

Chakraborty, Lekha; Harikrishnan S

**Working Paper**

## COVID-19 and fiscal-monetary policy coordination: Empirical evidence from India

Working Paper, No. 1002

**Provided in Cooperation with:**

Levy Economics Institute of Bard College

*Suggested Citation:* Chakraborty, Lekha; Harikrishnan S (2022) : COVID-19 and fiscal-monetary policy coordination: Empirical evidence from India, Working Paper, No. 1002, Levy Economics Institute of Bard College, Annandale-on-Hudson, NY

This Version is available at:

<https://hdl.handle.net/10419/273864>

**Standard-Nutzungsbedingungen:**

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

**Terms of use:**

*Documents in EconStor may be saved and copied for your personal and scholarly purposes.*

*You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.*

*If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.*



## **Working Paper No. 1002**

---

### **COVID-19 and Fiscal-Monetary Policy Coordination: Empirical Evidence from India\***

by

**Lekha Chakraborty**  
Levy Institute

and

**Harikrishnan S**

**February 2022**

---

\* This is the abridged version of the paper presented at the International Institute of Public Finance (IIPF) meetings at University of Iceland, Reykjavik on August 18, 2021. The authors would like to acknowledge the comments from Miriam Muting, the discussant of the paper at the conference. Thanks are also due to Andreas Haufler and Hoang Ha Nguyen Thi for their comments.

The Levy Economics Institute Working Paper Collection presents research in progress by Levy Institute scholars and conference participants. The purpose of the series is to disseminate ideas to and elicit comments from academics and professionals.

Levy Economics Institute of Bard College, founded in 1986, is a nonprofit, nonpartisan, independently funded research organization devoted to public service. Through scholarship and economic research it generates viable, effective public policy responses to important economic problems that profoundly affect the quality of life in the United States and abroad.

Levy Economics Institute  
P.O. Box 5000  
Annandale-on-Hudson, NY 12504-5000  
<http://www.levyinstitute.org>

Copyright © Levy Economics Institute 2022 All rights reserved

ISSN 1547-366X

## **ABSTRACT**

Against the backdrop of the COVID-19 pandemic, this paper analyzes the economic stimulus packages announced by the Indian national government and tries to identify some plausible fiscal and monetary policy coordination. The shrinking fiscal space due to revenue uncertainties has led to a theoretical plausibility of a reemergence of finite monetization of deficits in India. However, the empirical evidence confirms no direct monetization of the deficit.

**KEYWORDS:** Fiscal-Monetary Policy Coordination; Fiscal Deficits; Monetization; COVID-19

**JEL CLASSIFICATIONS:** E58; E62; E63

## 1. INTRODUCTION

Against the backdrop of the COVID-19 pandemic, this paper examines the economic stimulus packages in India and analyzes the policy coordination between the fiscal and monetary authorities. Globally, there is growing concern about the tendency toward segregating monetary and fiscal policy when assessing the macroeconomic impact of deficits on economic growth outcomes. In the times of the COVID-19 pandemic, if the path toward fiscal consolidation is through public expenditure cuts rather than tax buoyancy, it can adversely affect growth recovery.

We argue in this paper that while liquidity infusion has limitations in stimulating economic recovery, high levels of deficit can be substantiated through enhancing public investment, especially in health and capital infrastructure, as it is a dual crisis—a public health crisis and a macroeconomic crisis. It is not only the levels of deficit that matter, but the financing of deficits is also equally significant in times of crisis. If the emergency bond financing of deficits leads to a situation where the real rate of interest exceeds real economic growth, eventual monetization of deficits may be necessary. However, even if such a situation arises, due to the political economy considerations and the fear of inflationary pressures, a decision to monetize deficits could be a tough proposition. When a monetary policy stance has limitations in triggering the desired economic growth, fiscal dominance is crucial for growth recovery. However, the availability of fiscal space plays a significant role in determining the size of economic stimulus.

Against this backdrop, the paper is organized into six sections. Section 2 provides an overview of the fiscal and monetary stimulus packages announced in India. Section 3 succinctly provides an empirical review of the fiscal and monetary policy coordination efforts. Section 4 deals with the fiscal rules and financing patterns of deficits. Section 5 deals with the financing of deficits and section 6 concludes.

## **2. THE POLICY BACKDROP: FISCAL AND MONETARY STIMULUS IN INDIA TO TACKLE COVID-19**

Extraordinary times require extraordinary policy responses. In India, the pandemic lockdown was announced by invoking the National Disaster Management Act, 2005. The “lockdown strategy,” which proved to be neither good nor bad per se, was to control the coronavirus pandemic.

Constitutionally, public health is a state subject in India. However, Schedule 7’s entries 28 and 81 deal with interstate migration and quarantine. The intergovernmental framework is thus crucial to dealing with the pandemic through policy coordination and fiscal transfers, especially when states are doing the heavy lifting to control the pandemic despite their constrained fiscal space (Harikrishnan and Chakraborty 2020). Ideally the fiscal decentralization at the local level—known as the principle of subsidiarity—is an effective policy mechanism to deal with the pandemic, because the decision-making during crises happens at the level of government that is closest to the people. But in India, the COVID-19 policy response of a lockdown had been initially announced by the federal government.

Macroeconomic uncertainty in the time of a pandemic is hard to measure, and fiscal and monetary policy coordination is crucial to minimizing such uncertainties. Against the backdrop of macroeconomic uncertainty in the time of the COVID-19 pandemic, the fiscal deficit has risen to 9.5 percent of GDP for the 2021–22 budget. This is much above the envisioned threshold fiscal-deficit-to-GDP ratio of 3 percent. There is a rethinking of whether adhering to a numeric “ought to be” fiscal-deficit-to-GDP ratio of 3 percent is helpful in the current crisis. There is a growing consensus that keeping the deficit threshold so low in the time of pandemic is not growth enhancing.

The road map was also announced in the budget for 2012–22 for bringing down the excess deficit of 9.5 percent of GDP in FY21 to 4.5 percent by FY26. The point to be noted here is that a high fiscal deficit–GDP ratio was not entirely due to new expenditure priorities for tackling the pandemic (Chakraborty 2021). The fiscal deficit–GDP ratio has risen because of a combination of factors, including revenue uncertainties, economic stimulus–related spending, and the narrowing of (denominator) GDP, along with the initiative by the Indian government to enhance budget transparency.

Budget transparency has been enhanced in the 2021–22 budget by incorporating a part of off-budget borrowings into the fiscal deficit. Otherwise, the off-budget liabilities through public sector undertakings do not figure into the concept of fiscal deficit. However, the 2021–22 budget has not introduced a wider concept of deficit known as the “public sector borrowing requirement” (PSBR), which integrates all the borrowings incurred through public sector enterprises. The details of a major chunk of extra borrowings are kept in an annexure in the budget documents; only a part of such borrowings is included in the budget for 2021–22.

In India, there has not been a huge macro-fiscal stimulus package designed to provide cash transfers directly into the hands of people in need. Liquidity infusion was the major component of India’s economic stimulus program (Harikrishnan 2020). In the policy narrative of participation income versus basic income, the Indian government has emphasized participation income by enhancing the allocation for employer of last resort programs for providing job. The basic income component in the pandemic-relief economic package was limited to direct cash transfers for women and farmers. However, the magnitude of these cash transfers was insignificant due to the limited fiscal space available. On the monetary policy side, measures to infuse credit into the economy and lower policy rates were announced by the central bank in March 2020. The fiscal-monetary pandemic packages announced in India in 2020 are given in table 1. In addition to these measures, India’s central bank enhanced its liquidity infusion through several strategies to support growth recovery (Harikrishnan 2020). The central bank has enhanced the targeted liquidity operations to stressed sectors. In 2021, instead of normalizing procedures by rolling back these operations, the economic stimulus package has been continued by both the central bank and the national government.

**Table 1: The Fiscal-Monetary Economic Pandemic Package in India, 2020**

| Components  |                      | Amount (in crores) <sup>1</sup> |
|---|----------------------|---------------------------------|
| <b>Measures announced by the Reserve Bank of India (RBI)</b><br>1. Measures to infuse liquidity into the system<br>2. Reduced the interest rates  |                      | 801603                          |
| <b>March 27th Package – including Prime Minister’s Garib Kalyan Yojna, scheme for betterment of the poor (PMGKY)</b><br>1. Welfare spending for pensioners<br>2. Direct cash transfers for women<br>3. Food security<br>4. Tax concessions<br>5. Financial security                 |                      | 192800                          |
|   | <b>Total</b>         | <b>994,403</b>                  |
| <b>Post-May 12th Announcements</b>  |                      |                                 |
| <b>Liquidity Infusion</b><br>1. Liquidity infusion to:<br>a. Medium and small enterprises (MSMEs),<br>b. Nonbanking financial corporations (NBFCs),<br>c. Microfinance institutions (MFIs)<br>d. Power “distribution companies” (DISCOM)<br>2. Employment provident fund/tax relief |                      | 594,550                         |
| <b>Agriculture and Allied</b><br>1. Agriculture infrastructure<br>2. Fisheries<br>3. Animal husbandry<br>4. Micro food enterprises  |                      | 310,000                         |
| <b>Employment Guarantee and Social Infrastructure</b><br>1. Increase in allocations for employment guarantee program<br>2. Funding for social and industrial infrastructure   |                      | 150,000                         |
|   |                      | 48,100                          |
|   | <b>Total</b>         | <b>1,102,650</b>                |
|   | <b>Total Package</b> | <b>2,097,053</b>                |
| Extension of PMGKY (via PM’s announcement on June 30th) to extend free ration (food grains and pulses) to poor, through November 2020   |                      | <b>90,000</b>                   |

**Note:** These are the economic measures announced in India in early 2020 to combat the pandemic. Later, several components of this economic stimulus package were extended, for instance, through additional liquidity infusion to stressed sectors and extension of food security, social security, employment guarantee allocations, etc., instead of announcing additional tranches of stimulus packages. In the budget for 2021–22, a new public health infrastructure component was announced with an allocation of Rs. 64,180 crores over the next six years.

**Source:** Harikrishnan (2020)

<sup>1</sup> One crore rupee is equivalent to 10 million rupee.

As the central bank puts it upfront, these are extraordinary times and policies need to respond with “whatever it takes to” to deal with the pandemic. Intertemporally, the policies have been focused on systematically flattening the curve by containing the COVID-19 pandemic through vaccination. However, no crisis will be followed by a quick rebound to V-shaped growth (Harikrishnan and Chakraborty 2020). Evidence is increasingly pointing toward the situation worsening to a dual crisis—a public health crisis and a macroeconomic crisis—like never before.

An October 2020 report from the IMF highlighted that “the Great Lockdown is the worst economic disruption since Great Depression, and far worse than the global financial crisis,” and its estimates in early 2020 suggested that “the cumulative loss to global GDP over 2020 and 2021 from the effects of the COVID-19 pandemic would be around \$9 trillion, greater than the economies of Japan and Germany combined” (Gopinath 2020).

The pandemic policies of the RBI and the government were twofold. One was the focus on measures that related to instantaneous economic firefighting measures, for instance, how to ensure liquidity infusion into the system to stabilize the market reactions. The second was the long-term policy imperatives. In India, the Great Lockdown was announced by the prime minister on March 25, 2020. Subsequently, an economic package was announced in an iterative manner (table 1).

To put the monetary policy stance in perspective, in India, an agreement on a “new monetary framework” was signed between the government and the RBI in February 2016, by which the single objective of Indian monetary policy was to be price stability based on inflation-targeting rules (Chakraborty and Harikrishnan 2020). This policy transition from the RBI governor’s discretion to a rule-based monetary policy has constrained the central bank’s ability to react with ease to economic growth slowdown and other uncertainties. Yet another point to be considered is the central bank’s “operational” independence after the creation of a monetary policy committee (MPC) in India. The RBI governor’s role in making crucial monetary policy decisions has been taken over by the MPC, and is based on their voting. As per section 45ZL of the Reserve Bank of India Act, 1934, the RBI shall publish, on the fourteenth day after every meeting of the MPC, the meeting minutes, which shall include all the resolutions adopted in the meeting, the votes of each MPC member, and decisions regarding policy rates—whether to increase, decrease, or maintain the status quo.



Let us unpack the RBI's COVID policy response. On May 22, 2020, on the basis of an urgent offline MPC meeting (occurring before their regular meeting), the RBI responded by reducing the repo rate (i.e., the rate at which banks borrow funds from the central bank against eligible collateral) under the liquidity adjustment facility (LAF) by 40 basis points, to 4 percent, with immediate effects (RBI 2020; Chakraborty and Harikrishnan 2020). This was a further reduction from the 4.40 percent announced in March 2020.

The reverse repo rate is the rate at which banks park their surplus funds with the RBI under the LAF. The reverse repo rate under the LAF stands reduced to 3.35 percent from 3.75 percent. These reduced rates were introduced in June 2000. Since then, the repo rate has remained the reference rate for signaling the monetary policy stance. The cash reserve ratio (CRR) has been cut by 100 basis points; the marginal standing facility (MSF) rate (overnight borrowing facility from the central bank for further liquidity) and the bank rate stand reduced to 4.25 percent from 4.65 percent. The MPC also decided to continue with the “accommodative stance” and their decisions are made with the objective of achieving the medium-term target for consumer price index (CPI) inflation of 4 percent within a band of +/- 2 percent. The recent MPC meetings, held on December 8, 2021, also kept the repo rates unchanged at 4 percent and reverse repo at 3.35 percent. The accommodative stance has also been maintained to protect growth recovery.

In addition to policy rate adjustments, the central bank has also provided liquidity infusion into the system. The RBI has responded to the COVID-19 crisis by infusing liquidity into the economy beginning in April 2020. The liquidity package was injected through open market operations (OMO) purchases through targeted long-term repo operation (TLTRO) auctions. In order to distribute liquidity more evenly across the yield curve, the RBI conducted one “operation twist” auction involving the simultaneous sale and purchase of government securities in April 2020.

In addition to infusing liquidity, the “regulatory easing” measures were announced to: (i) promote credit flows to the retail sector, MSMEs, and real estate developers; (ii) extend the regulatory benefits under the special liquidity facility for mutual funds (SLF-MF) scheme to all banks; (iii) extend the loan moratorium and support working capital financing until the end of August 2020; (iv) provide credit support to exporters and importers; (v) extend of the tenor of small business refinancing

facilities; and (vi) increase the state's ways and means advance (WMA) by 60 percent (compared to 30 percent earlier) to monetize the deficit.

Even after bringing the rates (for borrowing) down to almost unprecedented levels, there was a huge increase in the funds parked by commercial banks in the RBI's reverse repo account—which went up from Rs. 3 lakhs crores on March 27, 2020 to Rs. 8.4 lakhs crores by the end of April of the same year (Harikrishnan 2020). With unemployment rates going through the roof, needless to say, there has been a phenomenal crash in demand. In such a scenario, focusing almost solely on liquidity measures serves only to plaster over the problem.

How this crisis will permanently shift the economic structure depends on the epidemiology of the virus and the nature and severity of the economic shocks. In this uncertain environment, how countries emerge from the effects of the pandemic depends largely on the effectiveness of the policies they design now. Monetary policy needs to play a proactive stabilizing role in this scenario. However, the announcements so far have mainly been targeted at reducing policy rates and infusing liquidity. Pumping money into banks and NBFCs without adequate fiscal measures to boost demand runs the risk of increasing bad loans. The point is that without demand being stimulated, these policies are not enough to trigger sustained growth recovery. Stiglitz and Rasheed (2020) pointed out that credit-related stimulus measures have relatively lower multiplier effects on the economy. The fiscal rules have taken the deficit financing rules for granted and deal with only numerical targets for the deficits. However, excessive use of any financing pattern of deficits—whether money financing or bond financing—has macroeconomic repercussions and cannot be tackled by focusing on the fiscal rules alone.

### **3. FISCAL-MONETARY POLICY COORDINATION: A REVIEW**

The significance of policy coordination between fiscal and monetary authorities can be traced back to the “unpleasant monetary arithmetic” (UMA) of Sargent and Wallace (1981). The UMA revealed that fiscal policymakers (where the fiscal authority has the first-mover advantage, and the monetary policy follows) dominate in deficit financing decisions. If the bond financing of deficits becomes

unsustainable when the real rate of interest is above the economy's real growth rate, the central bank eventually has to monetize the deficits. Under this fiscal dominance hypothesis, attempts by the central bank to keep inflation low through inflation targeting cannot last and must ultimately give way to higher inflation in the longer run. Under UMA, inflation today or inflation tomorrow is the only plausible macro policy option (RBI 2012).

On the contrary, a situation of central bank independence and inflation targeting with no fiscal policy dominance is referred to as “unpleasant fiscal arithmetic” (UFA). The UFA thus reverses the order of adjustment assumed under UMA, and transfers the first-mover advantage from fiscal agencies to the central bank authorities. By introducing strict fiscal policy rules, it obliges fiscal agencies to adjust to the antiinflationary policy of the independent central bank and thus UMA turns into UFA (Chakraborty 2015).

A recent treatment of the fiscal-monetary policy coordination is the “fiscal theory of the price level” (FTPL), pioneered by Leeper (1991), Sims (1994), and Woodford (1994). This fiscalist literature argues that the price level is independent of monetary policy but dependent strictly on fiscal policy; therefore price level indeterminacy problems can be solved by having the central bank peg the nominal interest rate at a level consistent with the central bank's desired inflation rate, rather than by controlling the growth rate of the (base) money supply (Sims 1994; Woodford 1994).

Even prior to the COVID-19 pandemic, these theoretical debates found relevance in the macro policy transition in India from discretion to rules. The fiscal policy institutions have moved away from a discretionary fiscal stance toward fiscal rules.

Since 2016, Indian monetary policy authorities have created policy rules for inflation targeting and preserving central bank independence.<sup>2</sup> The macroeconomic policy transition from discretion to rules gives rise to one pertinent question: Do monetary rules require fiscal rules? Such monetary-fiscal linkages are treated in the literature (for instance, Sargent and Wallace [1981]) by analyzing the macroeconomic channels through which deficits affect the monetary policy stance. Unfortunately,

---

<sup>2</sup> For details, see Urjit Patel Committee recommendations (RBI 2014) and the new monetary framework, signed by the Government of India and the RBI in February 2015.

over the years, the coordination between fiscal and monetary policy has been weakening and the policy debates have been confined to just numeric values of deficits. Apparently there has been a widening acceptance that numeric fiscal rules are associated with greater fiscal discipline (Alesina and Perotti 1995).

Blanchard (2019a, 2019b) provided a fresh perspective on these debates in his presidential address at the American Economic Association meetings by emphasizing the fact that high public debt is good if it can be substantiated by using it for enhancing public investment or reducing output. When monetary policy becomes ineffective with zero bound interest rates, fiscal policy dominance is crucial for growth recovery.

#### **4. FISCAL RULES AND MONETIZATION OF DEFICITS**

Against the backdrop of macroeconomic uncertainty, which is hard to measure, it is pertinent to discuss the appropriate concept of public deficit and the optimal financing patterns of the deficit with special emphasis on seigniorage. Seigniorage is technically the ratio of the change in reserve money in the system to GDP. This section deals with the measurement issues related to deficit and in turn interprets data on the trends and financing patterns of public deficits in India.

Intertemporally, there has been a transition from one concept of deficit to a series of measurements of deficit. This evolution from a single measure toward a series of *purpose-specific* deficit measures worldwide was a significant prelude to the creation of India's fiscal rules.

From the conventional approach of a *single measure* of budget deficit, India has resorted to measuring a series of deficits, viz., primary deficit, fiscal deficit, monetized deficit, and revenue deficit (Chakraborty 2016).

The ideal concept of deficit for studying the macroeconomic impact of deficit is the public sector borrowing requirement (PSBR). In other words, ideally, any measurement of the deficit should consider the public sector's deficit as a whole instead of the sectoral deficit of different public sector

entities. But problem lies in covering the public sector as a whole with a comprehensive measurement of their deficit because there are more exhaustive lists of government entities and there are intra-public sector transactions for which data is not readily available (Chakraborty 2016).

Apart from the above-discussed PSBR, various concepts of the deficit and their use as indicators for evaluating the government's budgetary performance are recent phenomena in India. This evolution is also a result of the paradigm shift to a series of purpose-specific deficit measures worldwide, away from the conventional approach of a single measure of the budget deficit.

The generation of purpose-specific deficits has huge relevance in facilitating the analysis of a fiscal policy stance's impact on macroeconomic activity. However, the formulation of numerical bounds and fiscal rules has shrunk the possibility of advancing such debates around the macroeconomic impacts of fiscal stance, and the debates have confined to the numerical fiscal rules (Chakraborty 2016).

The *budget deficit* is that part of the deficit that was covered by 91-day Treasury bills and the withdrawal of cash balances from the RBI. As the budget deficit is the borrowing from the central bank, it increases reserve money into the system and could fuel inflation and destabilize the monetary system. Thus, the emphasis was placed on reducing the volume of the budget deficit. As the RBI holds dated government securities, which also increase the volume of reserve money in the system, the budget deficit could only give a partial picture of the total increase in the reserve money. This is the monetized deficit, which is the increase in net RBI credit to the central government.

Despite the concerted policy changes undertaken by the Indian government and the RBI to contain the monetized deficit, it has not yet been phased out. Though the net RBI credit to the government (i.e., the monetized deficit) has been controlled through fiscal-monetary policy coordination, the net foreign exchange reserve is on the rise. Further, the shift in the financing pattern of deficits from seigniorage to bond financing that has occurred prior to the deregulation of the interest rate regime in India has implications for the fiscal seigniorage.

The traditional measure of the budget deficit and its expanded form, the *monetized deficit*, excludes part of the government's resource gap, which is financed through borrowing outside the RBI. Thus, in recent years, the emphasis has been placed on containing the *fiscal deficit*, which is the government's net borrowing requirement. Conventional measurement of the fiscal deficit is defined as the difference between total government receipts (non-debt-creating) and the total government expenditure net of repayment of previously incurred debt. In India, the gross fiscal deficit is defined as the excess of the total of revenue expenditure, capital outlay, and net lending over revenue receipts and non-debt-creating capital receipts (including the proceeds from disinvestment).

Along with fiscal deficit, other important deficit indicators introduced to assess the government's budgetary performance are *primary deficit* and *revenue deficit*. In India, the primary deficit is an indicator for assessing the impact of the current year's discretionary fiscal action on the government's indebtedness. Revenue deficit as a concept has received immense attention in recent years. Revenue deficit is the gap between revenue receipts and revenue expenditure. The "golden rule" states that revenue deficit should be zero.

The trends in deficits in India as a percent of GDP are given in table 2. The trends in deficits revealed that the budget deficit and monetized deficit were controlled intertemporally, though the latter has shown a rise in the recent years. The revenue deficit is not yet completely phased out in India. The primary deficit and fiscal deficit have moved in tandem and have shown a comparatively slight decline as percent of GDP in the recent years. The fiscal deficit is financed through the issuance of bonds, seigniorage financing, ad-hoc Treasury bills, and external financing. Over the years, the Indian government has resorted more to internal than external financing, and market borrowing (bond financing of deficits) has emerged as the most important source of financing the fiscal deficit. The rationale behind the market borrowing by the central government was to create and widen the investor base for government securities outside the captive market with attractive interest rates thereby reducing government's dependence on deficit monetization.

**Table 2. Levels of Deficits in India (Rs crores)**

|                           | 2019–20          | 2020–21          | 2020–21            | 2021–22            |
|---------------------------|------------------|------------------|--------------------|--------------------|
|                           | Actuals          | Budget Estimates | Revised Estimates  | Budget Estimates   |
| Fiscal Deficit            | 933,651<br>(4.6) | 796,337<br>(3.5) | 1,848,655<br>(9.5) | 1,506,812<br>(6.8) |
| Revenue Deficit           | 666,545<br>(3.3) | 609,219<br>(2.7) | 1,455,989<br>(7.5) | 1,140,576<br>(5.1) |
| Effective Revenue Deficit | 480,904<br>(2.4) | 402,719<br>(1.8) | 1,225,613<br>(6.3) | 921,464<br>(4.1)   |
| Primary Deficit           | 321,581<br>(1.6) | 88,134<br>(0.4)  | 1,155,755<br>(5.9) | 697,111<br>(3.1)   |

**Note:** Figures in parentheses represent deficit as percentage of GDP

**Source:** Government of India (2021), Union Budget 2021–22 document

In India, the golden rule is invoked for the reduction of revenue deficit to zero or negative levels. A limit on fiscal deficits of 3 percent to 5 percent of GDP was imposed with the rationale of preventing the crowding out of private investment. However, empirical evidence do not suggest “direct” or “financial” crowding out in the context of India (Chakraborty 2016; Vinod, Karun, and Chakraborty 2020) where deficits crowd out private corporate investment; they also do not induce a rise in interest rates or the output gap. What is missing in the design of numeric fiscal rules is the macroeconomic channel through which the deficits affect the output gap. It is not only the levels of deficit, but also the financing pattern of deficits, that create macroeconomic consequences. This aspect was overshadowed in the debates related to fiscal rules and budget management policies.

## 5. FINANCING OF DEFICITS IN INDIA

The financing pattern of deficit reveals that gross market borrowing constitutes 68.9 percent of total borrowings. The other sources of financing constitute around 26 percent (table 3). In the budget for 2021–22, creating fiscal space for continuous support of an ongoing series of economic stimulus packages was a matter of concern. When revenues are uncertain, the ambitious asset monetization program announced in the 2021–22 budget for generating revenue needs a supporting regulatory framework. In the 2021–22 budget, the economic stimulus was announced not as a macroeconomic stimulus to revive demand by providing huge cash transfers or universal basic income (UBI); the concern was that if the people’s propensity of save is greater than to spend during the pandemic,

dropping “helicopter money” in the hands of people in the form of UBI cannot create the required demand stimulation. The statistics shows that precautionary savings by the private sector are currently on the rise. Instead of massive cash transfers, India has designed “targeted” economic stimulus, especially to capital infrastructure and the public health sector.



**Table 3. Sources of Financing Fiscal Deficit in India (Rs crores)**

|   | 2019–20        |                  | 2020–21          |                  | 2020–21           |                  | 2021–22          |                  |
|---|----------------|------------------|------------------|------------------|-------------------|------------------|------------------|------------------|
|   | Actual         | Percent of Total | Budget Estimates | Percent of Total | Revised Estimates | Percent of Total | Budget Estimates | Percent of Total |
| <b>Debt Deficit (Net)</b>                         |                |                  |                  |                  |                   |                  |                  |                  |
| Market borrowings (G-sec + T bills)               | 624,089        | 66.84            | 535,870          | 67.29            | 1,273,788         | 68.9             | 967,708          | 64.22            |
| Securities against small savings                  | 240,000        | 25.71            | 240,000          | 30.14            | 480,574           | 26               | 391,927          | 26.01            |
| State provident funds                             | 11,635         | 1.25             | 18,000           | 2.26             | 18,000            | 0.97             | 20,000           | 1.33             |
| Other receipts (internal debt and public account) | 44,273         | 4.74             | 50,848           | 6.39             | 39,129            | 2.12             | 54,280           | 3.6              |
| External debt                                     | 8,682          | 0.93             | 4,622            | 0.58             | 54,522            | 2.95             | 1,514            | 0.1              |
| Draw down of cash balance                         | 4,971          | 0.53             | (-)53,003        | (-)6.66          | (-)17,358         | (-)0.94          | 71,383           | 4.74             |
| <b>Grand total</b>                                | <b>933,651</b> | <b>100.00</b>    | <b>796,337</b>   | <b>100.00</b>    | <b>1,848,655</b>  | <b>100.00</b>    | <b>1,506,812</b> | <b>100.00</b>    |

**Source:** Government of India (2021), Union Budget 2021–22 documents

## 6. CONCLUSION

In the context of a lack of fiscal space emanating from revenue uncertainties, a relook into the fiscal rules and the financing pattern of fiscal deficit has become necessary. The lack of fiscal space can affect the expenditure requirements in the time of pandemic and in turn affect the sustained economic recovery. We argue for the monetization of deficits, with a clear excessive deficit procedure to bring the deficit back to its prior equilibrium in the long run. The monetary financing of the fiscal program is crucial for avoiding prolonged fiscal austerity measures, which are always detrimental for growth recovery, and it is no different in times of crisis. Monetary policy has limitations in its impact on growth outcomes, so it is crucial to explore the fiscal dominance. The impending decision by the US Federal Reserve to increase the interest rate has put tremendous pressure on the central bank of India, an emerging economy, to increase the interest rate to avoid capital flight. However, with growth recovery as the predominant goal, the interest rates are kept status quo. Therefore, the policy alternative is to keep the macroeconomic fundamentals strong (including the fiscal deficit–GDP ratio and inflation under control).

The policy dilemma here is that if the deficit is controlled to the threshold levels of GDP through expenditure compression, economic growth suffers. However, if the real rate of interest grows greater than the economy's real growth, eventual monetization of deficits becomes inevitable. The shrinking fiscal space due to revenue uncertainties has led to the theoretical plausibility of a reemergence of finite monetization of deficits in India. However, the empirical evidence confirms no direct monetization of deficit.

## REFERENCES

- Alesina, A., and R. Perotti. 1995. "The Political Economy of Budget Deficits" *IMF Staff Papers* 42: 1–31.
- Blanchard, Olivier. 2019. "Public Debt and Low Interest Rates." *American Economic Review* 109(4): 1197–229.
- Chakraborty, Lekha. 2021. "Union Budget 2021–22: The Macroeconomic Framework." *Economic and Political Weekly* 56 (9).
- . 2016. *Fiscal Consolidation, Budget Deficit and Macroeconomy*. New Delhi: Sage Publications.
- . 2015. "Fiscal Seigniorage 'Laffer-Curve Effect' on Central Bank Autonomy in India." NIPFP Working Paper No 156. New Delhi: National Institute of Public Finance and Policy (NIPFP).
- Chakraborty, Lekha, and S. Harikrishnan. 2020. "The RBI Pandemic Predicament." *The Financial Express* (New Delhi), June 25.
- Gopinath, Gita. 2020. "The IMF Presentation of World Economic Outlook." Washington DC: International Monetary Fund.
- Government of India. 2021. "The Union Budget Documents 2021." New Delhi: Ministry of Finance.
- Harikrishnan, S. 2020. "India's Pandemic Response—Has It Been Enough?" Austaxpolicy: Tax and Transfer Policy blog, July 13. Available at: <https://www.austaxpolicy.com/indias-pandemic-response.../>
- Harikrishnan, S., and Lekha Chakraborty. 2020. "The Political Economy of Lockdown." *The Financial Express* (New Delhi), June 10.
- Leeper, E. M. 1991. "Equilibria Under Active and Passive Monetary and Fiscal Policies." *Journal of Monetary Economics* 27: 129–47.
- Reserve Bank of India (RBI). 2012. "The Report of Currency and Finance." New Delhi: Reserve Bank of India.
- . 2014. "The report of the Expert Committee to revise and strengthen the monetary policy framework." Urjit Patel Report. New Delhi: Reserve Bank of India.
- . 2020. "Monetary Policy Committee Minutes." New Delhi: Reserve Bank of India.

- . 2021. “Monetary Policy Statement, 2020–21: Resolution of the Monetary Policy Committee (MPC), December.” Press Release, December 22. New Delhi: Reserve Bank of India.
- . 2021. “Monetary Policy Committee Minutes.” New Delhi: Reserve Bank of India.
- Sargent, T. J., and N. Wallace. 1981. “Some Unpleasant Monetary Arithmetic.” *Federal Reserve Bank of Minneapolis Quarterly Review* 531(fall).
- Sims, C. 1994. “A simple model for the study of the determination of the price level and the interaction of monetary and fiscal policy.” *Economic Theory* 4: 381–99.
- Stiglitz, Joseph, and Hamid Rashid. 2020. “Which Economic Stimulus Works?” Project Syndicate blog, June 8.
- Vinod, H., H. Karun, and L. Chakraborty. 2020. “Encouraging Private Corporate Investment in India.” In H. Vinod and C. R. Rao (eds.), *Handbook of Statistics*, Vol 42. North Holland: Elsevier.
- Woodford, M. 1994. “Monetary Policy and Price Level Determinacy in a Cash-Advance Economy.” *Economic Theory* 4: 345–80.