Monetary and Fiscal Policy

Task Requirement (Question)

Assignment # 2 -ECON 1250

Q1. In this module we learned about several real-world complications that make monetary and fiscal policy more challenging than simple theory would suggest. Given the state of the Canadian economy and the causes of that state—think back to earlier discussions about the current economy—what should be the appropriate mix of fiscal and monetary policy, from a Keynesian perspective? From a neoclassical perspective? Which makes the most sense to you? Provide evidence (include and least one link/citation) to provide support to your conclusion.

Q2. Visit the following link of Bank of Canada to prepare the tables and graphs using the following information.

https://tradingeconomics.com/canada/gdp-deflator

1. GDP Deflator% (Jul 2019-Jan 2022)

2. Unemployment rate % (Jul 2021-June 2022)

3. Interbank rate % (Bank of Canada rate) [Jan 2021-Jul 2022]

4. GDP growth rate % [Jul 2019-Feb 2022]

5. What kind of pattern did you find in the above economic indicators? Positive or negative correlations? Do they all move in the same direction at the same time? Explain the performance of above economic indicators in your own words.

Answer to question 1:

The Keynesian perspective of government intervention believes that as the wage is rigid, changes in spending, investment, consumption, and government expenditure can result in a change in output. In contrast, the neoclassical perspective believes that wage is flexible and thus, through a market-driven process economy will adjust itself.

Given the state of the economic situation in Canada, I would like to go with the Keynesian perspective of fiscal and monetary policy. As the economy is facing a fall in growth and moving towards recession, it is expected that government should bring in expansionary fiscal policy. This way, through the additional budget allocation to infrastructural development, job creation will take place that will increase the aggregate demand in the market. With increased demand, supply will increase, and demand labour will increase, leading to a fall in employment and a rise in disposable income. Hence, through the expansionary fiscal policy, the government of Canada can boost the economic situation through a cyclical process.

On the other hand, with the rise in the economy, as the price will increase, the government need to take a contractionary monetary policy that will increase the interest rate and reduce the money supply in the market. This will control inflation and thus safeguard the interest of

the consumers in the market. By controlling inflation, the government can hold confidence in the market and keep a balance in market demand and supply. For example, the Canadian government response to covid19 can be mentioned where the government took the fiscal and monetary policy. Financial aid of $290 billion and medical aid of $60.3 billion was introduced by the government as expansionary fiscal policy, and as monetary policy government introduced a $95 billion credit facility, farm credit and other direct and indirect monetary policies (imf.org 2020).

Answer to question 2:

Key economic indicators of the Canadian economy have been collected and presented below in table 1:

Table 1: Key economic indicators of Canada

Date	GDP deflator %	Unemployment rate %	Interbank rate %	GDP growth rate %
Jul 2019	109.6	5.7	1.83	1.8
Oct 2019	109.6	5.8	1.86	1.7
Jan 2020	110.5	6.4	1.66	-.6
April 2020	109.4	12.9	.37	-12.4
Jul 2020	108.6	10.1	.26	-4.9
Oct 2020	111	8.9	.24	-3.1
Jan 2021	112.4	8.5	.19	.2
April 2021	115.9	7.9	.18	11.7
Jul 2021	118.6	7.2	.21	3.8
Oct 2021	120.1	6.3	.25	3.2
Jan 2022	122.4	5.8	.65	2.9
April 2022		5.1	1.7	

Source: (Tradingeconomics.com 2022)

To analyse the association among these variables, correlation has been calculated first and presented in table 2 below:

Table 2: correlation of key economic indicators canada

	GDP deflator %	Unemployment rate %	Interbank rate %	GDP growth rate %
GDP deflator %	1			
Unemployment rate %	-0.41843	1		
Interbank rate %	-0.39386	-0.60129	1	

GDP growth rate %	0.557308	-0.71135	0.03445	1

As per the table 2, there is strong negative association (-.71) between GDP growth rate and unemployment rate. This showcase as the GDP growth increased in Canada, unemployment fell which is in line with the previous literary sources which demonstrates with rise in GDP, economy tends to generate more job resulting fall in the unemployment rate. GDP growth rate has a positive association with GDP deflator. It is in line with previous literary sources which demonstrates with rise in GDP growth rate; price level tends to increase, resulting overall inflation to rise which increases the GDP deflator too. Association between GDP growth rate and the interbank rate is positive; however, it is weak as the correlation is 0.03 only. This is in line with the previous literary source, which demonstrates that as the GDP growth rate increases, demand for loanable funds increases, leading to inflation. To control inflation, the interest rate is increased by the central bank, and the interbank rate is also increased, which is decided by the bank and not by the central bank. Table 2 also demonstrates a negative association between interbank rate and GDP deflator with correlation -.39. If the interbank rate increases with the increasing demand of loanable funds, demand for borrowing will decrease, leading to a fall in inflation. This will result in fall in GDP deflator; hence, the negative association is in line with previous literary evidence. The association between interbank rate and unemployment rate with correlation -.60 is in line with the previous literary evidence. As the interbank rate grow, borrowing fall and job creation fell. Hence the association is negative and change in one variable result in a change in other variables in an inverse direction. Lastly, table 2 demonstrates the association between the unemployment rate and GDP deflator. With correlation -.42 the association is negative and valid as per previous literary sources. If the GDP deflator increase, market demand reduces and with a reduction in market demand job creation fell resulting in rise in unemployment.

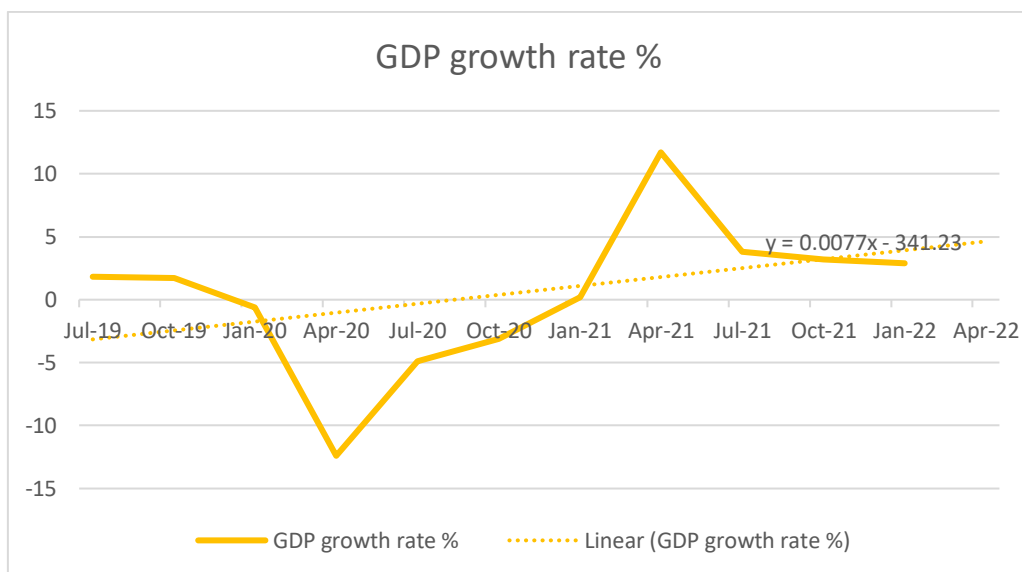To check the association in a different quarter, graphs have been drawn below:

Figure 1: GDP growth rate of Canada

Figure 1 demonstrates that the Canadian economy GDP has increased at .77% rate where GDP faced dip in 2020 due to pandemic. However, in the third quarter of 2021, it faced a continuous fall due to a crisis in the international market of Russia Ukraine war.
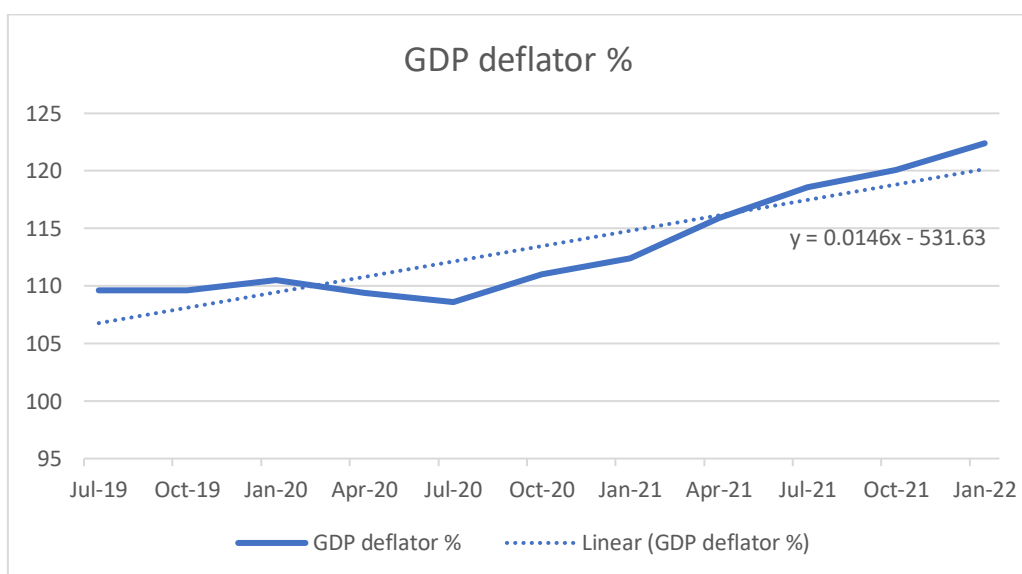

Figure 2: GDP deflator of Canada

Figure 2 demonstrates that as the time increased, GDP deflator increased with 1.46% rate in each quarter. Though there has been fall in economy during 2020 due to pandemic, yet, the economy recovered since third quarter of the same year, resulting an upward trend in GDP deflator. Hence, the change is in line with GDP growth rate.
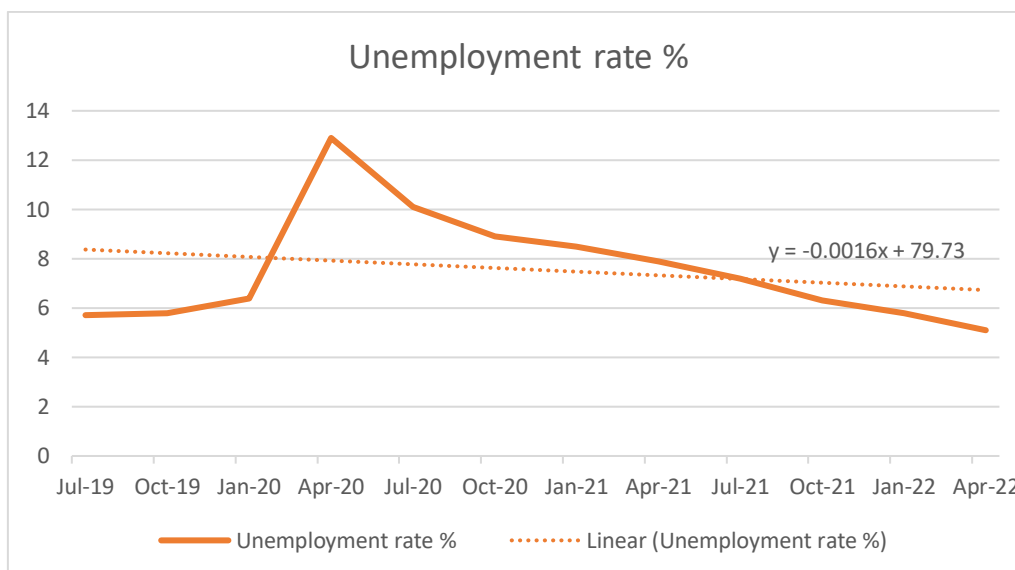
Figure 3: Unemployment rate of Canada

As per the figure 3, unemployment rate of Canadian economy fell sharply since third quarter of 2020. This fall is mainly generated due to the increase in GDP as demonstrated in figure 1, which showcase strong negative association between GDP growth rate and unemployment rate.
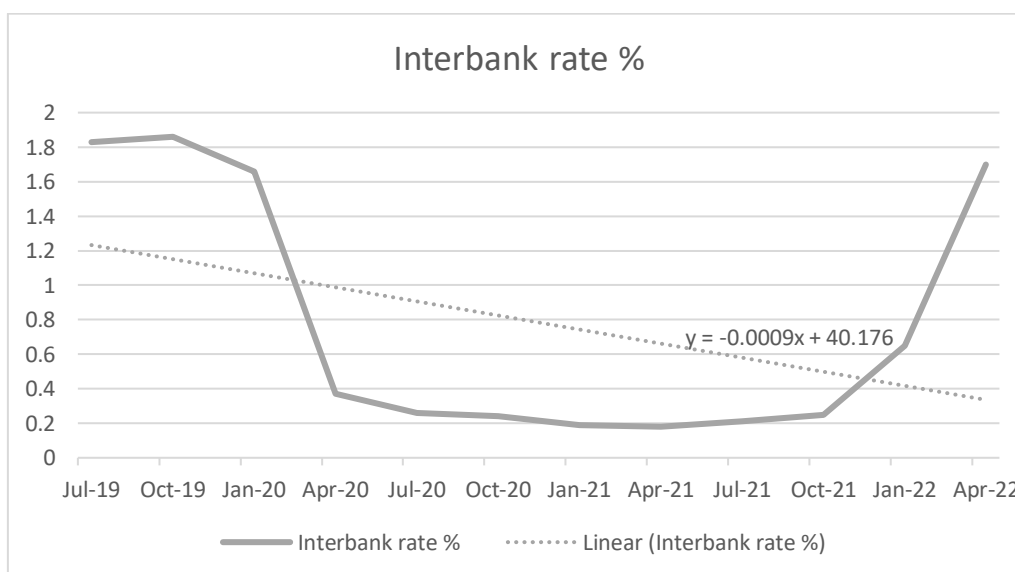

Figure 4: Interbank rate of Canada

Figure 4 showcase that interbank rate fell sharply till third quarter of 2020 from third quarter of 2019. Post this it stabilise and continued to increase from third quarter of 2021. This showcase change in line with the GDP growth rate with weak association.

References:

Imf.org (2020). Policy response. https://www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19#C

Tradingeconomics.com (2022). Canada GDP Deflator - 2022 Data - 2023 Forecast - 1961-2021 Historical – Calendar. https://tradingeconomics.com/canada/gdp-deflator