

Reflections on Monetary Policy

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I

Among economic historians, it is conventional to view the collapse of the Bretton Woods arrangement in the early 1970s as marking a transition from a post World War II *Golden Age* (of low real interest rates, low levels of sovereign indebtedness, little speculative trading in global financial markets and a high degree of financial stability) to a *Leaden Age* (characterized by slow growth, high unemployment, severe business cycles and a growing incidence of financial crises). Without necessarily attaching to it any of the pejorative connotations intended by the originator of the term (Mrs. Robinson (1956), and her followers such as Foley (1986) and Pollin (1998)), nor claiming for the term a universal applicability across all countries, *Leaden Age* could still serve as a succinct and convenient phrase to capture the generally heightened uncertainty surrounding national policy making in the post Bretton Woods scenario.

The process of financial change in the aftermath of the abandonment of Bretton Woods¹ impinged on the United States and the United Kingdom financial systems in the 1970s, on

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most other advanced countries in the 1980s and on the LDCs only in the last decade. The change has been unevenly distributed across countries, and even though the general direction of movement has been unambiguously forward, the pace has varied between countries owing to intrinsic structural differences rooted in contestability of markets, structure of competition, industrial concentration and general “financial literacy”.

At the outset, I must clarify that this article is not intended as a critique of financial liberalization and globalization *per se*. Rather its preoccupation is with understanding how key features emanating from these twin processes, (especially the growing ascendancy of domestic and financial markets), have considerably narrowed the *manoeuvring window* of monetary policy. Much of the discussion surrounding these issues has been spearheaded by academicians and central bankers alike, monetary policy being one area of economics, where dialogue between theorists and policymakers has been thriving fruitfully (Goodfriend (2005)).

II

Prior to the onset of financial liberalisation, the prevailing paradigm for monetary policy rested on the famous triad of ***instruments-intermediate targets/indicators-objectives***.² The guiding principles behind the triad were essentially threefold:

- (i) The intermediate targets (usually simple-sum or Divisia monetary aggregates) were “controllable” via the instruments (either a short-term interest rate or the monetary base) within tolerable margins of error.
- (ii) The monetary targets bore a stable relationship with macroeconomic aggregates (such as output, inflation and long-term interest rates), so that the intermediate targets served both as early warning signals of portending changes in the macro-aggregates, as well as guideposts for the intended trajectories of these aggregates.

- (iii) The flexible exchange rate regime currently in operation, implied a certain independence for the pursuit of national monetary policies (in the case of the EU, this statement had to be suitably qualified).

Let us refer to the three principles above as the *Old Trinity*.

Financial liberalization seems to have irreversibly jeopardized all three of the above premises. Firstly, as noted by Tobin (1983), the leverage exerted by the monetary authorities on non-financial variables, was precisely because money bore an exogenously fixed nominal interest rate, inducing portfolio substitution between “money” and “non-money” assets, in response to changes in interest rate levels. The process of financial liberalization implies a greater role for market forces in the pricing of bank deposits, whose demand thus becomes more dependent on the **spread** (between nominal rates on money and near- money assets) than on the **level** of nominal rates. Since monetary authorities are much better at influencing short-term rate levels than the spread, this factor seriously erodes their ability to control monetary aggregates.³ A similar argument can be developed in the context of monetary base control, using the classic Brunner-Meltzer money supply model (Jordan (1984)).

Secondly, the link between monetary aggregates and important macroeconomic magnitudes (especially nominal income) has been rendered tenuous (in the wake of financial liberalisation) due to a host of factors, such as

- (i) the blurring of the distinction between money and near-money.
- (ii) the breakdown of the money demand function (Akhtar (1983), Cotula (1984) etc.)⁴
- (iii) the easing of credit and liquidity constraints (owing to the emergence of variable rate lending and large-scale “liability management”- see Goodhart (1986, 1989)) and
- (iv) the rising role of arbitrageurs in financial markets, which has introduced volatility in the yield curve (Brown & Manasse (1989)).

Finally, the international dimension of financial liberalisation is reflected in a greater integration of global capital markets in recent years. International capital flows, always on the lookout for profitable portfolio opportunities, are quick to respond to domestic interest changes, setting up a tendency for real interest differentials between countries, to become insignificant. This implies, of course, that the pursuit of domestic monetary policy is seriously circumscribed by the unpredictable responses of global capital flows (see on this aspect, the detailed academic analyses of Felix (1997) and Calvo *et al* (1996) with the policy implications being fully spelt out by Rangarajan (2000) and more recently by Reddy (2005), p. 11-19).

The upshot of the previous discussion appears to be a vastly reduced potency of monetary policy consequent to financial liberalisation⁵.

III

As the forces of financial liberalization and global capital flows unleashed themselves in the 1970s and 1980s, central bankers the world over came to realize the futility of the *Old Trinity*, and the quest for new guiding principles for monetary policy assumed an almost obsessive urgency. In retrospect, what is most remarkable about the years subsequent to this disillusionment is the emergence of a broad consensus on the theory and practice of monetary policy. The theoretical aspects of the consensus pertain to the widespread acceptance of dynamic *New Keynesian* models of monetary policy, encompassing key concepts from *Keynesian*, *monetarist*, *rational expectations* and *real business cycles schools* of thought (Goodfriend & King (1997), Clarida *et al* (1999), Woodford (2003) etc.) but occasionally also incorporating additional eclectic features such as *credit market frictions*, *financial accelerator mechanisms* etc. (e.g. Bernanke *et al* (2002)). On the policy side, inflation emerged as the single dominant concern of central bankers the world over, with other

objectives such as growth, exchange rate stability, financial stability, etc., receiving varying degrees of emphasis.

A *New Trinity* reflecting this consensus started building around the three facets of

- (i) a flexible exchange rate
- (ii) an inflation target, and
- (iii) a monetary policy rule.

The *New Trinity* spans a wide spectrum of flexible exchange rate arrangements. The inflation target could be explicit or only an implicit target band, and the monetary policy rule may be nothing more than a “contingency plan” specifying “how the central bank should adjust the instruments of monetary policy in order to meet its inflation and other targets” (Taylor (2001), p.263).

The above discussion should be of help in putting in perspective several issues of practical relevance for monetary policy. Below, we take up for brief discussion a smorgasbord of such issues in the Indian context.

IV

The primary issue relates, of course, to whether (and to what extent) financial liberalization has transformed the way monetary policy measures impact the economy. This is largely an empirical issue, with a considerable body of evidence accumulated for the developed economies. In two earlier papers, I (along with a colleague) have attempted an econometric investigation of the Indian evidence in this regard (Nachane (2001), and Nachane & Laxmi (2004)). Not only are the monetary policy lags “long and variable” as famously conjectured by Friedman (1961), two further complications seem to emerge. Both, the magnitude of the “elasticity” of output and prices with respect to monetary policy, as well as the *multiplicative*

uncertainty (a term due to Goodhart (1999)) associated with its measurement, have been amplified by financial liberalization in India. This seems to be the main reason for the cautious approach to the conduct of monetary policy, much in evidence all over the world (the Indian case being no exception), and not really to any inherent conservatism of central bankers *per se*, or their tendency to “down weighting of small probability events”, and even less to their lack of initiative in reacting “ very slowly to new information and risks” as often alleged (e.g. Nowaihi & Straca (2003), p.35-36).

V

The second issue that I believe to be important, relates to “ fiscal dominance” of monetary policy. The issue tends to get slurred in the simplistic IS-LM framework, because of what Kuttner (2002) refers to as the *common funnel* assumption (aggregate GDP responds identically to a demand shock, irrespective of whether the stimulus is fiscal or monetary). Practitioners know this to be a gross over-simplification. Apart from the well-documented effects of the fiscal-monetary policy mix on the *composition* of output, on the *real* interest rate and on the current account (e.g. Brimmer & Sinai (1986)), recent work has stressed the fact that the government’s inter-temporal budget constraint seriously undermines the central bank’s ability to control inflation (e.g. Huang & Padilla (2002)). Central bank autonomy may be partly a solution to “fiscal dominance” but such autonomy can never be complete, and given the nature of modern democracies the fiscal authority will continue to command enormous *countervailing* power, given that those entrusted with it are elected representatives, who additionally have, in many countries, a large say in making higher appointments to the central bank⁶. There is a growing literature that traces the consequences of “ fiscal dominance” and “co-ordination failures” between the two authorities (e.g. Dixit & Lambertini (2002), Eggertsson (2002) etc.).

In India, monetary policy right up to recent times was often viewed as a “handmaiden” to fiscal policy. Some moves in the direction of RBI autonomy have been made in the last decade (Mohan (2005) and Jadhav (2003)) but fall considerably short of the norms prevailing globally (Blinder (2000)). The FRBM Act 2003 has been welcomed in several quarters as a step towards granting adequate safeguards to monetary policy commitments from the consequences of *fiscal exuberance* and ensuring better monetary-fiscal co-ordination generally (e.g. Goyal (2002)), but some of its provisions such as RBI’s proposed withdrawal from the primary market for government securities seem controversial. The professed rationale of this measure (viz. that it will tighten fiscal discipline overall, and one may add, establish a yield curve more accurately mirroring the market’s inflationary expectations) is overshadowed by the legitimate concerns raised about the ensuing high real interest rates and the steep rise in the government interest burden (EPW Research Foundation (2005)) as also the virtual relinquishing of RBI influence on the long-term rate of interest (of critical importance in translating monetary policy impulses to the real side of the economy).

VI

The stock market, apart from being a sensitive barometer of macroeconomic conditions, has also emerged as an important channel of monetary transmission, in the current liberalized financial environment⁷. Thus, it should hardly come as a surprise that the stock market looms large on central bankers’ consciousness. A key issue then is whether and to what extent, monetary policy should respond to stock market developments (see e.g. Borio & Lowe (2002), Bernanke (2003), Lansing (2003) etc.). It is best to distinguish two contrasting situations.

The first refers to the emergence of a “speculative bubble”, which some see as a fit occasion for the central bank to intervene, pricking the bubble before it assumes dangerous

proportions. Most economists and policymakers, however, advise against the idea on two grounds – firstly, bubbles may be difficult to diagnose *ex ante*, and secondly, the monetary intervention required might be forbiddingly large, exposing the economy to the risk of a deep depression.⁸ The consensus of opinion favours the use of micro-prudential measures for this purpose (in India such measures are superintended by the SEBI).

The second situation refers to the potentially adverse impacts that a monetary policy restraint could have on the stock market. There is, in evidence, a certain hesitation among central bankers to apply the brakes on an overheated economy, for fear of spoiling the *stock market party*. The stock market's possible reaction then appears as an important constraint on policymakers' ability to tighten monetary policy in the face of an inflationary threat.⁹

VII

The theoretical ascendancy of the rational expectations school has had important repercussions on policy making, and in particular one principle has emerged as sacrosanct viz. that, that policy is best which “surprises” markets the least¹⁰. As a logical corollary, monetary policy is adjudged accordingly as it is aligned with market expectations or not. In practice, however, the line dividing *what markets expect* from *what markets want* is an extremely thin one. And hence monetary policy in its eagerness to track market expectations, may quite likely find itself being driven by market desires – a classic case of the tail wagging the dog. Because markets in general, and financial markets in particular, have rather short horizons, excess zeal towards keeping financial markets happy is often likely to compromise important long-term objectives of monetary policy¹¹. The financial press ideally should have an important role to play as a communications channel between policymakers and markets, clarifying for the latter the macroeconomic fundamentals on which good policy bases itself, thus reducing the likelihood of policy “surprises”. In India (and perhaps to

varying extents the world over), the financial press has long abdicated this responsibility, setting up instead, what Blinder (1997) so graphically describes, as an “incessant din of market chatter” besides installing its own “grading system” for monetary policy¹². This has had the undesirable effect of keeping the monetary authority under tremendous pressure to perform its tasks without incurring the displeasure of financial markets. On this, I can do no better than to quote Blinder (1997) again “..it is just as important for a central bank to be independent of markets as it is to be independent of politics”.

VIII

The above discussion can lay no claim to exhaustiveness. There are several other issues of relevance for the conduct of monetary policy in a financially liberated environment viz. whether monetary authorities should adopt explicit Taylor-type rules (see e.g. Taylor (1993), Clarida et al (1998)), whether monetary policy should respond only to the final targets of inflation and output or also to intermediate targets such as asset prices and exchange rate movements (see e.g. Cecchetti et al (2000), Filardo (2000) etc.), the regional dimensions of monetary policy (see Nachane *et al* (2002)) and so on – the list is virtually endless

There is one final point which seems to have virtually attracted no attention in the literature. This refers to the fact that in most LDCs financial liberalisation is often “government driven” rather than an autonomous evolution in response to market forces. Additionally, the financial innovations, very often, are virtually transplanted from abroad, with little adaptation to domestic conditions. Together, these features imply that the financial liberalisation process in LDCs lacks spontaneity, is somewhat artificial and often premature, and hence may interface with policy in ways quite distinct from the pattern recorded in advanced countries. In particular, it would be a topic of considerable research interest to examine whether this

feature implies higher “sacrifice ratios”¹³ for LDCs as compared to developed countries, in the pursuit of financial stability as an explicit objective of monetary policy.

Endnotes

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- ¹ It would be interesting to explore if a causal nexus exist between these developments.
- ² This framework still survives in many countries, albeit in a somewhat battered form.
- ³ Currency, no doubt, is an exception to this phenomenon, but most likely, an increasingly unimportant one.
- ⁴ This feature is somewhat mitigated if *Divisia indices*, rather than *simple-sum aggregates*, are used in the definition of money (Gabb & Mullineux (1995)).
- ⁵ This conclusion is not true in its entirety. Several transmission channels will still remain open, and a few new ones will emerge. A change in interest rates could still affect aggregate consumption via its impact on permanent income, as well as through intertemporal substitution (Bayoumi & Koujianou (1989)), though this channel is likely to be a sluggish one. More importantly, as stressed by Goodhart (1989), the increased elasticity of global capital inflows to domestic monetary policies, implies that the reduced effects on domestic demand are compensated by a greater impact on exchange rates. The latter has, as a matter of fact, emerged as a major channel of monetary policy in several OECD countries, in recent years. A major advantage of the exchange rate channel is claimed to be its direct effect on input prices and inflation, but on the flip side, it makes investment in the manufacturing sector tradeables, unduly dependent on the vacillations in domestic monetary policy (thus impeding the long-term growth prospects of the economy).
- ⁶ This point is also of crucial significance in the Indian context.
- ⁷ As is well-known this channel operates primarily via a wealth effect as also alterations in firms' cost of capital (see Rigobon & Sach (2003))
- ⁸ "Opponents of bubble-popping often cite the example of the Great Depression, claiming it was exacerbated by the Fed's overzealous attempts to rein in speculative stock market excesses" (Lansing (2003), p.2)
- ⁹ This overriding concern with stock markets seems largely to be unwarranted, the observed impacts of the stock market being transitory in a majority of the cases.
- ¹⁰ This conclusion is critically conditioned on its twin premises (rational expectations and efficient markets), both of which have been increasingly questioned in recent years (see e.g. Barberis & Thaler (2002), Mullainathan (2002), Shiller (2003) etc.).
- ¹¹ "I believe that markets tend to get hyper-excited by almost any stimulus, sometimes succumb to fads and fancies and are often short-sighted.If this is true, a central banker who follows the markets too assiduously is liable to overreact to current data and tacitly adopt the markets' short time horizons as his own" (Blinder (1997), p.15)
- ¹² The judges in this system are usually the captains of industry and finance, who use these occasions "to hold up for our inspection their financial fashion plates" (to use one of Keynes' favourite expressions—see Keynes (1972)[1931], p.192). Parenthetically speaking, I may add that professional economists are conspicuous by their virtual absence in the financial press—whether it is a deliberate retreat on their part or whether they have been banished from this realm, could be a matter of debate.
- ¹³ The sacrifice ratio may be defined as the aggregate of welfare sacrificed (if any) with respect to objectives such as inflation, output growth, exchange rate stability etc. for achieving a given level of financial stability. Needless to say, the computation of such ratios in practice, would prove a forbidding task.

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