Monetary and Fiscal Policy

A healthy, growing economy is important as it directly impacts our standard of living. In an ever changing economy, our government attempts to regulate economic growth. The government has two main tools available to influence the economy, namely fiscal and monetary policy. While fiscal policy is the strategy of the government taxing and spending to stimulate economic growth, the role of monetary policy uses changes in the money supply to effect economic growth.

Gross Domestic Product, or GDP, is the total dollar value of all the goods and services produced in our country. GDP is a common measure as to the overall health of the economy. A recession is technically defined as two or more consecutive quarters of GDP contraction.

The federal government, through fiscal policy, can influence the economy. Fiscal policy is implemented through tax and spending policies. Through a combination of tax rate reductions and increases in spending, the government can spur economic growth. Conversely, by increasing tax rates, thus lowering disposable income and consumer spending, they can slow down economic growth. Consumption is an important as it accounts for approximately 70% of the GDP calculation.

The Federal Reserve (Fed) is the central bank for the United States. The Fed can influence interest rates several ways, but the most common is by adjusting the rate at which banks borrow overnight from each other. This rate, set by the Fed, is called the Federal Funds Rate. This rate effects interest earned on savings accounts, money market, and certificates of deposits.

When the economy is weak and unemployment is high, the Fed typically lowers interest rates. The goal behind lowering rates is that financial institutions are able to offer loans to individuals and businesses at low rates, thus encouraging consumption and capital expenditures. This leads to improved conditions for business hiring, thus lowing the unemployment rate. When economic conditions improve, the demand for goods and services increase thus causing prices to rise which may cause inflation, at which point the Fed moves to increase interest rates to slow down consumption, the rate of economic growth, and possible inflation.

While it is agreed that a healthy economy is in everyone’s best interest, it is often disagreed how to achieve optimal economic growth. It is constantly debated what is the appropriate mix of fiscal and monetary policy and their true long-term implications on the economy.

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