Chapter 6
Monetary Policy and Fiscal Policy

Monetary policy:
Monetary policy refers to the policy of the monetary authority that is concerned with the supply of money stock and rate of interest. Like fiscal policy, the objectives of monetary policy are to stabilize the economy at full employment level and to promote economic growth. For achieving these objectives aggregate demand is influenced through the adoption of monetary policy. For instance, at times of recession aggregate demand is stimulated by increasing money supply and decreasing interest rate. On the other hand, at times of inflation aggregate demand is contracted by tightening the money supply and raising the rate of interest.
Monetary policy is a set of tools used by a nation's central bank to control the overall money supply and promote economic growth and employ strategies such as revising interest rates and changing bank reserve requirements.

Goals of Monetary Policy:

Inflation

Contractionary monetary policy is used to target a high level of inflation and reduce the level of money circulating in the economy.

Unemployment

An expansionary monetary policy decreases unemployment as a higher money supply and attractive interest rates stimulates business activities and expansion of the job market.

Exchange Rates

The exchange rates between domestic and foreign currencies can be affected by monetary policy. With an increase in the money supply, the domestic currency becomes cheaper than its foreign exchange.

Instruments of monetary policy: There are four major instruments that can be used to influence the aggregate demand of the economy. These are as follows:

1. Open market operation
2. Bank rate
3. Cash reserve ratio
4. Selective credit control

Fiscal policy:
Fiscal policy is the policy of government with regard to the level of government purchases, the level of transfers, and the tax structure (Dornbisch and Fischer). Government adopts fiscal policies to overcome recession and control inflation as well as to promote and accelerate economic growth.

The overall management of Government's **revenue** and **expenditure** is fundamentally guided by the fiscal policy.

A well-balanced fiscal policy plays a very important role in meeting spending priorities with available resources, creating congenial environment for achieving faster economic growth and maintaining macroeconomic stability of the country.

Fiscal Policy is the decision of the **government** about:

- How to earn revenue and gather resources from various sources
- For what to spend those earnings and resources
- How much to spend and
- When to spend

Instruments of fiscal policy: There are mainly three instruments that are used in operating fiscal policies. These are as follows:

- Government expenditure or G;
- Tax rate or t; and
- Government borrowing.

Types of Fiscal Policy:

Expansionary:

- Increase in government purchases,
- Decrease in taxes, for the purpose of increasing aggregate demand and expanding output

Contractionary:

- Decrease in government purchases
- increase in taxes for decreasing aggregate demand and thus controlling inflation.

Role of Fiscal Policy in Developing Countries

- The main goal of fiscal policy in a newly developing economy is the promotion of the highest possible rate of capital formation.
- To accelerate the rate of capital formation, the fiscal policy has to be designed to raise the level of aggregate savings and to reduce the actual and potential consumption of the people.
- Another objective of fiscal policy, in a poor country is to divert existing resources from unproductive to productive and socially more desirable uses.
- An important aim of fiscal policy in a developing economy is to create an equitable distribution of income and wealth in the society.
- Furthermore, fiscal policy in a poor country has an additional role of protecting the economy from high inflation domestically and unhealthy developments abroad. Though inflation to some extent is inevitable in the process of growth, fiscal measures must be designed to curb inflationary forces.
- The approach to fiscal policy in an economy which is developing must be aggregative as well as segmental.
- The foremost aim of fiscal policy in underdeveloped countries is to mobilize resources in the private and public sectors.
- Fiscal policy helps to accelerate the rate of economic growth by raising the rate of investment in public as well as private sectors.

- Aim of the fiscal policy should be to make investment on social and economic overheads such as transportation, communication, technical training, education, health and soil conservation.
- Fiscal instruments are also used in under developed economies to provide subsidized food and production inputs to the poor people.
- The fiscal tools should be employed in such a way as to divert resources from less useful production to more useful channels. This can be done by various tax incentive measures and government subsidy programs.
- Increase in production and productivity can be influenced by fiscal policy to a greater extent.
- By providing fiscal incentives to the private sector and by setting up industries in the public sector in these geographical areas, the government can achieve balanced development of the country.
- Fiscal policy can take several steps to control inflationary forces in the economy. They are:

- Reducing the purchasing power of the people through Compulsory Deposit Scheme
- Mobilizing resources through public debt
- Levying of Expenditure Tax
- Imposing more taxes on renter class
- Raising the rate of Capital Gains Tax
- Raising the percentage deduction of provident fund
- Making of public investment in such production projects as have short gestation period
- Mobilizing more resources by way of public borrowing and using the same in production projects.

Unemployment:

Unemployment is defined as a state of affairs when there are a number of persons who are able and willing to work at prevailing wage rates do not find work. To put it differently, the word unemployment is used for those people who are involuntarily unemployed. People who are voluntarily unemployed or unfit for work are excluded from the category of unemployed.

Types of unemployment

Frictional unemployment: Frictional unemployment is unemployment that exists as a result of individuals' shifting between jobs and looking for new jobs. The distinguishing feature of frictional unemployment is that it is short-lived. When presently frictionally unemployed persons get jobs, the new frictionally unemployed persons come into existence and thus there is always some frictional unemployment prevailing in the economy. The frictionally unemployed persons are said to be "between jobs".

Structural unemployment: Structural unemployment refers to workers who have lost their jobs because they have been displaced by automation, because their skills are no longer in demand or for other similar reasons. Structurally unemployed persons will need to acquire new skills and training before they will be absorbed in the new technologically superior jobs. Structural unemployment tends to last much longer than frictional unemployment because more time is required for people to get new training or acquire new skills.

It may be noted that frictional and structural types of unemployment together constitute what is called **natural rate of unemployment**. The natural rate is estimated to be 4 to 6 percent of the labor forces. Full employment is said to prevail despite the existence of natural rate of unemployment which can never be eliminated.

Cyclical unemployment: Cyclical unemployment is the portion of unemployment that is due to the fact that the aggregate demand of the community is not sufficient to absorb the entire production that can be produced with the full employment of resources. As this type of unemployment appears in a phase of business cycle (recession), it is called cyclical unemployment.

Disguised unemployment: The word disguised means concealed or hidden. So disguised unemployment is that type of unemployment that cannot be seen. This type of unemployment is hidden in the sense that persons are apparently employed but contribute nothing to the total output. The acid test of disguised unemployment is that if such persons are withdrawn from their place of work, it does not bring any decline or fall in the total output.

Seasonal unemployment: Seasonal unemployment arises because of the seasonal character of a particular productive activity so that people become unemployed during the slack season. Agriculture is a seasonal occupation so that the farmers have not sufficient work to do during the slack season. Other examples of seasonal industry are the ice factories, the rice mills, the sugar mills, etc.

Measures to remove unemployment:

The frictional and structural unemployment cannot be removed by any way because they are unavoidable by nature. But seasonal, disguised and cyclical unemployment may be removed by the following measures:

Measures to remove seasonal unemployment: To remove seasonal unemployment, rearranging the production process has to be made, and where this is not possible, complementary and subsidiary jobs have to be created for the people suffering from seasonal unemployment.

Measures to remove disguised unemployment: To remove this sort of unemployment, capital formation has to be kept sufficiently high so that employment opportunities are successively enlarged to absorb the additions to working force of the country as a result of population growth. For this purpose, every possible encouragement should be given to savings and their productive utilization in increasing the rate of investment.

Measures to remove cyclical unemployment: Government can adopt the following measures to remove the cyclical unemployment:

1) The government may decide to induce the private investor to invest more. For this purpose, government may pursue a chief money policy of lowering the rate of interest.

2) Alternatively, the government may encourage private investment by reducing various taxes or by giving subsidies or other facilities related to investment.

3) The government may try to boost up private consumption by reducing consumption related taxes or personal income tax.

4) The government may itself decide to increase its expenditures by resorting to a public works program.