

Essay on macroeconomics

[Economics](#), [Budget](#)



The most recent event in the country that I can think of is the 2012 Presidential Election. What has this to do with the economy?

The most obvious connection between a presidential election and economic activity is that, if the incumbent government is eyeing for a reelection, then pre-election programs include execution of expansionary fiscal policy since such policy (either increase in spending or a tax cut) tend to increase economic growth, reduces unemployment and increases the political support for the politician.

I learned that fiscal policy pertains to discretionary changes in government spending and tax collection with the goal of achieving full-employment and non-inflationary domestic output. The usefulness of fiscal policy in affecting the economy through its impact on the aggregate demand was given emphasis by John Maynard Keynes who argued that it is possible for the economy to experience underemployment (output below the full-employment level) especially in the short run; hence, government intervention either through fiscal or monetary policy is necessary to cure such problem. Keynes argued that prices, wages and interest rates are sticky, especially in the short run. Moreover, Keynes adhere to the idea that the economy does not automatically tend toward full-employment equilibrium, hence underemployment happens in the economy. The underemployment can be cured by fiscal or monetary policies to raise aggregate demand.

The idea of Keynes is opposite to that of the classical economists who assumed that prices, wages and interest rates are flexible in the sense that they automatically adjusts whenever the economy is not in full employment.

Keynes put forward that the argument of the classical economists applies in the long-run; but as Keynes said: “ In the long run we are all dead”.

The classicists believed that individual interest and competition determine prices and factor rewards and that the price system is the best possible device for resource allocation. Moreover, classical economists argue that policies to stimulate aggregate demand have no impact on output.

So, going back to the discussion of government intervention in the economy which is generally believed to improve economic outcomes, Keynes advocated the idea that with the use of discretionary fiscal or monetary policy, the government can stabilize the economy (assuming perfect timing of the policy to affect the persisting problem).

Fiscal policy has several effects on the economy. The expansionary fiscal policy (either an increase in government spending or tax cut) is normally exercised during periods of low output or recession. Obviously, the primary goal is to pump prime the economy. On the one hand, the increase in government spending has direct proportional effect on the aggregate demand and has multiplier magnifies the effect of spending resulting to a greater increase in level of national output (or GDP).

On the other hand, a tax cut can also be used as a discretionary fiscal policy tool. A tax cut do not directly affect aggregate demand but impacts consumption spending (disposable income increases with a tax cut!). The corresponding increase in consumption spending due to a tax cut leads to increase in aggregate demand that in turn affects GDP. Generally,

expansionary fiscal policy stimulates demand in the economy that eventually increases GDP.

Further, fiscal policy is also used when the economy experiences inflationary pressure (e. g., occurrence of demand-pull inflation). The contractionary fiscal policy (through decrease in spending or increase in tax) may help in controlling demand-pull inflation – or an inflation that is caused by the increase in aggregate demand. Intuitively, such policy slows down economic activity, and therefore slows down the increase in the price level.

However, despite these fiscal policy solutions to stabilize the economy, certain flaws are also present. One is the problem of timing. There is the operational lag between the time fiscal action is taken and the time that action affects output, employment, or the price level; as result, the fiscal action become ineffective. Another lag is the so-called administrative lag. Usually it takes some time before policy-makers can take action on inflationary problem in the economy, perhaps partly due to the democratic structure of the government.

Another flaw that I could think of is the crowding out effect of expansionary fiscal policy. Crowding out of investment is likely to happen when the government uses expansionary fiscal policy that has the effect of increasing the interest rate that tends to lower private spending (reduced consumption due to increased savings; reduced investment due to higher interest rate). In the case of trading economies, it is also possible to happen that the budget deficit of the US results to the crowding out of investment spending in other countries like Germany or Britain. The budget deficit tends to lower the value

of US dollar relative to Euro and the Pound. In effect, the prevailing interest rate in Germany or Britain will increase as a result of the more valuable currency. Higher interest rate leads to a decline in investment spending, hence the crowding out effect.

But what is budget deficit? Budget deficit can be simply understood as the shortfall of tax revenue from government spending; that is, the government is spending more than what it is earning from tax revenue. Normally, governments finance the deficit by borrowing in the bond market. And how will this affect the economy? When the government runs a budget deficit, public savings is negative and national savings is reduced. When the government borrows in the bond market to finance the deficit, the supply of loanable funds (also used to finance investments of firms and households) is reduced. As a result, the interest rate rises. As I understand it, higher interest rate tends to discourage borrowing (households will chose not to borrow to build new homes; firms will not borrow to build new factories). Generally, the government's borrowing in the bond market to finance the deficit lowers private investment. This is another case of crowding out.

The budget of the government shows the planned expenditures and revenues of the government for some periods, typically 1 year. And to come up with a budget, the government has to make a forecast of the economy since the forecast reflects an estimate or prediction of the economic activities in the next period or periods. A budget surplus occurs when all taxes and other revenues exceed government expenditures. A budget deficit is incurred when expenditures exceed taxes. An annually balanced budget is

realized when the actual dollar expenditures equals the actual dollar revenues in a given period. A cyclical balanced budget occurs when the actual budget is equal to the functional budget; the functional budget calculates what the government revenues, expenditures, and deficits would be if the economy were operating at potential output. Cyclical spending and deficits consist of the taxes and spending that adjust automatically to the state of the economy. A functional spending and revenues consists of discretionary programs enacted by the legislature.

There is also the possibility for the economy to experience twin deficit. The unusual episodes of expansionary fiscal policy (through (personal income) tax cuts) in the US in the 1980s resulted to federal budget deficit. The deficit caused the reduction in the national savings that in turn lead to large trade deficit. This is the twin deficits or the double deficits. The argument for the twin deficit is that when the government cuts taxes, the disposable income of the domestic residents of the economy is increased; with the increased income, people increases consumption of goods and services (including foreign products). The rise in the consumption of foreign products leads to trade deficit (imports exceeding exports).

Higher national debt has a potential negative effect on the economy's net national worth. For one, debt financing tend to increase the interest rate that in turn, reduces investment. With lower capital stock, output will also be lower. Second, not only that the increase in national debt can reduce the capital but it can also increase the nation's external debt.

Aside from fiscal policy, I am also interested on discussing in this paper the basic macroeconomic relationships. I have mentioned above about the effect of aggregate demand on the level of GDP. In this part, a little learning about GDP and GNP is tackled.

The Gross National Product or GNP takes into account the total income of all residents of a nation, including the income from factors of production used abroad; it can also be understood as the total expenditure on the nation's output of goods and services. Meanwhile, the Gross Domestic Product or GDP refers to the total income earned domestically, including the income earned by foreign-owned factors of production; alternatively, it is the total expenditure on domestically produced goods and services. What is accounted as part of GDP and what is accounted in GNP? In the case of a Japanese-owned factory operating in Mexico, the value of the final goods produced by the factory is accounted as part of Mexico's GDP; and also accounted in Japan's GNP.

Between GNP and GDP, the latter is a reasonably accurate and very useful indicator of a country's economic performance. Nevertheless it has certain limitations which include failure to take into account for nonmarket or illegal transactions, changes in leisure and in product quality, the composition and distribution of output, and the environmental effects of production.

As I mentioned government opt to use expansionary fiscal policy to promote economic growth. Economic growth is the increase in the total output of a country over time. It is measured as the annual rate of increase in the country's real GDP. My understanding of economic growth is like this: it

occurs when people allocate resources in some ways that gives more value to the resources. The simplest illustration is that of cooking a sumptuous meal in the kitchen. A person mixes ingredients using the most appropriate recipe to convert the limited quantity of inexpensive ingredients into the good tasting meal taking into account the pollution and nuisance generated in cooking. Economic growth is realized when better recipe is used that generates the best meal with fewer side effects. The same applies to the aggregate economy. Given the country's limited scarce resources, increase in the national output over time can be achieved by using the most efficient technique of converting the resources to the most valuable output of the economy. One of the visible proof that the country is experiencing economic growth is the improvement in the standard of living of the people in the economy. That is to say, economic growth makes people in the economy better off.

Moreover, economics in general have taught me that every decision involves a trade off. In a micro level, this concerns the behavior of an individual consumer to give up some boxes of milk for some pounds of meat. In the aggregate, this may involve the trade-off between inflation and unemployment. This is true in the short run. The government's attempt to lower inflation has the effect of temporarily increasing the unemployment. The trade off exist because of the slow adjustment of some prices in the short run. One way of reducing inflation is by reducing the quantity of money in the economy. This tends to increase the interest rate, and then reduces private spending that in turn reduces aggregate demand, and therefore the level of prices. In a very simple sense of supply and demand, lower prices

tends to discourage production, and low production implies low employment, hence the increase in unemployment. But then again, the trade off is only temporary.

Another trade off on the aggregate economy level is between economic efficiency and equity. Efficiency means that the society in general is getting the most it can from its available but limited resources; while equity is the fair distribution of economic resources among the members of the society. There are government policies that favors one from the other, hence the trade off. For instance, the government's goal of redistributing income from the rich to the poor (prioritize equity) tend to reduce efficiency since the reward system becomes distorted and economic members are discourage to work productively.

These, generally, are the things that I have learned in macroeconomics.