

TEST BANK



Chapter 2 Economics: The Framework for Business

TRUE/FALSE

1. An economy is both a social and a financial system.

ANS: T DIF: LL1 REF: Page 15 OBJ: 1

2. Financial or social systems are not essential to the development of a strong economy.

ANS: F DIF: LL1 REF: Page 15 OBJ: 1

3. The study of economics focuses on how people, businesses, and governments choose to allocate resources.

ANS: T DIF: LL1 REF: Page 15 OBJ: 1

4. A key economic goal is to provide a deep understanding of past choices that can be used to guide future business decisions.

ANS: T DIF: LL1 REF: Page 15 OBJ: 1

5. Economists forecast business needs based on a deep understanding of past choices.

ANS: T DIF: LL1 REF: Page 15 OBJ: 1

6. A surprisingly small number of key variables have a significant impact on the performance of the economy.

ANS: F DIF: LL1 REF: Page 15 OBJ: 1

7. The complexity of the economy makes economic forecasting an inexact process.

ANS: T DIF: LL1 REF: Page 15 OBJ: 1

8. Broad economic trends in employment, inflation, and economic growth provide a context that has an important impact on businesses throughout the economy.

ANS: T DIF: LL2 REF: Page 15 OBJ: 1

9. Microeconomics is the study of broad, economy-wide issues such as the unemployment rate, gross domestic product and inflation.

ANS: F DIF: LL2 REF: Page 15 OBJ: 1

10. Macroeconomic conditions impact day-to-day life by influencing variables such as the availability of jobs, the amount of take home pay households have available after paying taxes, and the buying power of those incomes.

ANS: T DIF: LL2 REF: Page 15 OBJ: 1

11. The study of economics falls into two broad categories called meta-economics and econometrics.

ANS: F DIF: LL2 REF: Page 15 OBJ: 1

12. Luke is taking an economics class that focuses on decisions made by individual business firms and consumers. Luke's class is concerned with microeconomic issues.

ANS: T DIF: LL2 REF: Page 15 OBJ: 1

13. Capitalism is based on private ownership, economic freedom, and fair competition.

ANS: T DIF: LL2 REF: Page 16 OBJ: 2

14. Capitalism places paramount importance on the need for the government to intervene in the economy to ensure a fair and equitable distribution of income.

ANS: F DIF: LL2 REF: Page 16 OBJ: 2

15. Market equilibrium is the point at which the supply curve intersects the demand curve.

ANS: T DIF: LL2 REF: Page 20 OBJ: 2

16. Federal law has made all types of monopolies illegal in the United States.

ANS: F DIF: LL2 REF: Page 19 OBJ: 2

17. A typical supply curve shows that an increase in the price of a good will cause producers to decrease the quantity they supply.

ANS: F DIF: LL2 REF: Page 20 OBJ: 2

18. Market equilibrium identifies the price at which quantity supplied is equal to quantity demanded.

ANS: T DIF: LL2 REF: Page 20 OBJ: 2

19. Consumers will see prices fall when the quantity demanded exceeds quantity supplied.

ANS: F DIF: LL2 REF: Page 20 OBJ: 2

20. The price paid for goods and services will rise when the quantity demanded exceeds quantity supplied.

ANS: T DIF: LL2 REF: Page 20 OBJ: 2

21. Everlene's Bakery competes against many other bakeries in the same city. However, each bakery uses different recipes and each claims to offer better products than their rivals. For example, Everlene's advertises that it produces the "World's Best" chocolate chip cookies. This suggests that Everlene's market is an example of pure competition.

ANS: F DIF: LL2 REF: Page 18 OBJ: 2

22. The fundamental rights of capitalism guarantee that businesses will be profitable and taxes will be low, thus providing a strong motivation to start a business.
- ANS: F DIF: LL2 REF: Page 17 OBJ: 2
23. In the United States, the government places no restrictions on the right to own property and the freedom to will that property to family members.
- ANS: F DIF: LL2 REF: Page 17 OBJ: 2
24. An entrepreneur with limited funds who wants to start a new business would probably be most successful in an oligopolistic market, because the amount of competition in such markets is very limited.
- ANS: F DIF: LL2 REF: Page 19 OBJ: 2
25. Government policies promoting free trade are consistent with the right to free choice which is fundamental to capitalism.
- ANS: T DIF: LL2 REF: Page 18 OBJ: 2
26. Brooklyn's Beachfront Bed and Breakfast loses money due to a sharp drop in the number of guests during the winter months. If Brooklyn's demand curve is like most demand curves, one way to attract more guests would be to offer lower rates during the off season.
- ANS: T DIF: LL3 REF: Page 20 OBJ: 2
27. Morgan's Moped and Bicycle Store is located on the property of a five-star resort in southern Florida. The mopeds and bikes are rented based on one-hour increments. Morgan lowers her standard prices to attract patrons during daily rain storms in June and August. This is an example of decreasing supply.
- ANS: F DIF: LL3 REF: Page 20 OBJ: 2
28. In a planned economy the government plays only a minor role in the operation of the economy.
- ANS: F DIF: LL1 REF: Page 20-21 OBJ: 3
29. In capitalism what gets produced is largely determined by central government planning.
- ANS: F DIF: LL2 REF: Page 20 OBJ: 3
30. The North Korean and Cuban governments still own most of their nation's enterprises and actively control the performance of their nation's economies.
- ANS: T DIF: LL2 REF: Page 22 OBJ: 3
31. Communism is an economic and political system in which a strong central government owns and controls almost all productive enterprises.
- ANS: T DIF: LL2 REF: Page 22 OBJ: 3

32. By the end of the 1980's, communism began collapsing across the Soviet Union and its satellite nations.
- ANS: T DIF: LL2 REF: Page 22 OBJ: 3
33. The few nations that still rely on a communist economic system have actually seen major improvements in their economic performance over the past decade.
- ANS: F DIF: LL2 REF: Page 22 OBJ: 3
34. Karl Marx envisioned communism as a system that would improve the lot of the common worker.
- ANS: T DIF: LL2 REF: Page 22 OBJ: 3
35. One problem that plagued many communist economies was that the absence of free markets resulted in crippling shortages and surpluses of goods and services.
- ANS: T DIF: LL2 REF: Page 22 OBJ: 3
36. A strength of a pure planned economy is that it is likely to grow rapidly and produce enough products and services to support its people in the long term.
- ANS: F DIF: LL 1 REF: Page 22 OBJ: 4
37. In the U.S. economy, various branches of government own major enterprises such as the postal service, schools, parks, libraries, universities, and the military.
- ANS: T DIF: LL 1 REF: Page 22 OBJ: 4
38. The U.S. federal government is the nation's largest employer.
- ANS: T DIF: LL 1 REF: Page 22 OBJ: 4
39. The federal government creates regulations that prohibit competition and stimulate consumers to work.
- ANS: F DIF: LL 1 REF: Page 22 OBJ: 4
40. Privatization is the conversion of government-owned enterprises to private ownership.
- ANS: T DIF: LL 1 REF: Page 22 OBJ: 4
41. Many countries that have restructured to become more market-oriented have seen dramatic increases in the standard of living for most of their people.
- ANS: T DIF: LL 1 REF: Page 22 OBJ: 4
42. The economic restructuring necessary to move toward greater reliance on markets has proven to be relatively easy for most previously planned economies to achieve.
- ANS: F DIF: LL 1 REF: Page 22 OBJ: 4

43. While the U.S. relies heavily on free markets, it is actually a mixed economy in which the government owns several major enterprises and regulates many aspects of business operations.
- ANS: T DIF: LL 2 REF: Page 22 OBJ: 4
44. The two most common types of real world economies are pure capitalism and pure socialism.
- ANS: F DIF: LL 2 REF: Page 22 OBJ: 4
45. Competition encourages companies to operate efficiently and responsively. The government does its part to stimulate fair competition by creating regulations to protect consumers and workers.
- ANS: T DIF: LL 2 REF: Page 22 OBJ: 4
46. Privatization is an important element of the movement toward a greater market orientation in many nations.
- ANS: T DIF: LL 2 REF: Page 22 OBJ: 4
47. Gross domestic product (GDP) includes the value of output produced within a nation even if that output is produced by a foreign-owned company.
- ANS: T DIF: LL 2 REF: Page 22 OBJ: 5
48. Gross Domestic Product (GDP) measures the total value of all goods and services produced within a nation's physical boundaries over a given period of time.
- ANS: T DIF: LL 1 REF: Page 22 OBJ: 5
49. GDP tends to overstate the amount of output produced by a nation's economy.
- ANS: F DIF: LL 1 REF: Page 23 OBJ: 5
50. GDP, as the measurement of the total value of goods and services, includes the output produced within households and output produced by illegal activities.
- ANS: F DIF: LL 1 REF: Page 22 OBJ: 5
51. The value of a Hyundai Sonata built in Montgomery, Alabama would be included in U.S. GDP even though Hyundai is actually a Korean corporation.
- ANS: T DIF: LL 1 REF: Page 22 OBJ: 5
52. The unemployment rate includes only individuals over the age of 21 who were involuntarily laid off or fired from their previous jobs.
- ANS: F DIF: LL 1 REF: Page 23 OBJ: 5
53. The unemployment rate measures individuals 16 years of age and older without jobs who are actively seeking employment.

ANS: T DIF: LL 1 REF: Page 23 OBJ: 5

54. Individuals quitting their jobs experience structural unemployment.

ANS: F DIF: LL 1 REF: Page 23 OBJ: 5

55. Cyclical unemployment results from layoffs during recessionary periods.

ANS: T DIF: LL 1 REF: Page 23 OBJ: 5

56. Frictional unemployment may occur even when the economy is healthy, and may ultimately result in a better match between workers and jobs.

ANS: T DIF: LL 1 REF: Page 23 OBJ: 5

57. The predictable nature of the business cycle makes it easy to forecast when the next upturn or downturn in business activity will occur.

ANS: F DIF: LL 1 REF: Page 23 OBJ: 5

58. An economy is said to be in a recession when GDP decreases for two consecutive quarters..

ANS: T DIF: LL 1 REF: Page 24 OBJ: 5

59. The two key phases of the business cycle are contraction and expansion.

ANS: T DIF: LL 1 REF: Page 23 OBJ: 5

60. Contraction is a period of economic downturn marked by rising unemployment, business cutbacks, and decreases in consumer spending.

ANS: T DIF: LL 1 REF: Page 24 OBJ: 5

61. Recovery is a period of increasing employment, business expansion, and increased consumer spending.

ANS: T DIF: LL 1 REF: Page 24 OBJ: 5

62. Unfortunately, depressions are a common problem in most free-market economies.

ANS: F DIF: LL 1 REF: Page 24 OBJ: 5

63. Inflation occurs as the average prices of goods and services rise.

ANS: T DIF: LL 1 REF: Page 24 OBJ: 5

64. Less expensive labor pools overseas might create layoffs at a U.S.-based engine plant. This is an example of structural unemployment.

ANS: T DIF: LL 2 REF: Page 23 OBJ: 5

65. To measure productivity, multiply the number of inputs by the cost of each input.

75. In the broadest sense, economics studies the choices that

- a) people make in disposing of unnecessary resources.
- b) governments make in creating natural resources.
- c) companies make in producing goods and services for corporate use.
- d) people, governments, and companies make in allocating resources.

ANS: D DIF: LL1 REF: Page 15 OBJ: 1

76. From the business perspective, a key reason to study economics is to

- a) gain a better understanding of past business choices in order to make better future decisions.
- b) avoid the temptation to focus on past events.
- c) ensure that demand exceeds supply.
- d) learn how to achieve a monopoly position in markets with the potential to generate high profits..

ANS: A DIF: LL1 REF: Page 15 OBJ: 1

77. The study of economics is divided into two core categories known as:

- a) production and consumption.
- b) data collection and forecasting.
- c) macroeconomics and microeconomics.
- d) supply economics and demand economics.

ANS: C DIF: LL1 REF: Page 15 OBJ: 1

78. An economic system is a structure for

- a) measuring gross domestic products.
- b) allocating limited resources.
- c) forecasting trends.
- d) none of the above

ANS: B DIF: LL1 REF: Page 15 OBJ: 1

79. Macroeconomics focuses on:

- a) the major issues facing the national economy, and has little or no relevance to individuals.
- b) the small individual units operating within the economy.
- c) the major issues facing the national economy, but these issues often impact an individual's well-being.
- d) the role of government, while microeconomics focuses on the private sector.

ANS: C DIF: LL2 REF: Page 15 OBJ: 1

80. _____ is a structure for allocating scarce resources.

- a) An economic system
- b) An econometric plan
- c) A factor distributor
- d) The gross domestic product

ANS: A DIF: LL1 REF: Page 16 OBJ: 1

81. Microeconomic analysis would be best suited for:

- a) helping a firm determine the best pricing strategy for its products.
- b) determining the best government tax policies to deal with a high rate of inflation.
- c) explaining the reasons for an increase in the nation's unemployment rate.
- d) measuring the total output produced by a nation's economy.

ANS: A DIF: LL2 REF: Page 15 OBJ: 1

82. Which of the following would be studied in the greatest detail in a macroeconomics course?

- a) How a large automobile manufacturer decides how many SUVs to produce in a given model year.
- b) How consumers would respond if a restaurant raised its prices.
- c) How a firm in an oligopolistic market would respond to a change in the pricing strategy of other firms in its market.
- d) Factors that influence the nation's unemployment rate.

ANS: D DIF: LL2 REF: Page 15 OBJ: 1

83. Changes in key industries hold the potential to transform a nation's economy. Which changes would most likely create that effect in the U.S.?

- a) Cure for cancer
- b) New database for accounting
- c) Greater number of college graduates with computer science degrees
- d) Decreased number of individuals on welfare

ANS: A DIF: LL2 REF: Page 16 OBJ: 1

84. GeeGee's is a community-based bakery known for its scrumptious tea cakes. The recipe calls for expensive spices imported from Asia. Recently the cost of these spices has risen dramatically, leading GeeGee's to consider increasing its prices. In order to analyze how this change would affect consumer choices, GG's management could perform a

- a) microeconomic analysis.
- b) macroeconomic analysis.
- c) transformational economic analysis.
- d) structural analysis.

ANS: A DIF: LL3 REF: Page 15 OBJ: 1

85. If low cost solar power were to become a viable energy source in households across the U.S., what would be the economic impact on energy prices?

- a) Energy costs across the country would increase with adoption of the new energy source.
- b) Housing prices would decrease as new homes are built with this new energy source.
- c) Prices would increase as this is a new energy source.
- d) Prices would decrease as competition increases in energy production.

ANS: D DIF: LL3 REF: Page 16 OBJ: 1

86. In capitalism people strive to raise their standard of living. Businesses contribute to this goal by _____.

- a) offering value to the consumer.
- b) using available resources.
- c) attracting available talent.
- d) forming oligopolistic markets.

ANS: A DIF: LL1 REF: Page 17 OBJ: 2

87. A basic characteristic of _____ is that both producers and consumers are free to make their own economic decisions on many basic issues.

- a) socialism
- b) capitalism
- c) communism
- d) mercantilism

ANS: B DIF: LL1 REF: Page 17 OBJ: 2

88. In _____ many firms compete by selling differentiated products.

- a) monopoly
- b) monopolistic competition
- c) oligopoly
- d) natural monopoly

ANS: B DIF: LL1 REF: Page 18 OBJ: 2

89. _____ is a market structure with many competitors selling virtually identical products.

- a) Natural competition
- b) Pure competition
- c) Oligopoly
- d) Monopolistic competition

ANS: B DIF: LL1 REF: Page 18 OBJ: 2

90. Firms in oligopolistic markets tend to

- a) keep prices as low as possible.
- b) avoid price competition whenever possible.
- c) be very concerned about the possibility of new firms entering their market.
- d) have very small market shares.

ANS: B DIF: LL2 REF: Page 19 OBJ: 2

91. Which of the following is not a fundamental right of capitalism?

- a) Right to own property
- b) Right to compete
- c) Right to keep profits and not pay taxes
- d) Right to run a business

ANS: C DIF: LL2 REF: Page 17-18 OBJ: 2

92. Which of the following is not a degree of competition?

- a) Oligopolistic competition
- b) Monopolistic competition
- c) Natural competition
- d) Pure competition

ANS: C DIF: LL2 REF: Page 18-19 OBJ: 2

93. Companies that attempt to monopolize a particular market are likely to violate the:

- a) Fair Competition Standards Act of 1911
- b) Taft-Sharpley Free Enterprise Act of 1957
- c) Sherman Anti-Trust Act of 1890
- d) Market Competition Enhancement Act of 1978

ANS: C DIF: LL2 REF: Page 19 OBJ: 2

94. Competition among businesses

- a) is consistent with the goals of socialism.
- b) is a primary feature of a communist economic system.
- c) ensures that everyone is a winner.
- d) drives higher quality and lower prices in capitalism.

ANS: D DIF: LL2 REF: Page 18 OBJ: 2

95. According to your textbook, the “Happy Cows” campaign, created by the California Milk Board, has directly increased sales of California cheese by more 1 billion pounds. This benefits

- a) Wisconsin dairy farmers and the consumers of Wisconsin cheeses.
- b) California dairy farmers and the consumers of California cheeses.
- c) U. S. cheese producers.
- d) European cheese producers.

ANS: B DIF: LL2 REF: Page 19 OBJ: 2

96. Prior to 1999, most consumers believed that there was virtually no difference between cheese produced by the thousands of dairy farms in different states. But the “Happy Cows” campaign created by the California Milk Board created a perception that California cheese is better. This successful product differentiation means that the cheese market is no longer:

- a) purely competitive
- b) monopolistic
- c) consistent with capitalism.
- d) oligopolistic

ANS: A DIF: LL2 REF: Page 19 OBJ: 2

97. In 1999, Coca-Cola considered a plan to install thermometers in vending machines that would charge more for cold beverages on particularly hot days. If the demand curve for Coke is like most demand curves, on hot days such a strategy would have:

- a) resulted in a shortage of Coca Cola.
- b) resulted in a lower quantity of Coke demanded than at the lower price.
- c) increased the available supply of competing soft drinks.
- d) had no effect on the amount of Coke consumers would buy.

ANS: B DIF: LL2 REF: Page 21 OBJ: 2

98. If the cost of an ice-cold Coke is more expensive during the summer months, consumers will

- a) not buy at all.
- b) buy no more or less due to the increase in price.
- c) buy more due to the increase in price.
- d) buy less due to the increase in price.

ANS: D DIF: LL2 REF: Page 21 OBJ: 2

99. In 2005, General Motors introduced a blockbuster promotion by offering customers the employee discount prices for any vehicle. Chrysler and Ford followed the trend and offered the same program. This intense price competition among three major automobile producers resulted in lower profits for all three companies. This outcome illustrates a problem for firms in:

- a) pure competition.
- b) pure monopoly.
- c) monopolistic competition.
- d) oligopolistic markets.

ANS: D DIF: LL3 REF: Page 19 OBJ: 2

100. The government often allows only one company to provide electricity in a given geographic area because allowing several companies to do so would result in an inefficient duplication of infrastructure. This suggests that electric utilities are

- a) trust busters.
- b) oligopolies.
- c) natural monopolies.
- d) pure players.

ANS: C DIF: LL3 REF: Page 19 OBJ: 2

101. A market structure with pure competition has all of the following characteristics except:

- a) the firms use product differentiation allowing consumers to easily identify their favorite brands.
- b) there are many firms competing in the market.
- c) firms can easily enter and leave the market.
- d) no individual firm has any control over the price of the product.

ANS: A DIF: LL3 REF: Page 18 OBJ: 2

102. _____ is the market structure that is most likely to result in higher prices, lower quality and fewer choices for consumers.

- a) Pure competition

- b) Monopolistic competition
- c) Oligopoly
- d) Monopoly

ANS: D DIF: LL3 REF: Page 19 OBJ: 2

103. During the second half of the 20th century the economies of many European nations became more socialistic, especially when compared to the economy of the United States. This suggests that these European countries had _____ than the United States:

- a) more government owned enterprises
- b) lower taxes
- c) a more unequal distribution of income
- d) a much faster rate of economic growth

ANS: A DIF: LL1 REF: Page 21 OBJ: 3

104. The main economic goal of the government in a socialist economy is to:

- a) keep taxes as low as possible.
- b) operate key economic enterprises in the best interests of the general public.
- c) achieve the highest possible rate of economic growth.
- d) provide the widest array of economic freedoms to its citizens.

ANS: B DIF: LL1 REF: Page 21 OBJ: 3

105. Compared to capitalism, in a socialist system we would expect to find:

- a) a smaller role for the government.
- b) more emphasis on economic growth and a higher standard of living for the typical household.
- c) a greater incentive for entrepreneurs to start new businesses.
- d) more taxpayer subsidized social programs intended to promote a more equal distribution of wealth.

ANS: D DIF: LL1 REF: Page 21 OBJ: 3

106. The ideas of political philosopher Karl Marx are most closely linked to the economic system known as:

- a) communism.
- b) capitalism.
- c) socialism.
- d) mercantilism.

ANS: A DIF: LL2 REF: Page 22 OBJ: 3

107. Communist economies have faced a number of issues that have interfered with their effectiveness. The issues include all of the following EXCEPT

- a) crippling shortages and surpluses.
- b) abundant natural resources.
- c) corruption
- d) suspension of individual rights and choices.

ANS: B DIF: LL2 REF: Page 22 OBJ: 3

108. Government laws against monopolies are

- a) a key way the government promotes competition in a capitalist system.
- b) inconsistent with the role of government in a capitalist system.
- c) the main reason the U.S. economy is best classified as a socialist system.
- d) the main way the government ensures an equal distribution of income in the U.S. economy.

ANS: A DIF: LL2 REF: Page 19 OBJ: 2

109. Abraham Lincoln once stated, "You cannot help the poor by destroying the rich. You cannot lift the wage earner by pulling down the wage payer." This quote is most consistent with the philosophy of a:

- a) socialist economy.
- b) communist economy.
- c) planned economy.
- d) capitalist economy.

ANS: D DIF: LL3 REF: Page 16-17 OBJ: 2

110. Today the economies of virtually all nations would be classified as:

- a) pure socialism.
- b) mixed economies.
- c) pure capitalism.
- d) pure communism.

ANS: B DIF: LL 1 REF: Page 22 OBJ: 4

111. One reason pure market economies are non-existent is because

- a) they are too expensive to maintain.
- b) they don't adequately provide for the the sick, the elderly, and the environment.
- c) they result in very high tax rates that undermine incentives.
- d) they don't do enough to encourage entrepreneurship.

ANS: B DIF: LL 1 REF: Page 22 OBJ: 4

112. Most business enterprises in the United States are privately owned, but the federal government owns a number of major enterprises (e.g., U.S. Postal Service, U.S. Department of Education, etc.). This suggests that the U.S. economy is best classified as a:

- a) pure market economy.
- b) mixed economy.
- c) true command economy.
- d) pure planned economy.

ANS: B DIF: LL 1 REF: Page 22 OBJ: 4

113. To stimulate competition and protect both consumers and workers, the federal government

- a) places heavy taxes on firms in monopolistic competition.
- b) places limits on international trade in order to stimulate domestic production.

- c) creates regulations to intervene in the free market.
- d) creates business systems to meet the needs of all consumers.

ANS: C DIF: LL 1 REF: Page 22 OBJ: 4

114. In the United States, the federal government:

- a) consistently runs a budget surplus since it operates most of its enterprises at a profit.
- b) has been very reluctant to regulate business behavior.
- c) plays only a very minor role in the economy.
- d) is the largest employer, providing jobs for nearly three million Americans.

ANS: D DIF: LL 1 REF: Page 22 OBJ: 4

115. In recent years, the most common reason for tax reforms in formerly planned economies has been to:

- a) create a more equal distribution of income.
- b) create new incentives for domestic and foreign investment.
- c) eliminate the threat of hyperinflation.
- d) protect the environment.

ANS: B DIF: LL 1 REF: Page 22 OBJ: 4

116. _____ is the process of converting government-owned businesses to private ownership.

- a) Privatization
- b) Globalization
- c) Competition
- d) Collusion

ANS: A DIF: LL 1 REF: Page 22 OBJ: 4

117. The Rainland government enjoys a socialist economic system, but in recent years has found that new business growth has stalled. In an effort to stimulate more growth the government will probably

- a) create regulations giving consumers and workers more protection.
- b) take over most new businesses and operate them as government enterprises.
- c) reduce taxes and cut back on some social programs.
- d) increase the number of citizens who qualify for free education and healthcare.

ANS: C DIF: LL 2 REF: Page 22 OBJ: 4

118. The government of Puritania has begun a program to restructure of the economy, with a goal of moving toward a more market-oriented system. Which of the following is least likely to occur as the result of this restructuring?

- a) A rise in social unrest as citizens try to adjust to the economic reforms.
- b) Privatization of formerly government owned enterprises.
- c) Cuts in social programs such as free or low cost healthcare.
- d) Slower rates of economic growth and lower standards of living for the majority of citizens.

124. Two key phases of the business cycle are

- a) trend and random variation.
- b) inflation and recession.
- c) contraction and expansion.
- d) inflation and deflation.

ANS: C DIF: LL 1 REF: Page 24 OBJ: 5

125. In the business cycle, a period in which GDP declines for at least two consecutive quarters is known as a(n):

- a) expansion.
- b) depression.
- c) trough.
- d) recession.

ANS: D DIF: LL 1 REF: Page 24 OBJ: 5

126. In the business cycle, a period of rising economic growth and increasing employment is a

- a) recovery.
- b) peak.
- c) contraction.
- d) disinflation.

ANS: A DIF: LL 1 REF: Page 24 OBJ: 5

127. _____ is a period of robust economic growth and high employment indicating that businesses are capitalizing on new market opportunities.

- a) Expansion
- b) Recovery
- c) Depression
- d) Contraction

ANS: A DIF: LL 1 REF: Page 24 OBJ: 5

128. _____ means that prices on average are rising.

- a) Deflation
- b) Inflation
- c) Disinflation
- d) Hyperinflation

ANS: B DIF: LL 1 REF: Page 24 OBJ: 5

129. To evaluate the impact of inflation, the government uses

- a) inflation and disinflation.
- b) the consumer price index (CPI) and producer price index (PPI).
- c) productivity and unemployment.
- d) monetary policy and fiscal policy.

ANS: B DIF: LL 1 REF: Page 25 OBJ: 5

130. The Consumer Price Index (CPI) measures the

- a) change in the rate of inflation over time.
- b) change in weighted average price over time in a “market basket” of goods and services bought by the typical consumer.
- c) change in prices of a set of goods that represent the minimum acceptable standard of living for the nation’s consumers.
- d) percentage of their income consumers must use to pay for goods relative to their average incomes in the same time period.

ANS: B DIF: LL 1 REF: Page 25 OBJ: 5

131. Changes in the PPI can predict changes in the Consumer Price Index (CPI) because

- a) consumers pay what retailers charge.
- b) they are computed using the same market basket.
- c) producers often pass along price increases to consumers.
- d) consumers and producers often buy the same goods.

ANS: C DIF: LL 1 REF: Page 25 OBJ: 5

132. The amount of goods and services produced by an economy divided by the number of resources used to make those goods and services, measures economic

- a) consumer price index.
- b) deflation.
- c) inflation.
- d) productivity.

ANS: D DIF: LL 1 REF: Page 25 OBJ: 5

133. The nation of High Land has seen a steady increase in the output of goods and services produced within its borders in the last year. This would indicate

- a) a rise in High Land’s GDP.
- b) a rise in High Land’s CPI.
- c) a rise in High Land’s unemployment rate.
- d) a decline of the national tax rate.

ANS: A DIF: LL 2 REF: Page 22 OBJ: 5

134. A decrease in _____ indicates that it now takes more resources (inputs) to produce a given amount of goods and services (outputs) than in the past.

- a) inflation
- b) productivity
- c) structural unemployment
- d) the business cycle

ANS: B DIF: LL 2 REF: Page 25 OBJ: 5

135. Manufacturing jobs have migrated overseas due to increased productivity and low wages of workers in other countries. This contributes to _____ unemployment for American workers in the manufacturing sector.

- a) structural
- b) frictional
- c) seasonal
- d) cyclical

ANS: A DIF: LL2 REF: Page 23 OBJ: 5

136. An economy is experiencing hyperinflation when average prices of goods and services:

- a) rise faster than productivity.
- b) increase by more than 100% in a year.
- c) increase more than 50% per month.
- d) decrease more than 50% per day.

ANS: C DIF: LL 2 REF: Page 24 OBJ: 5

137. Denise is a hard worker, but within the last year she and her boss have not seen eye to eye. Angela, her boss, has become more demanding and harder to reach to get clarification on projects. After one too many long working days with little or no job satisfaction, Denise walks into Angela's office and submits her resignation. Denise knows that her resume is strong and feels confident she will find work. Denise is now facing

- a) seasonal unemployment.
- b) structural unemployment.
- c) frictional unemployment.
- d) cyclical unemployment.

ANS: C DIF: LL 2 REF: Page 23 OBJ: 5

138. With the tragedy of the 9/11 attacks and the devastation of Hurricane Katrina, workers in both New York City and New Orleans experienced

- a) structural unemployment.
- b) frictional unemployment.
- c) cyclical unemployment.
- d) seasonal unemployment.

ANS: A DIF: LL 3 REF: Page 23 OBJ: 5

139. The items included in the CPI's "market basket" are chosen to represent:

- a) goods and services bought by the average consumer.
- b) goods and services bought by the business sector.
- c) the cost of government supplied goods and services.
- d) all goods and services produced by domestic businesses.

ANS: A DIF: LL 3 REF: Page 25 OBJ: 5

140. Pampered Pooch is a dog groomer in the area looking to increase productivity for the business. Currently, in an eight hour day, Pampered Pooch can wash and groom 12 large dogs. To calculate productivity the management of Pampered Pooch would

- a) divide the number of dogs groomed per day (12) by the amount of labor per day (8 hours).

- b) divide the total weight of the dogs by 12, then multiply the results by the number of hours of labor per day (8 hours).
- c) divide 8 hours by 12 dogs per day.
- d) divide 12 dogs by a 7 day work week and multiply the result by 8.

ANS: A DIF: LL 3 REF: Page 25 OBJ: 5

141. Martha has noticed that the CPI has increased by 7% over the past year. The best conclusion for Martha to make based on this information is that

- a) her cost of living has increased by 7%.
- b) her income has increased by 7%.
- c) the weighted average of prices of goods and services in a market basket bought by a typical consumer have increased by 7%.
- d) the price of necessities such as food, rent, and medicine have increased by an average of 7%.

ANS: C DIF: LL 3 REF: Page 25 OBJ: 5

142. _____ refers to government efforts to influence the economy through taxation and spending decisions designed to encourage growth, boost employment, and curb inflation.

- a) Monetary policy
- b) Fiscal policy
- c) Pricing policy
- d) Production policy

ANS: B DIF: LL 1 REF: Page 26 OBJ: 6

143. When tax revenue is higher than government expenditures, the government incurs a

- a) budget deficit.
- b) windfall.
- c) budget surplus.
- d) national debt.

ANS: C DIF: LL 1 REF: Page 26 OBJ: 6

144. The federal government runs a budget deficit when its

- a) spending outpaces revenue from taxes.
- b) tax revenue outpaces its expenditures.
- c) monetary policies reduce the amount of money in circulation.
- d) gold reserves are inadequate to support the existing money supply.

ANS: A DIF: LL 1 REF: Page 26 OBJ: 6

145. _____ refers to actions that shape the economy by influencing interest rates and the supply of money.

- a) Fiscal policy
- b) Monetary policy
- c) Revenue policy
- d) Deficit policy

ANS: B DIF: LL1 REF: Page 26 OBJ: 6

146. The Federal Reserve is primarily responsible for conducting:

- a) fiscal policy.
- b) treasury policy.
- c) tax policy.
- d) monetary policy.

ANS: D DIF: LL 1 REF: Page 26 OBJ: 6

147. The M2 money supply includes

- a) all currency, credit cards, and most savings accounts.
- b) all currency, most savings accounts, money market accounts, and certificates of deposit.
- c) only currency and short term money market accounts.
- d) all currency.

ANS: B DIF: LL 1 REF: Page 27 OBJ: 6

148. In the U.S., the control of the money supply is the responsibility of

- a) the U.S. Department of the Treasury.
- b) the Federal Reserve.
- c) the U.S. Department of State.
- d) the U.S. Congress.

ANS: B DIF: LL 1 REF: Page 26-27 OBJ: 6

149. Banks help increase the money supply by

- a) printing more money.
- b) extending loans to credit-worthy consumers.
- c) holding more money in their accounts with the Federal Reserve.
- d) sending more money to the Treasury Department.

ANS: B DIF: LL2 REF: Page 27 OBJ: 6

150. The primary way the Fed controls the supply of money is by:

- a) establishing the amount of currency the U.S. Treasury is allowed to print each month.
- b) changing the reserve requirement.
- c) buying and selling government securities on the open market.
- d) allowing banks to borrow more money from the U.S. Treasury.

ANS: C DIF: LL2 REF: Page 28 OBJ: 6

151. If the Fed wants to increase the money supply it should:

- a) raise the reserve requirement.
- b) raise the discount rate.
- c) cut taxes.
- d) buy government securities.

ANS: D DIF: LL 2 REF: Page 27 OBJ: 6

152. Members of the U.S. Congress have voted themselves an annual pay raise while the country is operating under a budget deficit. The pay raise for all members of Congress will generate
- a) an increase in the federal debt.
 - b) a decrease in social programs.
 - c) an increase in the reserve requirement.
 - d) a decrease in the interest rate.

ANS: A DIF: LL 2 REF: Page 26 OBJ: 6

153. In an effort to instill public confidence in the banking system after the 1929 stock market crash, Congress established the _____ to protect deposits in banks and thrift institutions for up to \$100,000 per customer, per bank.

- a) Federal Deposit Insurance Corporation (FDIC)
- b) Federal Reserve System
- c) Federal Open Market Committee
- d) Federal Reserve Requirement

ANS: A DIF: LL 2 REF: Page 27 OBJ: 6

154. Michael has inherited \$500,000 from the sale of a family business. His banker is advising he find multiple banks to deposit his money. Why?

- a) The Open Market Operations of the Federal Reserve would invest his money in other securities and might lose it without needing to justify the expenditure.
- b) The Federal Reserve does not keep that much money in any one bank due to federal regulations prohibiting the buying and selling of securities.
- c) The Federal Deposit Insurance Corporation will only insure up to \$100,000 in each account per customer, per bank. He would need more than one bank to ensure his money is federally protected in the event of an economic collapse of the banking system.
- d) He needs to diversify his holdings in more than one bank to protect himself against fraudulent lending practices of banks.

ANS: C DIF: LL 3 REF: Page 27 OBJ: 6

155. Early in his first term, President George W. Bush faced an economy in the beginnings of a recession. Which of the following would represent an example of a fiscal policy President Bush might suggest to deal with this situation?

- a) Ask Congress to cut total spending on social programs to avoid running a budget deficit.
- b) Ask Congress to cut taxes in order to give consumers and businesses more income to spend and invest.
- c) Order the Fed to raise the required reserve ratio.
- d) Urge Congress to give the U.S. Treasury the authority to print more money.

ANS: B DIF: LL 3 REF: Page 26 OBJ: 6

ESSAY

156. Explain how macroeconomics differs from microeconomics. Illustrate these differences by identifying some specific topics these two branches would examine.

ANS:

Macroeconomics is the study of a country's overall economic issues, such as the employment rate, the gross domestic product, and taxation policies. While macroeconomic issues may seem abstract, they directly impact your day-to-day life, influencing key variables such as what jobs will be available for you, how much cash you'll actually take home after taxes, or how much you can buy with that cash in any given month.

Microeconomics focuses on smaller economic units such as individual consumers, families, and individual businesses. Thus, microeconomics would look at how individual firms decide how much output to produce, what prices to charge, and how much labor to hire. It would also look at how consumers decide which products to buy, and why the wage rates of some workers are higher than the wages earned by other workers.

On a broader scale, the constant, changing interplay between micro and macroeconomic factors—individual behavior and broad trends—determines the shape of the entire economy.

NOTE: The examples of micro and macro topics in this answer are by no means exhaustive. Students may come with other equally satisfactory illustrations.

DIF: LL3 REF: Page 15 OBJ: 1

157. Define transformational economic trends and describe the impact they have on today's domestic and international businesses.

ANS:

Changes in key industries hold the potential to transform the economy of the entire nation, with ripple effects throughout the world.

What if...solar power became a viable energy source? According to the U.S. Department of Energy, photovoltaic power—solar energy—will be price competitive with traditional sources of electricity within the next ten years. Clearly, the economic forecast for limitless solar power would be downright sunny.

What if...we found a cure for cancer? Towards the end of 2005, an international team of researchers completed the first database of human genetic variations. Scientists believe that this powerful tool will thrust forward the search for genes that cause devastating diseases such as cancer, diabetes, and psychiatric disorders. The potential to correct genetic problems could revolutionize global health care with a direct impact on the world economy.

What if...Big Business could actually shape our minds? Leveraging breakthrough brain scan technology, researchers have recently watched people's brains light up with pleasure in response to seeing the Coca-Cola logo. Imagine the implications for marketing... Meanwhile, other experts have feverishly begun mapping the brains of money managers to learn why some investors have an uncanny knack for reading the market. The results could fuel a whole new industry of "neuroceutical" drugs to help people chemically re-map their brains to make more money.

DIF: LL3 REF: Page 16 OBJ: 1

158. What are the fundamental rights of capitalism? Include an example of each to support your answer.

ANS:

The right to own a business and keep after-tax profits: Remember that capitalism doesn't guarantee that anyone will actually earn profits. Nor does it promise that there won't be taxes. But if you do earn profits, you get to keep your after-tax income and spend it however you see fit (within the limits of the law, of course). This right acts as a powerful motivator for business owners in a capitalist economy; the lower the tax rate, the higher the motivation.

The right to private property: This means that individuals and private businesses can buy, sell, and use property—which includes land, machines, and buildings—in any way that makes sense to them. This right also includes the right to will property to family members.

The right to free choice: Capitalism relies on economic freedom. People and businesses must be free to buy (or not buy) according to their wishes. They must be free to choose where to work (or not work) and where to live (or not live). Freedom of choice directly feeds competition, creating a compelling incentive for business owners to offer the best goods and services at the lowest prices. U.S. government trade policies boost freedom of choice by encouraging a wide array of both domestic and foreign producers to compete freely for the consumer's dollars.

The right to fair competition: A capitalist system depends on fair competition among businesses to drive higher quality, lower prices, and more choices. Capitalism can't achieve its potential if unfair practices—such as deceptive advertising, predatory pricing, and broken contracts—mar the free competitive environment.

DIF: LL3 REF: Page 17 OBJ: 2

159. Define the four degrees of competition. Include at least one example for each.

ANS:

Pure Competition: A market structure with many competitors selling virtually identical products. In today's U.S. economy, examples of pure competition have virtually disappeared. Examples might include agricultural products.

Monopolistic Competition: A market structure with many competitors selling differentiated products. Producers have some control over the price of their wares depending on the value that they offer their customers. And new producers can fairly easily enter categories marked by monopolistic competition. Examples might include colleges and fast food establishments.

Oligopoly: A market structure with only a handful of competitors selling products that are either similar or different. The retail gasoline business and the car manufacturing industry, for instance, are both oligopolies. Other examples might include breakfast cereals and soft drinks.

Monopoly: A market structure with just a single producer completely dominating the industry, leaving no room for any significant competitors. Monopolies usually aren't good for anyone but the company that has control, since without competition there isn't any incentive to hold down prices or increase quality and choices. Because of these undesirable drawbacks, most attempts to monopolize markets in the United States are illegal. However, the government does allow monopolies to operate in certain special cases. The classic example is a natural monopoly, such as a cable television system, water company, or electric utility. (The pricing and output decisions of such natural monopolies are often regulated by the government to protect the public interest.) The government also fosters temporary monopolies when it grants patents or copyrights.

NOTE: Student answers should include a specific definition, however the examples will vary based on the text and classroom discussions.

DIF: LL3

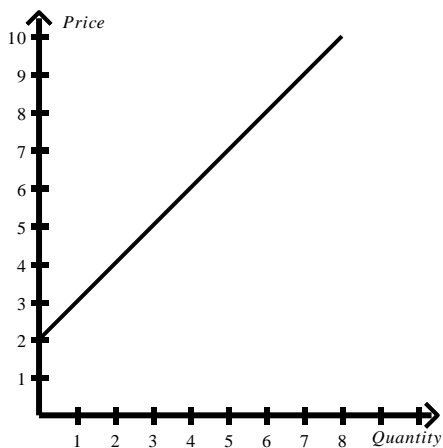
REF: Page 18-19 OBJ: 2

160. What is supply? How can the supply relationship be illustrated? What is demand? How can this relationship be illustrated? How can supply and demand be used to determine the market price of a good?.

ANS:

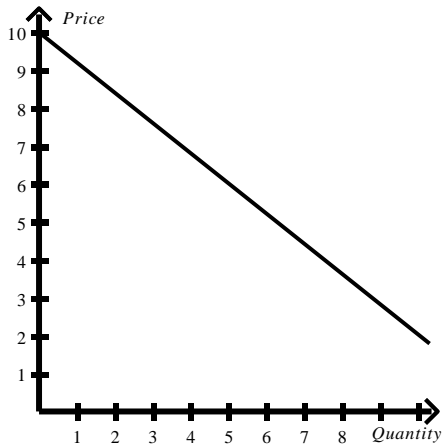
Supply: Supply refers to the quantity of products that producers are willing to offer for sale at different market prices. Because businesses seek to make as much profit as possible, they are likely to produce more of a product that commands a higher market price, and less of a product that commands a lower price.

The relationship between price and quantity from a supplier standpoint can be shown on a graph called the **supply curve**. The supply curve maps quantity on the x-axis (or horizontal axis) and price on the y-axis (or vertical axis). An example of a supply curve is shown below:

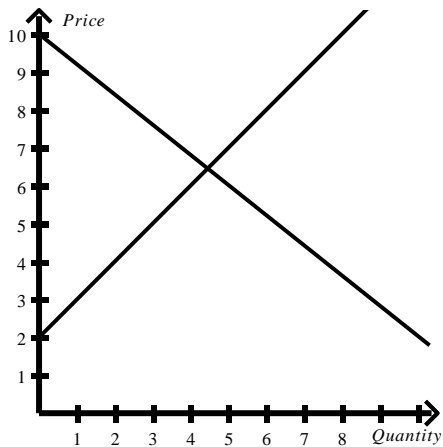


Demand: Demand refers to the quantity of products that consumers are willing to buy at different market prices. Since consumers generally seek to get the products they need (or want) at the lowest possible prices, they tend to buy more of products with lower prices and less of products with higher prices.

The relationship between price and quantity from a demand standpoint can be shown on a graph called the **demand curve**. Like the supply curve, the demand curve maps quantity on the x-axis and price on the y-axis. But different from the supply curve, the demand curves for most goods and services slopes down as it moves to the right, since quantity demanded tends to drop as prices rise. An example of a demand curve is show below:



The concepts of supply and demand can be combined to locate market equilibrium. The equilibrium price is the price at which the quantity supplied is equal to the quantity demanded--which can be found by graphing the supply and demand curves and finding the point where they intersect. The market price moves toward its equilibrium value and tends to stabilize at that value (unless something disturbs the supply or demand curve). If we combine the above supply and demand curves, we can see that the equilibrium price in this market is approximately \$6.45.



DIF: LL3 REF: Page 20 OBJ: 2

161. What is a business cycle? Describe the basic phases of a typical business cycle.

ANS:

The business cycle is the periodic expansion and contraction of economic activity that occurs in a nation's economy over a period of years. The two key phases of a business cycle are contraction, when output (GDP), income, and employment are falling, and expansion when production, incomes and employment are rising. The bottom of a contraction is called a trough, while the high point of an expansion is called a peak. If a contraction results in a decline in GDP for at least two consecutive quarters the downturn is classified as a recession. A depression is an extremely severe and long-lasting recession. Depressions are rare; the last full-blown depression in the United States occurred in the 1930s.

DIF: LL5 REF: Page 23 OBJ: 2

162. Define the differences and similarities between the command economies of socialism and communism.

ANS:

Socialism is an economic system based on the principle that the government should own and operate key enterprises that directly affect public welfare, such as utilities, telecommunications, and healthcare. While the official government goal is to run these enterprises in the best interest of the overall public, inefficiencies and corruption often interfere with effectiveness. Socialist economies also tend to have higher taxes, which are designed to distribute wealth more evenly through society.

Communism is an economic and political system that calls for public ownership of virtually all enterprises, under the direction of a strong central government. The communist concept was the brainchild of political philosopher Karl Marx, who outlined its core principles in his 1848 *Communist Manifesto*. Marx's approach was idealistic. He aimed to create a fair society in which each individual would contribute according to his or her ability and consume according to his or her needs. The communism that Marx envisioned was supposed to dramatically improve the lot of the worker at the expense of the extremely wealthy "capitalists" who owned the factories and other means of production.

DIF: LL3 REF: Page 21 OBJ: 3

163. What is gross domestic product? How well does it measure what it is intended to measure?

ANS:

Gross domestic product (GDP) is a measure of the total value of goods and services produced within a nation in a given time period. Conceptually, all goods produced within a nation's borders should be included in its GDP, even if the firm producing the output is a foreign owned corporation. Thus, Hondas produced in the United States are included in U.S. GDP even though Honda is a Japanese firm. But Mattel toys produced in China are not included in U.S. GDP even though Mattel is considered to be a U.S. corporation.

GDP tends to understate a nation's total production because it does not include output produced illegally, nor does it include the value of output that is not reported because the producer is trying to avoid paying taxes. Another major omission is the work done within households. When households cook their own meals, mow their own lawns, or do their own household repairs, the value of their labor is not included in GDP. But if they hire others to do these tasks, the value of these goods and services is included in GDP (assuming of course that the people performing these services report their incomes).

DIF: LL3 REF: Page 22 OBJ: 5

164. Explain the reason for the current trend toward a mixed market system. Include in your answer examples of this trend.

ANS:

Virtually all nations have mixed economies, falling somewhere along a spectrum that ranges from pure planned at one extreme to pure market at the other. Over the past thirty years, most major economies around the world have moved toward the market end of the spectrum.

Government-owned businesses have converted to private ownership. Socialist governments have reduced red tape, cracked down on corruption, and established new laws to protect economic rights. Lavish human services have shrunk. And tax reform has created new incentives for investment.

Examples will vary among students. Students should mention the social aspect of market economies with the government running the postal service, road maintenance, and education. The government stimulates economic growth with regulations that protect consumers and workers as well (Federal Product Safety Commission standards, Food & Drug Administration guidelines, etc.)

DIF: LL 3 REF: Page 22 OBJ: 4

165. What is unemployment? Identify and describe the four types and each one's effect on the economy.

ANS:

The United States Department of Labor tracks employment levels largely through the **unemployment rate**, which includes everyone age 16 and older who doesn't have a job and is actively seeking one.

Frictional unemployment involves a worker quitting or being terminated and has a short term impact on the economy as the worker is able to find new employment within a relatively short amount of time.

Structural unemployment, on the other hand, is usually longer term. This category encompasses people who don't have jobs because the economy no longer needs their skills. In the U.S. growing numbers of workers in the past decade have found themselves victims of structural unemployment as manufacturing jobs have moved overseas. Often their only option is expensive retraining.

Two other categories of unemployment are **cyclical**, which involves layoffs during recessions, and **seasonal**, which involves job loss related to the time of year. An example of seasonal unemployment is the loss of jobs by landscapers during cold winter months.

DIF: LL 3 REF: Page 23 OBJ: 5

166. Compare and contrast the Consumer Price Index (CPI) and Producer Price Index (PPI) as measures of price changes in the economy.

ANS:

The government uses two major price indexes to evaluate inflation: the **Consumer Price Index (CPI)**, and the **Producer Price Index (PPI)**.

The CPI measures the change in weighted average price over time in a consumer “market basket” of goods and services that the average person buys each month. The U.S. Bureau of Labor Statistics creates the basket—which includes hundreds of items such as housing, transportation, haircuts, wine, and pet care—using data from more than 30,000 consumers. While the market basket is meant to represent the average consumer, keep in mind that the “average” includes a lot of variation, so the CPI may not reflect individual personal experience. If you don’t have a pet, for example, changes in veterinary costs wouldn’t affect you, although they would (slightly) impact the CPI.

The PPI measures the change over time in weighted average wholesale prices, or the prices that businesses pay each other for goods and services. Changes in the PPI can sometimes predict changes in the CPI, because producers tend to pass on price increases (and sometimes also price decreases) to consumers within a month or two of the changes.

DIF: LL 3 REF: Page 25 OBJ: 5

167. Explain the difference between monetary and fiscal policy and explain how they are formulated.

ANS:

Fiscal policy refers to government efforts to influence the economy through taxation and spending decisions that are designed to encourage growth, boost employment, and curb inflation. This type of policy is enacted by Congress through the budget process.

Monetary policy refers to actions that shape the economy by influencing interest rates and the supply of money. The Federal Reserve System, better known as the Fed, manages U.S. monetary policy. It does so by controlling the amount of reserves banks have available for making loans. The most important tool for this purpose is open market operations, which consist of the Fed’s purchase and sale of government securities.

DIF: LL 3 REF: Page 26 OBJ: 6

168. Explain how the Fed can use the reserve requirement to influence interest rates and the availability of loans. Why is the Fed reluctant to make frequent changes in the reserve requirement?

ANS:

The Fed requires that all of its member banks hold funds, called reserves, equal to a stated percentage of the deposits held by their customers. This percentage is called the reserve requirement (or required reserve ratio). The reserve requirement helps protect depositors, who may want to withdraw their money without notice.

Currently, the reserve requirement stands at about 10%, depending on the size and type of a bank’s deposits. If the **Fed increases the reserve requirement**, banks must hold more funds, meaning they will have fewer funds available to make loans. This **makes credit tighter and causes interest rates to rise**.

If the **Fed decreases the reserve requirement**, some of the funds that banks were required to hold become available for loans. This **increases the availability of credit and causes interest rates to drop**. Since changes in the reserve requirement can have a dramatic impact on both the economy and the financial health of individual banks, the Fed uses this tool quite infrequently.

DIF: LL 3 REF: Page 28 OBJ: 6

169. Identify and explain the three key tools the Federal Reserve uses to expand and contract the money supply.

ANS:

The Fed uses three key tools expand and contract the money supply:

- Open market operations
- Discount rate changes
- Reserve requirement changes

Open Market Operations: This is the Fed's most frequently used tool. Open market operations involve buying and selling government securities, which include treasury bonds, notes, and bills. These securities are the IOUs the government issues to finance its deficit spending.

When the economy is weak, the Fed *buys* government securities on the open market. When the Fed pays the sellers of these securities, money previously held by the Fed is put into circulation. This directly stimulates spending. In addition, any of the additional funds supplied by the Fed that are deposited in banks will allow banks to make more loans, making credit more readily available. This encourages even more spending and further stimulates the economy.

When inflation is a concern, the Fed *sells* securities. Buyers of the securities write checks to the Fed to pay for securities they bought, and the Fed withdraws these funds from banks. With fewer funds, banks must cut back on the loans they make, credit becomes tighter and the money supply shrinks. This reduces spending and cools off the inflationary pressures in the economy.

Discount Rate Changes: The discount rate is the interest rate the Fed charges on its loans to commercial banks. When the Fed reduces the discount rate, banks can obtain funds at a lower cost and use these funds to make more loans to their own customers. With the cost of acquiring funds from the Fed lower, interest rates on bank loans also tend to fall. The result: businesses and individuals are more likely to borrow money and spend it, which stimulates the economy.

Reserve Requirement Changes: The Fed requires that all of its member banks hold funds, called reserves, equal to a stated percentage of the deposits held by their customers. This percentage is called the reserve requirement (or required reserve ratio). The reserve requirement helps protect depositors, who may want to withdraw their money without notice.

If the Fed increases the reserve requirement, banks must hold more funds, meaning they will have fewer funds available to make loans. This makes credit tighter and causes interest rates to rise. If the Fed decreases the reserve requirement, some of the funds that banks were required to hold become available for loans. This increases the availability of credit and causes interest rates to drop.

DIF: LL 3

REF: Page 27-28 OBJ: 6