UNIT 21 FISCAL AND MONETARY POLICIES: GROWTH AND STABILISATION

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21.0 OBJECTIVES

After reading this unit, you will be able to:

- state the processes through which macroeconomic policy attempts to achieve economic growth with stability;
- describe the instruments of fiscal policy vis-à-vis their effectiveness for macroeconomic impact;
- explain the broad approach to 'monetary policy' used to control money supply in an economy;
- delineate the 'alternative strategies' available to ensure the required money supply in an economy;
- highlight the macroeconomic impact of monetary policy measures on an economy;
- present arguments, for and against, for government intervention to rectify the macroeconomic instabilities;

- discuss the efficacy of 'alternative approaches' in stabilising an economy from macroeconomic shocks; and
- write a note on 'summary assessment of macroeconomic policies' on the 'economic growth' of an economy in general.

21.1 INTRODUCTION

Macroeconomic policy aims at lowering the risks and uncertainty in economic decision making in order to ensure a stable and growth conducive environment. Further, the distributional aspect (to ensure economic parity across groups and generations) also comes within the domain of its policy intervention. It thus attempts to provide a framework within which the factor markets (labour and capital) and product markets operate. Macroeconomic policies include 'fiscal policy' (taxes, government spending and borrowing) and 'monetary policy' (exchange rate determinants, monetary and credit rules). The level and nature of economic activity in an economy is influenced by these policies through their impact on: (i) the decision-making process of economic agents and (ii) the macroeconomic environment they provide.

Economic growth is the quantitative expansion of aggregate output produced in a period. Quality of growth, on the other hand, is concerned with both the composition of growth across sectors as well as with the distribution of gains from growth across all sections of society. Growth can be decomposed into expansion of employment and average productivity per person (the two of which thereby become the determinants of growth). The fiscal and monetary policies impact the degree and nature of growth of the economy by influencing both these determinants of growth.

An economy exhibiting pronounced business cycles, very high or variable inflation, recurring financial crisis, frequent recessions, acute balance of payment situations would be considered 'economically unstable'. Such an economic atmosphere engenders an atmosphere of risk, uncertainty and low confidence in the investment climate of the economy. Stabilisation implies containing both internal and external imbalances in the economy. External imbalance refer to balance of payment imbalances (a component of which is external trade imbalance). Internal imbalance refers to: (i) rising inflation, (ii) volatile outputs, (iii) increasing unemployment and (iv) increasing fiscal deficits. Stabilisation aims at correcting or containing all these four factors of internal imbalance.

21.2 FISCAL POLICY

The policy through which the government makes adjustments to its planned spending, and determines the quantum of tax and non-tax revenues raised, is known as fiscal policy. According to the Keynesian School, adjustment of taxes and/or government spending tends to alter the aggregate demand and influence the incentives faced by the firms and individuals to undertake different kinds of economic activities. Fiscal policy is an effective instrument to stabilise the economy over the course of a business cycle. It is used to influence macroeconomic variables like aggregate demand, savings and investment and income distribution. There are *three* broad fiscal policy stances viz.

- *Neutral Fiscal Policy:* employed in the case of stable economic conditions.
- *Expansionary Fiscal Policy:* employed during a downturn or recessionary

conditions (when a fiscal stimulus package which includes enhanced government spending or lowered tax rates or a combination is adopted).

- *Contractionary Fiscal Policy:* employed when the economy is overheated or when there is boom. It may involve increased taxes and lowered spending.

The gap between government spending and revenue (i.e. fiscal deficit) is taken as an indicator of the fiscal policy stance. Opinion on fiscal deficit has ranged from its stimulating effect in combating economic slowdown to its debilitating effect in giving rise to unsustainability of public debt. However, more specific ultimate objectives of fiscal policy are concerned with (low) inflation, (low) unemployment and (high) growth.

21.2.1 Instruments of Fiscal Policy

To fulfil the twin objectives of low unemployment and price stability, the fiscal policy authority adopts the following instruments:

- Public Expenditure: This is used to stimulate or regulate an economy when it faces situations like recession or boom. Any variation in public expenditure will have an important bearing on the level of consumption, investment or total income. Public expenditure constitutes an important share in total expenditure of an economy and is mainly composed of expenditure on public works, relief expenditures, subsidies, transfer payments, salaries and social security benefits. Usually, an expansionary fiscal policy action is used in case of recessionary situation. On the contrary, fiscal constraints are employed during boom to avoid the consequences of hyper-inflationary tendencies.

- Taxation Policy: The tax structure of an economy occupies an important place as a fiscal policy tool. Taxes determine the size of disposable income in the hands of economic agents and thereby the corresponding inflationary and deflationary gaps. Tax policy has to be easy during depression while during inflation or boom periods, it must curtail the spending ability of consumers and investors.

- Public Debt: A properly managed public borrowing programme and debt repayment serves as a powerful instrument in combating the macroeconomic instabilities like inflation or deflation. Government borrowing takes place through: (i) commercial banks, (ii) non-bank financial intermediaries, (iii) the central bank or by the printing of new money. Borrowing from general public against the sale of bonds and securities help to reduce the consumption and private investment spending and control inflation. If banks have excess reserves, borrowing from the banking system enables the government to undertake investment projects stimulating the economy out of depression. Withdrawals from the treasury add to easing depression, but account for a negligible fraction of government borrowings. Debt monetisation (in the form of printing money) adds liquidity in the system but is inflationary in its effect. A proper mix of public debt alternatives is therefore necessary to ensure desirable economic outcomes.

- Budget: Budget document (financial plan of the government – usually for a year) serves as an important policy tool to handle the economic fluctuations. Discretionary changes in expenditures and/or tax rates through managed/balanced budget are used to stimulate the economy when in a recession and to achieve price stability during the boom periods. A counter

cyclical budgetary policy may also be adopted by unbalanced budgeting. During the depression an unbalanced budget implies deficit financing whereas during economic overheating episodes, it would be surplus budget implying lower government expenditures and higher taxes.

21.2.2 Macroeconomic Impact

The fiscal policy is adopted to achieve the following impact on the economy:

- Price Stability: Taxes and spending help the government in stabilising the fluctuation in prices and by placing a check on higher inflationary pressures.
- Employment Generation: Fiscal policy, through its contribution to infrastructural development, generates employment opportunities particularly in developing countries where private sector investment is relatively low.
- Resource Mobilisation: Fiscal policy enables the mobilisation of resources needed for public spending through taxes, public and private savings through issuance of bonds and securities.
- Resource Allocation: Fiscal policy can be an instrument in allocation of funds mobilised through fiscal instruments (e.g. for social infrastructure, human and physical development).
- Income Redistribution: By applying the instruments of taxes and transfers, fiscal policy performs the redistributive role. Taxes collected from rich and spent on the development of poorer sections help reduce economic inequalities.
- Balanced Regional Development: To ensure a balanced regional development in a federal structure like India, fiscal transfers (statutory and discretionary) are provided to the less developed regions.
- Balance of Payments: Fiscal policy actions like 'input tax credits' or subsidised capital to industries help promote exports. It thereby helps to increase the forex reserves and maintain a stable external position.
- Capital Formation and Economic Growth: Government tax rebates and increased spending boost private investment. Increased total investments in the economy broaden the capital base (capital deepening and capital widening) and promote economic growth.

Check Your Progress 1 [answer within the given space in about 50-100 words]

1) In what way macroeconomic policies impact economic growth?

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2) What does the term 'stabilisation' basically imply?

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3) What are the three broad fiscal policy stances?

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4) State the four main instruments of fiscal policy.

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5) In what respects an economy experiences impact on account of fiscal policy pursued?

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21.3 MONETARY POLICY

Monetary policy is the process by which the monetary authority of an economy, usually a central bank, regulates either the cost of borrowing (typically of very short-term borrowing) or the money supply. Conventionally, monetary policy aims at targeting the: (i) desired level of output (and thereby the rate of growth) in the economy, (ii) maintenance of a stable price level and (iii) management of exchange rate (or the balance of payments). It thus aims at controlling fluctuations in aggregate demand. While fiscal policy involves a trade-off between output stabilisation and distortions from tax and spending changes, monetary policy involves a trade-off between price and output stability. The *stance* of a monetary policy to avert the macroeconomic instabilities therefore includes the following:

- Easy Monetary Policy: A policy stance favouring low interest rates, increased liquidity and easy access to credit aimed at stimulating the real economic activity. Such a policy action is executed during the recessionary

economic episodes wherein investment and employment are below normal levels.

- Tight Monetary Policy: A restrictive policy stance intended to restrict the level of effective demand by inducing higher interest rates, constraining the money supply or credit access. This type of policy action is usually executed during boom periods in order to cool down the economy from overheating.

- Accommodative Monetary Policy: A monetary policy action wherein the supply of money is allowed to expand in line with the demand for it. If the demand for money rises due to sustained real growth in the economy, accomodatory monetary policy is preferable and any failure to increase the money supply would obstruct growth. If, on the contrary, the increased demand for money is due to temporary and unsustainable hike in economic growth, resorting to accommodative monetary policy would lead to inflation in prices and wages.

Thus, although, in the early years, the central monetary authority was charged with a large number of objectives, over time, literature on monetary policy highlights two important objectives viz. one **to protect the economy from shocks**, and two, **to ensure price stability**.

21.3.1 Instruments of Monetary Policy

To ensure a stable price level together with a sustainable growth path, the central banks adopt two kinds of instruments. These can be broadly classified as: (i) quantitative credit controls and (ii) qualitative credit controls. The former comprise of two instruments viz. (i) reserve ratios and (ii) policy rates. The latter comprise of several instruments like (i) margin requirements, (ii) moral suasion, (iii) credit rationing, etc.

Reserve ratios consist of cash reserve ratio (CRR), statutory liquidity ratio (SLR) and open market operations (OMO). CRR is the cash required to be kept with the RBI as a percentage of a bank's total deposits. The bank can neither lend this portion to anyone nor can it earn interest or profits on it. CRR is used to vary money supply in economy. SLR represents the percentage of a bank's total deposits that are required to be invested in government approved securities. SLR restricts funds available for lending. The bank earns interest on SLR funds. OMO refers to policy actions of buying and selling of government securities to regulate the short-term money supply. If additional liquidity is needed in the economy, RBI will buy the government securities and pump in funds. In case of excess liquidity, RBI sells the securities to suck out excess money circulating in the economy. In particular, OMO is applied to avoid temporary liquidity mismatches in the market caused by foreign capital flows.

Policy rates comprise of: (i) bank rate (BR), (ii) repo rate (RR) and reverse repo rate (RRR) and (iii) marginal standing facility rate (MSFR). Bank rate refers to the rate of interest at which a central bank lends long-term funds to commercial banks. RBI uses bank rate to regulate the money supply with the 'liquidity adjustment facility' (LAF) extended through the RR and the RRR. **Repo Rate** (being acronym as Repo for repurchase option) is a collaterised lending to banks to meet their short term liquidity needs. It is the rate at which banks are allowed to borrow money from RBI by selling securities to it with an agreement to repurchase the same at a predetermined rate and date. Repo operations inject liquidity into the system. On the other hand, **Reverse Repo Rate** involves the

borrowing of RBI from commercial banks against the securities. The interest rate paid by RBI in this case is called the reverse repo rate. The reverse repo transactions enable banks to park excess money with the RBI thereby absorbing excess liquidity. Another rate, called the **Marginal Standing Facility (MSF) Rate** refers to a new LAF window which allows banks to borrow overnight funds from the RBI in case of an emergency situation. This is extended against government securities when the inter-bank liquidity is not forthcoming.

Qualitative credit controls are selective tools applied to regulate the channelling of cash and credit to priority sectors like small-scale industries, consumer goods industries and agriculture. These include: (i) margin requirements, (ii) moral suasion, (iii) credit rationing, (iv) publicity and (v) direct action. Margin requirement is the difference between market value of the security and the amount of loan advanced against the security. The **margin requirement** is increased when flow of credit is to be restricted in the economy and vice versa. **Moral suasion** (also known as 'moral persuasion'), refers to RBI's convincing the commercial banks to follow its directives on the flow of credit. RBI persuades the banks to put a cap on credit supply during high inflation episodes and be liberal in lending during economic downturn. **Credit Rationing** is also a maximum cap placed on the loans and advances made by the commercial banks. The credit ceiling is applied in situations (or sectors) where credit needs to be checked especially where it is used for speculative investments. **Publicity** is a tool used by the central bank to disseminate its views on the current economic affairs and its likely directions to ensure stability. **Direct Action** are the power vesting with the RBI to undertake strict course of action against commercial banks which decline to follow the orders or directives from the central bank.

21.3.2 Alternative Strategies

The main purpose of monetary policy is to ensure a stable growth in aggregate demand. It entails avoiding aggregate demand either arising too fast resulting in inflation, or rising too slow resulting in high unemployment and lower economic growth. There are two broad indicators [viz. (i) the monetary targets and (ii) interest rate targets] that a central bank uses as intermediate targets to move towards the *final* or ultimate targets. Like in the case of fiscal policy, the *final targets* of monetary policy too are maintaining stability or growth in macroeconomic variables like unemployment rate, inflation rate and the growth rate of real income.

Monetary Targeting: To understand the use of the monetary targeting as an intermediate measure, it is assumed by the policymakers that other things remaining constant, an increase in money supply will reduce the level of unemployment (by increasing the level of economic activity) and might trigger inflation in the short run. On the contrary, slower growth in money supply leads to lower inflation and a higher short run unemployment. Past data and expert forecasts about the probable trajectory of economy would be employed to decide the monetary target. Once the target for the money growth rate is decided, the monetary policy operates consistently as if the chosen target for the money growth rate is the ultimate target of the monetary policy.

Interest Rate Targeting is a substitute for monetary targeting. The operative mechanism is that, once the central bank sets a target rate for the call money rate, the central bank will undertake 'open market operations' (OMOs) with a view to keep the actual interest rates at or close to the target rate. If the actual rate exceeds the target rate, securities are purchased through OMOs. This would increase the

liquidity and the actual rates would come down. Since the OMOs raises or lowers the bank reserves (and thereby the bank deposits and therefore the money supply), the interest rate targeting is *an alternative* to monetary targeting. A central back can target either of the two, but not both. Note that it is convenient to track the short-term rates contemporaneously and hence these are controlled more effectively. The call rates can therefore be regarded as *short-term operating target*. Changes in money supply can be noticed with a lag of a week or two with some errors. Interest rate targeting focuses on the short-term interest rate (such as call money rate) as long-term interest rates can be contemporaneously observed but not easily controlled.

The choice between the monetary aggregate and interest rate targeting is guided by the conditions in an economy. For instance, monetary targeting is an ideal case for monetary policy in case the central bank faces an interest rate insensitive (i.e. vertical) LM curve. This strategy enables the fulfilment of both the intermediate and the final targets. On the contrary, in case of a non-vertical LM curve (interest rate sensitive), even though the monetary target is achieved, the ultimate target, such as full employment may be missed.

21.3.3 Macroeconomic Impact

Monetary policy (MP) is primarily concerned with the price and exchange rate stability, along with promotion of economic growth. Further, it also helps in the following.

- **Promotion of Savings and Investment:** By regulating the interest rates and inflationary tendencies by applying the expansionary or contractionary policy stances, MP can help to influence savings and investment.

- **Regulating Imports and Exports:** By extending priority loans at low interest rates, MP helps to induce export-promotion and import substitution thereby helping to enhance the external account position of the economy.

- **Managing Business Cycles:** The upswings (boom) and downswings (recession) of a business cycle may be regulated by applying tight policy action during boom and easy policy action during recession. It helps in averting the destabilising ramifications of business cycle fluctuations.

- **Regulation of Demand Conditions:** By influencing the availability of credit and its cost, monetary policy acts as an effective tool to control the demand conditions according to the economic circumstances.

- **Employment Generation:** By influencing the level of savings, investment and aggregate demand, MP impacts favourably on employment creation.

- **Infrastructural Development:** By facilitating subsidised or concessional funding to priority sectors like small-scale industries, agriculture other credit constrained sections, MP helps in infrastructural development.

- **Managing and Developing the Financial Sector:** The central bank manages the banking sector in order to ensure its smooth functioning and provision of financial services far and wide across the country.

Check Your Progress 2 [answer within the given space in about 50-100 words]

1) Distinguish between CRR and SLR.

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2) Differentiate between RR and RRR.

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3) What is meant by 'priority sector' lending?

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4) When is 'monetary targeting' used as a tool? How does it help?

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5) How is interest rate targeting an alternative to monetary targeting?

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21.4 STABILISATION

On suitable policies to counteract macroeconomic instabilities, there have existed two extreme views viz. fine-tuning versus leave-it-alone policies. Adherents of the first view (called activists) consider the economy as potentially (and inherently)

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unstable. They maintain that the economy is subject to frequent aggregate demand-supply shocks. Therefore, if the policymakers do not employ active stabilisation policies (monetary and fiscal), the shocks would result in undesirable and inefficient movements in output, inflation and unemployment. Policy intervention can and should be used to avert such shocks and stabilise the economy. The second view, with Milton Friedman as its pioneer, holds diametrically opposite position that the economy inherently tends to be stable. They point out that active economic policy interventions themselves could potentially cause erratic, substantial and inefficient fluctuations. They therefore advocate a hands-off macroeconomic policy.

21.4.1 Active Versus Passive Policy Interventions

Policymakers face the problem of long lags and difficulty in predicting the lengths of such lags. As a result, application of monetary and fiscal policy is affected. There are various stages in policy intervention and lags are associated with each stage. Broadly, these may be categorised into: **inside lag and outside lag**. Inside lag represents the period of lapse between occurrence of an economic shock to the economy and implementation of suitable policy action to correct that shock. This lag is further categorised into: **recognition lag, decision lag** and **action lag**. **Recognition lag** refers to the time elapsed between the occurrence of a shock and recognition by the policymakers that a policy intervention is required for its correction. It is relatively shorter when an expansionary policy action is warranted and longer when a contractionary policy action is desired. The **decision lag** represents the time elapsed between the recognition of the need for an action and the actual policy decision. The **action lag** denotes the time elapsed between the policy decision and its implementation. The decision and action lags are short for the monetary policy because the monetary authorities meet frequently and major policy actions can be initiated as soon as the decision is made. It is relatively longer for the fiscal policy due to complex procedure of policy making and implementation. For instance, the administration may have to prepare legislation which goes through reviews needing to be approved by the houses of parliament before the policy action can be initiated.

The **outside lag** represents the time between the initiation of a policy action and its effect on the economy. This lag arises due to lagged response of the macroeconomic variables like spending, income and employment. Note that the outside lag is a distributed one as the effect of a policy action on the economy is spread over time. Outside lags are usually longer for monetary policy compared to fiscal policy. The effectiveness of monetary policy actions (change in money supply or in interest rates) depends upon the behaviour of economic agents like investors. Many firms prepare the investment plans in advance. Thus, a change in monetary policy instrument is not considered to affect the economic activity until about two quarters after such change. Existence of such lags, the passivists argue, renders active policy interventions risky and in fact de-stabilising.

Assume that an economy operating at the full employment level faces an un-anticipated aggregate demand shock that, at time t_0, reduces the output below its potential level. In the 'do nothing' scenario, the output will fall initially but soon recover to full employment again at time t_e. Suppose policymakers adopt an active policy. Due to lags, the shock is perceived at time t_1, decision to intervene is taken at time t_2, the expansionary policy is initiated at time t_3, and finally it may *start* having effect from time t_4 onwards. It is possible that economy is already recovering by the time expansionary policy is implemented. Thus, due to the

mismatch in timing and/or the ‘poor dosage’, economy might overshoot the level of full employment. To correct the divergence from the full employment level, contractionary policy action is now executed at t_5 and after some lag, the output starts falling down to the full employment level. It may continue falling even to lower levels. Thus, instead of stabilising the economy, policy intervention in presence of lags tends to be destabilising. The advocates of active policy, however, maintain that the presence of lags does not necessarily make the policy actions irrelevant altogether, *particularly during conditions of acute and persistent economic downswings* like that of 2008. But there are some problems of planning which are as follows.

Difficulties in Economic Forecasting: There are several methods used in economic forecasting: from a simple leading indicator technique to macroeconometric time-series models. The macroeconometric models are employed to forecast unemployment, inflation and other endogenous variables treating the policy parameters as exogenous. However, the accuracy of the forecast depends on, how well the model is built. There are often large margins of error in prediction. Events like the great depression, the recession recovery of 1982, the Asian financial crisis of 1997 and the global meltdown in 2008 indicate that many such episodes are difficult to predict. Policymakers need to be cautious of such errors of prediction.

Ignorance and Expectations: A policy intervention based on an understanding gained from an econometric model using past data, ignores the effect the intervention itself will have on the behaviour of the economic agents. Rational economic agents form their expectations on the same knowledge of economy that is available to the policy maker and the economic agent. Thus, any announced policy action becomes largely ineffective. For instance, if expansionary stimulus is given, the economic agents will anticipate inflation and adjust their contracts accordingly, rendering policy ineffective.

Time Inconsistency: Economic policy is neither independent of nor devoid of consequences of political processes. However, there are many reasons for deficiencies in political discretion. Due to the shifting of power from one group to another, the political process remains erratic. Even if the policymakers are trustworthy, and discretionary policy action appears preferable to the fixed policy rule owing to its flexible nature, there still is the time inconsistency problem i.e. the problem of a policy maker reneging on the announced policy. For instance, given that low inflation and low unemployment are both major goals of economic policy, suppose the central bank announces that low inflation is the stated goal of monetary policy. But once the economic agents have formed their inflation expectations and set the wages and prices accordingly, the central bank at a later date might have an incentive to renege on the announcement and initiate an expansionary monetary policy to reduce unemployment. Thus, the presence of lags, ignorance and expectations, problems of economic forecasting and time inconsistency problem are some of the grounds on which arguments are made to caution against an activist policy. Many other ‘alternative approaches’ to stabilising the economy from macroeconomic shocks are also found in the literature. These are as follows.

21.4.2 Rules Versus Discretion

There is a debate on whether pre-determined rules-of-thumb based policy interventions, or, discretionary policy interventions should be the choice. The policy is Rules Based if the policymakers declare in advance how it responds to

various situations and demonstrate their credibility by implementing the announced policy, usually obtaining the desired results. A discretionary policy action would then be feasible if it is possible on the part of policymakers to size up the events as they occur and decide what policy action they consider relevant at the time. The debate over Rules versus discretion is different from the debate over active versus passive policy. A policy can be executed by following a rule and yet be either active or passive. For instance, a 3 percent constant growth in the money supply would constitute a *passive* policy rule. An *active* policy rule on the other hand might state that: Money Growth = 3% + (Unemployment Rate – 4%) which assumes that the natural rate of unemployment equals 4 percent.

21.4.3 Automatic Stabilisers

Automatic stabilisers are aimed at reducing the lags – especially inside lags – linked to the process of stabilisation through monetary and fiscal policy intervention. An automatic stabiliser refers to a process that automatically corrects the influence of a shock to the economy. An automatic stabiliser thus avoids inside lag. An important automatic stabiliser is the income tax. It leads to economic stabilisation through its dampening effect on the multipliers that a shock to the aggregate demand may effect. Another automatic stabiliser could be unemployment compensation like the system of unemployment-insurance and welfare systems which automatically raises the allowance in case of economic downturn.

21.4.4 Monetary Policy Rules

Though it is not unanimously agreed that the fixed policy rule is superior to the discretionary policy intervention, there are some arguments advanced in favour of rule-based conduct of monetary policy. The following brief account provides some insights about the three policy rules proposed.

Steady Growth of Money Supply: It is advocated by monetarists that a slow and steady growth in money supply would lead to economic stability ensuring a stable output, employment and prices. However, according to the critics, it is effective in stabilising the aggregate demand only if the velocity of circulation of money is stable. But the shifts in money demand, following an economic shock, makes the velocity of money unstable. Therefore, many economists favour that the money supply should be adjusted according to different shocks to the economy.

Nominal GDP Targeting: Many economists propose nominal GDP targeting as an alternative policy rule. Under this rule, central bank proposes a planned path for nominal GDP. It lowers the money growth in order to lower the aggregate demand (if nominal GDP is above the target) and infuse more money, if nominal GDP is lower. Many consider this to be a better stabilisation policy rule than the simple monetarist rule stated above.

Inflation Targeting: According to this rule, the central bank would announce an explicit target for inflation rate (usually a low one) and then change the money supply as per the deviations of actual inflation rate from the target rate. Inflation targeting also takes care of possible fluctuations in the velocity of money and therefore prevents economy from its adverse macroeconomic ramifications. In addition, inflation targeting is easy to explain to the general public and hence appears more effective. In India, RBI has been resorting to inflation targeting over last several years.

Check Your Progress 3 [answer within the given space in about 50-100 words]

1) On what grounds, caution is expressed on active policy intervention to correct macroeconomic instability?

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2) State the alternative approaches to stabilize the economy apart from active or passive intervention.

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3) What is an 'automatic stabiliser'? Give examples.

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4) What are the arguments made in favour of fixed policy rule viz-à-viz discretionary policy intervention?

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21.5 ECONOMIC GROWTH

At a macroeconomic level, in developed economies, it has been observed over long periods that there is a fairly stable relation between capital and output. Thus, capital formation is regarded as an important determinant of growth. However, in developing economies factors such as institutions are seen as important and determinants of growth are considered to include productive investment, knowledge accumulation including R & D, development of human capital, prevalence of rule of law and state of governance, infrastructure, stable macroeconomic environment, etc. Thus, trade policy, industrial policy, conducive legal framework, etc. are considered important to provide a background for sustained economic growth. Productive investment itself plays a dual role – it

stimulates aggregate demand via expenditure multiplier effect and adds to productive capacity after a gestation period.

Thus, monetary and fiscal policies can induce growth process through macroeconomic stabilisation. Further, they influence growth, both on the demand side and the supply side. Aggregate demand stimulus, given existing productive capacity, will spur output. On supply side, policies impact growth through influencing return on investment (via interest rate), public investment in infrastructure and human resources, correcting structural imbalances, investing in certain public institutions, etc. Knowledge and technology are thus important drivers of growth. Policies encouraging investment in R & D by firms and encouraging savings to finance productive investment positively impact growth. Further, in the realm of fiscal policy, it is not only the aggregate government spending out but also the composition of such spending that impact growth. In particular, public expenditure on education and health is important in human capital formation. Fiscal policy influences the quality and the distributive nature of growth (since it can be used to stimulate specific sectors and distribution of incomes arising from productive activity). Use of fiscal policy for such objectives also impacts aggregate growth.

21.6 LET US SUM UP

Both monetary and fiscal policies (whether active or passive, rule based or discretionary) play important role in stabilisation as well as in aiding economic growth. However, monetary policies proper are essentially macroeconomic in nature and play greater role in macroeconomic stabilisation than fiscal policies. However, once stable macroeconomic environment is ensured, fiscal policies play a greater direct role in stimulating and sustaining growth. It is thus recognised that a degree of coordination and coherence in both these policies is warranted and that they therefore must be used in a complementary manner.

21.7 KEY WORDS

Macroeconomic Policies : Are aimed at lowering the risks and uncertainty in economic decision making so as to ensure a stable and growth conducive environment.

Fiscal Policy : Policies related to taxes and government spending used to influence macroeconomic variables like aggregate demand, savings & investment and income distribution.

Monetary Policy : Is the process by which monetary authority of an economy regulates money supply. It aims at targeting: (i) desired level of growth rate and (ii) maintaining price and exchange rate stability.

Stabilisation : Policies initiated deliberately or built into processes as ‘automatic stabilisers’ to avoid economic shocks experienced by the economy from time to time.

Growth : Expansion of aggregate output produced during a period.

21.8 SOME USEFUL BOOKS

1) David R (2016). *Advanced Macroeconomics*.

2) Mishkin F. S. (2007). *The Economics of Money*, Banking and Financial Markets, Pearson Education.

3) Snowdon B & Vane H. R. (2005). *Modern Macroeconomics*, Edward Elgar Publishing.

21.9 ANSWERS OR HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) The two main determinants of growth are employment and average labour productivity. Macroeconomic policies viz. fiscal and monetary policy, by influencing the degree and nature of growth of both these determinants, impact and influence growth.

2) It implies the containment of both the internal and external balances in the economy.

3) Neutral, expansionary and contractionary.

4) Public expenditure, taxation, public debt and annual budget.

5) Price stability, employment generation, resource mobilisation, etc.

Check Your Progress 2

1) CRR is the amount of cash as a proportion and deposits with the bank required to be kept with the central bank. SLR is the percentage of bank's deposits requires to be invested in government securities. While CRR does not earn any interest, SLR does.

2) RR or repo rate refers to the rate at which banks can borrow funds (against sale of securities) from RBI. There is an understanding of its repurchase. The repurchase is effected by incorporating RR as implicit interest. RRR is the rate paid by the RBI to the commercial banks on their surplus funds kept with RBI. It is to facilitate the parking with RBI of excess funds available with banks.

3) These are sectors like small scale sector, agriculture and consumer goods industries which are advanced low interest loans to give a boost to such sectors.

4) It is an intermediate or short term policy measure used to increase money supply in the economy. It is used to create employment by increasing the level of economic activity when unemployment is considered high in the economy.

5) Effected through OMOs which influences the interest rates, since it leads to altering the money supply in the direction desired, in effect it is the same as monetary targeting.

Check Your Progress 3

1) Difficulties in economic prediction, ignorance & expectations, etc.

2) Rules versus discretion, automatic stabilizers, etc.

3) They are something built into a policy for automatic correction. Examples are income tax, direct income transfer, unemployment allowance increase, etc.

4) Steady growth of money supply, nominal GDP targeting and inflation targeting.