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Article

Monetary and Fiscal Policies in India

* **Dr. Nitu Maan**
Associate Professor
Maharishi Arvind University, Jaipur
Email:-maannitu1982@gmail.com, Mob. - 9414575887

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Introduction

Economic stability and economic developments 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 emphasized on price stability and growth within broad content 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."

Monetary and fiscal policies in any country are two macroeconomic stabilization tools. However, these two policies have often been pursued in different countries in different directions. Monetary policy is often pursued to achieve the objective of low inflation to stabilize the economy from output and price shocks. On the other hand, fiscal policy is often biased towards high growth and employment even at the cost of higher inflation. For achieving an optional mix of macroeconomic objectives of growth and price stability, it is necessary that the two policies complement each other. However, the form of complementarily will vary according to the stage of development of the country's financial markets and institutions.

With increasing independence of central bank in the conduct of monetary policy from fiscal dominance during the last few decades, there has been a renewed interest in the issue of monetary and fiscal policy coordination.

The recent global financial crisis has once again demonstrated the importance of coordinated response of monetary and fiscal policies. Sovereign debt problem in many countries in the Euro area, in particular, has also underlined the need for monetary and fiscal policies coordination.

Monetary & Fiscal Policies: 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.

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. 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 (M3) 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.

Monetary Policy in India

Monetary policy represents one of a number of policies available to the authorities in the pursuit of macroeconomic objectives; the objectives usually considered are low inflation, high or full employment, balance of payments equilibrium and a satisfactory rate of growth

of real income. In a broader context, monetary policy as part of overall economic policy is basically as set of techniques, the users of which are located at the central bank and not in the government. This suggests fundamentally three major aspects of monetary policy in India:

a) The degree of autonomy of the central bank v/s the government,

b) The optimum policy mix between monetary policy and fiscal policy,

c) The relations between monetary policy and other instruments of economic policy.

The preference for a high degree of independence for the central bank is desirable due to the observation that, although economic policy is framed as a whole by the Government, the objective of monetary stability is not given a sufficiently important place in the formulation and implementation of economic policy.

In India, monetary policy has always emphasized the objectives of price stability and growth. What this, in effect, has meant in practical policy setting is formulating a balance between the two objectives depending on the evolving situation but in the broad context of keeping the inflation rate within a reasonable bound.

Apart from these two important goals, there has been a conscious attempt on the part of the Reserve Bank in recent years to maintain orderly conditions in the foreign exchange market, and to curb destabilizing and self- fulfilling speculative activities. This has assumed strategic importance for the sustainability of the external sector in the face of growing cross- border capital flows in to the economy. With the increasing order of domestic and international financial integration, exchange rate expectations do impact on the domestic stance of monetary policy and hence the significance of inflation. In the transitional phase, however, given the exchange market imperfections, the exchange rate objective may occasionally predominate due to emphasis on the avoidance of undue volatility. In fact, sometimes, as was the case recently, it could be the most dominant reason for short term monetary policy adjustments.

In a broader framework, the objectives of monetary policy in India continue to be price stability and growth. These are pursued, inter alia, through ensuring credit availability, with stability in the external value of the rupee as well as overall financial stability. The relative emphasis on any one of the objectives is governed by the prevailing circumstances.

In the Indian context, the objective of monetary policy has been to accelerate economic development in an environment of reasonable price stability. The monetary authority has to ensure that no legitimate productive activity is retarded by shortage of finance but at the same time the funds shall not become excessive to cause inflation. It is in this sense that the monetary policy adopted by the RBI has come to be known as that of controlled monetary expansion.

Controlled monetary expansion implies two things: 1) Expansion in the supply of money, and 2) Restraint on the secondary expansion of credit.

1) **Expansion in the Supply of Money**: In a developing economy money supply has to be expanded sufficiently to match the growth of real national income. Although it is difficult to say what relation the rate of increase in money supply should bear to the rate of growth of national income, more generally the rate of increase in money supply has to be somewhat higher than the projected rate of growth of real national income for two reasons:

- As incomes grow the demand for money as one of the components of savings tends to increase.
- As increase in money supply is also necessitated by the gradual reduction of the non- monetized sector of the economy. In India, the rate of increase in money supply has been far in excess of the rate of growth in real national income. It has resulted, to a large extent, in the creation of consistent inflationary pressure in the economy.

2) **Restraint on the Secondary Expansion of Credit**: Government budgetary deficit for financing a part of the investment outlays constitutes an important source of monetary expansion in India. In the circumstances an important aim of monetary policy is to restrain the secondary expansion of credit. This indeed poses difficult problems Since the general tendency in such a situation is for a marked expansion of credit for the private sector also. While exercising restraint, care is taken that the legitimate requirements of production and trade are not affected adversely.

Besides, the bank has to manage the public debt of the government in such a way as to ensure the raising of public debt at low interest rates, and at the same time, keeping interest rates attractive enough for promoting savings in the economy.

The fulfillment of the above twin goals requires:

a) A correct choice of instruments of monetary policy designed to regulate the flow of credit and

b) An effective credit planning.

RBI is empowered, under its statute, to use the usual instruments of monetary policy such as the bank rate, open market operations, variable reserve ratios, selective credit controls and so on. The choice of instruments of the monetary control that can be used is limited, however, by various environmental factors like:

- Seasonality in demand for credit,
- Nature of money market,
- Availability of black money and parallel economy,
- The gradual expansion of the monetized sector,
- Inflationary financing of development,
- The existence of non- banking financial intermediaries.

Monetary policy as an instrument of economic policy has certain advantages. Monetary policy changes, unlike in the case of fiscal policy, can be made at any time during a year. Monetary policy has been operated with a view to ensuring a reasonable degree of stability consistent with the needs of economic development.

The first and most important part of the monetary policy frame work in a country is the task mandated to the monetary authorities. In a democracy, this task is typically specified in the central bank act. It is interesting to note that despite overwhelming changes in the financial sector in India, the mandate to the monetary authorities in India mentioned in the Reserve Bank of India act 1934 has remained unchanged.

The preliminaries of the Reserve Bank of India act 1934 set the mandated tasks as " to regulate the issue of bank notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage." (Kaushik Bhattacharya, 2003)

A major failure of the monetary policy lies on the price front. The monetary authorities in India have not been in a position to curb an inflationary rise in prices: for regulating money supply, the monetary authority must have a reasonable degree of control over the creation of reserve money. The degree of independence in regulating reserve money depends upon institutional arrangements governing the functioning of the monetary authority. In India, government finances have come under increasing pressure in recent years. The increasing monetization of the budget deficit raises important questions on the roles of fiscal and monetary policy.

Reforms in the Indian Monetary Policy During 1990s

The monetary policy of the RBI has undergone massive changes during the economic reform period. After 1991 the monetary policy is disassociated from the fiscal policy. Under the reform period an emphasis was given to the stable macro economic situation and low inflation policy.

The major changes in the Indian monetary policy during the decade of 1990s -

1) **Reduced Reserve Requirements:** During 1990s both the cash reserve ratio (CRR) and the statutory liquidity ratio (SLR) were reduced to considerable extent. The CRR was at its highest 15% plus and additional CRR of 10% was levied, however it is now reduced by 4%. The SLR is reduced form 38.5% to a minimum of 25%.

2) **Increased Micro Finance:** In order to strengthen the rural finance the RBI has focused more on the Self Help Group (SHG). It comprises small and marginal farmers, agriculture and non agriculture labour, artisans and rural sections of the society. However, still only 30% of the target population has been benefited.

3) **Fiscal Monetary Separation:** In 1994, the government and the RBI signed an agreement through which the RBI has stopped financing the deficit in the government budget. Thus, it has separated the monetary policy from the fiscal policy.

4) **Changed Interest Rate Structure:** During the 1990s, the interest rate structure was changed from its earlier administrated rates to the market oriented or liberal rate of interest. Interest rate slabs are now reduced up to 2 and minimum lending rates are abolished. Similarly, lending rates above Rs. two lakh are freed.

5) **Changes in Accordance to the External Reforms:** During the 1990, the external sector has undergone major changes. It comprises lifting various controls on imports, reduced tariffs etc. The monetary policy has shown the impact of liberal inflow of the foreign capital and its implications on domestic money supply.

6) **Higher Market Orientation for Banking:** The banking sector got more autonomy and operational flexibility. More freedom to banks for methods of assessing working funds and other functioning has empowered and assured market orientation.

Evaluation of the Monetary Policy in India

During the reforms though the monetary policy has achieved higher success, it is not free from limitations or demerits. It needs to be evaluated on a proper scale.

1) **Failed in Tackling Budgetary Deficit:** The higher level of the budget deficit has made the monetary policy ineffective. The automatic monetization of the deficit has led to high monetary expansion.

2) **Limited Coverage:** The monetary policy covers only commercial banking system leaving other non- bank institutions untouched. It limits the effectiveness of the monetary policy in India.

3) **Unorganized Money Market:** In our country there is a huge size of the unorganized money market. It does not come under the control of the RBI. Thus, any tools of the monetary policy does not affect the unorganized money market making monetary policy less affective.

4) **Predominance of Cash Transaction:** In India, still there is huge dominance of the cash in total money supply. It is one of the main obstacles in the effective implementation of the monetary policy, because monetary policy operates on the bank credit rather on cash.

5) **Increase Volatility:** As the monetary policy has adopted changes in accordance to the changes in the external sector in India, it could lead to a high amount of the volatility.

There are certain drawbacks in the working of the monetary policy in India. However, during the economic reforms it has got different dimensions.

Fiscal Policy in India

Fiscal policy has been an important component of government's economic policy during recent decades especially after the great depression of the thirties of the last century. According to Keynes, 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.

In India, the fiscal policy has to perform a significant role. Among other things, the budgetary policies are expected to achieve the following objectives:

- To promote and accelerate the growth of productive investment in the economy both in the public and the private sectors;
- To mobilize the maximum volume of real and financial resources for the investment plan of the public sector, keeping in view the expanding demand for real and financial resources of the private sector, and in this way, to promote the growth of marginal and average rates of savings in the economy;
- To promote the maintenance of a reasonable measure of economic stability in keeping with the maximum rate of growth of the economy;
- To redistribute the growing national output.

There are vast differences in economic conditions, in the cultural, legal and political environment within which economic policy must operate and in the state of development of the art of taxation and the science of government.

Evaluation of India's Fiscal Policy

An evaluation of India's fiscal policy should bring out as to how far this policy has succeeded in the achievement of the objectives set before it. The analysis here is confined to the following three objectives:

- To promote saving and capital formation;
- To reduce economic inequalities;
- To bring about domestic stability, especially to curb inflationary tendencies in the economy.

Fiscal Policy and Savings and Capital Formation

A major objective of fiscal policy has been to promote saving and capital formation and to mobilize these as instruments of economic development.

Relationship between taxation and savings is assumed to be direct and simple. Taxation is believed to reduce the disposable incomes of all sections of society and thereby reduce their conspicuous consumption; the resultant tax revenue will increase public sector savings. In pursuance to this assumption, taxation has been used to mobilize resources for increasing the domestic savings. In the process of mobilizing huge sums of additional taxes the tax structure of the country has also changed. Empirical studies have shown that though additional taxation had some positive influence on government savings, such influence was not substantial. This would indicate that the fiscal strategy which was designed to mobilize additional taxation with a view to increasing government savings for development purposes had achieved only partial success. This finding is further supported by the performance of the public sector in the field of capital formation.

Where as taxation was so designed as to divert increased income for public sector savings, a major objective laid down for public expenditure was to increase capital formation in the public sector. Subsequent studies have shown that this unimpressive performance of the public sector in capital formation through assets creation has continued to persist. Three main reasons attributed to this unhealthy growth have been as follows:

- The economic performance of the public sector as a whole has been disappointing not only in generating surplus but also in- service efficiency.
- The attitude of some sections of public sector employees has not been helpful for achieving the envisaged objectives of the public sector.
- All the funds invested in the public sector have not gone to increase capital formation. Consequently, the physical assets created in the public sector are not of the required standard and quality. This has been partly reflected in the upward trend in the capital-output ratio.

The cumulative effect of all these has been that after fifty years of economic planning the country is starved of resources for public investment.

Fiscal Policy and Income Inequalities

The most important objective of direct taxes has been to achieve equity. The effectiveness of these taxes in reducing the inequality of income and wealth depends upon the progressive structure of the tax rates. The available evidence shows that only income tax has been progressive though not significantly, and all other direct taxes have been mostly proportional. Three reasons explain this situation.

- Though the nominal tax rates have been steeply progressive the effective tax rates have been made lower owing to exemptions, rebates and deductions.
- Wherever tax rebates and deductions are available, the complexity of tax laws and procedures of assessment have been used for tax avoidance under legal protection.
- Tax -evasion is evident particularly at the higher slabs of income and wealth as the average marginal effective tax rates become lower at higher levels of income and wealth.

Similarly, in the case of incidence of indirect taxes, the estimates made by the Jha committee have shown that these are proportional with reference to the levels of consumer expenditure. As a rule increase in productivity has failed to absorb the rise in costs due to taxation and other related factors. Added to the burden of cost by high prices, scarcities, harsh living conditions and lack of employment opportunities, the tax system and changes effected in it from time to time have increased social discontent and the sense of grievance against public authority.

Administration of the tax system as a whole leaves much to be desired. Failure to properly administer a tax system threatens the canon of equity because full payment of taxes is then made only by those whose elasticity of conscience is such that they cannot do otherwise. It may further increase the evasion of tax because the large amount of evasion breaks the morale of the honest tax payers. Also, a poor quality tax management may collect large proportions from easy- to-tax sector, thereby further creating intersectoral inequity in the incidence of the tax.

Fiscal Policy and Inflation

A major failure of the fiscal policy has been on the price front-its inability to arrest inflation. Taxation both direct and indirect and public expenditure have fuelled inflationary forces in

the country. Public expenditure adds to the demand-pull inflation, where as taxation, especially indirect taxes; add to the price rise thought the process of shifting. It is generally believed that as soon as rates of union excise duties and sales tax are raised, the prices of these commodities will automatically rise. This belief is well founded because of the actual practice of the businessmen where manufacturers, wholesalers and retailers immediately shift the increased amount of tax in the form of higher prices of goods.

The other important source of inflation in the budget is deficit financing. During the earlier plans, deficit financing, as a means of financing government investment to create productive capacity, was vehemently defended. This argument was based on the assumption that all the funds obtained through the mechanism of deficit financing were invested to create productive capital assets. The development experience during the last 50 years of planning, however, does not support this assumption. Several empirical studies have shown the close and direct association between deficit financing and price level in the country.

In short, the failures of fiscal policy have been too many, almost on all the major fronts that we have reviewed above. But its single foremost achievement has been that it has been used effectively as an instrument to raise huge additional resources required for both investment and consumption purposes in each of the successive five year plans.

Changes in Indian Fiscal Policy after Economic Crisis

At present, the focus around the world, as also in India, has shifted from managing the crisis to managing the recovery. The key challenge relates to the feasible fiscal exit strategy that needs to be designed and implemented. As a response to the current global crisis, the Indian government has adopted significant discretionary fiscal stimulus packages to promote investment and sustain aggregate demand. It is time now to move away from the stimulus packages and concentrate on long-term policy scenarios to control the fiscal situation as well as improve GDP growth. The magnitude of fiscal adjustment needed in the next couple of decades is almost unprecedented, especially for countries like India with relative high debt.

The key challenge involves balancing between public interventions and maintaining market confidence in the sustainability of public finances. This will involve focusing policy attention on removing some of the structural bottlenecks on raising the potential GDP growth rate. Essentially, this will imply efforts to improve the investment climate for both domestic and foreign investors, remove entry barriers to corporate investment in education and vocational

training, improve the delivery of public goods and services, and expand physical infrastructure capacities, including a major effort to improve connectivity in the rural regions. Infrastructure is a key binding constraint on India's growth and the government should take up long-term projects to improve infrastructure facilities. The government also needs to step-up investment in human capital development through increased spending in areas such as primary education, primary health, and research and development. Investment in human capital will help achieve inclusive growth, and furthermore such expenditures should be considered as part of capital expenditure rather than as revenue expenditure (which is how they are categorized now) since they yield a return in the long-term by way of inter-generational equity and economic growth. These measures will constitute the package of second-generation structural reforms and will enable the Indian economy to climb out of the downward cyclical phase and then extend the upward phase for a longer period than was achieved in the last cycle. On the revenue side, one way to exit is to increase or restore excise duties, which were reduced during the economic slowdown, to previous levels. The consequent revenue gains can be used to generate employment in public infrastructure projects. However, given the uncertainty about the robustness of the recovery, completely reversing the tax cuts would affect the growth prospects. Partial reversing may help strengthen the revenues of the government without disrupting the growth prospects. Another possible option is to broaden the tax base. This will require changes to the tax structure, which is likely to become more important than before. An important step in this direction is the expected introduction of the GST in October 2010. GST is going to replace CENVAT, state VAT, and service tax. Both the central governments and states have to levy GST concurrently on all goods and services other than a small list of exemptions. GST will have a two-rate structure: a standard rate for most goods and a lower rate for necessities. A combined rate of 12% (8% for states and 4% for the central government) is seen to be revenue neutral.

The proposed GST will be a comprehensive indirect tax levy on the manufacture, sale, and consumption of goods as well as services at a national level. The GST is likely to reduce indirect taxes paid on most of the goods and services as it would avoid the cascading effect. Product prices, therefore, can be expected to fall and ensure growth in demand. In addition, the integration of goods and services taxes will improve tax collections and thereby help increase economic growth. It will also end the long-standing differential treatment of the

manufacturing and services sectors. Apart from eliminating cascading effects, double taxation, and other issues, the introduction of GST will facilitate credit on uniform terms across the entire supply chain and across all states. The consensus GST rates may emerge to be 14%. Even this will sharply bring down the incidence of indirect taxes in the economy and release new growth impulses.

Another tax reform that is likely to be become effective in near future is the Direct Tax Code (DTC), which is designed to greatly simplify the dual tax structure. DTC will achieve this by eliminating distortions in the tax structure, expanding the tax base, and improving tax compliance by introducing moderate levels of taxation (Rajiv Kumar and Alamuru Soumya, 2010).

Themes of the 'New Fiscal Policy'

In the broad framework of the economic liberalisation approach of the recent years, the major themes of the fiscal policy have been concretised in India. There is broad agreement on these themes and as mentioned in (Dhingra, I.C., 2009), they can be summarised as follows:

1) A systematic effort to simplify both the tax structure and the tax laws,
2) A deliberate shift a regime of reasonable direct tax rates, combined with better administration and enforcement, to improve compliance and raise revenues,
3) The fostering of a stable and predictable tax policy environment,
4) Greater recognition and weight given to the resource allocation and equity consequences of taxation,
5) More reliance on nondiscretionary fiscal and financial instruments in managing the economy, as compared to ad hoc, discretionary physical controls,
6) Concerted efforts to improve tax administration and reduce the scope for arbitrary harassment,
7) Growing appreciations of the links between fiscal and monetary policy,
8) Fresh initiative to strengthen methods of expenditure control.

Issues and Challenges in Monetary and Fiscal Policies Formulation

The biggest challenge facing the conduct of fiscal and monetary policy in India is to continue the accelerated growth process while maintaining price and financial stability. (Rakesh Mohan, 2008)

The conduct of fiscal and monetary policy since the early 1990s has broadly succeeded in setting the economy on a higher growth path. Far reaching fiscal reforms have been undertaken during this period, which are finally bearing fruit through increased revenue mobilisation, some compression in expenditure, and consequent reduction in the fiscal deficit, leading to the beginning of some reduction in the debt GDP ratio. The exercise of fiscal restraint and admirable fiscal and monetary policy cooperation has enabled the increasing effectiveness of monetary policy: the cessation of automatic monetisation of the fiscal deficit, increased importance of market borrowing in financing the deficit, introduction of the market stabilisation scheme, and the corresponding measures to deregulate interest rates to enable market discovery, have all contributed to the strengthening of monetary policy transmission.

The self imposed rule based fiscal correction at both the national and sub-national levels has to be consolidated and carried forward. Achievement of the current objectives will still leave the combined fiscal deficit in India at around 4.8% of GDP and somewhat higher if the off budget items are also taken into account. By international standards this is still very high and if this level continues it will be difficult to make much of a correction to the debt- GDP ratio to bring it down to desirable levels within the foreseeable future. The government draft on private sector savings will therefore continue, and hence it will also be difficult to reduce substantially the various stipulations that mandate banks and other financial institutions to invest in government securities, thereby constraining further development in monetary policy and financial sector framework. The existence of such a high level of fiscal deficit also contributes to the persistence of an interest rate differential with the rest of the world which then also constrains progress towards full capital account convertibility. The sustained interest rate differential is also connected with the existence of a persistent inflation differential with the rest of the world.

A key challenge for fiscal and monetary policy in the coming years is to further reduce inflation expectations toward international levels. In view of higher inflation rates, higher

interest rates, and exchange rate dynamics reflecting growth prospects and capital account movements, rather than inflation or interest rate differentials, there is a need to operate an intermediate regime with a managed floating exchange rate, and an active management of the capital account so as to have the necessary discretion and flexibility to operate monetary policy in order to maintain domestic macroeconomic and financial stability.

In the fiscal policy area, the success achieved in revenue buoyancy through tax rationalisation and compliance has to be strengthened further. Large proportions of the self employed remain outside the tax net, thus continued strengthening and modernisation of tax administration now needs to be emphasised, relative to further reforms in tax policy in terms of relative emphasis. This would enable further shifts in tax revenue toward direct taxes from indirect taxes, thereby aiding greater economic efficiency. At the state- level also, the move to VAT has provide very significant tax rationalisation, and emphasis now needs to be put on its administration: In this sphere, the next step of reform would, of course, be the proposed move towards a unified "Goods and Service Tax" regime encompassing the centre and the states. The foundations of an efficient fiscal regime in India have, therefore, been achieved.

The second issue on the expenditure side relates to the funding of public investment, particularly related to infrastructure. As documented, public investment has been reduced over the past decade or so. Where as private investment has clearly substituted or complemented public investment successfully in areas such as telecom, ports and airports, and partially in roads and power, total investment in infrastructure in clearly inadequate, and could constrain further acceleration in overall economic growth. Third, the government is already engaged in expanding programmes and spending for human development. Funding for these needs will continue to require enhancement.

The acceleration of economic growth to the next level is therefore likely to lead to an enhancement of government spending as a proportion of GDP, Which would be consistent with the experience of other countries as their per capita incomes increased. This, then is the main challenge confronting Indian fiscal policy.

Going forward, therefore, there will be a continuous need to adapt monetary management to the emerging needs of a fast growing and increasingly open economy. This will necessitate ongoing refinement of instruments and modes of management, especially as global

developments are expected to have an increasing role in determining the conduct of monetary and exchange rate policies the India. Consequently, the expansion of monetary aggregates departs from their traditional relationship with real GDP growth. The task of monetary management is then to manage such growth without endangering price or financial stability.

In the years ahead, the economy will depend increasingly upon the ability of financial markets to allocate resources efficiently for the most productive purposes. Further development of financial markets will also be needed in view of the growing openness and fuller capital account convertibility. However, the issue remains how long and to what extent such an exchange rate management strategy would work given the fact that we are faced with large and continuing capital flows apart from strengthening current receipts on account of remittances and software exports. This issue has assumed increased importance over the last couple of years with increased capital flows arising from the higher sustained growth performance of the economy and significant enhancement of international confidence in the Indian economy.

Large capital inflows in recent years, far in excess of the current account surplus, have, therefore necessitated a certain amount of capital account management, along with intervention in the form market to curb volatility in the exchange rate. Management of volatility in financial markets and implications for the conduct of monetary operations will continue to need attention. Greater inflows will inevitably exert pressure on the Reserve Bank's ability to manage the impossible trinity of independent monetary policy, open capital account and a managed exchange rate, keeping in view that the impact of exchange rate fluctuations on the real sector in developing economies is much higher than in mature economies, particularly in labour intensive low technology price sensitive goods. India always had a modest current account deficit though, because of remittances and service exports, the trade deficit has widened significantly in recent years. These are the issues that monetary policy will have to continue to deal with while addressing the impact of capital flows. (Parthasarathi Shome, 2002)

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**** Corresponding Author***

Dr. Nitu Maan, *Associate Professor*

Maharishi Arvind University, Jaipur

Email:-maannitu1982@gmail.com, Mob. - 9414575887