Chapter III Macro Economic Policies - A Theoretical Survey

3.1 Introduction :

This chapter offers a theoretical survey of macroeconomic policies, the policies which are discussed in greater detail within the context of Indian economy in subsequent chapters. As already mentioned earlier, macroeconomic policies here include monetary policy, fiscal policy and exchange rate policy. All these three policies should be viewed as useful tools of an overall economic policy, which is geared to the achievement of some macroeconomic goals, for example, a growing level of output and a low and stable rate of inflation. Each policy as part of an overall macroeconomic policy has different aspects; Thus, monetary policy refers to the changes in the amount of nominal money stock brought about presumably by central bank of a country and its effects on interest rates. Fiscal policy, on the other hand, covers public spending and taxes; it is the policy which is concerned with the receipts and expenditure of governments, the relation between these two flows and their economic effects on all functions in which governments are engaged. Exchange rate policy refers to changes in nominal exchange rate required to keep a 'satisfactory' balance of payments of an economy. It is important to keep the distinction between policy goals and policy instruments. The instruments are the economic variables that governments can control directly(e.g.nominal money stock, taxes, public spending), the goals are the ones they hope to affect as a result(e.g.output, inflation)[1]. It is not inconceivable

1. D.C.Rowan (1983) - Output, inflation and growth - an an introduction to macroeconomics, MacMillan.

that the governments can hope to achieve some specific goals with a mixture of fiscal and monetary policies. It should be noted, however, that governments cannot achieve as many goals as it wishes. Since that would require availability of more instruments. In general, the number of targets or goals in most economic systems exceeds the number of policy instruments at the disposal of the economic authorities. In India, we have many economic goals such as high-level employment, economic growth, more equal income distribution, Price stability and balance of payments equilibrium, to name but a few of the most important ones. The economic authorities have relatively few economic instruments with which to accomplish these goals.

One solution to this problem would be either to reduce the number of goals or to increase the number of instruments. It is often politically difficult, if not impossible, to set aside certain goals completely and cast them in the role of irrelevant variables. The other option, increasing the number of instruments, while more feasible, is not without its costs in increased government intervention. Bureaucratic efficiency decreases as the problem of coordination mounts and resources are tied up as the process of coordination becomes larger. These considerations usually preclude a simple reduction in thenumber of goals or an increase in the number of instruments used to solve the economic policy problem.

The solution more commonly attempted (to the extent that one is sought at all) is what we shall call the shifting hierarchy

of goals. Certain goals are given priority in their attainment, and as progress is made in reaching them priority is redirected so that available economic instruments are used to achieve other goals.

The role of policy makers under this strategy, then is to identify the priorities of the goals and to constantly reorder them as progress is made toward achieving them. It is not inconsistent, therefore, for the central bank first to give priority to full employment and then to shift it to price stability.

An important conclusion is that policy instruments are not independent in their uses. The value of one instrument affects the value of other instruments necessary to achieve a particular group of goals, so that some degree of coordination in their application is required. How to achieve this coordination is one of the most important unsolved problems of Indian economic policy.

The problems of economic policy therefore center on choosing goals and establishing their priorities, coordinating the use of existing instruments of economic policy, and developing new instruments. It is in this context that Macro-economic policy must function and in which its success must be evaluated.

In short, at the macro level, the usual classification of the means of influencing the economy at the disposal of the authorities distinguishes :(a) Monetary policy (b) fiscal policy (c) Exchange rate policy.[2]

2. Turnovsky S.J. (1977) Macroeconomic analysis and Stabilization Policy; Cambridge University Press.

3.2 Monetary Policy :

Monetary policy is defined as discretionary action taken by the authorities (by Reserve Bank) aimed at influencing (i) the nominal money supply, and/or (ii) nominal interest rates, and/or (iii) the ease with which, at any given set of interest rates, money can be borrowed - which is usually termed 'availability'. In theoretical analysis, one can apply demand/supply analysis to the money market, which implies that the authorities can in principle set either the nominal money stock or the interest rate but not both. At a rather formal level of analysis this is correct. However, it assumes that 'the interest rate is determined in a market by demand/supply. In practice, however, many interest rates are determined administratively and, in the short run, are only loosely related to market forces. Hence, to a certain extent, the authorities can influence both the quantity and its cost. This explains why both are referred to in our definition.

Monetary policy achieves its impact on the economy by influencing the volume of money and the cost and availability of credit. These variables are interdependent. The rate of interest is closely related to changes in the stock of money. One may regard the achievement of a given stock of money as the equivalent of establishing a given interest rate. At different times a given stock of money may be associated with more than one interest rates owing to the influence of other factors. If one had a sufficiently

accurate model of the economic system, one could infer the impact of the any monetary policy on the economy. Unfortunately, our models at their present state of development are not accurate enough to make policy decisions. At best a welfare evaluation can be obtained showing alternative consequences stemming from various policy decisions. There is considerable uncertainty surrounding the consequence of any policy decision. In general, the choice of a policy instrument will be governed by (1) economic objectives to be achieved (2) the lags associated with the instrument (3) the relative strength of the instrument in relation to objectives we are trying to attain, and (4) its effect on resource allocation. The chief instruments of monetary policy are open market operations, Discount rates(or Bank rate) and Reserve requirements. Open market operations and Discount rate are aimed primarily at determining the monetary base, whereas reserve requirements affects the size of the money multiplier. Open market operations are the sale and purchase of government securities to finance the public sector borrowing requirements. The discount rate(or bank rate) is the rate at which the authorities will rediscount short-term bills presented to them by financial institutions. Reserve requirements represent a request to banks that a certain proportion of the value of either assets or deposits be held in specified assets. The three instruments are to a large degree substitutes for one another.[3] Some substantiation of this is given by the fact that Central banks in other countries have singled out different instruments among the three

3. Wadsworth J.E. & Leonard de Juvigny(1979)(ed.) - New approaches in monetary policy, Sijthaff & Neordhaff international Publishers, B.V.

basic ones as their principal instrument of monetary policy. For example, in the United Kingdom and Japan, the discount rate is the most important monetary instrument, while the reserve requirement is most important in Australia and New Zealand and also in India. The choice among the three major instruments must be made by considering their impact on factors other than the reserve base and the money multiplier.

The instrumental variables just described are directly controllable by the authorities. However, the links between these and goals variables are very complex. These instruments affect another set of variables which may be called indicators. These may include bank assets and liabilities, hich powered money, short term interest rates and also money stock measures. They are termed indicators as they 'indicate' the direction and strength of monetary policy in a particular period being closely related to the instruments themselves. The indicators are not directly controllable by the authorities. This is because there may be uncertainty over the exact links between instruments and indicators. Besides, exogenous factors may influence the indicator variables. Indicator variables in turn affect a further set of variables called targets. These may include monetary aggregates, bank credit and long-run rates of interest. Particular values for these variables are not desirable in their own right. However, they are the targets of monetary policy which the authorities believe will facilitate attainment of the ultimate macroeconomic objectives. The distinction between the targets of monetary policy and the goals of overall economic policy is therefore crucial.

The classification of variables into instruments, indicators and targets and the specification of their interrelationship in an elaborate framework is necessary since the authorities cannot be certain of the ultimate effects of a particular policy action on the goal variables and also as these actions may have lagged effects on the goals. One reason for an elaborate framework is the problem of uncertainty. This usually takes one of two forms; firstly, the actual structure of the economy may be unknown so that the authorities have no clear idea how a change in an instrument variable affects the goal variables. Secondly, within a well established structure, stochastic variations will occur in the basic functions.[4] For example, the demand for money function may shift due to an exogenous disturbance and this may affect the result of any change in a particular policy instrument. It is the existence of large potential exogenous influences that introduces major uncertainty into monetary policy. The aim of an indicator variables is to give a clear independent (of exogenous factors) signal of the strength and direction of policy. If it does so any divergence of the money supply, for example, from its target level can be assumed to be due to exogenous factors. The second major reason for an elaborate framework is the existence of lags in implementation and effect of monetary policy. It is in fact, the lagged response of certain variables to a policy change that is one of the key reasons for the use of intermediate (indicator and target) variables.

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4. Saving, T.R. (1967) "Monetary Policy Targets and indicators", Journal of Political economy, 75 (August) P.P.446-56.

Before focussing on the major issues of Monetary policy, it should be noted that the policies recommended by economists are based on the theoretical paradigm that the economists have of the real world. In the context of Macroeconomic policy two major schools of thought among others, are visible: The neo-keynesians and Monetarist. It is worthwhile to examine the approach of these schools to macroeconomic policy before dealing with specific issues of Monetary policy.

3.3 Neo-Keynesian Views on Policy :

The Neo-Keynesian school of macroeconomic policy is based on the premise that either monetary policy or fiscal policy can and should be used to stabilize the economy. Because neo-Keynesians believe that either policy tool can increase or decrease aggregate demand with equal effectiveness, these economists argue that the choice of a policy instrument in any given situation should be governed by the effects that such instruments will have on secondary macroeconomic goals.

Secondary, macroeconomic goals are based on considerations of equity and efficiency. From the viewpoint of equity, itis felt that, ideally, each sector of the economy should feel the impact of policy - both when it is beneficial and when it requires sacrifice. Efficiency is regarded as an important secondary macroeconomic goal because policies that reduce the efficient allocation of resources within the economy will be less effective in correcting present problems and will cause or contribute to economic problems in the future.

Monetary Policy

Neo-Keynesians believe that monetary policy has a greater adverse effect on secondary macroeconomic goals than fiscal policy does.[5] They argue that monetary policy affects economic sectors unevenly and distorts the composition of output. When the monetary authorities reduce the growth rate of the money supply, neo-Keynesians believe interest rates will rise. When interest rates rise, residential construction and state and local government construction are especially hard hit. Small businesses also suffer disproportionately when faced with monetary restraints, because their ability to borrow declines relative to the ability of large corporations to borrow. Monetary ease, on the other hand, also produces undesirable side effects. Neo-Keynesians believe that interest rates will decline in periods of monetary ease and that this decline in turn will lead to excessive speculation in the construction industry. Such speculation will encourage other business firms to over invest in construction, thereby setting the stage for the next economic downturn. Hence, neo-Keynesians advise against policies of excessive monetary restraint or ease, because both extremes have an uneven impact on the composition of output.

An excessive reliance on monetary policy is denigrated by neo-Keynesians because of the impact of such actions on asset markets. A tight money policy drives up interest rates and produces an inverse effect on the market value of bonds and stocks. Households that hold a major share of their wealth

5. W.L.Smith(1969)"A Neo-Keynesian view of monetary policy," In controlling monetary aggregates, Federal reserve bank of Boston, Monetary conference, June.

in the form of bonds and stocks suffer a disproportionate loss when the value of their wealth decreases. Conversely, these same households enjoy a disproportionate gain under a policy of monetary expansion.

Another negative aspect of excessive reliance on monetary policy, the neo-Keynesians feel, is the reduction of the efficient functioning of the financial system. In an advanced economy, the financial system facilitates the mobility of money capital within the economy. By mobility, we mean the extent to which impersonal transfers of money and assets, such as stocks and bonds, can be conducted between lenders and borrowers. A policy of excessive monetary restraint will produce crisis in the financial system and increase the risk associated with transactions to lenders and borrowers alike. This increased risk can permanently remove participants from the financial markets, thereby reducing the mobility of capital.

Lastly, neo-Keynesians believe that placing too much reliance on monetary policy can adversely affect economic growth by causing excessive swings in market interest rates. These wide swings are considered to cause increased uncertainty on the part of investors and to reduce the rate of capital formation. The capital stock will therefore grow at a lower rate: the rate of growth in output will similarly decline.

Given this appraisal of the adverse effects on secondary macroeconomic policy goals of relying too heavily on monetary

policy, neo-Keynesians recommend that monetary policy be kept in the 'middle of the road' to avoid extreme ease or extreme restraint, Neo-Keynesians argue that to determine whether monetary policy is in the middle of the road, long-run concepts of normal interest rates and normal money-supply growth rates must be used to formulate policy. However, since the monetary authorities can initiate changes in monetary policy with a short implementation lag, allowance is made for the possibility of small and prompt deviations from the middle-of-the-road monetary policy. These relatively minor deviations, neo-Keynesians posit, can be used to offset small and unexpected changes in aggregate demand. The extent to which monetary policy should be allowed to deviate from the middle of the road is dictated by the subjective importance the monetary authorities attach to the effects of these deviations on secondary macroeconomic goals.

Fiscal Policy

In light of their recommendations concerning monetary policy, the neo-Keynesians quite logically conclude that fiscal policy should be primarily employed to stabilize the economy. It follows from this conclusion that if a middle-of-the-road monetary policy is to be maintained, then fiscal policy must be conducted so that the monetary authorities are not forced to adopt a policy of extreme ease or extreme restraint.

Fiscal policy must provide the required stimulus or restraint when aggregate demand departs too far in either direction from the full-employment level. According to the neo-Keynesians, the appropriate measure of fiscal ease or restraint is the full-employment surplus, which, they argue should be positive during inflationary periods and negative during recessionary periods. The full-employment surplus can be varied by changing the level of government expenditure or the rate of taxation. Neo-Keynesians are the first to admit however, that certain institutional factors inhibit the effect of both of these approaches on the full-employment surplus.

3.4 Monetarists views on policy[6]:

Fiscal Policy

Monetarists believe that during major and extended recessions, fiscal policy can and should be used to increase the levels of aggregate demand and of employment. However, given any economic contraction other than a major recession, monetarists regard fiscal policy as a weak tool, at best, compared to monetary policy. The essence of their position is that an increase in government expenditure, financed by increased taxes or the sale of bonds to the public, does not cause a permanent shift in the aggregate demand curve, even if the economy is at less than the full-employment level. When the interest rate is at or above the natural interest rate, an increase in the government's demand for goods and services is offset by a decrease in the private sector's demand for these goods and services. When this occurs,

6. M. Friedman (1956) "The quantity theory of Money -- a re-statement." In Friedman (ed) Studies in the quantity theory of Money, University Press, Chicago.

the private sector is said to be crowded out. In their views, fiscal policy is ill suited and an important care for inflation and it usually attempts to remedy temporary deviations from internal balance and hence their effects are only temporary.

In addition to this argument against fiscal policy, monetarists believe, as do neo-Keynesians, that a sizable lag exists between the time that the need for an economic stimulus becomes apparent and the time that that stimulus actually becomes effective. This means that if the economic problem is one of recession, the increase in aggregate demand that results from an expansionary fiscal policy will not occur until the economy is well into the expansionary phase of the business cycle. Hence, monetarists argue, this ill-timed economic stimulus produces excess aggregate demand and sets the stage for inflation. Instead of ensuring greater economic stability, fiscal policy actually increases economic instability due to the procyclical nature of its implementation.

Monetary Policy :

Contrary to what their name implies, monetarists generally voice modest claims about the effectiveness of monetary policy. In fact, most monetarist statements on monetary policy are made about things that monetary policy cannot do.[7] At the present time, monetarists believe that our knowledge of how changes in the quantity of money are transmitted to the real sectors of the economy is insufficient to enable us to make accurate predictions about how changes in nominal GNP can be categorized as changes

7. Friedman, M. (1968) "The role of Monetary Policy" American Economic Review, 58 (March), P.P. 1-17

in real GNP or as changes in the price level. In other words, knowing that nominal GNP will rise 4% next year does not provide us with sufficient information to determine how that 4% will be divided between increases in real output and increases in the price level. Thus, monetary policy cannot be relied on to control either real output or prices in the short run-the two primary concerns of macroeconomic policy.

One aspect of this unreliability in the short run is the time lag between the moment when a monetary policy is implemented and the point at which it becomes effective. As in the case of fiscal policy, monetarists believe that expansionary monetary policy in a moderate recession is worse than ineffective, because it will increase the cyclical instability of the economy. This increased instability is due to an impact lag between the time when the monetary stimulus is required and the time when it produces a substantial impact on the economy.

The consequence of this time lag, monetarists argue, is that although the monetary authorities may quickly and correctly diagnose the beginning of a recession, expansionary monetary policy may not begin to stimulate the economy until it is well into the recovery phase of the business cycle. This means that when full employment is restored, it will be accompanied by excess demand that will result in inflation. If the monetary authorities attempt to contract the money supply in an effort to stop the inflation, they will initiate a recession and the policy cycle will repeat itself. The monetarists conclude,

therefore, that attempts by the monetary authorities to dampen the cyclical behaviour of the economy actually do just the opposite. Monetarists believe that discretionary monetary policy not only is unreliable in the short run but also cannot be used to achieve certain long-run policy goals.

According to the monetarists, monetary policy, by means of fixing, or pegging, a certain positive rate of inflation, cannot reduce the rate of unemployment below the natural rate of unemployment. Some nonmonetarist economists who believe that monetary policy can still be used to reduce unemployment in the short run advocate a policy of monetary growth to create the necessary inflation. Monetarists are opposed to this policy because it will only be effective if labor has failed to anticipate the inflation. Once the rate of inflation has been fully and correctly assessed, the unemployment rate will rise until it returns to the natural rate of unemployment. The social benefit of increased production and employment then becomes lost, but the social cost of the continuing inflation remains. In addition, the possibility exists that the monetary authorities, in an attempt to once again reduce the rate of unemployment, may increase the inflation rate via even greater monetary growth. Hence, monetarists are opposed to inflationary policies, because they provide only transitory benefits at best and are apt to create long-run economic problems.

In the same vein, monetarists do not favor monetary policies that are designed to peg the interest rate. In the not-too-distant past, many central banks favored such a policy.

The monetary authorities held this view because they believed that monetary policy had only a weak effect on the economy; if interest rates could be kept low, then the cost of servicing the national debt could be reduced. Monetarists believe that the monetary authorities could successfully reduce the interest rate below the natural interest rate, but this condition can exist only in the short run. The policy of pegging the interest rate below the natural interest rate works only if the public does not anticipate the inflation that is bound to result. When the inflation is fully anticipated, the nominal interest rate is higher than it was before the pegging operations began by an amount equal to the expected rate of inflation.

The monetarists believe that every major recession has been caused by an absolute contraction of the money supply, that minor recessions have probably resulted from declines in the growth rate of the money supply, and that every major period of inflation has been caused by an excessive expansion of the money supply. According to the monetarist view, the obvious means of preventing major economic disturbances is a monetary policy that avoids sharp swings between policies of monetary ease and monetary restraint. The surest way to achieve this goal, monetarists argue, is to remove all discretionary power to establish monetary policy from the monetary authorities and to replace this discretionary policy with a simple rule stipulating that the monetary base or some appropriate measure of the money supply will grow at a constant annual rate.

Although a minor debate exists among monetarists regarding the exact rate of growth of the money supply to be chosen, Friedman has suggested that a growth rate of 3-5% in M2 would be satisfactory. More recently, David I Meiselman has suggested that the M1 measure of money should be kept at a constant quantity (that is, that its growth rate should be zero). Monetarists contend that a policy based on announced monetary rules would prevent the occurrence of major economic recessions and would lessen the impact of minor fluctuations by eliminating discretionary monetary policy - a source of greater economic instability.

A necessary concomitant to a monetarist monetary rule is a flexible exchange rate system. A nation under a fixed exchange rate system cannot pursue a monetary policy that is independent of the monetary policies of the countries with which it maintains fixed exchange rates. If only one of these nations expands its money supply at an inflationary rate, then all of the nations in the system must absorb this excess money if the exchange rates are to remain constant. Hence, inflation, which starts in one country, will spread to all other countries. Conversely, if one nation experiences a monetary collapse, like the one that occurred in the United States in the 1930s, then the money supplies of all other nations on the fixed exchange rate will experience a monetary collapse. Thus, a decline in the money supply in one nation will cause a recession in that nation, and that recession will subsequently be transmitted to the other

nations with which that nation maintains fixed exchange rates. Because monetarists advocate a monetary rule of a fixed rate of growth in the money supply, they are opposed to fixed exchange rates and recommend a flexible exchange rate system.

3.5 Issues related to Monetary Policy[8]:

Besides the analysis of the theoretical role of money, it is important to establish the main issues that the empirical work shouldattempt to resolve. An issue that has become of major importance in the empirical debate is the type of economic model to be used. The role of money can be explained in a full 'structural' model of the economy. In such a model, equations are specified to explain fully the endogenous variables of the model such as consumption and investment in terms of both exogenous and other endogenous variables. Ideally, all the many complex links between economic variables should be included in a model of this type. However, the result is usually a highly complex model with an enormous number of equations that may be viewed as being too cumbersome to evaluate the role of one variable like the money supply. Alternatively, therefore, the 'reduced form' approach has become preferable in this area. A reduced form equation may be defined as a relationship derived from a full structural model between the endogenous variable to be explained(i.e. economic activity) and the exogenous variables that determine it. Use of such an approach may reduce the number of equations to be estimated to one and so minimise the complexities of obtaining results.

8. Datta, B.(1978) "Money and economic activity - Problems and issues", in reserve Bank of India: Recent developments in Monetary theory and Policy, Bombay

A number of arguments may be advanced in favour of the 'reduced form' approach, most of which may be associated with the monetarist school. Firstly, it is argued by monetarists that the transmission mechanism of money is too complex and operates through too many channels for a structural model to capture it in full. Therefore, a reduced form approach is more practical. Secondly, monetarists are generally interested in the gross association between money and variables such as economic activity, nominal income and price level. As such, the numerous avenues through which money affects these variables are of limited interest to them. It is believed that the private sector's economic behaviour is basically stable and therefore allocative details are less significant.

The major issue is whether money is statistically significant a variable in explaining the variations in nominal income. M. Friedman and D. Meiselman interpreted the quantity theory and Keynesian theory as essentially theories of money income determination. Accordingly, the general comparative static income expenditure model can explain either the fluctuations in price level or the fluctuations in real income, but it is inadequate to explain the simultaneous determination of real income and price level. Hence, the Keynesian and quantity theory approaches have been interpreted as providing alternative explanations for changes in level of money income.

The second major issue in the context of monetary policy is the factors affecting demand for money and stability of the relationship. The use of demand for money equations to test the role of money has been an important part of empirical analysis since it guarantees a significant role for money in determination of nominal income. It is argued that from a position of equilibrium in the money market ($M_S = M_D$) any increase in the money supply must call forth appropriate adjustments in income and the rate of interest (whatever may be the transmission mechanism may be) before equilibrium is restored. More specifically, a rise in the money supply must generate an increase in the level of income to remove the excess supply of money. The stability of money demand does not rule out long-term movements in the velocity of circulation. What is rejected is the possibility of short-term fluctuations in velocity which may offset any changes in the money supply. Besides the issue of Aggregate demand for money, the disaggregated study of demand for money involving estimates for demand for currency demand for demand deposits also warrants attention. This is because setting of targets or monetary budget involves a realistic assessment of the likely levels of money demanded by the public on one hand and requirements of credit by different sectors including government and Foreign factors on the other. The study of demand for money at the disaggregated level enables the policy makers to make predictions about or to forecast possible changes likely to occur in the components of money stock.

In recent years, greater attention is given to the practice of setting growth targets for the money supply and/or other monetary aggregates. This new approach to monetary policy has been espoused by many countries with a view to achieving some prespecified macroeconomic goals. Of course, the mode of quantifying monetary targets differs considerably from country to country. The relevant issue here is about the choice of the target. What should be appropriate target of monetary policy! In the presence of more than one macro variables for targetting, what is the criteria of deciding about the appropriability of a variable to be the best target of the monetary policy! In addition to the issue of targets, the intermediate variable indicating the stance of policy also assumes significance. The indicator shows the relative easeness or tightness of the policy. The question is which variable indicates correctly the stance of the given policy. What criteria should be used to find out the appropriate indicator of monetary policy?

It is true that there exists wide agreement about the goals or objectives that the stabilisation policies should pursue and it is equally true that diversity of opinion abounds regarding the role that should be assigned to the different instruments of economic policy. In India, more specifically, price stability as an objective of economic policy is being assiduously pursued and attended to by the policy makers and one often hears such assertions that economic policies must have a strong systematic bias in favour of minimising inflationary pressures. In this context, the package of stabilisation measures

often include monetary growth rate rule, Monetary targetting, reduction in government spending etc. These measures aim at price stability. This is because it is found that inflation, if not checked, goes on increasing at a rapid rate and it quite often generates higher variability of inflation and inflationary expection which further accentuate inflationary trends. The increased variability of inflation creates uncertainty for the individual decision making units and forecasting rate of inflation becomes extremely difficult. It is important to examine the relationship between higher inflation rates and the variability of inflation. The hypothesis will be that of a positive association between higher inflation rates and the variability of inflation rates.

The primary emphasis of monetary policy is usually placed on its role as an instrument of macroeconomic demand management. Hence great importance is attached to the permissible magnitude of monetary expansion consistent with the anticipated rates of growth of the economy as well as some broad assumptions regarding price trends. However in the formulation of policy, in addition to the quantity of money supply expansion, the 'quality' of money supply expansion also merits special significance. This is because the quality of money supply expansion in certain situations might compensate for more than the anticipated increase in the quantity of money supply, in other words, different 'sources' of money supply expansion may exert varying degrees of pressures on aggregate demand. This suggests that monetary policy formulation requires a study of the composition of the 'sources' of

money supply; This exercise can reveal whether the structural change has occurred in the composition of the money stock and what implications it has for the formulation of Monetary policy.

In summary, the major issues related to Monetary Policy are :

1) The role of money in influencing economic activity, and more specifically the money income.

2) The factors affecting demand for money, their relevant elasticities and the stability of this relationship.

3) At the disaggregated level, what are the important variables affecting demand for currency and demand for deposits ? What are the estimated equations ?

4) What is the most appropriate monetary target variable ? What are the criteria for choosing the target variable ? which variable should be assessed to gauge the stance of the Monetary Policy ?

5) The composition of 'sources' of changes in money supply and whether this composition has undergone a qualitative change ? What implications it has for formulation of Monetary budget prepared for a year.

3.6 Fiscal Policy

It is defined as the discretionary manipulation by the authorities of (i) Government expenditure on goods and services, (ii) the function relationg the tax yield to GDP and (iii) the

function relating transfer payments to GDP. More specifically, fiscal policy involves alterations in government expenditures for goods and services, or the level of tax rates. Unlike monetary policy, these measures involve direct government entrance into the market for goods and services(in the case of expenditures), and a direct impact on the private demand(in the case of taxes). Basically, this process of shaping taxation and public expenditure is intended (i) to help down the swings of the business cycle and (ii) to contribute toward the maintenance of a growing, high-employment economy free from excessive inflation or deflation. In general, the fiscal authorities 'lean against the prevailing economic winds", thereby helping provide a favourable economic environment within which the dynamic forces of private initiative can have the widest opportunity for achievement. This description of fiscal policy could lead one to believe that fiscal policy helps stabilize the economy only so long as the authorities are carefully watching trends, are successfully anticipating future developments, and are meeting promptly to take decisive actions. Such 'discretionary fiscal policies", involving the making and changing of explicit decisions, are important. However, they are but a part of fiscal policy.[9] The modern fiscal policy has great inherent automatic stabilizing properties. Automatic changes in tax receipts, unemployment compensation and other welfare programs, farm aid programs etc. have the effect of reducing partly any fluctuation in the economy. It is found that as soon as income begins to fall off, the tax receipts of the government also fall off. Similarly, it is the case with unemployment compensation; soon after men are laid off

9. Dennis, G.E.J.(1981): Monetary Economics, Longman, New York

they begin to receive payments from the unemployment compensation funds. When they go back to work, the payments cease; and the taxes collected to finance unemployment compensation rise when employment is high. During boom years, therefore, the unemployment reserve funds grow and exert stabilizing pressure against too great spending; conversely, during years of slack employment, the reserve funds are used to pay out income to sustain consumption and moderate the decline. The various parity programs to aid agriculture act like built-in stabilizers. When rupee spending drops off and farm prices fall, the government pays out rupees to farmers and absorb surpluses. When inflation brews and prices soar, the government warehouses put forth farm goods and absorb rupees, thus cushioning any movement. It should be noted that the built-in stabilizers are first line of defense in the authorities arsenal but are not by themselves sufficient to maintain full stability since a built-in stabilizer acts to reduce part of any fluctuation in the economy, but does notwipe out 100 per cent of the disturbance. It leaves rest of the disturbance as a task for fiscal and monetary discretionary action.

Discretionary fiscal policy entails a change in the structure of the government budget. A discretionary change in tax schedules alters the volume of tax revenues collected at any selected level of economic activity; a discretionary change in government transfer programs results in a changed level of transfer payments at any level of business activity; and so on. Thus, a discretionary fiscal policy action shifts the schedule in Figure 1 that shows the federal budget balance associated with different levels of business

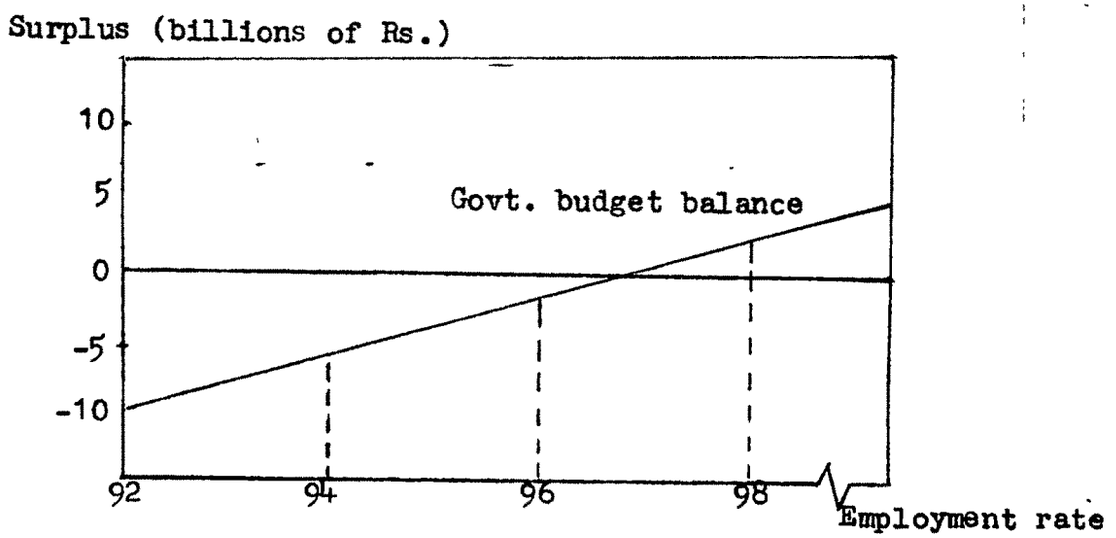

Figure - 1 Employment and the Budget Surplus (Deficit)

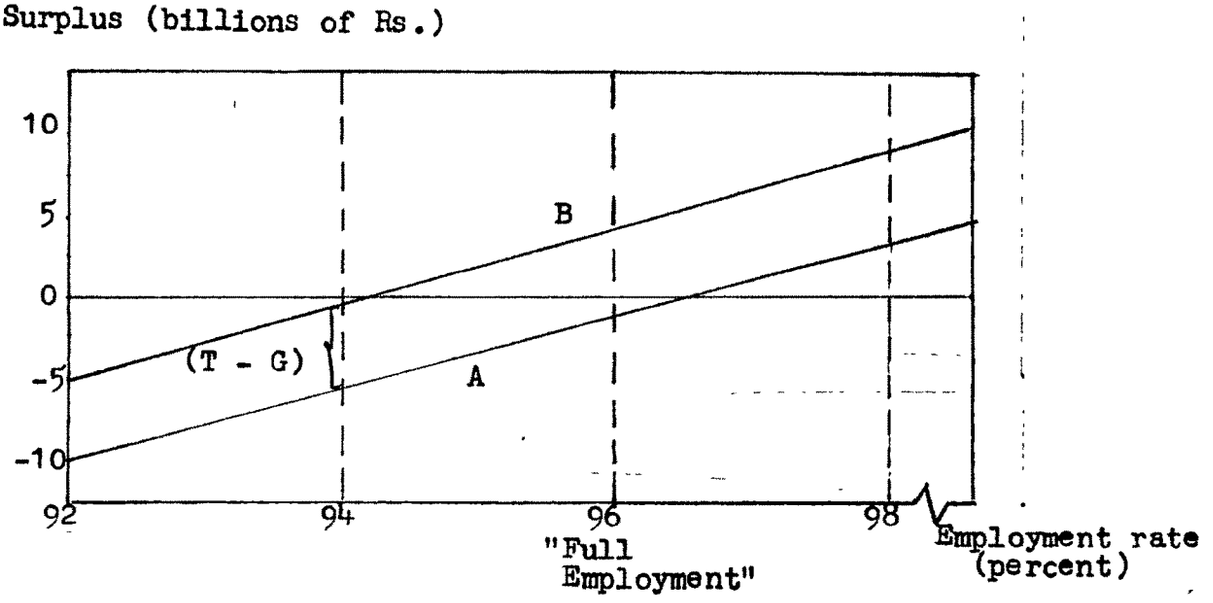

Figure 2 Discretionary Fiscal Policy and the Budget Surplus

activity. For example, a discretionary increase in taxes (by, say, a reduction in the exemption level or by an across-the-board increase in percentage tax rates) would shift the budget balance schedule upward to reflect an increase in the surplus (decrease in the deficit) that accompanies any level of economic activity.

In Figure 2 there are two schedules representing, with different sets of government tax and outlay programs, the state of budget balance associated with different levels of business activity. If schedule A in Figure 2 accurately reflects of the relationship between employment and the budget balance prior to a discretionary fiscal policy action, a budget shift in the direction of schedule B could result from a discretionary increase in taxes, a discretionary reduction in transfer payments, or a discretionary reduction in government spending. Reversing the direction of the discretionary change in tax structure or outlays would shift the schedule representing the budget balance downward (as from schedule B toward schedule A).

During an extended contraction, the appropriate fiscal response of a movement toward budget deficit can result, obviously, from discretionary policy actions as well as from an automatic response in tax receipts and government outlays. Conversely, during an overly rapid, prolonged expansion, discretionary policy actions can produce the movement toward budget surplus that stabilization requires. Of the two budget postures (reflecting, again, a given set of government tax, transfer, and expenditure programs) represented in Figure 2

budget A is clearly more expansionary than budget B because the budget deficit is larger (surplus smaller) at every level of economic activity with budget A.

3.7 Measuring the Impact of Fiscal Policy :

Historically, the degree of stimulation (or restriction) of economic activity stemming from fiscal policy has been regarded as dependent on the size of the observed budget surplus or deficit. The budget has been popularly regarded as stimulative when in deficit (government outlays exceeding revenues), and restrictive when accruing a surplus. A glance back at Figure :2 should dispel the notion that observed surpluses or deficits are adequate measures of the impact of fiscal policy. Because the observed surplus or deficit is the result both of the structure of the budget and of the current level of economic activity, it is impossible to obtain a clear-cut judgement on the impact of fiscal policy from the currently measured surplus or deficit. A budget deficit may just reflect a depressed level of economic activity rather than a stimulative fiscal policy program. Hence, the very same budget structure might be judged restrictive, expansionary, or neutral, depending on the prevailing level of economic activity.[10]

The relative impact of two alternative fiscal policy programs can be judged by comparing the surplus (or deficit) generated by those alternative programs at a given level of

10. Gupta, G.S. and G.S. Laumas (1983) :"Some Properties of Fiscal and Monetary Policy Multipliers", Southern Economic Journal, 49,4 (April) P.P. 1137-40.

employment. While this comparison can be made at any arbitrarily selected level of employment, the comparison is conventionally made at an assumed level of employment of 96 percent of the measured labor force. In the 1960s, this level of employment was assumed to approximate full employment; consequently, the resulting measure of budget posture was labeled the full employment surplus. It is now more frequently referred to as the high employment surplus or deficit.

In Figure 2, budget A shows, at "full employment" a deficit (negative high employment surplus) of some Rs.3 billion while budget B yields just under a Rs.4 billion surplus. With the larger high employment deficit under budget program A reflecting either larger government outlays or smaller tax revenues at aby level of employment, fiscal program A is more stimulative (or less restrictive) than program B is. This conclusion, of course, does not rest on the observed government budget balance. Indeed, the great advantage of the high employment surplus as a measure of fiscal influence on the economy lies in its ability to separate discretionary changes in the budget from induced (automatic) budget balance changes. The high employment surplus while vastly superior to observed deficits and surpluses as a measure of fiscal posture, is still strictly limited; it only permits us to compare budgets, to identify more or less expansionary budget programs. To go further, to judge whether any particular budget program is compatible with noninflationary, full-employment equilibrium, we would need more information than is contained in a budget balance schedule. We also would

need to know the strength of private demand for consumption goods, investment goods, and net exports.

When private demand is excessively buoyant, a government budget that provides a high employment surplus would be optimal. With unduly anemic private demand, discretionary fiscal policy actions that provide a high employment deficit would be ideal. More specifically, if for simplicity we ignore the international sector of the economy. We know that commodity market equilibrium prevails only when planned injections into the income stream (investment and government spending) are equal to leakages (private saving plus net tax revenues) from that stream. That is, the equilibrium condition is $I + G = S + T$ or, rearranging, $I - S = T - G$.

If, with output at the full-employment level, planned saving exceeds planned investment (a private sector surplus), then equilibrium can prevail only if government spending exceeds net tax revenues (a government sector deficit at full employment), if full-employment planned saving falls short of planned investment (a private sector deficit), equilibrium would prevail only if net tax collections exceed government spending (a public sector surplus). For a budget structure that yields government budget balance at full employment to be compatible with full-employment equilibrium, the private sector must be planning to invest and save equally (private sector budget balance) at full employment.

Redirecting attention to Figure-2, with the budget structure represented by schedule-A, were the economy in equilibrium with 6 percent unemployment, the measured budget deficit(T - G) would correspond to an equal excess of planned saving over planned investment. While the budget would be permitting a sizable measured deficit, it could not legitimately be called expansionary because it permits the 6 per cent unemployment level of output to remain the equilibrium levels. However, with a sizable increase in planned investment, the same budget would permit demand-pull inflation! The only budget consistent with full employment equilibrium is one that fills the gap between full-employment output and aggregate demand. It goes without saying that the budget structure which fills that gap, providing full employment equilibrium, is not independent of monetary policy because money supply changes also alter private demand.[11]

3.8 Issues related to Fiscal Policy :

The orthodox theory of public finance advocated a 'balanced budget' for the government on the ground that a continuing imbalance would either pile up deficits or involve a rising public debt. Hence, the orthodox theory stipulated that the revenue and expenditure of the government must balance in an accounting period. However, over a period of time, the concept of budgetary deficit evolved from an initial stage of 'war deficits' to a final stage of 'development deficit'.

11. Evans M.K.(1969), Macroeconomic Activity New York: Harper and Row.

On development grounds, the concept of unbalanced budget was accommodated. It was also argued that the budgetary deficits are a temporary phenomenon only and with the revival of economic prosperity, the deficits will be wiped out through surplus budgets and in the long run, there will be no deficits. But this expected scenario has not materialised in many countries, India being no exception to that. The phenomenon of Long run balancing of the budget has failed to occur. Instead, countries including India are experiencing substantial growth of budgetary deficits with its serious implications to price stability and financial soundness of the economy. In this context, while the absolute level of deficits is important what is more important is the changing composition of the total budgetary deficit. The various components on revenue account and capital account are not definitionally different but they have different implications. This is an issue of fiscal policy which requires closer examination.

Historically, the degree of stimulation(or restriction) of economic activity stemming from fiscal policy has been regarded as dependent on the size of the observed budget surplus or deficit. The budget has been popularly regarded as stimulative when in deficit(government outlays exceeding revenues) and restrictive when accruing a surplus. On the other hand, the discretionary fiscal policy is assumed to stabilise the economy; The higher deficits and/or substantially larger government spending would usually be expected to exist in the period of contraction while lower deficits and/or less government spending would

be associated with the period of expansion. This suggests that the question examining whether the government deficits and/or government expenditure has behaved in the manner cited above would be an important issue signifying the appropriability of fiscal actions. The issue relates to the stabilizing or destabilizing properties of government deficits and this will have to be examined over the growth cycles. It will tell whether the fiscal deficits attempt to aggravate or precipitate cycles or they attempt to smoothen the fluctuations. Besides the issues of composition of budget deficits and stabilizing properties of deficits, the issue of the relationship between deficits and money stock is an important one. The public sector is widely recognized to exercise important influence on the stock of money, either directly or indirectly. The extent of this influence depends on the method of financing the deficit. Specifically if the deficit is financed by domestic or external non-monetary borrowing, the money stock will remain essentially unaffected, but if it is financed through the banking system, ceteris paribus, the money stock will increase. The real issue is whether the monetary policy is independent of the government budget. What is the underlying relationship between budgetary operations and the reserve money and other money stock measures? would an increase in government deficits result into a corresponding increase in money supply? How far is it true that monetary policy is passive and accomodating to budgetary operations?

There is a further important aspect of fiscal policy and that of the role of fiscal policy in economic development. The principal way in which fiscal policy influences growth in a country at some stage of development is through the efficacy of mobilizing resources for development; fiscal policy also affects growth by influencing the efficiency of resource allocations. There is further equity dimension of fiscal policy where the key issue is who bears the tax burden of fiscal policy and who benefits from public expenditure.

3.9 The exchange rate Policy :

The considerations involving international trade and finance are of great significance in the design of economic policy. The balance of payments and exchange-rate ramifications play a prominent part in policy deliberations. The economic policy has to take account of open economy influences.

Ideally, a country always desires to maintain internal as well as external balance; By internal balance, we mean the simultaneous occurrence of two policy goals of full employment and price stability and by external balance, one understands a situation where a nation is neither gaining nor losing international monetary reserves. Under a flexible exchange rate system, the level of required international reserves is zero and since this level never varies, the system is said to be in external balance at all times. Under fixed exchange rate system, if the foreign exchange market is in equilibrium,

then the central bank is not acquiring or losing foreign exchange and the country's stock of international monetary reserves remains constant. In other words, the change in international monetary reserves would be zero. It is no denying the fact that the choice of an exchange rate policy has implications for the external economic viability of a nation.

The debate on exchange rate flexibility was launched in the early 1950s, by two great economists of very different ideological persuasions, Milton Friedman and James Meade, arguing in favor of replacing the postwar system of (more or less) fixed exchange rates by floating rates.[12] Friedman made two important positive arguments in favor of flexibility and one criticism of the case against. First, he argued that a floating exchange rate would give a country the freedom to choose its own monetary policy without having to be concerned about the balance of payments impact this would have: any inconsistency between its monetary policy and that of the rest of the world would be absorbed by a change in the exchange rate, rather than leading to reserve losses or gains that would feed back on the rate of monetary expansion. This was a point of crucial importance to Friedman, but steady expansion of the money supply was the key to achieving macroeconomic stability. Second, he argues that when it was necessary to achieve a change in the real exchange rate in

12. M.Friedman(1953), "The case of For Flexible Exchange rates" in his Essays in Positive economics(Chicago: University of Chicago Press).
J.E.Meade(1955) "The case for variable exchange rates" Three Banks Review, September.

order to adjust the balance of payments, it was much easier to do this by a single change in the nominal exchange rate rather than by revising thousands or millions of individual wages and prices in terms of national currency so as to have the same effect by changing the internal price level.

His criticism of the case against floating related to the question of destabilizing speculation, as it was then called. The Estonian economist Ragnar Nurkse(1907-59) had, during the Second World War, supervised a study of the interwar experience with floating exchange rates, in which it had been concluded that speculative pressures had time after time resulted in floating rates being violently unstable. Friedman countered this with the simple but powerful argument that speculators who really destabilized rates, in the sense of pushing them away from equilibrium (rather than making disequilibrium rates change suddenly), must lose money! Because a speculator makes money by buying something when it is relatively cheap and selling when it is relatively dear, which raises prices at the trough and reduces them at the peak, that is, stabilizes rather than destabilizes. A speculator who did the opposite must lose money. Since this is not what the game of speculation is supposed to be about, the key to the observed volatility of exchange rates must lie elsewhere. Ever since monetarists have been convinced that that key lies in unstable government policies(especially monetary policy).

In contrast to the laissez faire desire to minimize the role of government of Friedman, Meade's attitude was that of the technocratic manager seeking tools adequate to the job. Monetary policy was one such tool, but it was not sufficient alone, nor in combination with fiscal policy: it needed to be combined with an expenditure-switching policy. Exchange rate policy provided the natural candidate (inasmuch as it alone does not involve creating microeconomic distortions). Meade also discussed the threat of destabilizing speculation. He did not share Friedman's confidence that this phenomenon could be ruled out on the grounds that it would be inimical to the interests of the speculators, but instead argued that it could be overcome by strong and internationally coordinated intervention policies. Although the matter is still not finally settled, the volatility of rates observed in the 1970s would suggest that Meade's fears on this score were more realistic than Friedman's confidence that it would not happen. A possible explanation is that the speculators who lose money are not the core of professionals in the market, who would surely get out of the business if they could not beat the market and make money, but a part of that large fringe of traders, tourists, and even central banks who take open positions in foreign exchange lost substantially under risk and uncertainty.

Opponents of flexible exchange rates developed a series of counterarguments in the years that followed, to supplement

the fear that floating would mean volatility because of speculation. In the first place, they argued that this volatility would tend to make international trade and investment more risky and would therefore impede international integration. Second, they argued that removing the constraint on monetary policy provided by the need to defend a fixed exchange rate should be counted as a cost and not a benefit: countries need a discipline of that sort to prevent their political leaders engaging in irresponsible inflationary finance. Supporters of flexibility replied either that the democratic process and not the need to defend a fixed exchange rate should be allowed to decide how much inflation a country should have or that under floating inflationary finance would quickly lead to a depreciation and thus to internal inflation, which hits the public directly in a way that reserve losses do not, so that discipline would actually be more effective under floating. Third, opponents of floating argued that a fixed rate provided a built-in stabilizer: a boom or recession would draw in more or fewer imports with a fixed rate and thus tend to dampen the change in income, whereas the income expansion would be bottled up at home by a floating exchange rate, leading to inflation or slump. Supporters of flexibility retorted that this situation was crucially dependent on the assumption of no capital mobility, since a domestic boom would tend to raise interest rates and thus draw in capital rather than depreciate the currency where capital was mobile.

Two further arguments against floating were added in the 1970s, mainly by the global monetarists (who thus adopted a position on this issue opposed to that of old-fashioned monetarists). First, they argued that exchange rate changes could produce expenditure-switching effects only if there were money illusion; in its absence, a devaluation would simply induce an offsetting inflation rather than a payments improvement. This issue has never been completely resolved, but the claim is certainly not universally accepted: what absence of money illusion, plus the strong but usually unmentioned assumption of the uniqueness of equilibrium, jointly imply is that a devaluation alone will not have a lasting effect in altering competitivity. However, the sophisticated advocate of exchange rate policy envisages its use as a part of a package, not as an isolated policy instrument and there is no reason for believing that it cannot be useful in that context just because money illusion is absent - as it surely is . Second, it was argued that exchange rate flexibility would tend to accelerate the average rate of inflation because of ratchet effects: a depreciation would produce a proportionate inflation, whereas an appreciation would not reduce prices proportionately because of downward stickiness, so that variable exchange rates would ratchet up the price level. This sounds pretty plausible, but no decisive empirical evidence in favor of the hypothesis has yet been presented.

In parallel with the long-running debate on fixed versus floating exchange rates, there emerged in the 1960s a literature

on intermediate options. One strand of this was initiated by Robert Mundell, with a paper that asked: what is the optimal currency area?[13] By this, he meant the optimal area within which exchange rates should be fixed. Typically, each country has a single money, and different countries have different monies, so that exchange rates are fixed within countries but may vary between them. Mundell argued that one should ideally have one money for each area within which factors were mobile but between which they were not, since factor mobility would make exchange rate changes redundant, while a change in the exchange rate could provide a helpful substitute for factor mobility where this was absent. Shortly afterward Ronald McKinnon argued that the critical factor was the openness of the economy rather than the degree of factor mobility, since a relatively closed economy could hope to use a devaluation to promote expenditure switching, while in a highly open economy the main result would be to raise the price level. Later participants in the debate argued that the key factor was the willingness to accept the same rate of inflation. Others pointed to the necessity for a common fiscal system, in order to provide an alternative mechanism for easing interregional adjustments in the form of fiscal transfers. Today, the dominant tendency is to argue that schemes for currency unification should be judged on the basis of a cost-benefit appraisal involving all these factors, rather than appealing to some single criterion to the exclusion of all others.

13. R.A.Mundell(1961) "A theory of optimum currency areas", "American Economic Review, November.

A second strand to the debate on intermediate options arose from the observation that there are more alternatives available than free floating and permanent fixity. For example there are also the two other systems that have in fact been widely employed in the postwar world: managed floating, where there is no particular rate that the authorities are committed to defend but where they nevertheless intervene at their discretion, and the adjustable peg, where the authorities accept a commitment to defend the rate at the particular level where it is currently pegged, but where they reserve the right to change that rate under certain circumstances. There is also a fifth possible exchange rate regime, generally known as the crawling peg.[14] This involves a country accepting a parity (or peg) for its currency but changing this gradually over time in a series of small steps rather than in the sudden discrete changes that are characteristic of the adjustable peg. Such changes may be determined according to a formal rule, for example, revalue when reserves rise and devalue when they fall, or they may be determined by discretionary decisions - either announced in advance or made as the occasion arises in response to what are considered relevant criteria. The countries that have employed the crawling peg for longest, Colombia and Brazil, both make discretionary decisions, guided in large measure by the objective of maintaining PPP with the United States so as to neutralize the effect of their high domestic rates of inflation.

The crawling peg is an intermediate regime that fits naturally into the scheme of those who see exchange rate flexibility as a

14. R. I. McKinnon (1971), Monetary theory and Controlled Flexibility in the foreign exchanges, Princton essays on international Finance No.84.

technocrat's tool. It gives a country the power to reconcile any internal rate of inflation with continued external balance; the one thing that exchange rate flexibility really can neutralize efficiently is differential inflation. This power has up to now been used to allow countries to inflate faster than the world average, but it could equally well be used as a tool to enable countries to repel imported inflation and enjoy a greater degree of price stability than the norm. Second, a crawling change in the exchange rate can be used to promote expenditure switching when this is needed.

A third strand to the debate on intermediate options concerned another form of limited flexibility, known as the wider band. The band refers to the scope around a parity within which the exchange rate is allowed to fluctuate, even though it is pegged to the parity. In the Bretton Woods system as it prevailed up till 1971, countries agreed to hold their exchange rates within a 2 per cent band, that is, within margins 1 percent either side of parity. The wider band or band proposal envisaged widening the band of 2 percent to something in the range of 5 percent to 10 percent. The main idea was to provide somewhat more freedom for contracyclical monetary policy to vary between countries.

A new topic has become important since the move to floating exchange rates by the principal industrial countries in 1973. This concerns the exchange rate policy to be pursued by the remaining countries, who include virtually all of the

developing countries. It is generally agreed that it would be unwise or even impractical for these countries to adopt floating rates: the limited scale of the market and the lack of depth of domestic capital markets preclude that option. Prior to 1973, the only question that was left was when and how to change one's parity, for example, by adopting a crawling peg. But nowadays it is necessary to decide not merely whether to peg but also to what to peg. When all the major countries were pegged to each other, pegging to the dollar meant pegging to everything else: now that the major currencies are floating, pegging to the dollar means having one's rate fluctuate in terms of everything else. These fluctuations may have some logic for the United States, but to a small country pegged to the dollar they have none whatsoever, and are pure shocks. Hence the question has arisen how the country can choose a peg - in the sense of a currency or basket of currencies to which to peg - with the object of minimizing the damage done by the exchange rate fluctuations between the major currencies. This has become known as the question of choosing an optimal peg.[15] Broadly speaking, the answer is that countries should seek to stabilize their effective exchange rates by pegging to a basket of currencies. The effective exchange rate is defined as the trade-weighted geometric mean of the bilateral exchange rates with a country's trading partners and competitors. Stabilizing the effective exchange rate means that, although exchange rate changes between the major countries will still influence the competitive positions and costs of individual industries and firms, at least these effects will tend to balance out over the

15. J.Williamson(1982) "A Survey of the emergent Literature on the optimal peg", Journal of Development Economics August.

economy as a whole and so not disturb macroeconomic equilibrium. A possible disadvantage of pegging to a basket, which has to be weighed against the macroeconomic benefit, is the microeconomic risk imposed on individual traders when they no longer have a major international currency in which they can write contracts and against which their own currency is reasonably stable.

3.10 Issues related to exchange rate policy :

In the context of international setting, it is the external economic viability and adaptability of an economy to the adverse or favourable changes of the international economic climate that merits attention. This requires an analysis of the variables considered crucial in its international economic standing. The analysis helps us to arrive at a conclusion regarding the role of the international economy in regard to domestic development policy. The issue relates to the feasibility or otherwise of an autonomous, non-dependent path of development in the economy. The crucial variables to be studied usually include (a) the balance of payments statistics (b) stock of official exchange reserves and changes in it and (c) flow of net and gross external debt. These variables do indicate the overall balance of payments situation in an economy which is very useful. However, even such an exercise gives only a partial picture and Analysis of the external economic viability of a nation is never complete in the absence of an analysis of the sources of finance for real transfers, if any, from abroad.

The details of these can be obtained from a breakdown of balance of Payments(BOP) return into real transfers/defined as current account balance less interest charges on foreign Loans) and and sources of finance.

Besides this, a study of external economic viability necessitates an analysis of trends in exports and an assessment of export perfcrmance. This gives a much needed insight into the major constraints, both internal and external, affecting the volume of exports. Some of the internal factors could be costs of production, the pressure of domestic demand and infra-structural or sectoral bottolenecks. The external factors could be growth of world trade, demand for the exports of a country and increasing incidence of protectionism menifested in the price and/or quantitative restrictions.

There is a further important issue of the role that exchange rate plays in promoting exports. It is reasonable to ask if there is a satisfactory explanation in the wider context of the policy framework which considers the possible impact of exchange rate depreciation on exports. To what extent is this an appropriate policy for managing the balance of payments problems. Furthermore, do export promotion policies have a role to play in augmenting the exports ? In what way they alleivate the balance of payments situation!