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REVIEW ARTICLE

A STUDY ON THE ROLE OF MICRO ECONOMIC POLICY

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A Study on the Role of Micro Economic Policy

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INTRODUCTION

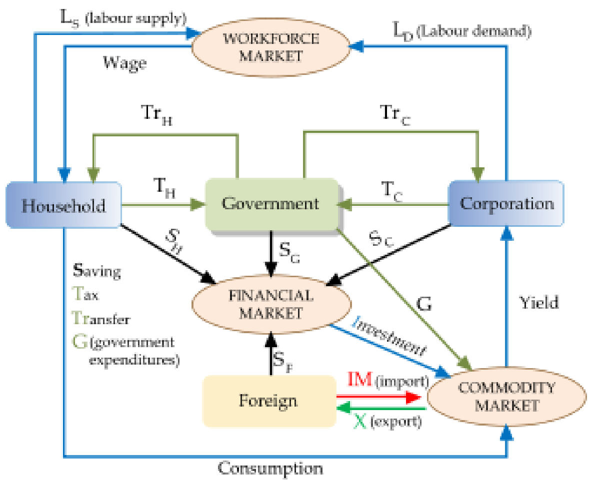
Macro Economics is a branch of economics dealing with the performance, structure, behavior, and decision-making of the entire economy. This includes a national, regional, or global economy with microeconomics, macroeconomics is one of the two most general fields in economics.

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.

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.

Circulation in Macroeconomics



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 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 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.

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.

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.

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 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 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.

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.

Government Economic Objectives

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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