

## **Global Turmoil: Role of Monetary and Fiscal Policy**

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### **ABSTRACT**

The global Economic meltdown has effect on all the countries in the world. The Indian economy is also not exception to this situation because world economy cannot perform in seclusion in today's faster growing world. All the economies are interlinked to each other and any major ebb and flow in economic conditions causes numerous impacts for all other economies.

The global economic crisis started with Subprime disaster in the US. Many strong economies are suffering from the crisis of credit and liquidity due to the interconnectedness of each other in international trade relations. This situation has the negative impacts on GDP, Employment, exports, FDI and economic development of the nation.

Government and Policy makers are always taking precautionary measures for maintaining the economic stability and corrective actions in inflationary and recession situations. The striking balance of Monetary and Fiscal policies may help to overcome the situation to some extent. Monetary and Fiscal policies can be framed and implemented according to the economic situations.

Central Banks of countries can influence the economy through the use of monetary policy by controlling the monetary variables such as rate of interest, the money supply and the volume of credit. The fiscal policy can be used to help on economy out of recession or reduce demand pressures in a boom.

Monetary and fiscal policies are complementary to each other. Monetary policy influences the level of aggregate income and spending in the economy by influencing the money supply and cost of borrowing. Fiscal policy affects income and spending through its effects on size, composition and timing of government revenue and spending. These two policies can play the role in a perfect balancing for promotion of inclusive growth. This paper will focus on the important and balanced role of monetary and fiscal policy in economy with reference to the current scenario in Indian Economy.

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**Key Words:** Fiscal Policy, Global recession, Monetary policy.

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## **Introduction**

The global economy experienced a sustained period of growth with moderate fluctuations coupled with low inflation, a phenomenon popularly termed as the 'great moderation' till the commencement of the recent global crisis (Mohanti 2010). The world economic crisis was began in 2007-08 continues to expand, ramifying through the international economic system as it touches virtually every region, nation and people on the globe. The major cause of the global financial crisis was the massive growth and then collapse of a new asset class – securitized sub prime mortgages in US. On one level, sub prime mortgages have a positive social role – helping people with relatively poor credit ratings to possess their own homes. However, the scale of the lending, the way these mortgages were sold that is surprising which ultimately lead to a shock to confidence in the global financial system .

Globalization facilitated the world economy to come closer for rapid inclusive growth. Globalization assisted almost all the developed and developing countries to come together with the help of international trade relations. These trade relations showed economic growth of the world economy. But unfortunately, due to the inter connectedness of economic relations recession was spread in an increasing speed to all over world from US.

Until the emergence of the global crisis, the Indian economy was passing through a phase of high growth driven by domestic demand where growing domestic investment had been financed mostly by domestic savings. Inflation was also low and stable. Sequential financial sector reforms, forward looking monetary policy and rule-based fiscal policy together contributed to the improved macroeconomic performance. The phased liberalization of the economy to trade and capital flows along with a broadly market-driven exchange rate regime no doubt, enhanced the role of external demand in supporting the growth process, but it also exposed the economy to the forces of globalization. India, initially remained somewhat insulated to the global developments, but ultimately was impacted significantly through all the channels –financial, real and more importantly, the confidence channel (Subbarao, 2009).

The impact of global recession can be controlled with the help of policy makers. The monetary and fiscal policy can be used effectively as it is one of the instruments for scheming the recession.

## **Objectives and Research Methodology**

The main objectives for the paper are

1. To get acquainted with the concepts of Monetary and Fiscal Policy.
2. To discuss the interaction of Monetary and Fiscal policy in economy.

3. To discuss the role of these policies in current scenario with special reference to India.

This paper analyzed the above objectives on the basis of secondary data. The Secondary data has been taken from books on macroeconomics, research articles, Government reports and speeches of economists as well as government authorities.

### **Literature Review**

In the financial sector reforms, a various steps have been taken to increase the effectiveness of monetary policy and these include improvement in the payment and settlement systems, development of secondary market in government securities with a diversification of investor base, reduction in non-performing assets and reduction in the overall transactions costs. In particular, the current initiatives of RBI to develop money market and debt markets should contribute to improving the transmission mechanisms of monetary policy. All the reforms in the monetary and financial sectors may not have the desired results with creditable fiscal adjustment (Reddy, 1999) .

According to Shankar Acharya (2002) , conceptualization and practice of monetary policy has clearly had the drastic changes during the nineties. According to him, monetary policy at the end of the decade was a far more complicated function than at its beginning. However, some of the old problems and dilemmas remain. In particular, the usefulness of monetary policy continued to be constrained by an excessively loose fiscal policy as well as an insufficiently responsive financial system.

Deepak Mohanty (2010) discusses the global financial crisis and monetary policy response in India. At present, the focus around the world and also in India has shifted from managing the crisis to managing the recovery. The key challenge relates to the exit strategy that needs to be designed, considering that the recovery is as yet delicate but there is an uptake in inflation, though largely from the supply side, which could create inflationary expectations. Now, the RBI's measures should help anchor inflationary expectations, he opines, by reducing the overhang of liquidity without putting it in a risk the growth process as market liquidity remains comfortable.

According to Santosh Mehrotra (2010) , the role of policy makers in ensuring sustained economic growth, especially in an atmosphere of global economic crisis. The global economic crisis hit the Indian economy at a time when it was having a journey of extraordinary high growth. He argues that while the global crisis has particularly impacted exports, and hence growth, and worsened the fiscal balance, India is already returning to an 8 per cent per annual growth. This limited impact, has been driven by the fact that both savings and investments have risen sharply in the first decade of the millennium, and are likely to remain high. It is

domestic savings/investment as well as domestic markets that are driving the growth. The paper also highlights a series of long-term challenges that policy-makers must address if rapid growth is to be sustained, and poverty be reduced sharply.

### **Monetary Policy**

Monetary policy is one of the important macroeconomic concepts. Monetary policy theory down the principles which are concerned with the influence of the quantity or supply of money in the economy. Monetary practice is concerned with actual monetary measures, based on monetary theories which translate monetary policy decision into action. Mr. H.G. Johnson defined Monetary policy in ' Monetary Theory and Policy ' as 'policy employing the central bank's control of the supply of money as an instrument for achieving the objectives of general economic policy.'

According to A.G. Hart "A policy which influences the public stock of money substitute of public demand for such assets of both that is policy which influences public liquidity position is known as a monetary policy." The objectives of a monetary policy in India are similar to the objectives of its five year plans. That is rapid economic growth, price stability, exchange rate stability, Balance of Payment equilibrium , Full employment and neutrality of money.

The objectives of Monetary policy which every central bank of a nation tries to attain by employing certain tools (Instruments). Normally, the tools or instruments of Monetary policy classified as Quantitative or General tools and Qualitative or selective tools. The General tools are classified as Bank Rate Policy, Open Market Operations and Variations in Reserve Ratios. The Selective tools are classified as Fixing margin Requirement, Consumer Credit Regulation, Publicity, Credit Rationing, Moral Suasion and Control through Directives. In India, the RBI has always aimed at the controlled expansion of bank credit and money supply, with special attention to the seasonal needs of a credit.

### **Fiscal Policy**

Fiscal policy is a method to determine public revenue and public expenditure. Fiscal policy is an important instrument in the modern time. According to Arther Simithies "fiscal policy is a policy under which government uses its expenditure and revenue programme to produce desirable effects and avoid undesirable effects on the national income, production and employment.' A.G. Buechler defines fiscal policy as ' the use of public finance expenditure ,taxes ,borrowings and financial administration to further our national economic objectives'

The objectives of fiscal policy is to achieve desirable price level, to achieve the desirable consumption level, to achieve the desirable employment level ,to achieve equal distribution

and to stabilize the economic situation of the nation. The major instruments of the fiscal policy are Public Expenditure, Taxes and Public Debts.

### **Interaction of Monetary and Fiscal Policy**

Monetary and fiscal policies in any country are two macroeconomic stabilization tools. However, these two policies have often been pursued in different countries in different directions. As instruments of regulatory, economic policy, monetary and fiscal policies can be complementary to each other. Flexible and vigilant fiscal and monetary policy will allow one country to hold the economic stabilization.

Monetary policy is often pursued to achieve the objective of low inflation to stabilize the economy from output and price shocks. On the other hand, fiscal policy is often biased towards high growth and employment even at the cost of higher inflation (Alesina and Tabetini, 1990; Aurbach, 2004). For achieving an optimal mix of macroeconomic objectives of growth and price stability, it is necessary that the two policies complement each other. However, the form of complementarity will vary according to the stage of development of the country's financial markets and institutions.

Fiscal- Monetary mix which refers to the relative strength of the fiscal and monetary mix. A change in the mix is an approach which tightens one policy while easing the other in such a way that aggregate demand and in turn total output remain constant. Variations in the mix of taxes, government spending and monetary policy, government can change the fraction of GDP devoted to business investment, consumption, net exports and government purchases of goods and purchases.

During inflation, economic stability can be achieved more successfully by combining the policy of surplus budgeting with dear money policy. Conversely, in a slump, recovery can be started faster by reinforcing the policy of deficit budgeting with cheap monetary policy. Thus, for achieving economic stability, it may be necessary to combine both monetary and fiscal policy instruments.

Increasing independence of central bank in the conduct of monetary policy has been seen from fiscal governance during the last few decades. Another development, which led to create a number of studies on this issue, was the Stability and Growth Pact (SGP) and formation of European Monetary Union (EMU). Under this arrangement, individual countries pursue independent fiscal policies within the SGP, but have a common monetary policy. Thus, this arrangement has emphasized the importance of monetary and fiscal policy coordination (Muscatelli *et.al*, 2002). Additionally, the recent global financial crisis has once again confirmed the importance of coordinated response of monetary and fiscal policies. Sovereign

debt problem in many countries in the euro area, in particular, has also underlined the need for monetary and fiscal policy coordination.

In the perspective of developing economies, it is often seen that there is complete fiscal dominance and the central bank is obedient to the fiscal authority (Fischer and Easterly, 1990; Calvo and Vegh, 1999). Therefore, it is argued that the issue of coordination may not arise since the very concept of coordination arises only when the two institutions are independent. However, it is argued that actual implementation of the two policies could significantly differ from what could be expected from the institutional arrangements (Arby and Hanif, 2010). Furthermore, irrespective of the dependence/independence of the two policies, there will be interaction between these two policies. The nature of the interaction, however, will be conditioned by the institutional framework. The institutional arrangements have been changed in many developing countries as they are moving towards making central banks more independent, implying time varying behavior of the interaction between the two policies, which has important implications for the objectives of macroeconomic stabilization.

As like other countries in the world some changes in India have also taken place in the monetary and fiscal policy frameworks, particularly since the beginning of the 1990s. These consist of complete phasing out of automatic monetization of fiscal deficit through the creation of *ad hoc* treasury bills (also called *adhocs*) in 1997 and inclusion of RBI from buying government securities in the primary market from April 2006 under the Fiscal Responsibility and Budget Management (FRBM) Act, 2003. These changes are quite significant and have altered the basic nature of the interaction between monetary and fiscal policies. However, the central government continues to incur large fiscal deficits, which has implications for the demand management of the Reserve Bank.

### **Role of Monetary and Fiscal Policy in India**

Due to the global recession, the economy of India suffered as well. However, as the area of financial and banking sector is still under the government regulation, India has sustained the shock of economic meltdown. The Indian Government has taken a number of decision or measures to cope with the critical situation like strengthening the banking and tertiary sectors, increasing the quantity of exports and many more.

The contamination from the global financial crisis required suitable monetary and fiscal policy responses to ensure enough liquidity in the economy, the orderly functioning of markets, and the financial stability. The government of India and RBI responded to the challenge strongly through its fiscal and monetary policies. The government has introduced three fiscal stimulus packages. These are expanded safety- net program for the rural poor, the

farm loan waiver package and payout following the Sixth Pay Commission report for stimulating demand in the economy.

Reserve Bank of India, to the other side, announced the series of actions to make easy the operations of financial markets and ensure financial stability and to minimize the effects of global economic turmoil. The measures taken are extension of additional liquidity support to banks. The RBI has been effectively able to manage domestic liquidity and monetary conditions consistent with its monetary policy. This has been enabled by the appropriate use of a range of instruments available for liquidity management with the Reserve Bank such as the Cash Reserve Ratio (CRR), which was reduced to 5% in July 2009 from 9% in August 2008 and Statutory Liquidity Ratio (SLR) stipulation and Open Market Operations (OMO) including the Market Stabilization Scheme (MSS) and Liquidity Adjustment Facility (LAF).

RBI reduced the Repo rate to 4.75% and the Reverse Repo Rate reduced to 3.25% in July 2009 which was earlier 9% and 6% respectively in October 2009 in order to increase the flow of money into the economy for the stability and sustained growth. This way the monetary policy instruments played the important role for India in the background of global turmoil.

As like RBI's has taken the measures with the help of monetary policy, Government of India has also started with their action plan through fiscal policy. Government of India activated a series of incentive packages. Actions included an overall central excise duty cut of 4 percent, ramping up additional plan expenditure of about Rs. 200 billion, further state government borrowings for planned expenditure amounting to around Rs. 300 billion, interest subsidies for export finance to support certain export oriented industries, a further 2 percent reduction of central excise duties and service tax for export industries (that is a total 6 percent central excise reduction). This step helped to boost the demand of the products.

### **Conclusion**

The economic environment of global turmoil affected the entire world. Nowadays, the whole world is treated as a global village. Due to the interconnectedness of the countries to each other through international trade, the recessionary situations spread with high speed. The policymakers of all the countries had taken the corrective actions to react to the situation. The Indian Government has been concerned about the impact of global recession. The steps taken by the regulatory authorities in India helped to absorb the shocks of global turmoil.

The Indian economy reacted the global crisis well with growth going down to 5.8 percent in the second half of 2008-09 and then bouncing back to 8.5 percent in 2009-10. This growth has been achieved with help of combination of monetary and fiscal policies. The RBI has required to pump in sufficient liquidity into the banking system to enable banks to meet the



requirements of the economy. Banks have been provided adequate liquidity to meet the requirements in terms of lending. Reduction in the lending rates has also been indicated. These steps were supported by fiscal measures. One of the such measures was the reduction in Cenvat rate for boosting the demand of products into the economy. This way, on one side, by pumping the money in the economy's liquidity has been created and on the other side, by reducing indirect tax rates demand for the goods and services has been created. This way balancing or interaction of monetary and fiscal policy helped to stabilize the economy.

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