Talking Points

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FISCAL, MONETARY AND FINANCIAL SECTOR POLICIES: PRACTITIONER'S PERSPECTIVES ON INTERFACE

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I am thankful to the Centre for Economic Policy and Public Finance (CEPPF) for inviting me to deliver the 10th Anniversary Address in the august presence of Deputy Chief Minister, Mr. Sushil Kumar Modi. I must congratulate the CEPPF, in particular, Professor Shaibal Gupta on the commendable work done in a span of ten years. I am here to demonstrate my support to the CEPPF in all its activities. I wish the CEPPF on its 10th Anniversary a well deserved and productive future.

The Global Financial Crisis (GFC) was the most significant event in the economic history of the world since Second World War. The impact of the GFC on the world economy is well known. In addition, GFC has influenced

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he mainstream thinking on fiscal, monetary and financial sector policies. Prior to the GFC, the emphasis was on independent monetary authority and financial regulation. After GFC, flow of information between the concerned at a minimum and coordination arrangements between them are considered desirable. But, there is a confusion about the balance between independence and inter-dependence. In India also, there is confusion but in a different context. This is evident from the recent tensions between RBI and Government in matters relating to monetary policy and regulation, in the context of fiscal stress. In the 10th Anniversary address today, I will explore the interface, mainly in Indian context.

Fiscal policy, for all practical purposes, deals with government revenue collection, expenditure and borrowings to influence the economic activity. Monetary Policy relates to the quantity of money available and the cost at which borrowing can take place in order to influence the economy in particular, by ensuring price stability. The monetary authority of a country, the central bank, is entrusted with this task by the Government. Financial regulation policy deals with the laws and rules that govern the functioning of financial institutions, financial markets and financial instruments, in order to influence the economy by ensuring orderly markets and promoting financial stability. Regulatory authorities or a central bank in some cases, are entrusted with the task by the Government.

The first section of the presentation gives some illustrations of interface, namely, how each of the three impacts the other. The second section summarises the global thinking and practices on the subject during pre Global Financial Crisis (GFC) and post-GFC period. The third part elaborates the evolution of practice in India during pre-reform period, and post reform period including the new coordination (2010) and new monetary policy framework (2016).

Interface:

The monetary operations of central banks impact fiscal position in several ways, and similarly fiscal measures do impact the conduct of monetary policy.

Firstly, most of the open market operations deal with government securities, and so they impact supply of and demand for government securities, in the financial markets. This will naturally have implications for government debt management with fiscal consequences. Secondly, the cost of borrowing by the government at any particular point of time will be influenced by the stance of the monetary policy since the setting of policy interest rates is a monetary function. Thirdly, interventions in foreign exchange markets and the management of forex reserves have often quasi-fiscal costs with ill defined benefits to the overall economy. Fourthly, the surplus of income over expenditure on account of monetary policy operations, accrue to the government and get transferred to the government at some stage. Finally, the central banks are required to provide liquidity as a lender of last resort, but it is well known that the boundaries between liquidity and solvency are somewhat thin. The potential burden on tax payers in case of risks that arise out of lender of last resort operation will have to be borne by the government.

Fiscal policy has implications for conduct of monetary policy. The level of issuance of government bonds is an important consideration for conduct of monetary operations. If government bond markets dominate financial market, signifying fiscal dominance, the central banks market tactics will have to be in consonance with the fiscal strategies. Further, the domestic assets of central banks are essentially government securities and the level of such securities held by the central bank is determined by the supply and demand for such securities in the financial markets. The choice of maturity of government securities also influences the yield curve and the transmission of monetary policy.

The links between regulation of financial sector and fiscal management have evolved over the years. Regulators prescribe liquid assets to be maintained by the regulated and these are mostly government securities. Thus, the regulatory requirements of liquid assets to be held, is an important link between public debt and financial sector regulation, in particular, banking regulation. The use of regulatory instruments in support of public debt is not uncommon; a good example being high level of Statutory Liquidity Ratio in India. Other Regulatory prescriptions such as directed lending and mandated subsidised lending are also used as support to fiscal policy.

Some of the regulatory objectives can also be met through or with the support of fiscal measures. Fiscal policy especially taxation can nullify or reinforce the regulatory intent. Financial transaction taxes are a prime example of using fiscal measures for objectives of financial stability. More generally, taxes can be used for curbing excessive speculation and thus supplement measures of the regulatory authorities in favour of stability. The Tobin tax, a tax on the transactions in forex markets, is a good illustration of fiscal measures with regulatory intentions.

The monetary policy measures affect some regulatory aspects of the financial sector especially banking sector. The monetary transmission occurs essentially through the financial institutions and the financial markets, in particular, banking sector, and hence relevance of regulation for monetary policy.

In brief, the three policies like all other policies have an over-arching objective of welfare with each policy having its own defined set of objectives and appropriate operating instruments to achieve the specified objectives. It is believed that one of the contributing factors to the Global Financial Crisis (GFC) was the underestimation of the inter-dependence of these policies, and over-emphasising their independence.

Global Practices:

The thinking on relative roles of fiscal, monetary and regulatory policies that predated the GFC may be traced to 1970s. At that time the Bretonwood system collapsed with USA opting out of it, the huge oil price increase occurred, Euro Dollar market emerged and hyper inflation was feared, particularly in advanced economies. The government budgets were already under strain. These cumulatively resulted in emphasis on (a) fiscal consolidation, (b) assigning price stability exclusive or a dominant place in monetary policy objectives along with independence to central banks and (c) deregulated and liberalised financial sector regulation.

With the eruption of the GFC, immediate coordination became inevitable with the sole objective of avoiding a depression and suffering. Coordination had to take place among the policies at country level and among the countries at the global level. In parallel, the issue of institutional arrangements and the overall thinking on redefining the respective roles of policies and their inter-relationship in normal times emerged. There is no consensus as yet on a new approach, but several modifications to the pre-GFC approach have been conceded.

The rethinking provoked by GFC about the basic framework of the three policies in the Advanced Economies may be summarised as follows. Exclusive focus of monetary policy on price stability had its pitfalls. It has become clear that financial stability considerations, in particular, the asset prices, cannot be ignored. The possibility of excess liquidity provided by the monetary authorities for a prolonged period impacting the excesses in finance is noted.

The assumption that financial markets correct themselves and have a benign influence on growth is questioned. The incentive mechanisms in the financial institutions and the possibility of excessive financialisation in the financial markets are recognised.

Fiscal stimulus to avoid a crisis was undertaken through monetary policy, was the first line of defence. However, there is a view that fiscal activism may be warranted now since effectiveness of monetary policy is in doubt at this stage.

The most significant development is the recognition of need for interactions between policies and the need for continuous flow of information and arguably coordination on a continuing basis. As a consequence, in almost all countries, coordinating mechanisms have been made explicit and they have been brought under the government or under the overall umbrella of the central bank.

Indian Experience: **Pre and Post Reform**

The BoP crisis in 1991 prompted economic reforms. The reforms include fiscal stabilisation, according a degree of autonomy in conduct of monetary policy and deregulation of financial sector. They also included marketisation of government borrowing programme, adoption of global standards of banking regulation and establishment of separate capital market, insurance and pension regulatory bodies.

Fiscal policy consolidation broadly followed global consensus but in a gradual manner. Some fiscal transparency and fiscal rules have been attempted through the Fiscal Responsibility and Budget Management Act enacted in 2003 with appropriate technical support from a working group of RBI.

The RBI entered into agreements with the Central Government beginning 1993-94, to phase out issuance of ad hoc Treasury Bills and eliminate it altogether from April 1997 substituted by Ways and Means Advances (WMA) within limits, putting an end to the era of automatic monetization of budget deficits. This provided greater manoeuvrability to RBI in monetary management. It is true that Reserve Bank open market operations often have the effect of monetising the fiscal deficit, but that is done through market mechanisms; and is not automatic or at the instance of Government or at predetermined terms. Incidentally, since 2003, the asset composition of RBI balance sheet shifted in favour of foreign assets; thus reducing the share of RBI as holder of Government securities. As regards monetary policy, RBI unequivocally rejected inflation targetting as a single objective. It did not share the enthusiasm for capital account convertibility and decided to manage impossible trinity.

From 2004, the government and the RBI had to face unfamiliar challenges. These related to large capital inflows, unprecedented expansion in credit, asset bubbles and absorption of a highly elevated oil prices. These resulted in some tensions between the government and the RBI in the areas of monetary management and external sector but fiscal consolidation was noticeable. While concerted action was possible for strengthening the private sector banking system, the regulatory actions of a prudential and counter-cyclical nature by the RBI were undertaken despite some resistance from government and financial markets. The reforms in the direction of empowering RBI and marketising financial sector continued.

There was some divergence between global thinking and the Indian policies during 1993 to 2008. RBI continued as full service central bank, unlike in U.K. where regulation was entrusted to Financial Service Authority, distinct from central bank. The objectives of monetary policy in India continued to be price stability and credit for productive activities with relative emphasis, depending on the context. Inflation targetting was not adopted in India though importance of inflation expectations was recognised. Dominance of banking, in particular, public sector continued though presence of private sector increased. There was a cautious deregulation of the banking sector. Counter-cyclical prudential policies were followed, and capital account was managed.

Relevant Features of Reform

There are several features of the reform that are noteworthy from the point of view of interface. First, the Government shed its authority in regard to financial and external sector to the RBI regulators, and markets. RBI gained operational autonomy, aligned the policies with Government and worked closely with Government on structural changes. Often as in the case of end to automatic monetisation and exchange controls, practice preceded legal mandate.

Second, the Reserve Bank of India played an active role as advisor to Government in all aspects of reform of financial sector. For example, financial sector reforms were based on a Committee headed by a former Governor, Narasimham; reform of Insurance sector by a Committee headed by a former Governor, Malhotra; the external sector reform was based on the Committee headed by Rangarajan and later by Tarapore, both central bankers. The Fiscal Responsibility Legislation was based on the technical work done by the Reserve Bank of India.

Third, as the reform progressed, the coordination function at an operational level was assigned by the Government to a Committee on Capital Markets headed by the Governor, with regulators as members and the Joint Secretary, Ministry of Finance, as Convenor.

RBI's balance sheet was strengthened through negotiations with fiscal authorities, thus enhancing the effectiveness of policy reform. Firstly, in the early 1990s, the Reserve Bank of India incurred heavy losses due to extending exchange guarantee for non-resident deposits. The Government took over the liabilities to give relief to the balance short of RBI. Secondly, in the late 90s, the accumulated adhoc treasury bills at concessional rate of interest had to be converted into marketable securities by the RBI for which there was a fiscal cost. It was met out of RBI's surplus of income over expenditure to avoid burden on fisc. The marketable securities were required for sterilisation operations. Thirdly, since 2004, as part of the management of capital account, the cost of stabilisation which had to accompany forex intervention was shared between fiscal and monetary authorities through the arrangement of Market Stabilisation Scheme. A common thread in all these arrangements was that they were intra public sector transactions that were transparent and strengthened effectiveness of public policy. All of them strengthened the balance sheet of RBI to enable it to serve the economy and government.

In regard to regulation, however, Narasimham Committee's major recommendation that there should be no dual control over banks has not been implemented. Government continues to be a privileged owner of enterprises in the financial sector – thus constraining the regulator's effectiveness.

The Governance structure of RBI and the newly established regulators do not enjoy autonomy, in law. All senior appointments are at the discretion of Government and their services can be terminated without giving notice and without assigning any reason. While serving officials of Government cannot vote in RBI Board, in regard to regulators, serving officials are active with full voting rights. But, in fact, they exercised autonomy because policy of Government preferred to allow freedom till 2010.

The overall thinking in Government about reforms changed from the moment Raghuram Rajan Committee gave its recommendations in 2008; and Justice Sri Krishna Committee gave its report in 2013. The influence of RBI on the general thinking on reformed changed and a new framework took its place.

New Framework: Coordination

With the establishment of Financial Stability and Development Council (FSDC) in December 2010, all coordination functions are directly with the Ministry. The Union Finance Minister is the chair person of the Council. The members include the Governor, four Secretaries to Government, a Chief Economic Adviser and four Heads of Regulatory bodies. The Council has been made responsible for financial development, financial stability, financial literacy, financial inclusion, and most important, inter regulatory coordination.

New Framework: Monetary Policy

The legislative mandate for a new monetary policy framework in India has been provided by amendments to Reserve Bank of India Act. This came into force in June 2016. The primary objective of the monetary policy now is to maintain price stability while keeping in mind the objective of growth. The monetary policy framework in India has to be operated by the Reserve Bank of India. The central government under the new framework determines the inflation target in terms of consumer price index once in five years. The regime is described as flexible inflation targetting because the target is 4 per cent, but with upper tolerance level of 6 per cent and the lower tolerance of 2 per cent. The Monetary Policy Committee consists of three members including the Governor from the RBI, and three outside experts nominated by the government through a procedure prescribed under the law. In sum, the new monetary policy framework represents the global practice of monetary policy, namely, independence to pursue the objective of price stability.

New Reality

FSDC makes the Government responsible for financial sector development and stability. In emerging market economies, the instability in the financial sector co-incides with political instability. Hence, the government will find it difficult to handle the issues of financial instability when the source of instability is the instability of the government itself. Further, as in the most emerging market economies, adequate technical expertise is concentrated in the central banks relative to government or research bodies.

The government by virtue of its role as a coordinator and at the same time as the owner of the regulated entities puts / makes the central bank and the regulators somewhat ineffective unless they are on the same wave length as the government. The financial intermediaries in banking, insurance and even non banking mutual funds, etc. continue to be dominated by the presence of public sector. Hence, the regulators' standard tools are ineffective.

The government has the tradition of utilising financial sector in particular bank deposits, as an extended arm of the budget without the

Parliamentary oversight. The fiscal stress has the potential to influence the relationship between the regulator and the government owned regulated, the later having fiscal implications.

In the past, the Reserve Bank of India pursued multiple objectives and the Deputy Governor was closely associated with the formulation of the monetary policy. Under the new regime, the financial stability considerations are not explicitly taken into account. In regard to external sector also, the stability considerations are not explicitly built into the monetary policy objectives. Is there a danger that the advantages of in-built coordination available in full service central bank been foregone? Is there an identity crisis because of the juxta-position of the MPC in a full service central bank?

The transmission of the monetary policy still depends on the banking system which is dominated by public sector banks. The standard tools of the monetary policy assume that the system responds on the basis of material and market oriented incentives and disincentives. However, (it is presumed that) Public Sector bank responds to monetary policy signals keeping broader public interest in view. The Finance Minister invariably addresses the public sector bankers after the monetary policy statement to guide the banks on their course of action. The effectiveness of "independent" monetary policy is blunted by the criticality of government owned banks for transmission of monetary policy.

The banking regulation has been coordinated closely with monetary policy in the past. Under the new regime, it is not necessary that they should be coordinated. However, in reality, the regulatory prescriptions take into account the need for ensuring smooth borrowing program of central and state governments.

The regulatory framework of banks is not neutral to ownership in the sense that governance of public sector banks continues to be determined by the government. The fiscal authorities use the banking system to implement some of the government developmental programs and RBI as a regulator does facilitate the use of public deposits with the banks for pursuing governmental programs.

Finally, with fiscal stress, the sharing of sceneiorage itself has become a bone of contention between RBI and Government. As per law, the dividend pay out to the government is to be made by a decision of the Board every year out of the surplus of income over expenditure after providing for the transfers of surpluses to the reserves, as required. In the recent past, however, it is manifest that fiscal considerations are driving the transfers of surpluses from RBI and, in fact, even the timings of the transfers wherein interim dividend was paid to the government, is unprecedented.

CONCLUSION

Globally, the policy-makers are in search of a framework that permits independence in policy but ensures that considerations of inter-dependence are built-in.

In India also, we are in search of a framework that reconciles the severe fiscal stress, independent monetary policy with a single objective, full service central bank, regulation of financial sector, dominated by public ownership, strong presence of government in the governance of the relevant institutions and finally coordination resting with Finance Ministry in the Government.

There are compelling reasons to review the new framework keeping in view global developments and our experience so far.

Firstly, the understated fiscal stress in recent past reflects lack of transparency. The combined fiscal deficits of the Centre and States are high. It conceals the rising stocks of contingent liabilities. The situation could be described as fiscal dominance with a vengeance that undermines efficient functioning of monetary policy and regulation of financial sector. The recommendations of the XIV Finance Commission to establish an independent Fiscal Council in Union Government should, therefore, take highest priority.

Secondly, framework of inflation targetting has served its narrow objective of containing inflation though it is yet to stand the test of cyclical fluctuations in global economy, especially oil prices. Strict adherence to inflation targetting with inadequate fiscal rules, has potential for impct on stability or growth, or both. The external sector balance seems to be under stress presumably because of inadequate attention to it in the new framework. There are indications of pressure on financial sector stability including in non-bank financial companies. In aggregate, these may warrant a review of efficacy of inflation targetting as a single objective and reiteration of Reserve Bank of India's identity as a full service central bank.

Thirdly, despite the recommendation by the Narasimhan Committee in the early 1990s that the dual control over the commercial banks should be done away with, not much has happened. Consequently, the Reserve Bank of India is constrained in its regulation and supervision of these banks unlike the private sector banks. Overall efficiency of financial intermediation cannot improve to meet demands of global uncertainties and compulsion of financing high growth till public sector banks are corporatised and subjected to provision of Company Law and regulation of RBI on par with private banks.

Finally, the coordination function with the government tends to be used to serve the fiscal dominance rather than macro stability especially because of the limited expertise available in the Government and the political compulsions prevalent in the country. The interdependence between fiscal, monetary and regulatory policies in Indian conditions and global uncertainties demand continuous coordination between the three. There is a strong case to reconstitute the Financial Stability and Development Council with Governor as the Chairman while continuing the secretariat in the Government.

Let me conclude by wishing the CEPPF a happy Tenth Anniversary and a bright future.