Answer on Question#56535 - Economics – Macroeconomics

Question

The economy of Kenya has a budget deficit of KSH 500B and debt of 2.9 trillion. Using an appropriate model, explain the macroeconomic implications of such a debt and a deficit.

Answer

According to http://www.tradingeconomics.com/kenya/government-debt-to-gdp Kenya debt is 49,8% to Kenya GDP. This % is used by investors to measure Kenya government's ability to make future payments on this debt, and to borrow new costs.

In extreme circumstances the government may increase the money supply to pay the debt.

If the government sells short term gilts to the banking sector then there will be an increase in the money supply, this is because banks see gilts as near money therefore they can maintain them lending to customers.

There are many macroeconomic implications of such budget deficit and debt:

- Higher Debt Interest Payments – as borrowing increases, the government have to pay higher interest rate payments to those who hold bonds (lend government money). In some circumstances, higher borrowing can push up interest rates because markets are nervous about government's ability to repay. This means they have to pay even higher interest rate costs, that will increase budget deficit;
- Inflationary Pressure – it is rare for government borrowing to cause inflation. But, the combination of quantitative easing and very high levels of borrowing make inflation more likely. If markets fail to buy enough gilt to finance the deficit, the deficit can always be financed through 'monetization'. i.e. creating money. This creation of money creates inflation, reduces the value of exchange rate and makes foreign investors unwilling to hold Kenya debt. So far quantitative easing has not caused inflation because of the falling velocity of circulation. But, if the economy was close to full capacity, printing money to 'monetize the debt' would lead to inflation;
- Higher Interest rates – to finance a budget deficit, the government need to sell bonds. If markets fear there is a chance of default, they will demand higher interest rates to give return for greater risk. Higher interest rates on government bonds tend to push up other interest rates in the economy and reduces spending and investment. (This impact of higher interest rates in reducing private sector spending is known as financial crowding out). Also these higher interest rates increase the cost of paying interest payments;
- Crowing Out – a classical monetarist argument is that high levels of government borrowing cause 'crowding out'. The government borrows from the private sector by selling bonds. Therefore, the private sector has less money to spend and invest. Therefore although government spending increases, private sector spending falls and there is no boost to the economy. However, this is unlikely to apply in a recession because in a recession private

sector saving is rising. The government are spending to offset the rise in private sector saving;

- Higher taxes in the future – the government will need to reduce borrowing as a % of GDP. It means future budgets will need to increase taxes and / or limit spending. The danger is that if taxes are increased too early too quickly it could snuff out the recovery and cause a further downturn. If they don’t raise taxes markets may be alarmed at size of borrowing. There will be difficult choices for the future chancellors; it is a difficult situation to be in.