

Extent of the impact of monetary and fiscal policies in addressing macroeconomic indicators (GDP and inflation) in economies like India that are vulnerable to external geopolitical shocks

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ABSTRACT

This research paper investigates the extent to which monetary and fiscal policy measures can reduce the impact of external geopolitical shocks on economic growth and inflation in vulnerable emerging economies, in countries like India. The US tariff imposition along with the geopolitical crisis in West Asia during 2025-2026 is used as a real-life situation facing emerging economies. The geopolitical crisis has resulted in almost 10% depreciation of the rupee, a \$16.4 billion net capital outflow, and maximum repatriation of FDI investment that has never been witnessed in India. Through the use of quarterly data from 2016 to 2026, this research paper investigates the mechanism of shock transmission via oil prices, capital flows, and exchange rates. It also discusses the new FCNR(B) 2026 as a measure to attract dollar deposits in the country. Overall, it compares the impact of monetary policy and fiscal policies in offsetting the shocks.

Key words: inflation, India, geopolitical policy, monetary policy, fiscal policy, FCNR(B) 2026

1. Introduction

Monetary policy is part of a macroeconomic government policy drafted by the Reserve Bank of India. This policy covers measures taken to regulate the volume of credit created by the banks, through the use of monetary instruments under the control of the central bank. These instruments are used generally to achieve price stability, financial stability, and adequate availability of credit for growth. With greater digitalisation, individuals are in a position to access credit and banking services more easily, aligning with the RBI's broader objective of financial inclusion. [1]

The monetary policymaker, then, must balance price and output objectives., Banks like the ECB, which only target inflation, admit that they pay attention to stabilising output and keeping the economy near full employment. In the case of the Fed, which has an explicit *dual mandate* from

the U.S. Congress, the employment goal is formally recognised and placed on an equal footing with the inflation goal.

Monetary policy is not the only tool for managing aggregate demand for goods and services. Fiscal policy—taxing and spending—is another, and governments have used it extensively during the current crisis. However, it typically takes time to legislate tax and spending changes, and once such changes have become law, they are politically difficult to reverse. Added to that are concerns that consumers may not respond in the intended way to fiscal stimulus (for example, a loosening of the fiscal policy in the form of a tax cut may result in greater savings rather than spending), and it is easy to understand why monetary policy is generally viewed as the first line of defence in stabilising the economy during a downturn. There are certain exceptions where the goal of the economy is to have a fixed exchange rate; an example of this is China, where all monetary policies are tied to the exchange rate objective. [4]

In recent years, a large number of central banks all over the world have adopted “inflation targeting” as their main target. There could be one other goal that the central bank may want to achieve, but by and large it is price stability, which is the aim. This is true for both developed and developing economies. [2]

Central banks conduct this by adjusting the supply of money. The banks can only impact the supply of money. They are unable to affect the demand for money. The supply of money is adjusted through buying or selling of securities in the open market. This is also known as “Open Market Operations”. These transactions affect short-term interest rates, which in turn influence economies, longer-term rates and economic activity. When central banks lower interest rates, monetary policy is easing. When they raise interest rates, monetary policy is tightening. [2]

In the case of a developing economy like India, the government aims to "regulate the issue of banknotes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage; to have a modern monetary policy framework to meet the challenge of an increasingly complex economy; and to maintain price stability while keeping in mind the objective of growth." (Reserve Bank of India / preamble). For India, there is an absolute necessity to increase its per capita income as well as productivity while keeping inflation under check. [3]

2. Literature review and background

In developing economies, there is an increasing interest in studying monetary policy. Recent studies have looked at various factors that may affect the effectiveness of monetary policy, such as the profitability of central banks (Buitier, 2008) and financial unions (Kamar and Naceur, 2007). Indeed, the authors have distinguished between two types of monetary policy:

accommodative and stabilising. An accommodative monetary policy is defined as a policy that provides a steady supply of credit to an expanding economy. A stabilising monetary policy, on the other hand, is a policy that serves to mitigate or offset unwanted changes in the economy. In the first accommodative scenario, *money growth accommodates output growth and price inflation.* In the second stabilising scenario, the monetary authority *varies money growth* to counter the effects of other shocks, depending on the objectives of monetary policy. Many central banks in developing countries lack independence in their operations, resulting in unclear objectives for monetary policy. Researchers such as Behrman (1981) and Crockett (1981) have argued that *lags, rigidities, and disequilibrium* analysis are key factors in understanding short-term macroeconomics in these countries. Porter and Ranney (1982) have also focused on analysing the structural differences between developing and developed countries. The stabilising function may be to *target economic growth.* Thus, the central bank increases liquidity to enhance credit expansion and stimulate the economy during a downturn. In an extreme scenario, the government could play a leading role in structural, economic and social development. Indeed, the central bank may be forced to extend credit to finance increased government spending [5]

In developed economies, monetary policy refers to the actions taken by a central bank to control the money supply and interest rates. According to economists such as Friedman, Cagan, Mishkin, Tanzi, and others, an increase in the money supply leads to an *increase in the availability of credit*, and a *reduction in the interest rate* is needed to stimulate the demand for money. However, the effectiveness of monetary policy is influenced by various factors such as the *elasticity of money demand* with respect to *income and interest rates*, the *elasticity of aggregate spending* with respect to *interest rates*, and the *mobility of capital in an open economy*. Furthermore, factors on the supply side of the economy, such as *labour market conditions* and *capacity constraints*, can also impact the effectiveness of monetary policy. Additionally, the objectives of monetary policy and the government's budget deficit can also play a role in determining the impact of monetary policy on the economy. Overall, a comprehensive analysis of the effectiveness of monetary policy requires an *assessment of the flexibility and constraints on both the supply and demand sides of the economy.* Economic models that attempt to identify a reaction function for the monetary authority focus on the activities of central banks in developed countries. The objective pursued by most central banks in recent decades has been a low level of inflation. Since inflation was believed to respond to changes in unemployment, this implied a primary focus on labour market and output gaps in the "real" economy when setting monetary policy. In contrast, "financial" sector developments were thought to be of no great importance in setting the instruments of monetary policy. First, the general adoption of a positive (+2%) inflation target has prevented the downward adjustment of prices that would be the natural product of increases in productivity and positive supply

shocks. As a result, prices have been drifting upwards (and significantly) for decades. Second, the recurrent use of monetary easing to spur demand and raise inflation becomes increasingly ineffective, inviting an ever-stronger policy response that could eventually work but might well prove hard to control. Third, stimulative monetary policy has had a variety of *unintended and unwelcome* consequences. Fourth, as the threat posed by these unintended problems has cumulated over time, "*exit*" and the "*renormalisation*" of policy have become ever harder to achieve. [5]

The type of monetary policy used will differ based on developing / developed economies. Inflation targeting is a monetary policy tool for both sets of economies. But the rate differs. In developed economies, it is $\pm 2\%$, and in developing economies, it is $\pm 4\%$.

3. Research Gap and Methodology

The gap that this paper attempts to understand is the reasons behind choosing various monetary and fiscal policies for developing economies in India, what are the goals, and what are the instruments? In the case of the Reserve Bank of India, what are the reasons behind the instruments adopted, and has this been successful in achieving the final target? In the case of an external geopolitical crisis, what policy measures should the RBI adopt, and are they successful in achieving stability or even growth of macroeconomic indicators?

The methodology adopted would be a mixed method type that would use quantitative analysis from authentic sources to analyse the impact of policy measures in developing economies like India. The explanation would use qualitative data available in understanding the impact as well as the path ahead by continuing to use the prevalent policy measures.

4. Analysis

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 the *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. The reforms pursued by the fiscal and monetary authorities in tandem helped improve the efficacy of macroeconomic management (RBI (2013)). [7]

The shift to inflation targeting attracted sustained controversy. Critics, including some within the finance ministry and among heterodox economists, argued that a ± 4 per cent CPI target was too tight for a developing economy with large food-price shocks and that anchoring on headline rather than core inflation forced monetary tightening in response to supply shocks the RBI could not control. Others questioned whether the MPC's external members possessed genuine independence given the appointment process. The framework's resilience was tested during the COVID-19 pandemic and again in 2020–2022, when CPI repeatedly approached or exceeded the 6 per cent ceiling, prompting the November 2022 explanatory letter to the government. Debate continues over whether the target should be defined on core inflation or on a wider band economy. [8] As per the new framework, the central government, in consultation with RBI, sets (i) an inflation target and (ii) an upper and lower tolerance level for retail inflation. The target has been set at 4%, with an upper tolerance limit of 6% and a lower tolerance limit of 2%. The upper and lower limits indicate that although it is desirable for inflation to be close to 4%, deviation between these limits is acceptable, and there is no government intervention. The target and bands are revised every five years. In March 2021, the existing targets were carried forward. The MPC uses tools such as interest rates to control the level of inflation in the economy. One such rate is the *policy repo rate, reverse repo rate and other open market operations*. The repo rate is the rate at which the RBI lends money to banks. An increase in the policy repo rate makes borrowing money more expensive and hence is expected to control inflation by reducing the money supply. MPC increased this rate from 4% in April 2022 to 4.4% in May 2022, to 4.9% in June 2022, to 5.4% in August 2022, and to 5.9% in September 2022. [9]

During the Covid-19 period from June 2020 to April 2022, the MPC kept the policy repo rate constant at 4%. From May 2022 the MPC implemented a series of incremental rate hikes, increasing the repo rate by a cumulative 2.5% in order to address a surge in inflation. This was also when the US Fed was tightening monetary policy in response to rising inflation. Since February 2023, the MPC has held the repo rate steady at 6.5%. In addition to documenting the MPC decisions over the last eight years and commenting on the voting patterns of the MPC members. The Indian economy encountered several significant shocks, including demonetisation in 2016, the Covid-19 pandemic in 2020 and 2021, and more recently, the intensified geopolitical tensions following the Russian invasion of Ukraine in 2022 and the current conflicts (2026) in the Middle East. These events likely influenced the inflation trajectory and also the conduct of monetary policy. The Covid-19 pandemic period, for example, saw significant deviations from the established inflation targeting (IT) framework. Traditionally, the repo rate served as the primary tool for IT. However, during FY2021 and FY2022, the RBI, faced with

unprecedented challenges due to the pandemic, executed a shift wherein the reverse repo rate (i.e., the rate at which banks , deposit excess funds with the RBI) effectively became the primary policy instrument. Given that, by statute, the MPC is authorised solely to set the repo rate, it can be inferred that during this period, the MPC thought best that this would be the best target to achieve the final goal. This period also saw the introduction of several unconventional monetary policy measures aimed at injecting liquidity into the financial system and maintaining low government bond yields to reduce borrowing costs (Lakdawala et al., 2023). These measures, which fell outside the MPC's purview, were not reflected in MPC statements but were instead announced separately by the RBI Governor. This approach constituted a further departure from the IT framework. In the post-Covid period, the IT framework was put to the test by a series of external shocks. Under current legislation, the RBI is deemed to have failed in its IT mandate if the headline CPI inflation falls below 2% or exceeds 6% for three consecutive quarters. This scenario materialised for the first time in calendar year 2022, when CPI inflation surpassed the upper threshold of 6% for three consecutive quarters, from January to September. This inflationary surge was largely attributed to the Russia-Ukraine conflict, which exacerbated supply chain disruptions that had initially emerged during the Covid-19 pandemic, resulting in persistently high inflation in India. The RBI commenced tightening monetary policy in April 2022. [10]

Table 1. A comparison of the instrument and the goal in India from 2016 onwards

Year	Instrument (inflation)	Goal - GDP	Unemployment
2016	4.95%	8.26%	7.6%
2018	3.94%	6.45%	7.7%
2020	6.62%	-5.78%	7.86%
2022	6.70%	6.99%	4.82%
2024	4.95%	7.10%	4.17%
2026* - partial info	4.38%	7.6%	4.9-5.5%

Source: Inflation (**CPI annual %**):

- 2016: <https://economicdatagdp.com/country/in/2016>
- 2018: <https://www.macrotrends.net/global-metrics/countries/ind/india/inflation-rate-cpi>
- 2020: <https://www.macrotrends.net/global-metrics/countries/ind/india/inflation-rate-cpi>
- 2022: <https://www.macrotrends.net/global-metrics/countries/ind/india/inflation-rate-cpi>
- 2024: <https://www.macrotrends.net/global-metrics/countries/ind/india/inflation-rate-cpi>
- 2026: <https://tradingeconomics.com/india/inflation-cpi>

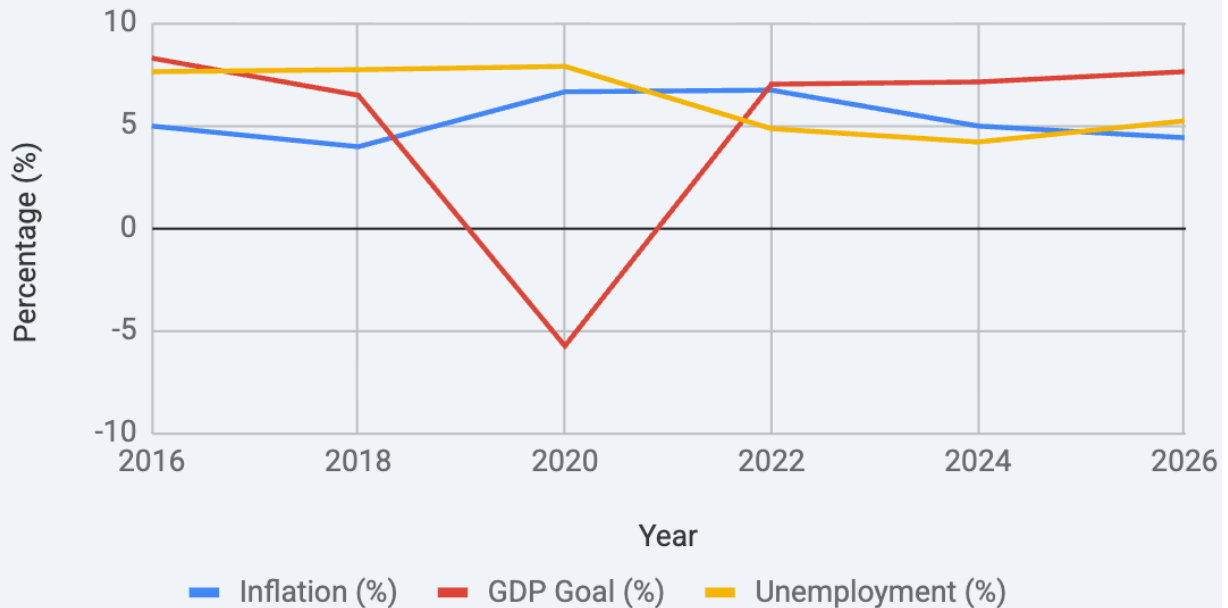
5. GDP Growth (annual %):

- 2016, 2018: <https://economicdatagdp.com/country/in/2016> and /2018
- 2018 (official alternative): https://www.indiabudget.gov.in/budget2019-20/economicsurvey/doc/vol2chapter/echap01_vol2.pdf (Economic Survey 2018-19, p.1)
- 2020, 2022: <https://www.macrotrends.net/global-metrics/countries/ind/india/gdp-growth-rate>
- 2024: <https://www.macrotrends.net/global-metrics/countries/ind/india/gdp-growth-rate>
- 2026: <https://tradingeconomics.com/india/full-year-gdp-growth> (MOSPI, fiscal-year basis)

6. Unemployment (%):

- 2016, 2018: <https://economicdatagdp.com/country/in/2016> and /2018 (World Bank national estimate)
- 2020, 2022, 2024: <https://www.macrotrends.net/global-metrics/countries/ind/india/unemployment-rate>
- 2026: <https://tradingeconomics.com/india/unemployment-rate> (MOSPI/CMIE monthly data)

Economic Indicators Trend (2016 - 2026)



Foreign Direct Investment is one of the major instrument that add to domestic investment. It is likely to bring with it superior technology and enhanced working methods. Investment is important for growth in the economy and domestic saving may not be sufficient. Thus, FDI helps in bridging the gap between domestic saving and investment required. Many developing countries like India, are facing the deficit of savings. India being one of the fastest growing economies of the world , its liberalisation policies are helping the economy to grow and develop. Foreign Direct Investment (FDI) is defined as "investment made to acquire lasting interest in enterprises operating outside of the economy of the investor. " India, post liberalisation, has not only opened its doors to foreign investors but also made investing easier for them by implementing the following measures: Foreign exchange controls have been eased on account of trade. Domestic companies can raise funds from overseas securities markets and have considerable freedom to invest abroad for expanding their global operations. Foreign investors can remit earnings from Indian operations. Foreign direct investment (FDI) rules in various sectors have eased out over the years, and in some sectors, 100% FDI is allowed (infrastructure, telecommunication, IT, software and others). Except for the following sectors – gambling, lotteries, chit funds, Nidhi companies, TDR trading, real estate businesses, tobacco manufacturing, atomic energy, and railway operations – India has opened up most of its sectors to FDI. This investment usually involves participation in management, joint ventures, and transfer of technology and expertise. There are two types of FDI: inward foreign direct

investment and outward foreign direct investment, resulting in a net FDI inflow (positive or negative) and "stock of foreign direct investment", which is the cumulative number for a given period. Direct investment excludes investment through purchase of shares. Foreign Direct Investment (FDI) inflow into the core sectors like defence manufacturing, renewable energy, telecommunication, etc., is assumed to play a vital role as a source of capital, management, and technology in countries like India, which are deficient in advanced technology. FDI has a positive effect on the host economy's development effort (Caves, 1974; Kokko, 1994; Markusen, 1995; Carves, 1996; Sahoo, Mathiyazhagan and Parida, 2001). On this line, it has been argued that FDI can bring the technological diffusion to the sectors through knowledge spillover and enhances a faster rate of growth of output via increased labour productivity in India. There has been evidence of a long-run relationship between Gross Domestic Product, FDI and exports from India (Sahoo and Mathiyazhagan, 2003). Many countries, like India, have offered incentives to encourage FDI entering their economy. India too has opened up its economy and allowed MNEs in the core sectors such as power and fuels, electrical equipment, transport, chemicals, processing, metallurgy, drugs and pharmaceuticals, textiles, and industrial machinery. This started in the 1990s, and India has progressively allowed a larger and larger share of FDI in various sectors. [11]

7. Reasons for recent development in FDI outflows from India since 2025

In the recent past there has been a large outflow of FDI from India which has resulted in stock market volatility and an increasing gap between required investment and domestic savings. A result of this is that the real GDP growth has been around 7.7%. This could largely be due to low inflation levels rather than an upsurge in output and productivity. Given the US-Iran crisis and the impact that it has had on the fossil fuels sector, inflation is now set to increase. Along with this, there has been an outflow of FDI and a depreciation of the rupee. This has led to the government initiating steps to stem the flow of FDI and reverse it.

On June 5, 2026, RBI Governor Sanjay Malhotra did not use those exact words. But the package of measures he announced at the conclusion of the Monetary Policy Committee meeting - six specific actions spanning government bonds, NRI equity investments, foreign currency deposits, overseas borrowings, export proceeds, and the regulatory framework for foreign portfolio investors - carried that same unconditional quality.

The RBI controlled the monetary and regulatory levers: FAR expansion, General Route liberalisation, NRI limits, FCNR(B) support, ECB swap facility, export realisation period. The Ministry of Finance controlled the fiscal lever: the tax exemption on G-Sec returns for FIIs. Both arrived on the same day, in an orchestrated sequence. [13]

Table 2: Macroeconomic aggregates from 2025 onwards for India

Year	Inflation levels	Exchange rate (rupee per USD\$)	FDI withdrawals (US\$bn)	FPI (US\$bn)
2nd quarter 2025	1.7%	85.77	12.38	+1.6
3rd quarter 2025	1.4%	88.80	14.0	-5.7
4th quarter 2025	0.78%	89.88	18.2	-0.2
1st quarter 2026	3.12%	94.78	9.0	-12.0
2nd quarter 2026	3.7%	94.65	13.42	-9.6

Source: https://rbi.org.in/Scripts/BS_PressreleaseDisplay.aspx?prid=61750
<https://www.pib.gov.in/PressReleasePage.aspx?PRID=2220004®=3&lang=1>

FPIs pulled out a net of \$13.4 billion from equities and \$0.3 billion from debt markets in March of 2026. Amount of FII pulled out from the Indian market in March, April, May, and June, 2026

To stem this flow, the FCNR(B) was announced in July 2026. The scheme was supposed to run for a minimum period till August 31st, but given the response, it could be extended to September 2026. An FCNR(B) deposit is a foreign-currency fixed deposit that allows eligible NRIs and Persons of Indian Origin (PIOs) to maintain funds in India without converting them into Indian rupees for the deposit tenure.

Unlike a regular savings account, an FCNR deposit is a term deposit. It is held in a selected foreign currency for a fixed period, while interest is earned in the same currency. This can be attractive for NRIs who expect to use the funds in that foreign currency in the future. [15]

Table 3: FII withdrawals and exchange rate fluctuation for March - June 2026

Month	FII withdrawals	exchange rate fluctuation
March 2026	101,000 crore	₹93.81 to ₹95.63 per USD
April 2026	70,000 crore	91.90 to 94.35 per USD
May 2026	280,000 crore	93.90 to 97.12
June 2026	49,340 crore	₹95.55 to ₹94.92

Source: <https://www.exchangerates.org.uk/USD-INR-spot-exchange-rates-history-2026.html>
<https://rbi.org.in/>

The scheme closed on the 31st of August 2026. Which was the minimum time period that was allowed for the scheme to be valid. The government and the RBI did not extend the scheme beyond 31st August 2026, though they could have till September 2026.

The scheme is entitled 'Dollar Deposits by NRIs in Any Bank' for a fixed rate of interest and for a fixed time period. (3 or 5 years) The amount returned is the principal plus the interest, and payment would be in dollars.

RBI's 2026 swap window applies to fresh or renewed *FCNR deposits* mobilised by banks for a minimum tenure of 3 years and a maximum tenure of 5 years, for deposits booked or renewed between 8 June 2026 and 30 September 2026. [16]

Fresh FCNR(B) 3-to-5 year deposit rates have surged up to **7.0%** following the Reserve Bank of India's temporary lifting of interest rate caps and absorption of 100% hedging costs. [17]

The Reserve Bank of India (RBI) has shortened the swap facility window for foreign currency non-resident (bank) or FCNR (B) deposits by a month to August 31, from the originally announced deadline of September 30, noting the higher-than-expected foreign currency inflow. The central bank has received \$52.30 billion of inflows through these deposits until August 13, the latest update from RBI showed.

Total foreign inflows due to the special measures announced by RBI amounted to \$56.84 billion until August 13, up from \$40.81 billion previously reported by the central bank as of 31st July, 2026. The inflows were largely driven by FCNR(B) deposits, which accounted for \$52.30 billion

of the inflows. Dollar inflows from external commercial borrowings (ECBs) and overseas foreign currency borrowings (OFCBs) have been comparatively modest at \$1.74 billion and \$2.80 billion, respectively. Inflows through the FCNR(B) scheme have exceeded the \$26 billion mobilised under a similar scheme in 2013, less than two months after the latest window opened on June 8. [18]

The problem of plenty of deposits under the FCNR(B) scheme increases domestic cash influx (12-13 lakh crores), a possibility of the money market rates dropping below the RBI's repo rate and a risk of fuelling inflation due to increased deposits in the system.

There is also a fear of future redemption of these deposits and a depreciation burden that the banks would have to bear due to the exchange rate fluctuations that are likely to occur till the time of maturity.

8. Limitations

The limitation of this paper was that no primary research was conducted, whether in terms of data or interviews with bank officials. This was primarily due to lack of time and finance. As the main emphasis was on authentic secondary data from credible organisations. The researcher hopes that the data and the qualitative analysis are unbiased and do not voice the opinion of the researchers from whom the data has been collected.

9. Conclusion

Monetary policy is crucial and can be observed over the years after the outbreak of covid-19 and more effectively in 2016, as this was the year when the MPC came into existence in India. Since then the government has been managing the inflation rate despite various geopolitical crises. For example, covid-19, the Russian-Ukrainian conflict, and the current US-Iran conflict. The RBI to address the large outflows of FII's had adopted FCNR(B) 2026 to stem the continuous depreciation of the rupee. The result being that there has been a huge inflow of dollars, but the problem is how to deploy them effectively such that they do not add to inflation and that they are productively invested, as well as the fact that on maturity, the banks do not have any major problem in returning the principal and interest in dollars. However, going ahead, perhaps inflation targeting may not be the correct policy to follow. Other factors like exchange rate or investment decisions or GDP growth might take a greater emphasis rather than just looking at inflation. A broad-based target by the RBI may be a better goal to meet given the continuous geopolitical crises that seem to be emerging in the world.

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