Universe Scientific Publishing

Analysis: Addressing Inflation and Preventing Recession through Fiscal Policy and Monetary Policy

Yichen Tang[1], Yuxuan Xu[2]

1.International Department of Shandong Experimental High School, Jinan, Shandong, 250001
2.Guanghua Cambridge International School, Shanghai, 200120

Abstract: The COVID-19 pandemic has dealt a huge blow to the global economy since 2020. Under such circumstance, the most essential economic issues are combating inflation while precluding further recession. This paper mainly concentrates on the fiscal policies and monetary policies in both short run and long run that can solve the economic issue above. The authors first recommend increasing government expenditures as the short run fiscal policy. For the long run fiscal policy, the authors introduce several tax policies which can boost economic growth while stabilizing prices. Besides, the authors recommend short term monetary policies, open market operation and forward guidance, to tackle the economic issue. Next, authors propose the quantitative easing as a long run monetary policy. After listing some specific polices that address inflation while prevent recession, authors then discuss the pros and cons of four kinds of monetary and fiscal policy combination under differentiated economic conditions.

Keywords: Macroeconomics, Fiscal Policy, Monetary Policy, Policy combination

1. Introduction

In 2020, the pandemic hits the economy worldwide. Under such condition, the US government introduces the CARES policy to address inflation and prevent recession. Policymakers use a combination of fiscal and monetary policy measures to address economic challenges such as inflation and the risk of recession. Meanwhile, the federal reserves (FED) also implemented a number of policies aimed at stabilizing financial markets and supporting the economy. This instance demonstrates the necessity of policy management to tackle inflation while avoiding recession. This paper will mainly focus on the recommendation of such policies and how to balance these policies in both long run and short run.

2. Recommendations for Fiscal Policy

2.1 Introduction to Fiscal Policy

In general, fiscal policies are policies that use government spending and taxation to address inflation and recession. They can be classified into discretionary and non-discretionary. Discretionary fiscal policies are when Congress creates a new bill that is designed to change AD through government spending or taxation; non-discretionary policy is permanent spending or taxation laws enacted to work counter cyclically to stabilize the economy. Our discussion of fiscal policy in this paper is based on the discretionary fiscal policy.

2.2 Recommendations of Short Run Fiscal Policies

The most vital short-term objectives are to stabilize price and achieve full employment. The great way to raise level of employment is through increasing government expenditures. Therefore, government can raise its spending in the operation and maintenance of infrastructure to stimulate economic growth in the short run. Increasing such constructions help create instant jobs to tackle unemployment. This helps to prevent recession by increasing economic activity; meanwhile, it addresses inflation by reducing the pressure on prices from increased demand.

As for price stabilization, government prepares a surplus budget during prosperity and, during depression, a deficit budget. However, there is a conflict between the two short term goals. Attaining full employment may lead to instability in prices, and vice versa.

2.3 Recommendations of Long Run Fiscal Policies

Fiscal policy has a greater impact on the long run. The long-term goal of boosting and stabilizing economic growth is largely conditioned by capital formation. To step up economic growth, government could implement tax policy on, for example, income taxes. At times of inflation, effective taxes can help reduce consumer demand and decrease prices; during recession, reducing tax rates for low and middle-income earners can increase consumer spending, which will in turn boost economic growth.

Tax policy alone, however, can be ineffective in some situations. Therefore, government should increase capital investment in education and infrastructure to combine with tax policy, and the increased revenue from taxes can be put into use. Investing in new infrastructure projects can make goods and services produced and sold more efficiently, and in turn enhance the productive capacity of the economy. Infrastructure investments can encourage mixed-income and affordable housing, and catalyze additional investments by the private sector to drive economic development. Elevating education level can also increase human capital of the workforce, leading to higher productivity and innovation to boost economic growth.

3. Recommendations for Monetary Policy

3.1 Introduction to Monetary Policy

Monetary policy is the policy used by central bank which aims to accommodate the economic environment. Its goal is to coordinate the money supply and interest rate, which will affect both private and public investment, in order to further shift the AD curve, adjust real GDP, and relieve the unemployment.

Before the Great Recession in 2008, the common monetary policies are regulating the discount rate, required reserve ratio, and amount of bonds in the open market. During this time, there are relatively few currencies in circulation on the market. Therefore, any subtle changes in the money supply can drastically affect investment. However, in order to address the crisis in 2008, FED was enforced to expand the money supply. Money in the open market became so ample that is difficult to influence the investment when it is adjusted. Under such condition, FED takes advantage of manipulating the administered interest rate by constraining the discount rate and interest on reserves to controls money demand, interest rate and real GDP. Also, FED still applies to the Open market operation to ensure that the money is still ample in the open market which lay the foundation for the implementation of other monetary policies. Our discussions of the monetary policy below are based on the ample reserve situation.

3.2 Recommendations of Short Run Monetary Policies

The effect of monetary policy is more significant in the short term. The main strategies used by FED in the short run are forward guidance and open market operation.

Forward guidance refers to the communication from a central bank about the state of the economy and the likely future course of monetary policy. FED can announce its intention: rather tighten the monetary policy to curb inflation or keep the inflation low for a prolonged time to activate the investment. If FED takes advantage of forward guidance properly, future expectations and behaviors of people and firms in the financial market are more likely to be rational. In this case, the impact of changing in interest rate will be smooth, eliminating the possibility of the drastic shift in interest rates. At the same time, recession and the demand-pull inflation can be prevented.

Open market operation (OMO) is the buying and selling of government securities by the central bank in the open market. By buying and selling government bonds, central banks control the amount of money in the open market, which will adjust the interest rate. To address inflation, the central bank can sell government securities to reduce the money supply, which reduces excess demand in the economy. During the time of crisis, OMO can inject liquidities in the open market to boost the economy.

3.3 Recommendations of Long Run Monetary Policies

Utilizing the quantitative easing and gradually tighten monetary policy to regulate the interest rate could lay a solid foundation for the long-term economic growth.

Quantitative easing (QE) mainly focuses on the purchasing or selling of the long-term securities. Compared to OMO, QE involves broader assets exposure, ranging from government securities to mortgage-backed securities. In terms of addressing inflation, QE can offset the reduced spending and demand, which tend to cause deflation. Besides, QE is capable of lowering long- run interest rate to boost the economy to prevent recession.

If money supply's incrementing rate is so great that is far beyond the level of economic development, the long run inflation tends to occur. Therefore, if the central bank wants to forestall the long-term economic crisis, it must tighten the monetary policy gradually.

4. The Combination of Policy Mitigation and Trade-off Market Issues

Patterns of the Combination of Fiscal and Monetary Policies:

In weighing economic development and inflation, Policymakers have analyzed and derived the pros and cons of using expansionary or tight monetary and fiscal policies in different economic situations, for use by economists in selecting the use of policy combinations by considering the priorities of different objectives in different periods.

(1)Double -expansionary policy is appropriate when aggregate social demand is seriously insufficient, productive resources are heavily idle, and solving unemployment and stimulating economic growth become the primary objectives of macro-control. This combination can activate the economic activity and promote employment in the short run. Besides, it is an effective measurement to prevent recession. However, in the long run, this combination is more likely to cause inflation, even hyperinflation, and lead to severe government deficit and public debt.

(2)Double contractionary policy is appropriate when aggregate social demand is extremely inflated, aggregate social supply is inadequate, prices are rising sharply and the primary objective of inflation control is to curb inflation. In any case, this combination may reduce economic growth and employment in the short term. Such a combination may lead to political unpopularity due to reduced government spending or increased taxation.

(3)Contractionary fiscal policy and expansionary monetary policy is suitable for situations where government spending is excessive, prices are basically stable, the structure of the economy is reasonable, but business investment is not very aggressive or the economy is not overly prosperous, and promoting faster economic growth becomes the main objective of economic operation. And economic development is also threatened when interest rates are lowered using an expansionary monetary policy. This is because it discourages investment by companies due to lower returns, thus reducing company output and aggregate supply, leading to cost-push inflation and even to recession. At this point, it's not possible to reduce further and thus any cuts have little effect. This violates the government's macro-objective of lower price stability.

(4)Expansionary fiscal policy and contractionary monetary policy is appropriate when society exhibits a coexistence of inflation and economic stagnation. If the government simultaneously reduces income taxes, workers will also have an increased incentive to work for greater disposable income and thus become more efficient. At the same time, this will also attract more labor to the market, increasing the likelihood of a talented workforce. In any case, there is a risk that the use of expansionary fiscal policy will reduce productivity. If the government increases aggregate demand by raising government spending, for example by providing more transfers, including unemployment benefits, this could in turn discourage the incentives of workers.

5. Conclusion

The main topic of this essay is about policies that combats inflation while prevents potential recession. Firstly, authors recommend the fiscal policy in the short run, such as increasing government expenditures in more practical infrastructures, and it in the long run by discussing about the tax's role in capital formation and the government spending in technology and education. Next, they recommend the monetary policy. They list the characteristic and benefit of forward guidance and open market operation in the short run, while explaining the importance of quantitative easing and gradually tighten monetary policy in the long run. At last, they evaluate the different combinations of these policies in various economic situations in both long run and short run.

References

[1]Deng, Z. J. “The Relationship between Fiscal and Monetary Policy and Socio-Economic Development.” [J]Contemporary Finance, vol. 31-33, no. 361005, 2006.

[2]Michae Levy,(2009). American Recovery and Reinvestment Act, United States, 2009.

[3]Principles of Economics. “27.2 the Use of Fiscal Policy to Stabilize the Economy.” University of Minnesota Libraries Publishing edition, 2016.

[4]Yang Zihui. A Study on the Impact of Fiscal and Monetary Policies on Private Investment -Analysis of Applications Based on Directed Acyclic Graphs[J].Economic Research. 2008(05):81-93.

[5]BeckWorth, David. “Bill English on the Effectiveness of QE and the Consequences of Fed Losses” Macro Musings, October 3, 2022.

[6]Benito, Andrew. “How does monetary policy affect labor demand and labor productivity?”. IZA world of Labor, July, 2017.

[7]Sherk, J. “Not Looking for Work: Why Labor Force Participation Has Fallen During the Recession.” Backgrounder 2722, Heritage Foundation Center for Data Analysis, 2012.

[8]Taylor, J., Williams, J. “Simple and Robust Rules for Monetary Policy.” Handbook of Monetary Economics, 2010.