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A DISCUSSION WITH RAGHURAM RAJAN, GOVERNOR OF THE RESERVE BANK OF INDIA

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Welcome:

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Keynote Address:

RAGHURAM RAJAN
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PANEL DISCUSSION: CENTRAL BANKING AFTER THE GREAT RECESSION:

Moderator:

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Panelists:

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CHARLES EVANS
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P R O C E E D I N G S

MR. WESSEL: Thank you. Good morning. I'm David Wessel. I'm Director of the Hutchins Center on Fiscal and Monetary Policy, here at Brookings.

Our mission is to improve the quality and public understanding of fiscal and monetary policy. And in today's world, if we needed any reminders, the financial crisis taught us that this is no longer something that any country can consider in isolation -- that happens here affects the rest of the world -- and vice versa.

So, our mandate, as we interpret it, is global, and that's, of course, also true of Brookings, which has now outposts not only in the Middle East and in China, but, also, in India.

So, on behalf of Brookings and the Hutchins Center, I want to welcome you today, and tell you how pleased and proud I am to have such an illustrious panel to discuss what I think is one of the pressing issues in monetary policy at the moment.

Our keynote speaker, of course, is Raghuram Rajan, Governor of the Central Bank of India, on leave from the University of Chicago -- well-known for his very clear expositions and for, of course, famously seeing the crisis coming somewhat before some other economists and officials did.

But I think what really distinguishes Governor Rajan is, he is the only central banker who I've ever seen described in the press as a sex symbol. And I'm not making it up. I have the clip right here.

Governor Rajan will speak for about 20 minutes, and then we're fortunate to have an extraordinary panel: Charles Evan, President of the Federal Reserve Bank of Chicago, Alexandre Tombini, Governor of the Reserve Bank of Brazil, Eswar Prasad, one of my colleagues and the author of *the Dollar Trap*, which is relevant to this conversation, and Vitor Constancio, the Vice President of the European Central Bank.

And we'll have time at the end for some questions, so I hope you'll have some -- but recognize that our time is short. This is going to be central banking, speed-dating style, because some of our panelists here have other commitments.

So, with that, Governor Rajan.

GOVERNOR RAJAN: Thank you very much, David, and good morning to everyone.

So, as the world is recovering from the great financial crisis, my objective here today is to draw attention to something we all need to be concerned about, which is the conduct of monetary policy in this integrated world.

And my worry is that the current environment, where there's extreme monetary easing -- largely through unconventional policies -- in a world with substantial debt overhang and, you know, need for structural change, constraining domestic demand, one could argue that a sizeable portion of the effects of such policies below the borders -- sometimes will weaken the exchange rate -- sometimes through capital floors.

But more problematic is that these kinds of policies eventually prompt a reaction. And what we get is, you know, in the immediate run, comparative easing -- which occurs across the world. But over time, we get forms of comparative easing, which, I think, are detrimental to global demand.

So, with the aggregate global demand weaker and more distorted than it should be -- and financial risks higher -- I worry that this kind of policy eventually becomes unsustainable.

So, my call is to rethink the international rules of the game, as the world has changed. I think both emerging markets, as well as advanced economies, need to adapt -- else, I fear, we are embarking on the next leg of a wearisome cycle, a cycle we've seen before.

And so I titled my talk differently from the one in the announcement. I call it "Competitive Monetary Easing: Is It Yesterday Once More?"

Now you will recognize that central bank is usually reluctant to air their concerns in public. We have fora where we meet, such as the BIS, but, occasionally, when the needed change has political elements to it, central bankers are not shy of airing their concerns publicly.

And I take my cue from two central bankers whom I respect greatly: Ben Bernanke, of course, in his 2005 "Global Savings Glut" speech, and Jaime Caruana, in his 2012 speech at Jackson Hole. And both these speeches essentially raise concerns similar to mine, though from different perspectives.

Now, finally, before I start getting into the meat of my speech, I should disclose my interests in this era of transparency. For the last few months, India has experienced large inflows of capital, not outflows, and is seen by markets as an emerging economy that has made some of the necessary adjustments.

So, at this point, we are well-buffered with substantial reserves, though I would hesitate ever to say that we are completely isolated from the global economy.

So, take my remarks as motivated by the desire for a more stable, international system, rather than something that comes from my own country's situation. I want to start a debate, which, hopefully, over time, you know, will get amplified, and we will come up with a system that works equally for rich and poor countries, for large and small countries.

Now my central focus is what is generally termed unconventional monetary policies, but I mean by this both various forms of balance sheet intervention, such as quantitative easing or -- as I will argue -- exchange rate intervention -- but, also, policies such as holding interest rates for an extremely long period of time, at really low levels.

Now let me start by saying, I think these policies have a role. When markets are broken or grossly dysfunctional, central bankers have a responsibility to think innovatively. And I would argue that, to the benefit of the world, they did just that immediately after the fall of Lehman.

And the various programs they undertook -- for that, I think, they are deservedly heroes. And I was not a central banker then, so I think I'd have no conflicts of interest in saying this.

The key question, however, is, what happens when, beyond the point where markets are dysfunctional, these policies are prolonged? And I would argue the benefits there, even for the country initiating these policies, are much less clear. Let me list four concerns, and then focus on the last two.

One is, of course, is unconventional monetary policy the right tool? Once the immediate crisis is over, does it distort behavior and activities so as to stand in the way of recovery? Is extremely accommodative monetary policy the way to fix a crisis that was partly caused by excessively lax policy? That's one set of concerns. And you can gauge where I stand on that, but I'm not going to focus on that.

Second set of concerns -- do such policies buy time, or does the belief that the central bank is taking responsibility prevent other, more appropriate policies from being implemented?

Put differently, when central bankers say, however reluctantly, that they are the only game in town, do they become the only game in town?

Third question is, will the exit from unconventional policies be easy? So, however much we may value the benefits from entering, you also have to worry about exit, and how does exit take place?

And fourth is, what are spillovers from such policies to other countries?

Let me focus on the last one. I've made comments on the first two earlier, and I don't think they're as germane to this discussion. Of course, the benefits of these policies do play a role in what I want to talk about. Let me talk about exit, and then spillovers.

The macroeconomic rationale for unconventional policy is partly it has low costs, provided inflation stays quiet. So, it has low costs and, potentially, large benefits through wealth effects, through a variety of other channels.

However, central bankers, such as Governor Stein at the Fed, have raised concerns about financial sector risks that build up with prolonged use of unconventional policy. Asset prices boom on entry, but they may not just revert to earlier levels on exit, but they may overshoot on the downside.

And asset price fluctuations can have enormous collateral damage -- partly because leverage on the way up increases in the financial sector -- and amongst borrowers -- as policy stays accommodative.

You know, one way to describe what's happening is, a boost to asset liquidity makes lenders believe that asset sales will backstop loan recovery, so they increase loan-to-value ratios, leverage goes up, and when liquidity tightens, too many lenders are relying on asset sales to bring things back to normal. And, unfortunately, when everyone's looking for the exit through asset sales, you have fire sale prices, loan recovery plummets, and deep problems across the board.

Now leverage need not be the only reason. There's a very nice paper recently by Ferroli, et al (inaudible), part of the coauthors, who argue that, you know, even without leverage, you could have investment managers piling into a trade because it looks attractive -- and even as they pile in, returns increase; more reason to pile in.

But, of course, if investment managers don't like to look at the worst performer -- if they want to make sure that they're not lost in line, in terms of returns, if relative performance evaluation matters, then they pile in more and more as you have monetary policy which is extremely accommodative, because the alternative of investing in safe assets is relatively unprofitable.

But when policy changes, everybody looks to the exit, because now investing in safe assets is so much more attractive, and they recognize that prices will fall as everybody exits.

So, what you get is a version of herding, but a version of herding which is very dramatic, and which increases as the length of accommodation increases.

The point -- whatever you believe about these kinds of models -- is that, you know, prudential regulation is really not a sufficient defense in the face of extremely accommodative monetary policy.

Governor Stein, I think, in his inimitable fashion, has said that's one reason it gets into every crack. Monetary policy gets into every crack. We regulate the institutional side that is regulated -- the banks, et cetera -- but the shadow financial system is also persuaded by the same monetary policy, and they may be a larger part of these kinds of actions.

Essentially, monetary policy creates enormous incentive effects, and many of them are recognized only after the fact. We don't know where the risks have been taken until exit actually happens. And by that time, it could be too late.

Now a second concern, which I want to express here, is the spillover effects -- that these effects are not just felt domestically, but perhaps one of the most vulnerable parts is the international side.

And in many of these situations, it's cross-border flows that are driven by the low yields in the domestic economy. And the appreciating exchange rate as the money crawls in and rising asset prices in the recipient country tend to make this a self-fulfilling effect.

And, of course, these also tend to imply that leverage -- at least in the on phase of the boom -- seems much less than it actually is, because asset prices picking up means equity values also pick up. And it seems like people aren't that highly levered.

Now exchange rate flexibility is often, you know, a mantra about what these countries should do. But in an environment where investors are running in, sometimes exchange rate flexibility exacerbates the boom, rather than diminishes -- because, as (inaudible) has pointed out, there are positive feedback effects as exchange rates appreciate.

In fact, what we see in the recent turmoil -- countries that had allowed their exchange rate to appreciate the most also seemed to suffer the most as thoughts about quantitative easing ending started being expressed.

Now, you know, macro-prudential, micro-prudential -- they have limited effect in some of these situations. Spain, as you all know, had the first serious, you know, countercyclical prudential measures, but they were relatively ineffective against the housing boom -- partly because the housing boom was driven by the (inaudible) who were less directly under the supervision of the central bank.

Now, also, you might think that one should see the effects of these booms in other policies, such as fiscal policy. But in an environment where you have booms, you have transactions taking place, you have capital gains taxes being collected, property taxes being collected, sales tax being collected, and the financial sector itself pays high income tax, your fiscal may look well in order, because so much money is pouring in -- but, in fact, it is from a cyclically adjusted basis, and it's very hard to cyclically adjust during a boom; you're actually running a large deficit.

So, even rich recipient countries with strong institutions, such as Ireland and Spain, have not been immune to capital-induced fragility.

So, when it comes time to exit -- so entry into unconventional policies -- to the extent it furthers these capital flows -- can be problematic for recipient countries, but it doesn't mean they're very happy on exit -- because in the interim, what has built up is leverage, asset prices have inflated, et cetera. And so at that point, the recipient country could be imbalanced. It could be running larger fiscal deficits, larger current account deficits.

And, you know, when the tide goes out, those countries are found swimming naked -- but not always because they want to -- sometimes, because of bad policy, but, sometimes, because the boom masks the need to adjust.

Indeed, I would argue that some people keep saying that transparent and well-communicated exits would be useful -- but in a situation where you have herd behavior, sometimes transparency and good communication is not the best thing to do. When everybody realizes that interest rates are going to go up in June 2015, when the realization is (inaudible) to them, what do you think the reactions of investment managers who've been sort of herding into other markets might be? It would be a faster and more immediate exit.

I think there are places where good communication helps. When the Fed distinguished between tapering and the eventual interest rate adjustments the Fed would do, that helped calm markets down. But now the markets want to know when interest rates will start being raised -- not so much because this would necessarily help, but it would help a lot of people decide when they want to get out of some of the risky trades that they've probably taken. I'm not sure transparency here will necessarily calm markets, rather than exacerbate market volatility.

So, the point here is, emerging markets are not being irrational when they protest both the initiation of unconventional policies, as well as an exit whose space is solely governed by conditions in the source country. It's because they've become levered, and the recipients of crowding in trades during the expansion -- and, therefore, some conditionality, some attention to the conditions they face -- even while the general direction is to exit -- may be appropriate.

So, I have called earlier for better coordination in monetary policy. And I don't mean by this that central bankers sit around a table and decide monetary policy for the United States -- absolutely not -- nor do I mean that the U.S. Fed or the ECB should call around other countries and say, "I'm going to do this. Do you agree or not?" No.

Let me explain what I mean -- but, quickly, let me first state the case for why we should pay attention to better coordination or cooperation. I think those words sometimes could be used interchangeably.

You know, earlier, the view was, coordination didn't matter -- that when every central bank did what was appropriate for its domestic situation, exchange rates would adjust appropriately. Every house in order would ensure the world was more or less in order. There were some gains towards going towards a global equilibrium, but they were relatively small.

I would argue that in a world where monetary policy is often not set with respect to a country's situation, but at perhaps even second or third best, because of political compulsions, political constraints on doing other policies like fiscal or structural reform -- as, also, constraints on monetary policy transmission, driven by things like debt overhang -- it is quite possible that a country's monetary policy may not be set at even the domestic optimal, let alone the global optimal.

And in such situations, more discussion, in a way that I will argue, could lead to better policies -- because, in addition to that, the transmission through global capital floors, driven by agency considerations, rather than by considerations of (inaudible) of fundamentals, adds another tweak to this turbulent recipe.

Here, you know, a number of economists will start rethinking the need for coordination. John Taylor, for example, argues that if monetary policy is extremely accommodative in some countries, other countries may also be forced, because of transmission (inaudible) to also have weak policy or accommodative policy -- and the net effect may be, the world is too low in equilibrium, as far as interest rates go.

Olivia Jahn talks about it -- not in terms of at a particular point in time, but over time. If one country starts initiating extremely accommodative policy, and there's a large outflow of capital flows, country on the receiving end may start intervening in a dramatic way. And, in fact, in this situation, both countries may be better off in adopting more moderate policies.

The point here is, both simultaneously, as well as in a dynamic way, there are arguments that are made for less extreme monetary policies. And in that sense, that is really what I'm going to -- that we have to reexamine the benefits versus the costs of these unconventional monetary policies.

And at this point, I'm just saying, examine, and then decide what we need to do. And I'll tell you what I mean, exactly. I see two dangers if we don't do something about what we're talking about.

First, you know, if we don't look at spillovers -- if we say every country's going to do what it's going to do because it has domestic mandate; we shouldn't worry about what happens outside -- then you're going to get reactive policies in the rest of the world.

For example, following the market turmoil, I have no doubt that a number of emerging markets are going to examine the level of reserves, and decide whether they're adequate -- and perhaps feel that because they're inadequate, they have to start building more. So, we are going to go back to the global savings glut situation that Chairman Bernanke spoke about so eloquently before.

What that means is, we have to examine the spillover effects of these policies. And I think what we have to avoid is the danger that emerging markets take away from the recent episode of turmoil the message: "Don't expand domestic demand and run large deficits. Maintain a competitive exchange rate. Build large reserves, because when trouble comes, you're on your own." In a world (inaudible), is that the message that we want to send?

Let me finally conclude by talking about the remedies. I think there are two basic remedies that suggest themselves.

First, less extreme monetary policy on all sides -- and by "monetary policy," I also mean exchange rate intervention. And second, better global safety nets to mitigate the need for countries to self-insure.

Now whenever I talk about some constraints on monetary policy, the immediate reaction is, "Well, countries have a domestic mandate. How can they violate that?"

Now let me try and play this back in a different way, to see how it sounds, when an emerging market defense exchange rate intervention -- which I say is another form of (inaudible) policy -- and the developed countries say, "Look, guys, you shouldn't be doing this. This is problematic. This has serious negative spillover effects."

We are all, in many ways, agreed that sustained exchange rate intervention to manipulate exchange rate is a bad thing -- both from the countries' perspective, as well as the world.

But why do we say that -- because the defense could be, "Look, we are a developing country, and we have a domestic mandate to support growth"? Institutional constraints in enhancing productivity or a vulnerability to sudden stops means that we need a comparative exchange rate.

And quantitative external easing -- let's give it a fancy acronym: QEE -- is what exchange rate intervention is. That is absolutely necessary to fulfill our domestic mandate.

Defense number two: Would the world not be better off if it grew strongly? QEE is essential to our growth.

Third, we take into account feedback effects to our economy from the rest of the world while setting policy. Therefore, we're not oblivious to the effects of QEE on other countries.

And defense number four: Monetary policies with a domestic focus is already very hard to communicate and to implement. It would be impossibly complex if we took into account the conditions of other countries.

Now despite these defenses, we are against monetary policy done through quantitative external easing.

I need three minutes more.

Despite this, we're against that, and the reason we say is, "Look, you have to be worried about feedback effects. You have an international responsibility.

Spillover effects matter. Countries have to pay attention to what happens to other countries."

So, essentially, my first proposal is exactly that. Let us evaluate every balance sheet policy, as well as extreme monetary policy (inaudible), on the aggregate effects for the world. If we rule out QEE, let's have an independent assessor assess whether some of these other policies have effects other than through the exchange rate -- whether they create so much domestic growth that they upset, through imports, et cetera, the net negative feedback effects.

And, clearly, this is one thing that could be done. If we had an impartial assessor who could assess these policies, we could have a debate about whether such an impartial assessor exists. You know, apparently, power politics does affect the assessments of multilateral institutions -- but, also, multilateral institutions often bind to the same models and the same frameworks as used by the central banks of industrial countries.

And these frameworks -- basically, monetary policy's always an extremely effective tool to elevate activity. Exchange rate flexibility does wonders for insulating the (inaudible) spillovers, and the world is largely decoupled, rather than coupled.

Now many of these models don't have realistic models of credit, of monetary transmission in a world with debt overhang, and don't have the institutional constraints that make some of these actions not work.

What do I think will happen? I don't think we can get an independent assessor that works for the entire world in the short run. It's something we should work towards -- and I think we can get there, over time.

But I think in the short run, all I'm asking for is, central banks, as they consider exit, worry about the immediate spillovers to countries from the policy -- but not just immediate spillovers. Also think about the long-run or the medium-run reactions that will be engendered, and thereby, have an ability to accept some attention to other countries in the mandate.

Right now, that attention comes directly from the feedback effects -- not from the direct effects on other countries, just from the feedback back to your own economy. Perhaps thinks about the direct effects would also be useful to think about what reaction those countries will have. Will they start intervening in a big way after this volatility's over?

And perhaps that consideration would be enough to get countries to actually have a line in their statement which says, "Look, we are paying attention to these other countries. We will moderate the pace of exit if there's extreme financial market turmoil in a variety of emerging markets -- not change the fact that we need to exit, not change the fact that interest rates will be largely aligned to domestic conditions, but recognize the spillover effects in the process of exit.

Second, we need better international safety nets. Clearly, they will help in, you know, reducing the need for countries to build reserves going forward. I think the IMF's suggestion of a global stability mechanism and, perhaps, short-term credit lines would deal with the fundamental problem of stigma which prevents a number of emerging markets from approaching the IMF.

I think, ultimately, multilateral institutions are a far better solution to the problem of global illiquidity. And global illiquidity, in my mind, is something that has emerged much more in recent years. It used to be countries were insolvent earlier. Global illiquidity is a bigger problem. I think we need to worry about that.

So, let me end by saying, this is not an emerging market problem; it's not an industrial country problem. It's a problem of collective action. We are being pushed towards comparative monetary easing. I don't think that's a good situation for the world to be in.

If I use terminology that is reminiscent of the Depression era and on system, it is because I fear in a world with weak aggregate demand, we may be engaged in a futile competition for a greater share of it.

In that process, unlike the Depression era, we are creating financial and cross-border risks that exhibit themselves when unconventional policies come to an end.

So, a first step to prescribing the right medicine is to recognize the cause of the sickness. In my view, extreme monetary easing, through whatever means -- exchange rate intervention or quantitative easing -- is more cause than medicine. And the sooner we recognize that, the more sustainable (inaudible) we will have.

Thank you.

MR. WESSEL: Thank you, Governor Rajan -- even though that was a considerable period longer than the 20 minutes. And the text of the Governor's remarks is -- or will soon be -- on the Indian Central Bank website, as well as on our own.

I'd like to, if I could, focus the conversation on the last part of the Governor's remarks -- the notion that spillover effects are so great that the European Central Bank and the Federal Reserve should think about, more than they do now, what impact their policies will have on the jobs of the Brazilian and the Indian central bankers. And I'm sure India will return the favor, and keep the U.S. interests in mind when they make their policy.

But if I could start with you, Vice President Constancio, your body language suggested to me that you weren't offering a ringing endorsement of Governor Rajan's approach.

MR. CONSTANCIO: Yeah, that's correct -- because he bases his analysis on a strong criticism of unconventional monetary policies in advanced economies that I cannot subscribe to.

Then his proposals are, as he calls them, somewhat modest proposals. I can sympathize with some aspects of the proposals, but I will not subscribe to the criticism on the grounds that he justified them.

Why? Because, in his narrative -- which is more or less, "Well, until '09, it was all right to pursue those policies," but then to extend them was wrong -- in his criticism last year, in a speech where he called them "a step to the dark" -- and when he also (inaudible) at the need of advanced economies to increase interest rates, I think he's missing two aspects -- which have to do with the (inaudible).

What would have happened if the advanced economies had not pursued such expansionary monetary policies after '09? And I think the world would be in a worse position than where it is.

The second point, which is missing, is that it is fact that there is still a negative outlook gap in advanced economies -- and high unemployment, in particular, in Europe -- whereas, in the emerging economies, the outward gap is much smaller, and so they are much closer to full employment.

So, in substantive environments, the coordinating game could be that the advanced economies would do the utmost to sustain aggregate demand and growth, and that the emerging economies would accept as part of the consequences some degree of appreciation of their currency.

But as Governor Rajan knows very well, when he was Chief Economist in the IMF, that sort of multilateral attempt to have this coordination fails, because, indeed, there was never the acceptance of some degree of appreciation in emerging economies.

So, these two facts are important --

MR. WESSEL: Appreciation of their currencies.

MR. CONSTANCIO: Yeah, right -- as one of the ways to, you know, adjust to what was going on.

Even if we could discuss -- and there is academic literature discussing it -- that the capital flows to emerging markets were just the consequence of monetary policy, there are other factors -- and many other papers -- that show that uncertainty, as measured by Vicks or a global inherited risk are as important as monetary policy, to explain those capital flows.

But even disregarding that, I think that the rest of the narrative is really not correct.

And on the proposal, the proposals that the central banks should look into the possible reaction and feedback on others -- well, it's a way of internalizing the medium-term effects of their policy. That may happen.

There are several forums where central bankers meet, and can discuss the situations, and so on -- but, also, they have, of course, to pay attention to the situation in their own countries. And I go back to the point that the slack is still bigger in advanced economies than in emerging economies.

So, some degree of this sort of dialogue and consideration is warranted, I agree. And especially, I agree with the second point -- that we would benefit very much from better global safety nets -- mostly via the IMF -- with real liquidity lines, and not the sort of facilities that we have had so far -- as it is being discussed, and Governor Rajan develops a bit more in his written text. With that, I agree.

I also remind everyone, there are also other policies. (inaudible) last year, in Jackson Hole, talked about some degree of targeted capital controls -- also, as a sort of alternative to the appreciation of the currencies.

And there are also the maco-pru policies that Governor Rajan downplayed. But if they are taken seriously, the point is that we can and should control the total leverage of the financial system -- both the advanced economies and in emerging economies.

And if that sort of prudential policies are really taken seriously -- and that means use them aggressively, in my view; otherwise, they won't work -- that would help, also, very much, to contain the effects that concern Governor Rajan.

MR. WESSEL: Thank you.

President Evans, could you talk a little bit about the extent to which, as a U.S. monetary policymaker, you think about effects on the rest of the world, beyond the feedback effects, to which Governor Rajan said? And can you conceive of making monetary policy -- which is already kind of complicated -- even more complicated by trying to factor that in?

MR. EVANS: Well, let me try to address that. You know, at the end of his comments, Governor Rajan said that he thought that highly accommodative monetary policy was currently, you know, more of the cause of the problems that we have than the cure. I'm not really aware of the theoretical development of that. I'd really enjoy a broader treatment of that.

But let me take up the case, you know, where highly accommodative monetary policy is actually important today.

The U.S. economy's been very strong. A strong U.S. economy's an important input for strong global growth. After the Asian financial crisis in the late '70s, a strong U.S. consumer was a very important mitigant for keeping the global economy growing -- as much as it was. And, you know, we certainly paid attention to all of those developments in the U.S.

Similarly, the withdrawal of a strong Japanese economy over the last 20 years, you know, points out the global risk that we all face if large economies withdraw from being a strong participant. Goodness knows what would be the case if the U.S. and Europe were to, you know, be in (inaudible) situation like that.

U.S. consumer is slowly improving, but it's just a shadow of its former self, and I think we all need to be paying attention to that when we think about the international implications.

In terms of spillovers, I do have a chart that should've been on everybody's seat. It sort of focuses my attention on our dual mandate responsibilities. I don't know if everybody has it.

MR. WESSEL: The one that looks like a bull's eye. There's some on the podium.

MR. EVANS: It's a circular chart, and I call it the bull's eye accountability. And it's an attempt to describe our experience with inflation and -- I don't see anybody pulling this out, so (inaudible).

So, basically, if you look at this it describes policymakers' attitudes and combinations of inflation and unemployment. And the one thing for today that it clearly shows is that we've been running inflation well below our two-percent inflation objective for quite some time.

That's a monetary policy issue. Every central bank needs to deal with that. And when we say that we have an inflation objective, we need to hit that objective an average two percent.

And in the current environment, I think low inflation is just a problem globally. It's a serious, serious concern. If policymakers around the world fail to get on top of this emerging risk before too long, I'm not sure anyone is going to come out of this very well. So, this is the environment where I think that highly accommodative monetary policy in the U.S. and around the world is called for, since we've set ourselves up for this higher inflation objective than what we're currently experiencing.

And then, finally, you know, in the context, I know this is all very difficult and uncomfortable for a number of economies. We do pay attention to our effects and their effects on us -- but, like I say, we do pay most attention to our own situation.

But Milton Friedman, back in 2002, offered some advice to the Bank of Japan when they were still suffering from low -- and, you know, disinflation. And he said, you know, "You should be buying more assets and getting more money out there, to get inflation up," because that's what you do when you have a monetary problem.

And so I think that's sound advice for --

MR. WESSEL: But one can argue that there are benefits and costs to unconventional monetary policy, and come to the conclusion that the benefits exceed the cost. Governor Rajan's suggesting that the costs, the risks, the harm you're doing to emerging markets is greater than you recognize -- and you just don't believe that.

MR. EVANS: Well, you know, we obviously tried to pay attention to the effect that those economies have on our economy, and the effect that we have on theirs. But, at some point, our mandate, our responsibilities are for, you know, the U.S. We like to cooperate, you know, as much as we can with everyone.

But if we are led to a low-inflation experience which is indicative of, you know, very low aggregate demand/high unemployment, we're not going to be doing anybody any good around the world.

Like I tried to make the point at the outset, the kinds of things that have helped everybody out are when we had strong global growth. And, you know, when the U.S. is able to help out, that's good. And when Europe, and Japan, and other countries are able to help, that's also good.

MR. WESSEL: Governor Tombini, to what extent do you think the ECB and the Fed are either blind to or just refusing to see the things that Governor Rajan points to -- or do you disagree with him?

GOVERNOR TOMBINI: Well, let me say --

MR. WESSEL: It's a yes or no question.

GOVERNOR TOMBINI: Five minutes -- well, let me say that I found Rajan's presentation very instigating. And I share some of the views expressed there.

If I can read your presentation, it will say unconventional monetary policy saved the world -- but after some time, you have to consider the feedback or the spillover effects on other seconds.

Secondly, that emerging markets are especially affected by the spillovers. And the longer these unconventional monetary policies stay, the more market addiction you create, and then the more difficult it is to exit those policies.

And, also, I take your point that using micro-prudential can be effective up to a certain point, but depending on the volumes that we're talking about, in terms of flows, they become ineffective.

And, well, while I agree with some of the points, I think two caveats from my side -- and one personal view.

The two caveats are, first, that I think this international cooperation -- I'm somehow skeptical that it can have full cooperation. I know that you have sort of nuanced the kind of cooperation you'll see. I see a lot of value in the kind of meetings we had at G20 for the macro sort of exchange -- and the DIS for the more monetary policy-oriented discussions, I think, is helpful.

We -- the Brazilians, myself -- I have been very candid on the kind of effect I think those policies produce in my own jurisdiction, and I hope those comments have been taken into consideration over the period that I've been participating in those events.

So, I think this is one issue.

The other issue is that I don't see anything very new with respect to spillovers from unconventional monetary policies. I think we, emerging markets -- and I think our case would have been able to sort of ride these global financial cycles in different ways.

In the expansionary phase, we take our measures in, and try to build up our buffers or recourse to the multilateral liquidity facilities. I agree that we need to do away with the stigma problem in the future, but we have found our strategy to (inaudible) global financial cycles.

So, our own experience is the following: During this sort of pre-GFC period, what you have done is to, through sterilized intervention in the foreign exchange market, you're now able to build up reserves, and kind of insulate our monetary policy framework in Brazil (inaudible) relatively independent policy from the rest of the world.

We have sufficiently dipped markets. We can sterilize the monetary impact of these interventions (inaudible) domestic liquidity, sort of keeping domestic (inaudible) expansion under control.

So, this was prior to the GFC.

After the GFC, the volumes -- the coincidence of policies in advanced economies in the same direction made our life a bit harder, and this strategy was not sufficient anymore. So, we had to resort to a broader toolkit. And we put the micro-prudential policies, we continued to intervene. -- micro-prudential to rein the domestic rate of expansion, which was quite significant between 2008 and 2010 -- and some price capital flow measures were also implemented to sort of help to insulate our policy environments.

The good thing is that we built up a buffer, and this buffer now is being handy to sort of open in the exiting phase or the normalization phase. So, I think, going forward, if you have more normal conditions in advanced economies, as far as monetary and financial condition is a concern -- if you have, as we see here in this country, the credit multiplier's sort of much higher than the war on the crisis -- on the onset of the crisis -- then we are more comfortable to resort to our old strategy, to insulate our monetary policy by means of sterilized foreign exchange interventions in the future.

So, I think we have learned how to ride those cycles. I don't know if it's optimal, but we have done this --

MR. WESSEL: Right. Well, your last point -- so it sounds to me like what you're saying is, yes, because the exit from unconventional money policy is going to be a little rocky, you have built much bigger reserves to anticipate that.

So, you're not actually disagreeing with Governor Rajan about that point, but you kind of take it as a given that that's what you have to do to protect Brazil from the hurricane that will come.

GOVERNOR TOMBINI: Combining these two caveats that I was making.

MR. WESSEL: Yeah, right.

GOVERNOR TOMBINI: One is that this is not different from other cycles -- just it's an extreme case --

MR. WESSEL: Right.

GOVERNOR TOMBINI: -- okay, on the one hand.

And the other -- some skepticism with the capacity of us to sort of effectively coordinate --

MR. WESSEL: Right.

GOVERNOR TOMBINI: -- policies -- in particular, a monetary policy -- at this juncture.

But I think most of the points that Rajan made is important to sort of increase -- I see the point of welfare gains to be amass with greater coordination in the future.

MR. WESSEL: Right.

Professor Prasad -- so I think we could probably agree on better safety nets and better liquidity facilities. And I think everybody would agree here that the world would be a better place if there was more growth.

But to pick up on Governor Tombini's point -- Governor Rajan is saying that the particular combination of policies we have is less than optimal, and that a different combination of policies with less unconventional monetary policy in the U.S. and Europe, I suppose -- if you ever get any unconventional monetary policy -- would make the world a better place.

So, help us arbitrate that. You're good at this.

DR. PRASAD: So, David, I'm neither a central banker -- nor, for that matter, a sex symbol -- so I can speak bluntly.

I think each of the fine gentlemen on this dais is doing exactly the right thing, given their mandates and given the responsibilities they have to take care of their countries or economic areas.

But the reality we face is that each of these policies, in terms of the cost/benefit calculus, looks very different, depending on where you sit.

From Governor Evans's point of view, there are some benefits of quantitative easing in the Fed. In the U.S., it's pretty much balanced. And, of course, no other policies are working well, so it made sense to give it a shot.

But from the point of view of emerging markets, as Governor Rajan has pointed out, the benefits were far less apparent than the risks, which basically hit the emerging markets right in the face. And that's the reality they are having to contend with.

But I think the difficult issue -- which none of the (inaudible) central bankers here can address clearly, of course -- is the fact that we are taking other policies as given. And that, ultimately, is the difficult issue here. Even if every central bank here tries to do the right thing, so long as they're constrained by other policies, I don't see this moving in a productive direction -- because the reality is, monetary policy does have spillover effects, especially in an integrated world economy.

And so long as you rely on monetary policy as the main tool with which to buffer growth, generate financial stability, and maintain high-productivity growth, it's not going to be a solution that can be coordinated, simply because each of these central banks is working under enormous constraints, both domestically and on the international front.

So, the big issue here is whether we can have coordination at a domestic level between monetary policy and other policies.

You know, Governor Rajan is being a pragmatist -- and, I think, rightly so, because he says, "Yes, we would like to live in an ideal world where other policies are helping me do the right thing."

And Governor Rajan, in particular, is managing an enormously difficult balancing act, trying to keep the value of the currency stable, trying to keep low inflation, trying to keep growth high, trying to maintain financial stability -- all in an environment where fiscal policies and structural policies are not only not helping him, but are pulling in the other direction. And many of the others on this dais face exactly the same problem.

So, my concern with calls for coordination, reasonable as they are, is that they are ending up taking those constraints as given. And if you do that, essentially, we end up having the central bankers fight proxy battles on behalf of politicians who are feckless and not willing to do the right thing.

So, my concern, really, here is that these fine gentlemen end up fighting a battle that they ought not to be fighting.

But, again, Mr. Rajan has a point -- that we cannot say that the world needs to be an ideal place. But my concern, really, is that, with every central bank being in this position right now -- it's not just the fact that it's undertaken qualitative easing -- the ECB, which might, the BOJ, which has, and it's likely to open the monetary spigots further -- the message for emerging markets is very clear.

And I think both Governor Tombini and Governor Rajan have articulated this very clearly. There is going to be more whiplash coming from advanced economy policies, because, again, they are doing what makes sense from their point of view. We haven't made much progress in international safety nets. We don't know how much of reserves are enough.

So, it takes perfect sense, from the point of view of the domestic mandate for these central banks, to go out and intervene massively -- intervene massively, because it helps their economies in terms of the domestic objective of maintaining growth, to export growth, and building up reserves. And who can blame them?

And I think this is the difficulty right now. We are in a situation where central bankers, both in the advanced economies and emerging markets, feel that their counterpart should take on more of the burden. And the problem is that it's very difficult in this environment to make progress, because, really, the constraints are not monetary policy, but other policies.

So, if you don't fix that problem, I don't see an easy way out.

MR. WESSEL: I think it's interesting that it took the non-central banker to blame the fiscal authorities and the politicians --

DR. PRASAD: We have no time.

MR. WESSEL: I want to particularly thank Governor Rajan. Believe it or not, he didn't deliver his whole speech. He left out the paragraph where he complains about the way the press cover emerging markets.

Governor Rajan, without responding to every point -- so we have time for a few questions -- I think there were two things I'd like to hear you respond to.

One is Professor Prasad's point -- that your complaint is not with the Federal Reserve; it's with the politicians in these countries.

And, secondly, do you really think it would be responsible for -- and why don't you start with this -- the Federal Reserve to say, "We will settle for less inflation than our mandate and higher unemployment than our mandate, because we think that will have spillover benefits for India"? Is that what you're recommending?

GOVERNOR RAJAN: No, first, let me get this away from India. This is not about India. This is about a broader problem of global coordination.

Second, the reason to air the stuff is precisely because I think we need to work on political authorities. We need to work on the multilateral organizations, which I don't think are treating this right -- and, of course, in the last analysis, also, on other central banks.

Now I want people to note what Governor Tombini said, which is that the way we now have to protect ourselves is by significant levels of reserves.

So, it would be in the interest to have a dialogue where there was a sense that the reaction to this kind of turmoil has to be policies which result in less turmoil, because it benefits in the longer run in increasing aggregate global demand.

And this is where I think we started -- so by no means do we want slower growth in industrial countries. We want the U.S. to grow as fast with modern inflation as possible.

The question is, can it do it through other policies than the ones it's following now? And if you say there's no other policy available -- this is the only one -- then I think what I'm saying is, okay, let's also look at this policy, and look at the benefits versus the costs. If the costs to the rest of the world exceed the benefits to the United States, then perhaps there are other possibilities we've ruled out, such as sustained extreme rate intervention to keep a comparative exchange rate.

Should this not also be questioned? I'm not prejudging the answer. If the answer is that these policies are very beneficial, more power to them. If, on the other hand, they are only moderate beneficial, but the costs are large, I think we should consider whether this should be in the tool of policies.

The final point I wanted to say is that I think we're all in a similar place. We all, as Professor Prasad said, are constrained by our domestic environment. The point I'm trying to make is, this is not a healthy place. And we need to move from where we are.

Now I have no illusions that India's interest rate policy will affect what happens in the United States. But I do think that if the emerging markets are pushed to a sustained bout of intervention once again, if nothing else changes, it would be detrimental to global demand.

Look at the countries that have gotten into trouble now -- countries that were running large current account deficits. The message we all are taking away is, don't run large current account deficits. It's bad for you, and, when push comes to shove, you're on your own.

I think, if you look at the language of the World Economic Outlook this time, it is, the industrial countries are going to do what they have to do; emerging markets have to adjust.

I think we need language which is more even-handed. Industrial countries and emerging markets need to do what they have to do to keep global growth at a higher level. During the crisis, it was, industrial countries aren't a problem; emerging markets have to step up, because they have more space. That kind of language has to be the kind of language you continue using.

We all have our constraints. It's not that emerging markets have infinite ability to adjust -- and so we should keep that in mind, going forward.

MR. WESSEL: Thank you.

So, we have time for a few questions. And I'm sorry this is so constrained by forces beyond my control -- because it's actually an important, interesting discussion.

I want to start, if I may, with Ben Bernanke. Can someone bring a mic down to the front?

MR. BERNANKE: A couple of really quick things -- first, just on consultation -- as you know, the Fed Chairman or Vice Chairman meets with emerging market governors at least eight to ten times a year, for an hour or more, at the BIS and other contacts, to explain policy and to hear comments. So, there's an awful lot of consultation. So, that's just an observation.

Secondly, I think a lot of what you've been talking about today just reflects the fact that you are very skeptical about unconventional monetary policy. As you say, the rules of the game should prevent policies with "large adverse spillovers and questionable domestic benefits."

I mean, if you have a different empirical assessment, as Vitor and I do, and you think that these are effective policies -- and that, in fact, emerging markets are probably better off than if these policies not being used -- you would have a different view.

And so I think there's an important empirical question here. And I think there's a little bit of a political thing here, which is that the effects of a stronger U.S. economy on India's export position are -- it's a less visible thing than is the capital flows and those kinds of volatilities.

The final thing, though -- I do want to take you to task. As a Professor of University of Chicago, ignoring money -- you make a very clever equivalence -- you say equivalence class is between exchange rate intervention and unconventional monetary policy.

There's one very important difference, which is that exchange rate intervention sterilizes the effects on monetary policy or in the money supply. So, you're ignoring the money supply.

What that means, of course, is that unconventional monetary policies -- like going off the gold standard in the 1930s -- are demand-augmenting. They increase the total demand in the global economy, whereas exchange rate interventions, like the tariffs of the 1930s, are demand-diverting. They take from a fixed amount of demand; they move it from one country to another.

There is a very important difference between those two policies.

GOVERNOR RAJAN: Can I just respond to that last -- so the underlying assumption, Ben -- you're absolutely right. You're absolutely right about the difference. The underlying assumption is, debt overhang and a variety of other constraints in the economy prevent the demand-augmenting side of monetary policy, creating more of these adverse (inaudible). That was the underlying assumption, which I stated in my first sort of opening statement.

But you're absolutely right; there is a difference. But all I'm calling for is, we should examine the situation and the spillover effects -- by all means, empirically, to the extent we can.

So, I'm not saying when one should rule these out. Sometimes, the policy growth effects may far outweigh the negative effects.

MR. WESSEL: On the aisle here. Then there's one in the back -- so why don't you give the one right there -- yeah.

QUESTIONER: Congratulations, Governor Rajan, first, on the remarkable turnaround the (inaudible) economy has seen in your tenure, since you took over last year.

My first question is, how much of this do you attribute to your own policies and the Finance Minister's policies?

MR. WESSEL: 100 percent.

QUESTIONER: And the second question is, there have been reports of late of underlying tensions between you and the upcoming BJP Narendra Modi-led party.

Can you address those concerns, especially on the hawkish stance on inflation that you have taken forward? Thank you.

GOVERNOR RAJAN: The success belongs entirely to the Finance Ministry, and not to the Reserve Bank of India. You know, we work together, and I think one of the benefits is that there is a greater sense of comfort on fiscal consolidation. We do have to go further -- and the quality of fiscal consolidation, we need to look at.

There is a greater appreciation of our monetary framework now, since we've elaborated on it. And, you know, it's a work in progress. I think the single-biggest factor in the stabilization of the external markets was, the current account deficit came down significantly, from north of five percent to now, around a rate of one percent. In fact, the last quarter is going to be zero -- or near-about.

That's not the longer run (inaudible). I think we will have a 2, 2.5 percent current account deficit. But there were a number of changes that were made to make that happen.

On the differences with the new government -- I haven't had any discussion with the new government. I think is all press-invented differences, and I think it should be seen as such. It's speculation, rather than any actual differences.

MR. WESSEL: Thank you.

So, I'm going to take two or three questions, and then we'll just have to end it there. So, there's one here.

QUESTIONER: Thanks. My question goes particularly to Governor Evans and Vice President Constancio -- because, of course, you know, policies of monetary easing, also, are trying to target inflation. And both your jurisdictions, despite some differences, of course -- the European Central Bank hasn't undertaken any policies of quantitative easing yet -- but especially in your jurisdiction, the inflation target is well below the two-percent situation. And the eurozone is even slightly worse.

But despite the growth of your balance sheet, you cannot say, you know, that those policies were successful, in terms of inflation targeting.

So, I'm wondering whether you two gentlemen could sort of clarify, you know, how do you explain the fact that inflation has stayed well below the target of below two percent?

MR. WESSEL: Thank you.

QUESTIONER: Peter Wolgart, from the German Institute of Global and Area Studies.

And as a German (inaudible), I have my arguments with monetary expansion, you know, and covering things -- but this is the issue, I think.

First of all, as the Federal Reserve, obviously, it is not only the U.S. dollar; it's world currency. And there is responsibility, by definition, for the rest of the world. And, clearly, I think just managing, you know, the monster economy of the U.S. cannot be valid.

In addition, I wondered, you know, are we right to maintain that this two-percent inflation is due to monetary factors? Of course not. We know what is behind it. These are structural changes in the world economy, and money, and labor supply increasing.

So, the question is, clearly this whole relation -- monetary policy to increase employment, and it seems to be, you know, very naïve. And I wonder if we can still continue looking at these variables in such a naïve way.

MR. WESSEL: Thank you.

Is there one more?

Okay. So, those questions are related. If you guys are pushing so hard on the monetary gas pedal, President Evans, why are we having such a hard time getting inflation up to two percent?

MR. EVANS: Well, that's a good question. I think our policies have been effective at stimulating demand -- offset headwinds that we're facing. I still think that we have a debt overhang, that consumers still have a way to go to improve their situation, and, you know, wages have been low, as well. Income growth has been low.

I think our policies have stimulated demand through the normal transmission mechanism. Financing rates are lower. The auto sector's come back. Mortgages are better, if you have the credit capacity to pass a test and get a mortgage -- and housing is up.

So, I think the normal transmission channel has been working, although it is still a little bit of a clog, in terms of headwinds and overcoming that.

In terms of inflation, I think that inflation, at root, is a monetary phenomenon. So, when it ends up being low, even if there are relative price changes which might find their way into the index, we need to make sure that we get inflation back up to target, and that's what we've been trying to do.

MR. WESSEL: Vice President Constancio --

MR. CONSTANCIO: Yes.

MR. WESSEL: Inflation -- where is it?

MR. CONSTANCIO: Yeah. Well, the reasons are, first, that there is a situation of weak demands -- which, in Europe, is particularly acute, I'd say.

For instance, investment is still 18 percent below what it was in 2007, before the crisis. There is high unemployment. That puts a lot of pressure (inaudible). And when the services represent the overwhelming and the most part of the economy, wages explain a lot of inflation in services. And so that's one of the main reasons.

There are others, though. We had inflation in beginning of 2012, which was really very close to two percent -- slightly higher -- and it has been reduced. And if -- mechanically or arithmetically -- you take out the effects of energy cost developments -- particularly oil -- and processed food, those two things explain 70 percent of the drop in inflation.

And on those two things, there is embedded the effect of the exchange rate. The exchange rate itself explains a drop in inflation of 0.5. So, without the developments of the exchange rate since beginning of 2012, our inflation rate would be now around one percent.

So, all these factors have to be taken into consideration. And we have increased our monetary base, with our LTROs -- the three-year liquidated provision that we granted to the banks. But, of course, no increase in overall money, which, in December, was increasing annually by one percent.

So, I was interested to see our German friend attributing the decrease in inflation to labor supply. Well, why? Then it's effects -- and not so much to money.

But, indeed, all these factors mean that we have increased our balance sheet -- some different means. It didn't work.

And it is true, as Ben Bernanke just reminded us, that there are different ways and different impacts -- but in essence, it's a more direct way of, you know, increasing the monetary base by giving money to nonbanks that sell those securities, and then the effect not only on credit -- in the banks -- made a difference, if, indeed, those agents would not, say, repay their own debts, and use that money to buy other things, and increase deposits in the banks, and so on. So, there are more direct effects of such a policy.

And that's, as you know, what we have been looking into, in a situation where, indeed, inflation has become too low in Europe.

MR. WESSEL: Thank you very much.

I'm sorry that we have to end the conversation here. I feel like there should be a big banner here -- to be continued. I want to definitely thank Governor Tombini, Vice President Constancio, President Evans, and Governor Rajan for coming here today, in a period of time in Washington where there's competing demands on all these times.

I saw Governor Tombini at 8:00 this morning, and he told me he had three other meetings between breakfast and this morning.

So, thank you very much.

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