The Puzzle of Government Intervention in the Economy

GDP, inflation, and unemployment: each of these measures helps to tell us how the economy is doing.

- **GDP** tells us if the economy is growing: spending by consumers (C), businesses (B) and the government (G) … as well as international trade (X-M). We want GDP to be increasing.
- **Inflation** tells us if prices are going up. Since this makes things more expensive, we want to see inflation as low as possible (we will almost always have a little inflation, though).
- **Unemployment** tells us if people are working. We want everyone who wants a job to be working, since this is good for the economy … people don't spend money if they aren't making money. We will always have a little unemployment, but we want to keep it low.

Economic Expansion

1. What makes GDP (and therefore the economy) grow? Why is this a good thing?

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2. Unfortunately, the world is not perfect and we cannot have GDP growth without some degree of inflation (the opposite is also true). Think about supply and demand and explain why a growing economy tends to bring increased inflation.

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3. The good news is that when we have a growing economy (with GDP going up), unemployment tends to go down (the opposite is also true). Explain why unemployment goes down (and more people get jobs) when the economy is growing.

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4. Summarize the relationship between GDP, inflation, and unemployment:

   When GDP *increases*, inflation ________ and unemployment ________.

   When GDP *decreases*, inflation ________ and unemployment ________.

The Government Getting Involved

5. To grow the economy, you need to have the components of GDP [C+I+G+(X-M)] growing. What makes it more likely for consumers and businesses to spend more money?

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6. How can the government intervene to give consumers and businesses incentives to spend?

7. Now that we've talked about C and I, what about G? What can the government do *directly* to increase GDP?

Monetary and Fiscal Policy

8. Remember fiscal policy? Fiscal policy is conducted by Congress (with the power to tax and spend). What are the two ways that fiscal policy can affect GDP? Who does it affect?

9. Remember monetary policy? Monetary policy is conducted by the Federal Reserve (with control over interest rates and the money supply). What are the two ways that monetary policy can affect GDP? Who does it affect?

Trade Policy

10. The last piece of the puzzle is trade policy: affecting X and M. How can the government affect how much the country imports and exports? Give examples.

When the government uses fiscal, monetary or trade policy to grow the economy, it is called **EXPANSIONARY** policy. This has the result of increasing GDP and decreasing unemployment, but runs the risk of inflation increasing.

When the government uses fiscal, monetary or trade policy to slow down the economy, it is called **CONTRACTIONARY** policy. This has the result of decreasing inflation, but also slows down GDP growth and runs the risk of increasing unemployment.