Analysing the Raghuram Rajan Committee Report on Financial Sector Reforms

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The Raghuram Rajan Committee has articulated "GenNext" reforms for fixing the problems of the financial sector. This note questions the relevance of the macroeconomic framework of the committee and argues that moving towards price determinacy via interest rate pegging is fallacious in the Indian context.

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The Raghuram Rajan Committee on Financial Sector Reforms (hereafter CFSR) has placed its draft report on the Planning Commission web site for public debate. The mandate of the CFSR has been to "outline a comprehensive agenda for the evolution of the financial sector". The report delineates "A Hundred Small Steps" to reform India's financial sector. The fascinating part of the report is its articulation of "GenNext" reforms related to financial inclusion, stability and growth within a macroeconomic framework it thought appropriate in the Indian context.

Before one comments on the relevance of the CFSR's macroeconomic framework, the major highlights of the report may be in order. To start with, one cannot agree more with the CFSR on the need for a disciplined and predictable monetary, fiscal and debt management policies for the success of financial sector reforms and, in turn, the critical importance of a well-functioning financial system for macroeconomic stability. Also there cannot be two opinions on the need for financial inclusion. The CFSR delineates a plethora of measures for financial inclusion, recognising that access to credit rather than cost of credit matters for the nearly three-quarter of poor households who are outside the purview of banking in India. This is all the more true when the report acknowledges that the poor engage in credit dealings with the indigenous moneylenders at an exorbitant interest rate, which is well above the mandated lending rate for banks.[1] While advocating GenNext reforms, the CFSR emphasises the significance of a well-functioning regulatory mechanism and strongly argues for establishing new regulatory institutions and new legislative fiats for fixing the financial sector.

Narrow View

The report is neatly organised into eight chapters, focusing on the multifold issues related to the macroeconomic framework of financial sector reforms, financial inclusion, a growth-friendly regulatory framework and level playing fields for financial sector reforms and also the measures to create an efficient and liquid market, and establish robust credit infrastructure. However, the devil lies in the details. As observed by Acharya (2008), the macroeconomic framework of the CFSR is curiously academic and aloof from the realities of the Indian macroeconomic setting and experience, and the narrow view of macroeconomics adopted by the committee leads it to a surprisingly adventurist recommendation that "(the) RBI should have a single objective of low inflation". Unpacking the recommendation further, the CFSR states:

> The RBI should formally have a single objective, to stay close to a low inflation number, or within a range, in the medium term, and move steadily to a single instrument, the short term interest rate (repo and reverse repo) to achieve it.
>
> [Proposal 1, page (5), CFSR].

This implies that the CFSR recommendation broadly conforms to the "fiscalist literature" that price level indeterminacy problems can be solved by having the central bank peg the nominal interest rate at a level consistent with the central bank's desired inflation rate, rather than by controlling the growth rate of the (base) money supply. The question arises; can the RBI really stabilise future inflation in India by changing interest rates in response to inflation and should that be the only objective of the central bank of a developing country like India?

If we look at it theoretically, the Taylor rule of inflation targeting says that inflation is determined when the central bank systematically raises nominal interest rates to more than one-for-one with inflation and the output gap. This "active" interest rate target is supposed to eliminate the price indeterminacy that results from fixed nominal interest rate targets. However, inflation could be as indeterminate under "active" interest rate targets as it is under standard fixed interest rate targets [Cochrane 2001]. Inflation targeting, among many other things, also requires the operation of monetary policy by an "independent" central bank. Prescribing

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inflation targeting, the CFSR thus wants the delinking of fiscal from monetary policy operations, leave aside the concern whether inflation targeting suits a country with a contra cyclical fiscal policy.[2]

Monetary Targeting

So far the RBI has responded to a spectrum of interactive multiple objectives. It is interesting to recall here the Sukhamoy Chakravarty Committee (1985) recommendation for "monetary targeting" which was inevitably meant to accommodate not only the price stability objective, but also to capture the complex interaction of the objectives of monetary policy; placing this policy within the context of the entire economy. The concept of monetary targeting that the committee used was very different from what was being advocated in other countries. To quote the Chakravarty Committee (1985), "The phrase monetary target is not necessarily to be equated with rigid targets. Only pure monetarists might view monetary targeting as being nothing other than an inflexible rule. What the committee has advocated is *monetary targeting* with feedback." In practical terms, this implied that target ranges had to be modified in the light of the information available on expected output performance, which might be a consequence of several factors, and there is a great deal of ignorance in India on what constitutes monetarism [Rangarajan 2001]. However, the CFSR strongly recommends a shift from monetary targeting to inflation targeting.[3]

Whatever were the reasons for the acclaimed failure of monetarism, the recently developed "fiscal theories of price determination" (hereafter FT) contend that there is an important class of policy rules in which there exists a unique rational expectations solution that shows the price level to be dependent upon (non-Ricardian) fiscal policy and independent of monetary variables. However, if the central bank chooses to accommodate fiscal tendencies, may be due to political pressures, FT is consistent with Friedman's dictum (that "inflation is always and everywhere a monetary phenomenon"), as this is a case where there is no basic dispute between monetarists and fiscalists. What is at issue is the fiscalist claim that the price level is fiscally determined in cases in which the central bank refuses to be accommodating and keeps the monetary base on its predetermined path (a case which breaks any link between money growth and inflation). With a growing monetary base, the price level could explode relative to the money base path – as fiscalist solution implies – or conforms to the money base path as in case of monetarist analysis [McCallum 2001]. However, the policy conclusions drawn from the fiscal theory of the price level would be harmful as it implies that a government could exogenously fix its real spending, revenue and seigniorage plans, and the result could be painful fiscal tightening, government default or unplanned recourse to the inflation tax [Buiter 2001].

The meticulous taxonomy of FT throws up dual conjectures: a weak conjecture, where the fiscal theories are consistent with Friedman's dictum; and a strong conjecture of FT in which fiscal policy affects the price determination independent of the money supply process, with special reference to the case of interest rate targeting in which money supply is endogenous. The CFSR focuses on the strong conjecture, especially when the central bank no longer accommodates fiscal tendencies through indefinite monetisation of deficit. Thanks are due to the Chakravarty Committee which paved the way for the historic agreement between the central government and RBI to phase out the monetisation of the fiscal deficit. Theoretically, even the shift in the financing mode of the fiscal deficit from seigniorage financing to bond financing may lead to the eventual monetisation or an "unpleasant monetarist arithmetic" if the government solvency constraint imposes an upper limit on public debt.[4] When such a financing constraint forces the fiscal policymakers to finance its deficit through the monetisation, any attempt to lower the inflation rate today, even if successful, will require a higher inflation rate tomorrow. The dual assumptions beneath such a framework are a fiscal policy dominance and that the demand for bonds has an upper bound. As made explicit by Sargent and Wallace (1981), under such situations the only choice available to the central bank is not whether to monetise a government deficit but when – now or later, which implies that *tighter money now can mean higher inflation eventually.*

Though the "monetarist arithmetic" has not been unpleasant so far in India after liberalisation, the monetary base did not remain at the predetermined path, even when the central bank refused to accommodate the fiscal tendencies. Despite the attempts to reduce the seigniorage financing of deficit, the reserve money growth has remained steady in India due to the increasing share of net foreign exchange assets (NFA) of RBI in reserve money creation. It was the prime context in which the monetary stance began exchange rate pegging as well, as the external sector for the first time became the main cause of expansion of monetary base in India. Now, the monetary policy stance in India stands again at the crossroads, when the CFSR recommends that it should focus only on inflation, leaving behind all other objectives of monetary policy.

While there is a broad consensus over the fact that price stability should remain the main objective of monetary policy in India, reservations linger about endorsing it as the only objective. The CFSR recommends that in the context of surging capital flows, the monetary policy stance should maintain price stability through interest rate pegging, leaving the exchange rate to be determined by the market.[5] When capital inflows create a "trilemma" (which is otherwise referred to as the "impossibility of trinity" in maintaining an open capital account, a fixed exchange rate, and an independent domestic monetary policy simultaneously), ideally what could the central bank be doing in India to avoid an unholy trinity of financial contagion? The dual recommendations of the CFSR in this context are for full operational independence to RBI to achieve the inflation objective through legal fiat; and an inevitable de facto opening of the capital account.

Capital Account

Theoretically, the case for capital account liberalisation significantly rests on the "efficient market hypothesis", which assumes that the prices of financial assets are a rational embodiment of all the known information about prospective

returns from the asset. It is an empirical question whether the disequilibrating effects on financial markets of speculative behaviour of "noise traders" are only a temporary phenomenon in India, while the uncertainty elements in financial markets are of the "white noise" kind. Capital account liberalisation is also associated with the risks of financial contagion, capital flight and the possibility of a sudden precipitous devaluation of a country's currency. Reservations still persist with regard to whether India should go for a wholesale capital account convertibility as it is subject to important caveats relating to moral hazard, asymmetric information and agency problems [Nachane 2007].

The CFSR recommendation for inflation targeting is myopic for many other reasons as well. For example, the short-term interest rate, the principal policy tool used to affect inflation in countries working with inflation targeting, does not have a significant effect on inflation in India [Jha 2008]. The apprehension is that even if RBI takes it up, it would not be able to go far because the term structure of interest rate has not yet become fully operational in India due to segmented financial markets, which further reveals a weak interest rate transmission channel. The lags in the interest rate-pass-through from the policy rate to reference rates constrain the operation of inflation targeting further.

More importantly, empirical evidence further reveals that inflation determination in India requires ingredients much beyond an interest-rate policy. The structural content of inflationary pressures in India, arising from the stochasticity in the supply-side determinants cannot be undermined. For instance, when inflationary pressures are predominantly caused by food and fuel prices, the adjustments in the repo rate cannot solve the price indeterminacy problems. Empirical evidence from an error correction model on price determination in India by Balakrishnan (1992) found statistical evidence in favour of structuralist variables. The statistical evidence favoured the structuralist model to the monetarist model, even when the model was placed in a Bayesian econometric framework [Balakrishnan, Rao and Vani 1994]. As pointed out by Rakshit (2007), it is extremely important to make a distinction between price increases, which reflect a movement towards a new equilibrium following a one-off shock, and continuing inflation due to some fundamental and enduring macroeconomic imbalance.

Lastly, the CFSR retains the notion that the "fiscal deficit is bad" and advocates rule-based fiscal consolidation as a significant prelude to inflation targeting. The CFSR thereby floats the disillusionment with the status quo of "fiscal dominance" in India and wants fiscal agencies to adjust to the anti-inflationary policy of an independent central bank. Is the CFSR facilitating an "unpleasant" fiscal arithmetic? Whatever it may be, it is erroneous to dot central bank alone for the price indeterminacy in India. Equally inappropriate is to recommend price stability as the sole objective of the monetary policy stance in India, that too via interest rate pegging.

NOTES

1 The credit dealings of the poor with the "bad lemons" in the market might also catalyse Ponzi schemes in the rural credit markets. While focusing on credit infrastructure (where the report gets into the areas where reforms are less controversial, but hundreds of small steps perhaps as important), the CFSR suggests that with the promulgation of the Warehousing Act, 2008, warehouse receipts can become a new, reliable form of collateral in the agricultural sector, where till now there was no other security except land, which has its own infirmities. The CFSR visualises that the advent of warehouse receipts system could expand agricultural credit by over Rs 1,20,000 crore based on the assumption that about 15-20 per cent of the annual agricultural produce is stored in warehouses. However, it is a matter of debate, as pointed out by Stigliz (1990), whether collateral based credit financing or "group guarantees" in lieu of tangible assets-based collateral through "peer monitoring" models of credit financing suits well the path of financial inclusion. Another innovative market-based solution to financial inclusion that the CFSR floats is a proposal for creating a market for priority sector lending through Priority Sector Loan Certificates. However, the point to be noted here is that at a time when the US economy is poised on the verge of a "Minsky Moment" (that point in a business cycle when a major asset sell off takes place leading to a collapse in asset prices and reduced market liquidity) that India thinks of wholesale (market-based) financial reforms.

2 Using the VAR-FPE framework, Chakraborty and Chakraborty (2007) showed that the fiscal policy is contracyclical in India.

3 Prescribing inflation targeting as the sole objective of monetary stance, CFSR identifies closely with the New Consensus Macroeconomics (NCM). One of the prominent clichés of the NCM approach is that it has replaced the quantity theoretic approach to monetary policy with a non-quantity theoretic approach of eliminating high levels of inflation by adjusting nominal interest rates to changes in the price level [Arestis and Sawyer 2003].

4 Theoretically the shift in the mode of financing of the deficit from seigniorage to bond financing may also result in crowding out via the rate of interest mechanism. However, empirical evidence showed that there is no real and financial crowding out in the context of India [Chakraborty 2007].

5 The rubric of CFSR argument is rooted in the context that "capital inflows lead to inevitable appreciation of the real exchange rate, leaving the country with the Hobson's choice of taking it as inflation or nominal exchange rate appreciation" (page 5, CFSR). This argument may be based on the fact that the process of central bank intervention in the forex market to sterilise the incremental liquidity has quasi-fiscal costs associated with it as it may impose the danger of raising the real interest rate, which can further induce the capital flows. However, it is an empirical question whether quasi-fiscal costs are significant or not in India. Such empirical probes of issues are conspicuously absent in the CFSR.

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