

## AP Economics Summer Reading Assignment

Economics has been nicknamed “the dismal science” because it often portends gloom and doom in the human condition. However, since economics is a science, albeit a social science, it can not only be used to explain why people, businesses and governments make the decisions they do but can also be used to predict how decisions made today can impact the future.

Your summer assignment for economics is to read the following descriptions of Fiscal and Monetary Policy. These descriptions will help you learn to think like an economist by revealing basic principles and terminology that will be used throughout our introductory AP economics course. As you read these descriptions, you will need to do two simple tasks for each of the 2 parts.

- 1) **Summarize each chapter(section)** by writing a brief explanation (three to four paragraphs) of what major economic principle(s) is (are) explained in the chapter; and
- 2) **Define all of the vocabulary words that are underlined.**

**This assignment will count 30 points** toward your first quarter grade

If you have any questions you can contact Mr. Prescott at [pprescott@aacps.org](mailto:pprescott@aacps.org) or at [phelpsp@yahoo.com](mailto:phelpsp@yahoo.com).

This assignment will not be accepted late and will be due the first day of class.

## Fiscal Policy

Fiscal policy is the means by which a government adjusts its levels of spending in order to monitor and influence a nation's economy. It is the sister strategy to monetary policy with which a central bank influences a nation's money supply. These two policies are used in various combinations in an effort to direct a country's economic goals. Here we take a look at how fiscal policy works, how it must be monitored and how its implementation may affect different people in an economy.

Before the Great Depression in the United States, the government's approach to the economy was laissez faire. But following the Second World War, it was determined that the government had to take a proactive role in the economy to regulate unemployment, business cycles, inflation and the cost of money. By using a mixture of both monetary and fiscal policies (depending on the political orientations and the philosophies of those in power at a particular time, one policy may dominate over another), governments are able to control economic phenomena.

### **How Fiscal Policy Works**

Fiscal policy is based on the theories of British economist John Maynard Keynes. Also known as Keynesian economics, this theory basically states that governments can influence macroeconomic productivity levels by increasing or decreasing tax levels and public spending. This influence, in turn, curbs inflation (generally considered to be healthy when at a level between 2-3%), increases employment and maintains a healthy value of money.

### **Balancing Act**

The idea, however, is to find a balance in exercising these influences. For example, stimulating a stagnant economy runs the risk of rising inflation. This is because an increase in the supply of money followed by an increase in consumer demand can result in a decrease in the value of money - meaning that it will take more money to buy something that has not changed in value.

Let's say that an economy has slowed down. Unemployment levels are up, consumer spending is down and businesses are not making any money. A government thus decides to fuel the economy's engine by decreasing taxation, giving consumers more spending money while increasing government spending in the form of buying services from the market (such as building roads or schools). By paying for such services, the government creates jobs and wages that are in turn pumped into the economy. Pumping money into the economy is also known as "pump priming". In the meantime, overall unemployment levels will fall.

With more money in the economy and less taxes to pay, consumer demand for goods and services increases. This in turn rekindles businesses and turns the cycle around from stagnant to active.

If, however, there are no reins on this process, the increase in economic productivity can cross over a very fine line and lead to too much money in the market. This excess in supply decreases the value of money, while pushing up prices (because of the increase in demand for consumer products). Hence, inflation occurs.

For this reason, fine tuning the economy through fiscal policy alone can be a difficult, if not improbable, means to reach economic goals. If not closely monitored, the line between an economy that is productive and one that is infected by inflation can be easily blurred.

### **And When the Economy Needs To Be Curbed...**

When inflation is too strong, the economy may need a slow down. In such a situation, a government can use fiscal policy to increase taxes in order to suck money out of the economy. Fiscal policy could also dictate a decrease in government spending and thereby decrease the money in circulation. Of course, the possible negative effects of such a policy in the long run could be a sluggish economy and high unemployment levels. Nonetheless, the process continues as the government uses its fiscal policy to fine tune

spending and taxation levels, with the goal of evening out the business cycles.

### **Who Does Fiscal Policy Affect?**

Unfortunately, the effects of any fiscal policy are not the same on everyone. Depending on the political orientations and goals of the policymakers, a tax cut could affect only the middle class, which is typically the largest economic group. In times of economic decline and rising taxation, it is this same group that may have to pay more taxes than the wealthier upper class.

Similarly, when a government decides to adjust its spending, its policy may affect only a specific group of people. A decision to build a new bridge, for example, will give work and more income to hundreds of construction workers. A decision to spend money on building a new space shuttle, on the other hand, benefits only a small, specialized pool of experts, which would not do much to increase aggregate employment levels.

### **Conclusion**

One of the biggest obstacles facing policymakers is deciding how much involvement the government should have in the economy. Indeed, there have been various degrees of interference by the government over the years. But for the most part, it is accepted that a degree of government involvement is necessary to sustain a vibrant economy, on which the economic well being of the population depends.

## **Monetary Policy**

Monetary policy is one of the tools that a national Government uses to influence its economy. Using its monetary authority to control the supply and availability of money, a government attempts to influence the overall level of economic activity in line with its political objectives. Usually this goal is "macroeconomic stability" - low unemployment, low inflation, economic growth, and a balance of external payments. Monetary policy is usually administered by a Government appointed "Central Bank", the Bank of Canada and the Federal Reserve Bank in the United States.

Central banks have not always existed. In early economies, governments would supply currency by minting precious metals with their stamp. No matter what the creditworthiness of the government, the worth of the currency depended on the value of its underlying precious metal. A coin was worth its gold or silver content, as it could always be melted down to this. A country's worth and economic clout was largely to its holdings of gold and silver in the national treasury. Monarchs, despots and even democrats tried to skirt this inviolate law by filing down their coinage or mixing in other substances to make more coins out of the same amount of gold or silver. They were inevitably found out by the traders, money lenders and others who depended on the worth of that currency. This is the reason that movies show pirates and thieves biting Spanish doubloons to ascertain the value of their booty and loot.

The advent of paper money during the industrial revolution meant that it wasn't too difficult for a country to alter its amount of money in circulation. Instead of gold, all that was needed to produce more banknotes was paper, ink and a printing press. Because of the skepticism of all concerned, paper money was backed by a "promise to pay" upon demand. A holder of a "pound sterling" note of the United Kingdom could actually demand his pound of silver! When gold became the de facto backing of the world's currency a "gold standard" was developed where nations kept sufficient gold to back their "promises to pay" in their national treasuries. The problem with this standard was that a nation's economic health depended on its holdings of gold. When the treasury was bare, the currency was worthless.

In the 1800s, even commercial banks in Canada and the United States issued their own banknotes, backed by their promises to pay in gold. Since they could lend more than they had to hold in reserves to meet their depositors demands, they actually could create money. This inevitably led to "runs" on banks when they could not meet their depositors demands and were bankrupt. The same happened to smaller countries. Even the United States Treasury had to be rescued by JP Morgan several times during this period. In the late 1800s and early 1900s, countries legislated their exclusive monopoly to issue currency and banknotes. This was in response to "financial panics" and bank insolvencies. This meant that all currency was issued and controlled by the national governments, although they still maintained gold reserves to support their currencies. Commercial banks still could create money by lending more than their depositors had placed with the bank, but they no longer had the right to issue banknotes.

### **Modern Monetary Policy**

Modern central banking dates back to the aftermath of great depression of the 1930s. Governments, led by the economic thinking of the great John Maynard Keynes, realized that collapsing money supply and credit availability greatly contributed to the savagery of this depression. This realization that money supply affected economic activity led to active government attempts to influence money supply through "monetary policy". At this time, nations created central banks to establish "monetary authority". This meant that rather than accepting whatever happened to money supply, they would actively try to influence the amount of money available. This would influence credit creation and the overall level of economic activity.

Modern monetary policy does not involve gold to a great extent. In 1968, the United States rescinded its promise to pay in gold and effectively removed itself from the "gold standard". Since then, it has been the job of the Federal Reserve to control the amount of money and credit in the U.S. economy. In doing this, it wants to maintain the purchasing power of the U.S. dollar and its comparative worth to other currencies. This might sound easy, but it is a complex task in an information age where huge amounts of money travels in electronic signals in microseconds around the world.

### **The Effectiveness of Monetary Policy**

Economists debate the relevant measures of money supply. "Narrow" money supply or M1 is currency in circulation and the currency in easily accessed checking and savings accounts. "Broader" money supply measures such as M2 and M3 include term deposits and even money market mutual funds. Economists debate the finer points of the implementation and effectiveness of monetary policy but one thing is obvious. At the extremes, monetary policy is a potent force. In countries such as the Russian Republic, Poland or Brazil where the printing presses run full tilt to pay for government operations, money supply is expanding rapidly and the currency becomes rapidly worthless compared to goods and services it can buy. Very high levels of inflation or "hyperinflation" are the result. With 30-40% monthly inflation rates, citizens buy hard goods as soon as they receive payment in the currency and those on fixed income have their investments rendered worthless.

At the other extreme, restrictive monetary policy has shown its effectiveness with considerable force. Germany, which experienced hyperinflation during the Weimar Republic and never forgot, has maintained a very stable monetary regime and resulting low levels of inflation. When Chairman Paul Volcker of the U.S. Federal Reserve applied the monetary brakes during the high inflation 1980s, the result was an economic downturn and a large drop in inflation. The Bank of Canada, headed by John Crow, targeted 0-3% inflation in the early 1990s and curtailed economic activity to such an extent that Canada actually experienced negative inflation rates in several months for the first time since the 1930s.

Without much debate, the effectiveness of monetary policy, its timing and its eventual impacts on the economy are not obvious. That central banks attempt influence the economy through monetary is a given. In any event, insights into monetary policy are very important to the investor. The availability of money and credit are key considerations in the pricing of an investment.

### **Operations of a Modern Central Bank**

The Central Bank attempts to achieve economic stability by varying the quantity of money in circulation, the cost and availability of credit, and the composition of a country's national debt. The Central Bank has three instruments available to it in order to implement monetary policy:

1. Open market operations
2. Reserve requirements
3. The 'Discount Window'

**Open market operations** are just that, the buying or selling of Government bonds by the Central Bank in the open market. If the Central Bank were to buy bonds, the effect would be to expand the money supply and hence lower interest rates, the opposite is true if bonds are sold. This is the most widely used instrument in the day to day control of the money supply due to its ease of use, and the relatively smooth interaction it has with the economy as a whole.

**Reserve requirements** are a percentage of commercial banks', and other depository institutions', demand deposit liabilities (i.e. chequing accounts) that must be kept on deposit at the Central Bank as a requirement of Banking Regulations. Though seldom used, this percentage may be changed by the Central Bank at any time, thereby affecting the money supply and credit conditions. If the reserve requirement percentage is increased, this would reduce the money supply by requiring a larger percentage of the banks, and depository institutions, demand deposits to be held by the Central Bank, thus taking them out of supply. As a result, an increase in reserve requirements would increase interest rates, as less currency is available to borrowers. This type of action is only performed occasionally as it affects money supply in a major way. Altering reserve requirements is not merely a short-term corrective measure, but a long-term shift in the money supply.

**Lastly, the Discount Window** is where the commercial banks, and other depository institutions, are able to borrow reserves from the Central Bank at a discount rate. This rate is usually set below short term market rates (T-bills). This enables the institutions to vary credit conditions (i.e., the amount of money they have to loan out), there by affecting the money supply. It is of note that the Discount Window is the only instrument which the Central Banks do not have total control over.

By affecting the money supply, it is theorized, that monetary policy can establish ranges for inflation, unemployment, interest rates ,and economic growth. A stable financial environment is created in which savings and investment can occur, allowing for the growth of the economy as a whole.