Chapter VII

Synthesis of Macroeconomic Policies And Prospects for Economic Liberalisation

In the broadest context, monetary policy, fiscal policy and exchange rate policy are part of overall economic policy which is geared to the attainment of macroeconomic objectives. Since they are part of an overall economic policy, they are fundamentally related, the precise relationship between them very much dependent on the institutional and structural features on an economy. The imperatives of consistency, continuity and efficacy of overall economic policy require closer coordination and mutual harmony between monetary policy, fiscal policy and exchange rate policy. The very conception, formation and implementation of each of these policies cannot be mutually exclusive of each other even in situations wherein one can talk about pure monetary policy and pure fiscal policy. Hence at any time, the nature and stance of any specific policy cannot be at variance and cannot be incompatible with that of other policies. The issue of compatibility and mutual consistency between the macroeconomic policies is important for Indian economy where economic policies have been found to be interdependent. There are well known linkages between different macroeconomic policies. At the external front, for example, the greater accumulation of foreign exchange reserves results into an increase in international component of reserve money and thus leads to an autonomous increase in money supply which is not fundamentally policy induced; similarly, budgetary operations(fiscal policy) can affect money supply by changing the monetary liabilities and assets of the banking system. The essential point is that such effects emanating from external and/or fiscal activities of government cannot be overlooked when formulating monetary policy. A policy aimed at liberalizing financial markets might result into hike in rates of interest which might be antithetical to the public debt management operations. Any policy before it is instituted has to discount any possible adverse effect it carries on the achievement of objectives associated with other policy. In India, expansionary fiscal policies have caused unnecessary expansion of money supply and inflation which in turn has distorted relative prices and costs without causing larger increases in output. On the other hand, sudden squeeze on liquidity in the economy has, at occassions, resulted into losses of output and greater unemployment. Thus, a restrictive monetary policy aimed at stabilising inflationary expectations might end up causing substantial losses in output which could go contrary to the governments program of capital formation geared towards augmenting output in the economy. All these suggest that the overall economic policy, at best, has to be a synthesized version of monetary policy, fiscal policy and exchange rate policy. A stable inflation rate could be achieved by monetary targetting which in turn would necessitate streamlining of government expenditure. This will reduce fiscal imbalances and also the compulsions of reckless borrowing from the banking system, Thus rendering overall economic policy more meaningful. Macroeconomic stability in terms of prices is also conducive to the stability in the real exchange rate which is an important variable affecting the exports. Larger export earnings could reduce the need to borrow from high cost international sources thus facilitating task of external debt management. This is important because in cases of higher and higher inflation at domestic level, it is found that the government seeks to off set this inflation by maintaining the nominal exchange rate - the price of foreign currency in units of domestic currency. Their aim is to hold down the domestic price of imports to dampen inflation. But as a result, the exchange rate becomes progressively overvalued. In addition to this, governments may also use price controls or subsidies to hold down prices.

This approach may work in the short run, but it creastes other distortions which then require new controls. For instance, the over valuation of the exchange rate will reduce the supply of exports, while the aggregate excess demand created by inflation will increase the demand for imports. Together these may result in a balance of payments crisis, followed by the introduction of tighter direct controls on imports. The external deficit will have to be financed by extra borrowing, and so debt builds up. Price controls, meanwhile, will either increase the budget deficits or simply reduce the incentive to produce.

In these circumstances, governments are faced with the need to act on several frouts. For the short term the need to stabilize the economy, usually through a combination of devaluation and deflation by restrictive monetary policy.

To improve resource allocation, they also need to ease the various controls. In this sense, the exchange rate policy or reform of trade policy is part of a broader economic program which takes cognizance of domestic internal policies. This also suggests that it is virtually impossible to sustain an exchange rate policy in the economy facing a stabilization crisis typified by large government deficits, debt and high inflation.

Financial policies as suggested by Neo-liberals are another important policies which influence pattern of industrialization and growth through their effects on savings and cost of capital. They are related to other policies too. In India, interest rates are administered and they are not market determined. This has resulted into the encouragement of investment at low rates of return and excessively capital intensive technology. But it seems dismantling of policy of administered interest rates in India has to be a gradual process; the policy of freeing the interest rates 'Market determined abruptly can cause exorbitant increases in costs of capital and costs of borrowing which could affect adversely. Private sector and government sector alike. Even higher positive real rates of interest rates could be achieved by gradually increasing nominal interest rates in a phased manner while keeping price stability via a more appropriate monetary policy. It seems financial policies cannot be formulated and implemented without considering other policies. As a matter of fact, macroeconomic stability, low public sector deficits and proper exchange rate management may have to precede attempts to liberalize financial policies.

It is abundantly clear that any macroeconomic policy is rendered more meaningful. Only in an overall economic policy framework; it is possible that a policy might be comparatively more suited to the attainment of an objective with which it bears closer relation but its impact is realized only when the policy is implemented in consonance with other policies which are also framed accordingly only when they are framed in view of their linkages and possible contradictions, attempts to stabilize the economy could materialize and each policy could succeed in accomplishing its assigned goal without causing further adjustment problems and without accentuating unhealthy trends at the price or cost front.

One of the clearest lessons from the experiences of developing countries is the link between trade policy and macroeconomic policy. Many trade reforms have started with a program of stabilization in which inflation has been reduced through the control of public spending and the application of higher monetary control and the trade deficit has been reduced both by domestic deflation and a substantial devaluation. The devaluation, improving the incentive for both import substitution and exporting, it a vital step in trade policy reform. In many developing countries, trade policy reforms have followed macroeconomic stabilization. The fact that domestic economic policies have repercussions on the external balance and they in turn, are affected by it is also borne out by Indian economy, more so, in the context of fiscal policy and external balance. The consequence of any persistent fiscal imbalance may not remain limited to the domestic sphere. In macro terms, India's fiscal and monetary policy has traditionally been focused on issues of domestic balance, notably price stability. Price stability clearly has an bearing on India's competitiveness in external markets. There is also reason to believe that the relatively conservative stance of Indian fiscal and monetary policy has assisted the management external balance. Thus, some of India's success in accelerating real export growth in the period 1972-79 could be attributed to the strongly deflationary stance of fiscal and monetary policy adopted in the wake of the first oil shock of 1974. Similarly a persistent short fall in public savings performance could result in a secularly expansionary fiscal policy, which in turn, could inhibit improvements in the foreign trade balance and aggravate the problem of overall balance of payments management viewed this way, it is clear that economic policies are related and in a sense, interdependent.

Economic Policy and Liberalisation in India :

It is no denying the fact that from the early 80's the Indian economy has been experiencing winds of liberalisation and measures to this effect have been implemented in the areas of trade, taxation and industrial policies. Therefore it is quite natural to have an assessment of the package of liberalisation introduced recently.

Basically, liberalisation, competition and technology are considered the three principal instruments of the Economic policy measures introduced since early '80s. More specifically, the substantive transformation that is sought through these measures entails a transformation :

a) from an over regulated economy based on a plethora of physical controls to one based on a few strategic controls; it does not mean total dismantling of controls.

b) from a seller's market to a buyer's market,

c) from a relatively low technology, low productivity situation to an eventual stage of high technology and high productivity.

d) from a highly protected to a relatively internationally open economy.

The policy makers hope to achieve this transformation by implementing measures of liberalisation in the areas of priority sectors, import policy, tax rates, industry and industrial policies etc. It seems in more recent years, the results of measures introduced earlier have started surfacing and they seem to be quite favourable, if not spectacular, for the Indian economy. For example, there is a conspicuous spurt in the capital formation of the private corporate sector; the period 1985-89 of the seventh plan withessed annual rate of growth of 16 percent in the fixed real capital formation of private sector. Indeed, the 8th plan has put even a higher estimate of 18 percent for the same. This picture of a marked turn around in industrial investments is evidenced by the intensified boom on the stock markets and the sharp increase in the number of new companies floated more recently. Significantly, the known investment programs of the major private sector companies at present run into over 25000 crores.[@] What is clear and important is the fact that the decade of 80's has witnessed a sharp reversal in the low rates of growth in industrial investment which Indian economy experienced during the fifteen years 1965-66 to 1980-81. Due to the introduction of a liberalized industrial licensing policy in the early 1980s, combined in the case of core products like steel, cement and fertilizers with a liberalised pricing system, private sector investments began to be made almost simultaneously by a number of firms in a wide range of industrial products. This is best illustrated by the cement production which was a little less than 20 million metric tons in 1980-81 has reached 40 million metric tons by end of 1987. In fertilizer industry also, the private corporate sector is said to be committed to an additional investment of about Rs. 4400 crores in the period 1986-88[@@]

@ Reserve Bank of India Bulletin, 1989 June.

@@ Economic Survey 1989-90.

It seems we are going to witness a sharp increased investment the coming years in industries like cement, fertilizer, synthetic fibres, petrochemicals, cars, two-wheelers electronics and the telecommunication industry which are already expanding. In this context, what is important is only a question of time before the massive investments made by the private corporate sector will translate themselves into a major upsurge in production.

Apart from field of Industry, steady waves of liberalisation of early 80's covered right from its very beginning a corresponding liberalisation in the area of trade and technology. The present decade witnessed Indian economy being opened upto substantial imports of foreign goods and foreign technology. This is amply revealed by the fact that the non-oil imports of India have risen. Significantly from Rs.7280 crores in 1980-81 to Rs.13670 crores in 1985-86, an increased of 87.7 percent. Noticeably, the imports of capital goods have nearly doubled from Rs.1820 crores to Rs.3600 crores. Similarly, the number of technical and financial collaborations sanctioned has risen sharply from 526 in 1980 to 1024 in 1986. Unlike earlier decades, measures of 80s involved import liberalisation alongwith complete delicensing of some industries and this has affected industrial growth favourably. The new measures also entail replacing of quantitative limits on imports by tariffs to expose domestic industry to a reasonable amount of external competition.[@]

@ Long term fiscal policy (LFTP).

In the area of taxation, the marginal tax rates for personal income has been brought down from 62 percent to 50 percent and that for personal wealth was also sharply reduced from 5 percent to 2 percent in 1985-86 budget. In the more recent budget, the exemption limit for income tax has been raised from Rs.18000 to Rs.22000. The overhaul of central excise taxation through the introduction of MODVAT (Modified value added tax) also merits mention; prior to the introduction of MODVAT, excise taxes were levied on inputs, leading to distortions in the production structure. The MODVAT system of providing proforma credit for taxes paid on inputs (as anounced in the LFTP and introduced in the 1986 budget) basically aimed to progressively relieve inputs from excise and countervailing duties.

In sum, it is clear that a number of steps toward liberalising the regulatory framework have been taken in recent years. At least for the industrial sector, it seems to have paid off butwhether that trend continued for a longer time period is a moot question. The little evidence so far of liberalisation that is gathered points to the fact that for a vast economy like India, planning might be necessary but total planning is neither necessary nor feasible. In the present context, the question is not one of moreor less government intervention but that of choosing the right kind of intervention; The institutional reforms involving measures and liberalisation should replace the in appropriate mix of bureacratic controls. It seems the transformation of Indian economy in terms of major objectives as is sought to be achieved through liberalisation policies involving trade, financial markets, industry etc. could materialize only if policies of liberalisation and mechanism of competition are maintained and continued for a longer time period.