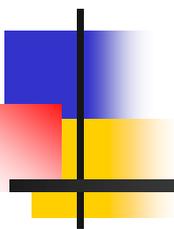


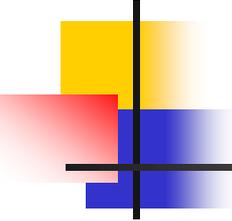
Discussion of Rethinking Macro: International Economy Issues



Raghuram Rajan

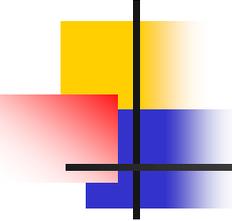


The University of Chicago Booth School of Business



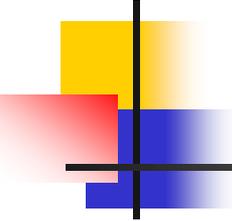
The world is messy...

- Pre-crisis consensus – neat separation: targets and instruments
 - Monetary policy
 - Financial stability
- Financial crisis and aftermath suggested
 - The banking sector and the non-banking financial sector are linked.
 - The macro-economy and the financial sector are linked.
 - Countries across the world are also linked
- One source of linkage:
 - liquidity=>leverage=>liquidity
- Subsequent economic analysis indicates there are no clean policies with narrow separate effects, everything is interlinked and there are unintended consequences.
 - Excellent paper recognizes all this and more
 - Does not make policy recommendations.



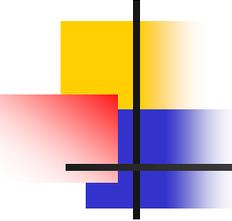
For example: Monetary policy spillovers in an EM

- Let the exchange rate adjust...
- Problems
 - Positive feedback investment
 - Leveraging and moral hazard
 - Asymmetric fiscal policy
 - Limited monetary policy independence and credibility
- Some exchange adjustment is necessary but it is no panacea: in between trilemma and dilemma



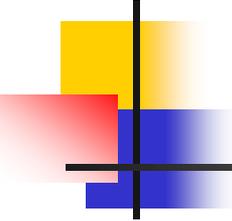
Fear of foreign capital

- Innkeeper and guests
 - They leave en masse when the call comes.
- Build foreign exchange buffers when capital flows in.
 - Cannot make full use of capital flowing downhill.
 - Perforce liquidity provider to foreign capital
 - Impact on monetary policy
- Cannot even draw down buffers fully.
 - Flows and stock both matter
 - Hysteresis



What to do? Rethinking macro

- Recognize that there are spillovers and these could be significant.
- Recognize there are no policy interventions that will lead back to separation easily.
 - Exchange rate flexibility
 - Macro-prudential
 - Capital regulation
- A theory of muddling through!



The monetary policy pass...

- An acute form of belief in separation is to argue that monetary policy had nothing to do with the crisis.
 - It was those bankers...
- A less acute form is to argue that even if it had mild effects, these are unavoidable, use macro-prudential
 - Ignores the effects of easy liquidity on leverage
 - Bias towards overly easy monetary policy – too easy in boom, too easy in bust
 - Gets into all the cracks unlike macro-prudential (Stein).
- Effects are accentuated with minimum inflation mandate
 - Pressure to get increasingly more aggressive
 - Inflation may not budge but leverage will
- What should central bank mandates be if they have better traction against high inflation than low inflation, and monetary policy does influence financial stability?
 - Rules of the game?