**DISCUSSION ON NATIONAL MONEYTARY POLICY**

Module code:

Module title:

**EXECUTIVE SUMMARY**

Monetary policy and fiscal policy are two important macroeconomic management tools, each of them is implemented by the Government through manipulating different elements of the economy. Each policy aims to different target but they are in close relationship and pursuing a common goal of sustainable economic growth. In particular, monetary policy is a tool of the Central Bank to regulate the process of money supply, interest and credit, which results in changing the national cash flows and the amount of money available in the market to achieve objectives of stabilizing prices, i.e. to curb inflation at a low and stable level, which support economic growth. This essay is focus on inflation - an important element of the economy by analyzing the national fiscal deficit, its relationship with inflation and the way this relationship be used to stabilizing the economy. In additions, another element of the economy is exchange rate which would be examined in specific manipulation as an inflation controlling technique. The essay will also discuss the methods of accounting for price changes in hyperinflationary times by referring to relevant International Financial Reporting Standards (IFRS).

1. **Fiscal deficit in a national economy.**

The fiscal deficit is an event of macroeconomic, which occurs when the government expenditures are higher than its revenue in a certain period, and it indicates that the government has to externally borrow to offset the deficit (Investopia,2018). According to Keynes (1936), the government should actively accept the fiscal deficit when implementing an economic stabilization policy.

The increase in government spending is not the only factor causing budget deficits. An equally important factor is the decline in government revenue which is caused by two main reasons: government tax deduction policy or income and investment returns deduction due to a weakening economy. The U.S Treasury Department reported an accumulated fiscal deficit of US $ 14 billion in December 2018 as a result of tax cut policy by the President Trump (CNBC,2019). In 2018, the Government spending was US $ 900 billion than the amount the U.S government collected.

It is very important for the Government to control the fiscal deficit and the way government finances spending is also vital for economic growth. If the economy is funded primarily based on taxes, it will deform the development investment motivation and can eventually inhibit growth. If the deficit is financed through debt, it will affect the size of private enterprises and increase interest rates. The Keynesian studies considered that fiscal deficits lead to an increase in domestic production, making private investment more optimistic about the future of the economy, which lead to more investment. On the other hand, Easterly et al. (1992) considered that there is a negative relationship between fiscal deficit and growth. Gale & Orszag (2002) stressed that fiscal deficits are likely to slow growth because of a net decline in foreign capital inflows and thus lead to a reduction in the nation's investment and national income in future.

1. **Relationship between fiscal deficits and inflation and how this relationship could be used to achieve economy stability.**

Inflation indicates the decrease in purchasing power of a national currency, inflation is measured at the rate at which the average price level in an economy has increased over a period.

Fischer (1993) demonstrated that a large fiscal deficit and economy growth is inversely correlated. The result of the fiscal deficit will increase inflation, thereby adversely affect economy growth. Rubin et al. (2004) further explained that negative growth is due to the persistent fiscal deficit leading to a sharp decline in national asset prices, increasing inflation concerns and impairing investor’s confidence. Koohoon Kwon and Lavern McFarlane (2006) pointed out the strong positive correlation between public debt and inflation in countries with high public debt ratios, but this relationship becomes looser toward countries who have low public debt rates. In additions, the money supply factor is always the cause of inflation in both groups of these countries whether they have debt or no debt. In summary, the research models have confirmed that fiscal deficits are financed through increasing money supply leading to inflation. In other words, the inflation effect of the fiscal deficit depends on how the deficit is financed and its impact on aggregate demand.

When a country has deficit in national fiscal system, to achieve the goal of controlling inflation, stabilizing the economy and reducing fiscal deficit, this country will likely focus on reducing public sector spending. President Donald Trump has proposed a plan to cut government spending of US $ 2,700 billion in the next 10 years, which primarily focuses on the field of Social security, Medicaid program and Medicare; 2 percent would be cut down in the defense budget (Damian,2018), more than US $ 213 billion will be cut out of the Supplement Nutrition Assistant Program (Dottie et al,2018). The budget for the State Department and the US Agency for International Development fell by 33% (Carol,2018).

1. **How exchange rate could be used to control inflation in an economy.**

Exchange rate is the rate at which one national currency be exchanged to other national currency. Research by Agenor and Montiel (1996), Svensson (2000) and Woo (1984) mentioned major transmission mechanisms of how exchange rate fluctuations affect inflation. First, exchange rate fluctuations directly affect inflation through the price of imported goods in the consumer price index. When the domestic currency depreciates, the price of imported goods for consumption or production converted to domestic currency will lead to rising consumer prices as well as rising production costs leading to domestic price increasing. Second, the impacts are caused through the shift of consumption between domestically produced goods and imported goods. When the domestic currency depreciates, the price of imported goods or the use of imported materials in local currency becomes more expensive, so consumers tend to use domestically produced goods which increases demand of domestic goods and their price. According to Garcia and Restrepo (2001), changes in exchange rates also impact inflation through valuation and expectations. In most developing countries with high economic uncertainty and inflation, people tend to lose faith in the domestic currency. When the currency depreciates, it will easily lead to speculation of increasing the level of devaluation. Moreover, the devaluation of domestic currency can be considered a signal that the government is losing control of inflation. This provides a solid foundation for people to expect higher inflation in the future, and expected inflation also plays a remarkable role in the increase of real inflation.

To control inflation, the first solution that countries often apply is to reduce the amount of money in circulation. The central bank will sell short-term securities, foreign currencies or issue government debt instruments to withdraw money from the economy. Besides, the central bank will set high interest rates, which encourage people to deposit money into banks resulting in reduction in money in circulation. In additions, to overcome inflation, the government can use its tightening fiscal policy by reducing consumption in the state sectors or setting limit in wages increase which may decrease the demand for population spending.

1. **Methods of accounting for price changes in hyperinflationary times.**

The adjustment of financial statements in the context of inflation economy has been noted early by different countries in the world. In the International Accounting Standard No. 29 (IAS 29), it promulgates a guidance on accounting treatment in hyperinflation economy. It is recommended to adjust financial statements in some cases such as: rate inflation accumulated in 3 years is 100% or higher (on average 26% / year); people want to keep their assets in the form of non-cash asset or in form of more stable currency; interest, wages and prices are attached to the price index; credit transactions are performed at the price which offset the estimated purchasing power decreasing level, etc.

There are two main accounting methods in hyperinflationary times, they are current purchasing power (CPP) and current cost accounting (CCA). Under CPP method, it divides all accounting title into monetary items and non-monetary items. At the closing date, a general price index which reflects the inflation impacts is applied as measuring unit, all non-monetary items are restated to price index to reflect their real value. Monetary items are not required to be restated (PWC,2018). With CCA method, the value assets and liabilities in the Financial position statement will be reasonable reassessed to the fair market value rather than their historical cost, any difference resulting from this revaluation will be added to the Profit or Loss statement. However, in actual, it is difficult to release a fair market value because it requires many indicators and complicated calculations (ACCA,2018).

It indicates that in a high inflation economy, if accounting treatments are not adjusted, the financial statements will no longer be useful. Because the national currency lost its purchasing power quickly that the comparison of the transaction value and other events that happened in an accounting period also became misleading. Un-adjustment in accounting method also makes it difficult for business managers to consider the financial situation and make the right decisions. This leads to a viewpoint of how to adjust account in financial statements to reasonable values to solve the problem of price impact on financial statements. From the perspective of accounting theory, when all assets are measured with the same base of valuation: historical cost or market price, this will meet the demand of easier information for the financial statement users (Olivera,2018).

**References**

1. ACCA global (2019). *IFRS 13, Fair Value Measurement | ACCA Global*. [online] Accaglobal.com. Available at: <https://www.accaglobal.com/lk/en/student/exam-support-resources/professional-exams-study-resources/strategic-business-reporting/technical-articles/ifrs-13.html> [Accessed 29 Mar. 2019].
2. Carol Morello (2018). *Head of USAID defends big cuts in foreign aid budget*. [online] The Washington Post. Available at: <https://www.washingtonpost.com/world/national-security/head-of-usaid-defends-big-cuts-in-foreign-aid-budget/2018/03/21/a34cbf26-2d27-11e8-8ad6-fbc50284fce8_story.html?utm_term=.c2d27f3db15d> [Accessed 29 Mar. 2019].
3. Center on Budget and Policy Priorities. (2018). *President's Budget Would Cut Food Assistance for Millions and Radically Restructure SNAP*. [online] Available at: <https://www.cbpp.org/research/food-assistance/presidents-budget-would-cut-food-assistance-for-millions-and-radically> [Accessed 29 Mar. 2019].
4. Damian Paletta and Seung Min Kim (2018). *Trump calls for 5 percent spending cut in some programs.* [online] The Washington Post. Available at: <https://www.washingtonpost.com/business/economy/trump-calls-for-5-percent-spending-cut-in-some-programs/2018/10/17/112ce5a8-d236-11e8-b2d2-f397227b43f0_story.html?utm_term=.49785860247d> [Accessed 29 Mar. 2019].
5. Easterly, W., Rebelo, S. (1992). Fiscal Policy and Economic Growth. *Journal of Monetary Economics*, 32(3), pp. 417-58.
6. Fischer, S. (1993). The role of macroeconomic factors in growth. *Journal of Monetary Economics*, 32(3), pp.485-512.
7. Gale, W.G., Orszag, P.R. (2002). The Economic Effects of Long–Term Fiscal Discipline. *Discipline, Tax Policy Center Discussion Paper.*
8. GJORGIEVA-TRAJKOVSKA, Olivera; KOLEVA, Blagica; GEORGIEVA SVRTINOV, Vesna. (2018). FINANCIAL REPORTING IN HYPERINFLATIONARY ECONOMIES. *Journal of Economics*, 3(2), ISSN 1857-9973, pp.50-57.
9. Investopedia. (2018). *Fiscal Deficit*. [online] Available at: <https://www.investopedia.com/terms/f/fiscaldeficit.asp> [Accessed 26 Mar. 2019].
10. Jeffery, A. (2019). *US posts $14 billion budget deficit as revenues sag after Trump tax cuts*. [online] CNBC. Available at: <https://www.cnbc.com/2019/02/13/us-posts-14-billion-budget-deficit-after-trump-tax-cuts.html> [Accessed 29 Mar. 2019].
11. Monfared, S. and Akın, F. (2017). THE RELATIONSHIP BETWEEN EXCHAGE RATES AND INFLATION: THE CASE OF IRAN. *European Journal of Sustainable Development*, 6(4).
12. Pwc.fr. (2018). [online] Available at:<https://www.pwc.fr/fr/assets/files/pdf/2018/10/pwc-en-hyperinflation-in-argentina-which-implications-for-your-consolidated-financial-statements-2.pdf> [Accessed 29 Mar. 2019].
13. Rubin, R.E., Orszag, P.R., Sinai, A. (2004). Sustained Budget Deficits: Longer-Run U.S. Economic Performance and the Risk of Financial and Fiscal Disarray. Paper presented at the AEA-NAEFA Joint Session, Allied Social Science Associations Annual Meetings, The Andrew Brimmer Policy Forum, “National Economic and Financial Policies for Growth and Stability,” San Diego.