



Lesson: Fiscal Constraints and Financial Markets

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Fiscal Constraints and Financial Markets

After reading this chapter, the students will get insights into:

1. The basic concept of Rule based and Discretionary Monetary Policy.
2. The debate of the choice between rules and discretionary monetary policy.
3. Time consistency of policy.
4. The government budget constraint.
5. Ricardian Equivalence
6. Structure of Financial Markets along with Regulatory Mechanisms.
7. Financial Crises and the responses.

1. Introduction

In the chapter on Monetary Policy, we explored the various concepts of monetary policy and how the central monetary authorities utilize the various tools in conducting an efficient monetary policy which is in consonance with the economic and financial system of a nation. For instance, the central banks indulge in open market sales of treasury bills and other financial assets in the phase of deflation, recession or when it upholds a target for the rates of interest to be maintained in the system.

Various other steps are taken when the system suffers from inflation. The steps to combat inflation include open market purchases of treasury bills, increasing the cost of borrowing of funds and tightening the supply of money.

It is however not only the monetary policy which governs or operates to increase the viability of the system. The other end of the policy framework includes the tools of fiscal policies. Just like the monetary authorities, the governmental authorities also formulate policies and programs to maintain a stable and viable system in a nation.

However, it is not only a single sacrosanct monetary or fiscal policy which is followed in every situation. The basic tools and measures to conduct the policies vary as per the economic and financial conditions that prevail during a given point of time. For instance, a policy of boosting demand may not improve the output situation much when it is also contributing to the already existing pressures of inflation. This is termed as a situation of “Stagflation” and thus the normal policy of boosting demand in a downturn phase of economy may enhance the troubles of the economy in terms of pushing inflation further upward. Thus, a different policy has to be carried out each time.

However, the monetary and the governmental authorities do not have an unlimited tendency or capability or resources to carry out these activities of maintaining a stable and a viable financial system indefinitely. Everything is constrained and so does the monetary and governmental authorities.

Government faces a budget constraint for carrying out its functions. We all have read about the sources of governmental revenue being tax income, loans, income from public sector entities that are involved in direct sale of goods and services, grants from other nations. On the other hand, lays the governmental expenditures which vary in each nation as per the developmental, political, economical and financial needs of the environment.

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In a developed nation, the governmental expenditures are less on carrying developmental programs. However, boosting security measures, carrying scientific research and development remains high on their agendas. This is not so for the developing nations where governmental commitments first and foremost remains for boosting output generation and carrying out activities to combat the evils of poverty, excessive inflation or deflation, unemployment etc.

It has been apparent that the governments in the developing world usually are in debt since their expenditures far outweigh their incomes. The governmental budgets run in deficits and thereby it reduces the credibility of the governments of the nations and also hampers the viability of the financial and economic environment of the nation.

Sometimes, these deficits are large enough to crash the entire economies of nations or put them in depression or bankruptcy. Similar situations may occur in the financial system of the nation, if the activities of financial domain have been carried in a rampant and an unjustified manner that may lead to the downturn in the financial indicators of interest rates, exchange rates etc and thereby lead to collapse of even the financial system.

In the following sections, we shall study whether the monetary policies are conducted based on any rule or whether the authorities possess discretionary powers to conduct any such policy at any given point of time. Similarly the subsequent sections will also throw light on the conduct of fiscal policies and the constraints keeping which in mind the governmental fiscal operations are carried out. We shall then throw light on how the financial systems operate in a sound regulatory environment and what conditions can lead to financial crises.

2. Rules vs. Discretion

In this section, we shall examine and elaborate on the basic concepts of rules and discretion based on which monetary policies are carried out.

A policy is any action or plan of strategy carried out to fulfill a certain objective of short, medium or long run. A policy may not however be always designed or formulated to fulfill a goal; it is sometimes also framed in response to an action, study or event. These policies are framed keeping in sight the current and future economic scenarios that prevails and are expected to prevail in the future.

We shall now throw light on the basic concept of a discretionary and rule based monetary policy. A discretionary monetary policy is said to prevail when the authorities are only directed to carry out operations to maintain a stable and viable economic system and to boost the economic performance of the country with the various policy tools or instruments at their disposal. In such a situation, the policies so framed by the monetary authorities are termed as "***Discretionary Monetary Policies***".

On the other hand, when the operations or actions to be carried out by the central monetary authorities are restricted by a rule; then such a policy scenario is termed as a "***Rule based Monetary Policy***". A rule restricts the discretionary powers of the monetary authorities and they are then asked or supposed to function in such an environment. A rule may restrict the ability of the central monetary authorities to determine the monetary base of a nation or it may even restrict the authorities of their defined objectives. These rules are subject to revision as per the changing economic conditions. However, sometimes, these rules are not quickly and immediately revised in consonance with the revisions taking place in economic units' expectations. In such cases, the policies become predictable even if the state of the world remains ambiguous.

The rules restrict but do not completely eliminate the discretionary powers of the central bank. The rule may restrict the central bank by defining an objective that the policy must achieve, however achieving that goal with the employment of various instruments remains in the discretionary powers of the central monetary authorities. However, sometimes even the instruments choice is even limited. Then the discretionary powers of the monetary authorities may occur in the form of deciding the time frame within which such objectives are to be pursued with the defined instruments.

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We shall now examine the debate that exists on the topic of whether rules or discretions should be resorted to in conducting a successful and efficient monetary policy. The debate of the choice between the two basic categories of monetary policy revolves around the following two grounds:

- 1) Desirability of having elected members to make the choices
- 2) Economic implications of the policy

The issue of having desirable candidates or experts revolves around the experts making the economic judgments that govern the conduct of monetary policy or leaving it to the discretion of monetary authorities.

While the issue of economic implications of the policies are judged on the basis of benefits and costs of conducting these policies together with whether the policy is formulated efficiently in light of the current economic situation of the nation to further enhance or improve the economic performance in the future. It is argued that if the economic policy that is framed keeping in light the current state of the world but is unlikely to contribute positively in boosting the economic performance of the nation in future, then the cost of pursuing such a policy becomes less.

From the basic definitions it can be grasped that discretionary policies are based on subjective judgments that are made and then actions are quickly designed and implemented after any change is observed in the economic system. The rule based policy possesses its benefits for being predictable so that the fluctuations in the economic variables can be minimized and there can prevail environment of certainty in the system. However, if the rules of the monetary policy are extremely rigid and totally lack the element of flexibility, the choice of instruments and objectives gets completely restricted for the monetary authorities. Not responding or revising these rules in the ever changing economic scenarios then imposes a huge burden on the economy of carrying out the rule based monetary policy. The discretionary policies inherit the ability to respond uniquely to every situation which is also the demand of the events that unfolds. Not every recession is the same as the previous recession that took place in a given nation. Though the outcomes of recession remains same in the form of falling output, employment and price level, but the basic cause that triggered this recession may vary and thus the correcting response of monetary authorities demand some discretion that can implement policy that targets the revival or

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completely eliminate the functioning of the sector from which the root element of the recessionary trend began. Thus, keeping in sight that each event is unique, the need of having a discretionary policy with a unique response mechanism becomes essential.

On the other hand, since the economic and financial systems remains highly uncertain and sometimes lose their credibility and viability, the need to have some monetary rules defined becomes the need of the hour. The rules inject some sort of certainty in the system and once the policy outcomes the predicted, achieving the policy goals also becomes easier since expectations are build in the market that have the character of being self-fulfillment. Some sort of uncertainty however still remains in the systems which are now highly interconnected with the financial systems of the other nations. Thus when some events unfold which was not planned for and was highly unexpected, keeping the rules rigid does more harm than good.

Thus, the only way forward that appears is to design a policy that has the characteristics of both rules based and discretionary monetary policy. In the light of dynamic economic scenarios, the discretionary policies become essential but to keep this discretion within some control, some rules should be implemented. In this way, a finely tuned system can be maintained.



3. Time Consistency of Policy

Though a wide range of literature in economics support or vouch for the discretionary monetary policy where the actions are taken by the monetary authorities are in quick response to the events or scenarios that unfold with time in a given economic system. However, there is a time inconsistency problem inherent in the discretionary monetary policy, considering which a rule based policy is regarded as a superior response. The time inconsistency problem concerns the general output-inflation tradeoff for a monetary policy.

When the Discretionary monetary policy is framed disregarding the expectations about economic decisions that were built in the past by the various players and economic units in a given nation, then it is said to be "Time Inconsistent". A governmental policy that is optimal at a given point in time may not be so in the future. Since people form rational expectations and do expect the government to deviate from its current policy, the desired outcome of the governmental policy may not be achieved since people will have already revised their expectations.

Thus, the time inconsistency problem arises because the monetary authorities possess an incentive to deviate from their first monetary policy announcement. Sometimes it is done deliberately in order to influence the expectations being made by the various units in the economic system. However, the public and other decision making units may lack their trust in the monetary authority who understand that the authorities will deviate from their stand in the future. This can be understood in an inflation-employment example.

In an economic system that is facing stagflation – that is higher inflation with lower output, the central authority may step in whose basic objective is to achieve the twin goal of lower inflation and higher output and employment. In such a case, the central bank will announce that its policy goal is to reduce or maintain a low level of inflation. Since the basic assumption of rational expectations lies at the heart of the economic system, people will respond to this policy announcement by making an expectation of lower inflation and will get the prices and wages set accordingly. Once the price levels have been reduced in the system, the authorities now possess an incentive to deviate from their previous announcement and undertake an expansionary monetary policy to boost output and employment.

However, with rational expectations, people do understand that central bank's previous announcement was not credible and thus they revise their expectation with the bank

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changes its policy course in the new environment. Thus, the banks' expected outcome of enhancing the level of output generation and thereby promoting employment is not met.

In such a situation, it is argued that a fixed policy tool that is designed and implemented keeping the past expectations and present and future economic conditions in sight, is superior to a discretionary stance. In a rule based monetary policy, rules are devised that are inconsonance with the state of the world today and are likely to efficiently improve the performance of the system in the next period. Since with a rule based policy, people do realize that government has credibly committed itself to a viable policy even in the future and thus they do not revise their expectations which lead to the achievement of an efficient future growth path for the economic variables. This is so, because the rule based policies have already incorporated the people's expectation that they will frame in the future based on the changes that will occur in the system today.

Thus, it is argued that policies that can viably commit the present and future course of event of the governmental and monetary authorities can generate positive gains for the nation as a whole.

Thus, the conclusion that emerges from the discussion in section 2 and 3 is that the policies should be framed as per the demands or needs of the characteristics that the system may possess at any given point of time.

Discretionary policy do contain an edge over the rule based monetary policies in a wide range of situations owing to its inherent flexibility even in short period of time, it loses this edge to the rule based policy when people's behavior is governed by rational rather than adaptive expectations.

However, it should be acknowledged that not all time-consistency problem of discretionary monetary policy is harmful to the public. Sometimes, the outcome surprise that the monetary authorities plan to bring in by changing the course of policy overtime may actually benefit the public. However, such a beneficial surprise to public can only be generated if the central banks can bring the surprise without affecting people's expectations for the future.

4. The Government Budget Constraint

Just as we study about the constraints that a firm or a household faces in undertaking conducting its financial transactions in the micro economics course. In the macro economics however, we talk about the budget constraint of the macro unit of government. The government in any nation has certain expenditures that it has to carry which are in the welfare interest of the people of the nation. However, the governments cannot conduct such expenditures indefinitely in any amount. The governmental expenditures are limited or constrained by its income which comes from the sources of taxes, sale of goods manufactured by public enterprises, interest income on loan provided to other nations etc. Such a limiting of governmental expenditures by government income is termed as "**Governmental Budget Constraint**".

We shall in the following section build an arithmetic expression for the governmental budget constraint and identify the various concepts of deficits and governmental debts that are an essential part of the functioning of the government in any developing or underdeveloped nation.

$$\text{Deficit}_t = rB_{t-1} + G_t - T_t \quad \text{equation - 1}$$

Where, B_{t-1} is the governmental debt at the end of year t-1. This debt shall also persist at the beginning of the year t. arithmetically this can be illustrated as:

$$B_{t-1} = B_t$$

r in the equation – 1 relates to the real rate of interest in the time period t. Thus, the expression rB_{t-1} indicates the real interest payments that the government has to make on the magnitude of debt held by it at the end of the financial year t-1.

The expression G_t reflects the governmental spending on goods and services in the time period t.

Similarly, T_t reflects the composite income of the government from the taxes earned by it in the time period t minus the transfers it made in the same period.

Thus, from the identity in equation-1, we can say that the governmental budget deficit equals governmental spending, including the interest payments it has to make on the debt withheld from the past period minus taxes that are incorporated as net of transfers.

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Since, the real rate of interest has been incorporated in the equation, the measure of deficit in the equation – 1 is also termed as “***inflation adjusted deficit.***”

In an accounting sense however, only nominal interest rates are considered. Thus, the expression for the governmental budget constraint can be illustrated as:

$$\text{Deficit}_t = B_t - B_{t-1} \quad \text{equation-2}$$

Using equation-1, equation-2 can be rewritten as:

$$rB_{t-1} + G_t - T_t = B_t - B_{t-1} \quad \text{equation-3}$$

Thus, the governmental budget constraints create a link between change in government deficit in two periods with the initial level of debt, interest payments, governmental spending and taxes net of transfers. The equation-3 can be further modified to obtain an expression for change in governmental debt between two periods:

$$B_t - B_{t-1} = rB_{t-1} + G_t - T_t$$

Where the expression on the left hand of the equation is termed as change in governmental debt. The first component on the right hand of the equation reflects the interest payments on the debt withheld from the past and the second component reflects the primary deficit of the government.

On further modification of equation – 3, we can rewrite it as;

$$B_t = (1+r) B_{t-1} + G_t - T_t \quad \text{equation-4}$$

Thus, the magnitude of debt at the end of year t equals (1+r) times the debt withheld from the period t-1 and primary deficit.

Full repayment of Debt in period-2

Here, we shall examine what happens if the government decides to repay the debt fully in period-2.

Considering equation-4,

$$B_t = (1+r) B_{t-1} + G_t - T_t$$

Since the government decides to repay the debt in 2nd period, $t=2$, while $t-1 = 1$. With full tax repayment in period 2, $B_2 = 0$ and $B_{t-1} = 1$. On substitution, we can rewrite equation-4 as;

$$0 = (1+r)*1 + G_2 - T_2 \quad \text{equation-5}$$

Rearranging the expressions in equation-5, we get:

$$T_2 - G_2 = (1+r) \quad \text{equation-6}$$

This implies that in order for the government to repay the debt fully in period-2, it must ultimately run a primary surplus of the magnitude of $(1+r)$. As implied, the primary surplus can be maintained by the excess of taxes over governmental spending. Thus, the government will have to implement measures that lead to reduction in its spending or increase in its taxes.

If one shall that the entire surplus to repay the debt comes from increase in taxes, while governmental spending remains unaffected. Thus, the decline in taxes by $(1+r)$ in period-1 has to be exactly offset by a rise in tax-rate by $(1+r)$ in period-2.

Similarly, the expression for surplus to be maintained for debt repayment in period-t can be written as:

$$T_t - G_t = (1+r)^{t-1} \quad \text{equation-7}$$

Thus, from the analysis done, we can conclude that:

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- A decrease in taxes in a given period is exactly offset by an increase in taxes in the following period, if governmental spending remains unchanged.
- The longer the government delays the increase in taxes and the higher the interest rate, the higher is the eventual increase in taxes.

5. Ricardian Equivalence

Ricardian equivalence offers a theory of how governmental deficits effect the output generation when governmental budget constraint is taken into account. Ricardian equivalence illustrates that when the government attempts to stimulate the level of demand in an economy through spending that is financed by debt, then the stimulation to the demand does not have any positive effect on the level of economic activity of the nation.

When the government undertakes a demand stimuli measure of decreasing taxes by one unit in the present period with a subsequent announcement of increasing the taxes in the future, then this stimulation to demand fails to bring any expansion in level of economic activity to be carried out in the nation and ends up having no effect at all on the demand for consumption made by residents of the nation as a whole.

DID YOU KNOW?

The concept of Ricardian Equivalence was given by English economist David Ricardo during the nineteenth century.

The concept was further developed by Robert Barro in 1970 and since then the concept is largely known as "Ricardo Barro Equivalence".

Why this occurs is that, people take the tax cut today as saving to pay increased tax rates in future. They treat the extra money as savings that can be utilized to pay higher taxes in the subsequent period.

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Thus, the basic implication of this theory is that any governmental spending which is financed by either increasing its debt or lowering the taxes today will have no effect all on the level of consumption of the public at large. The basic premise of ***Rational Expectations*** is inherent in the theory which leads it to this implication.

However, there are several criticisms of Ricardian Equivalence. Some of them are discussed as under:

- Consumers do not behave rationally in their decision making process about consumption and savings as they are characterized by the feature of being myopic.
- It has been argued based on observed evidence even though the average propensity to save rises in the event of a tax cut; people do spend some of the marginal tax cut.
- If the tax cuts are accompanied with higher, then the governmental borrowing needs are diminished in the future, which weakens the possible effect of higher taxes in the subsequent period.
- Increased governmental spending during recession that comes from the sources of private sector savings boosts demand, output and employment.
- The increase in governmental spending increases output by multiplier effect thereby eliminating the need to raise taxes in the future.

6. Financial Systems

In this section, we shall understand the basic concept of a financial system and how the structure of the financial systems varies across nations.

In a financial or an asset market, we observe that various sorts of financial activities take place which can be broadly categorized under the major heads of exchange of funds by borrowing or lending. Since such transactions occur at local, regional, national and global level, the structure of the financial systems in which these transactions takes place also vary.

At a micro or local level let us consider a firm; a financial system may be defined as the various implemented procedures that enable the pursuance of financial activities of various magnitudes. Similarly, at a regional level the financial system enables the exchange of funds between borrowers and lenders which are then accommodated for undertaking

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various activities of monetary and real nature. At a global level, the structure of the financial system is very wide and it encompasses all financial institutions, national and international lenders and borrowers from across the world. The magnitude and the scale at which these activities are carried out is the largest.

Based on the structures the players in the financial systems also vary. For instance at a firm level, the financial activities of accounting, revenue and cost determinations, balance sheet verifications are done by the financial analysts and other workforce to carry out all the financial activities. The regional or national financial systems encompass all sorts of financial institutions existing in the boundary of the nation which includes Central Bank, banks, financial intermediaries, financial markets that are indulged in rendering a wide range of financial services. The players, magnitude of activities are the largest in the global financial systems where the financial institutions of World Bank, International Monetary Fund, Central Banks of nations and the major banks that are involved in rendering the financial services defined previously but internationally, outside the geographical boundaries of the nations in which they are situated.

Over the passage of time, the structure of these financial systems has altered at all the levels of local, regional and global. From the past, there have occurred great changes in the way transactions were carried out in these systems. For instance, barter practice in the Indian financial system and gold standard, Bretton woods system and Managed floating system at the global level.

6.1 Regulation of Financial Sectors

The financial sectors are governed by various regulatory policies that vary from nation to nation. The central banks are devised as national monetary authorities in each nation that regulates the activities of players of national and international nature that operate in the financial markets. Each institution or financial system possess its own regulations better regulate the activities of these players and thus every financial institution remains liable to operate in the systems by abiding to these regulations.

In the Indian financial system, financial sector is dominated by the activities of commercial banks followed by that of the insurance sector. The Indian Financial System has emerged greatly over the period and is identified as one of the most diversified system in the whole world. The sector keeps expanding and enhancing the domain of its operations which has led to the existence of a one of the largest financial systems in India which is at par with the

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financial systems of the most developed economies in the world. The various players in the Indian Financial Sector remains, Central Bank, Commercial Banks, Other Bank intermediaries, Non-banking financial intermediaries, Insurance Companies, Mutual Funds, Pension Funds, Cooperatives and other small financial entities that facilitate small magnitude of financial transactions.

The regulatory structure of the Indian Financial Sector remains complex with the existence of multiple regulatory organizations. The largest and most significant role is played by the central monetary authority or Central Bank of India known as Reserve Bank of India which regulates the conduct of and supervises the commercial banks, financial institutions, non-banking financial companies and urban cooperative banks. These financial institutions in turn regulate and supervise other financial entities for instance; housing finance companies are regulated by National Housing Bank.

Apart from the financial regulations of these institutions that rest with RBI and NABARD, the control of management functions of these institutions is vested in the powers of Central and State Governments. Insurance Funds are regulated by Insurance Regulatory and Development Authority (IRDA) whereas the Pension Funds sector is regulated by Pension Funds Regulatory and Development Authority (PFRDA). The power of exercising regulatory control over mutual funds, capital markets is vested with the Securities and Exchange Board of India.

The multiple regulatory structure of the Indian financial system is in sharp contrast with the regulatory mechanisms of other nations such as USA where Financial Stability Oversight Council acts to monitor the various risks to American Financial System. It also facilitates communication among the financial regulators. Australian system possesses two regulatory authorities that conduct such that undertake prudential regulation and conduct regulations. In the United Kingdom, such regulatory powers are vested with the Bank of England together with Prudential Regulation and Conduct Regulation Authority.

7. Financial Crises and Regulatory Response

The financial sectors across the world has have had various levels of freedom of operation and regulation based on the nature and structure of financial activities that make-up the financial systems of the nations. However, despite best practices of regulation and operational freedoms, the financial sectors have faced crises and failures since the history of

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the evolution of these systems. The financial sectors remain highly vulnerable to these failures. These failures however do not remain in the financial sectors but also engulf eventually other sectors of the economy into its domain. Since the economies today remain interlinked where even the integration of financial sectors occurs at a large scale, the failures or financial crises spill over to the trading or interlinked economies and trigger the outbreaks of downturn, recession and depressions until rectifying measures are undertaken to correct bring the economies back into an upward trend in their respective business cycles of economic activities.

The world has witnessed various financial crises, the worse among which remain the Foreign Exchange crises of 1992 that originated from Germany, The Mexican Peso Crisis of 1994, and The East Asian Crises of 1997. The most recent crash of the financial system witnessed by the world has been the Global Financial Crisis of 2008 which originated in the geographical boundaries of United States or America from the unrestricted Credit Boom of subprime lending, Rapid asset price appreciation, creation of a new variety of institutions which promised returns based on favorable economic conditions together with excessive Liberalization and Deregulation of Financial transactions.

In response to these crises and failures, have emerged a wide range of responsive mechanisms that have led to the financial sectors on the path of recovery. Considering the range of financial crises engulfing entire economies of origin and most recently the world economy in the Sub-Prime Crisis of 2008, some common regulatory practices have been incorporated in the regulatory frameworks by each nation individually. Common practices to inject some immunity to the financial systems has been in the form of Governmental Safety Nets, constituting lender of last resort, deposit insurance, restriction of competition, Asset restrictions and Capital requirements and above all regular supervision of these financial sectors.

In response to the Global Financial Crises of 2008, various financial sector reforms have been undertaken as response mechanisms such as the constitution of a Financial Stability Board, adoption of BASIL III Capital Requirements, Liquidity Standards, Sound Compensation practices, better harmonization of existing data and closing the existing data gaps.

These reforms have led to the initiation of the process of recovery and the economies are expected to emerge more strengthened and efficient overtime as the recovery process takes on its course and spills over to the affected nations that make up the global economy.

Exercises:

Ques.1: Which of the following is a category of monetary policy?

- a) Rule based
- b) Discretionary
- c) Both a and b
- d) Neither a or b

Ques.2: Which of the following category of monetary policy is preferred under the assumption of rational expectations?

- a) Rule Based
- b) Discretionary
- c) Both a and b
- d) Neither a or b

Ques.3: Who regulates the Insurance Sector in India?

- a) IRDA
- b) PFRDA
- c) Both a and b
- d) Neither a or b

Ques.4: Which monetary policy is regarded as Time Inconsistent?

- a) Rule Based
- b) Discretionary
- c) Both a and b
- d) Either a or b

Ques.5: Which of the following has been the primary cause of Global Financial Crises of 2008:

- a) Credit Boom
- b) Excessive Liberalization of Financial Systems
- c) Both a or b
- d) Neither of the above

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Ques.6: Differentiate between rule based and discretionary monetary policy.

Ques.7: When is a rule based policy said to dominate the discretionary monetary policy regime.

Ques.8: Derive Government Budget Constraint and the expression for debt repayment by government in t-periods.

Que.9: Write a short note on the concept of Ricardian Equivalence. What are the criticisms offered against the prevalence of ricardian equivalence?

Ques.10: Define the term "Finance Systems". What are the regulatory mechanisms in Indian Financial System?

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