

A Critical Appraisal of Fiscal & Monetary Policy in India

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Abstract

This research article is unique in itself aimed at addressing the monetary and fiscal policy in India and its implications on Indian economy framework. For achieving the objectives, relevant data was gathered from secondary data sources. It is expected that the outcome of the study shall give a general idea on evolution and implications of monetary and fiscal policy in India. Moreover It is highly desirable that the outcome of this study shall prove useful for policymakers, program evaluators and general public to develop a general guideline on the emergence of banking sector & its future implications.

Keywords – Monetary policy, Fiscal Policy, Government, Economy

Introduction

History of Fiscal Policy in India

India faced a severe macroeconomic crisis in 1991. A series of economic reforms, implemented in response, have, arguably, supported higher growth and a more secure external payments situation. Removal of controls and trade barriers, along with modernization of regulatory institutions, characterized reforms in industry, trade, and finance. However, growth only marginally accelerated in the 1990s compared to the previous decade. At times, structural reforms seem to have stalled, and little progress has been made in areas such as labor market and bankruptcy reforms. Perhaps the most striking aspect of reform is the lack of progress in restoring fiscal balance. A high fiscal deficit of around 9.5% of GDP, widely perceived as unsustainable, contributed to the crisis of 1991. Containing this deficit was one of the key structural adjustments undertaken by the Indian government at the time. This effort met with some success: the fiscal deficit came down to 6.4% of GDP, and growth accelerated to a peak of 7.5% in 1996-97. From 1997-98 onwards, however, growth has slowed and the deficit has widened, returning attention to India's fiscal policy and prospects.

India's current fiscal situation is potentially grave, and could lead to an economic crisis (fiscal, monetary and/or external) with severe short-term losses of output and even political turmoil, or, alternatively and more subtly, many years of continued underperformance of the

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economy. Most of the papers in this conference establish the gravity of the fiscal situation, even in the short run, through extensive projections based on various assumptions of growth, interest rates and deficits, as well as detailed crosscountry comparisons (and some regressions) of the Indian situation with that of other developing economies. Most of the conference papers restrict themselves to examining the implications of intertemporal budget algebra, as pioneered by, e.g., Buiter (1990) and Fischer and Easterly (1990). The prima facie solution to the looming problem is obvious: control fiscal deficits. The deeper question is how is this to be achieved, and to what extent? One complicating factor is the existence of off-budget items that are not accurately measured or monitored. The uncertainty associated with these items makes formulating budgetary policies more challenging. Besides, fiscal policy obviously cannot be analyzed in isolation. Monetary and exchange rate policies have to be considered in conjunction with it (not to mention microeconomic policies and institutional reforms) for achieving desired combinations of growth and stability under realistic assumptions about sustainable capital inflows from abroad.² Even on the fiscal side alone, this perspective shifts the focus to considering optimal paths of public consumption, investment, taxes and borrowing, rather than an emphasis only on primary balances. Ultimately this broader framework poses technical and empirical questions that would benefit from an explicit theoretical analysis as a foundation for econometric modeling and estimation.

The Indian Fiscal Situation Even before independence, there was a broad consensus, across the political spectrum, that once independence was achieved, Indian economic development should be planned, with the state playing a dominant role in the economy and achieving self-sufficiency across the board as a major objective (Srinivasan 1996). Within three years of independence, a National Planning Commission was established in 1950, charged with the task of drawing up national development plans. The adoption of a federal constitution with strong unitary features, also in 1950, facilitated planning by the central government. Several central government-owned enterprises were established, and a plethora of administrative controls (the so-called 'license-quota-permit raj') was adopted to steer the economy towards its planned path. At the same time, fiscal and monetary policy remained quite conservative, and inflation relatively low – the latter reflecting the sensitivity of the electorate to rising prices. During 1950-80, India's economic growth averaged a very modest 3.75 percent per year, reasonable by pre-independence standards, but far short of what was needed to significantly diminish the number of poor people. The license-permit raj not only did not deliver rapid growth, but worse, unleashed rapacious rent-seeking and administrative as well as political corruption (Srinivasan 1996). In the 1980s, India's national economic policymakers began some piecemeal reforms, introducing some liberalization in the trade and exchange rate regime, loosening domestic industrial controls, and promoting investment

in modern technologies for areas such as telecommunications. Most significantly, they abandoned fiscal conservatism and adopted an expansionary policy, financed by borrowing at home and abroad at increasing cost. Growth accelerated to 5.8 percent during the 1980s, but the cost of this debt-led growth was growing macroeconomic imbalances (fiscal and current account deficits), which worsened at the beginning of the 1990s as a result of external shocks and led to the macroeconomic crisis of 1991. The crisis led to systemic reforms, going beyond the piecemeal economic reforms of the 1980s. An IMF aid package and adjustment program supported these changes. The major reforms included trade liberalization, through large reductions in tariffs and conversion of quantitative restrictions to tariffs, and a sweeping away of a large segment of restrictions on domestic industrial investment. Attempts were made to control a burgeoning domestic fiscal deficit, but these attempts were only partially successful, and came to be reversed by the mid-1990s.

Evolution of monetary policy in line with the changing character of the economy

1935 to 1949: Initial Phase

7. It is interesting to note that the Reserve Bank came into being in the backdrop of the great depression facing the world economy. Given the unsettled international monetary systems, the Preamble to the RBI Act, 1934 provided the edifice for the evolution of monetary policy framework. Until independence, the focus was on maintaining the sterling parity by regulating liquidity through open market operations (OMOs), with additional monetary tools of bank rate and cash reserve ratio (CRR). In other words, exchange rate was the nominal anchor for monetary policy. In view of the agrarian nature of the economy, inflation often emerged as a concern due to frequent supply side shocks. While the price control measures and rationing of essential commodities was undertaken by the Government, the Reserve Bank also used selective credit control and moral suasion to restrain banks from extending credit for speculative purposes.

1949 to 1969: Monetary Policy in sync with the Five-Year Plans

8. India's independence in 1947 was a turning point in the economic history of the country. What followed was a policy of planned economic development. These two decades were characterised not only by a predominant role of the state but also by a marked shift in the conduct of monetary policy. The broad objective was to ensure a socialistic pattern of society through economic growth with a focus on self-reliance. This was intended to be achieved by building up of indigenous capacity, encouraging small as well as large-scale industries, reducing income inequalities, ensuring balanced regional development, and preventing

concentration of economic power. Accordingly, the government also assumed entrepreneurial role to develop the industrial sector by establishing public sector undertakings.

9. As planned expenditure was accorded pivotal role in the process of development, there was emphasis on credit allocation to productive sectors. The role of monetary policy, therefore, during this phase of planned economic development revolved around the requirements of five-year plans. Even if there was no formal framework, monetary policy was relied upon for administering the supply of and demand for credit in the economy. The policy instruments used in regulating the credit availability were bank rate, reserve requirements and open market operations (OMOs). With the enactment of the Banking Regulation Act in 1949, statutory liquidity ratio (SLR) requirement prescribed for banks emerged as a secured source for government borrowings and also served as an additional instrument of monetary and liquidity management. Inflation remained moderate in the post-independence period but emerged as a concern during 1964-68.

1969 to 1985: Credit Planning

10. Nationalisation of major banks in 1969 marked another phase in the evolution of monetary policy. The main objective of nationalisation of banks was to ensure credit availability to a wider range of people and activities. As banks got power to expand credit, the Reserve Bank faced the challenge of maintaining a balance between financing economic growth and ensuring price stability in the wake of the sharp rise in money supply emanating from credit expansion. Besides, Indo-Pak war in 1971, drought in 1973, global oil price shocks in 1973 and 1979, and collapse of the Bretton-woods system in 1973 also had inflationary consequences. Therefore, concerns of high inflation caused by deficit financing during 1960s gathered momentum during the 1970s. Incidentally, the high inflation in the domestic economy coincided with stagflation – high inflation and slow growth – in advanced economies. In such a milieu, traditional monetary policy instruments, viz., the Bank Rate and OMOs were found inadequate to address the implications of money supply for price stability. As banks were flushed with deposits under the impact of deficit financing, they did not need to approach RBI for funds. This undermined the efficacy of Bank Rate as a monetary policy instrument. Similarly, due to underdeveloped government securities market, OMOs had limited scope to be used as monetary policy instrument. During this phase, the average growth rate hovered around 4.0 per cent, while wholesale price index (WPI) based inflation was around 8.8 per cent.

1985 to 1998: Monetary Targeting

11. In the 1980s, fiscal dominance accentuated as reflected in automatic monetisation of budget deficit through ad hoc treasury bills and progressive increase in SLR by 1985. Concomitantly, inflationary impact of deficit financing warranted tightening of monetary policy – both the CRR and Bank Rate were raised significantly. The experience of monetary policy in dealing with the objectives of containing inflation and promoting growth eventually led to adoption of monetary targeting as a formal monetary policy framework in 1985 on the recommendations of the Chakravarty Committee. In this framework, with the objective of controlling inflation through limiting monetary expansion, reserve money was used as operating target and broad money as intermediate target. The targeted growth in money supply was based on expected real GDP growth and a tolerable level of inflation. This approach was flexible as it allowed for feedback effects. CRR was used as the primary instrument for monetary control. Nonetheless, due to continued fiscal dominance, both SLR and CRR reached their peak levels by 1990.

12. The worsening of fiscal situation in late 1980s was manifested in deterioration of external balance position and collapse in domestic growth in 1991-92, in the backdrop of adverse global shocks – the gulf war and disintegration of the Soviet Union. The resultant balance of payments crisis triggered large scale structural reforms, financial sector liberalization and opening up of the economy to achieve sustainable growth with price stability. Concurrently, there was a shift from fixed exchange rate regime to a market determined exchange rate system in 1993. In the wake of trade and financial sector reforms and the consequent rise in foreign capital flows and financial innovations, the assumption of stability in money demand function as well as efficacy of broad money as intermediate target came under question. At the same time, there was a notable shift towards market-based financing for both the government and the private sector. In fact, automatic monetisation through ad hoc treasury bills was abolished in 1997 and replaced with a system of ways and means advances (WMAs). During this period, average domestic growth rate was 5.6 per cent and average WPI-based inflation was 8.1 per cent.

Review of Literature

Chowdhury, Abdur, "Monetary and Fiscal Policy as a Stabilization Tool: The Case of Korea and Turkey" (1989). Monetary and Fiscal Policy as a Stabilization Tool: The Case of Korea and Turkey The aim of this article has been to test the comparative effectiveness of monetary and fiscal policy as a stabilization tool in Korea and Turkey. A STABILIZATION 45 reduced-form methodology, vector auto-regression, is used in the empirical analysis. This technique is employed rather than a single equation or a structural model approach since it avoids imposing potentially spurious a priori constraints on the

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model. A four-variable vector autoregressive model is initially estimated for each country. The variables include income, exports, a monetary, and a fiscal policy variable. The dynamic characteristics of the models are analyzed by estimating variance decompositions and impulse response functions. Finally, the vector autoregressive systems are compared with a modified version of the St. Louis equation on the basis of out-of-sample forecasting performances. The results suggest that monetary actions exert a significant, permanent effect on economic activity in Korea while fiscal actions have no statistically significant, lasting influence. On the other hand, fiscal rather than monetary actions exert the dominant influence on economic activity in Turkey

Richard hemming & Kalpana Kochar (1998) “The role of Monetary and fiscal Policy in the growth Process” This paper has described the contribution structural reforms in the areas of fiscal and monetary policy can make to growth-oriented adjustment. In principle, there appears to be a much-expanded role for fiscal policy compared with less ambitious adjustment strategies. While the focus of monetary policy should continue to be stabilization, there is scope nonetheless for structural change to enhance efficiency, although this is likely to be less influential than fiscal reform.

The set of reforms described in the paper is not intended to be exhaustive. Moreover, while the reforms are derived from principles that are probably of general applicability, it should be emphasized that the precise package of reforms that can most successfully foster improved resource allocation and growth is very much dependent on the circumstances of the country in question.

Lastly, it should be borne in mind that the empirical support for the suggested reforms is not overwhelming. While in many cases such reforms have been successfully implemented, there is a risk that they may not have their intended effect, or at least that any impact will be much less than expected. The economic principles that point to their beneficial consequences are not natural laws; they are simply the best basis for reform that we currently have.

Kulkarni, K. G., & Saxena, S. C. (2000). Have the Monetary and Fiscal Policies been Effective in India? his paper analyzes the impact of fiscal and monetary policies on output in India. The econometric evidence suggests that less than 5 per cent of the variation in output is explained by fiscal and monetary policies before the crisis in 1991. However, post-crisis data reveals the growing importance of both the macro-economic policies in explaining output variation. The paper discusses theoretical arguments, surveys prior studies and attempts to explain the reasons for the empirical results.

L. Lambertini & R. Rovelli, 2003. 2001 “Monetary and fiscal policy coordination and macroeconomic stabilization. A theoretical analysis” examined the relations

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between monetary and fiscal policies in the process of macroeconomic stabilization .Our model suggests that each policy maker prefers to be the second mover in a “Stakelberg” situation, i.e. where one policy makers pre commits its policy choice. At the same time, both Stakelberg solutions are preferable, for each policymaker, to the Nash solution. We argue that there is a natural way to choose among two Stakelberg games. The solution implies that the government acts as a leader and sets fiscal policy according to the minimization of the Social Welfare Function (which fully internalizes also the objective of price stability). This optimal solution mirrors the existing institutional arrangements, where fiscal policy decisions ate typically taken before, and less frequently than monetary policy decisions. We interpret our results in relation to the debate on monetary-fiscal coordination in EMU and on the role of the Stability and Growth Pact. We argue that a coordination mechanism along the lines of the Broad Economic Policy is desirable.

V.V. Chari, Patrick J. Kehoe, (1999) “Optimal fiscal and monetary policy provide an introduction to optimal fiscal and monetary policy” using the primal approach to optimal taxation. We use this approach to address how fiscal and monetary policy should be set over the long run and over the business cycle.find four substantive lessons for policymaking: Capital income taxes should be high initially and then roughly zero; tax rates on labor and consumption should be roughly constant; state-contingent taxes on assets should be used to provide insurance against adverse shocks; and monetary policy should be conducted so as to keep nominal interest rates close to zero.by studying optimal taxation in a static context. We then develop a general framework to analyze optimal fiscal policy. Finally, we analyze optimal monetary policy in three commonly used models of money: a cash-credit economy, a money-in-the-utility-function economy, and a shopping-time economy.

Objectives of Research Study

- To study the history of monetary policy and fiscal policy in India
- To analyse in detail the main facets of monetary and fiscal policy
- To provide an account of similarities and differences among these two policies

Research Methodology

This research is a direct outcome of secondary data in which relevant data was extracted from research papers, reports and published data on different government websites. The main purpose is to provide an overview of monetary and fiscal policy in India. The data has been analysed and interpreted by descriptive means to address the objectives and arrive at appropriate conclusions.

Analysis & Discussion

Monetary Policy vs. Fiscal Policy: An Overview

Monetary policy and fiscal policy refer to the two most widely recognized tools used to influence a nation's economic activity. Monetary policy is primarily concerned with the management of interest rates and the total supply of money in circulation and is generally CARRIED out by central banks, such as the U.S. Federal Reserve (Fed). Fiscal policy is a collective term for the taxing and spending actions of governments. In the United States, the national fiscal policy is determined by the executive and legislative branches of the government.


KEY HIGHLIGHTS

- Both monetary and fiscal policy are macroeconomic tools used to manage or stimulate the economy.
- Monetary policy addresses interest rates and the supply of money in circulation, and it is generally managed by a central bank.
- Fiscal policy addresses taxation and government spending, and it is generally determined by government legislation.
- Monetary policy and fiscal policy together have great influence over a nation's economy, its businesses, and its consumers.

Monetary Policy

Central banks typically use monetary policy to either stimulate an economy or to check its growth. By incentivizing individuals and businesses to borrow and spend, the monetary policy aims to spur economic activity. Conversely, by restricting spending and incentivizing savings, monetary policy can act as a brake on inflation and other issues associated with an overheated economy.

The Fed frequently uses three different policy tools to influence the economy:

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- **Open Market Operations:** Open market operations are carried out on a daily basis when the Fed buys and sells U.S. government bonds to either inject money into the economy or pull money out of circulation.¹
- **Reserve Requirements:** By setting the reserve ratio, or the percentage of deposits that banks are required to keep in reserve, the Fed directly influences the amount of money created when banks make loans.
- **Discount Rate:** The Fed also can target changes in the discount rate, which is the interest rate it charges on loans it makes to financial institutions. This tool is intended to impact short-term interest rates across the entire economy.

Monetary policy is more of a blunt tool in terms of expanding and contracting the money supply to influence inflation and growth and it has less impact on the real economy. For example, the Fed was aggressive during the Great Depression. Its actions prevented deflation and economic collapse but did not generate significant economic growth to reverse the lost output and jobs.

Contractionary vs. Expansionary Monetary Policy

Monetary policies can be either contractionary or expansionary. Implementing one type of policy depends on the current economic climate and the ultimate goals.

- **Contractionary Monetary Policy:** Central banks will use contractionary monetary policies when inflation becomes a concern as the economy gets overheated. In this case, prices rise as purchasing power drops.
- **Expansionary Monetary Policy:** This type of monetary policy is used to help spur growth when there's a recession or slowdown. Expansionary monetary policies have limited effects on growth by increasing asset prices and lowering the costs of borrowing, making companies more profitable.

Monetary policy seeks to spark economic activity, while fiscal policy seeks to address either total spending, the total composition of spending, or both.

Fiscal Policy

Fiscal policy refers to the steps that governments take in order to influence the direction of the economy. But rather than encouraging or restricting spending by businesses and consumers, fiscal policy aims to target the total level of spending, the total composition of spending, or both in an economy.

The two most widely used means of affecting fiscal policy are:

- **Government Spending Policies:** Governments can increase the amount of money they spend if they believe there is not enough business activity in an economy. This is often referred to as stimulus spending. They can borrow money by issuing debt securities (like government bonds) if there are not enough tax receipts to pay for the spending increases, allowing them to accumulate debt. This is referred to as deficit spending.
- **Government Tax Policies:** By increasing taxes, governments pull money out of the economy and slow business activity. Fiscal policy is typically used when the government seeks to stimulate the economy. It might lower taxes or offer tax rebates in an effort to encourage economic growth. Influencing economic outcomes via fiscal policy is one of the core tenets of Keynesian economics.²

When a government spends money or changes tax policy, it must choose where to spend or what to tax. In doing so, government fiscal policy can target specific communities, industries, investments, or commodities to either favor or discourage production—sometimes, its actions are based on considerations that are not entirely economic. For this reason, fiscal policy is often hotly debated among economists and political observers.

Fiscal policy essentially targets aggregate demand. Companies also benefit as they see increased revenues. However, if the economy is near full capacity, expansionary fiscal policy risks sparking inflation. This inflation eats away at the margins of certain corporations in competitive industries that may not be able to easily pass on costs to customers; it also eats away at the funds of people on a fixed income.

Contractionary vs. Expansionary Fiscal Policy

Governments can execute their fiscal policies through contractionary or expansionary measures:

- **Contractionary Fiscal Policy:** Governments can turn to contractionary measures to slow down the economy and curb inflation. These steps include raising taxes and reducing government spending. It isn't uncommon that a recession follows to bring balance back to the economy.
- **Expansionary Fiscal Policy:** This is commonly done during recessions to encourage people to spend. Governments often turn to measures like stimulus checks issued to taxpayers. They may also increase government spending as a way to boost employment. Expansionary fiscal policies are commonly associated with deficit spending.

Conclusion

Monetary and fiscal policy are different tools used to influence a nation's economy. Monetary policy is executed by a country's central bank through open market operations, changing reserve requirements, and the use of its discount rate. Fiscal policy, on the other hand, is the responsibility of governments. It is evident through changes in government spending and tax collection. When central banks lower interest rates by using monetary policy, the cost of borrowing and investment becomes cheaper. This allows consumers to assume more debt and make large purchases. Businesses are also able to invest in their growth. Fiscal policy, on the other hand, helps increase gross domestic product (GDP) through expansionary tools. This occurs because demand for goods and services increases, which leads to a rise in prices and output. Monetary and fiscal policy are two different tools that central banks and governments use to influence the economy. Both are employed to help bring stability to a country's economy. They often work best when they are implemented together, where monetary policy shifts a country's financial markets while fiscal policy affects how much money people have in their pockets. Both fiscal and monetary policy play a large role in managing the economy and both have direct and indirect impacts on personal and household finances. Fiscal policy involves tax and spending decisions set by the government, and will impact individuals' tax bill or provide them with employment from government projects. Monetary policy is set by the central bank and can boost consumer spending through lower interest rates that make borrowing cheaper on everything from credit cards to mortgages.

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