

CHAPTER 11 & 12 FISCAL POLICY

1. Fiscal policy: changes in government spending and taxes
 - a. $G = T \rightarrow$ balanced budget
 - b. $G < T \rightarrow$ surplus
 - c. $G > T \rightarrow$ deficit
 - d. Used to impact business cycle (to affect changes in the business cycle)
 - e. Is it effective? No it is not (at least not in the way the government intends).
 - i. So why do we study this? Important because it's what government uses today
2. Discretionary fiscal policy: can change government spending, taxes, and debt whenever they want
 - a. Budget deficit: planning to spend more than they'll take in
3. Keynesian economics
 - a. Keynes believed that spending motivated firms to supply goods and services
 - i. Less spending leads to less output
 - ii. If wages did decline, it would reduce incomes and exert a negative impact on aggregate demand
 - iii. When nominal interest rates fall to extremely low levels, significant additional reductions capable of stimulating the economy would be impossible
 - b. Equilibrium takes place when total spending in economy = current output
 - c. Changes in output, rather than changes in prices, direct economy toward equilibrium
 - i. Increase in total spending demand would generate expanding sales and reduce the inventories of firms
 - ii. If total spending is less than full employment output, high rates of unemployment will be present, output will continue below economy's potential, and these conditions will persist as long as the spending on goods and services remains weak
 - d. Not working very well, so we go back to Neoclassical economics: leave economics alone
4. Crowding out: a reduction in private spending as a result of higher interest rates generated by budget deficits that are financed by borrowing in the private loanable funds market
 - a. The crowding-out effect implies that the demand stimulus effects of budget deficits will be weak because borrowing to finance the deficits will increase interest rates and thereby crowd out private spending on investment and consumption.
 - b. Crowding out model: higher interest rates crowd out private spending
5. Expansionary fiscal policy
 - a. Does it cure unemployment? No
 - b. What does it leave us with? Long term debt
6. Self-correcting mechanism: if the economy is about to go down the tubes, it's a bad time to spend money
 - a. $AD = C + I + G$
 - i. C decreases so AD decreases
 - b. Cost of production has fallen

7. Automatic stabilizers: built-in features that tend automatically to promote a budget deficit during a recession and budget surplus during an inflationary boom, even without a change in policy
 - a. Government programs already in place, such that should you decide we need to follow Keynes' advice, they do that
 - b. Unemployment compensation
 - i. Unemployment = too little AD → cure: increase AD, increase government spending, and decrease taxes
 - c. Progressive income tax

CHAPTER 13 MONEY AND BANKING

1. What is money? Anything generally accepted in exchange for goods and services and in repayment of a debt (anything used to buy something or repay debt)
 - a. EX: coins, currency
 - b. Types of money
 - i. Commodity money: backed by an asset
 - ii. Fiat: by government decreed
2. How is money measured?
 - a. M1 (money supply): the sum of (1) currency in circulation (including coins), (2) checkable deposits maintained in depository institutions, and (3) traveler's checks
 - b. M2 (money supply): equal to M1 plus (1) savings deposits, (2) time deposits (accounts of less than \$100,000) held in depository institutions, and (3) money market mutual fund shares
 - c. Is a debit/credit card money? No
3. Liquidity: how easy it is to turn an asset into cash and protect its market value
4. Functions of Money
 - a. Medium of exchange
 - i. Before money we had barter, so this makes trading easier
 - ii. Barter sucks because you have to have a coincidence of desires
 - b. Store of value
 - i. Can put it away and 50 years later still have its value
 - c. Standard of value
 - i. You have a common denominator so you can do cost/benefit analysis
5. Fractional Reserve Banking
6. Bank Reserves
 - a. Required reserves: the minimum amount of reserves that a bank is required by law to keep on hand to back up its deposits.
 - i. Required reserve ratio: the ratio of reserves relative to a specified liability category (for example, checkable deposits) that banks are required to maintain
 - b. Excess reserves: actual reserves that exceed the legal requirement

7. How money is created
 - a. Through the loan process (extending loans)
 - b. Deposit Expansion Multiplier (DEM): the multiple by which an increase in reserves will increase the money supply
 - i. Inversely related to the required reserve ratio
 - ii. Will the introduction of new currency reserves fully expand the money supply by the amount of the multiplier? No, the actual deposit multiplier will generally be less than its potential for 2 reasons.
 1. The DEM will be reduced if some people decide to hold the currency rather than deposit it in a bank.
 2. The actual deposit multiplier will be less than its maximum potential if banks fail to use all the new excess reserves to extend loans.
8. Monetary base: currency + reserves (in the vault or at the FED)
9. The FED
 - a. Run by
 - i. the Board of Governors: the decision-making hub of the Fed
 1. establishes the rules and regulations
 2. sets the reserve requirements and regulates the composition
 - ii. Federal Open Market Committee (FOMC): a committee of the Federal Reserve system that establishes Fed policy with regard to the buying and selling of government securities- the primary mechanism used to control the money supply
 1. Composed of the 7 members of the Board of Governors and the 12 district bank presidents of the Fed
 - b. Chairman of the Board: Ben Bernanke
 - i. Appointed by President
 - ii. Directs the Federal Reserve staff, presides over board meetings, and testifies frequently before Congress
 - c. Is the Fed politically independent?
 - d. How the Fed controls the growth rate of the nominal money supply
 - i. Major monetary tools (chart page 264)
 1. Reserve requirement
 - a. An increase in the reserve requirements will reduce the supply of money
 2. Discount rate
 - a. The interest rate the Federal Reserve charges banking institutions for short-term loans
 - i. Federal funds market: a loanable funds market in which banks seeking additional reserves borrow short-term funds (generally for 7 days or less) from banks with excess reserves. The interest rate is called the federal funds rate.
 3. Open market operations