Fiscal and Monetary Policies

Fiscal Policies

Major objectives of the govt. at any point of time is to attain economic growth and to maintain price stability. These objectives are fulfilled using the fiscal and monetary policies.

Fiscal Policy: Policies where the govt. uses the balance of taxation (withdrawal) and government expenditure (injection) to influence level of aggregate demand. Fiscal policies are aimed at fine-tuning the economy or to smooth out cyclical fluctuations.

- Govt. expenditure and taxation can also act as **automatic stabilisers**. For example, when the GDP rises, the tax revenue will increase and the rise in withdrawals as tax shall dampen the growth in GDP. Similarly, if GDP rise, unemployment falls and thus the govt. expenditure in terms of unemployment benefits paid shall reduce. This in turn will reduce the disposable income left with people and hence the consumption falls, production falls and the GDP falls.
- **Discretionary fiscal policy** is the one which the govt. enacts purposefully so as to tame an economic situation.

Expansionary fiscal policy aims at reversing a low AD condition (recession) by way of cutting down taxes or increasing govt. expenditure. When taxes fall or govt. expenditure rises, it will result in more disposable income with the people.

Fiscal Policies

This in turn will increase the aggregate demand (AD), production, employment and finally the income (GDP).

Contractionary fiscal policy aims at reducing the aggregate demand (during a boom or inflation) by way of increasing the taxes or reducing the govt. expenditure. Increasing taxes leaves lesser disposable income with the people and thus aggregate demand falls. Similarly, when govt. expenditure falls, it reduces further employment, income and thus the AD demand falls, causing the boom to end.

The impact of the expansionary or contractionary fiscal policies are unpredictable as it is difficult to asses the final outcome of a change in tax or govt. expenditure. Random shocks may also affect the outcome.

Crowding Out Effect

When govt. expenditure increases, it causes a rise in employment and income. As the income of people rises, more goods and services will be demanded and hence AD rises which might lead to inflation. When inflation rises, the Central Bank will raise interest rate so as curb inflation. As a result, investment falls and GDP falls. Thus the expansionary policy aimed at rising AD and GDP might result in the fall of GDP, partly. This is crowding out effect.

Monetary Policies

Monetary Policy

Policy which is intended to affect the aggregate demand by Central Bank's action of altering the interest rates or money supply. The Central Bank controls money supply and credit using various monetary tools, which are:

- Bank rate: The rate at which commercial banks borrow money from RBI for long-term purposes. During inflation when money supply is in excess, RBI will keep the bank rate high. When bank rate is hight, people/commercial banks will find it costlier to avail loans and hence the money supply can be reduced. When there is a recession, bank rate will reduced so as to increase AD and spending in the economy.
- Repo rate and Reverse repo rate

Repo rate is the rate at which commercial banks borrow money from RBI for short-term purposes (Repo rate will be hiked during inflation/boom and lowered during recession).

Reverse repo rate is the rate of interest that commercial banks receive when they park their funds with the RBI.

Monetary Policies

- Open Market Operations (OMOs): Open market operations refers to buying/selling of govt. securities by the Central Bank from/to commercial banks and the general public.

When there is excess money supply (inflation), RBI will sell govt. securities and receive money in return. This will reduce the money supply in the economy. When money supply is less, RBI will buy govt. securities and pay back money to the commercial banks/public, thereby infusing more credit in to the economy.

- Margin requirements: The margin refers to the difference between the actual credit allotted and the value of the security offered.

When money supply is excess in the economy (inflation/boom), RBI keeps the margin requirements high so that it reduces the credit supply. When money supply/credit is low in the economy (recession), the margin requirements will be made lesser so that people get more loan amount. This way, money supply/credit increases in the economy.

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- Reserve requirements

Cash Reserve Ratio (CRR): Refers to the percentage of total deposits that the commercial banks are supposed to park with the RBI in the form of cash.

Statutory Liquidity Ratio (SLR): Refers to the percentage of total deposits that the commercial banks are mandated to keep with themselves in the form of near liquid assets.

During an inflationary situation, both the ratios are raised so as the curb the amount of credit supply in the economy. If banks are mandated to keep more money with them as reserves, they will be left with less amount to lend and hence lowers the money supply.

Other qualitative measures such as selective credit control (to target sectors) and moral suasion (in the form of directions) are also followed by the Central Bank.

Money Market

Role of the Central Bank:

- Issuer of the currency in India
- Banker to the government: All govt. payments and receipts are through the RBI. The bank acts as advisory agent to the government when it comes to the finances.
- Bankers' bank and supervisor: All the commercial banks are regulated by the RBI and it also provides the clearing house function
- Lender of last resort: RBI is the lender of last resort/ last hope for the commercial banks and govt.
- Custodian of foreign exchange reserves: RBI keeps and manages the foreign exchange reserves of the country.
- Controller of money supply and credit.

To control the money supply and credit flow in the economy, the Central Bank using monetary tools.

THANK YOU