Passing the Buck*

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Reserve Bank of India governor Raghuram Rajan has been railing against the monetary authorities in the developed economies for some time now. Initially his complaint was that they unilaterally decide on infusing liquidity or withdrawing it through their "quantitative easing" and "taper" policies, even though this move affects "emerging markets" like India. The resulting inflows and outflows of capital into these countries make monetary and exchange rate management difficult. Rajan wanted coordination between central banks so that these measures can be calibrated, hopefully to suit all.

This way of phrasing his opposition to developed country policy chooses to ignore why developed country central bankers do what they do. To start with, all developed country policy makers who, like Rajan, see much virtue in financial markets, argue that financial institutions on the verge of insolvency had to be bailed out, even though it was their errant behaviour that had led to their near-failure and the financial crisis. Buying into their equity, buying out their stressed assets and giving them cheap credit, were the solutions favoured.

Further, despite initial talk of providing a stimulus to stall and reverse the real economy decline that the financial crisis triggered, conservative opinion, again of the kind that Rajan is known to favour, soon turned against the tendency to enlarge the fiscal deficit on government budgets to finance the stimulus. With an emphasis on austerity in economies performing both moderately well and poorly, monetary policy had to replace fiscal policy as the principal means to address the crisis. This required more liquidity infusion into the system, over and above that needed to save the banks and return them to profitability. What became clear over time was that a little bit of money did not go far enough in addressing the crisis—the system had to be flooded with cash.

The result was the decision to pump large volumes of liquidity into the system through versions of the quantitative easing (or QE) policy. QE essentially involves the purchase of bonds normally from banks, but also from other agents. The consequences of such purchases are three-fold. First, it infuses liquidity into the system, allowing banks to lend more because they have accumulated reserves and because they have transferred risk off their balance sheets by the sale of securities. Second, it raises the price of assets because of the increased demand for securities in the 'market'. Third, since the corollary of a rise in asset prices is a fall in yield, the move results in a decline in interest rates. The resulting cheapening of credit it is expected would spur demand and combat the recession.

Starting with the Troubled Asset Relief Programme (TARP) in 2008, and then through QE II which injected around $600 billion over 8 months and finally QE III that involved purchases of $85 billion a month for several months, the balance sheet of the Federal Reserve or the assets it held through purchases ballooned from $800 billion in 2008 to more than $4 trillion recently.

What was remarkable is that this huge infusion of liquidity had not sent prices soaring in the US economy because of "too much money chasing the available goods". Nor was there any significant increase in production as a result of increased capacity utilization driven by credit financed demand. The reason was that with households and businesses already heavily in debt, they were (and are) not willing to borrow more even at lower interest rates and banks were cautious about lending to over-indebted clients. The expectation that increased liquidity in the system would translate into increased consumer, housing and investment credit proved misplaced. But the absence of inflation encouraged staying with the quantitative easing policy.

So where did the money go? Part of it remained in the books of the banks, which were happy to have got rid of the excessive volumes of risky assets they held. But another part was flowing into assets like equity, bonds and gold, both within the US and abroad. The result has been huge asset price inflation. Stock markets globally are at record highs (witness the movements in the Sensex). As financial analyst Michael Hieise puts it: "the collateral damage from ultra-loose monetary policy is accumulating. Risks to financial stability are growing as investors are piling into riskier assets in search of higher returns. Already, some assets such as junk bonds are trading at what look like inflated prices."

It is not only the stock market that is showing signs of pre-crisis type buoyancy. In the UK, housing prices are reportedly extremely high compared to historical averages, rents and incomes. The IMF estimates that the UK house price to income ratio was 30 per cent above its long-term average. In France, New Zealand, Australia, Canada and Belgium the discrepancy was even higher. This too is reminiscent of the pre-crisis boom.

The problem, however, is that with fiscal policy in the form of tax-financed or deficit-financed expenditure off the board, there is no option to relying on the monetary lever. So asset price inflation of the kind that preceded the 2008 crisis has to be ignored, so long as the prices of ordinary goods and services were not registering runaway increases. While it is true that the US Fed, encouraged by positive growth numbers, has decided to taper out its bond purchase policy, that process is slow. And precisely when that is occurring the normally conservative European Central Bank under Mario Draghi startled analysts in early September by reducing interest rates to record lows and announcing a policy to buy private sector bonds worth hundreds of billions of euros as a measure to stall a deflationary crisis. For Draghi this was unavoidable also because the weak dollar that liquidity infusion by the US results in, forecloses any effort at using the depreciation of the euro to revive export demand and growth.

So Raghuram Rajan was expecting an unlikely show of altruism from countries that were seeking to resolve their own problems, when he said that unilateral decisions to turn on and off the monetary tap that adversely should be abjured. It is true that such policies affect developing countries, as illustrated by the sudden slide of the rupee when the taper was first announced in the middle of 2013. Fearing that interest rates in the US would rise, capital was withdrawn from emerging markets weakening currencies, that earlier had been strengthened by large capital inflows. Such currency volatility is indeed a problem and needs a response. But Rajan needs to look to policies he can adopt, and not to those he could advise his developed country counterparts to pursue. He needs to find ways to reduce the overhang of footloose finance in India's capital markets, and slow the inflow of capital that was not needed to finance the balance of payments. That would at least partially insulate India from the whimsical decisions of foreign financial investors. But to consider such options amounts to going against his own ideological inclination.

However, recognizing that his effort at admonishing his peers is not going to cut much ice, Rajan has changed track in recent times, appealing to developed country self interest. Pointing to the asset price inflation noted earlier, Rajan declared in an interview in early August that another round of turmoil in global financial markets, or even another financial crisis are a real possibility, if the policy of quantitative easing remained in place. "A number of years over which we, as central bankers, have convinced markets that we continuously come to their rescue and that we will keep rates really low for long — that we do all kinds of ways of infusing liquidity into the markets — has created markets that tend to push asset prices probably significantly beyond fundamentals, in some cases, and make markets much more vulnerable to adverse news. My worry is that, with inflation not being strong, this can continue for some time until things are so stretched that any signs of inflation, and a rise in interest rates, could precipitate a fairly strong market reaction. Certainly that volatility hurts across the world," he is reported to have said. In his view, "monetary policy can only do so much and beyond a certain point if you try to use monetary policy it does more damage than good."

While he softened his stand on the dangers of a crisis a few days later, he has gone on to provide new arguments to establish the futility of aggressive monetary policy. In a recent Chicago address he declared that the huge monetary stimulus adopted by the rich nations was recreating the environment that existed in the years that followed the Asian financial crisis of the late 1990s. At that time, these countries, having been hit by capital outflows and having to adopt IMF-style bailouts, began emphasizing reserve accumulation as insurance against boom-bust cycles. This depresses global demand and leaves it to developed country consumers to trigger the recovery. With the recent quantitative easing policy having had a similar effect, the objective of the whole exercise is defeated. Rather than stimulate global demand it depresses it.

Here again Rajan is appealing to the self-interest of the developed. So, if they do not respond, as is likely, it not because of a lack of effort. Time perhaps to stop passing the buck and invest that energy in exploring policy alternatives that developing countries can implement. Maybe finding ways of shutting out some at least of the capital inflows and addressing India's vulnerability may be a better way to go.

*** This article is originally published in the Frontline, Print Edition, October 3, 2014.**