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ROLE OF MONETARY AND FISCAL POLICY IN INDIA'S DEVELOPMENT PROCESS

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ABSTRACT

The study examine the immediate aftermath of the fiscal reforms was essentially brought about through cut in investment expenditure, as rise in committed revenue expenditure could not be curtailed. Within a short span, it became increasingly obvious that the Indian approach to fiscal correction was not sustainable. While reduction in investment spending affected future growth prospects with consequent slowdown in revenue receipts, the interest payments and public debt continued to grow, resulting in reversal of fiscal consolidation process in the latter half of the 1990s.

KEYWORDS

Economic Growth, Economic Reforms, Fiscal Policy, Monetary.

INTRODUCTION

Economic stability and economic development are always intertwined. One of the essential prerequisite for growth of the country as well as for sustaining it in this era of highly globalised world is existence of the price stability. Of course, there are chances of occurrence of fluctuations in the economy. To overcome these fluctuations; we need monetary and fiscal policies. The main objectives of the monetary policy are price stability, providing adequate credit to productive sectors and financial stability. India has always emphasised on price stability and growth within broad context of controlling the inflation. The four key channels of monetary policy transmission are interest rate, credit aggregates, asset prices and exchange rate channels. 'Expectation' has emerged recently as the fifth channel of the transmission mechanism of monetary policy.

Fiscal policy aims to increase the rate of growth and employment rate as well. Also, government tries to control fluctuations in aggregate demand through fiscal policy measures. By definition fiscal policy is "The government's attempt to influence the economy by varying its purchases of goods and services and taxes to smooth the fluctuations in aggregate expenditure; use of the government budget to achieve macroeconomic objectives such as full employment, sustained long-term economic growth and price level stability"[1]. The Active pronouncement of fiscal policy came in to existence after Great Depression period with J.M.Keynes's interventionist approach. He emphasised on aggregate demand and role of government intervention in the economic activity. According to him fiscal adjustments in any period are in the direction of stimulus or restraint and these adjustments take place through government purchase of goods and services, transfer payments and taxes.

The study begins with evolution of monetary and fiscal policies in India. The next section takes the brief review of performance of Indian economy so far. In the third section study reviews the literature, especially the recent literature available on role of monetary and fiscal policies in economic growth and transmission mechanism channels operating in India. Further, it attempts to evaluate the achievements of the monetary and fiscal policies in the context of economic growth, poverty reduction, employment and development of the country

MONETARY & FISCAL POLICY: AN INDIAN PERSPECTIVE

The Reserve Bank of India was set up in 1935. An active role by the Reserve Bank of India in terms of regulating the growth in money and credit became evident only after 1950s. During 1950s monetary growth was extremely moderate and there was an increasing dependence on market borrowing and deficit financing. These became pronounced in the 1970s and thereafter. Current revenues of the central government exceeded current expenditure so that there was a surplus available to finance in part the deficit on capital account, a deficit that is normal for a developing country. This means that the government had to borrow at home and abroad, not only to finance its investment as would normally be the case in a developing country, but also its current consumption.

In 1983-84 out of $22.8 billion of public and publicly guaranteed external debt, roughly 17 per cent was owed to private creditors. On the eve of the macroeconomic crisis in 1990-91, external debt had tripled to $69.3 billion, of which around 30 per cent was owed to private creditors. Thus, debt to private creditors grew five-fold in seven years. The balance of gross fiscal deficit, after taking into account the domestic and external borrowings, small saving, and provident funds, was monetized through the sale of ad hoc treasury bills to the Reserve Bank. For example, in 1988-89 and 1989-90, before the crisis year of 1991, gross fiscal deficits of the centre and states together was rupees 35,668 and 45,196 crores respectively, and nearly 17 to 25 percent of these sums, namely 6,244 crores and 10.911 crores respectively, were financed by the issue of ad hoc treasury bills . **(Srinivasan, 2001)**

Since the onset of the reforms process, monetary management in terms of framework and instruments has undergone significant changes, reflecting broadly the transition of the economy from a regulated to liberalized and deregulated regime. While the twin objectives of monetary policy of maintaining price stability and ensuring availability of adequate credit to productive sectors of the economy to support growth have remained unchanged; the relative emphasis on either of these objectives has varied over the year depending on the circumstances. Reflecting the development of financial markets and the opening up of the economy, the use of broad money as an intermediate target has been de-emphasised, but the growth in broad money (M 3) continues to be used as an important indicator of monetary policy. The composition of reserve money has also changed with net foreign exchange assets currently accounting for nearly one-half. A multiple indicator approach was adopted in 1998-99, wherein interest rates or rates of return in different markets (money, capital and government securities markets) along with such data as on currency, credit extended by banks and financial institutions, fiscal position, trade, capital flows, inflation rate, exchange rate, refinancing and transactions in foreign exchange available on high frequency basis were juxtaposed with output data for drawing policy perspectives. Such a shift was gradual and a logical outcome of measures taken over the reform period since early nineties. **(Y.V.Reddy, 2002)**

A Liquidity Adjustment Facility (LAF) has been introduced during June 2000 to precisely modulate short-term liquidity and signal short-term interest rates. The LAF, in essence, operates through repo and reverse repo auctions thereby setting a corridor for the short-term interest rate consistent with policy objectives. It has emerged as a tool for liquidity management and signaling of interest rate in the market. The RBI has also been able to use open market operations effectively to manage the impact of capital flows in view of the stock of marketable Government securities at its disposal and development of financial markets brought about as part of reform.

METHODOLOGY

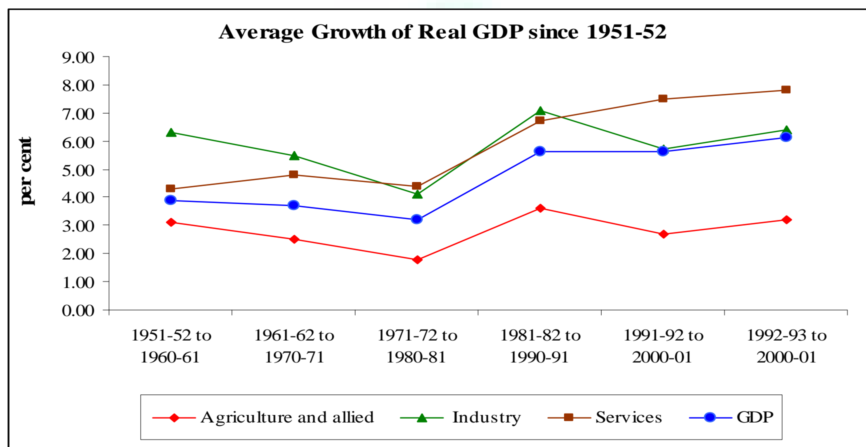
The study draws on the secondary data from Reserve Bank of India, Central Statistical Organisation and Finance ministry, Government of India. The study takes an overview of Indian economy since 1950s. But while evaluating the performance of fiscal and monetary policies in India, it has considered the time period during 1990 to 2006.

OVERVIEW OF INDIAN ECONOMY

Before evaluating the performances of monetary and fiscal policies in the Indian context, it is necessary to review overall performance of Indian economy. **Figure 1** presents the India's growth performance since 1951-52. The three decades from 1950-51 to 1980-81 saw average growth of 3 per cent per year. During this period, growth of per capita GDP was hardly 1.5 per cent a year. In other words, average living standards increased painfully slowly in India during these three decades. The economy geared up in 1980s with the improved performance of all three sectors, agriculture, industry and services. Per capita growth was increased to 3.4 per cent per annum. A growth rate of above 8 per cent was achieved by the Indian economy during the year 2003-04. Though GDP of India has improved steadily since 1979, in comparison to East Asian Countries and other developed countries India has a long way to go.

The growth rate for 2004-05 (7.5 per cent) is less than that of 2003-04; it is still among the high growth rates seen in India since independence. Many factors are behind this performance of the Indian economy in 2004-05. High growth rates in Industry & service sector and a benign world economic environment contributed to its growth to the extent. However, share of agriculture sector to GDP has declined considerable since independence. One of the obstacles in the way of agricultural progress is bad monsoon. Thus, there is a paramount need to move Indian agriculture beyond its centuries old dependency on monsoon. This can be achieved by bringing more area under irrigation and by better water management.

FIGURE 1



Source: Central Statistical Organisation, Government of India.

India has become one of the highest saving rates in the world. It increased from 26.4 per cent in 2002-03 to 29.7 per cent in 2003-04. It further raised from 31.1 per cent in 2004-05 and 32.4 per cent in 2005-06. The rise in the savings rate in 2005-06.It has shown an uneven upward trend over the past four decades and there have been considerable changes in its composition. Historically, domestic saving has been dominated by household saving in physical assets. However, the recent increase in saving has been driven mainly due to increase in private corporate sector savings and the household savings. The third component, namely public savings, weakened in the early 1980s and continues to decline in the recent years. Though a rise in savings rate is impressive, it cannot be viewed in isolation from the investment rate. As shown in the table the decadal average growth rate of savings well as capital formation reflects the increasing trend which is good indicator for an economy.

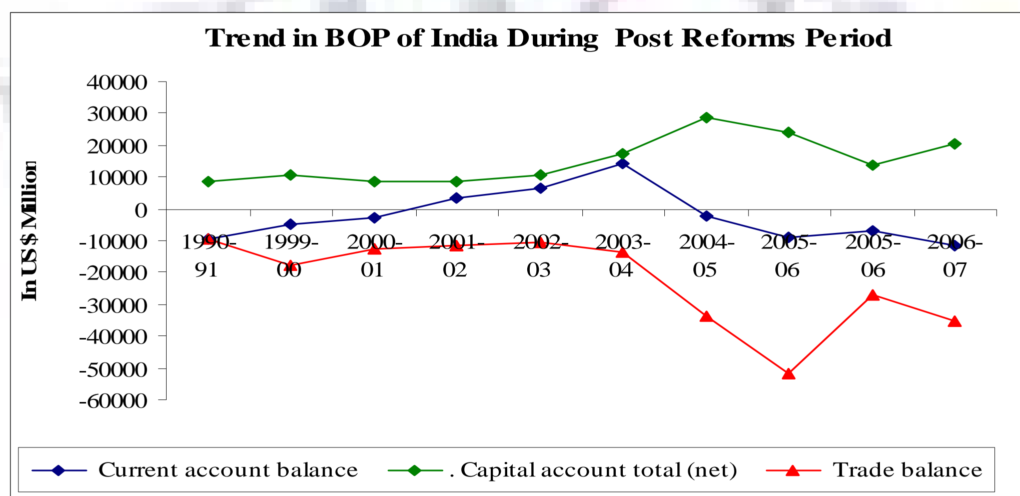
TABLE 1: AVERAGE PERCENTAGE OF GROSS DOMESTIC SAVINGS (GDS) AND GROSS FIXED CAPITAL FORMATION (1950-51 TO 2005-06) (as per cent of GDP)

	1950-51 to 1959 -60	1960-61 to 1969-70	1970-71 to1979-80	1980-81 to 1989-90	1990-91 to 1999-00	2000-01 to 2005-06
GDS	9.97	12.66	17.51	19.41	23.13	26.32
GFCF	10.55	14.02	15.84	20.22	22.28	24.10

Source: Calculations based on the data collected form Economic Survey of India, Government of India, 2006-07

India's BOP situation has strengthened since 1991 crisis. In spite of increase in current account deficit from US$2.5 billion in 2004- 05 to US $ 9.2 billion, equivalent to 1.1 per cent of GDP, in 2005-06 (US$4.4 billion), India continued to be among the top nations with high levels of reserves. These reserves provide an opportunity towards deepening of trade reforms and other administrative measures. With a growing trade balance the current account surpluses during 2001-2002 turned into a current account deficit in 2004-5. These trends seem to be continuing in 2006-007 with pressure on BOP due to movements in oil prices on one hand and the increase inflows of foreign investments including remittances non-resident Indians maintains balance in BOP on the other. **Figure 2** shows the BOP situation in brief. On the background such performance of external sector, the recommendation of three- phase strategy of moving towards fuller capital account convertibility is under consideration.

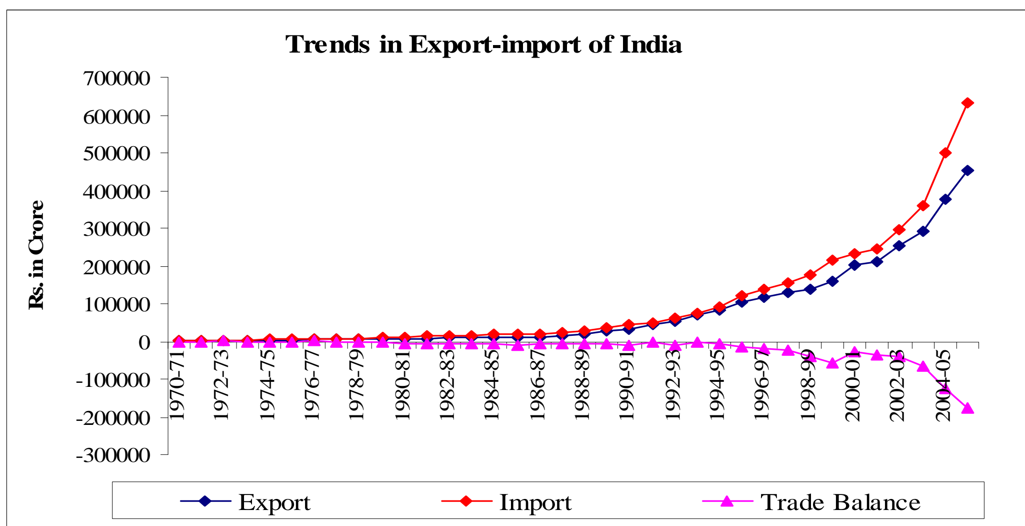
FIGURE 2



Source: Directorate General of Commercial Intelligence and Statistics. Government of India.

India persuaded inward-looking trade strategy for three decades since independence. Only with the reforms of 1991, deliberate efforts towards integrating India with the world economy. Prior to the oil shock of 1973, the volume of world exports grew at an annual average rate of about 7.85% per year during 1951-73. India's exports grew at a much slower rate of 2.66% per year and the ratio of exports to GDP declined from 7% in 1951-1952 to around 4 % in the early seventies. The two oil shocks of the seventies, on the one hand, put pressure on balance of payments because of a steep rise in the cost of oil imports.During1973-86 period of oil shocks and recovery, world exports grew only at 2.7% per year, but Indian exports grew at 4.4% per year. During 1986-1997, world export growth (in volume) recovered to 6% per year, and Indian exports grew even faster at 11.7% per year. India's share in the value of world merchandise exports, which stood at 2.1% in 1951, declined to 0.4% in 1980 and has recovered since to 0.6% in 1999. **(Srinivasan, 2001).**

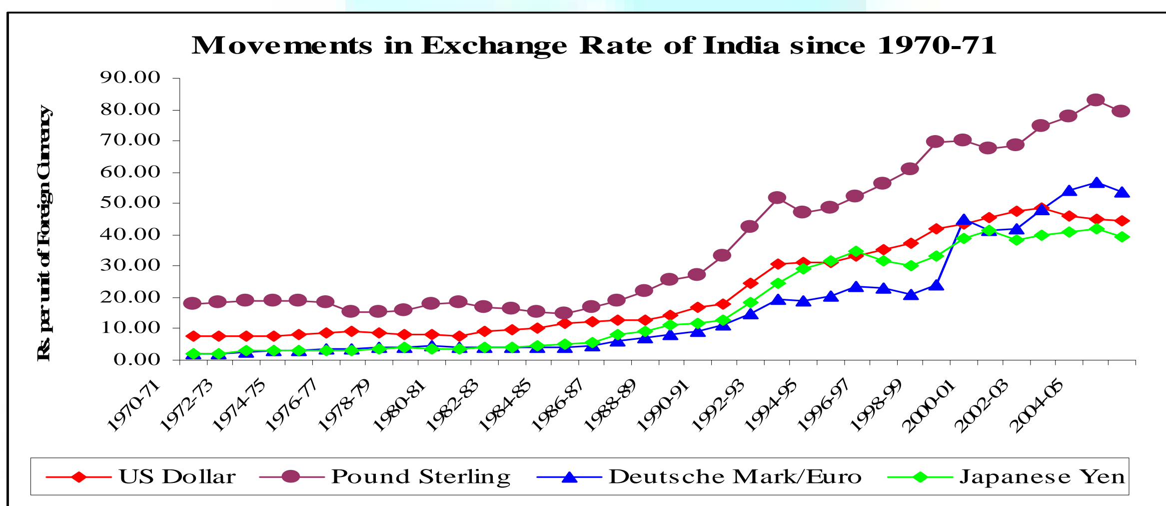
FIGURE 3



Source: Directorate General of Commercial Intelligence and Statistics. Government of India.

Indian foreign trade during post reform period has been growing continuously. Trade in services has been growing faster than merchandise trade, and the share of services in total external trade increased from 25.8 per cent in 2004-05 to 27.4 per cent in 2005-06 whereas share of agricultural trade has declined. The exchange rate system in India has transited form fixed exchange regime to market- determined exchange rate regime. Indian economy experienced rise in capital inflows during 1993-94, 1994-95 and the first half of 1995-96 which was accompanied by export growth exerting upward pressure on rupee. The rupee came under pressure during 1995-96 due to sudden and sharp reversal of market sentiments and expectations. The period of 1997-2000 witnessed adverse effects of Asian Financial crises and hardening of oil prices on rupee. Except for a brief period of instability on account of border tensions in May 2002, the period onwards 2002 was marked by appreciating trend of rupee against dollar.

FIGURE 4



Source: www.rbi.org.in

Though among developing countries India's inflation performance can be considered as satisfactory prices are rising more than twice as fast as in China, India's chief rival. Prices are also increasing considerably faster than in industrialised countries. Thus, inflation remains a one of the main concerns for Indian policy makers. During 1950s, the average decadal rate of inflation was very low at 1.7 per cent which increased to 6.4 per cent during 1960s. The average inflation rate during 1970s was still higher at 9.0 per cent. The maximum inflation recorded in the year 1974-75 at 25.2 per cent was mainly attributed to the failure of kharif crops in 1972-73 and hike in oil crude oil prices. During 1980s, the decadal average of inflation rate was 8 per cent while period of 19991 to 1997 again experienced the two digit inflation rate ranging form 10 to 15 per cent. The point to inflation during 1999-2000 was less than 4.78 which was recorded in previous year. The average point to pint inflation was 3.2 per cent during 2000-01. It was maintained below 5 per cent till the date except for the years 2003-04 (5.7 per cent) and 2004-5 (6.3 per cent).

REVIEW OF LITERATURE

This section reviews the literature dealing with selected issues like growth, transmission mechanism, institutional arrangement and policy interface. A study titled with *'The Fiscal Policy and Growth'*[1] has mainly focused on the role of Fiscal Policy in Economic growth in India. This study looks at the contribution of the 'Currency and Finance Report (2000-01)', especially at the chapter on 'the Role of Fiscal Policy Reinvigorating growth'. The study has covered time from 1991 to 2001 and by using econometric tools like dummy variable model and unit root test it replicates a couple of the equation in the report. The two questions raised in the study are whether fiscal policy can play a significant role in the revival of the economy and whether the creation of deficits in order to revive the economy is likely to have an adverse effect on economy. By taking Maharashtra as example, the author has found that deficit harm the growth. The study concludes that earmarking taxes for socially desirable expenditure such as investment in physical and social infrastructure useful in making the government's budgetary announcements more credible.

In addition to the fiscal policy and growth there is another study titled with *"Fiscal correction for Economic growth-Data analysis and suggestions'*[2]. This study mainly concentrated on relationship between fiscal policy and growth in terms of fiscal correction as well as rapid fiscal deterioration both at central and state levels. This study covered time period from 1980 to 2000. It begins with an overview economic situation across country especially with respect to India and china. Then the study examined central and state finance performance from 1980s. It reveals that fiscal situation of both the central and state governments is unsustainable and poses a grave threat to economic growth. Due to there is a lack of relation between public borrowing and public expenditure and inappropriate investment in infrastructure. To overcome this problem the study suggested that by reducing debt service payment and expansion of tax. Lastly, it concludes that India's growth in the future is the continuing fall in public investment at both centre and state levels so the key solution is increase charges on public services and privatization.

As per as issue of growth is concerned, monetary policy also plays an important role in the growth. 'Science *of Monetary Policy- Some Perspectives on the Indian Economy'*[3] is good example of above study which exposits the monetary policy design problem within the limits of an empirical framework for the Indian economy. The paper first looks at a few theories that have been advanced to explain the stylised facts of economic fluctuations. Further, it examines the main features of business cycles in the Indian economy over the past 50 years. In the process, it presents forecasts of aggregate economic activity for 2002-03 and 2003-04. Second, it empirically measures the threshold rate of inflation within the framework of growth-inflation trade-offs and derives the optimal rate of monetary expansion needed to smooth out fluctuations and stabilise the inflation rate at its threshold level. Third, it specified a theoretical model (linking growth, inflation, interest rates and money supply) capable of deriving an optimal fiscal deficit which maximises the real growth rate and applies it within the Indian context to measure the desired amount of fiscal consolidation. Finally, it provides estimates of a comprehensive macroeconomic conditions index which can very effectively be incorporated into a simple Taylor-type interest rate rule (reaction function) for monetary policy. The RBI governor Mr. Y.V Reddy[4] gives his opinion on the above that "The conduct of monetary policy will continue to provide support to agricultural growth, infrastructure development, fiscal consolidation, building social infrastructure areas by creating an appropriate atmosphere of macro-economic stability, especially price and financial stability; which will, undoubtedly, facilitate accelerated growth".

There is a recent study titled *'Monetary Transmission in India'*[5], which covers various aspects like objectives, framework and instruments of monetary policy. Alongside the evolution of institutional development which were to have a fundamental bearing on the monetary policy transmission. The time period of the study is from 1980 to 2005. It has examined the monetary transmission channels, operating procedure. Further, it asses the monetary policy impulses impact output and prices through interest rates and exchange rate movements in addition to the traditional monetary and credit aggregates. As per as monetary transmission concerned there is a need to maintain an adequate level of foreign exchange reserves and this in turn both enables the conduct of monetary policy. A key lesson is that flexibility and pragmatism are required in the management of the exchange rate and monetary policy in developing countries rather than adherence to strict theoretical rules.

Interest rate channel is important factor for monetary transmission mechanism in India. There is study titled *'Does Higher Fiscal Deficit Lead to Rise in interest Rate- An Empirical Investigation'*[6], which discusses the role of interest rate in fiscal policies. The study has taken time period from 1991 to 2004 and VAR model has used to find the causality between fiscal deficit and interest rate for empirical evidence. According to this study funding of government requirements through market borrowings would not only induce rise in interest rates, but the increased funding cost in turn would also contribute to the rise in fiscal deficit. In the Indian context, the empirical investigating results that growing fiscal gap put upward pressure on interest rate. Rise in interest rates and likely crowding out of private initiative as a result could be avoided by easy condition by an accommodating monetary policy.

The same issue has prescribed in different that proposition of an increase in the fiscal deficit, financed by government borrowing, necessarily raises the real rate of interest and thus 'crowds out' private investment. The existence of a definitive positive relationship between real rates of interest and the fiscal deficit-GDP ratio is tested empirically for India and for a number of other countries in the world. The study find out that interest rates do not necessarily depend on the fiscal deficit and that policies based on this understanding are erroneous[7]. Inflation also another factor comes under transmission mechanism which is related to interest as well as fiscal deficit. Interest rate and inflation rates would depend critically on both the size of the deficit and, equally important, on the respective shares of monetisation and market borrowings in this overall deficit which implies that interest rate targeting as well as inflation control are ultimately both monetary and fiscal policy issues[8].

Policy interface is a last issues of review literature, regarding this there is study titled *'Fiscal and Monetary Policy Interface-Recent Developments in India'*[9], which explains a broad frame work for appreciating the interface between monetary and fiscal policy. The study gives brief background about two policies then explains existence of both policies in pre-reform. It shows the evidence of 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. Consequently, the reform measures are initiated in the nineties, which were relevant to the fiscal monetary policy interface. Lastly, in the part of outlook on the policy mix, we came to know that monetary and fiscal policy was established in the place of system of Ways and Means Advances (WMA). However, the interface between fiscal and monetary policy leads positive impact on debt policy, management interaction and coordination. He concludes that though India has good record on account of performance of the policies faces a challenge of economic stability, especially price and financial stability in this era of market integration.

CRITICAL EVALUATION OF MONETARY AND FISCAL POLICY IN INDIA

APPRAISAL OF FISCAL POLICY

The external payments crisis of 1991 was, to a large extent, an inevitable consequence of the deteriorating fiscal situation during the 1980s. The 1980s, especially the second half, was marked by high and persistent fiscal deficits, accompanied by large revenue deficits. This had led to a significant enlargement of the debt-servicing obligations. In order to contain the burgeoning debt-service obligations, Government tapped financial surpluses of the household sector

[1] Ajit Karnik 2001
[2] Rakesh Mohan 2000
[3] M.J.Manahor Rao 2003
[4] Address by Dr. Y. V. Reddy, Governor, Reserve Bank of India at the Bank of Greece, Athens, Greece on April 2, 2007.
[5] Rokesh Mohan, 2006
[6] Rajan Goya, 2004
[7] Surjit Das, 2004
[8] Manohar Rao M.J, 2000
[9] Y.V.Reddy, 2000

through statutory pre-emptions from financial intermediaries at below market clearing interest rates. This gave rise to a degree of financial repression. At the same time, increased financing of the Government deficit through automatic monetisation compromised the effectiveness of monetary policy and fuelled inflation. Against this background, when the Indian economy faced an unprecedented macroeconomic crisis in 1991, not surprisingly, fiscal consolidation constituted a major plank of the policy response. The role of fiscal policy is inducing growth but stresses the costs of fiscal deficits. Although the present stream of public financing cannot be sustained any longer, the State will be failing in its duty if it absolves of its responsibility by binding itself to inflexible fiscal rules that can be obeyed only at the cost of much needed public investment (Bagchi, 2001).

The primary objective of the fiscal reforms as announced in the Union Budget 1991-92, was essentially to achieve a reduction in the size of deficit and debt in relation to GDP. It was envisaged that this would be achieved through revenue enhancement and curtailment in current expenditure growth while enlarging spending on investment and infrastructure so as to provide momentum to the growth process. Accordingly, fiscal reforms in India were initiated in three distinct but interrelated areas: i) restoration of fiscal balance[10]; ii) restructuring of public sector[11]; and iii) strengthening of the fiscal-monetary co-ordination. Contemporaneously, the steps towards improving fiscal-monetary coordination encompassed deregulation of financial system, elimination of automatic monetisation, and reduction in pre-emption of institutional resources by the Government.

Before the fiscal reforms there was apparent in India during the late 1980s, as there was rapid deterioration in Government finances. During this period, the expenditure of the Central Government rose much faster than its revenue leading to a steep rise in the Centre's fiscal deficit to GDP ratio. For the States, given the restrictions on their capacity to borrow, the increase in expenditure was relatively aligned to the corresponding rise in revenue. Reflecting these developments, there was a sharp increase in the outstanding liabilities of both Central and State Governments as ratio to GDP from 41.6 per cent and 16.7 per cent, respectively, in 1980-81 to 55.3 per cent and 19.4 per cent, respectively, in 1990-91. The fiscal performance during the reform period, however, was characterised by a clear divide in the mid-1990s in the attainment of fiscal targets. There was evidence of the successful fiscal correction during 1991-92 to 1996-97 (except for 1993-94) in terms of a significant fall in the fiscal deficit and in public debt as a proportion of GDP. The revenue deficit has not only persisted, but has grown in size during this period. The resultant dissaving arising from the revenue deficit has reduced the aggregate saving and investment capacity in the economy. Consequently, there was a steady fall in the share of capital expenditure, impacting on the infrastructure investment and thereby threatening the growth potential of the economy. Several pointers indicate a reversal of the fiscal consolidation process in the recent years. These include decline in tax to GDP ratio, downward rigidity in current expenditure, steady deterioration in public investment in productive sectors, slow progress of Public Sector Undertakings (PSUs) restructuring and faster accumulation of public debt.

While a move towards fiscal adjustment was discernible in the pronouncements made as a part of long-term fiscal policy announced in the mid-1980s, a comprehensive fiscal reform programme at the Central Government level was initiated only at the beginning of the 1990s as part of the economic adjustment programme initiated in 1991-92. Fiscal reforms at the Centre covered tax reforms **(Appendix.1),** expenditure pruning, restructuring of PSUs, and better coordination between monetary and fiscal policies. Corrective measures on the fiscal front initiated at the beginning of the 1990s produced some promising results during the first half of the decade. Expenditure growth could be curtailed leading to a decline in the fiscal deficit and the outstanding liabilities of the Government to GDP ratio. During 1990-91 to 1996-97 (excluding 1993-94), the reduction in total expenditure to GDP ratio by more than 3.5 percentage points narrowed the fiscal gap by 3 percentage points and reduced the debt-GDP ratio by over 5 percentage points. However, the fiscal consolidation even during the first half of the 1990s was brought about primarily through curtailment in capital expenditure. Decline in consumption expenditure was relatively small. From 1997-98, expenditure started rising once again, and by the year 2001-02, all the major fiscal parameters, *viz.*, revenue deficit, fiscal deficit, and public debt rose to levels higher than those prevalent at the beginning of the reform process **(Table: 2).**

TABLE 2: MAJOR FISCAL INDICATORS OF THE GOVERNMENT SECTOR* (in Per cent)

Item	1981-82 to 1989-90		1990-91 to 1996-97		1997-98 to 2001-02	
	Average Growth	Ratio to GDP	Average Growth	Ratio to GDP	Average Growth	Ratio to GDP
Revenue Receipts	16.14	19.01	14.17	18.57	11.64	17.72
Total Expenditure	16.21	28.84	13.12	27.01	14.62	27.68
Capital Expenditure	12.93	8.23	6.59	4.81	16.29	3.96
Revenue Expenditure	17.78	20.62	14.61	22.20	14.43	23.73
Gross Fiscal Deficit	17.83	8.03	11.60	7.38	21.48	9.13
Revenue Deficit	31.39	1.65	19.93	3.63	31.48	6.07
Development Expenditure	15.59	18.11	11.00	15.32	13.43	14.33
Non-Developmental Expenditure	17.23	10.45	16.13	11.69	16.03	13.35

Note: * Government sector refers to finances of Central and State Governments.

Source: Union and State Governments' Budgets.

The efficacy of tax reforms for augmentation of tax revenue, expenditure correction, restructuring of public sector, public debt management policies and institutional reforms appears to be rather limited so far. Tax reforms have generally led to a rise in tax revenue to GDP ratio across countries (Shome, 1992; Shome, 1995). In the Indian context, the expected increase in tax buoyancy *a la* 'Laffer curve effect' did not occur. Since the onset of tax reforms, the tax-GDP ratio of the Central Government has suffered a persistent decline. This has been a major drag on the reform process. The tax-GDP ratio declined from an average of 9.9 per cent during the 1980s to 9.7 per cent in the first half of the 1990s and further to 9.0 per cent in the second half of the 1990s. The pattern is, however, not the same across different types of taxes. Direct tax collection to GDP ratio rose steadily from 2.0 per cent in the 1980s to 2.3 per cent in the first half of the 1990s and further to 2.9 per cent in the latter half of the 1990s. On the other hand, the ratio of indirect tax collection to GDP declined from 7.9 per cent in the 1980s to 7.3 per cent and 6.1 in the first and second halves of the 1990s, respectively.

The decline in the tax to GDP ratio is explained by a combination of factors that led to a sharp fall in total tax buoyancy from 1.07 for the period 1981-93 to 0.96 for 1981-2001, implying buoyancy could be less than unity during the post-tax reform period 1994-2001. While the buoyancy of direct taxes is estimated to be higher at 1.19 for the period 1981-2001 as compared with 1.07 for the pre-tax reforms period (1981-1993), the buoyancy of indirect taxes dipped considerably to 0.88 from 1.07 in the corresponding period **(Table:3)**. The increase in direct tax collections despite a significant cut in marginal tax rates could be attributed to the combined effect of better compliance, broadening of the tax base and increase in income. The introduction of presumptive tax, adoption of economic criteria for identification of potential taxpayers and removal of some exemptions helped in base widening.

[10]The strategy for restoring fiscal balance comprised tax and non-tax reforms, expenditure management and institutional reforms.

[11] Public sector restructuring mainly involved divestment of Government ownership.

TABLE 3: BUOYANCIES OF CENTRAL TAXES

Tax	1981 to 1993	1981 to 2001
Total Tax to GDP	1.07	0.96
Direct Tax to GDP	1.07	1.19
Corporate Tax to GDP	1.02	1.13
Personal Tax to GDP	0.92	1.23
Indirect Tax to GDP	1.07	0.88
Excise Tax to Manufacturing	0.96	0.83
Excise Tax to GDP	0.97	0.84
Customs Tax to Imports	1.20	0.77
Customs Tax to GDP	1.24	0.93

Note: Separate estimates for 1994-2001 were not attempted to ensure that adequate degrees of freedom are available

Source: Computed using data on taxes from Union Budget documents and gross domestic product from National Accounts Statistics.

Non-tax revenue of the Central Government as a proportion to GDP recorded an improvement from 2.1 per cent in 1990-91 to 3.0 per cent in 2001-02. The trends in components of non-tax revenue reveal that increase in dividend and profits, and economic services, fully account for the improvement in Centre's collection of non-tax revenue, as growth in other components continued to be stagnant during the reform period. Surplus transfers from the Reserve Bank, which is a major component of dividend and profits, increased from Rs.210 crore in 1990-91 to Rs.10,320 crore in 2001-02, thereby raising its share in the total from 1.8 per cent to 15.2 per cent **(Table: 4).** The size of the transfer from the Reserve Bank, *inter alia,* grew on account of earnings from the deployment of foreign currency assets, conversion of 4.6 per cent Treasury Bills into marketable securities and discontinuation of the practice of crediting large sums to the National Industrial Credit (LTO) Fund.

TABLE 4: COMPOSITION OF NON-TAX REVENUE OF THE CENTRAL GOVERNMENT

Item	1980s	1990-91	1996-97	2001-02
Interest Receipts	68.5	72.9	67.9	52.4
Dividends & Profits *of which*	8.2	6.5	11.8	25.5
Reserve Bank Profits	4.1	1.8	4.6	15.2
General Services	3.5	4.2	4.0	4.2
Social Services	3.2	0.5	0.4	0.4
Economic Services	9.0	7.2	10.2	13.7
Fiscal Services	5.5	2.6	1.3	0.5

Source: Union Government Budgets.

As such, any programme of stabilisation-cum-adjustment, has to give considerable attention to the expenditure side of fiscal restructuring. It is important to plan expenditure reduction while improving quality of public spending to aim simultaneously at supporting growth with equity and improving fiscal balances. In India, expenditure/GDP ratio of the Centre had risen from about 12.3 per cent in 1970-71 to around 20 per cent in the latter half of the 1980s. This had placed a difficult burden on budgetary balances. With a view to narrowing down the fiscal gap, particularly by bridging the revenue deficit, a cut in current expenditure was considered essential. The steps taken to compress expenditure led to a reduction in the size of overall public expenditure as a ratio to GDP in the initial years of the 1990s. The Government expenditure of Centre as a ratio to GDP declined from 17.74 per cent in 1990-91 to 17.11 per cent in 2003.04 (RE). During 1990-91 to 1996-97, although revenue expenditure fell by 1.2 per cent, it increased again by about 1.45 percentage points between 1996-97 and 2003-04. On the other hand, there was a steep fall of 2.4 percentage points in the capital expenditure to GDP ratio between 1990-91 and 2003-04, Thus, since the beginning of the 1990s upto 2003-04, while the percentage of revenue expenditure to GDP increased from 12.93 per cent in 1990-91 to 13.09 per cent 2003-04, the capital expenditure to GDP declined from 5.59 per cent in 1990-91 to 4.02 per cent in 2003-04 **(Table.4).** The deterioration in capital expenditure contributed to the decline in the share of public investment from 9.3 per cent of GDP in 1990-91 to 6.3 per cent in 2001-02.

TABLE 5: TRENDS IN GOVERNMENT EXPENDITURE (Percentage to GDP)

Year	Revenue Expenditure	Capital Expenditure	Total Expenditure
1990-91	12.93	5.59	18.52
1991-92	12.6	4.46	17.06
1992-93	13.76	4.44	18.2
1993-94	12.59	3.92	16.51
1994-95	12.06	3.81	15.87
1995-96	11.77	3.23	15.01
1996-97	11.62	3.08	14.69
1997-98	11.84	3.4	15.24
1998-99	12.43	3.61	16.04
1999-00	12.86	2.53	15.39
2000-01	13.3	2.29	15.58
2001-02	13.21	2.67	15.88
2002-03	13.75	3.02	16.77
2003-04 (RE)	13.09	4.02	17.11

Source: Union and State Governments' Budgets.

The major contributing factor imparting a downward rigidity to the revenue expenditure relates to items of committed expenditure, of which, interest payments and expenditure on wages and salaries are prominent. Interest payments as a ratio to GDP increased from 3.8 per cent in 1990-91 to 4.7 per cent in 2001-02 for the Central Government., while for the States, the corresponding rise was steeper from 1.5 per cent to 2.8 per cent During the phase of fiscal consolidation, even though the debt to GDP ratio for the Central and State Governments fell from 61.7 per cent in 1990-91 to 56.5 per cent in 1996-97, the rise in the weighted average interest rate on Central Government and State Governments market borrowings.

Downward rigidity has also been discernible in expenditure on subsidies, which is another major constituent of the revenue expenditure. Owing to the conscious efforts made by the Government, total explicit subsidies of the Central Government, which constituted 2.14 per cent of GDP in 1990-91 were reduced to nearly 1 per cent by 1995-96. Cut in subsidies in the beginning of the reform period was brought about largely through the phasing out of export subsidies (cash compensatory support) which amounted to nearly Rs. 2,750 crore (0.5 per cent of GDP) in the year 1990-91. During the second half of the 1990s, the size of subsidies again started rising and increased to 1.36 per cent of GDP by 2001-02 **(Table: 6)**.

TABLE 6: CENTRAL GOVERNMENT EXPENDITURE ON SUBSIDIES – MAJOR HEADS (in Rs.crore)

Year	Food	Fertilizers	Interest	Exports	Total
1990-91	2,450	4,389	379	2,742	12,158
1995-96	5,377	6,735	34	318	12,666
2001-02	17,499	12,595	210	N.A.	31,207

Source: Union Government Budgets.

The downward inflexibility in the subsidies was essentially on account of the growing size of food subsidy, which recorded nearly a six-fold rise over the reform period. It has been observed that a sizeable proportion of food subsidy is due to the carrying cost of the food stock (Balakrishnan and Ramaswami, 2000). Thus, a significant part of subsidies goes to make up for the inefficiencies embedded in institutional arrangements meant for providing subsidy rather than benefiting the targeted group. There is another institutional step envisaged in this direction is Fiscal Responsibility and Budget Management Bill (FRBM), 2000. The conduct of fiscal policy during 2004-05 was shaped by the Fiscal Responsibility and Budget Management (FRBM) Act, 2003 and FRBM Rules 2004 (notified by the Central Government on July 5, 2004), which set a new beginning to the fiscal consolidation process. There has been a significant improvement in the gross tax/ GDP ratio from 8.8 per cent in 2002-03 to 9.2 per cent in 2003-04 and further to 9.9 per cent in 2004-05. A noteworthy feature is a sustained rise in the direct tax/GDP ratio to 4.3 per cent in 2004-05.

The FRBM approach deals with inter-generational equity in fiscal management and long-term macro-economic stability by envisaging complete elimination of revenue deficit by March 2006. The bill also envisages a reduction in total liabilities of the Centre to no more than 50 per cent of GDP by March 2011. At the same time, FRBM is an important step towards reforms the Indian Public finances and it reduces the fiscal deficit to low levels may be counter productive as it may fail to sustain high rates of economic growth (Bagchi, 2001).

TABLE 7: FISCAL PROJECTIONS AS PERCENTAGE OF GDP IN INDIA (in per cent)

Particulars	2005-06	2006-07	2007-08	2008-09
Gross tax revenue	9.72	10	10.33	10.7
Revenue receipts	9.36	9.31	9.32	9.42
Tax revenue, net to Centre	7.2	7.41	7.55	7.91
Non-tax revenue	2.16	1.91	1.53	1.51
Capital receipts	5.46	5.14	4.38	4.31
Recoveries of loans	0.39	0.33	0.28	0.25
Others receipts	0.12	0.1	0.09	0.08
Borrowings and other liabilities	4.96	4.71	3.8	3.98
Total receipts	14.76	14.42	13.46	13.74
Non-plan expenditure	10.04	9.65	8.98	8.84
Interest, debt servicing	4.14	4.08	3.82	3.91
Defense	2.06	2.01	1.96	1.91
Subsidies	1.28	1.13	0.92	0.82
Grants, loans to States, UTs	0.61	0.58	0.55	0.52
Others non-plan expenditure	1.95	1.85	1.76	1.67
Plan expenditure	4.72	4.77	4.47	4.89
Total expenditure	14.76	14.42	13.46	13.74
Revenue expenditure	11.91	11.63	11.2	11.02
Capital expenditure	2.85	2.79	2.26	2.65
Revenue Deficit	2.61	2.35	1.98	1.66
Fiscal Deficit	4.96	4.71	4.32	3.98

Note: GDP: Gross Domestic Product, BE: Budget Estimates, RE: Revised Estimates

Source: Report of the Task Force July 2004, Ministry of Finance, Govt. of India.

Fiscal situation in post reforms predicted that gross revenue expenditure, net tax revenue to the centre and plan expenditure are showing increasing trend. On contrary, revenue receipt, non-tax revenue, capital receipt, recoveries of loans etc are moving towards declining trend. As per the fiscal projection on Fiscal deficit will decreases from 4.96 per cent in 2003-04 to 3.98 per cent in 2008-09. At the same time Revenue deficit will also decline from 2.61 per cent in 2003-04 to 1.66 per in 2008-09. One thing is clear that adoption of FRBM will succeed in reaching in it objectives. However there is need to take more concentration on total expenditure as well as revenue expenditure as per the projection both expenditures deteriorate in future.

APPRAISAL OF MONETARY POLICY

The post reformed period was manifested with major changes in the institutional environment and monetary management in India. During 1993 and 1994, for the first time monetary policy had to deal with the monetary impact of capital inflows with the foreign exchange reserves increasing sharply from $ 9.2 billion in March 1992 to $ 25.1 billion in March 1995. In 1995-96, the change in perception with reference to exchange rate after a prolonged period of nominal exchange rate stability vis-a-vis the US dollar brought into play the use of monetary policy to stabilise the rupee – an entirely new experience for the central bank. Similar situations arose later on also. Monetary policy had begun to operate within a changed institutional framework brought about by the financial sector reforms. It is this change in the institutional framework that gave a new dimension to monetary policy. New transmission channels opened up. Indirect monetary controls gradually assumed importance. With the progressive dismantling of the administered interest rate structure and the evolution of a regime of market determined interest rate on government securities, open market operations including 'repo' and 'reverse repo' operations emerged for the first time as an instrument of monetary control. Bank Rate acquired a new role in the changed context. The 1990s paved the way for the emergence of monetary policy as an independent instrument of economic policy **(Rangarajan, 2001).**

It may be useful at this point to set out briefly the events as they unfolded in the 1990s and the response of monetary authorities. The decade of 1990s began disastrously for India. Both the fiscal and balance of payments situations went out of control. The year 1990-91 had to contend against a high fiscal deficit and a widening gap in the balance of payments triggered by the steep increase in oil prices. In 1989-90, gross fiscal deficit of the central government had touched 8.05 per cent of GDP and the inflation rate stood at 9.1 per cent. Monetary policy in 1990-91 had to be tight for all these reasons. While monetary growth somewhat moderated to 15.1 per cent in 1990-91 as compared with an expansion of 19.6 per cent in the previous year, inflation rate rose as high as 12.1 per cent.

A definitive shift in economic policy occurred in mid-1991. However, structural reforms could be introduced successfully only, if a degree of stabilisation was achieved. A major step to correct the balance of payment situation was the devaluation of the rupee effected in July 1991. However, devaluation could yield results only if it was accompanied by a monetary policy that put a lid on the expansion of aggregate demand. A tightening of the monetary policy had in fact begun even earlier in April/May 1991, with increases in interest rates and reserve requirements together with direct controls on credit and an interest surcharge of 25 per cent on import finance. The Bank Rate was raised by 1 percentage point from 10 per cent to 11 per cent in July 1991. The minimum lending rate on credit limits over Rs 2 lakh was raised by 1.5 percentage point from 17 per cent to 18.5 per cent in July 1991. The Bank Rate was further raised by 1 percentage point from 11 per cent to 12 per cent in October 1991 and the minimum lending rate for large borrowers was raised to 20 per cent. Simultaneously, interest

rates on deposits were raised up to a maximum of 13 per cent. As the balance of payments showed improvement and the inflationary pressures showed signs of abatement, the process of reducing the lending rate started from March 1992. Along side, as part of the financial sector reforms and because of the anticipated decline in gross fiscal deficit of the central government, the statutory liquidity ratio on incremental deposit liabilities was reduced to 30 per cent from 38.5 per cent.

Beginning 1992-93, a conscious effort was made to reduce interest rates in the system, as there was a deceleration in inflation and improvement in the economic situation. In 1992-93 the inflation rate as measured by the wholesale price index came down to 7 per cent. The opportunity was also taken to progressively rationalise the lending rate structure. As the macroeconomic situation further improved, the reserve requirements were brought down. The incremental Cash Reserve Ratio was discontinued in April 1992. A part of the impounded cash balances were also released. Apart from the reduction in incremental SLR, the basic level of SLR was reduced. With the restoration of stability, the stage was set for a vigorous introduction of several financial sector reforms outlined in the Narasimham Committee. An effort was also made to develop the Government Securities Market. The reform measures in this area included the introduction of 364-day and 91-day treasury bills on auction basis, auctions of dated securities and Repo auctions. The exchange rate regime underwent a significant change in March 1993, when the dual exchange rate system came to an end and a unified market came into being, with the exchange rate being determined by the forces of supply and demand.

Monetary policy in 1993-94 was formulated with the major consideration of ensuring adequate support to the banking system for the revival of output by reducing the cost of money and increasing the availability of credit. The minimum lending rate was brought down by 2 percentage points to 15 per cent by September 1993. The minimum lending rate on term loans of 3 years and above was lowered to 14 per cent. A reduction in the deposit rate was also effected. The incremental SLR was brought down from 30 per cent to 25 per cent. The year was marked by a substantial increase in the foreign exchange assets which went up by US $ 9.4 billion. As a consequence, monetary expansion became very large at 18.4 per cent in 1993-94 as against 14.8 per cent in the previous year and the inflation rate crossed 10 per cent. Open market operations were extensively used to neutralise the expansionary impact of capital inflows. This became possible only because the government securities issued in the previous two years had more or less market determined interest rates and the RBI had a stock of such securities. For the first time, external sector became the main cause of expansion in money supply. Real GDP grow by 6.2 per cent.

There was a clear improvement in the overall performance of the economy in 1994-95. The rate of growth of real GDP touched 7.8 per cent. Current account convertibility on the external account was formalised through the acceptance of Article VIII of International Monetary Fund. There was, however, a slippage in the gross fiscal deficit. Macro economic management faced problems of large capital inflow in the first half of the year, a sharp credit expansion in the second half of the year and an uneasy fiscal balance at the end of the year. An important development in the area of fiscal and monetary policy was the agreement between the government and the RBI to phase out the system of ad hoc treasury bills over a period of three years. The system, as it existed then, amounted to an automatic monetisation of the budget deficit. Monetary policy in 1994-95 had to be framed against the backdrop of a high inflation rate caused by large growth in reserve money triggered by large capital inflows. In the second half of 1994-95, the RBI undertook certain measures to moderate the inflow of capital. The foreign currency non-resident deposits were brought under the purview of CRR. In October 1994, the RBI, however, reduced the lending rates of scheduled commercial banks for credit limits over Rs 2 lakh. Further reductions in Statutory Liquidity Ratio were also made. The government long-term borrowing rate came down slightly to 12.35 per cent. In order to sterilise the expansionary impact of the surge in foreign currency assets, the CRR which had been lowered in the previous year was raised by 1 percentage point. Nevertheless, the monetary expansion was high at 22.4 per cent.

Real economic activity continued to remain buoyant in 1995-96. For the second year in succession, the rate of growth of the economy exceeded 7 per cent. Monetary policy had to act against a background of an inflation rate exceeding 10 per cent in the previous two years. Another important factor influencing monetary policy in the year was the turbulence in the foreign exchange market which started in August 1995. The nominal rupee-dollar rate which had remained totally stable since March 1993 came under pressure. Even a small variation in the exchange rate after years of total stability triggered panic reaction and precipitated a sudden drop in the value of the rupee. The exchange market intervention (net sales) by the Reserve Bank in the spot market led to the withdrawal of liquidity from the money market, leading to sharp increase in the call rates which then restored stability in the exchange market. But the stability in the exchange market was shaken again in mid-January 1996. The Reserve Bank took a number of measures in early February 1996 to accelerate receipt of export proceeds and to prevent acceleration in import payments. These measures enabled the rupee to stage a strong recovery and in fact, the Reserve Bank started purchasing foreign exchange to prevent a sharp strengthening of the rupee. Between October 1995 and March 1996 the cumulative impact of RBI foreign exchange intervention and release of resources through reduction of CRR was an injection of liquidity, though for a period of two or three months, there was a negative impact which had the effect of pushing up money market interest rates. This was also a year when there was a strong demand for funds both from the government and the commercial sector.

The raising of funds through the capital market dropped substantially in 1995-96, while investment demand continued to remain high. The mobilisation of resources from the primary market by non-government public limited companies came down from Rs 26,440 crore in 1994-95 to Rs 16,371 crore in 1995-96. As a consequence, there was a pressure on bank credit and interest rates. In fact, non-food credit by the banking sector expanded by 22.5 per cent in 1996-96, on top of a 30 per cent increase in the previous year. Even though money supply in 1995-96 showed a smaller expansion partly for the reason that the base figure was high, the expansion in bank credit was nevertheless high because the lendable resources of the system increased as a result of the reductions in CRR. In the event there was a significant drop in the inflation rate in 1995-96.

The economy continued to grow at a rate exceeding 7 per cent in 1996-97, for the third year in succession. Given the stability in prices, a major effort was made to bring down the CRR. There was a sharp scaling down of the CRR by as much as 4 percentage points to 10 per cent between April 1996 and January 1997. Capital inflows also recovered in the second half of the year. As a consequence, nominal interest rates at the shorter end declined sharply. The treasury bill rate for 91 days which stood at 12.97 per cent in April 1996 came down to 10.17 per cent in October 1996 and declined further to 7.5 per cent in February 1997. Interest rates at the longer end, however, experienced marked stickiness partly because inflationary expectations had not come down. The money supply growth rate during the year 1996-97 was 16.2 per cent and with the economy growing at 7.5 per cent, the inflation rate remained low at 5.4 per cent. Signs of the slackening of growth of the economy were visible from early 1997. The Bank Rate was reactivated in April 1997 by linking several interest rates to it. It was also the rate at which refinance was to be provided by RBI. An attempt was thus made to make the Bank Rate as the 'signal' rate. The Bank Rate was reduced from 12 per cent to 11 per cent in April 1997 and further to 10 per cent in June 1997. In October 1997 the Bank Rate was further reduced by 1 percentage point to 9 per cent. A programme to reduce the CRR from 10 to 8 per cent which was announced in October 1997 could not be fully implemented because of the East Asian crisis. Because of the series of measures introduced in relation to CRR and Bank Rate, the government borrowing rate started to decline. The trend of decline in the interest rate got interrupted in the wake of the measures to stabilise the exchange market. In January 1998 the Bank Rate was raised to 11 per cent and the CRR to 10.5 per cent. While the rupee did depreciate, the depreciation was much less than what the East Asian currencies experienced. During 1998-99 and 1999-2000 inflation rate continued to remain low. The money supply growth rate in the two years was 19.4 per cent and 13.9 per cent, respectively. The economy grew at 6.8 per cent and 6.4 per cent, respectively. With inflation rates remaining low, there was a softening of interest rates. The long-term borrowing rate of the government started declining. By April 2000, the Bank Rate was brought down to 7 per cent and the CRR to 9 per cent. During 2000-01, Bank Rate was raised and then leveled back to 7 per cent and CRR to 8 per cent. The liquidity adjustment facility (LAF) has evolved as an effective mechanism for absorbing and/or injecting liquidity on a day-to-day basis in a more flexible manner and, in the process, providing a corridor for the call money market. The CRR was reduced from 5.5 per cent to 5.0 per cent in June 2002, to 4.5 per cent in June 2003, augmenting the lendable resources of banks by about Rs.13,500 crore.

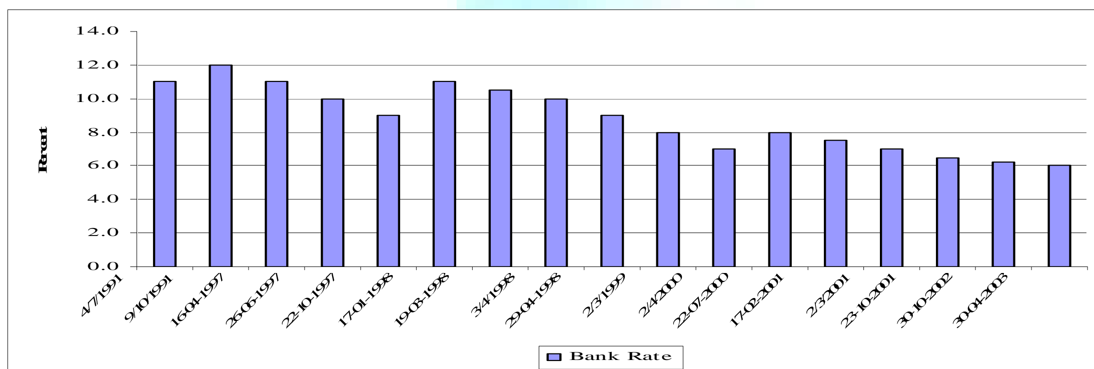
The Bank Rate and the LAF repo rate were reduced by 25 basis points each in October 2002 followed by a 50 basis point cut in the LAF repo rate on March 3, 2003. Comfortable liquidity conditions engendered by large capital inflows enabled a general reduction in market interest rates with varying sensitivity to policy signals across the maturity spectrum. Lending rates of banks exhibited, however, somewhat sluggish downward movements. The softening of interest rates was enabled by the benign inflation environment. The policy stance was reinforced by a 25 basis point cut in the Bank Rate in end-April 2003 and in the cash reserve

ratio (CRR) in mid-June, followed by a 50 basis point reduction in the LAF repo rate towards the end of August. Banks took advantage of easy liquidity conditions to cut deposit rates and lending rates. Responding to the Reserve Bank's initiative, banks switched over from tenor-linked prime lending rates (PLRs) to benchmark PLRs (BPLRs). As at end-March 2004, BPLRs were lower by 25-200 basis points than the PLRs which prevailed a year ago and Market Stabilisation Scheme (MSS) was introduced in April 2004 to strengthen the Reserve Bank's ability to conduct monetary and exchange rate management. However in 2004 there was stance that to keep adequate liquidity and adopt status quo to pursue interest rate. The fixed reverse repo rate and the repo rate increased by 25 basis points each to 5.75 per cent and 6.75 per cent, respectively, effective June 9, 2006. The stance of monetary policy during 2005-06 would depend on several factors, including macroeconomic prospects, global developments and the balance of risks. It indicates that Indian economy progressively liking to world economy. It means global inflation interest rate and investment demand have relevance effect on domestic interest rate. As per as LAF concern, it has increase by 50 points to 5.25 percent in 2006 to moderate the inflation. However, Still there is high rate of inflation at 6.5 per cent in March 2007 as compare to last three years (around 3-4 percent). To curb this inflation RBI has hiked the repo by 0.25 per cent as also the CRR by 0.5 per cent. However there is exist of new reason that "Inflation expectations loom large in most parts of the world. Therefore, many central banks have responded pro- actively to tighten liquidity so that inflation is held in check-P.Chidambaram, (2007)"[12].

USE OF MONETARY POLICY INSTRUMENTS SINCE 1991

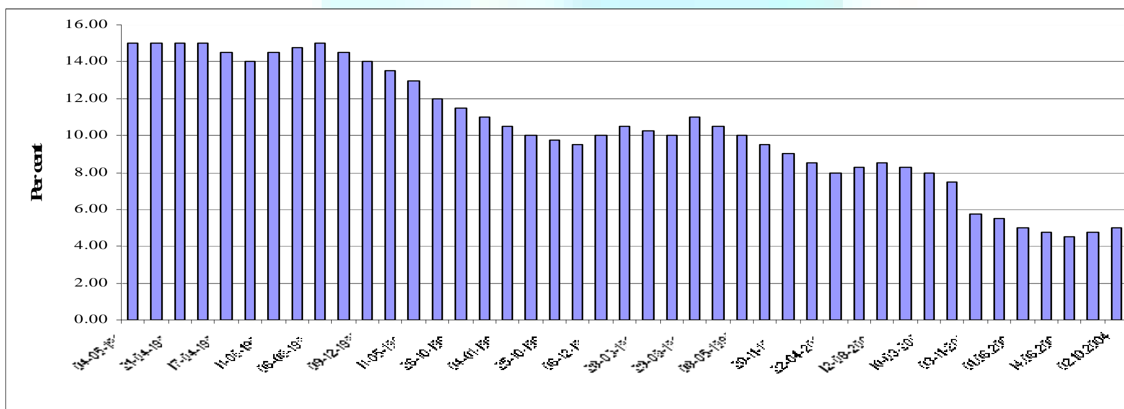
As per as instruments concern there are Bake Rate, CRR, SLR, Reverse Repo Rate and Repo Rate. Of course, these are part of interest rate instrument where it can be called quantitative instruments. To begin with the status of first instrument i.e,. Bank rate. This instrument used in the difficult time when the inflation more than one digit. Bank rate was so high in 10, September 1991**(Figure 5)**. But it has declined consistently till 2003 at around 6 per cent and it has changed more (four times) in 1998 is the highest.

FIGURE 5: PATTERN OF BANK RATE FROM 1991 TO 2003



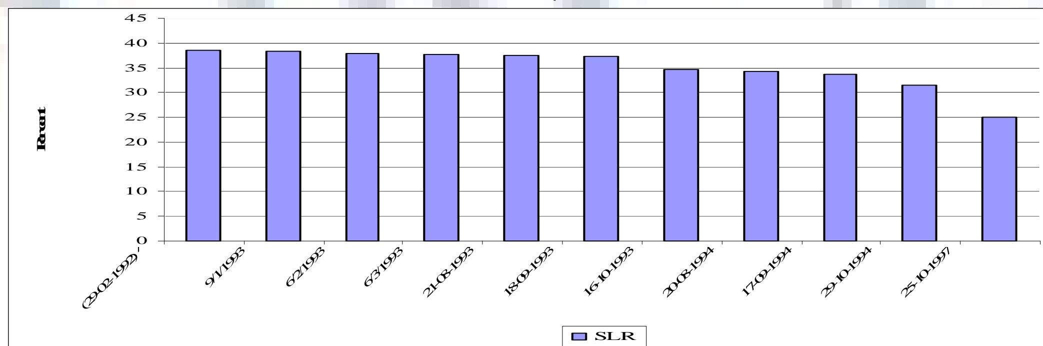
Source: www.rbi.org.in

FIGURE 6: PATTERN OF CASH RESERVE RATIO FROM 1991 TO 2004



Source: www.rbi.org.in

FIGURE 7: PATTERN OF STATUTORY LIQUIDITY RATIO FROM 1993 TO 1997



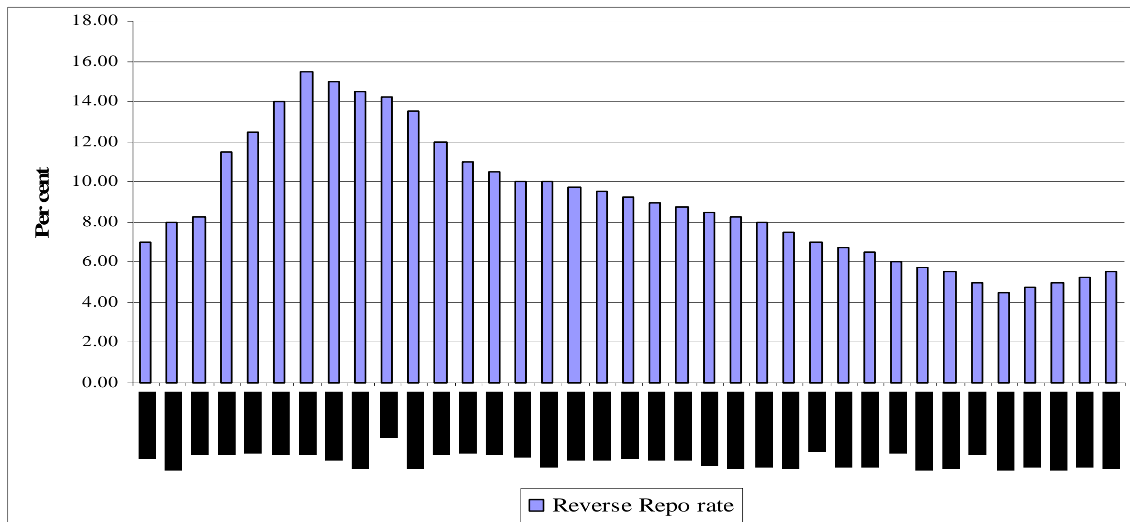
Source: www.rbi.org.in

[12] Finance Minister P.Chidamaberam gave this statement regarding inflation, published in Hindu, April, 11 2007.

Cash Reserve Ratio (CRR) is another instrument of quantitative method. As compare to Bank rate, CRR is active instrument because of quick effect on inflationary pressure. In the **Figure 5** gives the clear pattern of CRR during reform as well as post reform period. CRR was stood in between 10 to 14 per cent during the reform period. Then there was decreasing cyclical pattern from 1997 to 2004. The period from 2001 to 2004 was lowest rate was maintained because of low inflation rate.

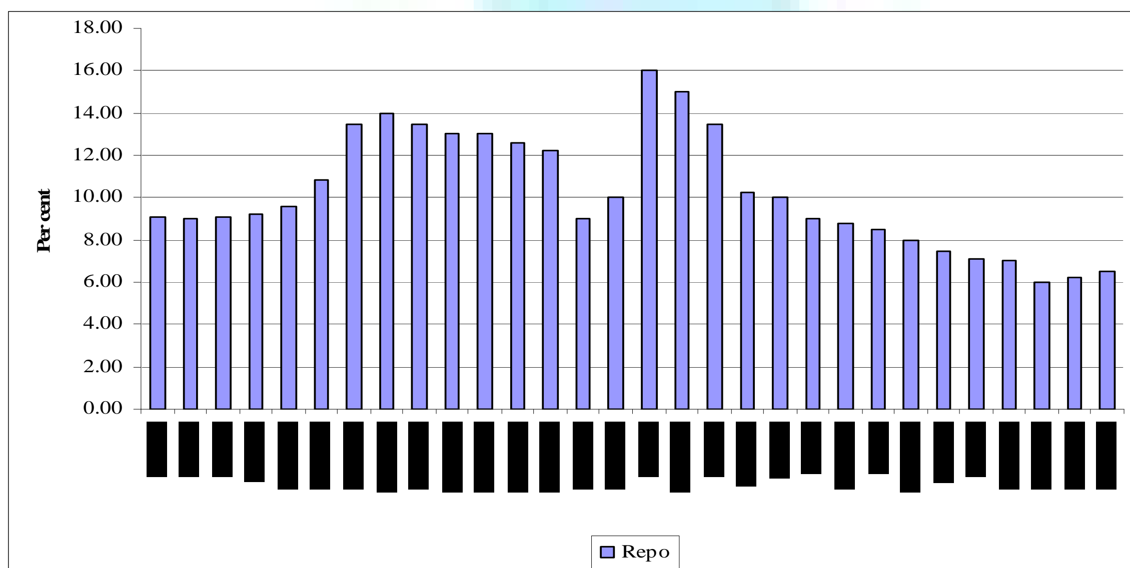
The lowest number of time adopted instrument is Statutory Liquidity Ratio. By short it known as SLR. During the reform period, SLR was kept at 38 per cent and lowest rate of SLR was 25 per cent which is still now same. The pattern of SLR shows that static downward trend. SLR was stood between 35 to 40 per cent from 1992 to 1993. After that SLR range become 25 to 35 from end of 1993 to 1997 **(Figure 7)**.

FIGURE 8: PATTERN OF REVERSE REPO RATE FROM 2000 TO 2006



Source: www.rbi.org.in

FIGURE 9: PATTERN OF REPO RATE FROM 2000 TO 2006



Source: www.rbi.org.in

Reserve repo rate and repo rate are the created under Liquidity Adjustment Facility (LAF). Of course, both rate are become integral part of the RBI as effective instruments. Reverse repo rate has started in 10th of July, 2000 **(Figure 8).** The highest rate of Reserve repo rate is 15 per cent in the same year as well as highest number of time this rate has been varied. But now it is 6 per cent after there is hike in the inflation rate.

Last but not the least, Repo rate is recent emerging monetary instrument which also comes under LAF. **Figure 9** reveals pattern of repo rate from 2001 to 2006. Like reverse repo rate this rate also used in most of time in 2001. One thing is to be clear that both rates are playing crucial role in determining liquidity in the economy. The peak rate of repo rate is 16 per cent which more than reverse repo rate. This has happened in the month of August, 2000.

CAVEATS TO MONETARY AND FISCAL POLICY

Since 1950-51, India has adopted mixed economy wherein government plays an important role in welfare of people. Hence it becomes essential to formulate policies with the focus on economic and social wellbeing of people. While formulating and implementing these policies, the policy makers come across many challenges. This is true with monetary and fiscal policy in India as well. Here we discuss some of the problems posed by gaps in formulation and implementation of monetary and fiscal policies.

- There is need for better coordination and cooperation between both the policies so that Indian economy can attain its objectives such as price stability and growth. Thus, high level of interface between both the policies is prerequisite for better performance of the economy.
- Needless to say that fiscal sustainability is another big challenge for government. There is variation in debt/GDP ratio over period of time. As the interest rate exceeds the output growth rate, the gap between the two rates increases resulting in higher debt-GDP ratio. This would require generation of adequate primary surplus equivalent to the gap between the interest rate and the rate of growth to stabilize the interest rate. But sufficient condition is that the initial debt stock equals the present discounted value of primary surpluses in the future.

- There is inflationary bias in monetary policy; therefore there is existence of a dynamic inconsistency. It can arise from number of factors such as knowledge of the changing characteristics of the economy like political pressure and state-contingent policy response. But only way is that seigniorage revenue and the incentives provided to the monetary policy to publicly credible.
- There is a mismatch between announced inflation target and public's expectations regarding future inflation which should be corrected.
- Threat from other countries economic fluctuations is also one of the challenges for Indian economy, because of increase market integration and globalization in the world. There is a record of crisis like South East Asian crisis (1997) which had spillover effect in the world. To protect the domestic economy form such type of threats there is need of analysing implications of the policy implementation.
- Threat of deflation is similar to the above caveat but it is totally in separated. Because threat of deflation comes when monetary policy revitalise the economy have taken real interest rate in various countries to levels below their real growth rates, producing what has been termed as the deflationary. E.g. Japanese experience has underscored the lower bound of monetary policy effectiveness and has brought the potential threat of inflation into forces. It increases the real debt burden casing bankruptcies and bank failures. To overcome this challenge, there should be contingency plans, emergency liquidity facilities, coordinated monetary and fiscal intervention, credible and transparent inflation targets are suggest in literature as part of the strategy to fight the deflation.
- As far as monetary policy is concerned, there is need to involve the constant rebalancing of objectives in terms of the relative importance assigned to them , the selection of instruments and operating frameworks and a search for improved understanding of the working of the economy.
- It is crucial to monitor all available information for signs of overheating with a view of keeping inflation expectations stable and ensuring that the gains from high growth are consolidated. Accordingly, sensing how close is the economy to its potential growth is the vital judgment that has to be made to set the timing and direction of monetary policy.
- The revision is consistent with the observed improvement in corporate profitability and internally generated resources that has been sustained over the period 2003-07, and to which we have been drawing attention for some time. Corporate profitability has remained strong despite a sharp rise in input costs and in interest payments
- An important challenge for the monetary policy authority is to judge the durability of the recent upsurge in growth. The current growth momentum is more cyclical than structural, the stance of monetary policy would need to reflect sensitivity to the inevitability of a downturn. On the other hand, the judgment that structural factors predominate would warrant a different policy stance.
- The monetary policy should give creative solution to problems which are in non-disruptive manner. It is in this context that prudential and other measures such as provisioning and risk weights on bank loans to specific sectors are being used so as to enhance the sensitivity to risks emanating from these sectors rather than standard monetary policy responses that address aggregate demand.
- There should be existence of effective and better tax administration because when some services are taxed and some are not, there will always an attempt on the part of service provider to label their service as belonging to the non-taxable category. More importantly, the central VAT (CENVAT) only extends into manufacturing. Tax credits are not given for services purchased by manufacturers, or manufactures purchased by service producers. This serves to break VAT chains, distorts production through cascading taxation, and increases the likelihood of evasion.
- Inadequate taxation of services has been an important weakness of the tax system. The share of the services sector in GDP has grown sharply over time. Here problem of equity arises. Because most of poor people preferred basic good and rich people prefer service goods (luxury goods). Therefore there is need for systematic tax framework.

SUMMARY AND CONCLUSION

The study conclude that the immediate aftermath of the fiscal reforms was essentially brought about through cut in investment expenditure, as rise in committed revenue expenditure could not be curtailed. Within a short span, it became increasingly obvious that the Indian approach to fiscal correction was not sustainable. While reduction in investment spending affected future growth prospects with consequent slowdown in revenue receipts, the interest payments and public debt continued to grow, resulting in reversal of fiscal consolidation process in the latter half of the 1990s. Downward rigidity in the revenue deficit, which amounts to dissaving by the Government sector, has significant implications for the growth target of 8 per cent set in the Tenth Five Year Plan. This would require an investment rate of about 32 per cent, whereas, over the years, the investment rate has stagnated at around 24 to 25 per cent of GDP. However, it may be noted that such rules generally make a clear distinction between public consumption and public investment expenditure while envisaging a complete elimination of revenue deficit. Rule based fiscal policy would facilitate the path for durable fiscal consolidation through mandatory fiscal discipline, enhanced accountability and improved transparency in fiscal operations.

With the growing globalisation and integration of economies, monetary authorities are now required to pay greater attention to external developments. The conduct of the monetary policy in India would continue to involve the constant rebalancing of objectives in terms of the relative importance assigned, the selection of instruments and operating frameworks, and a search for an improved understanding of the working of the economy and the channels through which the monetary policy operates. Over the past few years, the process of monetary policy formulation has become relatively more expressive, consultative and participative with external orientation, while the internal work processes have also been re-engineered. The stance of monetary policy and the rationale are communicated to the public in a variety of ways.

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