Business Standard

Subir Gokarn: The monetary-fiscal battleground

An effective monetary policy rule requires an effective fiscal policy rule

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The Reserve Bank of India's (RBI's) Expert Committee to Revise and Strengthen the Monetary Policy Framework, chaired by Deputy Governor Urjit Patel, submitted its report last week. Broadly, it recommends that inflation, as measured by the consumer price index (CPI), be targeted in the range of two and six per cent, suggesting a three-year time frame in which to achieve the mid-point of the range, that is, four per cent. It recommends a number of financial market reforms to facilitate monetary transmission. It also proposes a formal monetary policy committee structure for taking monetary policy decisions, comprising six outsiders and three insiders, each having one vote. Overall, the changes are significant, constructive and generally consistent with contemporary practice in a wide range of countries, many of which are reasonably comparable with India.

The critical question, however, is whether the transition will effectively solve India's current inflation imbroglio. The answer to this depends entirely on the broader macroeconomic context in which monetary policy is formulated. The report itself makes some key recommendations for the fiscal domain, which together constitute an admission that a monetary policy framework is only as good as the fiscal policy framework allows it to be.

But, before getting into the substantive issues that the report raises in this regard, consider the irony of the finance ministry's reported reactions to the recommendations. For several years now, the RBI was criticised for resisting essentially similar proposals made by a number of committees and commissions, at least two of which were instituted by the ministry itself. Now, when the RBI itself switches sides, the ministry apparently feels that at least some of its more significant recommendations are inappropriate!

The main bone of contention is that targeting consumer inflation in today's conditions will lead to a permanently contractionary monetary stance. The committee's recommended target range is based on two analytical foundations. One is an estimate of a "threshold" rate of inflation, above which there are risks that inflation will spiral upwards. The other is an assessment of the historical pattern of growth and inflation, from where it is deduced that the proposed range is consistent with the so-called "zero output gap" scenario, in which the economy is growing at a rate equal to its capacity to do so without causing inflation to accelerate.

Both these premises could be challenged, but that is another story. The point here is that an inflation-targeting framework requires the central bank and the government to enter into a compact on the target rate. The ministry's reaction to the recommendations could be construed to mean that it thinks the target range is too restrictive. If so, then it needs to come out with its own acceptable inflation measure and range and the analytical foundations for it. This is essential for an effective transition of the policy framework.

Coming to the fiscal references in the committee's report, there are three significant ones. First, there is the familiar refrain that the government should quickly get back to a fiscal trajectory consistent with the now-lapsed Fiscal Responsibility and Budget Management (FRBM) Act. This calls for a zero revenue deficit and a fiscal deficit of three per cent of gross domestic product, entirely devoted to asset formation. After having come within

range of this target in 2008, the fiscal arithmetic has regressed considerably and only some drastic re-engineering - including, preferably, the implementation of the goods and services tax - will work. The question is whether this is possible within the three-year time frame proposed by the committee to achieve the mid-point of the target range. In essence, a monetary policy rule such as the one proposed is most effective when there is a fiscal policy rule in place as well.

Second, the committee also recommends that the government's current practice of postponing required adjustments in administered prices be done away with. This is a huge impediment to monetary policy effectiveness, because it significantly distorts the measurement of inflation. Long periods of stability in, say, fuel prices, followed by a large lumpy revision, understate headline inflation first and then overstate it. While it is analytically possible to correct for this to some extent, the headline number is what sticks in people's minds and on the basis of which policy effectiveness is judged. So, will the government co-operate in raising (or lowering) petroleum, coal, fertiliser and other prices, in the process surrendering the presumed political benefits of discretion in this regard?

Third, and particularly important, is the recommendation that the statutory liquidity ratio (SLR) be re-structured to become compliant with the "liquidity buffer" concept proposed in the Basel III prudential framework. This requires two things to be done. The ratio itself, currently at 23 per cent of net demand and time liabilities, needs to be brought down sharply - in fact, the mandate itself needs to be ended. And the exemption currently enjoyed by the banks from marking the value of securities held by them to their market value will have to be terminated. You cannot call an asset "liquid" if it is not valued at its market price. These changes will unquestionably cause some turbulence in the balance sheets of banks and will need to be phased in. But this is the less significant problem.

The SLR is a captive source of borrowing for the government. The combination of the mandate and the mark-to-market exemption serves to reduce its cost of funds. The recommended changes will even out the playing field, leading to borrowing becoming more expensive for the government. Of course, this might induce it to borrow less, which is good, but then again, it might not, which will simply aggravate fiscal stress. How will the government take to such a weakening of its claims on the banking sector's funds?

Ultimately, the effectiveness of any policy framework depends on its consistent achievement of targets. It will do nobody good if a monetary policy committee is to submit every quarter an inflation report saying that they failed to meet the inflation target, but it wasn't the fault of the monetary policy; fiscal excess, inefficiently adjusted administered prices and a transmission mechanism hindered by the burden of the SLR were the reasons why the target couldn't be met. With a conducive fiscal environment, many monetary policy rules will be effective; without it, none would be. Context is everything.

The writer is director of research, Brookings India, and former deputy governor, Reserve Bank of India. Views are personal