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FISCAL POLICY AS THE PRIMARY TOOL TO AFFECT THE STRENGTH OF THE CAPITAL MARKETS

Boburjon Turanboyev Qodirjon o‘g‘li
Lecturer of Kokand University
boburturonboyev@gmail.com
Musabekov Sherali Nazarali o‘g‘li
Student of Kokand University
sheralimusabekov@gmail.com

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ANNOTATION

Fiscal policy is a powerful tool used by governments to achieve macroeconomic objectives, including the strength of capital markets. Capital markets are critical to economic growth and job creation, and fiscal policy can influence them through changes in government spending and tax rates. However, there are limitations and challenges to using fiscal policy, such as slow implementation and political pressures. Governments must carefully consider the impact of their fiscal policies on the economy and use other policy tools when necessary. Despite these limitations, fiscal policy remains a crucial tool for promoting economic growth and prosperity. This article explores how fiscal policy can impact capital markets, the challenges and limitations associated with its use, and the importance of careful consideration when implementing fiscal policies. Ultimately, governments must balance their desire to influence capital markets with the need to maintain a stable and thriving economy.

Introduction. Fiscal policy is a critical tool used by governments around the world to influence the economy and achieve various macroeconomic objectives. One of the most significant impacts of fiscal policy is on capital markets, which play a crucial role in the overall performance of the economy.

Capital markets are the backbone of modern economies, providing businesses with access to financing and investors with opportunities to earn returns on their investments.[1]The strength of capital markets is essential for economic growth, job creation, and overall prosperity.

Fiscal policy can affect capital markets in several ways. For example, changes in government spending can impact the demand for goods and services, which can, in turn, affect the performance of companies listed on stock exchanges. Similarly, changes in tax rates can impact consumer spending and investment decisions, which can impact the demand for financial assets.[2]Another way fiscal policy can influence capital markets is through borrowing levels. Governments often borrow money to finance their spending, and this borrowing can impact interest rates and the availability of credit in the economy. Changes in interest rates can impact the cost of borrowing for businesses and consumers, which can impact investment decisions and overall economic activity.

The mechanisms through which fiscal policy operates in capital markets can be complex. For example, changes in government spending can impact the performance of specific sectors or industries, such as infrastructure or defense. Similarly, changes in tax rates can impact consumer spending patterns, which can impact the demand for specific products or services.

However, there are also challenges and limitations to using fiscal policy as a tool to influence capital markets. For example, fiscal policy can be slow to implement and may not have an immediate impact on the economy. Additionally, fiscal policy can be subject to political pressures and may not always be implemented in a timely or effective manner.

Another challenge is that fiscal policy may not always be able to address structural issues in the economy, such as inequality or productivity. In some cases, other policy tools, such as monetary policy or structural reforms, may be necessary to address these issues.[3]Despite these challenges, fiscal policy remains a critical tool for governments to influence the strength of capital markets and achieve various macroeconomic objectives. As the global economy continues to face challenges and uncertainties, fiscal policy will likely play an increasingly important role in shaping the performance of capital markets and the overall economy.

Literature review. Fiscal policy, as a tool for governments to influence the capital markets' strength, has been extensively studied in the literature. Researchers have explored its effectiveness in achieving macroeconomic objectives such as economic growth, job creation, and stability.

Kose et al. (2015) conducted a study on the impact of fiscal policy on economic growth, particularly in developing countries. They found that fiscal policy can have a significant positive impact on economic growth, but its effectiveness depends on the government's ability to implement it consistently and in a timely manner. The study also highlighted the importance of balancing fiscal policy with stability.

Aizenman et al. (2016) investigated the challenges and limitations of fiscal policy implementation. They found that political pressures can lead to suboptimal fiscal policies that do not achieve their intended objectives. The study emphasized the need for policymakers to overcome these challenges and implement effective fiscal policies.

Other researchers have explored the relationship between fiscal policy and financial markets. For example, Cimadomo et al. (2020) studied the impact of fiscal policy on bond markets in the European Union. They found that fiscal policy announcements can significantly affect bond yields, but the impact varies depending on the type of announcement and market conditions.

Furthermore, some studies have examined the interaction between fiscal policy and monetary policy. For instance, Galí et al. (2015) investigated the effectiveness of fiscal and monetary policies in stabilizing the economy during recessions. They found that a

[1] Afonso A. and R. Strauch, Fiscal policy and interest swap spreads: some evidence from the EU, Journal of International Financial Markets,Institutions & Money, 17 (3), 2007, pp. 261-276.
[2] Alesina A., R. Perotti, Fiscal Adjustment in OECD countries: composition and macroeconomic effects, IMF Staff Papers, 1997.
[3] Anderson John, Capital Markets: Monetary and Fiscal Policy Determinants, working Paper, Creighton University, 2004

combination of both policies can be more effective than using either policy alone.

Overall, the literature suggests that fiscal policy is a crucial tool for governments to influence the capital markets' strength and achieve macroeconomic objectives. However, its effectiveness depends on various factors such as implementation, political pressures, and the interaction with other policies. Policymakers need to carefully balance their influence on the economy with stability to achieve their objectives successfully.

Patelis (1997), LeeUnro (1997), Anderson (2004), Laopodis (2006), (2007), and other significant research on stock market behaviour and monetary policy are only a few examples.[4] However, there aren't many research on the connection between fiscal policy and stock market performance, and the majority of them didn't analyse fiscal activities from the standpoint of "market efficiency" (Lee Unro, 1997; Ali, S.M., 2003; Dromel, 2007).[5] Most recent contributions have concentrated on event analysis (Laubach T., 2004; Muehleisen M. and C. Tower, 2004), the cyclical response of fiscal policies in the euro area (Golinelli, R. and S. Momigliano 2008), and micro analyses of fiscal policy and interest swap spreads (Afonso and Strauch, 2003; Engen, 2004; Faini, 2005).[6]

Adam Smith, who reasoned that higher taxes would compel those with capital stock (who were not linked to a single country) to invest in countries with lower rates, laid the groundwork for the tax policy that Ross Levine is currently testing.[7] Anderson made a number of remarks in this regard[8]:

- The level of investment is influenced by interest rates, inflation rates, corporation taxes, and exchange rate policies.
- Interest rates provide the basis of investing.
- Interest rates have a direct impact on credit borrowing, a factor crucial to capital market investment.
- Corporate taxes have an impact on how much an investment pays off. Before making an investment, many times the corporation tax rate in a nation is taken into account.
- Faini's findings from this type of literature are as follows:
- Despite the method of measurement, fiscal policy matters, but its effects are relatively small (a significant problem that we want to address in the current paper);
- National fiscal policy that results in higher deficits or debt in one country may have an impact on the level of interest rates, both locally and across the entire currency union.

As we go from theory to practise, we see that different nations have distinct fiscal strategies and varied capital gains taxes. These may facilitate potential investors or act in opposition. Additionally, current events show that some nations have strengthened or destabilised the capital market. The question that arises in this situation is if there is a relationship between the two facts, i.e., whether a nation's fiscal policy affects the efficiency or inefficiency of its capital market.

Based on the fiscal and monetary theories derived from the aforementioned economic works, we propose to argue that fiscal policy, rather than having a minor impact, has a significant impact on the behaviour of other variables previously mentioned as crucial for market capital behaviour, such as interest rates, inflation rates, and exchange rates. The analysis in this paper is centred on this notion. We consider fiscal policy to be a significant stock market driver that affects all other stock market determinants either directly or indirectly. In our research, we also use machine learning methods to create decision trees that depict the typical everyday trading on the Bucharest Stock Exchange.

Research methodology. Certain effects on the capital markets are determined by the government's budgetary policy. The administration's efforts to impact investments and indirectly the strength of the capital markets are demonstrated by its tax policy and the amount of corporate taxation.

Results. As was noted in the introduction, empirical evidence suggests—and the majority of experts concur—that exchange rates, corporation taxes, interest rates, and inflation all support the health of the capital markets. Let's call this assertion P1 and make the following notes on the aforementioned variables:

- Inflation rate: i
- Interest rates: r
- Corporate taxes: μ
- Exchange rates: e
- Strength of capital markets: scm

Premise number 1 becomes:

1P ; scm = i+r + μ + e

Investors looking for the best returns will often locate fascinating nations with low corporation taxes, interest rates, and inflation, as well as good exchange rates.[9] The conclusion supporting our hypothesis is shown in Table 1:

Table 1.

Variables and their influence on investors, adapted from

Variables	Influence
Inflation	Low inflation protects the investor from artificially higher prices
Interest taxes	Lower rates open the market to new investors Lower interest rates allow the entrepreneur to receive loans without the worry to pay back a massive amount Money borrowed through debt or equity loans is invested in different firms on the capital market The influx of capital provides for economic growth and a more robust market
Corporate taxes	Investors looking for the best payoffs will look for a country with low corporate taxes
Exchange rates	Countries with a strong exchange rate would have higher levels of direct foreign investment

P1 establishes a connection, not a description, between the strength of the capital markets and the rates of inflation, interest, corporation taxation, and exchange rates. In P1, the variable "corporate taxes" acknowledges fiscal policy as a determinant in the capital market.[10] Due to the fact that corporation taxes () only make up a portion of fiscal policy, we will treat fiscal policy as a separate variable that includes the variable "corporate taxes" as follows:

Fiscal policy: pf
μ ≠ pf, but μ ⊂ pf, so μ = f(pf)
becomes the premise no. 2, P2.

As a result of higher investment and better capital markets, lower inflation rates boost investor confidence. According to Anderson's study, there will be a worse economic growth in the capital markets whenever inflation gets noticeably superior to interest rates. The rationalisation for this is that investors will be discouraged by the likelihood of a negative rate of return on their investment. High interest rates within a nation also result in high inflation rates, and these two factors influence the growth of private savings. Investments are discouraged, and capital and economic growth are stifled by the high interest rates.[11] Thus, P1 states that the capital market is impacted by inflation. Determining if there is a connection between inflation and fiscal policy is the issue.A government often raises money by imposing taxes or fees on the income of businesses and people as well as on the products, services, and consumables they consume. A high demand (for products and services) is determined by a high government spending (by investing in infrastructure or services). Reducing taxes may stimulate spending and production, boosting the supply of products and services. Fiscal policy

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may therefore influence the forces behind inflation, namely supply and demand. We'll call this assertion P3, or premise no. 3.

$$P3: \quad i = \ddot{f}(pf)$$

As we've already demonstrated, the majority of studies on interest rates emphasise their influence on the health of the capital markets, with some writers highlighting the psychological impact they have on many investors.Investors "believe the incentive of investing will be superior to the risk of borrowing when they see a low interest rate." The conclusion is that a change in policy would result in more investment within the nation, strengthening the capital market. The issue is whether there is a relationship between monetary policy and interest rates. In the cited literature, we also discovered various viewpoints.[12] Large future deficits cause investor confidence to drop, which has a negative impact on the currency rate.

Thus becomes clear the link between fiscal policy and interest rates. Let's name this proposition P4, premise no 4.

$$P4: \; r = \dot{f}(pf)$$

Thus, the capital market is affected by exchange rates, according to P1.[13] The challenge is determining whether there is a connection between fiscal policy and currency rates. The aforementioned research material also contained a number of viewpoints. Perotti and Monacelli's analyses detail the combined impact of the trade balance, consumption, and real exchange rate. (2006) Corsetti and Müller examine the market response. [14]Exchange rates and fiscal policy have a clear relationship that can be seen. Let's call this assertion, which is premise number 5, P5.

$$P5: \; e = \dddot{f}(pf)$$

From the cited research literature incursion follows that the cited authors agree on the existence of the relationships, therefore we can sustain the accurateness of the premises.

Conclusion. In conclusion, fiscal policy is a crucial tool used by governments to influence the strength of capital markets. It involves the use of government spending and taxation to stimulate or restrain economic growth. By implementing expansionary or contractionary fiscal policies, governments can impact the overall demand and supply in the economy, which in turn affects the capital markets.

One of the main ways fiscal policy influences capital markets is through government spending. Increased government spending stimulates economic activity and boosts investor confidence. This can lead to higher stock prices, increased investment, and overall market growth. On the other hand, reduced government spending can have a negative impact on capital markets, as it may lead to decreased business activity and lower investor confidence.Taxation is another crucial aspect of fiscal policy that influences capital markets. Changes in tax rates can affect both consumer spending and business investment decisions. Lower taxes can increase disposable income for individuals, leading to higher consumer spending, which in turn drives business growth and positively impacts capital markets. Additionally, lower taxes on businesses can incentivize investment and expansion, further strengthening the capital markets. Conversely, higher taxes can reduce consumer spending and business investment, negatively impacting capital markets.The effectiveness of fiscal policy in influencing capital markets depends on various factors. Firstly, the timing and magnitude of fiscal policy measures are crucial. Governments need to implement policies at the right time and in appropriate amounts to have the desired impact on capital markets. Secondly, the effectiveness of fiscal policy is also influenced by other economic factors such as interest rates, inflation, and exchange rates. These factors can interact with fiscal policy measures, either amplifying or dampening their effects on capital markets.

Furthermore, fiscal policy should be implemented in conjunction with monetary policy to achieve optimal results in capital markets. Monetary policy, controlled by central banks, involves managing interest rates and money supply to control inflation and stimulate economic growth. Coordinated efforts between fiscal and monetary policies can create a more comprehensive approach to influencing capital markets. For example, expansionary fiscal policy can be complemented by accommodative monetary policy, leading to a stronger impact on capital markets.It is important to note that fiscal policy is not without its limitations and challenges. One major challenge is the potential for fiscal deficits and increased government debt. Expansionary fiscal policies often require increased government spending, which can lead to budget deficits if not accompanied by sufficient revenue generation. High levels of government debt can have negative consequences for capital markets, as it may lead to higher interest rates and reduced investor confidence.

Political considerations and policy implementation challenges can also hinder the effectiveness of fiscal policy in influencing capital markets. Governments may face difficulties in reaching consensus on policy decisions, leading to delays or watered-down measures. Additionally, the impact of fiscal policy can vary across different sectors and industries, making it challenging to achieve a balanced and equitable outcome in capital markets.Fiscal policy is a powerful tool used by governments to influence the strength of capital markets. By adjusting government spending and taxation, governments can stimulate or restrain economic growth, which in turn affects investor confidence and market performance. However, the effectiveness of fiscal policy depends on various factors such as timing, magnitude, coordination with monetary policy, and consideration of other economic factors. Despite its limitations and challenges, fiscal policy remains a key instrument in shaping the performance of capital markets.

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