RESERVE BANK OF INDIA

G20 Finance Ministers and

Central Bank Governors' Meeting

Sydney, Australia, February 22, 2014[1]

We need to address the spillover effects through capital flows of what could be termed "balance sheet interventions" by central banks. Such interventions include what has come to be known as quantitative easing, as well as the more traditional exchange rate intervention. These interventions contribute, in my view, to global financial instability.

As the BIS has demonstrated, when monetary policy in source 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 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. 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 flows mask the need to adjust. Even those recipients with strong institutions have not been immune to capital-flow-induced fragility.

So when monetary policy in source countries tightens, some recipient countries are leveraged, imbalanced, and vulnerable to capital outflows. Recipient countries may rationally protest the initiation of unconventional policy, but having become more vulnerable because of spillovers, also call for an exit whose finer details are responsive, at least in part, to conditions they face. Most, however, support exit because they recognize the problems stemming from prolonged easy money.

Unfortunately, we live in a world where monetary transmission is global, while monetary objectives are local. Let me leave to another occasion the debate on whether objectives should continue to be local.

By ignoring cross-border monetary transmission of unconventional policies, we are overlooking the elephant in the post-crisis room. I see two dangers here. One is that the rules of the game are breaking down. Our collective endorsement of unconventional monetary policies essentially says it is ok to distort asset prices if there are other domestic constraints to reviving growth, such as the zero-lower bound. But net spillovers, rather than fancy acronyms, should determine internationally acceptable policy.

Otherwise, countries could legitimately practice what they might call quantitative external easing or QEE, whereby they intervene in the exchange rate and build huge reserves. The reason we frowned on QEE is because we believed the adverse spillover effects for the rest of

[1]Remarks by RaghuramRajan, Governor RBI.

the world were significant, but if we are unwilling to evaluate all policies based on their spillover effects, I do not see how we can rule QEE out.

The second danger is a mismanaged exit will prompt fresh distortionary behaviour. Even as source country central banks go to great pains to communicate how their removal of accommodation will be contingent on domestic activity, they are silent on how they will respond to foreign turmoil. Market participants conclude that recipient countries, especially those that do not belong to large reserve currency blocks, are on their own, and act accordingly.

Indeed, the lesson some emerging markets will take away from this episode is (i) don't expand domestic demand and run large deficits (ii) maintain a competitive exchange rate (iii) build large reserves, because when trouble comes, you are on your own. In a world with deficient aggregate demand, is this the message the international community wants to send? Are we setting the stage for a global savings glut once again?

We are where we are. Going forward, we need to build a better framework, not blaming one side or the other, but trying to reach a better co-operative outcome.

Central bank mandates will not change in the short run nor will the perhaps excessive burdens on them to revive growth. But they should at least acknowledge the importance of spillovers in their statements and testimony, if not their willingness to condition their actions, even a little bit, on them.

Multilateral organizations should become more even handed in their assessment of spillovers, and work to build a better liquidity net that is free of stigma. In addition to reviewing existing liquidity facilities, the IMF could be asked to map out Regional Financial Arrangements and Bilateral Swap Arrangements to pinpoint countries that have little protection, and work to reduce their vulnerability.

Finally, emerging markets will have to avoid the temptations of flighty foreign capital and work to build resilience.

Let me clarify these remarks are intended to move us to a better co-operative equilibrium, and are not prompted by India's current situation. India has adjusted, with the fiscal deficit down to 4.6 percent, better than required by its fiscal consolidation path. The current account deficit is only 1.5 percent on an incremental basis.

Inflation has fallen in the last couple of months, the exchange rate has remained stable since September, and reserves have grown. Growth should pick up from the current 5%. India has moved fast to fix vulnerabilities, though, with elections looming, we are not complacent.

In conclusion, we are glad industrial countries are strengthening. As they recover, it is important that we continue the spirit of co-operation we had in the darkest days of the crisis. We should not send the message that now recovery is in place, emerging markets are on their own.