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FISCAL AND MONETARY INTERFACE IN INDIA

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Dr. Vijay Kelkar, Chairman, Dr. Rathin Roy, Director, family of Dr. Raja J. Chelliah and distinguished friends.

At the outset, I express my deep debt of gratitude to NIPFP for inviting me to deliver the prestigious Dr. Raja J. Chelliah Memorial Lecture. Dr. Chelliah combined in himself a popular teacher, a deep scholar, a builder of institution, a policy-maker, and above all, a gentleman. I am aware that in this gathering there are several people to whom he has been a benefactor. We are fortunate that Dr. Chelliah built this world class institution, one of the few institutions in India that can claim an international stature. Credit should go to the successive Chairmen and Directors who have contributed to the outstanding performance of Dr. Chelliah's creation.

Fiscal and monetary policies are two pillars of macroeconomic policy, both for accelerating growth and ensuring stability. Their relative roles and the nature of interface have been of great interest to both academics and policy makers. But the narrative of academicians on the subject may not be the same as that of practitioners. "Whereas theories raise fundamental

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questions about the functioning of the system and enunciate a model or behavioural laws under certain assumptions, practitioners generally rely on historical perspectives and experience as guide post. Policies are more often based upon sound judgements and taking into account the economic milieu in combination with socio-political compulsions and circumstances. Therefore, policies evolve contextually to the particular environment. Naturally, policies cannot be understood or explained without reference to geographical location, historical context and overall environment." (Kanagasabapathy, 2001)

I intend presenting before you, a practitioner's perspective of how the interface evolved in our country. I will briefly recall the pre-reform status of the interface, from 1950 to 1991. This will be followed by a detailed account of the manner in which the interface was transformed during 1991 to 2003. The transformation was through mutual consultations between Government and RBI. This framework of interface was supplemented by unconventional measures between 2003 and 2008. It was put to test after the Global Financial Crisis - something that was experienced in other economies as well. This stressful interface between 2008 and 2015 has been replaced by an entirely new framework in 2016.

I propose to suggest that the new framework is in some ways a continuation of the past and new in some fundamental ways. The new framework is closer to theory than before and is closer to the practice being followed in advanced economies. Thus, there is a double convergence.

Keeping in view my experience in the past and taking advantage of consultations with eminent economists, I shall attempt to list the tasks ahead in a summarized manner. Looking ahead, I do sense that there are important broader systemic aspects that should be visited with more attention and deliberation than they have received so far.

Pre-Reform

Since 1950, the plan priorities took precedence over all other economic considerations. Deficit financing was defined as change in the government indebtedness to RBI and this became a source of financing of plans. The RBI was consulted during formulation of five year plans. But, in reality the demands on RBI were higher than planned. The premise was that plans fund capital expenditure and hence non-inflationary over the medium term. Since 1957, RBI was obliged to automatically monetize deficits. RBI adopted a policy of controlled expansion of money supply approach, but as the budget deficit increased and automatic monetization was demanded, RBI was left with only one task. It was to ensure that the adverse effects of automatic monetization were constrained. "After independence, as part of planned development, the economic policy in India moved from fiscal neutrality to fiscal activism. The Government expected to raise funds at fine rates. A large borrowing programme with a strong preference for low interest rate added to the demand for support from RBI or increasing monetization of fiscal deficits"(Reddy, 2000). Government wanted to raise borrowings at artificially low interest rates. In 1967, I was party to semi-official subsidizing of government borrowing programmes in Andhra Pradesh.

There was a dramatic change in the interface with the nationalization of banks in 1969.With this, monetary and credit policies were virtually integrated with credit allocation, direction, and pricing. The most important part of the financial system, namely, banks became part of the Government, and interest rates became part of the plan process. RBI was simultaneously addressing supply and demand aspects of economy and performing regulatory and developmental functions simultaneously. All this was implemented in close association with the government. The interface between printing and spending money between the government and central bank and between commercial banks and government were finally in the nature of a joint family and thus transactions within the family remained unaccounted.

High fiscal dominance and financial repression were the hall mark of 1980s.The borrowing programme exceeded the estimates significantly. There was political demand from the State Governments for a share in deficit in excess of plan estimates. There was a realization that something should be done by RBI to restore order. The result was appointment of Sukhamoy Chakraborty Committee on Monetary System. But the problem was targeting the broad money when the Government could not be stopped from monetizing its deficit. The period witnessed excessive deficits, funded by automatic monetization. The Reserve Bank had to take extensive recourse to SLR and CRR and selective credit controls and administered interest rates to conduct monetary policies. Along with other problems, this fiscal and monetary environment became a major contributing factor to the BoP crisis of 1991.

Reform

There was a paradigm shift in the interface as part of the reform which commenced in 1991.At a very broad level, the paradigm shift occurred through a series of acts of abnegation of power by the Government to RBI and the markets. First, there was an end to the automatic monetization of government deficits. Secondly, fiscal rules were put in place through the enactment of fiscal responsibility legislation. Thirdly, the exit from the financial repression commenced. Fourthly, a decision was taken to eliminate administered interest rates or at least align with market rates. Fifthly, providing refinance by RBI to various entities was gradually phased out. Sixthly, the policy of transfer of profits to the Government was rationalized and made formula-based by RBI. Finally, the separation of Debt Office from the RBI was proposed, subject to fulfilment of preconditions. Many of these reforms are still a work in progress.

I moved to the Reserve Bank of India from Ministry of Finance in 1996 and had the privilege of participating in this journey for several years. By then, the first agreement limiting the automatic monetization had been signed.The next step was to introduce what came to be known as system of Ways and Means Advances (WMA). In a way, we were to commit the Government to agree to a ceiling on annual temporary overdraft facility. We were to settle the interest rate which would necessarily be higher than under the earlier Treasury bill arrangement. This was managed by assuring the Government that as debt manager, RBI will always give money to the Government, except that it will be through bonds rather than automatic monetization. Subsequently, this arrangement was formalised. The point is that it was only the Government which could limit the fiscal dominance.

In due course, it was decided mutually that the RBI would not subscribe to the primary issues of the Government Securities. Both these arrangements were made well before the law was contemplated or implemented. The legal provisions governing automatic monetization and subscription to primary issuance which should normally be in the RBI Act were incorporated in the fiscal responsibility legislation. In brief, structural reforms in fiscal monetary interface required total trust and coordination.

Attention was then turned to the balance sheet of RBI consistent with the reforms. We had to address the legacy problems and framework for the future. The legacy problems included huge stock of Treasury bills. These had to be either marked to market or written off. If it were the former, the losses would be heavy requiring injection of capital by Government. If it were the latter, it would be a bad precedent to write off the loans of the sovereign.We in RBI suggested that we convert Treasury Bills into marketable securities at market rates, thus enhancing the stock of Government Securities in the RBI balance sheet for use in future. We convinced the Government that any additional interest that they have to pay to the RBI would naturally go back to the Government as profits. This stock of securities became extremely useful a few years later for purposes of sterilization and open market operations (OMOs). The important point is that both RBI and the Government are part of consolidated public sector balance sheet, but the arrangements between them can be made in a way that strengthens the reform objectives. The reform objectives were to move away from the joint family approach giving sanctity to different balance sheets within the public sector.

Inevitably, the issue of transfer of surpluses to reserves and profit to Government came up. A criteria was developed by the RBI for transfer of reserves on the basis of our requirement and comparison of international practices. The same had been approved by the Board as required under law. The Government was taken into confidence before the matter was considered by the Board. An agreement was reached that it would be gradually raised to 12 per cent of the assets. The goal was established and the path was fixed. This gave some manoeuvrability for both the Government and the RBI from time to time. It was a sort of flexibility within the rules.

With regard to recapitalization of banks as well, we advised the Government to convert the non-convertible bonds into marketable securities over a period, consistent with the reform. This added to fiscal burden, but RBI convinced the Government that it will go back to government as additional profit. The interface between monetary and fiscal policy cannot ignore the banking system, especially if it is also in the public sector. These were again transactions within the joint family which were messy earlier and required to be made consistent with market economy.

Once RBI decided to put an end to automatic monetization and participation in primary issues, it was necessary to devote attention to development of Government Securities market and money market to facilitate efficient market borrowing and effective transmission of policy. New institutions such as primary dealers and satellite dealers had to be promoted and encouraged with necessary financing also. Successful implementation of the reformed fiscal monetary interface required active involvement of RBI in developing financial markets for Government Securities. This reinforces the importance of financial sector in reducing the fiscal dominance.

In this period of reform, monetary targeting framework was actively pursued and M3 targets showed a secular decline. The administered interest rates were rationalized. The statutory pre-emption were reduced from 63 per cent in 1992 to 35 per cent in a span of six years. Bank Rate was activated for refinancing purposes. The development of money markets and government securities market, along with a reduction in fiscal deficits during the period, paved the way for use of indirect instruments.

The credit for this fiscal-monetary interface, which was a watershed in the economic history of India, should go to four Prime Minister's and four Finance Ministers as they belonged to different political formations that included Congress, a third front and BJP. Two Governors, Rangarajan and Jalan can also take credit for this.

Finally, the interface between fiscal and monetary policy is essentially a political economy issue; and the extent to which it should be apolitical is also a political economy issue. Technocrats can facilitate this process.

Innovations

The settled fiscal-monetary framework that was arrived at after careful deliberation and consensus came under threat from an entirely unanticipated source, namely large capital inflows. Early signs of such inflows were noticed in 2003 warranting innovations. However, this did not deter the Government and RBI to put the settled framework of the interface firmly in the form of legislative actions.

Changes to RBI Act and Bank Regulation Act, in addition to a new legislation on government securities were enacted.During this period, there was regime shift from direct to indirect instruments of monetary policy. The full-fledged Liquidity Adjustment Facility was an innovation that was brought to fusion in June 2004.The fiscal-monetary coordination was evident in another innovation namely Debt-Swap Scheme. It enabled the State governments to swap high cost loans with market borrowings.

An interesting example of innovation is Market Stabilization Scheme (MSS). Under the scheme, the operational autonomy of RBI in the exchange rate management was surrendered. The surrender of independence of the RBI in fact helped strengthen the RBI. To quote the 'Currency and Finance Report of 2009- 12' of RBI:

"A large number of countries, such as Chile, China, Colombia, Indonesia, Korea, Malaysia, Peru, Philippines, Russia, Sri Lanka, Taiwan and Thailand have issued central bank securities. However, the central banks of many of these countries faced deterioration in their balance sheets. As such, the MSS considerably enhanced the degree of freedom for monetary policy. It strengthened the Reserve Bank's ability to conduct exchange rate and monetary management operations. It also enabled the Reserve Bank to use the MSS tool flexibly to both absorb and impart liquidity later when needed".

Global Crisis and Stress

The Global Financial Crisis compelled coordinated fiscal-monetary actions in all countries. Coordination was inevitable under the circumstances. In reality, the monetary authorities had to take unconventional measures which had large quasi-fiscal implications. Coordination of policies at global level was also required in the light of the `agreement in the meeting of G20. Both fiscal and monetary stimulus in India were undertaken and supplemented by regulatory forbearance by RBI. After some time, it became evident to RBI that withdrawal of stimulus should be commenced. The fiscal authorities however did not seem to be on board. The uncoordinated responses could be witnessed during the period of withdrawal of stimulus. This proved to be stressful. However, it must be recognized that coordination becomes difficult during extraordinary situations and this was no exception.These developments led to the questioning the monetary policy frame work that was in place.

The New Framework

The conduct of monetary policy in India underwent a transformation since 2014, transiting to a flexible inflation targeting framework. During 2014-15, a formal architecture for flexible inflation targeting was put in place through an agreement between the RBI and Government. The liquidity management framework was also revised in the write up of the new monetary policy framework. Recent amendment to the RBI Act, 1934 came into force in June, 2016. The Amendment explicitly provided the legislative mandate on the monetary policy framework of the country. The primary objective has been defined explicitly which is "to maintain price stability while keeping in mind the objective of growth". Constitution of MPC was mandated and entrusted with the responsibility to determine the policy rate required to achieve inflation target.

The new formal fiscal and monetary framework for the interface in India provides greater clarity than ever before on the respective role of monetary and fiscal authorities. We now have a rule-based fiscal policy mandated by FRBM Act and a rule-based monetary policy through the amended RBI Act.

There are elements of continuity. The monetary policy committee is in some ways a formalization of an improvement over the Technical Advisory Committee appointed by RBI over ten years ago. RBI had also articulated the concept of self-imposed inflation target. Inflation expectations survey had already been taken up. However, the institutional changes are significant for formalizing them.

Double Convergence

Globally, there was an impressive convergence between the academics and policy makers on the conduct of monetary policy by 1990s. "According to Goodhart (2000), there are three key tenets around which the coalition of academics and practitioners has been formed, viz, first, the monetary authorities' primary objective should be price stability, second, the Central Bank should have sufficient independence to vary its operational instrument without fear or favour and third, its main, almost its only such instrument, is its control over short-term interest rates."(Kanagasabapathy, 2001)

India did not subscribe to these views at that time. We in RBI looked at multiple indicators of the economy's conditions and gave importance to price stability, but not as the primary objective at all times. We emphasized coordination of policies in view of the structural transformation under way and complexities in our economic system. Our instrument was not confined to interest rate though gradually it became the primary instrument. We did not hesitate to use several instruments namely, direct and indirect instruments as well as regulatory actions.The reform process and the policy actions to meet immediate challenges were coordinated resulting in multiple objectives with a focus on price and financial stability. Multiple instruments were used to assure price and financial stability and these were not restricted to monetary instruments.

The global consensus, which was reinforced by what was called a 'Great Moderation', prevailed till the onset of the Global Financial Crisis. After the experience with Global Financial Crisis, inflation targeting approach was diluted to make it flexible. The single objective was supplemented with considerations of financial stability. Independence of central banks is now subject to orientation in favour of coordination with other agencies.

The new framework adopted by India shows convergence with the current global consensus on the interface. I am not referring to the relative emphasis between the banks and non-banks on which there are intense persisting debates.

There is also a convergence of RBI's framework with practices in some countries. "In pursuance of the recommendations of the Expert Committee, the first issue of the MPR was released along with the fourth bi-monthly monetary policy statement in September 2014, providing a medium-term outlook and the balance of risks around a variety of potential shocks. With the publication of MPR, India joins a select band of countries that lay emphasis on transparency and forward looking communication to ensure public understanding and accountability of monetary policy formulation and operations." (RBI, 2014-15)

Tasks Ahead

I discussed the tasks ahead with Prof. Govinda Rao and formulated what appeared to be the tasks ahead.The most important of these, of course, is the need for the Government to achieve fiscal consolidation to create enough fiscal room for conducting counter-cyclical fiscal policy. Over time, it is important to subject the Government to market discipline to achieve efficient financial intermediation in the country. This requires minimizing and eventually removing the financial repression. This requires the reduction (and eventual elimination) of SLR and the gradual reduction of CRR as well as replacement of quantitative restrictions.

Another important issue relates to debt management. There have been a lot of discussions on the establishment of an independent debt management agency. The proposal was first suggested by the RBI for reasons of conflict of interest, but owing to large and persistent fiscal deficit, there have been difficulties in carrying out this reform. Simply passing the baton to the Finance Ministry will not reduce the conflict of interest. It remains to be seen how an independent expert agency can be created to get a comprehensive account of liabilities and assets of the Government.

The experience with the implementation of FRBM Act has shown that while it has helped to restrain Government's deficits and debt, strict adherence to both the magnitude and quality of fiscal adjustment has been a problem. In this context, many countries with fiscal rules have an independent agency reviewing the progress of implementation and reporting to the Parliament. In fact, after the Global Financial Crisis in 2008, many countries have created an independent institution primarily to (a) evaluate budget forecasts; (b) review the implementation of FRBM Act, and (c) estimate the cost of various policy pronouncements made by the political executive from time to time.

The effectiveness of monetary policy depends not only on the actions of the monetary authority but also on other related policies and efficiency of transmitting institutions. With over 70 per cent of the banks and overwhelming proportion of the financial sector in the public sector, there are issues of incentives and accountability and political interference. The fact that overwhelming proportion of the non-performing assets are with the public sector banks shows that the reform will have to go much beyond simply recapitalizing the banks. Furthermore, professional approach and capacity to evaluate lending proposals and ability to undertake risks cannot be expected in public owned institutions bailing them out from time to time with taxpayers' money.

Despite considerable reforms, the interest rate structure is still largely administered. Differential Tax treatments, administered interest rates in public provident funds and small saving instruments not only impart downward rigidity to the structure of interest rates but also alters the saving behaviour of the public in unintended ways as it changes after tax rates of return on them.These have significant impact on monetary transmission mechanism.

An important area of reform is to develop a healthy secondary market for government securities. This should be the medium to long term goal as the government borrowing will have to be brought under market discipline. This is necessary to avoid monetizing the deficit directly or indirectly. There is hardly any worthwhile secondary market and measures have to be initiated to widen and deepen them. Pre-emption of resources for Government at less than the market rates has hidden the true cost of government spending in the country.

Looking Ahead

Looking ahead beyond the debates on economic reforms, there are important areas that warrant attention by fiscal and monetary authorities in their joint efforts to enhance growth and ensure stability. These relate to the external sector, fiscal assessment, financial system and possible risks.

Experience has shown that external sector balance is critical for our economy. We have paid a heavy price when there was stress in the external sector.

All indications are that global economy is still under stress. Economic activity is expected to be sluggish in the short run and is not expected to pick up significantly in medium-term either.The political developments in U.S. may have repercussions in the policy of the U.S. Fed, which is mandated under law to serve the interests of USA. Fed may therefore give more weight to its domestic considerations than global obligations to establish its credentials of being accountable.

The efforts to expand the basket of currency in SDR may be intensified. If that happens, the Indian rupee will be a prime candidate and first one to be considered. We may take a view whether such inclusion is of advantage to us. There are differences in opinion on whether China has benefitted from its currency becoming a part of SDR.

The financial system is critical to the interface between fiscal and monetary policy. India is a bank dominated economy, and in the short to medium term, this is unlikely to change. Transmission of monetary policy depends on banks and, in particular, on their ownership and governance structures and functioning. Many risks with regard to public sector banks rest with the sovereign. The incentive structures for the institution as well as the management and staff are not in alignment with the market incentives. In brief, the normal assumption in the conduct of monetary policy that the regulated entities would respond to market signals may be unrealistic.

From the public sector banks' point of view, there are serious problems with externally imposed policy and operational constraints. They continue to have high burden on account of CRR as well as SLR. In addition to this, they have to go through priority sector lending. They are encouraged to invest in infrastructure in which they have little expertise and encouraged to help develop bond markets. The common thread between fiscal policy, monetary policy and financial sector policy is public sector banks. The future of financial system and indeed modernization of financial sector of India depends on how we overcome the intractable problems of the public sector banks. Obviously, there is a political economy consensus for no change or minimal change.

A critical input in the fiscal-monetary policy interface is the assumptions regarding the fiscal deficit. There are occasions where the central bank's assessment of the likely fiscal deficit may differ from the government's assurance. In communications regarding monetary policy, the central bank may formally take a position that they would go by the assurance of the government. It is hoped that in the new framework the MPC may not face such constraints.

The uncertainty regarding the transfer of surplus of income over expenditure from RBI to Government still prevails. Technically, it is possible to take the stand that there is no need for a central bank to worry about the capital in as much as the government could always recapitalize as and when needed. In some countries, therefore, the government takes a hundred per cent of the surplus into the budget. However, this implies that the government would willingly and credibly provide the capital when needed. Therefore, in many countries, the central bank is provided with adequate capital to meet contingencies without having to approach the government. The adequacy of capital is determined by several factors and is unique to each country.

It can be argued that both government balance sheet and RBI balance sheet are a part of the public sector balance sheet and therefore the transfer of reserves from RBI should be of no concern. However, the transfer from RBI to the government has implications on the money supply.The suggestion to use the reserves of RBI to recapitalize banks is not consistent with the standard practice of surpluses accruing to the budget. In any case, it would amount to the regulator being asked to fund the capital requirements of the regulated in case of a shortfall.

In the fiscal-monetary policy interface, the focus has generally been on the fiscal deficit of the union government. In point of fact, for the purpose of monetary policy analysis, the combined fiscal deficit of the union and state is appropriate.

Experience in many countries and in our own country has shown that a robust fiscal-monetary policy framework should be equally effective during different phases of the business cycle. It is well known that in certain phases of the cycle, differences between fiscal and monetary authorities get magnified. We have been fortunate that we have had soft cycles in the recent past. A robust framework should be able to withstand the political cycles. These are imponderables.

It is useful to assess possible concentration of risks to the sovereign on account of financial institutions including banks, LIC, which holds a large share of public sector banks' equity, and special purpose vehicles for implementing public-private partnership projects.

Concluding Remarks

Traditionally, the debate in the context of monetary policy has been a choice between rule versus discretion, committee versus individual, targeting versus non-targeting and independence versus coordination. The Global Financial Crisis has shown that the reality is more nuanced and that of balance. The buzz words now are constrained discretion, flexible rules and flexible inflation targeting. Similarly, there is an increasing emphasis on coordination along with independence. Increasingly, monetary policy is becoming more of an art even if it is not less of a science.

Let me conclude with a word of optimism. All the members nominated to the monetary policy committee of RBI are economists with impeccable integrity, professional credentials and a reputation for independent thinking. I could not have picked a better team. We are in safe hands.

Thank you.

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