ECONOMICS CHAPTER 15/16/17 TEST REVIEW

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- The consumer price index represents a "market basket" of goods that an urban consumer would purchase. For example, if the CPI drops from 100 to 50, the prices in an average consumer's "basket" have dropped by half.
- **Know the "Fed" inside and out.** The Federal Reserve has many different tasks, including: the regulation of banks, controlling the money supply, conducting monetary policy to promote the health of the economy, and to act as a bank for banks (lender of last resort). It was started to provide consumers with access to funds for business expansion, and it helps the government by selling securities (open market operations). There are 12 districts. It sets interest rates, which also helps stabilize the economy, and makes adjustments to a poor economy or one that is overheating. It clears checks too.
- The federal reserve has 3 tools of monetary policy. It can adjust the required reserve ratio, the discount rate, and open market operations.
- Be able to explain both expansionary and contractionary fiscal policy. Expansionary fiscal policy includes cutting taxes and increasing government spending. Contractionary policy tries to take money out of the hands of people, and does the opposite. If the Fed wants banks to lend out more money, it can apply expansionary money policy by reducing the discount rate, buying back government securities from banks, and lowering the RRR.
- Know the difference between the DISCOUNT RATE and the FEDERAL FUNDS RATE. The discount rate can be adjusted by the Fed—it is the rate at which the Federal Reserve will loan money to banks. The Federal Funds rate is the rate at which banks will loan to each other.
- Balanced fiscal policy is difficult to put into practice because of political pressures, the difficulty of predicting future economics scenarios, and the difficulty of coordinating a plethora of government economics agencies.
- When revenues exceed expenditures, there is a budget surplus. When expenditures exceed revenues, there is a budget deficit.
- Know the following classical economists and their contributions to the discipline: Adam Smith—"The Wealth of Nations," David Ricardo—Comparative Advantage Theory T. R. Malthus—"An Essay…on Population." Classical Economists believe that the economy should always be left alone; it will self-correct on its own. Classical economics failed miserably in the 1930s (Hoover believed in it and paid for it).
- Know the following modern, Keynesian Economists: John Maynard Keynes came up with the idea that government should use fiscal policy to manage economy, spend more and tax less when economy is weak and vice-versa. Arthur Laffer—Laffer curve for taxation (Keynesian economics essentially failed in the 1970s—it could not explain stagflation).
- High national debt reduces funds available for businesses to invest, makes it harder for the government to fund projects, and can slow the growth of GDP.
- Banks sometimes hold excess reserves because they anticipate high customer demand for their deposits (they think a lot of money will be taken out). This could happen, for example, during the Christmas shopping season.
- Generally speaking, tax cuts can stimulate the economy in about 6 months.
- Taxes serve as an automatic stabilizer.
- Be able to calculate the required reserves of a bank. When a deposit is taken out of a bank, a bank's reserves DROP.
- Monetarists believe: 1)The money supply is the single most important factor in GDP growth and 2) an increase in the money supply results in an increase in real GDP.
- According to the Quantity Theory of Money, increasing the money supply results in INFLATION.
- As you can see, monetarists and quantity theorists DO NOT get along.
- A "run" on a bank occurs when depositors rush to withdraw their money at the same time.
- A stimulative fiscal policy, combined with a restrictive monetary policy will most likely cause interest rates to RISE. Stimulative fiscal policy means that there will be tax cuts and government spending increases, and tight money policies (like selling government securities, raising the discount rate, and raising RRR) mean that money will not be plentiful. If the Fed sells a

significant amount of government securities, the total amount loaned by banks decreases. These conditions guarantee fierce competition for money, which means interest rates rise.

- The purchase of government securities will have the greatest effect on GDP if the required reserve ratio is high and the interest rate has a large affect on government spending. This is because bond sales would deprive banks of a lot of loanable funds if the RRR is high, and the sale of government bonds dries up the money supply, causing those who want money to spend more—by paying a higher interest rate.
- **BE ABLE TO EXPLAIN AND CALCULATE COMPARATIVE ADVANTAGE!!!!**
- A country that has an absolute advantage in producing 2 goods should produce the good that has less of an opportunity cost.
- When a country produces a large amount of exports in 1 area, it means that it has a comparative advantage, but no assumptions can be made about the wages paid to workers.
- If the demand for money is very insensitive to changes in the interest rate, the money demand curve will look flat, and monetary policy will be very ineffective. Interest rate hikes or drops won't cause people to change their behavior.
- If the Fed buys bonds, bond prices rise and interest rates fall (high bond value= lower interest rates). This also increases the amount of excess reserves that banks hold and encourages them to make loans to the general public.
- An increase in the money supply lowers the interest rate, causing greater investment and more GDP.

Be able to calculate the amount of money created, based on the reserve ratio:

Money Created = 1/ RRR * amount deposited

EX: If I deposit $5,000 in a bank with a 10% RRR, the actual increase in the money supply is:

1/ (.10) * 5000 = 50,000 increase in the money supply

The actual amount "created" can be calculated by subtracting the above result from the initial deposit

50,000- 10,000 deposit = $40,000 "created"

You need to know how much is deposited to determine how much a bank can loan out.

When the RRR is lowered, the money multiplier INCREASES, and the amount of excess reserves INCREASES.

You should be acquainted with the following terms to do well on this unit test:

Appropriations bills BUDGET DEFICIT/ BUDGET SURPLUS Bank holding company
Crowding-out effect Easy money policy Tight money policy Open-Market Operations
Money creation Money Multiplier Formula Inside Lag Outside Lag Monetarism
Board of Governors Federal budget Fiscal policy
Federal Advisory Council—research arm of the Fed Multiplier effect
National debt OMB (Office of Management and Budget)—under Executive Office of the President
Prime rate Required Reserve Ratio (RRR) Treasury bill Treasury bond Treasury note
Keynesianism/Keynesian Economics—also know that it worked in the 1930s, failed in the 1970s
Federal Funds Rate Productive capacity Discount Rate