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# SOME ISSUES ON STABILIZATION POLICY: AN INDIAN PERSPECTIVE

**Dr. Sreelata Biswas**
Assistant Professor, Department of Economics
Sudhiranjan Lahiri Mahavidyalaya (Accredited by NAAC),
Majdia, Nadia, West Bengal

## I. Introduction

The stabilization narrative has become prominent in economic policy management since the days of Great Depression (1930). At that time only the fiscal policy is considered as the only policy instrument of macro management. Monetary policy comes into play as another tool of macro management since the growth of the financial system. With the growing complicacy of the finance capital it has become an obvious outcome that the fiscal policy is used for internal stabilization and monetary policy instruments are buffer to the external macro management. There is still ongoing debate on the degree of government intervention in the arena of macroeconomic management. Some argue that the government intervention aggravates the de-stabilization and others defend it proposing that the without government intervention economic instability gets prolonged. This paper is biased towards the second proposition that just and effective dose of government intervention is essential for macro stability. Both the conditions of 'just' and 'effective' are sounds good but very difficult to implement. For example, it takes considerable amount of inside lag to implement the changes in income tax structure. In India, it is scheduled for the annual budgetary declaration. Government has to pass bill at the legislative assembly or in parliament to introduce any social program such as universal basic income or any shorts of transfer income that can enhance the purchasing power of the poor which again basically a sorts of inside lag to implement the policy action against the lack of effective demand within the economy. Any inside or outside lag can aggravate the problem. So stabilization policy hinges around the promptness of the transmission mechanism.

Present work is divided into some sections. Section II goes into the details of the nature of the policy taken for the stabilization. Section III illustrates the instances of fiscal policy taken in different points to nullify the macroeconomic disturbances. The role of monetary policy towards macroeconomic stabilization in this era of financialization is dealt in the section IV. Section V depicts the art of policy mixing as per the requirement and finally Section VI concludes the paper.

## II. Nature of Policy

The "Hindu Socialist" period of growth (Virmani, 2004; Nayyar , 2006) is considered as the most stable period of growth just after the end of colonial period. At that period economy was almost closed. The period had enjoyed only 3.5 percent of growth compared to the 6 percent growth of the rest of the developing world (Ahluwalia, 1988). GDP growth collapsed in 1991-92 due to balance of payments crisis in 1991. But stabilization and structural reform measures of 1991-93 restored macroeconomic stability and it was one of the swiftest recovery seen anywhere in the world during that decade [Acharya 2001, 2002]. The growth was revived following the new economic reform. On the backdrop of the Indian growth story in brief now we will see the basic nature of the policies followed historically in India.

The nature of any policy depends on several factors. One of the important factors is how the policy is taken. Depending on the mode of execution or operation policies are primarily classified into two categories: (a) active and (b) passive.

Active policy management requires the pre-emptive role from the policy makers to nullify any external shock immediately or within a very short span of time. Larger the lag, larger is the inconsistency in the policy implementation. Even misalignment of the policy prescription be it in terms of quality or quantity will result into aggravating the problem under consideration. For example, the effectiveness of monetary policy depends on the readiness of the monetary transmission mechanism.

Passive policy management is basically built-in system and addressing those problems which are for medium to longer time frame. For example, the income tax slab is remained fixed for at least one financial year and it remains so until there are

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major economic changes in the economy. So we can think of that active policy issues are for very short term fluctuation whereas passive policy measures are meant for longer duration. We will see some examples on that in the next sub-sections.

**III. Fiscal Policy:**

Fiscal policy acts as automatic stabilizers of the macro economy. Overheated economy is counter balanced by counter cyclical fiscal management and a recessionary situation is overcome by the use of pro cyclical fiscal macro management. For example during the period of recession government can reduce the income tax or corporate tax so that the economy can get the temporary liquidity. That liquidity again boost the aggregate demand. Fiscal policy deals with the various aspects of income expenditure side of the government. Government still plays significant role in India in every sphere of economic activities even after the Three decades of economic reform towards the downsizing of the government. There is plethora of literature post the Washington Consensus supporting the minimalist government. Most of these literatures are indicating the inefficiency of the government expenditure . But this type of pro capitalist proposition is somehow devoid of the notion of welfare state. In a very narrow sense welfare state should provide some basic human services such as child care, education and health.

These basic human services become very critical at the time of severe economic crisis. We have seen such a huge economic crisis during the recent happening of economic lock down due to Covid-19 for almost two years whole over the world. Perhaps the role of the government has been redefined due to the crisis. The way government managed the supply chain disruption during the period of Covid_19 has once again proved the strategic role of government to ensure the minimum basic services for the poor. India has demonstrated a very successful countrywide vaccination programme almost at free of cost with the help of taxpayers' money to tame the spread of Covid well ahead of the world. If we compare our nation with respect to other developed nations by the percentage of GDP as government expenditure (see Table_ 1) then we can see that it is much lower in India compared to the other advanced nations. It has remained more or less constant in percentage of GDP term during the last three decades compared to the other European nations, U.S. or even China.

There is a considerable amount of debate on the trade off between the fiscal prudence and the government's welfare expenditure. The memory of global financial meltdown is not yet faded. It was just a bailout of the corporate by the government. At that time government had sacrifices its tax revenue for the sake of corporate. Tax payers' money was used for the revival of the private corporate sector. The lending of the last resort by the central bank has made the availability of credit to the private sector to come out of the shock of the financial crisis. Slowly and gradually we have sailed through the global financial crisis. So it's again reframing the role of government in this era of financialization. Indian capital market nose-dived following the global financial crisis along with the other prominent global markets; it was the government's fiscal stimulus measures that helped the recovery of the capital market.

Government expenditure even if it is purely consumption based is pertinent to run the system at the time of crisis. The unskilled labour force that has lost their regular job during the period of Covid had faced severe food crisis. At that time government has increased the rationing allocation such as free food grains of 5 Kilogram per person and 1 Kilogram pulses for Three months for the poor. Government has allocated Rs. 1.70 Lakh Crore under the Pradhan Mantri Garib

This consumption based allocation which again can be approximated as a just investment for the human capital without having any return on investment. Even if we think about that this is investment for the future productivity still it is impossible to quantify the return at present. The positive externality of the pro poor consumption based government expenditure will not certainly justify the efficiency by any means but it resounds the distributive justice of the government expenditure at the time of crisis. Certainly this is stabilization at the cost of efficiency. Social cost of consumption based government expenditure is undoubtedly much higher than the opportunity cost. Contingent allocation for the future is a drawdown from the present cash flow. But government has to keep this fund ready for welfare purpose. Welfare at one hand and efficiency at other hand can't go together. Stabilizing an economy at the cost of efficiency is only possible by the government. The role of private capital is limited to the extent of corporate social responsibility.

**Table_1: Government Expenditure (% of GDP)**

| Country | 2022 | 2020 | 2010 | 2000 | 1990 |
|---|---|---|---|---|---|
| United States | 36.26 | 44.82 | 39.75 | 33.88 | 37.2 |
| Japan | 44.09 | 44.55 | 37.74 | 35.95 | 29.36 |
| United Kingdom | 44.30 | 49.87 | 50.56 | 36.76 | 41.11 |
| South Africa | 32.47 | 34.57 | 28.28 | 22.65 | 28.7 |
| **India** | 28.62 | 31.06 | 27.45 | 25.64 | 25.37 |
| Brazil | 46.38 | 49.92 | 42.16 | 34.48 | No data |
| China | 33.40 | 35.4 | 25.09 | 16.27 | 18.21 |
| Germany | 49.48 | 50.46 | 47.87 | 45.10 | 44.73 |
| Russian Federation | 36.00 | 39.15 | 35.5 | 30.65 | No data |

Source: www.imf.org retrieved on 26/09/2024.

There is certainly no alternative to consumption based government expenditure during the period of unforeseen situation but it is certainly not desirable as freebie just before any general election or even as any political agenda. Even economists are talking about the government transfer of universal basic income (UBI) for the poor who don't have access to the basic amenities such as food, health etc. Certainly this will not be directly capacity building expenditure by the government. It will cost heavily to the government exchequer. It will provide a degree of stability to the consumption level of the poor. But certainly it will not be credit expansionary to the government. This constant drawdown from the government income may create a stable demand even for discretionary products such as usage of data but still that level of demand comfort may not be desirable for long term. Rather production incentivised government expenditure such as supporting any locally abundant resource based small scale industry and creating job will have sustainable impact in the long run. There are some strategic changes in the government expenditure to downsize the government since the reform process following the recommendation of the Expenditure Reforms Commission as well as Expenditure Management Commission.

**IV. Monetary Policy (**impossible trinity: price stability, exchange rate stability and capital mobility)

Monetary policy perhaps plays the most important role in stabilizing the modern macro economy. The stabilizing role is becoming complex with the over deepening of finance compared to the real economy. The complexity has grown with the growth of the economy. Money neutrality in classical sense is just a text book presence in this era of exotic finance. The size of hot money with respect to real economy has increased enormously in large sized developed and developing economies including India. The intense destabilizing nature of hot money demands timely and just intervention of central bank.

As per the preamble of The Reserve Bank of India (RBI) Act, 1934 RBI will be responsible for maintaining monetary stability, currency stability and credit growth for the sake of overall economic growth. Central bank is an independent institution in India. But we have often come across with the conflict between the government and the central bank in India. This is just because of concurrent interest of overall economic growth. Central bank acts as the lender of the last resort and the most significant liquidity provider to the government. So it is very pertinent to assume that government has to depend on central bank for get rid of the extreme economic crisis with the help of the central bank.

**Price stability** is the prime responsibility of the central bank not in India but it is a global dictum. Off late RBI comes out with targeted level of inflation band. RBI has missed the targeted level several times. Rules based monetary policy has failed in most of the cases due to transmission lag. Even transmission lag varies due to discretionary nature of a particular group of banks. This heterogeneity of the financial structure hinders the fast and just monetary transmission. Moving towards the market determined interest rate and strict regulatory framework for monetary transmission have yielded significant level of

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price stability in case of demand driven price instability. India has not suffered wild price instability so far except in some cases of oil price fluctuation which is again a very basic global factor as India is largely crude importer. It is found that wide price fluctuation may cause growth volatility. Growth is sacrificed during the period of very high inflation and also in some cases during the period of very low general price level. Former of course indicates supply side disturbance of the economy while the later clearly because of demand side disturbances of the economy. There is mentioned about some ranges of threshold level of inflation at which growth can be maximized. Price volatility mainly on the upward side impacts the government and this becomes robust if the election is at the door. At that situation government embarks on heavily by providing some fiscal impetus such as reducing import duties or giving some dearness allowances.

**Currency volatility** is the most important concerns in today's globalized world. So far India has not witnessed any currency crisis even after the severe Balance of Payments (BOPs) crisis in 1990. Reserve Bank of India is primarily responsible for currency stabilization. India enjoys major share of foreign inflow since the inception of full current account convertibility. Foreign Portfolio Investment (FPI) in Indian stock market is affecting the Indian currency nowadays. Portfolio investment is hot in nature. The opportunist nature of portfolio investment comes very fast and goes also very fast. It looks for opportunity around the world. Once it finds greater return on investment from other market it just goes away to that market selling in our market. The current sell off in the Indian stock market and associated currency depreciation certainly have causal linkage with the huge selling of our domestic equities by foreign portfolio investors. Market has corrected by close to 15 percent from the peak of September, 2024 level and Indian Rupee has depreciated almost 8 percent with respect to US Dollar or US Dollar Index during the same period following the sell of Indian equities by the FPIs for the last Six months. Reserve Bank of India (RBI) has played a crucial role to stabilize and neutralize the impact of flight of foreign currency at this juncture by buying dollar from the open market and swapping domestic currency denominated instrument with a basket of currencies denominated instrument. The presumption behind this operation is that central bank has enough hard currency reserve. If that reserve is not enough then central bank will not be able to do the open market operation. Dollar reserve acts as an important buffer for the future stabilization of the currency. There is a pertinent debate on the optimum amount of foreign exchange reserve India should hold for future stabilization of currency and to keep the capital account swing in control as it has to bear significant amount of cost due to forgoing of best alternative use of the foreign exchange reserve.

## V. Policy Mix and Fine Tuning

So far we have discussed the roles of different institutions in stabilising the economy. We have seen that in most of the cases roles are overlapping between government and the central bank. But the most important point is that the overlapping roles are not defeating to each other. Rather they are supporting to each other both at institutional level as well as on the basis of achieving a target. Say the most important macro variable to the central bank is inflation whereas achieving a decent growth target is the end of government policy making. And there is profound literature supporting the bi-directional causality between growth and inflation on the basis of different time frame and frequency of data.

So it is very pertinent to propose that there should be some level of interconnects, supporting dialogues, framing the joint platform and keeping the trust among the stakeholders for the stabilisation of the economy. The exact balance between the fiscal and monetary mix which is basically the equilibrium point in the IS-LM framework as per the standard macro text book is a utopia.

The historically best coordinated outcome between the government and the central bank can be sited as the economic recovery after the Covid-19 pandemic (2020-2021) not in just in India but also whole over the world. Complete shutdown of the economy have resulted into structural break into GDP growth (refer to Table_2). India suffered a negative annual growth rate of -5.8 percent after the break out of the Covid-19 followed by nationwide lockdown from March 25, 2020 to May 31, 2020, spanning over 68 days. The economy has started recovery following the unlocking process gradually and it enjoyed a double digit growth of almost 10 percent in the subsequent year. The average annual growth rate of close to 8 percent is continued for the next three years despite global economic slowdown. The success can be accrued to the consorted attempt jointly taken by Government of India and Reserve Bank of India. Government has taken some immediate relief measures such as direct cash transfer to Jan Dhan account holders, providing free LPG cylinder, providing adequate amount of free food grains through rationing etc.

Interest rate is the price of the loanable fund available with the economy. So changing interest rate can control the demand supply of the loanable fund. As economy was completely devastated due to lock down and restrictions so government needs to provide sectoral support in terms of low cost capital. So the central bank that is Reserve Bank of India has maintained an accommodative monetary policy stance throughout the pandemic and it is still maintaining the accommodative stance even if the US Federal Reserve has started their tapering since December, 2021. The promptness of the RBI towards the emergency of the pandemic was noticed in the meeting of the Monetary Policy Committee (MPC) hold on 27th March, 2020 just one week after the first nationwide lock down. RBI has assured that it will do whatever it requires to get rid of the crisis at that meeting (RBI, 2020).

Table_2: India GDP Growth Rates (2020-2025)

| Year | Growth Rate (%) |
|---|---|
| 2020-2021 | -5.8 |
| 2021-2022 | 9.7 |
| 2022-2023 | 7.6 |
| 2023-2024 | 9.2 |
| 2024-2025 | 7.0 |
| 2025-2026 | 6.5(projected) |

Source: Economic Survey, 2024-25.

## VI. Conclusion

We have seen some very active stabilizing steps recently both by the Central bank and the government. RBI has maintained steady repo rate for a long time to cope up with the rising price level. RBI has cut the repo rate by 25 basis point recently in March, 2025 after observing the continuous falling of general price level. The lowering of repo rate will certainly reduce the cost of investment and increase the level of capital expenditure. Government has come with massive Goods and Services Tax (GST) reform recently to boost the consumption demand of the economy. Introducing only two tax slabs will certainly boost the consumption demand of the economy. Not only will that it make the business processes easier than earlier.

So it is very much pertinent to say that comparatively cheaper capital along with the easier business process will certainly boost the economic growth in the medium term. Higher interest rate and higher level of fiscal deficit both reduce the rating of the nation. To keep the nation globally sound we need the coordination between the government and the central bank. Historically we have seen conflict between the two authorities several times but it is certainly not desirable. Stable higher growth rate along with lower and stable price level should be the ultimate motive of sustainable inclusive growth.

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