

# TEST BANK



## TEST PLANNING TABLE FOR CHAPTER 2

<b>Learning Objective</b>	<b>LL1: Knows Basic Terms and Facts</b>	<b>LL2: Understands Concepts and Principles</b>	<b>LL3: Applies Principles</b>
<b>LO1:</b> Define economics and discuss global economic crisis	1, 2, 3, 4, 5, 6, 7, 8, 10,15, <b>80, 81,82, 83, 84, 85, 87</b>	9,11, 12, 13, 14 <b>86, 88, 89</b>	16 <b>91, 92,</b> <b><u>174, 175, 176, 177,</u></b> <b><u>178, 179</u></b>
<b>LO2:</b> Analyze the impact of fiscal and monetary policy on the economy	17, 18, 19, 20, 21, 22, 23, 24, 25, 26, <b>93, 94, 95, 96, 99, 100, 101</b>	<b>90, 97, 98,103, 104, 105, 106, 107, 110</b>	<b>108,109,112, 113, 180, 181, 182, 188, 190, 191</b>
<b>LO3:</b> Explain and evaluate the free market system and supply and demand	31 <b>102, 115, 116, 125, 127, 129</b>	27, 28, 29, 30, 32, 33, 34, 36, 37, 38, <b>111,114,118, 119, 120, 121, 122, 123, 124, 126, 128, 130, 137</b>	35,39, 40, <b>117, 131, 132, 133, 135, 136, 138, 184, 192</b>
<b>LO4:</b> Explain and evaluate planned market systems	41, <b>139, 140</b>	42, 43, 44, 45, 46, 47, 48 <b>141, 142</b>	<b>134 183,</b>
<b>LO5:</b> Describe the trend toward mixed market systems	49, 50, 51, 52, 53, 54, <b>143, 144, 145, 146, 147, 148, 149</b>	55, 56, 57	<b>150,151,152, 153, 184</b>
<b>LO6:</b> Discuss key terms and tools to evaluate economic performance	59, 60, 61, 63, 64, 65, 66, 67, 68, 69, 70, 71, 72, 73, 74, 75, <b>154, 155, 156, 157, 158, 159, 160, 161, 162, 163, 164</b>	58, 77, 79, <b>166, 167, 168,</b>	62,76,78 <b>165,169,170, 171, 172, 173,</b> <b><u>185,186, 187,</u></b> <b><u>189</u></b>

True/False questions are in plain text.  
 Multiple choice questions are in **bold text**.  
 Essay questions are in **bold underlined text**

*Our answers were displayed as such:*

**ANS:** B      **DIF:** LL 1      **REF:** Page 7      **OBJ:** 1

**Ans:** B

**DIF:** Difficulty (Learning Level 1)

**REF:** Page number of the book where the answer can be found

**OBJ:** Learning Objective 1

## Chapter 2: Economics: The Framework for Business

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### TRUE/FALSE

1. An economy is both a social and a financial system.  
ANS: T            DIF: LL1            REF: Page 17            OBJ: 1
2. Financial or social systems are not essential to the development of a strong economy.  
ANS: F            DIF: LL1            REF: Page 17            OBJ: 1
3. The study of economics focuses on how people, businesses, and governments choose to allocate resources.  
ANS: T            DIF: LL1            REF: Page 17            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 17            OBJ: 1
5. An economic system is a structure for measuring gross domestic product.  
ANS: F            DIF: LL1            REF: Page 17            OBJ: 1
6. Economists forecast business needs based on a deep understanding of past choices.  
ANS: T            DIF: LL1            REF: Page 17            OBJ: 1
7. A surprisingly small number of key variables have a significant impact on the performance of the economy.  
ANS: F            DIF: LL1            REF: Page 17            OBJ: 1
8. In the early 2000s the Federal Reserve decreased the interest rate in order to decrease spending and discourage investment.  
ANS: F            DIF: LL1            REF: Page 17            OBJ: 1
9. The \$700 billion economic bailout package passed by Congress in 2008 was an example of monetary policy.  
ANS: F            DIF: LL2            REF: Page 18            OBJ: 1
10. The complexity of the economy makes economic forecasting an inexact process.  
ANS: T            DIF: LL1            REF: Page 18            OBJ: 1

11. 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 17                    OBJ: 1
12. 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 17                    OBJ: 1
13. 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 17                    OBJ: 1
14. The study of economics falls into two broad categories called meta-economics and econometrics.
- ANS: F                    DIF: LL2                    REF: Page 17                    OBJ: 1
15. Constant change is the most predictable economic force in the last few decades.
- ANS: T                    DIF: LL1                    REF: Page 17                    OBJ: 1
16. 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: LL3                    REF: Page 17                    OBJ: 1
17. Fiscal policy is the government's effort to influence the economy through taxation and spending decisions to encourage growth and boost employment while curbing inflation.
- ANS: T                    DIF: LL1                    REF: Page 19                    OBJ: 2
18. The twelve Federal Reserve Banks regional banks are privately owned by the member commercial banks in their individual districts.
- ANS: T                    DIF: LL1                    REF: Page 21                    OBJ: 2
19. Ben Bernanke is the current chairman of the Federal Reserve.
- ANS: T                    DIF: LL1                    REF: Page 21                    OBJ: 2
20. The Federal Reserve does not regulate banks; only state regulatory agencies perform this function.
- ANS: F                    DIF: LL1                    REF: Page 21                    OBJ: 2
21. The Federal Reserve provides banking services to member banks and is the central bank of the United States.
- ANS: T                    DIF: LL1                    REF: Page 21                    OBJ: 2

22. The Fed is headed by a 10-member Board of Governors.  
ANS: F                      DIF: LL1                      REF: Page 21                      OBJ: 2
23. The Federal Reserve Bank is in charge of both fiscal and monetary policy.  
ANS: F                      DIF: LL1                      REF: Page 21                      OBJ: 2
24. The federal government experiences a budget deficit when its revenue from taxes is higher than its expenditures.  
ANS: F                      DIF: LL1                      REF: Page 20                      OBJ: 2
25. The government experiences a budget surplus when its tax revenue exceeds its expenditures.  
ANS: T                      DIF: LL1                      REF: Page 20                      OBJ: 2
26. The M1 money supply consists solely of currency (coins and paper money) issued by the government.  
ANS: F                      DIF: LL1                      REF: Page 21                      OBJ: 2
27. Capitalism is based on private ownership, economic freedom, and fair competition.  
ANS: T                      DIF: LL2                      REF: Page 23                      OBJ: 3
28. 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 23                      OBJ: 3
29. Market equilibrium is the point at which the supply curve intersects the demand curve.  
ANS: T                      DIF: LL2                      REF: Page 27                      OBJ: 3
30. Federal law has made all types of monopolies illegal in the United States.  
ANS: F                      DIF: LL2                      REF: Page 25                      OBJ: 3
31. 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: LL1                      REF: Page 26                      OBJ: 3
32. Market equilibrium identifies the price at which quantity supplied is equal to quantity demanded.  
ANS: T                      DIF: LL2                      REF: Page 27                      OBJ: 3
33. Consumers will see prices fall when the quantity demanded exceeds quantity supplied.  
ANS: F                      DIF: LL2                      REF: Page 26                      OBJ: 3

34. The price paid for goods and services will rise when the quantity demanded exceeds quantity supplied.  
ANS: T                    DIF: LL2                    REF: Page 26                    OBJ: 3
35. 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 Bakery is an example of pure competition.  
ANS: F                    DIF: LL3                    REF: Page 25                    OBJ: 3
36. 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 24                    OBJ: 3
37. 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 25                    OBJ: 3
38. Government policies promoting free trade are consistent with the right to free choice, which is fundamental to capitalism.  
ANS: T                    DIF: LL2                    REF: Page 24                    OBJ: 3
39. 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 26                    OBJ: 3
40. 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 26                    OBJ: 3
41. In a planned economy the government plays only a minor role in the operation of the economy.  
ANS: F                    DIF: LL1                    REF: Page 27                    OBJ: 4
42. In capitalism what gets produced is largely determined by central government planning.  
ANS: F                    DIF: LL2                    REF: Page 27                    OBJ: 4
43. The North Korean and Cuban governments still own most of their nations enterprises and actively control the performance of their nations economies.  
ANS: T                    DIF: LL2                    REF: Page 28                    OBJ: 4

44. 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 28                      OBJ: 4
45. By the end of the 1980's, communism began collapsing across the Soviet Union and its satellite nations.
- ANS: T                      DIF: LL2                      REF: Page 28                      OBJ: 4
46. 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 28                      OBJ: 4
47. Karl Marx envisioned communism as a system that would improve the lot of the common worker.
- ANS: T                      DIF: LL2                      REF: Page 28                      OBJ: 4
48. 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 28                      OBJ: 4
49. 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: LL1                      REF: Page 28                      OBJ: 5
50. The U.S. federal government is the nation's largest employer.
- ANS: T                      DIF: LL1                      REF: Page 28                      OBJ: 5
51. The federal government creates regulations that prohibit competition and stimulate consumers to work.
- ANS: F                      DIF: LL1                      REF: Page 28                      OBJ: 5
52. Privatization is the conversion of government-owned enterprises to private ownership.
- ANS: T                      DIF: LL1                      REF: Page 28                      OBJ: 5
53. 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: LL1                      REF: Page 28                      OBJ: 5
54. 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: LL1                      REF: Page 28                      OBJ: 5



55. 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: LL2                    REF: Page 28                    OBJ: 5
56. 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: LL2                    REF: Page 28                    OBJ: 5
57. Privatization is an important element of the movement toward a greater market orientation in many nations.
- ANS: T                    DIF: LL2                    REF: Page 28                    OBJ: 5
58. 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: LL2                    REF: Page 29                    OBJ: 6
59. 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: LL1                    REF: Page 29                    OBJ: 6
60. GDP tends to overstate the amount of output produced by a nation's economy.
- ANS: F                    DIF: LL1                    REF: Page 29                    OBJ: 6
61. 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: LL1                    REF: Page 29                    OBJ: 6
62. The value of a Hyundai Sonata built in Montgomery, Alabama would be included in U.S. GDP even though Hyundai is actually a South Korean corporation.
- ANS: T                    DIF: LL3                    REF: Page 29                    OBJ: 6
63. 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: LL1                    REF: Page 29                    OBJ: 6
64. The unemployment rate measures individuals 16 years of age and older without jobs who are actively seeking employment.
- ANS: T                    DIF: LL1                    REF: Page 29                    OBJ: 6
65. Individuals quitting their jobs experience structural unemployment.
- ANS: F                    DIF: LL1                    REF: Page 29                    OBJ: 6

66. Cyclical unemployment results from layoffs during recessionary periods.  
ANS: T                    DIF: LL1                    REF: Page 29                    OBJ: 6
67. 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: LL1                    REF: Page 29                    OBJ: 6
68. 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: LL1                    REF: Page 30                    OBJ: 6
69. An economy is said to be in a recession when GDP decreases for two consecutive quarters.  
ANS: T                    DIF: LL1                    REF: Page 29                    OBJ: 6
70. The two key phases of the business cycle are contraction and expansion.  
ANS: T                    DIF: LL1                    REF: Page 30                    OBJ: 6
71. Contraction is a period of economic downturn marked by rising unemployment, business cutbacks, and decreases in consumer spending.  
ANS: T                    DIF: LL1                    REF: Page 30                    OBJ: 6
72. Recovery is a period of increasing employment, business expansion, and increased consumer spending.  
ANS: T                    DIF: LL1                    REF: Page 30                    OBJ: 6
73. The four basic types of unemployment are natural, cyclical, voluntary, and induced.  
ANS: F                    DIF: LL1                    REF: Page 29                    OBJ: 6
74. Unfortunately, depressions are a common problem in most free-market economies.  
ANS: F                    DIF: LL1                    REF: Page 30                    OBJ: 6
75. Inflation occurs as the average prices of goods and services rise.  
ANS: T                    DIF: LL1                    REF: Page 30                    OBJ: 6
76. 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: LL3                    REF: Page 29                    OBJ: 6
77. To measure productivity, multiply the number of inputs by the cost of each input.  
ANS: F                    DIF: LL2                    REF: Page 31                    OBJ: 6

78. During the peak holiday season, retail workers are hired in great numbers to meet the demands of holiday shoppers. At the end of the holiday season many of those workers are released from their jobs, thus creating seasonal unemployment.

ANS: T                      DIF: LL3                      REF: Page 29                      OBJ: 6

79. It is important that any government examine multiple measures of its own economic health, rather than relying on simply one or two dimensions.

ANS: T                      DIF: LL2                      REF: Page 30                      OBJ: 6

### MULTIPLE CHOICE

80. The economy, as a system, represents
- the non-efficient use of material resources.
  - the flow of resources from production through consumption.
  - the means of production only.
  - the means of capitalistic systems.

ANS: B                      DIF: LL1                      REF: Page 17                      OBJ: 1

81. In the broadest sense, *economics* studies the choices that
- people make in disposing of unnecessary resources.
  - governments make in creating natural resources.
  - companies make in producing goods and services for corporate use.
  - people, governments, and companies make in allocating resources.

ANS: D                      DIF: LL1                      REF: Page 17                      OBJ: 1

82. From the business perspective, a key reason to study economics is to
- gain a better understanding of past business choices in order to make better future decisions.
  - avoid the temptation to focus on past events.
  - ensure that demand exceeds supply.
  - learn how to achieve a monopoly position in markets with the potential to generate high profits.

ANS: A                      DIF: LL1                      REF: Page 17                      OBJ: 1

83. A \_\_\_\_\_ is targeted to borrowers with low credit scores, high debt-to-income ratios or signs of a reduced ability to repay the money they borrow.
- home equity line of credit
  - revolving line of credit
  - fixed rate mortgage loan
  - subprime mortgage loan

ANS: D                      DIF: LL1                      REF: Page 18                      OBJ: 1

84. Economics is divided into two core areas of study known as:
- production and consumption.
  - data collection and forecasting.
  - macroeconomics and microeconomics.
  - supply economics and demand economics.
- ANS: C                      DIF: LL1                      REF: Page 17                      OBJ: 1
85. An economic system is a structure for
- measuring gross domestic products.
  - allocating limited resources.
  - forecasting trends.
  - none of the above
- ANS: B                      DIF: LL1                      REF: Page 17                      OBJ: 1
86. Macroeconomics focuses on:
- the major issues facing the national economy, and has little or no relevance to individuals.
  - the small individual units operating within the economy.
  - the major issues facing the national economy; issues that often impact an individual's well-being.
  - the role of government, while microeconomics focuses on the private sector.
- ANS: C                      DIF: LL2                      REF: Page 17                      OBJ: 1
87. \_\_\_\_\_ is a structure for allocating scarce resources.
- An economic system
  - An econometric plan
  - A factor distributor
  - The gross domestic product
- ANS: A                      DIF: LL1                      REF: Page 17                      OBJ: 1
88. Which of the following would be studied in the greatest detail in a macroeconomics course?
- How a large automobile manufacturer decides how many SUVs to produce in a given model year.
  - How consumers would respond if a restaurant that raised its prices.
  - How a firm in an oligopolistic market would respond to a change in the pricing strategy of other firms in its market.
  - Factors that influence the nation's unemployment rate.
- ANS: D                      DIF: LL2                      REF: Page 17                      OBJ: 1
89. Some argue the Federal Reserves lowering of interest rates from mid-2000 to the end of 2002 greatly increased the money supply; however, opportunities to invest yielded paltry returns leading bankers to offer \_\_\_\_\_ in order to earn a higher return.
- revolving lines of credit
  - home equity lines of credit
  - fixed rate mortgage loans
  - subprime mortgage loans
- ANS: D                      DIF: LL2                      REF: Page 18                      OBJ: 1

90. Why are the members of the Fed Board of Governors appointed to 14-year terms that are staggered, with one expiring every 2 years?
- To encourage new approaches and fresh ideas from the Board of Governors.
  - So that no single president can appoint all of the members and thereby ensuring that the Fed can act independently.
  - To ensure that there are experienced members during all economic cycles.
  - Because after 14 years they are automatically eligible to run for Fed Chair.
- ANS: B                    DIF: LL2                    REF: Page 21                    OBJ: 2
91. GeeGee's is a community-based bakery known for its scrumptious tea cakes. GeeGee's recipes call 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, GeeGee's management could perform a
- microeconomic analysis.
  - macroeconomic analysis.
  - transformational economic analysis.
  - structural analysis.
- ANS: A                    DIF: LL3                    REF: Page 17                    OBJ: 1
92. 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?
- Energy costs across the country would increase with adoption of the new energy source.
  - Housing prices would decrease as new homes are built with this new energy source.
  - Prices would increase as this is a new energy source.
  - Prices would decrease as competition increases in energy production.
- ANS: D                    DIF: LL3                    REF: Page 17                    OBJ: 1
93. \_\_\_\_\_ refers to government efforts to influence the economy through taxation and spending decisions designed to encourage growth, boost employment, and curb inflation.
- Monetary policy
  - Fiscal policy
  - Pricing policy
  - Production policy
- ANS: B                    DIF: LL1                    REF: Page 19                    OBJ: 2
94. When tax revenue is higher than government expenditures, the government incurs a
- budget deficit.
  - windfall.
  - budget surplus.
  - national debt.
- ANS: C                    DIF: LL1                    REF: Page 20                    OBJ: 2
95. The federal government runs a budget deficit when its
- spending outpaces revenue from taxes.
  - tax revenue outpaces its expenditures.
  - monetary policies reduce the amount of money in circulation.
  - gold reserves are inadequate to support the existing money supply.
- ANS: A                    DIF: LL1                    REF: Page 20                    OBJ: 2

96. \_\_\_\_\_ 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 21                      OBJ: 2
97. After the collapse of the dot com bubble and the 9/11 terrorist attacks, the stock market depreciated and unemployment increased leading many to fear that the country was on the brink of a full-blown recession. In order to stimulate the economy the Federal Reserve Bank
- a) lowered taxes in an effort to increase spending.
  - b) lowered interest rates from 6.5% to 1.25% in an effort to increase spending.
  - c) increased taxes in an effort to increase spending.
  - d) increased interest rates from 1.25% to 6.5% in an effort to increase spending.
- ANS: B                      DIF: LL2                      REF: Page 17                      OBJ: 2
98. When Congress responded in early October 2008 to the economic crisis gripping the United States with the passage of a \$700 billion economic bailout plan, they were using \_\_\_\_\_ to address the declining economic conditions in the country.
- a) fiscal policy
  - b) open market operations
  - c) monetary policy
  - d) price stabilization policy
- ANS: A                      DIF: LL2                      REF: Page 20                      OBJ: 2
99. 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: LL1                      REF: Page 21                      OBJ: 2
100. \_\_\_\_\_ is the current chairman of the Federal Reserve.
- a) Alan Greenspan
  - b) William Gates
  - c) George Bush
  - d) Ben Bernanke
- ANS: D                      DIF: LL1                      REF: Page 21                      OBJ: 2
101. 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: LL1                      REF: Page 21                      OBJ: 2

102. The father of modern capitalism is \_\_\_\_\_
- a) Karl Marx
  - b) Ben Bernake
  - c) Adam Smith
  - d) Walther Bagehot

ANS: C                      DIF: LL1                      REF: Page 23                      OBJ: 3

103. 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 21                      OBJ: 2

104. 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 22                      OBJ: 2

105. The Federal Reserve is the \_\_\_\_\_ of the United States.
- a) financial market
  - b) central bank
  - c) state business regulator
  - d) foreign exchange controller

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

106. In setting monetary policy, the Federal Reserve oversees the operation of \_\_\_\_\_ Federal Reserve Banks, which carry out Fed policies and perform banking services for commercial banks in their districts. These Federal Reserve Banks are owned by \_\_\_\_\_
- a) 12; the member commercial banks in their district.
  - b) 15; the federal government.
  - c) 12; the state government where they are located.
  - d) 15; the Treasury Department.

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

107. 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: LL2                      REF: Page 22                      OBJ: 2

108. Recently, I.B. Rheele read in the newspaper that the Federal Reserve chairman had expressed concern about inflation and indicated the Federal Reserve would be taking some action in order to prevent inflation from spiraling out of control. The Federal Reserve could use all of the following tools except:
- selling government bonds in the open market.
  - increasing the discount rate.
  - increasing banks reserve requirements.
  - increasing government spending on roads and bridges.

ANS: D                      DIF: LL3                      REF: Page 22                      OBJ: 2

109. 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
- an increase in the federal debt.
  - a decrease in social programs.
  - an increase in the reserve requirement.
  - a decrease in the interest rate.

ANS: A                      DIF: LL3                      REF: Page 20                      OBJ: 2

110. In an effort to instill public confidence in the banking system after the 1929 stock market crash, Congress established the \_\_\_\_\_ to protect customer deposits in banks and thrift institutions.
- Federal Deposit Insurance Corporation (FDIC)
  - Federal Reserve System
  - Federal Open Market Committee
  - Federal Reserve Requirement

ANS: A                      DIF: LL2                      REF: Page 23                      OBJ: 2

111. Which of the following directly impacts the variety of products and prices in the free market system?
- Government pricing policies
  - New product development plans
  - The constant interaction between buyers and sellers
  - Corporate marketing programs

ANS: C                      DIF: LL2                      REF: Page 23                      OBJ: 3

112. 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?
- 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.
  - The Federal Reserve does not keep that much money in any one bank due to federal regulations prohibiting the buying and selling of securities.
  - The Federal Deposit Insurance Corporation will only insure up to \$250,000 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.
  - He needs to diversify his holdings in more than one bank to protect himself against fraudulent lending practices of banks.

ANS: C                      DIF: LL3                      REF: Page 22                      OBJ: 2



113. Early in your first term, as President of the United States you faced an economy in the beginnings of a recession. Which of the following would represent an example of a fiscal policy you might suggest to deal with this situation?
- Ask Congress to cut total spending on social programs to avoid running a budget deficit.
  - Ask Congress to cut taxes in order to give consumers and businesses more income to spend and invest.
  - Order the Fed to raise the required reserve ratio.
  - Urge Congress to give the U.S. Treasury the authority to print more money.

ANS: B                    DIF: LL3                    REF: Page 20                    OBJ: 2

114. In capitalism people strive to raise their standard of living. Businesses contribute to this goal by \_\_\_\_\_
- offering value to the consumer.
  - using available resources.
  - regulating available talent.
  - forming oligopolistic markets.

ANS: A                    DIF: LL2                    REF: Page 23                    OBJ: 3

115. A basic characteristic of \_\_\_\_\_ is that both producers and consumers are free to make their own economic decisions on many basic issues.
- socialism
  - capitalism
  - communism
  - mercantilism

ANS: B                    DIF: LL1                    REF: Page 23                    OBJ: 3

116. In \_\_\_\_\_ many firms compete by selling differentiated products.
- a monopoly
  - monopolistic competition
  - an oligopoly
  - a natural monopoly

ANS: B                    DIF: LL1                    REF: Page 25                    OBJ: 3

117. Which of the following industries operates under a market structure of monopolistic competition?
- Clothing industry
  - Agricultural industry
  - Soft drink industry
  - Utility industry

ANS: A                    DIF: LL3                    REF: Page 25                    OBJ: 3

118. Firms in oligopolistic markets tend to
- keep prices as low as possible.
  - avoid price competition whenever possible.
  - be very concerned about the possibility of new firms entering their market.
  - have very small market shares.

ANS: B                    DIF: LL2                    REF: Page 25                    OBJ: 3

119. 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 23                      OBJ: 3

120. 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: Pages 24-25                      OBJ: 3

121. 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 25                      OBJ: 3

122. 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 24                      OBJ: 3

123. In 2006, the price of a gallon of gasoline rose from \$2.00 per gallon to over \$4.00 per gallon. If the demand curve for gasoline is like most demand curves the increase in the price of gasoline:
- a) resulted in a shortage of large trucks and SUVs.
  - b) resulted in a lower quantity of gasoline demanded than at the lower price.
  - c) resulted in an increase in the number of miles driven by consumers.
  - d) had no effect on the amount of gasoline consumers would buy.

ANS: B                      DIF: LL2                      REF: Pages 26-27                      OBJ: 3

124. A supply curve shows that as prices rise
- a) the quantity of products produced declines.
  - b) the equilibrium point shifts upward.
  - c) the number of products demanded stays the same.
  - d) the quantity of products produced rises.

ANS: D                      DIF: LL2                      REF: Page 26                      OBJ: 3

125. Demand is defined as
- the number of consumers in a market.
  - the quantity of products that consumers are willing to buy at different prices.
  - the amount of products produced.
  - the annual quantity of products sold by retailers.
- ANS: B                      DIF: LL1                      REF: Page 26                      OBJ: 3
126. Supply refers to the quantity of products that producers are willing to offer for sale
- at different market prices.
  - in different competitive markets.
  - during an economic downturn.
  - when demand increases.
- ANS: A                      DIF: LL2                      REF: Page 26                      OBJ: 3
127. The \_\_\_\_\_ is the point where the quantity demanded equals the quantity supplied.
- microeconomic point
  - product sales position
  - equilibrium point
  - none of the above
- ANS: C                      DIF: LL1                      REF: Page 27                      OBJ: 3
128. The demand curve shows the relationship between the
- prices of products and the quantity of products demanded at different prices.
  - quantity of products produced and sold.
  - macroeconomics and microeconomics.
  - suppliers' prices and consumers' prices.
- ANS: A                      DIF: LL2                      REF: Page 26                      OBJ: 3
129. The \_\_\_\_\_ shows the quantity of products that producers will offer at various market prices.
- supply matrix
  - demand curve
  - supply curve
  - demand analysis
- ANS: C                      DIF: LL1                      REF: Page 26                      OBJ: 3
130. If the cost of an iced-tea is more expensive during the summer months, consumers will
- not buy at all.
  - buy no more or less due to the increase in price.
  - buy more due to the increase in price.
  - buy less due to the increase in price.
- ANS: D                      DIF: LL2                      REF: Page 26                      OBJ: 3

131. Anne notices that jeans priced at \$120 at her clothing store aren't selling much. She wants to quickly increase sales of these jeans before next season's fashions come in. What is her best approach?
- Keep the prices the same but move the jeans to another section of the store.
  - Drop the price of the jeans so that demand will increase.
  - Raise the price of the jeans to make them seem more exclusive.
  - Put even higher priced jeans next to the \$120 jeans.

ANS: B                      DIF: LL3                      REF: Page 27                      OBJ: 3

132. 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:
- pure competition.
  - pure monopoly.
  - monopolistic competition.
  - oligopolistic markets.

ANS: D                      DIF: LL3                      REF: Page 25                      OBJ: 3

133. 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
- trust busters.
  - oligopolies.
  - natural monopolies.
  - pure players.

ANS: C                      DIF: LL3                      REF: Page 25                      OBJ: 3

134. Jay Fizzle lives in an economic and political system that calls for public ownership of virtually all enterprises, under the direction of a strong central government. He most likely, lives in a \_\_\_\_\_ country.
- capitalist
  - socialist
  - theocratic
  - communist

ANS: D                      DIF: LL3                      REF: Page 28                      OBJ: 4

135. A market structure with pure competition has all of the following characteristics EXCEPT:
- the firms use product differentiation allowing consumers to easily identify their favorite brands.
  - there are many firms competing in the market.
  - firms can easily enter and leave the market.
  - no individual firm has any control over the price of the product.

ANS: A                      DIF: LL3                      REF: Page 24                      OBJ: 3

136. \_\_\_\_\_ 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 25                      OBJ: 3

137. 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 25                      OBJ: 3

138. 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 24                      OBJ: 3

139. 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 27                      OBJ: 4

140. 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 25                      OBJ: 4

141. 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 28                      OBJ: 4

142. Communist economies have faced a number of issues that have interfered with their effectiveness. The issues include all of the following except:
- crippling shortages and surpluses.
  - abundant natural resources.
  - corruption
  - suspension of individual rights and choices.

ANS: B                    DIF: LL2                    REF: Page 28                    OBJ: 4

143. Today the economies of virtually all nations would be classified as:
- pure socialism.
  - mixed economies.
  - pure capitalism.
  - pure communism.

ANS: B                    DIF: LL1                    REF: Page 28                    OBJ: 5

144. One reason pure market economies are non-existent is because
- they are too expensive to maintain.
  - they don't adequately provide for the sick, the elderly, and the environment.
  - they result in very high tax rates that undermine incentives.
  - they don't do enough to encourage entrepreneurship.

ANS: B                    DIF: LL1                    REF: Page 28                    OBJ: 5

145. 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, etc.). This suggests that the U.S. economy is best classified as a:
- pure market economy.
  - mixed economy.
  - true command economy.
  - pure planned economy.

ANS: B                    DIF: LL1                    REF: Page 28                    OBJ: 5

146. To stimulate competition and protect both consumers and workers, the federal government
- places heavy taxes on firms in monopolistic competition.
  - places limits on international trade in order to stimulate domestic production.
  - creates regulations to intervene in the free market.
  - creates business systems to meet the needs of all consumers.

ANS: C                    DIF: LL1                    REF: Page 28                    OBJ: 5

147. In the United States, the federal government:
- consistently runs a budget surplus since it operates most of its enterprises at a profit.
  - has been very reluctant to regulate business behavior.
  - plays only a very minor role in the economy.
  - is the largest employer, providing jobs for nearly three million Americans.

ANS: D                    DIF: LL1                    REF: Page 28                    OBJ: 5

148. In recent years, the most common reason for tax reforms in formerly planned economies has been to:
- create a more equal distribution of income.
  - create new incentives for domestic and foreign investment.
  - eliminate the threat of hyperinflation.
  - protect the environment.

ANS: B                      DIF: LL1                      REF: Page 28                      OBJ: 5

149. \_\_\_\_\_ is the process of converting government-owned businesses to private ownership.
- Privatization
  - Globalization
  - Competition
  - Collusion

ANS: A                      DIF: LL1                      REF: Page 28                      OBJ: 5

150. The Rainland government enjoys a socialist economic system, but in recent years it has found that new business growth has stalled. In an effort to stimulate more growth, the government will probably
- create regulations giving consumers and workers more protection.
  - take over most new businesses and operate them as government enterprises.
  - reduce taxes and create new laws to protect economic rights.
  - increase the number of citizens who qualify for free education and healthcare.

ANS: C                      DIF: LL3                      REF: Page 28                      OBJ: 5

151. The government of Puritania has begun a program to restructure 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 rise in social unrest as citizens try to adjust to the economic reforms.
  - Privatization of formerly government owned enterprises.
  - Cuts in social programs such as free healthcare and unemployment benefits.
  - Slower rates of economic growth and lower standards of living for the majority of citizens.

ANS: D                      DIF: LL3                      REF: Page 28                      OBJ: 5

152. The Shero nation was founded on a capitalistic market system. The newly elected Prime Minister won by campaigning on the platform based on socialist principles. If the Prime Minister of Shero implements her campaign promises, which of the following trends will the citizens of the country be most likely to experience?
- A dramatic decrease in government corruption.
  - More rapid economic growth for businesses.
  - Lower tax rates for all people and an emphasis on free markets.
  - Higher taxes for wealthier citizens and more government funded services for the poor and elderly.

ANS: D                      DIF: LL3                      REF: Page 28                      OBJ: 5

153. Natasha is very unhappy with conditions in her country. She has very little economic or political freedom. Virtually all productive enterprises are owned by the government, and they seem to be run very inefficiently. The result is frequent shortages and surpluses of goods and services. These conditions suggest that Natasha's country relies on a \_\_\_\_\_ economic system.
- a) communist
  - b) socialist
  - c) capitalist
  - d) monopolistic

ANS: A                      DIF: LL3                      REF: Page 28                      OBJ: 5

154. \_\_\_\_\_ measures the total value of all goods and services produced within a nation's borders over a given period of time.
- a) The consumer price index
  - b) Gross domestic product
  - c) Net national production
  - d) The production function

ANS: B                      DIF: LL1                      REF: Page 29                      OBJ: 6

155. The economic measure that provides the most information about what is happening to prices of consumer goods is the:
- a) GDP.
  - b) PPI.
  - c) GNP.
  - d) CPI.

ANS: D                      DIF: LL1                      REF: Page 31                      OBJ: 6

156. 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: LL1                      REF: Page 30                      OBJ: 6

157. 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: LL1                      REF: Page 30                      OBJ: 6

158. 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: LL1                      REF: Page 29                      OBJ: 6



159. \_\_\_\_\_ 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: LL1                      REF: Page 30                      OBJ: 6

160. \_\_\_\_\_ means that prices on average are rising.

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

ANS: B                      DIF: LL1                      REF: Page 30                      OBJ: 6

161. 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: LL1                      REF: Page 31                      OBJ: 6

162. The Consumer Price Index (CPI) measures the

- a) change in the prices of gas and energy.
- 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: LL1                      REF: Page 31                      OBJ: 6

163. 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: LL1                      REF: Page 30                      OBJ: 6

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

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

ANS: D                      DIF: LL1                      REF: Page 31                      OBJ: 6

165. 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: LL3                      REF: Page 29                      OBJ: 6

166. 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: LL2                      REF: Page 31                      OBJ: 6

167. 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 29                      OBJ: 6

168. 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: LL2                      REF: Page 31                      OBJ: 6

169. 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: LL3                      REF: Page 29                      OBJ: 6

170. With the tragedy of the 9/11 attacks and the devastation of Hurricane Katrina, some workers in New York City and New Orleans experienced
- structural unemployment.
  - frictional unemployment.
  - cyclical unemployment.
  - seasonal unemployment.

ANS: A                      DIF: LL3                      REF: Page 29                      OBJ: 6

171. The items included in the CPI's "market basket" are chosen to represent:
- goods and services bought by the average consumer.
  - goods and services bought by the business sector.
  - the cost of government supplied goods and services.
  - all goods and services produced by domestic businesses.

ANS: A                      DIF: LL3                      REF: Page 31                      OBJ: 6

172. 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
- divide the number of dogs groomed per day (12) by the amount of labor per day (8 hours).
  - divide the total weight of the dogs by 12, then multiply the results by the number of hours of labor per day (8 hours).
  - divide 8 hours by 12 dogs per day.
  - divide 12 dogs by a 7 day work week and multiply the result by 8.

ANS: A                      DIF: LL3                      REF: Page 31                      OBJ: 6

173. 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
- her cost of living has increased by 7%.
  - her income has increased by 7%.
  - the weighted average of prices of goods and services in a market basket bought by a typical consumer have increased by 7%.
  - the price of necessities such as food, rent, and medicine have increased by an average of 7%.

ANS: C                      DIF: LL3                      REF: Page 31                      OBJ: 6

**ESSAY**

174. Explain how macroeconomics differs from microeconomics. Illustrate these differences by identifying some specific topics these two branches of economics 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 17            OBJ: 1

175. Describe the events that led up to the 2008-2009 global economic crisis.

ANS:

The events that lead up to the global economic crisis began almost a decade earlier. Even though the United States economy experienced unprecedented growth during the last half of the 1990s the situation began to change with the collapse of the dot com bubble and the 9/11 terrorist attacks. In response to these events the Federal Reserve dramatically increased the money supply with a sharp reduction in the interest rates. As a result, the economy was awash with money, but opportunities to invest yielded paltry returns. At this time subprime mortgages loans came into play. Subprime mortgage loans are targeted to borrowers with low credit scores, high debt-to-income ratios, or other signs of a reduced ability to repay the money they borrow. These mortgage loans allowed hundreds of thousands of people who could not previously purchase homes borrow money to purchase one. As demand for homes increased, home prices continued to rise creating even greater demand. Banks and investment houses invented a range of stunningly complex financial instruments to slice up and resell the mortgages as specialized securities. Hedge funds swapped the new securities, convinced that they were risk-free. With a lack of government regulation financial institutions did not maintain sufficient reserves in case those mortgage-backed funds lost value.

Like all good times, the meteoric rise in housing prices came to an end peaking in 2006, at which time they began to fall precipitously. As housing prices depreciated many subprime borrowers found themselves owing their lenders more than the value of their home. This led to an increase in foreclosure rates. As mortgage values dropped, financial institutions such as Bear Stearns and Washington Mutual began to collapse creating a wave of fear that spread throughout the entire banking industry. As fear spread throughout the industry banks become unwilling to lend money, so funds were not available for businesses to finance their day-to-day operations or invest for the long term. As credit dried up large and small companies alike began to announce layoffs.

DIF: LL3            REF: Page 17            OBJ: 1

176. What made it possible for many people to be able to purchase a home for the first time ever in the early 2000s?

ANS:

Subprime mortgage loans made it possible for many people to purchase a home for the first time ever in the early 2000s. These mortgage loans are offered to borrowers with low credit scores, high debt-to-income ratios, or other signs of a reduced ability to repay the money they borrowed.

Was the Federal Reserve's lowering of interest rates by the end of 2002 in order to increase the money supply and encourage investments a success? Why or why not?

While the Federal Reserve's lowering of interest rates from 6.5% in mid-2000 to 1.25% by the end of 2002 was a short-term success the long-term effects have been disastrous. Increase in the money supply coupled with subprime mortgage loans created increasing demand for homes causing prices to rise year after year. Eventually home prices peaked and then began to depreciate rapidly causing many subprime borrowers to owe lenders more than the value of their homes. Once this happened, they could not refinance to lower their payments, so foreclosure rates climbed. As mortgage values dropped financial institutions that specialized in trading mortgage backed securities such as Bear Stearns and firms such as subprime lender Washington Mutual began to fail setting off a financial panic.

DIF: LL3            REF: Pages 17-18            OBJ: 1

177. How did the use of subprime mortgage loans contribute to the economic crisis?

ANS:

Subprime mortgages are loans to borrowers with low credit scores, high debt-to-income ratios, or other signs of a reduced ability to repay the money they borrow. These subprime mortgage loans were attractive to borrowers and lenders offering many subprime borrowers the opportunity to purchase a home for the first time. Lenders were willing to loan these subprime borrowers money often with little or no documentation of income, since the fees charged for these loans were so attractive and the higher rate earned on these loans as compared to many other investments. As demand for these loans skyrocketed, home prices continued to rise creating even more demand for these risky loans. As housing prices peaked in 2006 and then began to drop precipitously many of these subprime borrowers found they owed their lenders more than the value of their homes. Once this happened they were not able to refinance to achieve lower monthly payments. Foreclosure rates climbed at an increasing pace. As the rate of foreclosures increased, financial institutions such as Bear Stearns and Washington Mutual began to feel pressure and ultimately collapsed setting off a wave of fear that washed over the entire banking industry.

DIF: LL3            REF: Page 18            OBJ: 1

178. What were the long-term effects of the peak in housing prices in 2006?

ANS:

The long-term effects of the peak in housing prices in 2006 were not immediately obvious. The Federal government and the Federal Reserve had intervened in the economy at an unprecedented level. In March 2008, the Federal Reserve saved Bear Stearns from a collapse, while later that same year the Treasury Department seized Fannie Mae and Freddie Mac. In October of 2008 the Federal Reserve bailed out global insurance giant, AIG. Not to be outdone by the banking industry, two of the Big Three automakers borrowed heavily from the Treasury Department in order to avoid immediate bankruptcy.

These are just a few of the specific events that students should address. It is important for students to mention the impact the financial crisis will have on the federal deficit along with government involvement in the economy signaling a great shift toward a mixed economic approach.

DIF: LL3 REF: Page 18 OBJ: 1

179. How did macroeconomics and microeconomics both play a role in the global economic crisis of 2008?

ANS:

Students' answers may vary, but should show an understanding of macroeconomics and microeconomics. It is critical that students mention the macroeconomic effects of lax regulation of the subprime mortgage loan market along with an increase in the money supply caused by the Federal Reserve's lowering of interest rates. Students should discuss the microeconomic impact of decreasing household saving rates and increasing level of indebtedness.

DIF: LL3 REF: Page 18 OBJ: 1

180. 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: Pages 23-24 OBJ: 3

181. 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.

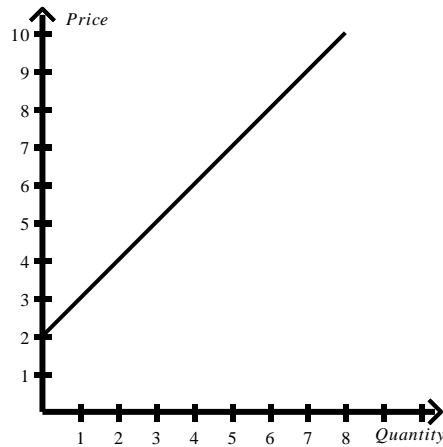
DIF: LL3 REF: Pages 24-25 OBJ: 3

182. 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:

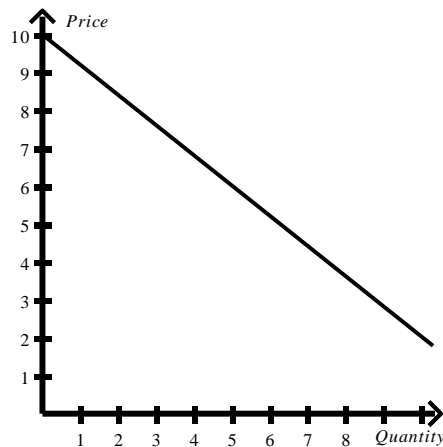
**Supply**: Supply refers to the quantity of products that producers are willing to offer for sale at different market prices. Because businesses seek to make as much profit as possible, they are likely to produce more of a product that commands a higher market price, and less of a product that commands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



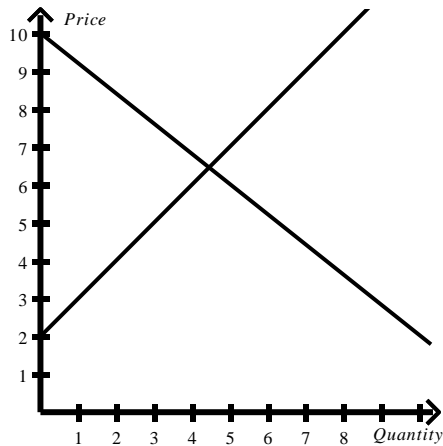
**Demand:** Demand refers to the quantity of products that consumers are willing to buy at different market prices. Since consumers generally seek to get the products they need (or want) at the lowest possible prices, they tend to buy more of products with lower prices and less of products with higher 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 shown 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: Pages 26-27 OBJ: 3

183. 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: Pages 27-28 OBJ: 4

184. 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: LL3            REF: Page 28            OBJ: 5

185. 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 29            OBJ: 6

186. 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: LL3            REF: Page 29            OBJ: 6

187. 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: LL3            REF: Page 31            OBJ: 6

188. Explain the difference between monetary and fiscal policy and explain how they are formulated and by whom.

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: LL3            REF: Pages 19-22            OBJ: 2

189. 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: LL3            REF: Page 30            OBJ: 6

190. 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. It decreases the money supply.

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. It also increases the money supply. 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: LL3                      REF: Page 22                      OBJ: 2

191. 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, increasing the money supply. 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 decreases the money supply, 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: LL3            REF: Page 22            OBJ: 2

192. Assume that the price of gasoline is currently falling. What will happen to the quantity of gasoline supplied at your local gas station? Under this circumstance, what else might the local gas station focus on selling to keep profits growing? When the price of gasoline was rising rapidly, how did that impact the demand for transportation and the selection of cars available to consumers? Explain your answers in terms of the principles underlying demand and supply curves.

ANS:

Students' answers may vary, but should show an understanding of the forces of supply and demand

According to the principles of the supply curve, as the price of gasoline falls the amount that your local gas station will be willing to sell will decrease, since the gas station has much less incentive to focus on selling gasoline. The station may put more effort into selling items where they can make more profit, such as the food and beverages in station's convenience store, repair services or other car-related products.

According to the demand curve, quantity demanded drops as prices rise. When gasoline prices were rising, lower demand was evident as consumers chose lower-cost alternatives to cars such as public transportation and bicycles. Demand decreased for gas guzzling" cars such as SUV's and it increased for cars with more fuel efficiency. The interaction between buyers and sellers of gasoline and cars resulted in the accelerated production of fuel efficient cars, such as the Toyota Prius and other hybrids. Today there is an increasing selection of fuel efficient cars from domestic and foreign auto makers.

DIF: LL3            REF: Pages 26-27            OBJ: 3