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Economics, Money

The Title of the Article: Britain's Deficit-driven Growth

The Source of the Article: Wall Street Journal

Section of the Syllabus: Fiscal and Monetary Policy, Deficit Financing.

Candidate Name:

Candidate Number:

The Article

Please find the article at the following URL:

http://blogs. wsj. com/moneybeat/2014/09/23/britains-deficit-driven-growth/?

KEYWORDS= macroeconomics

The Commentary

This article discusses the pros and cons of the deficit financing led growth that the UK is experiencing presently. The growth figure that UK has registered from the past year is quite high compared to the other economies in Europe. The widening public deficit is a matter of concern among several quarters. The government has still not shown any signs of withdrawal of the fiscal stimulus that it has been providing for quite some time.

Referring to Macroeconomic theory we know that an expansionary fiscal policy leads to a rightward shift in the AD curve leading to an increase in income and rate of interest as shown in figure 1. The increased government expenditure leads to a rightward shift in the AD curve from AD0 to AD1. This shift brings the economy to a new equilibrium with an increase in income from y0 to y1.

Figure 1

pAS

AD1

AD0

y0y1y

The article also expresses concern about the government's failure to rein in the rising deficits. The income tax revenue has not been rising enough to close the gap between spending and government income. The cut in corporate tax rate is a big reason for the low revenue flows in the government exchequer. The income tax revenue may rise with the rise in income, as pointed out by a consultancy in London.

The article cites the example of the USA where the government has been able to churn out enough revenue to close the deficits in spending. But the example in US is not to be followed. Too much of fiscal tightening, which USA is going through presently, slows down economic growth. In fact, in the US, the fiscal tightening is being offset by monetary expansion by the Fed. Again, a fiscal stimulus in an economy which is presently experiencing a boom can lead to an inflationary situation. High spending in times of boom is not healthy for the economy. In the peak period of the business cycle, the government should adopt austerity measures and recover the deficits. A counter-cyclical fiscal policy should always be the right measure to be followed.

A high fiscal expansion may lead to an inflationary situation because of the rise in income. Rising government spending may crowd-out private investment and may harm the economic activities. In this situation, a contractionary monetary policy can offset the fiscal expansion. This has been pointed out in the article. As we have seen in figure 1, a fiscal expansion leads to a rightward shift of the AD curve resulting in an increase in income. A contractionary monetary policy results in a leftward shift in the AD curve offsetting the rise in income from the fiscal expansion. This situation is depicted in figure 2 below. The leftward shift in the AD curve from AD1 to AD2 leads to a fall in income to y2. The author suggests a monetary tightening by the Bank of England to compensate for the government's failure to rein in public expenditure and failure to impose austerity measures.

Figure 2

P

AS0

AD1

AD0

y0 y2 y1y