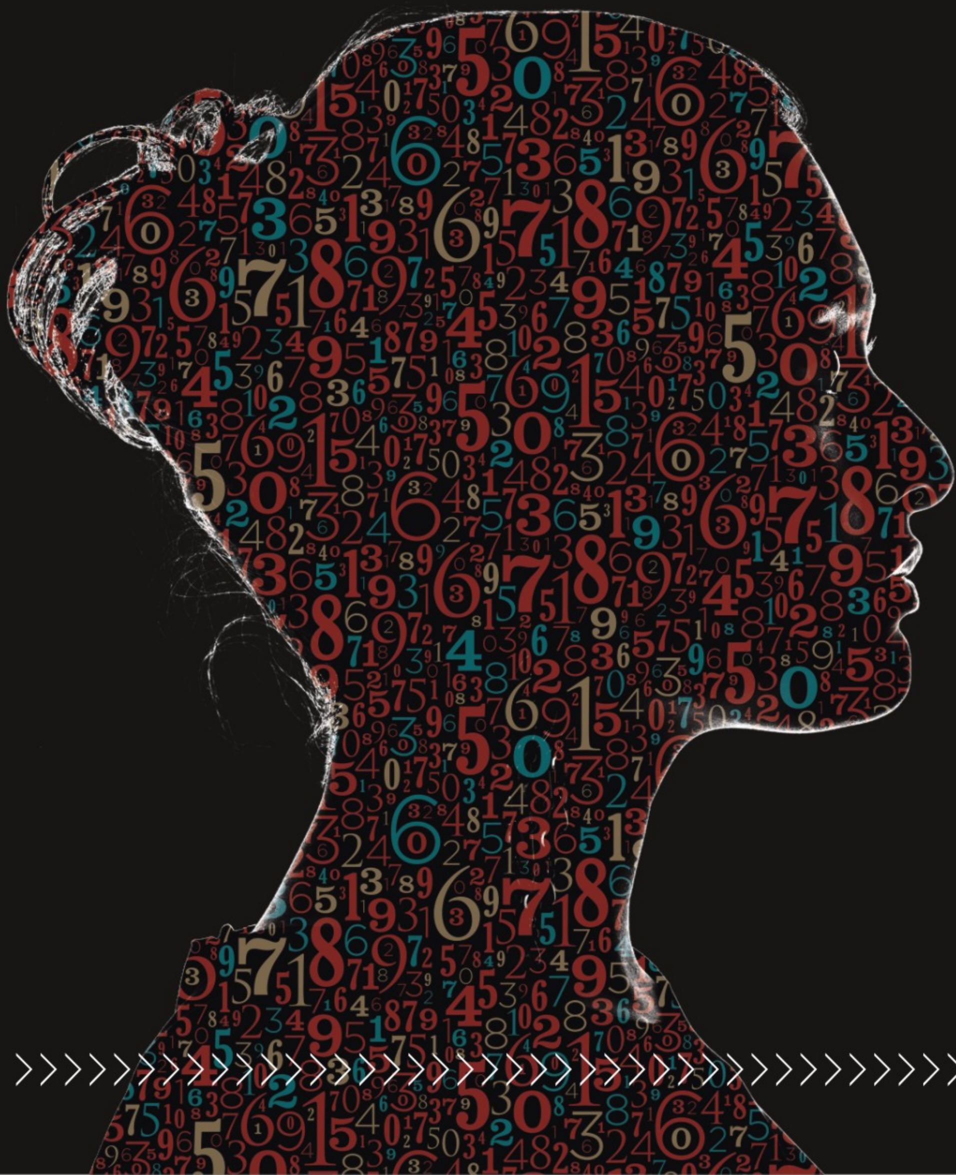


# Knowledge Series : Fiscal Stimulus

February 2009

**Opportunity favours the prepared mind.**

DSP BLACKROCK
INVESTMENT MANAGERS

# What is Recession?

- Recession is defined as a significant decline in economic activity/ output spread across the country, lasting more than a few months, normally visible in real GDP growth, real personal income, employment, industrial production, and wholesale-retail sales
- Its usually preceded by several quarters of slowing but positive growth- But when GDP growth slows down, businesses stop expanding, employment falls, unemployment rises, and housing prices decline
- Recession normally takes place when consumers lose confidence in the growth of the economy and spend less
- Its natural for countries to experience mild recessions, as it is a built-in/ endogenous factor of a society

**→ Recession is not due to lack of productive capacity in the economy**

**→ Real problem is due to insufficient spending to support the normal level of production**

**Recession is a natural result of the economic cycle and will adjust for changes in consumer spending and consumption or increasing and decreasing prices of goods and labor**

# What/ Who Decides Output in an Economy?

- John Maynard Keynes, the well known British economist of the 20th century wrote his seminal work - *The General Theory of Employment, Interest & Money* during the great depression of the 1930s, in which he studied factors affecting output and growth in an economy
  - **Output (both goods and services) is decided by those with the purchasing power**
  - Basically, people who earn money with one hand and spend it with the other ultimately decide how much goods and services will be produced in the economy
  - Fluctuation in spending or aggregate demand by this section of consumers could result in short term fluctuations in output and employment
  - Hence, firms will try to meet demand for goods and services at a ‘set’ price by altering the supply

**Demand affects output and growth in the economy**

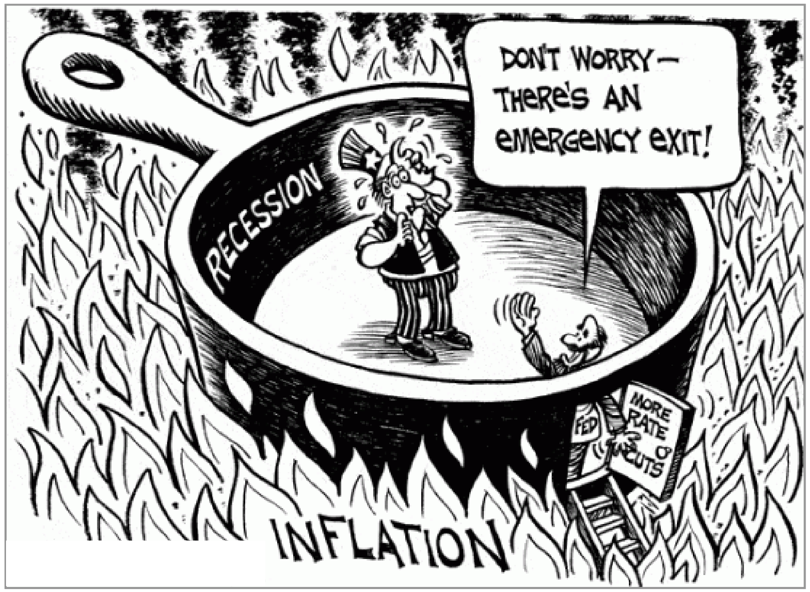
# How do Producers ‘Fix’ Prices?

- If demand for product ‘X’ has fallen, the producer should have to decrease its price in order to boost its demand
- However, it is impractical & difficult to increase/ decrease price of products frequently as setting a fresh price level every day will be a nightmare for both producers as well as consumers
- Further, the input costs in production of ‘X’ may also keep varying, thereby rendering it next to impossible for the producer to plan for the future, or even to merely recover his cost of production if he sells below a certain price
- The producer can then let the price of ‘X’ remain the same, but will have to decrease production (responding to lower demand)- Hence he meets the demand at a set price by matching his supply with the prevalent demand

**Producers meet the demand at a set price by matching supply with the prevalent demand**

# What Happens in Recessionary Times?

- Demand falls to very low levels, which makes it unsustainable for producers to maintain output
- This results in a significant drop in production of goods and services
- Hence it is important to introduce measures in the economy that boost demand
- There could be various methods to help in doing this: Interest rate cuts, Stimulus packages etc




**If ↓ in demand results in ↓ in production, it is important to take measures to boost demand**



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# Countering Recession

- As mentioned earlier, the best way to counter recession is to introduce measures to push up demand

## Fiscal Stimulus Package

**Increase Govt. Spending**

Effective way to increase aggregate demand of goods and services

*(This measure was suggested by Keynes)*

**Decrease Taxes**

Resulting in increase in the disposable income in the hands of the people

- **Multiplier Effect:** People use the extra income (due to decline in taxes) on consuming extra goods and services. For example: When one buys more bread from the baker, the baker buys more milk from the milkman, who buys something else, thereby generating an increase in demand on various levels

**Fiscal Stimulus Package results in an ↑ in demand: An instant source of ENERGY**

# Countering Recession (cont’d)

- Fiscal Stimulus is a potent tool to fight recession, but its crucial to get the following right
  - **Timing** of the stimulus package
  - **Size** of the stimulus package
  - This is a tricky business since it is almost impossible to figure out the where the recessionary period began and where it will end- Wrong timing could spoil things further by increasing fiscal deficit as well as inflation

**Timing of the Stimulus Package is crucial, otherwise this itself can fuel further problems**

**Thank You**