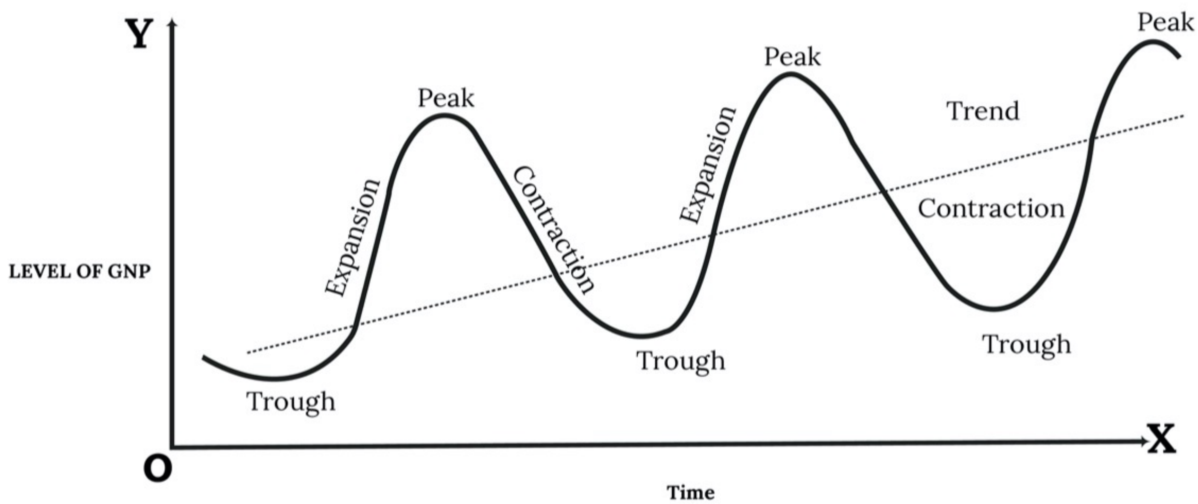
Introduction to Monetary and Fiscal Policies

Topics Covered

- ***Business Cycles***
- ***Supply Side and Demand Side Economics***
- ***Monetary Policy***
- ***Effects of Monetary Policy***
    - ***Expansionary Monetary Policy***
    - ***Contractionary Monetary Policy***
- ***Fiscal Policy***
- ***Effects of Monetary Policy***
    - ***Expansionary Fiscal Policy***
    - ***Contractionary Fiscal Policy***
- ***Difference between Monetary Policy & Fiscal Policy***

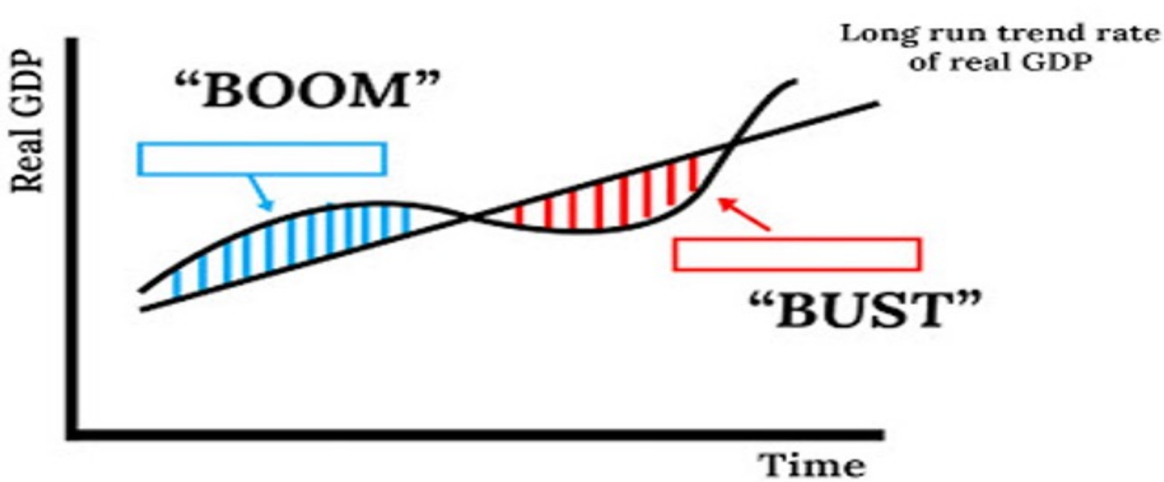
Business Cycles

A business, bank, institution or economy would not experience consistent growth there always exist ups and downs in an economy like in real life.



Definitions:

The business cycle is the natural rise and fall of economic growth that occurs over time. The cycle is a useful tool for analysing the economy. It can also help in making better financial decisions.

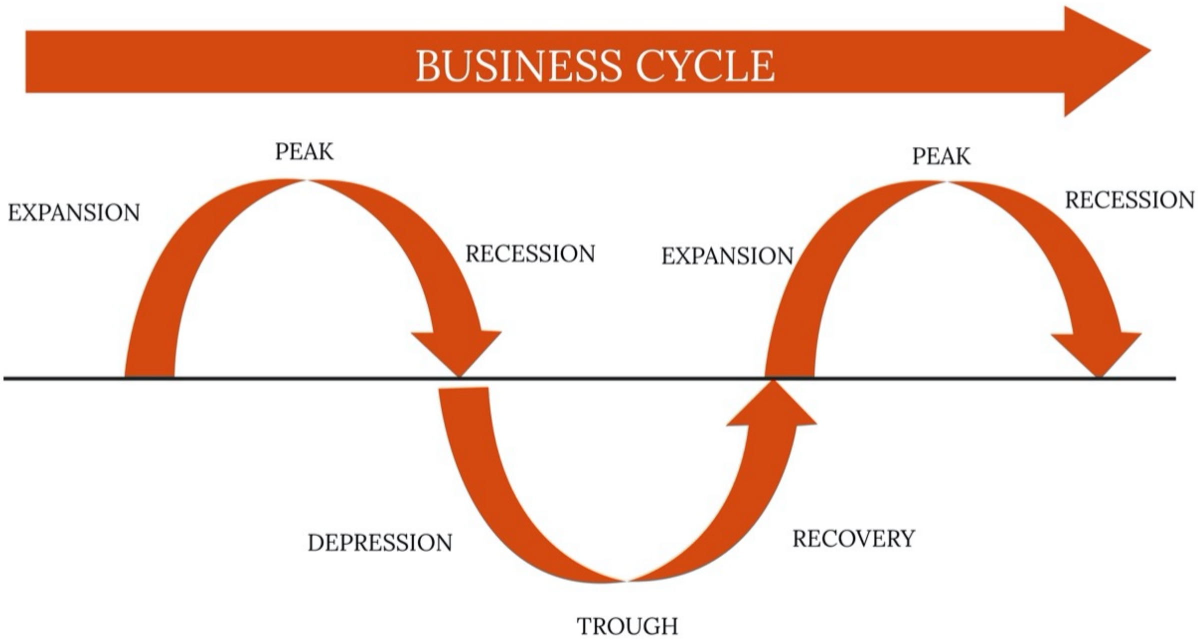


- The business cycle is the fluctuation in economic activity that an economy experiences over a period of time. A business cycle is basically defined in terms of periods of expansion or recession.
- The business cycle or economic cycle is the downward and upward movement of gross domestic product (GDP) around its long-term growth trend.

Features of Business cycles:

- During expansion, the economy is growing in real terms (i.e. excluding inflation), as evidenced by increase in indicators like employment, industrial production, sales and personal incomes.
- During recession, the economy is contracting, as measured by decrease in the above indicators.
- Expansion is measured from the trough (or bottom) of the previous business cycle to the peak of the current cycle, while recession is measured from the peak to the trough.
- The length of a business cycle is the period of time containing a single boom and contraction in sequence. These fluctuations typically involve shifts over time between periods of relatively rapid economic growth (expansions or booms), and periods of relative stagnation or decline (contractions or recessions).
- Business cycles are usually measured by considering the growth rate of real gross domestic product. Despite the often-applied term cycles, these fluctuations in economic activity do not exhibit uniform or predictable periodicity.
- The common or popular usage boom-and-bust cycle refers to fluctuations in which the expansion is rapid and the contraction severe.

Stages in a business cycle



As shown in the above figure, the steady growth line represents the growth of economy when there are no business cycles.
On the other hand, the line of cycle shows the business cycles that move up and down the steady growth line.

The different phases of a business cycle are explained below.

1. Expansion:

- The line of cycle that moves above the steady growth line represents the expansion phase of a business cycle.
- In the expansion phase, there is an increase in various economic factors, such as production, employment, output, wages, profits, demand and supply of products, and sales.
- In addition, in the expansion phase, the prices of factor of production and output increases simultaneously. In this phase, debtors are generally in good financial condition to repay their debts; therefore,

creditors lend money at higher interest rates. This leads to an increase in the flow of money.

- In expansion phase, due to increase in investment opportunities, idle funds of organisations or individuals are utilised for various investment purposes.
- Therefore, in such a case, the cash inflow and outflow of businesses are equal. This expansion continues till the economic conditions are favourable.

2. Peak:

- The growth in the expansion phase eventually slows down and reaches to its peak. This phase is known as peak phase. In other words, peak phase refers to the phase in which the increase in growth rate of business cycle achieves its maximum limit.
- In peak phase, the economic factors, such as production, profit, sales, and employment, are higher, but do not increase further. In peak phase, there is a gradual decrease in the demand of various products due to increase in the prices of input.
- The increase in the prices of input leads to an increase in the prices of final products, while the income of individuals remain constant. This also leads consumers to restructure their monthly budget. As a result, the demand for products, such as jewellery, homes, automobiles, refrigerators and other durables, start falling.

3. Recession:

- As discussed earlier, in peak phase, there is a gradual decrease in the demand of various products due to increase in the prices of input. When the decline in the demand of products becomes rapid and steady, the recession phase takes place.
- In recession phase, all the economic factors, such as production, prices, saving and investment, starts decreasing. Generally, producers

are unaware of decrease in the demand of products and they continue to produce goods and services. In such a case, the supply of products exceeds the demand.

- Over the time, producers realise the surplus of supply when the cost of manufacturing of a product is more than profit generated. This condition firstly experienced by few industries and slowly spread to all industries.
- This situation is firstly considered as a small fluctuation in the market, but as the problem exists for a longer duration, producers start noticing it. Consequently, producers avoid any type of further investment in factor of production, such as labour, machinery, and furniture. This leads to the reduction in the prices of factor, which results in the decline of demand of inputs as well as output.

4. Trough:

- During the trough phase, the economic activities of a country decline below the normal level. In this phase, the growth rate of an economy becomes negative. In addition, in trough phase, there is a rapid decline in national income and expenditure.
- In this phase, it becomes difficult for debtors to pay off their debts. As a result, the rate of interest decreases; therefore, banks do not prefer to lend money. Consequently, banks face the situation of increase in their cash balances.
- Apart from this, the level of economic output of a country becomes low and unemployment becomes high.
- In addition, in trough phase, investors do not invest in stock markets. In trough phase, many weak organisations leave industries or rather dissolve. At this point, an economy reaches to the lowest level of shrinking.

5. Recovery:

- As discussed above, in trough phase, an economy reaches to the lowest level of shrinking. This lowest level is the limit to which an economy shrinks. Once the economy touches the lowest level, it happens to be the end of negativism and beginning of positivism.
- This leads to reversal of the process of business cycle. As a result, individuals and organizations start developing a positive attitude toward the various economic factors, such as investment, employment, and production. This process of reversal starts from the labour market.
- Consequently, organisations discontinue laying off individuals and start hiring but in limited number. At this stage, wages provided by organisations to individuals is less as compared to their skills and abilities. This marks the beginning of the recovery phase.
- In recovery phase, consumers increase their rate of consumption, as they assume that there would be no further reduction in the prices of products.
- As a result, the demand for consumer products increases.
- In addition, in recovery phase, bankers start utilizing their accumulated cash balances by declining the lending rate and increasing investment in various securities and bonds.
- Similarly, adopting a positive approach, other private investors also start investing in the stock market. As a result, security prices increase and rate of interest decreases.

U Shaped Recovery:

A U-shaped recovery describes a type of economic recession and recovery that charts a U-shape, established when certain metrics such as employment, GDP, and industrial output sharply decline and then remain depressed typically over a period of 12 to 24 months before they bounce back again.

A U-shaped recession features a steep decline in economic output followed by a relatively longer trough than a V-shaped recession, followed by a longer recovery out of that trough. The downturn here is usually deeper and longer than that of a V-shaped recession.

V Shaped Recovery:

In a V-shaped recovery, an economy that has suffered a sharp economic decline experiences a fast and strong rebound. Such recoveries are generally spurred by a significant shift in economic activity caused by rapid readjustment of consumer demand and business investment spending. Because of the economy's rapid adjustment and quick recovery in the major metrics of macroeconomic performance, a V-shaped recovery can be thought of as a best-case scenario for an economy in recession.

How Is a U-Shaped Recession Different from a V-Shaped Recession?

Both a U- and V-shaped recession features a sharp decline followed by a somewhat symmetrical recovery. The main difference is in how long the economy remains depressed at its trough: a V-shape remains there for only a short period with a quick rebound; a U-shape may remain there for far longer before eventually recovering.

W Shaped Recovery:

A W-shaped recovery generally is characterized by a period of extreme volatility in comparison with other types of recoveries.

A W-shaped recession begins like a V-shaped recession, but then turns back down again after showing false signs of recovery. W-shaped recessions are also called "***double-dip recessions***" because the economy drops twice before the full recovery is achieved.

A W-shaped recession is painful because many investors who jump back into the markets after they believe the economy has found a bottom end up getting burned twice—once on the way down and then once again after the false recovery.

K Shaped Recovery:

The term "K-shaped" recovery gained prominence in 2020 and 2021 in the wake of the sharp recession in the U.S. that accompanied the COVID-19 pandemic, and was used to describe the uneven economic recovery across different sectors, industries, and groups of people in the economy.

Unlike other letter-shaped descriptors of economic recessions and recoveries (L-shaped, V-shaped, U-shaped, or W-shaped), which describe the path of economywide macroeconomic aggregate variables like gross domestic product (GDP) or total employment, a K-shaped recovery describes the path of different disaggregated economic variables, such as income across different segments of society or employment in different industries, relative to one another.

What makes a K-shaped recovery different is that while some parts of the economy may enjoy a booming recovery immediately following the recession, others may remain mired in sluggish growth or even continue to decline. The general shape of such divergent performance of different parts of the economy will resemble the arms of a letter "K" if charted together, with one rising and the other declining.

What exactly this means depends on how the aggregate macroeconomic data is broken out to suggest the K-shaped profile. It can mean that some industries quickly return to strong growth in output while others see declining activity, or that some types of asset values rise while others continue to fall, or that some segments of society see increasing wealth and income while others lose wealth and income. It can mean all three of these, or other possibilities.

Q) Match List I with List II and select the correct answer using the codes given below the lists:

List – I List-II

A. Boom 1. Business activity at high level with increasing income, output and employment at macro level

B. Recession 2. Gradual fall of income, output and employment with business activity in a low gear

C. Depression 3. Unprecedented level of under employment, and unemployment, drastic fall in income output and employment.

D. Recovery 4. Steady rise in the general level of prices, income, output and employment.

Codes:

(a) A-1 ; B-2 ; C-3 ; D-4

(b) A-1 ; B-2 ; C-4 ; D-3

(c) A-2 ; B-1 ; C-4 ; D-3

(d) A-2 ; B-1 ; C-3 ; D-4

Q) In the context of Indian economy, consider the following pairs:

Term Most Appropriate description

1. Melt down - Fall in stock prices
2. Recession - Fall in growth rate
3. Slow down - Fall in GDP

Which of the pairs given above is/are correctly matched?

(a) 1 only

(b) 2 and 3 only

(c) 1 and 3 only

(d) 1,2 and 3

Role of price mechanism in the business cycle

- Price mechanism plays a very important role in the recovery phase of economy. As discussed earlier, during recession the rate at which the price of factors of production falls is greater than the rate of reduction in the prices of final products. Therefore producers are always able to earn a certain amount of profit, which increases at trough stage.
- The increase in profit also continues in the recovery phase. Apart from this, in recovery phase, some of the depreciated capital goods are replaced by producers and some are maintained by them.
- As a result, investment and employment by organisations increases. As this process gains momentum an economy again enters into the phase of expansion. Thus, a business cycle gets completed.

While the business cycles are in progress, the central banks of the respective countries try to use particular methods and tools in order to keep the economy in check, be it sucking out too much of money from the economy or pump liquidity into the economy. This is nothing but the monetary policy.

Whenever there is economic growth, the wealth of the people of the country also increases. Due to increase in wealth, the spending increases. As the spending increases, the demand increases leading to increase in price causing inflation.

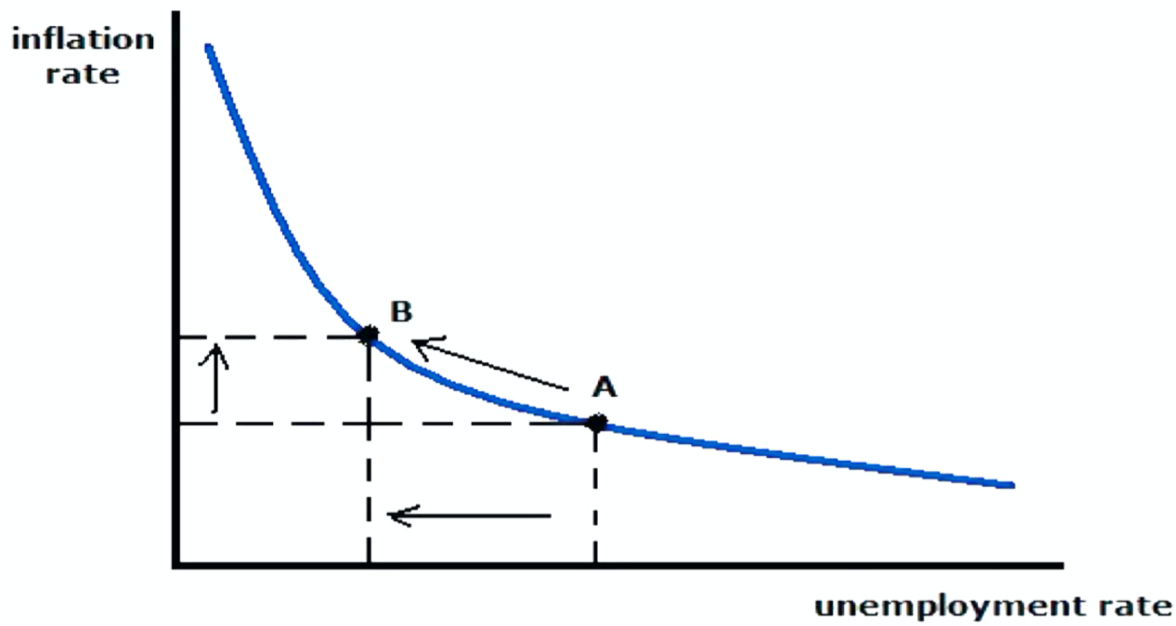
Two major problems the economy faces : Inflation and Unemployment.

- More growth leads to Inflation
- Less growth leads to Unemployment

More growth leads to Inflation: As an economy grows, businesses and consumers spend more money on goods and services. In the growth stage of an economic cycle i.e. Boom stage) demand typically outstrips the supply of goods, and producers can raise their prices. As a result, the rate of inflation increases. If economic growth accelerates very rapidly, demand grows even faster and producers raise prices continually.

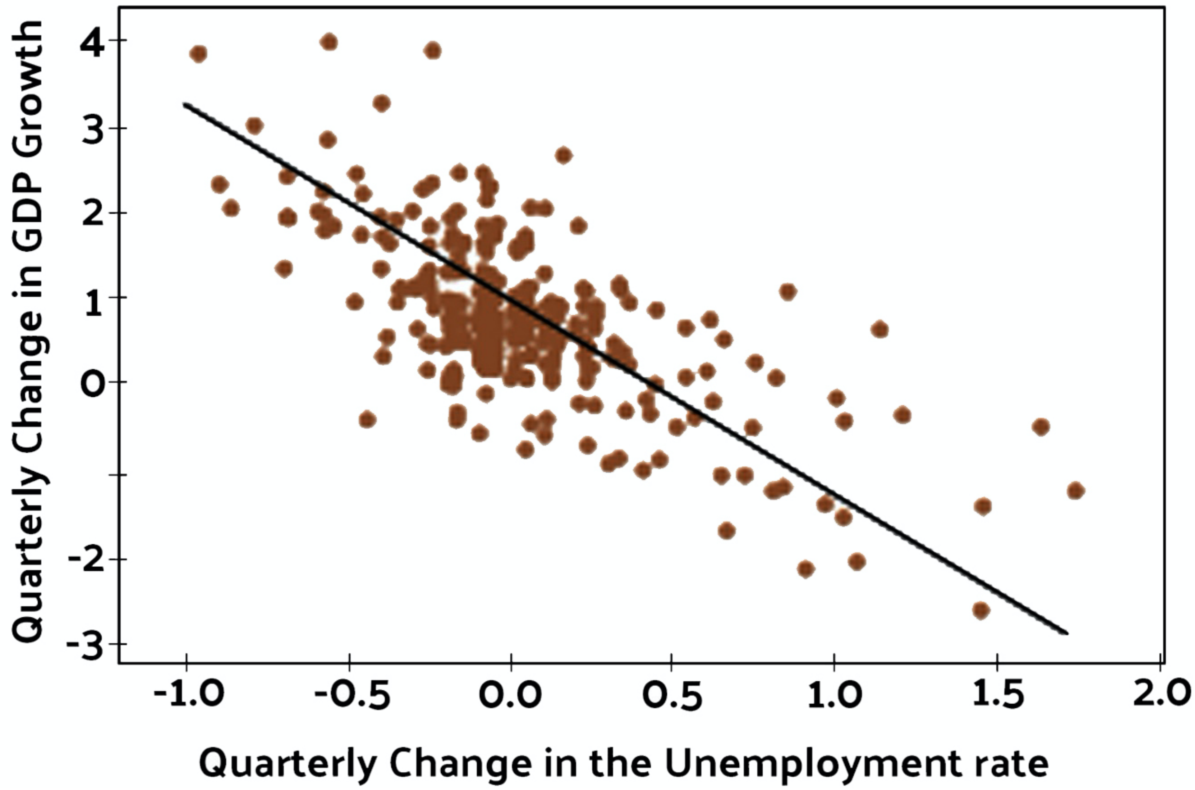
Philips Curve

The Philips curve is an economic concept developed by A.W.Philips stating that inflation & Unemployment have a stable and inverse relationship.



Okun's Law

Okun's Law pertains to the relationship between the economy's unemployment rate and its gross national product (GNP). It states that when unemployment falls by 1% GNP rises by 3%.



Less growth leads to Unemployment: Less or slow or negative growth (recession) will lead to rise in unemployment. In the growth stage of an economic cycle i.e., Bust stage) there is less demand for goods, firms will produce less and swill need fewer workers. In this period, some firms will go bankrupt making many people redundant. Firms will be reluctant to hire workers when there is uncertainty and negative growth.

At any given point of time i.e., Boom or Bust, the problem of inflation or unemployment or both will exist. To control this problem the government will adjust the monetary and fiscal policies.

Supply side and Demand side Economics:

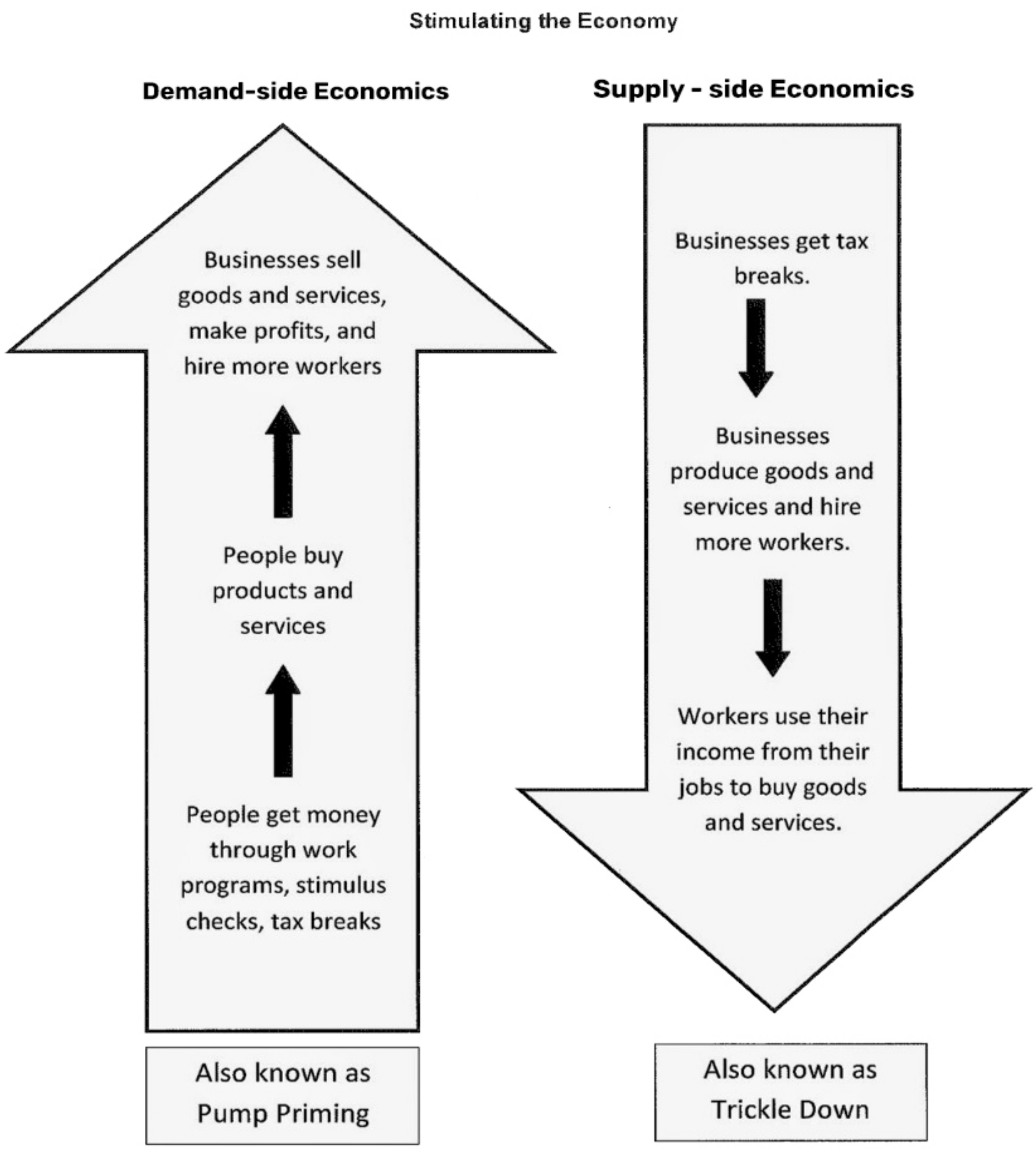
Supply and Demand are two of the most important concepts in economics, but which matters the most? This is a basic concept of economics which claims that the value of a commodity is determined by its availability (or supply) and how badly people want it (which we call demand).

- ***Supply-siders*** put supply at the heart of the economy. They focus on business investment.
- The idea is that the economy grows when the supply grows. You create more products, make those products more accessible to the consumers, and then they are more likely to invest in the economy. In this theory, supply essentially creates demand, so economic policies should be focused on improving the supply side of the economy.

"Supply Creates its Own Demand"

- This economic theory states economic growth is best encouraged through policies that lower barriers on production.

- ***Demand-side*** economics argues that economic growth increases most as a function of increasing demand for goods and services rather than increasing supply.(Demand-side economists argue that the best way to avert recessions and depressions is to stimulate demand by investing in large-scale infrastructure projects, such as building highways).
- Demand side economics is all about increasing demand of the consumer.
- The idea here is that the quickest way to spur demand is to increase the relative wealth of the people who want to make purchases.
- Two ways to increase demand are to create jobs and raise minimum wages. Tax rebates and tax cuts are two other ways to increase discretionary funds to drive consumer spending. One danger of too much consumer demand is inflation.



The supply-side economics lays greater emphasis on the point of view of:

(a) Producer

(b) Global economy.

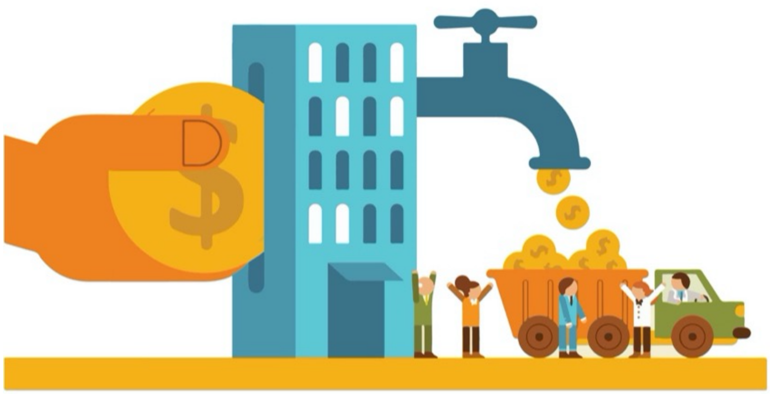
(c) Consumer

(d) Middleman

Monetary Policy

Did you know?

Fiscal derives from the Latin noun *monetarius*, meaning "money." of or relating to money or to the mechanisms by which it is supplied to and circulates in the economy.



The use by the Central Bank of interest rate and other instruments to influence money supply to achieve certain macro-economic goals is known as monetary policy. Credit policy is a part of monetary policy as it deals with how much and at what rate credit is advanced by the banks.

Objectives of monetary policy are:

- Accelerating growth of economy
- Price stability
- Exchange rate stabilization
- Balancing savings and investment
- Generating employment

Monetary policy can be expansionary or contractionary: Expansionary policy increases the total-supply of money in the economy as in 2008-09 all over the world including India to beat recession/slowdown; and a contractionary policy decreases the total money supply by tightening credit conditions (2010 onwards in India). Expansionary policy is traditionally used to combat unemployment in a recession by lowering interest rates, while contractionary policy has the goal of raising interest rates to control inflation.

Historically, Monetary Policy was announced twice a year – a slack season policy (April-September) and a busy season policy (October-March) in accordance with agricultural cycles.

Initially, the Reserve Bank of India announced all its monetary measures twice a year in the Monetary and Credit Policy. However, since monetary Policy has become dynamic in nature, RBI reserves its right to alter it from time to time, depending on the state of the economy.

Also, with the share of credit to agriculture coming down and credit towards the industry being granted whole year around, the RBI since 1998-99 has been making the policy in April. A review of the policy takes place every quarter. Within the quarter at any time, there can be changes-major and minor, depending on the need.

- So basically, when the central bank uses its tools to increase the money supply in the economy, it is called an expansionary monetary policy.
- When the central bank uses its tools to decrease the money supply in the economy, it is called a contractionary monetary policy.

Expansionary Monetary Policy

- Expansionary monetary policy is when a central bank uses its tools to stimulate the economy. That increases the money supply, lowers interest rates and increases aggregate demand. That boosts growth as measured by gross domestic product. It usually diminishes the value of the currency, thereby decreasing the exchange rate. It is the opposite of contractionary monetary policy.
- A policy by monetary authorities to expand money supply and boost economic activity, mainly by keeping interest rates low to encourage borrowing by companies, individuals and banks. An expansionary monetary policy can involve quantitative easing, whereby central banks purchase assets from banks. This has the effect of lowering yields on bonds and creating cheaper borrowing for banks. This, in turn, boosts banks' capacity to lend to individuals and businesses. An expansionary monetary policy also risks ramping up inflation.
- Expansionary monetary policy aims to increase aggregate demand and economic growth in the economy.
- Expansionary monetary policy could also be termed a 'loosening of monetary policy'. It is the opposite of 'tight' monetary policy.

Contractionary Monetary Policy

- A contractionary monetary policy is a macroeconomic strategy used by a central bank to decrease the supply of money in the market in an effort to control inflation. The money supply is controlled by adjusting interest rates, purchasing government securities on the open market, and adjusting government spending.
- A contractionary policy is used to decrease the money supply, by increasing interest rates to discourage borrowing and decreasing government spending to reduce the availability of money. This leads to higher interest rates, lower income, and a drop in demand, production, and employment.

- The government exercises a contractionary monetary policy only when it seeks to slow down inflation or depress an impending economic bubble. This forces banks to charge higher interest rates to anticipate the lower money supply, businesses contract their borrowing and cease expansion. This leads to higher unemployment and lower demand as consumer spending is depressed and the economy is tightened to the extent of recession.

Effects of Monetary Policy

Expansionary Monetary Policy

Problem : Recession and Unemployment
Measures: (1) Central Bank buys securities through open market operations
(2) It reduces Cash Reserve Ratio(CRR)
(3)It lowers Bank Rate

↓

Money supply increases

↓

Interest rate falls

↓

Investment increases

↓

Aggregate demand increases

↓

Aggregate output increases by a multiple of the increase in investment

Contractionary Monetary Policy

Problem: Inflation
Measures: (1) Central Bank sells securities through open market operations
(2) It raises Cash Reserve Ratio(CRR) and Statutory Liquidity Rtio(SLR)
(3) It raises Bank rate
(4) It raises maximum margin against holding of stocks of goods

↓

Money supply decreases

↓

Interest rate raises

↓

Investment expenditure declines

↓

Aggregate demand declines

↓

Price level falls

Observations:

- There is always a dilemma whether to pursue growth at the cost of inflation, or vice versa. It is not always easy to balance the two at the optimum level.
- Moreover, monetary policy many a times cannot be a solution for stabilizing the economy. For example, The great depression of October 1929.So, as a supplement, the fiscal policy is also used to stabilise the economy.

Let us look at a small example of the first observation

RBI Dilemma: Inflation Vs Growth

RBI often finds itself in a dilemma as it often faces the problem of trade-off between inflation and growth.

To control inflation tightening of monetary policy (that is, high interest rate and high cash reserve ratio (CRR) are required. But this tightening of monetary policy discourages investment and hurts economic growth. Therefore, when inflation is very high the RBI is prepared to sacrifice some growth to curb inflation.

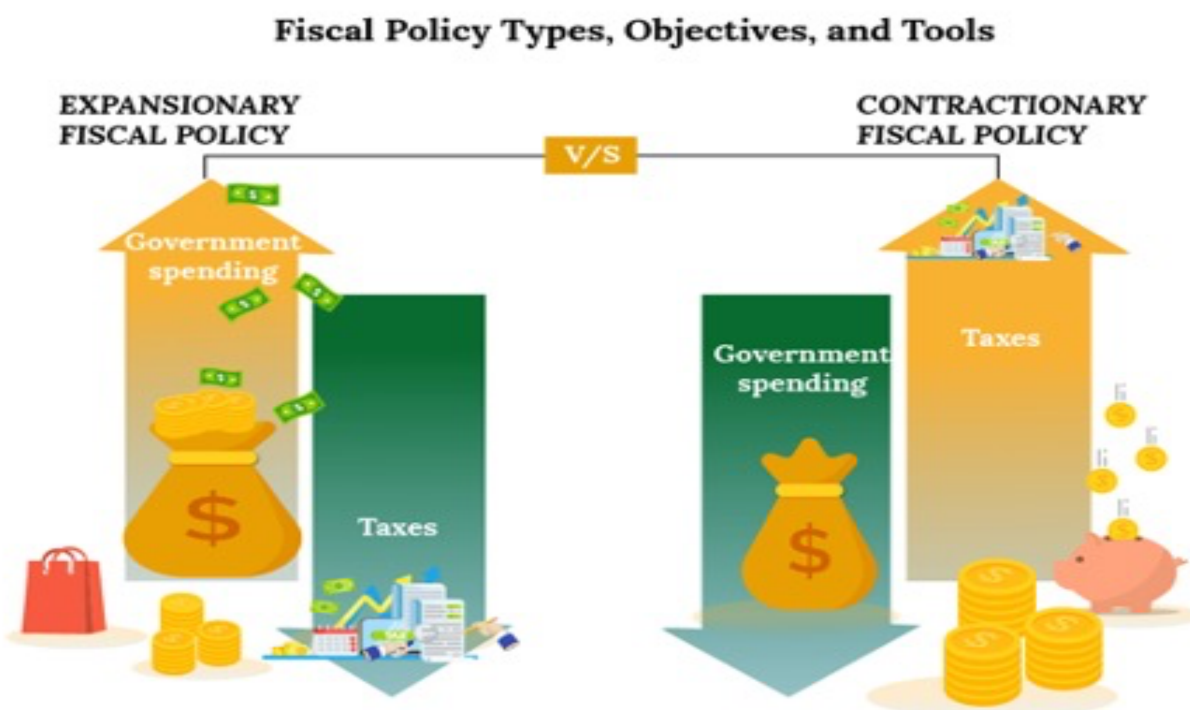
On the other hand, when to promote growth RBI follows expansionary or easy monetary policy, namely, lowering of interest rate and cash reserve ratio (CRR) it leads to increase in aggregate demand and causes inflationary pressures. Therefore, RBI has to adopt a monetary policy that balances its concerns for controlling inflation on the one hand and promoting growth on the other though in actual practice doing such balancing act is a difficult task.

We discuss below monetary policy adopted by the RBI since 2006-07. Over the last many years RBI has been changing its monetary policy stance depending on the prevailing economic situation and keeping in view its concern for controlling inflation and facilitating growth. Targets for growth of monetary policy and credit expansion are set, so as to achieve growth with price stability.

Fiscal Policy

Did you know?

Fiscal derives from the Latin noun *fiscus*, meaning "basket" or "treasury." In ancient Rome, *fiscus* was the term for the treasury controlled by the emperor, where the money was literally stored in baskets and was collected primarily in the form of revenue from the provinces.



- The fiscal policy is basically the revenue generating policy of the Government.
- The government finances expenditures on the basis of this fiscal policy. The two methods of financing are borrowing and taxation.
- That part of government policy which is concerned with raising revenue through taxation and with deciding on the amounts and purposes of government spending.
- The government's policy in regard to taxation and spending programs. The balance between these two areas determines the amount of money the government will withdraw from or feed into the economy, which can counter economic peaks and slumps.
- Government spending policies that influence macroeconomic conditions.
- These policies affect tax rates and government spending, in an effort to control the economy.
- Government policy for dealing with the budget, especially with taxation and borrowing.
- The policy of a government in controlling its own expenditures and taxation, which together make up the budget
- Fiscal policy is the means by which a government adjusts its levels of revenue and spending in order to monitor and influence a nation's economy.

Fiscal policy involves use of taxation and government spending to influence economy. In other words, fiscal policy relates to raising and spending money in quantitative and qualitative terms.

Fiscal policy deals not only with the quantity but the quality of public finance as well. In other words, not merely how much is raised and spent but how has it been raised? Is it raised by way of taxes or borrowings? Are they excessive or irrational etc? Also, the way the finances so raised are used – wastefully or productively. How much is spent on plan heads and how much populistically targeted etc also is studied.

Economic effects of fiscal policy

- The fiscal policy has the power to affect the level of overall demand in the economy. The primary objective of fiscal policy is to maintain the price stability, economic growth and employment of the country. Hence an appropriate fiscal policy can help in combating rising inflation rates.
- Fiscal policy determines government spending and tax rates. Expansionary fiscal policy, usually enacted in response to recessions or employment shocks, increases government spending in areas such as infrastructure, education, and unemployment benefits. According to Keynesian economics, these programs prevent a negative shift in aggregate demand by stabilizing employment among government employees and people involved with stimulated industries. Extended unemployment benefits help stabilize the consumption and investment of individuals who become unemployed during a recession.
- Contractionary fiscal policy can be utilised to reduce government spending and sovereign debt or to correct out-of-control growth fuelled by rapid inflation and asset bubbles.

Why is the fiscal policy given by the government and the monetary policy by the central bank?

	Fiscal Policy	Monetary Policy
Definition	Fiscal policy is the use of government expenditure and revenue collection to influence the economy.	Monetary policy is the process by which the monetary authority of a country controls the supply of money, often targeting a rate of interest to attain a set of objectives oriented towards the growth and stability of the economy.
Principle	Manipulating the level of aggregate demand in the economy to achieve economic objectives of price stability, full employment, and economic growth.	Manipulating the supply of money to influence outcomes like economic growth, inflation, exchange rates with other currencies and unemployment.
Policy-maker	Government (e.g. U.S. Congress, Treasury Secretary)	Central Bank (e.g. U.S Federal Reserve or European Central Bank)
Policy Tools	Taxes, amount of government spending	Interest rates, reserve requirements, currency peg; discount window, quantitative easing, open market operations, signalling.

- The goal of a central bank usually reflects the desire to control inflation, focus on price stability and promote a healthy economy.
- The central bank knowing the limitations of an unsustainable economic growth, may take a balanced path. However, the government may not always take this view.
- The independence of the central bank is vital to achieve the above said objectives.
- The government on the other hand may go for populist measures to show a high rate of economic growth, thereby high levels of employment, without too much focus or cognizance of its inflationary pressures, which could be detrimental in the long run.
- Therefore, the goals and jurisdictions of the government and central banks are more or less well defined, though we sometimes see spill overs and encroachments.

What's next?

We have by now understood that the economy is never constant. It keeps going up and down. Moreover, the actions of the government and the central banks are either the affect or effect of the economic changes. One important economic concept that we frequently come across in this regard, is the inflation. So let's study what inflation is all about.

Q) Do you agree that the Indian economy has recently experienced V-shaped recovery? Give reasons in support of your answer.