

UNIT 4

MACROECONOMIC POLICY INSTRUMENTS

Introduction to Macroeconomic Policies

In this unit, we will explore various macroeconomic policies that governments use to stabilize and grow their economies. Understanding these policies is crucial as they play a key role in influencing the overall economic environment, affecting variables such as national income, employment, and the general price level.

Key Concepts

- **Fiscal Policy:** Government's revenue (taxes) and expenditure policies.
- **Monetary Policy:** Actions by the National Bank to control the money supply and interest rates.
- **Income Policy:** Regulations affecting wages and income distribution.
- **Foreign Exchange Policies:** Government strategies regarding currency exchange rates.
- **Price Ceiling:** A limit on how high a price can be charged for a product.
- **Price Floor:** A limit on how low a price can be charged.
- **Minimum Wages:** The lowest legal salary that can be paid to workers.

4.1 Definition and Types of Macroeconomic Policies.

Overview

Macroeconomic analysis examines the economy as a whole, focusing on output, income, employment, and price levels. Nations use macroeconomic policies to achieve desired changes in these variables, helping to stabilize the economy during recessions or control inflation when the economy overheats.

Classical economists once believed that economies could self-correct through natural mechanisms. However, the Great Depression of the 1930s revealed the need for government intervention to restore economic stability, as argued by Keynes. Macroeconomic policies are now recognized as essential tools to achieve objectives such as maximum output, economic growth, full employment, price stability, and equitable income distribution.

4.2 Fiscal Policy

What is Fiscal Policy?

Fiscal policy involves the government's revenue collection (taxation) and expenditure to influence the economy. It aims to manage economic fluctuations and achieve objectives like economic growth and full employment.

Tools of Fiscal Policy

There are two main tools:

1. **Taxation:** Direct and indirect taxes that influence consumer income and, consequently, demand and GDP.
2. **Government Spending:** Expenditures on public goods and services, which can boost or reduce economic activity.

Components of Government Spending

- **Government Spending (G):** Expenditures on public services, infrastructure, and defense.
- **Transfer Payments:** Direct payments to individuals, such as social security or unemployment benefits.
- **Grants in Aid:** Federal assistance to local governments.
- **Net Interest Payments:** Interest on government debt minus interest received by the government.

Types of Fiscal Policy

1. **Expansionary Fiscal Policy:** Used during a recession to increase aggregate demand, output, and employment. It involves increasing government spending and/or reducing taxes to put more money in the hands of consumers.
2. **Contractionary Fiscal Policy:** Used during inflationary periods to decrease aggregate demand and control rising prices. This involves reducing government spending and/or increasing taxes to withdraw money from the economy.

4.3 Monetary Policy

What is Monetary Policy?

Monetary policy is managed by the National Bank (or similar authority), which controls the money supply and interest rates to achieve economic stability. It aims to control inflation, promote economic growth, and manage liquidity in the economy.

Tools of Monetary Policy

- **Interest Rates:** Modifying interest rates to influence borrowing and spending.
- **Government Bonds:** Buying or selling bonds to adjust the money supply.
- **Foreign Exchange Rates:** Regulating currency value relative to others.
- **Reserve Requirements:** Changing the amount of money banks must hold in reserve to control lending.

Conclusion

Macroeconomic policies are essential for managing an economy's stability and growth. By understanding these policies, you can better appreciate the tools governments use to achieve economic objectives, and the impact these tools have on the broader economy.

Tools of Monetary Policy

Monetary policy refers to the actions taken by a central bank, like the National Bank of Ethiopia (NBE), to manage the money supply and interest rates in the economy. The main goal is to control inflation, stabilize the currency, and achieve economic growth. Here are the primary tools used by the National Bank:

1. **Open Market Operations (OMO):**
 - OMO involves the buying and selling of government bonds by the National Bank.
 - **Buying Bonds:** When the National Bank purchases bonds, it pays with Birr (Ethiopian currency), which increases the money supply in the economy.
 - **Selling Bonds:** When the National Bank sells bonds, it receives Birr, which decreases the money supply.
 - This tool is used to manage the liquidity levels in the banking system and influence the money supply.

2. Discount Rate (DR):

- The discount rate is the interest rate the National Bank charges commercial banks when they borrow funds.
- **Lowering the Rate:** Reduces the cost for banks to borrow money, encouraging them to lend more, which increases the money supply.
- **Raising the Rate:** Makes borrowing more expensive for banks, which can reduce the money supply.
- In Ethiopia, the discount window facility for commercial banks started in March 2001.

3. Required Reserve Ratio (RRR):

- This is the percentage of deposits that banks must hold in reserve and not lend out.
- **Lowering the RRR:** Releases more funds for banks to lend, increasing the money supply.
- **Raising the RRR:** Reduces the amount banks can lend, decreasing the money supply.
- In January 2012, the NBE reduced the minimum deposit reserve from 15% to 10%, aiming to encourage lending, especially to the export sector.

Types of Monetary Policies

Monetary policies can be classified into two main types:

1. Expansionary Monetary Policy:

- This policy is used when the economy is in a slowdown or recession.
- **Objective:** Increase economic activity and reduce unemployment.
- **How:** The central bank lowers interest rates, which encourages borrowing and spending. It may also reduce the RRR or buy securities to inject more money into the economy.
- **Effect:** Increases the money supply, stimulates investment, and boosts consumer spending, moving the economy towards its potential GDP.

2. Contractionary Monetary Policy:

- This policy is used when there is too much money in the economy, leading to inflation.
- **Objective:** Reduce inflation by slowing down the economy.
- **How:** The central bank raises interest rates, making borrowing more expensive, and may increase the RRR or sell securities to absorb excess money from the economy.
- **Effect:** Decreases the money supply, reducing spending and investment, which helps control inflation.

Income Policy and Wage

Income policies are measures taken by the government to control wages and prices, especially during periods of high inflation. These policies can include voluntary guidelines or mandatory controls like price and wage freezes.

1. Wage Determination in a Free Market:

- Wages are determined by the interaction of supply and demand for labor.
- **Supply Increases:** Wages tend to fall.
- **Demand Increases:** Wages tend to rise.
- In a competitive market, wages adjust based on these factors.

2. Minimum Wage:

- A minimum wage is the lowest legal wage that can be paid to workers.
- **Purpose:** Protect workers from excessively low pay and ensure a minimum standard of living.
- Minimum wages can also help reduce poverty and income inequality.

3. Pricing Policy:

- Governments may impose price controls, such as **price ceilings** (maximum prices) and **price floors** (minimum prices), to manage inflation.
- **Price Ceiling:** Keeps prices from rising too high, but can lead to shortages.
- **Price Floor:** Ensures prices don't fall too low, but can create surpluses.

Understanding these concepts helps grasp how central banks and governments influence the economy through various tools and policies to maintain stability and growth.

Foreign Exchange Policies

Understanding Exchange Rates and Their Effects

Foreign exchange policies play a critical role in a country's economy, influencing prices, trade, and overall economic stability. These policies determine how a country manages its currency in relation to others, impacting everything from the cost of imports and exports to the decisions of international investors.

Exchange Rates and Currency Value

An exchange rate is essentially the price of one currency in terms of another. For example, if you exchange 1 U.S. dollar for 30 Ethiopian Birr, the exchange rate is 30 Birr per dollar. This rate is determined by the supply and demand for currencies in the foreign exchange market, where currencies are bought and sold.

Foreign Exchange Market Participants

1. **International Traders:** Companies buying and selling goods and services across borders need to exchange currencies. For example, an Ethiopian company exporting goods to the U.S. will exchange U.S. dollars for Ethiopian Birr to pay local expenses.
2. **Tourists:** When tourists travel, they exchange their home currency for the currency of the country they visit.
3. **Investors:** Investors buying foreign assets or stocks need to exchange their currency for that of the country where they are investing.
4. **Financial Investors:** These investors engage in short-term investments in foreign financial instruments.

Types of Exchange Rate Policies

1. **Fixed Exchange Rate Policy:**
 - The government sets and maintains the currency's value relative to another currency, such as the U.S. dollar.
 - **Devaluation:** The government might lower the currency's value to make exports cheaper and imports more expensive, boosting domestic industries.
 - **Revaluation:** The government might increase the currency's value, making imports cheaper but hurting export competitiveness.
2. **Flexible (Floating) Exchange Rate Policy:**
 - The value of the currency is determined by the market, based on supply and demand.
 - **Depreciation:** When the currency's value decreases due to market forces, making exports cheaper and imports more expensive.
 - **Appreciation:** When the currency's value increases, making exports more expensive and imports cheaper.

Impact of Exchange Rate Fluctuations

- **Depreciation and Devaluation:** These make exports cheaper and imports more expensive, improving the balance of payments by encouraging foreign demand for domestic goods.

- **Appreciation and Revaluation:** These make exports more expensive and imports cheaper, potentially worsening the balance of payments by reducing foreign demand for domestic goods.

Factors Influencing Exchange Rates

1. **Inflation Rates:** Lower inflation typically leads to an appreciating currency, as the value of goods and services remains stable.
2. **Interest Rates:** Higher interest rates attract foreign capital, leading to a stronger currency.
3. **Balance of Payments:** A deficit (more imports than exports) can lead to currency depreciation.
4. **Government Debt:** High national debt can lead to inflation and depreciation of the currency.
5. **Terms of Trade:** If export prices rise faster than import prices, the currency may appreciate.
6. **Political Stability and Performance:** Countries with stable political environments attract more investment, strengthening their currency.
7. **Recession:** During a recession, lower interest rates can weaken the currency.
8. **Speculation:** Expectations of a currency's value rising can increase demand, causing the currency to appreciate.

Advantages and Disadvantages of Exchange Rate Systems

- **Fixed Exchange Rates:**
 - **Advantages:** Provide certainty and reduce speculation, making trade and investment more predictable.
 - **Disadvantages:** Can limit the government's ability to respond to economic shocks and require large foreign exchange reserves.
- **Floating Exchange Rates:**
 - **Advantages:** Allow the economy to adjust to external shocks and provide flexibility in economic policy.
 - **Disadvantages:** Can lead to instability and unpredictability, affecting investment and trade.

Exchange Rate Structure in Ethiopia

Ethiopia's exchange rate policy has evolved over time, starting with a fixed exchange rate and gradually moving towards a more flexible system. Since the 1990s, Ethiopia has adopted a system where the exchange rate is determined by an interbank foreign exchange market, reflecting a gradual liberalization of the currency market.

Conclusion

Foreign exchange policies are crucial for a country's economic health. Understanding how exchange rates work and the factors that influence them helps in making informed decisions about trade, investment, and economic policy. Whether a country uses a fixed or floating exchange rate, each system has its advantages and disadvantages, and the choice of system depends on the specific economic goals and circumstances of the country.