Economic policy making: Moving on

Gita Gopinath, incoming economic counsellor to the International Monetary Fund (IMF), and Paul Krugman, recipient of the 2008 Economics Nobel prize, have separately made important contributions to thinking about economic policy that are highly relevant for India. They argue that (1) cookie-cutter macroeconomics needs to be questioned in its foundations, especially when applied to Emerging Market Economies (EMEs) (2) micro-foundations matter, but not quite in the way that economists have thought it does for some time.

PUBLIC INTEREST

RATHIN ROY

The language and grammar of most macroeconomic research in India is based on business cycle theory. Simply put, there is a trend growth rate with ups and downs — variations around the trend. This is captured by empirically constructing a polynomial that is stochastically robust to econometric testing. This exercise is devoid of economic theory and has little merit; one cannot infer causal relations from stochastic correlates. Alternatively "output-gap" analytics is deployed — posit a potential output for the Indian economy and then observe whether actual output is close to, or further from, this potential output. This output gap is then used to recommend whether fiscal and monetary policy should encourage or dampen economic activity to secure macroeconomic stabilisation.

Ms Gopinath argues that if external and internal shocks frequently change the trend rate of growth, then these changes could well be depicted as if they were a cycle, if shocks both raise and lower the trend. She argues that empirically, this is what EMEs face. When there are shocks to trend, then business cycle based policy interventions are inappropriate. IS-LM type analysis — what Mr Krugman calls the simplest model that practicing economists use — is better suited. Essentially, fiscal and monetary policy are used to adapt to shocks to aggregate supply and demand that may impel an economy to a lower trend growth rate, or to adapt to situations where the trend growth rate increases.

Despite the protestations of ideologues on the left and right of the political spectrum, Indian administrations have followed sensible policies that derive from such analysis. They have not hesitated to use all instruments at their disposal to signal willingness to keep the economy on track when shocks have caused either inflation or current account problems. Recognising that shocks have not placed the Indian economy (at least to date) at the zero lower bound, economic policymakers have resisted calls to boost aggregate demand through larger fiscal deficits. Equally, recognising that the causation underlying the negative correlation between fiscal deficits and real output growth runs from the latter to the former (the causality established in IS-LM type analysis), governments have rejected calls for extreme austerity in times of crisis. This has been an exemplary social democratic choice across different political administrations, steering clear of puritanical advice based on Marxian or neoliberal frameworks that have little worth in practical policymaking.

On micro-foundations, the orthodoxy was that macroeconomic analytics must be consistent with the self-interested utility maximising framework that underpinned microeconomic theory. Mr Krugman argues that this is invalid. When assessing micro-foundations it is important to be clear about (1) whether these actually demonstrate the working of the laws of demand and supply. For example, in the Indian context, an increase in petroleum prices should result in a fall in demand for petroleum. This does not happen. To then argue for lower petroleum taxation would be to proceed on erroneous micro-foundations, and damaging to the macro-economy. (2) Whose micro-foundations we are talking about? Mr Krugman cites one example – the literature on minimum wage hikes shows that these actually *increase* economic activity — a fact that *refutes* what standard microeconomic models conclude.

This take on the role of micro-foundations in policymaking is important in the Indian context. When increases in import demand at the margin derive from discretionary luxury consumption, it is important to consider whether the pattern of demand underlying the growth process needs to change, and what macro (and sectoral and micro) interventions can foster such change. When it is clear that inequality is becoming an impediment to economic growth, then it is important to unpack the components of aggregate demand. If this unpacking indicates that relative prices have moved heavily in favour of discretionary spending by the top 10 per cent, then it is important to consider whether economic policy should stay blind to this or actively intervene to alter it, instead of just compensating losers with handouts. If this means interventions to secure a mass increase in affordable housing, then it is necessary that enabling macroeconomic and institutional policies be implemented to secure this outcome. If micro-foundations require a more decentralised approach to public good provisioning, then fiscal policy must respond by altering the balance of intergovernmental spending in favour of the states and the third tier. On this count, Indian policy thinking has been unsatisfactory and there is much conceptual work to be done.

Thus, the mainstream of the economics profession is moving on, in the right direction, with insights about economic policy analysis that have great value in the Indian context. Economic policy debates in India need to get with it, and move on from the outmoded plan vs market fault-lines.

The writer is Director, National Institute of Public Finance and Policy. Views are personal