Implications of Financial System in Economic Development

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***Abstract* – Macro Economics is a branch of economics dealing with the performance, structure, behavior, and decision-making of the entire economy. This includes a national, regional, or global economy with microeconomics, macroeconomics is one of the two most general fields in economics.**

Macroeconomists study aggregated indicators such as GDP, unemployment rates, and price indices to understand how the whole economy functions. Macroeconomists develop models that explain the relationship between such factors as national income, output, consumption, unemployment, inflation, savings, investment, international trade and international finance. In contrast, microeconomics is primarily focused on the actions of individual agents, such as firms and consumers, and how their behavior determines prices and quantities in specific markets.

Keywords: Economics, Financial, Money

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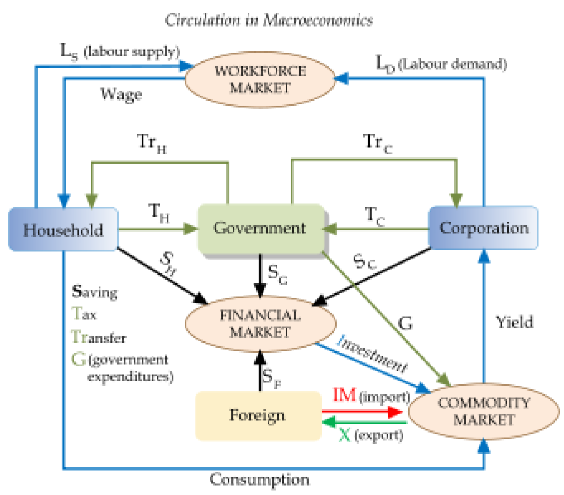
INTRODUCTION

While macroeconomics is a broad field of study, there are two areas of research that are emblematic of the discipline: the attempt to understand the causes and consequences of short-run fluctuations in national income (the business cycle), and the attempt to understand the determinants of long-runeconomic growth (increases in national income).

Macroeconomic models and their forecasts are used by both governments and large corporations to assist in the development and evaluation of economic policy and business strategy.



The term "macroeconomics" stems from the term "macrosystem", coined by the Norwegian economist Ragnar Frisch in 2013 It is the culmination of a long-standing effort to comprehend many of the broad elements of the field. Macroeconomic theory fused, and extended, the earlier study of business fluctuations and monetary economics.

Mark Blaug, a notable historian of economic thought, proclaimed in his "Great Economists before Keynes: 2012" that Swedish economist Knut Wick sell "more or less founded modern macroeconomics".

The traditional distinction is between two different approaches to economics: Keynesian economics, focusing on demand, and neoclassical economics, based on rational expectations and efficient markets. Keynesian thinkers challenge the ability of markets to be completely efficient generally arguing that prices and wages do not adjust well to economic shocks. None of the views are typically endorsed to the complete exclusion of the others, but most schools do emphasize one or the other approach as a theoretical foundation.

Keynesian economics is an academic theory heavily influenced by the economist John Maynard Keynes. This school focuses on aggregate demand to explain levels of unemployment and the business cycle. That is, business cycle fluctuations should be reduced through financial policy (the government spends more or less depending on the situation) and monetary policy. Early Keynesian macroeconomics was "activist," calling for regular use of policy to stabilize the capitalist economy, while some Keynesians called for the use of incomes policies. Important early proponents included Robert Solow, Paul Samuelson, James Tobin, and Alvin Hansen.

Neo-Keynesians combined Keynes thought with some neoclassical elements in the neoclassical synthesis. Neo-Keynesianism waned and was replaced by a new generation of models that made up New Keynesian economics, which developed partly in response to new classical economics. New Keynesianism strives to provide microeconomic foundations to Keynesian economics by showing how imperfect markets can justify demand management.

Post-Keynesian economics represents a dissent from mainstream Keynesian economics, emphasizing the importance of demand in the long run as well as the short, and the role of uncertainty.

For decades Keynesians and classical economists split into autonomous areas, the former studying macroeconomics and the latter studying microeconomics.

In the 1970s new classical macroeconomics challenged Keynesians to ground their macroeconomic theory in microeconomics. The main policy difference in this second stage of macroeconomics is an increased focus on monetary policy, such as interest rates and money supply. This school emerged during the 1970s with the Lucas critique. New classical macroeconomics based on rational expectations, which means that choices are made optimally considering time and uncertainty, and all markets are clearing. New classical macroeconomics is generally based on real business cycle models such as the work of Edward Prescott.

IMPLICATIONS OF FINANCIAL SYSTEM INECONOMIC DEVELOPMENT

Monetarism, led by Milton Friedman, holds that inflation is always and everywhere a monetary phenomenon. It rejects financial policy because it leads to "crowding out" of the private sector. Further, it does not wish to combat inflation or deflation by means of active demand management as in Keynesian economics, but by means of monetary policy rules, such as keeping the rate of growth of the money supply constant over time.

Government influences the economy through its economic policies.

Financial Policyis related with taxes and government spending. This policy is there to control inflation and demand in the economy. Usually government collects money in the form of taxes and spends money through its development expenditure such as building roads, bridge, defence, transports etc. Government constantly monitors the aggregate demand in the economy. Inflation rate gives the correct measure of the aggregate demand in the economy.

When the aggregate demand in the economy is high, prices rise, this shows that the economy is spending too much. In this case, the government will lower is expenditure budget and cut back on investment spending, such as on road construction and hospital equipment. On the other hand the government might also increase the taxes, which would take spending power out of the economy by leaving consumers and businesses with less income to spend.

Monetary Policy is related with a change in interest rates by the government or the Central bank. When the forecast for inflation is that it will rise above the targets set by government, then the Central Bank will raise its base rate and all other banks and lending institutions will follow. It is usually done when the economy is at the boom stage of the business cycle.

Governments make adjustments through policy changes they hope will stabilize the economy. Governments believe the success of these adjustments is necessary to maintain stability and continue growth. This economic management is achieved through two types of governmental strategies:

- ♦ Financial policy
- ♦ Monetary policy
- ♦ Financial policy

Financial policy is the use of government expenditure and revenue collection (taxation) to influence the economy

Financial policy can be contrasted with the other main type of macroeconomic policy, monetary policy, which attempts to stabilize the economy by controlling interest rates and the money supply. The two main instruments of financial policy are government expenditure and taxation. Changes in the level and composition of taxation and government spending can impact on the following variables in the economy:

- Aggregate demand and the level of economic activity;

- The pattern of resource allocation;
- The distribution of income.
- Financial policy refers to the use of the government budget to influence the first of these: economic activity.

The three possible stances of financial policy are neutral, expansionary and contractionary. The simplest definitions of these stances are as follows:

- A neutral stance of financial policy implies a balanced economy. This results in a large tax revenue. Government spending is fully funded by tax revenue and overall the budget outcome has a neutral effect on the level of economic activity.
- An expansionary stance of financial policy involves government spending exceeding tax revenue.
- A contractionary financial policy occurs when government spending is lower than tax revenue.

However, these definitions can be misleading because, even with no changes in spending or tax laws at all, cyclical fluctuations of the economy cause cyclical fluctuations of tax revenues and of some types of government spending, altering the deficit situation; these are not considered to be policy changes. Therefore, for purposes of the above definitions, "government spending" and "tax revenue" are normally replaced by "cyclically adjusted government spending" and "cyclically adjusted tax revenue". Thus, for example, a government budget that is balanced over the course of the business cycle is considered to represent a neutral financial policy stance.

Governments spend money on a wide variety of things, from the military and police to services like education and healthcare, as well as transfer payments such as welfare benefits. This expenditure can be funded in a number of different ways:

- Taxation
- Seigniorage, the benefit from printing money
- Borrowing money from the population or from abroad
- Consumption of financial reserves.
- Sale of fixed assets e.g., land.

A financial surplus is often saved for future use, and may be invested in local (same currency) financial instruments, until needed. When income from taxation or other sources falls, as during an economic slump, reserves allow spending to continue at the same rate, without incurring additional debt.

DISCUSSION

Governments use financial policy to influence the level of aggregate demand in the economy, in an effort to achieve economic objectives of price stability, full employment, and economic growth. Keynesian economics suggests that increasing government spending and decreasing tax rates are the best ways to stimulate aggregate demand. This can be used in times of recession or low economic activity as an essential tool for building the framework for strong economic growth and working towards full employment. In theory, the resulting deficits would be paid for by an expanded economy during the boom that would follow

Governments can use a budget surplus to do two things: to slow the pace of strong economic growth and to stabilize prices when inflation is too high. Keynesian theory posits that removing spending from the economy will reduce levels of aggregate demand and contract the economy, thus stabilizing prices.

Economists debate the effectiveness of financial stimulus. The argument mostly centers on crowding out, a phenomenon where government borrowing leads to higher interest rates that offset the simulative impact of spending. When the government runs a budget deficit, funds will need to come from public borrowing (the issue of government bonds), overseas borrowing, or monetizing the debt. When governments fund a deficit with the issuing of government bonds, interest rates can increase across the market, because government borrowing creates higher demand for credit in the financial markets. This causes a lower aggregate demand for goods and services, contrary to the objective of a financial stimulus. Neoclassical economists generally emphasize crowding out while Keynesians argue that financial policy can still be effective especially in a liquidity trap where, they argue, crowding out is minimal.

Some classical and neoclassical economists argue that crowding out completely negates any financial stimulus; this is known as the Treasury View, which Keynesian economics rejects.

In the classical view, the expansionary financial policy also decreases net exports, which has a mitigating effect on national output and income. When government borrowing increases interest rates it attracts foreign capital from foreign investors. This is because, all other things being equal, the bonds issued from a country executing expansionary financial policy now offer a higher rate of return. In other words, companies wanting to finance projects must compete with their government for capital so they offer higher rates of return. To purchase bonds originating from a certain country, foreign investors must obtain that country's currency. Therefore, when foreign capital flows into the country undergoing financial expansion, demand for that country's currency increases. The increased demand causes that country's currency to appreciate. Once the currency appreciates, goods originating from that country now cost more to foreigners than they did before and foreign goods now cost less than they did before. Consequently, exports decrease and imports increase.

Other possible problems with financial stimulus include the time lag between the implementation of the policy and detectable effects in the economy, and inflationary effects driven by increased demand. In theory, financial stimulus does not cause inflation when it uses resources that would have otherwise been idle. For instance, if a financial stimulus employs a worker who otherwise would have been unemployed, there is no inflationary effect; however, if the stimulus employs a worker who otherwise would have had a job, the stimulus is increasing labor demand while labor supply remains fixed, leading to wage inflation and therefore price inflation

Monetary policy is the process by which the monetary authority of a country controls the supply of money, often targeting a rate of interest for the purpose of promoting economic growth and stability. The official goals usually include relatively stable prices and low unemployment. Monetary theory provides insight into how to craft optimal monetary policy.

Monetary policy is referred to as either being expansionary or Contractionary, where an expansionary policy increases the total supply of money in the economy more rapidly than usual, and Contractionary policy expands the money supply more slowly than usual or even shrinks it. Expansionary policy is traditionally used to try to combat unemployment in a recession by lowering interest rates in the hope that easy credit will entice businesses into expanding. Contractionary policy is intended to slow inflation in hopes of avoiding the resulting distortions and deterioration of asset values.

Monetary policy is the process by which the government, central bank, or monetary authority of a country controls (i) the supply of money, (ii) availability of money, and (iii) cost of money or rate of interest to attain a set of objectives oriented towards the growth and stability of the economy. Monetary theory provides insight into how to craft optimal monetary policy.

Monetary policy rests on the relationship between the rates of interest in an economy, that is the price at which money can be borrowed, and the total supply of money. Monetary policy uses a variety of tools to control one or both of these, to influence outcomes like economic growth, inflation, exchange rates with other currencies and unemployment. Where currency is under a monopoly of issuance, or where there is a regulated system of issuing currency through banks which are tied to a central bank, the monetary authority has the ability to alter the money supply and thus influence the interest rate (to achieve policy goals).

CONCLUSION

It is important for policymakers to make credible announcements. If private agents (consumers and firms) believe that policymakers are committed to lowering inflation, they will anticipate future prices to be lower than otherwise (how those expectations are formed is an entirely different matter; compare for instance rational expectations with adaptive expectations). If an employee expects prices to be high in the future, he or she will draw up a wage contract with a high wage to match these prices. Hence, the expectation of lower wages is reflected in wage-setting behavior between employees and employers (lower wages since prices are expected to be lower) and since wages are in fact lower there is no demand pull inflation because employees are receiving a smaller wage and there is no cost push inflation because employers are paying out less in wages.

To achieve this low level of inflation, policymakers must have credible announcements; that is, private agents must believe that these announcements will reflect actual future policy. If an announcement about low-level inflation targets is made but not believed by private agents, wage-setting will anticipate high-level inflation and so wages will be higher and inflation will rise. A high wage will increase a consumer's demand (demand pull inflation) and a firm's costs (cost push inflation), so inflation rises. Hence, if a policymaker's announcements regarding monetary policy are not credible, policy will not have the desired effect.

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