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Economic policymaking: Combinations and outcomes

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Abstract
This paper tries to tackles a fascinating issue called 'Monetary Policy'. Few interesting debates are prevalent on the issue. Monetary policy is one of the main tools that governments can use to influence the economy. Monetary authorities work through the money supply and can use open market operations, their own lending rates and reserve or cash ratios to influence money markets and hence the real economy. Just as with fiscal policy, once the gap in the economy is identified, expansive monetary policy should be used in a recessionary gap and restrictive monetary policy in an inflationary gap. Monetary policy is superior to fiscal policy in many ways, but its greatest weakness is that it does not work nearly as well in recessionary gaps as in inflationary gaps.

Keywords: Monetary policy, fiscal policy

Introduction
The world is surrounded by news and commentary on the macro economy. To understand it, we need to grasp the meaning of GDP, inflation and unemployment and see what their "Normal" levels of meaning are and how they relate to one another. Though these levels and relationships are far from mechanical, they provide an essential foundation to understanding what governments are doing in a macro economy.
It is necessary to deal with fiscal policy, because it is one of the key tools that authorities have to influence the economy and bring GDP closer to its ideal growth rate. It consists of changes in government spending and taxes. To try to gauge how much spending and taxes need to change to bring GDP to potential. Two important concepts can be listed: the multiplier, and crowding out. However, spending and tax revenues also move automatically across the business cycle, helping make the economy more stable.
Fiscal policy is supposed to work in the economy, to close recessionary or inflationary gaps. It is evident to understand deficits and debts in the real world. How is it really used? What are government deficits and debts? When governments run deficits and need to borrow money, how and where do they do it? When are these deficits and debts more of a problem? Clear up some common misconceptions, and point to what the most important concerns are with deficits and debts at the present time.

The Need of the study
This paper will provide the tools to develop reader's own position in many current economic debates, such as fiscal stimulus vs. austerity, the merits of quantitative easing, the need for higher interest rates or the future growth path of many modern economies.

Objectives
The paper will inspire readers to examine fiscal and monetary policy and their appropriateness to the situation of an economy, and anticipate the results of fiscal and monetary policies and structural- reform on a country.
Should countries continue pursuing growth rates as a policy objective?

Hypothesis
Countries must start looking beyond growth as a measure of their economic health. In ·order to sustain their economic supremacy they must re-evaluate their choices based upon available resources.

Research Methodology

This paper will employ a non-technical approach to analyze how governments use policy to influence a country's economy. It explores the tools of economic policy making like fiscal policy and monetary policy.

Data Collection and Analysis

The financial crisis, it was it kind of started snowballing; the first event is in 2007. 2008 is when things really go very wrong. So, you can see the Fed began to cut interest rates very, very quickly. And, it went down, all the way down to 0.25 and it was there by 2009. And then it stayed there. Well, there's a clear reason why it stayed there, because you can't go below zero. You can take your interest rates to zero, but you can't have them be negative, right? So the Fed took interest rates down as far as it could at the moment of the crisis, but it couldn't go any further.

Now, the ECB. It came down slower with interest rates. It got a little concerned about inflation at the end of 2011, brought them up, but it also is almost all the way down. The crisis continues in Europe. So, what do you do if you can't take interest rates down any further, and you continue to be in a recessionary gap?

Let's look at another example. In Japan, their crisis was in, started in the 90s. They had a domestic banking crisis that was followed by the Southeast Asian financial crisis. Then, they sort of started to recover. And then, the global financial crisis came. So, here we've got some different interest rates. But, their rates went down to zero very quickly and stayed there. The nominal call rate or the nominal discount rate went all the way down to zero. Now, the real rates, the ones that go negative, are subtracting inflation from those nominal rates. But, normally, a central bank would not set a negative interest rate. So, you can see, they went down to zero. They came up just a little bit in the period the early 2000s, when things were looking a little better for Japan. They went down again and stayed at zero after that.

So, when you've gone to zero, you've gone about as far as you can go. You can't go any further. What then does a central bank do if it still needs to stimulate the economy, as in the case of Japan, which has been in a very long recessionary gap? Or, the case of the United States or the ECB or the Bank of England where rates were as low as they could go, and the economy still needed an expansive policy. Well, the, one of the solutions that authorities have devised in this period of the financial crisis, is something that we call quantitative easing.

Quantitative easing simply means, if we think of that transmission mechanism for monetary policy. We start by increasing the money supply for an expansive monetary policy. This is the only thing central bank can actually do. This should cause the interest rates to go down. That then should cause investment to go up. Which then would cause aggregate demand and, hence, GDP to go up. That would be our cause effect chain, our transmission mechanism, for monetary policy.

But what happens if the central bank is increasing the money supply as it knows it should and interest rates won't go down? Or, what if, as we just observed, it's increasing the monetary, the money supplies, it knows it should. Interest rates have gone down, but they've gone as far as they can go. And, we're still not seeing more investment and therefore more aggregate demand in GDP. We know how sometimes this transmission mechanism breaks down. And you can't get your money supply policy over here into the real economy, more aggregate demand, more GDP. Well, one of the thing that central banks have started to do, and this was started by Japan in their long crisis, was to say, okay maybe the reason that this money is not getting over there to the real economy is the financial crisis itself. Banks are afraid, they're lacking liquidity, they look at their balance sheets, they don't like the way they look. And so, whenever the central bank provides liquidity to them through open market operations, they take the money and they just hold onto it. They keep it in their reserves, because they're worried about the future. So, what central banks, beginning with the Bank of Japan, said was, alright, if they need money to feel comfortable. In order for the transmission mechanism to work, lend the money, somebody spends it, we go to GDP, let's just create a lot of money until banks finally have enough reserves, enough cash that they feel comfortable beginning to lend again. So, that is what quantitative easing is. It's where the central bank carries out very aggressive open market operations. Selling many or buying many more bonds than usual, and paying for them with much more cash than usual. So, that the cash gets into the commercial banks, and they begin to have enough liquidity that they can eventually start to lend money.

Testing Hypothesis

It's always discussed that trying to get growth towards potential, that's any country's objective. So, the idea is not grow as much as you can, but of course we're looking for growth. Whether that's a reasonable objective, is it reasonable in today's world to be constantly pursuing growth? And we know that that's something that politicians like that helps them to win elections. It is a fact that's something that corporations like, that's a sign of success. It is known that it's something we personally like. It can be seen that our incomes go up in times of growth, or it is found that it is easier to get a job; however it's worth us asking ourselves whether for the world, as a whole, that's a reasonable objective.

Of course, there are countries that need to move out of poverty, and for those countries growth is necessary. For the rest of the world, what about growth? Do we want to continue pursuing growth the way we have in the past? Or maybe a better way of framing the question, should we continue to pursue growth the way we have in the past, and can we even pursue growth the way we have for so many years? If we compare growth rates in the past with the growth rates of the 20th century, the rates were completely off the charts. There's nothing in human history, at least in history that we have recorded and that we're aware of to compare with the growth rates in GDP in nominal terms, in real terms, and in per capita terms that we observed in the 20th century. Countries like Japan, Spain and China grew very fast for a relatively long period of time.

So, it's worth asking ourselves whether we should continue pursuing these kinds of growth rates as a policy objective. Now, you'll see that many countries are not able to grow the way they used to. You look at the figures in this chart, and you see a group of countries, a group of developed countries, and you look at their growth rates all the way back from the 6os. And look at the trend. Look at how they are all converging to a much lower level. We know that growth is needed to bring people out of poverty. Growth in developed countries would sure make it a lot easier to continue keeping our social programs financed, to continue paying pensions in an aging society, but we should be careful not to shoot too high. In fact, if we look at some of the policies, specifically at quantitative easing, where now four major groups of countries, or what we call the G4, have all done quantitative easing in an effort to get growth started with new measures, because the old ones weren't working anymore. And in some cases, we've seen results, but if we look at Japan, we have to wonder whether quantitative easing has done something and what will be the result of so much monetary expansion?

If we look at fiscal policy, we also see that world debt is higher than it ever was. We passed the 100 trillion marks early in 2015. How much more could we expand fiscal policy with debt levels that high? And what do we do to get out of them? What does Japan do to get out of a debt that is above 240% of GDP? What does Greece do to get out of its very high debt? And obviously, when debt levels are this high, we have to ask ourselves whether we can continue to use fiscal policy to stimulate the economy. So, going forward, I think we're going to have to find a new paradigm. I'm not sure what it is, just a few things to keep in mind. We do have a lot of research showing that more income does not necessarily make people happier past a certain point. So, the question that we need to ask ourselves is, are we barking up the wrong tree? We know growth is good for some things. It's certainly popular. But maybe this blind pursuit of growth, whatever the cost, is something we have to rethink and approach differently in the future. So it's an underlying question. It's a deep question. I hope you'll keep it in mind as we move into a world of more scarce resources, of a very high population, where growth is getting more and more difficult to achieve.

Finding and Interpretation

What's good, and what’s bad about fiscal policy? To compare it with the other options, the first thing we can see is that fiscal policy is really fast. Imagine that the Government decides it's going to build a highway. Once it decides that and the hard part is getting it to decide and getting it to pass the law that can be a long time. But once a government makes a decision, it goes out it starts paying workers, it starts paying for material, it starts paying fuel costs. And this goes straight into aggregate demand and straight into GDP. So this is a great strength of fiscal policy compared to other things. However, a weakness is that the people who are carrying out fiscal policy are not economists; they're not technical experts, most of them. And they also have another agenda. In other words, when we look at some of the other policies like monetary policy, we'll see the people who are making the decisions, are usually PhD economists, working with big models. Very well informed of the latest developments and that's all they think about is stabilizing the economy. But the politicians, who approve our budgets and our taxes, are thinking of all kinds of things, everything but the economy, sometimes. So, and they may not understand exactly what's going on.

Sometimes a problem we have with fiscal policy is simply that it gets misused in many ways. It gets used to win elections; it gets used in response to misinformation or hysteria. And so this is probably the greatest weakness of fiscal policy is that it's not implemented by independent economic experts. Sometimes, this effect is so important that we talk about fiscal policy actually generating a political business cycle. So the politicians just after the elections will have the courage to say, okay, we really need to get this deficit down, get this debt down. Let's cut spending. Let's raise taxes. They can do that because they're not facing elections right away, right. But a little bit of time passes, the last couple years before the elections, they might say, okay, people will vote for us. If we increase spending on their programs and cut their taxes, this would generate a deficit, maybe at the wrong time. Stimulate growth in the economy. And cause the economy to kind of move a bit in response to political, changes, rather than what it really needs.

Another important consideration here is as we said before; fiscal policy is fast once you've decided what to do. But the time span between when the problem occurs and when you actually decide what to do about is extremely long. Think about what the United States going through in recent months. With the debate over the debt ceiling, over mandatory spending cuts and, and mandatory tax increases. It's taken a long time for government to make up their mind what to do and they still haven't finished deciding in many ways. How to tackle the debt in the long run? How to -get rid of the structural deficit? So, decision-making is not very efficient in many of the institutions that carry out fiscal policy. And this means that sometimes, by the time they make up their mind, the fiscal policy might be inappropriate. It might take them so long to decide, for example, to increase government spending. That by the time they decide, the economy is in an inflationary gap and it will be the wrong policy. Some economists think that all of these different factors are so important. That really fiscal policies a destabilizer and we should take it out, right? I don't think that's likely to happen anytime in the future. But it's true, that fiscal policy is carried out by very, very politically influenced institutions. And this is probably its greatest weakness and the reason why we have so many structural deficits and rising debt over time.

What's good and what's bad about monetary policy? Well, the biggest problem you can see if you think through that chain of events, where here's the money supply. It influences the interest rate that influences aggregate demand, and that determines GDP. If you think through this, we may call transmission mechanism. Sometimes monetary policy is not very effective. Let's imagine a situation where the Central Bank wanted to raise GDP because the economy is in a big recessionary gap. Only thing it can do is to increase the money supply, but let's imagine that when they increased the money supply, that maybe the interest rate falls. Okay, that would be step two in our transmission mechanism. But let's imagine that people in the economy actually don't really want to borrow money because the recession looks pretty deep, they don't know when we're going to come out. Or imagine that commercial banks don't really want to lend money. Because they're not sure that their loans are good in the first place. And they don't want to lend to more they won't, they don't want to create more bad loans. So, you can see that monetary policy would break down, wouldn't it? You would increase the money supply, you can do that, and you’re a central bank. Maybe even the interest rate would fall. But maybe that lower interest rate would not make its way through the rest of the transmission mechanism and effect GDP. This happens often. They are doing all they can do it's not raising GDP.

What else can they do? And here's where you could hear a term that you read all the time in the press which is quantitative easing. So we'll go through that will see how that works, but quantitative easing is a response. To one of the weaknesses of monetary policy, which is that sometimes, we can't - in a recessionary gap - we can't get the change in the money supply to actually affect the economy. So, that’s a weakness, and we could say in general that monetary policy work pretty well in inflationary gaps. But it works les well in recessionary gap because of this problem.

What Ben Bernanke, used to like to say is you can’t push on a string. When you pull the string toward you as you do in an inflationary gap trying to reduce the level of GDP that works, banks respond right? But when you are trying to push the string in the situation where the economy's in a recessionary gap, and you as a central bank are trying to raise GDP, sometimes the string just wrinkles up, and you never get to your objective.

Other weakness in monetary policy is it takes quite a long time to affect the economy. So remember when we talked about fiscal policy, we said it takes a really long time for parliaments and, and congresses sometimes to decide what to do. But once they decide what to do, if they increase government spending or decrease government spending that immediately affects the economy. With monetary policy, the situation's a little bit the opposite. It doesn't take them long to decide what to do because they're not elected officials, they meet together frequently and they say, "Wow, we've got a recessionary gap coming in a few months we need to respond in time." So they decide what to do. That's fast. But then, when they change the interest rate, it may take quite a while before it feeds its way through to fresh investment and fresh GDP growth. So, the lag between the time they decide what to do, and the time it actually affects the economy can be quite long, maybe 12 months or 18 months. It takes quite a while. So this is another weakness of monetary policy.

The great strength of monetary policy is, that the people who are deciding what to do for the economy are not elected officials. They are actually trained economists with a lot of technical skill. Many of them are PHD economists. Many of them are the best PHD economists, because the jobs in central banks are very prestigious, and therefore we have people who are really specialists who don't have a political agenda. Because they don't have to worry about what party is in power and who's winning elections. And all they think about is where is potential GDP, and how can we bring the economy there? This is their one objective. So, this is the great strength of monetary policy. And when central banks are truly independent, this is a great asset to them because they really concentrate on stabilizing the economy and getting it where it should go. If one thing doesn't work, they'll try something else. And this is their one objective, and their one reason to be working whether they are.

Implications

Well, what quantitative easing has looked like in different countries after Japan was winding down its quantitative easing. The central bank, how much does it hold on its balance sheet of bonds, and other things but, mainly it's the bonds. If the central bank is buying a lot of bonds from the banking system and paying for them with lots of cash to try to give liquidity, then the balance sheet growing. And, so in regards to the Japanese balance sheet, the central bank assets were 30% of Japanese GDP. That's higher than any other country and then, the kind of wound down their quantitative easing.

But the United States and the U.K both of them down there at about 7% of GDP. That would be how much all the reserves of the central bank were, bonds and the other things that they hold. Now, in 2008, suddenly that number jumps dramatically for both of those countries. In the U.S., it goes up to about 15% of GDP. In the U.K., it goes up above 20% of GDP. What's going on is both of these countries are doing quantitative easing. They're buying lots and lots of bonds from commercial banks. Giving cash to them, trying to get this transmission mechanism to work, and that additional cash to work its way through into the real economy and, at the same time their balance sheet growing with these additional bonds that they've bought. And, both of them have stayed up at there, those high levels. There hasn't been any winding down of quantitative easing, as there was in Japan.

Now, one of the things you see in the newspapers all the time, is news about whether the Fed is going to taper. The term they use is taper its quantitative easing program. Currently, the Fed is buying $85 billion in bonds every month from commercial banks. That's a lot of bonds. And, we know that in open market operations, you buy bonds from commercial banks. You put cash into the economy if you want to shift the money supply out to the right. But, $85 billion is much more than the Fed has ever bought from banks on a regular basis before. The Fed has said that it is going to continue doing this until the unemployment rate is at a reasonable level in the United States. The new Fed chairman says she will continue with this program. Markets are always watching for some sign that the fade will taper quantitative easing. When that happens, a lot of things could happen in financial markets. There could be an effect on stock markets. There have been a lot of discussions about what is this actually does.

What’s clear is that quantitative easing has been a great benefit to governments. When the Fed is buying huge amounts of bonds in secondary markets through commercial banks actually the interest rate is dropping. And so, when that low interest rate reaches the government in a new option, it pays very little to finance its borrowing. So, this is great for governments. It saved lots of money. It's maybe not so great for financial institutions, for pension funds, specifically, or insurance funds, which put money in bonds to get a return, and they're not getting much of a return. It's a mixed bag for households because households save some money. They're getting not very good returns on their savings. They also borrow some money. They're borrowing at low rates. So, it's been a kind of a mixed bag for households. It's been negative for other countries because U.S. bonds are attracting so much money and paying so very little returns that foreign investors that hold bonds are, are not benefiting very much from those investments.

So, quantitative easing is one of the big topics that is discussed in the present time, it is important to understand why it was done. It was done because the transmission mechanism had broken down. Interest rates could no longer go any lower. And, monetary authorities are trying to find a way to exercise what tools they have and influence the real economy and bring people out of recessionary gap.

Conclusions & Suggestions

Comparing monetary policy with fiscal policy, we can say that there are a lot of strengths for monetary policy and in many ways as we look at the reality of policy making. We see that sometimes monetary policy is the winner in effectiveness. Sometimes however being subject to human error, and, and to mistake in forecast they've made big mistakes in the past.

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