Chapter 18 – Impacts of Government Borrowing

Government budget balances can affect the trade balance. How? Well, remember that a net inflow of foreign financial investment always accompanies a trade deficit, while a net outflow of financial investment always accompanies a trade surplus. So we come to the idea of **twin deficits** that occur when a country is running both a trade and a budget deficit. *However*, there is no expectation that the budget deficit and trade deficit will move in lockstep, because of the other parts of the national saving and investment identity (investment and private savings) will often change as well.

Exchange rates can also help to explain why budget deficits are linked to trade deficits. A budget deficit can result in an inflow of foreign financial capital, a stronger exchange rate, and a trade deficit. The U.S. budget deficit rises and foreign financial investment provides the source of funds for that budget deficit. This causes a stronger exchange rate. Makes it more difficult for exporters to sell their goods abroad while making imports cheaper, so a trade deficit (or a reduced trade surplus) results.

A series of large budget deficits can become a cause for concern among international investors. This could lead to an outflow of international financial capital, which can cause a deep recession by: depreciating the exchange rate, thus reducing banks' ability to repay international loans and reducing aggregate demand.

The underpinnings of economic growth are investments in physical capital, human capital, and technology. Set in an economic environment where firms and individuals can react to the incentives provided by well-functioning markets and flexible prices. Government spending can also encourage certain elements of long-term growth. Examples include spending on roads or water systems, on education, or on research and development that creates new technology.

A larger budget deficit will increase demand for financial capital. This government borrowing can reduce the financial capital available for private firms to invest in physical capital. If private saving and the trade balance remain the same, then less financial capital will be available for private investment in physical capital. When government borrowing soaks up available financial capital and leaves less for private investment in physical capital, economists call the result **crowding out.**

A higher interest rate tends to discourage firms from making physical capital investments. If government decides to finance an investment in public physical capital with higher taxes or lower government spending in other areas, it may not be directly crowding out private investment. Indirectly however, higher household taxes could cut down on the level of private savings available. If a government decides to finance an investment in public physical capital by borrowing, it may be at the cost of crowding out investment in private physical capital.

In most countries, the government plays a large role in society's investment in human capital through the education system. A highly educated and skilled workforce contributes to a higher rate of economic growth. However in the U.S. in recent decades, increased financial resources at the K-12 level *have not* brought greater measurable gains in student performance. Some education experts question whether the problems may be due to structure, <u>not</u> just to *the resources spent.*

Other government programs seek to increase human capital either before or after the K–12 education system. For example, Head Start, a program for early childhood education directed at families with limited educational and financial resources. Government also offers support for universities and colleges. For the U.S. economy, and for other high-income countries, the primary focus at this time is more on how to get a bigger return from existing spending on education and how to improve the performance of the average high school graduate, rather than dramatic increases in education spending.

Review Topics for Test 5:

Government budgets – balanced, surpluses, shortages, deficits and debt

Types of individual personal income taxes – proportional, progressive and regressive

Other types of taxes – corporate, excise, estate

Fiscal Policy vs. Monetary Policy – expansionary vs. Contractionary

Discretionary Spending vs. Automatic Stabilizers

Policy impacts on the Aggregate Model

Crowding Out

Physical vs. Human capital