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Macro framework for financial reforms

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India's macroeconomic policy framework has worked quite well in delivering high growth and low inflation this decade. Why fix what ain't broke? And why at a time when monetary policy has enough problems to cope with — rising inflation, large capital inflows, and spillovers of financial instability from abroad? Besides, aren't macroeconomic reforms a distraction from the urgent business of financial sector reforms?

Let us start with the last question. The links between macroeconomic management and financial development are deep and run in both directions. Disciplined and predictable monetary, fiscal and debt management policies create a foundation for financial sector reforms. A well-functioning financial system, in turn, is essential for the effective transmission of macro policies. Thus, it will be necessary to move forward on both fronts to get results.

Why now? The simple answer is that the economy's increasingly complex structure and its rising integration into global trade and finance have created new challenges. The macro framework has to adapt to meet these challenges.

Cross-border capital flows have generated huge complications for monetary policy. Both inflows and outflows have ramped up and are likely to remain large and volatile. This is a reality that policymakers will have to live with.

Reimposing capital controls is not a good option; even existing controls are losing their potency as agile investors invariably find ways to evade them. The only viable alternative is to have predictable and consistent policies that at least do not create volatility themselves and that give policymakers the flexibility to respond rapidly to shocks emanating from abroad.

The process of capital account opening can, in fact, serve as an adjunct to other reforms if handled adroitly. For instance, allowing foreign investors to participate more freely in corporate and government debt markets could increase liquidity in those markets, provide financing for infrastructure investment, and reduce public debt financing through banks.

The recent bout of rupee appreciation has revived calls for exchange rate management. This is not easy when the capital account is relatively open. The pressures eventually come home to roost in domestic inflation or sudden spurts in the nominal exchange rate.

Foreign exchange intervention to keep the rate stable has its limits as the costs of sterilising inflows — so they don't feed into domestic liquidity — increase rapidly. Sustained intervention can also create unrealistic expectations about the RBI's ability to manage multiple objectives with one instrument.

What are the options for monetary policy? The RBI has done a good job of managing the multiple mandates foisted upon it — keeping inflation under reasonable control, holding back some of the pressures on the exchange rate and coping with capital inflows, all against the background of strong growth. But this high-wire act may have reached its limits.

Focusing on a single objective — low and stable inflation — is the best way that monetary policy can promote macroeconomic and financial stability. Let us dispel some myths about this approach. First, it does not mean sacrificing or ignoring growth. Indeed, well-anchored inflation expectations constitute the best tonic that monetary policy can provide for growth. There is no long-run tradeoff between growth and inflation, and for monetary policy to try and engineer a short-run tradeoff can be dangerous.

Under an inflation objective, growth would not be ignored; rather, it would influence monetary policy actions through its effects on inflation. There is also no reason for an inflation objective to create a deflationary bias; inflation below the objective would invite interest rate cuts just like inflation above it would invite increases.

Along with measures to sharpen implementation (using policy interest rates as the primary instrument) and increase transparency, the inflation objective would make monetary policy more effective and strengthen the RBI's hands rather than pinning them down.

Fiscal policy is a wildcard. There has been encouraging progress in reducing the budget deficit, but perhaps this is just a cyclical improvement due to a strong economy. The farm loan waiver and the generous Pay Commission report raise serious concerns about whether fiscal rectitude will fall prey to the election cycle.

Durable reductions in the fiscal deficit and public sector borrowing requirement are crucial to reduce the constraints on monetary policy and allow financial sector reforms, especially banking reforms, to proceed.

The principal elements of this framework—strengthening fiscal, financial and monetary institutions—would reinforce each other. Ultimately, this whole package will be essential to boost NextGen financial reforms, prepare the economy for the complex challenges that lie ahead, and create a foundation for high and sustainable growth.

(The author, a professor at Cornell University, was a member of the research team for the High-Level

Committee on Financial Sector Reforms)