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Acknowledgements

We are indeed grateful to Dr. Manmohan Singh, Dr. C. Rangarajan, Dr. Alok Sheel, Shri P. Chidambaram, Prof. Indira Rajaraman, Dr. K.C. Chakrabarty, Dr. Ashok Gulati, Dr. Surbhi Jain and Dr. Nidhi Satija whose papers have been included in this volume.

We are also thankful to the various organisations, institutions and departments—Ministry of Finance, Deptt. of Economic Affairs; Ministry of Commerce and Industry; Office of the Economic Advisor; Secretariat for Industrial Assistance; Ministry of Agriculture; Ministry of Statistics and Programme Implementation; Central Statistical Organisation (CSO); Reserve Bank of India; for making their reports, policy documents, discussion papers and other relevant information available.

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Resurgence and Limitations of Keynesianism

C. RANGARAJAN and ALOK SHEEL

The dominance of Keynesian economics in the post Second World War period is largely credited to the widely-held belief that it was expansionary fiscal policy that was effective in countering the Great Depression of the 1930s. The case for Keynesian stimulus is straightforward, following directly from the National Income identity ($Y = C + I + G + \text{Net Exports}$) and the investment-income multiplier. An expansion of government consumption and investment merely substitutes for the contraction in private demand to restore the economy to trend growth and full employment through the multiplier process. When domestic demand destruction is combined with external demand shock, and monetary policy is also ineffective, theoretically there is no alternative to fiscal expansion to restore growth over the short-term. It is relevant to note that Keynes made no distinction between government consumption and government investment as far as impact is concerned.

Fiscal policy, however, soon became a political minefield, easy to navigate while in expansionary mode, but difficult to exit following the recovery. Fortified by the Philips curve that postulated a trade-off between inflation and growth, and difficulties in estimating potential growth, governments kept pushing the fiscal envelope to increase growth even when fiscal stimulus was not necessary, and even when it was contra-indicated. Fiscal policy therefore had an inherent inflationary bias that tended to crowd out private demand. This ultimately culminated in the 'stagflation' of the seventies, with the widely acclaimed Phillips curve breaking down.

Milton Friedman sounded what appeared at that time to be the death knell of Keynesian economics by placing monetary policy at the heart of macro-economic stabilisation. He identified inflation as basically a

monetary phenomenon. While strict monetarism was never followed, Paul Volcker's dogged and aggressive monetary tightening finally tamed hyper-inflation. Inflation rates have been well anchored ever since in advanced economies. Over time, monetary policy tools were streamlined and became more rule-bound, with several central banks following variants of the 'Taylor Rule'.

The dominance of monetary policy was assisted, on the one hand, by the decline in the role of the public sector in the economy, and the deepening and sophistication of financial markets through which monetary policy is transmitted. It therefore emerged as a powerful, and arguably more easily manageable, alternative tool to stabilise the economy. Discretionary fiscal policy fell into disrepute, although fiscal policy continued to play a role through 'automatic stabilisers', such as unemployment benefits, that kicked in as economic activity fell below trend, and were automatically phased out as growth recovered, keeping the structural balance stable.

Given the sharp contraction in economic activity in the wake of the global financial crisis of 2007-08, both monetary and discretionary fiscal policy were used in what was an unprecedented aggressive and globally coordinated policy response under the aegis of the G20. As the crisis deepened and lingered, and conventional monetary policy rapidly reached its lower zero-bound limits, unconventional monetary policies, such as quantitative easing (outright purchase of long-term government bonds and private assets) quickly followed.

The effectiveness of unconventional monetary policies during the Great Recession is controversial. There is a broad consensus that the liquidity pumped in by central banks was effective in countering the deflationary spiral that characterised the Great Depression in the US. Beyond this, opinion is divided as the current recovery from recession is the worst on record in the post-war period. Monetary policy seems stuck in a liquidity trap, with the liquidity pumped in by central banks being washed back through a sharp and unprecedented increase in bank reserves parked with central banks. The excess liquidity is also creating asset bubbles and spilling overseas, with both asset prices and emerging market exchange rates responding to signals from US monetary policy rather than to economic fundamentals.

The current revival of Keynesianism is underpinned by the realisation that while both monetary and fiscal policy have a role to play in macro-

economic stabilisation, discretionary fiscal stimulus remains a powerful macro-economic policy tool in certain circumstances. We need to understand what policy is optimal in different circumstances.

While each growth crisis has its own defining features, and are often hybrid in nature, for the purpose of analytical clarity one could perhaps classify growth crises into three different types as follows:

If the decline in growth is because of demand (domestic or external, or both) slackening over the business cycle—usually associated with spare capacity and inflation falling below target—this could be termed a Type A growth crisis.

If the decline in growth is because of a supply shock (such as oil price increase, monsoon failure or 'sudden stops')—usually associated with rising inflation and falling real growth—this could be termed a Type B growth crisis.

If the decline in growth is because of a collapse in both demand and supply caused by financial crises and associated deleveraging and deflationary tendencies—this could be termed a Type C growth crisis. This is the kind of protracted crisis that advanced economies are currently experiencing.

In Type A crises, conventional easy monetary policy along with a small dose of 'automatic' fiscal stimulus over a relatively short period should ordinarily be adequate to revive growth, as the decline in private demand is cyclical. The attendant increase in public debt on account of the decline in revenue (because of lower growth) and stimulus would be relatively modest, and the economy should be in a position to grow out of this subsequently.

In Type B crises, Keynesian fiscal stimulus will only aggravate the crisis—as in the stagflationary seventies—as trend growth may shift downward permanently if the supply shock is permanent. Since there is no decline in private demand, macro-economic stimulus is not warranted. Indeed, monetary tightening may be warranted to keep a lid on inflation, although this would do little to address the underlying supply shock which lies at the root of the crisis. If the supply shock cannot be neutralised through administrative actions, a combination of adjusting to the decline in growth over the short-term and structural reforms over the medium term to raise growth potential (including addressing specific supply shocks) is the optimal strategy. Such a strategy

is however politically challenging, as there would be pressure for fiscal and monetary expansion to counteract the decline in growth.

In Type C crises, the need for stimulus is manifest on account of the decline in private demand. Since monetary policy transmission channels are likely to be impaired by deleveraging, and constrained by zero-bound interest rates, the burden of stimulus falls disproportionately on fiscal policy. Fiscal multipliers in such circumstances are therefore potentially higher than usual, and even more so if the collapse in demand is global. Fiscal multipliers however can still be hobbled by Ricardian equivalence and deleveraging. Tax cuts and direct transfers could be used to pay down debt, or saved in anticipation of future tax increases, rather than consumed. The optimum fiscal strategy in such circumstances would be to, first, accelerate the deleveraging, and second, design a fiscal mix that relies minimally on broken transmission channels. This could involve direct government expenditure in areas such as investment in infrastructure which has both demand and supply side features, and can crowd in private investment.

There are three caveats to the stylised argument above. The first caveat is that if the underlying crisis is national or regional, the recovery could be accelerated by external demand, and therefore extended stimulus may not be necessary. This is what happened in the aftermath of the East Asian crisis. However, if the financial crisis is global, such as the present one, a period of extended fiscal stimulus may be necessary till such time private demand returns, leading to a dramatic rise in public debt over a relatively short period.

The second caveat is that if trend growth is permanently impaired there is danger of 'over-stimulation'. Hence inflation—both consumer and asset prices—rather than the growth rate, should be the signal for policy makers to exit stimulative policies. Many observers are now of the view that the US Federal Reserve should have tightened policy much earlier, in 2003 and 2004, when asset prices were exploding, even though core consumer price inflation remained within its target of 2 per cent. Likewise, in his testimony before the US Congress on May 22, 2013, while giving the first indications of 'tapering' to markets, Ben Bernanke cited financial stability as a concern even though employment, inflation and GDP growth were all below target.

The third caveat is that the dramatic increase in public debt, the lagged effect of a protracted period of high budget deficits and falling revenues on account of low growth, would need to be addressed and an answer found.

The historical record indicates that growth crises caused by financial crises can be protracted. Financing large fiscal deficits over an extended period is therefore an issue, and depends on a number of factors. Keynes never elaborated how the additional government expenditure is to be financed. Financing deficits through money creation and through borrowing from the public have clearly different effects. Excessive money creation can stoke inflation while pure borrowing can push up interest rates.

The 'flight to quality' creates some fiscal space during financial crises as it enables governments to finance larger deficits than usual without an adverse fall out on borrowing costs. Where government deficits are countervailed by large private surpluses, as in the case of Japan, it is even possible to run up public debt in excess of 200 per cent of GDP without apparent macro-economic instability such as inflation or high borrowing costs. This fiscal space is limited by the quantum of private surpluses available, beyond which government's borrowing costs would begin to rise. However, where there is a large external demand for domestic debt—as in the case of the US—it may be possible to finance large deficits over extended periods even in the absence of private sector surpluses.

Beyond private and external sources of demand for public debt stands the central bank, the lender of last resort. In the current era of fiat money they can theoretically finance any level of budget deficit to meet their nominal interest rate target, which is exactly what quantitative easing is doing. They are constrained only by prudential self-restraint as uncontrolled money creation can destabilise their macro-economic objective of price stability and full employment, which is precisely what occurred in the stagflationary seventies. Indeed, in such circumstances, to a great extent the divide between fiscal and monetary policy collapses as monetary policy becomes simply an extension of fiscal policy, as it enables the government to finance large deficits without tax increases while keeping borrowing costs low.

Where the initial public debt is high, and private sector surpluses and external appetite are exhausted, large budget deficits sustained over long periods can lead to market revolt without the central bank backstop. This is precisely what happened in the European Monetary Union, where the European Central Bank is not mandated to support sovereign bonds of individual countries, and where some 'peripheral' countries had run up large amounts of public debt. Following the market revolt, peripheral sovereign bond yields in the Euro Zone stabilised only after ECB's announcement of its programme of outright purchase of peripheral sovereign bonds without limit in pursuit of its financial stability mandate, which is the equivalent of a central bank backstop.

From the above it would be clear that the ability of a country to run large budget deficits over an extended period in a recessionary period would vary from country to country. The flip side of this is that the deeper a country's pocket in a recessionary environment, and the bigger and longer deficits it runs relative to its underlying growth potential, the more difficult it might be to exit these policies when the economy shows signs of recovery without creating macro-economic instabilities that might derail the recovery itself.

This is the problem that both Japan and the US face today: the former has a huge public debt, while the latter's central bank has a swollen balance sheet. It is difficult to see how these can be unwound without renegotiating social compacts or a destabilising phase of financial repression. Indeed, all countries will need a map for the short and medium-term. Unless there is a convincing programme of medium-term fiscal consolidation, market revolt in the short-term can become severe.

The current Type C crisis in advanced economies has spilled over into EMDEs through trade and investment channels, leading to a Type A crisis, and in some cases a Type B crisis. Macro-economic policies in these economies should therefore be very different from those in advanced economies. The focus in those countries should be not so much on stimulus as on addressing the underlying supply shocks and structural reforms, including investment in infrastructure through a change in the fiscal policy mix.