What is Monetary Policy and Fiscal Policy? How does it work in the US and Saudi Arabia?

The U.S. Federal Reserve has cut interest rates nine times since January 2001, and US interest rates are at their lowest levels in 40 years. Why has it had little success in halting the U.S. economy's slide to recession so far? In Japan, interest rates are close to zero and the government has spent trillions in fiscal stimulus packages. Yet, why is it that after a decade of stagnation, Japan is in recession?

These are the types of questions we address in this section. The underlying issue is what is monetary and fiscal policy and how do they work? We will use the US as an example to illustrate the issues. We will also take a close look at monetary policy in Saudi Arabia and what it means for the country's economic management.

Generally, fiscal and monetary policies are used to influence economic growth and inflation in the economy. When the central bank cuts interest rates in order to prevent a recession, it is called monetary policy. When a government changes its spending or tax policies, it is called fiscal policy. The primary objective of monetary and fiscal policy is to maintain a healthy rate of economic growth while keeping inflation low. Both monetary and fiscal policy are called demand-management policies because they try to increase the economy's output (measured by Gross Domestic Product or GDP) indirectly by increasing the economy's aggregate demand for goods and services.

Monetary Policy

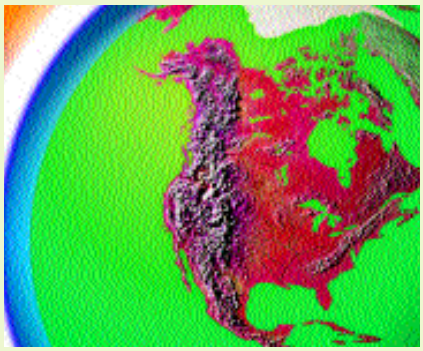
Central banks try to influence the economy by changing interest rates and money supply. If economic growth slows down, the central bank would cut interest rates or increase money supply. This lowers the cost of borrowing, and also makes more funds available to the banking system to lend to consumers, businesses and investors, thereby helping to increase demand and output. However, money supply or interest rates are usually not under the direct control of central banks; they are determined in the marketplace by the interaction of demand and supply. Thus, central banks try to influence these variables by controlling monetary policy tools or instruments that are directly under their control.

One such tool is the *discount rate*. This is the rate the central bank charges banks to borrow funds from it. Banks borrow from the central bank when they are short of funds to lend. The central bank can encourage (or discourage) banks from borrowing by decreasing *or increasing* the discount rate. This allows the central bank to control bank lending indirectly.

In the US, the discount rate is primarily symbolic. It serves as a way for the Federal Reserve (Fed) to signal to the markets its desired interest rate level. The Fed normally does not borrow or lend to the banks directly. Instead, it increases or decreases bank reserves through *open market operations*, i.e., buying and selling government securities in the open market. The funds generated are traded among the banks in a market known as the federal funds market. The interest rate charged by banks to borrow from each other is called the *federal funds rate*. Note that the Fed does not participate in the federal funds market directly. The Federal Reserve influences this market by announcing the federal funds target rate and then carries out the open market operations needed to achieve its target rate.

It is the federal funds rate that the Fed has cut ten times since January of this year. After the latest cut on November 6, the federal funds target rate stands at 2.0 percent, down from 6.50 percent in January. The actual federal funds rate prevailing in the market in recent days has tracked the target rate quite closely; it stands at 2 percent. The cuts in the federal funds rate has caused market interest rates to decline. The benchmark 3-month US dollar interbank lending rate (LIBOR) has declined from 6.40 percent in early January to 2.02 percent currently. Similarly, the benchmark 2-year US Treasury note has declined from 5.40 percent in December to 2.43 percent currently.

Monetary policy, however, is not a panacea, as is clear from the US Fed's experience. One reason is that monetary policy works indirectly and takes time to act. It takes a while before a cut in the federal funds target rate "reaches" the consumers and businesses, and it takes some more time for them to increase borrowing. It takes yet some more time for the increased borrowing to be translated into more production, more employment and, hence, more GDP for the economy as a whole. In the US, typically, an interest rate cut takes six to nine months to have an impact on the economy. This can partly explain why the ten interest rate cuts by the Fed have not yet helped to turn the economy around. The first interest cut done ten months ago on January 31 was just beginning to take effect when the September 11 events



occurred. The other nine cuts still have some ways to go.

There are some situations in which interest rate cuts lose their power on the economy. Economists call these situations liquidity trap, i.e., when interest rates have reached such a low level that they cannot be cut any further, or further cuts will not induce people to borrow more. Japan seems to be in this situation. Its interest rates have fallen close to zero, yet consumers and investors are not borrowing more. This is because there are many other factors (e.g., profit and business expectations, existing level of debt) that also influence borrowing.

A third situation in which monetary policy loses its potency is the opposite of the world situation today. Persistent interest rates cuts to expand the economy beyond its capacity often lead to higher inflation. Once the economy's resources (labor and capital) are fully employed, there is little excess capacity left to increase production. In this case, increases in money supply simply end up increasing inflation. Perceptions of high inflation down the road cause markets to add an inflation risk premium to long-term interest rates. This is why typically, at the end of a monetary policy easing cycle one sees long-term interest rates rising even as short-term rates are very low (i.e., the yield curve steepens).

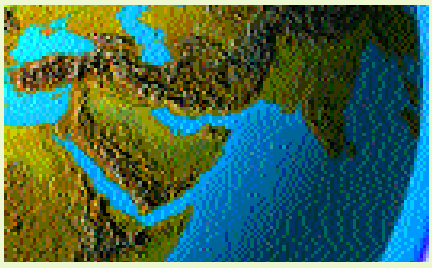
Fiscal Policy

The government can also try to use fiscal policy to get out of a recession. In fact, the Bush administration is pushing a multi-billion tax cut and spending package as a way for the US to quickly climb out of the recession. When the government spends money or cuts taxes, it puts money directly in the hands of consumers, businesses and investors. Thus, many see it as a potent way of creating demand that will lead to increased production and GDP.

Fiscal policy also has its limitations. When the government increases spending, it has a bigger impact on the economy than when it gives an equivalent tax cut to the public. Because each dollar the government spends is a direct addition to demand for goods and services, while each dollar in tax cut may or may not be spent. Generally, one dollar in tax cut leads to a "less than one dollar" increase in demand. Fiscal policy is difficult to fine tune because it takes a long time to be approved (parliamentary or congressional debates, appropriations, etc. take time). Once in place, fiscal policy also takes time to be removed when it is no longer needed (again for the same reasons). Monetary policy, on the other hand, can react much more quickly. Fiscal policy is also ineffective when the economy is at full employment. One extremely powerful argument against fiscal policy is that it often leads to budget deficits and adds to the country's national debt. Because of these reasons, the US had almost stopped using fiscal policy for short-term aggregate demand management for over a decade. Only now, as an after effect of the September 11 induced recession, the conventional view against fiscal policy may be beginning to change.

Monetary Policy in Saudi Arabia

The Saudi Arabian Monetary Agency (SAMA) relies on four policy instruments in conducting monetary policy: minimum reserve policy (cash reserve ratio), Repos, foreign exchange rate swaps, and placement of public funds. The most powerful instrument is the cash reserve ratio, under which SAMA specifies a minimum reserve requirement for banks. The cash reserve ratio is not however used for day-to-day liquidity management. This is done through the use of repos. SAMA engages in short-dated (overnight) sale/repurchase agreements with banks depending on the liquidity needs of banks. Foreign exchange swaps with maturities up to one year are used for liquidity management and occasionally against currency speculation. Also SAMA may place government institutions' (e.g., GOSI, Ministries) funds with commercial banks. This policy tool is entirely at SAMA's discretion and is complementary to the primary instruments, repos and foreign exchange swaps.



The key aims of Saudi Arabian monetary policy are to stabilize inflation, maintain a fixed exchange rate of the Saudi Riyal against the US dollar and allow free movement of currency and capital. There are no exchange controls and money for trade or capital accounts can be transferred without any limitations. SAMA enforces this policy by standing ready to buy or sell Riyals at the fixed exchange rate at any time, and making interest rates on Saudi Riyal closely track the dollar rates. Note that the logic behind pegging Saudi riyals against the dollar is that oil and related petrochemical products prices, which constitute the bulk of Saudi exports, are denominated and priced in dollars.

Economic theory says that when a country fixes its exchange and interest rate and it is subject to high capital mobility, it loses its ability to conduct an independent monetary policy. We will not go into the technicalities of the argument. Essentially, what it says is that under these circumstances, the central bank cannot set a level of money supply that is different from what the market wants (except for short periods). Any excess money will be dissipated abroad through opposing capital flows and forces in the foreign currency markets.

In terms of economic policy, this means that in Saudi Arabia, fiscal, not monetary, policy is the primary instrument for economic growth management. In other words, fiscal policy can be used to increase or decrease GDP(see our *1st quarter 2001 Saudi Economic Review* for discussion on this topic), while monetary policy is targeted to fixing the exchange rate and interest rates.