Fiscal and Monetary Policy Interface : Recent Developments in India*

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I am thankful to the organisers, especially Dr. Ramakrishnan for persuading me to join you and share my thoughts and experiences on fiscal and monetary developments in India. Clearly, the main focus of the workshop is on fiscal management, and the participants are drawn from several countries with divergent sizes, structures and stages of development of their economies. Therefore, in this presentation, a judicious mix is made of general observations, experience of India and some issues on the interface between fiscal and monetary policies. Of course, the subject is viewed essentially from the perspective of a central banker. The first part provides a broad framework for appreciating the interface between monetary and fiscal policies. The second part relates to India and describes the pre-reform status, the consequences, the reform measures, a critique and the current status, concluding with outlook and features. The third part poses several issues that appear to be of general interest to policy makers, especially in developing and transition economies.

Framework

At the outset, it must be recognised that both fiscal and monetary policies are essential components of overall macroeconomic policy and thus cannot but share the basic objectives such as high economic growth on a sustainable basis implying equity considerations also, a reasonable degree of price stability and a viable balance of payments situation. However, all these objectives may not always be in harmony, and major concerns of each component may be different apart from the differences in time horizon of the concerned policy focus. For policy makers, one of the challenges is the coordination between the fiscal and monetary policies and undoubtedly the nature of interaction between them depends on country- specific situation. Yet, there are a range of issues involved in monetary and fiscal coordination which can be addressed within a broad common framework.

In considering the issues of coordination between fiscal and monetary policies, it would be useful to clarify what constitutes fiscal policy and what monetary policy is about. A clear statement on this, useful for policy makers, is available in the IMF publication "Government Budgeting and Expenditure Controls : Theory and Practice", by Mr. Premchand. Thus, fiscal policy consists "of the use of taxes, government spending, and public debt operations to influence the economic activities of the community in desired ways and is concerned with the allocation of resources between the public and private sectors and their use for the attainment of stability and growth". The use of the term fiscal policy here is limited because, as mentioned by Mr. Premchand, it excludes debt management which has been viewed as part of monetary policy. The point is further elaborated when it is stated that "Government action can be considered to be purely a fiscal policy matter only when the effect of borrowing is neutral in terms of the availability of money to the private sector. Pure fiscal policy is, however, rare, because any change in revenues and expenditures involves changes in the financing of the budget surplus or deficit and, hence, always has an interface with monetary policy. Management of the debt – particularly, the composition of the instruments, the timing of their issue, and their duration – are aspects more closely associated with monetary policy".

Very briefly stated, for policy purposes, the most critical link or even overlap between the two policies relates to public debt operations and debt management.

In the academic literature, the optimal mix of monetary and fiscal policies has been analysed with respect to different exchange rate regimes. In the abstract academic world of perfect capital

mobility and no non-traded goods for a country with a small share of world output, apparently the issue of an optimal mix between monetary and fiscal policies simply does not exist. In this academic approach, fiscal policy is effective if the exchange rate is fixed while monetary policy is effective when exchange rate is flexible. However, in the real world, choices are not clear for the policy makers though theory does provide some clues to practice.

At an applied level, the relationship between fiscal and monetary policies may be analysed in the context of public debt, especially in terms of choice between bond financing and money financing of fiscal deficit. There has been a theoretical debate on the subject and there is a view point that under certain specific conditions, monetisation of government deficit may not have an adverse effect. At the same time, it is clear that monetisation beyond a certain level could have adverse consequences over a period. A distinction also needs to be made between direct monetisation and monetisation through operations in the secondary market.

Fiscal deficit, defined to be on cash basis for this discussion, can be financed either through bond issuance or money creation. Bond financing entails net placement of government debt in financial markets, either in domestic or in foreign markets. Money financing, on the other hand, involves change in the monetary base arising out of changes in net central bank credit to government and thus is a combined effect of central bank's contribution to primary issues, open market operations and clean advances.

Furthermore, such financing of the fiscal deficit may be non-voluntary or voluntary. Thus, a central bank may be obligated to extend credit to government through what has been described as "automatic monetisation". Similarly Government securities may be placed in captive market by legal stipulations, say on Provident Funds, insurance and banking. Moreover, the financing of fiscal deficit may be at market determined or market related rates or at highly concessional rates, the latter being a byproduct of non-voluntary financing.

It should be obvious that each form of financing of fiscal deficit has its own consequences, and does impact on monetary policy. While reliance on domestic credit has implications for credit availability for commercial sector, interest rates and monetary base, reliance on foreign borrowing additionally impinges on management of external sector. Non-voluntary financing may also result in crowding out of the private sector. The analytics of fiscal-monetary policy interface is thus not confined only to the quantum of monetisation of fiscal deficit, but extends to optimal financing mix for the fiscal deficit that stabilises inflation, interest rates and exchange rates at levels conducive for macroeconomic stability.

While monetisation of government deficit could provide primary liquidity to the market, liquidity creation could take place through other channels also, namely: the central bank enlarging its holding of foreign currency assets; expanding its lending to the commercial sector; and conducting open market operations divested from the government's budgetary considerations.

Pre-reform Status

After independence, and as part of planned development, the macro-economic policy in India, as was the case in many other developing countries moved from fiscal neutrality to fiscal activism. Such activism meant large developmental expenditures, much of it to finance long-gestation projects requiring long term finance. The sovereign was also expected to raise funds at fine rates, and understandably at below the market rates for private sector. A large borrowing programme with a strong preference for low interest rates added to the demand for increasing monetisation of fiscal deficits. The Reserve Bank of India had to manage the effects of large scale monetisation through preemption of commercial bank's resources by hiking Statutory Liquidity

Ratios and Cash Reserve Ratios well beyond the limits warranted by genuine prudential requirements, while the Government also preempted resources from other captive institutions such as provident funds, and nationalised insurance. At one stage, well over one-half of the total resources raised by the banking system was preempted and as much as 15-16 per cent was impounded under the cash reserve ratio at extremely low rates of remuneration. Under these circumstances, it became necessary to allocate credit and fix interest rates for both deposits and credit, leading to a complex administered interest rate regime with complicated cross-subsidisation.

At the same time, as part of developmental initiatives, the Reserve Bank provided funds for development of industry, agriculture, housing, etc. through development financial institutions. The Reserve Bank also had to ensure successful borrowing of mandated amounts at mandated uniform interest rates, by States and Public enterprises as part of the national planning effort.

Consequences

Fiscal activism described above was expected to result in a virtuous cycle of development. No doubt, it served many useful purposes. However, the financial returns to government out of its investments, either directly or through its enterprises turned out to be far lower than the cost of debt. Hence, while liabilities in terms of public debt were expanding, assets created out of such borrowings failed to yield commensurate results. Such a gap between the cost of borrowing and the return continued to widen over time. It is this imbalance between returns and cost of borrowing that resulted in gradual deterioration into a 'soft budget–constraint', particularly on account of easy monetisation and artificially low cost of debt. Many efforts to improve financial returns of investments made by government did not yield adequate results. Hence, while assessing the consequences of pre-reform status, it is essential to recognise that in all likelihood, it was not the fiscal activism *per se* but the soft-budget constraint enabled by the pattern of financing of debt coupled with persistent inadequate returns on investments that caused macro imbalances.

In view of soft-budget constraints, the fiscal deficits persisted, and over a period, deficits on the revenue account surfaced. The automatic monetisation of deficits at low interest rates mounted through recourse to issue of *ad hoc* treasury bills at low interest rates at much less than half the market related rates. The temporary mismatches between government receipts and expenditures during the year also became larger over time, since there was no compulsion towards cash management.

Preemption of a large proportion of bank deposits and an administered interest rate regime resulted in high cost and low quality financial intermediation. The spreads between deposit and lending rates of commercial banks increased, while the administered lending rates did not factor in credit risk.

There were inadequate incentives to state governments to ensure fiscal prudence, since the quantum and terms of borrowing were not related to fiscal promise or performance. Many public enterprises also tended to become beneficiaries of preemption of banks' resources and directed lending.

For the Reserve Bank, fiscal dominance became the single largest area of concern. Monetary policy was constrained by large and persistent fiscal deficits. The Reserve Bank's role as a debt manager often dominated its role as monetary authority. The Reserve Bank as regulator of commercial banks used to some extent, regulations to subserve fiscal objectives. The market for government securities and in fact for debt segment could not be developed since a large part of government's borrowing was financed through non-voluntary mechanisms. Monetisation of

deficits required the Reserve Bank to seek several rearguard actions affecting the financial system, and over a period, led to macro-economic imbalances.

The impressive growth performance of the 'eighties' with reasonable stability should be assessed in the light of severe macro-economic imbalances, partly attributable to the fiscal monetary interface. The imbalances were evident from persisting revenue deficits, large current account deficits and weaknesses in the financial sector. The economy was thus vulnerable to a crisis, which in fact was triggered by the Gulf war of 1990-91.

Reform Measures

The reform measures initiated in the nineties, which were relevant to the fiscal monetary policy interface can be summarised as under :

First, the system of issuance of *ad hoc* treasury bills and automatic monetisation was replaced with a system of Ways and Means Advances (WMA). The quantum available to government as WMA to meet temporary mismatches between receipts and expenditure is now annually agreed upon between the Reserve Bank and the Government. The interest rate is also agreed upon and is currently at Bank Rate. There is a Cash and Debt Management Group consisting of officials from the Government of India and the Reserve Bank to coordinate cash and debt management.

Second, an increasing proportion of the fiscal deficit of the government is being financed by borrowings at market related rates of interest.

Third, there has been a reduction in one preemptions of commercial banks' resources from well over one-half to about a one third of their resources. Thus, the mandatory component of market financing of government borrowing has decreased.

Fourth, the administered interest rate regime has been dismantled and there are very few prescriptions of interest rates. Consequently, the spread between deposit and lending rates of banks has come down. Furthermore, the difference between the rate at which creditworthy corporates are able to raise debt and the rate at which the sovereign is borrowing has also narrowed.

Fifth, Bank Rate has been activated and open market operations, including repo activities have been intensified. In the conduct of monetary policy, the emphasis now is moving towards indirect instruments.

Sixth, a policy decision has been taken by the Reserve Bank to eliminate its long term lending operations to commercial sector and to moderate other forms of monetisation by reducing direct funding of developmental activity. Seventh, an appropriate legal, institutional and technological framework has been put in place for regulation and development of money, government securities and forex markets. Both, the primary and secondary segments of government securities market have exhibited more participants, larger turnover and greater depth.

Eighth, most public enterprises have been moved out of what is described as "approved market borrowing programme" and thus the enterprises are encouraged to borrow from market through voluntary subscriptions. Furthermore, States are also encouraged to access markets on a stand-alone basis for a part of their borrowing programme.

Ninth, transparency in most of these operations is emphasised and data are released to market participants on all aspects of the Reserve Bank's operations, including those that impinge on fiscal issues.

Finally, there have been several initiatives and measures in the fiscal arena to containing fiscal deficit as also the revenue deficit. Reform of public sector enterprises has also been initiated. Public sector banks now have the brief of diversified ownership.

Critique

These reform measures have been subject to several doubts and criticisms, and the more important of them need to be reckoned.

First, several analysts have pointed to the puzzle in India of high fiscal deficits in the recent years without any spillover or adverse effects of higher inflation, higher interest rates and larger current account deficit on the external front. It will be useful to explore several features of the situation that could explain this puzzle. The level of fiscal deficit should be viewed both as a percentage of Gross Domestic Product and the domestic private savings. Furthermore, private investment demand has been somewhat subdued in the recent years because corporates faced with domestic and international competition seem to have concentrated more on capacity utilisation and productivity increases. There has also been a decline in the extent of monetised deficit. It has also been observed that a significant part of output growth in these years was on account of the services sector, which did not require large private investments. With liberalisation of trade, there has been competitive pressure on prices of internationally traded goods, especially manufactured goods, resulting in lower inflation rates. These apart, the government's borrowing programme was conducted with what analysts described as 'outstanding skills' by resorting to several new institutional arrangements and innovative instruments but these are certainly not inexhaustible. The current account in balance of payments was also characterised by strong inflow of private remittances and software exports, which moderated the trade deficit. Clearly, as analysts point out, this extraordinary constellation of factors cannot be expected to last for long.

Secondly, it has been argued that the WMA and market related borrowing programme have not imparted the sensitivity and hard budget constraint that were expected. Hence, it is opined that the new arrangements have had no beneficial impact other than hiking interest costs to Government and increasing its revenue deficits. In this regard, it should be obvious that quite possibly the system of automatic monetisation could have resulted in even higher deficits than were noticed, especially due to the unprecedented political uncertainties. Furthermore, on all accounts, there is greater sensitivity and transparency to the whole process than hitherto, and this is evidenced by clear statements on fiscal containment incorporated in the electoral manifestos of major political parties. Most important, development of debt markets is critical to efficient financial intermediation, especially for financing infrastructure and that would be inconceivable without a vibrant market for government securities. The government securities market also provides benchmarks for interest rates and is critical for transmission of monetary policy, especially for use of indirect instruments. The system of automatic monetisa tion and concessional finance would be difficult to reconcile with efforts towards such vibrant markets for government securities. It should also be noted that a significant part of government debt is through small savings, etc. the real cost (that is grossed for tax treatment) of which works to be out higher than the market borrowing programme. Above all, as brought out clearly by Professor Vivek Murthy of Indian Institute of Management, Bangalore in a recent study on the subject, the market orientation of government borrowing programme had a significant favourable impact on the cost of borrowings by the corporate sector. In other words, recourse to automatic monetisation and concessional resources to finance fiscal deficit is some sort of a burden or tax on the non-governmental sector. The benefits of the new framework governing monetary-fiscal interface go well beyond the simple quantum or cost of monetisation or market borrowing programme of government. The proponents of consolidated balance sheet approach to government and central bank do, sometimes, ignore the dynamics of financial markets and the macro economy while focussing on mere accounting aspects.

Thirdly, some observers argued that the Reserve Bank even in the new framework of fiscal-monetary mix has done little either to ensure fiscal discipline or pursue independent monetary policy. The Reserve Bank has on several occasions articulated the implications of fiscal dominance and Governor Dr. Jalan has been quite explicit on this subject in his recent statements on Monetary and Credit Policy. The final decisions on fiscal deficit are essentially the outcomes of dynamics of political economy expressed through sovereign will of Parliament. It is only through an accord between a government and a Central Bank that fiscal discipline can be brought about. One of the notable achievements of Governor Dr. Rangarajan has been in bringing about such an accord through formal agreements to end automatic monetisation. However, once a final decision is taken on the fiscal deficit by the government, the Reserve Bank's endeavour is to ensure that it is financed in a way that is least disruptive to the macro economic stability, and is conducive to growth. In fact, exercise of monetary policy without sensitivity to the reality of fiscal dominance will be counterproductive.

Current Status

Obviously, it would be inappropriate to conclude that the reform process in this respect is anywhere near being complete. However, distinct improvements in macro balance and performance can be noticed. Thus, there is evidence of greater degree of operational autonomy for monetary policy now than before. There is also increasing recourse to indirect instruments of monetary policy and greater effectiveness in transmission channels of monetary policy. Greater flexibility in interest rates is now noticeable, both for government and corporate sectors. There is a widespread awareness of the long term implications of a large borrowing programme on fiscal sustainability and macroeconomic stability. Government is receiving relatively high profit transfer from the Reserve Bank. There are signs of a more competitive and less inefficient financial sector. Finally, there are clear signs of developments towards deeper and dynamic financial markets.

The overall positive impact of the reform measures may be discerned from the fact that India has maintained impressive growth rates during recent years, with reasonable price stability, and stable interest and exchange rate regimes. It must be recognised that this overall performance has been exhibited alongwith several bouts of adverse exogenous factors in the late nineties. The adverse factors include, surges in capital inflows, East-Asian crisis, sanctions imposed by U.S.A., border conflicts with a neighbouring country, electoral uncertainties, and more recently, steep increases in oil prices. There is, therefore, reason to believe, that monetary-fiscal interface in India has been improving, which is exhibited in the resilience to withstand external shocks while at the same time maintaining impressive growth and macro stability.

Outlook

While the policy mix and progress of reform has served the country well so far, the medium term outlook, however, is conditional upon several hard policy initiatives.

First, while structurally the framework for coordination between fiscal and monetary policies has been put in place with the introduction of WMA system, fiscal dominance is persisting. Operational autonomy for monetary policy, critical for longer term price stability and improved state of financial sector, demands rapid, qualitative and sustainable fiscal adjustment.

Second, the systems and operating procedures in some of the public sector banks and of the larger enterprises operating in financial markets may have to be reviewed and changed to enhance the effectiveness of monetary policy initiatives.

Third, further progress in development of various segments of financial markets is critical to enhance the policy effectiveness. The major challenge here is to both regulate and develop

markets without being intrusive while recognising the imperfections.

Fourth, while pursuing with initiatives taken with State governments, the issue of separation of debt management functions from monetary authority needs to be addressed.

Fifth, overall progress in both fiscal and monetary fronts would critically depend on the reform in not only publicly owned entities but also the real sector.

Features

Major features of reform in fiscal-monetary policy interface are not significantly different from other areas of reform in India though reform of financial sector commenced early in the cycle of reform process. First, has been 'ownership' of reform in the sense, the reform is designed and detailed by expert committees such as Narasimham Committee on financial sector and Rangarajan Committee on external sector. Second, various steps have been taken in a gradual manner and not as a big bang. Third, a pragmatic approach is adopted in the sense that some elements of non-change is accepted for a while to win over opinion in favour of the desired change. Fourth, a consultative process has been instituted; and for example, even draft guidelines or circulars of Reserve Bank are circulated widely by putting them in the public domain before finalising. Standing Committees with membership from market participants and academics meet periodically to advice the Reserve Bank in financial market reforms. In the consultative process, care is taken to ensure confidentiality on specific proposals for action, whenever a potential for anticipatory actions is expected.

Finally, trust and coordination, especially between the Government and the Reserve Bank is given a high priority. Apart from continuous consultations on legislative, policy and operational aspects of reform, there is a continuous dialogue in various matters of technical analysis and research between Ministry of Finance and the Reserve Bank.

On earlier occasions in my presentations, the developments in monetary policy had been characterised, as three C's, Continuity, Context and Change. In the context of monetary-fiscal interface, three more Cs need to be added, namely, Coordination, Consistency and Credibility.

Issues

It is inappropriate to draw any general lessons from the Indian experience, since, as mentioned early in the presentation, monetary-fiscal policy interface, like most other policies is country specific. However, in this regard, there seems to be merit in clarifying some broad issues, which are often debated and sometimes misunderstood. These issues are : How are monetary and fiscal impacts of debt policy different? How do actions of monetary authority affect management of public debt, and how does management of public debt affect conduct of monetary policy? What are the various aspects of coordination between monetary and fiscal actions?

Impact of Debt Policy

As mentioned already, there is no ideal level of fiscal deficit, and critical factors are : How is it financed and what is it used for? However, the fact remains that it is the fiscal policy that determines the size of debt and government debt is the most critical though not the only link with monetary policy. While the *size* of public debt is determined by fiscal policy, the composition of *debt* is decided by debt management policy. The monetary impact depends on who holds the debt and how the holding changes rather than by who initially issues or subscribes to the debt. The fiscal effect depends on the rate at which the size of debt is changing and the cost of servicing the debt. The monetary effect is determined by the effect of public debt on aggregate demand.

Interactions in Management

The actions of monetary authority affect public debt mainly in two ways. The initial financial

cost to government of placing debt depends, to some extent on the stance of monetary policy, *i.e.,* whether expansionary or restrictive. The choice, design and operation of monetary policy instruments also impact the debt service costs. For example, liquidity of government securities may be enhanced by monetary authority through open market operations and reserve requirements.

The management of public debt affects the conduct of monetary policy, especially the operational autonomy of the central bank in at least three different ways. The perceived sustainability of public debt often affects interest rates. The public debt management affects the demand for money. Above all, the management of public debt, in countries like India, plays a critical role in development of domestic financial markets and thus on conduct of monetary policy, especially for effective transmission.

Coordination

In view of the complex nature of interface, coordination between fiscal and monetary policies has to be considered from several angles. As mentioned at the very outset of this presentation, both are aspects of shared overall macro-economic policy objectives. Hence, at the first level, the question is whether the relevant fiscal-monetary policy mix is conducive to the macro objectives. The relevant policy mix relates to the level of fiscal deficit, the pattern of financing especially the extent of monetisation and the dependence on external savings.

Secondly, whether operating procedures of monetary and fiscal authorities, especially debt and cash management are consistent and mutually reinforcing. The interactions between operations of monetary authority and public debt management described earlier in this part of the presentation are obviously relevant.

Thirdly, whether credibility of both monetary and fiscal policies is achieved in a desirable direction. Thus, a credible monetary policy can help moderate interest rates provided the fiscal authority does not give rise to a different set of expectations.

Fourthly, whether due cognizance has been taken of the fact that monetary and fiscal policy adjustments operate in different timeframes. Monetary policy as is well known, can be adjusted to alter monetary conditions at a shorter notice than fiscal policy. Monetary policy changes can be undertaken at any time, unlike fiscal policy changes most of which are generally associated with the Annual Budget.

Finally, harmonious implementation of policies may require that one policy is not unduly burdening the other for too long. Mutual respect and reinforcement is undoubtedly the ideal to which both policies and authorities should subscribe.

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