

KOFA HIGH SCHOOL SOCIAL SCIENCES DEPARTMENT
AP ECONOMICS

CRITICAL THINKING EXAM - CHAPTER # 19



NAME :

DATE :

MULTIPLE CHOICE - EACH QUESTION WORTH 4 POINTS

1. * *The demand for money increases when national income increases because :*
 - A. *Spending on goods and services increases***
 - B. *Interest rates increase*
 - C. *The budget deficit increases*
 - D. *The money supply increases*
 - E. *The public becomes more optimistic about the future*
2. * *Which of the following is most likely to increase if the public decides to increase its holdings of currency ?*
 - A. *The interest rate***
 - B. *The price level*
 - C. *Disposable personal income*
 - D. *Employment*
 - E. *The reserve requirement*
3. * *Crowding out due to government borrowing occurs when :*
 - A. *Lower interest rates increase private sector investment*
 - B. *Lower interest rates decrease private sector investment*
 - C. *Higher interest rates decrease private sector investment***
 - D. *A smaller money supply increases private sector investment*
 - E. *A smaller money supply decreases private sector investment*

4. * *The principal reason for requiring commercial banks to maintain reserve balances with the Federal Reserve is that these balances :*

- A. *Provide the maximum amount of reserves a bank would ever need*
- B. *Give the Federal Reserve more control over the money – creating operations of banks*
- C. *Ensure that banks do not make excessive profits*
- D. *Assist the Treasury in refinancing government debt*
- E. *Enable the government to borrow cheaply from the Federal Reserve's discount window*

5. * *If the Federal Reserve lowers the reserve requirement , which of the following is most likely to happen to interest rates and gross national product ?*

	<u>Interest Rates</u>	<u>Gross National Product</u>
A.	<i>Increase</i>	<i>Decrease</i>
B.	<i>Increase</i>	<i>Increase</i>
C.	<i>Decrease</i>	<i>Decrease</i>
D.	<i>Decrease</i>	<i>Increase</i>
E.	<i>No change</i>	<i>No change</i>

6. * *The purchase of securities on the open market by the Federal Reserve will :*

- A. *Increase the supply of money*
- B. *Increase the interest rate*
- C. *Increase the discount rate*
- D. *Decrease the number of Federal Reserve notes in circulation*
- E. *Decrease the reserve requirement*

7. * *If a banking system's reserves are \$ 100 billion , demand deposits are \$ 500 billion , and the system is fully loaned – up , then the reserve requirement must be :*

- A. *10 %*
- B. *12.5 %*
- C. *16.6 %*

D. 20 %

E. 25 %

8. * *To counteract a recession , the Federal Reserve should :*

A. *Buy securities on the open market and raise the reserve requirement*

B. Buy securities on the open market and lower the reserve requirement

C. *Buy securities on the open market and raise the discount rate*

D. *Sell securities on the open market and raise the discount rate*

E. *Raise the reserve requirement and lower the discount rate*

9. * *Which of the following combinations of monetary and fiscal policies is coordinated to increase output ?*

Monetary Policy

Fiscal Policy

A. *Decrease the reserve requirement*

Increase taxes

B. *Increase the discount rate*

Increase government spending

C. *Sell securities*

Increase taxes

D. *Sell securities*

Decrease government spending

E. Purchase securities

Decrease taxes

10. * *The Federal Reserve can increase the money supply by :*

A. *Selling gold reserves to the banks*

B. *Selling foreign currency holdings*

C. Buying government bonds on the open market

D. *Buying gold from foreign central banks*

E. *Borrowing reserves from foreign governments*

11. * *Which of the following means of reducing military spending would have the greatest positive impact on gross domestic product for the United States ?*

A. *Combining two domestic military bases into one overseas base*

B. *Cutting retirement benefits to military personnel*

- C. Closing overseas military bases and relocating those operations to the United States*
 - D. Closing overseas military bases and laying off military personnel*
 - E. Canceling contracts with domestic producers for new airplanes*
12. * Which of the following could cause simultaneous increases in inflation and unemployment ?
- A. A decrease in government spending*
 - B. A decrease in the money supply*
 - C. A decrease in the velocity of money*
 - D. An increase in inflationary expectations*
 - E. An increase in the overall level of productivity*

SHORT FREE RESPONSE QUESTION # 1 - WORTH 10 POINTS

* The reserve requirement for the banking system is 20 percent . Currently Third National Bank has no excess reserves . Then Mrs. Behroz deposits \$ 100 . in her checking account at Third National .

1. Explain , without using a mathematical formula , why Mrs. Behroz's deposit can lead to an increase in the money supply that is greater than \$ 100 .

The bank may make loans (or buy securities) based on excess reserves (80 % of Mrs. Behroz's deposit) . The bank does make loans based on excess reserves , and the deposit created by the loan is redeposited in the banking system (fractional reserves) . Points :

- *Loan equals deposit minus required reserves*
- *Bank makes loan or buys securities*
- *Loan is redeposited in the banking system*

2. Discuss two possible limitations of this process .

The possible limitations to the process are :

- *The reserve requirement amount (\$ 20.) is dead weight = not productive*

- *The bank willingly holds excess reserves*
- *Customers do not want to borrow*

SHORT FREE RESPONSE QUESTION # 2 - WORTH 10 POINTS

** The Federal Reserve has three **primary** tools to expand or contract the money supply .*

1. List the three tools :

- 1. **Open market operations***
- 2. **Required reserve ratio***
- 3. **Discount rate***

2. Which tool does the Federal Reserve use the most often ? Also , explain why .

Open market operations . It gives the Fed has more immediate and more controlled influence on the money supply . As it is generally not visible to the public , it is not burdened by political considerations . It also does not disrupt banking operations .

SHORT FREE RESPONSE QUESTION # 3 * > WORTH 12 POINTS

Why is there a trade – off between unemployment and inflation ? Why does this trade – off present a problem for economic policy makers ?

Unemployment and inflation have an inverse relationship , thus when you try to fix one it is likely that you will adversely affect the other . A higher unemployment rate will most likely be associated with a lower inflation rate . A higher inflation rate will most likely be associated with a lower unemployment rate .

If policy makers are trying to solve an unemployment problem , they will try to stimulate demand so that employers will hire workers to take advantage of the increased demand . On the other hand , the increase in demand will drive prices up causing inflation to rise.

If policy makers are trying to stop inflation they will try to discourage demand (reducing government spending and / or increasing interest rates) which will result in businesses cutting back on production and therefore variable costs , including labor its biggest variable cost . This will result in some jobs being eliminated and the unemployment rate going up.

LONG FREE RESPONSE QUESTION # 1 - WORTH 10 POINTS

** Suppose the economy is experiencing rising unemployment , slowing increases in real GDP and modest inflation . The Federal Reserve decides to follow an expansionary policy .*

1. *Describe what this policy might include .*

The Federal Reserve would buy bonds on the open market , reduce the discount rate , and / or reduce the reserve requirement . Each of these actions is designed to stimulate an economy that is showing signs of entering a recession .

2. *If the policy is effective , explain the short – run effect it would have on each of the following :*

- A. *Interest rates >*

Reduce interest rates . More money is available for loans , and the price of this money would fall .

- B. *Private investment >*

With lower interest rates , investment and some consumption would increase .

- C. *GDP >*

With an increase in investment and consumption , aggregate demand will increase and GDP will increase .

- D. *Employment >*

As a result of the increase in aggregate demand and in GDP , employment will also increase to produce the larger output .