GOVERNMENT INTERVENTION IN ECONOMY AND ITS IMPACT ON ORGANIZATIONS' DEVELOPMENT

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Abstract

The macroeconomic environment and governments influence the performance, the behaviour and the future of organizations and industries, as well. The intervention of government in a country's polices is a matter of many debates, and several concepts and theories about this problem could be found in the literature.

The real life emphasizes that some aspects of the theory could be recognized, but nevertheless they are influenced by the specific context of any country. Based on the literature, this paper makes a brief overview on economic cycles and the macroeconomic theories having in view the government intervention in economy.

The purpose of this research is to underline the importance of equilibrium between the market forces and government intervention in economy for the sake of the organizations' development and people's welfare.

Keywords: macroeconomic theories**,** Government intervention, market forces, organizations' development, macroeconomic factors.

JEL classification: E_{12}, E_{13}, E_{32}, E_{44}, F_{01}.

1. Introduction

Keynesian economics became the basis of economic policy in many countries in the post war period, especially in Europe. In the 1950s and 1960s the combination of low unemployment and high rates of economic growth seemed to offer proof of *Keynes's* theories. The experience of the 1970s was however to call *Keynes's* doctrine into question (Keynes, J.M., 1936). The decade produced an uncomfortable mixture of high inflation and high unemployment. The label given to this period in our economic history was *stagflation*. The main criticism of economic management in the 1970s was directed towards the inflationary impact of increases in Government expenditure.

Classical economic doctrines were to re-emerge into favour, labelled as *neo-classicism.* The argument was that Government intervention distorts the market, is inefficient and is inflationary. Governments should limit their role to reducing inflation by controlling the money supply and leave the economy to market forces. This *economic liberalism* supported by monetarist policies provided the underpinning for the economic reforms in the UK in the Thatcher era of the 1980s. The argument was that the free operation of market forces will maximize the creation of wealth and that the benefits of this wealth will "trickle down" to all members of society. Although showing some success in the 1980s, monetarism lost credibility when high unemployment persisted in the 1990s.

There has been a revival in neo-*Keyne*sian thinking, but with the emphasis on "supply side" policies rather than demand management. (E.g. increase in labour mobility; increasing access to investment).

Finally, the success of the USA economy suggests that a new economic model might be emerging, free from the cycles, which have plagued capitalist economies throughout the 20th century. But, the reality of the beginning of 21st century demonstrated that different factors might distort the cycles, such as terrorism, political elections, increases in the price of imported oil, the development of information and communication technologies, financial market rules and others.

Therefore, the world economy which had a "soft" landing in 2002-2003, but which was reluctant to show significant revival so far in 2004-2006, entered the financial and then economic crisis by the middle of 2007 that has had significant impact on organizations' development and not in a few cases survival.

2. Comments on macroeconomics and theories

Macroeconomics is defined as the aggregate of all economic activity whether carried out by individuals, organizations or government. Having in view the main government's economic objectives, normally expressed in terms of growth, unemployment and inflation, several theories have been stressed along the time, since market economy appeared in the world. Briefly, these theories could be presented in the figure 1.

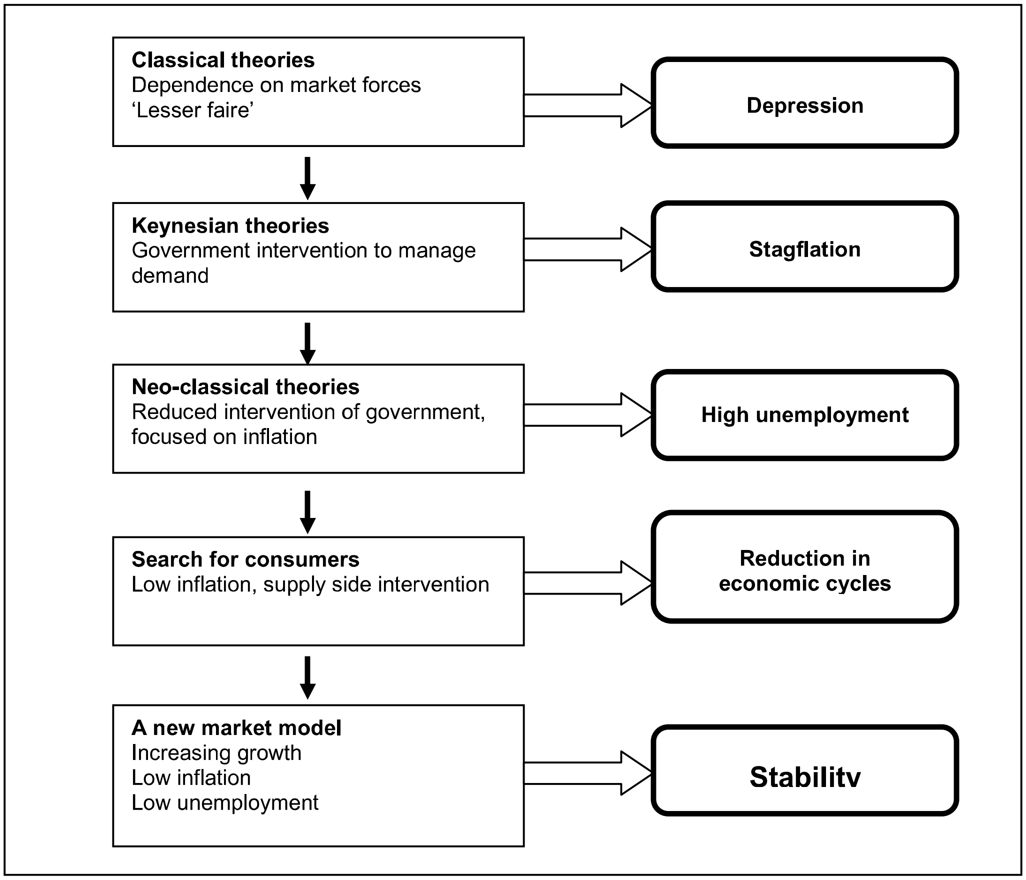

Fig.1. The phases in macroeconomic theories

This figure emphasizes the following ideas:

- The classical economic thinking is based on "lesser faire" conception about government intervention, which means that market itself is the regulator. The result could be seen as a depression of growth and unemployment's increase.
- The Keynesian concept is based on government intervention, mainly in the distribution of income by using taxation. The effect is seen as an increase of aggregate demand, welfare and social egalitarian distribution, specific to social democratic political vision and basically to mixed economies. History proved that stagflation is the label of this period, characterized by a flat develops of growth, increased inflation and unemployment, influenced twice by oil price shock.

• The neo-classical or liberal or monetarism thinking is focused on low government intervention and the connection between rising inflation and reduced unemployment. Government intervention is a matter of severe criticism, having in view the loss of control on expenditures and on the mechanism of increasing demand with negative consequences on increase of inflation and generally on the efficiency. The idea is to keep a low level of inflation with high unemployment.

• A consensus between Keynesian and neo-classical theories has in view the economic cycle of boom and recession and the increase of income inequalities. The evolution in the last 20 years proved that generally the unemployment is direct influenced by the growth and indirect by the inflation, but the result is the reduction in economic cycle.

• The new economic model, experienced by US economy, proved that economic growth leads to reduced unemployment and creates inflationary pressures.

The main factors that contributed to this sustained success and made the performance of the US economy over the pasts 10 years are:

• Increases in productivity have kept down the pressure on wage costs as the economy expanded. This was a new and welcome phenomenon.

• Availability of capital – particularly to support investment in the new technology sector

• Booming private consumption and a dramatic reduction in the savings ratio of the average American.

• Falling prices of imports, especially oil.

This "ideal" economy is dependent on several factors, which have to act together, such as: economic stability, new technology and innovation, availability of capital and labour, free trade and entrepreneurs. If any of these factors will fail in time it will probably affect the main trend of the objectives. The government intervention appears in controlling the inflation by the interest rate policy. The reality has proved this threaten on 11 September 2001 when the terrorist actions unstable the US economy and different companies and industries which were acting globally.

These briefings make us understand that the macroeconomic policy and performance depend on several factors, as: economic growth, inflation, unemployment, interest rates, exchange rates and not at last the governments policies and targets.

3. Market imperfections and economic cycles

The market cannot adjust automatically to eliminate unemployment because of the market imperfections, the impact of aggregate demand and the cumulative effect of market disturbances. In this context, the Keynesian theory brings the solution of the government intervention by fiscal policy, increased public sector expenditure and favouring low income groups lead to cost reduction and creation of demand.

These factors balance the economic growth and efficiency and bring social justice; equity and concern for environment for a while and at a point stagflation will arise characterized by inverse relationship between inflation & unemployment.

The market imperfections, which restrict the relevance of the classical economic model, are:

- Employment levels may not respond directly to the level of wages. Firms will only take on more workers if there is an increase in aggregate demand.
- Labour itself may be inflexible or unwilling to move geographically in search of new jobs.
- The skills required by a firm may not be readily available in the labour market. So workers with inappropriate skills will not find work. Keynes argued that the mechanism of the market, far from being self-correcting, could in fact make matters worse. For example as unemployment rises it reduces the level of aggregate demand in the economy – which leads to more unemployment.
- The reverse is also the case – if firms take on additional workers, this will increase aggregate demand, which in turn leads to more jobs being created. Keynes argued that aggregate demand determined the level of economic activity. In his view, if the Government intervened to stimulate the economy in periods of low growth or visa-versa, then the damaging effects of economic cycles could be reduced.

There was also a social philosophy to Keynes's approach, i.e. low-income groups tend to spend a higher proportion of their income than high-income groups. Therefore Government intervention, which favours low-income groups – such as reduction in taxes, or increases in welfare benefits – would have a greater impact on aggregate demand. In this respect the economic management could be successfully combined with social policy such as the redistribution of income.

The economic liberalism theory (Friedman, M., 1968, p. 1-17) is based on the idea that the reduction in unemployment leads to acceleration in inflation. The arguments are related to efficiency and socio-political environment. On one hand the distortion of price signals and market mechanisms by government intervention reduce taxes and subsidies, monopoly practices of trade unions and inflation from tentative to increase aggregate demand and on the other hand too much power in the hands of governments lead to conflicting interests, increase of self-perpetuating expenditures, erosion of market incentives and limited ability of governments to know what is in the public interest. Therefore the theory has as policies:

- Fostering of individual initiative & enterprise;
- Reduced power of trade unions;
- Laissez-faire policies, by reduced involvement of government in economy and tolerance for high unemployment;
- Primacy objective of economic policy is the control of inflation by reducing the money supply and interest rates.

An overall view of the economic cycles and government interventions is drowning in fig.2.

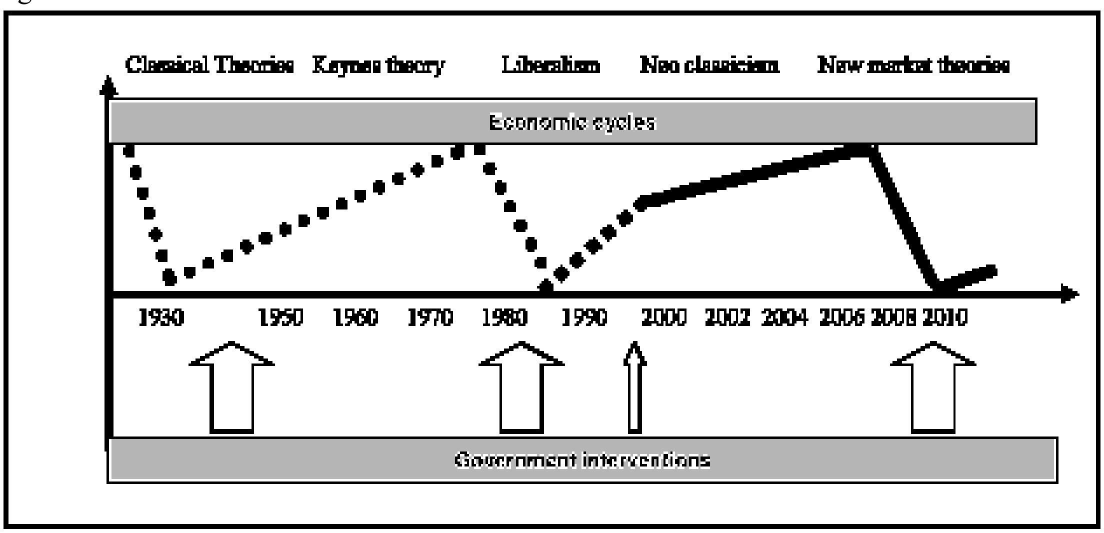

Fig. 2. Economic cycles and government interventions - An overall view

Having in view these two main theories and the facts demonstrated along time, it might be underlined that the causes of economic cycles are (Herd, R., 1999, p. 9):

- Swings in economic activity, mainly in aggregate demand;
- Economic growth leads to reduced unemployment and a scarcity of labour;
- This stimulates an increase in wage rates, which leads to inflation;
- Government – or the central bank – responds to this situation by raising interest rates;
- This alters the supply of money in the economy;
- Costs to firms therefore increase and they reduce their levels of investment;

• Growth in the economy slows into decline or recession;

• Government responds by reducing interest rates and the cycle begins all over again.

The Government interventions in economy might have different effects being "models of their particular development strategies" (Geiger, T., Geiger, F., 1973, p. 96). A good example is the cases of Singapore and Hong Kong, two very similar British colonies initially, which had adopted very different economic approaches since the 1960s, are becoming similar again. The Singapore government is well known for its economic intervention, while the Hong Kong government is equally well known for its free-market approach, while the two have enjoyed equal economic success. Recent events suggest that while the Hong Kong government has become increasingly interventionist, the Singapore government has become free-market oriented. Some analysis and findings (Lamb, N.M.K., 2000, p. 397-421) lead to the conclusion that, whether voluntary or reluctantly, the two governments have to adopt a mixture of interventionist and free-market strategies as their societies and economies mature. Projection of political, social and economic factors indicate that Singapore will continue to be more free market-oriented while Hong Kong will be more interventionist.

4. Factors of macroeconomics with impact on organization development

The macroeconomic factors set the context in which organizations have to operate successfully (fig.3). They determine the "rules of the game" in terms of such things as: investment, profitability, competition, confidence, stability and the role of Government (Grant, R., 1998, Johnson, G., Scholes, K., 1997).

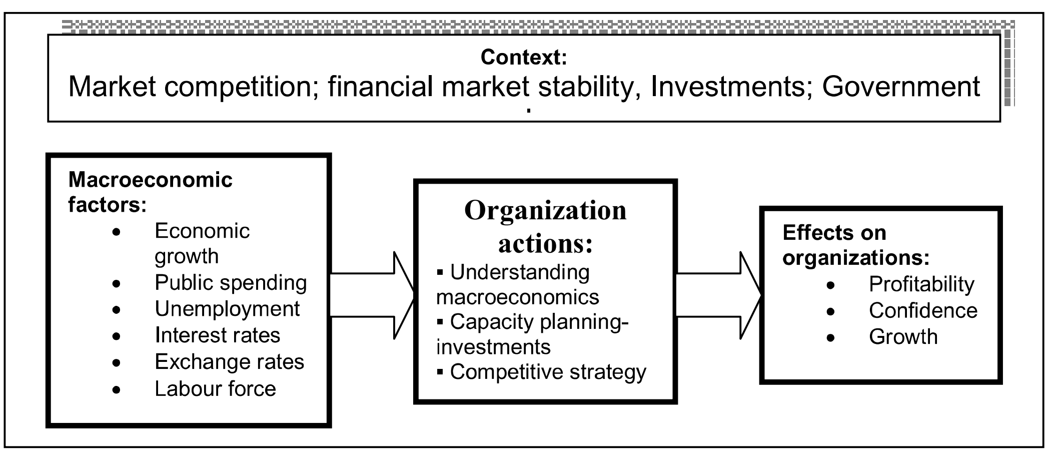

Fig.3. Macroeconomic factors impact on organization's development

The macro economy is influenced by, but not controlled by government policies. It is also linked tightly to social values and policies – for example on maximum working hours and minimum wages or the level of unemployment.

Government policies affect demand; labour and income distribution and changes in governments due to political parties' success in elections need to have small impacts. But, some macroeconomic factors are important for any organization, among are the followings:

- Economic growth: level of demand;
- Public (Government) spending: demand opportunities;
- Inflation: raw material prices, pricing policy;
- Unemployment: salaries and wages;
- Interest rates: cost of borrowing;
- Exchange rates: translation of overseas earnings into local money;
- Labour force: availability of skills in the marketplace.

As the world economy was hit by a global credit shock in mid-2007 from the USA and since then, global financial markets have suffered a sustained period of stress and instability, the UK and USA example of Government interventions are really useful.

The UK Government "has taken decisive action to support the stability of the financial system and wider economy. Tackling a downturn of this nature and dealing with its consequences requires a comprehensive policy response to support the economy: fiscal and monetary policy, financial sector interventions, and targeted support for individuals and businesses" (*Financial stability*, 2009, p. 45-69).

The main actions "have been targeted at tackling problems in individual institutions, addressing system-wide instability, and getting credit flowing through the economy once more", among are the followings (*Financial stability*, 2009, p. 45-69):

- providing broader support for the economy by implementing a timely, targeted and temporary fiscal stimulus and allowing the automatic stabilizers to operate in full;
- sharp cuts in interest rates by the Bank of England's Monetary Policy Committee;
- authorizing the use of a new monetary policy instrument by the Bank of England to ensure that the inflation target can be met;
- introducing more targeted measures to mitigate the risk of a deeper or more prolonged downturn and to provide additional support to those who need it most;
- implementing a clear plan for sustained fiscal consolidation;
- renewing financial regulation;
- reducing the impact of bank failure and protecting and supporting consumers;

• improving efficiency and competition in capital markets, and strengthening regulators and the international regulatory framework;

• private and public capital injections in banks from many EU Member States, as well as the US, Japan, South Korea, Switzerland and others.

The USA Government has established stricter rules for a key source of funding for home, auto and credit-card loans that has been blamed for worsening the financial crisis by allowing trillions of dollars in risky investments to be sold around the world (Goldfarb, Z.A., 2010, p. 12).

The organizations are able to focus on macroeconomics and economic cycle's movements understanding, capacity planning by investments or disinvestments and designing and implementing competitive strategies.

The prosperity of any country, and as a consequence of country of origin companies, is characterized by sustained economic growth, low inflation and low unemployment. But, the exchange rate is important for commodity prices in general and oil prices in particular. Any national currency weakens leads to inflationary pressure. The interest rate appears to be the key factor of economic policy. If the interest rate rises significantly to counter inflationary pressures, the confidence fails and slows the economic growth (Stapleton, T., 2000, p. 128).

The Government intervention in economy has to help organizations to pass successfully through negative loop of the economic cycles, supporting but not imposing:

• The demand for goods and services as a function of the level of income by public investments and jobs creation;

• The cost of labour by policies regarding the minimum wages and conditions of employment;

• Redistribution of public income by shifts in taxation, social support and indirect investments;

• Money and financial markets regulations by interest rate, inflation and exchange rate control.

5. Conclusions

Classical economics described macroeconomic factors in terms of market forces. These market forces were able to achieve the optimal balance between supply and demand across a range of goods and services. For example, according to followers of classical economics unemployment was the direct outcome of overpriced labour – lower wages would lead to increased levels of employment.

The economic and social depression of the 1930s with its high levels of unemployment proved that the interpretation of classical economics was inadequate – largely because the marketplace was not perfect. The crises of the 1997's prove that the market imperfections might be compensated by the Government's interventions.

Management strategy and policies have to be related to the environmental volatility, to the government's intervention into the economy. Strategies for change have to be applied and reaction of customers and the market have to be taken into account.

Government's intervention gives a chance in order to harmonize the business and general economic environment to market requirements and international standards, but the equilibrium between market and government's forces has to be assured.

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