Relationship between Public Debt and Monetary Policy in India

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Introduction:

Now, we have to examine the conduct of monetary policyduring the past years with to assess its effectiveness in differenteconomic situations which prevailed during the period being reviewed.At the outset, it would be useful to note that between1990-91 and 2003-04 net national product rose by 58.5 percent andthe wholesale prior index rose by 215.3 percent, while M, increased by as much as 683.9 percent between March 1991 and March 2004.While output growth exhibited considerable variability from year toyear due to weather induced fluctuations in agricultural output, the trend in prices was generally upward through the annual change in prices also exhibited large variations. The expansion in M, was steep particularly in the later half of the seventies. In certain years during the last decade and a half the external sector had a noticeable impact on the domestic economic scene the oil stock of 1993 and 19992000 being the important developments in the external sector during this period, apart from a notable increase in remittances from abroadby non-resident Indians from the mid-seventies in response to certaininterest rate incentives under special deposit schemes.

The important tools of monetary policy which wereavailable in the monetary authority to perform its tasks were interest rate policy,refinance policy, variations in cash reserve, requirements, quantitative control of bank credit and moral suasion. Open marketoperations did not have much scope as the market in governmentsecurities was narrow and the demand for such securities arose mainlyout of statutory requirements in the absence of attractive coupon rateson these securities. Selective credit control applied to certain pacifiedcommodities and did not cover the bulk of bank credit in the absence of a broad-based money market; the Bank Rate had a limited role.

Interest rate policy lost its edge when the discount rate on Treasury Bills ceased to be changed since 1994, and yields ongovernment securities were maintained at relatively low levels through the mechanism of the statutory liquidity ratio and its frequent upwardrevision. Though upward revisions in the yields on governmentsecurities have been effected over the recent years, these revisionswere of minor significance as real yields were often negative. Further, they also did not result in increasing the scope for open market operations. Interest rate policy was on occasions successfully used during the period being reviewed as a means of influencing demand for bank credit from the non-government sector notably in 1994 when the Bank Rate was raised sharply and again in 1999-2000 when the increase in the maximum bank lending rate was an unprecedented 3percentage points. The single, most important factor influencing the conductof monetary policy since 1990 is the phenomenal increase in reservemoney. The major component of this increase was the increase in credit by government on which the bank had little control in table.

Increase in Reserve Money (1970-1985)

Period	Total increase in Reserve money	Increase in Reserve Bank credit to Government	Increase in net Foreign Exchange Assets of RBI	Other Items
1	2	3	4	5
March 1990 toMarch 1995	2997	3074	-183	106
March 1995 to March 2000	9077	5835	4997	-1755
March 2000 to March 2005	15020	17369	-2344	-5

The steep rise in the level of reserve money gave a strongimpetus to monetary expansion, and the expansionary impactreserve money increased over the years as the average moneymultiplier rose reflecting the gradual decline of the currency-depositratio in the wake of a substantial geographical expansion of the branch network of banks since 1990. The deflationary impact of a fall in the net foreign exchange assets of the Reserve Bank whenever it occurred was generally neutralized by the rise in Reserve Bank credit togovernment. The Reserve Bank had little flexibility in influencingreserve money growth through cutting down its refinance to banks, both because of its preferred-sector orientation and its otherwise relatively small magnitude.

In view of the above, the only feasible approach to the control of monetary expansion was to influence the value of the money multiplier by raising the cash Reserve Ratio. This was done repeatedlyand the rise in the average money multiplier was more or less arrested after the mid seventies and stabilized at a level slightly below 3.0.This achievement fell far short of the requirements of the situationin several years during the period under review when a drastic reductionin the rate of growth of M_3, was called for.

The considerable variations from year to year of the incremental money multiplier (as observed from the year and data)gave rise to a view that the timing of the increase in reserves moneyand that in money supply did not often coincide, even allowing for some lag, the former could not be considered as the root cause of inflationary pressures witnessed in the economy. The factors influencing price behaviour were no doubt complex but there can beno doubt that monetary expansion of a substantial order emanatingfrom current and lagged effects of increases in reserve money wasan important factor leading to inflationary pressures.

As fiscal deficits were generally accommodated by theCentral Bank, monetary policy had a difficult role to perform. However,at times when drastic monetary control measure were the need ofthe hour the Reserve Bank and the government have closely co-ordinated their actions and have thereby achieved the desired results.Instances of such co-ordination have demonstrated the powerfulimpact of such concerted action by the Reserve Bank and thegovernment and serve to stress the importance of close consultationsbetween them in order to develop common perceptions of theemerging trends in the economy and the desirable lines of policyaction.

It is essential to discuss monetary policy in action during years over the last decade. Our discussion will mainly focus on the recognition lag and the implementation lag in monetary policy, andgiven its limitations, not so much on the final outcome of monetarypolicy actions. Relevant data monetary aggregate are presented in.

Conclusion

Till recent times public debt was not conceived of asplaying a significant role in public finance. The classical economistseven in the policy of balanced budgets and to their debt creationhad no value. Loan financing for public project was accepted on theground that the debt would be ultimately liquidated and the

projectswould be of a self-financing character. However, the general beliefstill was that the debt should be rapid as soon as possible to free thestate from its burden. Keynes did suggest the policy of deficit financingduring a period of depression in the economy, but by its very nature the deficit was to be financed by the expansion of money supply. Itwas during the period of Second World War that the method of debtcreation came to be accepted as one of the methods of financingwar expenditures. The main benefits of this method were, firstrestraining the total consumption in the economy and thus encouraging the creation of larger saving and secondly, helping the state in its policy of controlling the inflationary trends during the war period. The volume of public debt went on rising during the period and its role and importance in the economy were realized both by the policy makers and theoreticians'. The trend was carried further during the post-war period and public debt since then hasbeen widely used by the developing countries as instruments forfinancing their economic development. The creation of debt, internalas well as external, for financing economic development has nowbecome an accepted method.

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