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**RESERVE BANK OF INDIA**

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October 11, 2011

**RBI Working Paper Series No. 15 for September 2011**

The Reserve Bank of India today placed Working Paper titled "[An Empirical Analysis of Monetary and Fiscal Policy Interaction in India](#)" by Janak Raj, J.K. Khundrakpam and Dipika Das In a cross-country context, there has been a renewed interest in analysing the interaction between fiscal and monetary policies in the recent years. Several factors have contributed to this trend. These include: i) increasing independence of central bank in the conduct of monetary policy; ii) Stability and Growth Pact (SGP) and formation of European Monetary Union (EMU) under which individual countries pursue independent fiscal policies, but have a common monetary policy; and iii) the demonstrated need for a coordinated response of monetary and fiscal policies during the recent global crisis.

In India, fiscal dominance of monetary policy eased substantially with the elimination of automatic monetisation of fiscal deficit in 1997 and prohibition on direct government borrowing from the Reserve Bank in April 2006. Further, the operating procedure of monetary policy underwent a paradigm shift in the early 2000 with the introduction of liquidity adjustment facility and the interest rate channel becoming the main monetary policy signaling instrument. The paper therefore, empirically examines the interaction between monetary and fiscal policies in India using quarterly data for the period 2000Q2 to 2010Q1. In particular, the paper focuses on examining whether the monetary and fiscal policy responses to shocks in output and inflation are consistent for purpose of macroeconomic stabilisation. The analysis is carried out through the impulse response functions and variance decomposition analysis obtained from a vector autoregression (VAR) model.

The major finding of the paper is that, even after the elimination of automatic monetisation of fiscal deficit in 1997 and restrains on RBI from buying government securities in the primary market under the FRBM Act from April 2006, fiscal policy continues to substantially influence the conduct of monetary policy. Specifically, the reaction of the two policies to shocks in inflation and output is mostly in the opposite direction. While monetary policy reacts in a counter-cyclical manner, fiscal policy reaction is primarily pro-cyclical in nature. The positive impact of expansionary fiscal policy on output is highly short-lived, but there is a significant negative impact in the medium to long- term.

The Reserve Bank of India introduced in April this year, a 'RBI Working Paper Series' (RBI - WP) to provide a platform to the Reserve Bank Staff for presenting their research studies as well as to receive feedback from informed researchers.

The views expressed in all the research publications of the Reserve Bank, including the RBI Working Papers Series, do not necessarily reflect the views of the Reserve Bank and as such should not be reported as representing the views of the Reserve Bank of India.

Feedback, if any, on the papers could be addressed to the respective authors of the research studies.

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