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Monetary Policy and Fiscal Policy: Instruments &Strategies of Development

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The Centre for Public Policy (CPP) of Indian Institute of Management, Bangalore, hosts 9th Annual International Conference from August 11-13, 2014 on Public Policy. Present article originates with the interest of financial policy of Indian Government. Dr. Arvind Mayaram, Arun Maira and Harun R Khan were among plethora of experts at 3-day meet at IIM.

Deputy governor, Reserve Bank of India, Harun R Khan batted in favour of the central bank managing the government's public debt system for better supervision. There's merit in continuance of the present institutional arrangement. If at all, separation of debt management from the central bank has to be effected, it should be preceded by well-thought strategy focusing on perfect coordination among the Debt Management Office, the Ministry of Finance and the If at all, separation of debt management from the central bank has to be effected, it should be preceded by well-thought strategy focusing on perfect coordination among the Debt Management Office, the Ministry of Finance and RBI." Khan said.

His key note address in the event about financial debt management encourages me to study the monetary and fiscal policies of India.

Monetary policy and Fiscal policy are two significant strategies of Central Government to achieve macroeconomics objectives. **The classical economists** believed that the government can affect the level of output, overall price level and interest rates, revenue and expenditure by these two strategic policies. Monetary regulations of all varieties are expressions of monetary policy, since they are influential in controlling the volume of money available throughout the economic system. So an appropriate and effective monetary policy has to bring all sorts of financial intermediaries. When the government makes use of its revenue and

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expenditure programmes and affects the aggregate level of demand for goods and services in the economy, then this action is essentially known as fiscal policy.

According to **Kaushik Basu, Former Chief Economic Adviser**, fiscal policy deals with the taxation and expenditure decisions of the government these include, tax policy,expenditure policy, investment or disinvestment strategies and debt or surplus management. In overall sense, **Academic's Economic Dictionary** explains that fiscal policy is a policy that is concerned with the revenue and expenditure of the government.

OBJECTIVES OF THE STUDY:

- To study the different financial strategies of the development.
- To find out important objectives of monetary and fiscal policy
- To explore the strong points relating to development strategies

RESEARCH METHODOLOGY: This article is confined to overall work culture of monetary and fiscal policies as important instrument and strategies of development of economy. Data and information have been gathered from secondary published sources viz. reference books, journals, newspaper, websites etc.

Monetary Policy as an instrument

Reserve Bank of India states that Monetary Policy refers to the use of instruments under the control of central bank to regulate the availability, cost and use of money and credit. Significant **objectives of the monetary policy** is to maintaining price stability, Ensuring adequate flow of credit to the productive Sectors of the economy to support economic growth, Rapid economic growth, Balance of payment equilibrium, Full employment and even Equal income distribution.

The Monetary and Credit Policy is the policy statement, traditionally announced twice a year, through which the Reserve Bank of India seeks to ensure price stability for the economy. RBI use monetary policy as an instrument to achieve above objectives including control of

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inflation through various methods. These methods can be grouped as quantitative methods and qualitative methods.

Important methods of Monetary Policy for Economic development: These methods maintain and control the total volume of credit or money supply in the economy through following tools:

- ✓ **OMO:** Open market operations indicate the buying and selling of govt. securities in the open market to balance the money supply in the economy. The RBI has taken various measures to deploy credit in different sector of the economy. The certain %age of the bank credit has been fixed for various sectors like agriculture, export etc.
- ✓ **CRR and SLR**: The reduction in SLR enhances the liquidity of commercial banks. Under SLR, banks have to invest a certain percentage of its time and demand liabilities in government approved securities. The RBI is authorized to vary the CRR between 3% and 15%.Statutory liquidity ratio (SLR): It is the ratio of a bank's time and demand liabilities to be kept in reserve with the RBI. The money supply in the economy is influenced by CRR directly.
- ✓ **LAF:** Liquidity Adjustment Facility consists of daily infusion or absorption of liquidity on a repurchase basis, through repo (liquidity injection) and reverse repo (liquidity absorption)auction operations, using government securities as collateral.
- ✓ **RRR**: Reverse Repo Rate is the rate at which RBI borrows from commercial banks. It is an Indirect Instruments of RBI to control money supply and inflation in the economy.
- ✓ **Repo Rate**: Repo rate is the rate at which the RBI lends shot-term money to the banks against securities. When the repo rate increases borrowing from RBI becomes more expensive.

Narsimham Committee was formed by Government of India to recommendation in banking sector during 1990s. One of the recommendations of the committee was to accept inflation as mandatory state of the economy. Inflation is broadly understood as the general rise in the prices of goods and services year on year. Monetary policy was known as best policy in the world to control inflation because being a complex

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phenomenon associated with the money supply and currency values, Inflation has been tackled by monetary policy. Despite of the range of monetarist, there was general consensus that monetary tightening had failed to have its desired impact to control inflation during 2009. Monetarists are in opinion that during that period Indian monetary policy took "Baby steps" to control inflation that is why mom inflation jumped in double digit with 17.32% in 2010 and it became challenge for the RBI. Further New RBI Governor made global changes in monetary policy of RBI to control inflation in 2012.

Fiscal Policy as an instrument

Fiscal policy deals with the taxation and expenditure decisions of the government. These include, tax policy, expenditure policy, investment or disinvestment strategies and debt or surplus management. Important objectives of fiscal policy are Increase in capital formation, Degree of Growth, to achieve desirable price level, to achieve desirable consumption level, to achieve desirable employment level, to achieve desirable income distribution etc.

There are three possible positions of Fiscal Policy as an instrument of economic development. A Neutral position which applies when the budget outcome has neutral effect on the level of economic activity where the government expenditure is fully funded by the revenue collected from the tax. An Expansionary position is when there is a higher budget deficit where the govt. spending is higher than the revenue collected from the tax. A Contractionary position is when there is a lower budget deficit where the govt. spending is lower than the revenue collected from the tax.

Important methods of Monetary Policy for Economic development: Two most important instruments of fiscal policy refer to the Revenue and Expenditure policy of the Govt. which is generally used to cure recession and maintain economic stability in the country.

Revenue Budget: It includes Direct Tax comprises of Individual Income Tax, Corporate Tax, and Wealth Tax @ 1%. Other revenue budget is Indirect Tax comprises of sales tax, central excise duty, VAT, @ 12.5%, service tax @ 12%• customs duty and Educational cess @ 3%.

Expenditure Budget: The central government is responsible for issues that usually concern the country as a whole like national defence, foreign policy, railways, national highways, shipping, airways, post and telegraphs, foreign trade and banking. The state governments are responsible for other items including, law and order, agriculture, fisheries, water supply and irrigation, and public health. Some items for which responsibility vests in both the Centre and the states include forests, economic and social planning, education, trade unions and industrial disputes, price control and electricity.

Indian Fiscal policy adopt a basket of the methods for economic stability and overall development which includes reduction of Govt. Expenditure, increase in taxation, and imposition of new taxes, wage Control, increase in savings, maintaining surplus budgetand curb the deficits etc. Besides, fiscal policy works to increase in imports of raw materials, decrease in exports, increase in productivity, provision of subsidies, use of latest technology and rational industrial policy etc.

Time to time economic scholars suggest the changes in fiscal policy On the basis of above methods, **Subbarao, RBI Governor** has explained in 2012 that, India is unique in the sense of fiscal policy and said that Indian Economy is one of the economies in the world that is supply constrained. We need to improve infrastructure, supply of food, especially of protein foods and skilled labour for effective results from Indian fiscal policy. Other side, **Mr. Bhatt**, an economic reviewer suggested that the need of today is the injection of demand to the India economy. This can occur only through direct fiscal action by government.

Monetary Policy Vs Fiscal Policy

In India, the monetary union follows methods to keep the overall inflation at such levels so as to keep the overall gap between the actual aggregate consumption and desired consumption close to zero. Fiscal policy is then used to minimize the country specific welfare losses arising out of such policies. Also, fiscal policies have been used to stabilize the **terms of trade** and maintain them at their natural levels. Given the common monetary policies and the price levels for all the nations under the union, the fiscal authority of the home country is led to follow contractionary policies in case of deterioration the **terms of trade.**

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As present monetary policy is acting as renowned economist **J.M. Keynes and few classical economists** believed that taxes and expenditure decisions, that is fiscal policy, should be used to stabilize the economy. According to him, government should cut taxes and increase spending to bring the economy out of a slump, this kind of a policy action is known is expansionary fiscal policy. On the other hand, government should increase taxes and cut expenditure to bring the economy out of inflationary pressure, that is, it should follow a contractionary fiscal policy.

Contrast to this, present fiscal stimulus packages are being given away by the government because of the impact of the global financial meltdown on the Indian economy. The global crisis has had a huge impact on our exports, financial markets, production (due to a slowdown in demand) and also on job market to a certain extent.

Although most economists believe that we can not do much in terms of own policy action when it comes to exports and exports will continue to suffer until importing economies like US and European Union will recover, but a boost can certainly be given to the domestic demand. Hence present fiscal policy actions aim at stimulating domestic demand and have focus on sectors that provide huge employment. Roughly 70% of our demand is domestic hence the government believes such policy actions should pull out India out of the slowdown.

Traditionally, both the policy instruments were under the control of the national governments. Thus traditional analyses made with respect to the two policy instruments to obtain the optimum policy mix of the two to achieve macroeconomic goals as the two were perceived to aim at mutually inconsistent targets. But in recent years, owing to the transfer of control with respect to monetary policy formulation to Central Banks, formation of monetary unions like European Monetary Union formed via the Stability and Growth Pact and attempts being made to form fiscal unions, there has been a significant structural change in the way in which fiscal-monetary policies interact

When an economy is a part of a monetary union, its monetary authority is no longer able to conduct its monetary policies independently as per the requirements of the economy. Under such situation the interactions between fiscal and monetary policies undergo certain changes.

In present globalized economic era, there is need to change both policies as per global economic situation especially in case of debt management and deficits with more freedom. In this regard **RBI's Deputy Governor Mr. Harun R Khan** stated in a keynote address at the Indian Institute of Management, Bangalore on 13th August, 2014 that our **DMS** (debt management services) monetary policy revolves around three broad pillars: cost minimization, risk mitigation and market development. He continued saying and supporting the demand of RBI in 2009 for a separate debt management policy free from other control to work effectively.

Referring to the international framework where debt management separated from central banks has gained acceptance, the deputy governor has harped on contextual difference among countries, in 2009-10, during the global financial crisis, Reserve Bank carried out government borrowing of about Rs 4 lakh crore without disrupting the debt market or elbowing out private sector's credit requirement. In spite of rising interest rate scenario, the Reserve Bank was able to complete the government's borrowing programme in a non-disruptive fashion at a reasonable cost.

CONCLUSION:

Though the objectives and instruments of monetary and fiscal policy are equally important for the development of an economy but even there is a dilemma as to whether these two policies are complementary, or act as substitutes to each other for achieving macroeconomic goals. Policy makers are viewed to interact as strategic substitutes when one policy maker's expansionary (contractionary) policies are countered by another policy maker's contractionary (expansionary) policies. For example: if the fiscal authority raises taxes or cuts spending, then the monetary authority reacts to it by lowering the policy rates and vice versa. If they behave as strategic complements, then an expansionary (contractionary) policy of one authority is met by expansionary (contractionary) policies of other.

The issue of interaction and the policies being complement or substitute to each other arises only when the authorities are independent of each other. But when, the goals of one authority is made subservient to that of others, then the dominant authority solely dominates the policy

making and no interaction worthy of analysis would arise. Also, it is worthy to note that fiscal and monetary policies interact only to the extent of influencing the final objective. So long as the objectives of one policy are not influenced by the other, there is no direct interaction between them.

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