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Role of India's monetary and fiscal policy in global economic slowdown

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Abstract

This paper attempts to examine the effectiveness of monetary and fiscal measures taken by Indian Government to counter the effects of global economic slowdown on Indian economy. Looking at global economic slowdown to augment domestic liquidity and to ensure that credit continues to flow the productive sector of economy Reserve Bank had reduced CRR from 9.0 percent to 5.0 percent, SLR 25.0 percent to 24.0 percent, Repo Rate 9.0 percent to 4.75 percent and Reverse Repo Rate 5.0 percent to 3.25 percent from July 2008 to July 2009. Fiscal policy of 2008-09 cuts the excise duty, customs duty and service tax to increase the demand of industrial goods.

Keywords: Monetary Policy, Fiscal Policy, Economic Slowdown

Introduction

The global financial crisis is into its third year now. Many have termed it the worst financial crisis of the last century. The current global financial crisis that started in the US sub-prime sector and broader financial markets is deepening and spreading throughout the world, turning now into a full-blown global economic crisis. While the intense focus of governments has mostly been on dealing with the short-run fall out of the worsening crisis, policymakers, economists and the general public are also beginning to turn their attention to financial regulation in an attempt to figure out what went wrong and how to prevent such a crisis from occurring again. The purpose of the present paper is to examine the effectiveness of monetary and fiscal measures taken by Indian Government to counter the effects of global economic slowdown on Indian economy.

There is a widespread perception that India along with other emerging market economies has been the victim of relentless globalization in general and the excess of financial institution in advanced countries in particular. The world economic crisis, let us recall, first surfaced in the US sub-prime mortgage market in August 2007, soon spread to markets for other securities in both the US and elsewhere, and in the process caused, within a few months, a huge financial meltdown, a string of bankruptcies and a sharp economic slowdown in practically all industrialized countries (Mihir Rakshit, 2009) ^[1]. The fiscal stimulus packages mounted by governments across the world of the organization of Economic Cooperation and Development are of unprecedented size. But when forecasts made one week are routinely torn up the next, it looks as though optimism can only rest on complacency or ignorance (Paul Krugman, 2009) ^[2].

Global Prospects and Policy during crises period

The global financial and economic crisis keeps getting worse. A couple of weeks back the giant city bank had to be bailed out with several hundred billion dollars in cash and guarantees from the US authorities. In July 2008, the IMF foresaw stated that the world economy growing at 3.9 percent in 2009, advanced economies at 1.4 percent and developing countries at 6.7 percent. April 2009 IMF forecasts had been slashed down to minus 1.3 percent, minus 3.8 percent and 1.6 percent respectively.

For the Asian giant, China, both the IMF and UNCTAD expect growth to slow to about 8.5 percent in 2009 from the scorching 12 percent pure of 2007. Interestingly; several china-based analysts foresee much sharper deceleration.

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World Bank forecast 2009 stated that amidst global economic recession and financial regality, net private capital inflows to developing countries fell to US \$ 707 billion in 2008, a sharp drop from a peak of US \$ 1.2 trillion in 2007. Developing countries are expected to grow by only 1.2 percent this year, after 8.1 percent growth in 2007 and 5.9 percent growth in 2008. When China and India are excluded, GDP in the remaining developing countries is projected to fall by 1.6 percent, causing continues job losses and throwing more people into poverty. Global growth is also expected to be negative, with an expected 2.9 contraction of global GDP in 2009 (World Bank, 2009) [7].

Indian Economic Outlook during global crises period

The overall impact of global economic slowdown on India would, however, be minimal as the factors driving growth here are more local in nature. Unlike the rest of Asia, India is a strong domestic demand story, so any slowing in the US is likely to have a more muted impact on India. Strong growth in domestic consumption and significant spending on infrastructure are the two pillars of India's growth story. No sector has a dominant influence on earnings growth and risks to our estimate are limited.

Gross domestic product is the main indicator of the growth prospects of the country. In January 2009 policy review of India projected growth for 2008-2009 of 7.1 percent with a downward bias. GDP growth rate at constant prices in the year 2008-2009 is 6.7 percent as against 7.1 percent in the advance estimated over the quick estimates of GDP for the year 2007-08. The downward revision in the GDP growth rate is mainly on account of lower performance in almost all the sectors excluding construction, community, social and personal services than anticipated.

Table no. 1 indicates that the growth rate of GDP in India was 9.0 percent in 2007-08, which goes down at 6.7 percent in 2008-09. This downturn in growth rate was mainly due to downturn growth in agriculture and allied sector 1.6 percent from 4.9

Table 1: Rate of Growth in India at Factor cost at 1999-2000 prices

Particulars	(Percent)		
	2006-07	2007-08	2008-09
Agriculture, forestry & fishing	4.0	4.9	1.6
Mining & quarrying	8.8	3.3	3.6
Manufacturing	11.8	8.2	2.4
Electricity, gas & water supply	5.3	5.3	3.4
Construction	11.8	10.1	7.2
Trade, hotels & restaurants	10.4	10.1	N.A.
Transport storage & communication	16.3	15.5	N.A.
Financing, insurance, real estate & Business services	13.8	11.7	7.8
Community, social & personal services	5.7	6.8	13.1
Total GDP at factor cost	9.7	9.0	6.7

Source: Central Statistical Organization.

percent, manufacturing 2.4 percent from 8.2 percent, construction 7.2 percent from 10.1 percent and finance and insurance 7.8 percent from 11.7 percent over previous year. GDP growth in India shows continuously rising trends during 2004-05 to 2006-07 i.e. 7.5 percent in 2004-05 which goes up to 9.7 percent in 2006-07, after that this goes down and estimated at 6.00 percent in 2009-10. It means India's economy is affected by Global financial crisis since mid of 2007.

Role of Monetary Policy of India in Global Economic Slowdown

Bank balance sheets remain healthy and adequately capitalized. The CRAR of all scheduled commercial banks (SCBs) taken together was 13.0 percent at end-March 2008, well above the regulatory requirement of 9 percent. No SCB has CRAR below 9 percent. Of the 79 SCBs, 77 banks had CRAR above 10 percent, while 2 banks had CRAR between 9 and 10 percent. Asset quality of the domestic banks also remains satisfactory with net NPAs being only 1.0 percent of net advances and 0.6 percent of assets at end-March 2008 (Table 2).

Table 2: Key Indicators of Scheduled Commercial Banks in India

Items	2004-05	2005-06	2006-07	2007-08
Capital to Risk-weighted Assets Ratio (CRAR) (Percent)	12.8	12.3	12.3	13
Of which: Tier I CRAR	8.4	9.3	8.3	9.1
Net Non-Performing Assets (Percent to net advances)	1.9	1.2	1.0	1.0
Net Non-Performing Assets (Percent to assets)	0.9	0.7	0.6	0.6
Net profits (percent to assets)	0.9	0.9	0.9	1.0
Net interest margin (Percent to assets)	2.8	2.8	2.6	2.3

Source: Report on Trend and Progress, 2007-08, Reserve Bank of India.

Reserve Bank of India's Monetary Policy Response

Looking at the global financial and economic conditions, the Reserve Bank of India has taken many measures since mid-September 2008, to augment domestic liquidity and to ensure that credit continuous to flow to productive sectors of the economy. Since then Reserve Bank of India had reduced the Cash Reserve Ratio from 9 percent in August 2008 to 5 percent with effective from 17 January 2009 and the Statutory Liquidity Ratio was 25 percent since 25 October 1997 that decreased to 24 percent from November 2008, whereas, the Bank rate is constant at 6 percent since April 2003. Beside this, Reverse Repo Rate was reduced from 5 percent of December 2008 to 3.25 percent in July 2009 and Repo Rate under LAF was reduced from 9 to 4.75 percent from July 2008 to July 2009 (Table 3).

Table 3: Current Policy Rates of Reserve Bank of India

Policy Rate	Previous Rate	Current Rates
Bank Rate	6% as on 29/04/2003	6%
CRR	9% as on 31/08/08	5 % (w.e.f. 17/01/2009)
SLR	25% as on 25/10/1997	24 % (w.e.f. 8/11/2008)
Repo Rate	9% as on 30/07/2008	4.75 % (w.e.f. July 2009)
Reverse Repo Rate	5% as on 8/11/2008	3.25% (w.e.f. July 2009)

Source: Reserve Bank of India Statistical Statements.

The various monetary and liquidity measures, taken together, have released actual / potential liquidity amounting to over Rs. 4,90,000 crore since mid-September 2008 (about 9 percent of GDP) (Table 4). In brief, the proactive policy initiatives to avoid contraction of the RBI balance sheet coupled with the increase in the money multiplier are aimed at ensuring non-inflationary growth of money supply in the

economy to support the needs of the real economy. Despite large capital outflows and the concomitant sales of foreign exchange by the Reserve Bank and the depletion of its assets side, the Reserve Bank was able to substitute them with equivalent domestic assets so as to stabilize the growth of reserve money. Year-on-year growth in reserve money (adjusted for changes in the CRR) was 19.0 percent at end-March 2009 as compared with 25.3 percent in the previous year. Reserve money expansion, thus, remains consistent with the growth requirements of the Indian economy and long-run trends. In contrast to the trends in major advanced economies (discussed next), there has been no excessive expansion of reserve money. Hence, the issue of unwinding and exit of the current excessively accommodative monetary and liquidity policies, which is of extreme concern in the major advanced economies, is not relevant for us in view of the consistent growth in reserve money.

Table 4: Actual / Potential Release of Primary Liquidity in India

(Since mid-September 2008)	
Measure / Facility	(Rs. Crore)
Monetary Policy Operations (1 to 3)	
1. Cash Reserve Ratio (CRR) Reduction	1,60,000
2. Open Market Operations	68,835
3. MSS Unwinding / De-sequestering	97,781
Extension of Liquidity Facilities (4 to 8)	
4. Term Repo Facility	60,000
5. Increase in Export Credit Refinance	25,512
6. Special Refinance Facility for SCBs (Non-RRB)	38,500
7. Refinance Facility for SIDBI / NHB / EXIM Bank	16,000
8. Liquidity Facility for NBFCs through SPV	25,000
Total (1 to 8)	4,91,628

Source: Reserve Bank of India Statistical Statements.

Role of Indian's Fiscal Policy in Global Economic Slowdown

In India the inflation rate was as high as 12.91 percent in September 2007. To reduce this rate fiscal policy and monetary policy of India decided to tight policy to control on inflation. But global crisis started form September 2007, the crude oil prices goes at low level. India's inflation rate tremendously goes down at negative level during 2008-09. To facing global financial crisis the fiscal policy of India had taken some measures.

Reduction in Customs Duty

In the fiscal policy 2008-09, the measures had taken by government to counter the effect of global economic slowdown on the Indian economy and to reduce high inflation rate. These included; customs duty on project imports reduced to 5 percent from earlier level of 7.5 percent. Duty on steel melting scrap and aluminum scrap reduced to nil from 5 percent of earlier. Duty reduced on certain life saving drugs from 10 percent to 5 percent and CVD made fully exempt. Duty on specified convergence products reduced to 5 percent from earlier level of 10 percent to establish parity of endues. Duty on specified machinery reduced to 5 percent from the earlier level of 7.5 percent. Customs duty on crude and non-refined sulphur reduced to 2 percent from 5 percent to boost domestic fertilizer production. Customs duty on unworked or simply prepared corals was reduced from 10 percent to 5 percent. Duty on rough cubic zirconia was reduced from 5 percent to nil. Duty on cubic zirconia (polished) was reduced from 10

percent to 5 percent. Custom duty on tuna bait was reduced from 30 percent to nil. Duty on specified machinery for manufacture of sports goods was reduced from 7.5 percent to 5 percent. Exemption from additional duty of customs of 4 percent levied was withdrawn from power generation project.

Reduction in Excise Duty

The fiscal policy of 2008-09 carried this forward by reducing the general CENVAT rate on all goods from 16 percent to 14 percent. Beside this, sector specific initiatives were also taken such as; excise duty was reduced from 16 percent to 8 percent on all drugs and on instant sterile dressing pad, from removers etc, excise duty was made fully exempt on anti AIDS drug. In the automobiles sector, excise duties were reduced on small case from 16 percent to 12 percent, hybrid car from 24 percent to 14 percent; electric cars from 8 percent to nil; specified parts of electric cars from 16 percent to nil. The excise duty on busses and other vehicles for transport of more than 13 persons were reduced from 16 to 12 percent.

Service Tax Exemptions

Since its introduction in 1994-95, the number of services had increased over the years and reached up to 106 services in 2007-08. The rate of service tax was 12 percent since 2006-07; it reduced to 10 percent from 24 February 2009. It also raised the annual threshold limit of service tax exemption from small service providers from the earlier levels of Rs. 8 lakhs to Rs. 10 lakhs. All these measures made by government of India in fiscal policy of 2008-09 helps to reduce prices of various commodities and increase demand for such commodities. Reduction in excise and customs duties downs the effects of global financial crisis on Indian economy through increasing effective demand.

Tax Policy (Indirect Taxes)

In recent years, tax policy has been guided by the need to increase the tax-GDP ratio and achieve fiscal consolidation. In these years, the tax-GDP ratio improved significantly from 9.2 percent in 2003-04 to 12.6 percent in 2007-08. This has been achieved through rationalization of the tax structure (moderate levels and a few rates), widening of the tax base, and reduction in compliance costs through improvement in tax administration. The onset of the global financial crisis in September 2009 led to a reversal of trends with de-growth in export markets and domestic slowdown. A dip in industrial and manufacturing growth and the prognosis of an impending crisis prompted the Government to announce three fiscal stimulus packages in quick succession on 07th December 2008, the 2nd January 2009 and 24th February 2009.

Central Excise Duty

To provide continued fillip to the manufacturing sector and accelerate its recovery, the reduction in ad-valorem excise duty rates to 8 percent, affected in two phases as part of the fiscal stimulus packages announced on 7.12.2008 and 24.2.2009, is being continued. To mitigate the problem of credit accumulation excise duty rate has been increased from 4 percent to 8 percent.

Customs Duty

In the wake of global slowdown, to provide a level playing field to domestically produced goods against imports; the

peak rate of customs duty on non-agricultural goods has been retained at 10 percent. Customs duty concessions have been provided on specified inputs and capital goods for exporters in sectors such as leather, textiles, and synthetic footwear. To provide a level playing field to domestic manufactures of set top boxes, customs duty exemption has been withdrawn, and 5 percent duty imposed. To mobilize some revenues, the specific rates of Customs duty on gold and silver have been increased.

Conclusion

Looking at global economic slowdown to augment domestic liquidity and to ensure that credit continues to flow the productive sector of economy Reserve Bank had reduced CRR from 9.0 percent to 5.0 percent, SLR 25.0 percent to 24.0 percent, Repo Rate 9.0 percent to 4.75 percent and Reverse Repo Rate 5.0 percent to 3.25 percent from July 2008 to July 2009. The various monetary and liquidity measures used by Reserve Bank of India have released liquidity amounting to over Rs. 4,90,000 crore since mid-September 2008, that is about 9 percent of GDP, which increases effective demand in the Indian market. Fiscal policy of 2008-09 cuts the excise duty, customs duty and service tax to increase the demand of industrial goods. Fiscal policy of 2009-10 will continue to counter the effects of global slowdown by creating demand through increased public expenditure in identified sectors. This fiscal stimulus packages increases the demand for industrial and service sector goods. The community, social and personal services growth rate increased from 6.8 percent of 2007-08 to 13.1 percent in 2008-09. The process of fiscal consolidation during 2002-03 resulted in improvement in fiscal deficit from 5.9 percent of GDP in 2002-03 to 2.7 percent in 2007-08.

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