CONVERGENCE OF FISCAL AND MONETARY POLICY FOR V-SHAPE RECOVERY OF THE INDIAN ECONOMY

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ABSTRACT

The dark clouds of recent pandemic are hovering around the entire world. It has necessitated the urgent need for upgraded and prepared medical facilities especially for the developing countries like India. On social and economic front, the impact is equally catastrophic creating sense of uncertainty and ambiguity in the minds of consumers, business and investors as well as the government. The present scenario calls for extensive reforms and changes in order to revive the overall sentiment's and bring the Indian economy on track. This paper highlight's the importance of mutually reinforcing fiscal and monetary policy reforms for V-shaped recovery of the economy. India needs to unleash the same animal spirit which was demonstrated in the post-1991 liberalization. Structural reforms together with the right channelizing of capital in critical sectors is the need of the hour. Fiscal policy is an instrument of economic development and aims at accelerating the rate of development through direct controls or pushing for structural reforms. Monetary policy aims at facilitating economic growth through suitable interest rate policies thereby infusing capital in the strategic sectors of the economy.

Keywords	economic reforms, v shaped recovery, structural reforms, fiscal policy, monetary policy
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INTRODUCTION

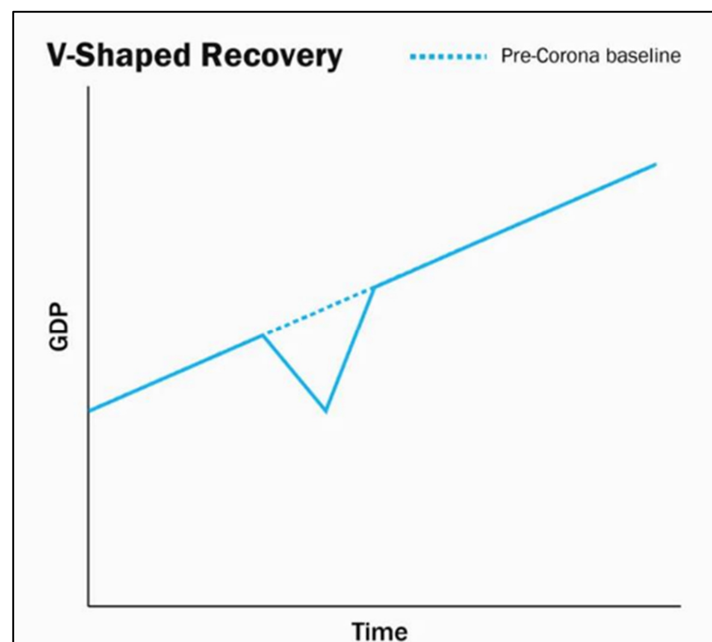
The pandemic faced today has clearly eliminated the distinctions between developed nations and developing countries. The world has been the witness of such pandemics in the previous centuries with equally disastrous consequences as seen today—Asian influenza in 1957, Hong-Kong influenza in 1968, Spanish flu in the 20th century. There was an outbreak of Severe Acute Respiratory syndrome in 2002, which had a tremendous impact on economic activities. The economies face both micro and macro-level issues creating a vicious circle of low production, unemployment, and consequently social unrest. The situation is grave, especially for developing countries like India, which has been already grappling with healthcare infrastructural issues. Thus, there is an arduous task for the policymakers to strike the right chord and maintain a balance between lives and livelihoods.

The silver lining is that India has been able to withstand economic shocks since independence. We have come a long way from being an economy with a GDP of merely Rs 2.7 Lakh cr to that of targeting a 5 trillion economy in coming years. The economy did reach its lowest ebb pre-liberalization era but soon become one of the fifth largest economies in the world.

The scenario today is grave due to the 'Act of God.' However, optimism is also seen among the policymakers and some economists, keeping in mind a large consumer base. There has also been much debate about the shape of economic recovery India would witness. The majority of literature refers to V-shaped recovery, especially after such pandemics. Chief Economic Advisor K Subramanian's comment that the worst is over for the Indian economy is witnessing a V-shaped economic growth after the world's most stringent lockdown.

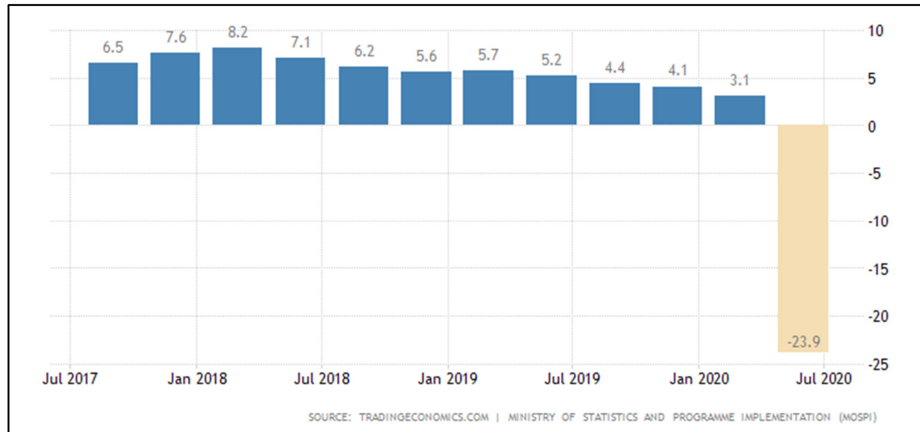
V-shaped recovery is when the economy rebounds after a steep fall. Incomes and jobs are lost temporarily, and later due to multiple factors, the economy treads back on the growth trajectory.

Figure 1: Shape of the V-Shaped Recovery



Source: https://www.brookings.edu/blog/up-front/2020/05/04/the-abcs-of-the-post-COVID-economic-recovery/

Figure 2: GDP levels



Source: Tradingeconomics.Com I Ministry of Statistics and Programme Implementation (MOSPI)

India witnessed a huge contraction in Gross Domestic product with a record growth contraction of -23.9% in the second quarter of the Fiscal Year.

Figure 3: Sector-wise GVA (Gross Value Added) decline

QUARTERLY ESTIMATES OF GVA

INDUSTRY	CHANGE OVER PREVIOUS YEAR	
	April-June 2019-20	April-June 2020-21
Agriculture, forestry & fishing	3.0%	3.4%
Manufacturing	3.0%	-39.3%
Construction	5.2%	-50.3%
Trade, hotels, transport, communication & services related to broadcasting	3.5%	-47.0%
Public administration, defence & other services	7.7%	-10.3%
Gross Value Added (GVA)	4.8%	-22.8%
Gross Domestic Product (GDP)	5.2%	-23.9%

Source: https://www.drishtiias.com/current-affairs-news-analysis-editorials/news-analysis/01-09-2020/print

GVA is the sum of a country's GDP and net of subsidies and taxes in the economy.

Thus, the economy's dismal scenario due to the pandemic and consequently followed by necessary lockdown requires resilient stimulus packages to reboot the economy. This does not mean that public expenditure is the only cure for reviving the economy. It is both the government-backed up by the monetary policy which would substantiate the recovery.

Counter-cyclical macroeconomic policies are designed to stimulate the economy backed up by structural reforms like labor and Farm reforms recently announced. The reforms are expected to break the rigidities, which has been a significant obstacle on the path of entrepreneurs wanting to increase the production cycle aggressively. For example, Contract Farming Bill will allow the marginal farmers to enter into a contract with large business houses and large retailers on pre-determined prices for their produce. This would lead to a trickle-down effect.

Similarly, labor reforms announced by the government would give breathing space to the industrialist (reducing the compliance filings). There is an urgent need for our industries to gear up to break the cycle of unemployment. The government's new labor code is a historic step towards giving new life to the staggering industries. Fixed Term Employment, an extension of Occupational Safety, Health and Working Condition Code, 2020, and allowing migrant workers to avail ration facilities will give a sense of security to the workers, thereby increasing their productivity and industrial output.

Monetary policy should initiate credit growth, which is the lifeline for industries, while the Fiscal policy has to catalyst investments on a large scale.

LITERATURE REVIEW

Spanish Flu occurred in 1920. Calvin Coolidge was elected the U.S. President, and his immediate step to repair the economy was to go for significant tax cuts. The combination of technology and pent-up capital resulted in the economic renaissance. This was also supported by the Mass manufacturing of millions of cars, and consequently, the other industries like Rubber, Steel, Restaurants also flourished.

There are three pillars of any kind of Disaster Management-government, business institutions, and community. Roger Kaufman (in 1995) gave importance to the extensive role of the government to serve and regulate the society during any kind of emergencies. In his empirical study 'Structural Changes and Development Policy 1979, Hollis B Chenery defined development pattern as "systematic variation in any significant aspects of the economic or social structure associated with a rising level of income." He, in his three-principal development-Accumulation process, Resource Allocation process, and Demographics and Distribution process, reiterated the importance of the government expenditure and revenue for bringing an increase in the GDP levels.

Professor V.K.R.V Rao analyzed Keynesian theory's applicability and maintained his work on "Financing for capital Formation and Price behavior in an underdeveloped Economic ". The importance of deficit Financing is a critical tool to increase the economy's capacity, thereby increasing the supply curve. This is true especially for developing nations like India where the structural rigidities pose an enormous challenge to the industrial development.

Fiscal Policy, according to Nurkse's theory, assumes an important role in harnessing incremental saving ratio. The incremental saving ratio can be raised through government stimulus packages to create social and economic overheads. Similarly, Raja J. Chelliah's report on Fiscal policy in underdeveloped countries stressed balancing both in real and money terms. It further added that implementing the financial plan and the achievement of balances in real and money terms would largely depend on Fiscal Measures.

Monetary policy's importance can be substantiated with IS-LM model of macroeconomics, which emphasizes that a fall in the real interest rates would increase the national output.

Mundell-Fleming model stated the relationship between the interest rate and economic growth. The monetary policy framework in India has gone through various transition phases. After independence, the central bank's role was aligned with the nation's planned development process. It played a significant role in regulating credit using bank rates, Open market operations, and Reserve requirements.

Based on the RBI Report of Expert committee under Dr. Urjit Patel's chairmanship, a formal transition towards a flexible inflation target was made in 2016. Recently the apex bank is also using unconventional monetary policy measures. These include interest rates on risk-free bonds, liquidity, and credit spreads. The objective is to align the conventional tools with unconventional measures to promote economic growth and stability. Monetary–fiscal coordination was highlighted in the monetary policy committee on March 27, 2020, stressing on Coexisting monetary and fiscal policy is essential to overcome the surmountable challenges due to COVID-19.

OBJECTIVES OF THE STUDY

1. To highlight the importance of Fiscal and Monetary tools for achieving Economic growth.
2. To understand the importance of convergence of Fiscal and Monetary Policies.

DOMESTIC MEASURES FOR ECONOMIC GROWTH-FISCAL AND MONETARY POLICY

Figure 4: Tools of Macro Economics

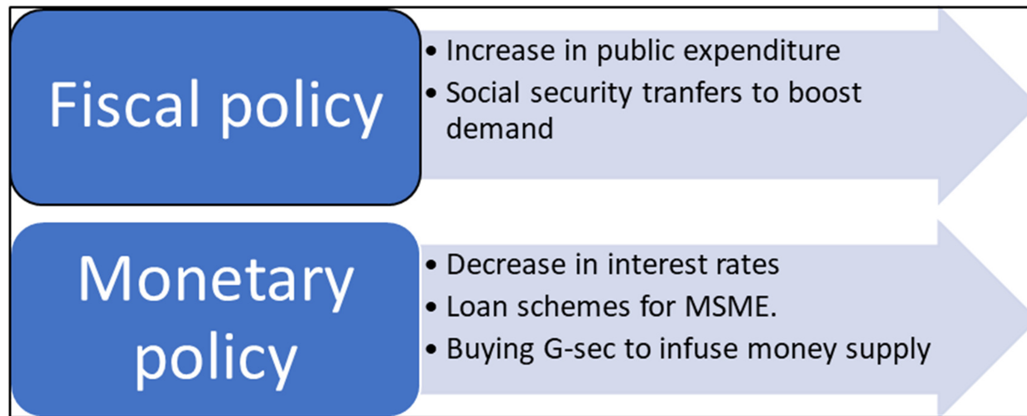
Source: Author compilation

Economic growth and development for any economy depend on Macroeconomics-Fiscal and monetary policies' two most important pillars. Appropriate and timely interventions by the government and banking authorities act as a catalyst for economic activities. Fiscal policy is the policy of the government. No country can achieve its macro-objectives of income, output, and employment with comprehensive and flexible fiscal actions. Fiscal policies' essential tools are public spending or expenditure, public borrowing, taxation, and deficit financing. There are two types of Fiscal Policies-Expansionary and Contractionary. When the economy is facing inflationary conditions, which affect the demand and consequent fall in the currency value, the government adopts a Contractionary policy, restricting its non-development expenditure, resorting to high taxation levels.

Contrary to this, during times like low economic activities, stagnant production, and dampened demand, there is a need for Expansionary Fiscal policy. During such phase of the Economy, the government resorts to increased public expenditure, especially the development and capital expenditure, leading to 'Crowd-in private investments. During the present pandemic scenario when India faces a considerable contraction in GDP, low private investments, and low demand, the government, through its fiscal stimulus packages, has vowed to undertake public expenditure on social and economic heads expected to stimulate production, employment and income.

Monetary policy is another crucial macroeconomic instrument to achieve the objectives of the economy. Its tools like Open market operations, bank rate, Reserve ratio requirements, and adopting selective methods and controls stabilize the economy. During Inflationary tendencies, the central bank adopts 'dear money policy,' thus restricting the excessive money supply. These require an expansionary monetary policy. The central bank injects liquidity in the market by lowering interest rates and giving special incentives like Loan Moratoriums to the small and medium industries. Recently RBI had announced a Repo–rate cut by 115 basis points from 5.15% to 4.40% as a measure to combat the impact of COVID-19. It also purchased government securities worth Rs. 10,000 crores in September 2020 to infuse money into the economy. Both Monetary and Fiscal policy needs to work in a coordinated manner to achieve the economic objectives of output, employment, income, and economic growth.

Figure 5: Expansionary Policies during the pandemic



Source: Author compilation

CONVERGENCE OF FISCAL AND MONETARY POLICY

Professor Arthur Lewis defines Economic growth as "growth of output per head of population." Growth is to bring a sustained increase in output or income. Gross capital formation is a crucial factor that determines growth. It refers to aggregate investments, stocks of physical capital goods like plants, machinery. The high growth rate is determined by various factors like the policies of the government, liquidity or credit growth in the economy, Technological progress, and progressive cycle of demand and supply. During normal circumstances in any economy, the growth of the economy takes its course with the factors stated above. However, during situations like war or pandemic like this business cycles gets disrupted. It is any government's task through its Fiscal and monetary tools to bring sustain the growth trajectory. This task becomes difficult and challenging, especially when the economy faces lower ebbs.

Pandemic like COVID 19 has been catastrophic for all types of economies. Under such circumstances, all the governments worldwide' task is to maintain a balance between lives and livelihood. Thus, both Fiscal and monetary policies have to work in sync to ensure that adequate measures are taken to minimize the damage. India's GDP showed a considerable contraction. Core sectors like construction, manufacturing, transport, and communication have shown an enormous decline. Lockdown (which was inevitable) resulted in a decline of house-hold incomes from about 9 percent in late February to a massive dip of 45.7 percent in mid-April. Although post-festive season, there have been green shoots, still lots have to be initiated to maintain a sustainable increase in income, output, and employment. Calibrated fiscal and monetary policy reforms have to be initiated to support the economy.

Fiscal policy tools like taxation, public expenditure, and public borrowing play an indispensable role in accelerating growth, especially when the private sector is reluctant to invest due to uncertainty looming around. Pandemic conditions followed by lockdown; problems related to migrant labors virtually halted production activities all over. During crises like this, fiscal policy through its public expenditure and counter-cyclical policy of deficit-financing is essential to combat depressionary phases. When private investments are virtually faced with a downward beat, the expansionary fiscal policy is the need of the hour. Public expenditure on structural and social, and economic overheads like investments on crucial infrastructural projects helps in a gibing boost to the economy. Simultaneously, tax benefits to the industrial sector add to the benefits. Infrastructural investment remains the best antidote –creating 'crowd –in investments- and boosting labor productivity. In this direction, the Government of India announced a Rs 1.10 lakh crore platform for infra debt financing with a Rs 6,000 crore equity infusion in the National Investment and Infrastructure Fund to boost infrastructure financing.

Creating a conducive environment for productive activities requires eliminating red-tapism, procedural bottlenecks. This also helps in attracting forcing investments, thereby helping the economy to recover faster. The monetization of public assets such as roads, bridges, and ports airports also helps resolve the credit crunch. Through the legislative way, social and economic reforms usher new hope to the areas that have been plagued with outdated norms. The government initiatives in bringing about Farm bills and labor codes are thus an earnest effort towards reforms' objectives. The new farm bill (although there are voices against it) would finally help the marginal farmers of India to directly sell their produce in the market without intermediaries taking their share. Also, Rs. one lakh crores Agriculture Infrastructure Fund (AIF) has been launched, facilitating farm gate infrastructure development.

The new labor codes would create a sense of security to the business houses, attract foreign investments, and increase production, employment, and income.

These social and economic reforms should also be in sync with the monetary policy initiatives to bring about a desirable growth trajectory. The apex bank must ensure that an adequate supply of capital is channelized by lowering interest rates, giving thrust to the investment demand. Recently the RBI also has given stimulus packages with two components one 50,000 crores for the National Bank for Agriculture and Rural Development (NABARD), Small Industries Development Bank of India (SIDBI), and National Housing Bank NHB). In addition to this, the RBI allowed a one-time debt restructuring for Micro, Small, and Medium enterprises. Infusing liquidity directly into Non-banking financial companies (NBFC) and giving financial reconstruction to the core sectors like power, construction, and real estate would calibrate with the fiscal stimulus announced. The convergence of Fiscal stimulus with that of monetary packages will have a dual effect as C. Rangarajan, former RBI Governor. One, it would inject liquidity, and the second, it would create demand. Recapitalization of banks has been another step to contain Bank non-performing assets.

Thus, fiscal policy interventions in the form of infrastructural investments, reforms in land, labor markets, banking sector steps in lowering interest rates, and reducing reserve ratio requirements would pave the way for uplifting the dark clouds of economic distress.

CONCLUSION

The positive signals or Green shots are beginning to show with the right mix of Fiscal and Monetary stimulus. GST-E bills, electricity, petrol, and diesel showed signs of recovery in September 2020. Data has shown that electricity generation marked growth of 4.2 percent in September 2020 from 3.3 percent in August. Similarly, auto-production recorded an upbeat production of 11.7 percent in September 2020. These sectors would undoubtedly have spillover effects in the coming months. Therefore, it is imperative that the role the government of India and the monetary policy is playing of diligent reformist is vital to be continued till the economy works at the pre-COVID times. Economic Growth is indispensable. The Government, with its complete focus on structural reforms and public expenditure, together with monetary policy support with a lower interest rate regime, will keep the wheel rolling. Strong Fiscal and monetary stimulus on reviving the economy with emphasis on inclusive and sustainable development will kick-start the cycle of growth and development.

Famous quote by Peter Drucker “The Ultimate resource in Economic Development is People. It is people, not capital or raw materials that develop an economy”. It is thus overcoming pandemic with emphasis on reviving all society segments through appropriate measures and policies towards a complete V-shaped recovery.

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