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Dr Reddy's prescription

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The global economy has reached a stage where economic management in different countries pose different sets of challenges, often leading to spillovers, affecting and complicating policy management for others. Increasingly, it is beginning to appear that crisis management was a lot easier than managing recovery. India also faces its own set of challenges as it finds itself entrapped by a nexus of high inflation, high fiscal deficit, high current account deficit (CAD) and lower growth. At this stage, when policymakers across the globe are trying hard to find answers to possibly the most difficult questions of recent times, Y.V. Reddy, former governor of Reserve Bank of India (RBI) and the chairman of the 14th Finance Commission, has put forward his assessment and policy prescription in his new book *Economic Policies and India's Reform Agenda: New Thinking*, which could be a useful guide for economic management in an otherwise complex world. The underlying idea of the volume, as Reddy notes, "is to provoke a discussion on the agenda for reform of the economic policy of India that is conscious of the emerging global developments".

The global setting

The global environment, as many commentators have observed, is not expected to be supportive in the foreseeable future. According to Reddy's assessment, growth will be lower and prices will be higher. The reasons for lower growth are widely understood, but two significant reasons are sighted for higher price. First, in the pre-crisis era, an important reason for low inflation was manufacturing activity in China with addition of a large labour force, which is unlikely to get repeated in any other country. Second, the advanced economies may now be willing to tolerate higher inflation due to a variety of reasons such as getting out of high level of public debt.

The India story

Though the Indian economy faces a range of challenges, the most significant and crucial part of economic management at the moment is external account. The CAD is at an alarming level and can pose serious financing challenges, leading to significant volatility in the currency and equity markets. CAD is expected to be in excess of 5% of the gross domestic product (GDP) in the current financial year. Reddy argues that zero CAD over the medium term should be the cornerstone of macro management.

This is significant as the Rangarajan committee on balance of payments in 1993 treated CAD at 2% of GDP as sustainable. Over the year, policymakers and analysts started treating CAD of 2.5-3% as manageable. However, in situations of stress, such as the case now, Reddy notes that "the international financial markets may not tolerate that level". Clearly, India is being able to manage CAD of this magnitude only because of the surge of liquidity in the international financial market. However, the supply of easy money may not last forever and even if it does for some time, it could have a different set of damaging consequences (*see http://bit.ly/VVIDQH*).

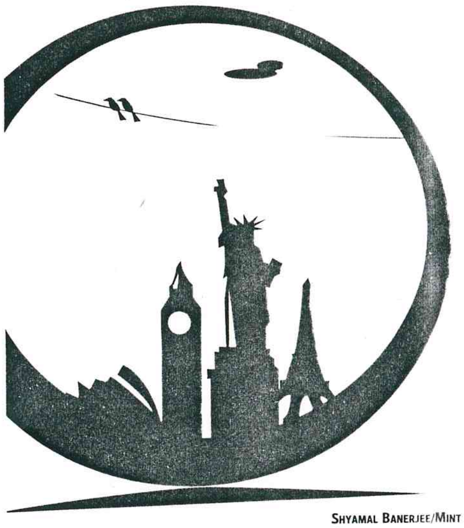
Further, the former governor is in favour of a policy focusing on new saving investment balance. Domestic saving will have to be encouraged to fill the investment gap being created due to zero CAD and can be done with better fiscal and monetary management. A target of zero CAD will naturally reduce the external vulnerability and volatility in the domestic financial markets, though the idea may not find ready acceptance among policymakers. A target of zero revenue deficit will also help create enabling conditions for higher growth. Importantly, both CAD and revenue at zero or close to zero will create the much needed policy space to tackle any economic shock.

Monetary policy dilemma

Another significant aspect of discussion and which could raise divergent views is central banking. Reddy argues that price stability as a single objective of the monetary policy is inadvisable. He notes: "There is preference for flexible inflation-targeting or credible commitment to price stability with recognition of the need for not ignoring stability of output and employment."

It is true that the single-minded objective of price stability by large central banks, notably the US Federal Reserve, was one of the reasons for the financial crisis, but multiple objectives can also create multiple challenges and may not necessarily reduce the chance of a mishap. In case of RBI, there is growing criticism for its "shifting goalposts" from headline inflation to core inflation to addressing growth risk to higher CAD risks. Despite multiple targets, inflation remains elevated, growth is at its lowest in a decade and external finance is almost in a touch and go situation.

Further, in Japan, the central bank is now being forced to rig the currency market to push inflation and output. It is not clear if the Japanese economy will be benefited in the long run and the rest of the world will be willing to bear the cost of the so-called chance of a Japanese revival.



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End note: Y.V. Reddy was in charge of the monetary policy in India when most of the excess in the global financial system was being built. Reddy and his team at the Mint Road, arguably, took counter-cyclical measures, which minimized the damage as the global financial crisis unfolded and the foresight was appreciated and acknowledged globally. Therefore, it is important that the ideas in policy management underlined by Reddy, such as on regulation, fiscal management, currency management and monetary policy, are debated, so that appropriate mechanism is devised which not only takes the economy forward from its present state, but also avoids a calamity in the future.

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