What central banks need to consider when making monetary policy in times of war and crisis

The central banks' lack of understanding about the non-monetary components of inflation in times of war and crisis, driven by disruptions in supply chains is reflected in its policy to tackle inflation through a series of interest rate hikes

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The central banks' lack of understanding about the non-monetary components of inflation in times of war and crisis is reflected in its policy.

The US Federal Reserve increased policy rates by 25 basis points on May 3, 2023 to tackle mounting inflation. Raising the interest rates in the continuum is detrimental as it induces global recession when other central banks especially in emerging economies are also compelled to raise the interest to pre-empt capital flight. This prolonged increase in interest rates

significantly impacts global economic growth recovery process as it continues to depress consumption and investment demand, against the backdrop of geo-political risks and macroeconomic uncertainties. The Fed policy rate stands now at 5.25 percent.

However, the inflation is not yet back at 2 percent. The core inflation (which excludes food inflation and fuel inflation) is as high as 4.6 percent. Though there are expectations that the US Fed might likely “pause” the hawkish mode, the mounting inflation continues to remain a challenge and prevent them from reaching a “terminal policy rate” soon. US Fed chair Jay Powell has admitted the downside risks of policy rate hikes on economic growth, and said that he cannot deny a “mild recession”. As prices remain stubbornly high, the other central banks will also opt for interest rate hikes which can further deepen the economic downturn.

Losing Grip on Macro-prudential Regulations

The **US Fed’s aggressive rate hikes** have adverse repercussions on the value of government bonds. A **Stanford Working Paper by Erica Jiang, Gregor Matvos, Tomasz Piskorski and Amit Seru** (March 2023) noted that “marked-to-market bank assets have declined by an average of 10 percent across all the banks” following the Fed’s rate increases, “with the bottom fifth percentile experiencing a decline of 20 percent.” This reveals that the US Fed Reserve is losing its grip not only on inflation but also on its communications and macro-prudential regulations. These challenges faced by the Fed Reserve are increasingly affecting not just the US economy, but also the rest of the world.

It is crucial to conduct financial stability stress tests to examine the impact of the Fed’s prolonged rate hikes on bond prices, especially in the backdrop of the **Silicon Valley Bank (SVB) fiasco**. The SVB collapse is an eye opener to check whether the macro-prudential policies are sufficient to avoid bank runs, in addition to policy rate management. Has the US Fed Reserve failed to keep banks safe? What are the macro-prudential norms required to pre-empt the simultaneous claim to withdraw their deposits which can lead to a bank run? The specific case of SVB points to the fact whether all the banks in the US met Basel III norms of capital adequacy. The US Fed’s credibility in terms of macro-prudential regulations, and deposit insurance are at stake.

Indian Banks Well Supported

However, Indian banks have little repercussions of SVB predominantly because of the firm macro-prudential norms in India and our banks meeting

Basel III norms of capital adequacy. In addition to that, specific liquidity infusion has been initiated by the Reserve Bank of India (RBI) and banks are supported with sufficient liquidity management. The RBI's next Financial Stability Report (FSR) is awaited in June 2023, which can be useful to analyse these issues further against the backdrop of SVB. The last available FSR published on December 29, 2022 projected the system-level capital to risk-weighted assets ratio (CRAR) in September 2023 under baseline, medium and severe stress scenarios at 14.9 percent, 14.0 percent and 13.1 percent, respectively. Having said that, the Indian central bank runs the risk of interest rate defence if the US Fed Reserve increases rates further.

The **RBI has paused rate hikes at 6.5 percent** to support the economic growth recovery process. The articulation of the RBI whether it is the terminal rate depends on how the US Fed rolls out its plans for interest rate management.

With the continuous hike in policy rates, the consequence of less credit availability deepens. The high risk of the US economy falling into a prolonged recession can catalyse economic insecurities. A significant portion of SVB's money was parked in US bonds, and continuous hikes in interest rates affected bond prices. Bond prices fell. Subsequently, when SVB communicated their plan to diversify, it led to a bank run as this announcement created panic and eroded the trust of depositors in the bank.

Though **they could avert a crisis by ensuring both insured and uninsured depositors** have access to their money by forming a "bridge bank", these are not sufficient for long term financial stability. The US Fed's overwhelming emphasis on price stability using flexible inflation targeting framework in a way undermines the need for strengthening the regulatory framework required for financial stability. A judicious macro-prudential

policy is required to deal with systemic risks. Until that is done, the system will remain fragile and volatile.

Rate Hike Impact on Debt Management

Debt market maturity transformation is yet another crucial role of central banks. Public debt management goes haywire when there is a continuous increase in policy rates. Debt management in a high interest regime can be tackled by keeping short-term deposits in long-term investments. However, the SVB case has revealed the intrinsic risk involved in this process when they kept depositors' money in the long-term gilt-edged government securities under the impression that long-term interest rates would not increase. When the Fed allowed policy rates to spiral high, it undermined how efficacious interest rate management is for maintaining financial stability.

Recognising inflation management is also "fiscal" in times of war and crisis is crucial. Keeping fiscal policy accommodative is effective, when monetary policy is partial in its impact on the economic growth recovery process. Tackling inflation through policy rate adjustments alone is a myopic take. Fiscal policies are crucial for containing inflation.

The central banks' lack of understanding about the non-monetary components of inflation in times of war and crisis, driven by disruptions in supply chains is reflected in its policy to tackle inflation through a series of interest rate hikes. The assumption of central bankers that these supply-side shocks can be tamed through the inflation expectations channel is not working. Going beyond the inflation targeting framework to strengthen the macro-prudential norms and other digital regulatory frameworks is therefore crucial for restoring central bank credibility. Finally, incorporating climate change related risks are equally important as these can affect financial stability.

The recent **RBI Report on Currency and Finance** published on May 3, 2023 flags the significance of greening the monetary policy.

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