## Unit-I

### Lecture-18

**Instruments of Monetary Policy:**

The instruments of monetary policy are of two types:

1. Quantitative: General or indirect (CRR, SLR, Open Market Operations, Bank Rate, Repo Rate, Reverse Repo Rate)

2. Qualitative: Selective or direct (change in the margin money, direct action, moral suasion)

Both methods affect the level of aggregate demand through the supply of money, cost of money and availability of credit. Of the two types of instruments, the first category includes bank rate variations, open market operations and changing reserve requirements (cash reserve ratio, statutory reserve ratio).

Policy instruments are meant to regulate the overall level of credit in the economy through commercial banks. The selective credit controls aim at controlling specific types of credit. They include changing margin requirements and regulation of consumer credit.

- **Bank Rate Policy:**

The bank rate is the minimum lending rate of the central bank at which it rediscounts first class bills of exchange and government securities held by the commercial banks. When the central bank finds that inflationary pressures have started emerging within the economy, it raises the bank rate. Borrowing from the central bank becomes costly and commercial banks borrow less from it.

The commercial banks, in turn, raise their lending rates to the business community and borrowers borrow less from the commercial banks. There is contraction of credit and prices are checked from rising further. On the contrary, when prices are depressed, the central bank lowers the bank rate.

It is cheap to borrow from the central bank on the part of commercial banks. The latter also lower their lending rates. Businessmen are encouraged to borrow more. Investment is encouraged. Output, employment, income and demand start rising and the downward movement of prices is checked.

- **Open Market Operations:**

Open market operations refer to sale and purchase of securities in the money market by the central bank. When prices are rising and there is need to control them, the central bank sells securities. The reserves of commercial banks are reduced and they are not in a position to lend more to the business community.

Further investment is discouraged and the rise in prices is checked. Contrariwise, when recessionary forces start in the economy, the central bank buys securities. The reserves of commercial banks are raised. They lend more. Investment, output, employment, income and demand rise and fall in price is checked.

- **Changes in Reserve Ratios:**

This weapon was suggested by Keynes in his Treatise on Money and the USA was the first to adopt it as a monetary device. Every bank is required by law to keep a certain percentage of its total deposits in the form of a reserve fund in its vaults and also a certain percentage with the central bank.

When prices are rising, the central bank raises the reserve ratio. Banks are required to keep more with the central bank. Their reserves are reduced and they lend less. The volume of investment, output and employment are adversely affected. In the opposite case, when the reserve ratio is lowered, the reserves of commercial banks are raised. They lend more and the economic activity is favourably affected.

- **Selective Credit Controls:**

Selective credit controls are used to influence specific types of credit for particular purposes. They usually take the form of changing margin requirements to control speculative activities within the economy. When there is brisk speculative activity in the economy or in particular sectors in certain commodities and prices start rising, the central bank raises the margin requirement on them.

The result is that the borrowers are given less money in loans against specified securities. For instance, raising the margin requirement to 60% means that the pledger of securities of the value of Rs 10,000 will be given 40% of their value, i.e. Rs 4,000 as loan. In case of recession in a particular sector, the central bank encourages borrowing by lowering margin requirements.

## Fiscal Policy of India

Fiscal policy deals with the taxation and expenditure decisions of the government. Some of the major instruments of fiscal policy are as follows: Budget, Taxation, Public Expenditure, public revenue, Public Debt, and Fiscal Deficit in the economy.

Fiscal policy means the use of taxation and public expenditure by the government for stabilization or growth of the economy. According to Culbarston, "By fiscal policy we refer to government actions affecting its receipts and expenditures which ordinarily as measured by the government's receipts, its surplus or deficit." The government may change undesirable variations in private consumption and investment by compensatory variations of public expenditures and taxes.

Fiscal policy also feeds into economic trends and influences monetary policy. When the government receives more than it spends, it has a surplus. If the government spends more than it receives it runs a deficit. To meet the additional expenditures, it needs to borrow from domestic or foreign sources, draw upon its foreign exchange reserves or print an equivalent amount of money. This tends to influence other economic variables.On a broad generalization, excessive printing of money leads to inflation. If the government borrows too much from abroad it leads to a debt crisis. Excessive domestic borrowing by the government may lead to higher real interest rates and the domestic private sector being unable to access funds resulting in the "crowding out" of private investment. So it can be said that the fiscal deficit can be like a double edge sword, which need to be tackled very carefully.

## Main Objectives of Fiscal Policy in India

The fiscal policy is designed to achieve certain objectives as follows:-

**1. Development by effective Mobilisation of Resources:** 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 Mobilisation of Financial Resources. The central and state governments in India have used fiscal policy to mobilise resources.

The financial resources can be mobilised by:-

**a. Taxation:** Through effective fiscal policies, the government aims to mobilise resources by way of direct taxes as well as indirect taxes because most important source of resource mobilisation in India is taxation.

**b. Public Savings:** The resources can be mobilised through public savings by reducing government expenditure and increasing surpluses of public sector enterprises.

**c. Private Savings**: Through effective fiscal measures such as tax benefits, the government can raise resources from private sector and households. Resources can be mobilised through government borrowings by ways of treasury bills, issuance of government bonds, etc., loans from domestic and foreign parties and by deficit financing.

**2. Reduction in inequalities of Income 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 Programmes to improve the conditions of poor people in society.

**3. Price Stability and Control of Inflation:** One of the main objectives 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.

**4. Employment Generation:** The government is making every possible effort to increase employment in the country through effective fiscal measures. 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 generate more employment. Various rural employment programmes 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.

**5. Balanced Regional Development**: there are various projects like building up dams on rivers, electricity, schools, roads, industrial projects etc run by the government to mitigate the regional imbalances in the country. This is done with the help of public expenditure.

**6. Reducing the Deficit in the Balance of Payment**: some time government gives export incentives to the exporters to boost up the export from the country. In the same way import curbing measures are also adopted to check import. Hence the combine impact of these measures is improvement in the balance of payment of the country.

**7. Increases National Income:** it's the strength of the fiscal policy that is brings out the desired results in the economy. When the government want to increase the income of the country then it increases the direct and indirect taxes rates in the country. There are some other measures like: reduction in tax rate so that more peoples get motivated to deposit actual tax.

**8. Development of Infrastructure:** when the government of the concerned country spends money on the projects like railways, schools, dams, electricity, roads etc to increase the welfare of the citizens, it improves the infrastructure of the country. A improved infrastructure is the key to further speed up the economic growth of the country.

**9. Foreign Exchange Earnings:** when the central government of the country gives incentives like, exemption in custom duty, concession in excise duty while producing things in the domestic markets, it motivates the foreign investors to increase the investment in the domestic country.