Module 9: Economics
Topic 3 Content: Fiscal Policy and Monetary Policy

Introduction

Glover Mint: Today's episode will focus on the ways the government is able to influence economic activity. WUSG News financial analyst, Cain S. Hayek, is here to explain.

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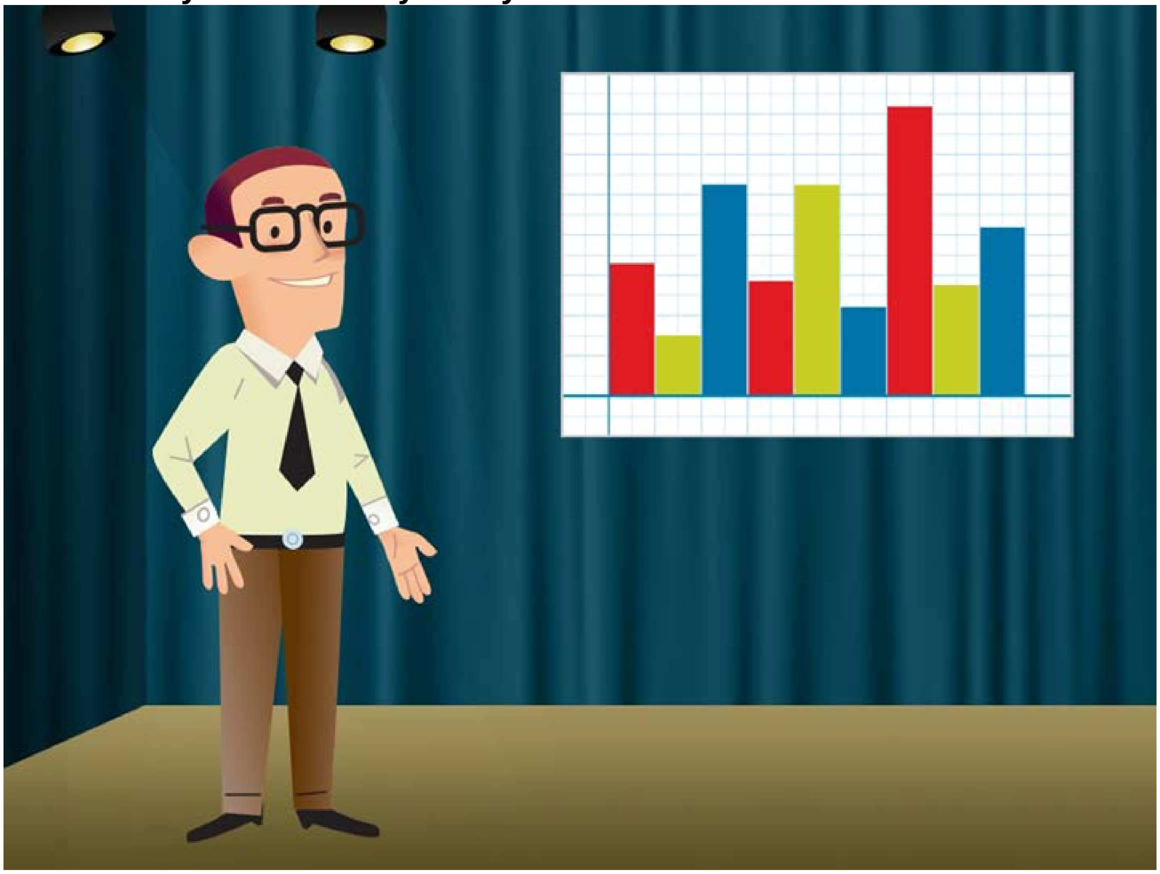
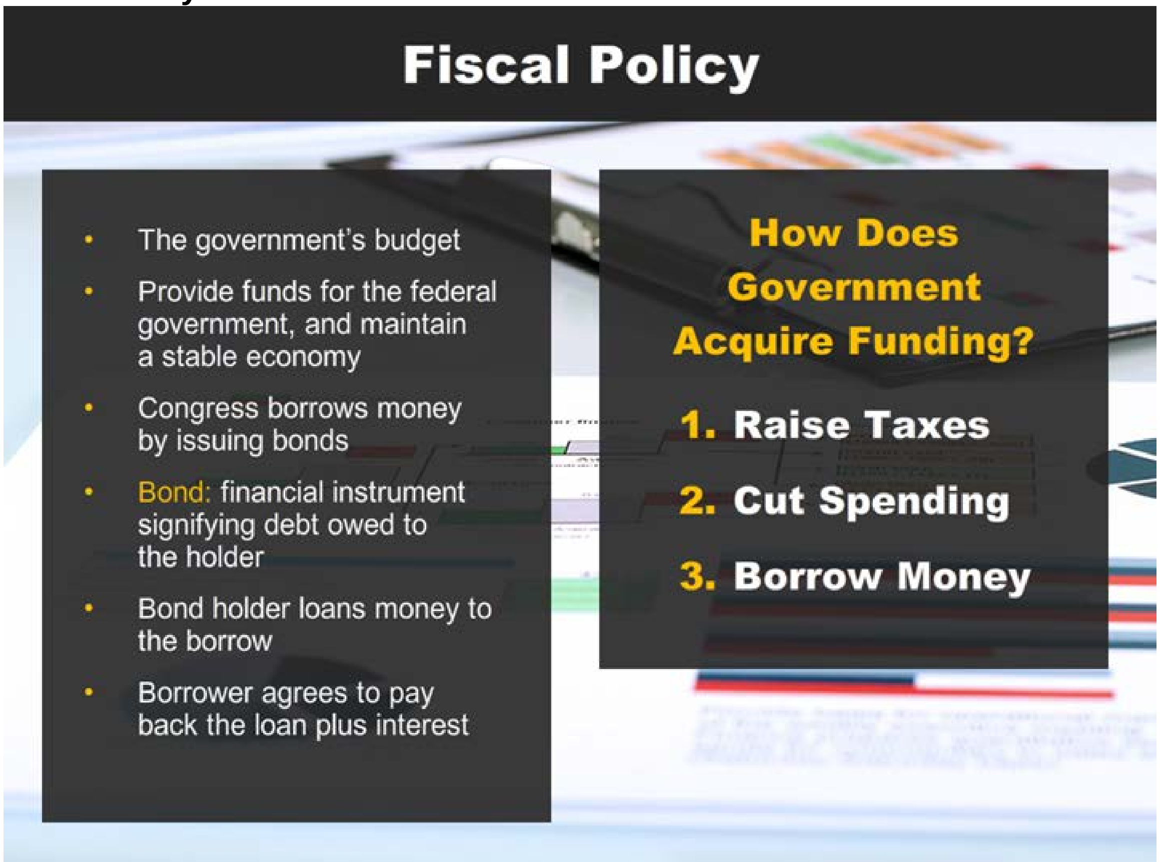
Fiscal Policy and Monetary Policy



Cain S. Hayek: Thank you, Glover. I hope the topic of today's episode doesn't intimidate any of our viewers. Fiscal policy and monetary policy may seem confusing at first, but the basics of them are actually quite easy to understand. Let's dive right in.

Fiscal Policy

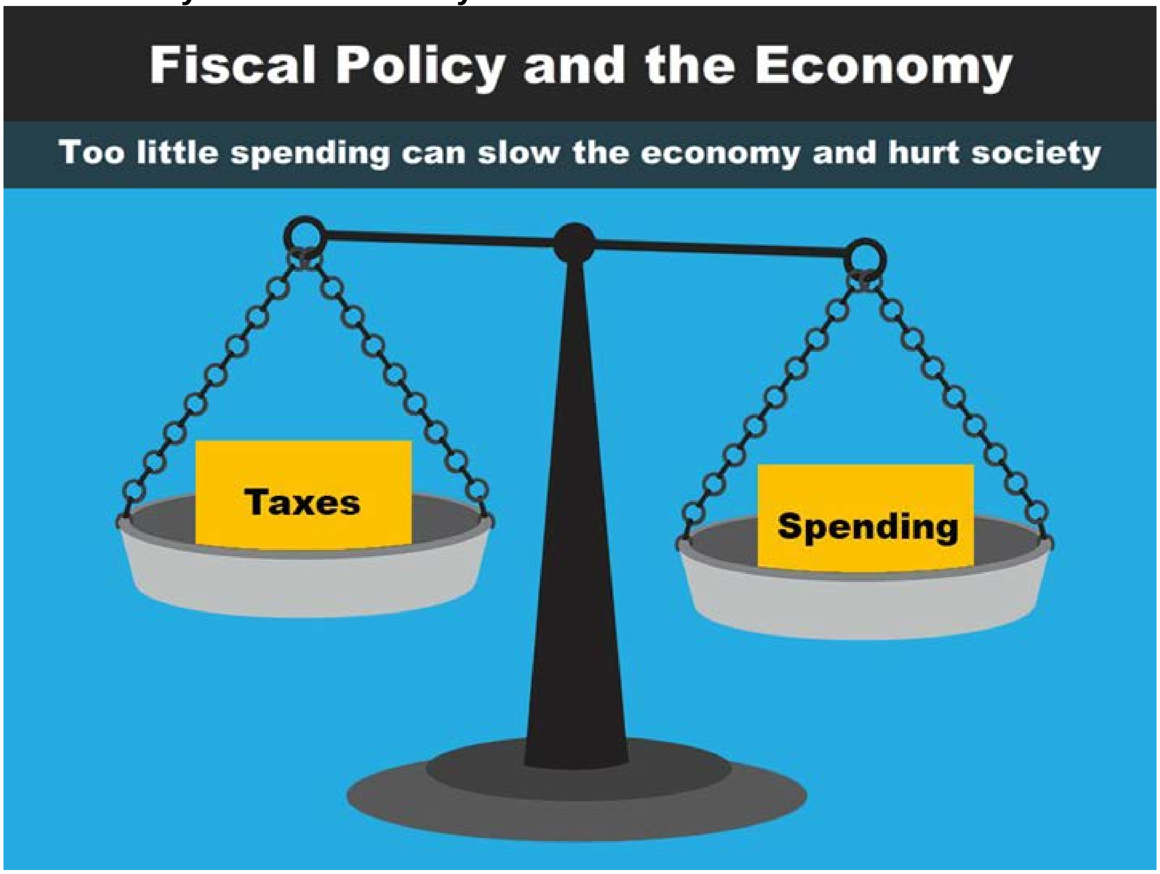


Cain S. Hayek: Fiscal policy refers to the government's budget. When the government changes tax rates or adjusts spending, it is altering fiscal policy. The goal of fiscal policy is to provide the funds the federal government needs to operate, while maintaining a stable economy. If the federal government needs money for a new program, there are three ways it may acquire the funding:

1. it may raise taxes;
2. it may cut spending on other government programs; or
3. it may borrow money.

The Constitution grants Congress the power to borrow money, which it does by issuing bonds. A bond is a financial instrument that signifies debt owed to whomever holds the bond. The holder of the bond is essentially lending money to the borrower, and the borrower is agreeing to pay back the loan, plus interest, at some point in the future. For example, you can buy a government bond for $100, and eventually get $200 back in the future.

Fiscal Policy and the Economy



Cain S. Hayek: As I said, the goal of fiscal policy is to provide government funding while maintaining a stable economy. If the government decides to raise taxes or cut spending in certain areas of the budget, those actions will have an impact on the economy. Fiscal policy can even be used to help strengthen the economy, either by increasing government spending or cutting taxes.

When the government targets key areas and increases the amount of money it spends, it can help stimulate the economy by providing the funding necessary to increase overall production and employment. The government may also decide to lower the tax rate, which can increase the amount of money that businesses are able to reinvest and the amount of money consumers are able to spend.

Fiscal policy is a bit of a balancing act and must be carefully monitored. If the tax rate is too high, it may hurt the economy, but if it is too low, there won't be enough money to fund the government. This causes large budget deficits, which the government must borrow money to cover. Similarly, too much government spending can trigger inflation and hurt the economy, but limiting government spending too much can slow the economy and hurt society in the long-term.

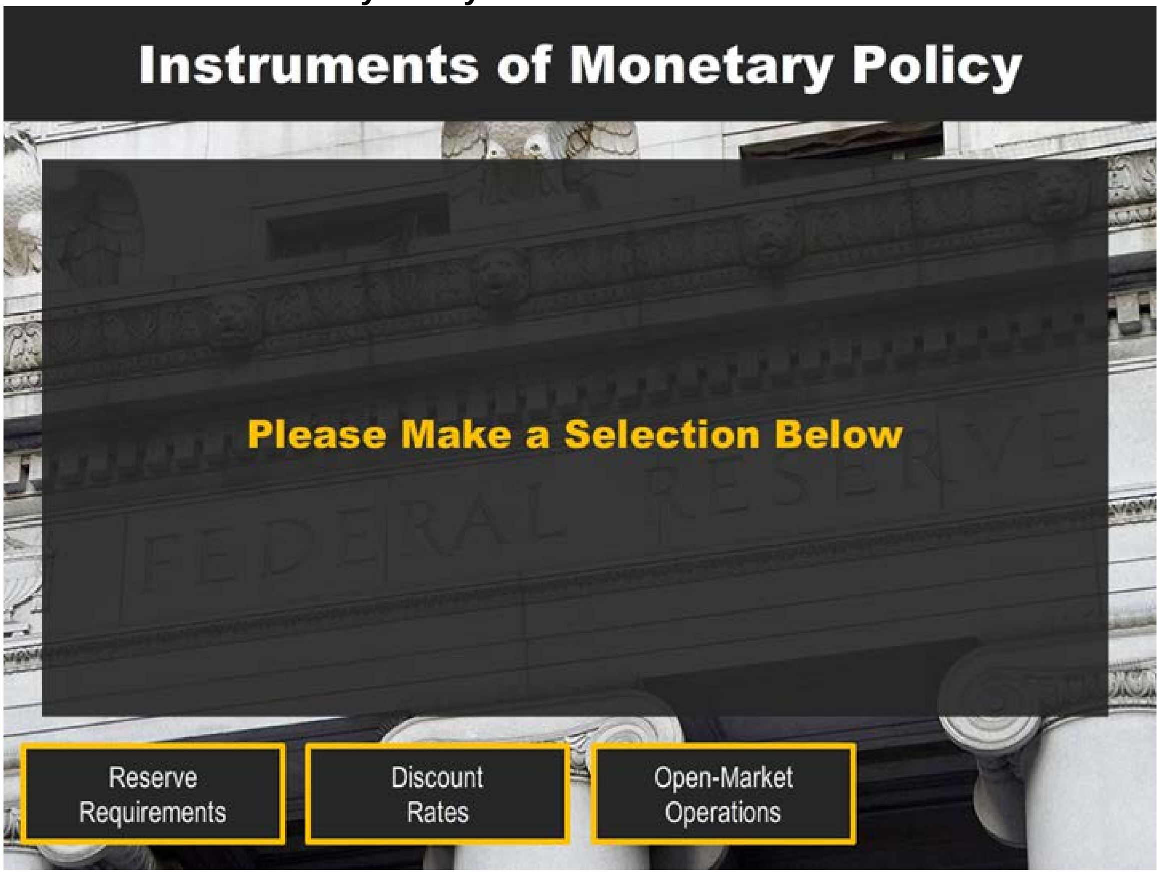
Monetary Policy

Cain S. Hayek: Monetary policy is a term used to describe the way a nation controls the supply of money. The amount of money circulating in a society, the rate of interest on borrowed money, and the rate of inflation are all a part of monetary policy. The goal of monetary policy is to limit inflation and keep the currency stable. Inflation is the sustained increase in the price of goods and services. For example, let's say that a loaf of bread cost $1.00 ten years ago. Today, that same loaf of bread costs $1.50. That means the cost of bread has inflated by 50% over the course of ten years. This is a simplistic definition, since inflation involves the pricing of numerous commodities. Inflation isn't an issue if it is properly managed; however, imagine what it would be like if you woke up tomorrow and your money was worth a fraction of what it is worth today.

The Federal Reserve

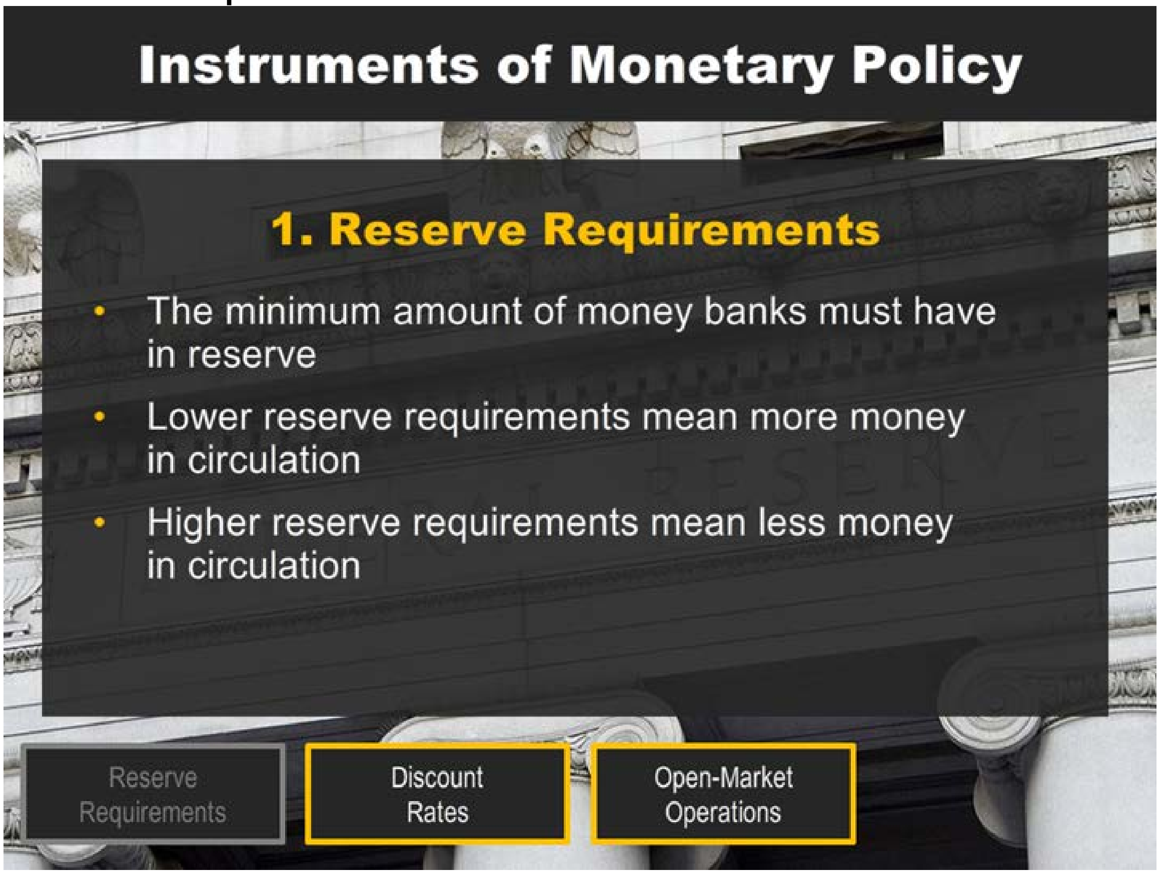
Cain S. Hayek: In the U.S., monetary policy is under the control of the Federal Reserve System, also known as the Fed. The Fed was created in 1913, and serves as the central bank of the United States. It is an independent regulatory commission that monitors and controls monetary policy by adjusting interest rates and the availability of lendable funds. The Federal Reserve is led by a board of seven people, one of whom serves as the chairperson. These are powerful positions, since the people who hold them essentially control the money of the entire nation. That is why members of the board are nominated by the President and confirmed by the Senate.

Instruments of Monetary Policy



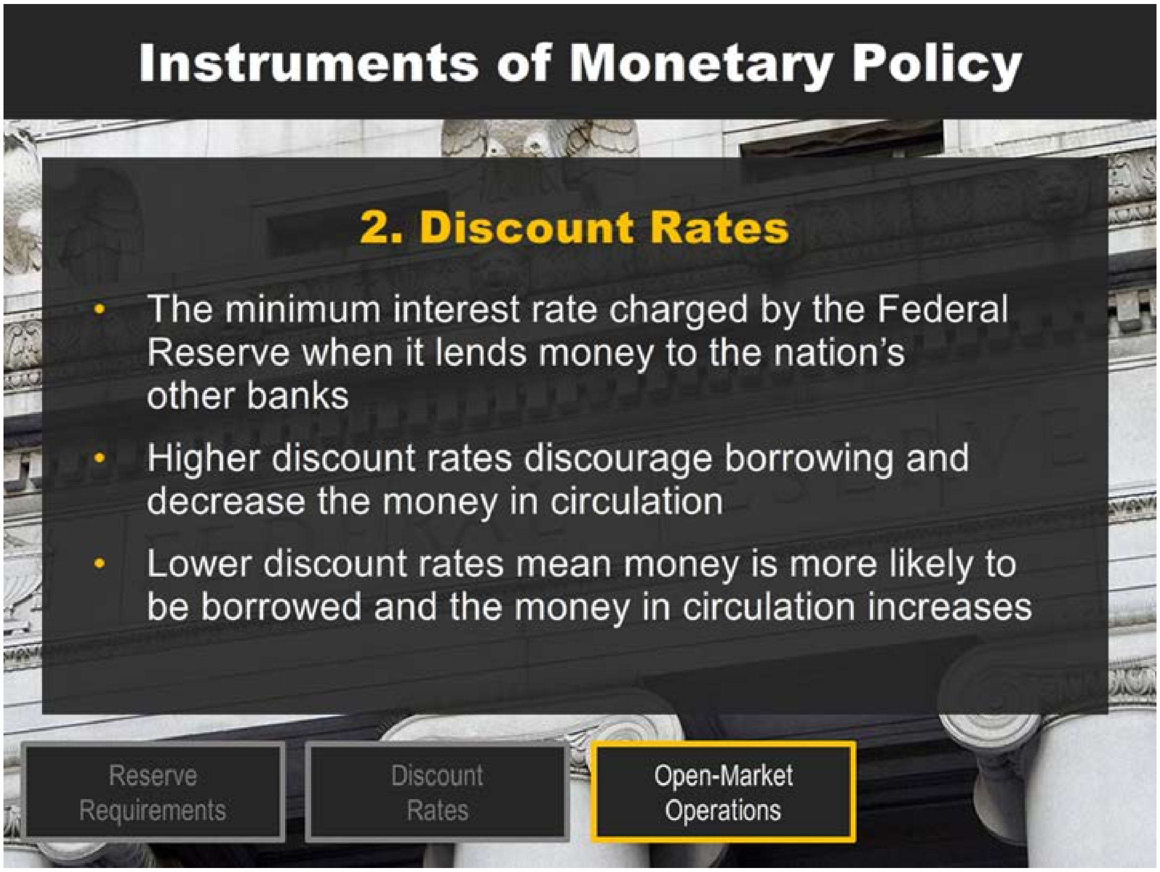
Cain S. Hayek: The Federal Reserve uses three instruments to adjust monetary policy: reserve requirements, discount rates, and open-market operations.

1. Reserve Requirements



Cain S. Hayek: A reserve requirement is the minimum amount of money banks must have in reserve. If the reserve requirement is lowered, there is more money in circulation. If the reserve requirement is raised, the amount of money in circulation decreases.

2. Discount Rates

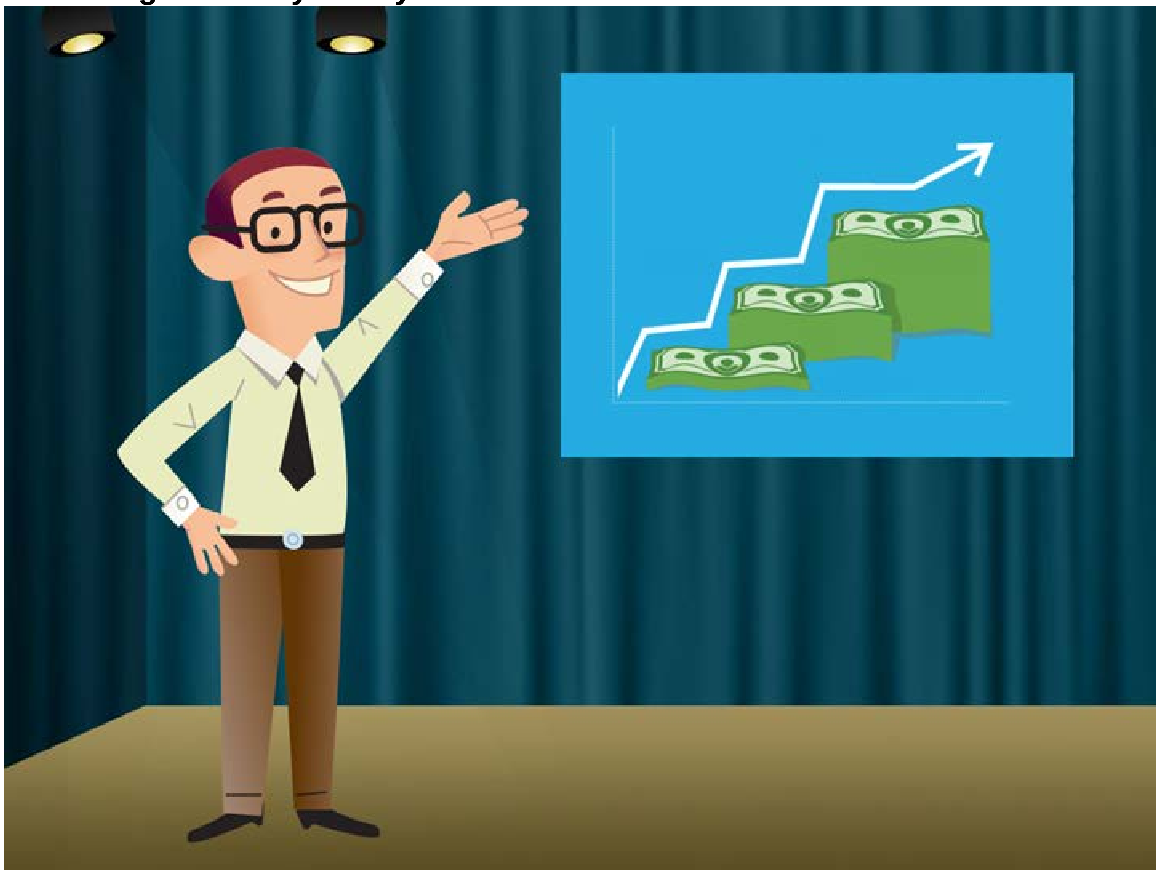


Cain S. Hayek: Discount rates are the minimum interest rate charged by the Federal Reserve when it lends money to the nation's other banks. When discount rates are raised, borrowing money is discouraged and the amount of money in circulation is reduced. When discount rates are lowered, money is more likely to be borrowed, and the amount of money in circulation increases.

4. Open-Market Operations

Cain S. Hayek: Open-market operations are the buying and selling of government securities, or bonds, in the open market. When the Fed buys bonds, money is injected into circulation, but when the Fed sells bonds, it has the opposite effect.

Balancing Monetary Policy



Cain S. Hayek: Monetary policy is complex, mainly because it takes a long time to see the impact of changes to the monetary policy, and the factors that influence it are constantly changing. Similar to fiscal policy, an efficient monetary policy must be continually monitored and carefully balanced. The economy can benefit greatly by expanding the amount of money in circulation; however, this can also increase the rate of inflation. Reducing the amount of money in circulation helps control inflation, but can also hurt the economy.

Ending of Episode

Glover Mint: Excellent work, Cain. In summary, fiscal policy refers to managing the federal budget and monetary policy refers to managing the amount of money in circulation. Both of these can be used to help stabilize and stimulate the economy. Thanks for watching.