Monetary and fiscal policy related to the recessionary gap essay

Literature, Russian Literature

Monetary and fiscal policy related to the recessionary gap. Economy of any country at a certain point can be in three possible states: equilibrium (full employment), inflationary gap, and recessionary gap.

The realities of the modern economy have shown that the state of equilibrium is very difficult to achieve, and therefore the government needs to look for tools to minimize inflationary or recessionary gaps. Recessionary gap appears in the situation when aggregate expenditures of the nation are not sufficient to consumer the volume of the GDP which is being produced during the year. The graph of recessionary gap is displayed in appendix 1. As the graph shows, potential GDP is going to equal 530 billion dollars. In case of equilibrium, the whole volume of goods and services produced will be purchased in the economy by consumers, government or as the result of exporting goods. As long as the expenditures in the economy reach the level of AE0 (530 billion dollars), there is no lag between production and consumption.

This state of the economy is the most favorable for the country. However, this reality cannot always be reached in the economy, as the graph shows. In the situation when total expenditures AE1 are lower than the volume of GDP (510 billion dollars), total expenditures of the economy appear to be not sufficient to reach the equilibrium. The volume of goods which is equal to 20 billion dollars therefore cannot be purchased, which leads to unemployment in the country. Both monetary and fiscal policy represent important instruments which are usually used by governments in order to decrease recessionary gap and bring economy to the equilibrium. In contrast with inflationary gap which can be reduced with the help of automatic regulators, recessionary gap requires government intervention. Recessionary gap appears in the situation when there is a downturn in the economy, and market alone is not able to stabilize the economy. However, well-balanced government intervention can be very efficient as long as it targets aggregate expenditures wisely.

“ Monetary policy can be used for two different purposes; in the long run it is required to deliver price stability, in the shorter run it is asked to help stabilize output over the business cycle.” (Wyplosz, 2005, p. 64). During recession, governments use policy of monetary expansion in order to increase aggregate expenditures in the country. The major monetary instruments which are being used by governments in order to decrease recessionary gap include:§ Purchase of government securities in the open market;§ Decrease of required levels of commercial banks’ reserves;§ Decrease of interest rates which Federal Reserve charges commercial banks. All of the mentioned tools are equally efficient in the situation when government needs to decrease recessionary gap. By purchasing government securities in the open market, the government increases money supply which is currently in possession of commercials banks.

As the result, they are able to lend more money to consumers at lower interest rates. By decreasing the level of commercial banks’ reserves, the government is able to achieve the same goal. Banks are able to take advantage of additional cash resources, and thus the cost of borrowing decreases. Decrease of interest rates which Federal Reserve charges commercial banks is also very efficient in the situation of recessionary gap. By enabling commercial banks to borrow more money at lower interest rates, government thus increases the banks' lending potential and decreases the cost of resources which companies or ordinary citizens are going to borrow. All of the mentioned monetary tools can be very efficient, as long as they are applied in a timely manner. The supply of money in the economy increases, and total expenditures reach the level which is sufficient to purchase the volume of goods and services which has been produced during the period.

Policy of monetary expansion increases the amount of money in the hands of citizens, so that they can spend more money on goods and services, and contribute to the aggregate expenditures of the nation. Companies get a chance to borrow more financial resources at a lower interest rate; they can therefore invest into new buildings or new technologies. Companies can also increase their exports of goods and services as the result of obtaining additional funds at a lower rate, and thus increase aggregate expenditures in the economy.

All of the mentioned factors contribute to the increase in the level of AE1, and cause its shift to the position of AE0. Even though monetary tools are considered very efficient for the economy by a large number of experts, fiscal tools are favored by others. The major fiscal tools which the government can use in order to decrease recession gap include:§ Increase in government purchases;§   Decrease in the level of taxation. The results of fiscal tools application are in many ways similar to the results of monetary tools application. Whenever the government increases its purchases, aggregate expenditures in the economy increase, and the AE1 line shifts to the position of AE0. The government can increase all kinds of spending in order to achieve this effect, for example, spending on education, research, or on purchases of various goods and services from the citizens. All of the recipients of the government funds benefit from them and their own spending increases after receiving the funds. Decrease in the level of taxation can also have a very positive effect on the economy and the levels of spending.

Those consumers who did not have enough money in their disposal as the result of high taxes are able to purchase those goods and services which they have long been planning to purchase. Companies also greatly benefit from lower levels of taxation because their operational income increases, and they can spend more money on new equipment, as well as hire more employees. The cost of companies' goods and services can also decrease as the result of the decrease of the level of taxation, and thus more consumers are able to purchase them. Both of the described fiscal tools have a multiplicative effect on the economy. The government can expect that a decrease of taxes to a certain level will cause a large increase in spending, which is equal to the volume of decrease multiplied by a certain number, which is known as a multiplier. Increase of government spending is also going to have a much more extensive effect on the economy, than the volume of spending itself, due to government spending multiplier.

Multiplier effect can be explained by the fact that both increase in government spending and decrease in taxation level trigger other processes in the economy, and they contribute to the overall effect of the tools which are being used. In the graph represented in appendix 1, the government would not need to increase spending exactly by 20 billion of dollars, even though that is the exact volume of recessionary gap. Depending on the multiplier which is applicable in this case, the government could increase spending by 4 billion dollars (if the budget multiplier equals 5), or by 5 billion dollars (in case if budget multiplier is 4). In both of these cases, increase of government would be sufficient to decrease recessionary gap. The government could also decrease taxes in such a way that the total decrease in taxation would equal 4 billion dollars (if the tax multiplier equals 5), or by 5 billion dollars (in case if tax multiplier is 4). However, it is necessary to mark due to the effect of the multiplier, government fiscal policy needs to be well-balanced. For example, in order to fight recessionary gap, the government can both increase government spending and increase taxes.

The effect of government spending would still be large enough despite a slight increase in taxes, because taxes multiplier is 1 unit lower than budget multiplier. At the same time, it would not be wise to increase government spending together with decrease in taxes. Decrease in taxes would be translated in lower amounts of taxes received by the government, which is a negative factor in the situation of recession. In such a case, government would not have sufficient resources to increase its spending, and recession gap would only widen. Therefore, the government needs to plan changes in taxation and in government spending very carefully for these tools to have the most favorable effect on the economy. It is generally believed that fiscal tools are the most efficient when the government has to fight recessionary gap, while monetary tools are better suited for problems dealing with inflationary gap.

For example, Keynes argued for the application of the fiscal policy tools while Friedman considered monetary tools the only efficient ones for the economy. One of the major reasons of this preference is the type of situation in which the theories were applied. Keynes created his theory in order to assist the country's economy during the period of depression when government was looking for ways to increase production and bring the economy out of economic crisis. " For Keynes, the quantity of money may be an important determinant of total outlay.

The relevant question to be asked is always: how will a change in the quantity of money affect aggregate effective demand?" (Hansen, 1949, p. 32). In his theory, " Keynes attributed rises in unemployment to a shortage of private capital investment and spending in the economy." (Denzeau, 2003, p. xvii). Keynes suggested ways to stabilize the economy of the country and motivate companies and individuals for spending, which would bring recessionary gap to minimum.

He argued for budget deficit and increased government spending. He considered budget deficit a favorable phenomenon for the economy which is in the state of crisis or depression and claimed that government needed to increase spending and decrease taxes in order to make injections in the economy (major tools of fiscal policy). These tools could work only in the situation when the economy was experiencing the decrease of production and did not realize its potential to the fullest. In other situations, these methods would immediately cause inflation- which actually occurred when Keynesian theory was applied at a wrong time. In order to assist the economies suffering from inflation, Friedman suggested his theory of laissez-faire and monetary tools of economy regulation. He stated that the countries needed to regulate money supply in the country in order to ensure that the economy is stable.

The government needed to slightly increase the money supply every year in order to meet the requirements of the growing economy, but the increase of supply needed to correspond with the needs of the economy very strictly. If the supply did not correspond with the amount of goods produced and happened to be higher, inflation would immediately occur in the country. The monetary tools which need to be applied according to Friedman include regulation of discount rate, commercial bank reserves as well as central banks' operations in the open market. He also greatly opposed Keynesian views on the benefits of budget deficit and considered budget deficit a very negative phenomenon for the economy because it could cause inflation. As conclusion, it is important to mention that both monetary and fiscal tools can be used to decrease recessionary gap, as long as they are applied in a timely manner and well-balanced. The most important fiscal tools are increase in government spending and decrease in the level of taxation. Monetary tools which can be applied to minimize recessionary gap include purchase of government securities in the open market, decrease in the level of commercial banks' reserves and their cost of borrowing from Federal Reserve banks. Appendix 1.

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