UNIT V

- Monetary Policy: Meaning ; Objectives and Instruments of monetary policy
- Fiscal Policy: Meaning ; Objectives and Limitations.

MONETARY POLICY

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.

In India, monetary policy of the Reserve Bank of India is aimed at managing the quantity of money in order to meet the requirements of different sectors of the economy and to increase the pace of economic growth.

OBJECTIVES OF MONETARY POLICY IN INDIA

- Stabilising business cycles
- Exchange rate stability
- Price stability
- Economic growth

The monetary policy is aimed to reduce inflation, unemployment and maintain interest rates in the economy.

INSTRUMENTS OF MONETARY POLICY

- First, they use open market operations. They buy and sell government bonds and other securities from member banks. This action changes the reserve amount the banks have on hand. A higher reserve means banks can lend less.
- The second tool is the reserve requirement. Here the central banks tell their members how much money they must keep on reserve each night. Not everyone needs all their money each day, so it is safe for the banks to lend most of it out. That way, they have enough cash to meet most demands for redemption.

- The third tool is the bank rate. That's how much a central bank charges members to borrow funds. It raises the bank rate to discourage banks from borrowing. That action reduces liquidity and slows the economy. By lowering the interest rate, it encourages borrowing.

However the RBI has the following instruments of monetary policy:

- Repo Rate: The (fixed) interest rate at which the Reserve Bank provides overnight liquidity to banks against the collateral of government and other approved securities under the liquidity adjustment facility (LAF).

- Reverse Repo Rate: The (fixed) interest rate at which the Reserve Bank absorbs liquidity, on an overnight basis, from banks against the collateral of eligible government securities under the LAF.
- Liquidity Adjustment Facility (LAF): The LAF consists of overnight as well as term repo auctions. Progressively, the Reserve Bank has increased the proportion of liquidity injected under fine-tuning variable rate repo auctions of range of tenors. The aim of term repo is to help develop the inter-bank term money market, which in turn can set market based benchmarks for pricing of loans and deposits, and hence improve transmission of monetary policy. The Reserve Bank also conducts variable interest rate reverse repo auctions, as necessitated under the market conditions.

- Marginal Standing Facility (MSF): A facility under which scheduled commercial banks can borrow additional amount of overnight money from the Reserve Bank by dipping into their Statutory Liquidity Ratio (SLR) portfolio up to a limit at a penal rate of interest. This provides a safety valve against unanticipated liquidity shocks to the banking system.
- Corridor: The MSF rate and reverse repo rate determine the corridor for the daily movement in the weighted average call money rate.

- Bank Rate: 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.

- 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 the Reserve Bank may notify from time to time in the Gazette of India.

- Statutory Liquidity Ratio (SLR): The share of NDTL that a bank is required to maintain in safe and liquid assets, such as, unencumbered government securities, cash and gold. Changes in SLR often influence the availability of resources in the banking system for lending to the private sector.
- Open Market Operations (OMOs): These include both, outright purchase and sale of government securities, for injection and absorption of durable liquidity, respectively.
- Market Stabilisation Scheme (MSS): This instrument for monetary management was introduced in 2004. Surplus liquidity of a more enduring nature arising from large capital inflows is absorbed through sale of short-dated government securities and treasury bills. The cash so mobilised is held in a separate government account with the Reserve Bank.

FISCAL POLICY

MEANING

Fiscal policy is the use of government revenue (taxes) and expenditure to influence a country's economy. The use of government revenues and expenditures to influence the macroeconomics variables developed as a result of the Great Depression, when the previous free enterprise economy approach to economic management became unpopular. Fiscal policy is based on the theories of the British economist Keynes, who theorized that government changes in the levels of taxation and government spending influences aggregate demand and the level of economic activity. Fiscal and monetary policy are the key strategies used by a country's government and central bank to advance its economic objectives.

OBJECTIVES OF FISCAL POLICY

General objectives of Fiscal Policy are given below:

1. To maintain and achieve full employment.
2. To stabilize the price level.
3. To stabilize the growth rate of the economy.
4. To maintain equilibrium in the Balance of payment position.
5. To promote the economic development.

In India the objective is economic growth with social justice.

OTHER OBJECTIVES OF FISCAL POLICY

- Mobilisation of economic resources
- Reduction of inequalities in income and wealth
- Price stability
- Control inflation
- Employment generation
- Balanced regional development
- Infrastructure development
- Improving balance of payment position
- Foreign exchange reserve

LIMITATIONS OF FISCAL POLICY

- Policy lags

Unless the variations in taxes and public expenditure are neatly timed, the desired counter-cyclical effects can not be realized.

- Forecasting

Success of fiscal measures depends on the accurate predictions of various economic activities.

- Nature of the policy

The ability of public authority to frame the correct size and nature of fiscal policy on the one hand and to foresee the correct timing of its application on the other is important.

- Inadequate fiscal measures

What variation in the level of taxation or public spending can reduce the effect of depression is difficult.

- Adverse effect on redistribution of income

If income is redistributed in favour of the low-income classes whose marginal propensity to consume is high, the effect will be increase in total demand. But the fiscal action will contract if larger part of the additional income goes to people having higher marginal propensity to save.

- Administrative problems in developing countries

In a democracy fiscal policy measures must be a time-consuming process.

- Adverse effect on debt management

The use of fiscal instruments during unemployment and depression is often associated with the subsequent problem of debt management.

- Ad verse psychological reaction

Large deficit programmes financed by borrowings bring about adverse psychological reactions. Rumours of government bankruptcy discourage investors and often flight of capital takes place.