PROBLEM SET 4

Chapter 25

MULTIPLE CHOICE QUESTIONS

1 - ) Consider the following statements;
   I. Unit of account
   II. Medium of Exchange
   III. Store of value
Which is/are property/properties of money?
   a. Only I
   b. I and II
   c. I, II and III
   d. II and III

2- ) Which of the following refers to the liquidity property of money?
   a. The fact that money is readily accepted and thus easily exchanged for goods.
   b. The fact that money is portable and comes in convenient denominations.
   c. The fact that money makes a good medium of exchange.
   d. All of the above.

3 - ) *Currency debasement* refers to:
   a. The loss in the value of money that occurs when governments raise taxes.
   b. A phenomenon that occurs immediately after a government declares its currency legal tender and promises not to print money too fast.
   c. The loss in the value of money that occurs when its supply is increased rapidly.
   d. The loss in the value of legal tender that occurs when the government fails to honor its debts.

4 - ) A currency that is not backed by gold, silver, or any other precious commodity equal to the face value of the money is known as
   a. Fake money.          c. Token money
   b. Weak money           d. Commodity money
5 - ) Which of the following is included in M2, but not included in M1?
   a. currency held outside banks
   b. travelers checks
   c. demand deposits
   d. savings accounts

6 - ) Karen transfers $500 from her saving account to her checking account. This transaction will
   a. increase M1 and not change M2.
   b. not change M1 and increase M2.
   c. increase both M1 and M2.
   d. decrease both M1 and M2.

7 - ) On the T-account of a bank:
   a. Deposits are an important liability.
   b. Assets are usually greater than liabilities plus net worth.
   c. Assets plus net worth equal liabilities.
   d. Reserves are on the liability side.

8 - ) Suppose that the Central Bank announces the required reserve ratio as 20% and Is Bank holds $400 of $1000 deposits as reserves. In this situation Is Bank has ________ reserve of $_______.
   a. Excess, 50
   b. Insufficient, 100
   c. Insufficient, 150
   d. Excess, 200

9 - ) If required reserve ratio (RRR) is 25%, the money multiplier is
   a. 10
   b. 25
   c. 4
   d. 75
10 - ) Assuming that banks are always fully loaned and people hold no cash, and given a required reserve ratio of 20%, an infusion of $100 billion in reserves will result in a maximum of:

a. $20 billion in deposits
b. $100 billion in deposits
c. $500 billion in deposits
d. $120 billion in deposits

11 - ) As commercial banks keep more excess reserves, money creation

a. increases.
b. decreases.
c. remains the same, as long as banks hold no excess reserves.
d. could either increase or decrease.

12 - ) The preferred tool of the Central Bank for conducting monetary policy involves:

a. Government spending and taxation
b. Changes in the discount rate
c. Open market operations
d. Changes in the reserve requirement

ESSAY QUESTIONS

1 - ) Consider the following Balance Sheet of a Bank.

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>LIABILITIES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserve</td>
<td>Deposit</td>
</tr>
<tr>
<td>$2000</td>
<td>$10000</td>
</tr>
<tr>
<td>Loan</td>
<td></td>
</tr>
<tr>
<td>$8000</td>
<td></td>
</tr>
</tbody>
</table>

a. When the required reserve ratio is 10%, would there be an excess reserve? If so, what is its amount?
b. If a group of investors deposit $15000, what will be the new balance sheet of the bank? (Assume there will be no excess reserves, and the bank is not the only bank in the economy)

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2 - Briefly explain the impact of the following actions held by the Central Bank on the money supply. Illustrate your explanations on a graph.

- a. Decrease in the discount rate.
- b. Increase in the reserve requirement ratio.
- c. An open market purchase of securities by the Central Bank.
Multiple Choice Questions

1 - ) The amount of money you wish to hold, or your demand for money, depends on:

a. How much of your financial assets you wish to hold in the form of money.
b. How much income you would like to have.
c. How much wealth you would like to have.
d. All of the above.

2 - ) Which of the following statements is incorrect?

a. The non-synchronization of income and spending is the mismatch between the timing of money inflow to the household and the timing of money outflow for household expenses.
b. When interest rates are low, people choose to hold a small amount of money.
c. The transaction motive is the main reason that people hold money.
d. When market interest rates fall, bond values rise.

3- ) Speculation motive refers to

a. a reason investors hold money rather than bonds,
b. a reason for holding bonds rather than money.
c. a strategy of the Fed to buy bonds.
d. None of the above

4 - ) An increase in the interest rate causes:

a. A shift of the money demand curve, sometimes to the left, and sometimes to the right.
b. A shift of the money demand curve to the left.
c. A shift of the money demand curve to the right.
d. No shift in the money demand curve.
5 - ) Suppose there is an increase in the money supply. This increase in the money supply will cause

a. a reduction in the interest rate and a rightward shift of the money demand curve.
b. an increase in the interest rate and a leftward shift of the money demand curve.
c. a reduction in the interest rate and a movement along the money demand curve.
d. None of the above

6- ) At the current level of output (i.e., income) and at the current interest rate, suppose there is an excess demand for money. Given this information, we know that there will be pressure for

a. bond prices to decrease and the interest rate to increase.
b. bond prices to decrease and the interest rate to decrease.
c. bond prices to increase and the interest rate to increase.
d. bond prices to increase and the interest rate to decrease.

7- ) If the Fed wanted to reduce the market interest rate, it would

a. raise the discount rate
b. decrease the reserve requirement
c. contract the money supply
d. sell US government securities in the open market

8- ) The demand for money curve shifts to the left with:

a. A decrease in the interest rate.
b. An increase in the price level.
c. A decrease in the level of output (income).
d. None of the above.
9 - ) Suppose there is a reduction in the price level. This reduction in the price level will cause

a. an increase in the interest rate.
b. a reduction in the interest rate.
c. a reduction in the equilibrium quantity of money.
d. an increase in the equilibrium quantity of money.
e. no effect on the interest rate.

Essay Questions

1 - ) Assume that the money market is initially in equilibrium. Suppose there is an increase in income. How will the equilibrium interest rate be affected? What would the Central Bank do if it were to keep the initial interest rate? Explain briefly by using the proper graph.

2 - ) Assume that the money market is initially in equilibrium. Suppose the Fed sells bonds. Graphically illustrate and explain the effects of this operation on the money market.