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THE ROLE OF GOVERNMENT & ITS RELATION TO MACRO ECONOMIC POLICY

The Role of Government & Its Relation to Macro Economic Policy

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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 micro economics, macroeconomics is one of the two most general fields in economics.

INTRODUCTION - MACRO 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.

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-run economic 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 1933. 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.

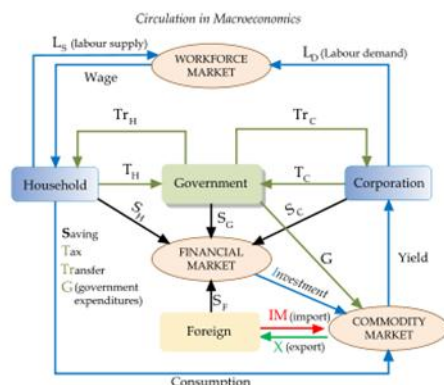
Mark Blaug, a notable historian of economic thought, proclaimed in his "Great Economists before Keynes: 1986" that Swedish economist Knut Wicksell "more or less founded modern macroeconomics".

LITERATURE OF THE REVIEW

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 TRADITION

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 fiscal 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.



MACROECONOMIC
DEVELOPMENT

THEORY

-

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.

NEOCLASSICAL TRADITION

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.

Monetarism, led by Milton Friedman, holds that inflation is always and everywhere a monetary phenomenon. It rejects fiscal 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 ECONOMIC POLICIES

Government influences the economy through its economic policies. These are

➤ Fiscal Policy

It is 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 its 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

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.

POLICIES - DETAILS

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:

- ❖ Fiscal policy
- ❖ Monetary policy
- ❖ Fiscal policy

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

Fiscal 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 fiscal 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.
- Fiscal policy refers to the use of the government budget to influence the first of these: economic activity.

STANCES - FISCAL POLICY

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

- A neutral stance of fiscal 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 fiscal policy involves government spending exceeding tax revenue.
- A contractionary fiscal 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 fiscal policy stance.

METHODS OF FUNDING

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 fiscal reserves.
- Sale of fixed assets (e.g., land).

All of these except taxation are forms of deficit financing

CONSUMING PRIOR SURPLUSES

A fiscal 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.

ECONOMIC EFFECTS OF FISCAL POLICY

Governments use fiscal 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 fiscal stimulus. The argument mostly centers on crowding out, a phenomenon where government borrowing leads to higher interest rates that offset the stimulative 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 fiscal stimulus. Neoclassical economists generally emphasize crowding out while Keynesians argue that fiscal 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 fiscal stimulus; this is known as the Treasury View, which Keynesian economics rejects.

In the classical view, the expansionary fiscal 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 fiscal 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 fiscal 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 fiscal 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, fiscal stimulus does not cause inflation when it uses resources that would have otherwise been idle. For instance, if a fiscal 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

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).

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.

If policymakers believe that private agents anticipate low inflation, they have an incentive to adopt an expansionist monetary policy (where the marginal benefit of increasing economic output outweighs the marginal cost of inflation); however, assuming private agents have rational expectations, they know that policymakers have this incentive. Hence, private agents know that if they anticipate low inflation, an expansionist policy will be adopted that causes a rise in inflation. Consequently, (unless policymakers can make their announcement of low inflation credible), private agents expect high inflation. This anticipation is fulfilled through adaptive expectation (wage-setting behavior); so, there is higher inflation (without the benefit of increased output). Hence, unless credible announcements can be made, expansionary monetary policy will fail.

Announcements can be made credible in various ways. One is to establish an independent central bank with low inflation targets (but no output targets). Hence, private agents know that inflation will be low because it is set by an independent body. Central

banks can be given incentives to meet targets (for example, larger budgets, a wage bonus for the head of the bank) to increase their reputation and signal a strong commitment to a policy goal. Reputation is an important element in monetary policy implementation. But the idea of reputation should not be confused with commitment.

While a central bank might have a favorable reputation due to good performance in conducting monetary policy, the same central bank might not have chosen any particular form of commitment (such as targeting a certain range for inflation). Reputation plays a crucial role in determining how much markets would believe the announcement of a particular commitment to a policy goal but both concepts should not be assimilated. Also, note that under rational expectations, it is not necessary for the policymaker to have established its reputation through past policy actions; as an example, the reputation of the head of the central bank might be derived entirely from his or her ideology, professional background, public statements, etc.

In fact it has been argued that to prevent some pathology related to the time inconsistency of monetary policy implementation (in particular excessive inflation), the head of a central bank should have a larger distaste for inflation than the rest of the economy on average. Hence the reputation of a particular central bank is not necessary tied to past performance, but rather to particular institutional arrangements that the markets can use to form inflation expectations.

Despite the frequent discussion of credibility as it relates to monetary policy, the exact meaning of credibility is rarely defined. Such lack of clarity can serve to lead policy away from what is believed to be the most beneficial. For example, capability to serve the public interest is one definition of credibility often associated with central banks. The reliability with which a central bank keeps its promises is also a common definition. While everyone most likely agrees a central bank should not lie to the public, wide disagreement exists on how a central bank can best serve the public interest. Therefore, lack of definition can lead people to believe they are supporting one particular policy of credibility when they are really supporting another.

TYPES OF MONETARY POLICY

In practice, to implement any type of monetary policy the main tool used is modifying the amount of base money in circulation. The monetary authority does this by buying or selling financial assets (usually government obligations). These open market operations change either the amount of money or its liquidity (if less liquid forms of money are bought or

sold). The multiplier effect of fractional reserve banking amplifies the effects of these actions.

Constant market transactions by the monetary authority modify the supply of currency and this impacts other market variables such as short term interest rates and the exchange rate.

The distinction between the various types of monetary policy lies primarily with the set of instruments and target variables that are used by the monetary authority to achieve their goals.

Monetary Policy:	Target Variable:	Market	Long Term Objective:
Inflation Targeting	Interest rate on overnight debt	on	A given rate of change in the CPI
Price Level Targeting	Interest rate on overnight debt	on	A specific CPI number
Monetary Aggregates	The growth in money supply		A given rate of change in the CPI
Fixed Exchange Rate	The spot price of the currency		The spot price of the currency
Gold Standard	The spot price of gold		Low inflation as measured by the gold price
Mixed Policy	Usually interest rates		Usually unemployment + CPI change

The different types of policy are also called **monetary regimes**, in parallel to exchange rate regimes. A fixed exchange rate is also an exchange rate regime; The Gold standard results in a relatively fixed regime towards the currency of other countries on the gold standard and a floating regime towards those that are not. Targeting inflation, the price level or other monetary aggregates implies floating exchange rate unless the management of the relevant foreign currencies is tracking exactly the same variables (such as a harmonized consumer price index)

INFLATION TARGETING

Under this policy approach the target is to keep inflation, under a particular definition such as Consumer Price Index, within a desired range.

PRICE LEVEL TARGETING

Price level targeting is similar to inflation targeting except that CPI growth in one year over or under the long term price level target is offset in subsequent years such that a targeted price-level is reached over time, e.g. five years, giving more certainty about future price increases to consumers. Under inflation targeting what happened in the immediate past years is not taken into account or adjusted for in the current and future year

MONETARY AGGREGATES

In the 1980s, several countries used an approach based on a constant growth in the money supply. This approach was refined to include different classes of money and credit (M0, M1 etc.). In the USA this approach to monetary policy was discontinued with the selection of Alan Greenspan as Fed Chairman.

This approach is also sometimes called monetarism.

While most monetary policy focuses on a price signal of one form or another, this approach is focused on monetary quantities

FIXED EXCHANGE RATE

This policy is based on maintaining a fixed exchange rate with a foreign currency. There are varying degrees of fixed exchange rates, which can be ranked in relation to how rigid the fixed exchange rate is with the anchor nation.

GOLD STANDARD

The gold standard is a system under which the price of the national currency is measured in units of gold bars and is kept constant by the government's promise to buy or sell gold at a fixed price in terms of the base currency. The gold standard might be regarded as a special case of "fixed exchange rate" policy, or as a special type of commodity price level targeting.

The minimal gold standard would be a long-term commitment to tighten monetary policy enough to prevent the price of gold from permanently rising above parity. A full gold standard would be a commitment to sell unlimited amounts of gold at parity and maintain a reserve of gold sufficient to redeem the entire monetary base.

SCOPE OF THE STUDY:

- Microeconomics: Object of interest is a single (or small number of) household or firm.
- Macroeconomics: Object of interest is the entire economy. We care mostly about:

1. Growth.

2. Fluctuations.

OBJECTIVES OF THE STUDY

Most of the governments round the world have four main objectives. These are

- Keep inflation under control
- Maintain a low level of unemployment

- Achieve a high level of growth rate
- Maintain a healthy balance of payments.

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