A stimulating alliance

Sustained engagement with States and easing their financial worries will rev up the economy

Highlights:

1. The Centre will release over ₹95,000 crores in one stroke to States this month, it said after meeting with Chief Ministers and State Finance Ministers to discuss the state of the economy and to sustain the recovery from the COVID-19 pandemic.
2. After all, no amount of central policy fixes will suffice to revive the country's long-somnolent investment cycle without States working in tandem.
3. The Government set aside the spate of recent confrontations with States over revenue, GST compensation concerns, and their fears about 'encroachment' on their powers, to initiate an economy-focused dialogue independent of Budget consultations and GST Council machinations.
4. Its ready acceptance of the States' request to expedite the sharing of taxable revenues — as in the case of GST compensation for this year — is a token of the faith it seeks to imbue.
5. While most States have positive cash balances, access now to double the funds than usual will help them ramp up capital expenditure.
6. The cash flow could also help several States catch up on their CAPEX targets, which hinges on an additional borrowing limit of 0.5% of their Gross State Domestic Product.
7. The Finance Ministry's clarification that the excise duty cuts on petrol and diesel shall not dent the tax pool shared with States has also soothed frayed nerves.

Cooperative ideas: Investor facilitation

1. The rare and 'one-off' meeting with CMs yielded several ideas and policy proposals, including a simple demand that the Centre share leads about prospective investors and enunciate a clear policy on green clearances.
2. While the Finance Ministry believes that investments are on the cusp of a take-off, public investments will need to do the heavy lifting for several more quarters before the private sector can be expected to spur the economy's growth.

3. The Centre and States need to combine forces to make it an easier and swifter journey through red tape for potential investors. Just 10 States have joined the single window clearance system for investors, and four more may join next month.
4. It not only makes sense to sustain this free-wheeling economic dialogue with States because the economy still needs collective hand-holding.

The monetary, fiscal challenges of cryptocurrency

These challenges will emerge when digital currencies gain traction. Policies must prepare for the transition

Digital money: Summary Micro level Advantages and Concerns

1. The ongoing technological revolution has meant that "digital money" — one manifestation of which are cryptocurrencies — is upon us. The microeconomic trade-offs are well-known and have been argued.
2. Digital currencies have the potential to spur financial innovation, increase efficiencies through faster and cheaper payments and augment financial inclusion.
3. Conversely, concerns around safety (cyber attacks and fraud), financial integrity (money laundering and evasion of capital controls) and energy usage (outsized energy needs to mine cryptos) are also well-documented.
4. Further, to the extent that privately-issued cryptos currently serve largely as speculative assets, the need for updating consumer protection and regulatory frameworks is also clear.
5. But even as the micro debate rages, there is much less appreciation of the macro consequences of privately-issued cryptocurrencies. What happens if, over time, cryptos evolve from speculative assets to become viable mediums

of exchange? What would this imply for the conduct of monetary, fiscal and exchange rate policies?

Macro issues: Erosion of effectiveness of Monetary policy

1. For starters, how would monetary policy be impacted if a private digital currency was competing with fiat currencies? Think of this as "dollarisation" by another name, but with a crucial difference as enumerated below.
2. Latin America is replete with economies becoming "dollarised". As domestic nationals lost faith in their own currency as a store of value, they shifted into and began transacting in US dollars for the security and stability it accorded.
3. What this did was to render domestic monetary policy ineffective, because domestic central banks cannot set interest rates and inject liquidity in a foreign currency.
4. The greater the substitution into US dollars, the lower the potency of monetary policy. In effect, these economies were importing the monetary policy of the US Fed.
5. Widespread adoption of privately issued digital currencies as a medium of exchange will have much the same impact. The larger the monetary base they cannibalise, the less potent will be domestic monetary policy in responding to business cycle needs and external shocks.
6. As the IMF points out, if cryptos are only used for "niche purposes" — narrow cross-country transfers and remittances — which are then quickly converted back into local fiat currencies, the implications for monetary policy will be contained.

Medium of exchange or speculative asset?

1. But what are the prospects for the widespread adoption of cryptocurrencies as a medium of exchange? The intellectual case for Bitcoin stemmed from the fear of debasement of fiat currencies through an unprecedented expansion of G3 central bank balance sheets after the global financial crisis.
2. Its founders, therefore, preempted fears of debasement by fixing Bitcoin's aggregate supply, in the hope it would evolve into a viable alternative medium of exchange.
3. But precisely because aggregate supply is inelastic, demand shocks result in outsized price volatility. This, in turn, renders Bitcoin an inappropriate medium of exchange. Instead, it's morphed into a speculative asset.

4. To get around this problem, "Stablecoins" have been introduced, whose value is pegged to a fiat currency by maintaining equivalent reserves (think of a "currency board" exchange rate regime).
5. By providing much greater price stability, these Stablecoins hope to serve as viable mediums of exchange and have proliferated rapidly in recent years. Does this pose a grave risk to monetary policy? Much will depend on the degree of currency substitution.

Existential challenge:

1. Instead, what central bankers and policymakers fear is a more existential challenge to the global monetary system. In a 2019 paper, Brunnermeir, James and Landau raise the prospect of mega tech companies running global e-commerce or social networking platforms issuing their own digital currencies to their global customer base that serves both as a unit of account and a medium of exchange on their platforms.
2. Given the self-reinforcing network externalities involved, adoption would be rapid as digital currencies are bundled with other data and services. We would then have the prospect of digital currencies being transacted on large scales actively competing with fiat currencies.
3. The report posits global economic activity could eventually be re-organised into "digital currency areas" (DCAs) that run across national boundaries, characterised by their own digital currency and unit of account issued by the network owner, with the size of these DCAs dwarfing national economies.
4. Once that happens, all bets are off with private network owners effectively running independent monetary policy.
5. From the perspective of a local economy, think of this as "dollarisation" except that monetary policy is being ceded not to the Fed, but – as the IMF warns — to a profit-maximising network owner, who may not have any incentive to use monetary policy to smooth shocks or issue emergency liquidity when needed.
6. The fate of economies to respond to shocks, at least in part, would be in the hands of private firms. This would present an existential threat to monetary policy as we know it.

Fiscal Challenges to the economy:

1. The implications are more straightforward. The greater the substitution into digital currencies the more the loss of seigniorage revenues to governments from the monopoly issuance of fiat currency.

2. Separately, fiscal revenues can also be adversely impacted by the increased tax evasion opportunities that crypto-currencies can facilitate.
3. To the extent that increased substitution into cryptos reduces the efficacy of monetary policy, the onus on fiscal policy to respond to economic shocks will commensurately rise.
4. This could create challenges in a post-Covid world. The pandemic has left a legacy of elevated public debt around the world. Fiscal policy, especially in emerging markets, will have the least space to act when it is most needed.

Impact on Ruppe:

1. To the extent that cryptos are mined abroad, demand for them — whether for transactions or speculative purposes — will be akin to capital outflows. In turn, if cryptos begin to get mined onshore, they will induce capital inflows.
2. These dynamics will increase capital account volatility and, to the extent that these cross-border flows circumvent capital flow measures, they de facto increase capital account convertibility, accentuating the policy trilemma that emerging markets confront.
3. This will also directly impact the currency market. As the 2021 Global Financial Stability Report underscores, there must exist a triangular arbitrage between, say, the local Rupee-Bitcoin market, the Dollar-Bitcoin market and the Rupee-Dollar market. Consequently, changes in the Rupee-Bitcoin markets will inevitably spill over into the Rupee-Dollar markets for markets to clear.

All told, the macro implications of widespread crypto adoption are complex and interlinked. For now, there is justifiable angst about growing household attraction for cryptos as speculative assets, with its attendant regulatory implications. But the true macro challenge will emerge and compound if and when unbacked private digital currencies are seen as viable mediums of exchange. That's what policy must anticipate and prepare for.