Issues in Indian macro policy

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Abstract

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1 Introduction

The purpose of macroeconomic policy is to create an environment of stability. The self-interested actions of private persons should lead to calm outcomes. Markets should absorb and bring coherence to the actions of private persons. Markets should offer mechanisms for risk transfer to private persons. Government institutions should support and enable the objectives of the government in a non-disruptive way. Policy frameworks should enhance economic stability.

Another way to think about macroeconomic stability is to describe the country when macroeconomic stability is lacking. In this state, there are risks of fiscal crises, currency crises, financial crises, etc. The threat of these crises creates fear in the eyes of private persons and of policy makers. Policy makers make bad choices – such as dirigiste policies in a faulty attempt to eliminate risk. These fears in the eyes of private persons lead to reduced investment, low risk taking, and excessive demand for liquid assets. These private responses hamper the growth process. Every now and then, a crisis erupts, which (a) Disrupts the process of firm investment and growth and (b) Harms the economy through poorly thought out crisis-management responses by the government.

Macro policy is made up of fiscal, financial and monetary policy. In each of these three areas, institution building is required which caters to the objectives described above. There are close interconnections and dependencies between the three elements. While monetary economics, fiscal policy and financial economic policy are often viewed as separate specialisations, an inter-disciplinary approach is required in thinking about macro policy.

A recurring theme in macro policy is the tradeoff between the short run and the long run. In the short run, there are always policy pathways which appear to solve a problem. But these are harmful to the very objectives of growth and stability in the long run. Sophisticated thinking in macro policy involves the slow process of nurturing sound institutions. The 'rules versus discretion' literature teaches us that a short term discretionary grab comes at the cost of long term harm.

Fiscal institution building involves (a) Well structured tax policy and tax administration; (b) Public debt management; (c) Automatic stabilisers in taxation and expenditure; (d) Fiscal rules which yield debt stability and counter-cyclical deficits.

Monetary institution building involves (a) Inflation targeting; (b) A floating exchange rate; (c) A capable financial system through which the central bank has an effective monetary policy transmission.

Financial institution building involves (a) State capacity in regulation;

(b) A robust Bond-Currency-Derivatives Nexus; (c) A competitive and stable banking system; (d) An open capital account.

Finally, a key component of the macro policy arrangement is the Ministry of Finance. The present Indian Ministry of Finance was not designed to suit the requirements of macro policy in a $2 trillion open economy. Reorganisation of the Ministry of Finance is required, and the development of State capacity at the Ministry of Finance is required.

The present state of progress on these 12 fronts in India is fairly poor. In 2015, the legal foundations of RBI were modified to establish a CPI inflation target. There are weaknesses in the design of the associated monetary policy committee. Important reforms of tax policy have taken place, but at the same time this work program contains basic flaws. Automatic stabilisers have come about on taxation and expenditure in limited ways.

The agenda for reform lies in establishing 12 policy projects that pursue these 12 areas. In three areas (inflation targeting, tax system, automatic stabilisers), important progress has been made, but there are important flaws that need to be address. In some of the remaining nine areas, technical work is at hand. The paper briefly summarises the state of play on each of these and identifies the next steps.

The remainder of this paper is organised as follows. Section 2 sketches the purpose of macro policy. Section 3 shows the 12 components that make up the machinery of fiscal, financial and monetary policy, and how they interconnect with each other. Finally, Section 4 sketches the way forward.

2 The purpose of macro policy

Macroeconomic *instability* is about economy-scale events which disrupt the planning of private persons. These include fiscal crises, currency crises, inflation crises, and financial crises. India now has modern business cycle fluctuations and is exposed to the risks associated with financial globalisation (Shah 2008). This calls for the commensurate institutional apparatus for macroeconomic stabilisation Shah & Patnaik (2010).

The purpose of macro policy is to create an environment of macroeconomic stability where such crises are reliably ruled out over long time horizons. This would permit the government and private persons to make decisions, and long-term plans, in a state of confidence.

A key feature of a stable macroeconomic arrangement is that it is incentive compatible. Private persons pursue their self interest, and the self interest of all private persons is rendered coherent by a system of financial markets. In contrast, when a government does battle with private persons ("speculators"), this is likely to come to grief. Financial markets must be deep and liquid, so that they become shock absorbers. Every now and then, some private persons will want to buy a lot or sell a lot: these orders should be absorbed in deep and liquid markets without inducing large price changes (Thomas 2006).

In similar fashion, a stable macroeconomic arrangement involves exposing private persons to financial risk. Stability is not obtained by molly-coddling private persons through distortionary and unsustainable government policies. As an example, macroeconomic stability is found in an exchange rate that fluctuates through market forces. If the government manages the exchange rate, we set ourselves up for large disruptive changes from time to time. For an analogy, the price of petrol will ultimately adjust: our only choice is to have small fluctuations every day, or large changes occasionally. The latter is *more* disruptive.

When private persons face risk, this calls for mechanisms for protection against risk. A stable macroeconomic arrangement involves giving private persons ample mechanisms for risk transfer. One person fears a rise in interest rates, another person fears a decline in interest rates, they undertake a trade whereby they insure each other. Of particular importance are risk transfer mechanisms are those where the risk is sent out of the country; this requires large scale foreign participation in domestic risk markets.

When there is fear of crises, many elements of public policy are often distorted. As an example, a government may engage in price controls in trying to avoid inflation crises. A government may interfere in the working of the currency market in order to avoid a currency crisis. A government may engage in restrictions on cross-border capital flows, in trying to avoid a financial crisis.

Crises are damaging *before* the event, because of the distortionary policies that they encourage. With weak institutions, the probability of crises goes up. With weak institutions, the quality of crisis management also goes down. When institutions are weak, considerable harm is caused when a crisis does take place. As an example, the currency defence that India launched in 2013 was rather harmful to the economy at the time (Shah 2015).

A wide array of bad policies are rooted in failures of macro policy. We gain from sound macro policy institutions because macroeconomic stability is a good thing, and we also gain from this institution building because we create conditions where the economic policy leadership is able to eschew many bad policies. As an example, when good institutions stabilise CPI inflation at 4%, the government is likely to do less damage when there is a surge of onion prices.

A government can always grab a short term gain through one measure at a time, that responds to the crisis of the day. But it is more valuable to create frameworks for behaviour, and an environment of predictable responses. The central bank must credibly commit itself to the course that when inflation is expected to rise, it will raise rates, and vice versa. It takes years and decades to build up this credibility, where people know that the central bank will indeed behave like this. The gains come about from the way in which the *expectation* of behaviour by public institutions reshapes private persons in beneficial ways. The power of rules over discretion (Kydland & Prescott 1977) is a fundamental tenet of macro policy, one that encourages us to build predictable institutions, and eschew erratic policy measures in response to every day events.

Economic agents need to trust State institutions over very long time horizons. In a 30 year infrastructure bond, the investor needs to trust macro policy for 30 years. When a young person is engaged in pension planning, she needs to trust macro policy for 70 years. This requires the discipline of sound macro policy which yields sound decisions, year after year, for decades on end. Only after such consistent track record is established will the institutions earn the trust of private persons. Every time a short term action is taken, which appears expedient for the moment, we set the clock back for the long and slow process of earning credibility.

As an example, there was a time when the Indian rupee was trusted as a store of value and a medium of exchange in East Africa, the Middle East, South-East Asia and South Asia. India lost this trust through the post-independence introduction of capital controls. The inflation crisis of 2006-2014, and demonetisation, have reduced confidence in the Indian rupee on the streets of Colombo. We have to now spend decades of prudent monetary policy, in order to regain the trust of private persons in the Indian rupee.

3 The components of a sound macro policy framework

Setting up the institutional capacity for macro policy involves fiscal, financial and monetary institutions. Each of these have a few sub-problems that are critical for macro policy. They also contain components, not covered in this paper, which are important in and of themselves, but are not important from the viewpoint of macro policy. In this paper, we limit ourselves to 12 critical components.

Fiscal institution building involves (a) Well structured tax policy and tax administration; (b) Public debt management; (c) Automatic stabilisers in taxation and expenditure; (d) Fiscal rules which yield debt stability and counter-cyclical deficits.

Monetary institution building involves (a) Inflation targeting; (b) A floating exchange rate; (c) A capable financial system through which the central bank has an effective monetary policy transmission.

Financial institution building involves (a) State capacity in financial regulation; (b) A robust Bond-Currency-Derivatives Nexus; (c) A competitive and stable banking system; (d) An open capital account.

Finally, a critical component of macro policy is a capable Ministry of Finance.

We now briefly describe these 12 components.

1. **Tax policy and tax administration** Macroeconomic stability requires a tax system that is able to fund the exchequer in an efficient way. When sound tax policy and sound tax administration are lacking, the country will be chronically short of tax revenues, which creates fiscal instability.

   This requires a personal income tax, a corporate income tax, a GST, and no other taxes/cesses/surchages. All rates should be low, the GST should have a comprehensive base and a single rate. Such sound tax policy must be associated with good State capacity in tax administration. The tax administration should be characterised by low compliance costs for private persons, predictability and fair play. These desirable features of sound tax policy and tax administration are, at present, lacking.

2. **Public debt management** Every government needs a mechanism to borrow. In India today, government borrowing is done by forcing bond purchases upon banks, pension funds, trusts and insurance companies. The only voluntary lenders to the government are mutual funds and foreign investors. Macroeconomic stability requires voluntary purchases of bonds by a wide array of investors. This requires the establishment of the Public Debt Management Agency (PDMA), which would be the investment banker to the government. It would engage with, and foster, this wide array of voluntary participants. This would yield deficit financing for the government with the minimum distortion.

3. **Automatic stabilisers** Discretionary fiscal policy, which responds rapidly to business cycle fluctuations in order to stabilise, is not a feasible path, particularly in a low State capacity environment like India. What would help in stabilisation, instead, are *automatic stabilisers*. These include

taxes such as the corporation tax – which automatically enlarge in good times and vice versa – and expenditure programs such as the NREGA, where expenditures automatically enlarge in bad times and vice versa. Through these, the fiscal deficit would automatically enlarge in bad times and shrink in good times.

4. **Fiscal rules** Macroeconomic stability requires the discipline of paying down debt in most years (by having a primary surplus) and running occasional primary deficits in difficult times. We should see a primary deficit in roughly one in five years. This discipline can be coded into a fiscal responsibility law. However, even more important than a fiscal responsibility law is the pressure of dealing with voluntary investors in the bond market. Persuading private persons to voluntarily fund the fiscal deficit will create pressures for prudent deficits, i.e. a primary surplus in most years.

5. **Inflation targeting** All fiat money requires a nominal anchor in order to achieve stability. There are three choices: to peg the rupee to the US dollar, to peg the rupee to the CPI basket or to peg the rupee to gold. From the viewpoint of fostering macroeconomic stability, for a continental economy like India, the CPI inflation target works best. In 2015, the RBI Act was amended to give RBI the formal mandate of delivering 4% CPI inflation. This is a great milestone in the establishment of macro policy institutions in the country. What is now needed is translating this into a potent monetary policy capability, through which the 4% target is reliably achieved, and staying the course for many decades.

6. **A floating exchange rate** While managing the exchange rate is always tempting in the short run, in the long run, there is no avoiding genuine macroeconomic adjustment. The choice lies between an exchange rate that adjusts by a small amount every day, or an exchange rate that does a few large adjustments on some days. The latter is more disruptive. In addition, exchange rate management repeatedly runs into conflict with the inflation target. Hence, we are better off with a policy framework where RBI focuses on delivering 4% CPI inflation and leaves the exchange rate to market forces.

7. **The monetary policy transmission** RBI controls the short term interest rate of the economy, i.e. the 91 day treasury bill rate. The monetary policy transmission is the mechanism through which changes

in the short rate impacts upon the economy. This requires the Bond-Currency-Derivatives Nexus, and a competitive banking system. At present, these two pillars of the financial system are lacking. As a consequence, RBI is relatively ineffective. Under these conditions, for RBI to impact upon the economy, and control CPI inflation, RBI needs to undertake very large changes in the short rate.

8. **State capacity in financial regulation** The financial system requires regulation, and in India today, we have yet to develop State capacity in regulation. This manifests itself in myriad difficulties, such as the banking crisis, the lack of the Bond-Currency-Derivatives Nexus, the high political and regulatory risk faced by private persons, the lack of deep and liquid markets which are shock absorbers, the lack of risk transfer mechanisms, etc. All these problems would be addressed by building sound financial regulatory institutions in the form of RBI and SEBI. This involves fundamental thinking about how financial agencies work Roy et al. (2019 (Forthcoming).

9. **The Bond-Currency-Derivatives Nexus** This is the collection of the following markets:

   - The spot market for government bonds
   - Derivatives on government bonds
   - The spot market for corporate bonds
   - Credit derivatives
   - The spot market for exchange rates
   - Derivatives on exchange rates
   - Complicated products that mix up the above.

   These sub-components are sometimes viewed as separate pieces. But they are deeply interconnected. Achieving a liquid and efficient market in any one of these components requires other components to work properly.

   This web of interconnections is of essence in thinking about these markets. E.g. some people think “we should have a good government bond market” but see this in isolation. The insight behind the phrase “Bond-Currency-Derivatives Nexus” is that all these markets are deeply interconnected and should be viewed as one big edifice. It is not possible to sub-divide them; it is not possible to pick and choose.

10. **Competitive and stable banking** At present, India is absorbed in a large banking crisis. This is not an isolated event; a similar banking crisis was observed in 1999-2002 also (Shah & Thomas 2000). This points to deeper failures of banking regulation. There is a need for financial regulatory reform, including the role and function of RBI, the establishment of the Resolution Corporation, and the reforms required in order to achieve State capacity in the working of financial agencies. Once regulatory capacity is achieved, entry barriers need to be removed, so that there is ample entry by private and foreign banks, which yields competition. The end objective is a banking system which does not regularly collapse into large and expensive crises, and one where there is high competition so that users get a fair deal and monetary policy is transmitted into the economy.

11. **An open capital account** All modern economies have an open capital account. In India, there is *de facto* openness for FDI and equity portfolio flows. These achievements need to be followed through by combating the cost of doing business, and by removing the capital controls implicit in source-based taxation. There are no impediments to opening up cross-border flows in financial derivatives, which would achieve risk transfer out of the country. Debt market liberalisation is problematic as long as there is exchange rate management. Once the exchange rate has reliably shifted over to a market determined exchange rate, it would be possible to liberalise debt flows fully.

12. **The Ministry of Finance** The Ministry of Finance is a critical component of the institutional apparatus for macro policy. It directly performs fiscal policy. It recruits the leadership for monetary policy and financial economic policy. It exerts influence through membership of the boards of all financial agencies. It plays a leadership role in organising and coordinating macro policy.

4 The agenda for reform

We now summarise the required work program in the 12 areas.

1. **Tax policy and tax administration** The Direct Tax Code is the key reform to put direct taxes on a sound footing. An integral part of this is a shift by India to 'residence based taxation', where India will tax the global income of Indian residents and not tax the activities of non-residents.

The GST needs to move up to a single rate, a low rate such as 10%, and a comprehensive base.

New work is required on drafting a tax administration law, which puts the behaviour of tax administrators on a sound footing. This would ensure due process on how subordinate legislation is drafted, how enforcement is done, check arbitrary power of inflicting tax raids, and setup sound procedures for adjudication.

2. **Public debt management** This requires the establishment of the Public Debt Management Agency, which would be the investment banker for the government. This was begun in 2015, but rolled back upon opposition from RBI. The legal strategy for the establishment of the PDMA has been worked out in Pandey & Patnaik (2017). Once the PDMA is setup, we should change over from the present system of forcible resource mobilisation from financial firms to a system of voluntary bidders in the auctions where government bonds are sold.

3. **Automatic stabilisers** This requires strengthening programs such as NREGA, which give welfare to citizens in a way that is self-adjusting. More money should be paid out (in the aggregate) in a business cycle downturn and vice versa. The actual expenditures should be highly counter-cyclical.

4. **Fiscal rules** A new FRBM Act is required, which requires a primary surplus in most years, e.g. in four out of five years. However, we must recognise that the construct of the money bill in the Constitution of India makes it easy for the government to violate FRBM strictures (Datta et al. 2018, *forthcoming*). Hence, true fiscal responsibility comes from the pressure of financing public debt from voluntary lenders.

5. **Inflation targeting** The RBI Act has been amended to give RBI an objective, of 4% CPI inflation. Decision making has been slightly broadened away from the RBI Governor through the establishment of a Monetary Policy Committee (MPC). However, the present structure of the MPC is one where the RBI Governor always controls the outcome. This needs to be reformed to achieve an MPC where there is genuine debate and dissension, and the power of the RBI Governor is limited Shah (2014). The key missing link today is in the monetary policy transmission, which requires banking reform and the Bond-Currency-Derivatives nexus.

6. **A floating exchange rate** India had achieved a floating exchange rate from 2009 to 2014. From August 2014 onwards, we went back to a highly managed exchange rate. This induces higher macroeconomic risk, and conflicts with the inflation target. RBI needs to go back to a framework where it focuses upon the 4% CPI target, and the market sets the exchange rate. This will also strengthen the monetary policy transmission.

7. **The monetary policy transmission** At present, small changes in the short rate, by RBI, do little to impact upon the economy. RBI carries the burden of achieving a 4% CPI inflation target, but is relatively ineffectual as the monetary policy transmission is weak. In order to get to a capable monetary policy transmission, RBI requires the Bond-Currency-Derivatives Nexus, banking reform, an open capital account and a floating exchange rate.

8. **State capacity in financial regulation** RBI and SEBI require State capacity in financial regulation. The roadmap for this has been constructed by FSLRC (FSLRC 2015, Roy et al. 2019 (Forthcoming).

9. **The Bond-Currency-Derivatives Nexus** The establishment of the Bond-Currency-Derivatives Nexus was begun in 2015, by moving the regulation of these markets from RBI to SEBI. This reform is integral to the establishment of the PDMA. These actions were, however, rolled back upon RBI opposition.

10. **Competitive and stable banking** Banking regulation at RBI has given large banking crises in 1999-2002 and then 2011 onwards. In order to achieve a sound and stable banking system, structural change at RBI is required. This requires narrowing down the mandate of RBI to two things: delivering the 4% CPI inflation target, and delivering safe and sound banking. RBI needs to develop State capacity in financial regulation in order to be able to do technically sound banking regulation.

    Alongside this, the Resolution Corporation is required, which is a specialised bankruptcy code for financial firms. The latter was begun in the form of the FRDI Bill which was drafted in 2016-2017, but this was rolled back upon opposition from bank and RBI trade unions.

    Bank privatisation is neither necessary nor sufficient for achieving a competitive and stable banking system. When banking regulation is weak, *private* banks are likely to lead to bigger problems than public sector banks, as has been seen in the 2008 global banking crisis. The main issue that needs to be dealt with in India is the lack of regulatory capacity at RBI.

11. **An open capital account** The Indian system of capital controls has fared poorly (Patnaik & Shah 2012, Patnaik et al. 2013). In 2015, the FEM Act was amended to split the overall space of capital controls into debt and non-debt. The regulation-making power for non-debt was shifted from RBI to the Ministry of Finance. This reform needs to be operationalised so as to achieve a genuine capital account reform.

12. **The Ministry of Finance** The present Ministry of Finance has evolved over the years. It has not been designed to fit the requirements of a $2 trillion open economy. Just as fundamental reforms are required of the financial agencies, fundamental reforms are required of the Ministry of Finance. A government committee report (Kelkar 2004) has worked on the subject. A modernised version of this thought process needs to be put into motion.

We see that considerable developmental work has taken place in many of the 12 required areas of reform. In some areas, the knowledge is mature, the law has been drafted, and this needs to be carried through. In other areas – e.g. tax administration – the early conceptual work has yet to begin. The Ministry of Finance needs to create the teams and project management frameworks, for carrying these 12 work streams through to fruition. Once these are completed, India will have a sound macro policy framework. Until these are completed, India will be hamstrung with macro instability, jittery policy responses caused by the fear of macro instability, and a climate of fear for private persons.

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