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The journey of economic reforms

It involve a choreographed dance of multiple institutions and individuals, over long periods

K P Krishnan **August 30, 2020** Last Updated at 22:22 IST

Today's policy announcement is typically yesterday's thinking. Policies, like ideas, are usually path-dependent. "Aarthikam Chintanam" or "thought(s) on finance or economy" is a monthly column that will explore the evolution of economic policy ideas in India.

The media tends to sensationalise the big days of economic reform, such as February 20, 2015 (the day that inflation targeting came) or May 11, 2016 (the day on which the Insolvency and Bankruptcy Code or IBC was passed). Though as symbolic milestones these days are important, when we look deeper, these major reforms are not a sprint but a relay race. They involve a choreographed dance of multiple institutions and individuals, over long periods. Developing and nurturing ideas, and the committee process, are key elements through which this works.

Newspaper headlines announced inflation targeting with a simple storyline. India had a sustained inflation problem. On February 20, 2015, the Reserve Bank of India (RBI) was given this formal objective. But the story actually runs from the 1990s all the way (potentially) to 2025. Back then, there was a long period when the RBI forced the USD/INR exchange rate to Rs 31.37 a dollar, at a time when there was a lot of capital inflow. The RBI bought dollars, which flooded the market with rupees, and kicked off inflation.

The RBI leadership of the time — C Rangarajan and S S Tarapore — was highly cognisant of these difficulties. They understood the constraints imposed by the "impossible trinity": No country can retain monetary policy autonomy and manage its own exchange rate and have capital account openness. They had the strategic insight that the way forward lay in an open capital account, coupled with a flexible exchange rate, and then monetary policy would be tied down to deliver an inflation target. These ideas were then socialised and refined within the RBI.

In 2007, the Percy Mistry committee recommended that India adopt inflation targeting. This was reiterated by the Raghuram Rajan committee in 2009. The insights of the previous years proved to be prescient when consumer price index (CPI) inflation breached 5 per cent in February 2006 and India went into a sustained inflation crisis.

In 2013, the Financial Sector Legislative Reforms Commission (FSLRC) led by Justice B N Srikrishna recommended the procedures through which the monetary policy committee would work, and the RBI would be held accountable to deliver low and stable inflation. This was followed by the Urjit Patel committee on monetary policy reform, set up by the RBI, which reiterated the, by then, consensus view.

For the end-game, a two-step strategy was

developed at the Ministry of Finance (MoF). The "Ways and Means

Illustration: Ajay Mohanty

Agreement" of the late 1990s, through which monetisation of the fiscal deficit by the RBI was stopped, began as an agreement between the RBI and MoF, and later became the Fiscal Responsibility and Budget Management (FRBM) Act. In a similar fashion, the plan was made to first establish inflation targeting through a "monetary policy framework agreement", between the RBI and MoF, and later amend the RBI Act.

The technical work for this was done in 2013 and 2014, and the agreement was signed between Rajiv Mehrishi and Raghuram Rajan on February 20, 2015. This was followed by amendments to the RBI Act. The RBI Act, of 1934, had a preamble that described the establishment of the RBI as a "temporary" measure. It is fitting that, in February 2016, these words were removed, for the RBI had finally found a purpose and a conceptual foundation.

The new framework rapidly delivered results. The sustained failure on inflation of previous decades was replaced by headline inflation (year-on-year CPI inflation) that generally stayed within the required range from 2 to 6 per cent. For the first time in India's recent history, monetary stability is within reach.

At the same time, there is considerable work to be done so that small changes in the policy rate are able to impact upon the economy, so as to achieve greater inflation control with a narrower band of possible values for CPI inflation and smaller changes in the policy rate. This will require implementing the well-established agenda for reform of banking regulation and bond market regulation, which will perhaps take another five years. If this works out, the saga of India's monetary policy regime runs from the candid acknowledgement in 1934 that the establishment of the RBI was a "temporary" measure, to the clarity of the RBI leadership in the early 1990s, to the second generation of reformers, that got it done in 2015 and 2016, to make the inflation targeting framework work fully by about 2025. These are long journeys, and each wave of reformers passes the baton on to the next one.

A similar story is seen with the bankruptcy reform. The first banking crisis of India, in the late 1990s, brought the problems of debt recovery to the fore. The first milestone here was the Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002, which gave lenders the power to recover collateral when there was a default on secured credit. The Raghuram Rajan committee of 2009 first talked about the need for a full-blown bankruptcy code.

The Budget speech of 2015 had a paragraph about a new bankruptcy framework for small and mid-size enterprises. At the MoF, this opportunity was enlarged into a project to build the bankruptcy code. The experience with FSLRC (2011-2015) had given a new level of confidence, and process understanding, on how such complex policy projects could be organised. This led to the appointment of the bankruptcy legislative reforms commission led by T K Viswanathan. This produced an interim report, with small incremental modifications to the Companies Act, and then the full report with a draft bankruptcy code. Researchers from Vidhi and Finance Research Group of Indira Gandhi Institute of Development Research helped draft the law. This law was enacted in May 2016. There are more examples like goods and services tax, anti-money laundering laws, etc, which are similar in nature. What we see in all of them is the journey of ideas, committees, and eventually drafting of law over a long time horizon (from 2002 to 2016) where the baton was passed from one generation of reformers to the next. India needs more of these in all sectors, and certainly in the areas of finance and the economy.

The writer retired as a secretary to GoI and is now a professor at the National Council of Applied Economic Research. Views are personal