

# Financial Policy Instruments

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LECTURE #3

MPPA LINKAGE PROGRAM

# MONETARY POLICY INSTRUMENTS

1. *Rediscount policy*; When the central bank increase commercial banks' *discount-rate*, the money supply will decrease.
2. *Open market operation*; If the government want to reduce money supply, they must sell government bonds (it is called "*open market selling*")
3. *Legal Reserve Ratio (LRR) manipulation*; LRR is the ratio between cash reserve and demand deposits. If the central bank want to reduce money supply, the LRR must be increased (it is called "*tight money policy*")
4. *Selective credit control*; the central bank may issue a "moral suasion" to influence credit policy of commercial banks.

# MONETARY INDICATORS

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## What is money?


M1: bank notes & coins, plus all savings in current account (demand deposit)

M2: M1 + savings + time deposits in commercial banks

M3: M2 + savings + time deposits in commercial banks and non-banking financial instruments.

# THE ROLE OF CENTRAL BANK

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1. To facilitate transactions and payments
  2. As the government's treasury; collecting taxes, facilitates government's payments (example: to the local governments) and to issue government's bonds and treasury bills (*surat berharga*)
  3. To supervise commercial banks. Example: financial audit, issue licences, regulates banking businesses, etc.
  4. To collect and to analyze national and international economic data.
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# CLASSICAL MONETARY THEORY

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Irving Fisher:

Total expense = value of goods/services purchased

$$MV = PT$$

M: money supply, jml uang beredar

V : velocity, how fast money is spent

P : prices

T : transactions, the volume of goods / services being exchanged with money.

# Marshall's Monetary Theory

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$$M = k P y$$

K: the proportion of GDP can be converted into cash. Equal to  $1/V$

Transaction volume is not calculated by transactions, but by the Y (GDP)

Example:  $k = \frac{1}{4}$  (1/4 of the GDP can be converted into cash). If the GDP = \$ 400 billion, then  $M = \frac{1}{4} \times 400 \text{ billion} = \$ 100 \text{ billion}$ .

# How does Central Bank Control the Money Supply?

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Monetary Base (uang inti): the net money from the monetary authority (Central Bank) in public hands.

Under commercial bank system, the MB can be considered as reserve in Central Bank.

$$MB = RS + C$$

MB: monetary base

RS : reserve

C : cash

# Determinants of Money Supply

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There are variety of monetary elements: demand deposit, time deposit, government bonds, LRR (Legal Reserve Ratio).

Then:

$$MS = R (D+T+G)$$

D: demand deposit

T: time deposit

G: government deposit (deposito berjangka pd bank umum)

Conclusion: there are at least 3 (three) elements determining the money supply: people (D & T variables), central bank (R) and G (the government).



## FISCAL VARIABLES IN OPEN ECONOMY SYSTEM

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$$Y = C + I + S + G + (X - M)$$

Y : national income (GDP)

C : consumption

S : savings

I : investment

X : export

M : import

Tx : taxes

G : government expenditures

T : transfer (subsidy).

# THE LOGIC OF FISCAL POLICY

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Fiscal policy objectives:

1. Robust economic growth
2. Reducing unemployment
3. Stabilizing prices.

There would always be conflicting objectives in fiscal policy. Example: How to control prices while maintaining adequate employment? Efforts to control price would reduce employment. On the other hand, efforts to increase employment would increase inflation.

# WHAT IS A GOOD TAX?

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1. The yield must be adequate / significant
2. The tax burden must be equal
3. Final tax bearer must be recognized appropriately
4. No excess burden
5. Support financial stabilization and economic growth
6. Administratively fair and easy
7. The costs for enforcing compliance must be affordable.