Government Macroeconomic Intervention

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A2 Economics

Macroeconomic Objectives

Regardless of economies extent of development most countries strive to achieve following macroeconomic objectives:

1. High economic growth rate – high GDP
2. Low and stable rate of Inflation
3. Low Unemployment
4. Stable / favorable position on Balance of Payments
5. Stable / favorable position of Exchange Rate

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Macroeconomic Policies

- Strategies used to achieve Macroeconomic Objectives are known as Macroeconomic Policies. Following Macroeconomic Policies are used to achieve previously mentioned Macroeconomic Objectives

1. Fiscal Policy
2. Monetary Policy
3. Supply Side Policies

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Macroeconomic Policies

- Unlike developing economies where government intervention is generally more prevalent, government involvement in developed economies is often just limited to legislation, regulation and formation of necessary institutions.

- Sometimes, governments use mix of Macroeconomic Policies to achieve their Macroeconomic Objectives.

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Fiscal Policy

- Fiscal Policy as devised through governments' annual budgets makes use of taxes and government spending to affect the national output.
- Governments run either budget deficits or surpluses or balanced budget. Unlike surpluses where taxation is greater than expenditure, for deficits government expenditure exceeds total taxation revenue.

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Fiscal Policy

- To run budget deficit governments need to borrow which is financed through local and international borrowing.

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Types of Fiscal Policies

- Discretionary Fiscal Policy: is when governments deliberately alter tax rates and government spending to manipulate economy's outcome.
- Automatic Stabilizers: unlike discretionary fiscal policy for which governments use national taxation and its spending instruments to artificially adjust national income (GDP), automatic stabilizers is when tax revenue and government spending levels automatically change following a change in economy's national income.

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Automatic Stabilizer

- During recessionary periods government spending automatically increase due to its increased spending on social security payments including unemployment benefits and government tax revenue falls due to lower national income.

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Automatic Stabilizer

- Similarly opposite is true during periods of high economic activity, also known as Boom, when government spending falls due to lesser spending on social security payments and higher tax revenue is collected due to economy's higher activity levels.

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Fiscal Policy as Supply Side Instrument

Economies can also use Fiscal Policy to influence economy's supply side conditions. Policies targeted at enhancing economies' production potential are collectively known as Supply-Side Policies.

1. Investment in human capital, provision of subsidy on capital goods etc are some examples of supply-side policies.

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Fiscal Policy as Supply Side Instrument

2. Similarly governments tax cuts are expected to encourage higher investments due to higher expected profits.

3. Government increased spending on infrastructure, education and health care etc will increase the economy's supply of educated labor force.

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Challenges of Fiscal Policy

- Apart from difficulty to alter government spending levels and tax rates due to political reasons sometimes changes in taxes and government spending take longer than expected to have the desired effect on the economy.

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Challenges of Fiscal Policy

- At times governments prefer to invest in sectors for which benefits are evident over shorter time periods like infrastructure. This shorter term vision of governments will result in massive opportunity cost in terms of lost well-being due to lower investment in sectors such as education / health care for which benefits occurs over much longer time periods.

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Challenges of Fiscal Policy

- Similarly a lot of government spending is continued out of fear that their discontinuation will result in reduced popularity of political party. This is why nationalization of inefficient state owned firms might be politically unpopular decision.

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Challenges of Fiscal Policy

- Similarly governments are often conscious of not adversely affecting disposable income levels of citizens for that too is not taken very positively by consumers and therefore there is fear that such a step might negatively affect political party's popularity.

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Monetary Policy

- Alteration of economy's money supply and / or interest rates to manipulate its economic outcome is known as Monetary policy. Monetary Policy is solely determined by economies' Central Banks.

- Expansionary Monetary Policy is used to combat economies' low economic growth. Increased aggregate spending due to low interest rates is expected to boost economic growth. On the contrary Contractionary Monetary Policy is used to reduce economics activity by increasing interest rates.

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Monetary Policy

- Interest rates are also expected to affect portfolio / indirect investment flows between countries and so affect their exchange rates.
- Higher interest rates are expected to appreciate country's exchange rate due to higher cash inflows and with lower interest rates the exchange rate is expected to depreciate due to cash outflows.
- However the relationship explained between monetary policy and economy's exchange rate might not be very strong.

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Supply-Side Policies

- Policies aimed at enhancing economies' production potential are known as Supply-Side Policies.
- Enhanced production potential is important for economy to increase its growth rates.

1. Increased investment in human capital through availability of better educational and health care services can improve labor productivity and so is one possible supply-side policy.

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Supply-Side Policies

2. Similarly provision of economic incentives and more equal access to capital is expected to boost economy's investment levels.

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Supply-Side Policies

- Unlike Demand Side Policies namely Fiscal and Monetary Policy that are generally easier to implement and have shorter time lags. Supply-Side Policies often involve more complexities and have longer time lags.

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Supply-Side Policies

- Effects of investment in human capital just like other type of investment generally take longer time to work through the economy as compared to changes in tax rates, government spending and interest rates.

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Fiscal Policy as Policy Instrument

How effective is Fiscal Policy in achieving different macroeconomic objectives?

- After from being able to stabilize economic turns (periods of high and low economic activity), fiscal policy can also be useful for correcting economies BOP disequilibrium.

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Fiscal Policy as Policy Instrument

- Use of expenditure dampening strategy to reduce aggregate demand is one possible way of reducing economy's current account deficit. High tax rates combined with low government spending on imported goods is expected to be effective strategy to reduce economies' import expenditure.

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Fiscal Policy as Policy Instrument

- Moreover use of tariffs and other protectionist tools can significantly limit economies' import and hence will help them combat temporary current account deficits.
- Though fiscal policy might be useful in eliminating small and temporary current account deficits but such measures in no way provide sustainable solution to economies' current account deficit that basically indicates economies' products' lack of competitiveness.

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Fiscal Policy as Policy Instrument

- Hence use of appropriate supply side strategies that are expected to enhance domestic products' competitiveness is only effective strategy to combat economies' permanent BOP disequilibrium.

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Monetary Policy as Policy Instrument

- Moreover monetary policy can also serve as useful supply side policy instrument. Increased availability of cheap loans for investment purposes can significantly improve economy's production potential.

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Conflicts between Macroeconomic Objectives

- As you might have noticed by now, often there is conflict between macroeconomic objectives. Hence economies often need to prioritize between different macroeconomic objectives. As depicted through Phillips Curve, unemployment and demand pull inflation are often inversely related to each other.

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Conflicts between Macroeconomic Objectives

- Stronger exchange rates can **negatively affect** economies BOP position reducing exports and increasing imports.

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Relationship between Internal and External Value of Currency

- Internal Value of currency refers to its purchasing power with regards to its affordability of local goods/services.
- External Value of the currency on the other hand refers to its purchasing power with regards to its affordability of foreign goods/services.

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Relationship between Internal and External Value of Currency

- Though economies' internal and external value of currencies might not always be very strongly related but often changes in one influence the value of other variable. For instance if Pakistani exchange rate depreciates against US dollars then expensive import of American goods/services might result in cost-push inflation in the economy. Hence internal value of currency might be adversely affected due to fall in currency's exchange rate.

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Relationship between Internal and External Value of Currency

- Similarly fall in currency's internal value of currency due to high inflation in the local economy might cause economy's products' to become less price competitive and therefore their demand in foreign markets might be adversely affected. Lower demand for economy's goods/services will result in lower demand for local currency which is expected to adversely affect currency's exchange rate.

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Relationship between Internal and External Value of Currency

- Since international demand for economy's products are not just the function of their prices and in reality they depend upon a lot of other factors including quality, durability and brand image. Therefore local inflation might not reduce demand for economy's goods/services by a very large extent. Moreover it is relative inflation rates that is significant factor in determining relative demand for economies' goods/services.

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Marshall-Lerner Condition

- Recently China was accused by US for deliberate depreciation of its exchange rate to artificially make its products more price competitive on international markets.
- This deliberate weakening of exchange rate that is also known as devaluation of exchange rate is done by policymakers to improve their Balance of Payments position.
- Economies having higher export potential and price elastic exports and imports are likely to experience improvements on their Balance of Payments due to weakening of their exchange rates.

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Marshall-Lerner Condition

- According to this model, if combined price elasticity of exports and imports of an economy is greater than one (meaning more elastic) then economies' Balance of Payments is expected to improve given their exchange rate weakens.
- Lower export prices (due to weaker exchange rate) result in higher demand for local goods/services.

  Increase in economy's quantity exported is greater (more than proportionate) than fall in products' prices and therefore country's overall export revenue increase.

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Marshall-Lerner Condition

- Similarly higher import prices (due to weaker exchange rate) result in lower demand for foreign goods/services. The fall in quantity demanded of foreign goods/services is greater (more than proportionate) than rise in products' prices and hence economy's overall import expenditure falls.

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Marshall-Lerner Condition

- Initially devaluation of economies' exchange rate might result in worsening of their Balance of Payments but eventually it will improve given economies' combined exports and imports price elasticity are more elastic.
- Moreover only economies that have substantial export potential in terms of their ability to produce diverse products and in large quantities will be able to benefit from such devaluation of economies' exchange rate.

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Phillips Curve

- New Zealand economist, Phillip developed graphical model to depict expected relationship between economies' inflation and unemployment rates.
- Researcher used historical data of economies' wage rates to predict their inflation rates during certain time periods. Changes in these inflation rates were then compared with their unemployment rates during same time periods.
- Phillip predicted trade-off between economies' unemployment and inflation rates. This means that during times of lower unemployment levels economies will most probably experience higher inflationary pressures.

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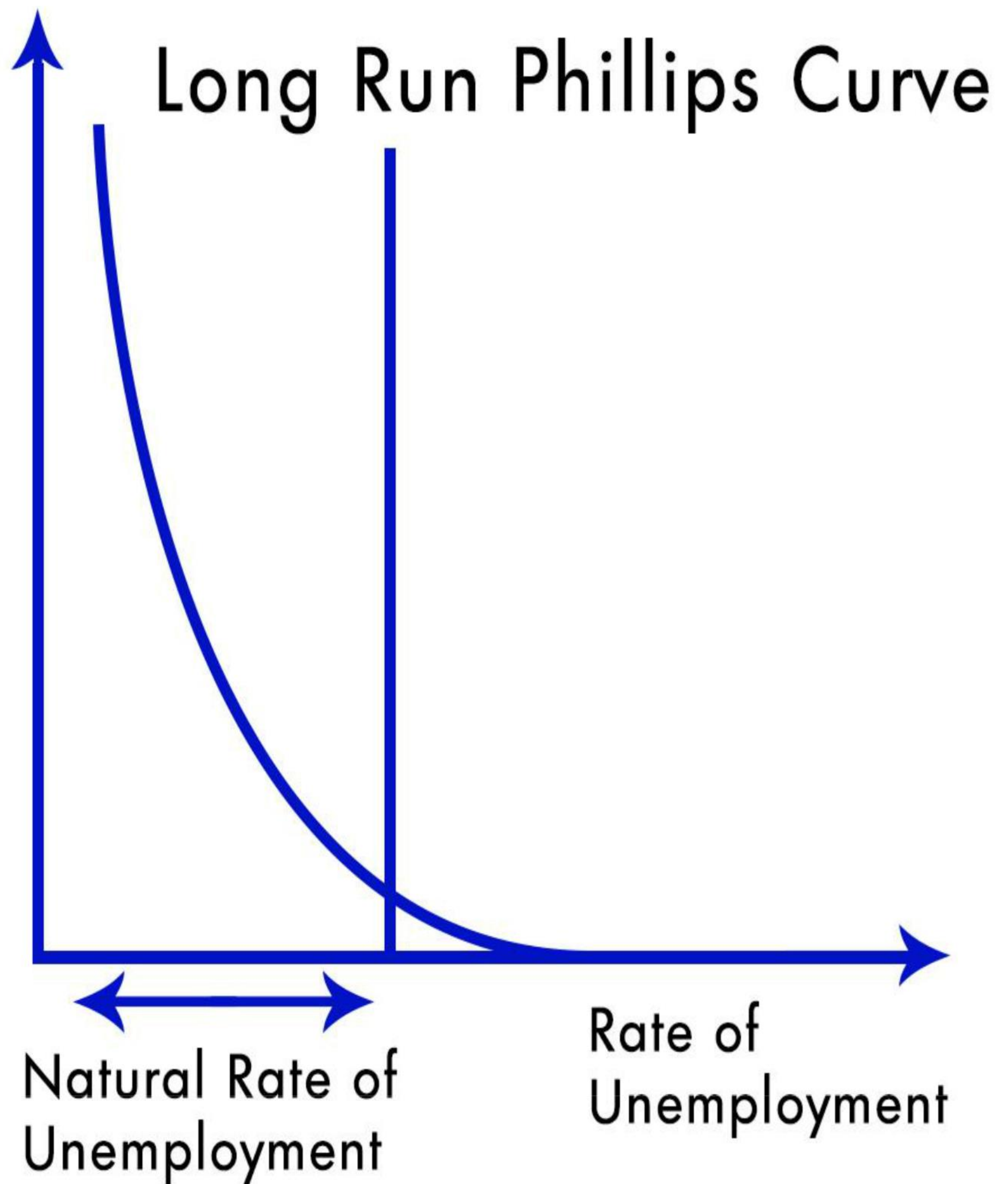
Phillips Curve



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Long-Run Phillips Curve

- Unlike Phillip's claim that there is trade-off between economies' inflation and unemployment rates, Milton Friedman presented a completely different view.
- According to him, economies' long-run Phillips Curve will be a vertical line which shows inability of government to reduce unemployment below natural rate of unemployment and hence increased government spending etc will only build more inflationary pressures in the economy and will leave the natural rate of unemployment unchanged.

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Long-Run Phillips Curve

- According to Classical each time government tries reducing unemployment through use of expansionary monetary and fiscal policies, initially producers might react to changes in economy's higher aggregate demand through greater production but then after realizing that wages and input costs have increased and therefore their profit margins have remained unchanged they will most probably cut back on their production levels.

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Long-Run Phillips Curve

- This will as the result bring unemployment levels back to natural rate of unemployment but additional inflationary pressures will build up. Hence economy will experience higher inflation rates at same levels of natural rate of unemployment. Hence Classical claim that economies' long-run Phillip Curve will be a vertical line.

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Budget Financing

- Fiscal Policy that deals with government expenditure and revenue directly influences economies' growth.
- Unlike monetary policy that is often autonomously devised by economies' central banks; fiscal policy is developed by members of national assembly.
- In times of budget deficit where government expenditure is expected to exceed its revenue (collected through taxation) governments needs to rely on internal and/or external sources of borrowing.

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Budget Financing

- Though temporary budget deficits might prove beneficial for economies especially when increased government expenditure is targeted at enhancing economies' production potential but countries that face persistent budget deficits are expected to face severe national debt problem.

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Budget Financing

- Governments can either raise loan from country's nationals by offering them government bonds or they can rely on international funding from other countries or international development organizations like World Bank, Asian Development Bank etc.
- Borrowed money has to be returned before or at maturity date with principal and interest. Government bond holders receive periodic interest payments.

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Budget Financing

- Government borrowing for investment purposes enhances economies' future output potential which allows them to successfully repay their loans. Excess government borrowing for current expenditure has no economic justification.
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