

**SOS POLITICAL SCIENCE AND
PUBLIC ADMINISTRATION**

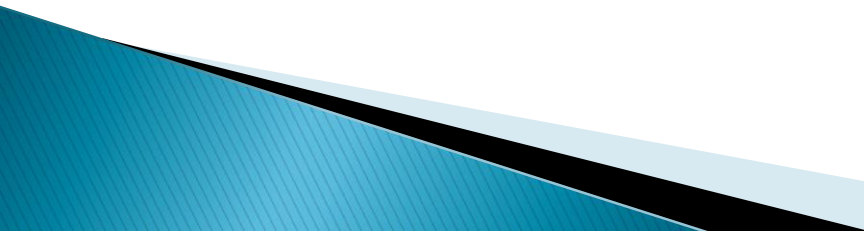
MBA FA 203

**SUBJECT NAME:
BUSINESS ENVIRONMENT**

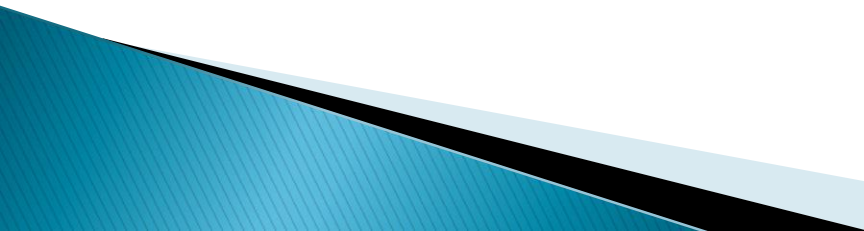
TOPIC NAME: FISCAL & MONETARY POLICY

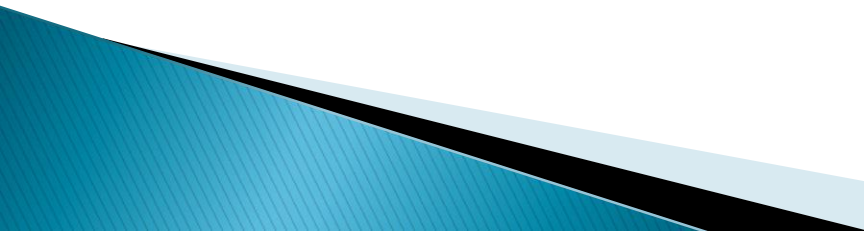


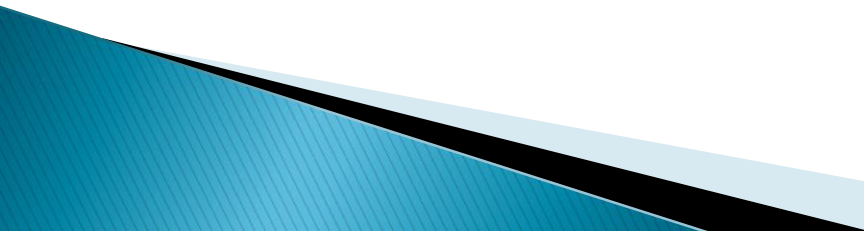
- ▶ Monetary policy and fiscal policy refer to the two most widely recognized tools used to influence a nation's economic activity. Monetary policy is primarily concerned with the management of interest rates and the total supply of money in circulation and is generally carried out by central banks, such as the U.S. Federal Reserve. Fiscal policy is a collective term for the taxing and spending actions of governments. In the United States, the national fiscal policy is determined by the executive and legislative branches of the government.

- ▶ Both monetary and fiscal policy are tools a government can access to support and stimulate the economy.
 - ▶ Monetary policy addresses interest rates and the supply of money in circulation, and it is generally managed by a central bank.
 - ▶ Fiscal policy addresses taxation and government spending, and it is generally determined by legislation.
 - ▶ Monetary policy and fiscal policy together have great influence over a nation's economy, its businesses, and its consumers.
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MONETARY POLICY:

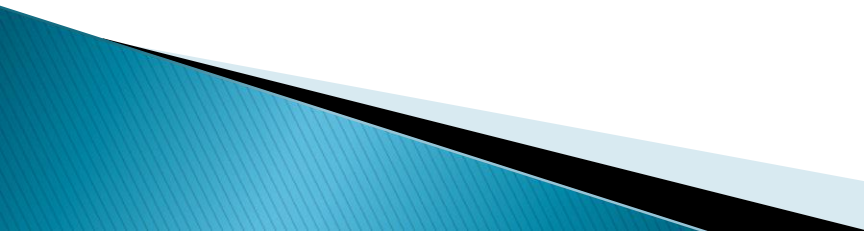
- ▶ Monetary policy, the demand side of economic policy, refers to the actions undertaken by a nation's central bank to control money supply to achieve macroeconomic goals that promote sustainable economic growth.
 - ▶ Monetary policy, the demand side of economic policy, refers to the actions undertaken by a nation's central bank to control money supply to achieve macroeconomic goals that promote sustainable economic growth.
 - ▶ Monetary policy can be broadly classified as either expansionary or contractionary.
 - ▶ Monetary policy tools include open market operations, direct lending to banks, bank reserve requirements, unconventional emergency lending programs, and managing market expectations (subject to the central bank's credibility).
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- ▶ Monetary policy consists of the process of drafting, announcing, and implementing the plan of actions taken by the central bank, currency board, or other competent monetary authority of a country that controls the quantity of money in an economy and the channels by which new money is supplied. Monetary policy consists of management of money supply and interest rates, aimed at achieving macroeconomic objectives such as controlling inflation, consumption, growth, and liquidity. These are achieved by actions such as modifying the interest rate, buying or selling government bonds, regulating foreign exchange rates, and changing the amount of money banks are required to maintain as reserves.
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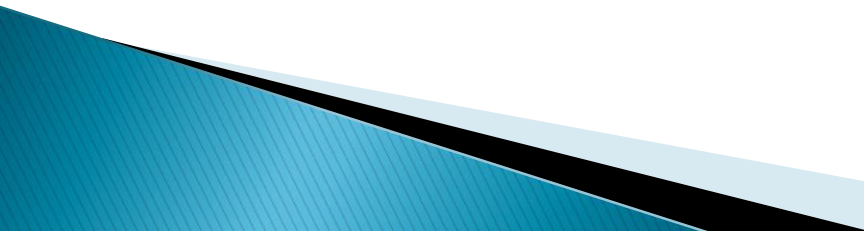
- ▶ Economists, analysts, investors, and financial experts across the globe eagerly await the monetary policy reports and outcome of the meetings involving monetary policy decision-making. Such developments have a long lasting impact on the overall economy, as well as on specific industry sector or market.
 - ▶ Monetary policy is formulated based on inputs gathered from a variety of sources. For instance, the monetary authority may look at macroeconomic numbers like GDP and inflation, industry/sector-specific growth rates and associated figures, geopolitical developments in the international markets (like oil embargo or trade tariffs), concerns raised by groups representing industries and businesses, survey results from organizations of repute, and inputs from the government and other credible sources.
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- ▶ Monetary authorities are typically given policy mandates, to achieve stable rise in gross domestic product (GDP), maintain low rates of unemployment, and maintain foreign exchange and inflation rates in a predictable range. Monetary policy can be used in combination with or as an alternative to fiscal policy, which uses taxes, government borrowing, and spending to manage the economy.
- ▶ The Federal Reserve Bank is in charge of monetary policy in the United States. The Federal Reserve has what is commonly referred to as a "dual mandate": to achieve maximum employment while keeping inflation in check. Simply put, it is the Fed's responsibility to balance economic growth and inflation. In addition, it aims to keep long-term interest rates relatively low. Its core role is to be the lender of last resort, providing banks with liquidity and serve as a bank regulator, in order to prevent the bank failures and panics in the financial services sector.

FISCAL POLICY:

- ▶ Fiscal policy refers to the use of government spending and tax policies to influence economic conditions, especially macroeconomic conditions, including aggregate demand for goods and services, employment, inflation, and economic growth.
 - ▶ Fiscal policy refers to the use of government spending and tax policies to influence economic conditions.
 - ▶ Fiscal policy is largely based on ideas from John Maynard Keynes, who argued governments could stabilize the business cycle and regulate economic output.
 - ▶ During a recession, the government may employ expansionary fiscal policy by lowering tax rates to increase aggregate demand and fuel economic growth.
 - ▶ In the face of mounting inflation and other expansionary symptoms, a government may pursue contractionary fiscal policy.
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- ▶ Fiscal policy is largely based on the ideas of British economist John Maynard Keynes (1883-1946), who argued that economic recessions are due to a deficiency in the consumption spending and business investment components of aggregate demand. Keynes believed that governments could stabilize the business cycle and regulate economic output by adjusting spending and tax policies to make up for the shortfalls of the private sector. His theories were developed in response to the Great Depression, which defied classical economics' assumptions that economic swings were self-correcting. Keynes' ideas were highly influential and led to the New Deal in the U.S., which involved massive spending on public works projects and social welfare programs.
- ▶ In Keynesian economics, aggregate demand or spending is what drives the performance and growth of the economy. Aggregate demand is made up of consumer spending, business investment spending, net government spending, and net exports. According to Keynesian economists, the private sector components of aggregate demand are too variable and too dependent on psychological and emotional factors to maintain sustained growth in the economy.

- ▶ Pessimism, fear, and uncertainty among consumers and businesses can lead to economic recessions and depressions, and excessive exuberance during good times can lead to an overheated economy and inflation. However, according to Keynesians, government taxation and spending can be managed rationally and used to counteract the excesses and deficiencies of private sector consumption and investment spending in order to stabilize the economy.
 - ▶ When private sector spending turns down, the government can spend more and/or tax less in order to directly increase aggregate demand. When the private sector is over optimistic and spends too much, too fast on consumption and new investment projects, the government can spend less and/or tax more in order to decrease aggregate demand.
 - ▶ This means that to help stabilize the economy, the government should run large budget deficits during economic downturns and run budget surpluses when the economy is growing. These are known as expansionary or contractionary fiscal policies, respectively.
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- ▶ Expansionary Policies
 - ▶ To illustrate how the government can use fiscal policy to affect the economy, consider an economy that's experiencing a recession. The government might issue tax stimulus rebates to increase aggregate demand and fuel economic growth.
 - ▶ The logic behind this approach is that when people pay lower taxes, they have more money to spend or invest, which fuels higher demand. That demand leads firms to hire more, decreasing unemployment, and to compete more fiercely for labor. In turn, this serves to raise wages and provide consumers with more income to spend and invest. It's a virtuous cycle, or positive feedback loop.
 - ▶ Rather than lowering taxes, the government may seek economic expansion through increases in spending (without corresponding tax increases). By building more highways, for example, it could increase employment, pushing up demand and growth.
 - ▶ Expansionary fiscal policy is usually characterized by deficit spending, when government expenditures exceed receipts from taxes and other sources. In practice, deficit spending tends to result from a combination of tax cuts and higher spending.
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FISCAL VS. MONETARY POLICY:

Fiscal Policy	Monetary Policy
Change in government spending and tax rates	Change in interest rates / money supply.
Set by the Government	Set by a Central bank
No specific target	Target inflation
Side effect on government budget / borrowing	Side effect on exchange rate and housing market
Strong political dimension to changing tax rates	Mostly independent from the political process

FISCAL POLICY	MONETARY POLICY
Higher taxes	Selling Treasury securities
Lower taxes	Buying Treasury securities
Higher government spending	Increasing the reserve ratio
Lower government spending	Increasing the discount rate