

***Envisioning India* Webinar at George Washington University, 9 Sep 2020**

titled

“Fiscal Dominance: A Theory of Everything in India”

(based on the Preface chapter of recently released book “[*Quest for Restoring Financial Stability in India*](#)”, SAGE India Publishing, July 2020)

by

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Below are detailed responses by Professor Acharya to questions posed by the commentators (Liaquat Ahamed, recipient of the 2010 Pulitzer Prize for History, and Dr. Rakesh Mohan, Former Deputy Governor of the Reserve Bank of India), as well as the webinar participants.

Q. With regard to the resolution of banking sector’s bad loans, did the government balk at the financial costs or the political costs?

A. It boils down to short-term electoral pressures one way or the other. As elections approached and growth had not been resurrected from the aftermath of demonetization and botched-GST rollout, temptations grew to simply rely on bank-fueled credit and liquidity stimulus (as with the previous government). Too large a credit and liquidity stimulus were, however, not possible as the central bank only made grudging compromises. Recall that oil prices rose sharply during April-Oct 2018 and at one point it was at \$85 per barrel with attendant inflation and current account deficit implications. One can assume that all this created pressure to raise funds from other avenues to distribute cash to the economy, a known feature of Indian election campaigns.

However, I stress that banking sector’s bad loans were NOT the only problem around which the central bank faced pressure then. The pressure was pervasive, *i.e.*, across the entire toolkit of the central bank (I provide in the Preface chapter of the book six examples of central banking policies where pressures were unrelenting). It cannot be denied though that the nexus of public sector banks and industrial firms was a large and salient underlying cause.

Q. Why not tell the full story in the book of how it exactly happened? It would be as interesting as an Agatha Christie novel.

A. This would indeed be useful to tell. The details would be important to know. I do not have knowledge of all the specifics. I was only a Deputy Governor. More importantly, I wanted to

keep the focus in the book squarely on the central bank as an institution and what is needed for it to be allowed to function at a distance from the pressures of fiscal dominance.

I continue to believe that even the grudging compromises we made as a central bank should be avoided in future through institutional mechanisms. The central bank should adopt greater reliance on rule-based and transparent policy-making (with records and reports) to thwart some of the pressures. The idea at times seems to be that some compromises will lead to cease-fire, but operationally, fiscal dominance works as follows: where the central bank compromises today is the starting point for negotiation tomorrow. James Foster (moderator) will no doubt confirm that there is some sound game-theoretic rationale for all this; indeed, dealing with fiscal dominance well is in essence an issue of the central bank playing the game (of chicken) with support from institutional fallbacks. I provide a possible roadmap to strengthen financial stability in India towards the end of the Preface chapter in the book. This was my main objective with the book.

Q. Was public sector bank recapitalization ever on the table?

A. It could have been. There was an occasional mention of it. But the post-demonetization and post-GST growth slowdown created a panic of sorts in the bureaucracy and the government; they started scrambling for short-term fixes. It is always expedient to turn to the central bank to accommodate growth through relaxation of bank regulations, adoption of easy monetary policy, payment of larger dividends from central bank balance-sheet, etc. I call this “phone central banking” and it has partly replaced behest lending by banks or “phone banking”. This creates a move away from thinking about what the country needs in the long-term.

This short-term "band-aid" approach to treating the economy is the long and the short of it all, in my view. It leads to mostly irrelevant tick-the-box type policy "reforms". This is what in the end prevents any significant movement in resolving the issue of what the country wants to do with its public sector banks (and other government-owned entities in the financial sector, such as in insurance, power, etc.).

Q. How did we get here in the first place?

A. It was the same short-run pressures taking hold of the then government around the 2009 election and thereafter, but that was induced by the global financial crisis and the accompanying global growth slowdown. The situation was qualitatively the same in 2018 as far as the short-run focus of the government on growth was confirmed; outcome could be considered similar, though I tend to think our resistance from the central bank to opening up credit and liquidity taps excessively prevented as worse an outcome as post-2009 from materializing. This was the main reason for giving the A D Shroff Memorial Lecture (contained in the book) on the importance of an independent central bank so as to induce a public discussion about the government pressures on us and their merits or lack thereof. The Lecture and ensuing discussion threw sand in the wheels of an "all-in" gamble for short-run growth. Of course, we aren't in a great place right now, I concede, especially given the COVID outbreak.

My key point is that we are here in the first place because our fiscal institutions are weak and the central bank's institutional framework for decision-making around financial stability is weak. At

a deeper level, therefore, I fault the quality of India's institutions. Government short-term pressures are always there in different parts of the world. There are leverage boom and busts elsewhere too. At least once it is patently obvious to everyone that one such boom and bust has just occurred, the central bank usually goes into a retribution mode and is allowed to anchor financial stability for a few decades thereafter. This did not happen in India.

My book is a pitch for strengthening the institutions governing our fiscal and financial stability so that we can avoid this repeated cycle and instead focus for once on structural reforms for the real economy (land, labor, agriculture, infrastructure, genuine ease of doing business, etc.).

Q. What will happen in the future given where we are?

A. The key challenge at present is to meet the fiscal needs for immediate repair and relief efforts relating to COVID which requires transfers to the most affected states, citizens and sectors of the real economy. It is crucial to create space for this expenditure; I believe this can be done best by restoring commitment to medium-term fiscal stability. I provide a possible roadmap for this towards the end of the Preface chapter. How this plays out in reality remains to be seen.

I also explain in the Preface that the reason fiscal dominance has reared its ugly head again after being so rampant in 70's and 80's is that India seems to be moving back towards an era of centralization and financial repression, which unfortunately bring along economic stagnation; worse, given India's supply side COVID-related issues, this can couple with inflation to give us the risk of stagflation. Indeed, the term "stagflation" is increasingly being mentioned in analyst reports and discussions.

Hence, it is crucial India reacts decisively – and with immediacy – to undertake transformational reforms on fiscal, financial and real sector fronts.

Q. Is re-privatization of public sector banks practical given the foreign ownership of private banks in India?

A. I published an op-ed today in Business Standard on how to fix the capital shortfall problem of India's public sector banks (https://www.business-standard.com/article/opinion/explained-how-to-solve-the-financial-sector-s-capital-shortfall-120090900070_1.html?1599597727). Therein, I suggest a possible plan:

- i. Bring down stakes in public sector banks to below majority, say 25%-30%;
- ii. Improve governance, incentives and risk-management at public sector banks by distancing the government from their operations;
- iii. Reprivatize fully the healthier public sector banks; and,
- iv. Prioritize the business model of weaker public sector banks to specialize in profitable but valuable functions such as micro-credit / micro-finance and reprivatize them fully in due course after improvement in valuations.

I tend to think it is doable and has to be done now as there is simply no other option that is not of great cost to the country's future. While private banks are indeed held by foreign owners, their

holdings are dispersed and I am not too concerned about such holdings. Indeed, given that government's fiscal deficits are large to absorb the entire economy's net savings, India may not have much of an option in the end but to allow equity flows of this type, given they are less fickle than debt flows.

Q. How bad have private sector banks in India been?

A. The problems of private banks in India have been ones of idiosyncratic governance failures and mostly resolved through management replacement, change of ownership, etc. Other well-run private banks have among the highest market to book ratios among financial intermediaries, not just within India but in fact *globally*.

As of now, capital surplus of private banks as a whole far exceeds the capital needs of public sector banks, based on some estimates we have constructed at NYU Stern (vlab.stern.nyu.edu/welcome/risk). Indeed, and in spite of being capital surplus, large private banks are raising capital proactively to deal with COVID-related losses, precisely because market discipline on them will be violent and the government pressures on the central bank to forbear on them won't arise as a hindrance to regulatory discipline.

Q. What has driven the recent fall in household savings in India that has made fiscal dominance pressures rise again?

A. This is a great question on which we don't have a clear answer. More research – both conceptual and empirical – is required.

The United States experience shows clearly that credit-fueled consumption by households does lead to reduced savings: household savings declined in the build-up to the global financial crisis and have risen substantially after the blow-up. It is easy to increase consumption if it is mostly being financed by borrowed money; in turn, households save less, as savings are not needed then to support future consumption... until it doesn't add up in the aggregate. It could be that this is the same situation in India as we have thrown much unsecured and secured credit at households, even though aggregate credit to GDP still remains low below 60%.

Another possibility is that with household wealth in real terms experiencing a decline in the past few years, households are closer to their consumption or financial constraints; so even though they would like to save more, they must pay greater attention to their immediate needs.

It is a complex but an important macroeconomic question to answer. Its ramifications are massive for fiscal dominance and how it will play out going forward.

Q. If fiscal dominance pressures are so strong, why not open up the economy, e.g., allow foreign residents to invest more freely in government bonds?

A. In general, I have always been in support of a calibrated opening up of the economy. However, the Rangarajan-Reddy “peking order” principle of what flows are most attractive and which ones the least deserves to be respected. Foreign direct investments and equity investments are less fickle and also more illiquid; in contrast, investments in government bonds (especially short-term) and dollar-denominated government bonds have the worst property in terms of

attracting hot money flows that might leave the country's shores at short notice when domestic or external macroeconomic disturbances materialize and create a depreciation spiral.

As such, India has been on a steady path since 1991 of a calibrated opening up of the external sector, more or less along these lines.

Q. Is independence in the letter of the law enough for the central bank to enjoy operational autonomy in its important functions?

A. The letter of the law is important as it is the fallback arrangement and determines the “norms” so to speak. For instance, the central bank should be able to regulate public sector financial firms (banks and non-banks) like private financial firms. Regulation should be ownership-neutral.

However, the letter of the law isn't enough. As Dr Y V Reddy, former Governor of the RBI, explains wittily in his masterful Foreword to my book, the RBI Act is among the weakest in granting autonomy to the central bank; nevertheless, it was easy to uphold financial stability in 70's and 80's when the government, the central bank and the public sector banks functions as a “Hindu undivided family” in which no one kept anyone's proper accounts! India was a centralized economy then so some of the costs of financial repression were not as critical and markets weren't sending adverse signals on imbalances, but this is no longer so (and even that regime was unsustainable as we witnessed with the balance-of-payments crisis).

Given the more private and decentralized nature of the economy at present, the central bank needs greater clarity of long-term purpose and objectives (deposit protection, price stability, external sector stability), adopt rule-based democratically accountable decision-making, and be willing at times to say no, speak truth to power, play the game of chicken to fend off fiscal dominance, lean against the winds, etc. Employing my favorite cricket analogy from the A D Shroff Memorial Lecture, the central bank must keep reminding itself and iterating to others that it must play the Test match and not a T-20. In the book, I call this the “Rahul Dravid” stance and approach to central banking. The burden to do all this has risen as fiscal dominance undercurrents are now stronger.

Q. Given that India's fiscal conditions haven't improved since 2016, was it a mistake to adopt the flexible inflation targeting framework? Was the adoption too premature?

A. My assessment is that the framework has done India much good. It was envisaged post the taper-tantrum episode of 2013. Recall that India had double-digit inflation and close to double-digit fiscal deficit then. External investors voted with their feet in the Summer of 2013. Inflation targeting has since anchored their – as well as household – inflation expectations steadily down.

The framework has also given the Monetary Policy Committee operational autonomy, without which a fiscal dominance of interest-rate setting process would have been easily achieved given the fiscal pressures of last few years. So rather than taking the view that the framework was a mistake, I suggest we assess the counterfactual of whether India's fiscal profligacy would have been even worse in the absence of an inflation targeting framework.

More broadly, rather than tinkering with the inflation targeting framework because the pre-requisites of fiscal and financial stability are not met, it would be better to focus on arranging these pre-requisites without any further ado. It takes time to build strong institutions; the inflation targeting framework needs to be given time to secure the gains where the central bank has built formidable credibility in sticking to its inflation-targeting mandate. The framework has already lowered the volatility of Indian Rupee substantially in foreign exchange markets compared to other emerging markets (e.g., Indonesia).

Strong institutions are needed, even on fiscal and financial stability fronts, to provide commitment to investors that India means business as far as *sustainable* growth is concerned.

Q. Finally, why not adopt an “inflation targeting framework” style approach for supervision and regulation?

A. I am totally for this form of approach. Regardless of the specifics of the framework, flexible inflation targeting is a well-designed institution that gives the central bank a mandate (with an exception or caveat), a policy tool, and a democratically accountable process. The biggest problem right now is that the central bank’s supervision and regulation have tremendous discretion that is never well-explained or written up in reports that can be held up to public scrutiny. This makes back-door compromises feasible all around, with the various constituencies. This shouldn't be so. That is a rather poor institutional design to safeguard financial stability.

Financial stability framework can be structured to follow meaningful targets with some room for well-explained exceptions and exceptions should have pre-set sunset clauses rather than evolving to be near-permanent status. The Federal Reserve system in the United States has improved its supervisory and regulatory framework substantially since the global financial crisis in this direction. Stress tests, for example, make much sense and the high level of bank capital as a result of these tests (even higher than Basel norms) has stood the United States in spite of the violence of the market reaction to COVID outbreak in March 2020.

I wouldn't say that the Fed has had a “Volcker moment” yet on financial stability, but India surely needs one where it simply takes the bull by the horn – as Paul Volcker did with arresting double-digit inflation – and holds on until the job of securing financial stability for a minimum of next few decades is complete!

Has COVID offered India that Volcker moment on financial stability?