India's fiscal and monetary framework: growth in an opening economy

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Outline of the Talk

- Opening out and growth, crises: good luck or good policy?
- Monetary and fiscal policy combination
- Lessons of the crisis; problems of exit
- Using structure and shocks for growth without inflation
- Policy improvements:
    - Short- and long-term term, demand and supply-side
        - Monetary
        - Fiscal stimulus and consolidation

Key Points

- Indian diversified growth sources, coordinated macro stimulus, protective financial regulation, helped minimize the impact of the global crisis
- Exit: resurgence of inflation before recovery fully established
- Crisis ⇒ AD, AS ⇒ Exit
- Importance of supply side factors for inflation; demand for output
- Lessons for macroeconomic policy: use structure and shocks for growth without inflation
  - Counter cyclical
    - Monetary: forward-looking, small steps, path, I smooth, anchor expectations
    - Exchange rate flexibility: inflation, capital surges
    - Temporary appreciation, CAD, support I cycle, global demand, inflation
    - Fiscal stimulus: stabilize demand shocks; cyclically adjusted deficits growth to reduce G debt; supply side: trade, tariffs, food stocks
  - Long-term policies: Reduce distortions that push up costs
    - Supply response: composition of G expenditure, governance, productivity
    - Fiscal consolidation: growth, caps ⇒ countercyclical deficits
    - Markets, policy, NIFA, CAC: sequence

Global crisis

- Two media myths: inflation ⇒ capacity constraints; deficits ⇒ disasters
- Policy demand shock, then Lehman: trade, finance, fear: growth fell, not inflation ⇒ AS not near vertical at capacity
- V shaped recovery also ⇒ demand shock reduced output
- WPI fell later with oil prices; CPI high; so rapid resurgence of WPI inflation ⇒ wages, cost push, supply curve shift up
- Fiscal stimuli ⇒ G deficits and consumption worked

$$Y > \downarrow C + I + \uparrow G + \downarrow X - M$$

- Output demand determined, inflation supply
- Global push allowed countercyclical macroeconomic policy

Crisis and Exit: Vs and Us in India

Indicators		Growth (Y-o-Y) (%)		Inflation (Y-o-Y) (%)		Money and Credit Growth (Y-o-Y) (%)	Interest Rates (%)	Balance of Payments (US $ billion)
		Industry	GFCF	WPI	CPI-Industrial Workers	Banks Credit	Overnight (call) money	Net Capital Flows
2008-09: Q1-Q4	Q1	5.35	6.54	9.57	7.75	24.94	6.83	4.85
	Q2	4.60	7.32	**12.49**	9.05	25.45	**9.46**	7.10
	Q3	**0.32**	**-0.12**	8.57	10.21	26.81	7.80	**-6.11**
	Q4	**2.53**	**2.71**	3.18	**9.51**	19.15	4.17	**1.41**
2009-10: Q1-Q4	Q1	**3.6**	**-0.7**	0.54	**8.91**	16.52	**3.22**	4.0
	Q2	**5.7**	1.6	-0.09	**11.56**	14.39	**3.25**	18.8
	Q3	**5.8**	**8.8**	**4.98**	**13.20**	**10.36**	**3.20**	14.7
	Q4	**8.8**	**17.7**	**10.18**	**15.08**	15.93	**3.30**	16.1
2010-11: Q1	Q1	**7.7**	**7.6**	**10.98**	**13.62**	18.27	**4.16**	

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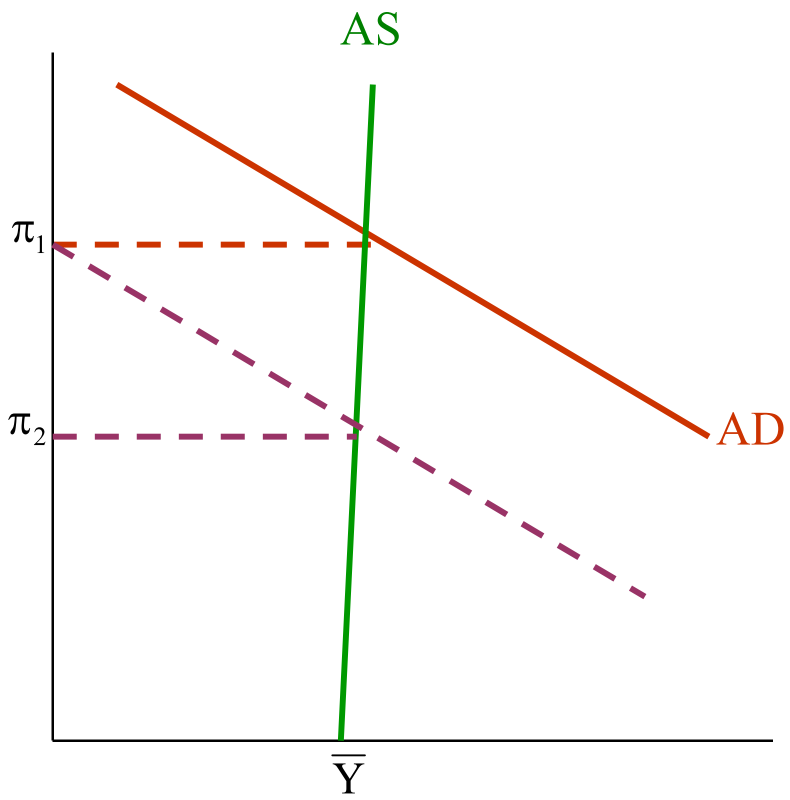


Aggregate demand and supply

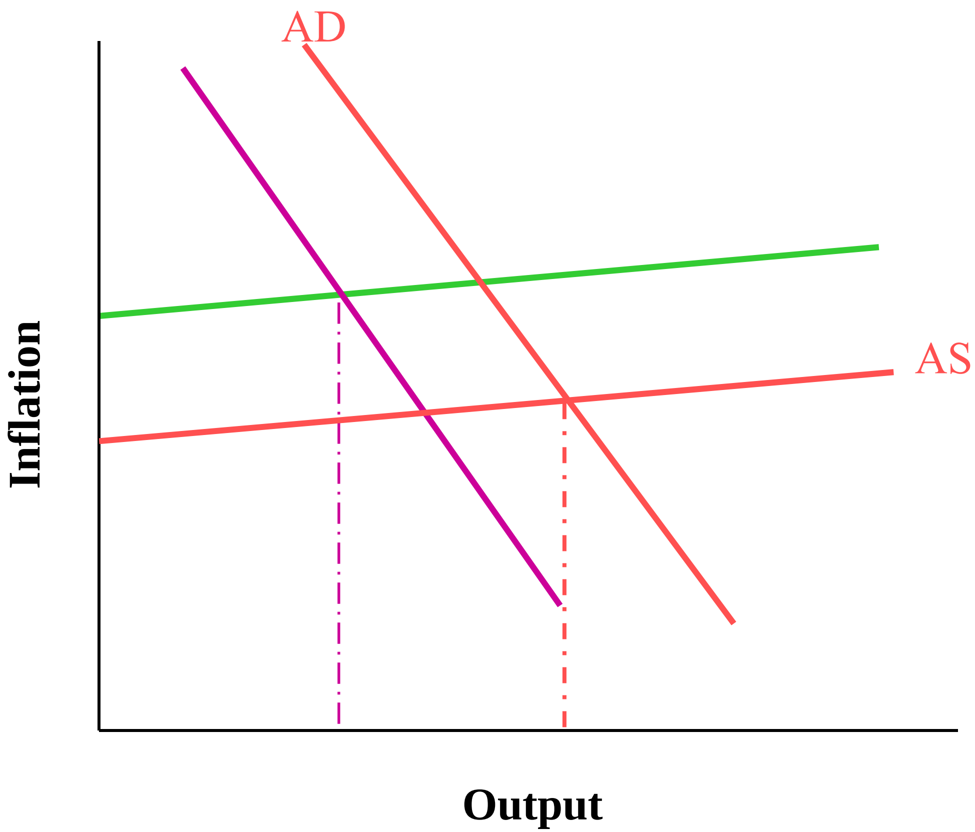
Experience and Analysis

- Demand impacts output
  - Slump after 1996 spike in policy rates
  - Continued with interest rate defense used in response to exchange rate volatility
  - 2002-03 LAF, interest rates fell with global rates, fiscal spend (highways), triggered high growth phase
  - Sharp rate rise in 2008 despite industry slowdown, triggered crash

- Rapid response to 2009 stimulus: Efficacy of coordinated countercyclical monetary and fiscal policy demonstrated

Crisis and Exit

- Policymakers error: output interest inelastic
  - But short-lags for policy rates
  - Two types of errors
    - Type II (Accept when false): Final goal now so apply mature economy concepts uncritically
    - Type I (Reject when true): Nothing has changed so new policy instruments do not work
- Exit: too late and therefore too much
  - Quantitative tightening blunt instruments
    - March -Sept 2010: rr (3.25%) to repo (6%)
  - But low impact on inflation
- Use structure and shocks
  - Reduce inflation with minimum cost to growth



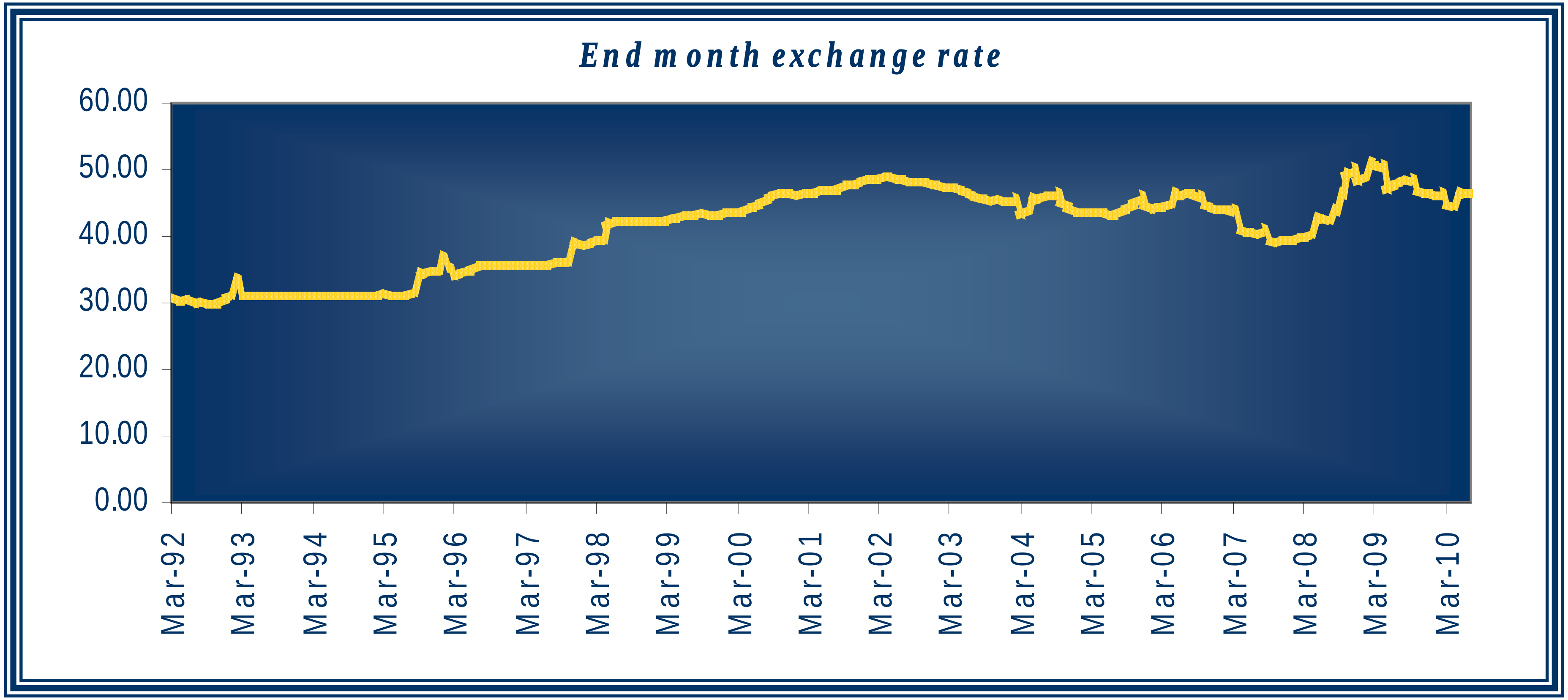
Aggregate demand and supply

Macroeconomic Policy and Structure

- Below potential or full employment output
- Short-term bottlenecks, shocks, but high longer-term supply elasticity
- Effective labour transition
  - AD, AS rather than 2 sector model
- Inefficiencies, distortions and cost shocks pushing up the supply curve
- Politics: Inflation sensitivity so fiscal populism, monetary tightening
- Inflation: Policy should shift down the supply curve
  - Monetary: Anchor inflation expectations; Exchange rate appreciation
  - Fiscal: Tariffs, taxes, food stocks, productivity, bottlenecks
- Output: compensate for demand shocks

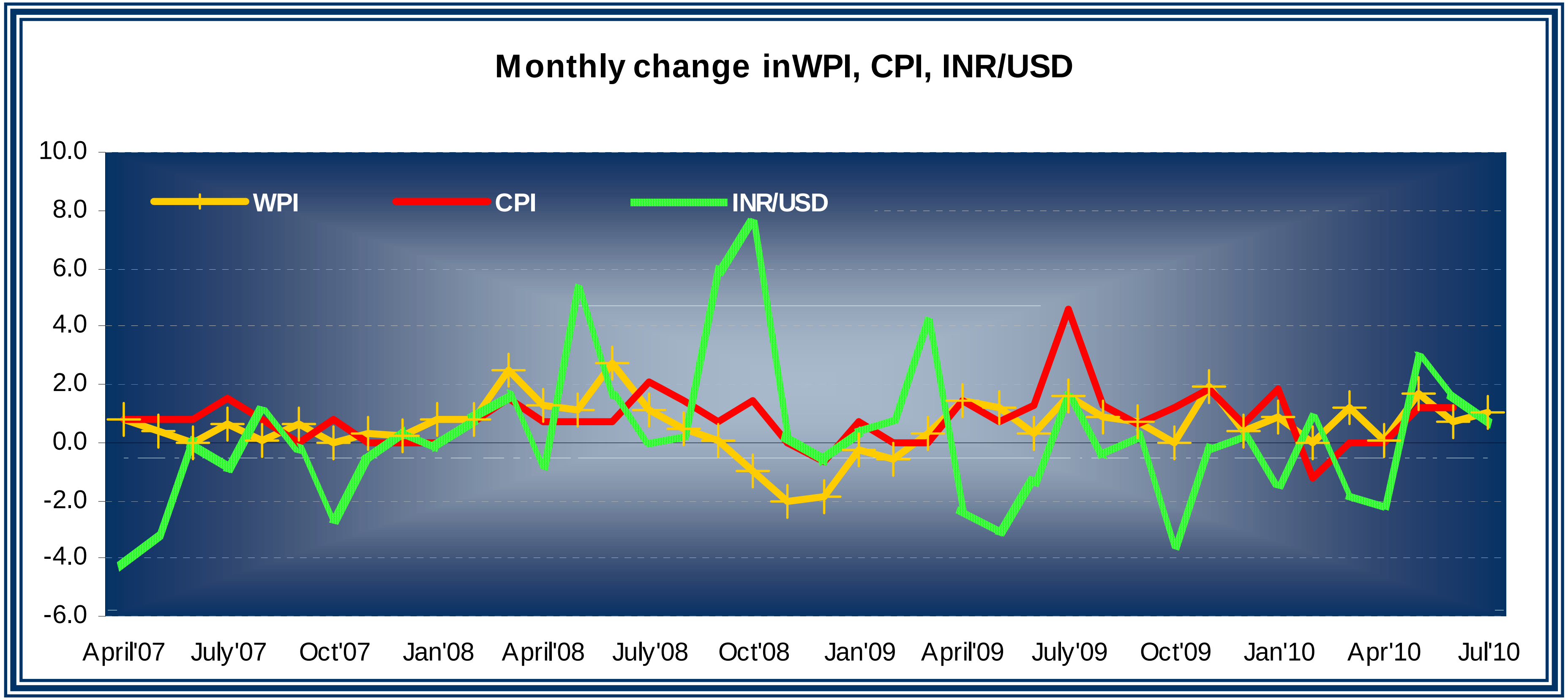
Interest and Exchange Rates

- Countercyclical interest rate policy
  - Inflation targeting?
    - But supply shocks: oil shocks, food prices: wages, E: procurement prices
    - If inflation due to supply shocks, appreciating exchange rate and improving supply response more effective than raising interest rates
    - Mild rise in interest rates to anchor inflationary expectations
    - Prices rigid downwards so allow first round price increases
  - Two way movement of exchange rates
    - Appreciation aborts temporary supply shock, reduces other policy distortions
    - Hedging, market development- limit volatility 10%
    - Enables smooth countercyclical interest rates
    - REER
  - Asset bubbles
    - Countercyclical sectoral prudential weights


End month exchange rate
60.00
50.00
40.00
30.00
20.00
10.00
0.00
Mar-92
Mar-93
Mar-94
Mar-95
Mar-96
Mar-97
Mar-98
Mar-99
Mar-00
Mar-01
Mar-02
Mar-03
Mar-04
Mar-05
Mar-06
Mar-07
Mar-08
Mar-09
Mar-10

Comparing volatilities during two external crises

Year	FPI (USDb)	CMR	Change in reserves (-increase) (USDb)	Rate of Growth (GDP)
1994-95	3.8	15.32	-4.6	6.4
1995-96	2.8	**34.83**	2.9	**7.3**
1997-98	1.8	**28.7**	-3.9	**4.3**
2007-08	29.4	8.33	-92.2	9.0
2008-09	-13.9	**10.62**	20.1	**6.7**


Monthly change inWPI, CPI, INR/USD
WPI
CPI
INR/USD
10.0
8.0
6.0
4.0
2.0
0.0
-2.0
-4.0
-6.0
April'07
July'07
Oct'07
Jan'08
April'08
July'08
Oct'08
Jan'09
April'09
July'09
Oct'09
Jan'10
Apr'10
Jul'10

Exchange Rate Regime

- Capital flows: External shocks not domestic cycle
- Depreciation: May 2008, 2010 aggravated inflation
- Spikes or low movement without intervention
  - FX markets rapid growth but still narrow
    - Slowed down since 2007
  - Excessive volatility hurts the real sector
- So intervention necessary: managed, not full float
- But two way movement, more flexibility

Exchange Rate Regime

- Automatic response to exogenous supply shock
  - Avoids decision lags, moral hazard
  - Generates two-way movement: temporary appreciation
- But permanent shock requires productivity ↑
  - Esp. in agriculture
    - Else real appreciation, permanent nominal depreciation required as correction
- Exit: E↓, π ↓, y^* ↑, r ↔ growth ↑
- Non-price factors for exports, E ↑ later if TD ↑
- Other policies to affect supply-side
  - Not only exchange rate

Capital inflows: surges and sudden stops

- Solution to impossible trinity
  - Monetary autonomy if
    - Flexible exchange rate; restrictions on capital account
    - R >R* ⇒ degrees of freedom for policy
- Indian strategy: sequence of CAC
  - External, equity (shares risks), long-term debt, short-term
    - Selective tightening as required
    - Research consensus: institutions and deep markets precondition
    - Package with strict sequence: policy, markets, CAC
    - FPI firms benefited, households did not, volatility: exited equity markets
    - Increase stable domestic retail participation: equity, G-secs markets
    - Intermediate high domestic savings better
- G-20: better international regulations
  - Allow faster CAC

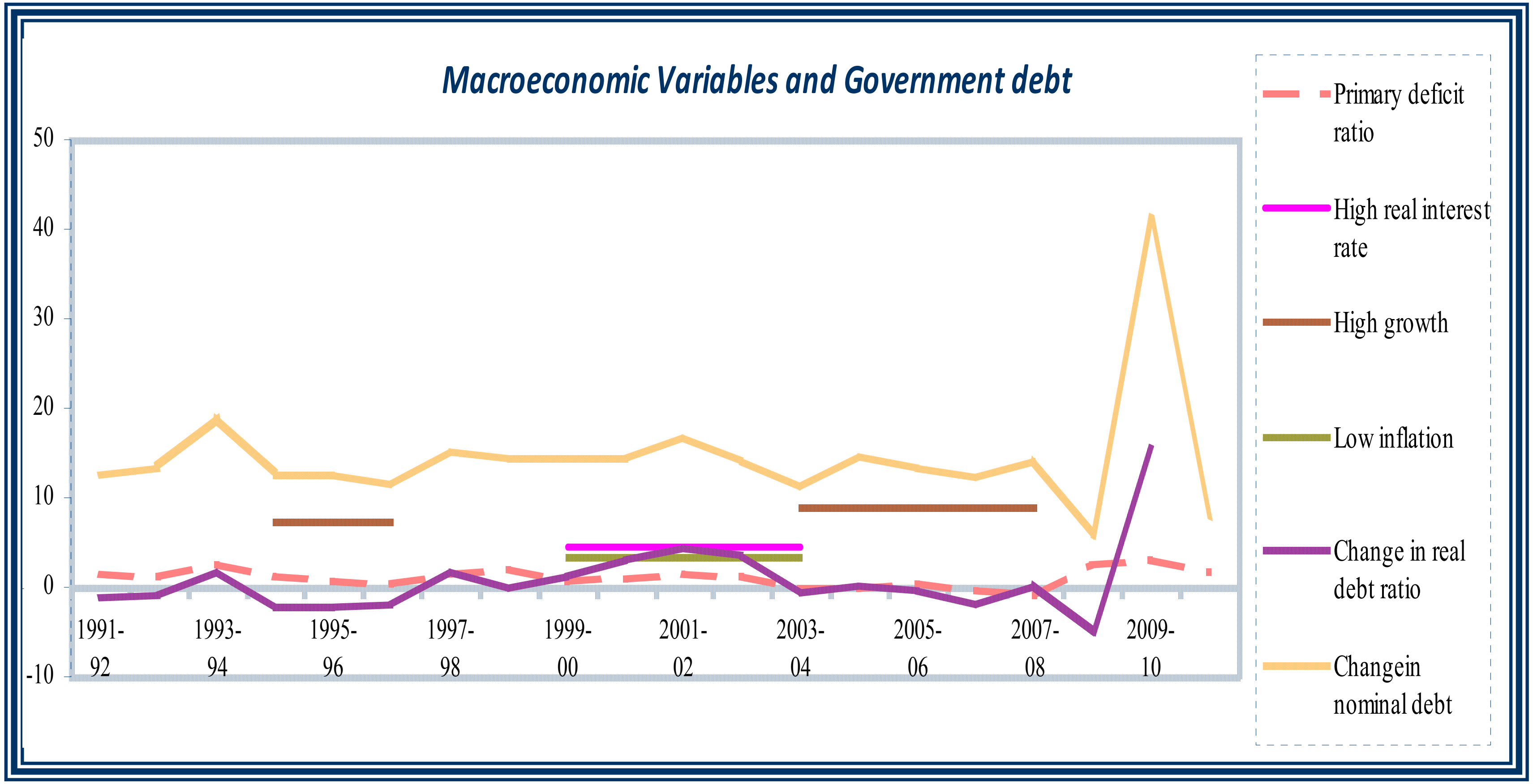
Fiscal policy

- India regarded as high risk
  - Low government capacity
    - But fiscal stimulus worked; concept of cyclical deficits required
    - One of the first countries to resume fiscal consolidation; latter will enable former
- Why are Indian G debt, deficits low risk?
  - EME crises: Latin America
    - Low saving
    - Low population density
    - Sovereign debt externally held
  - India opposite
    - High household savings cover some G dissaving
    - Sovereign debt largely internally held (unlike Greece)
    - Young population, high catch-up growth phase
    - Productive G expenditure required to enable supply response

M-T Fiscal Consolidation

- **Announced path of reducing FD**
- **Positives**
  - Growth → tax buoyancy; reduces debt ratio, B/Y
  - Change in b =(interest rate – inflation – growth rate) b_{t-1} + primary deficit ratio
  - Tax reform: DTC, GST; can reverse stimulus tax cuts
  - Government infrastructure spend: PPP, some improvement in institutions
  - Attempts to better target transfers (NREGA, UID) and improve governance

- **Negatives**
  - Expenditure management, delivery, organization poor
  - Composition of expenditure (capital expenditure 2% of GDP)
  - Debt 80% of GDP
  - Growth dividend wasted


Macroeconomic Variables and Government debt
50
40
30
20
10
0
-10
1991-92
1993-94
1995-96
1997-98
1999-00
2001-02
2003-04
2005-06
2007-08
2009-10
Primary deficit ratio
High real interest rate
High growth
Low inflation
Change in real debt ratio
Changein nominal debt

For Credible Fiscal Consolidation

- Change in composition towards expenditure that impacts supply
  - Human, social and physical capital
  - Inclusion reduces communal and identity politics
- Expenditure reforms: reduction in waste, leakages
  - Better targeting of transfers
- Any permanent rise in G linked to specific tax resource
- FRBM: plus caps and targets for ministries
  - Better incentives
    - Deficit targets $\Rightarrow$ letter not spirit
    - Off balance sheet items
  - Countercyclical G: Cyclically adjusted fiscal balance
    - DSGE for EME: growth, tax revenue $\uparrow \Rightarrow$ G $\uparrow$; experience
    - Reduce temptation to increase spending if growth high
  - G $\uparrow$: temporary, targeted and timely; monetary accommodation OK
- Better monetary and fiscal coordination: cyclical adjustment and growth

Good luck or good management?

- Good luck: Transitional catch-up process: potential growth 8-9%
  - Reached a critical threshold; multiple growth sources; diversified growth
  - Openness; technology; demographic profile; hard work; enterprise
  - S, I rates high almost 40 percent of GDP; infrastructure cycle

- Good management
  - Escaping crises
  - Steady improvement in institutions, regulation, markets

- Improvements: adapting macroeconomic policy better to structure

- Recognize: sequenced reform as a better reform strategy, not a failure of reform