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NEW THINKING ON MACRO ECONOMIC POLICIES AND RANDOM THOUGHTS ON INDIAN ECONOMY

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The presentation is divided into two parts, viz., (a) some very general statements on broad parameters of new thinking on macro economic policies, and (b) Random thoughts on Indian Economy.

New Thinking on Macro-economic policies

Firstly, the exclusive focus on price stability as the single objective of monetary policy is inappropriate. It is necessary to take into account the objective of financial stability in the conduct of monetary policy. Further, the monetary policy cannot be indifferent to asset bubbles, and it has to be conducted taking into account the importance of counter-cyclicality in public policy. The indicators of macro economic conditions cannot be confined to money supply alone, but should also include the credit conditions. Interest rate, as the single instrument of policy, may often be less than adequate.

Secondly, the regulation of financial sector should take into account the cyclical conditions and other macro prudential factors. Further, regulation of financial sector, to the extent it is countercyclical, should be coordinated with monetary policy. There may be institutions which are too big to fail, and hence should be treated differently from the other institutions. In other words, there are limits to the level playing field among the regulated entities. In addition to the interest of the depositors, and the micro prudential regulations in the conduct of their business, the liquidity aspects as well as the safety of the financial products in the financial markets should be considered on a continuous basis while adopting a counter-cyclical policy in the regulation. Banking services have significantly large direct impact on people at large. The regulation of linkages between banking and non banking financial services is critical for effective regulation of the financial sector.

Thirdly, in the management of external sector, persistent current account deficits or current account surpluses may not be desirable and, in particular, large current account deficits may contain risks of instability, though the right level of current account deficit cannot be easily defined. Capital flows can be volatile, and under certain circumstances, capital controls may be warranted. In regard to exchange rate, the corner solutions, viz., totally fixed or totally floating are not necessarily the only optimal solutions, and intermediate regimes are acceptable. Forex reserves, despite quasi-fiscal and other costs, do provide some cushion to national authorities to manage volatility, particularly at times of crisis in the global financial markets.

Fourthly, fiscal policy would have a critical role to play in the overall counter-cyclical public policy, and will have to be coordinated with monetary policy as well as with financial sector regulation and policies relating to open capital account. Fiscal consolidation during good times would provide head-room for stimulating the economies under stressful conditions. Recourse to fiscal measures may also be warranted at times of exceptionally strong capital inflows.

Fifthly, there is a fundamental review of some of the balances governing public policy in the overall approach relating to growth and stability. A balance between the role of the State and that of the market is being reviewed in favour of State and there is emphasis on more effective and purposeful regulation of the markets. Further, dangers of globalised finance with regulation at national level have been recognized, thus warranting well crafted harmonization between the extent of global coordination and space available for public policy at the national level. Moreover, a new balance is sought between the growth of financial sector and the growth of real sector, whereby, in particular, excessive financialisation and excessive leverage are contained.

Sixthly, the severe limitations of the existing global financial architecture in ensuring growth and stability on a sustainable basis have been recognized in several areas. These relate to monetary system, lender of lat resort, sovereign debt restructuring, odious sovereign debt, effective surveillance, etc. In the global financial architecture, international monetary system is a part, and it is linked to the lack of level playing field to countries in the management of their public debt. While pursuing global initiatives, national authorities have to be conscious of these infirmities in global, monetary and financial order.

Finally, governance has been found to be wanting in both public sector and private sector institutions. The separation of various functions in the public sector to avoid conflict of interest has, to some extent, resulted in ineffectiveness of public policy, particularly in terms of coordination in management of money and finance. Correspondingly, the emergence of large financial conglomerates in the private sector has brought into sharp focus the dangers of conflicts of interests in these institutions, despite the assurances of building fire walls among different functions and functionaries. There should, therefore, be preference to emphasize coordination in public policy and ensuring that institutional mechanisms exist in private sector to minimise both, the chances of conflict of interest and incentives towards excessive risk taking.

Random Thoughts on Indian Economy

<u>High Growth and Stability: Pre-crisis</u>:

During the years preceding the crisis, several policy actions have been taken to ensure what may be considered as a period of highest growth (9 per cent per annum) and impressive stability (inflation at about 5 per cent and resilient financial sector) in India, both by global standards and our own past. Monetary policy has been active, taking pre-emptive measures to maintain price stability; Regulation has been very active; Capital account management was well thought out; Several unique innovations, such as Market Stabilisation Scheme and financial inclusion, took place in managing of money and finance. The challenges of trillema had been managed in a thoughtful manner. The pre-dominance of public sector banks helped in reducing the problem of information asymmetry in regulation, but added to the problem of behest lending and some dilution in transmission of policy. In brief, the monetary and regulatory policy in India was active and innovative, while in many other countries, it was passive. It was not conservative in the sense of preferring status-quo or inaction.

Many of the policies adopted in India before the crisis converge with the new consensus on conduct of monetary policy and financial sector regulation. These do reveal the extent to which there has been over arching intellectual framework. There may not have been adherence to a particular ideological framework, but there was a definitive policy framework with a clear understanding of the domestic and global emerging realities.

An important lesson from Indian experience is the need for changes in thinking, to keep pace with global developments and domestic; and that should go beyond financial sector and give importance to macro economic factors. For example, despite pressures to the contrary, denomination of marketable sovereign debt (including sub-national debt) in foreign currency was avoided and holding of such debt by non-residents severally restricted. Similar restrictions were placed on surrogate sovereign (public sector enterprises) debt. The central bank, as manager of government debt, regulator of banking as well as money, forex and government securities also, moderated the adverse impact of high fiscal deficit. Its close interaction with State governments was also useful. The high level of domestic household savings provided comfort in this regard.

<u>Post Crisis Performance</u>:

At the outset of the crisis, the central bank had, in place, a full range of instruments to manage counter-cyclical policies and pressures on liquidity in money and forex markets. India, in addition, has the advantage of being better placed in terms of macro economic balances compared to rest of Asia, which has to cope with imbalances. Indian economy is better balanced on external account; Savings-Investment; Consumption-investment; and domestic-external demand.

However, it will be useful to compare the rate of growth of the major EMEs pre-crisis and their current rate of growth. Some EMEs seem to have outperformed India in recovery to pre-crisis levels. Their fiscal and external positions have deteriorated, but many of them continue to be far better than India now. Many of them have problem of high inflation, but not as acute as India. Some of them have serious problem of surge in capital inflows.

Current challenges and strengths:

Traditionally, India's weaknesses were in fiscal and in external sectors, and according to some observers, financial sector. Since the onset of the crisis, there has been deterioration in the fiscal parameters in India. It is not only the quantity, but the quality of fiscal situation which is important. The nature of stimulus has been such that the consumption expenditure and the committed expenditure have increased. Net of privatization receipts, the position may appear worse. There is, perhaps, a structural deterioration in fiscal situation. It is useful to compare quality of fiscal stimulus of India with other major EMEs.

In external sector, since the crisis, the current account deficit has widened. The stock of external liabilities is larger, probably of short term credit, portfolio flows and non-green field foreign direct investments. Thus, the quality of external investment position and current account of India which have deteriorated should be compared with other EMEs.

In any event, the challenge for monetary and financial sector policies in future, are different from those in pre-crisis period. At that time, India was protecting from mounting imbalances and excessive financialisation in global economy. Now, India has to protect itself from active and often divergent national level public policies in different countries for unwinding respective imbalances.

India's strengths continue to be in its demography, institutional dynamics, political system stability, innovative private sector, and above all, reasonable macro economic balance.

Towards a new agenda for financial sector:

In many official pronouncements, there is a reference to carrying forward economic reforms and, in particular, the reform of financial sector in India. Much of the thinking on agenda for reform may be set by pre-crisis wisdom. But, there are significant and fundamental debates that are going on in the world about the role of financial sector, institutional structures and regulatory framework. The issues are not merely technical like Basel III, but they are far more fundamental.

Some believe that fixing some weaknesses at the margin to the Anglo Saxon model of development of financial sector would suffice. There are many others, who are raising more fundamental issues. Essentially, most of the countries in the world are observing the developments carefully to capture the dawn of new wisdom. A few, in particular, U.S.A., U.K. and Europe, which were most affected, undertook legislative measures since they were most affected.

Indeed, there is a universal search for a new agenda for reform of financial sector based on new realities, both in terms of institutions and markets. Is there merit in waiting for the dawn of wisdom and craft a new agenda for reform of financial sector?

New agenda for economic reform:

The new agenda for reform of financial sector in India will have to be positioned not only with reference to global thinking and developments, but also in the context of a strategy for development of Indian economy, for two reasons. The anticipated global uncertainties and volatilities in medium term can be faced better within an agreed strategy. A fundamental rebalancing in global thinking about (a) roles of state and market; (b) policy space at national and global levels; and (c) links between real and financial sector are underway. India has to, both, contribute to and learn from these new paradigms. There are several structural rigidities in domestic economy which are constraining acceleration of growth and price stability, but which warrant medium to longer term strategic thinking.

The new thinking on broader economic strategy in the context of domestic economic realities, will have to address several issues, but of these, role of public and private sector is critical. There are two views on these, which are yet to be resolved.

"Much of what needs to be done to accelerate GDP growth to 9% or so will be done by the private sector, but the central and state governments have a crucial role to play in providing a policy environment that is seen as investor friendly and is supportive of inclusive growth" (Montek Singh Ahluwalia, Deputy Chairman, Planning Commission).

"The issue that arises now is whether we have reached the limit of private sector-led acceleration in investment and output growth? Will this now be increasingly constrained by the lack of public investment, both physical and social? An underlying theme encompassing most constraints now is the lack of adequate delivery of public services in both quality and quantity. The public service system is simply not functioning" (Dr. Rakesh Mohan, former central banker).

Above all, a view should be taken on the role of financial sector; whether it follows a well crafted strategy of development with appropriate roles for public sector (government and PE) and private sector; or it will virtually lead the growth dynamics through private sector.

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