

Dilemmas

It is said that state fiscal and monetary policies are effective when they result in changing the short-run equilibrium by shifting AD to the right (multiplier model)

Yet, since either the interest rate or the exchange rate can be targeted but not both, the extent to which these policies are effective depends on

- the degree of capital mobility
- whether the exchange rate regime is floating or fixed.

An adapted Mundell-Fleming model will give us some clues what to do

Effectiveness of monetary policies

Under flexible e-rate regime

Expansionary monetary policies involve lowering the i-rate or increasing the money supply. They bring about:

1/The short-run rightward of AD

AD/AS diagram

2/Hence an increase of the average price level hence two scenarios:

If inflation is moderate to important:

- It can affect consumption rolling back AD
- It can affect the SRAS leading to stagflation

AD/AS diagram

If inflation is low

3/Inflation worsens the CA, thus $E < H = DP_a < SP_a$

4/Hence P_a depreciates to improve the CA,

E-rate diagram

5/The stimulated exports expand AD

AD/AS diagram

6/The fall in the interest rates brings about

i-rate diagram

- lower savings reducing investment capacity
- a capital outflow, which if important, reduces the credit capacity, thus the money supply

7/This calls for further expansionary measures

Overall, the monetary policy under flexible e-rates is effective to stimulate AD depending however on inflation

Fixed e-rate regime

We need to consider the degree of capital mobility:

- If there are capital controls, to offset the depreciation, the state buys domestic currency and sells foreign which does not affect AD
- With no capital controls, the sterilization policies result in a fall in the interest rates making the domestic currency become riskier ($X > 0$) leading to further capital outflow, causing the depletion of foreign reserves, thus two scenarios:
 - The e-rate regime is abandoned
 - The interest rates are raised shifting back the AD.

Overall, in both cases the monetary policy under fixed e-rates is rendered ineffective

Effectiveness of fiscal policies

Under flexible e-rate regime

Expansionary fiscal policies involve increasing state spending. They bring about:

1/ A shift in AD hence Inflation

AD/AS diagram

2/ Improvements in infrastructure hence a shift in SRAS and LRAS

3/ An increased demand for money causing interest rates to rise that is:

- capital inflow increasing the supply of money
- Pa appreciates moving AD back since government expenditure is crowded out by falling exports.

i-rate diagram

AD/AS diagram

Overall, a fiscal policy under flexible e-rates is ineffective.

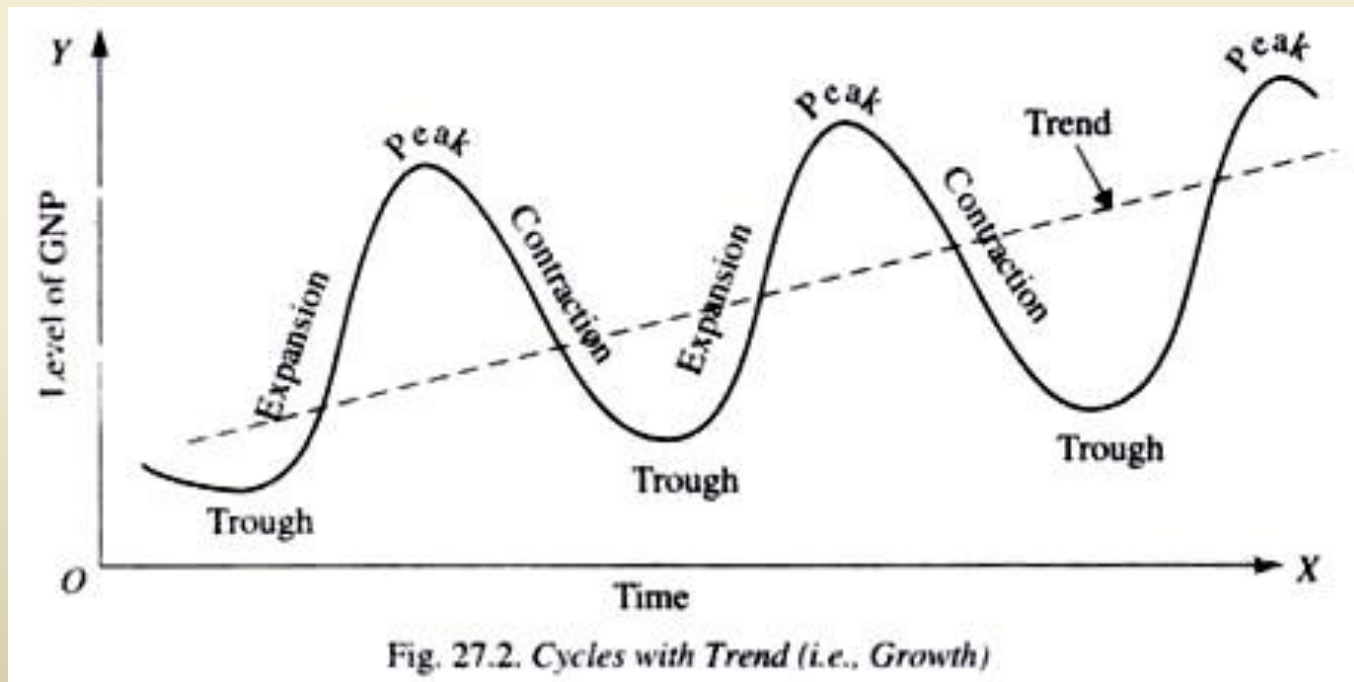
Fixed e-rate regime

We need to consider the degree of capital mobility:

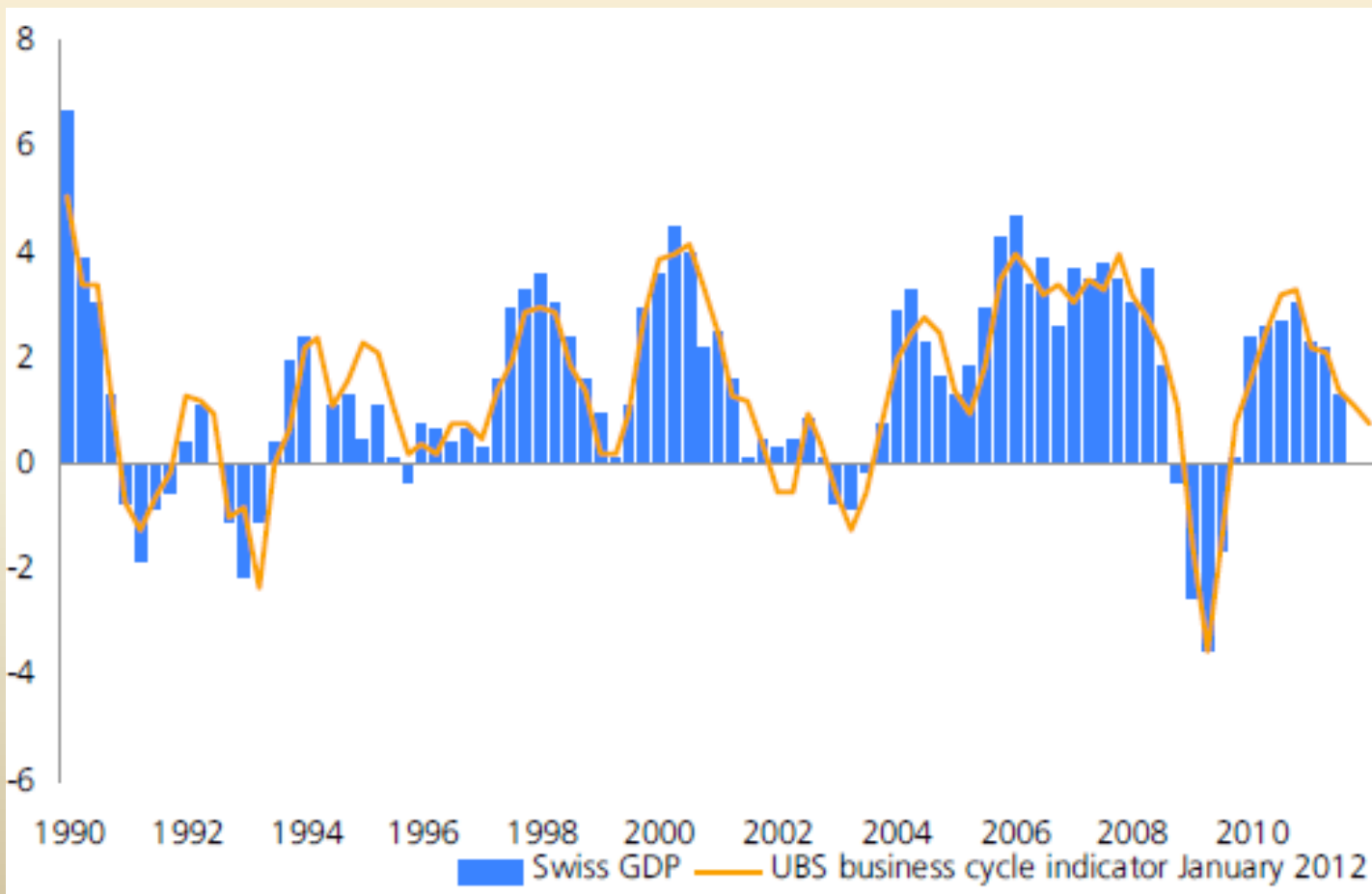
- If capital is immobile, demand for money pushes i-rates up as well as puts CA in deficit since Pa appreciates in the foreign markets. This is an ineffective policy.
- If capital is mobile, the rise in i-rates brings about a capital inflow which increases the domestic stock of money. This in turn
- puts pressure on lowering the i-rate eventually leading to capital outflow
- leads to a trade surplus, shifting AD on condition that it outweighs the trade deficit caused by the initial shift in AD. Here fiscal policy is somewhat effective.

Business cycles

Business cycles are a historic fluctuation in the output of an economy whose analysis aims at identifying the causes of positive and negative output gaps - phases.

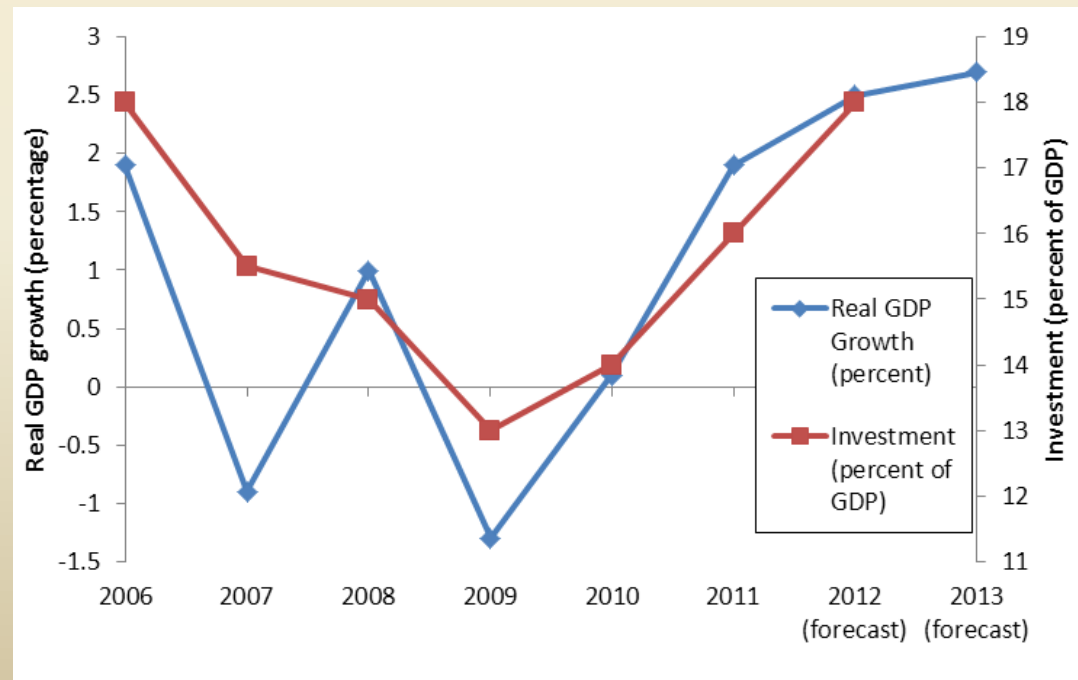


These fluctuations can be seen to either be endogenous to the market system, or caused by shocks that are exogenous to the market system.

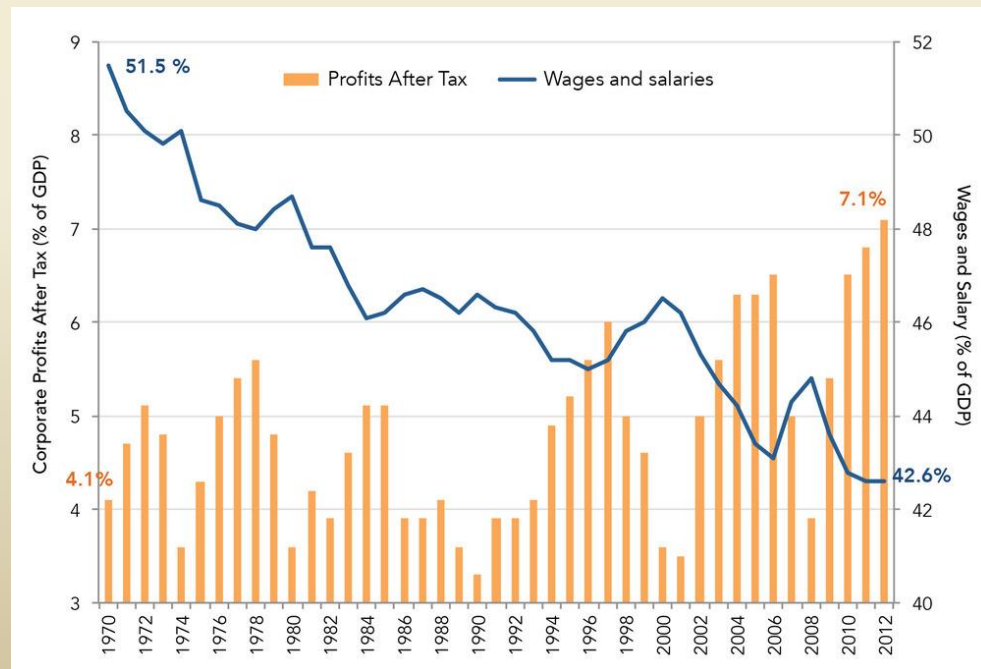


Endogenous

The Keynesian approach sees the fluctuations in investment to bring about changes in AD. It considers that each reduction (increase) in output generates a reduction (increase) in investment (accelerator effect) which generates a reduction (increase) in output (multiplier effect). Is it the case in Fiji?

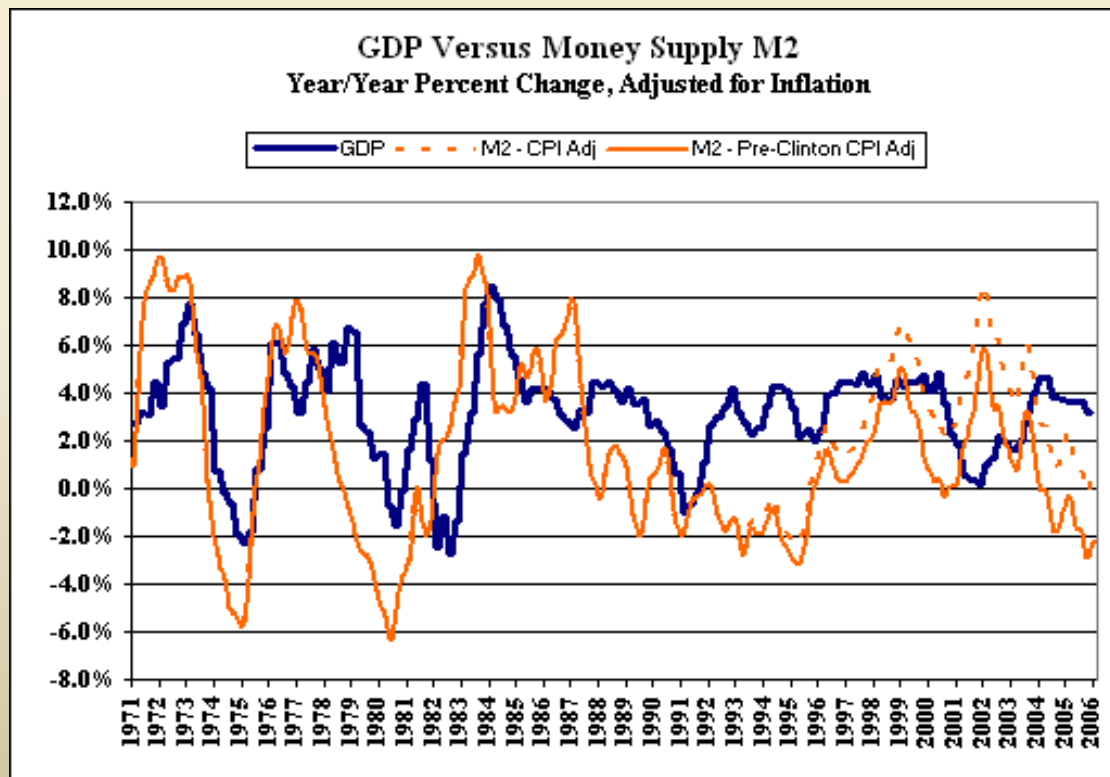


The Marxian approach sees the changes in the rate of profit to be the determinant of fluctuations in investment. It considers that an increase (decrease) in production costs (capital stock, wages) lowers (raises) the rate of profit. Thus, when the latter is small (large) firms are discouraged from (encouraged in) investing. Is the case in the US?

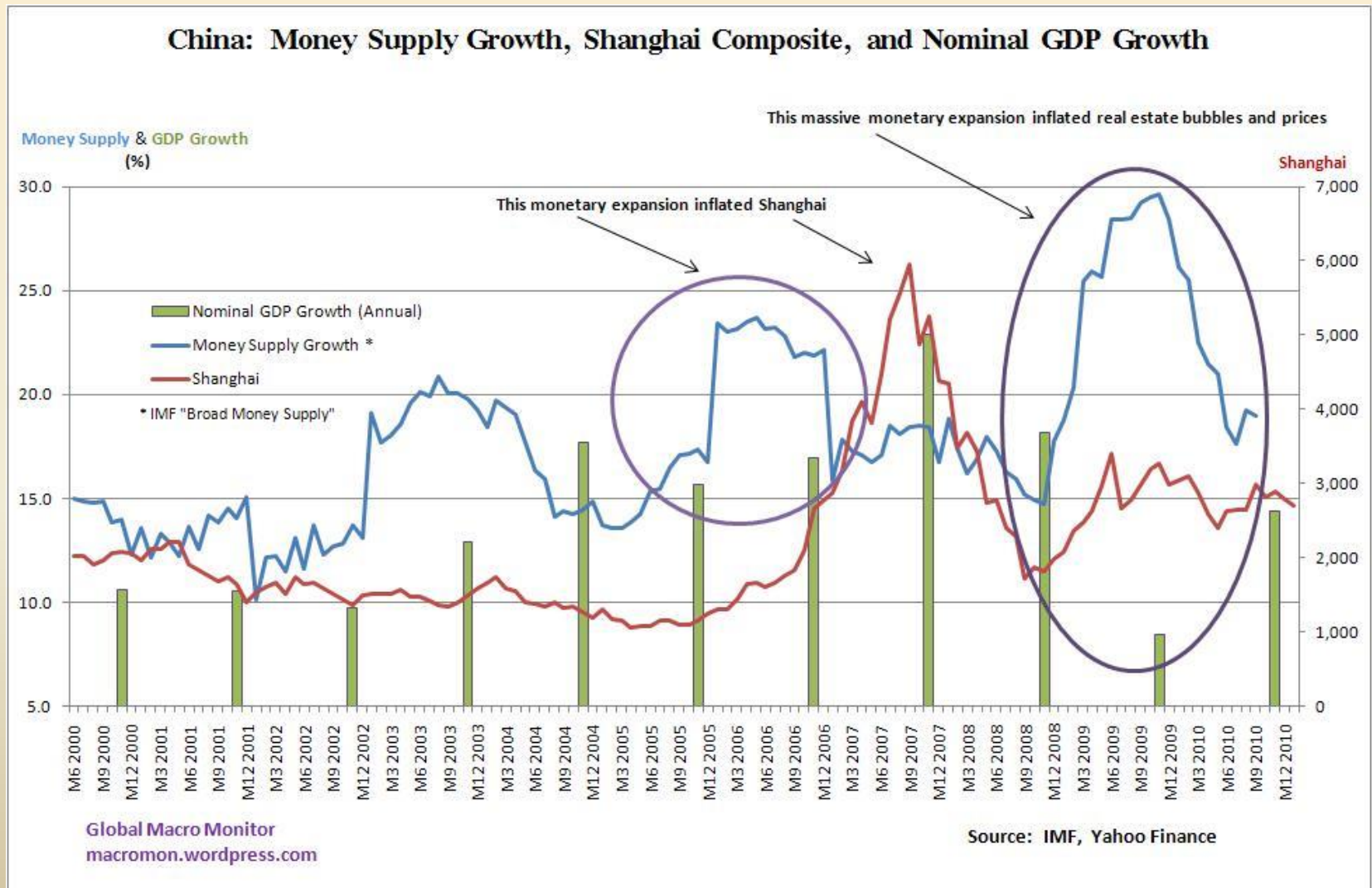


Exogenous

The monetarist approach sees the price level and the supply of money as the main factors. It considers that an increase (decrease) in the supply of money rises (lowers) the price level and output (quantity theory of money). Is it the case?



Is it the case?



Overall, regardless of the approach, the factor of production mainly responsible for business cycles is capital, that is, the management of the relationship capital-investment-savings.

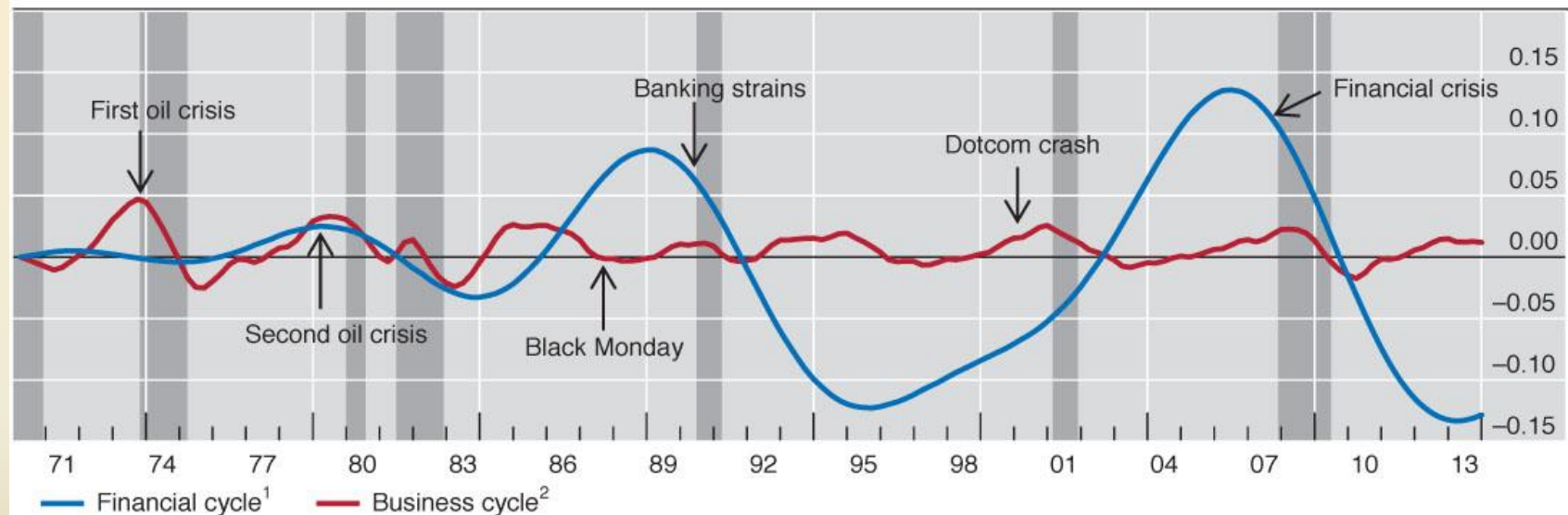
Hence the importance of financial cycle analysis rather than business cycles tout court.

Financial cycles trend over 10-20 years, as opposed to business cycles which are measured over 1-8 years, and focus on credit fluctuations rather than GDP changes.

e.g.US

The financial and business cycles in the United States

Graph IV.A



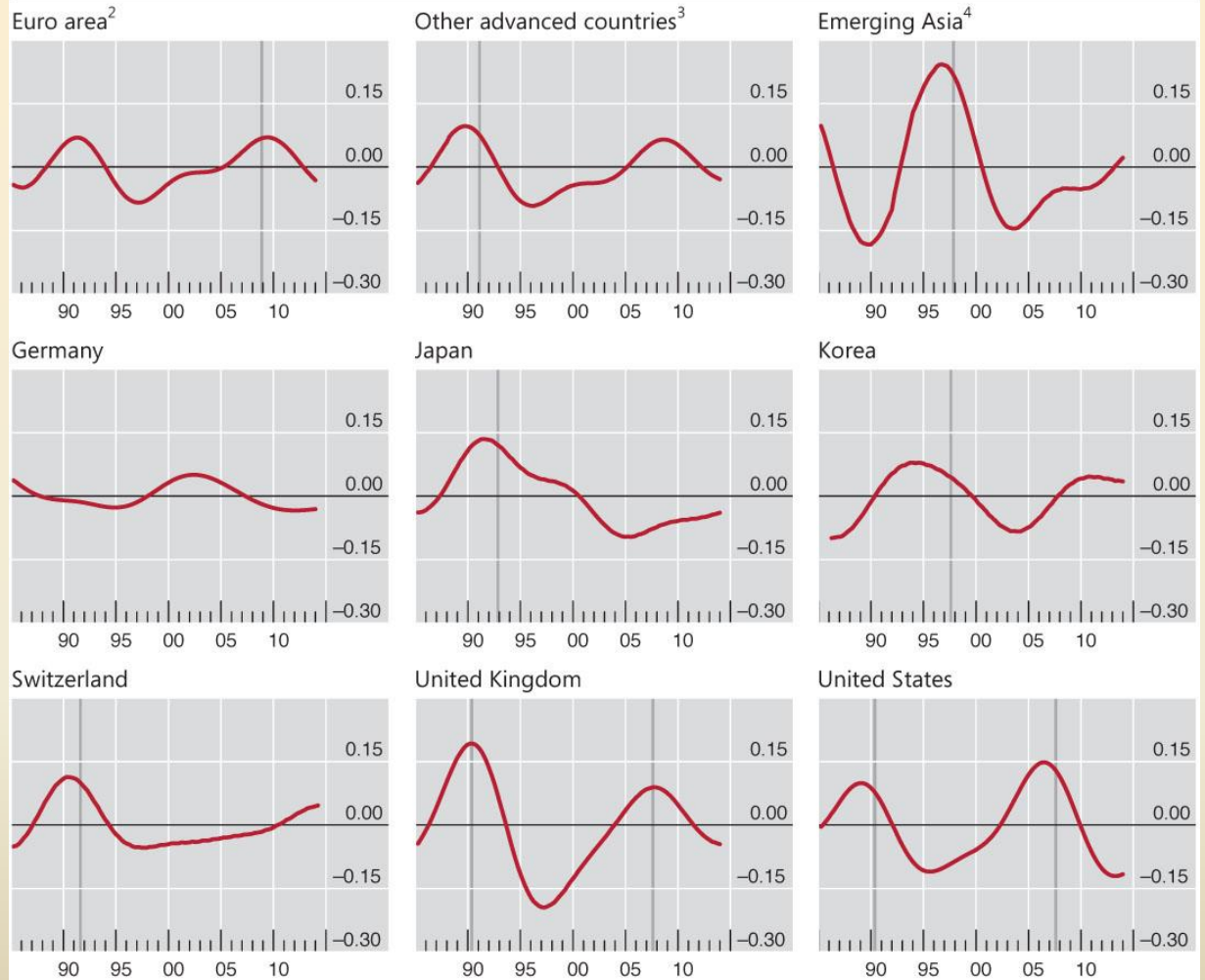
¹ The financial cycle as measured by frequency-based (bandpass) filters capturing medium-term cycles in real credit, the credit-to-GDP ratio and real house prices. ² The business cycle as measured by a frequency-based (bandpass) filter capturing fluctuations in real GDP over a period from one to eight years.

Source: M Drehmann, C Borio and K Tsatsaronis, "Characterising the financial cycle: don't lose sight of the medium term!", *BIS Working Papers*, no 380, June 2012.

Credit
cycle
peaks
(turning
points)
coincide
with
bank
crises

Financial cycle peaks tend to coincide with crises¹

Graph IV.1



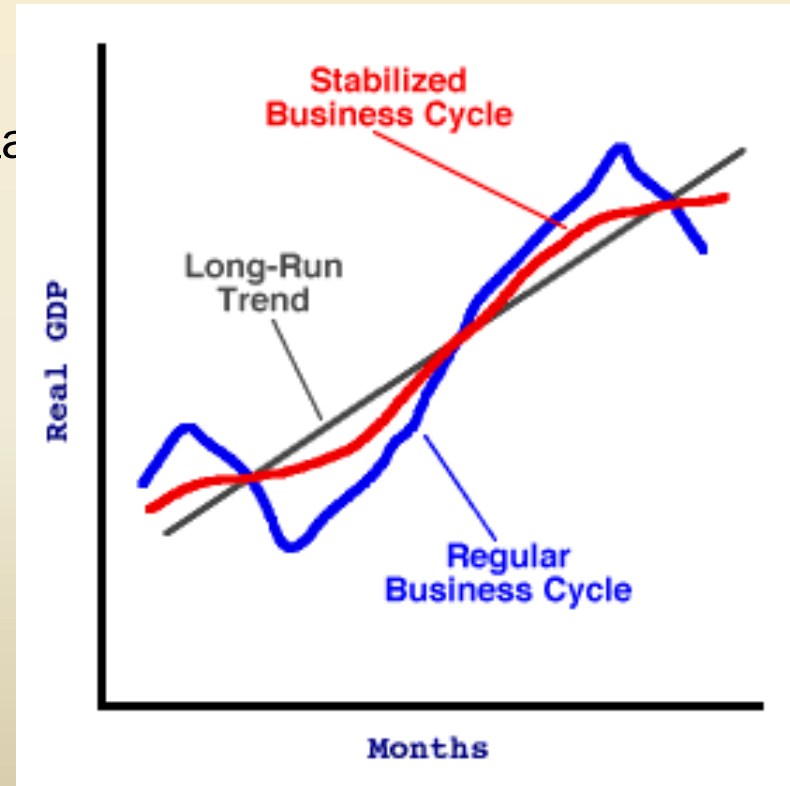
¹ The financial cycle as measured by frequency-based (bandpass) filters capturing medium-term cycles in real credit, the credit-to-GDP ratio and real house prices (Box IV.A). Vertical lines indicate financial crises emerging from domestic vulnerabilities. ² Belgium, Finland, France, Ireland, Italy, the Netherlands, Portugal and Spain. ³ Australia, Canada, New Zealand, Norway and Sweden. ⁴ Indonesia, Hong Kong SAR and Singapore.

Sources: National data; BIS; BIS calculations.

Stabilization

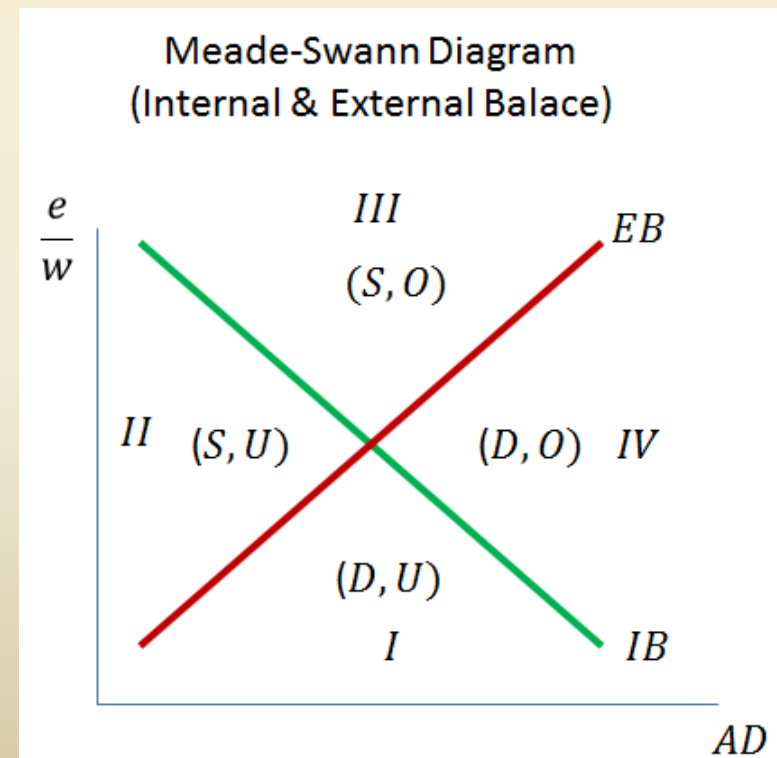
Thus knowledge of the cause of business and financial cycles, capital, should inspire some policies, whether pre-emptive or corrective, to render the cycles smoother.

- Pre-emptive – use of monetary
- Corrective – use of fiscal
recession



Stabilizing the economy in a macroeconomic equilibrium involves (Meade-Swann diagram) in the relationship between AD (usually G) and real exchange rate (e/w):

- Internal Balance (IB) = the real exchange rate and AD set where unemployment is at the “natural” rate.
- External Balance (EB) = real exchange rate and GDP set where the current account (CA) is in balance.



The figure is divided in four quadrants.

- Quadrant I = current account deficit (D) and unemployment is above the “natural” rate (U).
- Quadrant II = CA surplus (S) and unemployment is above the “natural” rate (U).
- Quadrant III = CA surplus (S) and “overheated” economy (O), one in which unemployment is below the “natural” rate
- Quadrant IV = CA deficit (D) and “overheated” economy (O), one in which unemployment is below the “natural” rate

If an economy is in QIII, what policies does it have to put in place to reach IE and IB simultaneously?

Lower e

Increase w

Lower G

Feasible?

