New Macroeconomic Consensus Rules Budget 2014-15

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A critique of the macroeconomic framework that underlies the fiscal consolidation approach of the Union Budget for 2014-15.

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With moderation in economic growth from the level of 9 per cent in 2010-11 to 4.5 per cent in 2012-13, there was general *consensus* that sustained high levels of fiscal deficit lead to various forms of macroeconomic imbalances and calls for immediate corrective fiscal policy response. Accordingly, as part of mid-year course correction, government successfully reduced fiscal deficit and laid down path for *fiscal consolidation*.

(from the *Preface* of "Macroeconomic Framework Statement 2014-15", emphasis added).

With contraction of government deficit there will be more room for private investment and capital inflows. This will also ease inflationary pressure providing comfort to RBI for easing monetary policy.

(from "The Medium Term Fiscal Policy Statement").

The purpose of this note is to present the macroeconomic framework behind this year's budget. Ever since the Fiscal Responsibility and Budget Management (FRBM) has come into force, the government is obliged to present a macroeconomic framework behind that year's budget. The essence of the macroeconomic framework behind this year's budget is quite clear from the two extracts given above.

New Macroeconomic Consensus

Let me first place the new macroeconomic consensus in a historical perspective. In the aftermath of the Great Depression in the 1930s, there was an attack on the prevalent orthodoxy in the discipline of economics from the centre-left by John Maynard Keynes, a Cambridge economist and from the left by Michal Kalecki, a Polish Marxist. Their argument was that capitalism suffers from fundamental instability if left to its own devices. While Keynes was of the opinion that the capitalist state can play the role of stabilising the system through active fiscal policy backed by monetary policy, Kalecki was more circumspect of its role especially because it required the state to be a supra-class identity which he believed was impossible in a deeply class-divided society. As a result of broadly following the Keynesian prescriptions, the advanced capitalist countries saw what is called the Golden Age from the end of the second world war to late 1960s before falling prey to an unprecedented spate of very high inflation in the 1970s.

Thence came the ideology of monetarism led by Milton Friedman, a Chicago economist, who argued that capitalism is a self-stabilising system unless the state destabilises it and high inflation of the 1970s was basically a result of the faulty state intervention preceding it. The underlying logic was that any attempt of expansionary fiscal policy can have at best a short-term effect, which gets reversed (since the system self-equilibrates to full employment of resources) but with a higher rate of inflation. It was based on (a) crowding-out of private investment due to an increase in the interest rates resulting from increased government borrowings; (b) given that supply of output in the long run is driven by rate of growth of labour, any attempt to increase demand through the fiscal deficit beyond this frontier increases inflation. It follows from this that an increase in the rate of growth can be brought only from the supply side. It was not a coincidence that a more extreme version of it came with Robert Barro in 1974 who argued that there is not even a short-term effect since for "rational" private agents optimising their consumption through periods and not just in the current period, any increase in the fiscal deficit is taken as a signal for an increase in taxation in the future so their current consumption falls by an equivalent amount, thereby, leaving demand unchanged in the current period itself.

The current macroeconomic consensus, also known by a misnomer New Keynesian synthesis (as there is hardly anything Keynesian about it), is basically a rehash of the old-monetarist argument although it comes in a new garb of agent's behaviour derived from "microeconomic foundations". In simple terms, it can be expressed through three relationships: (1) private investment decreases with the rate of interest (the investment-savings or IS curve); (2) rate of inflation increases with output (the Phillips curve); (3) the central bank should target the rate of interest compatible with full employment and low inflation (Taylor's rule). They also believe in the inherent stability of the capitalist system, which can at best move away from the full employment equilibrium in the short run because of labour market rigidities. Let us see how this works and why the two statements above in particular and current budget's philosophy in general follow straight from this framework.

Since both inflation and output can be influenced by interest rates set by the central bank, there is no additional scope for fiscal policy. If there is a recession in the economy, interest rates can be decreased to increase private investment (moving down the IS curve) and if there is high inflation, they could be increased to bring output down, thereby, controlling inflation (by moving down the Phillips curve). But what if there is high inflation along with a recessionary tendency in the economy as is being faced by the Indian economy today, a reality that is also the focus of the three documents appended with the budget? The mantra is "fiscal consolidation", which will bring output and, hence, inflation down. It will also be conducive to private investment since now the central bank has more elbow room to decrease the interest rates and let private investment soar. Moreover, a high fiscal deficit also means a high current account deficit since imports rise as a result of higher output without a commensurate increase in exports. In the absence of adequate capital inflows, this will lead to either a depletion of the foreign reserves or a depreciation of currency, both of which start a spiral of crisis in the external account. Correspondingly, a falling fiscal deficit leads to a fall in the current account deficit and an inflow of capital, thereby improving the external accounts of the country. So it is a win-win situation for all. Fiscal deficit is the villain in all of this, so spare no attempts to control it.

A Critique

While it seems all logical on the face of it, there is many a slip between the cup and the lip. As can be noticed, this framework is a combination of two arguments – impotence of fiscal policy and absolute dependence on monetary policy. Let us first look at the impotence of fiscal policy argument followed by a critique of an all-powerful monetary policy.

Is Fiscal Policy Indeed Impotent? The arguments of impotence of the fiscal policy have been extensively written about but it might help to reiterate them here especially since they are often lost sight of in these documents. The arguments are misplaced for the following reasons.

First, crowding out of private investment as a result of diversion of savings to finance the fiscal deficit is premised on an assumption of a fixed pool of savings. Surely an economy where expansionary fiscal policy is being implemented is functioning below its potential. So any increase in the expenditure by the government is going to add to the demand, which will generate income and hence additional savings to "finance" this deficit with no adverse effect on private investment. If anything, private investment could expand as a result of early signs of revival of demand in the economy as well as a rise in profits (crowding in).

Second, even if the deficit is monetised (adjusted through money supply), it need not lead to inflation through the route of "too much money chasing too few goods". Because too much money is not chasing too few goods as the basket of goods itself is expanding as a result of increase in demand.

Third, the assumption that the economy functions along its full employment frontier in the long run is faulty because what else is a long run but a series of short runs. So what is valid for a series of short runs will be equally valid for the long run as well. And if the rate of growth in the economy is determined by the rate of growth of demand, then government demand (whether consumption or investment) is as good as private sector demand (consumption or investment).

Fourth, there is no denying that there is a possibility of inflation or crowding out when the economy hits its full capacity/employment barrier but then that will be true of any source of demand including private investment. Why make the fiscal deficit the villain except for political reasons which want to keep the role of the government in demand management to the lowest.

Is Monetary Policy All-powerful? Let us now look at the three macroeconomic relationships which constitute the kernel of today's macroeconomic consensus.

The first relationship requires private investment to be an inverse function of the rate of interest. What if it is not so? Such can be the case for a variety of reasons. First, private investment is more sensitive to sales than to the cost of loans. So in recessionary conditions, even with a fall in the rate of interest investment might not recover given the uncertainties associated with future sales of products resulting from such investments. Moreover, there could be a kink in this relationship, i e, while an increase in the interest rate brings down investment, a decline does not bring a positive effect on investment. Second, even if it were a function of the interest rate, it is not just the current rate of interest but the expected rate of interest too which enters investment decisions of the capitalists. So a fall in the current rate of interest could set in an expectation for a further fall in the future, thereby, making the capitalists wait for such a future date. Third, there is a lower bound of zero to the nominal rate of interest and by then if investment has not recovered to the full employment level, it never will. The recent experience of a falling index of industrial production (IIP) due to an increase in the interest rate by the Reserve Bank of India (RBI), while the absence of an industrial recovery despite a fall in the interest rate is testimony to some of these arguments.

The second one entails a positive relationship between the level of output and inflation. Its anatomy is that with an increase in output, there is a rise in unit costs (labour as well as inputs) leading to inflation. This might not be true especially for labour-surplus economies like ours for the following reasons. First, an increase in employment does not necessarily entail an increase in real wages especially since there is a presence of a huge reserve army of labour except in the case of highly skilled labour. Second, even if the real wages rise, they might be more than compensated for a rise in labour productivity as the scale of production increases. Third, for given prices of inputs, there is no reason why an additional unit of output would necessarily require more units of input than the previous unit. If anything, there will be economies of scale here too, i e, per unit input costs might fall. Fourth, if the source of inflation is cost-push, either external through oil prices or internal through food prices, controlling demand might have no effect on inflation. The recent experience of the RBI with its failure to control inflation through a contracting IIP proves this point clearly. What is required for controlling inflation is an attack on the sources of inflation. For example, deregulation of oil prices in the name of controlling the fiscal deficit actually had an inflationary impact on the economy. Food price inflation can be only tackled by matching production with demand, better distribution and government-controlled prices at least of the essentials and not through dismantling the public distribution system (PDS) or allowing speculative trading in commodities.

The third relationship that the central bank could follow Taylor's rule is premised on certain assumptions, which might not hold in reality. First, the rate of interest that the central bank controls, i e, repo and reverse repo rates might have little effect on the rates of interest that affect investment, i e, prime lending rate (PLR). Second, even if it can influence the PLR, the so-called full employment equilibrium rate of interest is itself a function of expectations so it is possible that by the time the central bank changes the rate of interest towards this equilibrium rate, the goal post itself might have shifted.

For all these reasons, there are serious limitations of total dependence on monetary policy that this macroeconomic framework advocates.

Two Other Problems

There are two other serious misconceptions that this framework employs – capital account can be adjusted through astute monetary policy and labour market rigidities (read obstinacy of the labour unions) lead to unemployment.

Its faith in monetary policy to steer the external sector, especially the capital account comes from the assumption that the capital account can be made to adjust according to the needs of the current account through interest rate signals. Such is not the case especially for developing countries which do not happen to be safe havens for finance capital. It is more likely that international finance capital is mostly exogenous, in which case its trajectory decides what happens to the current account through the movements in the exchange rates rather than the other way round. Therefore, an endogenous current account means that the level of output is itself dependent on these autonomous capital flows. So, when there is an upsurge of inflows, the currency appreciates and affects the current account and the level of output adversely. On the other hand, it could steer consumption through wealth effects arising out of surging stock markets driven by this inflow and/or investment through the foreign direct investment route. The net effect will depend on which one dominates. Either way, monetary policy can do precious little in controlling the flow of international capital. What is needed is direct control of the capital account according to the needs of the home country.

What has been saved till the end is probably the starkest contrast between this New Keynesian framework and Keynes in the original, i e, the understanding of the labour market. Between the labour market and output market equilibria, the consensus gives primacy to the former and argues that the reason for unemployment is rigidities in the labour market while the level of output in the latter "comes out of the wash". Hence, their recommendations for policies towards labour market flexibilities. In sharp contrast to this, Keynes gave primacy to the latter by arguing that it is the output generated as a response to demand that determines the level of employment and, hence, gave primacy to the level of demand and his faith in fiscal as opposed to monetary policy.

What is assumed today as a consensus is far from one. The orthodoxy today needs to be challenged both in the theoretical and policy circles. In the absence of that, future of countries is grim much like what the "Chicago boys" did to Latin America in the late decades of the last century.