

FOREWORD

The issue relating to fiscal-monetary co-ordination has received renewed focus across advanced economies and emerging market and developing economies (EMDEs) in the aftermath of the global financial crisis. While the onset of the crisis saw close co-ordination between fiscal and monetary policies, both at the national and international levels, in the exit mode individual countries adopted different strategies to deal with their respective concerns of economic growth, inflation and financial stability. In the aftermath of the Great Recession, the recovery prospects in the euro area were jeopardised by the emergence and persistence of the sovereign debt problems with wide ramifications. Though the recent fiscal cliff deal in the US and policy actions in the euro area have reduced the tail risks to global growth and led to improvements in the global financial conditions, certain downside risks from slack policy implementation in the euro area and uncertainties in fiscal policies in the United States and Japan remain elevated. In the given scenario, the need for credible fiscal consolidation plans and co-ordination strategies to ensure an optimum fiscal-monetary mix assumes greater significance.

In contrast, EMDEs outside of Europe, which had remained relatively resilient to external shocks from major economies during the global financial crisis of 2007-09, have been facing the challenge of strengthening the recovery process while keeping inflation under control, necessitating unwinding of their accommodative monetary and fiscal policies. The persistence of the euro area crisis has made them more susceptible to volatility in capital flows as financial markets exhibit sudden bouts of risk-averse behaviour, leading to shifts in portfolios towards safe haven assets, impacting a wide range of economic activities in these economies. The fiscal-monetary co-ordination is becoming even more challenging for EMDEs in the backdrop of weak global recovery prospects, volatility in commodity prices and capital flows, posing challenges to macroeconomic policymaking.

Like other EMDEs, India was also impacted during the global financial crisis, which led to moderation in its real GDP growth in 2008-09. The policy response was seen in the use of both conventional and unconventional monetary policy measures as also fiscal stimulus measures to revive aggregate demand and support the growth process. The concomitant surge in government market borrowings was also effectively managed in a non-disruptive manner through additional monetary/liquidity management measures. With the growth process getting more entrenched and with the resurgence of inflationary pressures, an exit from the accommodative monetary policy pursued till October 2009, was calibrated between January 2010 and October 2011, while the fiscal consolidation process was resumed in 2010-11. The resurfacing of downside risks to economic growth in the second half of 2011-12 necessitated a pause in monetary tightening stance; on the fiscal side, government finances deteriorated, with a sharp widening of fiscal deficit, indicating a significant deviation from the recommended path of fiscal consolidation. During 2012-13 so far, a continuance of economic slowdown and moderation of inflation led to the calibrated easing of monetary policy, even as government undertook measures to rein in fiscal deficit. Alongside, in the aftermath of the global financial and the euro area debt crises, a substantial body of opinion has favoured the widening of the mandate of central banking beyond price stability to encompass financial stability and sovereign debt sustainability, keeping in view the close inter-linkages between the three objectives. This has cast a rethink on the institutional arrangements for debt management in India, going forward.

Against this backdrop, it was felt that it will be timely to reflect upon the dynamics of fiscal and monetary co-ordination, both in terms of its topical relevance and the challenges ahead in the context of return of fiscal

dominance after the global financial crisis, at the national and international levels. Accordingly, the theme of this Report for 2009-12 was selected as “**Fiscal-Monetary Co-ordination**”. After tracing the evolution of macroeconomic theory and international experiences in major advanced and select EMDEs, the Report undertakes an in-depth assessment of fiscal-monetary co-ordination in India in terms of its macroeconomic and monetary implications, impact on the Reserve Bank’s balance sheet and the medium-term outlook for fiscal-monetary coordination as well as the institutional arrangements for debt and cash management.

This Report has been prepared in the Department of Economic and Policy Research by a team of officers led by Smt. Balbir Kaur, Adviser under the overall supervision and guidance of Shri Deepak Mohanty, Executive Director. The core team comprised Dr. Mridul Saggar, Shri Somnath Chatterjee, Dr. Partha Ray, Shri Dhritidyuti Bose, Smt. Deepa S Raj, Dr. Anupam Prakash, Shri Indrajit Roy, Shri Arghya Kusum Mitra, Shri Anand Prakash, Dr. Rajeev Jain, Smt. Sangita Misra, Smt. Atri Mukherjee, Shri Binod Bhoi, Shri Sunil Kumar, Dr. Saurabh Ghosh, Smt. Sangeeta Das, Shri S.M. Lokare, Kum Indrani Manna, Shri Rakesh Kumar, Shri Dharendra Gajbhiye, Shri Bichitrananda Seth, Shri G. V. Nadhanael, Smt. P. B. Rakhe, Shri D.K.Raut, Shri Prabhat Kumar and Shri Anand Prakash Ekka. Shri Rajib Das and Shri Bhupal Singh also made significant contributions to the drafting of the Report. Valuable inputs from officers of other Departments, particularly Kum. J.M.Jivani and Shri N.Ramasubramanian, are highly appreciated. The peer reviewing team comprised Dr. Himanshu Joshi, Dr. Mohua Roy, Shri Sitikantha Pattanaik and Dr. Abhiman Das.

Many of the issues raised in the Report are evolving and debatable. They, however, provide an insight into the process of resolving conflicts between various policy priorities to achieve the desired outcomes. This group of young economists, who undertook the challenge of drawing a fine balance, did so, with courage, determination and forthrightness. I place on record my deep appreciation of their efforts.

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