Getting India Back on Track: An Action Agenda for Reform
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Chapter 1: Maintaining Macroeconomic Stability

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India’s long-term growth potential remains high. The young population is gaining formal education and hands-on training. Gains from internal and international trade are increasing. While elements of the Raj persist, India has largely moved to a market economy. Lately, however, India has been undergoing a sharp downturn. Two years ago the economy generated tremendous optimism. Today, despite the long-term story being intact, widespread pessimism prevails. This has brought a fresh focus upon the policies of macroeconomic stabilization that could dampen business cycles while ensuring that India remains on the path of steady state growth.

Conditions in the economy are daunting. Investment and growth have collapsed, and inflation is in double digits. Savings have dropped, with households flocking to gold. The fiscal soundness of the government is questioned. What is occurring in the downturn is inevitably related to the events of the boom that preceded it. During the boom years, inappropriate macroeconomic policy spread the seeds for the difficulties seen today, with a faulty fiscal stance and inappropriate monetary policy that produced India’s biggest-ever credit boom.

There is a considerable focus upon the problems of approvals and legal bottlenecks faced by investment projects, particularly in infrastructure. However, even if clearances are given to projects that have been stalled, they would still face serious obstacles in the financial system. The banks that binged on infrastructure lending during the boom are now not able to finance the next wave of infrastructure investment.

With a large current account deficit, the country needs capital inflows. Yet, the policy framework for capital flows is outdated, with various restrictions on cross-border flows. While India has de facto opened up its capital account, innumerable capital controls remain that do not allow capital to flow in. In 2013, policymakers embarked on a questionable adventure in trying to defend the rupee, an attempt that failed and caused heightened uncertainty. This episode serves as a reminder that macro/finance policy in India today is an idiosyncratic affair that lacks a well understood framework with deep institutional foundations. The country lurches from one crisis to the next.

Global financial markets are likely to remain in turmoil for several years, until the United States goes back to normalcy. Until this comes about, international financial markets will experience many shocks. Deep and liquid markets in a country's domestic economy are the essential shock absorbers through which the perilous waters of international financial integration can be navigated. Achieving such deep and liquid markets requires large-scale financial sector reforms, with a complete replacement of the existing regulatory framework.

These developments from 2008 onward have highlighted India's lack of a proper framework for macroeconomic and financial stability. When India was a low-income country with a largely closed current and capital account, it could afford to have the present institutional, legal, and regulatory framework. But there is a large mismatch between the institutional machinery of a developing country and the requirements of a $2 trillion economy. Until India reforms its fiscal, financial, and monetary policy frameworks, macroeconomic and financial uncertainty will only worsen.

Why Is Macroeconomic Stability Important?

Policymaking in India is often based on the assumption that the economy will follow a linear trend growth rate. This implicitly assumes that the Indian economy does not have business cycles—a continuation of the old socialist thinking, when the government determined the level of investment in the economy, agriculture was a large share of the economy and depended on monsoons, and services production was dominated by the government. When India was a socialist developing country, the sudden downturns that it experienced were due to exogenous shocks such as droughts, oil price shocks, and wars. The economy did not have investment-inventory cycles of the kind seen in all market economies.

These old instincts have not yet been erased, even though India is now a market economy and has graduated from being a developing country to being an emerging market. Both government officials and businesses seem to believe that India is in a world where its economy stays at the trend growth rate with no fluctuations around it. Every cyclical up or down is treated, all too often, as a "new normal" or the new trend growth rate. However, as in the typical emerging economy, India has growth rate cycles around a trend. Emerging economy business cycles are more volatile than those in advanced economies. India's growth swings from 4 percent to 10 percent, which is quite different from what is seen in places like the United States where the range of values is much more modest.

The most important single issue in Indian economics is that of achieving high and sustained trend growth. If, hypothetically, India is presented a choice between a high average trend growth rate, with sharp volatility around it, and a low average trend growth rate that is smooth and stable, the former is of course superior. As an example, South Korea went through painful macroeconomic crises in 1997 and 2008. However, South Korea achieved higher trend growth than India, and consequently is now a prosperous country. If avoiding crises were all that were important, India would have been better off than South Korea.

While recognizing that fluctuations are not bad in and of themselves, fluctuations of gross domestic product (GDP) matter to the extent to which they can damage trend growth. There are several mechanisms through which high fluctuations hamper trend growth. Events such as financial crises, high inflation, or a fiscal crisis can sometime create long periods of slow growth. Similarly, if the government intervenes in a knee-jerk manner setting back the development of markets and price-setting in markets, as has sometimes occurred in India, the resulting distortions can continue to create resource misallocation and prevent healthy functioning of the market mechanism for a long time. This would have the effect of reducing the long-term steady state growth rate.

- *Financial crises*. In the big booms, investment and credit expand hugely.

  When the downturn comes, a collapse in the financial system can have an adverse impact on growth. To forestall this, two strategies are required: sound financial regulation and macroeconomic stabilization that reduces the volatility of the business cycle.

- *Price stability*. Macroeconomic stability is synonymous with low and stable inflation. Sustained low inflation goes along with a low interest rate environment and reduced relative price fluctuations. This creates an environment within which the private sector is better able to make projections. The reduced uncertainty encourages long-term investment. In India, low and stable inflation was achieved for only seven years, from 1999 to 2006. Apart from this, inflation has consistently been high and unstable, which adversely affects investment and growth.

- *Inappropriate interventions*. The broad policy environment in India has a low threshold for justifying government intervention in the economy. When economic conditions are difficult, the government tends to engage in more frequent and more distortionary interventions in the economy. But rather than rectify matters, intervention merely generates another channel for trend GDP growth to worsen.
- *Fiscal crises*. In bad times, tax collections are lower and there is greater pressure for populist spending. In the Indian environment of chronic fiscal stress, a business cycle downturn can potentially turn into a damaging fiscal crisis. The state can be crippled in such a crisis for a few years, which would in turn damage trend GDP growth. This generates another channel through which high GDP growth volatility can reduce trend GDP growth.

Fluctuations are not bad in themselves. While economic policy should focus on achieving high long-run trend growth, it is advantageous for India to create the institutional foundations for macroeconomic and financial stability that will set the stage for such growth. Four elements of reform are needed for macroeconomic stability: fiscal consolidation, financial sector reform, capital account convertibility, and countercyclical monetary policy.

A Framework for Stabilization

Fiscal Consolidation

There is some evidence that at present, India has a pro-cyclical fiscal policy. When the economy does well, tax collections go up and the government finds this is an opportunity to spend more. In bad times, taxes go down and fiscal stress is high. The government then tries to reduce expenditure. This contracts the economy further, thus exacerbating the business cycle downturn. Chronic fiscal stress generates pressure for the government to engineer inflation, which is destabilizing in its own right.

The way forward requires two elements. Fiscal policy must get away from chronic stress into soundness. And fiscal policy must smoothly shift between surpluses in good times and deficits in bad times.

The first issue is fiscal soundness. India needs to graduate out of chronic fiscal distress into a framework of conservative fiscal policy. In good times, it should run a surplus of 2 to 3 percent of GDP (consolidated across the central government and the states), and in bad times, this should turn into a consolidated deficit of a similar magnitude.

The Fiscal Responsibility and Budget Management Act, 2003 (and its amendment in 2012), required the government to bring the fiscal deficit down and keep it at a constant level. This limited the scope of countercyclical fiscal policy. The deficit could not expand in bad times, and the government did not have to generate a surplus in good times. A new arrangement is required under which the government can undertake fiscal expansion during bad times. Under this arrangement, the primary balance would be positive in most years, thus ensuring that in all but a few extreme years, the debt-to-GDP ratio would go down. This adds up to a conservative framework of fiscal policy, one that would offer a measure of safety from the fiscal crisis that is always seems to be on India's doorstep.

How can fiscal policy be structured so as to move smoothly from surpluses of 2 to 3 percent of GDP in an expansion to a deficit of 2 to 3 percent of GDP in a downturn? The bulk of this movement should come from automatic stabilizers, or instruments that lead to fiscal expansion during GDP contractions and fiscal contractions during a boom, so that no discretionary actions are required. India has one important stabilizer in the form of the corporate income tax. Programs such as the National Rural Employment Guarantee Act (NREGA) need to be carefully engineered to ensure that spending goes up in a downturn and goes down in an expansion. The danger at present is that programs like NREGA involve large expenditures that are insensitive to business cycle conditions.

These two lines of thought induce macroeconomic stability in two respects. The ever-present fiscal crisis would subside, and fiscal policy would contribute to reducing business cycle volatility.

Reforming the Regulatory and Legal Framework for Finance

Financial crises are an important source of macroeconomic instability, particularly in emerging markets. India has experienced a diverse array of ailments, including banking distress, international finance crises, bankrupt pension systems, and securities scandals.

A sound framework for financial regulation is required to forestall these problems. This involves six elements:

1. *Consumer protection*: Regulations that are more fair to consumers would reduce risk in the system. They could prevent mis-selling by financial firms and the buildup of risk such as that seen in the chit funds and multilevel marketing schemes. Consumer protection would help reduce fraud caused by Ponzi schemes. A two-pronged strategy is needed. First, consumer protection should be the objective of all financial regulation. Regulations need to be written to achieve this objective, and if they do not, it should be possible to appeal and overturn them. Second, there should be a financial redress agency with a presence in every district of the country, urban and rural. It should have a fast adjudication mechanism in which consumers can file cases conveniently and cases do not take years to solve.
2. *Micro-prudential regulation*: One key element of consumer protection that bears individual mention is micro-prudential regulation, where regulatory agencies force financial firms to reduce the probability of failure. This would help address banking distress, bankrupt pension systems, and securities scandals.
3. *Resolution*: A critical piece of institutional machinery in any financial system is a resolution corporation that identifies distressed financial firms and shuts them down, while protecting the interests of unsophisticated consumers. Such an agency is, at present, lacking in India. This leads to the twin maladies of distressed financial firms growing unchecked and turning into a big problem, and then presenting problems that the government inevitably has to address.
4. *Shock absorbers*: Deep and liquid financial markets are an essential tool for risk absorption. When markets are shallow, shocks generate exaggerated price movements. In addition, when markets are shallow, risk transfer is not possible, and many financial firms end up holding on to excessive risk.

5. *Systemic risk regulation*: A strong database about the overall Indian financial system needs to feed into a sophisticated research program on systemic risk, which leads to concerted action by a council of regulators, the Financial Stability and Development Council.

6. *Regulatory architecture and governance*: A sound regulatory framework needs to be established, without overlaps and gaps, where there is clarity about the objectives of each agency, and where all agencies achieve high performance through strong accountability mechanisms.

All these elements are lacking at present. Hence, the current environment involves heightened risks to the economy. In the absence of this framework, policymakers are repeatedly hijacked by crises and respond to them in an idiosyncratic way. The inconsistent responses of policymakers exacerbate the ex-ante risk as perceived by economic agents.

The Financial Sector Legislative Reforms Commission, chaired by retired justice B. N. Srikrishna, has drafted a proposed Indian Financial Code to replace all existing Indian financial law and solve all these problems. The need of the hour is to translate this draft bill into an Act of Parliament.

Capital Account Convertibility

As emphasized above, achieving macroeconomic stability requires ruling out international financial crisis. This is closely related to the question of capital account liberalization.

India has a complex maze of capital controls. A number of public bodies switch controls on and off based on their views. Various financial sector laws and regulations treat foreign investors differently from Indian investors, with a bias against foreign investors. Today, the framework is so messy that even the government finds it hard to enforce its own rules. The various definitions of foreign direct investment and foreign portfolio investment often lack clarity and legal certainty. The lack of a transparent framework frequently turns away even those investors who want to bring money into India.

These controls have led to a complacent view among many policymakers that India is not vulnerable to the problems of international financial integration. This perspective is incorrect. While a maze of de jure capital controls exists, in practice, economic agents are able to move large sums of money across the border through legal and illegal means. When the rules favor equity but not debt, economic agents relabel transactions as equity. When the rules prohibit cross-border activity, capital is moved through trade misinvoicing.

A strong body of evidence now suggests that despite the de jure restrictions, India is largely a de facto open economy. The controls increase transaction costs and corruption but do not change the ultimate outcome. As an example, in September 2008, when Lehman Brothers collapsed, disruption of the Indian money market was among the worst of all emerging markets.

It is well known that an emerging market must establish sound frameworks for fiscal, financial, and monetary policy before opening the capital account. In India's case, there is a dangerous accession to de facto openness without laying the commensurate foundations of fiscal, financial, and monetary policy capability.

Shifting from de facto to de jure capital account convertibility would result in two kinds of gains. First, policymakers need to be fully clear of the risks that they are taking; there should be no illusions that India is protected by a wall of capital controls. Second, the rent-seeking, transaction costs, and corruption associated with the present framework would be eliminated.

The difficulties associated with foreign investors in an emerging market are critically related to asymmetric information. An investor in Connecticut who does not know much about Mozambique, for example, is vulnerable to rational herding, sudden stops, and capital flow surges. Because the root cause of the problem is asymmetric information, the solution to the problem lies in a deep engagement with financial globalization. This requires shifting from de facto to de jure openness on the capital account, making it convenient for foreign fund managers to establish operations in India (something that is now blocked by tax law) and creating a conducive environment through which global financial firms acquire organizational capital and human capital pertaining to India.

India is a major emerging market. Once India is de jure open, all large global financial firms will do business in India. People of Indian origin play a leading role in all large global financial firms. Unlike small emerging markets, India has a fair opportunity at overcoming this asymmetric information and thus achieving more knowledgeable foreign investors.

To sum up, India is in perilous territory with a complicated system of capital controls that does not yield safety, that generates an illusion of autarky in the minds of policymakers, and that hinders deep integration with financial globalization. It would be safer if the de jure were reformed to match the de facto arrangement.

Monetary Policy

A fourth important mechanism through which business cycle volatility can be reduced is countercyclical monetary policy. In good times, interest rates should go up, which cools the economy. In bad times, interest rates should go down, which stimulates the economy. Such monetary policy achieves low and stable inflation.

A properly structured monetary policy framework affects macroeconomic stability by providing predictability of future inflation, low fluctuations of inflation, and a force for stabilization. None of these features is visible in India today.

India’s consumer price inflation has risen to 10 percent per annum since 2006. The Reserve Bank of India (RBI) chases multiple objectives with multiple instruments. Furthermore, the RBI has neither a clear objective or measure of inflation, nor is it held accountable for inflation. Monetary policy law needs to define the objectives of India’s monetary policy, as it does in many advanced and most emerging economies. The law must lay down the instruments of monetary policy. The RBI needs to be made accountable and given independence in order to achieve these objectives.

Decisionmaking on monetary policy in India will become increasingly difficult in the next two years, especially once the U.S. Federal Reserve stops its quantitative easing and U.S. interest rates rise. It is well understood by now that once the capital account is open, a country has to choose between pegging the exchange rate and pursuing an independent monetary policy; it can't do both. If the business cycles in the Indian economy were perfectly aligned with those of the United States, India would not need an independent monetary policy. But if the United States is going to raise rates, India has to make a choice about its de facto open capital account: let the rupee be flexible or peg the rupee to the dollar and tighten along with the United States.

The lack of clear thinking at the RBI is a key source of macroeconomic instability in India. Knee-jerk reactions that focus on only one element of the impact of those policy changes are bound to be troublesome. It was an understanding of these difficulties in monetary policymaking—after many episodes of painful mismanagement that led to years of inflation, recession, stagflation, and large-scale unemployment—that led advanced economies to hand over the task to central banks. They were given independence from government and required to have structures such as monetary policy committees, which allowed informed decisions and a diversity of views. And they were held accountable.

With the Indian economy opening up in the past two decades, the difficulties of monetary policymaking have increased. By now, many government committees have suggested that it is time for India to move to a modern framework for monetary policymaking. India needs a central bank with independence and accountability, and with a professional monetary policy committee that decides monetary policy actions using well-defined instruments of policy. The latest of such recommendations is included in the Financial Sector Legislative Reforms Commission's draft law. While it may be very tempting for the government to be able to shape monetary policy at a particular point in time, it needs to understand that such short-term solutions are harmful in the long run. The government will be well-served by a framework that provides low and stable inflation. Anchoring expectations on inflation would require not only narrowing the objectives of monetary policy but also bringing in financial sector reforms that can strengthen the currently weak transmission mechanism of monetary policy.

India's aspiration should be to achieve a world where the rupee is a floating exchange rate—with absolutely no government involvement—and consumer price index inflation is reliably within the 4 to 5 percent range (on a year-on-year basis) for decades on end. It will take at least a decade of victory over inflation before the full economic gains come about.

Conclusion

Macroeconomic and financial stability in India is suspect, as the institutional machinery for macroeconomics and finance in India is grossly out of touch with the requirements of today's economy. Volatility is an integral part of the market economy and should not be shunned in and of itself. However, extreme fluctuations in macroeconomics and finance can damage long-run trend GDP growth. To address these problems, sound machinery for fiscal financial and monetary policy need to be established. Until this is done, India will continue to lurch from one crisis to the next.

The government should take the following steps to improve the policy framework for macroeconomic stability:

1. Enact a fiscal responsibility act that takes business cycles into account and allows for countercyclical fiscal policy. This could mean putting in place rules for

keeping the expenditure-to-GDP ratio at a specific level. A task force on framing of such a law should be put in place right away.

2. The Financial Sector Legislative Reforms Commission has submitted its report and proposed a draft law on how to improve financial regulation and ensure rule of law in the framework for capital controls. The government has started on the following. First, it has started working with regulators to voluntarily adopt sections from the draft. These include provisions relating to better consumer protection, and the process of framing of regulations through consultative and transparent procedures. . This initiative will have to be followed through and implemented by regulators. Second, the government must undertake a time bound consultation process on the draft and a timeline for completion of this process and table a new bill to Parliament. Finally, for the various new bodies that have been proposed by the commission, the government needs to set up task forces to start the process of design, obtaining office space, IT systems, and recruitment.
3. Countercyclical monetary policy should be achieved through a new monetary policy law to replace RBI Act, 1934. The new law should clearly define the objective of monetary policy in terms of achieving price stability. This objective should be measurable, and the RBI should be made accountable for it and given the independence and the powers to achieve it. To bring inflationary expectations down, this should be done as soon as possible, as it is one of the easiest among the difficult set of options for achieving macroeconomic stabilization. Yet, it is one where the framework for price stability has to be in place for some time before it can become credible.