The Deficit and the Debt

The two primary tools of discretionary fiscal policy are government spending (G) and taxes (T). When government conducts expansionary fiscal policy to counteract recession, G increases and/or T decreases. When G increases and/or T decreases, the government budget moves toward deficit. A budget deficit occurs when the government spends more than it collects in taxes and borrows to cover the difference. It does this by issuing bonds. The sum of past deficits is the debt. The debt incurs annual interest charges.

When the government conducts contractionary fiscal policy to alleviate inflationary pressures, G decreases and/or T increases. When G decreases and/or T increases, the government budget moves toward surplus. A budget surplus happens when the government taxes more than it spends. The surplus can be used to reduce the debt.

The effect of government borrowing can be modeled using the loanable funds market. A government budget deficit results in an increase in the demand (D) for loanable funds. A budget surplus reduces the demand for loanable funds. It results in an increase in the supply (S) of loanable funds if government pays off the debt.

1. Complete Table 5-6.1. Circle deficit or surplus, and in the other columns place an up arrow for increase, a down arrow for decrease, or NC for no change.

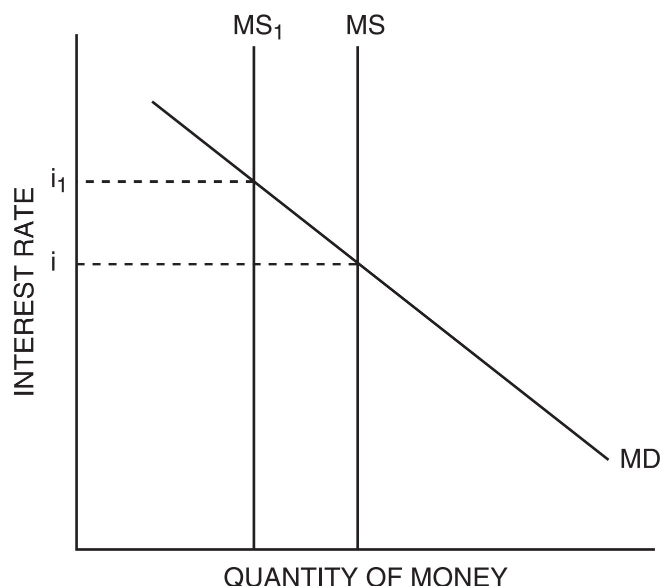
Table 5-6.1
Budget Effects of Fiscal Policy

Fiscal policy	Tools of fiscal policy	Effect on government's budget	Effect on debt	Effect on loanable funds market	Effect on real interest rate
Expansionary	G↑ T↓	**(Deficit)** / Surplus	↑	D↑ S **NC**	↑
Contractionary	G↓ T↑	Deficit / **(Surplus)**	↑	D↓ S↑	↓

The central bank of a country can counteract the effect of budget deficits on the real interest rate by conducting an open market purchase of government securities. When the central bank purchases the securities directly from the government, this is referred to as monetizing the debt and is seen as highly inflationary. The effect of an open-market purchase of government securities can be modeled using the money market.

Purchase your 4th Edition AP Microeconomics and Macroeconomics Teacher Resources and Student workbooks today!

2. Draw a graph of the money market showing how an open-market purchase of government securities affects the nominal interest rate.



3. How would the change in the nominal interest rate affect the real interest rate? Explain.
A decrease in the nominal interest rate results in a decrease in the real interest rate because the real interest rate equals the nominal interest rate minus the inflation rate.

4. Why is monetizing the debt inflationary?
When the central bank monetizes the debt it allows the government to borrow and spend freely. Monetizing the debt increases the money supply.

Purchase your 4th Edition AP Microeconomics and Macroeconomics Teacher Resources and Student workbooks today!