Econ 353 Money, Banking and Financial Markets
Summer 2008
Exam 4

Name ____________________________       ID # ___________________________

Note:

Questions 1-19 worth 4 points each;
Questions 20-22 each worth 8, 6, 10 points.

Write your answers on the exam paper. You are encouraged to write comments on the exam paper as well.

If you have any questions, please ask the instructor and/or comment at the margin of the exam paper.

Work on your own and good luck!
Questions 1-19: Choose the correct answer

1. The monetary base (high-powered money) consists of
   A) currency in circulation and Federal Reserve notes.
   B) currency in circulation and the U.S. Treasury's monetary liabilities.
   C) currency in circulation and reserves.
   D) reserves and Federal Reserve Notes.

2. When the Federal Reserve purchases a government bond from a bank, reserves in
   the banking system ______ and the monetary base ______, everything else
   held constant.
   A) increase; increases
   B) increase; decreases
   C) decrease; increases
   D) decrease; decreases

3. When the Fed extends a $100 discount loan to the First National Bank, reserves
   in the banking system
   A) increase by $100.
   B) increase by more than $100.
   C) decrease by $100.
   D) decrease by more than $100.

4. In the simple deposit expansion model, if the required reserve ratio is 20 percent
   and the Fed increases reserves by $100, checkable deposits can potentially
   expand by
   A) $100.
   B) $250.
   C) $500.
   D) $1,000.

5. An increase in the monetary base that goes into ______ is not multiplied, while
   an increase that goes into ______ is multiplied.
   A) deposits; currency
   B) excess reserves; currency
   C) currency; excess reserves
   D) currency; deposits

6. If the required reserve ratio is 10 percent, currency in circulation is $400 billion,
   checkable deposits are $800 billion, and excess reserves total $0.8 billion, then
   the money supply is
   A) $8000.
   B) $1200.
   C) $1200.8.
   D) $8400.
7. Everything else held constant, an increase in the required reserve ratio on checkable deposits will cause
   A) the money supply to rise.
   B) the money supply to remain constant.
   C) the money supply to fall.
   D) checkable deposits to rise.

8. The money supply is _____ related to expected deposit outflows, and is _____ related to the market interest rate.
   A) negatively; negatively
   B) negatively; positively
   C) positively; negatively
   D) positively; positively

9. The money supply is ______ related to the nonborrowed monetary base, and ______ related to the level of borrowed reserves.
   A) positively; negatively
   B) negatively; not
   C) positively; positively
   D) negatively; negatively

10. The Fed uses three policy tools to manipulate the money supply: ________, which affect reserves and the monetary base; changes in ________, which affect the monetary base; and changes in ________, which affect the money multiplier.
    A) open market operations; borrowed reserves; margin requirements
    B) open market operations; borrowed reserves; reserve requirements
    C) borrowed reserves; open market operations; margin requirements
    D) margin requirements; open market operations; reserve requirements

11. The interest rate which is charged on overnight loans of reserves between banks and also the primary indicator of the Fed's stance on monetary policy is
    A) prime rate.
    B) discount rate.
    C) federal funds rate.
    D) Treasury bill rate.

12. The quantity of reserves demanded rises when the
    A) discount rate rises.
    B) discount rate falls.
    C) federal funds rate rises.
    D) federal funds rate falls.
13. Everything else held constant, in the market for reserves, when the federal funds rate is 3%, raising the discount rate from 5% to 6%
   A) lowers the federal funds rate.
   B) raises the federal funds rate.
   C) has no effect on the federal funds rate.
   D) has an indeterminate effect on the federal funds rate.

14. When the Fed acts as a lender of last resort, the type of lending it provides is
   A) primary credit.
   B) seasonal credit.
   C) secondary credit.
   D) installment credit.

15. Which of the following is not an advantage of inflation targeting?
   A) There is simplicity and clarity of the target.
   B) Inflation targeting does not rely on a stable money-inflation relationship.
   C) There is an immediate signal on the achievement of the target.
   D) Inflation targeting reduces the effects of inflation shocks.

16. The theory that monetary policy conducted on a discretionary, day-by-day basis leads to poor long-run outcomes is referred to as the
   A) adverse selection problem.
   B) moral hazard problem.
   C) time-inconsistency problem.
   D) nominal-anchor problem.

17. The mandate for the monetary policy goals that has been given to the Federal Reserve System is an example of a ______ mandate.
   A) primary
   B) dual
   C) secondary
   D) hierarchical

18. Which of the following statements is wrong?
   A) Price stability should be the primary long-run goal of monetary policy.
   B) In the long-run, there is no conflict between price stability and other goals.
   C) Nominal anchor is a nominal variable which ties down the price level
   D) Inflation has social costs but does not have economic costs, that is, inflation would not lower economic growth.

19. Which of the following is not a requirement in selecting an intermediate target?
   A) Measurability
   B) Controllability
   C) Flexibility
   D) Predictability
**20. Essay Question:** Assume that no banks hold excess reserves, and the public holds no currency. If a bank sells a $100 security to the Fed, explain what happens to this bank and two additional steps in the deposit expansion process (what happens to bank B and C, refer to lecture notes), assuming a 10% reserve requirement. How much do deposits and loans increase for the banking system when the process is completed?

**Answer:** Bank A first changes a security for reserves, and then lends the reserves, creating loans. It receives $100 in reserves from the sale of securities. Since all of these reserve will be excess reserves (there was no change in checkable deposits), the bank will loan out all $100. The $100 will then be deposited into Bank B. This bank now has a change in reserves of $100, of which $90 is excess reserves. Bank B will loan out this $90, which will be deposited into Bank C. Bank C now has an increase in reserves of $90, $81 of which is excess reserves. Bank C will loan out this $81 dollars and the process will continue until there are no more excess reserves in the banking system. For the banking system, both loans and deposits increase by $1000.
**21. Essay Question:** The monetary base increased by 20% during the contraction of 1929-1933, but the money supply fell by 25%. Explain why this occurred. How can the money supply fall when the base increases?

**Answer:** The banking crisis caused the public to fear for the safety of their deposits, increasing both the currency ratio and bank holdings of excess reserves in anticipation of deposit outflows. Both of these changes reduce the money multiplier and the money supply. In this case, the fall in the multiplier due to increases of currency and excess reserves more than offset the increase in the base, causing the money supply to fall.
22. Essay Question: Explain the type of monetary policy strategy that the Federal Reserve has used in recent years. What are the advantages and disadvantages to this type of strategy? (Hint: The Fed uses an implicit nominal anchor in the form of an overriding concern to control inflation in the long run)

Answer: The Federal Reserve doesn't use an explicit nominal anchor such as a monetary aggregate or the inflation rate. Its strategy revolves around using an implicit nominal anchor in the form of an overriding concern to control inflation in the long run. This involves forward-looking behavior and "pre-emptive strikes" by policy actions to prevent inflation. This forward-looking behavior is necessary because of the long time lags between monetary policy action and its impact on inflation.

The advantages of this policy strategy include: 1. it doesn't rely on a stable money-inflation relationship; 2. the demonstrated success it had in the United States. The disadvantages of this policy strategy include: 1. there is a lack of transparency; 2. its success depends on the individuals in charge of policy; 3. there is low accountability of the central bank.