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1. Learning Outcomes

After studying this module, you shall be able to

- Know the importance of various policies taken up by government
- Learn the application of policy
- Identify which policy is appropriate
- Evaluate the fiscal and monetary policy
- Analyze the working of the policies

2. Introduction

The ultimate objective of all developing countries is to achieve the highest level of economic growth. These economies possess enough natural and manpower resources but these have remained under-utilized. The real rate of growth has remained below the targeted rate due to the shortage of capital and other resources. There is no doubt that markets do act in a way that they tend to encourage competition and thus bring about efficiency in the system but markets cannot be trusted to improve the status of the poor where the state has to play a positive role as JE Stiletto states "… market economies are not self-regulating. They cannot simply be left on auto pilot especially if one wants to ensure that the benefits are shared widely…." The state therefore has to play the roles of producer regulator and supplier of social goods like education health drinking water etc. The state is equipped with different policies to perform the above functions. Here we shall limit ourselves to the role of only monetary and fiscal policy in the process of development.

3. Monetary Policy

Monetary policy generally refers to those policy measures of the central bank which are adopted to control and regulate the supply of money & the cost and availability of credit in a country. According to Harry G. Johnson, "the monetary policy refers to a regulatory policy whereby the central bank maintains the control over the supply of money of the realizations of general economic goals". This concept of monetary policy is right for the developed economies. For the developing economies the role of monetary policy is not limited to control the supply of money, as in a growing economy the monetary authority has to moderate the credit and money supply in such a way that the requirements of industry and trade are met but there is a curb on the use of credit for unproductive and speculative motives. Thus according to Paul Enzi an ideal monetary policy is defined "as the effort to reduce to a minimum, the disadvantages and increase the advantages resulting from the existence and operation of a monetary system," we shall here examine the basic objectives, instruments, efficacy and limitations of monetary policy.

Objectives: Following are the main objectives of monetary policy:

(a) **Exchange rate stability**- Since all the economies of the world are open economies who have trade relations with each other, exchange rate stability is required to maintain stability in the balance of payment. Monetary policy seeks to regulate exchange rate in a manner that can improve exports and can generate surplus in the balance of trade.

(b) **Full employment**- Full employment is a situation wherein all those who are able and willing to work at the prevailing rates of wages get employment. To achieve it the level of demand and output should increase. For this there is a need for lower rate of interest so that credit becomes cheaper. It will reduce the cost of production which will increase both the level of output and the level of demand. This in turn will increase the level of employment in order to maintain this level of employment during the period of depression monetary policy must adjust accordingly and efforts should be made to maintain stability between saving and investment.

(c) **Economic growth**- Another equally important objective of monetary policy is economic growth. While in developed countries the main objective of the policy is to maintain the full employment level, in under developed countries the major problem is to raise the level of real income per capita. The low income levels in these economies are due to the low rate of capital formation due to which these economies fail to utilize their natural and human resources keeping their production capacity low. Monetary policy here can play a crucial role in promoting investment and accelerating the rate of capital formation as well discouraging investment in less useful activities.

(d) **Price stability**- Another objective for which monetary policy has been used in most of the developing economies is to attain internal price stability. Price stability means the elimination of wide fluctuations in prices which can not only disrupt the smooth working but can also lead to insecurity and social injustice. While inflation creates hardships to fixed income groups and consumers, deflation is disastrous for both entrepreneurs and labor. Monetary policy seeks to eradicate both these trends in the system. Since the effects of price instability are always cumulative, the monetary policy in the developing countries should help in maintaining price stability over a long period.

(e) **Reduction in economic inequality**- In most of the capitalist and mixed economies there is widespread inequalities in the distribution of wealth and income which divides the society into two classes. One of the objectives of monetary policy is to work as an instrument in achieving equitable distribution of both income and wealth.

In the early stages of development in the less developed countries the monetary policy should be directed in such a way that it should help in promoting savings, their mobilization and their investment in the productive activities. The monetary authority has to provide adequate facilities for mobilization of savings and various incentives to part with their funds. The structure of rate of interest should be such that it should provide incentive to the savers as well as induce the investors to go in for more loans and advances from the banks and other institutions.

One of the important focus areas of monetary policy in a developing economy is to work as an instrument to combat inflation as violent fluctuations in the internal price level adversely affects the rate of economic growth. For this monetary authorities can (a) restrict the supply of money and credit in the economy (b) can increase the cost of money by raising rate of interest (c) can adopt quantitative and qualitative methods to control the quantity and directions of credit or/ and under conditions of inflation going out of control can demonetize the existing currency which will unearth black money.

The basic instruments which are used by monetary authorities are (a) bank rate policy (b) open market operations (c) changing the statutory liquidity ratio (d) changing the cash reserve ratio (e) selective credit controls and (f) changes in Repot Rate and Reverse Repo Rate.

a) **Bank rate-** It refers to a rate of discount at which the central bank rediscounts the approved bills of exchange or it is the rate payable by commercial banks on the loans of the central bank. Bank rate and other rates of interest are inter related. A change in bank rate brings about corresponding changes in the rate of interest. Bank rate policy affects the flow of credit by influencing (a) the demand for credit (b) the cost of credit and (c) the availability of credit. An increase in bank rate will result in contraction in demand, an increase in cost and a smaller supply of bank credit as it is a signal for credit squeeze. In contrast a fall in bank rate will result in expansion of demand as well as an expansion of availability of credit. But in developing economies, the unorganized money market, external cyclical pressures and excess reserves with the commercial banks put a limit to the success of bank rate policy.

b) **Open market operations**- It involves buying and selling of securities by the central bank in the market. When the central bank sells securities a part of money in circulation is withdrawn and the cash reserves of the commercial banks will be reduced. As a result, money supply is reduced this may help in controlling inflationary pressures. Similarly, during deflation, central bank will start purchasing securities. This will increase the cash balances with the commercial banks and the economy. Open market operations by sale and purchase of securities also affect the cost of credit. The technique of open market operations is superior to bank rate as it has a direct effect on availability of liquidity of the banks. Since the initiative remains in the hands of the central bank, it has a direct influence on the cash reserves. In many of the developing economies, where the security market is not well developed, the open market operations may have limited effects as any large scale sale of securities may lower their prices and may disturb the borrowing programme of the Government. Therefore, many monetary economists assert that bank rate policy and open market operations should be used as complementary measures in the field of monetary management.

c) **Variable reserve ratios**- The commercial banks are required by law to keep a ratio of their aggregate demand and time deposit with the central bank. This technique can also be used for combating inflationary pressures. The monetary authority has the right to change this ratio, although a high CRR adversely affects the profitability of commercial banks. In the Indian system it was as high as 15% in 1990-91 from where it has been continuously reduced to 4% to recently.

Similarly, all commercial banks are legally bound to keep a part of their deposit in the liquid form which is known as Statutory Liquid Ratio (SLR). The monetary authority has the

power to determine SLR for the commercial banks so as to ease inflationary pressures as well as making large resources available to the state.

d) **Repo Rate and Reverse Repo Rate**- Repo rate is the rate at which the monetary authority lends to the commercial banks and the reverse repo rate is the rate which is paid by the authority on the funds kept by commercial banks with it. Thus, by repo rate the monetary authority injects liquidity into the system and by reverse repo rate it absorbs the liquidity. The Indian monetary authority i.e., RBI has stopped using bank rate and has decided to shift to a single policy rate regime of repo rate and the reverse repo rate is pegged at one percentage below the repo rate.

e) **Qualitative controls**- In developing economies, monetary authorities not only use quantitative methods of control as the money supply but also controls the credit to specific areas of economic activities so that speculative activities in the essential commodities can be prevented and the inflationary effects are checked. The whole idea is the availability of funds for production, movement of goods and export is not affected adversely but there should be effective control against speculative hoardings.

Monetary policy thus, can emerge as an important instrument of economic management and can help in correcting economic ills and can also help in achieving many macroeconomics goals. It can ensure a smooth functioning of an economy if a number of pre-conditions are met. It can contribute to sustainable economic growth by maintaining a low and stable price situation. If during the growth process an expansionary fiscal policy is used which will expand both plan and non-plan expenditure, monetary policy has to play a difficult role. On the one hand it is required to facilitate the fulfillment of the basic objectives of growth and on the other it has to plays the role of a countervailing force. The fact is that in developing economies there are certain conditions due to which the success of monetary policy is limited e.g. (a) there is persistence of unorganized money and capital market on which the monetary authority has no control (b) as these economies lack integrated structure

of rate of interest, changes in the bank rate do not affect the market rate of interest (c) people are illiterate and do not have banking habits. (d) There is lack of co-ordination and co-operation between the monetary authority and the other banks etc. Since the success of monetary policy depends upon various factors like availability of widespread banking institutions, banking habits, adequate bank deposits and entrepreneurial ability etc., the limitations of these put an obstacle and limits the ability of monetary policy to do good single handedly.

4. Fiscal Policy

Role of Fiscal Policy

Monetary policy alone cannot achieve the objective of sustained economic growth, stability and social justice in a developing economy. Therefore, it is necessary that the monetary policy be supplemented by an effective fiscal policy and both monetary and fiscal policies taken together can prove to be very effective in achieving the objectives of growth with stability.

Fiscal Policy refers to the policy of the Government as regards taxation, public expenditure and public borrowings with specific objectives in view. According to Arthur Smithies "Fiscal Policy is a policy under which the government uses its expenditure and revenue programmes to produce desirable effects and avoid undesirable effects on national income production and employment.

In fact, fiscal policy is a technique to attain and maintain full employment by manipulating and maintain full employment by manipulating public expenditure and revenue in such a way as to keep equilibrium between effective demand and supply of goods and services at a particular time, thus making it a policy based on the principle of functional finance.

Objectives- The objectives of fiscal policy differ from economy to economy according to their level of economic development. While in developed economies the role of fiscal policy is to stabilize the rate of growth and to maintain the level of full employment. In the developing economies fiscal policy aims at accelerating the rate of capital formation, a change in the pattern of investment maintaining sufficient supply of essential consumer goods on the one hand and capital goods on the other. It also aims at just an equitable distribution of national product.

Sometimes these objectives come in conflict with each other as the objective of high growth rate may come in conflict with the distributive objective. Similarly, equitable distribution may adversely affect the rate of saving, investment and thus retard the rate of economic growth. But efforts should be made to achieve reconciliation between these conflicts. The basic objectives of fiscal policy in a developing economy are influencing growth by influencing.

(a) Mobilization of resources- Since most of the developing economies are caught in the vicious circle of poverty which keeps a poor country in a state of poverty, the aim of fiscal policy is to break this vicious circle of poverty. For this there is an utmost need to increase the rate of investment and capital formation so as to accelerate the rate of growth. This can be done through voluntary savings. But as the level of per capita income is very low enough voluntary savings are not available. The Government, therefore, has to depend upon taxation and public borrowings. Fiscal policy can mobilize more resources if it is able to prevent the growth of black money and restrict the non-plan expenditure of the government. By curbing black money the consumption expenditure on luxury services can be reduced and saving propensity is raised.

(b) Efficient allocation of resources- The growth performance of an economy is not only influenced by the availability of resources but also by an efficient and rational allocation of these resources. A fiscal policy which is indifferent to efficient resource allocation retards the productive activity and thereby the rate of economic growth. Among the various instruments tax structure can be an effective determinant of the efficiency of use of resources. A progressive tax policy, a balance in the ratios of direct and indirect taxes and a rational tax structure can affect both the revenue generation and the competitiveness. Besides the expenditure policy of the government should also ensure the efficiency of resource use.

(c) Fiscal policy and equity- Maintaining equity in the distribution is not only an objective but a pre-condition of economic growth. The fiscal policy should be formulated in such a way that its various instruments are able to reduce disparity in the society so as to reduce political and social discontentment which generates instability in the economy. For this the fiscal policy should have a redistributive public expenditure and tax policy. Progressive tax policy, a curb on black money and higher expenditure of the government on social services or in areas which benefit the poor can reduce the gap between rich and poor.

(d) To accelerate employment opportunities- By adopting a counter cyclical fiscal policy, under which government spending being cut and taxes increased in the expanding phase of the business cycle and reducing taxes and increment govt. expenditure in contracting phase can open new job opportunities in the economy. A progressive tax policy will be both socially desirable and economically advantageous. Similarly, public debt policy can be used to control the non-essential private consumption expenditure as well as to raise small savings which can be used for financing the development expenditure and increase employment opportunities.

(e) Price stability- Since developing economies face the problem of shortage of capital and the scope of taxation and public debt is limited the govt. resort to deficit financing. This increase in supply of money creates inflationary conditions in the economy. A continuous increase in prices raises the cost of development projects.

The fiscal policy, therefore, should aim at curbing inflationary pressures which is inherent in the developing economies due to imbalance between demand and supply. For this a package of fiscal measures can be adopted which may include the withdrawal of purchasing power through taxes, compulsory savings and public borrowings. Tax policy should be progressive so that it should not harm the poorer sections and should encourage voluntary savings.

Although fiscal measures are insulators against inflation, theoretically as the govt. can raise taxes, decrease expenditure, increase public borrowings to mop up purchasing power and can adopt a surplus budget policy but practically these measures have limited success as frequent changes in the fiscal measures are not possible.

Fiscal policy works through four principal instruments (a) taxation policy (b) government expenditure policy both on goods and services and on transfer payments (c) public debt policy and (d) deficit financing. Taxation is the most significant measure of fiscal policy which directly affects people's disposable income and thereby the market demand. There are two types of taxes which can be used to moderate the pressure of demand.

Theoretically during inflation, the rates of direct taxes like income tax, expenditure tax etc should be increased or some new taxes should be levied so that less money is left in the hands of the people which will reduce consumption expenditure and thereby the market demand. Indirect taxes if increased add to the cost and are thus passed on to the buyers in the form increased prices. Therefore, indirect taxes are generally not increased in the inflationary situation as these will add to the inflation. Taxation policy may also affect the level of investment. A policy of tax reduction and tax concession gives incentive to investment and thereby helps in increasing output, income and employment and to faster growth of the economy. On the other hand, high tax rates may provide disincentive to investment and a fall in investment may lead to a fall in income and the aggregate demand.

Expenditure- Fiscal policy by reducing public expenditure during inflation and by increasing govt. expenditure during depression can help in maintaining stability. The problem with public expenditure policy is that it is the non-developmental expenditure which deteriorates the fiscal situation. The fiscal deficit which indicates the total resource gap between govt. expenditure and govt. revenue is a matter of concern. To finance this deficit if the government resorts to deficit financing, there is always an apprehension of rise in prices. To reduce this deficit, the govt. can increase taxation and reduce public expenditure. But in case of a rational tax structure when tax rates cannot be raised it is the reduction in public expenditure which should be used. While doing so the govt. should not reduce the capital expenditure as a ratio of GDP, otherwise the infrastructure development and thus the overall growth process would be disrupted. Besides there should be a check on direct subsidies and the interest payments which entail a large claim on public revenues should be managed properly.

Public Debt- The market demand is also influenced by public debt policy. Public debt is of two kinds (I) internal debt and (ii) external debt. In order to meet the increasing requirements of expenditure both central and state governments raise debts. The burden of public debt is not limited to the interest burden only. Much depends on how these funds are used. If a major part of the public debt is spent on unproductive activities, it becomes a dead -weight loss. But if these funds are used on developmental activities, they raise the productive capacity of the economy.

Public debt policy can be used to control the non- essential private consumption expenditure and to raise small savings for financing the development expenditure in these developing economies. The government can issue bonds with attractive rates of interest to encourage people to purchase these.

But no developing economy can depend too much upon public debt policy for the development process because public debt policy will prove effective only when these funds are collected through the idle balances lying with the people. If the public borrowings results in the fall in current consumption expenditure or reduce investment in the private sector, it will not have desirable effects.

Evaluation- There is no doubt that fiscal policy by adopting a combination of different instruments can help in achieving the objectives of economic growth by mobilizing resources, can help in reducing inequalities through redistribution can also help in stabilizing prices. But the measures of fiscal policy are mostly long term. Besides there are information lag, policy formulation lag and executions lags in the implementation of this policy.

Fiscal policy has achieved great success in the developed countries. It has a multidimensional role in the developing economies as it aims at improving the growth performance of the economy and ensuring social justice to the people. But the nature and fundamental characteristics of the developing economies are responsible for only a partial success of this policy.

The tax structure in these economies is narrow and rigid. A well-knit integrated tax policy is required for the success of fiscal measures conducive to economic growth. The non-monetized sector in the developing economies puts an obstacle in effective implementation of fiscal measures. Since majority of the people are poor and illiterate, they neither understand the implications of fiscal policy nor can they contribute to the govt. revenue. Besides there is large scale tax evasion due to which the govt. fail to collect the required amount from taxes. Beside the corrupt and inefficient administrative machinery is incapable to execute fiscal policy honestly and effectively. The developing economies even lack proper statistical information as regards savings, investment employment etc. which makes it difficult for the public authorities to formulate a rational and effective fiscal policy. The market imperfections, bottlenecks, shortages and lack of entrepreneurial skills do not allow fiscal policy to work effectively.

The ultimate aim of developing economies is to attain a high level of economic growth & the main obstacle in the path are the paucity of capital, technical know-how and certain social institutions. The state equipped with monetary and fiscal policy can keep an overall control. But one policy in the absence of the other cannot achieve the objectives of sustained growth stability and social justice. It is therefore, essential that both monetary and fiscal policies should play a complementary role to each other to take the developing economy from a stage of primary backwardness to a stage of self-sustained growth.

5. Summary

- Economic growth is the primary area of concern for a country. Hence, fiscal and monetary policy are used if any problems come in the way.
- Monetary policy generally refers to those policy measures of the central bank which are adopted to control and regulate the supply of money & the cost and availability of credit in a country
- Fiscal Policy refers to the policy of the Government as regards taxation, public expenditure and public borrowings with specific objectives in view.
- Fiscal policy is generally carried out by government.
- Monetary policy is carried out by the central banks.