

Rules of the Monetary Game

Prachi Mishra
Reserve Bank of India

Raghuram Rajan
University of Chicago

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Qualifier

Views are personal.
Not necessarily the official viewpoint of RBI.

Outline

- Context
- Concerns with the current international system
- Principles for setting new rules
- State of the literature
- How to proceed?

Context

- Great depression
 - Beggar-thy-neighbor policies
- Bretton Woods regime
 - Fixed (but sometimes adjustable) exchange rates
- Post Bretton Woods
 - No sustained unidirectional direct intervention in the exchange rate
- Global environment has changed
 - Pressure to reach inflation target/ restore growth
 - Unconventional monetary policies
 - Adverse spillovers
- Domestic mandates => Collectively sub-optimal path
- Rules of the game for responsible policy

Concerns with the current system

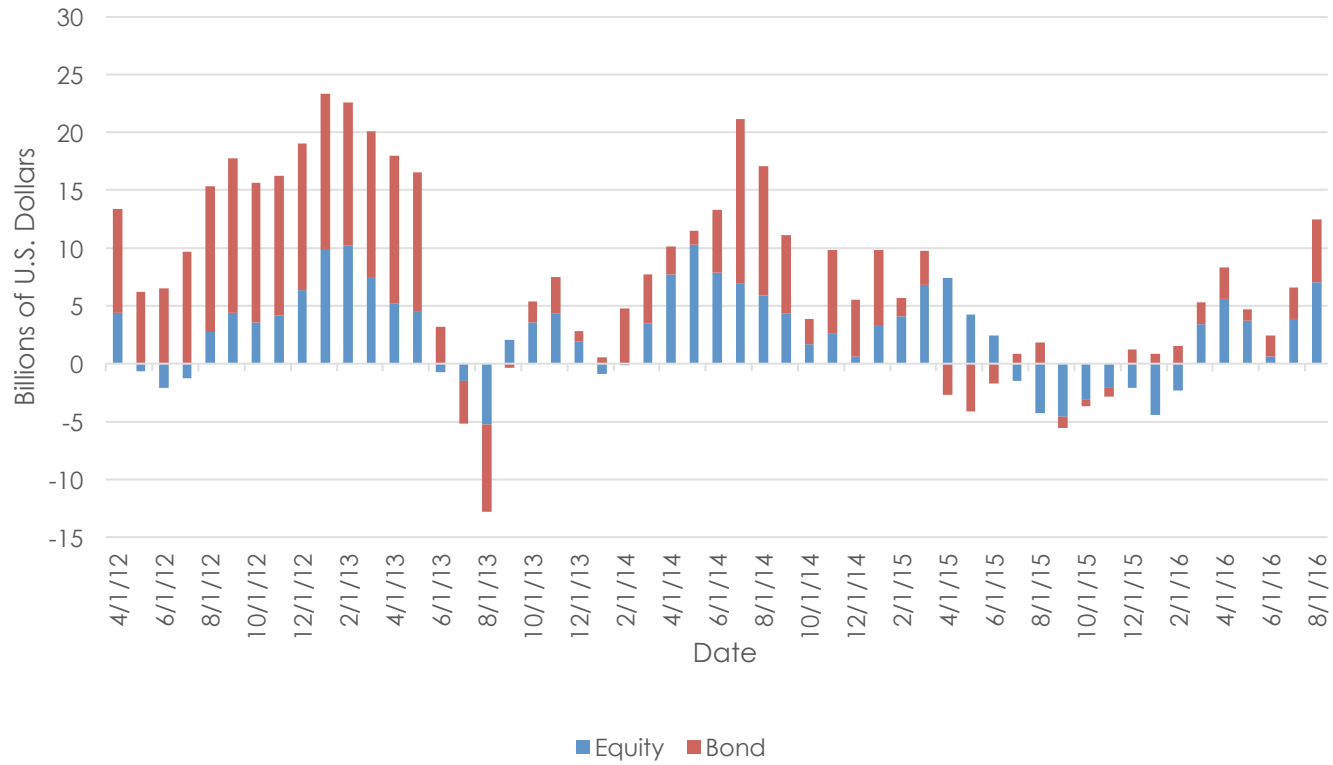
- MP → spillovers
- Normal circumstances
 - Demand creating > demand switching
- Unusual circumstances
 - E.g. debt overhang
 - Demand switching > demand creating

Concerns with the current system (contd.)

➤ Other effects

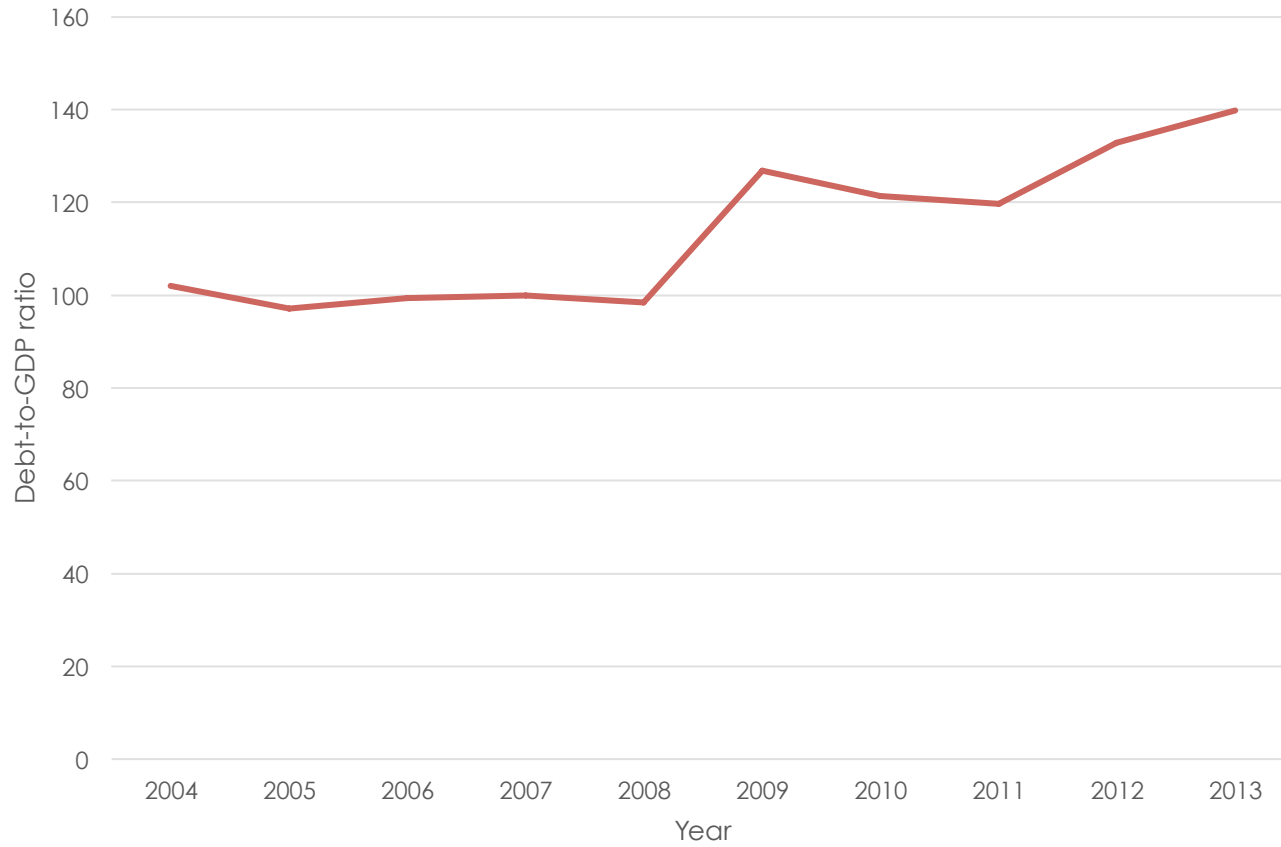
- Risk taking and leveraging anticipating substantial future liquidity
- Spillover to other countries through capital flows into credit and asset price booms -- inherit the accommodative policies of senders

Nonresident Portfolio Inflows to Emerging Market Economies



Source: IMF Global Financial Stability Report 10/16

Corporate debt-to-GDP Ratio for Emerging economies



Source: IMF Global Financial Stability Report 10/16

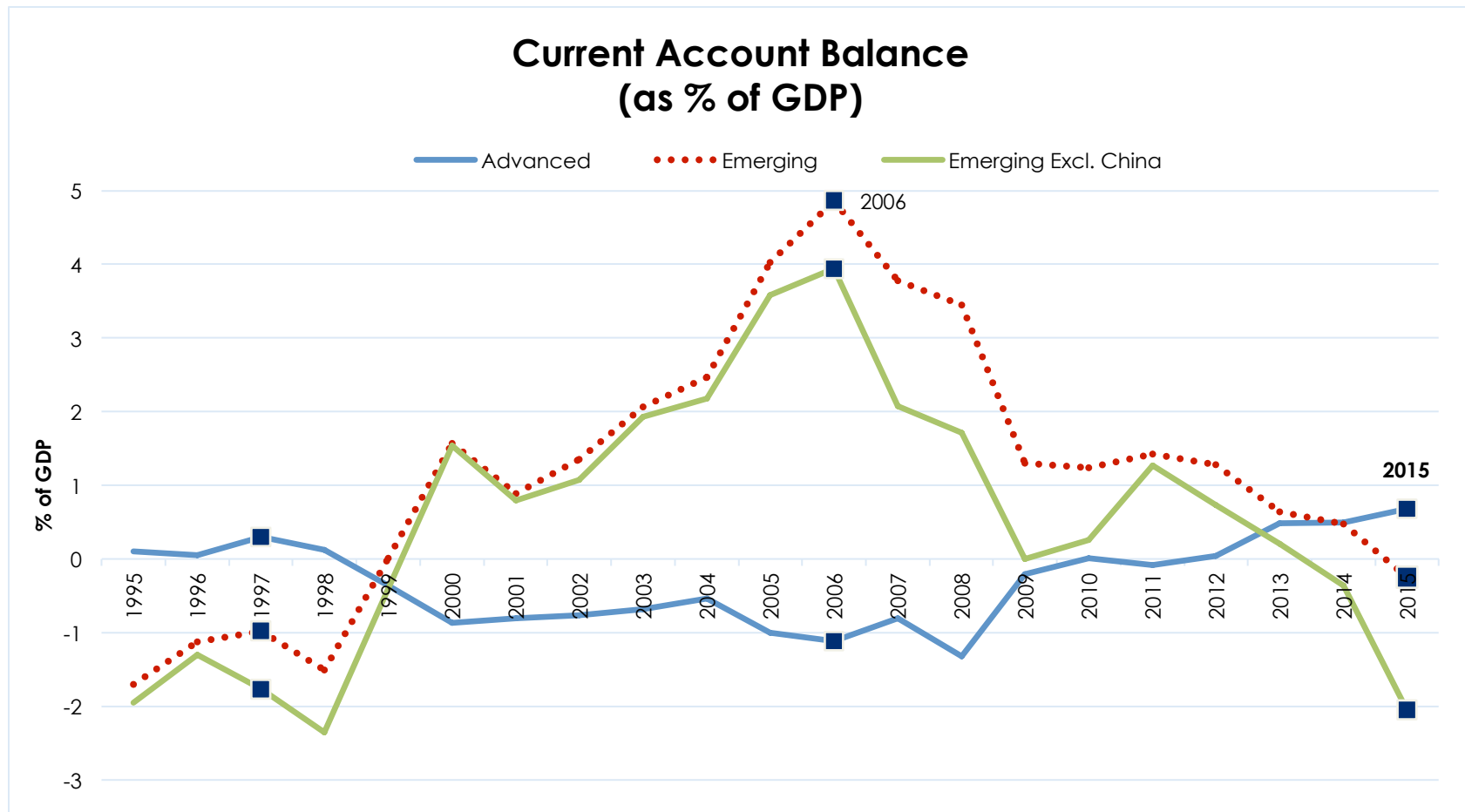
Concerns with the current system (contd.)

- Other countries can respond – e.g. by letting the exchange rate adjust. Bernanke(2015)
 - Limits to capacity of countries to respond
 - Especially if they do not have institutions or credibility
 - Response cannot be targeted, and never fully offsets
 - As countries develop, can allow more response
- Globally responsible assessment should take the world as is rather than a hypothetical ideal?

Concerns with the current system (contd.)

- Simply because a policy is called monetary or unconventional, it may not be beneficial for rest of the world
- What matters is the relative magnitude of demand switching vs creating effects and other net spillovers
- Race to the bottom (musical crises)
 - Capital flows countered by reserve build-up

Race to the bottom (musical crises)



Source. World Economic Outlook Database, April 2016. Emerging economies include "emerging and developing" countries.

Bottom-line

- MP
 - Spillovers
 - Influence countries to undertake policies that shift costs
 - Inefficiencies when countries set policies unilaterally

- Countries can agree to rules
 - Describe the limits of acceptable behavior
 - Reduce inefficiencies and increase welfare in all countries

Coordination vs Rules of the Game

- Coordination hard to contemplate
 - Who will a central bank coordinate with?
 - How to reach consensus across countries?
- Why not capital controls/ macro-prudential measures?
 - Blanchard (2016)
 - Bernanke (2015)

Coordination vs Rules of the Game (contd.)

- Need constrained independence: Rules of the Game
- We already have some rules of the game in place:
No direct targeting of the exchange rate
 - What about indirect targeting or implicit targeting?
 - What about risk spillovers through capital flows?
- Problem: Not sure how to measure effects of various policies on aggregate welfare.

Principles for setting new rules

Policy Rating	Criterion	Meaning	Example
Green	Positive effect on both home and foreign	Encourage by global community	<ul style="list-style-type: none">- Conventional MP in home- Booster shot to jump-start a large home economy + temporary adverse spillovers for foreign
Red	Net adverse spillovers over time	Avoid at all times	<ul style="list-style-type: none">- UMP: small positive effect on home; but large negative effect on foreign
Orange	Large positive effects for home+ sustained small negative effects for foreign	Use temporarily and with care (permissible but not on sustained basis)	Conventional MP if financial cycle such that low interest rates lead to financial stability risks

Some general principles

- Spillovers over time
- Account for policies in receiving countries
- Weigh spillovers to poor countries a little more at the margin
- Measure spillovers in dollar terms

Bottom-line: number of factors would determine policy ratings

- Time
- Stage of business and financial cycle
- Booster shot or a mild boost
- Standard monetary transmission channels operative
- Feasibility of response in foreign countries
- Effect on poor countries

Five common reactions

- Spillbacks
- Problems already discussed at various forums
- Complicated, hard to communicate
- Rules will constrain only systemic CB
- Domestic mandate

State of the literature

- More art than science
- Models may reflect policy biases and may be at an early stage
- More empirical analysis on the lines of Kamin (2016)
 - 25 bps decline in US yields “causes” exchange rate to depreciate by 1%
 - Demand creating and switching effects exactly offset each other

How to proceed?

4-step process

- I. Studies by independent groups of the effects of various policies
 - Group of eminent academics
 - Rate policies

- II. International meetings
 - No policies to be off the table

- III. International conference
 - New international agreement on the lines of Bretton Woods
 - Arbitration panel?
 - Enforced by multilateral organizations

- IV. Change central bank mandates

How to proceed? (contd.)

➤ Role of the Fund?

- Articles of Agreement (IV.1): “general obligation to collaborate with other members to assure orderly exchange arrangements”
- What is “general obligation”
 - “basis for the Fund to call on certain members to take specific actions or refrain from taking those”
- Set of policies to be widened?
- Financial stability implications?
- Countries are not obligated to take Fund advice
 - clear focus on downsides of particular policies can put political and economic pressure

Conclusions

- Much needs to be pinned down on international spillovers of domestic policies
- Economic analysis still at an early stage to get prescriptions, let alone international agreements
- Period of focused discussion to understand what are reasonable rules of conduct
- Next: 4-steps
 - Studies by independent groups
 - International meetings
 - Codify rules through international agreement or Articles of IMF
 - How countries can alter domestic mandate to incorporate international responsibility

Thank you!

Questions?