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# UNIT 6 MACRO ECONOMIC POLICIES

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## 6.0 OBJECTIVES

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After studying this unit, you should be able to:

- explain the meaning of macro economic policy.
- explain the meaning and objectives of fiscal policy.
- state the instruments of fiscal policy.
- explain the meaning and objectives of monetary policy.
- state the meaning and functions of a Central Bank.
- explain the concept of money supply in India.
- distinguish between quantitative and qualitative instruments of monetary policy.
- explain the role of Reserve Bank of India.

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## 6.1 INTRODUCTION

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The term macro in economics means 'relating to a nation'. Macro economic policy thus means a policy about economic aspects of a country. A national level policy is framed by the central government of the country. It is implemented by its various departments or by the specialized institutions created for this purpose.

The central government of a country follows specific policies with respect to agriculture, industry, services, employment, money supply, credit, taxes, government expenditure, borrowings, etc. All these are macro economic policies. These policies affect particular economic sectors in some cases and the entire economy cutting across all sectors of the economy in other cases. For example, any economic policy about agriculture is designed to regulate mainly the development of agricultural sector. Take another example say of taxation policy. It may affect all economic sectors of the economy: i.e. the entire economy. Such policy is truly a national level policy. Other examples of national level policies are policies regarding money supply, credit, employment, education, etc.

In this unit you will study two national level policies popularly known as fiscal and monetary policies. The fiscal policy aims at regulating the functioning and development of different sectors of an economy through affecting changes in government expenditure and taxation system. Monetary policy tries to fulfill the same aim through regulating money supply and through this the credit and investment conditions in the economy.

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## 6.2 MEANING OF MACRO ECONOMIC POLICY

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A macro economic policy refers to the deliberate measures taken at national level to regulate the functioning, growth and development of the economy and its sectors. The policy is framed by Government and implemented through institutions controlled or sponsored by the Government. Out of the various macro economic policies the two crucial ones are fiscal and monetary policies.

Fiscal policy is the income and expenditure policy of the government. Government needs money to run the country's administration, to provide facilities to the people and the business, to undertake developmental activities and so on. Tax is the main source of income for any government. The type of taxes government imposes has a great bearing on development of the various sectors of the economy. Government uses taxation as a tool for regulating economic activities in the country within the framework of overall policy objectives. Government expenditure is another tool. Government's spending has a bearing on the standard of living of the people, the business environment, the growth of various sectors, etc. The fiscal policy of a country finds its expression in government budget.

Monetary policy of a country broadly aims at regulating the money supply in the country. Regulation of money supply in the country has its effect on interest structure, credit structure, investment structure, prices, flow of foreign exchange etc. The policy is prepared by the central bank of the country and implemented mainly through the commercial banks. Reserve Bank of India is the central bank in India. State Bank of India, Punjab National Bank, Canara Bank, Union Bank of India, UTI Bank, Times Bank, etc. are the examples of commercial banks. In practice nearly all the financial institutions, banking or non-banking are involved in the implementation of the monetary policy, directly or indirectly.

Most of the objectives of monetary and fiscal policies are common. The ultimate aim of both policies is economic growth and development of the country. In the following sections we will have a look into the various objectives, instruments and the government agencies responsible for implementation of fiscal and monetary policies in India.

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## 6.3 MEANING OF FISCAL POLICY

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The adjective 'fiscal' is derived from the noun "fisc" (from Latin fiscus). Fisc means a state or state treasury. The word fiscal, therefore, refers to all matters pertaining to state treasury, particularly its source of revenues and its patterns of expenditures. Accordingly fiscal policy deals with government's power to tax and spend for the purpose of achieving certain declared policy objectives which generally relate to prices, output and employment.

There are two fundamental issues of fiscal policy. **First**, should taxes be raised or lowered? **Second**, should government spending be reduced or increased? Lowering taxes and raising government expenditure raises demand and helps in the expansion of economy. Raising taxes and cutting government expenditure reduces demand and has the effect of contracting the economy. The main concern of the fiscal policy thus is the ways in which the government raises and spends money. Government raises money through taxation,

borrowing and printing new money. Each source has its own implication. Government spends money on public works and transfer payments. Public works include roads, parks, bridges, government buildings, water supply, electricity supply, educational institutions etc. Transfer payments are in the form of old age pensions, interest payments, etc.

Fiscal activity can be **discretionary** and **non - discretionary**. A **discretionary** fiscal activity means deliberate actions by the government in spending and taxing to influence the nation's output and employment or to correct the situation arising from inflationary or deflationary tendencies in the economy. A **non - discretionary** fiscal activity means changes in government spending and taxes taking place automatically without any explicit decisions by the finance minister. For example, during inflationary situation an already existing progressive income tax policy has the effect of reducing people's power of spending. The distinction between discretionary and non - discretionary fiscal activities can be used to state the meaning of fiscal policy a little more precisely.'

To be more precise, **fiscal policy in the modern sense refers to the deliberate actions by the government in its spending and taxing activities to achieve certain objectives** like that of price stability and raise output and employment to the desired levels. Thus the modern fiscal policy is essentially a discretionary fiscal policy.

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## 6.4 INSTRUMENTS OF FISCAL POLICY IN INDIA

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As mentioned above, fiscal policy refers to the deliberate actions by the government in its spending and taxing activities. Broadly, fiscal policy in the Indian context involves the ways in which the central government raises and spends money. Let us explain these two aspects in detail.

### 6.4.1 Ways of Raising Money

How the government chooses to raise money? The ways of raising money are technically termed as 'sources of revenue' in public finance. These sources of revenue are one set of instruments of fiscal policy. Basically, a government has three sources of revenue : a) taxation, b) borrowing and c) printing new money. In India there is an additional source in the form of non - tax revenue. Out of these the printing of new money is generally the last resort. In the Indian context there are three ways of raising money (sources of revenue).

- 1) Tax revenue
- 2) Non - tax revenue
- 3) Capital receipts

Let us briefly describe each source of revenue.

1) **Tax revenue:** A tax is a compulsory payment to government. Taxes can be levied and classified in many ways. There are three principal types of taxes in any system: taxes on incomes, wealth, and activities of production, consumption etc. Main taxes levied by central government are:

1. Corporation tax
2. Income tax
3. Interest tax
4. Expenditure tax
5. Wealth tax
6. Gift tax
7. Customs
8. Union excise duties
9. Service tax
10. Other taxes and duties
11. Taxes on union territories

Out of the above the principal taxes in order of importance in the budget of the year 1997-98 are union excise duties (34%), customs (34%), income tax (14%) and corporation tax (14%). These four taxes together constitute nearly the entire gross tax revenue of the central government. The taxes, other than these four, constitute only about 3% of gross tax revenue. Income tax is the tax on income of the individuals. Corporation tax is also an income tax but on the profits of companies, i.e. before these profits are distributed to the owners of the companies. These two together constitute about 28% of gross tax revenue.

Income tax is a useful tool of reducing inequalities in the distribution of income, Union excise duties are taxes on manufacturing of goods. Customs are the taxes on imports and exports of goods, in India mainly on imports. More than two third of the total tax revenue comes from union excise duties and customs.

- 2) **Non - tax revenue:** It comprises of (i) interest on loans to states and union territories (ii) interest payable by government enterprises (iii) dividends and profits from public sector enterprises (iv) external grants (v) receipts from union territories. Out of the total non-tax revenue over 60% is from interest (i.e. (i) and (ii) (above). Dividends and profits from public sector enterprises constitute nearly 15%.
- 3) **Capital receipts:** The main items of capital receipts are loans raised by the government from public which are called market loans: borrowings by government from Reserve Bank and other parties through sale of treasury bills, loans received from foreign governments and bodies and recovery of loans granted by Central Government to the State and Union territory governments and other parties. Broadly capital receipts constitute fresh loans made and loans recovered. Out of the total borrowings the loans from the RBI constitute 'deficit financing'. The implication of deficit financing is that this directly leads to printing of notes leading to net additions to money supply in the economy. In 1997-98 budget it is to the tune of Rs. 16,000 crores representing nearly 1/4 of total fiscal deficit. Another source of capital receipts is the resale of the share of public sector undertakings.

The comparative position of the three categories of receipts in 1997-98 budget of the Central Government is summed up in the Table 6.1

**Table 6.1 : Receipts of Central Government of India  
(Budget Estimates 1997-98)**

Source of revenue	Amount (Rs. Crores)	(Percentage of total)
1. Tax revenue	153143	56%
2. Non-tax revenue	39750	15%
3. Capital receipts	79033	29%
Total	271926	100%

Clearly the government is dependent on borrowings (Capital receipts) to the tune of nearly 29%. It means to meet every one rupee of its expenditure government has to borrow 29 paise, This is the real burden for the government in the form of future liability of repayment of loans and interest.

## 6.4.2 Ways of Spending Money

This is the second aspect of fiscal policy. The budget of the central government classifies public expenditure into (a) plan expenditure and (b) non-plan expenditure. Each in turn is sub-divided into (i) revenue and (ii) capital expenditures.

**Plan expenditure** includes provision of expenditure for various projects, programmes and schemes included in the Central plan for the given year. **Non-plan expenditure** covers all expenditures of government not included in the plan. It includes (a) expenditure obligatory in nature, for example, interest payments, expenditure on defence and internal security, etc; (b) expenditure on maintaining the assets created in the previous plans and (c) expenditure on continuing services and activities at levels already reached in a plan period. Thus as more plans are completed the non-plan expenditure increases.

**Revenue expenditure** is the expenditure which does not result in creation of assets. It is for the normal running of government departments and various services, interest charges on

debt incurred by government, subsidies, grants to state governments and other parties. **Capital expenditure** consists of expenditure on acquisition of assets like land, buildings, machinery, equipment, shares, etc.

The relative position of plan and non - plan expenditure in 1997-98 Budget estimates of the central government is given in Table 6.2

**Table 6.2 : Expenditure of the Central Government  
(Budget Estimates 1997-98)**

Types of expenditure	Amount (Rs. Crores)	Percentage of total expenditure
1. Non - Plan Expenditure		
a. Revenue Expenditure	145854	63%
b. Capital Expenditure	23470	10%
Total (a + b)	169324	73%
2. Plan Expenditure		
c. Revenue Expenditure	37554	16%
d. Capital Expenditure	25298	11%
Total (c + d)	62,852	27%
3. Total Expenditure (Plan + Non Plan)	232176	100%

Plan expenditure is 27% of total budget expenditure. Nearly 314 of total expenditure is non - plan. This is because we have completed eight five year plans which means a total of 46 years of planning period and as more plans are completed, non - plan expenditure increases,

Capital expenditure is nearly 1/5 of total expenditure. Remaining 415th is routine revenue expenditure. A good part-of expenditure is on transfer payments like pensions, interest payments, subsidies etc. It will help in creation of income and employment if spent on goods and services by the recipients, Ill any case transfer payments is a very useful instrument of redistributing income in favour of the poor sections of the society. Capital expenditure, on the other hand, stimulates capital for nation, provides socially useful goods such as parks, roads, schools, hospitals etc, and provides jobs. It is a very good instrument of enhancing capital base of h e nation, creating infrastructure facilities, and stimulating income earning capacity of the society.

**Check Your Progress A**

1. What is a macro economic policy?

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2. Name the three ways of raising money by the Government of India.

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**6.5 BUDGETARY FRAMEWORK IN INDIA**

**6.5.1 Summary Format of Budget**

A summary format of the budget estimates of the Central Government of India for the

year 1997-98 is given below (Table 6.3). This format aims at highlighting deficit position during the year. There are many concepts of deficit e.g. revenue, budgetary, fiscal and primary deficit. Of these fiscal deficit is considered a comprehensive measure of deficit as compared to other. Let us explain the meaning of each type of deficit.

**Table 6.3 : Budget Estimates of Government of India for the year 1997-98**

	Amount in (Rs. Crores)
<b>1. Revenue Receipts</b>	153143
2. Tax Revenue (Net to Centre)	113394
3. Non-Tax Revenue	39749
<b>4. Capital Receipts</b>	79033
5. Recoveries of Loans	8779
6. Other Receipts	4800
7. Borrowings and other liabilities (including 91-days Treasury Bills)	65454
<b>8. Total Receipts (1+ 4)</b>	<b>232176</b>
<b>9. Non-Plan Expenditure</b>	<b>169234</b>
10. On Revenue Account Of which	145854
11. Interest Payments	68000
12. On Capital Account	23470
<b>13. Plan Expenditure</b>	<b>62852</b>
14. On Revenue Account	37554
15. On Capital Account	25298
<b>16. Total Expenditure (9+ 13)</b>	<b>232176</b>
17. Revenue Expenditure (10+14)	183408
18. Capital Expenditure (12 + 15)	48768
<b>19. Revenue Deficit (1 - 17)</b>	<b>30266</b>
<b>20. Budgetary Deficit (8-16)</b>	<b>#</b>
<b>21. Fiscal Deficit (1 + 5 + 6)- 16</b>	<b>65454</b>
<b>22. Monetised Fiscal Deficit \$</b>	<b>16000</b>
<b>23. Primary Deficit (21 - 11)</b>	<b>153143</b>

# With the discontinuance of the ad-hoc Treasury bills and tap 91 days Treasury bills the concept of conventional budget deficit loses its relevance.

\$ Expected level of RBI support to Central Government borrowing.

Source : Budget At A Glance : 1997-98, Ministry of Finance, Government of India.

## 6.5.2 Measures of Deficit

A deficit is said to occur when budget expenditure exceeds budget receipts. There are various concepts of deficits depending upon the type of expenditures and receipts taken into consideration. In the central government's budget of India three types of deficits are recorded. These are revenue deficit, gross fiscal deficit and gross primary deficit.

**1. Revenue Deficit : Revenue deficit equals the excess of revenue expenditure (both plan and non-plan) and revenue (both tax and non-tax) receipts.** This deficit represents only part of the budget. Revenue receipts are the receipts of routine nature and do not lead to any addition to the liabilities of the government. Revenue expenditure, is the expenditure of routine nature not involving creation of any assets. As such the revenue deficit indicates the extent to which the current receipts are insufficient to meet the current expenditure.

**2. Budgetary Deficit :** Budgetary deficit equals the excess of total expenditure over total receipts. This includes both revenue and capital items. In the 1997-98 budget onwards total expenditure and total receipts are necessarily equal and for all practical purposes the concept of budget deficit becomes irrelevant.

**3. Gross Fiscal Deficit :** It equals excess of total expenditure over total receipts excluding borrowings and other liabilities. In the 1997-98 budget it equals borrowings and other liabilities (including 91 days treasury bills). It is a measure of total borrowing requirements of the central government. During 1997-98 it was Rs. 64454 crores.

Fiscal deficit is the most relevant of all the measures of deficit. It is a measure of real volume of problem of financing expenditure. It also indicates increase in liabilities during the year and increase in liabilities during coining years on account of interest payments.

**4. Primary Deficit :** Primary deficit equals gross fiscal deficit less gross interest payments. Gross fiscal deficit equals borrowings and other liabilities. So primary deficit equals borrowing less interest payments. This is a measure of borrowing requirements other than to meet the interest obligations. Interest payments are the result of past liabilities. Primary deficit is a measure of liabilities arising a fresh on account of current expenditures.

### 6.5.3 Sources of Financing Gross Fiscal Deficit

From 1997-98 budget estimates gross fiscal deficit (GFD) for all practical purposes equals 'borrowing and other liabilities'. GFD is most relevant concept of deficit indicating the volume of problem of financing deficit before the central government. The main sources of borrowing, arranged in order of importance are :

- 1) **Other (i.e. other than market loan) long term and medium term borrowings:** The loans comprise conversion of treasury bills.
- 2) **Small savings, PPF and other deposit schemes for retiring government employees:** This includes deposit mobilization through post office saving schemes, public provident fund, and the schemes for retired government employees.
- 3) **Special deposit schemes:** This is in the form of investments by non - government provident funds, super annuation and gratuity funds of Life Insurance Corporation, Employee's State Insurance Corporation, etc.
- 4) **Market loans :** These loans are raised by selling government securities.
- 5) **Short term borrowings :** These are in the form of 364 days treasury bills offered to the financial institutions and other parties.
- 6) **State provident funds :** This source includes provident funds of government employees.
- 7) **Gold bonds :** These bonds mobilize idle gold resources of ordinary citizens to supplement the official reserves.
- 8) **External assistance :** This constitutes borrowings from foreign countries.

The relative importance of the above sources is given in Table 6.4.

**Table 6.4 : Sources of financing fiscal deficit - Budget estimates 1997-98**

Sources of financing	Amount (Rs. Crores)	Percentage of total
1. Other short-term, medium term and long term borrowings	29750	45.5
2. Small Savings, PPF and other deposit schemes for retired government employees	14,000	21.4
3. Special deposit schemes	10,006	15.3
4. Market borrowings	4,070	6.2
5. State provident funds	2,550	3.9
6. External assistance	2,435	3.7
7. Other receipts	2,643	4.0
Total	65,454	100.0

Of the above source 1-5 and 7 are internal borrowings and 6 is external borrowings. So more than 96% of financing is from within the country and about 4% from foreign countries. Total accumulation of public debt and other liabilities of the central government since 1950-51 is shown in Table 6.5.

**Table 6.5 : Accumulated public debt and other liabilities of Government of India**

Source	1950-51		1997-98	
	Amount (Rs. crores)	Percentage	Amount (Rs. crores)	Percentage
Internal	2830	99	677290	92
External <sup>4</sup>	30	1	56000	8
Total	2860	100	733920	100

The main short term implication of the above debt is the payment of huge sum of money as interest every year. In the 1997-98 budget estimates the interest payments amounted to Rs. 68,000 crores. This amounts to nearly 30% of total expenditure during the year.

## 6.6 OBJECTIVES OF FISCAL POLICY

Fiscal policy deals with government's power to tax and spend for the purpose of achieving certain declared policy objectives. It refers to deliberate actions by the government in its spending and taxing activities to achieve certain objectives. The three basic **objectives** of fiscal policy are promoting economic growth, employment and price stability. There are other objectives also. Let us have a look at these objectives.

### (1) Promoting economic growth

Economic growth means raising the level of real output. Government promotes economic growth in many ways. It creates conditions suitable for raising productions. For this purpose the government follows its expenditure pattern in such a manner that there is effective administration, proper infrastructural facilities, etc. It also provides subsidies and tax concessions to encourage production activity. Government also participates in production directly by opening public sector enterprises.

### (2) Creating employment opportunities

Government creates employment opportunities directly by opening public enterprises and undertaking public works programmes like building of roads, bridges, government buildings, etc. Government of India has launched many employment generation schemes. Government creates employment opportunities indirectly also by pursuing policy of encouraging labour intensive industries through subsidies and tax concessions. Government of India gives such tax concessions to small scale and cottage industries in India.

### (3) Ensuring stability in prices

Fiscal policy can play and actually plays an important role in avoiding fluctuations in prices. Undue rise in prices causes hardships to common man while undue fall in prices leads to fall in production and employment in the country. Government ensures some stability in prices, at least of essential goods for consumption and production, through fair price shops, keeping buffer stocks, giving fiscal incentives to raise production in the form of tax concession, subsidies, etc.

### (4) Reducing inequalities of incomes

Only government intervention through deliberate fiscal measures can be helpful in reducing inequalities. On the taxation side government follows a progressive tax rate policy of taxing higher incomes and taxing production of goods consumed by the rich at a higher rates. On the expenditure side, government spends money so collected on welfare schemes meant for the poor,

### (5) Regulating foreign trade and foreign exchange

Government encourages or discourages imports and exports by varying custom duties from time to time. For the past few years Government of India is following a policy of

liberalization of imports by lowering import duties with a view to step up production activity, attracting foreign investments, make the domestic market more competitive and encouraging exports. Liberalization of foreign trade also increases the flow of foreign exchange. This may ultimately be helpful in solving the balance of payments problems of the country.

**Check Your Progress B**

- 1. Distinguish between plan and non-plan expenditure of government.

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- 2. Define the concept of gross fiscal deficit as used in the central government's budget.

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- 3. Define fiscal policy.

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## 6.7 MEANING OF MONETARY POLICY

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Monetary policy is the deliberate exercise of the monetary authority's power to induce expansions or contractions in the money supply with the objective of influencing investment, income and employment and maintaining price stability in general within the broad framework of economic policy objectives of government. The central bank of a country is the monetary authority of the country. In India Reserve Bank of India (RBI) is the central bank of the country. Each country has a central bank known by different names.

The objectives of monetary policy are nearly the same as that of fiscal policy. However the nature of measures adopted and the agencies responsible for implementation are different. Fiscal policy is operated by government while the monetary policy by the central bank (i.e. RBI). Fiscal policy involves changes in taxes and government spending. Monetary policy involves variations in money supply, interest rates, lending by commercial banks etc.

To understand the meaning of monetary policy let us first explain the meaning of the concept of money supply and the institution of central bank.

### 6.7.1 What is a Central Bank?

Banking structure of a country comprises of central bank and the commercial banks. The commercial banks are engaged in accepting deposits from public and lending. In addition they provide many services to their depositors like cash withdrawals and transfer of funds from one bank to another etc.

The central bank is the supervisory bank over the commercial banks. It regulates the activities of these banks particularly the banking functions. If you have visited some banks You must have observed that all banks have nearly the same rules of making deposits and similar lending rates. It is because all such rules are framed by the RBI. The central bank, however, does not deal with the public directly. It deals with government and commercial banks only.

Following are the main functions of the central bank.

- 1. Sole authority to issue currency.
- 2. Looks after government accounts and advises government on economic matters.



minimum percentage of deposits in reserve. They are of two types: a) cash reserves and liquidity reserves. **Cash reserves** are kept by commercial banks with central bank.

**Liquidity reserves** are in the form of liquid assets such as cash, gold, securities, etc. and are kept by commercial banks with themselves. Their minimum ratios as fixed by the RBI are called Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) in India.

How does it work? Suppose a commercial bank has a total deposit of Rs. 100 crores. Further suppose the CRR and SLR together come to 20 percent. It means that the bank has to legally keep Rs. 20 crores as reserves. It also means that the bank has the capacity to grant loans upto Rs. 80 crores. Now if the minimum reserve requirements is 30 percent, the bank's capacity to grant loans falls to Rs. 70 crores. So if the central bank wants contraction of credit in the economy it can raise legal reserve requirements.

### 2) *Bank rate*

The central bank lends money on interest to the commercial banks just as the commercial banks lend money on interest to public. **The rate of interest charged by the central bank on their loans to commercial banks is called bank rate (or discount rate).**

Variation in bank rate influences credit conditions in the country. An increase in bank rate makes it more expensive for commercial banks to borrow. This exerts pressure to bring about a rise in interest rates (called lending rates) charged by the commercial banks on their lending to public. This leads to a general tightening of credit in the economy. The decrease in bank rate has the opposite effect and leads to general easing of credit in the economy. Inflationary conditions in the economy need tightening of credit while deflationary tendencies need general easing of credit.

### 3) *Open market operations*

These operations refer to the buying and selling of government securities by the central bank in the open market. When the RBI sells securities to the commercial banks or to the public the money flows out of commercial banks and into RBI. This reduces deposits of commercial banks and consequently their capacity to create credit. The buying of securities has the opposite effect leading to out flow of money from the RBI and into commercial banks leading to rise in deposits and credit creating capacity of these banks.

## 6.8.2 Qualitative (or Selective) Instruments

Qualitative instruments influence the direction of credit rather than total volume of credit. Margin requirements and moral suasion are the two principal instruments. RBI uses more selective instruments in addition to these two.

### 1) *Margin requirements*

Commercial banks lend against security in the form of property, merchandise or financial instruments like shares, bonds, debentures etc. While lending against a security banks keep a margin as a safeguard against fluctuations in the market value. For example if the current market value of security is Rs. 10 lakhs, the bank may give loan only upto 80% of the value and keep a margin of 20% as a safeguard. The central bank uses this margin requirement as an instrument of regulation of credit. It has the power to fix the minimum margin. Higher the minimum margin less is the credit granted against a security. Higher or lower minimum margins may be fixed on selection basis to discourage or encourage borrowings.

### 2) *Moral suasion*

It implies the central bank exerting pressure on banks by using oral and written appeals to expand or restrict credit in line with its credit policy. No written rules are enforced. Banks are only advised and persuaded to discourage or encourage lending. Moral suasion is a psychological device which relies on personal talk and public opinion.

### 3) *Ceilings on credit*

To check undue expansion of credit in certain directions, the RBI puts ceiling on granting of credit for certain purposes. This instrument can also be used to ensure equitable flow of credit towards all sectors of the economy.

### 4) *Discriminatory rates of interests*

RBI is empowered to direct commercial banks to charge different interest rates for

granting credit to different sectors. Priority sectors are generally given loans at lower rates. The scope of the priority sectors may be determined in accordance with overall economic policy of the government. At present agriculture, small industries, small traders, self-employed professionals, educated unemployed are some examples of priority sector.

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## 6.9 OBJECTIVES OF MONETARY POLICY

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The main objectives of monetary policy of RBI since the introduction of planning in India have been speeding up economic development and to control inflationary tendencies. Economic development is not a single objective but a mix of many objectives like economic growth, employment, economic equality etc. With the ever rising volume of foreign trade RBI regulates the flow of foreign exchange. These objectives are explained below.

### 1) *Economic growth*

Economic growth implies rise in real income or output. It requires investment. The banking system is a big source of credit for investment. By regulating the flow of credit in the desirable directions the RBI contributes a lot to the economic growth of the country.

### 2) *To control fluctuations in prices*

Both inflation and deflation are not good for the health of the economy. Inflation causes hardships to consumers and causes decline in exports. Deflation causes unemployment and reduces real output. Money supply is an important factor causing inflation. More money in the hands of people means more demand. If the real output lags behind money supply the prices are bound to rise. The RBI plays a useful and important role in controlling the unrestricted growth of money supply through its monetary policy measures.

### 3) *Employment*

More investment creates more employment opportunities. Bank loans are a very important source of financing investment in modern times. The loan granting capacity of commercial banks is determined by the RBI's credit regulation measures, both quantitative and qualitative. RBI can raise this capacity by lowering reserve requirements, lowering bank rate, buying government securities from the market and so on. In this manner RBI plays a very useful role in expanding employment opportunities in the country.

### 4) *Economic equality*

Inequality in the distribution of incomes is an economic and social ill. All governments show determination in ensuring a more equitable distribution of income. RBI plays an important role in this respect. It tries to ensure adequate flow of credit towards priority sectors like small scale and cottage industries and other less privileged sections of the society through selective credit controls. These sectors get loans at lower rates of interest and on easy terms. It blocks the unrestricted flow to the large industries by putting ceilings on bank credit.

### 5) *Foreign exchange*

Fluctuations in exchange rates may adversely affect foreign trade. These may reduce home currency value of exports and increase value of imports. This may put exporters and importers into losses. RBI plays a very useful role in controlling these fluctuations. It puts certain conditions on inflow and outflow of foreign exchange and take other measures to ensure some stability in exchange rates. In India RBI is the sole authority of foreign exchange management.

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## 6.10 ROLE OF RESERVE BANK OF INDIA

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RBI plays three types of roles : 1) The traditional role that a central bank is expected to play; 2) the supervisory role i.e. regulation of the functioning of commercial banks in India and 3) promotional role i.e. helping the developmental process in the country. The three roles are described below .

### 1) *Traditional role*

Traditionally, like any other central bank in the world, RBI performs the following

functions :

- Sole authority to issue currency notes and coins in India.
- Handles all accounts of government.
- Advises government on economic matters.
- Regulates banking activities of commercial banks who are required to keep a certain ratio of deposits as reserves with the RBI. In return RBI gives loans to these banks in times of need.
- Regulates lending by commercial banks to keep a check on money supply,
- Regulates all foreign exchange transactions to ensure smooth flow of foreign exchange and stability in exchange rates.

### 2) *Supervisory role*

Although RBI was established in India in the year 1934 to perform the traditional function stated above, the Banking Regulation Act, 1949 gave RBI the powers of supervision and control over commercial banks. These powers concern granting licenses to new banks, permission for opening more branches, framing rules for management and working etc. This role is to ensure smoothness in day to day working of commercial banks in India.

### 3) *Promotional role*

#### a) **Rural credit**

RBI takes direct interest in rural credit. Before 1982 it used to provide loans to the agricultural sector through cooperative institutions and state governments. Later this function was transferred by RBI to National Bank for Agriculture and Rural Development (NABARD) which was set up in 1982. After doing so RBI has not washed off his hands from its promotional function. It has opened up a new department called the Rural Planning and Credit Department to look after the problems of rural credit.

#### b) **Industrial finance**

The RBI has played a dominant role in setting up of credit institutions to finance industry. Main examples of such institutions are: Industrial Finance Corporation of India, State Financial Corporations, Industrial Development Bank of India, Industrial Credit and Investment Corporation of India.

#### c) **Finance of priority sectors**

The RBI directs commercial banks in India to give special attention to the credit needs of priority sectors like agriculture, small industries, small traders, self-employed professionals educated unemployed etc. It has designed schemes for these sectors implemented through the commercial banks.

### **Check Your Progress C**

Choose the correct alternative:

1. Monetary policy is operated by
  - a) Finance Minister
  - b) Commercial banks
  - c) Central bank
  - d) Government of India
2. One of the following is not the instrument of monetary policy
  - a) Moral suasion
  - b) Margin requirements
  - c) Open market operations
  - d) Deficit financing

3. Bank rate is the rate of interest charged by the RBI on loans to
  - a) Government of India
  - b) Commercial banks
  - c) Agricultural sector
  - d) Industrial sector
4. The alternative name of bank rate is
  - a) Lending rate
  - b) Open market rate
  - c) Discount rate
  - d) Discriminatory rate
5. One of the following is the qualitative instrument of RBI's monetary policy
  - a) Discriminatory rates of interests
  - b) Bank rate
  - c) Cash reserve
  - d) Open market operations
6. Monetary policy aims at regulating
  - a) Money supply
  - b) Availability of credit
  - c) Flow of foreign exchange
  - d) All the above
7. Advising government on economic matters is the following role of RBI
  - a) Traditional
  - b) Promotional
  - c) Supervisory
  - d) None of the above

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## 6.11 LET US SUM UP

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A macro economic policy refers to the deliberate measures taken at national level to regulate the functioning, growth and development of the economy and its sectors. Fiscal policy and monetary policy are the two crucial macro level policies.

Fiscal policy refers to the deliberate actions of government in its spending and taxing activities to achieve certain objectives. Government raises money through taxes; interest dividends of public sector enterprises, external assistance and borrowings. Government spends money on normal running of government (revenue expenditure) and on acquisition of assets (capital expenditure). In the 1997-98 budget estimates about 3/4th of total expenditure is revenue expenditure and 1/4th is capital expenditure.

The main objectives of fiscal policy are : (1) promoting economic growth, (2) creating employment opportunities, (3) ensuring stability in prices, (4) reducing inequalities of incomes and (5) regulating foreign trade and foreign exchange.

Monetary policy is the deliberate exercise of the monetary authority's power to induce expansions or contractions in money supply. Monetary policy is operated by the central bank (RBI). The central bank is the apex bank and supervises over the commercial banks. It performs many functions like issuing currency, looking after government accounts, regulate flow of credit, regulate the flow of foreign exchange, etc.

The instruments of monetary policy are of two types : quantitative and qualitative. Reserve ratios, bank rate and open market operations are the quantitative instruments. Margin

requirements, moral suasion. ceilings on credit and discriminatory rates of interests are the qualitative instruments adopted by the RBI. The main objectives of monetary policy are nearly the same as that of fiscal policy. These are : (1) economic growth, (2) control fluctuations in prices, (3) employment, (4) economic equality and (5) foreign exchange.

RBI plays three types of roles : traditional, supervisory and promotional. In its traditional role it performs the usual function a central bank is expected to play like issue of currency, handling government account, regulating the activities of commercial banks, etc. In its supervisory role it has the power of granting licenses to new banks, permission of opening branches, etc. In its promotional role RBI takes direct interest in rural credit through NABARD; in industrial credit through IDBI, ICICI, IFC, etc and in priority sectors through commercial banks.

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## 6.12 (KEY WORDS)

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**Macro policy** : National level policy of government

**Fiscal policy** : Deliberate actions by government in its spending and taxing activities.

**Plan expenditure** : Expenditure of government on projects and schemes in the central plan.

**Non-plan expenditure** : Expenditure of government not included in plan.

**Revenue expenditure** : Expenditure on normal functions of government and does not lead to creation of assets.

**Capital expenditure** : Expenditure by government on acquisition of assets.

**Gross fiscal deficit** : Total expenditure of government less total receipts excluding borrowing and other liabilities.

**Revenue deficit** : Revenue expenditure less revenue receipts.

**Budgetary deficit** : Total expenditure less total receipts of government.

**Primary deficit** : Gross fiscal deficit less interest payments.

**External assistance** : Borrowings from foreign countries.

**Monetary policy** : Deliberate actions of monetary authority to influence money supply.

**Cash reserve ratio** : Ratio of deposits kept by commercial banks with central bank.

**Liquidity reserve ratio** : Ratio of deposits kept by commercial banks with themselves.

**Bank rate** : The rate of interest charged by the central bank on loans to commercial banks.

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## 6.13 ANSWERS TO CHECK YOUR PROGRESS

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C. 1. c), 2. d), 3. h), 4. e), 5. a), 6. d), 7. a).

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## 6.14 TERMINAL QUESTIONS

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1. Explain the meaning of the following :
  - (a) Macro economic policy
  - (b) Fiscal policy
  - (c) Monetary policy
2. Explain the different ways of raising money by Government of India to finance its activities.
3. Distinguish between :
  - (a) Plan and non-plan expenditures
  - (b) Revenue and capital expenditures

4. State the different measures of deficit in the government's budget. How are these calculated?
5. What is gross fiscal deficit? How is it financed?
6. Explain the objectives of fiscal policy.
7. What is a central bank? State its functions.
8. What is money supply? State the different measures of money supply.
9. Explain the quantitative instruments of monetary policy.
10. Distinguish between quantitative and qualitative instruments of monetary policy. Explain qualitative instruments.
11. Explain the role of Reserve Bank of India.

**Note:** These questions will help you to understand the Unit better. Try to write answers for them, but do not send your answers to the University. These are for your practice only.