

# **Course: Foundations of Economics**

## **Lecture 9: Fiscal and Monetary policies**

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# FISCAL POLICY

- Fiscal policy
  - seeks to control aggregate demand by altering the balance between government spending and taxation
- The purpose of fiscal policy
  - correcting a fundamental disequilibrium
  - fine tuning
  - to influence aggregate supply

# FISCAL POLICY

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- Government finances, the terminology
  - central government
    - budget deficits and surpluses
      - financing a deficit

# FISCAL POLICY

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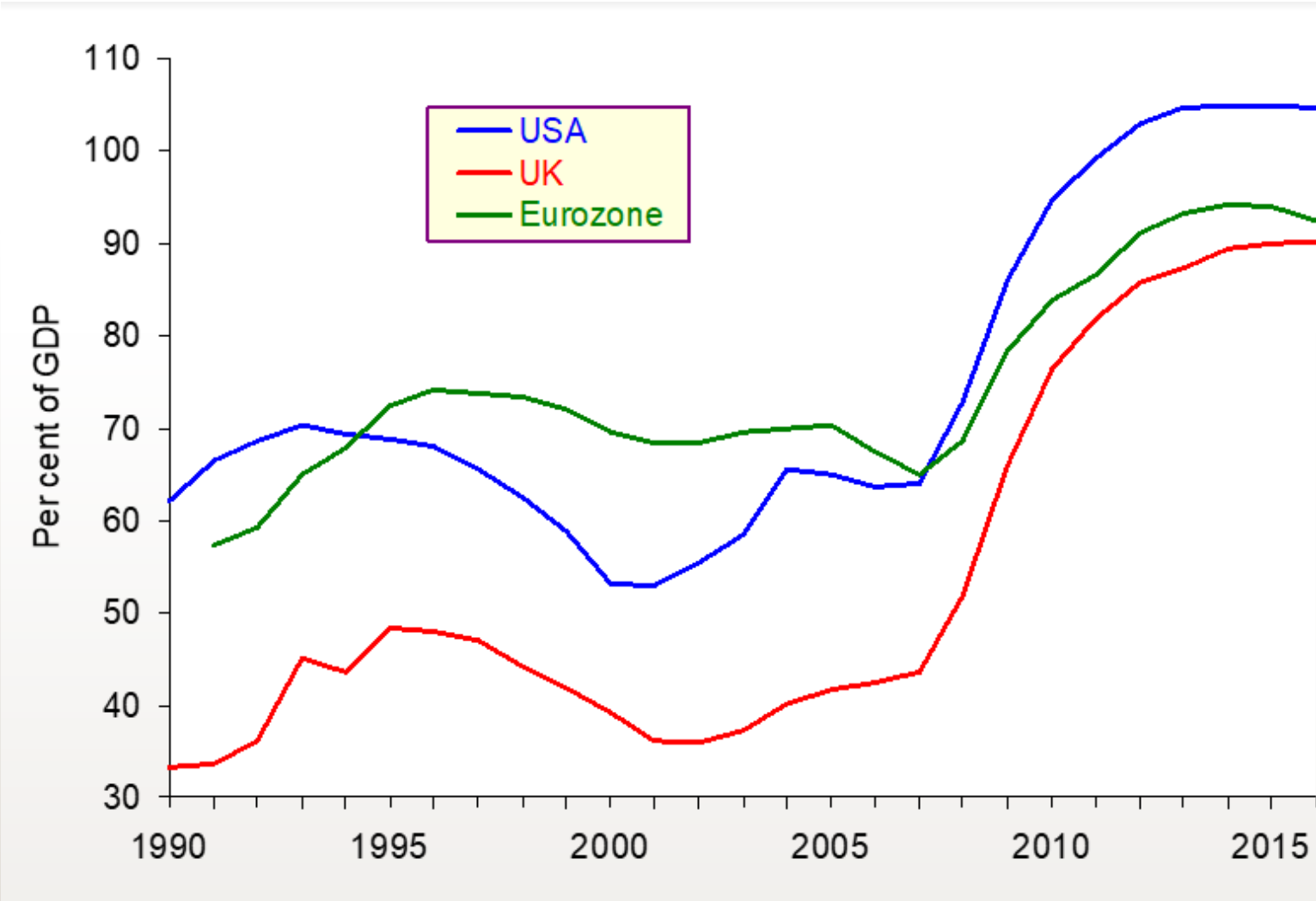
- Government finances, the terminology
  - central government
    - budget deficits and surpluses
      - financing a deficit
    - ✦ the national debt
  - general government (central and local)
    - ✦ general government deficits and surpluses
    - ✦ general government debt

# GENERAL GOVERNMENT DEFICITS/SURPLUSES AND DEBT AS % OF GDP

	General government deficits (–) or surpluses (+)		General government debt	
	Average 1995–2007	Average 2008–2016	Average 1995–2007	Average 2008–2016
Belgium	–1.3	–3.3	108.3	102.3
France	–2.9	–4.7	61.6	87.1
Germany	–2.9	–0.7	61.0	74.1
Greece	–6.4	–8.4	96.8	157.3
Ireland	+1.2	–10.0	41.7	96.5
Italy	–3.5	–3.2	106.4	121.6
Japan	–5.7	–7.4	148.5	230.8
Netherlands	–2.7	–2.6	55.2	63.8
Portugal	–4.3	–5.9	58.6	110.6
Spain	–1.4	–7.2	52.9	77.5
Sweden	0.0	–0.6	55.0	39.7
UK	–2.2	–6.7	42.0	79.8
USA	–2.8	–7.8	61.7	97.2
EU-15	–1.1	–3.9	64.0	84.0

*Note:* Data from 2015 based on forecasts

# US, UK AND EUROZONE GENERAL GOVERNMENT DEBT



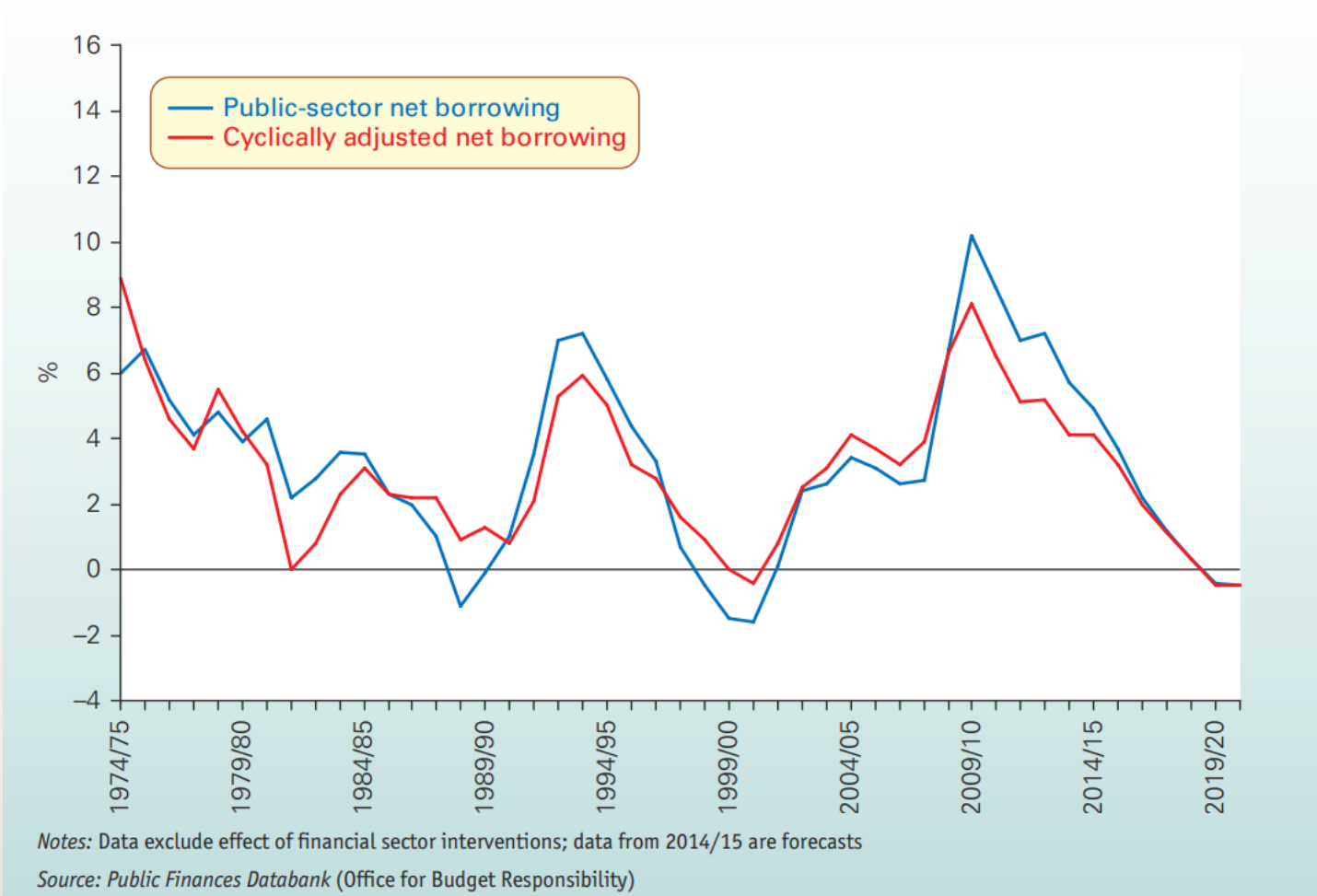
Source: Sloman (2016), Essentials of Economics, 7th ed, Prentice Hall, page 334.

# FISCAL POLICY

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      - financing a deficit
    - the national debt
  - general government (central and local)
    - general government deficits and surpluses
    - general government debt
- the whole public sector
  - ✦ public-sector net borrowing
  - ✦ public-sector net cash requirement

# UK public-sector net borrowing, % of GDP



Source: Sloman (2016), Essentials of Economics, 7th ed, Prentice Hall, page 330.

# FISCAL POLICY

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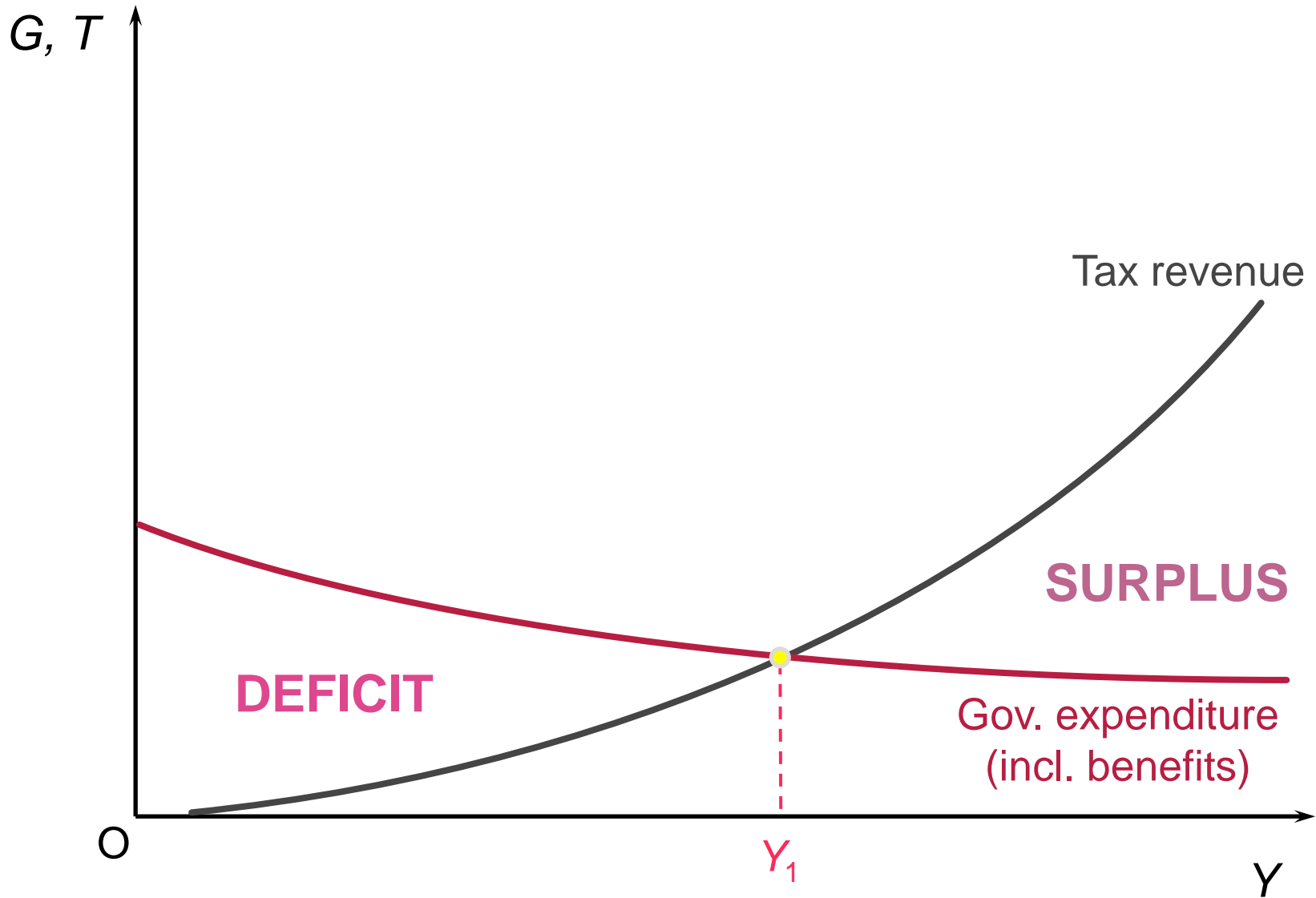
○ cyclically adjusted balances

# FISCAL POLICY

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- The use of fiscal policy
  - automatic stabilisers
  - discretionary fiscal policy
- Automatic fiscal stabilisers
  - tax stabilisers
  - benefits stabilisers

# National income and the size of the public-sector deficit or surplus



# FISCAL POLICY

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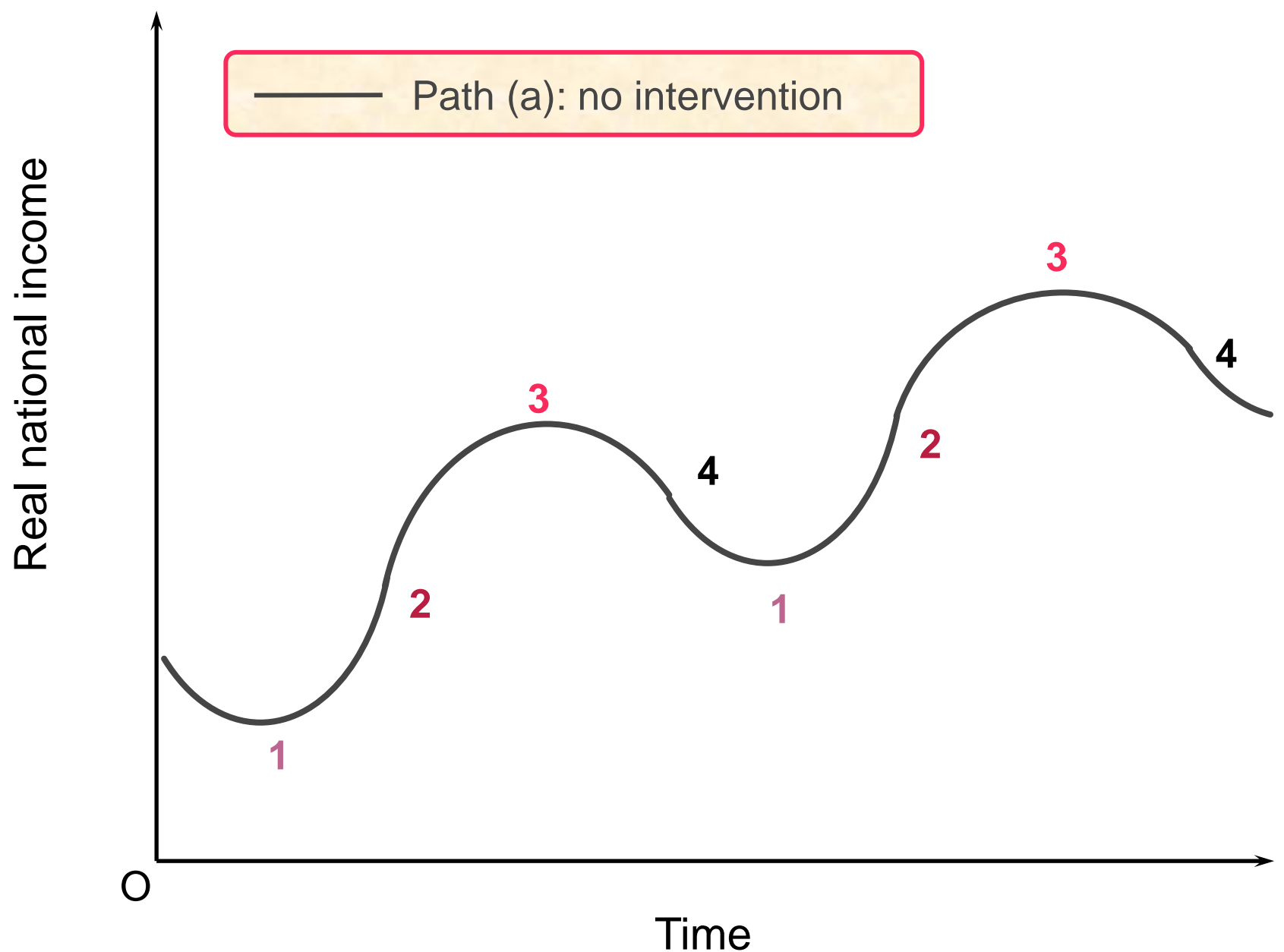
- Factors determining the effectiveness of fiscal policy
  - accuracy of forecasting
  - effect on  $J$  and  $W$
  - effect of changes in  $J$  and  $W$  on national income
  - timing of the effects
  - effects on the various macro objectives

# FISCAL POLICY

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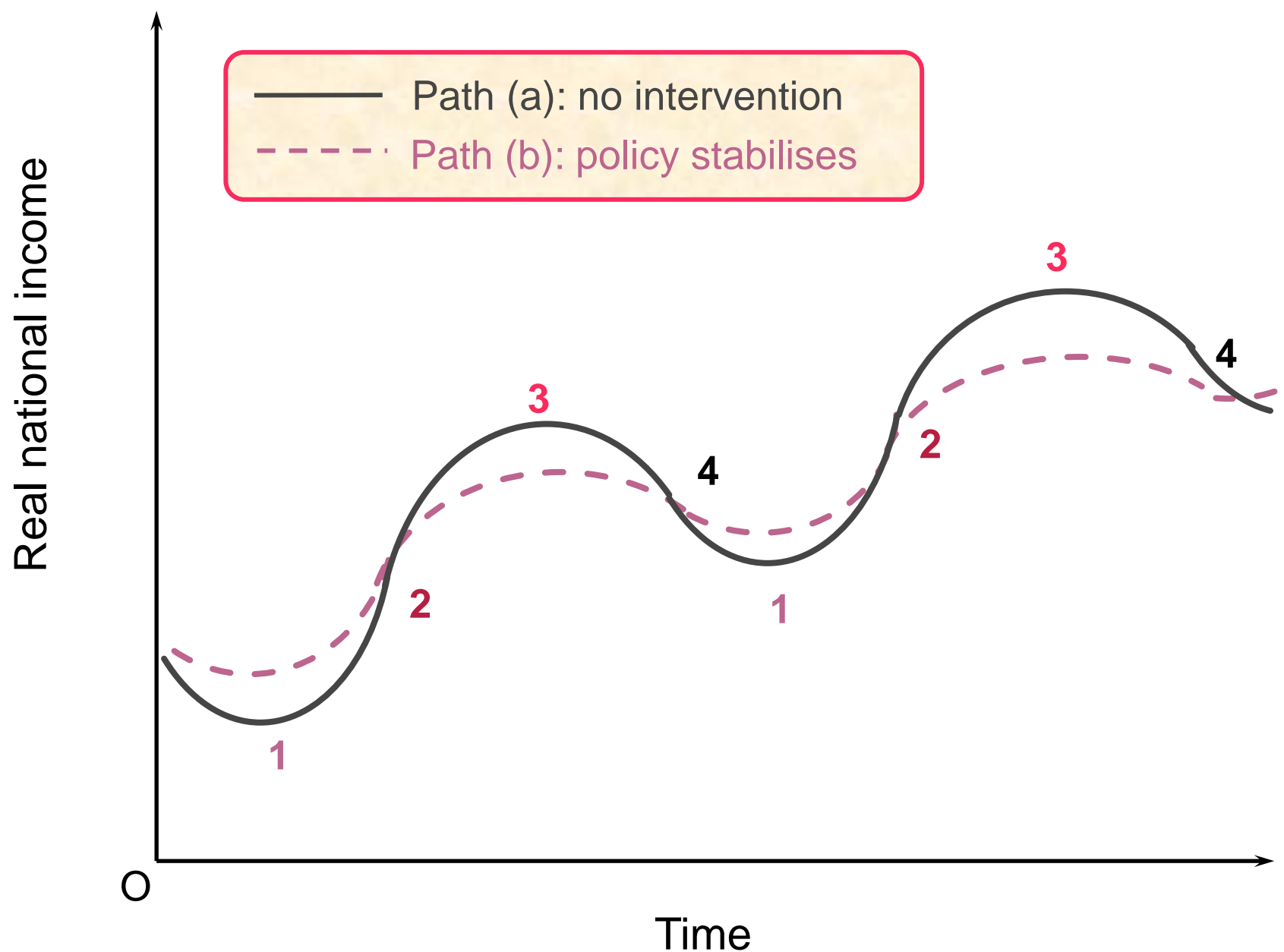
- Discretionary policy
  - problems of forecasting the magnitude of the effects
    - effects of changes in government expenditure
    - crowding out
    - effects of changes in taxes
    - size of the multiplier and accelerator effects
    - random shocks
  - problems of timing and time lags
    - various time lags
    - policy may be destabilising

# FISCAL POLICY: STABILISING OR DESTABILISING?



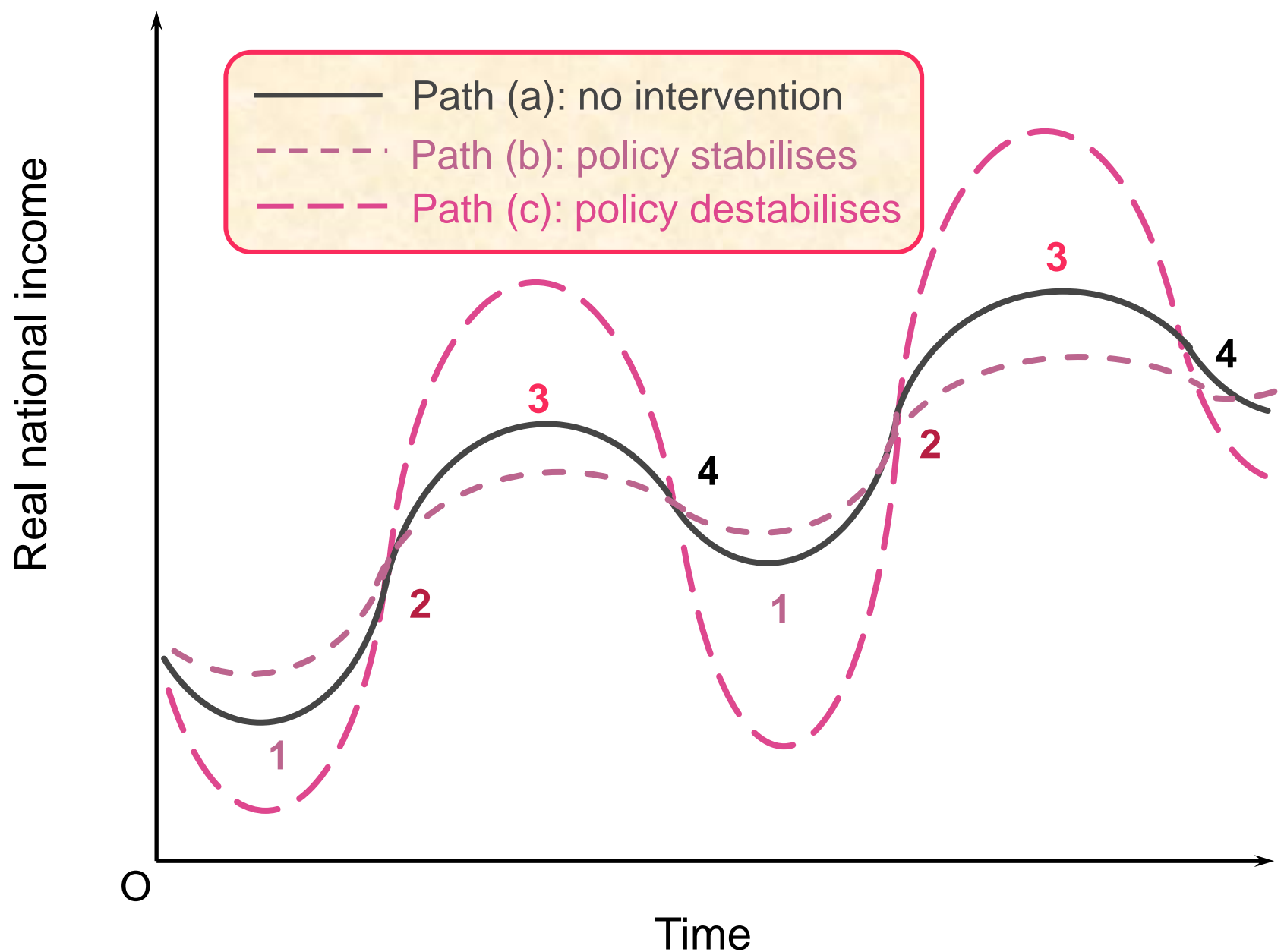
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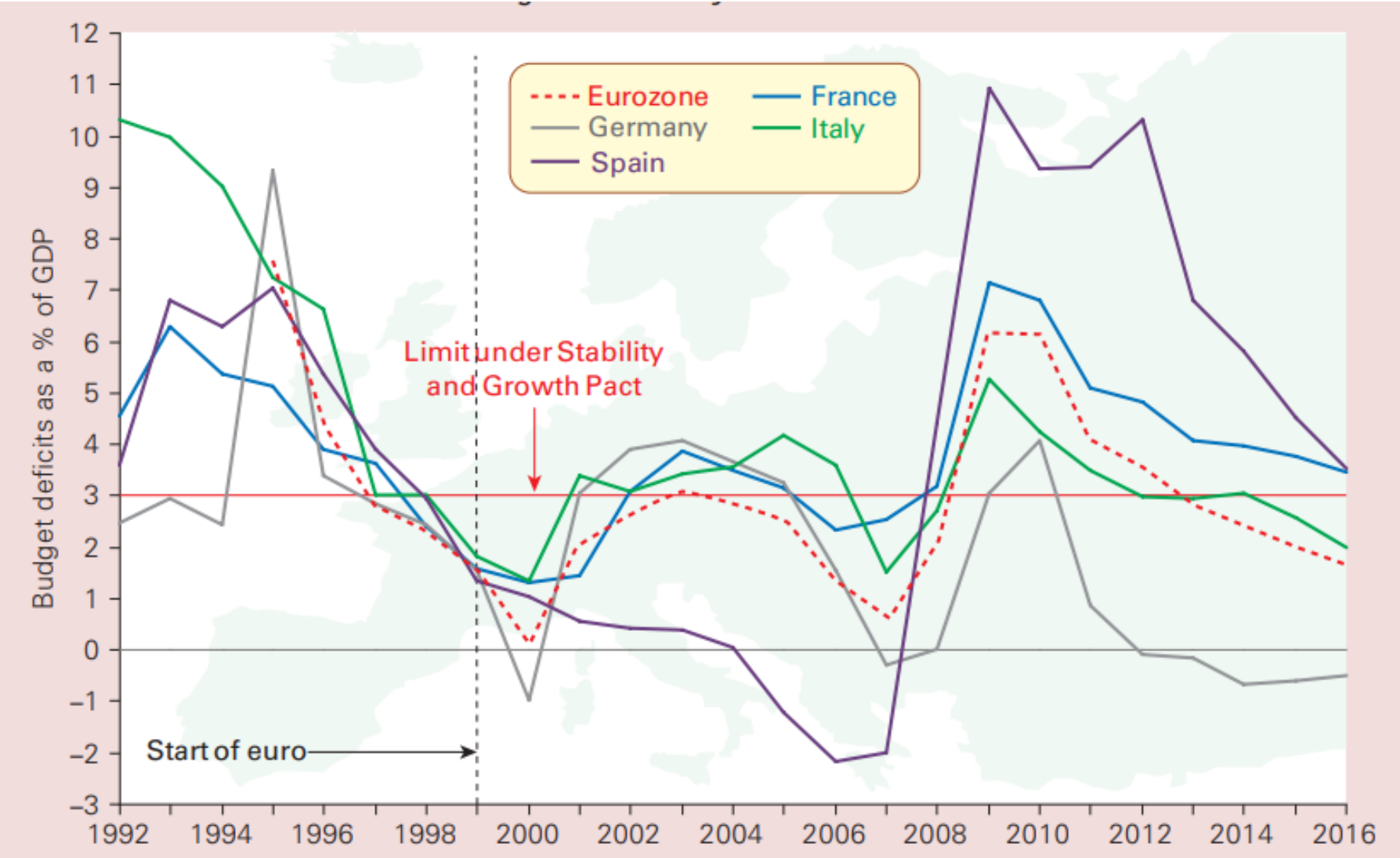
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# FISCAL POLICY

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- Fiscal rules
  - the evolving EU framework
    - Stability and Growth Pact

# GENERAL GOVERNMENT DEFICITS IN THE EUROZONE



Source: Sloman (2016), Essentials of Economics, 7th ed, Prentice Hall, page 334.

# FISCAL POLICY

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- Fiscal rules

- the evolving EU framework
  - Stability and Growth Pact

- ✦ Fiscal Compact

- the evolving UK framework

- ✦ Golden Rule and Sustainable Investment Rule
  - ✦ Fiscal Mandate

# MONETARY POLICY

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- The significance of monetary policy
  - the use of monetary policy
  - varieties of monetary policy
- The policy setting
  - the goals of the policy
  - monetary rules or discretionary policy?
  - relationship between the government and the central bank
  - degree of central bank independence

# MONETARY POLICY

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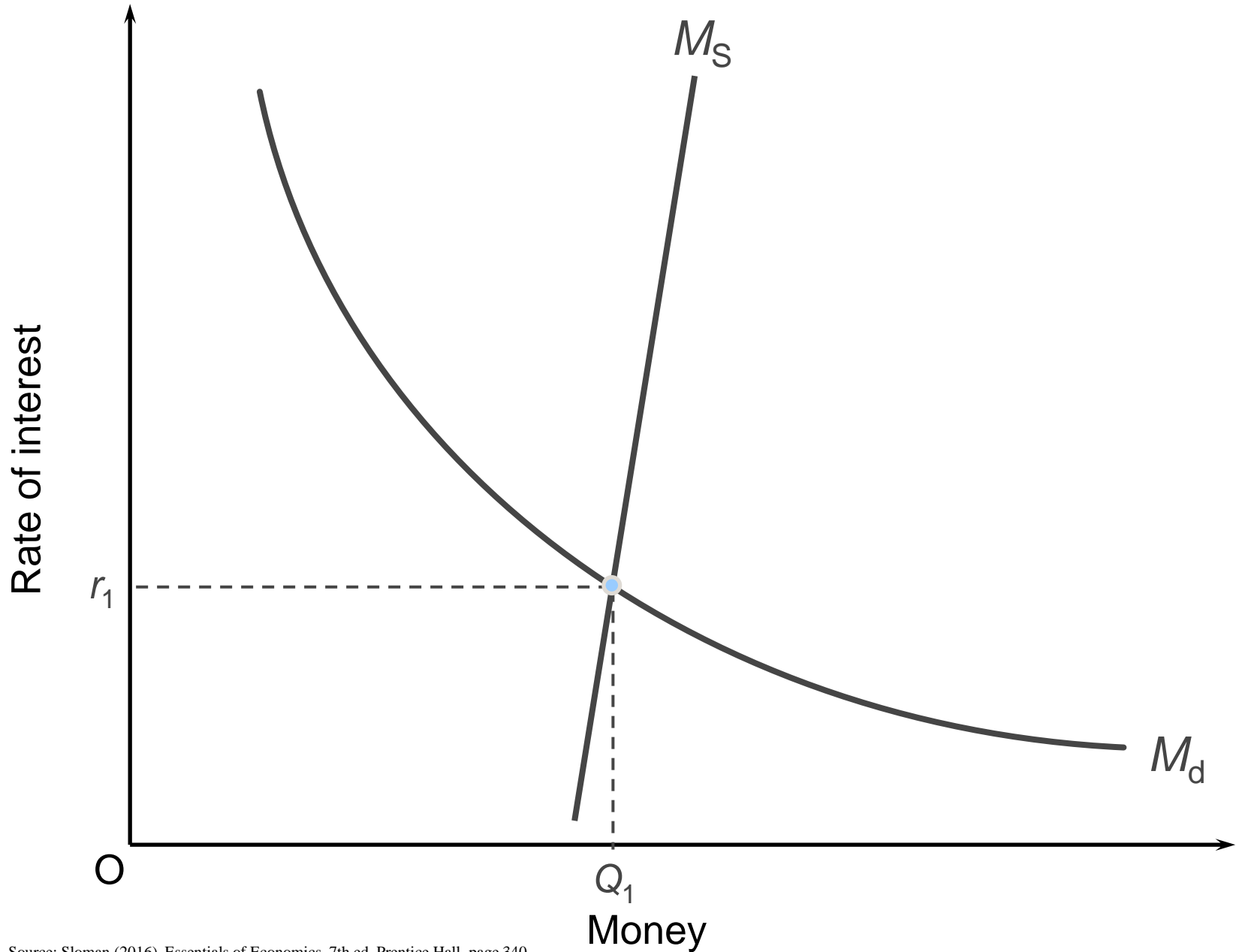
- Medium- and long-term policy
  - control of banks' liquidity ratio
  - restricting size of public sector deficits
- Issues with medium- and long-term monetary control
  - the effects of automatic fiscal stabilisers
  - the desire to cut taxes
  - difficulty in cutting government expenditure

# MONETARY POLICY

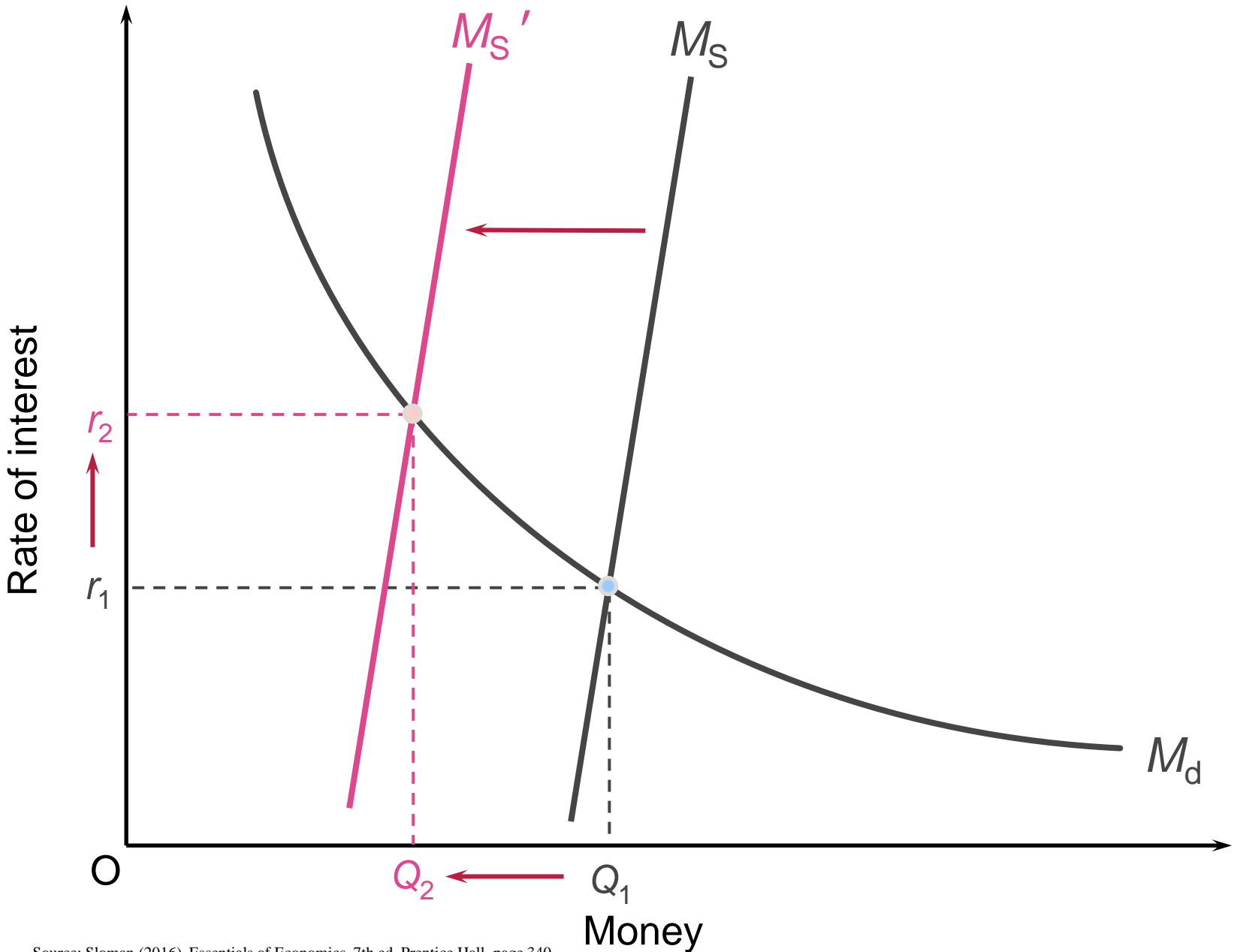
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- Alternative approaches to short-term control
  - controlling money supply
  - controlling interest rates
  - credit rationing

# THE DEMAND FOR AND SUPPLY OF MONEY



# THE DEMAND FOR AND SUPPLY OF MONEY



Source: Sloman (2016), Essentials of Economics, 7th ed, Prentice Hall, page 340.

# MONETARY POLICY

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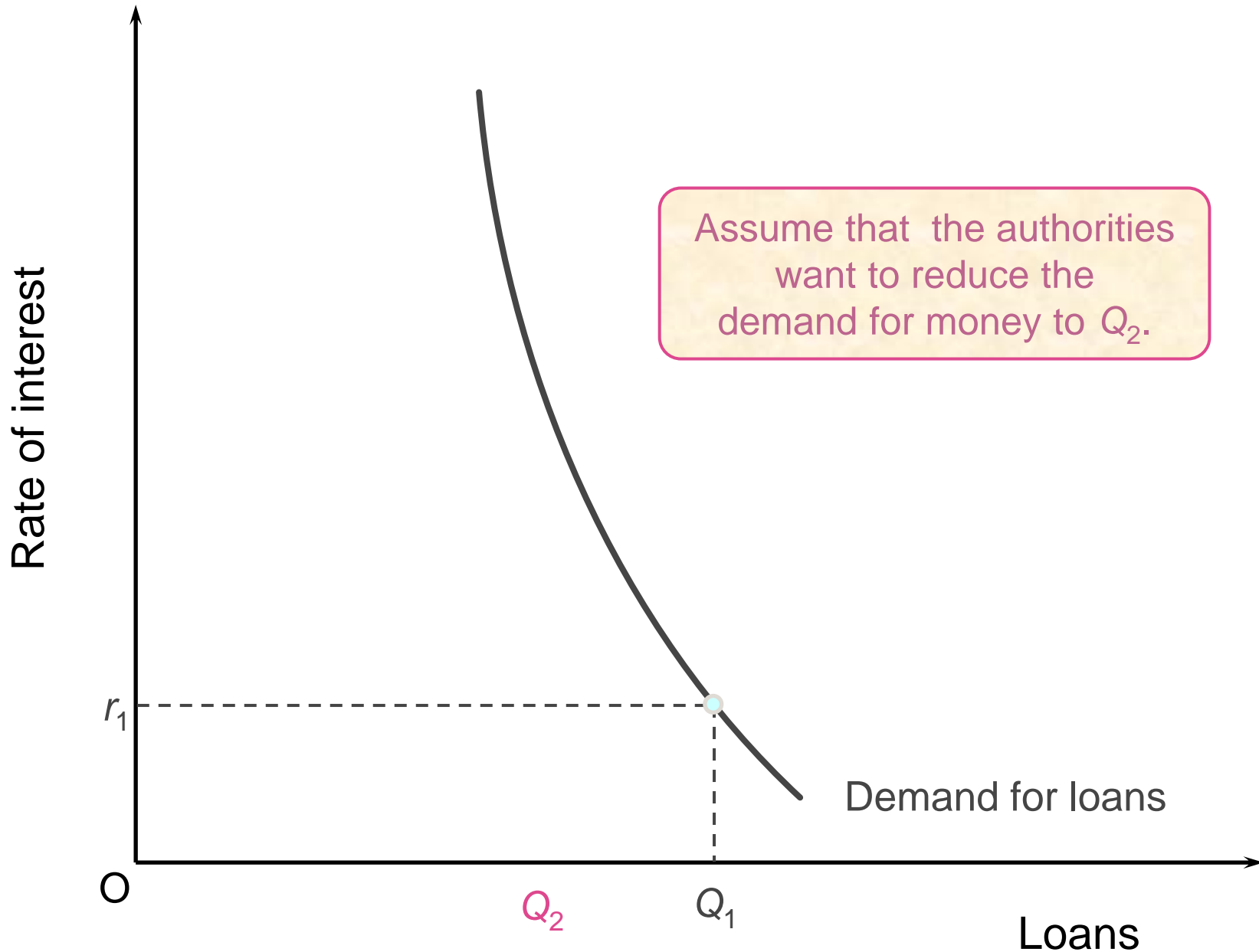
- Techniques to control money supply
  - open-market operations
  - reduced central bank lending to banks
  - funding
  - variable minimum reserve ratios
- Difficulties in controlling money supply
  - what to control?
  - ways in which banks can resist attempts to restrict the growth in the money supply
  - demand-determined money supply

# MONETARY POLICY

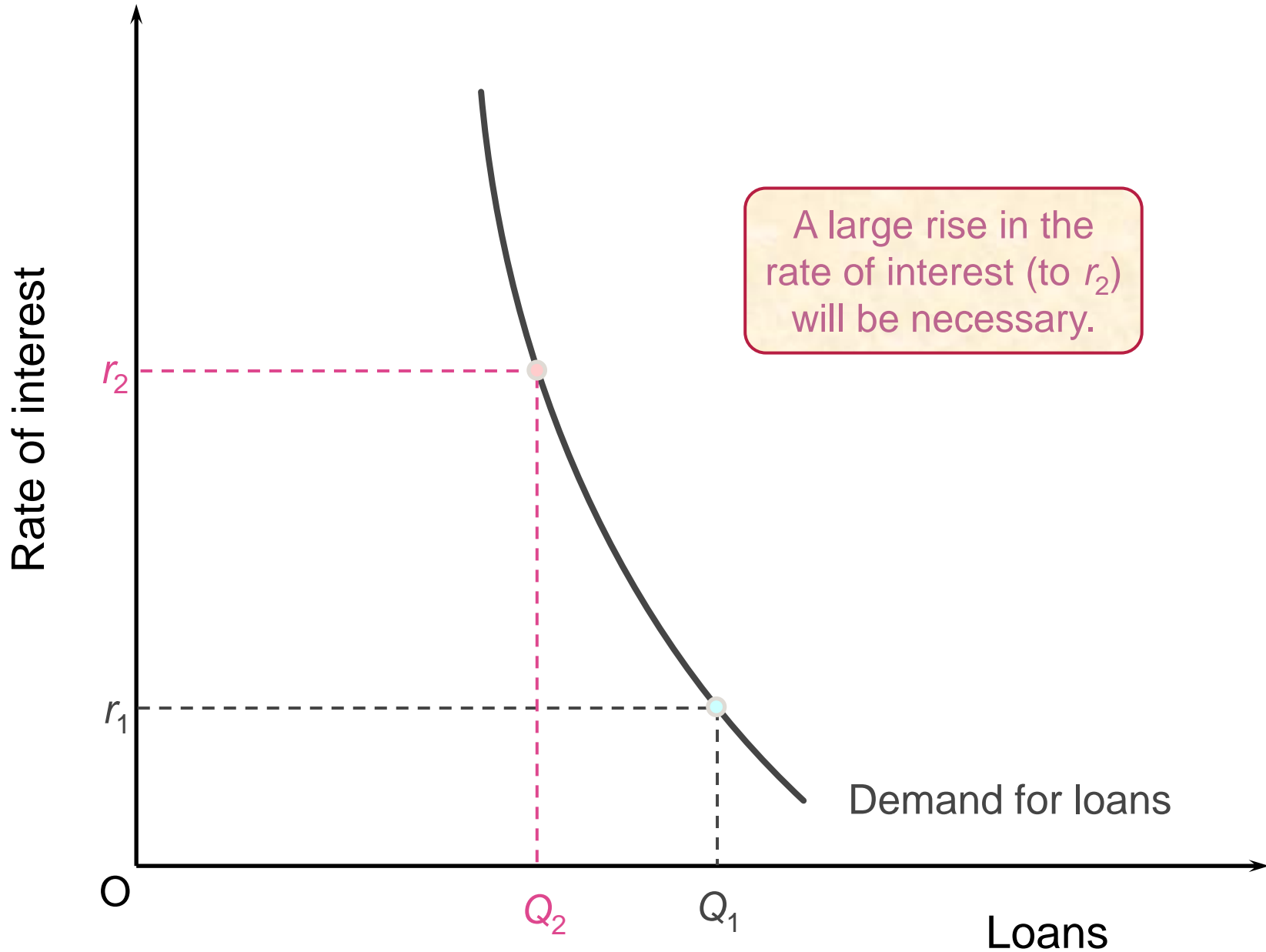
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- Techniques to control interest rates
  - announcing changes in interest rates (e.g. by MPC)
  - backing this up through operations in the repo market
- Effectiveness of controlling interest rates
  - inelastic demand for loans
    - problem of possibly high interest rates
    - reasons for an inelastic demand for loans

# AN INELASTIC DEMAND FOR LOANS



# An inelastic demand for loans



# MONETARY POLICY

- Effectiveness of controlling interest rates
  - inelastic demand for loans
    - problem of possibly high interest rates
    - reasons for an inelastic demand for loans
  - unstable demand for money
    - ✦ problem of changing expectations
    - ✦ speculation
  - possible conflict between domestic goals and exchange-rate goals

# MONETARY POLICY

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- Using monetary policy
  - difficult to achieve precise control of aggregate demand
  - problem of time lags
  - weak when pulling against expectations
  - problem of liquidity trap
- Use of interest rates to meet inflation target
  - impact on expectations

# DEMAND-SIDE POLICY

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- Attitudes towards demand management
  - combination of fiscal and monetary policies
  - type and flexibility of rules
- Case for rules and policy frameworks
  - political behaviour
    - seeking re-election or courting popularity
    - loss of credibility
  - time lags
    - initial under- and then over-correction
  - help to reduce inflationary expectations
  - create a stable environment for investment and economic growth

# DEMAND-SIDE POLICY

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- Case for discretion
  - can cause severe fluctuations in interest rates and can cause greater instability
  - which rule or target to choose?
  - rules and targets may conflict
  - rules and targets may become unsuitable
  - fine tuning can be improved by better forecasting and quicker action

# DEMAND-SIDE POLICY

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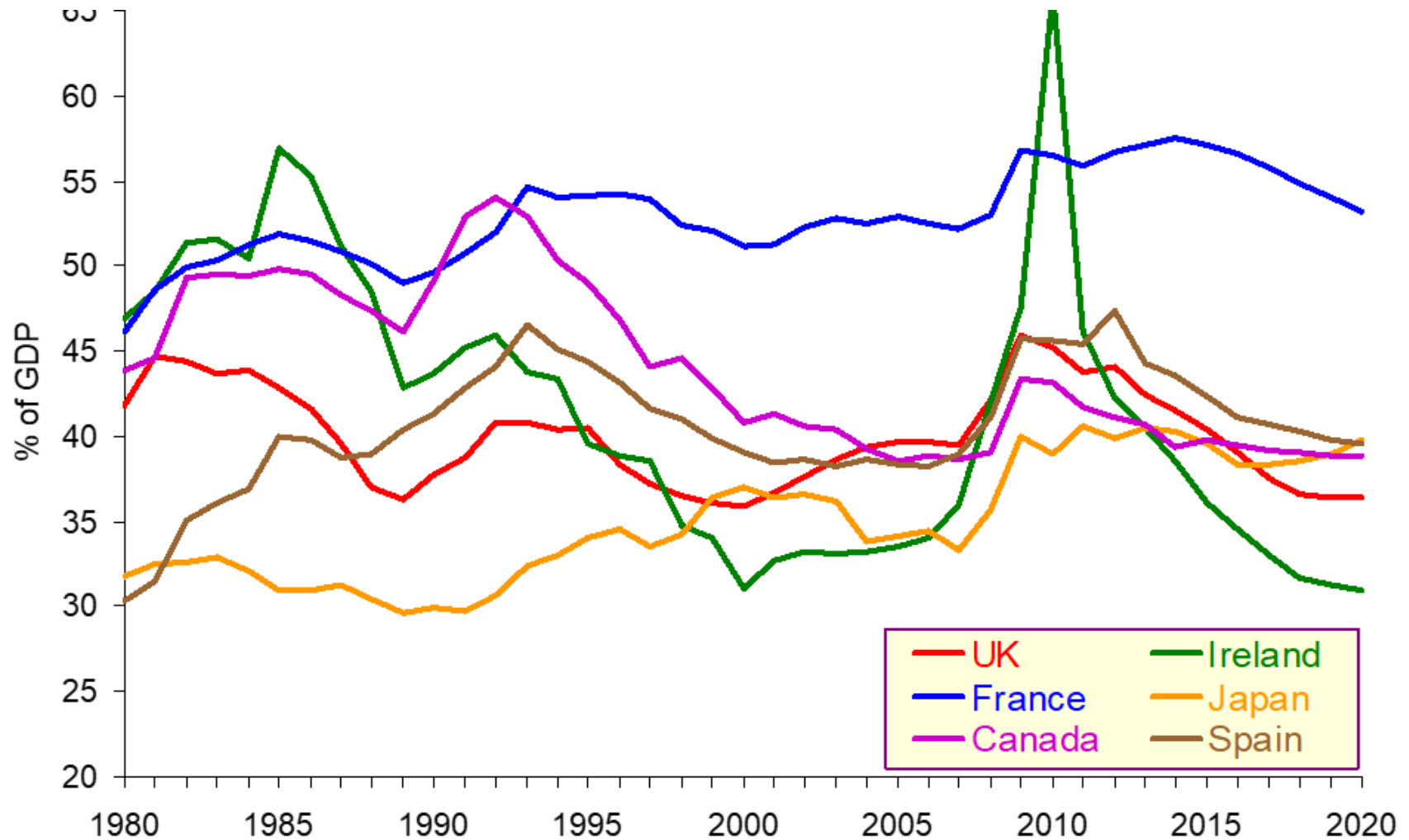
- Use of **inflation** targets around the world
- Issues with inflation targets
  - choice of the target
  - who sets the target?
  - changing the target
  - multiple targets
    - a Taylor rule for setting interest rates
    - targeting inflation and the money supply
  - basing interest rates on forecasts of inflation
  - the problem of deflation

# SUPPLY-SIDE POLICY

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- The use of supply-side policies
  - increase potential output
  - increase long-run rate of economic growth
  - Increase employment
  - reduce price pressures
- Market-orientated supply-side policies
  - reducing government expenditure

# General government expenditure (% of GDP)



Source: Sloman (2016), Essentials of Economics, 7th ed, Prentice Hall, page 352.

# SUPPLY-SIDE POLICY

- The use of supply-side policies
    - increase potential output
    - increase long-run rate of economic growth
    - Increase employment
    - reduce price pressures
  - Market-orientated supply-side policies
    - reducing government expenditure
- tax cuts
- ✦ importance of incentives
    - ◇ labour supply
    - ◇ capital expenditure

# SUPPLY-SIDE POLICY

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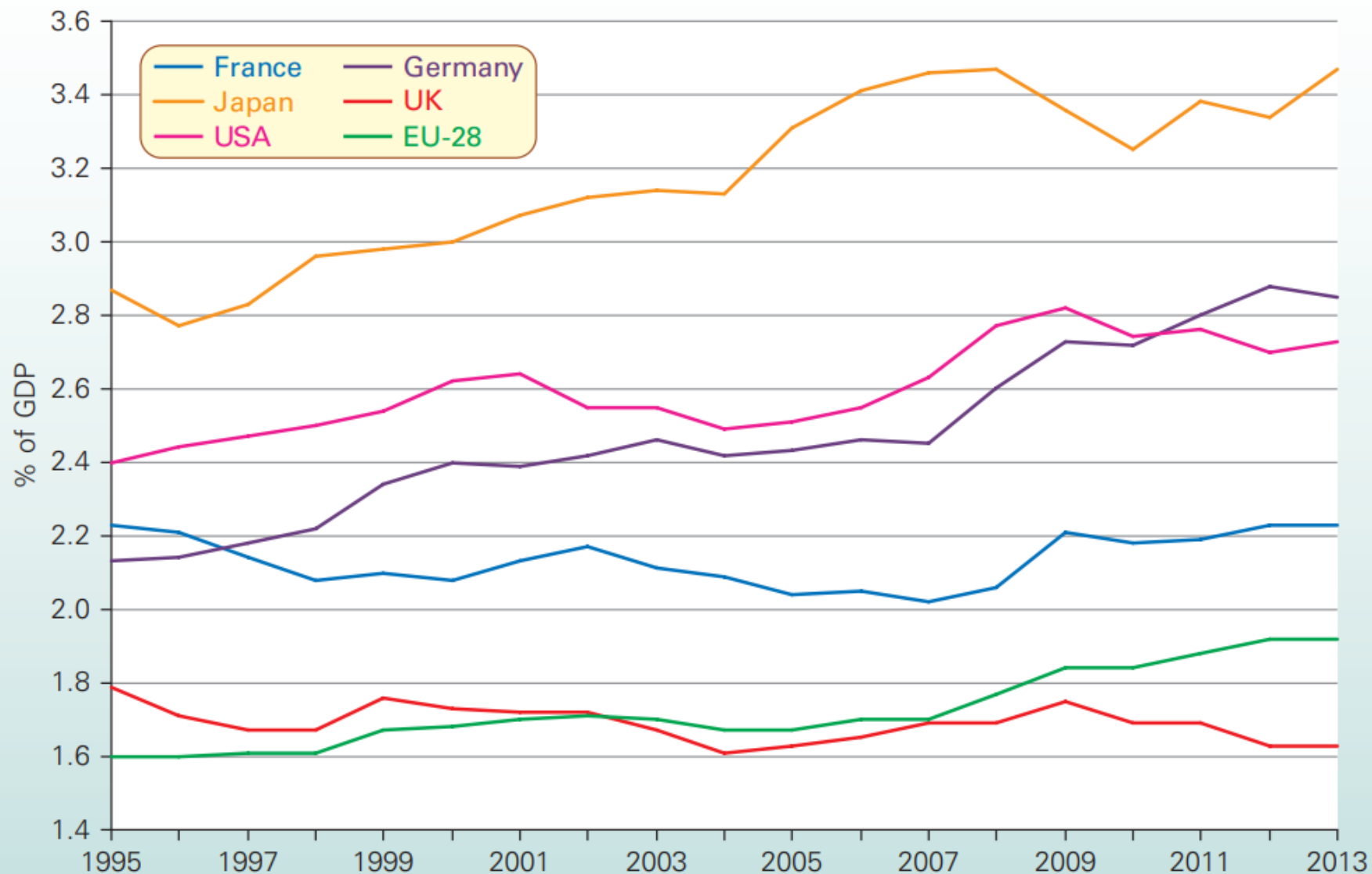
- Market-orientated supply-side policies (cont.)
  - reducing the power of labour
  - reducing welfare
  - policies to encourage competition
    - privatisation
    - deregulation
    - introducing market relationships into public sector
    - the Private Finance Initiative (PFI)
    - free trade and capital movements

# SUPPLY-SIDE POLICY

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- Interventionist supply-side policy
  - failure of the market to provide adequate training, R&D and investment

# Gross expenditure on R&D as a percentage of GDP



Note: EU-28 = the 28 member countries of the European Union since July 2013

Source: Based on data from *OECD.Stat* (OECD)

# SUPPLY-SIDE POLICY

- Interventionist supply-side policy
  - failure of the market to provide adequate training, R&D and investment
  - training and education
  - infrastructure and capital projects
  - help to firms
    - ✦ nationalisation
    - ✦ direct provision
    - ✦ funding research and development
    - ✦ assistance to small firms
    - ✦ regional and urban policy
    - ✦ advice and persuasion
    - ✦ information

# REFERENCES

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