Macroeconomic Policy and Development
There are three different approaches to economics

• Keynesian approach, focusing on demand
• Neoclassical approach, based on rational expectations and efficient markets
• Innovation Economics, focused on long-run growth through innovation
Macroeconomic Policies

• Fiscal Policy
• Is the use of government expenditure and revenue collection to influence the economy.

• Two main instruments of fiscal policy
  • Government expenditure
  • Taxation
Changes in the level and composition of taxation and government spending can impact on the following variables in the economy:

- Aggregate demand and the level of economic activity
- The pattern of resources allocation; and
- The distribution of income
Objectives of Fiscal Policy

The main objectives of fiscal policy in the case of developed countries are:

• Full employment
• Economic stability
Objectives of Fiscal Policy Cont’d

The main objectives of fiscal policy in the case of developing countries are:

• Increasing rate of investment
• Encouraging a socially optimum pattern of investment
• Reducing inequalities in income and worth
• Reducing unemployment
• Controlling inflationary tendencies
Three stances of fiscal policy

• Neutral stance of fiscal policy implies a balanced budget where G=T (Government spending = Tax revenue). Government spending is fully funded by tax revenue and overall the budget outcome has a neutral effect on the level of economic activity.

• Expansionary fiscal policy involves a net increase in government spending (G>T) through rises in government spending, a fall in taxation revenue or a combination of the two. This will lead to a larger budget deficit or a small budget surplus than the government previous had.

• Expansionary fiscal policy is usually associated with a budget deficit.
Three stances of fiscal policy cont’d

• Contractionary fiscal policy (G<T) occurs when net government is reduced either through higher taxation revenue, reduced government spending or a combination of the two.

• This will lead to a lower budget deficit or larger surplus.

• Contractionary fiscal policy is usually associated with a surplus.
Effectiveness of Fiscal policy

• Governments use fiscal policy to influence the level of AD in the economy
• The main objectives of fiscal policy are price stability, full employment and economic growth
• Keynesian economists believe that fiscal policy is the best way to stimulate AD
• Fiscal policy can be used in times of recessions to drive the economy towards full employment
Effectiveness of Fiscal policy Cont’d

• However, classical economist argue that fiscal policy is not effective

• Classical economists argue that when governments runs a budget deficit, the funds comes from three sources
  - public borrowing or issuing of bonds
  - Foreign borrowing
  - printing of money
Issuing of Bonds

• When governments fund a deficit by issuing bonds, interest rates can increase

• The increase in interest rate is due to a higher demand for credit in the financial markets created by government borrowing

• The high interest rate will reduce investment, causing a lower AD

• This is called crowding out
Crowding-Out Effect
Expansionary Fiscal Policy $\Delta G'$

**Graph:**
- IS1 and IS2 lines intersect at Y1, with a shift to IS2 at Y2.
- LM line intersects IS2 at Y2, showing an increase in income (Y).
- The diagram illustrates the effect of expansionary fiscal policy on output and interest rates.
Crowding-Out Effect
Expansionary Fiscal Policy $\Delta G'$

- When government expenditure increases, $G' \uparrow$, IS curve will shift outward by $\Delta G'$.
- If interest rate remains constant, when $Y \uparrow$, there will be excess money demand, as transactions demand for money has increased.
- In order to restore equilibrium in the money market $Ms' = Mt$
- Interest rate has to increase
Fiscal policy and exports

- High interest rates caused by government borrowing attracts foreign capital from foreign investors
- Foreign investors purchase domestic bonds, which increases the demand for the domestic currency
- The increased demand for domestic currency leads to the appreciation of the domestic currency
- This reduces the exports and increases the imports of the domestic economy, further lowering AD, contrary to the objective of fiscal policy
Other effects of fiscal policy

• Expansionary fiscal policy may lead to high inflation due to the increased aggregate demand. High inflation may also be due to the financing of a budget deficit through the printing of money.

• Other problems associated with expansionary fiscal policy include the time lag between the implementation of fiscal policy and detectable effects in the economy.

• In summary, classical economists argue that fiscal policy is not an effective economic tool.
Monetary Policy

• Monetary policy is the process used by a monetary authority (government or central bank) to control the supply, availability and the cost of money in the economy.

• Monetary policy can either be expansionary or contractionary.

• Expansionary increases whilst contractionary monetary policy reduces the quantity of money in the economy.
Objectives of Monetary policy

• Price stability
• High economic growth
• Healthy balance of payments
• Influencing the level of credit in the banking system, and
Monetary Policy Tools

• Monetary policy tools are designed to influence the level of liquidity in the financial system. These are classified as direct and indirect instruments.
Indirect policy tool
Open Market Operations (OMO)

• OMO describe the purchase and sale of financial instruments.
• The financial instruments used in the conduct of OMO are GoN securities such as Treasury bills which can be bought and sold outright.
• When the Central Bank wants to reduce the level of money supply in the economy it sells Treasury bills.
Open Market Operations (OMO)

• When the Central Bank wants to increase the level of money supply in the economy it buys the Treasury bills from the public.

• The transaction involves the Central Bank paying money for the Treasury bills it is purchasing from the public and the public handing over the Treasury bill certificates to the Central Bank.
Discount/Repo/ Bank Rate

• This is the rate at which the commercial banks and building societies borrow from the Central Bank.
• The Central Bank can use bank rate to indirectly influence the level of money supply in the economy. For example, if it wants to reduce the level of money supply in the economy it can increase the bank rate.
• This will make commercial banks and building societies borrow less or even stop borrowing altogether, because the cost of money has gone up. On the other hand, if the Central Bank wants to increase the level of money supply in the economy it can reduce the bank rate and hence make the cost of borrowing cheaper.
Moral suasion

• A persuasion tactic used by an authority (i.e. Federal Reserve Board) to influence and pressure, but not force, banks into adhering to policy.

• Tactics used are closed-door meetings with bank directors, increased severity of inspections, appeals to community spirit, or vague threats. A good example of moral suasion is when the Fed Chairman speaks on the markets - his opinion on the overall economy can send financial markets falling or flying.
Direct policy tool
Discount Window Lending

• Monetary authorities can lend funds to financial institutions
• This can be achieved through the extending new loans or calling in existing loans
• The central bank charges a discount rate to the borrowers
Reserve requirements

• Reserve requirements are the portion of deposit liabilities that deposit-taking institutions have to keep on hand or hold at the Bank of Namibia. If the Central Bank wants to increase the level of money supply in the economy it can reduce the reserve requirements.

• On the other hand, if it wants to reduce the credit-creating ability of the banks and building societies and hence money supply, it can increase the reserve requirements.