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Interactions between Macroeconomic Policy and Financial Markets

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Abstract: *Numerous organizations, corporations, and governments exist, each with unique ambitions and missions. However, nearly every single one desires two seemingly contrasting goals: growth and stability. Regarding financial health, macroeconomic policy is the lever by which governments can drive future growth and maintain present stability. Policy changes, both big and small, can dramatically affect a nation's development in the short and long term. Governmental policymakers can direct economic progress by carefully balancing monetary, fiscal, and developmental policies. This paper explores how these policies can be leveraged by governmental organizations (e.g., The Federal Reserve) to stabilize and encourage short-term and long-term economic health.*

Keywords: *Economic Health, Fiscal Policy, Financial Markets, Monetary Policy, The Federal Reserve.*

I. INTRODUCTION

1.1 Background and Role of the Government

Before diving into the specific means by which a government can drive economic growth, it is helpful to clarify the actual role a government must take. Governments are charged with managing many responsibilities. These include financial concerns, national security, law, social responsibility, etc. Even within the narrower realm of economic development, there are still many connected but discreet duties, such as supporting future growth, keeping unemployment low, balancing income inequality, and others. Different policies and circumstances can have varying effects on these outcomes, both negative and positive.

1.2 Inflation as an Example to Illustrate the Government's Role and Influence

A good example of conflicting forces and outcomes lies in inflation, which is generally driven by a supply and demand mismatch for goods or money (Frick, 2022). Despite its often negative depiction in the media, inflation can be beneficial. To a degree, it can encourage economic activity and growth. Under predictable inflationary conditions, consumers are more likely to buy goods today under the belief that they will need to pay more for them in the future. In addition, money that is borrowed today to make investments in growth (such as for new equipment or higher education) can be more easily paid in the future since the relative value of the amount borrowed will decrease (Oner 2010). However, this is only true of disposable income. For families that spend most of their income on necessities or receive a fixed income, inflation can be devastating since income increases will sometimes lag behind increases in the price of goods (Oner, 2010). While this summary is heavily simplified, it does demonstrate some of the opposing effects inflation can have. In this case, a government might aim to allow for some degree of inflation while ensuring it does not spiral out of control. In the real world, the US government and many other developed countries maintain goal inflation rates of about 2% (Garriga and Werner, 2022). Carefully balancing the numerous economic pressures that a country will experience, of which inflation is just one of many, is the fundamental charge of governmental policymakers.

II. OVERVIEW OF MONETARY POLICY

2.1 What is Monetary Policy

The first means by which a government can influence economic change is through monetary policy, or in other words, policies set by a country's central bank. In the United States, this would be the Federal Reserve. The Federal Reserve has several tools to influence the economy, but they generally lead to only one of two outcomes: jumpstarting economic downturns by making it more attractive to take loans and invest (termed expansionary policies) or braking economic overactivity by making it more appealing to save money (termed contractionary policies) (Federal Reserve Bank of San Francisco, 2012).

2.2 Federal Funds Rate

The federal funds rate is a critical metric that the Federal Reserve uses to determine its policies. This is essentially the interest rate banks charge each other to make short-term loans, and it directly relates to the attractiveness of borrowing by consumers and corporations. In essence, a lower federal funds rate encourages spending and vice versa. The current federal funds rate is 4.25% to 4.50%, though in the past 50 years, it has been as low as 0% during the Great Recession of 2008 and as high as 20% during a period of excess inflation in 1980 (O'Connell, 2022). The Federal Reserve will generally set a target federal funds rate and then attempt to steer the economy toward that rate. Some of the traditional ways a central bank can accomplish its goals are by changing the reserve requirement, conducting open market operations, and adjusting the discount rate (Federal Reserve Bank of San Francisco, 2012).

III. MONETARY PRINCIPLES THE FEDERAL RESERVE CAN INFLUENCE

3.1 Reserve Requirement

Changing the reserve requirement, the percentage of a private bank's deposit it is required to have immediately available, is perhaps the most straightforward method. When individual banks are required to hold more money as available cash (increasing the reserve requirement), they have less to loan out and will only do so at a higher interest rate, thus making taking out loans for growth investments unattractive. This is an example of a contractionary policy, while the inverse (decreasing the reserve requirement) would be an expansionary policy.

3.2 Open Market Operations

Conducting open market operations is another tool the Federal Reserve uses often. Here, the central bank would buy or sell bonds to other banks, which generally own some governmental bonds. When the Federal Reserve sells a bond to a private bank, the bank now has less money to loan out. This is akin to increasing the reserve requirement and will also lead to contraction. If the Federal Reserve instead buys back a bond a private bank previously owned, the opposite will occur.

3.3 Interest Rate

Finally, the Federal Reserve can affect the market interest rate for loans by adjusting the discount rate, which is the interest rate for loans taken by private banks themselves from the Federal Reserve. An increase or decrease in the discount rate will be mirrored in the federal funds rate and the market interest rate, which subsequently impacts the attractiveness of loans (Federal Reserve Bank of San Francisco, 2012). Overall, these policies can be extremely useful in maintaining stable growth. However, as previously mentioned, monetary policy can only affect the economy along one axis and can only be broadly applied. It is most useful when coordinated with other forms of macroeconomic policies.

IV. FEDERAL GOVERNMENT'S USAGE OF FISCAL POLICY

4.1 How Fiscal Policy Can Influence Growth

Fiscal policy describes a central government's taxation and spending plan, and adjustments to fiscal policy are the second arm by which a central government can encourage change. Modifying budgetary policies can be used to increase or decrease economic activity broadly, similar to monetary policies. For example, reduced taxes across the board leads to additional disposable income for households and corporations that they can spend or invest, which can spark economic activity. However, fiscal policies can also stimulate or deflate specific populations or industries, allowing the government to direct growth in a certain direction (Horton and El-Ganainy, 2012). In the US, for example, the federal government subsidizes the agriculture industry, with direct government farm payments totaling 16.5 billion dollars in 2022 (US Department of Agriculture, 2022).

4.2 Advantages and Disadvantages

Fiscal policies such as these have advantages and disadvantages. On the one hand, they allow the government to support industries with positive externalities (effects outside of economics) or have inherent risk worth mitigating. Subsidizing farming allows self-sufficiency in the case of nationwide or worldwide emergencies and counteracts the risk of natural fluxes in environmental conditions (Amadeo, 2022). On the other hand, fiscal policy is heavily political and can suffer from unequal application. Farming subsidies primarily benefit larger farms, with the top 10% of subsidy recipients receiving 78% of the aid given out in the past 20 years (Amadeo, 2022). In general, politicians and political parties can have very different thoughts on an ideal fiscal policy. Topics such as budget balancing, tax brackets, and industry subsidies are all prevalent and contentious subjects of debate. Industries themselves, of course, also have a heavy stake in the outcome of these debates and go through great efforts to influence the results. In 2022 alone, interest groups spent over 3 billion dollars on lobbying the federal government (OpenSecrets, 2022). This amount, while already substantial, does not account for lobbying at state or local levels. Finally, public perception influences also fiscal policy; certain actions, such as raising taxes, can lead to strong public pushback and political backlash, even when economically indicated.

4.3 Policies Directly Influencing Development of Human and Material Resources

Perhaps the most important mechanism by which governments can support growth is by enacting policies that directly encourage the development of human and material resources. This is the primary method by which a country promotes long-term growth, as defined by increases in productive capacity. This is often measured by gross domestic product (GDP) or GDP per capita. Countries with a mission of encouraging development and progress can expect to see their growth reflected in GDP. The United States, for example, has seen its GDP per capita (adjusted to 2011 dollars) increase from $2419 per person in 1775 to about $49675 per person in 2011 (Roser, 2013). Several determinants of economic growth can be targeted by governmental policies, with human capital, physical capital, natural resources, and technology often considered the most significant determinants (Boldeanu and Constantinescu, 2015). Human capital refers to the size and quality of the labor force. Common policies that improve human capital include encouraging immigration, improving public health, and elevating educational standards. Physical capital refers to the tools and infrastructure necessary for production. Building and maintaining roads are examples of actions that increase physical capital. Natural resources encompass land, waterways, mineral deposits, oil, and other beneficial assets located within a country. While increasing the absolute amounts of these resources can be difficult, policies can improve stewardship, access, and utilization.

Finally, advancing technology, whether via research or adaptation, has a compounding effect on the other factors of production. Note that many examples of fiscal policy, such as subsidizing alternative energy industries, would also fall under the broad umbrella of encouraging the long-term development of these determinants (Horton and El-Ganainy, 2012). Monetary and fiscal policies that do not do this are still helpful, though they exert most of their effects by stabilizing and encouraging short-term growth and economic health. In fact, balancing modern- day problems with future goals can be considered one of the chief duties of macroeconomic policymakers.

V. CONCLUSION

A nation's economic health and direction are complicated problems to approach, with numerous invested parties and external influences. Policymakers charged with the herculean task of keeping the economy in a progressive equilibrium are handed only imperfect tools that they must apply to the best of their ability. Despite these odds, there has been a longstanding trend of growth and progress. The economic machine may not be a perfect one, but it is undeniably an impressive one. Other areas of exploration can examine how can monetary and fiscal policy be leveraged to ameliorate the current recession as well as industry-specific downturns (e.g., the technology sector).

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