University of Central Florida (UCF) ECO3223 Midterm 3 Practice Exam (Sample)

Study Guide

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Questions

1. What role do incentives play in economic decision-making?
   A. They are irrelevant to economic behavior
   B. They motivate individuals or firms to act in certain ways
   C. They only apply to large corporations
   D. They primarily focus on governmental policies

2. What happens to the supply curve when there is an increase in consumer demand?
   A. The supply curve shifts to the left
   B. The supply curve shifts to the right
   C. The supply curve does not shift
   D. The supply curve becomes steeper

3. What typically happens to firms in a perfectly competitive market in the long run?
   A. They will all become dominant market leaders
   B. They will tend to earn only normal profits
   C. They will experience consistent losses
   D. They will frequently change their products

4. Why is the money multiplier much lower today compared to 25 years ago?
   A. People are holding less currency today
   B. The currency-to-deposit ratio is much higher today
   C. There is less currency available today
   D. Credit cards usage has not increased with total transactions

5. How have the money multipliers for M1 and M2 changed in the U.S. since the 1980s?
   A. Decreased
   B. Remained fairly constant even though the economy grew
   C. The M1 multiplier decreased while the M2 multiplier increased dramatically
   D. Increased dramatically as the economy grew

6. Which condition correlates with an increased demand for reserves affecting the federal funds market?

   A. Market funds rate will decrease

   B. Market funds rate will remain unchanged

   C. Market funds rate will equal the target rate

   D. Market funds rate will increase

7. What is the primary objective defined by the ECB's Governing Council?

   A. A zero rate of inflation

   B. An inflation rate close to two percent within each member nation

   C. An inflation rate close to two percent using HICP

   D. A one to three percent inflation rate

8. What is the length of the term served by the governors of the Federal Reserve System?

   A. Four years that can be renewed

   B. Fourteen years

   C. Four years, the same as the U.S. President, and the terms are not renewable

   D. Seven years

9. What component is essential for effective market regulation?

   A. Ensuring all firms are equally profitable

   B. Internalizing externalities

   C. Minimizing the number of firms in the market

   D. Restricting consumer access to information

10. What does it indicate when markets are in "long-run equilibrium"?

   A. Firms are experiencing supernormal profits

   B. Firms are making normal profits and there is constant entry and exit of firms

   C. There are no firms in the market

   D. Firms are only producing at a loss

Answers

1. B
2. C
3. B
4. B
5. A
6. D
7. C
8. B
9. B
10. B

Explanations

1. What role do incentives play in economic decision-making?

A. They are irrelevant to economic behavior

B. They motivate individuals or firms to act in certain ways

C. They only apply to large corporations

D. They primarily focus on governmental policies

Incentives play a crucial role in economic decision-making as they are powerful motivators that influence the behavior of individuals and firms. When people or businesses are presented with incentives, whether positive (such as rewards, profits, or benefits) or negative (like penalties or losses), they are likely to adjust their actions based on the expected outcomes associated with those incentives. This means that when individuals or firms perceive that a certain action will lead to a favorable outcome, they are more likely to pursue that action. For instance, if a company realizes that increasing its production will lead to greater profits due to higher demand, it has the incentive to produce more. Similarly, individuals may be incentivized to work harder if there is a promise of a raise or bonus. This shift in behavior due to incentives reflects a fundamental principle of economics — that rational actors make decisions aimed at maximizing their utility or profit. The other options do not accurately capture the broad applicability and impact of incentives in economic behavior. While incentives can indeed vary between different types of entities, they are relevant to all economic agents, not just large corporations, and they encompass much more than governmental policies. Thus, the understanding that incentives motivate actions in diverse economic contexts underscores their significance in decision-making processes.

2. What happens to the supply curve when there is an increase in consumer demand?

A. The supply curve shifts to the left

B. The supply curve shifts to the right

C. The supply curve does not shift

D. The supply curve becomes steeper

When there is an increase in consumer demand, the supply curve does not shift directly; rather, it is the market dynamics of demand and supply that change. An increase in consumer demand typically results in higher prices for the goods as consumers are willing to pay more to secure them. This higher price incentivizes producers to increase the quantity supplied to the market. The supply curve itself represents the quantity that suppliers are willing to provide at various price levels and remains unchanged in terms of its position unless there is a factor that affects the supply itself, such as changes in production costs or technology. Therefore, while the immediate effect of increased demand leads to a higher equilibrium price and quantity in the market, the shape and position of the supply curve remain the same in this scenario. As market prices adjust due to increased demand, the movement along the supply curve reflects the changes in quantity supplied, but the supply curve itself does not shift. This reasoning aligns with why the choice stating that the supply curve does not shift is the correct answer.

3. What typically happens to firms in a perfectly competitive market in the long run?

   A. They will all become dominant market leaders

   B. They will tend to earn only normal profits

   C. They will experience consistent losses

   D. They will frequently change their products

In a perfectly competitive market, firms operate under conditions where there are many sellers offering identical products, and there is free entry and exit in the market. In the long run, the competitive forces within the market drive firms towards a state where they earn only normal profits. Normal profits occur when a firm's total revenue equals its total costs, including both explicit and implicit costs. This situation arises because, in the long run, if firms are making economic profits (profits above normal), new firms are attracted to the market. This entry of new firms increases the supply of the product, which in turn drives down market prices. Conversely, if firms are incurring losses, some will exit the market, reducing supply and driving prices up. As a result of these dynamics, in the long run, firms can only sustain normal profits. This reflects an efficient allocation of resources, where firms cover all their costs, including a normal return on their investment, but do not earn excessive profits that would attract new competitors. Therefore, the tendency for firms in a perfectly competitive market, in the long run, is to stabilize at this point of earning normal profits.

4. Why is the money multiplier much lower today compared to 25 years ago?

   A. People are holding less currency today

   B. The currency-to-deposit ratio is much higher today

   C. There is less currency available today

   D. Credit cards usage has not increased with total transactions

The money multiplier is defined as the ratio of the amount of money in the banking system to the monetary base, and it is influenced by the behavior of the public regarding their currency and deposits. A higher currency-to-deposit ratio indicates that people are holding a greater proportion of their money in the form of physical currency rather than in bank deposits. Over the last 25 years, the trend has shown that individuals are increasingly choosing to hold their wealth in the form of cash rather than deposits, which reduces the banks' ability to lend out money. This results in a lower money multiplier because a larger portion of money is retained by the public as currency and is not being converted into deposits that the banks can use to generate new loans. In contrast, other factors that could affect the money multiplier, such as the total amount of currency available or the increase in credit card usage, do not lead to a direct decrease in the multiplier. The significant shift in how people manage their finances, particularly the inclination to hold more cash relative to deposits, explains the observed decrease in the money multiplier today.

5. How have the money multipliers for M1 and M2 changed in the U.S. since the 1980s?

A. Decreased

B. Remained fairly constant even though the economy grew

C. The M1 multiplier decreased while the M2 multiplier increased dramatically

D. Increased dramatically as the economy grew

The correct choice indicates a decrease in the money multipliers for M1 and M2 in the U.S. since the 1980s, which reflects the underlying dynamics of the banking system and broader economic trends. Since the 1980s, several factors have influenced the money multipliers. One significant factor is the increased regulation and changes in banking practices that have occurred over the decades. For instance, banks have adopted more conservative lending practices, which can lead to a lower money multiplier effect because banks hold onto a larger portion of deposits as reserves rather than lending them out. This behavior is particularly noticeable during economic downturns when uncertainty prompts banks to maintain higher reserve ratios. Moreover, the rise of electronic money and payment systems has also influenced how money is created in the economy. Both M1, which includes physical cash and demand deposits, and M2, which adds savings accounts and other near-money assets, have seen shifts in how they are measured and the velocity with which money circulates. The trend in stable or declining multipliers suggests that increases in monetary base (such as during quantitative easing) do not necessarily translate into proportional increases in M1 and M2, as banks may not lend out as much. In summary, the choice that states

6. Which condition correlates with an increased demand for reserves affecting the federal funds market?

A. Market funds rate will decrease

B. Market funds rate will remain unchanged

C. Market funds rate will equal the target rate

D. Market funds rate will increase

An increase in demand for reserves in the federal funds market typically indicates that banks require more reserves than are available in the system. This heightened demand leads to a tightening of the reserve supply, putting upward pressure on the market funds rate, which is the interest rate at which banks lend reserves to each other overnight. When banks face higher demand for reserves, they are willing to pay more to obtain those reserves. As a result, the market funds rate will increase to reflect this higher demand. The increased rate serves to allocate the limited reserves effectively among banks in need, ensuring that those institutions that require reserves for meeting their obligations can obtain them, but at a higher cost due to increased demand. In contrast, if the market funds rate were to decrease or remain unchanged, it would not reflect an increased demand for reserves, and if the rate were to equal the target rate without any pressures, that would imply a balance rather than a heightened demand scenario. Therefore, an increase in the market funds rate aligns with the condition of increased demand for reserves.

7. What is the primary objective defined by the ECB's Governing Council?

A. A zero rate of inflation

B. An inflation rate close to two percent within each member nation

C. An inflation rate close to two percent using HICP

D. A one to three percent inflation rate

The primary objective defined by the European Central Bank (ECB) Governing Council is to maintain price stability, which is officially interpreted as an inflation rate close to, but below, 2% over the medium term. The measure used to assess this inflation target is the harmonized index of consumer prices (HICP), which provides a consistent basis for monitoring price changes across the Eurozone. By focusing on HICP, the ECB ensures that inflation rates are comprehensively and comparably reported across member countries, enabling the Governing Council to effectively manage and communicate its monetary policy. This focus is crucial because it helps to guide expectations among consumers and investors, thereby stabilizing the economy. An inflation target of close to 2% is seen as optimal for fostering economic growth while minimizing the risks of deflation, which can have severe negative consequences for the economy. In contrast, the other options suggest different inflation targets or definitions that do not align with the ECB's official mandate. The notion of a zero rate of inflation, while theoretically appealing to some, does not consider the necessity of moderate inflation for economic growth. A one to three percent rate could imply a lack of focus and specificity compared to the established target, and referencing individual member nations ignores the collective approach taken

8. What is the length of the term served by the governors of the Federal Reserve System?

A. Four years that can be renewed

B. Fourteen years

C. Four years, the same as the U.S. President, and the terms are not renewable

D. Seven years

The length of the term served by the governors of the Federal Reserve System is fourteen years. This term structure was designed to ensure a level of independence from political pressures, allowing governors to make decisions based on economic conditions rather than political cycles. Appointments are staggered to ensure that not all terms expire simultaneously, and it allows for continuity within the Federal Reserve's governance. This extensive term contrasts with shorter political positions, reinforcing the importance of economic stability and expertise in the central banking system.

9. What component is essential for effective market regulation?

A. Ensuring all firms are equally profitable

B. Internalizing externalities

C. Minimizing the number of firms in the market

D. Restricting consumer access to information

Internalizing externalities is indeed an essential component for effective market regulation. Externalities occur when the actions of individuals or firms have unintended effects on others that are not reflected in market prices, such as pollution or public health issues. When externalities are internalized, firms are compelled to take into account the costs or benefits of their actions on third parties, leading to more socially optimal outcomes. By internalizing externalities, regulation can help ensure that the market achieves efficiency. This means that those who generate negative externalities (like pollution) will face incentives to reduce their harmful behaviors, while those creating positive externalities (like education or innovation) may be encouraged to generate even more benefits for society. This concept is foundational in public economics and is critical for helping markets function more effectively. It addresses the gap where private firms do not naturally consider the societal impacts of their decisions, thereby guiding them towards behaviors that align more closely with societal welfare.

10. What does it indicate when markets are in "long-run equilibrium"?

A. Firms are experiencing supernormal profits

B. Firms are making normal profits and there is constant entry and exit of firms

C. There are no firms in the market

D. Firms are only producing at a loss

When markets are in "long-run equilibrium," it signifies that firms are making normal profits, which means they are covering all their costs, including opportunity costs, but are not generating supernormal profits. In this state, no economic profits exist that would incentivize new firms to enter the market or current firms to exit. Normal profits indicate that firms are able to sustain themselves in the market without the allure of excessive profits prompting new competition. The constant entry and exit of firms is a hallmark of competitive markets; when firms experience losses, some exit, reducing supply until prices rise and the remaining firms can cover their costs, while when firms are making supernormal profits, new firms enter, driving prices down until profits normalize. Therefore, this situation reflects a balance where the market forces of supply and demand have adjusted, ensuring that resources are allocated efficiently, and firms can sustain themselves without the threat of bankruptcy or the motivation to expand unnecessarily.