3 Government deficits

A government spends 25 per cent of GDP on government consumption and collects net taxes equal to 20 per cent of GDP. The real GDP of the country grows by 2.0 per cent per year. Inflation is 2,5 per cent, the nominal interest rate 5.5 per cent. The initial government debt is 60 per cent of GDP.

1. By how much does the budget need to be tightened in order to prevent the ratio of debt to GDP to increase further?
2. Suppose the necessary cuts have been made. What will then be the size of the nominal government deficit relative to GDP.
3. Suppose we look at another economy with the same figures except that the growth rate of real GDP is 4 per cent. What will happen to this country's debt level if it does not make cuts in the budget?
4. Comment briefly on the realism of assuming a fixed interest rate in 3.

Answers on back