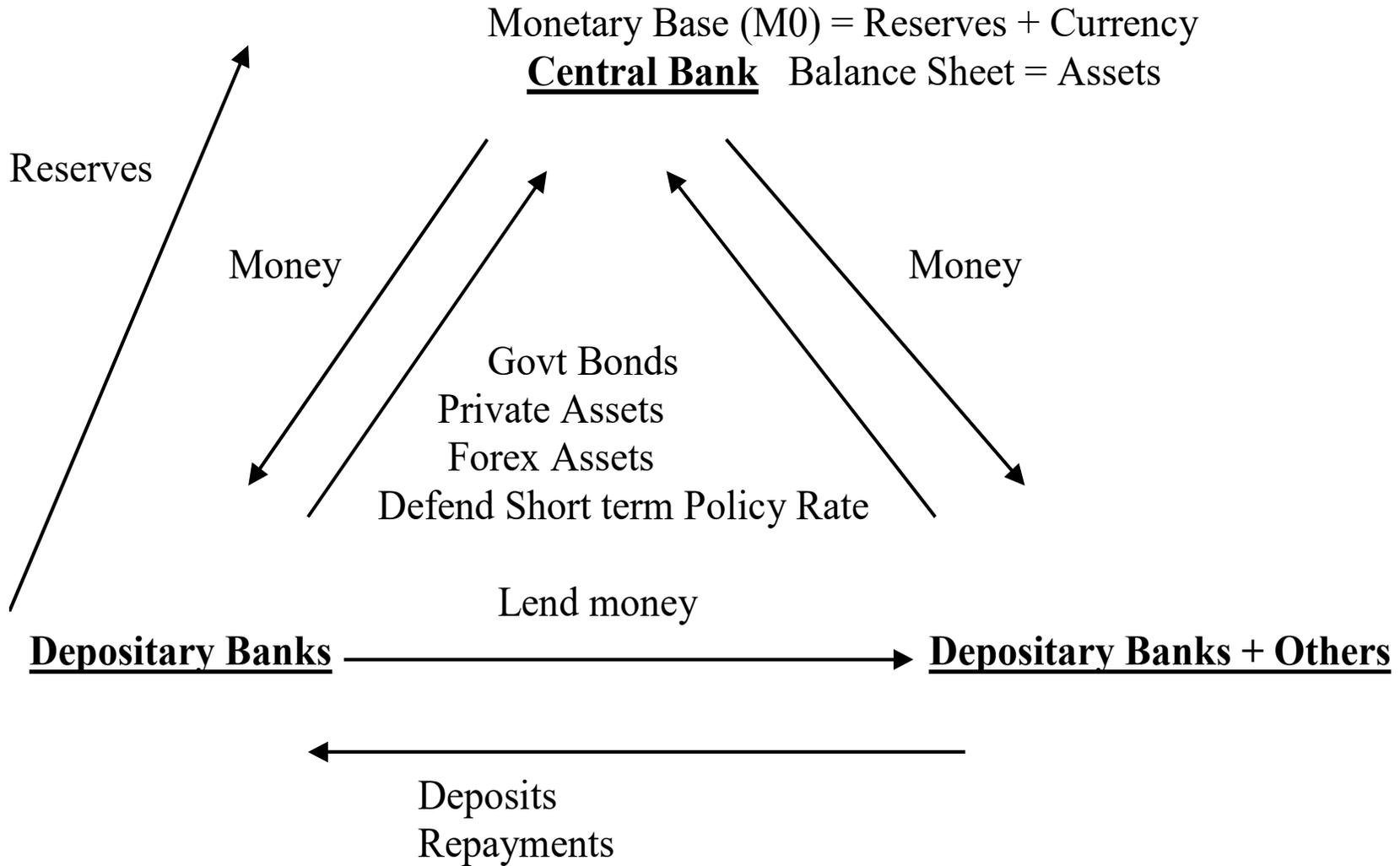
— **Chanda Kochhar**,
MD and CEO, ICICI Bank



“ While we continue to believe that there is some more scope for monetary easing, a clarity on this will emerge only with incremental food inflation data, effect of monsoon, and degree of volatility from global factors

— **Motilal Oswal**, CMD,
Motilal Oswal Financial
Services Ltd

The Rocket Science of Central Banking



Gold Standard

- Central banks have the monopoly to issue money
- Currency issued against gold reserves
- Post War Bretton Woods: Fixed ratio of currency to gold. Central Bank role limited.
- Deflationary except during gold influx
- 1970: US went off the gold standard, ushering the era of 'fiat money' – dollar floated against other currencies: Bretton Woods II
- Central bank's role enhanced: How much money to create?
- 1990s: Indian Rupee floated – 'Dirty Float'. Trapped in the impossible trinity – managed float at the cost of monetary independence
- [Gold remains shadow reserve currency](#): financial instability leads to rise in gold prices.

Gold



Monetary Policy Rules

- Discretionary versus Rule bound
 - US FED: [Taylor Rule](#), targeting both inflation and growth
 - BoE: Pure inflation targeting: set by government
 - ECB: 2% Inflation primary objective
- [Impossible Trinity](#): Only 2/3 possible: Fixed exchange rate, independent monetary policy, Free capital flows
 - US : floating X rate
 - EU: No monetary Independence
 - China: Capital flows restricted
 - India: ?
- Global spillovers increasing: capital, goods and services,
- US FED policy (US\$ effective global reserve currency)

Taylor Rule

$$r = p + .5y + .5(p-2) + 2$$

$$r = 1.5p + .5y + 1$$

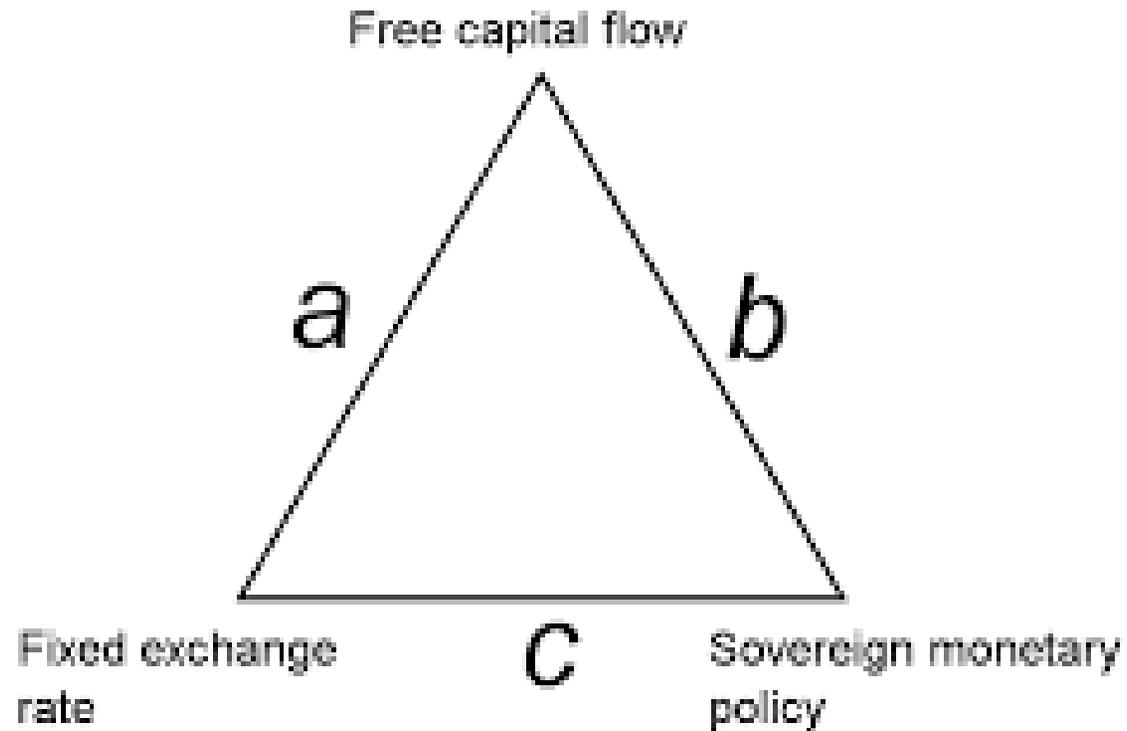
where

r is the federal funds rate

p is the inflation rate

y is real GDP gap

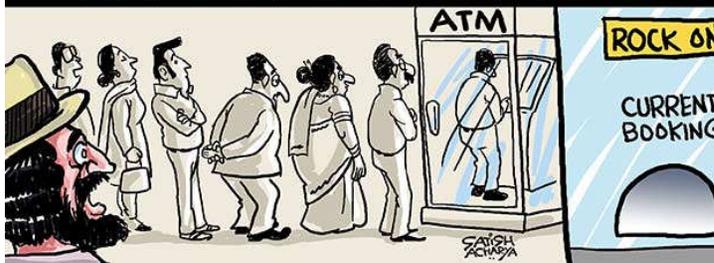
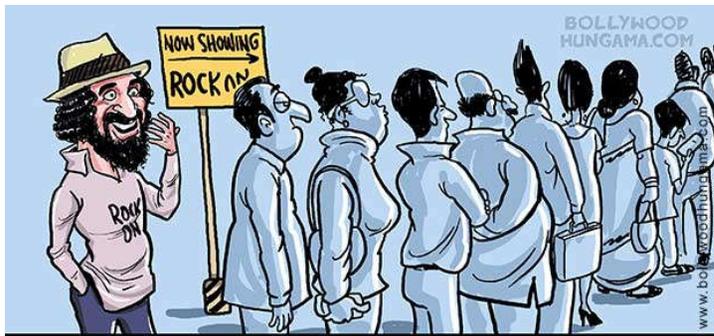
Choose A, B, or C



Objective of Financial Stability

- Original objective of central banks, overlooked over the years.
- Alan Greenspan: Central banks cannot/should not call asset bubbles, only clean up afterwards. Monetary policy too blunt an instrument to target asset prices as growth can be collateral damage.
- GFC:
 - Financial stability objective overlooked
 - Bagehot Rule overlooked in combating it: in times of financial crisis, central banks should “Lend without limit, to solvent firms, against good collateral, at 'high rates’.
- Current thinking: separate instrument required: macroprudential regulation, targeting the entire financial system, in addition to the traditional micro-regulatory that targets individual institutions.
- Demonetization: A financial stability issue

Demonetization



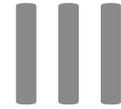
- Objective
 - Fake Currency
 - Black Money
- Tinbergen Rule
 - One objective
 - One instrument
- Fake Currency
 - Introduce new currency
 - Later demonetize old
- Black Money
 - Target Flows
 - Target assets

Macroprudential Regulation

- Countercyclical [capital requirement](#) - to avoid excessive balance-sheet shrinkage from banks in trouble.
- Cap on [leverage](#) - to limit [asset](#) growth by tying banks' assets to their [equity](#).
- Levy on non-core liabilities - to mitigate pricing distortions that cause excessive [asset](#) growth.
- Time-varying [reserve requirement](#) - as a means to control capital flows with prudential purposes, especially for emerging economies.
- To prevent the accumulation of excessive short-term debt:
 - [Liquidity](#) coverage ratio
 - [Liquidity](#) risk charges that penalize short-term funding
 - Capital requirement surcharges proportional to size of maturity mismatch
 - Minimum haircut requirements on [asset](#)-backed securities

Financial Repression

- The market interest rate equilibrates the demand and supply of money.
- Central banks influence the market interest rate through monetary policy instruments, supplying/absorbing as much liquidity as is necessary to defend the policy rate.
- Administered IRs without the liquidity support
 - drive savings away from the formal financial system if the rate is too low
 - Sets a cap below which policy rates cannot be driven down – such as administered rates on small savings in India.



THE GLOBAL FINANCIAL CRISIS AND MONETARY POLICY

GFC and Monetary Policy

- Quickly reached the zero bound
- UMP: Influencing interest rates even after they touch 0
- QE – quantitative and qualitative (operation twist)
- IR still near zero bound, even negative – deviation from Taylor Rule
- Balance sheet still bloated
- Fiscal Dominance in advanced economies.
- Taylor Rule no longer relevant
 - Lower equilibrium interest rate
 - Link between growth/employment and CPI weakening – [excess liquidity @ asset prices](#)
- Raise inflation target
- Lower equilibrium interest rate
- Target nominal GDP
- Change monetary policy rules

Wall Street Main Street

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Federal Reserve Balance Sheet

- **Jan 1, 2007**
- B'Sheet: \$ 0.9 Trn
 - \$ 8 Trn UST
- Financed:
 - \$0.8 Trn curr. In cir.
- **Nov 3, 2016**
- B'Sheet: \$ 4.5 Trn
 - \$ 2.5 Trn UST
 - \$ 1.7 Trn MBS
- Financed:
 - \$ 1.5 Trn curr. in cir.
 - \$2.1 Trn bank reserves
 - \$ 0.4 Trn Repos
 - \$ 0.4 Trn UST account

The Liquidity Trap

US Federal Reserve (US\$ Trillion)								
	M2	M0	MM	Reserves	Curr.	Balancesheet	Backwash	
3/1/2007	7.13	0.81	8.80	0.04	0.77	0.87		
11/1/2007	7.42	0.83	8.94	0.04	0.79	0.89	8.3%	
3/1/2008	7.62	0.82	9.30	0.04	0.78	0.88	-31.6%	
11/1/2008	7.99	1.43	5.59	0.06	1.37	2.08	1.3%	
3/1/2009	8.34	1.64	5.09	0.08	1.56	1.90	-9.8%	
11/1/2009	8.47	2.01	4.22	1.14	0.87	2.17	400.5%	
3/1/2010	8.48	2.10	4.04	1.19	0.91	2.28	39.1%	
11/1/2010	8.75	1.97	4.44	1.04	0.93	2.30	-740.8%	
3/1/2011	8.90	2.40	3.71	1.44	0.96	2.55	161.7%	
11/1/2011	9.60	2.60	3.69	1.59	1.01	2.82	56.4%	
3/1/2012	9.78	2.65	3.69	1.61	1.04	2.89	25.8%	
11/1/2012	10.29	2.64	3.90	1.55	1.10	2.83	111.6%	
3/1/2013	10.52	2.93	3.59	1.76	1.17	3.20	58.0%	
11/1/2013	10.92	3.68	2.97	2.46	1.22	3.85	107.7%	
3/1/2014	11.16	3.89	2.87	2.71	1.18	4.11	96.2%	
11/1/2014	11.58	3.83	3.02	2.58	1.25	4.49	-34.2%	
3/1/2015	11.89	4.03	2.95	2.73	1.30	4.49	#DIV/0!	
11/1/2015	12.27	4.01	3.06	2.60	1.41	4.50	-1300.0%	
3/1/2016	12.57	3.90	3.22	2.46	1.44	4.48	700.0%	
11/1/2016	13.12	3.58	3.66	2.10	1.48	4.47	3600.0%	
Total	5.99	2.77	-5.13	2.06	0.71	3.60	57.2%	

Money Multiplier

M2/ M0 : Money creation by the financial system

Backwash

Increase in Reserves/Increase in Balance sheet

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Rationale for QE

Combating Deflation

- $GDP = MM * Curr\ in\ Cir$
- $MM = M2/MO$
- $MO = Curr\ in\ Cir +$
Banking Reserves

Stimulating Growth

- Investment through lower IR
- Consumption through wealth effect of asset price inflation
 - Savers penalized

Criticism of UMP

- Not working. Still in [liquidity trap](#).
- Inflating asset prices: financial stability concern
- In a liquidity crisis, fiscal policy more effective – higher multipliers: Donald Trump?
- Divide between monetary policy and fiscal policy has disappeared: financial repression?
- Tepid growth because of structural not cyclical problems: secular stagnation (Summers)
- Monetary policy being asked to do too much.

Liquidity Trap



V

INDIAN MONETARY POLICY

India's New Monetary Policy Framework

- Till the nineties fiscal deficits monetized. Government now borrows from the market.
- Preamble in the RBI Act, as amended by the Finance Act, 2016:
 - provides that the primary objective of the monetary policy (original: monetary stability) is to maintain price stability, while keeping in mind the objective of growth
 - Government to set inflation target every 5 years
 - Gazette notification of August 5, 2016: 4% +/- 2%
 - 6 member Monetary Policy Committee:
 - 3 from RBI, including Governor and DG
 - 3 experts appointed by government

C.Rangarajan on the new MPF

- If inflation is outside the permitted range the central bank should move decisively to control it.
- If it is within the permitted range, considerable discretion to focus on other factors depending on their assessment of the prospects of real growth and financial stability.
- Since monetary transmission mechanism is slow and weak, policy IR cannot be the only instrument it should be supplemented with CRR that impact long-term (permanent) liquidity.

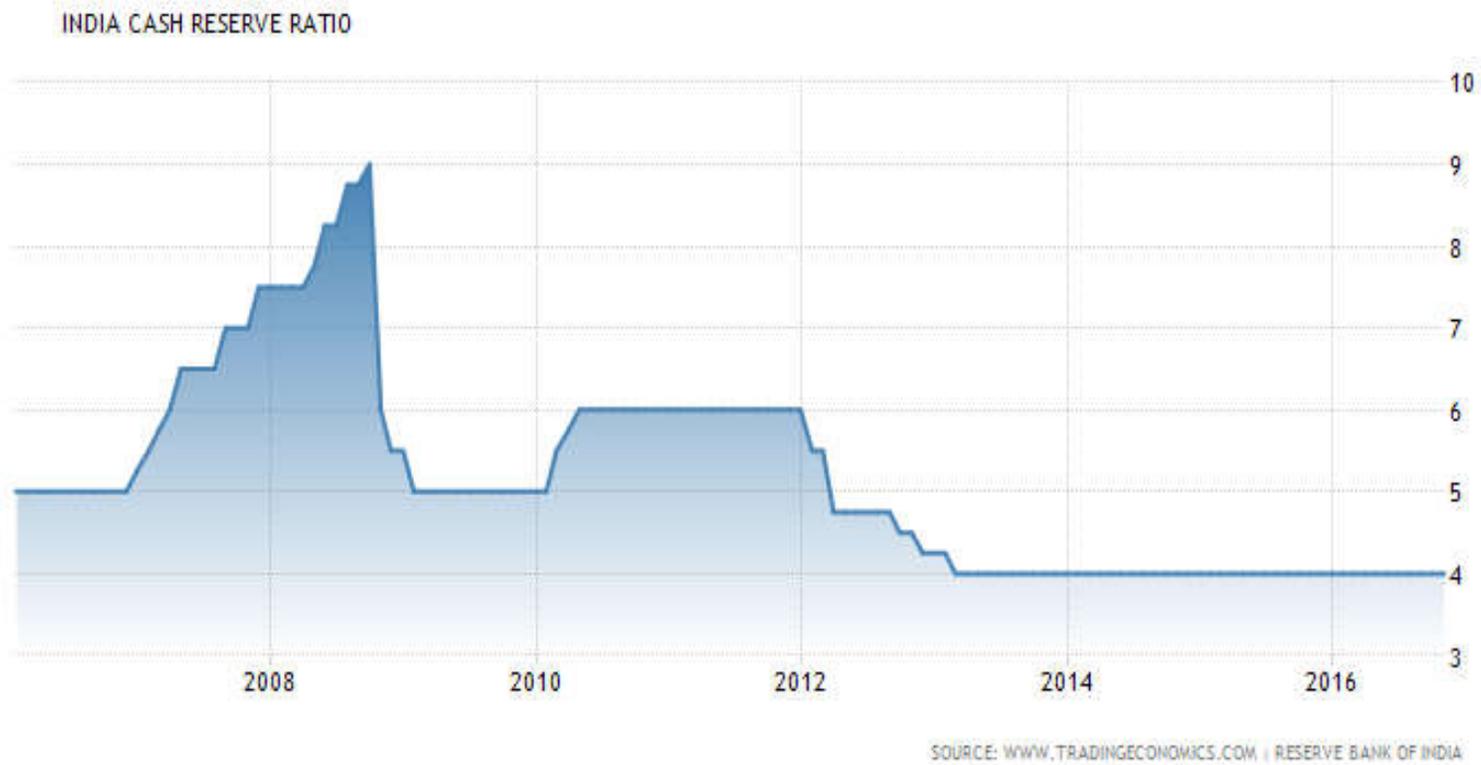
New MPF and the Impossible Trinity

- New monetary policy framework does not address the impossible trinity trilemma
- Need separate instruments to target the domestic and external cycles:
 - IR to stabilize domestic growth
 - Reserve management to target external cycle by stabilizing the REER.

India: Repo (Policy) Rate



Fractional Banking: India's Cash Reserve Ratio



Fiscal Dominance: India's Statutory Liquidity Ratio

- Barometer of Government's draft on financial savings
- Percentage of bank assets to be parked in government approved (SLR) bonds
- Declining very slowly.
- Was 24% till August 2012.
- Brought down in stages, now 20.75%

Current Indian Monetary Policy Rates

- Repo Rate (short-term): 6.25%
- Reverse Report Rate : 5.75%
- Cash Reserve Ratio: 4%
- Statutory Liquidity Ratio: 20.75%
- Marginal Standing Facility: 6.75%
- Bank Rate (Long-term): 6.75%
- (IB) Call Rate: should be within policy corridor
- (B) Base Rate: 9.3 – 9.65%
- FE Reserves: \$ 370 billion

Thank you for
your Patience