Symptoms of weak fiscal, financial, monetary institutions: Failure on inflation

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Symptoms of weak fiscal, financial, monetary institutions: The rupee defence of 2013

![Graph showing the rupee defence from 2012 to 2014 with a peak in October 2014 at 8.39 per cent.]

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Fiscal, financial and monetary institution building

December 13, 2014
The destination is well understood

<table>
<thead>
<tr>
<th>Fiscal</th>
<th>Remove financial repression</th>
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<td>Debt stability</td>
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<td>Counter-cyclical</td>
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<tr>
<th>Financial</th>
<th>Equity market</th>
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<tr>
<td></td>
<td>Bond-Currency-Derivatives Nexus</td>
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<td>Array of financial firms, not public sector</td>
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<td>Open capital account</td>
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<td>Globally competitive</td>
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<th>Monetary</th>
<th>Inflation targeting</th>
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<td>Independent and accountable.</td>
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The puzzle is: How to get there?
Interconnections in fiscal, financial, monetary institutions

**Fiscal - Monetary**
- Solvency of government a precondition for stabilising inflation
- Low inflation generates trust in low cost long-term borrowing

**Monetary - Financial**
- Bond-Currency-Derivatives Nexus is the monetary policy transmission
- Monetary policy rule is foundation for yield curve

**Financial - fiscal**
- Public debt management creates the bond market
- Liquid bond market makes low cost long-term borrowing possible
Public debt management

- Build the ‘Public Debt Management Agency’ (PDMA)
- A new institution that works for MOF and state governments
- Advice, and then execution
- Requires, and hence builds, the bond market.
- Long term: Indian Financial Code
Financial economics

- The equity market is the only real success story. One gap: stock lending.
- Bond-Currency-Derivatives Nexus: Mostly a failure.
- Banking system is in distress. A holding operation: is unlikely to play a big role in the next wave of investment.
- Capital controls removed for equity investment (other than irritants), but onerous for other asset classes.
- Sharp decline in the role of the onshore market for rupee and Nifty.
- Failures are ultimately in faulty working of RBI, SEBI, IRDA, FMC, PFRDA.
- Short term: Fix regulations.
Monetary policy

- High and unstable inflation has been a key source of macroeconomic instability.
- India had a market determined exchange rate from 2007 to 2013.
- We are back to much more exchange rate management.
- Fiat money (the Indian rupee) without a nominal anchor.
- Short term: Monetary Policy Framework Agreement
- Hurdle: Weak monetary policy transmission owing to gap in Bond-Currency-Derivatives Nexus.
These four pieces are moving

- Public debt management
- Financial reforms
- Capital account liberalisation
- Monetary policy – float the exchange rate, CPI as the nominal anchor.

In all these areas, the story is about establishing State capacity: clarity of objectives, accountability mechanisms.
Frontier #1: Financial repression

- Most buyers of government bonds are involuntary
- There has been a slight reduction in SLR
- Pensions, insurance – no change
- (NPS is better, but NPS is as yet small).
Frontier #2: Debt stability

- Average central primary deficit over the last 10 years: 2.41% of GDP.
- Things could get worse in coming 1-3 years:
  1. Inflation surprises from 2006 onwards have made things look unusually benign. Now things are going to worsen as inflation has come down.
  2. In the short term, better conduct of tax authorities will yield less revenue.
  3. Pressure to rescue PSU banks.
  4. Cutting expenditure is essential, hard, pro-cyclical.
Frontier #3: Deeper problems of the fiscal system

- We are intractably stuck on tax reform
- Both tax policy and tax administration are faring badly
- We are far from $max\ \text{GDP} \mid \text{tax revenue}$
We are intractably stuck on tax reform
Both tax policy and tax administration are faring badly
We are far from max GDP | tax revenue
Feedback loop of objective - resourcing - performance is absent
Generates pressure for politicians to make bad spending decisions.
Conclusion

- A mature market economy is one with sound fiscal, financial and monetary institutions.
- The destination is clear: small primary surplus, floating exchange rate, remove financial repression, make BCD Nexus work, open capital account, sophisticated and internationally competitive financial system.
- Complicated inter-connections in the journey there.
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- The destination is clear: small primary surplus, floating exchange rate, remove financial repression, make BCD Nexus work, open capital account, sophisticated and internationally competitive financial system.
- Complicated inter-connections in the journey there.
- Open questions on fiscal policy:
  - How to get to a sound framework for tax policy and tax administration?
  - How to get to a small primary surplus on average?
  - Voluntary buyers for bonds?
  - How to get bang for the buck in spending? Requires deep reforms of objectives - resourcing - performance loop.
Thank you.

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