IMPACT: International Journal of Research in
Humanities, Arts and Literature (IMPACT: IJRHAL)
ISSN (P): 2347-4564; ISSN (E): 2321-8878
Vol. 7, Issue 1, Jan 2019, 321-328

MONETARY POLICY AND FISCAL POLICY: - A COMPARISON

Arya Salim

Former, Guest Lecturer, Sree Narayana College, Kollam, Kerala, India

Received: 14 Jan 2019 **Accepted:** 21 Jan 2019 **Published:** 28 Jan 2019

ABSTRACT

It is the responsibility of the Central Bank of a country to control and coordinate the volume and direction ofcredit in the economy. The Reserve Bank of India is the central bank of India. The policy taken by the central bank to control the credit is known as monetary policy. The policy which involves the Government's actions to influence an economy through the use of taxation and spending is called fiscal policy.

KEYWORDS: *Monetary Policy, Credit, Fiscal Policy, Economic Growth*

INTRODUCTION

Monetary policy means a regulatory policy by which the central bank of a country regulates and controls the supply of money in the economy. It helps in changing the supply of money and credit. These policies are the measures which are undertaken by the Government or the monetary authority to control the availability, cost and the use of credit and money to achieve specific targets. This policy also aims at influencing the economic activity, growth, and development within an economy. The availability of credit has a great effect on the prices, national income and employment of an economy. According to A.J.Shapiro" Monetary Policy is the exercise of the central bank's control over the money supply as an instrument for achieving the objectives of economic policy". Fiscal Policy means those policies taken by the Government to control economic activity. It can be expansionary or contractionary fiscal policy. Here the Government uses its expenditure and revenue programs to produce good effects and avoid bad effects on economic activity. This policy can directly affect the total demand of an economy. Otto Eckstein defines fiscal policy as "changes in taxes and expenditures which aim at short-run goals of full employment and price level stability".

OBJECTIVES OF THE STUDY

- · To analyze the differences and similarities between monetary and fiscal policy.
- · To understand the effects of monetary and fiscal policy on the economy
- · To study the role of instruments of monetary and fiscal policy.

RESEARCH METHODOLOGY

The study is based on secondary data collected from books of national and international authors. This analysis is purely a descriptive one as it describes in detail the major aspects and issues related to the two main concepts monetary and fiscal policies.

MONETARY POLICY

R.P.Kent defines monetary policy as “The management of the expansion and contraction of the volume of money in circulation for the explicit purpose of attaining a specific objective such as full employment”.

OBJECTIVES OF MONETARY POLICY

- To maintain price stability:- Price stability means encouraging economic development and growth taking into consideration price stability. The concentration is on developing a background which is favorable for the developmental projects to run rapidly and smoothly keeping reasonable price stability.
- Regulation, supervision and development of financial stability:- Financial stability is the capability of an economy to absorb shocks and maintain confidence in the financial system. Internal and external shocks can adversely affect financial stability. Thus the central bank has an important role in keeping faith in the financial system through proper regulation aiming at growth as the main aim.
- Promoting the priority sector: - It includes agriculture, export, small scale, and cottage industries along with a weaker section of the population. RBI should provide timely and enough credit at a lower interest rate to weaker and low-income section. The NABARD should also focus on microfinance by focusing on Self Help Groups.
- Controlled expansion of bank credits:-RBI should keep a special watch on the flow of bank credit and the circulation of money supply within the economy.
- · External stability: - India’s connection with the global economy is getting stronger with the growth of imports and exports. RBI influences the exchange rate by buying and selling foreign currencies in the open market through the mechanism of managed flexibility.
- Encouraging savings and investments: - RBI can fix a low rate of interest to promote investment. When the commercial banks offer loans at a low rate of interest, people will be motivated to take loans from banks. These loans will be later be invested in different projects and businesses thus promoting investment in the economy.
- Redistribution of income and wealth: - With the help of monetary policy inflation can be controlled to a greater extend and deployment of credit to weaker sectors of society, there is a redistribution of income and wealth favoring the poor sections of the society.

- To promote efficiency:- The RBI should try to bring structural changes such as varying interest rates, making easy the credit delivery system, introducing new money market instruments etc. This brings efficiency in the financial system.
- Reducing the rigidity: - RBI maintains its regulation over the financial system whenever and wherever necessary. It also tries to brings about the flexibilities in the operations that also give some autonomy. It also bring about an environment with more competition and diversification.

The Instruments of Monetary Policy can be Classified Into two:

- **Quantitative Instruments: -** The control over the credit structure has been included in the legal framework of RBI under the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949. The quantitative method is also called a general method. By using this method, the total quantity of credit, in general, can be changed. But it does not take into account the uses to which such credit is put. These policies can affect the economy as a whole. It includes
- **Bank Rate Policy: -** Bank rate is the minimum rate at which the central bank of a country gives loans to the commercial banks of a country. It is also called discount rate because usually, the central bank lends to commercial banks by re- discounting their bills of exchange. Bank rate is also called the central bank's lending rate. At the time of inflation, RBI increases the bank rate. As a result, commercial banks increase their lending rate to the public. As a result of these people borrow only less money. Thus the money supply in the economy is reduced and inflation is curtailed. On the other hand, when there is a recession or depression in the economy, the bank rate is lowered.
- **Open Market Operations: -** It means the purchase and sale of Government securities by the central bank in the open market. At the time of inflation, the central bank sells securities to the commercial banks and the general public. The cash reserves of the commercial bank are reduced directly when they buy these securities. When people buy securities they make a large withdrawal of cash from commercial banks. Here their cash reserves are reduced. Thus commercial bank's ability to create credit is curtailed. This method is very common in developed countries.
- **Variable Cash Reserve Ratio: -** All the commercial banks are required to keep a certain percentage of their deposits with the central bank. In other words, a minimum reserve ratio refers to the minimum percentage of a bank's total deposit which is required to be kept with the central bank. RBI can increase or decrease this ratio. That is why it is known as variable cash reserve ratio. At the time of inflation, the central bank increases the CRR. At this time the commercial banks are required to keep more amount of their cash with the RBI. Therefore their cash reserve decrease. The credit they can supply to the public decreases. So the cash in the hands of the public decrease thus leading to a decline in aggregate demand. At the time of recession, CRR is decreased.
- **Repo Rate and Reverse Repo Rate:-** The rate at which the RBI lends money to the commercial banks is known as the repo rate. The RBI usually lends to the commercial banks against government securities which is safer. During inflation, repo rate is increased so that commercial banks have only less cash reserves because the cost of borrowing from the central bank has increased. During recession, repo rate is decreased. Reverse repo rate is the rate at which the central bank borrows money from the commercial banks.

- **Statutory Liquidity Ratio: -** SLR means the amount that the commercial banks are required to keep in the form of gold or government approved securities like bond and shares of various companies. SLR is maintained to expand bank credit or to meet unforeseen contingencies.

- **Qualitative Instruments: -** This is also called selective control methods. These methods usually aim at changing the volume of a specific kind of credit. The selective control methods affect the use of credit for particular purposes. The qualitative measures do not regulate the total amount of credit created by the commercial banks. These measures make the distinction between good credit and bad credit and control the credit which creates economic instability. These includes

- **Regulation of Margin Requirements: -** This method is used to avoid excessive use of credit to buy or carry securities by speculators. A margin is that proportion of the value of security against which loan is not given. It is the maximum value of the loan that a borrower can have from the banks on the basis of the collateral. At the time of inflation, when RBI wants to restrict the flow of credit in an economy it will increase the margin requirement of loan and vice versa at the time of recession. Rationing of credit: - Credit rationing is practiced whenever the flow of credit is to be checked especially for speculative activities in the economy. It refers to the fixing of credit quotas for various business activities. RBI fixes the quota and the commercial banks cannot exceed the fixed limits while granting loans. At the time of recession, RBI can increase the credit by reducing down payment and raising the number of installments

- **Moral Suasion: -** It means to request and persuasion. At the time of inflation RBI request the commercial banks to reduce the credit availability in the economy and increase credit supply at the time of recession. RBI also appeal the commercial banks to an extent their wholehearted co-operation to achieve the goals of monetary policies.

- **Direct Action: -** When a commercial bank is not ready to co-operate with the policies and actions of the central bank in order to achieve the desirable goals and objectives direct action is taken by RBI. This method is too severe and is rarely practiced. It may include refusal by RBI to rediscount bills, cancellation of license etc.

- **Regulation of Consumer Credit: -** The main aim of this instrument is to regulate the demand for durable consumer goods in the interest of economic stability. This aims at the controlling of consumer installment credit or hires-purchase finance. The RBI controls the use of bank credits by consumers in order to buy durable consumer goods on installments. The RBI uses two main devices. They are minimum down payments and maximum periods of repayment. At the time of inflation, the central bank increases the number of down payments and decrease the maximum periods of repayment. The opposite happens at the time of recession.

- **Publicity:** - Here, RBI publishes weekly or monthly statements of the assets and liabilities of the commercial banks for the people to get correct information. It also announces statistical data relating to money supply, prices, production, employment etc. The objective of this policy is to make the public aware of the policies adopted by the commercial banks.

FISCAL POLICY

Otto Eckstein defines fiscal policy as “changes in taxes and expenditures which aim at short-run goals of full employment and price level stability”.

Objectives of Fiscal Policy

- **To Achieve Full Employment: -** It is one of the main aims of fiscal policy. If there is a low level of production due to unemployment there will be very low economic growth. If there is unemployment the people will have no income to live their daily life. So the government should ensure full employment in the economy. Full employment means that situation where there is no involuntary unemployment in the economy.
- **To Maintain Price Stability: -** A sharp increase and a sharp decrease in the general price level are not desirable. A sharp rise in price level makes goods and services very costly and it becomes unaffordable to the consumers. A sharp fall in prices reduce the producer’s profit and thus discourage them from producing goods and services. So there is a big need for price stability.
- **To Speed up Economic Growth: -** The problem of unemployment can be solved to a great extent when there is a higher rate of economic growth. Sometimes some problems will be created in the maintenance of price stability. Especially developed countries give importance to the relationship of the actual growth rate to the potential growth rate permitted by the consumption- saving ratio, technological progress etc. The less developed countries give concentration to the increase in the potential growth rate as well as the relationship of the actual and potential growth rate.
- **To Facilitate Resource Allocation:** - Resource allocation means employing the available resources of the economy to the specific areas chosen among various competing alternatives. It gives an apt reply to the central problems of an economy like what to produce, how to produce and for whom to produce. Fiscal policy must ensure the optimum allocation of the resources. It should divert the resources from unproductive sectors to the productive sectors. It is the long run objective of the government.
- **Encourages Savings:** - Taking the case of developing countries, the rich class spends a lot of money on luxuries. The government can help the poor by imposing a tax on the luxuries and providing basic necessities to the poor class on low rate. The government can increase savings in this way by providing incentives.
- **Helps Control Inflation: -** The government can control inflation by imposing a high rate of tax on the income of people, thus reducing their purchasing power. Also, inflation can be controlled when the expenditure on unproductive projects is reduced.

Types of Fiscal Policy

- **Expansionary Fiscal Policy:** - Expansionary fiscal policy is to stimulate the economy. During a recession there will be a high rate of unemployment, very low production, then this policy is practiced. It means the government spending more money and lowering taxes. The objective is to put more money in the hands of consumers so they spend more and stimulate the economy. This fiscal policy encourages the government and consumers to spend more by buying more goods and services and increasing the aggregate demand. When the demand increases the production of goods and services increases which demand more employment for workers. In this way, the problem of unemployment is solved.
- **Contractionary Fiscal Policy: -** This is just the opposite of expansionary fiscal policy. This fiscal policy is a tool to slow down economic growth, especially in boom period when there is high inflation. This policy raises taxes and cuts spending. When tax is increased people give a higher proportion of their income as tax thus leaving a small part of disposable income. Since people have low income in their hands they demand less goods and services. So the aggregate demand is reduced in the economy. This lowers the level of production and employment. It eliminates the inflationary gap in the economy.

Instruments of Fiscal Policy

- Taxation: - When the government increase the tax people will spend less money and when the government decreases the tax people spend more. In this way, the government regulates the spending of consumers which can have an important impact on the direction of the overall economy. Increase in the spending which leads to higher revenue for businesses which enable them to hire more workers for production which in turn solve the unemployment problem.
- Government spending: - When the government increases the expenditure it lead to the promotion of economic activity and create jobs. For example, if the government starts a new project of building a metro rail it leads to the hiring of more workers which could reduce the problem of unemployment and inject money into the economy. Higher levels of government spending help to promote employment, economic growth, and development.

CONCLUSIONS

Economists and policymakers have two main types of tools to influence a country's economy such as fiscal and monetary policy. Fiscal policy means the government spending and revenue collection. For example, when the demand is low in the economy, the government can come forward and increase it's spending and create demand in the economy. On the other hand monetary policy relates to the supply of money, which is controlled through factors such as interest rates and reserve ratios etc.

REFERENCES

1. *M.L.Jhingan, 2010, Macroeconomic theory, Vrinda Publications pvt. Ltd.*
2. *Rosalind Levacic and Alexander Rebmann, 1982, Macroeconomics An Introduction To Keynesian-Neoclassical Controversies, Macmillan Press Ltd*
3. *Dr.H.L.Ahuja, 2012, Macroeconomics Theory And Policy, S.Chand and Company Ltd*
4. *Dr. S. Hariharaputhiran & G. Nagarajan, Fiscal Policy In Banking Sector In India, International Journal of Accounting and Financial Management Research (IJAFMR), Volume 1, Issue 1, July-August 2011, pp. 38-55*
5. *K.P.M. Sundharam and K.K.Andley, 2003, Public Finance Theory And Practice, S.Chand and Company Ltd*
6. *R.K.Lekhi and Joginder Singh, 2015, Public Finance, Kalyani Publishers.*
7. *Datt andSundaram, 2013, Indian Economy, S.Chand and Company Ltd.*