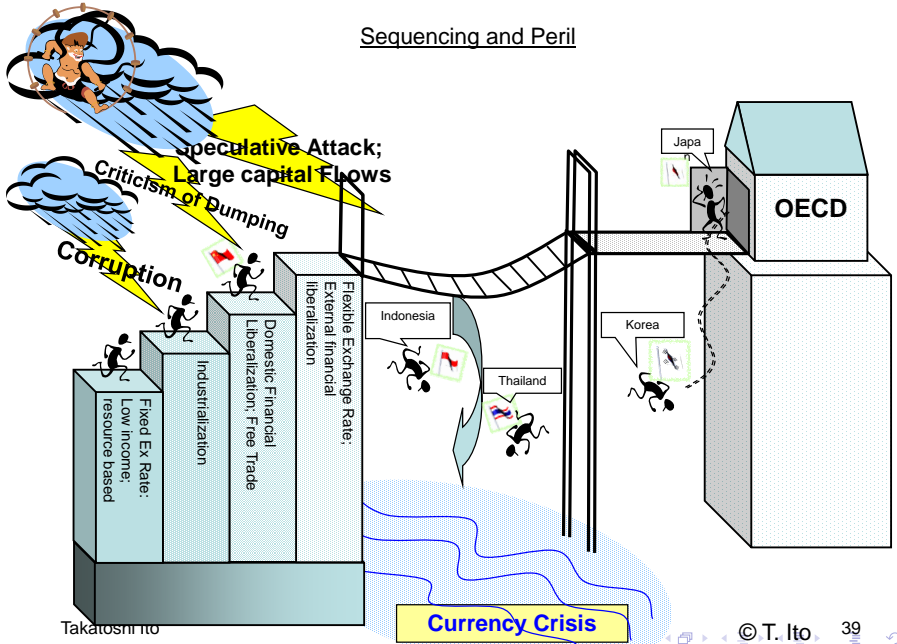


Fiscal, financial and monetary institution building

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December 13, 2014

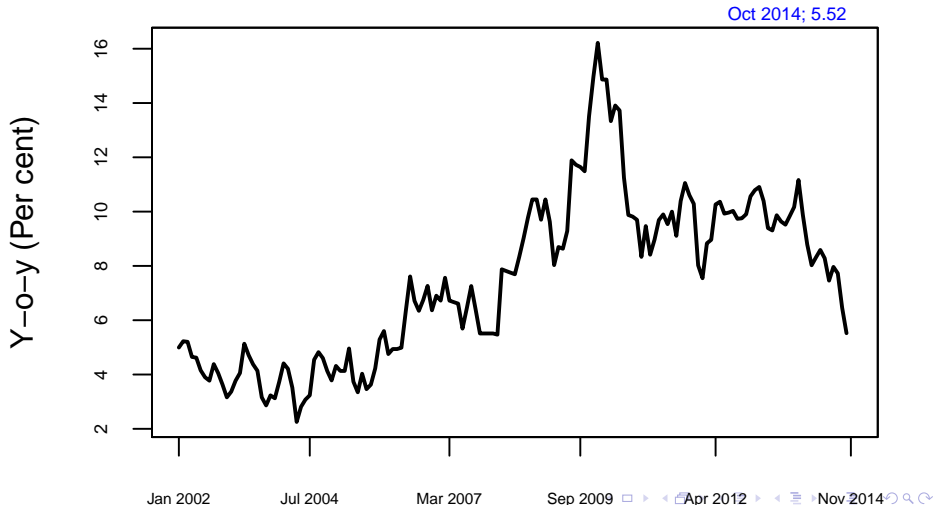
Sequencing and Peril



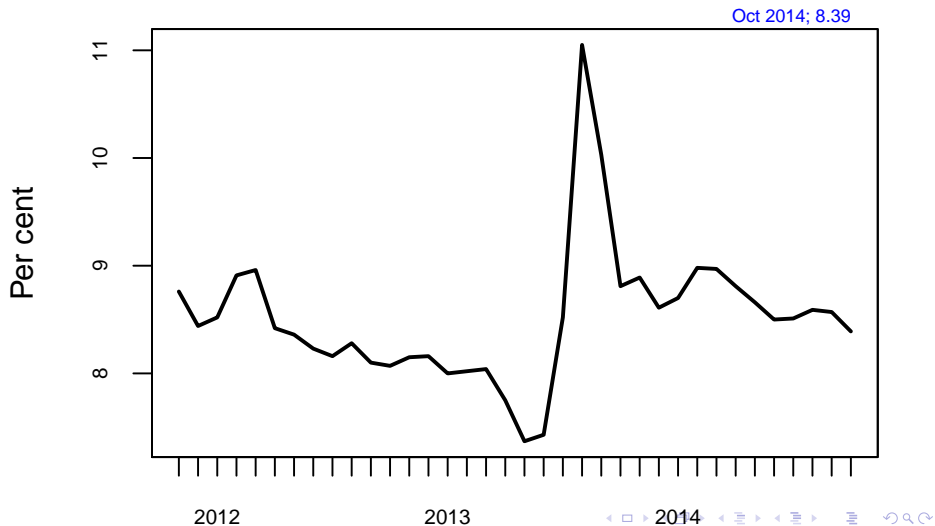
Takatoshirito

Currency Crisis

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



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



The destination is well understood

Fiscal Remove financial repression

Debt stability

Counter-cyclical

Financial Equity market

Bond-Currency-Derivatives Nexus

Array of financial firms, not public sector

Open capital account

Globally competitive

Monetary

Inflation targeting

Independent and accountable.

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.
- Long term: Indian Financial Code.

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.
- Long term: Indian Financial Code.

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* GDP | tax revenue

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- 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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- Complicated inter-connections in the journey there.
- Indian Financial Code largely solves financial and monetary policy and public debt management. Challenge of execution.
- 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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