

Answer on Question #44875 – Economics – Macroeconomics

In the broadest possible terms, an economy can face two possible problems-recession and excess inflation.using your knowledge of fiscal and monetary policy,which do you think is more effective in dealing with each of these problems? Explain

Solution

Expansionary fiscal policy involves government spending exceeding tax revenue, and is usually undertaken during recessions. Keynesian economics suggests such policy of increasing government spending and decreasing tax rates as the best ways to stimulate aggregate demand, and decreasing spending and increasing taxes after the economic boom begins. Keynesians argue this method be used in times of recession or low economic activity as an essential tool for building the framework for strong economic growth and working towards full employment. In theory, the resulting deficits would be paid for by an expanded economy during the boom that would follow; this was the reasoning behind the New Deal.

When there is an excess inflation, monetary policy can be used to contract the money supply in the economy by raising interest rates, which would reduce purchasing power, resulting in falling demand and decrease of inflation. Keynes, however, was not in favour of monetary methods. He suggested a method of progressive taxation, where the collections from the taxes would be saved and used once equilibrium is achieved in the economy, which he called 'forced savings'

Another method is to cut transfer payments and subsidies, thus cutting down consumption.