A2 – ECONOMICS (9708)

MACRO

CHAPTER 5

Govt. Macroeconomic Intervention

Topics
Topic 1: Government Macroeconomic Objectives
Topic 2: Fiscal Policy
Topic 3: Monetary Policy
Topic 4: Exchange Rate Policy
Topic 5: Supply Side Polices

First five are more imp

TOPIC 1: GOVT. MACROECONOMIC OBJECTIVES

Lecture 1

1. GOVERNMENT MACROECONOMIC OBJECTIVES

Definition: These are objectives that the government wants to achieve through its policies. There are several macroeconomic objectives:

Objective	Description
1. Redistribution of Income	The government aims to reduce the gap between high and low-income groups by imposing taxes. This can be done using a progressive tax system in which rich pay a higher percentage on their income as compared to the poor.
2. Control Inflation (Price Stability)	Inflation is referred to as the general persistent rise in general price level. The plans to keep prices stable by keeping a check on inflation. Since high rates of inflation reduce international competitiveness and can cause a loss of trust in investors. Inflation can be either demand-pull or cost-push.
3. Full employment (or Low Employment)	Unemployment is who are able and willing to work but do not have work. The government aims to reduce unemployment.
4. Economic Growth	Economic growth is regarded as the increase in county's GPD (Gross Domestic Product). Economic growth increase standard of living and can achieved by increasing factors of production or by increasing their efficiency.
5. Balance of Payment Stability	The BOP is the record of financial transactions with other nations. If the outflows are greater than the inflows the BOP is in a deficit. If the inflows are greater than the outflows BOP is in a surplus. Deficit drains the money from a country where as surplus can cause inflation in the long run hence the governments try to keep an equilibrium.
6. Environmental Considerations (Reduction in social costs)	Government wants sustainable growth and development which means that today's growth does not eliminate the consumption possibilities of future generations and this consideration may act as a constraint of the rate of economic growth.
7. Correcting Market Failure	These objectives that exist at the microeconomic level also affect the rate of economic growth. Example: Controlling monopoly power might restrict the level of growth because of lower R&D spending in the economy.
8. Productivity	Governments also want to improve the level of efficiency with which factors of production are being utilized in the economy. This is important to check an economy's performance relative to that of other countries.

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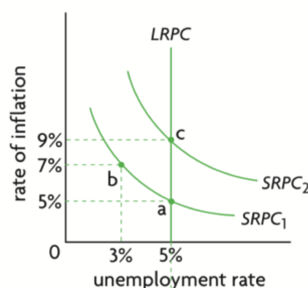
2. INTERRELATED MACROECONOMIC PROBLEMS

It is not possible to achieve all the five objectives simultaneously. Hence the government has to face tradeoffs. There are SIX main tradeoffs that the government faces:

1. Unemployment vs. Inflation

There is an inverse relationship between level of unemployment and inflation. This is because when unemployment rises individuals have less money at their disposal and hence demand less goods. Low demand leads to low inflation. On the other hand, when unemployment falls, more people have money at their disposal which increase the demand for goods pushing the prices up. This concept is explained by the Phillips curve

Definition | Stagflation: This occurs when inflation and high unemployment both occur together. This usually happens in the long-run.



2. Economic Growth vs. Current Account

An increase in economic growth resulting in higher real incomes could lead to an increase in imports of goods and services. This results in "stop-go" cycle of macroeconomic policy. As every time the growth started to accelerate the current account went into deficit and policy then had to be adjusted to slow down the growth rate to deal with the deficit.

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3. Inflation vs. Balance of Payment

If the domestic economy enters a period of inflation that is high relative to its trading partners as the price increase is more in the local economy, leading to expensive exports and reducing international competitiveness, making it more difficult to export and increase in cheaper imports. This not only puts pressure on the current account but also the exchange rate will depreciate.

4. Economic Growth vs. Sustainability

Economic growth results in environmental degradation as the process of industrialization requires energy suppliers to keep pace with demand. These usually come from natural resources like oil and coal which add to the pollution levels in the country. In order to make it sustainable in the short-run the country should slow down economic growth and invest in renewable and cleaner energy resources. But only developed countries can do that.

If we demand side policies for growth then this problem occurs

5. Economic Growth vs. Low Inflation

If the economy grows due to excessive demand this will increase the prices. If the govt. deflates the economy using increasing taxes or interest rate to control inflation, it will limit economic growth.

6. Economic Growth vs. Redistribution of Income and Wealth

As the economy grows the gap between the rich and the poor increases. This is because rich invest their money and are able to multiply their money at a faster rate as compared to the poor.

Usually due to absesne of progressive tax systems

TOPIC 2: FISCAL POLICY

Definition: Fiscal Policy is a government policy concerned about taxes and government spending to influence economic activity and macroeconomic objectives such as employment, economic growth, inflation etc. Government maintains a budget to provide services like education, health care etc. This is done through borrowing, privatization, and taxes.

Govt. Budget = Expected Revenue – Expected Govt. Spending

Balanced Budget: Revenue = Spending
Budget Deficit: Revenue < Spending
Budget Surplus: Revenue > Spending

1. AUTOMATIC STABILIZERS

Definition: Automatic stabilizers are factors that automatically, without any action by government authorities, work toward stabilizing the economy by reducing the short-term fluctuations of the business cycle. Since they are automatic, they represent 'non-discretionary' policy. There are two important stabilizers: **progressive income taxes** and **unemployment benefits**. Example: If the economy enters a period of recession, government expenditure will rise because of increased payments of unemployment and other social security benefits and revenues will fall because fewer people are paying income tax. This helps to offset recession.

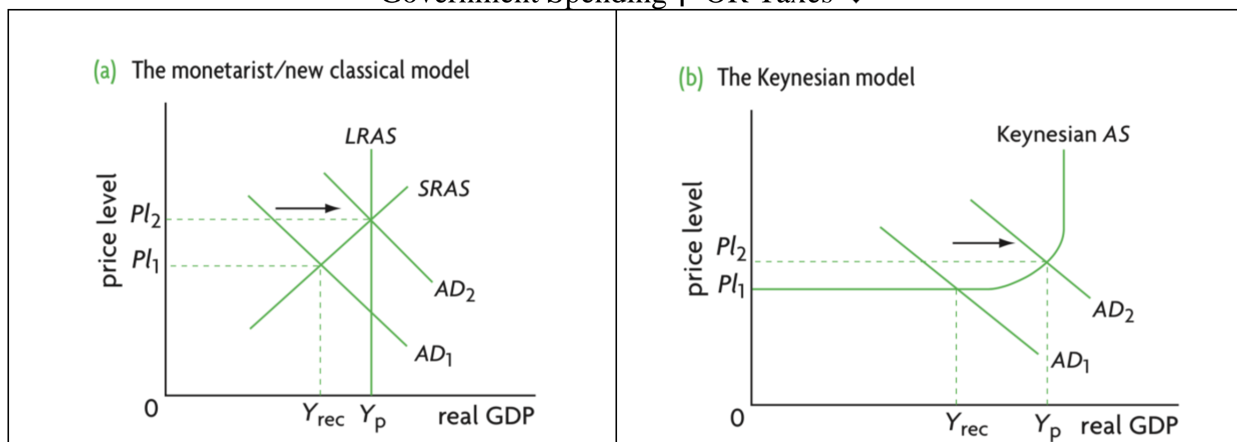
2. DISCRETIONARY FISCAL POLICES

Definition: Active and purposeful government intervention in the economy to influence aggregate demand is termed discretionary policy, meaning that the policy is at the discretion (or the choice and will) of the government. There are TWO types of fiscal policies:
1. Expansionary Fiscal Policy
2. Contractionary Fiscal Policy

1. Expansionary Fiscal Policy — Budget Deficit

Definition: In this the government increases government spending or decreases taxes to increase the aggregate demand in the economy and reducing unemployment. Expansionary fiscal policy can be used when there is a recessionary gap, and aims to shift the AD curve to the right leading to equilibrium at the full employment level of real GDP (potential GDP).

Government Spending↑ OR Taxes ↓



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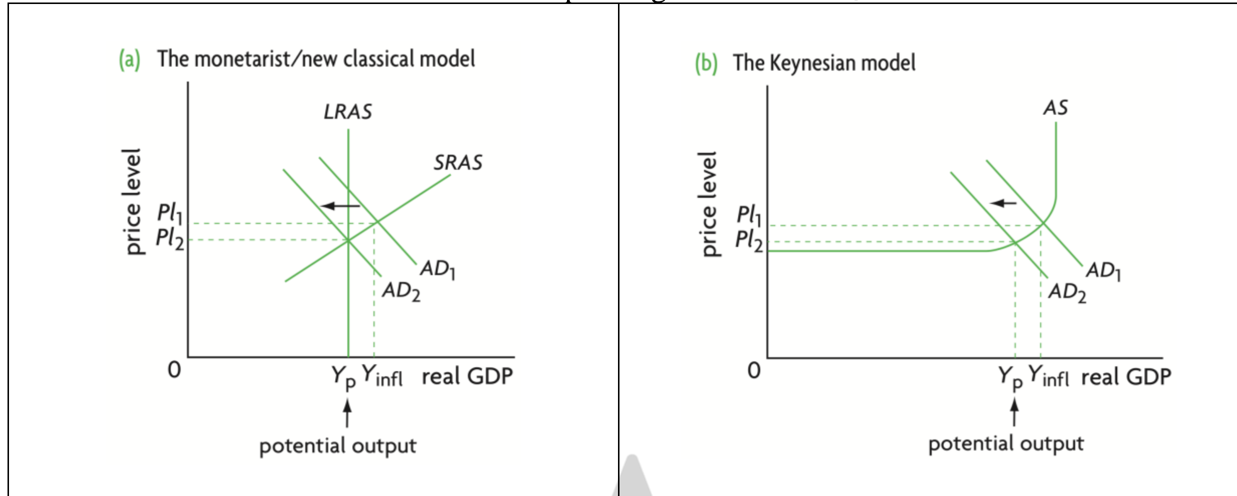
2. Contractionary Fiscal Policy Budget surplus

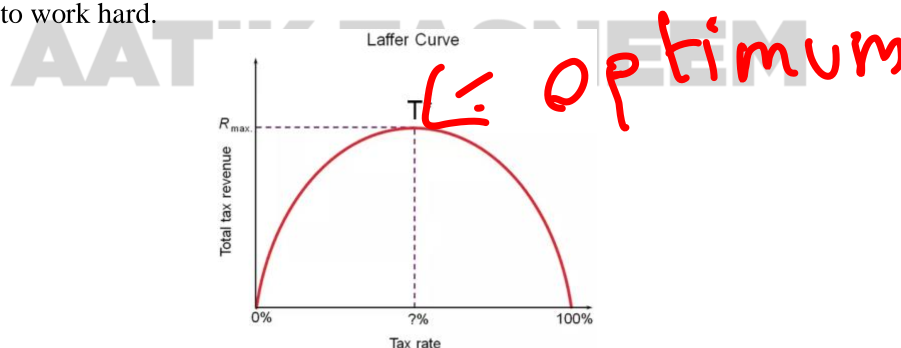
Definition: In this the government decreases government spending or increase taxes to decrease the aggregate demand in the economy and reducing inflation. Contractionary fiscal policy can be used when there is an inflationary gap, and aims to shift the AD curve to the left leading to equilibrium at the full employment level of real GDP (potential GDP).

Government Spending↓ OR Taxes ↑



Laffer Curve

Definition: The Laffer curve illustrates a theoretical **relationship between rates of taxation and the resulting levels of government revenue**. It illustrates that increasing tax rate may **increase tax revenue only to a certain extent, after that point the increase in tax rate will only decrease the total tax revenue**. As taxes increase from low levels, tax revenue collected by the government also increases. It also shows that tax rates increasing after a certain point (T* on the diagram below) would cause people not to work as hard or not at all, thereby reducing tax revenue. Eventually, if tax rates reached 100 percent, shown as the far right on his curve, all people would choose not to work because everything they earned would go to the government. Governments would like to be at point T* because it is the point at which the government collects maximum amount of tax revenue while people continue to work hard.



Advantages and Disadvantages of Fiscal Policy

Advantages	Disadvantages
1. Pulling an economy out of a deep recession. 2. Dealing with rapid and escalating inflation. 3. Ability to target sectors of the economy. 4. Direct impact of government spending on aggregate demand. 5. Ability to affect potential output.	1. Problems of time lags 2. Political constraints 3. Crowding Out 4. Inability to deal with supply-side causes of instability. 5. In a recession, tax cuts may not be very effective in increasing aggregate demand. 6. Inability to 'fine tune' the economy.

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TOPIC 3: MONETARY POLICY

Definition | Monetary Transmission Mechanism: This shows how changes in money supply or demand can influence the level of national income. We will have a look from both:
1. Change in the Money Supply
2. Change in the Money Demand

1. MONEY SUPPLY CHANGES

Definition | Monetary Policy: This is government policy that revolves around controlling money supply in the economy to achieve government objectives like inflation, unemployment, economic growth and balance the balance of payment. There are TWO types of monetary policies that the government can use:
1. Expansionary Monetary Policy
2. Contractionary Monetary Policy

1. Expansionary Monetary Policy | Increase Ms and Reduce Interest Rates

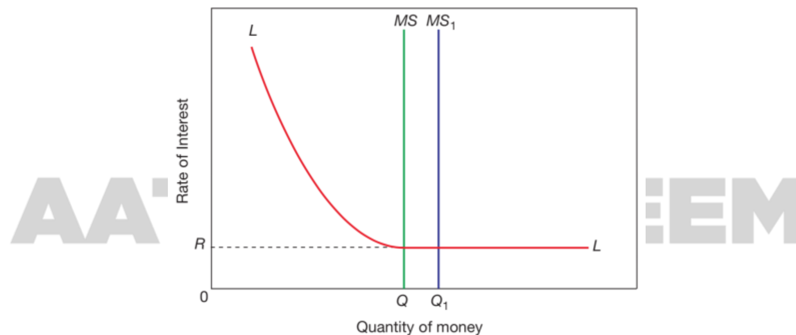
Definition: These policies are made to remove the deflationary gaps in order words increase prices, create employment, increase GDP and to accelerate economic activity. In this policy the government tries to **increase the Ms and reduce interest rates** to boost the economic growth. [The diagram would be same as expansionary fiscal]

2. Contractionary Monetary Policy | Decrease Ms and Increase Interest Rates

Definition: These policies are made to remove the inflationary gaps in order words reduce prices to restore full employment. In this policy the government tries to **decrease the Ms and increase interest rates** to reduce the inflation and improve BOP deficit. [The diagram would be same as contractionary fiscal]

3. Liquidity Trap | Ms Increases has NO effect on Interest Rate

Definition: This occurs when an increase in money supply does not affect the interest rate and so does not affect investment or AD. Keynes thought it could occur when the rate of interest is very low and the price of bonds is very high. In this case, he thought that speculators would expect the price of bonds to fall in the future, so if the money supply was to be increased they would hold all the extra money. They would not buy bonds for fear of making a capital loss and because the return from holding such securities would be low.



Limitations of Monetary Policy/Evaluations

Limitation	Description
1. Liquidity Trap	Economy might be trapped in a liquidity trap where increase in money supply will lead to unchanged interest rate and in return no change in the AD and price level.
2. Time Lags	Although monetary policy is quicker than fiscal policy but it takes time to impact. Supply does not affect the real economy instantaneously. It might be slow in the first quarters and with time create more impact.
3. Uncertainty	Policy makers are not aware of sudden unseen events. Example: Oil prices, political instability etc.
4. Reliability of Data	Economic data is imperfect. This problem is even worse in LEDCs. Hence the policy might be more effective in MEDCs however still even with that policy makers might not be able to make an appropriate decision.
5. Changes in the interest elasticity of investment	— Monetarists view investment is **interest elastic** and that's why monetary policy will have a strong multiplier effect on income, employment and prices. — Keynesians view that investment is **interest inelastic** and that's why monetary policy will have a weaker multiplier and smaller effect on income, employment and prices.

TOPIC 4: EXCHANGE RATE POLICY

Definition | Exchange Rate Polices: It is part of the monetary policy of a country because the exchange rate, interest rate and money supply are all intimately related. The main purpose is to build international competitiveness and clear balance of payment stability.

— If interest rates are high relative to the world, they will attack investment from abroad, increasing the demand for domestic currency and hence leading to an appreciation in the exchange rate which can lead to increase in imports and less exports and vice versa.

Exchange rate policy and type of exchange rate system

Fixed Exchange Rate	Floating Exchange Rate
In a fixed exchange rate system since the govt. is focused on maintaining the exchange rate at a particular level. In this situation monetary policy is powerless to influence the real economy and it must be devoted to maintaining exchange rate.	In a floating exchange rate system, monetary policy freed from this role, but even so it must be used in a way that it does not become unsustainable in the long run.

— **Situation 1 | Overvalue currency**: Some countries tend to overvalue their currency in order to encourage domestic production. This is because the local firms can easily import raw material from abroad and this would reduce the chances of imported inflation. This helps correct surpluses in the balance of payments.

— **Situation 2 | Undervalue currency:** Some countries undervalue their currency in order to stimulate exports. This is because a weaker currency makes exports cheaper and imports expensive. This helps the economy correct its deficits in the balance of payments.

Note: Exchange rate is only one factor in determining international competitiveness. Several other factors must be considered with it like quality of goods, consumers incomes, preferences etc.

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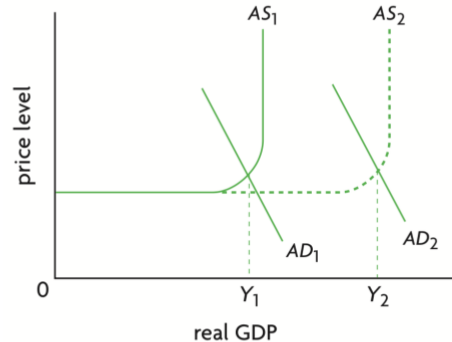
The exchange rate is used to influence the CA ;when the economy is experiencing deficits, they tend to undervalue the currency to boost exports.
When the economy is experiencing CA surplus, they tend to overvalue the currenc clear out surpluses by decreasing exports

TOPIC 5: SUPPLY SIDE POLICES

Definition: These are long-term strategies that aim to increase or improve the efficiency of factors of production to ensure long term growth in the economy. These policies help to control inflation, increase employment, improve the balance of payment etc. Since they expand the productive capacity they tend to shift the supply curve to the right.



1. Privatization

Definition: It is a government policy in which state-owned businesses are sold to the private sector. The objective is that the firms will be more efficient and can generate more profits since they will profit driven.

2. Deregulation

Definition: This policy aims to remove barriers to entry to encourage competition. These can include minimum wage rates, max price etc. This makes the market more competitive and more productive.

3. Capital investment

Definition: This policy aims to spend funds on research and development and new technologies. This helps in both product and process innovation which can give the country a competitive advantage in the international market.

4. Training and Education programs

Definition: This policy aims to increase the quantity and quality of labor in the economy by launching training and education programs. In order to encourage more workers, the government also lowers taxes to encourage individuals to join the labor force.

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5. Enterprise Zones

Definition: These are areas where there is high unemployment and the government gives incentives like tax holidays, interest free loans etc. to businesses to locate there. The objective is to boost economic activity in that area and increase the standard of living of individuals.

Conclusion: Supply side policies take time to reap benefits however they are highly effective when it comes to achieving government objectives of economic growth, lower inflation, lower unemployment and improved balance of payments.

Lecture 1