<u>Transcript of the Questions and Answers of the session "Global Liquidity and Financial Contagion"</u>

Panel: Sukhdave Singh, Louis Kasekende, Deepak Mohanty, Manuel Agosin, Amar Bhattacharya

Questions to the Panel

Aaron Mehrotra (BIS Hong Kong): I wanted to ask the panel about their views on FX intervention as a policy tool going forward both to deal with FX volatility and also to affect monetary conditions in the economy because it was shown both in the presentations by Deepak and Amar that central bank balance sheets have become very big, and in this region in particular they have become very big. So then this also implies that sterilized intervention has become very costly as a policy tool. Would this mean that then central banks will allow more volatility in the exchange rate, going forward?

Mythili Busnurmath (Economic Times) : I have three questions, and I will be very brief. My first question is to Sukhdave Singh. You spoke about excessive debt but how do you measure what is the word "excessive" mean? It is a very subjective word. Do you measure it in terms of total flows; do you measure in terms of country's absorptive capacity, the debt service coverage ratio, what is excessive? Is it country specific, are there any rules?

My second question is to Manuel Agosin from Chile. You talked about fiscal policy being acyclical or anti-cyclical. In a poor democracy, where fiscal policy almost necessarily by definition is expansionary, what is the additional responsibility cast on the monetary policy?

My third question is to Deepak Mohanty from the Reserve Bank of India. Very often we have been talking about adequacy of reserves. Earlier we measured in terms of number of months of import, then we expanded in terms of short-term debt i.e. residual maturity then we increased to what percentage of portfolios flows, but now I find the present Governor of the Reserve Bank of India talking in terms of about number of months of current account deficit. What is the logic and how sustainable is this kind of argument?

Devasish Prusty (Ministry of Commerce): My specific question to Louis Kasekende from Bank of Uganda. You spoke about designing real estate price indices. What sort of data structure do you factor in? Do you take into account the property prices in residential sector or in the commercial sector? Do you have kind of a central registry which talks about the quarterly or the periodic fluctuations in the prices? Could you elaborate more on that?

Stephany Griffith-Jones (IPD): I thought the panel was absolutely outstanding. Mr. Singh told us that when you liberalize the capital account, you should have the policy space to step back. I totally agree but the problem is I think political economy. From what Louis told us and what Manuel told us, can you restore capital controls, isn't it too difficult to do? This is partly because the markets develop and partly because from the position of the domestic financial sector, the international is so big. Isn't it better just perhaps not to open it completely and leave the space there? Secondly, I thought Manuel's presentation was excellent, but he says that the capital flows amongst developed countries are on the whole smaller. That was true in the past, in the reversals. But the flows into Spain in particular and even more into

Greece and the reversals were actually bigger than in Latin America in the 1970s and 80s. I think in a way this raises a tactical question whether the issue should be posed as one of emerging markets being more vulnerable than the developed countries or should we pose it as a general problem of volatility of the financial markets? It is also in the interest of the developed economies to have these kinds of broader defenses and this brings me back to the excellent point I think that Amar made about the need for a bigger fund. I think we should say that on behalf of the emerging countries and of the low-income countries, but it's also true for Greece, and Spain and Ireland, that we all need a bigger fund; we all need maybe even more prudential capital account management.

Shyamala Gopinath (Former Deputy Governor, RBI): What Louis mentioned that in Uganda, one source of instability is the amount of liabilities in the banks. Clearly that is an important source of vulnerability because banks can't default on their loans. In the capital account management policy that we have, there is a hierarchy of capital flows. We have allowed corporates to borrow, and except in certain exceptional cases circumstances, banks can't guarantee those foreign currency borrowings. So the lender is actually taking a risk on the corporate, and corporates failures don't really impact the system or create instability in the system. But if we allow banks to intermediate foreign currency borrowings, even having with limits on currency and maturity mismatches do not help, as eventually the liabilities have to be paid for by the banks, and if the banks can't pay, the central bank have to provide liquidity to them. The liquidity risk is therefore much higher when foreign currency liabilities of banks go up, and even if you have lent in foreign currency you may or may not be able to get back the funds when you actually need them. One needs to distinguish between the different kind of liabilities and on whose books these liabilities actually sit.

Nemat Shafik (IMF): You all talked about intervention in various forms. I wanted to ask any member of the panel, how you decide whether what you are facing is a tide or a Tsunami? Because human nature is such that and every country I have seen treats positive shocks as permanent and negative shocks as temporary. Interventions like capital flow management, exchange rate policy, macro-prudential policy, can work against tides, but Tsunamis require adjustment. How do you decide whether you are facing a tide or a Tsunami and how you decide whether to use exchange rate interventions, macro-prudential or capital flows management as your preferred tool, depending on whether you are facing a tide or a Tsunami?

Joseph Stiglitz: I want to raise a perspective of thinking about what central banks and central bank regulatory policies do. We haven't talked at all about industrial policies. It's been implicit in several of the remarks – recognition that monetary policy is also industrial policy. If you have an overvalued or undervalued exchange rate, it affects industrial structure; if you have a volatile exchange rate it affects the structure of the economy. The first issue is that to what extent monetary authorities should really think about how their policies affect the structure of the economy.

The second question is one raised by Mr. Singh which is that we talk about inviting foreign banks to improve the quality of financial institutions. I do encourage people if they want to learn about predatory lending, and abusive credit card practices, market manipulations to encourage American investment banks to come into countries because they really have superb talents in these areas. But in a more

serious way, a lot of the recent literature in industrial policy has talked about the benefits of learning-by-doing, the infant economy argument for industrial policy. The World Bank has been focusing in the last 5 years on the role of industrial policy in structuring the economy, and an important aspect of learning is learning how to lend, learning who are good borrowers, and this actually in some ways has showed up in the data that countries that have had more financial market liberalization i.e. have brought in more foreign financial institutions, tend to have done less SME lending and have grown more poorly. Once you think about this as an aspect of industrial policy that it is important to learn how domestic institutions learn about lending, and it may not be the optimal way to outsource financial services. Malaysia has done a very good job in many areas of learning from foreign companies that have come into their country but it won't happen on its own. They had explicit policies for maximizing the learning. I did want to comment on how you think about that within the financial sector.

The other comment/question I want to make is the issue about whether you should through tax; try to regulate liabilities or the assets side of the balances sheet. In a way this relates to the issue that Adair talked about yesterday, he said lot of the problem is not the flows of finance but the wrong form of the flows. So the question is, on the one hand, should government tax or discourage different types of liabilities side, and on the assets side, put in place speed bumps and other instruments. No matter where, you may need to impose certain things on the asset side and certain things on the liability side.

And the final couple of comments are one, that not just taxes are relevant but tax deductions. We actually have tax structures in many countries that encourage debt, and if you think that foreign liabilities are more dangerous than domestic liabilities, then you should remove that tax deductibility. It is not only taxing, it is actually re-subsidizing. Finally, I have always worried about distinction between bank borrowing and corporate borrowing for the following reasons. When we started regulating some of the bank activities like on predatory lending, what banks did is created corporations that they lent to, and the corporations engaged in predatory lending. So you can get better behavior in the banks but the banks then help create institutions that circumvent. Then the question is all the exposures are really on the bank's balance sheet in the end, the banks are looking at what is going on. And the question therefore is do we really have to have some more holistic regulatory framework.

Answers by the Panel
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Sukhdave Singh: Let me address the issues related to intervention. I think certainly any policy that you do has a cost with it. Monetary policy has a cost. I think you have to weigh that against the alternative. With respect to intervention, I remember a talk with a businessman shortly after we liberalized our exchange rate and we were talking to him that don't depend on the exchange rate, you must improve your productivity, and all that in order to gain sustainable competitiveness. He came back and he said, it takes me 1 year to drive down my cost by 5 per cent, if your exchange rate moves by 10 per cent, you have put me back. And that is really the issue that when your exchange rates moves up that much in a relatively short period of time, there is a cost to the economy. This is not related to fundamentals. I am all for your exchange rate moving in response to your changes in fundamentals as an economist, price changes do send important signals to the economy. But when you have this type of volatility, you are

committing suicide. I mean you are imposing cost on your businesses which they don't necessarily need to bear and as a policy maker the onus is on you because it is your responsibility. Yes, there is a cost and you have to deal with it.

Going back to whether it is a tide or tsunami, I mean, I think generally if I take the recent experience, our assessment in Malaysia is that generally we have been dealing with tides, and who do we have to thank for this? Not the Federal Reserve, actually it is the Europeans. Every time there was some concern with Europeans, there was capital outflow. This type of volatility we can deal with, that is why our reserves are there. But imagine another scenario, where we had a Tsunami of capital flows that just kept coming in and coming in and of course you can't allow the exchange rate to bear all of this, you had to intervene and then you run into the fiscal cost of it. That would have been a major issue, and in those situations that's when talks of CFMs actually become more and closer to reality.

Now, in terms of excessiveness of debt, I think there are various matrices out there in terms of what excessive debt could be, and in terms of the sustainability of the debt, but I think at the end of the day, my view on this is that as with everything in life, when you are dealing with something that potentially could be risky, moderation is actually the best policy. When you are borrowing now, think of the potential scenarios that you could get into down the line because what the investment banks will tell you. I mean investment banks have come to us to invest our reserves in commodities. So they will sell you all sorts of things but you have to be prudent enough to decide what will be the potential implication, I mean if there is a change in the government's fiscal position, can it still sustain the repayments on that debt.

One final point was addressed to me by Joseph Stiglitz is this issue of encouraging competition. It is absolutely necessary, if you allow for a free for all for the foreign banks to come in, they will set up in your urban centers and they will take the cream of the lending essentially and they will have no interest in serving your social purposes. This is why I think you have to have the necessary rules of the game, and in our case, the rules of the game have to do exactly in terms of lending to SMEs and also in terms of our agenda with respect to financial inclusion. So when we allow branching for example we have a requirement that for each urban branch that you open, you also have one in the semi-urban and in the rural areas. You can have these type of conditions on which foreign banks come in. It doesn't mean that you have to allow foreign banks to come on their own terms, you specify the terms.

Manuel Agosin: Let me try to talk about sterilized intervention first. Clearly central banks should not give it up. In fact in my own country, which adheres to an inflation targeting regime, whenever the central bank stepped out of it and did sterilized intervention, it was quite successful but contrary to conventional wisdom that says that sterilized intervention cannot be successful, eventually it was. However, it has a limit. I mean if you have 5 years, 10 years of capital inflows exceeding 5 per cent of GDP like it happened during the 90s; sterilized intervention can be extremely costly to the central bank. The central bank can incur losses that are very significant. So there is a limit to that.

Stephany's question about the European countries that have run into problems; I feel that this is more or less an example of what I was saying. First, you had a reduction in interest rates in Europe, enormous

reduction with the introduction of the Euro and large capital flows to the periphery to finance what? In many cases, either real estate or as we heard yesterday, consumption. So at some point the bubble burst and with the consequences that we know. I think clearly it is not just the matter of being emerging market or not, it is matter of how big the capital inflow is relative to your domestic financial markets.

Joseph's point about central banks doing the industrial policy well I have made the same point to my colleagues at the Chilean central bank without any success. They don't believe that they are doing industrial policy but they certainly are doing anti-industrial policy by either letting the exchange rate appreciate too much or making it too volatile.

Finally, the problem with some of the companies, with some of the corporates in our country is that they have gotten pretty big. Our big corporates are big not only in our country; they are big in the world economy. You take the Chilean groups; Chile is a little country but has big companies that are investing in many places. These are agents for borrowing in financial markets. I do not know what the solution is but at least one can flag the problems.

Louis Kasekende: In my personal experience, the problem that we have faced as the central bank is on the objectives, and mission creep and come out, telling the public that we could deliver on certain things. If you can tell the public that you can deliver on inflation, you are judged by that; I think that is the easiest position for a central bank, but once you start getting into, there is now talk about industrial policy, you talk about exchange rate, you have so many objectives that in most cases central banks do not have instruments to deliver on all these objectives. Having made that general comment, I come back to this issue of interventions and sterilized interventions, I think it will remain, but as I say in the case of Uganda, it will always be subordinated to the other objective of price stability.

How do you tell whether it is a tide or a Tsunami? Policy making can be very interesting. You can come up with rules and say if the exchange rate moved by so much on single day then I will move, but even if it moves at that level there are cost considerations that come in, and you resist the market and there are times when it resists rules and hence there is an element of art that comes on a day to day management of central banks.

On the issue that you have raised on prudential, may be related back to what Joseph was saying, in the case of Uganda we have resisted using capital control measures. There has been a debate but we have resisted using capital control measures. But you can use prudential. Deterrence of prudential measures is much higher than when you start talking about controls, what assets you should accumulate. So that is the sort of starting point for us. We have used prudential measures and they have worked for us but I think we need to continually assess the effectiveness of these prudential regulations, but for now they have worked. I take your point of a holistic regulatory framework that one might want to think about.

My last take is on the real sector survey. We do talk to estate agents, do regular surveys of estate agents, and I think as of now we are doing it on a quarterly basis; send a questionnaire, they give us information, and we have constructed the price index that we are looking at. Over time we will be having maybe registries in Uganda where some of the deals in are placed. The other problem you have with sales is that once you impose a tax most of the people do not want to disclose the prices at which

they have either bought or sold their house because of taxation. There are problems but we do use indices.

Deepak Mohanty: Three questions to me. FX volatility: do you have to care; yes one has to care about it. Is it only through interventions you can manage it? Not necessarily, there are other tools through which it could be done. If it is a managed currency then obviously no one cares about the volatility and public good and also as financial stability considerations, but again emerging markets don't have that kind of luxury. Because it could be done through other tool like what is happening in Japan and many commentators would think that lowering your interest rates and doing so much on QE essentially you are trying to weaken your exchange rate. People are managing their exchange rate even in advanced country.

The other question that whether it is costly, answer to that is both no and yes. One thing that is less realized that in case of emerging market economies that we have to grow our balance sheet. Central bank balance sheet reserve money has to grow; I have to grow my balance sheet by 10 per cent every year so the choice that I have whether I do it by expanding my foreign assets or by domestic assets. Given our situation where the fiscal deficit is so high and to enhance my balance sheet strength, so there is no cost up to that. Beyond a point then you can build some reserves for precautionary purposes and beyond that one can really talk about the cost.

Mythili's question, how much reserve is adequate? I don't think anything is adequate because you cannot put a number into that. Going by the latest experience that all the countries, irrespective of low or high of reserves, they got hit by this process. So that is what has happened, except China, all the currencies got affected by that process. Even India had 280 – 290 billions of reserves, but what was the talk? When we are going to the Fund? Because even the market didn't see that 280 billion which can be easily financed even if the current account expands for a 2 trillion economy can finance at least a year or two without much of a problem. But that much was also not seen as adequate. So I don't really know what really adequate level of reserves.

And finally to Joseph's question whether the central banks are really thinking of industrial policy? I don't know but certain they worry about the financial stability considerations because then we would have to also see the balance sheet of corporates and the private sector, and we do worry about the unhedged exposure and the impact exchange rate movement could have on their balance sheets.

Amar Bhattacharya: As a last speaker, just let me say I agree with everything that has been said. I wanted to maybe just close by answering a question that Usha, you had posed which is what should central banks then do. From the discussion we agree that price stability is the central focus but it is not enough. Second, I would say that exchange rate volatility will have to be a much greater concern of central banks and yes, foreign exchange intervention is one instrument, but you have to think about others, and some of those are macro-prudential in nature and we should look at experiences of countries and identify what macro-prudential tools can help both in a steady state sense but also in a time varying.

And third, you have to worry about financial stability or financial risk embedded in balance sheets. That has to be a very important function of central banks, and I am with Joseph in the sense that I would not take such a benign view of risk in the corporate sector, that it is not systemic. In the case of India, the pressures really came from corporate treasurers running for cover, so you cannot take the view that risk does not matter. So I think these three dimensions: price stability, excessive exchange rate volatility and its impact on the real economy and financial stability have all got to be concerns of central banks.