DIGITAL NOTES
ON

BUSINESS AND LEGAL ENVIRONMENT

I MBA - I Semester

Department of MBA

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UNIT-II
FISCAL AND MONETARY POLICIES

FISCAL POLICY AND MONETARY POLICY Public Revenues – Public Expenditure – Public Debt – Development Activities Financed by Public Expenditure – Monetary Policy – Demand for Supply of Money – Objectives of Monetary and Credit Policy, Recent Trends – Role of Finance Commission

1 FISCAL POLICY

The word fiscal comes from a French word 'fisc', which means a purse or treasure of Government. All the taxation and expenditure decisions of the government comprise the Fiscal Policy.

Conducting fiscal policy is one of the main duties of the government. Via fiscal policy, the government collects money from different resources and utilizes it for different expenditures. Since all welfare projects are carried out under public expenditures, fiscal policy is closely related to the development policy.

Fiscal Policy is different from monetary policy in the sense that monetary policy deals with the supply of money and rate of interest. The government and RBI use these two policies to steer the broad aspects of the Indian Economy. While government is conducts Fiscal Policy, RBI is responsible for monetary policy. RBI also helps the government in implementing its fiscal policy decisions.

Public Revenue, Public Expenditure and Public Debt (also known as Public Borrowings) are the major components of a nation's fiscal policy.

1.1 Public Revenue

Public revenue generally refers to government revenue. Some important sources or concepts that are included in public revenue consist of taxes, fees, sale of public goods and services, fines, donations, etc.

The main sources of public revenue are: Tax and Non-tax revenue

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1.2 Sources of Public Revenue

1.2.1 Tax Revenue

The chief source of public revenue is Tax. To define tax, it is said that tax is a mandatory imposition of duty on public authority by government organizations to meet requirements of general public as a whole.

Therefore, with the above defined term, some points are highlighted as below:

- A Tax is a compulsory duty levied by the government. If any individual refuses to comply with tax payments, he can be punished or penalized
- Tax basically involves some understanding and sacrifice on the basis of a tax payer
- Tax is a duty and not a penalty
- Most part of revenue income is generated from tax by the central government.

Taxes are imposed by the Central Government, State Governments, and local government bodies.

Central Government: It levy taxes on income excluding agricultural income customs duty, central excise duty and service tax.

State Government: It levies taxes on state excise duty, agricultural income, Stamp Duty, Value Added Tax (VAT), land revenue tax and professional tax.

Local Government Bodies: They levy Octroi, property tax, and tax for utilities like water supply, Sanitation etc.

Since Indian tax structure and system have faced certain reforms. These reforms include decrease in rate of all major tax that simplifies laws and rules & procedure, modernization of administration and enforcement machineries.

Broad classification of taxes is: Direct and Indirect Taxes

1.2.1.1 Direct taxes

Direct taxes are levied on wealth and income of individuals or organizations. These taxes are personal income tax, corporate tax, and gift or wealth tax. The impact of direct taxes is on the same person.

Direct taxes are developing in nature and the tax rate increases along with the tax base.

Progressive direct taxes are involved in falling income discrimination especially in rising countries.

Following major direct taxes are stated:

1.2.1.1.1 Personal Income Tax

Personal income tax is duty imposed on an individual or group of individuals after specific permissible deductions.

1.2.1.1.2 Corporate Tax

Corporate tax is a duty that has to be paid on the profits registered corporate firms.

Corporate tax is direct tax because the company is given legal entity.

1.2.1.1.3 Other Direct Taxes

List of other direct taxes include, Wealth tax, Interest tax, gift tax, Expenditure tax, etc the share of these taxes is unimportant.

1.2.1.2 Indirect taxes

- Indirect taxes are imposed on goods & commodities.
- These taxes include sales tax, excise duty, service tax, customs duty, VAT, etc.
- The impact of indirect taxes may be implied on different people.
- In direct taxes are not progressive but regressive in nature. Here, the burden to pay duties is indirectly or directly bearded by the consumer irrespective of their income level.
- Indirect taxes are of utmost importance for countries that are developing and face low-income levels.

1.2.1.2.1 Major Indirect Taxes

1.2.1.2.1.1 Excise Duty

These taxes are levied on manufactured goods and consumable goods in India. Excise duty is the chief and single largest source to generate revenue income.

1.2.1.2.1.2 Customs Duty

This duty is imposed on exports of selective range and imports. With revenue point of view, Custom duty has less importance.

1.2.1.2.1.3 Service Tax

This tax is imposed by specific category of firms, agencies or persons.

1.2.1.2.1.4 Goods and Service Tax

- Goods and service tax includes range of all taxes like excise duty, service tax, goods tax, VAT, etc.
- It covers goods and service charges in mostly all sectors.
- It generally simplifies the complexity of charges on good and services.

1.2.2 non-tax revenues

Non-tax Revenue comprises all revenues apart from taxes accumulated to the Government.

Non-tax revenues are funds that are generated from internal sources.

The sources of revenue are:

- Administrative revenues
- Commercial revenues
- Grants and gifts

Important sources of non-tax revenues include

1.2.2.1 Fees
A fee is a significant source of managerial non-tax revenue charged by Government authorities for depiction services to the members of the public. There is no compulsion to pay fees. All those utilize services may pay fees. Fees may be charged for getting licenses, passports or registrations, filing of court cases, etc.

1.2.2.2 Fine and Penalties
These are general sources of administrative non-tax revenues. These may be applied on public for non-compliance with certain rules and regulations. These are not considered as the major source of revenue for the government.

1.2.2.3 Special Assessment
This can be called as betterment charge. This tax is imposed to a certain category of members of a community who are generally benefited from governmental activities or public functions like constructions of road, railways, parks, etc. Therefore, government imposes special charges on such properties.

1.2.2.4 Surplus of Public Enterprises
The government has arranged public sector enterprises that are concerned in commercial activities. The surpluses generated of these enterprises are a significant source of non-tax revenue. These incomes are in the form of profits that are known as commercial revenues.

1.2.2.5 Grants and Gifts
Grants are financial support. These are provided to public authority to perform certain social activities. These are generated by higher public authority to lower ones. There is no repayment compulsion. Gifts and donations are voluntarily made by individuals, organizations or foreign governments to the Central Government. These gifts are made by natural feeling in case of disasters or natural calamities. Gifts are not considered as a source of income. Therefore, tax plays an important part in generating government revenue. Non-tax is important in developing revenue.

1.3 Public Expenditure
Public Expenditure refers to Government Expenditure. It is incurred by Central and State Governments. The Public Expenditure is incurred on various activities for the welfare of the people and also for the economic development, especially in developing countries. In other

words The Expenditure incurred by Public authorities like Central, State and local governments to satisfy the collective social wants of the people is known as public expenditure.

1.3.1 Need / Importance/ Significance of Public Expenditure

In modern economic activities, public expenditure has to play an important role. It helps to accelerate economic growth and ensure economic stability. Public Expenditure can promote economic development as follows.

- To promote rapid economic development. To promote trade and commerce.
- To promote rural development
- To promote balanced regional growth
- To develop agricultural and industrial sectors
- To build socio-economic overheads eg. roadways, railways, power etc.
- To exploit and develop mineral resources like coal and oil.
- To provide collective wants and maximize social welfare.
- To promote full - employment and maintain price stability. To ensure an equitable distribution of income.

Thus, public expenditure has to create and maintain conditions conducive to economic development. It has to improve the climate for investment. It should provide incentives to save, invest and innovate.

1.3.2 Classification of Public Expenditure

Classification of public expenditure refers to the systematic arrangement of different items on which the government incurs expenditure. Public expenditure can be classified as follows.

1.3.2.1 Revenue Expenditure

Revenue expenditures are current or consumption expenditures incurred on civil administration, defence forces, public health and, education, maintenance of government machinery etc. This type of "expenditure is of recurrent type which is incurred year after year.

1.3.2.2 Capital Expenditure

Capital Expenditure of the government refers to that expenditure which results in creation of fixed assets. They are in the form of investment. They add to the net productive assets of the economy. Capital Expenditure is also known as development expenditure as it increases the productive capacity of the economy. It is an investment expenditure and a non-recurring type of expenditure. For Eg. Expenditure - on agricultural and industrial development, irrigation dams, public enterprises etc., are all capital expenditures.

1.3.2.3 Development / Productive Expenditure

Expenditure on infrastructure development, public enterprises or development of agriculture increase productive capacity in the economy and bring income to the government. Thus, they are

classified as productive expenditure. All expenditures that promote economic growth development are termed as development expenditure.

1.3.2.4 Non-developmental / Non-productive Expenditure

Unproductive (non - development) expenditure refers to those expenditures which do not yield any income. Expenditure such as interest payments, expenditure on law and order, public administration, do not create any productive asset which brings income to government such expenses are classified as unproductive expenditures.

1.3.2.5 Transfer Expenditure

Transfer expenditure refers to those kinds of expenditures against there is no corresponding transfer of real resources i.e., goods or services. Such expenditure includes public expenditure on :- National Old pension Scheme, Interest payments, subsidies, unemployment allowances, welfare benefits to weaker sections etc. By incurring such expenditure, the government does not get anything in return, but it adds to the welfare of the people, especially to weaker sections of society. Such expenditure results in redistribution of money incomes within the society.

1.3.2.6 Non-transfer Expenditure

The non-transfer expenditure relates to that expenditure which results in creation of income or output. The non-transfer expenditure includes development as well as non - development expenditure that results in creation of output directly or indirectly. Economic infrastructure (Power, Transport, Irrigation etc.), Social infrastructure (Education, Health and Family welfare), Internal law and order and defence, public administration etc. By incurring such expenditure, government creates a healthy environment for economic activities.

1.3.2.7 Plan Expenditure

The plan expenditure is incurred on development activities outlined in ongoing five-year plan. Plan expenditure is incurred on Transport, rural development, communication, agriculture, energy, social services, etc.

1.3.2.8 Non-plan Expenditure

The non - plan expenditure is incurred on those activities, which are not included in five-year plan. It includes development and non - development expenditure. It includes, defence, subsidies, interest payments, maintenance etc.

1.3.3 Is all public expenditure good for an economy?

Public Expenditure if properly utilized is good for an Economy.

- Public Expenditure must be productive and used for developmental purposes.
- A proper authority should give the approval of public expenditure.
- Auditing of public expenditure should be done to ensure that money is spent for the purpose for which it is sanctioned.
- Public Expenditure should be incurred on essential items of common benefit.

- Public expenditure should promote flexibility and changes in spending policy of the state.
   There should be flexibility and changes in spending policy of the state.

Thus, the spending policy of the government must give benefits to the society as a whole.

1.3.4 Causes of Increase in Public Expenditure in India

The following are the main causes of growth of public expenditure in India

1.3.4.1 Growing Population

A high growth of population naturally calls for increase in public expenses as all state functions are to be performed more extensively^ Population growth has made necessary for governments of most countries to spend increasing amounts on education, health, infrastructure, subsidies and social security. In 2011, the population of India has increased to 121 crores.

1.3.4.2 Defence Expenditure

The defence expenditure of the Central Government has increased over the years. The defence expenditure minimizes the possibility of external threats, which in turn creates a good environment for social and economic activities of the nation.

1.3.4.3 Interest Payments

Government borrowings are on increase. The government borrows funds from domestic market and foreign sources to meet expenditure on various government activities. As a result, the government has to incur huge interest payments.

1.3.4.4 Subsidies

Government of India has been providing subsidies on number of items such as food, fertilizers, fuels, education etc. Because of massive amount of subsidies, the government expenditure has increased over the years.

1.3.4.5 Administration

The Central Governments expenditure on administration has increased due to growth in population and economic development. Government incurs on law and order, tax administration, civil administration etc. Due to inflation, the government has to revise the pay scale periodically. The production cost of public goods and services has also risen due to rising prices.

1.3.4.6 Rise in National Income

The national income of the country has increased over the years. The increase in national income resulted in more revenue to the government by way of tax revenue and other income, which in turn enabled the government to increase its expenditure.

1.3.4.7 Urbanization

Urbanization has led to increasing expenditure on civil administration. Government expenditure on courts, police, transport, railways, schools and colleges, public health measures, water and electricity supply, public parks, libraries etc. have increased due to growth of towns and cities.

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1.3.4.8 Rural Development

In developing countries, government has to undertake community development projects and other social measures to promote rural development. Such measures cause a rise in public expenditure.

1.3.4.9 Inflation

Rise in prices have caused an increase in public expenditure. The cost of supplying public goods and services has increased. Rising prices have also necessitated the payment of higher salaries and dearness allowances.

1.3.4.10 Democratic Government

A democratic government has to incur increasing expenditure on elections, legislatures, ministries, international conferences, embassies abroad etc. Public expenditure also increases when a country becomes a member of international organisations like UNO, WHO etc.

1.3.4.11 Social Security Measures

For the welfare of the people government provides social security measures which increases its expenditure. It provides measures such as sickness benefits, old - age pensions, free education, medical facilities, public works and relief programmes etc.

1.3.4.12 Growth of Transport and Communication

The government has to incur huge expenditure on construction of railways, roadways, national highways, bridges etc. to promote mobility and economic development. Thus, with growth of transport and v- communication public expenditure have increased.

1.3.4.13 Development of Agriculture

The government may develop agriculture by providing seeds, fertilizers, irrigation facilities, modern implements, cheap loans etc. All these will increase public expenditure.

1.3.4.14 Development of Industry

The government may encourage the growth of private sector industries through protection, subsidies to exporters, loans at cheap rate of interest etc. causing a rise in public expenditure.

1.3.4.15 Poverty Alleviation Programmes

In developing countries, governments are spending some sufficient funds on poverty alleviation and employment generation programmes. Some of the programmes are Swarnajayanti Gram Swarojgar Yojana, Indira Awas Yojana, National Food for Work Programme etc.

Research and Development

Research and Development is important to improve quality and to reduce costs. The government finances Research and Development projects undertaken by non - government organisations, universities and i other educational organisations.

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1.3.4.16 Economic Planning

To promote rapid economic development modern governments, adopt economic planning. The public-sector outlay on various sectors has been increasing with the increasing role of government.

1.3.5 Developmental Activities Financed by Public Expenditure

Rapid economic development requires huge expenditure to be incurred in the various sectors of the economy. As the private sector is usually hesitant and unwilling to invest huge amounts because the returns from such investments are either uncertain or long delayed, it is public expenditure which plays the crucial role in eco-nomic development (especially) in underdeveloped economy.

1.3.5.1 Development of Infrastructure /Social Goods

The theory of social goods or infrastructure development is of prime importance to the economies of the public sector. The market economy, if certain conditions are met, enables an efficient use of resources for providing private goods.

However, when it comes to providing public or social goods (e.g. parks roads, bridges, free or subsidized educational facilities), the market economy often runs into trouble. Social goods are goods which are required for the welfare of society as a whole, but for which the market fails to provide a value.

People are generally ignorant of the value or utility of social goods. An individual knows that once one category of social goods says a road, is constructed, he cannot be denied its use whether he paid for its construction or not.

Everyone assumes that others would pay for it. It is these failures of the market (i.e., provision of social goods) that bring the role of the government and public expenditure in focus for providing social goods for the welfare of the public in general.

Some economists divide social goods under two heads: Social and economic overheads. Social overheads like hospitals, schools and colleges and technical institutions and economic overheads like roads and railways, irrigation and power projects etc. are all essential for economic development. It is the responsibility of public expenditure to build up sound social and economic overheads as money for these things does not usually come from private sources.

1.3.5.2 Development of Public Enterprises

The development of heavy and basic industries is very important for the development of an underdeveloped country. But establishment of these industries involves huge investment and a considerable portion of risk. Naturally, the private sector cannot take the responsibility to develop these industries. The development of these industries has become a responsibility of Government of India particularly since the introduction of the Industrial Policy of 1956. A significant portion of the public expenditure has been utilized for the establishment and improvement of these public enterprises.

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1.3.5.3 Remove unemployment

Public expenditure is the most potent weapon to fight unemployment. The level of employment depends upon effective demand. The government can influence effective demand either by making more public expenditure or by resorting to such fiscal methods as may raise the level of private expenditure.

The role of public expenditure becomes very significant during the period of depression when the private entrepreneurs are not keen to take up investment activities.

The government can resort to counter cyclical fiscal policy, which means the taxes and government spending be varied in an anti-cyclical direction; government spending being cut and taxes increased in the expanding phase of cycle and government spending increased and taxes cut during the contraction phase. Increased govt, expenditure will open new job opportunities in the country, which means creation of demand of goods and services.

Mention may also be made of pump priming and compensatory expenditure to raise the level of employment in the economy. Pump priming refers to increase in private expenditure through an injection of fresh purchasing power in the form of an increase in public expenditure even through budgetary deficit.

It is argued that such an initial public expenditure may set in motion a process of recovery from the condition of depression. Compensatory expenditure refers to the variation in the government budget expenditure to compensate the deficiency in private demand so as to maintain high level of investment, employment and income stability.

In the words of Keynes, government expenditure becomes a balancing factor in order to maintain national income at a given level. Such expenditure may be progressively raised during depression phase of the business cycle, and progressively reduced in the recovery phase.

1.3.5.4 Increase Production

Public expenditure contributes to production through a large number of public enterprises both in industries and agriculture. Government incurs a lot of expenditure in the agricultural sector, e.g. on irrigation and power, seed forms, fertilizer factories, warehouses, etc., and in the industrial sector by setting up public enterprises like the steel plants, heavy electrical, heavy engineering, machine-making factories, etc. All these enterprises are calculated to promote production and thereby economic development.

1.3.5.5 Exploitation and Development of Mineral Resources

Minerals provide a base for further economic development. The government has to undertake schemes of exploitation and development of essential minerals, e.g. coal and oil. Public expenditure has to play its role here too.

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1.3.5.6 Promote Price Stability

Increase in public expenditure relieves the economy from the quagmire of depression and conversely public expenditure can be scaled down when there is a fear of inflationary rise in prices. Thus, public expenditure helps in stabilizing price.

1.3.5.7 Promote Balanced Growth

There is a tendency to use economic resources for the further development of already developed regions. But for overall growth, special attention needs to be paid for the development of backward areas and under developed regions. This requires huge amounts for which reliance has to be placed on public expenditure.

1.3.5.8 Reduce Inequality of Income

Another objective of public expenditure is to reduce the inequality of income. Expenditure on old age pensions, unemployment relief, free education, free mid-day meals etc. benefits the poorer classes of the community at the expense of the rich.

Thus, the public expenditure is playing a vital role for social welfare and economic prosperity of a nation.

1.4 Public Debt

Public debt is the debt owed by a central government. Among the non-tax sources, the major source of government revenues is public debt. As per the current budgetary practices, there are three sets of liabilities, which constitute a central government public debt, viz.

 Internal debt,
 External debt, and
Other liabilities.

The three sets of liabilities are as follows:

1.4.1 Internal Debt

The internal debt is classified into:

- Market loans,
- Short-term borrowings all of which are shown under the receipts side of the central budget, and
- Other long- and medium-term borrowings

They include special securities and T-bills issued to RBI, state governments, commercial banks and other financial institutions.

1.4.2 External Debt

Represents loans received from foreign government and bodies.

Both the internal and external debt is secured under a fund called as the Consolidated Fund of India.

1.4.3 Other Liabilities / Public Account Liabilities

Includes other interest-bearing obligations of the government such as:

(i) Post office savings deposits under small saving schemes, loans raised through post office cash certificates, etc.
(ii) provident funds,
(iii) interest bearing reserve funds of departments like railways and telecommunications, etc.

The obligations of 'other liabilities' are met by the Public Account, just as the internal and external debts are secured under the Consolidated Fund.

1.5 Growth of Public Debt

As a means of financing, the Government of India has made a liberal use of borrowing, both internal and external, as can be seen from Table 11.1. The figures of total indebtedness and its components are of staggering magnitude.

But far more important than the magnitudes are the rate at which they are growing (12.5 per cent average annual growth for total debt). Public debt as a proportion of national income has increased from 12 per cent in 1980-81 to 42 per cent in 2008-09.

1.6 Problems of Public Debt

The growing size of public debt in India has given rise to the problem of debt management.

The important objectives of debt management in the context of planned development of Indian economy are as follows:

- Promote savings and provide more funds for investment in the public sector without impinging on the private sector's need for funds; and
- Ensure large borrowing and other debt requirement without sacrificing the objective of price stability.

The first objective requires a debt policy capable of tapping funds from all possible sources in the economy. Varied instruments of resource mobilization should be employed to suit the requirements of different types of savers/investors. The policy should be flexible so as to offer terms, such as the interest rates maturities, suitable to the conditions prevailing in the money and the capital markets.

The second objective requires that the loan operations of the government should support the objective of maintaining the price stability in the economy. In other words, these operations should have the aim of minimizing the incidence of inflation.

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2 MONETARY POLICY

2.1 Meaning of Monetary Policy

Monetary policy refers to the credit control measures adopted by the central bank of a country.

Johnson defines monetary policy "as policy employing central bank's control of the supply of money as an instrument for achieving the objectives of general economic policy." G.K. Shaw defines it as "any conscious action undertaken by the monetary authorities to change the quantity, availability or cost of money."

2.2 Objectives of Monetary Policy

The following are the principal objectives of monetary policy:

2.2.1 Full Employment

Full employment has been ranked among the foremost objectives of monetary policy. It is an important goal not only because unemployment leads to wastage of potential output, but also because of the loss of social standing and self-respect.

2.2.2 Price Stability

One of the policy objectives of monetary policy is to stabilize the price level. Both economists and laymen favour this policy because fluctuations in prices bring uncertainty and instability to the economy.

2.2.3 Economic Growth

One of the most important objectives of monetary policy in recent years has been the rapid economic growth of an economy. Economic growth is defined as "the process whereby the real per capita income of a country increases over a long period of time."

2.2.4 Balance of Payments

Another objective of monetary policy since the 1950s has been to maintain equilibrium in the balance of payments.

2.3 Concept of Money

The term 'money' is derived from the Latin word 'moneta', which means 'mint or money', originally a title of the goddess Juno, in whose temple in Rome money was minted. Money cannot be defined on the basis of the material it is composed of. Money can be explained on the basis of its functions.

It was the classical economists who first attempted to provide an explanation for the holding of cash balances by people, even though such cash balance yielded no return as contrasted with other forms of assets. The classical economists claimed that money was demanded by people for their transaction needs. This is because no economic unit – firm or household- enjoyed a perfect synchronization between the seasonal pattern of flow of receipts and the flow of expenditures. It

is these discrepancies which give rise to balances that accumulate temporarily and are used up later when the expenditures catch up.

That is, these discrepancies give rise to the need for balances to meet seasonal excesses of expenditures over receipts. These balances are hence transaction balances. This is precisely what the Quantity Theory of Money (QTM) implies

QTM ÷ MV = PT

Where:

- M - quantity of money in circulation
- V - Velocity of money (number of times a unit of currency exchanges hands)
- P - average price level of all transactions
- T - physical volume of transactions

The idea of QTM is that no rational person holds money idle, for it produces nothing and thereby yields no utility.

2.4 Functions of Money

The four broad functions of money may be described briefly as follows:

2.4.1 Primary Functions

2.4.1.1 Money as a Unit of Value

The monetary unit serves as the unit in terms of which the value of all goods and services is measured and expressed (i.e. as rupee, or dollar, or mark, or pound sterling, or yen etc). The value of goods and services can be expressed as a price which implies the number of monetary units for which it will exchange. The real value of the monetary unit is subject to fluctuation.

2.4.1.2 Money as a Medium of Exchange

Money is generally referred to as the generalized purchasing power or as a bearer of options (since there is freedom of choice in the use of money). This function of money is served by anything which is generally accepted by people in exchange for goods and services. In earlier days copper or gold coins served as money. In modern days, however, paper currency, and cheques against commercial banks, current and savings deposits function as the major forms of money. In the well-developed financial system credit cards have become a very important form of payment.

2.4.2 Derivative Functions

2.4.2.1 Money as a Standard of Deferred Payments

Modern economic systems require the existence of a large volume of contracts where payment of principal and interest on debt as future payments are in terms of monetary units.

Money as a Store of Value

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The holding of money is, in effect, the holding of generalized purchasing power. The holder of money is aware of its universal acceptance any time. Also, the value of money remains constant in itself over time. Money is thereby an ideal store of value with which contingencies as well as speculative motives may be satisfied.

2.5 Kinds of Money / Monetary Aggregates

In economics money supply or money stock is the total quantity of money obtainable in a financial system at a particular point in time. There are some ways to define money, but standard actions usually include currency in circulation and demand deposits. Money supply information is record and published usually by the government or the central bank of the country. Public and private sector analysts have long monitored changes in money supply because of its possible effects on the price level inflation and the business cycle. That relation between money and prices is historically connected with the quantity theory of money. There is strong empirical confirmation of a direct experimental relation between long-term price inflation and money-supply growth. These motivate the current dependence on monetary policy as a means of controlling inflation.

Money is used in last settlement of a debt and as a ready store of value. Its different functions are connected with different experiential events of the money supply. Since most modern financial systems are regulated by governments through monetary policy, the supply of money is broken down into types of money based on how much of an effect financial policy can have on each. Narrow actions include those more directly affected by monetary policy, whereas broader actions are less closely connected to monetary-policy actions. Each measure can be classified by placing it along a range between narrow and broad monetary aggregates. The different types of money are typically classified as M's. The number of M's usually range from M0 (narrowest) to M3 (broadest) but which M's are really used depends on the system. The usual explain for each of the M's is as follows.

- **M0:** Currency in circulation + Bankers deposits with the RBI + Other deposits with the RBI (Net RBI credit to the Government + RBI credit to the commercial sector + RBI's claims on banks + RBI's net foreign assets + Government's currency liabilities to the public – RBI's net non-monetary liabilities).

- **M1:** Currency with the public + Deposit money of the public (Demand deposits with the banking system + other deposits with the RBI).

- **M2:** Currency with the public + Deposit money of the public (Demand deposits with the banking system + other deposits with the RBI) + Savings deposits with Post office savings banks.

- **M3:** M2 + Time deposits with the banking system

(Net bank credit to the Government + Bank credit to the commercial sector + Net foreign exchange assets of the banking sector + Government's currency liabilities to the public – Net non-monetary liabilities of the banking sector (Other than Time Deposits).

- **M4:** M3 + All deposits with post office savings banks (excluding National Savings Certificates).

In short, there are two types of money in a fractional-reserve banking system:

- Central bank money (physical currency, government money)
- Commercial bank money (money created through loans) - sometimes referred to as private money, or checkbook money

In the money supply statistics, central bank money is M0 although the commercial bank money is divided up into the M1-M3 components. Normally the types of commercial bank money that tend to be valued at lower amounts are classified in the narrow category of M1 though the types of commercial bank money that tend to exist in larger amounts are categorized in M2, M3 and M4 with M4 having the largest.

2.6 Instruments of Monetary Policy

The instruments of monetary policy are of two types: first, quantitative, general or indirect; and second, qualitative, selective or direct. They affect the level of aggregate demand through the supply of money, cost of money and availability of credit. Of the two types of instruments, the first category includes bank rate variations, open market operations and changing reserve requirements. They are meant to regulate the overall level of credit in the economy through commercial banks. The selective credit controls aim at controlling specific types of credit. They include changing margin requirements and regulation of consumer credit. We discuss them as under:

2.6.1 Bank Rate Policy

The bank rate is the minimum lending rate of the central bank at which it rediscounts first class bills of exchange and government securities held by the commercial banks. When the central bank finds that inflationary pressures have started emerging within the economy, it raises the bank rate. Borrowing from the central bank becomes costly and commercial banks borrow less from it.

The commercial banks, in turn, raise their lending rates to the business community and borrowers borrow less from the commercial banks. There is contraction of credit and prices are checked from rising further. On the contrary, when prices are depressed, the central bank lowers the bank rate.

It is cheap to borrow from the central bank on the part of commercial banks. The latter also lower their lending rates. Businessmen are encouraged to borrow more. Investment is encouraged. Output, employment, income and demand start rising and the downward movement of prices is checked.

2.6.2 Open Market Operations

Open market operations refer to sale and purchase of securities in the money market by the central bank. When prices are rising and there is need to control them, the central bank sells securities. The reserves of commercial banks are reduced and they are not in a position to lend more to the business community.

Further investment is discouraged and the rise in prices is checked. Contrariwise, when recessionary forces start in the economy, the central bank buys securities. The reserves of commercial banks are raised. They lend more. Investment, output, employment, income and demand rise and fall in price is checked.

2.6.3 Changes in Reserve Ratios

This weapon was suggested by Keynes. Every bank is required by law to keep a certain percentage of its total deposits in the form of a reserve fund in its vaults and also a certain percentage with the central bank.

When prices are rising, the central bank raises the reserve ratio. Banks are required to keep more with the central bank. Their reserves are reduced and they lend less. The volume of investment, output and employment are adversely affected. In the opposite case, when the reserve ratio is lowered, the reserves of commercial banks are raised. They lend more and the economic activity is favourably affected.

2.6.4 Selective Credit Controls

Selective credit controls are used to influence specific types of credit for particular purposes. They usually take the form of changing margin requirements to control speculative activities within the economy. When there is brisk speculative activity in the economy or in particular sectors in certain commodities and prices start rising, the central bank raises the margin requirement on them.

The result is that the borrowers are given less money in loans against specified securities. For instance, raising the margin requirement to 60% means that the pledger of securities of the value of Rs 10,000 will be given 40% of their value, i.e. Rs 4,000 as loan. In case of recession in a particular sector, the central bank encourages borrowing by lowering margin requirements.

For an effective anti-cyclical monetary policy, bank rate, open market operations, reserve ratio and selective control measures are required to be adopted simultaneously. But it has been accepted by all monetary theorists that (i) the success of monetary policy is nil in a depression when business confidence is at its lowest ebb; and (ii) it is successful against inflation. The monetarists contend that as against fiscal policy, monetary policy possesses greater flexibility and it can be implemented rapidly.