

Flexibility in policymaking is desirable. But pragmatism can't be a licence for total discretion

Policy Wants a Cracker



C Rangarajan

There have been calls for pragmatism in the pursuit of monetary and fiscal policies. These echo the discussions that happened more than 80 years ago that centred around what was then called 'Rules Vs Discretion'. That was the time when the rule-bound 'gold standard' was abandoned and was replaced by the paper-based system of currency. What was needed then, and what is needed now, is a balance between 'rules' and 'discretion'.

These are days of accountability. Autonomous institutions must be accountable. For being accountable, a clear enunciation of objectives is necessary. Objectives also sometimes need a quantitative dimension. The concept of price stability lacks clarity without a quantitative dimension.

It is critical to look into how rules are evolved and whether they allow discretion. Take the case of fiscal deficit rule or mandate. The Fiscal Responsibility and Budget Management (FRBM) Act prescribes that the central government deficit should not exceed 3% of GDP. After the recommendation of the 12th Finance Commission, states also adopted legislations prescribing a limit of 3% of state domestic product. Thus, the overall limit taking states and Centre together is 6% of GDP.

This is very different from what

the Maastricht treaty set for the EU countries. It was 3% of GDP for all levels of government put together. Thus, there is no question of 'one size fits all'. We can look at the logic for 6%. Among the three sectors — households, private corporate and public sector — the only surplus sector is households. It lends to other sectors. Household sector savings in financial assets — 'transferable savings' — have been around 10% of GDP and have been showing a declining trend.

A Sense of Margin

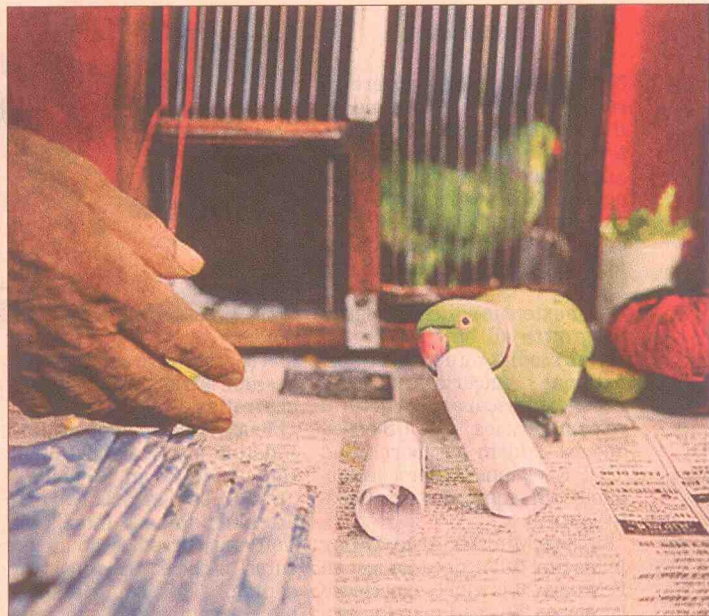
With a fiscal deficit of 6% of GDP, around 4% will be available to draw upon for the corporate sector, which includes private and public sector companies. This appears to be a fair distribution, and this is not fiscal fundamentalism in any sense.

Assuming that 3% of GDP is an acceptable level of deficit for the central government, the question is how much latitude should be given to the government.

Of course, the FRBM Act only requires the government to come to Parliament and explain the reasons for exceeding the mandated level. However, markets and analysts view the deviation more seriously. It has been argued that the fiscal deficit mandate should be seen over the entire business cycle rather than making it binding each year.

Viewing over the business cycle means that in boom years, the deficit should be below 3%, so that in lean years, the deficit could be higher than 3%. Unfortunately, even in good years, our deficit has not been below 3%. Therefore, a roadmap for taking the fiscal deficit down is very much needed. The sooner we reach 3%, the better.

Is the proposed limit of 3.6% for



The future's ours to see, even if it's que sera, sera

2015-16 reasonable? I believe so. In the coming fiscal year, the government will reap the full benefit of the fall in oil prices. Petroleum and fertiliser subsidies will go down almost automatically. In fact, if public investment is driving fiscal deficit, there should be a sharper decline in revenue deficit.

The rules on monetary policy are more complicated. What is an acceptable level of inflation? What is the range within which inflation can be allowed to move? What is the level of inflation beyond which the costs of inflation begin to raise steeply? A consensus is yet to arrive.

Observe Speed Limit

It is generally believed that in the Indian context, the acceptable level of inflation is 4% and the comfort zone is +/-2%. These numbers are derived from our past experience. Obviously, they are dependent on the given structure of the economy. It may be noted that in the developed econo-

mies, the acceptable level of inflation is only 2%.

The prescription of an acceptable level of inflation has also certain international connotations. Our domestic inflation cannot be allowed to deviate too far from what is happening in the rest of the world. If it did, it would have implications for the maintenance of stability in the exchange rate. The rule, as such, does not exclude monetary authorities focusing on other objectives. It only binds them to act when inflationary tendencies persist — or seem to persist — beyond the comfort zone.

Economics is not an exact science. It provides, at best, certain guidance. This is, indeed, true of all social sciences. Policies must rest partly on theory and partly on historical experience. Flexibility is, indeed, a desirable attribute. But pragmatism cannot become a licence for total discretion.

The writer is former governor, RBI

Inflation can't be allowed to deviate too far from what is happening in the rest of the world. If it did, it would have implications for the stability of the exchange rate