The President's Dilemma

Implementing Fiscal and Monetary Policy to Resolve an Economic Crisis

v1.2

Learn Through Experience

About the Buck Institute for Education
The Buck Institute for Education (BIE) is dedicated to improving 21st-century teaching and learning by creating and disseminating products, practices, and knowledge for effective Project Based Learning. Founded in 1987, BIE is a not-for-profit 501(c)3 organization that receives operational funding from the Leonard and Beryl Buck Trust, and funding from other education organizations, foundations, schools and school districts, state educational agencies, and national governments for product development, professional development, and research.

Project Based Economics

Authors
Nan Maxwell, PhD
John Larmer
John Mergendoller, PhD
Yolanda Bellisimo

BIE Production Editor
Suzie Boss

Interact Production Editor
Justin Coffey

Product Code: INT265

10200 Jefferson Blvd. • P.O. Box 802 • Culver City, CA 90232
Phone: (800) 359-0961 • www.teachinteract.com
ISBN# 978-1-56004-642-4

Table of Contents

Table of Contents

The President's Dilemma

Chapter Four

Purpose and Overview

Time required

10–12 class periods

10–12 class periods

Project scenario

In a mixed-market economy like the United States, the federal government uses fiscal and monetary policy tools to influence the behavior of individuals, firms, and financial institutions. However, in attempting to improve the performance of the nation's economy, the government encounters the problem of resource scarcity. Tradeoffs must be considered; some groups may be harmed in order to help another group in society. To explore these concepts and gain some understanding of macroeconomic analysis, students are presented with the following problem-solving scenario in this project:

> *Due to a rapid rise in oil prices, the United States is facing a severe economic crisis with high levels of inflation, high unemployment, and slow economic growth. The President, whose approval ratings are plummeting, has asked a Special Task Force of the Council of Economic Advisors to recommend a policy to deal with the crisis without increasing the national debt. The Task Force is asked to make an oral presentation with visual aides to a panel composed of representatives of constituencies that have a targeted interest in the economic solution proposed. As students learn about leading economic indicators and fiscal and monetary policy, letters arrive from three panel members. Each constituent argues for policies that benefit their interest group—unemployed middle-class workers, retired people, and business representatives. Students must consider both supply-side and demand-side options and weigh the costs and benefits of various solutions as they recommend policies that balance the needs of the nation.*

Concepts to be learned

To successfully resolve the problem and complete the products required in this project, students need to understand and be able to apply the following economic concepts:

- Budget deficit
- Consumer price index
- Contractionary policy
- Cost-push inflation
- Demand
- Demand-side theories
- Discount rate
- Crowding out
- Economic indicators
- Expansionary policy
- Federal reserve system
- Fiscal policy
- Government spending
- Gross Domestic Product (GDP)
- Inflation
- Interest rates
- Monetary policy
- Multiplier
- National debt
- Open market operations
- Opportunity cost
- Reserve requirement
- Scarcity
- Supply
- Supply-side theories
- Tax
- Tradeoffs
- Unemployment rate

NCEE content standards addressed

The President's Dilemma addresses the following *Voluntary National Content Standards in Economics* codified by The National Council on Economic Education, in partnership with the National Association of Economic Educators and the Foundation for Teaching Economics. For more information see www.ncee.net/ea/standards.

Standard #	Economic Concept
1	Scarcity
2	Opportunity cost
12	Interest rates
15	Investment
18	Gross Domestic Product
19	Unemployment and inflation
20	Fiscal and monetary policy

Concept Definitions

The curriculum is designed to teach the following concepts:

Budget deficit: A situation where the flow of expenditures exceeds the flow of income for the federal government. A deficit occurs when taxes on income and expenditures are insufficient to meet the payments for goods and services and interest on the national debt. Contrast with *national debt*.

Consumer Price Index (CPI): A measure of the average price of a fixed "market basket" of consumer goods and services that are commonly bought by households. This statistic is computed monthly by the Bureau of Labor Statistics.

Contractionary policy: A decrease in aggregate demand or supply that is brought about by a decrease in government spending, an increase in taxes, or a combination of the two (fiscal policy) or a decrease in money supply (monetary policy). Contractionary policies are used when the economy is overheating.

Cost-push inflation arises with sustained increases in the cost of production that cause the price of the product to increase

"Crowding out": When the federal government borrows money, the associated rise in interest rates decreases planned investment spending by private firms and individuals. As a result, government expenditures are said to "crowd out" those by private firms.

Demand: Purchases of a good or service that people are actually able and willing to make, given prices and choices available to them. The "**law of demand**" states that there is a negative (or inverse) relationship between price and quantity demanded. That is, as price increases (decreases) the amount of a good purchased decreases (increases). Consumers' demand is determined by their tastes, income, and price of other goods. The **demand schedule** is a table showing the quantities of a good that will be purchased at various prices. The **demand curve** is a curve that relates the price of a product and the quantity of the product that individuals are able and willing to purchase. **Aggregate demand** is the total demand for goods and services in the economy by households (for consumer goods), by firms and government (for investment goods), and by other countries (exports).

Demand-push inflation arises when aggregate demand exceeds aggregate supply and consumers bid up prices

Demand-side theories: Views that emphasize increasing aggregate demand as a means of maintaining economic stability in the economy. Should the economy be at the downturn of the business cycle, demand-side theorists believe that aggregate demand should be stimulated through expansionary policies. Should the economy be overheating, demand-side theorists believe that aggregate demand should be slowed through contractionary policies.

Discount rate: The rate of interest at which the Federal Reserve lends to the banking system. Short-term interest rates are geared to the discount rate through the banking system. If the capital market thinks that changes in the rate are likely to last for some time, long-term rates will also change.

Economic indicators: Statistics about the economy that allow analysis of current economic performance and predictions of future performance

Expansionary policy: An increase in aggregate demand or supply brought about by an increase in government spending, a decrease in taxes, or a combination of the two (fiscal policy) or an increase in money supply (monetary policy). Expansionary policies are used when the economy needs to be stimulated.

Federal Reserve System: The central banking system in the United States. The system consists of 12 regional banks and branches under control of the Federal Reserve Board. Although the Governors of the Board are appointed by the President of the United States, the financial capital of the reserve banks is owned by the member banks, making the "Fed" an independent agency. The Board effectively acts as a central bank and approves the discount rate and reserve ratio, and generally regulates the operation of the banking system. The Federal Open Market Committee, a subcommittee of the Board, effectively has the power to influence money supply through open market operations.

Fiscal policy: An attempt to attain certain economic goals, such as achieving full employment and increasing Gross Domestic Product (GDP), by varying the government's purchases of goods and services and its rate of taxation. The spending authorization and rates of taxation are established by Congress.

Government spending: Payments for goods, services, and interest made by the government. Fiscal policy includes the amount spent for goods and services by the federal government. The multiplier effect associated with government spending results from spending by any level of government.

Gross Domestic Product (GDP): The dollar value of all final goods and services produced by resources located in the country during a year

Inflation: An upward movement in the average level of prices. The result is diminished purchasing power of a given sum of money. Inflation is contrasted with **deflation**, which is a downward movement in the average level of prices. **Demand-push inflation** arises when aggregate demand exceeds aggregate supply and consumers bid up prices. **Cost-push inflation** arises with sustained increases in the cost of production that cause the price of the product to increase.

Interest rates: The price of loanable funds, which is usually expressed as annual percentage and measures the yearly cost of borrowing. The price paid per dollar borrowed per period of time. **Nominal interest rates**: The interest rate taken at its face value (that is, the interest rate expressed in current dollars and not adjusted for inflation). **Real interest rates:** The actual return to capital. Because comparing nominal interest rates includes a purely monetary component, the value of the rate must be purged of changes in prices to be compared over time. The rate obtained after eliminating the element of price change is the real interest rate.

Monetary policy: An attempt to attain certain economic goals, such as lowering the rate of unemployment or inflation. This can be done by varying the money supply, interest, and (in some cases) conditions of credit. The Board of Governors of the Federal Reserve establishes the policies.

Multiplier: The recipients of income will save a portion and spend a portion of it. Of the portion spent, the income generated to the next recipient will be partially saved and partially spent. The result of this continued pattern is that the total increase in aggregate income will, in the end, be several times larger than the increase in the initial income received (that is, it will be some multiple of the increase in initial income). The expression that gives the value of this multiple is the multiplier.

National debt: The total amount of money owed by the federal government to the owners of government securities. It is equal to the sum of the past budget deficits (less budget surpluses). Contrast with *budget deficit*.

Open market operations: The buying and selling of federal government securities by the Federal Reserve banks

Opportunity costs: The real sacrifice involved in achieving something. The value of the next best opportunity that is foregone in order to achieve a particular thing.

Reserve requirements: The proportion of deposits that a bank or other depository institution is legally required to hold in cash reserve. The proportion is set by the Federal Reserve as a monetary policy tool.

Scarcity: A condition where less of something exists than people would like if the good had no cost. Scarcity arises because resources are limited and cannot accommodate all of our unlimited wants.

Supply: The amount of a good or service that firms are prepared to sell at a given price. The firm determines how much of a good to supply using its marginal cost curve. **Industry supply** is the summation of all individual firms' marginal cost curves (in a constant cost industry). The **supply schedule** is a table showing the amount of a product that will be produced at a given price. The **supply curve** relates the quantity of a good supplied by a firm (or market) and each price. The **law of supply** dictates that the curve is upsloping, indicating that more will be produced as the price of the good increases. **Aggregate supply** is the total amount of goods and services available for consumption and consists of both domestically produced goods and services and imports.

Supply-side theories: Views that emphasize increasing aggregate supply as a means of maintaining economic stability. Should the economy be at the downturn of the business cycle, supply-side theorists believe that aggregate supply should be stimulated through expansionary policies. Should the economy be overheating, supply-side theorists believe that aggregate supply should be slowed through contractionary policies.

Tax: A compulsory transfer of money from individuals, institutions, or groups to the government. The tax may be based on either wealth or income or as a surcharge to prices. Taxation is one of the key elements in fiscal policy and a primary means by which a government finances its expenditures.

Tradeoff: An exchange relationship denoting how much of one good (or resource) is needed to get another good (or resource).

Unemployment rate: The number of people able and willing to work expressed as a percentage of the labor force. Labor force includes working individuals and unemployed individuals but does not include individuals who do not wish to work (e.g., retirees).

