MONETARY AND FISCAL POLICY

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MONETARY POLICY

- The policy by which the desired level of money flow and its demand is regulated is known as the credit and monetary policy.
- All over the world it is announced by the central banking body of the country—as the RBI announces it in India.
- In India there has been a tradition of announcing it twice in a financial year—before the starting of the busy and the slack seasons.
- But in the reform period, this tradition has been broken.
- Now the RBI keeps modifying this as per the requirement of the economy, though the practice of the two policy announcements a year still continues.

TOOLS OF MONETARY POLICY

RBI uses many instruments/tools to put in place the required kind of credit and monetary policy such as—CRR, SLR, Bank Rate, Repo & Reverse Rates, MSF Rate, OMOs, etc. on which it has regulatory controls.

These can be broadly categorised into 2 categories:

1. Quantitative tools
2. Qualitative tools

1. **CASH RESERVE RATIO (CRR):** The cash reserve ratio (CRR) is the ratio (fixed by the RBI) of the total deposits of a bank in India which is kept with the RBI in the form of cash. This was fixed to be in the range of 3 to 15 %. A recent Amendment (2007) has removed the 3 per cent floor and provided a free hand to the RBI in fixing the CRR.
2. **STATUTORY LIQUIDITY RATIO (SLR):** The statutory liquidity ratio (SLR) is the ratio (fixed by the RBI) of the total deposits of a bank which is to be maintained by the bank with itself in non-cash form prescribed by the government to be in the range of 25 to 40 per cent.
3. **BANK RATE:** The interest rate which the RBI charges on its long-term lendings is known as the Bank Rate. The clients who borrow through this route are the Government of India, state governments, banks, financial institutions, co-operative banks, NBFCs, etc.
4. **REPO RATE:** The rate of interest the RBI charges from its clients on their short-term borrowing is the repo rate in India.
5. **REVERSE REPO RATE:** It is the rate of interest the RBI pays to its clients who offer short-term loan to it.

FISCAL POLICY

- Fiscal policy has been defined as ‘the policy of the government with regard to the level of government purchases, the level of transfers, and the tax structure’
- As the policy has a deep impact on the overall performance of the economy, fiscal policy is also defined as the policy which handles public expenditure and tax to direct and stimulate the level of economic activity (numerically denoted by the Gross Domestic Product).
- It was J. M. Keynes, the first economist who developed a theory linking fiscal policy and economic performance.
- Fiscal policy is also defined as ‘changes in government expenditures and taxes that are designed to achieve macroeconomic policy goals’ (such as growth, employment, investment, etc.).

Fiscal policy denotes the use of **taxes** and **government expenditures**:

TAXES and their impact on the economy:

(i) Taxes have a direct bearing on people's income affecting their levels of disposable incomes, purchase of goods and services, consumption and ultimately their standard of living;

(ii) Taxes directly affect the savings of individuals, families and firms which affect investment in the economy—as investment affects the output (GDP) thereby influencing the per capita income;

(iii) Taxes affect the prices of goods and services as factor cost (production cost) is affected thereby affecting incentives and behaviour of economic activities, etc.

Government expenditures affect/influence the economy in two ways:

(i) There are some expenditure on government purchases of goods and services, for example construction of roads, railways, ports, food grains, etc., in the goods category and salary payments to government employees in the services category; and

(ii) There are some expenditure due to government's income support, to the poor, unemployed and old-age people (known as government transfer payments).