Fiscal Policy: Problems

1. True, if we are considering total debt which includes debt that the government owes to itself. This figure is over $18 trillion. Economists are far more interested in debt held by the public, however, which excludes intragovernmental debt. This is around $13 trillion.

2. False, a bond auction will yield less than the face value of the bonds which is the amount that the government must pay back. It must thus issue bonds with a face value greater than $100 billion.

3. False, if GDP grows faster than the nominal debt, then the debt to GDP ratio will fall. 2% budget deficits along with 3% growth will thus yield a decreasing debt.

4. Here an increase in the supply of bonds (from large debt) will have a greater affect on bond prices and interest rates. Crowding out is more problematic.

5. False, the U.S. has not experienced a sovereign debt crisis.

6.There are a few possibilities. The simplest is that the government is forced to balance its budget through some combination of reduced spending and higher taxes. Both are contractionary fiscal policy and cause the AD curve to shift to the left reducing output.

7. Default may reduce or eliminate interest payments on existing debt, reducing governmental expenditures. This may or may not be enough to balance the budget.

8. Zero. Here, the AS curve is vertical and changing the AD curve has no effect on output.

9. Recall that the As curve is flatter for low levels of the output gap, the location of the economy during recessions. Expansionary fiscal policy which shifts the AD curve to the right thus has larger effects on output.