

Fiscal Dominance – A Theory of Everything in India

Viral V Acharya^{*##}

Abstract

This article focuses on the different channels through which fiscal dominance of the central bank affects financial stability in India, notably through its effect on bank recapitalization and regulation, default closure norms, monetary policy decisions, bond market regulations, capital flow measures and central bank balance sheet. Fiscal dominance also has other side effects on the economy, such as crowding out of private sector investment, external sector fragility of corporate sector financing, financial fragility of firms reliant on market financing, and finally, poor transmission of monetary policy. The paper ends with recommendations on the steps a central bank can take to limit being fiscally dominated. This requires a firm commitment to long-term financial stability, which must be reflected in the central bank's objectives. The central bank must have autonomy over regulatory decisions, including for government-owned entities in the banking and financial sector. The central bank should adopt a mostly rules-based policy making approach rather than relying on excessive discretion. Finally, the central bank should be democratically accountable through transparency of actions and intent as well as an acknowledgement of limitations of its policy options.

JEL: E52, E58, E63, G28

Keywords: Financial Stability, Fiscal Dominance, Central Bank Independence, Monetary Policy Transmission

* Viral V Acharya is C V Starr Professor of Economics, Department of Finance, New York University Stern School of Business

Originally published in 'Quest for Restoring Financial Stability in India', © Viral Acharya 2020. All rights reserved. Reproduced with the permission of the copyright holder and the publishers, SAGE India Pvt Ltd, New Delhi.

§ I am grateful to Dr Rakesh Mohan, Ananth Narayan, Dr Y V Reddy, and participants at the New York University Stern School of Business Luncheon Seminar (28th January 2020) for valuable inputs.

Introduction

During my term as a Deputy Governor at the Reserve Bank of India (23rd January 2017 to 23rd July 2019), several issues kept me up at nights:

1. Why are efforts at restoring financial stability seen as contradictory to pursuing growth even though all evidence points to financial stability being a necessary condition for long-run growth?
2. Why does the central bank, when it seeks to implement financial stability reforms fully and sustainably, always face an uphill battle with the entire system?
3. Is there a common undercurrent of resistance which makes it hard to achieve consensus on long-term structural reforms to the financial sector even if they make much economic sense?
4. Does the pursuit of growth in India focus mostly on credit-based stimulus in the short run and is this what causes efforts to restore financial stability to routinely stall?
5. What prevents the central bank from letting it go as far as price-setting in government bond markets is concerned?

I explain below that while there may be specific triggers for each example and setting that can explain the resistance to a particular financial stability reform, the uniform answer to all these questions lies in *fiscal dominance*, which I will position as *a theory of everything in India*.

Fiscal Dominance in India

In economics, “fiscal dominance” is traditionally defined as a state of the country in which large government debt and deficit (spending over and above revenues) prevent the monetary policy authority such as a central bank from meeting its mandated economic targets such as inflation, growth or employment. Instead, the central bank is kept primarily focused on ensuring that the government can roll over its debt and deficit, and, that the government does not default on its liabilities. For instance, the central bank becomes willing to accept excessively low levels of interest rate and high levels of monetisation by participating in primary and/or secondary market for government debt – put simply, printing a lot of money and handing it out cheap – even if inflation is, or risks being pushed, beyond reasonable thresholds; the central bank does so as it is focused not on inflation but on aiding the government borrowing program.

Such a state is by and large considered undesirable for the country as large-sized government debt and deficit tend to be driven by short-term populist pressures, whereas the central bank is mandated to achieve long-term stable objectives for the economy and the financial sector. Fiscal dominance of the central bank can thus be adverse on at least two counts: first, it prevents the central bank and thereby the economy from achieving its long-run stability goals; and, second, instead of the central bank being an independent regulatory institution that can serve a useful “checks and balances” role for government’s excessive borrowing and spending programs, the latter are facilitated even more as the monetary policy decisions get fiscally dominated.

While this traditional notion of fiscal dominance is centred around *monetary policy*, I will generalise its application to potentially *all* financial sector policies and regulations. It has been my experience that fiscal dominance can induce the central bank (and even other regulators such as the securities exchange board) into adopting a range of suboptimal regulations for the financial sector that compromise stability and macro-prudential considerations.

At the outset, it should be clear that India is a likely candidate for the prevalence of fiscal dominance. However, to ensure we are on the same page, I will make the case, explaining along the way its relevance for external sector stability.

1. Indian government's fiscal deficit has always been rather large, at present among the top two in the G-20 nations, and by some consolidated measures, the highest. Much of the spending is incurred due to revenue expenditures (such as subsidies) and only a tiny share is attributable to capital expenditures (such as infrastructure development). The deficit composition is thus tilted towards short-term economic support rather than towards expanding the economy's pie in the long term; therefore, the size of the fiscal deficit has the potential to accelerate swiftly while serving short-sighted objectives of the government when political compulsions arise. The deficit also depends heavily on tax revenues, thereby on economic growth and notably on oil excise taxes. The latter become harder for the government to pass onto consumers when oil prices rise, a significant vulnerability in the fiscal deficit of Indian government¹.
2. In addition to the large fiscal deficit, India runs a current account deficit (imports exceed exports), which is also heavily dependent on the oil import bill. As a result, a part of India's consumption is regularly financed by the outside world. A coincident balance-of-payments outcome is the following. Among the three sectors of the economy – government, corporate and household – only the household sector in India is a saver net of consumption and investment. The net household savings have been steadily declining over the past several years, an important yet often ignored macroeconomic development. As a result, the dissaving by the Indian government – what it raises from others to meet its fiscal deficit – which has been rising, is now above the level of household savings.² Thus, the government is reliant at the margin on financing its deficit from the rest of the world. In turn, the corporate sector in India – which also dissaves – is also increasingly reliant on external financing.
3. These “twin deficits” – fiscal deficit and current account deficit – make India vulnerable to a “sudden stop” in which a deterioration in the quality of government or corporate balance-sheets, rising inflation (either due to domestic stimulus or oil price shock), Federal Reserve rate hikes and dollar absorption, or a surge in global risk-aversion, can trigger a withdrawal by foreign investors who have financed the external funding of the government and the corporate sector. The resulting fallout in the form of a sharply depreciating Indian rupee, a rise in oil import bill and inflation, further widening of the twin deficits, and the “death spiral” or loss of investor confidence that ensues, presents a substantial risk to India's financial stability. Such risk has materialised unexpectedly at least once a decade over the past thirty years with several minor hiccups in between. History tells us that we ignore this risk at our own peril.
4. One way that the government can try to address problems of large debt and deficit is not to undertake the tough structural adjustments in their level and composition, but instead do what is more expedient, which is to economically and financially repress the economy to fund its borrowings. The reason that such fiscal dominance has the potential to affect virtually *all* financial sector policies and regulations in India is that there are other important conflating factors. What is key to understanding the present Indian context is that there are strong remnants even today of the pre-1990 era of centralised economic structure and control, including over regulatory institutions such as the central bank. Implications are the following:
 - On the one hand, the over-arching presence of public sector banks, other large state-owned financial institutions (such as the Life Insurance Corporation of India) and state-owned

enterprises, creates the incentive that the government dominates the central bank and its financial sector policies to affect outcomes for the entities it owns and for its borrowing program. This skews the market terms against the private sector and distracts the central bank from its long-term policy goals.

- On the other hand, recognition that the government has incentives to influence policies such as that it is not at arm's length from the regulators, drives the private sector into hyper-active lobbying (read, an overdose of “consultations” with the government and regulators); this, in turn, induces an overall culture in the system of putting in place business-friendly policies that are pro-incumbents, at the cost of market-friendly policies that encourage creative destruction, asset reallocation, ease of doing business, and new entry.

Fiscal dominance in India is neither new nor unique to the period I served at the Reserve Bank.

Prior to the 2000's, the Reserve Bank used to participate in “automatic monetisation” of Indian government's deficits as it purchased directly the *ad hoc* Treasury bills. This form of fiscal dominance of the central bank's monetary policy was institutionally ruled out by the Fiscal Responsibility and Budget Management Act of 2003 that prevented the central bank from participating in the primary market for government securities.

Similarly, the Reserve Bank had in the 1990's imposed statutory liquidity requirements on banks of levels as high as 40% (and cash reserve ratio requirements at other times as high as 15%), effectively making government the preferred, if not the only, borrower of bank credit in the economy. Significant progress has been achieved in minimising such repression of the economy by substantially lowering these requirements since 2000's.

The progressive steps limiting fiscal dominance were undertaken in an economic environment of consolidating government debt and fiscal deficit trajectories, high economic growth, and rise in household financial savings. However, fiscal dominance has once again taken hold of the Indian economy as these conducive factors have gradually reversed. The most striking example is that a recent amendment of the Reserve Bank of India Act allows the central bank to re-enter the primary market for government debt under certain conditions, annulling the reform of 2003 and recreating investor expectations of deficit monetisation.

As I share my experience of fiscal dominance, I stress that its ramifications do reflect a legacy of the past, but importantly convey its potential to compromise financial stability in future.

In what ways does fiscal dominance affect India's financial stability?

I will lay out several channels through which I observed fiscal dominance affect India's financial stability. The list is by no means exhaustive and not all channels may always be active.

1. **Bank recapitalisation and regulation:** Since timely recognition of losses leads to an additional capital requirement for public sector banks which is typically met out of the government budget, the central bank finds itself pulled into regular negotiations with the government around adopting regulatory forbearance.³ Such forbearance takes the form of relaxed standards for loan loss recognition, protracted schedules for provisioning against realised losses, postponement in switching to modern accounting standards that recognise losses in anticipation rather than only after defaults have materialised, etc.⁴ In case of some asset classes such as loans to micro-, small- and medium-sized enterprises, the forbearance is not just a temporary reprieve of a few months,

which could be justified if the underlying issues were cyclical, but is steadily evolving into a near-permanent feature of bank regulation, preventing the recognition that underlying stress of this asset class is in fact structural in nature.

Given the repeating regulatory forbearances, most public sector banks remain short of true economic capital adequacy, even as their regulatory capital keeps being “managed” to look just about right. Rating agencies view such forbearances as “credit negative” for banks, highlighting that forbearances do not serve the purpose of ensuring financial stability. Worse, the compromised standards apply also to private sector banks, weakening their prudential regulation in the process and resulting in a race to the bottom. Overall, this is a rather unfortunate compromise of accounting integrity and capital adequacy of banking balance-sheets, a form of window-dressing to keep government’s fiscal deficit available for alternate expenditures.

2. **Default disclosure norms:** It would seem that government’s fiscal deficit should not have much to do with the disclosure of defaults by companies to their investors. Yet, in India it does! Most stock exchanges of the world or the securities regulations that govern them require that any materially relevant information must be disclosed by a firm with immediacy to investors who purchase the firm’s publicly traded securities such as shares or bonds. From an investor’s standpoint, a firm’s default on a bank loan, in fact default on a promise to any counterparty, would constitute one of the most important materially relevant pieces of information. Its timely disclosure would improve market discipline, aid efficient allocation of capital in favour of better-performing firms, protect minority investors from being front-run by those privy to information about defaults, and help rating agencies provide more accurate credit assessments (or at the least, reduce their scope for engaging in ratings inflation).

Despite clear recommendation by an independent committee and earnest efforts of the securities market regulator, India avoided providing timely default information to markets. The rationale is rather convoluted. If defaults are disclosed, then rating agencies would correct the ratings of defaulted entities. Downward rating migrations would increase the capital that banks must put up against such borrowers as they would need to be recognised as being truly of worse credit quality. This would increase the capital requirement of public sector banks and thereby the required budgetary allocation from the government. To rule out the latter, default disclosure to market investors was not required despite the regulatory push for the same.

This is an extraordinary chain of calculations whereby the disclosure policy of stock exchanges around firm defaults was determined by fiscal dominance. The lack of timely default disclosure implies that even some of India’s top-rated firms do not always make payments when due to their lending banks; similarly, many state-owned enterprises which are publicly listed and borrow in bond markets default regularly on required payments to their counterparties and yet are rated higher than safer private firms.

It should not then come as a surprise that the aggregate loan loss ratio of credit intermediaries in India has been one of the highest in the world and loan recovery one of the lowest. Fiscal dominance of disclosure norms ensured that relevant parts of the financial system simply did not possess the knowledge as to when the process of accelerating and collecting payments from a borrower should start. It is some relief that the securities regulator has pushed through the requirement of immediate (within 24 hours) disclosure by a listed borrower failing to repay securities such as bonds; in case of loans from banks or other financial institutions, disclosure is required for delays in payment of more than 30 days. While this bodes well all around for the

efficiency of credit ecosystem in India, single-day (rather than only 30-day) default disclosure norm – in line with global standards – would be the natural next step also for loan repayments.

3. **Monetary policy:** A convenient way to recapitalise public sector banks is by showering them with Treasury gains which arise on banking books when interest rates are cut, or expectations of future rate cuts bring down the yield curve and cause bond prices to rally. Given the desire to keep budgetary allocation for public sector banks' capital needs low, there is an implicit asymmetric pressure on the monetary policy authority's interest rate decisions: Rate cuts are preferred and inflation forecasting errors on the downside are okay (even welcome!), while rate hikes are particularly disliked along with inflation forecasting errors on the upside. Such asymmetric pressure can potentially induce deviations in monetary policy authority's objective and prevent it from attaining its mandated target of stable inflation. Of course, there is nothing wrong with rate cuts leading to Treasury gains on bank books; that this channel creates asymmetric pressure on the monetary authority to cut rates is what is rooted in fiscal dominance.

A corollary to the fiscal dominance of interest-rate policy is the asymmetric use of liquidity tools by the central bank. Liquidity injections that transfer a stock of government bonds to the central bank balance-sheet are seen more favourably than liquidity absorptions in which the central bank supplies government bonds to the market. When undertaken in large quantities, liquidity injections improve bond prices and transfer treasury gains to banks, helping recapitalise public sector banks while simultaneously lowering the cost of rolling over government debt. This creates an incentive to get the liquidity policy to be fiscally dominated rather than keeping it unconstrained to achieve the objective of ensuring that short-term money market rates tug closely the policy repo rate set by the monetary policy authority. In fact, once sufficiently fiscally dominated, the liquidity policy can control most of the government bond yield curve and prices, rendering the rate-setting process of monetary policy authority effectively irrelevant. For example, the central bank's one arm can keep the policy rate unchanged due to inflation concerns, while its other arm can act fiscally dominated in moving all other rates.

Similarly, fiscal dominance can imply that bank cash reserve requirement can become a tool to look to relax for backdoor heaping of profits onto banks for their recapitalisation. As such, the primary purpose of this requirement is prudential and developmental in nature: one, cash is the most robust defense against liquidity needs; and second, a cash requirement facilitates arbitrage as well as price-discovery in overnight inter-bank markets as banks are induced to actively manage their liquidity to meet the requirement.

4. **Market regulations:** In the eventuality that the monetary policy authority does manage to raise interest rates and if expectations of future rate hikes build up too (for instance, because inflation prints and measures of sustained "core" inflation are incontrovertibly hardening), then banks make losses on their Treasury positions, reversing the gains from rate cuts. Again, to reduce budgetary allocation of capital to public sector banks, the mark-to-market accounting treatment of government bonds by the central bank is nudged for being set as asymmetric: Treasury gains are transferred for most part as soon as bond prices rally; in striking contrast, Treasury losses are allowed to be recognised over several quarters. The result is another form of deep interference of fiscal deficit pressures on the accounting treatment of banking balance-sheets. Indeed, the central bank is often working the hardest to ensure that public sector banks can show profits and adequate capital to markets at quarter ends (rather than the bankers and the owners of banks bending over backwards to manage the interest rate risk they willingly took on).

More perversely, government bond yields could be hardening also due to the risk of fiscal slippage. This too leads to losses on bank Treasury positions. Therefore, regulatory forbearance in the form of asymmetric mark-to-market treatment of such losses weakens an important form of market discipline on fiscal slippage.

Furthermore, it can be difficult to generate interest in government bond auctions when investors face risks of rising deficits and borrowings by the government. In such a scenario, public sector banks and other government-owned entities in the financial sector can be, and are, required – through moral suasion – to buy up entire issue amounts in individual auctions at above-market prices. A natural financial regulation to respect the integrity of market auctions (prices and quantities) would impose concentration limits whereby no individual buyer can participate in an auction for greater than some threshold share. Such regulation, commonplace in Treasury auctions around the world, is not in place in India as it would be heavily contested by the government, creating another channel through which fiscal dominance affects bond market regulations. I must add that the Reserve Bank's continuing role as the debt manager for the Government of India only accentuates this channel.

5. **Capital flow measures:** As I explained earlier, government dissaving in India has in recent years exceeded the net savings of the rest of the economy, and hence, the government is increasingly reliant on external finance. By implication, capital management on the external sector front, which determines the extent of foreign debt flows that can enter the Indian economy and limits the short-term nature of such flows, becomes a regular bone of contention between the central bank and the government. While getting the central bank to monetise deficits and support bond markets remains the first line of fiscal dominance by the government, relaxing capital flow measures also represents an important line of such dominance.

As such, capital flow measures are macro-prudential in nature, *i.e.*, aimed primarily at financial stability rather than at relaxing government's financing constraints. Hence, these measures must be calibrated as a long-run strategy that is fine-tuned in relation to the stock of foreign exchange reserves that the central bank has – and is likely to be able to maintain – on its balance-sheet to defend the currency against sudden outflows. The calibration should also meet the “stress test” at least as severe as the past experience of such outflows witnessed during sudden-stop episodes such as the global financial crisis during Sep-Dec 2008 and the “taper tantrum” of May-Aug 2013.

In contrast, a short-term government focus on tiding over its next borrowing or budget hurdle can lead to preference for measures that make the external sector vulnerable. For instance, foreign-currency denominated sovereign bonds can be tempting to issue when global interest rates are low but would exacerbate the death spiral during a sudden-stop episode. Similarly, unless structural reforms are undertaken and fiscal consolidation credibly committed to, short-duration bonds may be the only feasible external source of funds during stress and therefore be preferred by the government, but such flows can promptly reverse should the stress worsen, aggravating the downward currency spiral.

If a central bank concedes to such myopic preferences arising out of government borrowing constraints, it ends up setting macro-prudential capital flow measures that are fiscally dominated rather than aimed at ensuring external sector resilience.

6. **Central bank balance-sheet:** Finally, given India's external sector vulnerabilities, it is paramount that the central bank balance-sheet be perched on the highest hill (think of Chhatrapati Shivaji Maharaj's choice for locating his fortresses): it should remain untouched and unperturbed in the

midst of almost any macroeconomic storm. The Reserve Bank has undertaken in the past – and in future too may have to undertake – massive foreign currency operations. The Reserve Bank has also been a counterparty for providing insurance against currency risk while raising emergency external funds from otherwise unwilling financiers. For performing this critical function seamlessly, the central bank must be regarded as being a counterparty of the highest credit quality, the equivalent of a AAA+ rating and perhaps even better.⁵ This necessitates that the central bank takes a long-run view of its balance-sheet resilience and saves from its annual earnings on a regular basis for the rainy day.

However, such preservation of central bank “capital” via transfer of its profits to future contingencies has seemed overly conservative to governments that have at times narrowly focused on filling up their bottomless pit of deficits year after year. There have also been successful demands in recent years for an “interim dividend” from the central bank, bypassing other arrangements such as Ways and Means Advances which limit the extent of interim monetisation of government deficits by the central bank. The result has been an erosion of central bank balance-sheet strength and an increasing compromise of the severity of stress scenarios it can withstand in future. Such fiscal dominance of central bank balance-sheet could perhaps be justified if the credit rating of the sovereign is of the highest quality and government bond markets benefit from foreign investors’ flight to safety when the global scenario turns adverse. Neither of these conditions is met by the Indian economy at present. As a result, erosion of the central bank capital to pay dividends to the government is tantamount to a coercive monetisation of fiscal deficits.⁶

Indeed, many observers see the erosion of central bank balance-sheet strength as only an extension of the fiscal dominance of state-owned enterprises, whose cash flows appear to be heavily tunnelled to meet government deficits and whose balance-sheets are providing leverage-financed dividends *via* on-paper divestments of one state-owned unit to another. In the long run, it would be better if these state-owned enterprises deployed their cash flows to engage in capital expenditures, but this conflicts with the short-run government objective of maintaining high fiscal deficit to finance its populist revenue expenditures.

From fiscal dominance to crises and low productivity traps

Given the pervasive influence that fiscal dominance in India has on financial sector regulation and policies, it is a natural corollary that it poses significant risks to the country’s long-run financial stability and growth.

Factors that make fiscal dominance a theory of everything in India imply that financial sector risk-absorption capacity and regulations that try to maintain it at a minimum prudential level are always stretched thin to meet the requirements of over-stretched government finances. They are like rubber bands being pulled so hard that they can snap unexpectedly!

These same factors drive the external sector towards fragility as the levels of government and corporate financing by foreign investors far exceed what would be necessary absent the domestic savings being drained out by government borrowing.

With such vulnerabilities, accidents can happen swiftly. For instance, if an external sector shock in the form of a significant oil-price rise coincides with the approaching of an election – when rise in government spending and increase in cash circulation create short-term stimulus and inflationary spike, then all hell can break loose for the macroeconomy.

Even outside such episodes, fiscally dominated economies feature poor efficiency of capital allocation by under-capitalised financial sector and favouring of incumbents over new entrants. In my view, these channels have slowed down India's transition from a rent-seeking economy to a value-creating one and translated into an overall loss of productivity and growth. If fiscal dominance remains unchecked in the wake of slowing growth, the outcome can in fact end up being a low-productivity trap for the economy.

Other side-effects of fiscal dominance

Factors underlying fiscal dominance have several other pernicious side-effects:

1. **Crowding out of the corporate sector**, not only of micro-, small- and medium-sized enterprises as banks stuff their balance-sheets with government bonds rather than lend to these enterprises, but also of highly-rated firms as investor appetite for safe bonds is more than met by government bonds widening the gap between bond yields of highly-rated firms and the government. Such crowding-out results in financial constraints and lower growth for the private sector.
2. **External sector fragility of corporate sector financing and investments**, as lack of domestic savings beyond government dissaving induces corporates to borrow abroad in substantial amounts, exposing them to the risk of sudden-stop withdrawals by foreign bond "tourists," in turn exposing the rest of the economy too to currency depreciations.
3. **Financial fragility of firms reliant on market financing**, as over-supply of government paper at typically longer durations of borrowing induces the private sector to borrow at shorter tenors, leading to rollover risk. This can have adverse financial stability implications, especially if non-bank financial companies first increase reliance on short-term debt in search of lower yields to pay and then are unable to roll it over.
4. **Poor transmission of monetary policy to the real economy**, given that government and corporate bond-market yield curve as well as bank deposit rates are determined under fiscal dominance not just by inflationary expectations and central bank policy rate decisions, but also by (i) quantity constraints imposed by the large supply of government paper, and (ii) administered interest rates on extra-budgetary resource mobilisation by the government (such as above-market rates offered by the Indian government on its borrowings through National Small Savings Funds). A central bank attempting to improve the transmission of its policy rate decisions by altering the quantity constraints, for example, by buying up or lending long-term against government paper, is effectively fiscally dominated and only ends up subsidising further fiscal slippage.

A Reform Agenda

In the rest of the article, I will present a two-pronged reform agenda as to how adverse effects of fiscal dominance on financial stability can be limited, first by undertaking institutional fiscal reforms, and second by the central bank adopting measures to limit being fiscally dominated.

Institutional reforms for India's fiscal management

It goes without saying that ideally, fiscal dominance must be addressed at its roots. Therefore, the heavy lifting for protecting the economy from fiscal dominance must come from those individuals within the government who value the quality of long-run outcomes for the economy. Such individuals, for

example, bureaucrats with careers spanning government terms and economic advisors who are typically technocrats, can strive for:

- A fiscal consolidation path to reasonable targets with prudent undertaking and management of spending programs;
- Reorientation of expenditure towards items that have economically meaningful long-term multiplier effects such as education and infrastructure;
- Objective monitoring of consolidated debt and deficit numbers by helping set up an independent, ideally bi-partisan, fiscal council (as already recommended by the Fiscal Responsibility and Budget Management Review Committee of 2016); and,
- Improved disclosure standards for government expenditure and deficit that preclude obfuscation of numbers by accounting *jugaad* (tricks) such as moving expenditures from before to immediately after the accounting date and from “above the line” (on-balance-sheet) to “below the line” (off-balance-sheet or extra-budgetary); such improvement would pave way for a focus away from accounting sleight of hand towards fiscal management and disinvestments in a true economic sense.

The emergence of bureaucrats and technocrats in the government who take and stick to the farsighted view rather than seek to dominate financial sector policies is the need of the hour.

How the central bank can limit being fiscally dominated

Given my experience at the Reserve Bank, I will highlight in greater detail the steps that a central bank can undertake to limit being fiscally dominated:

1. **Firm commitment to long-term financial stability:** First and foremost, the central bank must take the overall stance that financial stability must be persevered for in its every decision and even in the face of imminent government pressures. The central bank objectives are inherently long-term in nature:
 - As a banking regulator, the central bank oversees preserving the value of deposits from bank insolvency.
 - As a monetary authority, the central bank oversees ensuring inflation does not erode economy’s savings, facilitating financial inclusion of households over their holding primarily real assets such as gold and housing.
 - As the economy’s primary defense against external sector stress, the central bank is also in charge of managing the currency’s excessive volatility and limiting imported inflation.

These objectives can and must be interpreted to have a truly long-run dimension. In turn, such interpretation must be employed over and over to resist and defend pressures to compromise financial stability for short-run benefits of the government and other influential constituencies. Unfortunately, there are no short cuts to grow well sustainably. Restoring and maintaining financial stability must come first for the central bank.

2. **Independence and autonomy over regulatory decisions:** The central bank must be granted true independence in the letter of the law (*de jure*), and by implication, effective autonomy over its operations and regulatory decisions. Where the law itself renders the central bank independence

weak, central bank has a handicap to start with and is effectively (*de facto*) always under duress from the government. To this end,

- Appointments of top management and others governing the central bank must be undertaken in a timely manner and subject to an accountable process that limits the scope for opportunistic placements.
- Top management appointments must be for a term length that is at least as long as that of the government, ideally spanning government terms, and subject to termination only with cause and after a due process.
- Regulation should be ownership-neutral in that the central bank must be allowed by law to exercise the same powers over all regulated entities, whether they are state-owned or private.

Given the substantial presence of public-sector banks and government-owned entities in the financial sector, ownership-neutrality of regulation is an essential structural reform to move India towards establishing and maintaining financial stability on a durable basis.

3. **Adoption of policy rules over discretion:** The central bank should “tie itself to the mast” by adopting rule-based policymaking, *i.e.*, deploying specific tools for specific well-articulated objectives, so as to avoid the temptation to respond to the “calls of sirens.” Without such discipline, there can be a mission creep into objectives, loss of focus in strategy to meet the objectives, and sidelining of long-run stability goals. In particular,

- Basel capital and liquidity norms should be upheld in their true and full spirit, rather than softened through regular forbearances for the financial sector; forbearances must be exceptional and subject to a “sunset clause” of no longer than six months and not become permanent dilutions of the norms.
- Prompt Corrective Action framework for banks must be adhered to, and even strengthened in terms of ownership-neutral actions over all regulated entities, including public sector banks and other government-owned finance companies.
- Default disclosure with immediacy for even one-day delay in meeting loan repayments needs to be mandated not only for publicly listed firms but also to a Public Credit Registry for all borrowers (public or private, in a phased manner by size). This would improve creditor discipline and quality of lending allocations.
- Asset Quality Reviews and Macro-prudential Stress Tests need to be conducted on an annual basis for the entire financial sector (banks as well as non-bank financial companies), preparing for their eventual role as the standard for capital requirements. It is not good enough that the financial sector survives stress; it must continue to function and intermediate well, for which it must maintain extra capital buffers in good times. Specialised supervisory cadre at the central bank could just be the medicine that doctors prescribe for such treatment.
- Flexible inflation targeting framework adopted in 2016 has been recognised by rating agencies and multilateral institutions as a critical structural reform of the Indian financial sector. It is meant to build inflation credibility with external investors and to dampen the impact of sudden stops which risk external sector stability. It is a folly, therefore, to think that the framework does not factor in financial stability. The framework needs to be persisted with so that inflation and inflation expectations are more durably anchored; savers can't be short-changed in favour of borrowers by switching the target index from consumer price inflation to wholesale price inflation the moment rate cuts can no longer be justified.

- Cash reserve ratio requirement for banks must be maintained for prudential purposes rather than be tinkered with as a way of undertaking sectoral credit allocation, the latter being a feature of the pre-1990s centralised economy that the Reserve Bank has long moved away from. The cash reserve ratio requirement in India is already at its historical low level; hence, the Chinese model of using it as a sectoral credit allocation tool is best not emulated in India, especially given the Chinese requirement is 4-5 times higher than that in India.
 - Macro-prudential capital management needs to be kept on a well-telegraphed path, calibrated in relation to the central bank's stock of foreign exchange reserves that is likely to survive external sector stress. The long-standing wisdom at the Reserve Bank, articulated by its top management in 1990's and 2000's, of allowing foreign capital in a pecking order – from direct equity investment (the most preferred) to foreign-currency sovereign bond (the least preferred) – is well-founded given the fragility of various kinds of flows and financing instruments under a sudden-stop scenario.⁷
 - Central bank balance-sheet strength must always be maintained at pristine quality by adopting the minimum standard of an effective AAA+ rating as the basis for any distribution to the government. A complete distribution of central bank profits to the government must be eschewed as under fiscal dominance, this sets a precedent which catalyses the setting up of committees to rewrite existing rules as soon as the distribution is partial and requires some provisioning of profits by the central bank for the rainy day.
4. **Leaning against the wind and playing the game of chicken:** Under extreme fiscal dominance, whichever point of accommodation the central bank agrees to today becomes the starting point for further compromise tomorrow. Hence,
- The central bank must recognise this possibility in its policymaking by maintaining even higher standards of financial stability. This requires “leaning against the wind” in good times, for instance, by building buffers into the level of real interest rates, financial sector's capital and liquidity, and its own balance-sheet strength. Emerging risks at vulnerable banks and financial firms also need to be proactively managed rather than at the edge of the precipice.
 - The central bank must also defer pressures born out of government myopia by “playing the game of chicken.”⁸ The more readily the central bank is willing to compromise, the weaker is its bargaining and persuasive power with the government. The central bank must therefore learn to draw a line sometimes and say “No”. Such obduracy can help shift the government focus to more serious ways of dealing with its debt and deficit problems, such as expenditure prioritization, disinvestments, and fixing governance at public sector banks.⁹
5. **Democratic accountability:** Central bank's adherence to rules must be demonstrated to the public at large to the extent possible and at least with some reasonable lag. While the preparation and dissemination of statutory reports go a long way in achieving this, even extraordinary measures – rather than just being a fiat privilege of the top management – must be supported with well-articulated reports on their desired outcomes and possible unintended consequences. This way, the case for sunset clauses on extraordinary measures can be laid out upfront and escalating expectations for their extension be managed in advance.

Such accountability requirement would limit the scope of fiscal dominance over central bank policies: explicitly spelling out the underlying rationales for compromises would be difficult in many cases and simply hiding the truth under the rug would risk public embarrassment and possibly even opprobrium. Overall, transparency of actions and intent as well as an open

acknowledgment of the limitations of the central bank and its tools in addressing issues beyond its scope and remit can lead to a more professional way of dealing with outside pressures instead of the present policy of striking back-door, and therefore, opaque, compromises. I stress that the central bank must do this in public interest to remain democratically accountable, and by so doing, reduce the risk of its fiscal dominance along the way.

6. **Providing and encouraging reason and voice:** The central bank has a unique position from where it can provide both a 35,000 feet view of the macroeconomy as well as a microscopic documentary on whether and how the plumbing of the financial sector is functioning or impaired. Indeed, it usually relies on extensive research and data to inform its policymaking. Such research should be freely and widely publicised, explaining on the one hand the reasons for adopting specific policies, and on the other, encouraging its downstream researchers to conduct incisive analysis and unearth new facts that can provide early warning signals of instability. The quality of such research inquiries can reach the highest standards only when it is subject to scrutiny of outside experts and is required to clear a minimum hurdle for public dissemination.

Last but not the least, the central bank must use its voice and speak truth to the power by putting public interest before its personnel's career growth and promotions. Most take the factors driving fiscal dominance – a large-sized government debt and deficit – as given and operate without attempting to influence them; however, the central bank can and should use its role as the economy's institutional safeguard of financial stability to highlight the risks that fiscal dominance entails.

Dissent and diversity of thinking, while seemingly confrontational, help lift the quality of debate and discussion for better aggregation of views and eventually superior decision-making. Conversely, discouraging dissent and diversity risks errors from system-wide group-think and cognitive capture; the central bank becomes a flock of birds with a feather; and, public discussion gravitates towards its predictable choices, as after all, most analysts, commentators and media get rewarded if they correctly forecast what the central bank will do rather than agonise painstakingly over what the central bank should do!

Conclusion: The right stance – Financial stability comes first

The long, punctuated history of financial crises and growth slowdowns across the world illustrates beyond reasonable doubt that lack of financial stability impairs long-run growth and external sector resilience of economies. It has also been documented that lack of financial stability is by and large not a matter of misfortune; it ends up being engineered as the long-run side-effect of short-term policies such as providing sustained debt-fuelled stimulus to the economy, repeatedly monetising in one guise or the other fiscal deficits of an extravagant sovereign, and perennially hiding the true losses on financial sector balance-sheets.

Given the vantage point of having been exposed to this economic history, I started at the Reserve Bank in January 2017 with a clear conviction: given that the non-performing loans to assets ratio of the banking sector was close to double-digits and at the top of the G-20 countries, India needed to focus first on restoring financial stability and thereby position itself in a sound structural position for sustainable economic growth. The former Federal Reserve Governor, Janet Yellen, famously noted in January 2009, while pressing for comprehensive reforms in the aftermath of the global financial crisis:

“A clear lesson of history is that a ‘sine qua non’ for sustained economic recovery following a financial crisis is a thoroughgoing repair of the financial system.”

There is an important message therein for India. The historical strategy of leveraging up yet another asset class to grow when prior leverage boom has gone bust and its mess not yet cleaned up has repeatedly failed; this strategy has derailed the Indian economy’s long-term growth plans; unsurprisingly, there is no asset class left to lever up and structural reforms are now critical.

It should be clear than that financial stability is not just a lofty term to be used to justify any and all extraordinary central banking or regulatory measures, typically quick-fix bandages that are patched on to the surface wounds when underlying imbalances materialise and begin to stifle growth. Such remedial measures are designed with much speed and often without careful deliberation, leaving behind as a consequence an inevitable trail of unintended outcomes that sow the seeds of future instability. At best, extraordinary measures should be deployed to buy some time to undertake deeper structural reforms. When the extraordinary measures themselves become the primary tool for providing financial stability, the economy simply ends up fighting one war after the other, each one set up by an incomplete victory over the past one.

Financial stability is in fact about taking *the right stance* for the economy ahead of time – maintaining its financial sector in robust health and with ample immunity so that the economy can grow well in a sustainable manner. This can be achieved by positioning the financial sector structurally in such a way that even the ordinary toolkit of central banking and regulatory actions has the desired impact on households, corporations, and micro-, small- and medium-sized enterprises. This reduces the reliance on extraordinary measures on a frequent basis. Reaching such a stable state requires, as I have argued throughout the book, that

- The financial sector remains mostly well-capitalised and the under-capitalised entities are promptly corrected to healthier state or quarantined to avoid further haemorrhaging;
- Defaults and losses are recognised, resolved and disclosed publicly in a timely manner;
- The transmission of monetary policy to the real economy is strengthened via the development of efficient viable markets and without undue regulatory interference in price-setting by markets;
- The external sector is always safeguarded; and,
- The right balance is struck between the government, the private sector, the markets, and the regulators, especially the central bank, so they work in sync with each other without being under the dominance of, or being crowded out, by the government.

Maintaining financial stability necessitates that regulators such as the central bank lean against the winds of fiscal dominance by sticking to well-designed rules for decision-making (such as inflation-targeting mandate for monetary policy, prompt corrective action for dealing with under-capitalised banks, Basel standards for bank capital and liquidity requirements, etc.). Exercise of excessive discretion only opens the door to an excessive accommodation of short-term political pressures.

Unfortunately, pandemic stress in the form of COVID-19 outbreak has struck just as financial instability clouds over parts of India’s financial sector have gathered again. It should be clear then that to restore financial stability comprehensively, we can no longer keep kicking the can down the road. The right time to save for the rainy day is right now.

Notes

¹ The problem had been recognised by successive governments and the Fiscal Responsibility and Budget Management Act of 2003. However, the inability to enforce compliance to the Act's fiscal deficit targets within the stipulated timeframe reflects the strength of myopic preference of governments to spend relative to their long-term commitment to building fiscal credibility.

² Estimates of consolidated government borrowing – the “public sector borrowing requirement” – are in the range of 9-10% of Gross Domestic Product (GDP). Net household savings are estimated to be around 7% of GDP.

³ It needs to be acknowledged here that the government practice of recapitalising banks with “recapitalisation bonds” rather than outright capital injection implies that as per extant fiscal accounting norms, only the interest expense on these bonds adds to the immediate fiscal deficit. However, regardless of the fiscal norms, there is an increase in government's debt as a result of the recapitalisation. More subtly, if banks are to create credit upon recapitalisation, they would need to generate liquidity against some of their other government bond holdings by selling them in secondary markets, a move that is akin to the government directly raising the liquidity by issuing new bonds and transferring it as capital injection to public sector banks.

⁴ There may also be other political considerations in government preference for regulatory forbearance such as favouring incumbent defaulted borrowers who by virtue of not being classified as non-performing enjoy continued asset control and “extend and pretend” loans from banks.

⁵ Note that central banks are typically not rated by credit rating agencies. However, subjecting the central bank balance-sheet to stress scenarios and examining its equity capital in such scenarios relative to its liabilities can provide a simulated likelihood of default, and, in turn, an effective credit rating, for the central bank. Counterparties often “cap” their internal central bank rating to that of the sovereign; this practice only reinforces my point that central bank balance-sheet must be managed independently from that of the government so that the effective central bank rating can pierce through the sovereign rating, which would be desirable in times of external sector stress.

⁶ One exception to this is if the government uses the dividend to extinguish the central bank holdings of government bonds, whereby it reduces its future debt payments. This, however, has not been the manner in which the dividend from the central bank has been deployed by the government.

⁷ The complete pecking order can be stated as: (i) direct equity investment (the most preferred); (ii) portfolio equity flows; (iii) portfolio flows in domestic-currency long-term corporate and government bonds; (iv) long-term external commercial borrowings of corporates which are foreign-currency denominated; (v) portfolio flows in domestic-currency short-term corporate and government bonds; (vi) short-term external commercial borrowings, and, finally, (vii) foreign-currency sovereign bond (the least preferred).

⁸ In a strategic (game-theoretic) sense, fiscal dominance implies that the government moves first, making a take-it-or-leave-it offer to the regulators, essentially tying them down to its preferred sequential choices. In reality, the outcomes are better described as an alternating bargaining game between the government and the regulators.

⁹ Such obduracy was one of the many hallmarks of the late Federal Reserve Governor Paul Volcker (1927-2019), in arresting double-digit inflation in the United States, and once arrested, in keeping inflation at bay by refusing to compromise monetary policy for cheaper funding of President Ronald Reagan's expansionary manifesto. In the end, Paul Volcker's stance prevented the United States government from undertaking massive tax cuts and incurring significant fiscal slippage, and thereby stabilised the government's long-term bond yields.