Faced with a huge budget deficit, the governments of many countries have had their hands tied in reviving their economies.

a) Explain the factors that will determine whether a budget deficit is a major concern to an economy. [8]
b) Assess the policy options available to stimulate an economy if their budget deficit is of a major concern. [17]

Part (a)

Budget deficit occurs when the government spending exceeds the tax revenue she collects. Whether the budget deficit will turn out to be a major concern for the economy depends on several factors.

A budget deficit can be a major concern for the economy if the government does not have reserves to finance her deficit as this meant that she will need to borrow to finance this deficit. If the government borrows from the domestic sector via the sale of bonds or treasury bills, this will increase the demand for money and thus pushes up the interest rate assuming money supply remain constant. Consequently, this will discourage private borrowing, thus reducing private investment and consumption. As such if the excessive government spending comes at the expense at the fall in private investment and consumption, private investment will be crowded out, thereby rendering the expansionary fiscal policy as ineffective. Similarly, if the government borrows from the external sector, there will be a real burden imposed on the citizens.

Also, whether the budget deficit is a concern for the economy depends whether the government is prudent with their spending. If the money is put into productive uses such as towards infrastructure developing like improving roads and communication networks, education etc., then the productive capacity of the country will increase. This may in turn increase investment levels in the country, thereby potentially generating more tax revenue for the government. However, if the money is put into wasteful spending such as having meetings and conferences at 5-star hotels, then budget deficit may be a concern since the future generations may have to pay higher taxes to finance the debt.

A budget deficit may be a concern for the economy if it was persistent as this could mean there is something fundamentally wrong with the government budget position or there is something structurally wrong in the economy. For instance, if the reason for deficit is attributed to high level of unemployment benefits paid out and low level of income tax collected, this could imply that unemployment levels are high in the country and hence involves a loss of potential national output (i.e. GDP operating well below potential) and is a waste of scarce resources. However, if the budget deficit is only temporary, it may not be a concern then.

Lastly, the budget deficit is a concern for the economy if the size as a proportion of GDP is large as this means that the economy is not as competitive and relies heavily on fiscal stimulus for growth.

Knowledge, Application, Understanding and Analysis		
L3	For a developed explanation on the factors that determine whether a budget deficit is a major concern to an economy	7-8
L2	For an undeveloped explanation on the factors that determine whether a budget deficit is a major concern to any economy	4-6
L1	Smattering of valid points.	1-3

Part (b)

During a recession, the utmost priority for the government is to increase AD so as to stimulate the economy in view of poorer demand conditions. However, given the concerns of a budget deficit as mentioned in part (a), the government is faced with the dilemma of either reducing the budget deficit or at least not worsen the deficit as well as stimulating the economy. Thus, the government needs to examine the different policy options to decide which policy is best in stimulating the economy given the constraint of a budget deficit.

Fiscal Policy

Conventionally, stimulating growth via expansionary fiscal policy requires the government to increase government expenditure, reduce taxes or both to stimulate AD through G, C and I. The increase in G increases AD directly. The reduction in personal income taxes increases disposable income and hence C while the reduction in corporate taxes increases the after tax profits, thereby enabling the firms the ability to invest. The increase in AD will thereby increase national income and employment level, thus stimulating the economy. However, the increase in government expenditure and reduction in taxes may worsen the budget position.

On the contrary, having a budget deficit will require the government to adopt contractionary fiscal policy by reducing government expenditure, increasing taxes or both in order to improve the budget position. However, this decrease in government expenditure and increase in taxes may worsen the economic conditions in the country. *In view of that, the government may cut spending that is geared more towards non-productive uses such as unemployment and healthcare benefits and use the funds for more productive uses such as tax incentives to increase investment etc. to prevent the worsening of the budget position.*

Also, if the economy lacks competitiveness, then expansionary fiscal policy with supply-side elements may be the answer to improve the competitiveness and at the same time, have some positive spill over effects in the short run. For instance, the government could provide subsidies for education and training programmes which aim to expand the quantity of employable workers and increase the quality of the workforce. Hence, they raise employability of workers and labour productivity.

Monetary Policy

Taking into consideration that budget deficit is a major concern and there is a dire need to stimulate the economy; the central bank may instead implement an expansionary monetary policy. An expansionary monetary policy is carried out by reducing the interest rate through the increase in money supply. This will have a positive impact on the various components of AD, notably C, I and X-M. For instance, with a lower interest rate, consumption will increase given the lower cost of borrowing and the lower opportunity cost of consumption, spurring the consumption of big ticket items. The lower interest rate will also cause investment to increase given more projects are now viable as the rate of return exceeds the lower interest rate.

However, the effectiveness of expansionary monetary policy depends on several factors. Firstly, if the liquidity preference curve is highly interest inelastic, this means that an increase in money supply decrease interest rate substantially which makes the policy more effective. In contrary, if the liquidity preference curve is highly interest inelastic, then a given increase in money supply will bring about an insignificant fall in the interest rate, thus rendering the policy ineffective. Secondly, increases in money supply may not have any effect on interest rates if the interest rates are already very low or the economy is in a liquidity trap. In this case, AD is not affected. Thus, when the economy is in recession and is in the region of the liquidity trap, monetary policy will not help the economy out of recession. Thirdly, even if the interest rate can be varied significantly, if the MEI of a country is highly interest inelastic, the level of investment will change insignificantly. On the contrary, if the MEI is highly interest elastic, a given change in interest rate will cause a significant change in the level of investment. Lastly, consumption and investment may not rise despite the fall in interest rate. This is because if consumers and investors become less optimistic of the economy, especially so during a recession, they will not increase their consumption spending and investment level, thereby rendering the policy ineffective.

In addition, the lower interest rate will cause short-term capital outflow, assuming that there is free capital flow, this will dampen the exchange rate and hence making exports cheaper in terms of foreign currency and imports more expensive in terms of local currency. And assuming the Marshall Lerner condition is satisfied, net exports will increase.

Nonetheless, monetary policy will not work if the country is very open to capital flows such as in the case of Singapore as small changes in the difference between domestic and foreign interest rates would lead to large and quick movements of capital, thereby making it difficult to target interest rate.

However, exchange rate is not the sole factor in determining the level of exports and imports. The relative rate of inflation, change in income and expectation will also affect the demand for exports and imports between two countries. For instance, given that income level is likely to fall during a global recession, the demand for exports may fall. Thus, even when there is devaluation, it may not bring about a rise in net exports. This is also so if the Marshall Lerner condition is not satisfied or that there are binding contracts in place that prevent a rise in the volume of exports and imports. Also, when a country devalues its currency to increase its international competitiveness, this can trigger retaliatory action by other countries which in turn can lead to a general decline in international trade, harming all countries as a result.

Also, devaluation will have its repercussions if the country has no natural resources such as in the case of Singapore. She needs to import most of the foodstuff, raw materials and fuel and this means that any price increase in imports due to a weaker exchange rate will lead to higher domestic prices and higher costs of production, thereby having detrimental effect on the economy.

In all, there might still be a place for expansionary fiscal policy if there are no alternative effective policies or that the outcome of the other policies are insufficient to offset the effect of contractionary fiscal policy or absence of expansionary fiscal policy which were meant to reduce or maintain the budget deficit.

Knowledge, Application, Understanding and Analysis		
L3	For a developed discussion on how fiscal stimulus, monetary policy & devaluation can stimulate an economy given that budget deficit is a major concern	11-13
L2	For an undeveloped discussion on how fiscal stimulus, monetary policy & devaluation can stimulate an economy given that budget deficit is a major concern	8-10
	Or	
	For a developed explanation on how fiscal stimulus, monetary policy & devaluation can stimulate an economy given that budget deficit is a major concern	5-7
L1	Smattering of valid points.	1-4
Evaluation		
E2	For an evaluative discussion on the policy options available to stimulate an economy.	3 - 4
E1	For an unexplained judgement, or one that is not supported by economic analysis	1 – 2