In his speech, Dr. Raghuram. Rajan emphasized on the conduct of monetary policy in an integrated world. He noted that a good way to describe the current environment is one of extreme monetary easing through unconventional policies. In a world where debt overhangs and the need for structural change constrain domestic demand, a sizeable portion of the effects of such policies spillover across borders, sometimes through a weaker exchange rate. More worryingly, it prompts a reaction. Such competitive easing occurs both simultaneously and sequentially, and both advanced economies and emerging economies engage in it.

Dr. Rajan then laid emphasis on whether exit from unconventional policies would be easy. The macroeconomic argument for prolonged unconventional policy in industrial countries is that it has low costs, provided inflation stays quiescent. Hence it is worth pursuing, even if the benefits are uncertain. A number of economists have, however, raised concerns about financial sector risks that may build with prolonged use of unconventional policy. Asset prices may not just revert to earlier levels on exit, but they may overshoot on the downside, and exit can cause significant collateral damage. One reason is that leverage may increase both in the financial sector and amongst borrowers as policy stays accommodative. One channel seems to be that a boost to asset liquidity leads lenders to believe that asset sales will backstop loan recovery, leading them to increase loan to value ratios. When liquidity tightens, though, too many lenders rely on asset sales, causing asset prices and loan recovery to plummet. Because lenders do not account for the effects of their lending on the “fire sale” price, and subsequently on lending by others, they may have an excessive incentive to build leverage. These effects are exacerbated if, over time, lenders become reliant on asset sales for recovery, rather than on upfront project evaluation and due diligence. Another possible channel is that banks themselves become more levered, or equivalently, acquire more illiquid balance sheets, if the central bank signals it will intervene in a sustained way when times are tough because unemployment is high. Leverage need not be the sole reason why exit may be volatile after prolonged unconventional policy. Investment managers may fear underperforming relative to others. This means they will hold a risky asset only if it promises a risk premium (over safe assets) that makes them confident they will not underperform holding it. A lower path of expected returns on the safe asset makes it easier for the risky asset to meet the required risk premium, and indeed draws more investment managers to buy it - the more credible the forward guidance on “low for long”, the more the risk taking. However, as investment managers crowd into the risky asset, the risky asset is more finely priced so that the likelihood of possible fire sales increases if the interest rate environment turns. Every manager dumps the risky asset at that point in order to avoid being the last one holding it. Leverage and investor crowding may therefore exacerbate the consequences of exit.

Dr. Rajan also highlighted the spillovers from unconventional policies to other countries. When monetary policy in large countries is extremely and unconventionally accommodative, capital flows into recipient countries tend to increase local leverage; this is not just due to the direct effect of

*Remarks by Dr. Raghuram G. Rajan at the Brookings Institution, April 10, 2014.*
cross-border banking flows but also the indirect effect, as the appreciating exchange rate and rising asset prices, especially of real estate, make it seem that borrowers have more equity than they really have. Exchange rate flexibility in recipient countries in these circumstances sometimes exacerbates booms rather than equilibrates. Indeed, in the recent episode of emerging market volatility after the Fed started discussing taper in May 2013, countries that allowed the real exchange rate to appreciate the most during the prior period of quantitative easing suffered the greatest adverse impact to financial conditions. Countries that undertake textbook policies of financial sector liberalization are not immune to the inflows - indeed, their deeper markets may draw more flows in, and these liquid markets may be where selling takes place when conditions in advanced economies turn. Macro-prudential measures have little traction against the deluge of inflows - Spain had a housing boom despite its countercyclical provisioning. Recipient countries should adjust, of course, but credit and flows mask the magnitude and timing of needed adjustment.

Dr. Rajan also stressed upon more coordination in monetary policy as it would be an immense improvement over the current international non-system. In its strong form, he proposed that large country central banks, both in advanced countries and emerging markets, internalize more of the spillovers from their policies in their mandate, and are forced by new conventions on the “rules of the game” to avoid unconventional policies with large adverse spillovers and questionable domestic benefits. Given the difficulties of operationalizing the strong form, he suggested that, at the very least, central banks reinterpret their domestic mandate to take into account other country reactions over time (and not just the immediate feedback effects), and thus become more sensitive to spillovers. This weak “coordination” could be supplemented with a re-examination of global safety nets. He later proposed some suggestions on operationalizing coordination, first noting that in an ideal world, unconventional monetary policies such as QE or QEE should be vetted by an independent assessor for their spillover effects. However, the problem with such an idealistic process is to find an impartial assessor. The staff at multilateral institutions is excellent, and well capable of independent judgment. But political pressure subsequent to the initial assessment operates unevenly. Initial assessments typically remain unaltered when a small country complains (no country likes independent assessments), but are often toned down when a large economy protests. Perhaps then, it would be better to settle for a more modest proposal. Central banks should assess spillover effects from their own actions, not just in terms of immediate feedback, but also in terms of medium term feedback as other countries alter their policies. In other words, the source country should not just worry about the immediate flows of capital to other countries from its policies, but the longer run reaction such as sustained exchange intervention that this would bring about. This would allow central banks to pay more attention to spillovers even while staying within their domestic mandate.

He concluded by stating that the current non-system in international monetary policy is, a source of substantial risk, both to sustainable growth as well as to the financial sector. It is not an industrial country problem, nor an emerging market problem, it is a problem of collective action. We are being pushed towards competitive monetary easing. A first step to prescribing the right medicine is to recognize the cause of the sickness. Extreme monetary easing is more cause than medicine. The sooner we recognize that, the more sustainable world growth we will have.

Source: www.rbi.org.in
Regulating Capital Account

The FEDAI, set up in 1958 as a section 25 company, has been a multifaceted organization, playing an important role in each of its functional domain having immense contribution in development of the interbank forex market, promoting uniform bank-client business practices, training bank personnel working in foreign exchange desks, and most importantly, acting as an interface between the Reserve Bank and the Authorised Dealers. It played a major role in, the transition from a fixed exchange rate regime to almost floating exchange rate one; from a shallow interbank forex market to one whose activity not infrequently causes the regulator to sit up and take notice, and sometimes act; and from an era when every non-trade forex transaction with a client required a ‘Exchange Control Permit’ to a time when the Authorised Dealers (ADs) have more power and freedom than they are perhaps willing to exercise.

The argument in favour of opening up of the capital account was mainly based on ‘allocative efficiency’: the capital-scarce but project-rich developing countries can surely improve their welfare and better their lot with the help of capital inflows. The crisis in several Latin American countries and the East Asian countries in the late 1990’s pointed out the destabilizing effect of capital account openness and raised many question about its desirability. The macroeconomic preconditions emphasized were low inflation and strong fiscal position has not yet materialized.

The proximate problem that a central bank faces is maintaining a reasonably stable exchange rate, a variable that captures not only the external sector imbalances but also the future expectations of the relevant fundamentals. Through the instrument of derivatives, it is possible for exporters, importers and others to adjust their inter-temporal demand for foreign currency: to either postpone the present demand to a future time or advance the future demand to the present time.

Foreign Direct Investment (FDI), characterized by lasting interest and some degree of management control by the investor, is positioned high in the hierarchy of capital inflows not only because of it is resource augmenting but also because it usually brings in better technology and more efficient management and business practices. The framework for FDI, which gets legal sanctity under the regulations notified by the Reserve Bank under FEMA, is set by the Government of India in consultation with the Reserve Bank of India, and the only restriction on FDI pertains to sectoral investment limits - the degree of control that can be ceded to a non-resident- motivated by strategic or socio-economic considerations.

External Commercial Borrowings (ECBs) are divided into loan contracts denominated in foreign currency and those initiated by the domestic borrowers. The approach here has been that since the external liability of the economy should not be allowed to expand excessively, the ECBs need to be allocated, as it were, to their most productive use. The last, the ceiling on cost of borrowing, may seem to be excessive in view of the restriction on the quantum of borrowing. But it has to be appreciated that there is an automatic route for ECB, and it is necessary to address the adverse selection problem so that ECBs do not flow into risky projects.

Some Thoughts by Shri Harun R Khan, Deputy Governor, Reserve Bank of India delivered at the 9th Annual Conference of FEDAI in Cape Town on April 12, 2014.
The other tool mentioned for controlling Rupee volatility was restriction on derivatives. The view of derivatives has been to treat them as a tool of risk management and as an instrument of hedging foreign exchange risk. This is reflected in the regulatory regime for forex derivatives in the OTC market which has the following two distinguishing characteristics. First, the ability of a firm or an individual to execute a derivative contract is based on an underlying exposure embodying risk. Second, these contracts, at least those involving Rupee, are predominantly to be executed by physical delivery. Over the years, to enable the firms to manage their foreign exchange risk flexibly and efficiently, several relaxations have been introduced, such as, carrying out derivative transactions on the basis of past performance rather than on the basis of individual underlying contracts, cancelling derivative contracts even as the underlying exposure exists (and getting the benefit or bearing the loss thereof) with scope to rebook the contract against the same exposure, etc.

The issue of forex derivatives has become complex because of two reasons. First, there has come to exist a large offshore market in Rupee. Rupee futures are now traded in some of the international exchanges. There is a sizeable Non-Deliverable Forward (NDF) market in Rupee in several international financial centers. This market is opaque and the exact size or details of participants is not known. Interaction with market participants tend to indicate that the figures published by the Bank for International Settlements (BIS) in the last two triennial surveys may have been overestimated, but surely they are large enough to impact the domestic market, particularly during periods of heightened volatility.

The second issue relates to the on-shore Exchange Traded Derivative (ETD) market introduced in 2008 when the external situation was quite different. The objective was to afford real sector agents - particularly the small entities - an easy, safe, transparent and cost-effective instrument to hedge their currency risk. The market is very different from the OTC segment in respect of the two characteristics mentioned earlier: (a) there is no requirement of underlying exposure for accessing this market and as such, entry as well as exit is unrestricted and (b) contracts are cash settled. In other words, it may be used for hedging, but it is also a perfect instrument for speculation for it makes trading in exchange rate just like trading in any other financial asset.

The speaker concluded by saying that the FEDAI and its authorised foreign exchange dealers will have to constructively engage themselves in appreciation of the evolving regulatory dispensation and, more importantly, provide a friendly, efficient and transparent interface with the end-users. He also wished to emphasize that there is a need for establishing highest standard of code and ethics of doing business and guarding against temptations of perverse incentives, particularly in the financial sector.

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