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Economics Essay #4

<u>Title:</u> If there is a long drawn-out war with Iraq (or any other country), what implications might this have for Britain's fiscal deficit? Also trace out the possible effects, if any, on: a) Monetary Policy, b) Inflation and c) Unemployment.

The economic policy followed by a country engaged in war is ,certainly, different of that followed by a country when in peace. Britain now finds itself a few steps away from war with Iraq and the questions concerning the implications of this ,unnecessary for many, war are not little.
Firstly, before we analyze the effects of war with Iraq on fiscal policy and deficit of the UK we must briefly outline the role of fiscal policy and what is a fiscal deficit. Fiscal policy is a so-called demand management policy and is defined as the manipulation of government expenditures and/or of taxes in order to influence aggregate demand and thus economic activity and employment. In the case of Britain, there is a fiscal deficit. A rise in government expenditures and/or a decrease in taxes (i.e. an increase of injections over withdrawals) leads to an even greater (through the multiplier) rise in national income and thus of employment. Deficit spending could lead to an expansion of economic activity; this policy is known as expansionary (or, reflationary) fiscal policy.

It can be said, with great certainty, that Britain's fiscal deficit will increase largely during the war. Being an OECD[1] member country and a country with similar economic performance from time to time, Britain can be considered largely an economy with many common aspects to the U.S. economy in many aspects. The U.S. economy had three major peaks in deficits and all of them reflect wars: the Civil War of the 1860s, WWI and WWII. So one can expect that a long drawn-out war with Iraq will mean that the British economy will run on deficit for a long time. This should not suggest that deficits will occur after the war as well, though. U.S. economy has recovered and reduced the stock of debt after these wars. There are also political factors that need to be considered in the case of Britain. Because of the high public unrest and anti-war movement that occurred in Britain before the war the government might feel obliged to prove to the people that war against Iraq was a wise thought. UK government would be able to provide that short-term feel-good factor by cutting taxes and possibly increased spending. If pressure on the government mounts, and it is already mounting very fast with numerous resignations and public protests, it is very likely that it would see more clearly the benefits of cutting taxes and raising spending than bringing deficits down. The interests of the politicians must be taken into account and rarely are they in line with the interests of the citizens, especially in this war.

Monetary policy aims to control money supply, interest rates and rationing the amount of credit given from banks. Money supply in the U.K. is controlled by the central bank (BoE) which influences interest rates by its operations in the discount and gilt repo markets. Usually, there is a shortage of liquidity provoked by BoE. The BoE might sell more bills (or through gilt repos) to increase the interest rate.

In the case of war probably the need for liquidity will be even less than normal so the lines would be less steep and the interest rate higher.
Based on our previous assumption that fiscal deficit will grow because of lowered taxes and increased spending we can draw the assumption that unemployment will be low. Also, considering the government eager to avoid increased crime and vandalism caused by unemployment, being already in a difficult position, it will do its best to avoid the increase of it. Supply of workers will be almost totally inelastic. It would be almost inelastic because workers due to lower taxation would be motivated to work and the unemployed would be more willing to accept a job than keep searching for one.

It is very easy to assume the effect of war on inflation just by looking at the previous statements and thinking how the government would react. Inflation would increase of course. We can say that this would be a cost-push inflation

because the reasons that this type of inflation occurs are more likely to appear in war conditions, and the most important of them would be import-price-push inflation. In an import-price-push inflation war scenario Iraq would increase the price of oil (Iraq has 30% of international oil in its land.) independently of the level of aggregate demand. Oil prices could skyrocket. The joint effect of the war on these four economic measures is obviously not good. So if on paper a war does not contribute on the wealth of the nation why do it? As we mentioned earlier, there are other factors alongside economics which might play a dominant role such as politics and diplomacy in a wider sense. U.K. might be obliged to engage in a war even if this war will not result in any economic gains but possibly in losses.

BIBLIOGRAPHY

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[1] OECD is an organization with 30 member countries that provides governments a setting in which to discuss and develop economic and social policy.