UNIVERSITY OF THE PEOPLE

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Learning Journal Unit 7

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A budget deficit happens when a government's expenditures are more than its income. The budget deficit is often used as a measure of the economic well-being of a country. The term "budget deficit" is more commonly associated with the finances of the government rather than those of companies or people. (Barone, 2023)

Impact of Budget Deficit on Interest Rates:

When the federal government runs a budget deficit, meaning expenditures exceed revenues, it must borrow funds to finance the shortfall. This is done by issuing Treasury securities like bonds to investors and governments. As the deficit rises, the government must issue more Treasury bonds to borrow money.

Increasing the supply of bonds in financial markets can push bond prices lower and yields higher, since more supply means bonds must offer higher returns to attract buyers. Specifically, yields on short-term Treasury bills and long-term Treasury bonds will rise as more are issued to finance the growing budget deficit.

Rising Treasury yields increase interest rates throughout the economy. Lenders benchmark the interest rates they charge borrowers, like for mortgages and corporate loans, against the "risk-free" rate of return on Treasuries. As Treasury yields rise due to more deficit financing, interest rates charged to private borrowers tend to rise as well.

In addition, higher returns on Treasury bonds provide more competition for other fixed income investments like corporate bonds. This can further push up yields on corporate bonds and other private lending as they compete with Treasuries. Rising mortgage rates also make housing less affordable.

Overall, a growing federal budget deficit financed through Treasury bond issuance will place upward pressure on interest rates. This raises the cost of borrowing for both families and enterprises. Some estimates suggest each 1% of GDP increase in the budget deficit could raise interest rates by 0.5 to 1.0 percentage points.

Impact of Budget Deficit on Trade Balance:

A federal budget deficit also affects the nation's trade balance with other countries. When the government spends beyond its revenues, this injects new money into the economy. More money circulating stimulates overall spending and demand for goods and services.

This includes increased spending on imported consumer goods, raw materials, commodities, and other products from abroad. As budget deficits boost total spending, a portion leaks out through higher imports, widening the trade deficit.

At the same time, higher interest rates make dollar-denominated assets like Treasuries more attractive to foreign investors. This increases demand for the dollar, causing it to appreciate in foreign exchange markets. As the dollar strengthens, it makes U.S. exports more expensive in foreign currencies. This reduces export competitiveness and foreign sales. It further worsens the trade balance.

Some empirical estimates find that a 1% of GDP increase in the budget deficit could increase the trade deficit by 0.10% to 0.5% of GDP. However, the trade deficit impact depends on other factors like currency market conditions and trade policies.

In conclusion, federal budget deficits tend to place upward pressure on interest rates and widen the trade deficit, but the magnitude of these impacts varies based on economic conditions.

Policymakers should consider these effects when evaluating the overall costs and benefits of fiscal stimulus funded through budget deficits.

Reference:

Greenlaw, S., & Shapiro, D. (2017). Principals of macroeconomics 2e. Openstax. Licensed under CC-BY 4.0. https://openstax.org/details/books/principles-macroeconomics-2e

Barone, A. (2023). Budget deficit: causes, effects, and prevention strategies. Investopedia. https://www.investopedia.com/terms/b/budget-deficit.asp

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