Macroeconomic Policies

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

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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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International Development Organizations

- World Bank or International Bank for Reconstruction and Development (IBRD) as it was formerly known and International Monetary Fund also known as IMF were established at the end of Bretton Woods Conference by the end of World War II in 1944.

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International Development Organizations

- World Bank and IMF finance developing economies for specific projects and purposes. Unlike IMF that focuses on financing economies struggling from Balance of Payments deficits, World Bank primarily focuses on providing developmental loans and aids to poor / developing economies.

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International Monetary Fund

- IMF issues loan to economies struggling with Balance of Payments disequilibrium.
- Countries suffering from persistent BOP deficits are expected to experience exchange rate depreciation due to their currencies reduced demand on international markets. To prevent excessive cost-push inflation that is inevitable consequence of economy's expensive imports requires improvement of economy's exchange rate.

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International Monetary Fund

- Sufficient amounts of foreign currency reserves are needed to artificially increase currency's demand to stabilize economy's exchange rate. Lack of foreign currency reserves require developing economies to rely on international financing options to stabilize their economies' exchange rates.

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World Bank

- Though development of developing economies is World Bank's one of the key priorities but often their finance is not free of charge.
- Proponents of this strategy claim that interest-free loans or aids might not compel beneficiaries to make the most productive use of developmental grants.

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World Bank

- However some critics of World Bank claim that its stringent requirements for economies to qualify for developmental loans and its strict loan usage policies significantly affect economies' ability to benefit from such developmental loans / grants.

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World Bank: Specialization Areas

- Though World Bank unlike IMF has much wider development scope but there are certain priority areas / sectors that are more heavily financed by World Bank that other sectors / areas which include:

1. Agriculture and Rural Development
2. Access to clean drinking water and sanitation
3. Environmental Protection
4. Health and Education
5. Infrastructure Development
6. Governance: research to improve institutional framework of developing economies

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Criticism of World Bank

- As mentioned earlier, World Bank's excessive requirements concerning implementation of various structural and institutional framework limits economies' ability to make most productive use of developmental loans.

- Moreover, World Bank's forces loan recipient countries to undertake certain structural changes which are not best aligned with these countries factor endowments and state of technology.

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