Module 4 Review Guide

Government Functions in the Economy

- Provide legal and social structures
- Maintain Competition
- Provide public goods and services
- Redistribute Income
- Correct side effects of growth
- Stabilize the Economy

Ultimate Roller Coaster-Business Cycle

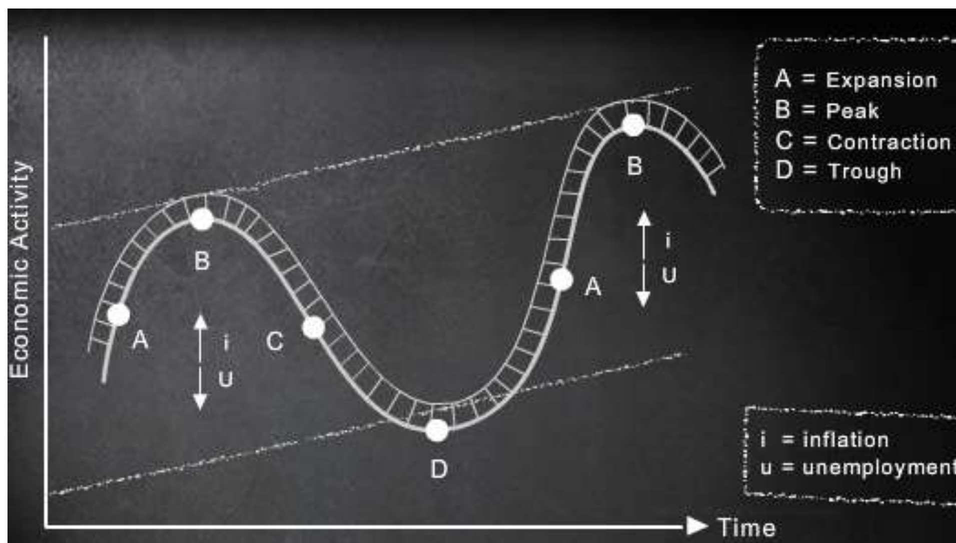
The business cycle refers to the entire economy, not just individual businesses.

The four phases of the business cycle are (A) **expansion**, like the upward climb of the roller coaster. During the expansion phase, Gross Domestic Product, or GDP, is increasing. Usually, this also means that the rate of inflation is increasing while the unemployment rate is decreasing.

The momentary pause at the summit is the (B) **peak**, where production reaches the highest current level. This is a time when the inflation rate is at it's highest.

Then comes the (C) **contraction** with decreasing economic activity, similar to the downslide of your cart. During a contraction, unemployment rises while inflation falls.

Finally, the (D) **trough** is the lowest point of the roller coaster ride and of the business cycle. The trough is the transition from a contraction to an expansion phase and thus the worst point in a period of decline. Each full cycle of the phases typically lasts between three to five years.



Government Regulation

Governments in a market economy like the United States sometimes create regulatory laws that businesses must follow. The primary goals of regulation are **low unemployment, price stability, and economic growth.**

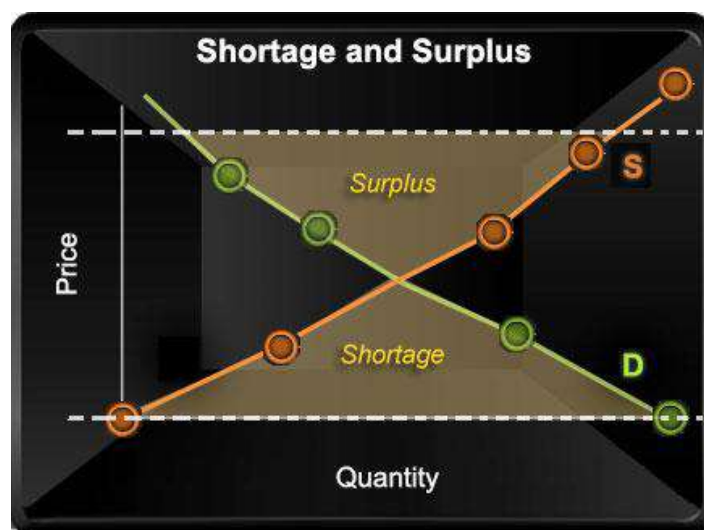
One way the government can regulate is by setting a price level for specific goods or services. For example, if the government sets a minimum price for the labor market, that means setting a minimum wage. This forces business to pay workers at least the amount set by the minimum wage.

Another specific example of government regulation are subsidies for agriculture. They are money paid to farmers to supplement their income. The subsidies influence the price and quantity of those goods that make it to market and protect farmers in the event of loss from events beyond their control, like weather. Without government regulation, such events and overproduction lead to wide fluctuation in prices for agricultural products.

Shortage/Surplus

If the price is too high (set above equilibrium), there will be a **surplus** because businesses will produce more than consumers will demand. Quantity supplied exceeds quantity demanded.

If the price is too low (set below equilibrium, there will be a shortage because businesses that produce the product will supply less than is demanded by consumers. Quantity demanded exceeds quantity supplied.



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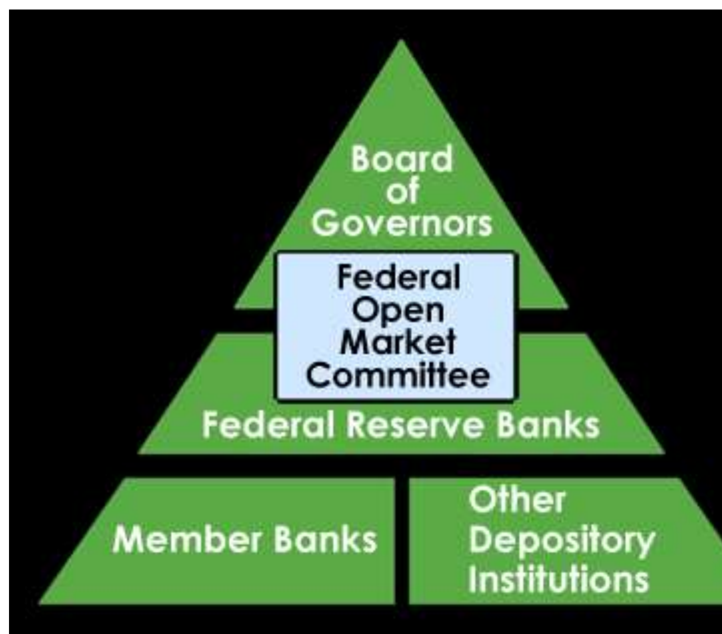
Natural Monopolies

Electricity, highways, police and fire protection, legal and justice services, and U.S. currency regulation are natural monopolies. Imagine a world where there is more than one company providing electricity to an area!!! Benefits include efficiency and fair prices for products with a natural monopoly market.

The Federal Reserve



Board of Governors

- **Analyzes economic data, supervises Federal Reserve Banks**
- Appointed by President; confirmed by Senate
- Analyzes economic data, supervises Federal Reserve Banks
- Administers financial regulations
- Participates in Federal Open Market Committee
- Communicates with leaders in other parts of government

Federal Open Market Committee

- Consists of Board of Governors, President of the New York Reserve Bank, and four other Reserve Bank Presidents on a rotating basis
- **Discusses economic outlook and potential adjustments to the money supply**
- Gathers for eight meetings per year in Washington, D.C.

Federal Reserve Banks

- Comprised of 12 Federal Reserve Banks, each serving its own region of the United States
- **Provides service to banks and the U.S. Treasury—"the bankers' bank"**
- Supervises bank operations within their region
- Handles check collection, electronic funds transfer, distribution of currency and coin to banks
- Provide service as banks for U.S. Treasury accounts— issue and redemption of U.S. government securities

Member Banks

- Consists of 38% of commercial banks (like Bank of America®)
- Are stockholders in regional Federal Reserve Bank, receive dividends
- **Receive services from regional Federal Reserve Bank**

Other Depository Institutions

- Not technically not part of the Federal Reserve System, yet subject to regulations
- Receive services from regional Federal Reserve Bank
- **Includes credit unions, savings and loan associations, commercial banks, and savings banks**

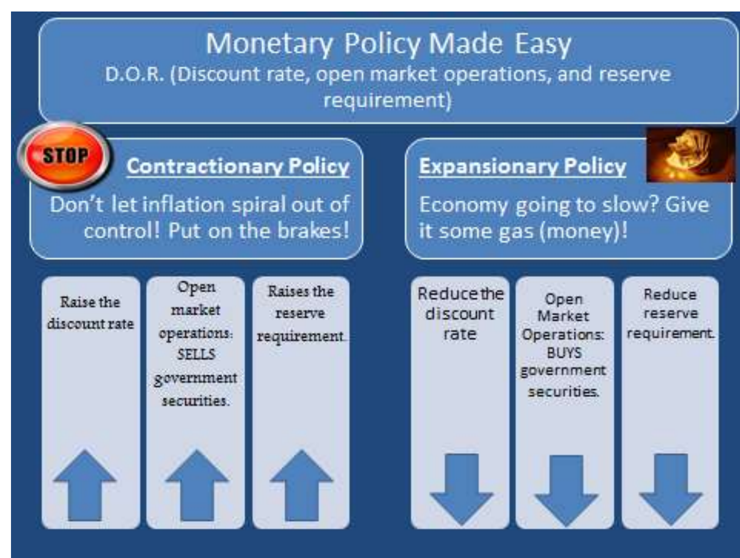
Monetary Policy and the Three Tools of the Fed

1. **Discount Rate**—the interest rate the Federal Reserve charges banks to borrow currency.

Decreasing DR=member banks borrow more money =banks loan more money to people
Increasing DR=member banks borrow less money=less loans available to people

2. **Reserve Requirement**—the percentage of a bank's deposits that must be kept as currency and coin in the bank.

Decreasing RR= banks keep less money in vault=banks loan more money to people
Increasing RR=banks keep more money in vault=less loans available to people



3. **Open Market Operations**—the Federal Reserve's frequent buying and selling of government securities (bonds), considered the most significant of the three tools.

Buy bonds= FED gives banks money for bonds=banks loan more money to people
Sell bonds=FED gets money from banks=less loans available to people by bank

Fiscal Policy: Congress's use of taxing and spending to monitor and control the economy

Taxing: Increasing taxes= slowing economic growth (contractionary)
Decreasing taxes= increasing economic growth (expansionary)

Spending: Increasing spending= increases economic growth (expansionary)
Decreasing spending= slowing economic growth (contractionary)