Fiscal and Monetary Policy

Monetary policy and fiscal policy are the two most widely recognized macroeconomic tools used to manage or stimulate a nation's economy.

Monetary policy refers to actions that central bank of a country takes to pursue macroeconomics objectives such as price stability, maximum employment and stable economic growth. Monetary policy is primarily concerned with the management of interest rates and the total supply of money in circulation and is generally carried out by central banks. In contrast, Fiscal policy is a collective term for the taxing and spending actions of governments. Monetary policy aims at influencing the economic activity in the economy mainly through two major variables, i.e., (a) money or credit supply, and (b) the rate of interest.

Active and Passive Monetary Policy

Depending on its responsiveness, a policy is said to be active or passive. Policy rule is said to be active if it responds strongly while it is said to be passive if it responds weakly.

Under an active monetary policy, a central bank uses its discretion to set monetary policy in response to changing economic conditions. Active monetary policy grants central Bank the flexibility and discretion to act based on its assessment of the nation’s economy. Hence, active policy allows the central bank to moderate economic fluctuations that could create instability.

Monetary policy is said to be passive, when the central bank reacts only weakly to macroeconomic changes in a country. It follows a predetermined set of rules that are not altered in response to economic changes. A rule requiring a 1 percent cut in short-term interest rates for every 1 percent drop in aggregate economic output, as measured by the inflation-adjusted gross domestic product, is an example of passive monetary policy based on predetermined rules rather than the discretionary actions of policy.

Objectives of Monetary Policy

The objectives of monetary policy refer to its goal such as reasonable price stability, high employment and faster rate of economic growth. Four most important objectives of monetary policy are the following:

1. Stabilising the Business Cycle:

Monetary policy has an important effect on both actual GDP and potential GDP. Industrially advanced countries rely on monetary policy to stabilise the economy by controlling business. But it becomes impotent in deep recessions

. Reasonable Price Stability:

Price stability is perhaps the most important goal which can be pursued most effectively by using monetary policy. In a developing country like India the acceleration of investment activity in the face of a fall in agricultural output creates excessive pressure on prices. The food inflation in India is a proof of this. In such a situation, monetary policy has much to contribute to short-run price stability.

3. Faster Economic Growth:

Monetary policy can promote faster economic growth by making credit cheaper and more readily available. Industry and agriculture require two types of credit—short-term credit to meet working capital needs and long-term credit to meet fixed capital needs.

4. Exchange Rate Stability:

In an 'open economy'—that is, one whose borders are open to goods, services, and financial flows— the exchange-rate system is also a central part of monetary policy. In order to prevent large depreciation or appreciation of the rupee in terms of the US dollar and other foreign currencies under the present system of floating exchange rate the central bank has to adopt suitable monetary measures. India by the Reserve

Target of Monetary Policy

Monetary Policy target is a rule according to which the central bank manages monetary aggregates as operating and/or intermediate target to influence the ultimate Monetary Policy objective. The targets are to be changed by using the instruments such as variation in the bank rate, the repo rate and other interest rates, open market operations (OMOs), selective credit controls and variations in reserve ratio (VRR) to achieve the objectives.

The following points highlight the main targets of monetary policy.

1. A stable price level:

One of the most popular views regarding the aim of monetary policy is that the value of money should be kept stable. A stable price level is advocated because the change in the value of money affects different persons differently and because such changes are likely to have various undesirable effects on the economy.

2. A gently rising price level:

Some writers hold the view that monetary policy should aim at maintaining a gently (i.e., slowly) rising price level Thus according to Keynes, in a society having unemployment a gently rising price level may be a better monetary policy than absolute price stability because it provides incentive to the producers, with the result that the volume of employment and income increases

3. A gently falling price level:

An opposite school of thought advocates a slowly falling price level as the aim of monetary policy. Thus, according to Dennis Robertson, in a progressive economy a gently falling price level confers greater benefits upon the fixed income-earners.

4. Neutral money:

It has been suggested that the central bank should establish what is called a‘neutral money’. It means that money should mere y perform the passive functions of acting as the medium of exchange and the unit of account, without having no dynamic functions which affect the economy. But, the objective of neutral money is not capable of wide practical application.

5. Exchange stability:

It is also suggested that the monetary policy should aim at maintaining stability in rate of exchange, as fluctuating exchange rates introduce uncertainty into foreign trade. But, it has been pointed out that exchange stability in some circumstances may also lead to instability in the domestic price level.

6. Avoidance of cyclical fluctuations:

It is also suggested that the monetary policy should be directed towards the elimination and control of business cycle fluctuations. But, it has been found that monetary policy alone cannot achieve this goal.

7. Full-employment and economic growth:

By far the most popular and accepted aim of the monetary policy is the realisation of full employment and rapid economic growth. According to Keynes, a cheap monetary policy, coupled with deficit spending through the creation of new money, may promote economic growth

Rule Versus Discretion in Monetary Policy

Economists broadly categorize policy-making frameworks as either rules or discretion.

In a rules framework, policy responses must follow a pre-specified plan. In the context of monetary policy, a ruled based policy gives a central bank a strict set of guidelines that dictate its future actions. For example, a rule-based policy could require a central bank to undertake expansionary or contractionary policies to maintain a particular price level. A rule involves the exercise of control over the monetary authority in a way that restricts the monetary authority's actions. Under the rule framework policy-makers may be forced to pursue the same course of action in all circumstances or may direct policy-makers to respond to different circumstances in different pre-determined ways. The common denominator is that rules are supposed to constrain policy-makers' actions in advance.

In a discretionary framework, policy-makers have wide latitude to design the best policy response for the given circumstances. In the flooding example, discretion means that policy-makers are free to craft a new disaster-relief policy in each period. In monetary policy, discretionary policymaking corresponds to the central bank seeking to influence or respond to momentary fluctuations in unemployment and inflation without a long-term strategy. The changes in interest rates undertaken by RBI are examples of discretionary monetary policy. Under discretion, a monetary authority is free to act in accordance with its own judgment. For example, if legislation directed the RBI to do its best to improve the economy's performance and gave the monetary authority the instruments that it has, the RBI would have a discretionary monetary policy.

Time-inconsistent and Time-consistent policy

Time-inconsistency describes situations where, with the passing of time, policies that were determined to be optimal yesterday are no longer perceived to be optimal today and are not implemented. A time-inconsistent policy may make the public happy in the short run but will ultimately fail to produce the long-run policy goal.

A policy lacks time consistency when a future policymaker has both the means and the motivation to break the commitment. A time-consistent policy meets the long-run policy goal but does not make people happy in the short run. .

The Government Budget Constraint

When government finds it difficult to raise adequate resources to finance its increased expenditure fully through normal taxes, it faces a resource constraint resulting in budget deficit which in recent years is also called fiscal deficit. Thus, government budget constraint is reflected in budget deficit.The government budget constraint is an accounting identity linking the monetary authority's choices of money growth or nominal interest rate and the fiscal authority's choices of spending, taxation, and borrowing at a point in time.

The Government Budget Constraint in a closed economy as reflected in budget deficit can be expressed as:

Budget deficit = Printed Money + Sale of Bonds

Similarly, the Government Budget Constraint in an open economy as reflected in budget deficit can be expressed as:

Budget deficit = Printed Money + Domestic borrowing through Sale of Bonds +(Use of Foreign exchange Reserve + Foreign Borrowing)

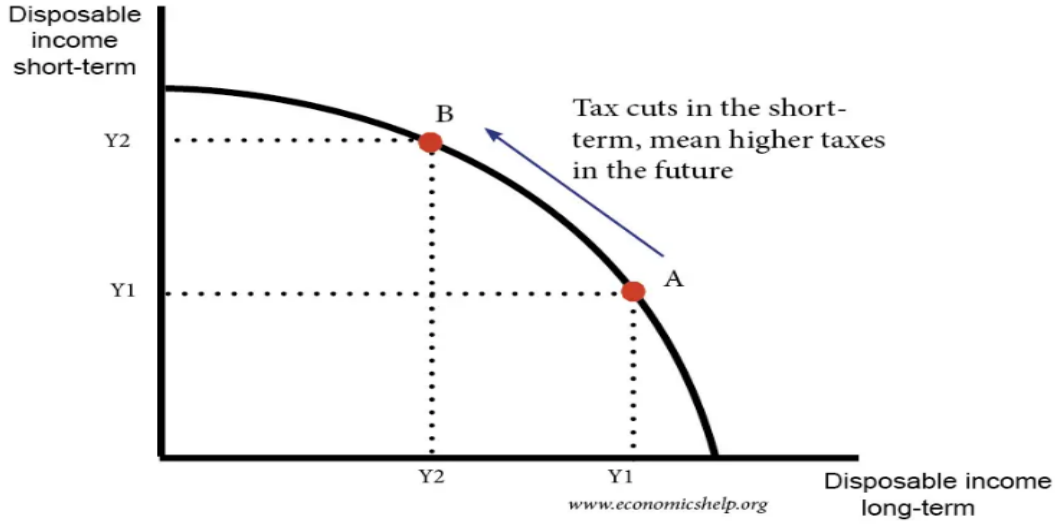
Ricardian Equivalence theory

David Ricardo, a 19th-century British political economist developed the Ricardian Equivalence the same theory was subsequently revised by Robert Barro, a Harvard professor. It is for this reason that the Ricardian Equivalence theory is otherwise known as the Barro-Ricardo equivalence proposition.

The Ricardian Equivalence is an economic proposition that holds that when there is increased debt-financed spending by the government in order to stimulate the economy, demands remain unchanged. Hence, this theory suggests that government deficit or a change in government spending does not cause a change in the overall demand in an economy. In other words, it maintains that government deficit spending is equivalent to spending out of current taxes.

The principle behind Ricardian equivalence can be illustrated by simple trade-off through as shown in the following diagram:

Impact of tax cuts under Ricardian Equivalence



As shown in the above diagram, when tax is cut from point A to B, disposable income increases in the short-term from Y1 to Y2, but disposable income in the long-term reduces by equivalent amount from Y1 to Y2. Therefore, a rational consumer believes their lifetime income is unchanged by a tax-cut.

To conclude, the underlying idea behind the Ricardian Equivalence proposition is that regardless of how a government increases its spending (either debt-financed or tax-financed spending), demand in the economy remains the same. This is because if consumers receive a tax cut financed by government borrowing they anticipate future taxes will rise. Therefore, their lifetime income remains unchanged and so consumer spending remains unchanged. In this way, it will tend to offset the macroeconomic effects of increased government spending.

Assumptions of Ricardian equivalence

1. Income Life-cycle hypothesis – Consumers wish to smooth their consumption over the course of their life. Thus, if consumers anticipate a rise in taxes in the future, they will save their current tax cuts to be able to pay future tax rises.
2. Rational expectations on behalf of consumers. Consumers respond to tax cuts by realising it will probably mean future taxes have to rise.
3. Perfect capital markets – households can borrow to finance consumer spending if needed
4. Intergenerational altruism – Tax cuts for present generation may imply tax rises for future generations. Therefore, it is assumed that an altruistic parent would respond to current tax cuts by trying to give more wealth to their children so they can pay the future tax rises

Problems with Ricardian equivalence

There are various problems with this theory of Ricardian equivalence which are as follows:

1. Consumers are not rational. Many would not anticipate that tax cuts will lead to tax rises in the future. Many households do not project future budget deficits and predict future tax increases.

2. The idea tax cuts are saved is misleading. In a recession, average propensity to consume may decline. But, this is different to the marginal propensity to consume. Evidence suggests that people do spend some of the tax cuts, even if their average propensity to save rises.

3. Tax cuts can boost growth and diminish borrowing requirements. In a recession, government borrowing rises sharply because of automatic stabilizers. If tax cuts boost spending and economic growth, the increased growth will help improve tax revenues and reduce government borrowing. If growth is increased and the economy gets out of recession this will improve the government's fiscal position.

4. No Crowding out in a recession. It is argued higher government spending financed by borrowing causes lower private sector spending. But, this isn't the case. The government is not preventing private sector spending but using private sector savings to increase aggregate demand.