Subject: GE – Principles of Macroeconomics **Paper Code: 62275604**

Topic: Monetary Policy and Fiscal Policy **Unit 5 – Money in a Modern Economy**

Price Policy and its Objectives

Price Policy refers to the policy of directing, regulating and controlling the relative price structure of the economy. The major objectives of a price policy are:

1. **Price Stability**: refers to elimination of wide fluctuations in prices. The consistent upward trend of prices is called inflation, is one of the macroeconomic concerns of many developing economy. The two main reasons for price inflation is a) rise in demand and b) fall in production or rise in cost. Inflation increases economic inequalities and similarly, deflation or fall in prices leads to fall in production and rise in unemployment.

2. **Full employment**: refers to the situation where all persons who are willing and able to work at the prevailing wage rate are employed. To achieve this, the level of demand and output need to be substantially raised.

3. **Economic Growth**: refers to the process of sustained rise in real income per capita. For developing and under developed countries there is a need to increase income and standard of living of the people.

4. **Reduction in Income- inequalities:** In capitalist and mixed economies there are widespread inequalities in distribution of wealth and income. So, one of the important objectives of price policy is to achieve equitable distribution of income and wealth.

There are two main price policy's – Monetary Policy and Fiscal Policy. Monetary policy refers to the policy which the government or RBI controls the supply of money, availability of money and the rate of interest. The central bank controls the supply of money by controlling the issuance of currency and the flow of credit through commercial banks.

Instruments of Monetary Policy

The various instruments of monetary policy used by the central bank can be broadly classified into two categories:

1. **Quantitative or General Methods*:*** The methods used by central bank to influence the total volume of credit in the banking system, are called quantitative methods or general methods of credit control. The important quantitative methods are: (a) Bank Rate, (b) Open Market Operations, (c) Cash Reserve Ratio, (d) Statutory Liquidity Ratio, (e) Repo Rate, (f) Reverse Repo Rate.

2. **Qualitative or Selective Methods:** The methods used by the central bank to regulate the flow of credit into particular directions of the economy are called qualitative methods of credit control. These methods effect the composition rather than the size of credit in the economy. The important qualitative or selective methods of credit control are; (a) Marginal Requirements, (b) Regulation of Consumer Credit, (c) Credit Rationing, (d) Moral Suasion and (e) Direct Action.

Quantitative or General Methods:

1. **Bank Rate:**
   It is the also known as the discount rate. It is the rate of interest that the RBI charges for providing funds or loans to the commercial banks. When the central bank finds that inflation has been increasing continuously, it raises the bank rate so borrowing from the central bank becomes costly and commercial banks borrow less money from it (RBI).
   The commercial banks, in reaction, raise their lending rates to the business community and borrowers who further 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 lowers their lending rates. Businessmen are encouraged to borrow more. Investment is encouraged and followed by rise in output, employment, income and demand and the downward movement of prices is checked.

2. **Open- Market Operations**:
   Open market operations refer to sale and purchase of securities in the money market by the central bank of the country. When prices start 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 or general public. 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 so they lend more to business community and general public. It further raises investment, output, employment, income and demand in the economy hence the fall in price is checked.

3. **Cash Reserve Ratio:**
   All commercial banks are required to keep a certain amount of its deposits in cash with RBI. This percentage is called the cash reserve ratio. A change in the cash reserve ratio is a more powerful method for influencing the volume of excess reserves with the commercial banks, but also the credit multiplier of the banking system.
   An increase in the CRR reduces the base of the cash reserves of commercial banks thus decreasing their potential credit creation capacity. Thus, a change in the reserve requirements affect the money supply in two ways: (a) it changes the level of excess reserve; and (b) it changes the credit multiplier.

4. **Statutory Liquidity Ratio:** is the amount of liquid assets such as precious metals like gold or other approved securities that a financial institution must maintain as reserve other than cash with themselves. The objective is to restrict credit, contain profits and fuel growth.

5. **Repo Rate**: it is the repurchase rate at which the central bank lends short term money to the banks against securities**.** Reduction in repo rate helps commercial banks to get money at a cheaper rate and an increase in repo rate discourages the commercial banks to borrow money as it becomes expensive.

6. **Reverse Repo Rate:** it is the rate at which banks lends to the RBI. It is mostly done when there is surplus liquidity in the economy.

Qualitative or Selective Methods:

The qualitative or selective methods are meant to regulate the terms on which the credit is granted in specific sectors. They seek to control the demand for credit for different uses by (a) determining minimum down payments and (b) regulating the period of time over which the loan is to be repaid. Various selective controls are discussed below:

1. **Marginal Requirements**: is the difference between the market value of the security and its maximum loan value. Control over margin requirement means control over down payments that must be made in buying securities on credit. If a security has market value of Rs. 100 and if the margin requirement is 60% the maximum loan value will be Rs. 40. Similarly, a margin requirement of 80% would allow borrowing of only 20% of the price of the security. Thus, an increase in the margin requirements will reduce the amount that can be borrowed for the purchase of a security.

2. **Regulation of Consumer Credit:** Under the consumer credit system, a certain percentage of the price of the durable goods is paid by the consumer in cash. The balance is financed through the bank credit which is repayable by the consumer in installments. The central bank can control consumer credit (a) by changing the amount that can be borrowed for the purchase of the consumer durables and (b) by changing the maximum period over which the installments can be extended.

3. **Rationing of Credit:** Credit rationing is a selective method of controlling and regulating the purpose for which credit is granted by the commercial banks. Rationing of credit may aim at (a) limiting the maximum loans and advances to the commercial banks, and (b) fixing ceiling for specific categories of loans and advances.

4. **Moral Suasion*:*** Moral suasion means guiding, requesting, persuading the commercial banks to cooperate with the central bank in implementing its general monetary policy. Through this method central bank mainly uses its moral influence to make the commercial banks follow its policies. For instance, the central bank may request the commercial banks not to grant loans for specific purposes. The effectiveness of this method depends upon the immediate and favourable response from the commercial banks.

5. **Direct Action***:* This method is most extensively used by the central bank to enforce both qualitative and quantitative credit controls. Direct action refers to the directions issued by the central bank to the commercial banks regarding their lending and investment policies. Direct action may take different forms: (a) The central bank may refuse to rediscount the bills of exchange of commercial banks whose credit policy is not in line with the general monetary policy of the central bank; (b) The central bank may charge a penal rate of interest, over and above the bank rate, on the money demanded by the bank beyond the prescribed limit; (c) The central bank may refuse to grant more credit to the banks whose borrowings are found to be in excess of their capital and reserves.

Fiscal Policy: is the policy related to revenue and expenditure of the government for achieving a set of objectives.

Instruments of Fiscal policy are:

1. **Taxation:** Taxes forces the people to save for the government. The government taxes as an instrument to increase or decrease the real purchasing power of the people. Increase in taxes decreases purchasing power and vice-versa.

2. **Public Expenditure:** Aggregate demand is influenced by the government expenditure on account of increase in public expenditure which increases aggregate demand. Public expenditure is of two types: (a) public expenditure to buy goods and services – this has a direct effect on aggregate demand and (b) public expenditure incurred on transfer payments. Transfer payments have an indirect effect on aggregate demand.

3. **Public Debt**: is of two kind- Internal debt and external debt. Internal debt refers to money owed by the government from the public. It is a part of country's national debt and external debt is the total debt a country owes to foreign creditors.

4. **Deficit Financing:** When the budget deficit is financed by borrowing from the public and banks, it is called deficit financing. Deficit financing refers to the borrowing undertaken by the government to make up for the revenue shortfall. It is the best stimulant for the economy in short term.