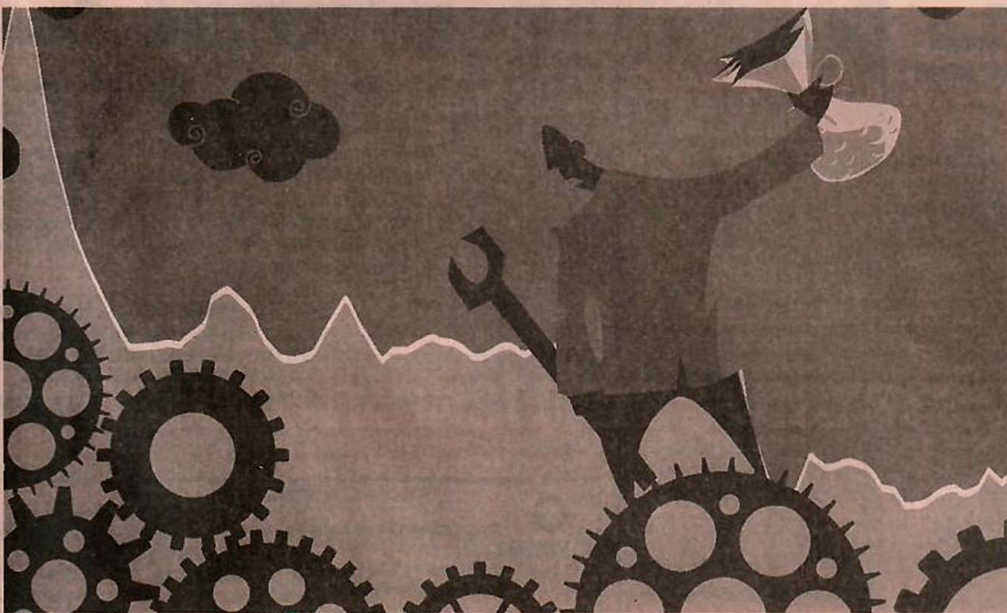
ILLUSTRATION BY BINAY SINHA



The task of the MoF

The roots of macro instability lie in our institutional arrangements for fiscal, financial and monetary policy

The Indian macroeconomy is unstable. We lurch from one crisis to the next. This has far-reaching implications for the economy, ranging across issues such as investment to corporate finance to planning for old age. The prime task of the Ministry of Finance is the fiscal, financial, and monetary institution building that will create macroeconomic stability. We need to reinvigorate the Ministry of Finance with this sense of purpose, and build capacity for its prime task.

The essence of the progress of a country is private investment. The most important problem of the Indian economy is the retreat of private investment. Private projects under implementation, as measured in the CMIE Capex database, peaked at ₹53 trillion (₹53 lakh crore) in 2011. This has steadily declined to ₹42 trillion in 2017. In this period, private "announced" projects dropped from ₹43 trillion to ₹26 trillion. These values are in nominal terms. The declines (21 per cent and 40 per cent) would be worse by roughly 25 percentage points if we took inflation into account.

SNAKES & LADDERS

AJAY SHAH

Private persons build for the long term through tangible investments projects. Even more important is the quiet process of sacrificing the short term to build organisational capital. Every firm faces tradeoffs between making profit right now versus building capabilities of the organisation. Investing in organisational capability gives higher output from the same capital and labour. It is likely that such thinking has also shifted in favour of short-termism in recent years. This harms productivity growth.

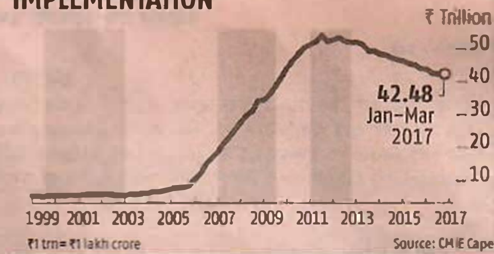
What has gone wrong? One important element that has gone wrong is the excessive level of macroeconomic drama. Let's look at our recent memory, from 2000 onwards.

We started with the IT bust and the Ketan Parekh scandal. There was a banking crisis, and firms such as UTI and IFCI collapsed. Then came the 9/11 attacks and a period of global uncertainty. Then came a remarkable boom from 2002 to 2008 — the biggest ever business cycle expansion in India's history. But within this, on May 17, 2004, when the UPA won the election, we had a stock market collapse. Then came the Lehman crisis, in which India was badly affected. In 2013, the Ministry of Finance and RBI mounted a defence of the rupee, raising rates by 400 basis points, which helped the BJP win in 2014. Then we got demonetisation, a major macroeconomic shock. From 2009 onwards, we have been hiding a big banking crisis. Along the way there were smaller crises like NSEL, Satyam, and Andhra Pradesh's ban on microfinance.

I have just enumerated 10 macroeconomic events and three smaller events in a period of 17 years. As a thumb-rule, I think that India goes through one dramatic macroeconomic event every one to two years. This level of drama is a problem.

Private persons are constantly tugged between the short term and the long term. The risks about the future come in two parts. On the one hand is the micro-economic risk: The risks associated with one firm and one industry. But the second part is macro-economic risk: The risks associated with the entire economy. With our track-record of one big mess every one or two years, the macro-economic environment is daunting. This encourages people to be cautious.

STOCK OF PRIVATE PROJECTS 'UNDER IMPLEMENTATION'



Corporate finance has to plan for this rough environment. In an environment of recurrent crises, it is safer to have more equity capital. This drives up the cost of capital, so certain projects become unviable and are not undertaken. This goes beyond firms to households. Macro stability shapes the behaviour of households on savings, choice of assets, and planning for old age. A household in the UK is certain that CPI inflation in the next 100 years will average 2 per cent. This is not the case in India.

Why do we suffer from macro instability? The problem lies in our institutional arrangements for fiscal, financial and monetary policy. Most of the institutional infrastructure around us dates back to the time when India had a $200 billion GDP and was a closed economy.

The country has been transformed — we have become a much more open economy and GDP has gone up by 10 times. But our institutional infrastructure is largely unchanged. We are like a teenager who has grown limbs but lacks the mental capacity to control them. Some shocks come from outside (e.g. the Lehman shock). When we have better institutions, we will cope with them better.

In fiscal policy, what is required is prudence on deficits and debts, and sound methods of borrowing. In financial policy, what is required is micro-prudential regulation of financial firms, a resolution corporation which shuts down weak financial firms, systemic risk regulation, and good sense in capital controls. In monetary policy, what is required is an RBI that has one objective: To stabilise CPI inflation at 4 per cent. Our present institutional infrastructure is faulty on all these fronts. These reforms require a group of properly working financial agencies such as the RBI, Sebi or the PDMA (Public Debt Management Agency) which stand outside the Ministry of Finance and require a restructured Ministry of Finance with new capabilities.

We tend to compartmentalise macro/finance policy into fiscal vs financial vs monetary. But there are rich inter-connections between all three. The Ministry of Finance must see all the moving parts of this machinery, and plan day-to-day tactical moves that take us to the full design.

Institution building for macro stability: This is the task of the Ministry of Finance. It has to plan out this full institutional landscape, and execute the required transformation. Once the transformation is complete, it can operate the levers of the system as is done by the treasuries of mature market economies, but that is many years away.

The prime function of the Ministry of Finance today is institution-building on fiscal, financial and monetary policy. This runs from the high-decibel political battles all the way to sound technical teams that will obsess on implementation.

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