# Monetary and fiscal policy interactions in the wake of the pandemic

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## Abstract

The Covid-19 pandemic triggered active interventions and policy support from both monetary and fiscal authorities across the world. In India, the authorities undertook multidimensional efforts to mitigate the impact of the crisis and preserve financial stability. The Reserve Bank of India deployed a range of instruments – conventional and unconventional – to provide liquidity, promote growth and ensure financial stability. The measures were aimed at sizeably expanding liquidity in the system to ensure that financial markets and institutions can function normally in the face of Covid-related dislocations. India's fiscal policy response to the pandemic was strategised with a step-by-step approach due to the unprecedented nature of the crisis and massive uncertainty. Fiscal spending in India initially focused on providing support in cash and in kind to vulnerable households. Now the focus has shifted to encouraging investment. Overall, the policy response aimed at making the economy more resilient and flexible to deal with the opportunities and problems of the post-Covid world.

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# Introduction

The devastating impact of the Covid-19 pandemic prompted immediate and decisive action from governments and central banks globally. Alongside large-scale fiscal expenditure to protect the economically vulnerable, monetary policy attempted to ease credit conditions and boost liquidity. The crisis featured an uneven impact across sectors and concurrent shocks to both supply and demand – as a result, coordinated policy response became the norm in most jurisdictions. In India too, monetary and fiscal policy moved in tandem to provide a Concerns regarding price and financial instability have been renewed based on steady increases of private and public sector debt and central bank balance sheets. Additionally, the conduct of monetary policy may be challenged by rising fiscal deficits during the recovery period. Thus, it is particularly important to review the nature and scope of monetary and fiscal coordination. This note highlights the policy response to the pandemic in India and the nature of India's monetary and fiscal interface.

# 1. Policy response to the pandemic in India

All levers of economic stabilisation – fiscal, monetary and prudential measures – were needed to revive the economy after the severe contraction in economic activity after the nation-wide Covid-19 lockdown. Greater allocation of government resources was required to finance the mounting health expenditures and support the livelihood of the work force. The paramount challenge for national authorities in the immediate aftermath of the crisis was to revive economic activity. Financial markets experienced pressure from extreme volatility in equity markets and currency pressure from capital outflows from EMEs. Thus, two predominant concerns were to maintain adequate liquidity and ensure financial stability. So, monetary and fiscal policy moved in tandem to provide support to growth. In the following sections, we outline broadly some of the policies announced since the start of the pandemic by the government and the Reserve Bank of India (RBI).

## 1.1 Monetary policy

The RBI has been on the frontlines of providing policy support, deploying the full range of instruments to ensure orderly functioning of financial markets and maintaining financial stability. Volatility in global financial markets and large-scale capital outflows due to extreme risk aversion prompted the RBI to ease currency market pressures through measures such as foreign exchange swaps.[1] The Indian rupee (INR) depreciated to its lowest level of INR 76.81 per USD in early 2020. But, this decline was modest in comparison with many emerging market peers.

With the tightening of financial conditions, the initial priority was to ensure liquidity and stability in all market segments. In February 2020, the RBI adopted a

[1] In the wake of sell-offs triggered by risk aversion and flight to safety in early 2020, the RBI conducted two six-month USD/INR sell/buy swap auctions on 16 March and 23 March 2020, injecting dollar liquidity of USD 2.7 billion to meet the increased demand for US dollars in the foreign exchange market (Indian Ministry of Finance (2021)).

multipronged approach announcing liquidity augmenting measures totalling INR 12.8 trillion (6.3% of nominal GDP). The measures included, but were not limited to, long-term repo operations, open market operations to buy Government of India securities, a one-time reduction in the cash reserve ratio of banks and widening of the monetary policy corridor.[2] These measures along with forex purchases resulted in expansion of surplus liquidity, as reflected in average daily net liquidity absorptions under the liquidity adjustment facility (LAF), from INR 3.43 lakh crore at the end of January 2020 to INR 5.47 lakh crore on 15 January 2021 (Economic Survey (2021)).

The Monetary Policy Committee (MPC) of the RBI attempted to provide countercyclical support to growth by reducing the policy rate by a cumulative 115 basis points since the outbreak of the pandemic. The cumulative rate reduction – taking into account the previous policy rate cuts since February 2019 – has been 250 basis points.

Despite persisting economic slack and low demand side risks, pandemic induced supply chain disruptions meant that the inflation rate remained elevated and crossed the upper tolerance level of the target for six months (June–November 2020).[3] The MPC, in its February 2021 meeting, deliberated on current and evolving domestic and global macroeconomic and financial developments and decided to "continue with the accommodative stance as long as necessary – at least during the current financial year and into the next financial year – to revive growth on a durable basis and mitigate the impact of Covid-19 on the economy, while ensuring that inflation remains within the target going forward". The RBI is regularly monitoring the current and evolving developments and remains steadfast to take any further measures while at the same time remaining fully committed to maintaining financial stability.[4]

During the crisis, the RBI has undertaken several measures to ease pressures for both central and state governments in India. The revenue generation slowed because of reduced economic activity while the need for fiscal resources for Covid relief increased. Against this background, the RBI conducted outright open market operations (OMOs) and "Operation Twist" operations (special OMOs) to manage the government borrowing programme in an orderly manner. The RBI conducted OMOs as a special case in 2020/21 in state development loans (SDLs) – market borrowings by sub-national (state) governments – and facilitated efficient pricing as a special case during 2020/21 in order to impart liquidity and facilitate efficient pricing.

Additionally, the RBI increased the limits for temporary Ways and Means Advances (WMAs) – a short-term credit facility – available for up to three months. The WMA limit for the central government for the first half of the financial year 2020/21 (April 2020 to September 2020) was increased from INR 1.2 trillion to INR 2.0 trillion. Similarly, the WMA limit of states was increased by 60% beyond the level existing on 31 March 2020. The "overdraft (OD) scheme for state governments" was reviewed to provide greater flexibility to state governments to tide over their cash-flow mismatches. The number of days for which a state / union territory can be in OD continuously was increased from 14 working days to 21 working days. Further, the number of days for which a state / union territory can be in OD in a quarter was

2 Details on all measures undertaken by the RBI during the Covid-19 pandemic may be found at www.rbi.org.in/scripts/bs_viewcontent.aspx?Id=3894#PR.

3 CPI inflation fell to 4.6% in December on the back of easing food prices and favourable base effects.

4 www.rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=1104.

increased from 36 working days to 50 working days. This facilitated the seamless mobilisation of resources under the combined government borrowing programme (both centre and states) at record low costs.

The 10-year benchmark G-Sec yield has largely remained stable and traded in a narrow band despite coming under sporadic pressure due to exogenous factors such as firming up of the US Treasury yields as well as global crude oil prices. These developments bear testimony to the effectiveness of the forward guidance provided by the MPC during the year, credibly demonstrated through the RBI's market operations. Since the RBI's asset purchase programme has solely been restricted to government securities only, there has not been any dilution in the quality of the RBI's balance sheet. As such, the space for fiscal policy has not been limited in any manner while independence for monetary policy has been preserved.

The RBI also supported fiscal efforts at reviving the economy through several developmental and regulatory policies announced during this period. Several targeted sector-specific policies have been initiated to maintain flow of funds and provide support to key sectors. For instance, additional liquidity facilities were set up for the National Bank for Agriculture and Rural Development (NABARD), the Small Industries Development Bank of India (SIDBI), the National Housing Bank (NHB) and the Export Import Bank (EXIM) to meet funding requirements in specific sectors.[5] Trade contraction deepened since the outbreak of Covid-19, so RBI measures to boost export credit and extension of time for payment for importers from six to 12 months are expected to provide much-needed support to the foreign trade sector.[6] The RBI has also provided relief to the vulnerable small enterprises by allowing lending institutions to restructure their debt, subject to the borrower's account being classified as standard pre-pandemic.[7]

Thus, since the start of the pandemic, the RBI has taken on multiple roles. Not only has it worked towards ensuring price and financial stability while supporting economic recovery, it also has taken on the mantle of undertaking developmental policies targeted towards easing financial stresses of vulnerable sections and ensuring a stable flow of funds to critical sectors in light of the uneven impact of the pandemic.

## 1.2 Fiscal policy

The government of India was proactive in tackling the spread of the Covid-19 pandemic by announcing a nationwide lockdown on 25 March 2020, when the confirmed positive coronavirus cases were approximately 500. The lockdown, initially announced for a period of 21 days, was extended with progressive relaxations until 31 May 2020. Since then, activities have opened in a phased manner. The brutal toll

[5] In April 2020, special refinance facilities were announced to NABARD, SIDBI and NHB for a total amount of INR 50,000 crore to enable them to meet sectoral credit needs. In order to enable EXIM bank to meet its foreign currency resource requirements, a line of credit of INR 15,000 crore was extended to the EXIM Bank for a period of 90 days (with rollover up to one year) enabling it to access a US dollar swap facility. An additional standing liquidity facility (ASLF) of INR 5,000 crore to NHB was announced in August 2020 – over and above the INR 10,000 crore already provided for supporting housing finance companies (RBI 2020a). See also Governor's Statement, MPC, (RBI 2020b).

[6] RBI (2020).

[7] In order to provide appropriate forward guidance and with a view to maintaining long-term financial stability in light of pandemic related stresses, the RBI set out a detailed Resolution for Covid-19 related stress, www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11941&Mode=0.

of the pandemic and the associated lockdown measures have adversely impacted economic activity in India, with the April–June 2020 quarter registering a contraction of 23.9% in real GDP. Taking a calibrated approach to fiscal interventions, the government provided fiscal assistance to poor and vulnerable households in cash and in kind during the initial stages and later broadened this coverage to various sectors of the economy.

The initial measures in April 2020 included cash transfers to poor households, distribution of free food grains and medical insurance to health workers. More comprehensive measures were announced under the various tranches of the Atmanirbhar Bharat package in May and November 2020. Policies were announced to aid the micro, small and medium enterprise (MSME) sector by increasing the coverage, providing collateral-free loans, a corpus to fund equity etc. Several schemes were announced to provide support to farmers and promote production of high-value primary products. Reforms in the energy sector and labour regulations were also announced with a view to promoting investment and productivity across the manufacturing sector. The size and composition of the stimulus, coupled with its calibrated shift in focus from consumption to liquidity to investment, suggest that it is aimed at promoting recovery primarily through the investment revival channel.

While some of the measures led to additional expenditures, many have been financed by reallocation of funds from other heads of expenditure. The government has also undertaken rationalisation measures during 2020/21 to target spending in priority areas over avoidable outgoes.[8] Ministries and departments of the government of India issued directions to strictly adhere to expenditure ceilings and avoid releases that may lead to idle parking of funds, and revisions to quarterly expenditure plans were made to accommodate stresses to the government's cash position.

The quality of government expenditure is crucial for promoting and sustaining the growth. While the initial focus of the government in the aftermath of the crisis was to provide socioeconomic assistance to vulnerable segments of society, later rounds of fiscal stimulus focused on measures to increase capital expenditure. Accordingly, capital expenditure recorded double-digit growth during April–November 2020/21, whereas revenue expenditure grew moderately. The re-prioritising of expenditure from consumption to investment is expected to increase growth over the medium term.

Going forward, managing the fiscal-monetary trade-off may be crucial once the economy revives and growth picks up. The exit from the accommodative stance of monetary policy has to be well calibrated and conducted in a phased manner without disrupting financial market sentiments and the economic recovery process. The independence of monetary policy is institutionalised in the flexible inflation targeting framework and the objective of the monetary policy is "to maintain price stability while keeping in mind the objective of growth".

8 Office Memorandum: Cash management guidelines for the remaining period of the FY 2020/21, 29 October 2020, dea.gov.in/sites/default/files/OMCash%20Management%20Guidelines%20for%20remaining%20period-2020-21.pdf.

## 2. Monetary-fiscal interactions: past lessons and current scenario

India has a complex history of fiscal-monetary policy coordination – something that may in fact prove to be an asset during these trying times. The current legislative framework, which delineates the roles of monetary and fiscal authorities along several dimensions, is a culmination of a long and multifaceted legacy of coordination. From the 1950s until the early 1990s, deficit financing in India was defined as change in government indebtedness to RBI, which became the source of financing for the five-year plans set out by the government of India. The premise was that the plans which fund capital expenditure would be non-inflationary in the medium term and, accordingly, the RBI was required to automatically monetise deficits. The interface changed further with the nationalisation of banks in 1969, which meant that interest rates became part of the planning process. This led to the RBI simultaneously addressing supply and demand aspects of the economy while also performing regulatory and developmental functions simultaneously (Reddy (2018)). Thus, high fiscal dominance and financial repression characterized the 1980s.

The reforms initiated in the early 1990s were a paradigm shift in the fiscal-monetary interface in India. They included the end to automatic monetisation of government deficits, the erection of fiscal rules through fiscal responsibility legislation, efforts to eliminate administered interest rates and phasing-out of the RBI's refinancing of various entities. The RBI actively helped develop the government securities market and the money market in the process of truly ending automatic monetisation. This yielded rich dividends by facilitating efficient market borrowing and effective transmission of policy. This also helped the economy step out of a regime of financial repression based on administered interest rates to vibrant money and debt markets that allowed interest rates to be largely determined by the market. The financial sector reforms during this period, especially the development of an active secondary market for government securities, laid the foundation for moving from direct to indirect instruments of monetary control in the medium term.[9] The reforms pursued by the fiscal and monetary authorities in tandem helped improve the efficacy of macroeconomic management (RBI (2013)).

The global financial crisis marked another phase in fiscal-monetary interactions in India. The orders of the day were global policy coordination and coordination between monetary and fiscal authorities. Both fiscal and monetary stimuli were undertaken in India and were also supplemented by regulatory forbearance (Reddy (2018)). The institutional architecture for the conduct of monetary policy underwent a fundamental shift, with the formal transition to a flexible inflation targeting framework and the constitution of a six-member MPC for setting the policy rate in 2016. These reforms marked the culmination of efforts made since early 2014 to strengthen the transparency, credibility and independence of monetary policy formulation. The amended RBI Act, incorporating the provisions and responsibilities of the MPC, came into effect in June 2016. The RBI is also entrusted with managing the domestic debt of the government of India and the various aspects of debt management such as quantum of issuance. The pattern of issuance across various tenors is decided by the government in consultation with the RBI. The Debt

[9] The statutory pre-emptions for banks were reduced from around 63% in early 1992 to 35% in a span of six years. The interest rate structure was rationalised and term deposit rates were deregulated.

Management Strategy of the government[10] is decided after deliberations in its half-yearly meetings in which the RBI participates. In the meeting, recent developments in financial markets, the possible impact of steps taken by the RBI and other issues of mutual interest are discussed with the fiscal authority before finalising the borrowing plan. The Medium-Term Debt Strategy spells out the medium-term (three- to five-year) strategy of debt management to be followed and captures the government's preferences with regard to the cost-risk trade-off while taking due account of constraints and potential risks. These institutional features support monetary-fiscal policy coordination without infringing upon monetary policy instrument independence with the central bank.

During the pandemic, the RBI has stepped forward to support the economy even as it continues to work towards maintaining price and financial stability. As domestic asset purchases have been confined solely to government securities, the RBI's balance sheet has not been compromised in any manner and it has adequate instruments at its disposal to sterilise the impact of liquidity on the domestic economy. In the February 2021 MPC meeting, the RBI announced plans to initiate the exit from some of the extraordinary measures announced during the Covid-19 pandemic. An increase in government borrowing can lead to a steepening of the yield curve, with important implications for monetary policy transmission. In the light of this, the RBI conducted simultaneous sale and purchase of securities, often referred to as Operation Twist, to manage the government borrowing programme in an orderly manner. The RBI also provided explicit guidance that systemic liquidity would continue to remain comfortable over the ensuing year and that it will ensure completion of the market-borrowing programme of the government in a non-disruptive manner. The RBI purchases government securities from the secondary market as part of its liquidity management operations and in line with the monetary policy stance. The RBI does not participate in the primary G-Sec market to provide financing to the government.

RBIs policies during the pandemic have facilitated resource mobilisation for the central and state governments at low costs.[11] While the fiscal deficit in India is going to be higher in 2020/21 than was intended, it is important to note that this has primarily been driven by falling revenues. The later rounds of fiscal policies announced in the wake of the pandemic emphasised that government spending would be shifting towards boosting investment rather than consumption. Of course, this will depend on the speed of the recovery. Some studies suggest that debt sustainability depends on the interest rate and growth rate differential – if the interest rate paid by the government is less than the growth rate, then the intertemporal budget constraint facing the government is no longer binding (Blanchard (2019)). If inflation remains in the lower range of the target (eg 4%) even with a real growth rate of 3.4%, the differential would remain negative (Indian Ministry of Finance (2021)). If fiscal deficits remain sustainable, there are unlikely to be any serious challenges for the conduct of monetary policy. Additionally, it is noteworthy that government debt is characterised by low currency and interest rate risks in India. This is due to the low share of external debt and the fact that most of the public debt has been contracted at fixed interest rates, making India's debt stock virtually insulated from interest rate

[10] Contained in the Medium-Term Debt Strategy (MTDS), www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=837.

[11] In the G-Sec market in which risk-free benchmarks evolve, a record low weighted average cost of 5.78% and an elongated weighted average maturity of 14.9 years testify to the credibility of monetary and liquidity management operations of the RBI (Indian Ministry of Finance (2021)).

volatility. This lends certainty and stability to the budget in terms of interest payments. However, the possibility of capital flow volatility as a result of excessive deficits can impact exchange rates which, in turn, may affect inflation. Monetary policy actions may then be constrained as a result of elevated inflation and inflation expectations. It should be noted, though, that both foreign and domestic currency denominated debt is predominantly in longer maturity, thus ameliorating any imminent concerns to debt management.[12] Nevertheless, a clear strategy of exit from the fiscal stimulus assumes importance. An orderly unwinding of RBIs countercyclical measures is also warranted along with the financial sector returning to normal functioning without relying on continuing regulatory relaxations as the new norm.[13]

## Concluding remarks

The RBI has played a crucial role during the pandemic, attempting to reinforce the policies of the government to cushion the fallout from the pandemic and place the economy on the path to recovery. It has worked towards ensuring price and financial stability while supporting economic recovery, while simultaneously undertaking developmental policies targeted at easing financial stresses of vulnerable segments and ensuring a stable flow of funds to critical sectors. On the issue of deviation from fiscal rules, it may be noted that the ideal prescription in times of recession caused by a once-in-a-century global crisis, would be a sustained, productive programme of permanent stimulus directed towards public investment in both physical and human capital (Krugman (2020)).

Even though the pandemic has led to a rise in the fiscal deficit, there are reasons to believe that as fiscal spending shifts towards capital expenditure and the economy recovers, with positive implications for revenue garnering, the fiscal deficit will decline and remain sustainable – thus reducing any potential challenges to central bank independence. It is important to bear in mind that, given the depth of the crisis, the uncertain recovery path and the uneven impact across sectors, fiscal and monetary authorities need to remain vigilant, maintain coordination and continue to intervene as and when needed. Coordinated fiscal-monetary policy exit from the accommodative policy mode in a carefully sequenced and timely manner, without disrupting economic revival, would go a long way towards improving macroeconomic management and strengthening financial stability.

12 The weighted average maturity of outstanding stock of dated securities of the GOI has increased from 9.7 years at 31 March 2010 to 10.7 years at 31 March 2020. The ratio of external debt to internal debt of the Central Government of India in 2019/20, stood at 7.3% (RBI 2020d).

13 www.rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=1099.

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