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A Study On The Impact And Growth Of Fiscal And Monetary Policies

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Abstract

In the recent past, several attempts by the RBI to control inflation through tight monetary policy have ended up slowing the growth process, thereby provoking prolonged discussion among academics and policymakers about the efficacy of monetary policy in India. Against this backdrop, the present study attempts to estimate the causal relationship between monetary policy and its final objectives; i.e., growth, and controlling inflation in India. In view of the fact that output gap is one of the determinants of future inflation, an attempt has also been made to study the causal relationship between output gap and inflation. Furthermore, any attempt to control inflation affects output with the same or even greater magnitude than inflation, thereby damaging the growth process. The relationship between output gap and inflation was found to be positive, as reported in earlier studies for India. Furthermore, the output gap causes inflation only in the short-to medium-run. The economy of India is that the seventh-largest-economy in the world measured by nominal Gross Domestic Product & the third largest by Purchasing Power Parity (PPP) and therefore the outlook for short term growth is additionally good as per the International monetary fund, the Indian economy is the “bright spot” within the global landscape. India additionally topped the world Bank growth outlook for 2015-2016 for the first time with the economy growth 7.6% (expected growth is 8.0+ in 2016-2017). “Fiscal policy is that a part of government policy that is concerned with Raising Revenue through Taxation”. It directly affects the monetary resources power within the hands of the general public. In economics and political science, fiscal policy is the use of government revenue collection (mainly taxes) & expenditure (spending) to influence the economy. Once the government changes the amount of taxation & government disbursement, it influences aggregate demand of economic activity. The fiscal policy will be accustomed stabilize the economy over the course of the fluctuation. Tax policy, expenditure policy, investment or disinvestment methods and debt or surplus management is that the core basis of the fiscal policy. In underdeveloped countries the importance of economic policy is extremely high.

Keywords: Monetary Policy, Government Policy, Raising Revenue, Fluctuation

Introduction

The economic decisions of households can have a significant impact on an economy. For example, a decision on the part of households to consume more and to save less can lead to an increase in employment, investment, and ultimately profits. Equally, the investment decisions made by corporations can have an important impact on the real economy and on corporate profits. But individual corporations can rarely affect large economies on their own; the decisions of a single household concerning consumption will have a negligible impact on the wider economy. By contrast, the decisions made by governments can have an enormous impact on even the largest and most developed of economies for two main reasons. First, the public sectors of most developed economies normally employ a significant proportion of the population, and they are usually responsible for a significant proportion of spending in an economy. Second, governments are also the largest borrowers in world debt markets. Government policy is ultimately expressed through its borrowing and spending activities. In this reading, we identify and discuss two types of government policy that can affect the macroeconomy and financial markets: monetary policy and fiscal policy.

Objectives

- ❖ To study the Impact of Monetary and Fiscal Policy in India.
- ❖ To Analyse the Growth of Monetary and Fiscal Policy in India.

Review of Literature

Satya Poddar, Ehtisham Ahmad, (2009) the authors have discussed at length, the contractual issue of carrying forward the sub national tax reform agenda. In addition they have also thrown light on the principles, issues and procedures related to the objective of achieving a common goods and services market. The authors state that, the replacement of the state sales taxes by the Value Added Tax in 2005 marked a significant step forward in the reform of domestic trade taxes in India. It addressed the distortions and complexities associated with the levy of tax at the first point of sale under the erstwhile system and resulted in a major simplification of the rate structure and broadening of the tax base.

G. Raghuraj, (2010) The author states that the strong coordinated response to the crisis, greatly helped in easing out the credit risk concerns and in stabilising global markets, although we are still faced with some degree of uncertainty about growth and financial stability. The author rightly points out that, even though the global imbalances reduced, structural problems associated with them are still persistent as the Aggregate Demand in advanced economies reduced during the crisis. The author states that, in India, there are signs of recovery in growth and therefore, steps towards Monetary Policy exit have begun from the Union Budget of 2010-11, aiming at a return to the process of Fiscal consolidation which would facilitate better monetary management.

Neven Mates (2011) Contrary to the general consensus, the paper argues that in the run-up to the crisis, fiscal policy in the advanced economies and China substantially contributed to the propagation of the global imbalances, while at the same time it reduced the fiscal space that was available to the advanced countries when the crisis occurred. On the policy response during the crisis, the paper suggests that the discretionary relaxation

was a mixed blessing at best: appropriate to some extent in countries that entered the crisis with solid fiscal and current account positions, but much less, if at all, in other countries, particularly those that faced problems of public debt sustainability.

Monetary Policy

Monetary policy acts as a macroeconomic policy which is under the control of the Central Bank. The Central Bank controls money input in the economy, impacting interest rates. This interest rate is directly related to gaining different macroscopic goals.

These goals include inflation, consumption as well as growth and liquidity. Hence, monetary policy plays a vital role in maintaining economic growth.

Money supply in the economy and rate of interest change are two critical parameters that affect monetary policy. Different policy tools that affect the economy are:

- Discount rate,
- Reserve requirement,
- Open market operations, and
- Interest on reserves

Monetary policy stimulates people and firms to invest in various economic activities. Therefore, it has an indirect impact on a country's economy. As there is very less political interference in monetary policy, it can be acted upon independently.

The main risk here is that if monetary policy becomes loose, it can inversely increase the money supply and inordinately impacts inflation. It functions on the flow of money in the economy and credit control. If we closely observe, monetary policy is highly complex.

British economist John Maynard Keynes (1883-1946) gave the concept of fiscal policy. He stated that the government is responsible for maintaining the business circle and regulating the economic product.

According to Keynesian economics, aggregate demand is a key factor in handling the production and development of the economy. Customers' spending, different spending during investment, the total expenditure of the government as well as total export value combine and form aggregate demand.

In fiscal policy, government revenue collection and expenditure are used to affect the country's economic condition. This policy includes the aggregate supply of economic consumption and employment. This also affects economic growth. There is a remarkable impact of changing government spending and tax rates observed in fiscal policy. The government determines the fiscal policy, which shows the direct effect on the economic condition of the country.

Two crucial policy tools that affect fiscal policy are:

- Taxes, and
- Public spending

The credit for a great impact on the economy goes to the tax and spending policies of the federal government. It gives an idea about the money spent by one individual.

Two important types of fiscal policy:

- **Expansionary Fiscal Policy:** In this policy, public expenditure increases, whereas the government decreases taxes.
- **Contractionary Fiscal Policy:** Here, public spending decreases with an increase in taxes by the government.

In fiscal policy, the political influence is very high, affecting the equilibrium of economics. This solid political dimension directly changes the tax rates.

Monetary Policy vs Fiscal Policy

- The monetary policy is governed by the Central Bank of the country. On the other hand, fiscal policy is directed by the Finance Ministry.
- Monetary policy is performed for a long duration compared to fiscal policy, which is lost for only one year.
- Monetary policy plays an important role in maintaining price stability. On the other hand, fiscal policy is responsible for giving a particular direction to the economy.
- The political impact on monetary policy is absent. Conversely, there is a significant impact of politics on fiscal policy.
- The monetary policy specifically deals with financial management as well as borrowing. Contrarily, fiscal policy comprises government revenue and spending.
- The political impact on monetary policy is absent. Conversely, in fiscal policy, there is a major impact of politics on policy.
- Economic stability is the main focus of monetary policy compared to fiscal policy, which focuses on the economy's growth.
- The economic status of a nation is directly dependent on the change in monetary policy. On the other hand, fiscal policy gets updated every year.

Role of Fiscal Policy Development of India

Development by effective Mobilization of Resources

The principal objective of fiscal policy is to confirm fast economic process and development. This objective of economic growth and development is achieved by Mobilisation of economic Resources.

Efficient allocation of Financial Resources

The central and state governments have tried to create economical allocation of financial resources. These resources are allotted for Development Activities which has expenditure on railways, infrastructure, etc. whereas Non-development Activities includes expenditure on defence, interest payments, subsidies, etc.

Reduction in inequalities of Income and Wealth

Fiscal policy aims at achieving equity or social justice by reducing financial gain inequalities among totally different sections of the society. The direct taxes like income tax are charged additional on the wealthy

individuals as compared to lower financial gain groups. Indirect taxes are additional within the case of semi-luxury and luxury things, that are largely consumed by the higher middle class and also the upper class.

Price Stability and Control of Inflation

One of the main objective of economic policy is to manage inflation and stabilize value. Therefore, the government perpetually aims to manage the inflation by Reducing fiscal deficits, introducing tax savings schemes, Productive use of economic resources, etc.

Employment Generation

The government is creating every potential effort to extend employment within the country through effective business enterprise measure. Investment in infrastructure has resulted in direct and indirect employment. Lower taxes and duties on small-scale industrial (SSI) units encourage additional investment and consequently generates additional employment.

Balanced Regional Development

Another main objective of the economic policy is to achieve a balanced regional development. There are numerous incentives from the government for fixing projects in backward areas like money subsidy, Concession in taxes and duties within the form of tax holidays, Finance at concessional interest rates, etc.

Reducing the Deficit in the Balance of Payment

Fiscal policy tries to encourage additional exports by manner of financial measures like Exemption of taxation on export earnings, Exemption of central excise duties and customs, Exemption of nuisance tax and tariff, etc. The exchange is additionally preserved by Providing financial advantages to import substitute industries, Imposing customs duties on imports, etc.

Capital Formation

The objective of economic policy in India is additionally to extend the speed of capital formation therefore as to accelerate the speed of economic growth. an underdeveloped country is trapped in vicious (danger) circle of poorness primarily on account of capital deficiency. so as to extend the speed of capital formation, the economic policy should be with efficiency designed to encourage savings and discourage and cut back disbursement

Increasing National Income

The economic policy aims to extend the value of a country. this is often as a result of fiscal policy facilitates the capital formation. This ends up in economic growth, that successively will increase the gross domestic product, per capita financial gain and value of the country.

Development of Infrastructure

Government has placed stress on the infrastructure development for the aim of achieving economic growth. The fiscal policy measure equivalent to taxation generates revenue to the government. a section of the government's revenue is invested with within the infrastructure development. because of this, all sectors of the economy get a lift.

Foreign Exchange Earnings

These policy tries to add extra exports by manner of financial Measures like, exemption of taxation on export earnings, exemption of excise tax and octopi, etc. exchange provides business enterprise advantages to import substitute industries. The exchange achieved by means of exports and saved by way of import substitutes helps to solve the balance of payments problem.

Impact of Fiscal Policy in Indian Economy

In economics, fiscal policy is the use of the government. revenue and expenditure collection to influence the economic. fiscal policy will be contact with other main kind of small policy monetary policy.

- ❖ The main impact of fiscal policy or govt. expenditure and taxation changes in a level and consumption of taxation and govt. expenditure variable in the economy.
- ❖ The main impact of Aggregate demand and level of activity.
- ❖ The pattern of resource allocation
- ❖ The distribution of income.

Overview of Fiscal and Monetary Policy

- Governments can influence the performance of their economies by using combinations of monetary and fiscal policy. Monetary policy refers to central bank activities that are directed toward influencing the quantity of money and credit in an economy. By contrast, fiscal policy refers to the government's decisions about taxation and spending. The two sets of policies affect the economy via different mechanisms.
- Money fulfills three important functions: It acts as a medium of exchange, provides individuals with a way of storing wealth, and provides society with a convenient unit of account. Via the process of fractional reserve banking, the banking system can create money.
- The amount of wealth that the citizens of an economy choose to hold in the form of money—as opposed to, for example, bonds or equities—is known as the demand for money. There are three basic motives for holding money: transactions-related, precautionary, and speculative.
- The addition of 1 unit of additional reserves to a fractional reserve banking system can support an expansion of the money supply by an amount equal to the money multiplier, defined as $1/\text{reserve requirement}$ (stated as a decimal).

- The nominal rate of interest is comprised of three components: a real required rate of return, a component to compensate lenders for future inflation, and a risk premium to compensate lenders for uncertainty (e.g., about the future rate of inflation).
- Central banks take on multiple roles in modern economies. They are usually the monopoly supplier of their currency, the lender of last resort to the banking sector, the government's bank and bank of the banks, and they often supervise banks. Although they may express their objectives in different ways, the overarching objective of most central banks is price stability.
- For a central bank to be able to implement monetary policy objectively, it should have a degree of independence from government, be credible, and be transparent in its goals and objectives.
- The ultimate challenge for central banks as they try to manipulate the supply of money to influence the economy is that they cannot control the amount of money that households and corporations put in banks on deposit, nor can they easily control the willingness of banks to create money by expanding credit. Taken together, this also means that they cannot always control the money supply. Therefore, there are definite limits to the power of monetary policy.
- The concept of money neutrality is usually interpreted as meaning that money cannot influence the real economy in the long run. However, by the setting of its policy rate, a central bank hopes to influence the real economy via the policy rate's impact on other market interest rates, asset prices, the exchange rate, and the expectations of economic agents.
- Inflation targeting is the most common monetary policy—although exchange rate targeting is also used, particularly in developing economies. Quantitative easing attempts to spur aggregate demand by drastically increasing the money supply.
- Fiscal policy involves the use of government spending and revenue raising (taxation) to impact a number of aspects of the economy: the overall level of aggregate demand in an economy and hence the level of economic activity; the distribution of income and wealth among different segments of the population; and hence ultimately the allocation of resources between different sectors and economic agents.
- The tools that governments use in implementing fiscal policy are related to the way in which they raise revenue and the different forms of expenditure. Governments usually raise money via a combination of direct and indirect taxes. Government expenditure can be current on goods and services or can take the form of capital expenditure, for example, on infrastructure projects.
- As economic growth weakens, or when it is in recession, a government can enact an expansionary fiscal policy—for example, by raising expenditure without an offsetting increase in taxation. Conversely, by reducing expenditure and maintaining tax revenues, a contractionary policy might reduce economic activity. Fiscal policy can therefore play an important role in stabilizing an economy.

- Although both fiscal and monetary policy can alter aggregate demand, they work through different channels, the policies are therefore not interchangeable, and they conceivably can work against one another unless the government and central bank coordinate their objectives.

Conclusion

The objective of monetary policy and fiscal policy is to keep the economy healthy. Both are put together for growth and the steadiness of the economy. The main distinguishing factor between them is that the Central Bank approves monetary policy. On the other hand, fiscal policy is directed by the government of a country. Hence, monetary policy is crucial to achieving macroeconomic policy. Based on this paper fiscal policy corresponding to economic development, worth stability, social justice, etc. is achieved given that the tools of policy like Public Expenditure, Taxation, Borrowing and deficit financing are effectively used. although there are gaps in India's economic policy, there's additionally an urgent would like for creating India's economic policy a rationalized and growth oriented one. The success of economic policy depends upon taking timely measures and their effective administration throughout implementation.

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