Engineering Economics

Chepter-5

1. Explain the Monetary Policy in detail(Meaning, Objectives, Tools).

Answer:-

Introduction to Monetary Policy

Monetary policy is the process by which monetary authority of a country (generally a central bank) controls the supply of money in the economy by its control over interest rates. In India, Reserve Bank of India (RBI) frames monetary policy.

Objectives of the Monetary Policy of India, As Stated By RBI

1. Price Stability

- The price stability refers to the maintenance of purchasing power of the money across the time.
- The cyclical fluctuations of booms and depressions affect all the stakeholders in the economy, some with positive effects and others with negative effects.

- The price stability results into smooth economic activities with its judicious impacts on stakeholder.
- Price stability promotes income generation, savings, investments and employment.

2. Exchange Rate Stability

- The exchange rate is the dual rate between the two trading nations having different local currencies.
- E.g. Indian Rupees vs US Dollar. RBI has to manage the money supply in such a strategic manner that the external value of the rupee is stabilized over a period of time.
- When rupee is traded at premium then Indian importer will be gainer and Indian exporter will be loser.
- The situation is reversed when rupee will be traded at discount.

3. High Economic Growth

- An increase in the capacity of an economy to produce goods and services, compared from one period of time to another.
- It is measured in Gross Domestic Product (GDP) or GDP per Capita.

4. Controlled Expansion of Bank Credit

- One of the important functions of RBI is the controlled expansion of bank credit and money supply with special attention to seasonal requirement for credit without affecting the output.

5. Promotion of Fixed Investment

- The aim here is to increase the productivity of investment by limiting non-essential fixed investment.

6. To Promote Efficiency

- It is another essential aspect where RBI pay a lot of attention.
- It tries to increase the efficiency in the financial system and tries to incorporate structural changes such as deregulating interest rates, ease operational constraints in the credit delivery system, to introduce new money market instruments etc.

7. Reducing the Rigidity

- RBI tries to bring about the flexibilities in the operations which provide a considerable autonomy.
- It encourages more competitive environment and diversification.
- It maintains its control over financial system whenever and wherever necessary to maintain the

discipline and prudence in operations of the financial system.

Tools of Monetary Policy

The basic objective of the monetary policy is to monitor and regulate the quantity (supply of money) and cost (interest rates). This is beneficial to the long term economic growth of an economy.

Tools used to implement monetary policy can be classified in two categories, Quantitative tools and Qualitative tools.

Quantitative Tools (Also known as General Credit Control Tools)

The quantitative tools regulate the money supply through its various tools like Bank Rate, Open Market Operations, Cash Reserve Ratio, Statutory Liquidity Ratio, Repurchase Option, Reverse Repo rate, etc. These are revised every quarter in India by RBI.

1. Repo Rate

- The (fixed) interest rate at which the Reserve Bank provides overnight liquidity to banks against the surety of government and other approved securities under the liquidity adjustment facility. Current repo rate in India (Aug 2017) is 6%.

2. Reverse Repo Rate

- The (fixed) interest rate at which the Reserve Bank absorbs liquidity, on an overnight basis, from banks against the surety of eligible government securities under the LAF.
- Current reverse repo rate in India (Aug 2017) is 5.75%.

3. Marginal Standing Facility (MSF)

- A facility under which scheduled commercial banks can borrow additional amount of overnight money from the Reserve Bank.
- Amount a bank can borrow is limited and by reducing into their Statutory Liquidity Ratio (SLR) portfolio at a penal rate of interest.
- This provides a safety valve against unexpected liquidity shocks to the banking system. Current MSF rate in India (Aug 2017) is 6.25%.

4. Bank Rate (BR)

- It is the rate at which the Reserve Bank is ready to buy or rediscount bills of exchange or other commercial papers.
- The Bank Rate is published under Section 49 of the Reserve Bank of India Act, 1934.
- This rate has been aligned to the MSF rate and, therefore, changes automatically as and when the MSF

rate changes alongside policy repo rate changes. Current bank rate in India (Aug 2017) is 6.25%.

5. Cash Reserve Ratio (CRR)

- The average daily balance that a bank is required to maintain with the Reserve Bank as a share of such per cent of its Net demand and time liabilities (NDTL).
- That balance may notify from time to time by the Reserve Bank in the Gazette of India. Current CRR in India (Aug 2017) is 4%.

6. Statutory Liquidity Ratio (SLR)

- The share of Net demand and time liabilities (NDTL) that a bank is required to maintain in safe and liquid assets, such as, government securities, cash and gold.
- Changes in SLR often influence the availability of resources in the banking system for lending to the private sector.
- Current SLR in India (Aug 2017) is 20%.

7. Open Market Operations (OMOs)

- These include both, outright purchase and sale of government securities, for injection and absorption of durable liquidity, respectively.

8. Market Stabilization Scheme (MSS)

- This tool for monetary management was introduced in 2004.
- Excess liquidity of a more stable nature arising from large capital inflows.
- It is absorbed through sale of short-dated government securities and treasury bills.
- The cash so mobilized is held in a separate government account with the Reserve Bank.

Qualitative Tools (Also known as Selective Credit Control Tools)

These tools are industry and segment specific hence they are also known as selective credit control tools

1. Credit Rationing

- Credit rationing refers to the situation where lenders limit the supply of additional credit to borrowers who demand funds, even if the latter are willing to pay higher interest rates. It is an example of market failure, as the price mechanism fails to bring about equilibrium in the market.

- The term rationing refers to the careful decision about the use of any limited or important resource.

The resource allocation is generally done in two popular ways 1) Based on Demand & Supply 2) Administered allocation by the central authority.

- The bank credit is a critical national resource. It has to be used in a planned manner as per the planned objectives as specified by the Government. The RBI is a central authority in India which manages credit rationing policy. It also depends on sectors, may be liberal credit policy for agriculture sector and tight credit policy for aviation industry.

2. Margin Requirements

- A Margin Requirement is the percentage of marginable securities that a customer must pay for loan or credit. e.g. A person buys house worth Rs. 1,00,000 against loan, Suppose bank gives loan of Rs. 80,000 only then person has to pay Rs. 20,000 . Thus marginal requirement in this example is 20%.

- It is also known as Safety Margin. The security oriented bank credit reduces the chances of bank lending becoming bad or turning into a Non Performing Asset (NPA). Safety Margin also depends on sector. E.g. May be 0% in education sector and 30% in real estate.

3. Moral Persuasion/Suasion

- Notice issue and don’t give loans in particular sector.

4. Direct Control

- RBI directly control commercial banks.

2. Explain the Fiscal Policy in detail(Meaning, Objectives, Tools).

Answer:-

Introduction to Fiscal Policy

Fiscal policy is the means by which a government adjusts its spending levels and tax rates to monitor and influence a nation's economy.

OR

Fiscal policy is the use of government revenue collection (mainly taxes) and expenditure (spending) to influence the economy.

The role of fiscal policy for economic growth relates to the stabilization of the rate of growth of an advanced country. Fiscal policy through variations in government expenditure and taxation profoundly affects national income, employment, output and prices.

When the government changes the levels of taxation and government spending, it influences aggregate demand and the level of economic activity. Fiscal policy can be used to stabilize the economy over the course of the business cycle.

It is the sister strategy to monetary policy through which a central bank influences a nation's money supply.

When a government's total expenditures exceed the revenue that it generates (excluding money from borrowings) then it is called fiscal deficit. Fiscal deficit is different than debt, which is an accumulation of yearly deficits.

Objectives of Fiscal Policy

I. To accelerate the Economic Growth

- The principal objective of fiscal policy is to ensure rapid economic growth and development. This objective of economic growth and development can be achieved by efficient Mobilization of Financial Resources.
- Government increases the financial resources internally as well as externally to boost the investment opportunities. Similarly it provides various incentives such as tax concessions to the entrepreneurs and MNC for this purpose. Government can achieve a high rate of economic growth and development if all these measures are carried out through fiscal policy.
- By means of higher rate of economic growth, the problem of unemployment can also be solved. However, it may create some problems in the maintenance of price stability.

II. Efficient allocation of Financial Resources

- The central and state governments have tried to make efficient allocation of financial resources. These resources are allocated for Development Activities which includes expenditure on railways, infrastructure, etc. While Non-development Activities includes expenditure on defense, interest payments, subsidies, etc.
- But generally the fiscal policy should ensure that the resources are allocated for generation of goods and services which are socially desirable. Therefore, India's fiscal policy is designed in such a manner so as to encourage production of desirable goods and discourage those goods which are socially undesirable.

III. Employment Generation

- The government is making every possible effort to increase employment in the country through effective fiscal measure. Investment in infrastructure has resulted in direct and indirect employment. Lower taxes and duties on small-scale industrial (SSI) units encourage more investment and consequently generates more employment. Various rural employment programs have been undertaken by the Government of India to solve problems in rural areas. Similarly, self-employment scheme is taken to provide employment to technically qualified persons in the urban areas.

IV. Price Stability and Control of Inflation

- One of the main objective of fiscal policy is to control inflation and stabilize price. Therefore, the government always aims to control the inflation by reducing fiscal deficits, introducing tax savings schemes, Productive use of financial resources, etc.

V. Equality of Income Distribution and Wealth

- Fiscal policy aims at achieving equity or social justice by reducing income inequalities among different sections of the society. The direct taxes such as income tax are charged more on the rich people as compared to lower income groups. Indirect taxes are also more in the case of semi-luxury and luxury items, which are mostly consumed by the upper middle class and the upper class. The government invests a significant proportion of its tax revenue in the implementation of Poverty Alleviation Programs to improve the conditions of poor people in society.

VI. Capital Formation

- The objective of fiscal policy in India is also to increase the rate of capital formation so as to accelerate the rate of economic growth. An underdeveloped country is trapped in vicious (danger) circle of poverty mainly on account of capital deficiency. In order to increase the rate of capital formation, the fiscal policy must be efficiently designed to encourage savings and discourage and reduce spending.

VII. Balanced Regional Development

- Another main objective of the fiscal policy is to bring about a balanced regional development. There are various incentives from the government for setting up projects in backward areas such as Cash subsidy, Concession in taxes and duties in the form of tax holidays, Finance at concessional interest rates, etc.

VIII. Increasing National Income

- The fiscal policy aims to increase the national income of a country. This is because fiscal policy facilitates the capital formation. This results in economic growth, which in turn increases the GDP, per capita income and national income of the country.

IX. Foreign Exchange Earnings

- Fiscal policy attempts to encourage more exports by way of Fiscal Measures like, exemption of income tax on export earnings, exemption of sales tax and octroi, etc. Foreign exchange provides fiscal benefits to import substitute industries. The foreign exchange earned by way of exports and saved by way of import substitutes helps to solve balance of payments problem.

Tools of Fiscal Policy

The tools of the fiscal policy are the arms which regulate and control the measures for attaining the objectives of the fiscal policy.

1. The quantum of **public expenditure** that can be manageable within the scope of the fiscal measures of fund raining.

2. The volume of **public debt** should be within the reasonable limit to the growth in the national income. As the taxable income supplements to the public borrowings for meeting the public expenditure, the opportunities of public borrowings are also the tools of the fiscal policy.

3. The **taxation** is a prime tool of the fiscal policy. The decisions about the volume of the tax income as a mode of financing the public expenditure is a crucial decision. It should develop a judicious balance between the government needs on one side and the incentives to work for income generation. Too much of taxation kills the incentive to works and it also becomes the basis for hiding the income and paying less tax. Moreover balance should be established

between the direct tax like income tax and indirect tax like excise, custom duties, etc.