Fiscal and Monetary Measures

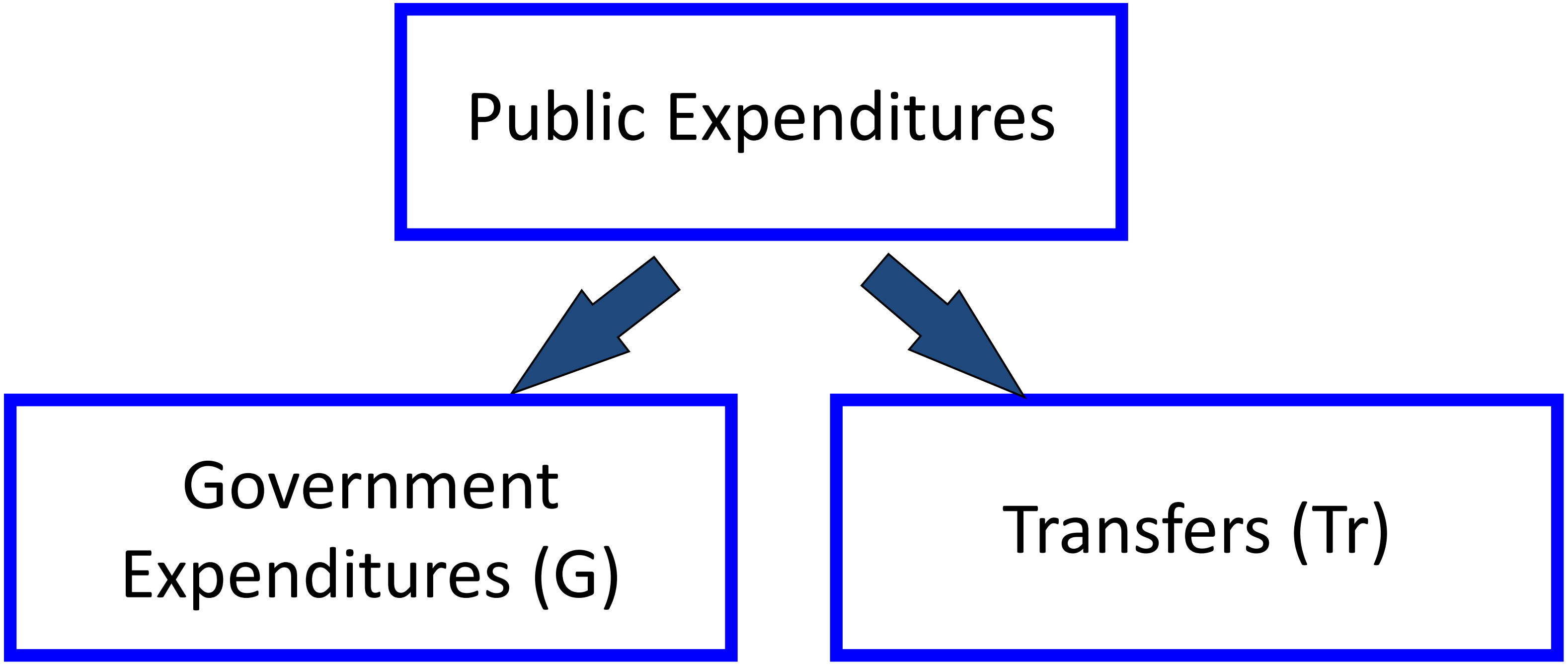
Fiscal measures are through fiscal policy, which is government revenue and government expenditure (Budget).

Keynes Aggregate demand function.

AD = C+I+G+NX

G = Government expenditure plays an important role

Public expenditures



Multiplier effect

How many times Y increases with a one unit increase in the consumption is consumption multiplier.

Y = AD

AD = C+I+G+NX

Y = C+I+G+NX

Each economic agent has marginal propensity to consume (MPC) and to save (MPS). Say, Mr. Som leaves 25% of income in a bar (MPC=0.25), so his MPS=0.75.

- Let’s analyse what will happen to the money spent:

  (1)Mr. Som’s extra income is Rs.1000

  Mr. Som spends 25% of Rs.1000 (= Rs.250) in a bar

  (2)Mr. Balu (bar-keeper) receives extra income of 250CZK

  Mr. Balu spends 25% of Rs.250 (Rs.63) in a neighbour bar

  (3)Mr. Teja (neighbour-bar-keeper) receives extra Rs.63

  Mr. Teja spends 25% of Rs.63 (=Rs. 16) in another bar

  …

  (10) Mr. B (a drug-store keeper) receives extra 0.005CZK for selling medicine against all the above gentlemen’s hangover.

Total income generated: Rs.1334.33

Fiscal policy during inflationary and deflationary situations

inflation

Tax rates…………………

Expenditure……………..

Deflation

Tax rates ……………………..

Expenditure…………………..

Monetary Policy is framed by the Central Bank

Quantitative measures and

Bank Rate Policy: The bank rate is the Official interest rate at which RBI rediscounts the approved bills held by commercial banks. For controlling the credit, inflation and money supply, RBI will increase the Bank Rate.

Open Market Operations: OMO The Open market Operations refer to direct sales and purchase of securities and bills in the open market by Reserve bank of India. The aim is to control volume of credit.

Cash Reserve Ratio: Cash reserve ratio refers to that portion of total deposits in commercial Bank which it has to keep with RBI as cash reserves.

Statutory Liquidity Ratio: It refers to that portion of deposits with the banks which it has to keep with itself as liquid assets(Gold, approved govt. securities etc.)

If RBI wishes to control credit and discourage credit it would increase CRR & SLR.

Qualitative measures

Qualitative credit is used by the RBI for selective purposes. Some of them are Margin requirements: This refers to difference between the securities offered and amount borrowed by the banks.

Consumer Credit Regulation: This refers to issuing rules regarding down payments and maximum maturities of installment credit for purchase of goods.

RBI Guidelines: RBI issues oral, written statements, appeals, guidelines, warnings etc. to the banks.

Rationing of credit: The RBI controls the Credit granted / allocated by commercial banks.

Moral Suasion: psychological means and informal means of selective credit control.

Direct Action: This step is taken by the RBI against banks that don’t fulfill conditions and requirements. RBI may refuse to rediscount their papers or may give excess credits or charge a penal rate of interest over and above the Bank rate, for credit demanded beyond a limit.