Gross domestic product (gdp) essay

Finance, Financial Analysis

Gross Domestic Product (GDP) is the worth of all final goods and services produced in the country within a given period.

It is composed of the spending on consumption of households (C), spending on investments of businesses and households (I), government expenditure of goods and services (G) and the demand overseas of net exports (NX), all of which has a positive relationship with GDP, thus the equation GDP = C + I + G + NX. (Dornbusch, 2003)During a recession, which is a decline in the growth of the economy (“ Fiscal Policy”), fiscal policies and monetary policies can be employed to be able to stabilize the economy in terms of its demand. Both of which is wherein there will be a manipulation of the components of the GDP. In the case of monetary policy is wherein the stock of money is being intervened by the Federal Reserve, whether to increase or decrease the stock of money where it sees fit. On the other hand, fiscal policy is the use government spending and taxes to stabilize the economy. In fiscal policy, the increase in government spending could be employed, or decrease in taxes or both in an expansionary policy and the reverse in the case of a contractionary policy.

The focus of this paper is to determine the effects of an increase in the government spending to induce growth in the economy. The case of increasing the government spending is a form of expansionary policy. Obviously in expansionary policy, the goal is to increase the aggregate demand which also increases the GDP. The goal of this expansionary policy is to decrease the unemployment rate prevailing. After such a policy is implemented, the aggregate demand increases however, there also may be effects on other economic factors. Initially, the increase in the GDP would be

large because of the multiplier effect, that is, a change in the spending does not directly affect the output but to put the other factors which may also increase the output to work (“ The Government and the Fiscal Policy”, 2007). For example, the increase in the government spending would generate more income for the people. Because of the increase in the income, the people will opt to increase consumption by spending more.

And since there will be an increase in the consumption of these people, there would also be other people who will experience an increase in their income who will also opt to spend more and it will go so on and so forth. However, this situation will still be dependent on the behavior of the people whether they have a tendency to save or to spend if such an increase in the income will occur. However, this increase in the income will be eventually offset by inflation.

If there will be an increase in the government spending; the interest rate should also increase because the money market was disturbed when there was a sudden increase in the government spending. To be able stabilize the money market, to set it an at equilibrium point again, the interest rate should increase. Because of the increase in the government spending, the interest rate also increased. There will be an increase in the prices of commodities and services. And, because of the increase in the prices of the commodities and services around, the consumers, both businesses and households, may have a change in their consumption pattern. Suppose there will be an increase in the price of investments, the businesses will opt not to invest just like when the prices were lower. The overpowering of government

spending against investment spending is called the crowding effect (Dornbusch, 2003).

In order to lessen the investment spending after the increase in the government spending, the interest rates need to increase. Also, the household consumption may also follow the same pattern. Because of this, despite of the increase in the component that is G in the GDP, there will be also changes in the components C and I. However, the effect of crowing out is not the same throughout economies. The more that the monetary policy of a country cannot affect the level of income, the more that the crowding out effect will increase the income more for people and increase the interest rate at a lower amount.

On the other hand, the more that an increase in the government spending cannot affect the interest rate, the increase in the income will be less and also, the increase in the interest rate is low. The multiplier of the government spending also is very important in determining the increase in the income and the interest rates. Nevertheless, all of the crowding out effects depends on the amount of increase in the interest rate when the government spending increases. The greater the increase in the interest rate, the greater the crowding out effect. Dornbusch, 2003) However, there are cases in which any increase in the government spending will have an effect in the interest rate. This is because the monetary policy has no effect whatsoever in the economy. Thus, giving the chance for the fiscal policy to maximize the effect, that is of the multiplier. This is the case of a liquidity trap.

On the other hand, there is also the reverse of the liquidity trap, thus, the effect of the monetary policy is at its maximum and the fiscal policy's effect is non-existent. In this situation, an increase in the government spending would only increase the interest rate without increasing the income. (Dornbusch, 2003)References: Dornbusch, R.

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