The Deficit and the Debt

Introduction and Description

This lesson introduces government budget deficits and the national debt. It analyzes the long-run effects of budget deficits on the economy. The effect of government borrowing is modeled using the loanable funds market.

This unit explains how a country's central bank 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 is modeled using the money market.

Activity 5-6 introduces budget deficits and surpluses, and the debt.

Objectives

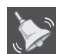
1. Define budget deficit, budget surplus, and debt.
2. Understand the long-run effects of government borrowing.
3. Explain what it means to monetize the debt and how this affects the economy.

Time Required

Two class periods or 90 minutes

Materials

1. Activity 5-6
2. Visual 5-5



Bell Ringer

Show students the current value of the national debt (found at http://www.brillig.com/debt_clock/, for example), and ask them what they think the number represents.

Procedure

1. Remind students that the two primary tools of discretionary fiscal policy are government spending (G) and taxes (T). When government conducts expansionary fiscal policy to counteract recession, government spending increases and/or taxes decrease. When the government conducts contractionary fiscal policy to alleviate inflationary pressures, government spending decreases and/or taxes increase.
2. Explain that the government's budget is balanced when G = T. 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 (when G > T). It does this by issuing bonds. The sum of past deficits is the debt. The debt incurs annual interest charges. A government budget deficit results in an increase in the demand for loanable funds.
3. Explain that a budget surplus occurs when the government taxes more than it spends (T > G). A budget surplus reduces the demand for loanable funds. It results in an increase in the supply of loanable funds if government pays off the debt.
4. Show the effect of government deficits and surpluses using a correctly labeled graph of the loanable funds market, as shown in Visual 5-5. A government budget deficit results in an increase in the demand for loanable funds. A budget surplus reduces the demand for loanable funds and results in an increase in the supply of loanable funds if government pays off the debt.
5. Have students complete Activity 5-6.

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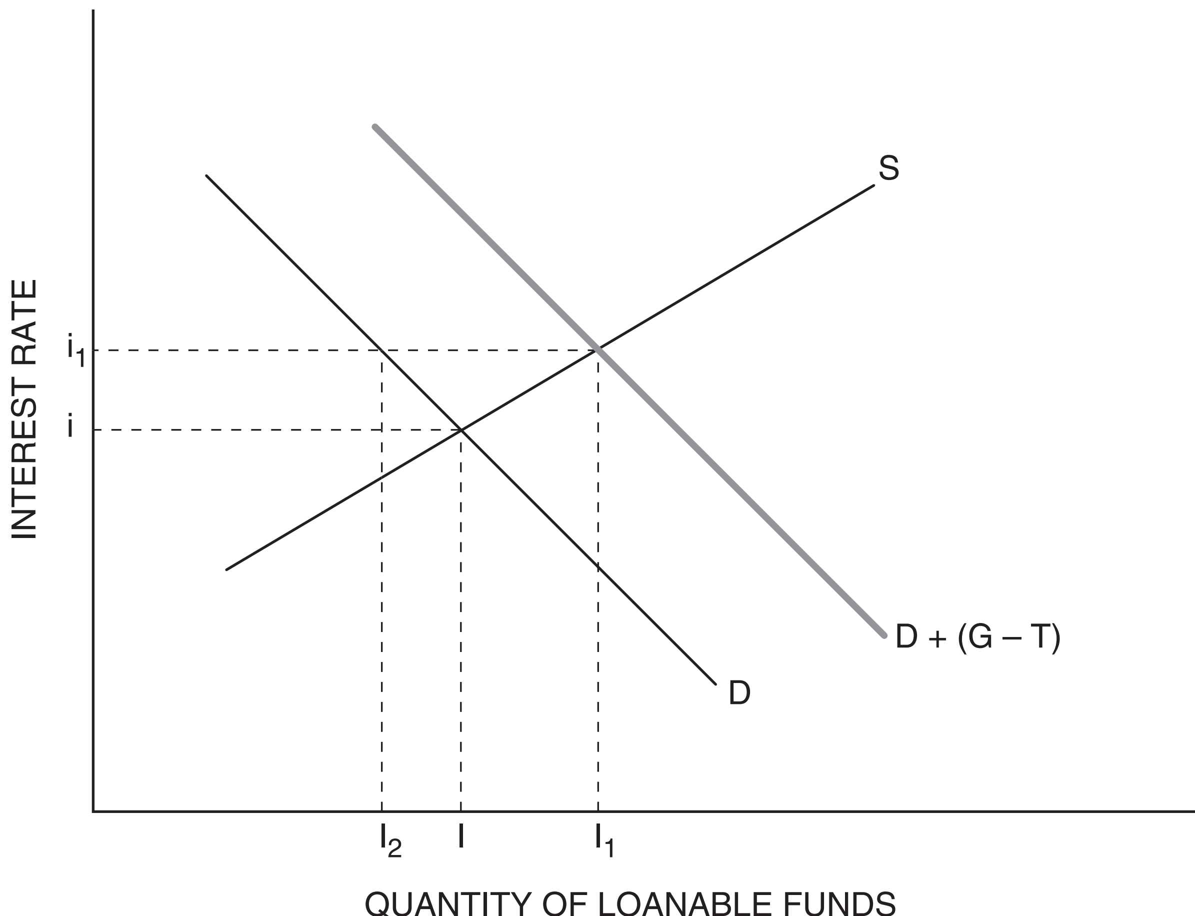
Loanable Funds Market



I and i are the initial equilibrium values.

D = private sector demand for funds (investment).

D + (G – T) = private + government demand for funds.

I_1 and i_1 are the new equilibrium values.

I_2 = new level of private investment.

$I_1 - I_2$ = government demand for funds (G – T).

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