Salient features;

FRBM Act provides a legal institutional framework for fiscal consolidation. It is now mandatory for the central government to take measures to reduce fiscal deficit and eliminate revenue deficits.

↓ balance gap b/w expenditure and receipts

This Act is binding to present govt and as well as future governments. and also the govt should implement fiscal consolidation policy. The govt can move away from the path of fiscal consolidation only in case of natural calamity, national security and other exceptional conditions which central govt may specify.

This Act prohibited govts to borrow money from RBI that is making monetary policy independent of fiscal policy. Also this act prevented monetisation of government deficits. This act required the govt to report quarterly to both the houses of parliament which made the govt accountable and more transparent fiscal operations.

- Monetization of govt deficit → or Monetised deficit
  or
  Deficit financing.

When govt is facing higher fiscal deficit, govt borrows from RBI
&
This is called monetization of deficit
↓
leads to increase in money supply in the economy.

Govt HFD ⟷ RBI
take loan (Cash into economy).
|
increases money supply.

If govt / GoI funds its deficits by borrowings from RBI and RBI prints new currency and lends to the govt, this type of funding leads to increase in money supply or liquidity in the economy. Therefore, this funding is known as deficit financing or Monetised deficit.

# Budgetary Deficit (BD) vis-ā-vis Fiscal Deficit (CFD)

| Budgetary Deficit (BD) | Fiscal Deficit (CFD) |
| --- | --- |
| – always used since independence | – Started using 1997. It replaced Budgetary deficit |
| – Total expenditure (Revenue + Capital) minus (–) total receipts including all borrowings from RBI but excluding other borrowing. (+RBI – other borrowing). | – Total Expenditure (Revenue + Capital Expenditure) minus (–) Total receipts (Excluding all borrowings) |

* Demand for Money ; $M^d$

amount of cash you want hold for different purposes.

3 types of demand for money ;

1) Transaction demand for money.
2) Speculative demand for money.
3) Precautionary demand for money.

1) Transaction demand for money ($L_1$) (TDM): The money demanded to meet the day to day transactions is known as transaction demand for money.

TDM depends on level of income. as level of incomes increases, the transaction demand will increase. & vice versa.

$$L_1 = f(Y) \quad Y \to \text{income}$$

$$Y\uparrow = L_1\uparrow$$

$$Y\downarrow = L_1\downarrow$$

2) Precautionary DM (PDM) ($L_3$): The money demanded to meet unexpected, unseen event or money for precautions against unexpected, unseen events is known as PDM.

– it depends on level of income. If level of income increase, the PDM will go up and vice versa.

$$L_3 = f(Y) \qquad L_3\uparrow = Y\uparrow$$
$$L_3\downarrow = Y\downarrow$$

# 3) Speculative Demand for Money (SDM) ($\alpha_2$)

$\alpha_2 = f(i)$ rate of interest (return)

$i\uparrow = \alpha_2\downarrow$ Inversely related
$i\downarrow = \alpha_2\uparrow$

---

W — Wealth (50,000)

keep it as

Speculative part of wealth — Cash | Bond. assumed no other place to invest.

**Cash**
- > Nominal value remains same.
- > Most liquid asset.
- > No returns.
- > Real value keeps on declining

**Bond**
- > Capital gain or return
- > Possibility of Capital loss.

• The money demanded for speculative purpose is known as SDM or $\alpha_2$. SDM depends on rate of interest. If rate of interest increases, the SDM will decrease and vice versa

So, $\alpha_1(Y) + \alpha_2(i) + \alpha_3(Y)$
= Total Demand for Money Md.

as $\alpha_3(Y)$ is marginal

so

$$Md = \alpha_1 + \alpha_2$$

$$\downarrow$$

$$(\alpha_1 + \alpha_3)$$

OR

$$Md = f(Y, i)$$

or

$$Md = f(\underset{(+)}{Y}, \underset{(-)}{i})$$ — related.

Monetary (MP) and Fiscal Policy (FP); they can never be independent

there relationship

Y is output

tax incentives

| FP | MP |
|---|---|
| G↑ & T↓ | $Md = MS$ |
| ↓ | $Md \uparrow \to M_1d$ |
| AD↑ | $M_1d > MS$ |
| ↓ | Excess Md. |
| Y↑ | ⇓ |
| | i↑ — rate of interest goes up. |

← Y - this is level

Assume this is economy.

So i↑ so investment decrease the AD↓ then

Y↓

↓

we miss

but govt wants $Y_F$ - output at full employment.

Alternatively,



Fiscal Policy | Monetary Policy

Higher inflation

Higher fiscal deficit

It should decrease money supply

$M_s \downarrow$

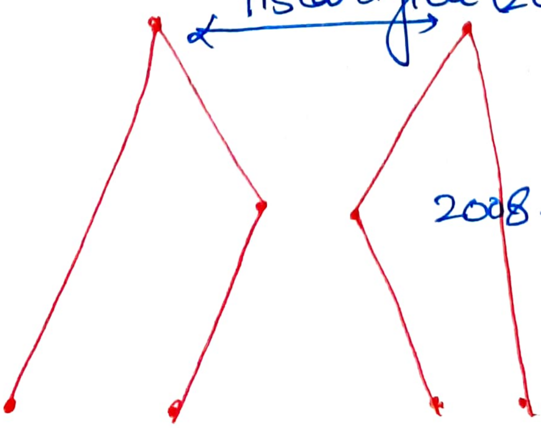
Funding from RBI $= M_s \uparrow$ ← contradictory impulses.

as per requirement of economy.

FRBM doesnot allow Monetary authority to fund fiscal policy → giving MP independence.

# * Implementation of FRBM Act;

Fiscal deficit (2004-05) — FRBM Act.



2008 - Global Financial crisis

Demand From private sector

$AD = C + I + G + X - M$

$G \downarrow$

$\downarrow$

if $G \downarrow$ & $T \uparrow \Rightarrow AD \downarrow$

So total
AD for goods & services
is
the sum of
Private demand + Government
demand.

The implementation of FRBM act improved the fiscal performance of central govt. GOI was on the path of achieving this objective right in time (FD=0). But due to the global financial crisis this was suspended and the fiscal consolidation as mandated in the FRBM act was put on hold. This crisis called for increase in government expenditure and cut in taxes so that aggregate demand of the economy can be increased. This fiscal policy moved away the govt. target or path of fiscal consolidation. The ~~straight~~ ~~simple~~ strict implementation of fiscal consolidation policy during pre crisis period created enough fiscal space for pursuing counter-cyclical fiscal policy.