Sophia

Economic Growth

by Sophia Tutorial

WHAT'S COVERED

This tutorial will cover economic growth, discussing how the government finances expansionary fiscal policy.

Our discussion breaks down as follows:

1. Fiscal Policy Goals: Short-Term vs. Long-Term
2. Financing Government Spending
3. Debt Repayment
   a. American vs. Foreign Bondholders

1. Fiscal Policy Goals: Short-Term vs. Long-Term

Fiscal policy is typically policy set by a central government authority, whereby spending by the government is adjusted to stabilize economic activity.

We know that the government actually has two tools: spending and taxation. Fiscal policy, then, focuses on the policies in these two areas. The government can use these two tools to stabilize our economy's movement through business cycles.

In the short term, the goals of fiscal policy are full employment and price stability; in other words, managing the unemployment rate and making sure that prices are not out of control.

The government uses taxation and spending to stabilize our economy when either unemployment or inflation rises.

In the long term, a third fiscal policy goal is **economic growth** over time. We want to make sure that our economy is producing more and becoming more efficient and productive over the years and decades.

Economic growth is the measure of the change in real GDP over periods of time. It is the percent change in the value of the sum of goods and services produced in a country's natural borders over a specified time interval.

BIG IDEA

Our short-term fiscal policy decisions can impact our long-term ability to achieve economic growth because of the short-term fiscal policy impact on our national debt.

TERMS TO KNOW

Fiscal Policy
Typically policy set by a central government authority, whereby spending by the government is adjusted to stabilize economic activity

Economic Growth
Measure of the change in real GDP over periods of time; percent change in value of the sum of goods and services produced in a country's natural borders over a specified time interval

2. Financing Government Spending

Without increasing taxes, the government must borrow money by selling Treasury securities to finance the increased government spending needed to stimulate the economy.

HINT

Remember, we do not want the government to increase taxes to finance its spending, because increasing taxes takes money away from people, when in fact the intent is to get people spending again to get the economy out of a recession.

Therefore, the government has to take on debt.

To increase demand and stimulate the economy in the short term, the government must spend more money than they collect in tax revenue.

When expenditures are greater than tax revenue, this is known as a**deficit**. Deficits are shortages that result from spending in excess of revenue.

TERM TO KNOW

Deficits
Shortages that result from spending in excess of revenue

3. Debt Repayment

Now, when the government borrows money to finance the expansionary policy needed, in the future, they have two options for debt repayment:

1. Tax revenue, increasing taxes once the economy has rebounded
2. New debt, to repay the old debt

Let's talk about the first option briefly. What if the government chooses tax revenue in the future to repay?

Well, the point of taking on the deficit was to stimulate or grow the economy by increasing demand and employment. In the long term, though, if contractionary policy is needed to repay the debts by increasing taxes, this will eventually have a negative effect on real GDP, decreasing demand and increasing unemployment.

Option two involves taking on new debts to pay the old debt. If new debt is chosen, we say the debt is rolled over. At the very least, **interest** must be paid to service the debt.

Interest defined is the cost of money. Nominal interest is the prevailing rate. Real interest rates reflect that prevailing rate adjusted for inflation, which means that the real interest rate is the nominal rate minus the inflation rate.

Interest is also a return on investment, where return varies based on the risk profile of the investment, time horizon, or opportunity cost of a comparable risk-free investment and inflation expectations.

Now, the government does not get to borrow money for free. They must pay bondholders interest and make these payments periodically.

TERM TO KNOW

Interest
The cost of money; nominal interest is the prevailing rate; real interest reflects the prevailing rate adjusted for inflation (real = nominal rate minus the inflation rate); return on investment where return varies based on the risk profile of the investment, time horizon, opportunity cost of a comparable risk-free investment, and inflation expectations

3a. American vs. Foreign Bondholders

Now, when discussing servicing the debt, it is important to compare the difference between U.S. bondholders and foreign bondholders.
If the bondholders are Americans, then the government is paying interest to its own people--Americans--and this payment is in U.S. dollars.

The money, then, would stay in the U.S. economy and the impact on real GDP would be minimal because taxes collected from Americans are being used to pay interest to other Americans who then make purchases.

However, if the bondholders are foreigners, then the government is paying interest to people in other nations. The money is leaving the United States economy, and taxes being collected from Americans are being used to pay interest to foreigners. Real GDP can fall, hampering our economic growth, which, as mentioned, is our long-term goal.

This can also impact our exchange rate, which is the subject of a different tutorial.**Foreign exchange**, remember, is the amount of a foreign currency obtained by exchanging a specified amount of domestic currency.

So, if the U.S. government is repaying foreigners, our exchange rate can actually fall because the demand for our currency can decrease.

TERM TO KNOW

Foreign Exchange

The amount of a foreign currency obtained by exchanging a specified amount of domestic currency

SUMMARY

Today we learned about the **short-term and long-term goals of fiscal policy**. We learned that the government must **finance government spending**--expansionary fiscal policy-- by issuing debt. The government then pays interest to borrow money, and subsequently handles **debt repayment** with tax revenue or by rolling it over. We compared the difference between **American vs. foreign bondholders**, noting that when money is leaving the U.S. economy in the form of interest paid to foreign bondholders, these deficits taken on in order to expand the economy in the short run can actually have a negative impact on our GDP growth in the long run.

Source: Adapted from Sophia instructor Kate Eskra.

TERMS TO KNOW

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