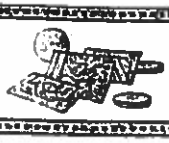
Name _____ Date _____ Class _____

FREE ENTERPRISE  ACTIVITY 20

DECISION MAKING AT THE FEDERAL RESERVE BOARD

The Federal Reserve Board uses three major tools to control the nation's money supply and to keep the economy running smoothly: reserve requirements, discount rate, *and* open market operations.

Directions: *Predict which tool the board would use in each situation below and explain how the board would use it.*

1. The Federal Reserve Board wants to decrease the money supply by limiting the amount of money that banks have to loan.

2. The Federal Reserve Board wants to increase the money supply by encouraging banks to borrow money from district Federal Reserve Banks.

3. The Federal Reserve Board wants to decrease the money supply by having banks raise their prime rate to discourage borrowers.

4. The Federal Reserve Board wants to increase the money supply by adding "new" money.

5. The Federal Reserve Board wants to "loosen up" the money supply by encouraging banks to lend more of their money.

6. The Federal Reserve Board wants to "tighten" the money supply by removing money from circulation.

THE MAGIC OF THE MULTIPLIER!

Have you ever heard the phrase "money doesn't grow on trees?"... Probably the last time you asked your parents for some money! They are correct but what they might not know is that if they give you money to spend, they can actually create money! Maybe if you can explain the multiplier effect, you can convince them to cough up some cash!

Here is how it works: Each time a person receives income, they have two choices, to spend or to save. Most people do a little of each. The MPC (marginal propensity to consume) is the fraction of each new dollar that people will spend on average. The MPS (marginal propensity to save) is the fraction of each new dollar that people will save on average. The key to the multiplier is that each time a person spends some of their money, it creates income for someone else, and that person will also choose to spend some and save some, sending a ripple effect throughout the economy. The original dollar amount results in a much larger impact on GDP.

Let's try it out: Assume your parents give you $100 and that the MPC is .75 and the MPS is .25

Round/Cycle	Income (GDP)	Consumption spending	Saving
1	You have $100	You spend $75	You save $25
2	Person A gets $75	They spend $	They save $
3	Person B gets $	They spend $	They save $
4	Person C gets $	They spend $	They save $
And so on...	And so on...	And so on...	And so on...
All Rounds =	1/(1-.75) x $100 = $400 in total income (GDP)	(MPC) .75 x $400 = $300 increase in consumption spending	(MPS) .25 x $100 = increase in total saving

What would happen if you saved the money and did not spend it at all? Would you stop the multiplier? Can you single handedly stop economic growth and rob others of their potential income? Not really...because as long as you put the money in the bank they will make sure they loan it out to someone who does want to spend it! Why? This is how the banks make profit!

Round/Cycle	Deposit	Reserve Requirement 10%	Excess Reserves	New Loan
1	Bank A $100	$10	$90	$90
2	Bank B $90	$	$	$
3	Bank C $	$	$	$
4	Bank D $	$	$	$
And so on...	And so on...	And so on...	And so on...	And so on...
All Rounds =	1/(1-.9) x $100 = $1000 in total economic activity (GDP)	RR .1 x $1000 = $100 increase in bank reserves	.9 x $1000 = $900 now available to be loaned out	

***<u>The Big Picture:</u> **The multiplier does not only apply to money you get from your parents but also the fiscal policy decisions of the government. Assume the MPC is .75 as it was in our original example:**

What happens when the government decides to raise taxes by $1 billion? (-.75/.25) x $1 billion = $3 billion dollar decrease in GDP!

Cut taxes by $5 billion? (-.75/.25) x $5 billion = $15 billion increase in GDP!

Increase government spending by $3 billion? (1/.25) x $3 billion = $12 billion increase in GDP!

Decrease government spending by $2 billion (1/.25) x $2 billion = $8 billion decrease in GDP!

EVERY ACTION HAS A *<u>MULITPLIED</u>* IMPACT ON GDP AND THE ECONOMY OVERALL!