Monetary policy

Monetary policy refers to the credit control measures adopted by the central bank of a country.

Monetary policy is the macroeconomic policy laid down by the central bank. It involves management of money supply and interest rate and is the demand side economic policy used by the government of a country to achieve macroeconomic objectives like inflation, consumption, growth and liquidity.

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.

Johnson defines monetary policy "as policy employing central bank's control of the supply of money as an instrument for achieving the objectives of general economic policy."

G.K. Shaw defines it as "any conscious action undertaken by the monetary authorities to change the quantity, availability or cost of money."

Objectives or Goals of Monetary Policy

The following are the principal objectives of monetary policy:

1. **Full Employment**

Full employment has been ranked among the foremost objectives of monetary policy. It is an important goal not only because unemployment leads to wastage of potential output, but also because of the loss of social standing and self-respect.

2. **Price Stability**

One of the policy objectives of monetary policy is to stabilise the price level. Both economists and laymen favour this policy because fluctuations in prices bring uncertainty and instability to the economy.

3. **Economic Growth**

One of the most important objectives of monetary policy in recent years has been the rapid economic growth of an economy.
Economic growth is defined as "the process whereby the real per capita income of a country increases over a long period of time."

4. **Balance of Payments**

Another objective of monetary policy since the 1950s has been to maintain equilibrium in the balance of payments.

Instruments of Monetary Policy

The instruments of monetary policy are of two types:

- *First*, quantitative, general or indirect; and
- *Second*, qualitative, selective or direct.

They affect the level of aggregate demand through the supply of money, cost of money and availability of credit.

- ✓ The first category includes bank rate variations, open market operations and changing reserve requirements. They are meant to regulate the overall level of credit in the economy through commercial banks.

- ✓ The selective credit controls aim at controlling specific types of credit. They include changing margin requirements and regulation of consumer credit.

We discuss them as under:

1. **Bank Rate Policy.**

The bank rate is the minimum lending rate of the central bank at which it rediscounts first class bills of exchange and government securities held by the commercial banks. When the central bank finds that inflationary pressures have started emerging within the economy, it raises the bank rate. Borrowing from the central bank becomes costly and commercial banks borrow less from it. The commercial banks, in turn, raise their lending rates to the business community and borrowers borrow less from the commercial banks. There is contraction of credit and prices are checked from rising further. On the contrary, when prices are depressed, the central bank lowers the bank rate. It is cheap to borrow from the central bank on the part of commercial banks. The latter also lower their lending rates. Businessmen are encouraged to borrow more. Investment is encouraged. Output, employment, income and demand start rising and the downward movement of prices is checked.

2. **Open Market Operations.**

Open market operations refer to sale and purchase of securities in the money market by the central bank. When prices are rising and there is need to control them, the central bank sells securities. The reserves of commercial banks are reduced and they are not in a position to lend more to the business community.

Further investment is discouraged and the rise in prices is checked. Contrariwise, when recessionary forces start in the economy, the central bank buys securities. The reserves of commercial banks are raised. They lend more. Investment, output, employment, income and demand rise and fall in price is checked.

3. Changes in Reserve Ratios.

This weapon was suggested by Keynes in his *Treatise on Money* and the USA was the first to adopt it as a monetary device. Every bank is required by law to keep a certain percentage of its total deposits in the form of a reserve fund in its vaults and also a certain percentage with the central bank. When prices are rising, the central bank raises the reserve ratio. Banks are required to keep more with the central bank. Their reserves are reduced and they lend less. The volume of investment, output and employment are adversely affected. In the opposite case, when the reserve ratio is lowered, the reserves of commercial banks are raised. They lend more and the economic activity is favourably affected.

4. Selective Credit Controls.

Selective credit controls are used to influence specific types of credit for particular purposes. They usually take the form of changing margin requirements to control speculative activities within the economy. When there is brisk speculative activity in the economy or in particular sectors in certain commodities, and prices start rising, the central bank raises the margin requirement on them. The result is that the borrowers are given less money in loans against specified securities. For instance, raising the margin requirement to 60% means that the pledger of securities of the value of Rs 10,000 will be given 40% of their value, i.e. Rs 4,000 as loan. In case of recession in a particular sector, the central bank encourages borrowing by lowering margin requirements.

Types of Monetary Policy

There are two types of monetary policy, these are:

1. Expansionary Monetary Policy_____ to cure recession or depression
2. Restrictive or Tight Monetary Policy ______ to control inflation

Expansionary Monetary Policy

An expansionary (or *easy*) monetary policy is used to overcome a recession or a depression or a deflationary gap. When there is a fall in consumer demand for goods and services, and in business demand for investment goods, a deflationary gap emerges. The central bank starts an expansionary monetary policy that eases the credit market conditions and leads to an upward shift in aggregate demand. For this purpose, the central bank purchases government securities in the open market, lowers the reserve requirements of member banks, lowers the discount rate and encourages consumer and business credit through selective credit measures. By such measures, it decreases the cost and availability of credit in the money market, and improves the economy.

The expansionary (*cheap*) monetary policy is explained in terms of Figure 1 (A) and (B) where the initial recession equilibrium is at *R*, *Y*, *P* and *Q*. At the interest rate *R* in Panel (A) of the figure, there is already an excess money supply in the economy. Suppose the central bank credit policy results in an increase in the money supply in the economy. This leads to a rightwards shift of the *LM* curve to *LM***1**. This increases income from *OY* to *OY***1** and aggregate demand expands and the demand curve *D* shifts upwards to *D***1** in panel (B). With the increase in the demand for goods and services, output increases from *OQ* to *OQ***1** at a higher price level *P***1**. If the expansionary monetary policy operates smoothly, the equilibrium at *E***1** can be at the full employment level

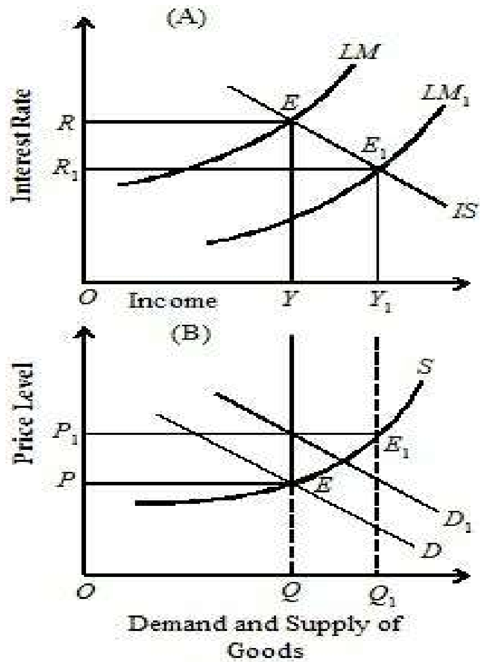

Fig. 1

Restrictive Monetary Policy

A monetary policy designed to curtail aggregate demand is called restrictive (or *dear*) monetary policy. It is used to overcome an inflationary gap. The economy experiences inflationary pressures due to rising consumers' demand for goods and services and there is also boom in business investment. The central bank starts a restrictive monetary policy in order to lower aggregate consumption and investment by increasing the cost and availability of bank credit. It might do so by selling government securities in the open market, by raising reserve requirements of member banks, by raising the discount rate, and controlling consumer and business credit through selective measures. By such measures, the central bank increases the cost and availability of credit in the money market and thereby controls inflationary pressures. The restrictive monetary policy is also explained in terms of Figure 1 (A) and (B) where the initial recession equilibrium is at $R1$, $Y1$, $P1$ and $Q1$. At the interest rate $R1$ in Panel (A) of the figure, there is already an excess money supply in the economy. Suppose the central bank credit policy results in a decrease in the money supply in the economy. This leads to a leftward shift of the $LM1$ curve to LM. This decreases income from $OY1$ to OY and aggregate demand falls and the demand curve $D1$ shifts downwards to D in panel (B). With the decline in the demand for goods and services, output falls from $OQ1$ to OQ at a lower price level P.

Fiscal Policy

Fiscal policy is defined as the policy under which the government uses the instrument of taxation, public spending and public borrowing to achieve various objectives of economic policy.

Fiscal policy means the use of taxation and public expenditure by the government for stabilisation or growth.

Fiscal policy consists of changes in government expenditures and/or taxes to achieve economic goals, such as low unemployment, price stability, and economic growth.

According to **Culberston**, "By fiscal policy we refer to government actions affecting its receipts and expenditures which are ordinarily taken as measured by the government's receipts, its surplus or deficit."

Arthur Smithies defines, fiscal policy as "a policy under which the government uses its expenditure and revenue programmes to produce desirable effects and avoid undesirable effects on the national income, production and employment."

Otto Eckstein defines fiscal policy as "changes in taxes and expenditures which aim at short-run goals of full employment and price level stability."

Though the ultimate aim of fiscal policy is the long-run stabilisation of the economy, yet it can be achieved by moderating short-run economic fluctuations.

Objectives of Fiscal Policy

The following are the objectives of fiscal policy:

1. To maintain and achieve full employment.
2. To stabilise the price level.
3. To stabilise the growth rate of the economy.
4. To maintain equilibrium in the balance of payments.
5. To promote the economic development of underdeveloped countries.

Instruments/ Tools of Fiscal Policy

Fiscal policy through variations in government expenditure and taxation profoundly affects national income, employment, output and prices. An increase in public expenditure during depression adds to the aggregate demand for goods and services and leads to a large increase in income via the multiplier process; while a reduction in taxes has the effect of raising disposable income thereby increasing consumption and investment expenditure of the people. On the other hand, a reduction of public expenditure during inflation reduces aggregate demand, national income, employment, output and prices; while an increase in taxes tends to reduce disposable income and thereby reduces consumption and investment expenditures. Thus the government can control deflationary and inflationary pressures in the economy by a judicious combination of expenditure and taxation programs.
We discuss the following instruments of fiscal policy.

Compensatory Fiscal Policy
The compensatory fiscal policy aims at continuously compensating the economy against chronic tendencies toward inflation and deflation by manipulating public expenditure and taxes. It, therefore, necessitates the adoption of fiscal measures over the long-run rather than once-for-all measures at a point of time. When there are deflationary tendencies in the economy, the government should increase its expenditure through deficit budgeting and reduction in taxes. This is essential to compensate for the lack in private investment and to raise effective demand, employment, output and income within the economy. On the other hand, when there are inflationary tendencies, the government should reduce its expenditure by having a surplus budget and raising taxes in order to stabilise the economy at the full employment level.

The compensatory fiscal policy has two approaches:
(1) Built-In Stabilisers; and
(2) Discretionary Fiscal Policy.

1. **Built-in Stabilisers**

The technique of built-in flexibility or stabilisers involves the automatic adjustment of expenditure and taxes in relation to cyclical upswings and downswings within the economy without deliberate action on the part of the government. Under this system, changes in the budget are automatic and hence this technique is also known as one of automatic stabilisation. The various automatic stabilisers are corporate profits tax, income tax, excise taxes, old age, survivors and unemployment insurance and unemployment relief payments. As instruments of automatic stabilisation, taxes and expenditure are related to national income. Given an unchanged structure of tax rates, tax yields vary directly with movements in national income, while government expenditure varies inversely with variations in national income. In the downward phase of the business cycle when national income is declining, taxes which are based on a percentage of national income automatically decline, thereby reducing the tax yield. At the same time, government expenditures on unemployment relief and social security benefits automatically increase. Thus there would be an automatic budget deficit which would counteract deflationary tendencies. On the other hand, in the upward phase of the business cycle when national income is rising rapidly, the tax yield would automatically increase with the rise in tax rates. Simultaneously, government expenditures on unemployment relief and social security benefits automatically decline. These two forces would automatically create a budget surplus and thus inflationary tendencies would be controlled automatically.

2. **Discretionary Fiscal Policy**

Discretionary Fiscal Policy requires deliberate change in the budget by such actions as changing tax rates or government expenditure or both.
It may generally take three forms:

(i) changing taxes with government expenditure constant,
(ii) changing government expenditure with taxes constant, and
(iii) variations in both expenditure and taxes simultaneously.

(i) When taxes are reduced, while keeping government expenditure unchanged, they increase the disposable income of households and businesses. This increases private spending. But the amount of increase will depend on whom the taxes are cut, to what extent, and on whether the taxpayers regard the cut temporary or permanent. If the beneficiaries of tax cut are in the higher middle income group, the aggregate demand will increase much. If they are businessmen with little incentive to invest, tax reductions are temporary. This policy will again be less effective. So this is more effective in controlling inflation by raising taxes because high rates of taxation will reduce disposable income of individuals and businesses thereby curtailing aggregate demand.

(ii) The second method is more useful in controlling defationary tendencies. When the government increases its expenditure on goods and services, keeping taxes constant, aggregate demand goes up by the full amount of the increase in government spending. On the other hand, reducing government expenditure during inflation is not so effective because of high business expectations in the economy which are not likely to reduce aggregate demand.

(iii) The third method is more effective and superior to the other two methods in controlling inflationary and deflationary tendencies. To control inflation, taxes may be increased and government expenditure be raised to fight depression.

Types of Fiscal Policy

There are two types of fiscal policy, these are:

1. Expansionary fiscal policy
2. Contractionary fiscal policy

Expansionary fiscal policy

Expansionary fiscal policy calls for increases in government expenditures and/or decreases in taxes in order to achieve macroeconomic goals.

Contractionary fiscal policy

Contractionary fiscal policy is implemented through decreases in government expenditures and/or increases in taxes to achieve macroeconomic goals.

In sum, we have

- ✓ *Expansionary fiscal policy:* Government expenditures are up and/or taxes are down.
- ✓ *Contractionary fiscal policy:* Government expenditures are down and/or taxes are up.

When deliberate government actions bring about changes in its expenditures and taxes, fiscal policy is said to be *discretionary*.
For example, a decision by Congress to increase government spending by, say, $10 billion in an attempt to lower the unemployment rate is an act of discretionary fiscal policy.

In contrast, a change in either government expenditures or taxes that occurs automatically in response to economic events is referred to as an act of automatic fiscal policy.
Suppose Real GDP in the economy turns downward, causing more people to become unemployed and, as a result, to automatically receive unemployment benefits. These added unemployment benefits automatically boost government spending.

Difference/ Comparison between monetary and fiscal policy

Monetary Policy	Fiscal Policy
Definition	
It is a financial tool that is used by the central banks in regulating the flow of money and the interest rates in an economy	It is a financial tool that is used by the central government in managing tax revenues and policies related to expenditure for the benefit of the economy
Managed By	
Central Bank of an economy	Ministry of Finance of an economy
Measures	
It measures the interest rates applicable for lending money in the economy	It measures the capital expenditure and taxes of an economy
Focus Area	
Stability of an economy	Growth of an economy
Impact on Exchange rates	
Exchange rates improve when there is higher interest rates	It has no impact on the exchange rates
Targets	
Monetary policy targets inflation in an economy	Fiscal policy does not have any specific target
Impact	
Monetary policy has an impact on the borrowing in an economy	Fiscal policy has an impact on the budget deficit