MULTIPLE CHOICE. Choose the one alternative that best completes the statement or answers the question.

1) Over the long run the primary determinant of movements in the money supply is the
   A) required reserve ratio.   B) currency ratio.
   C) excess reserves ratio.   D) nonborrowed base.

2) The relationship between borrowed reserves, the nonborrowed monetary base, and the monetary base is
   A) BR = MB - MBn.   B) MB = MBn - BR.
   C) BR = MBn - MB.   D) MB = BR - MBn.

3) Suppose that from a new checkable deposit, First National Bank holds two million dollars in vault cash, eight million dollars on deposit with the Federal Reserve, and one million dollars in required reserves. Given this information, we can say First National Bank faces a required reserve ratio of ____ percent.
   A) ten   B) twenty   C) eighty   D) ninety

4) In the simple deposit expansion model, a decline in checkable deposits of $1,000 when the required reserve ratio is equal to 10 percent implies that the Fed
   A) sold $1,000 in government bonds.
   B) sold $100 in government bonds.
   C) purchased $1,000 in government bonds.
   D) purchased $100 in government bonds.

5) Which of the following statements are true?
   A) A bank's balance sheet shows that total assets equal total liabilities plus equity capital.
   B) A bank's liabilities are its uses of funds.
   C) A bank's assets are its sources of funds.
   D) A bank's balance sheet indicates whether or not the bank is profitable.

6) If the required reserve ratio is 15 percent, currency in circulation is $400 billion, checkable deposits are $800 billion, and excess reserves total $0.8 billion, then the M1 money multiplier is
   A) 0.651.   B) 2.5.   C) 1.67.   D) 2.3.

7) Total Reserves minus vault cash equals
   A) bank deposits with the Fed.   B) excess reserves.
   C) currency in circulation.   D) required reserves.
8) Everything else held constant, in the market for reserves, when the federal funds rate is 3%, lowering the discount rate from 5% to 4%  8) ____
   A) raises the federal funds rate
   B) has no effect on the federal funds rate.
   C) has an indeterminate effect on the federal funds rate.
   D) lowers the federal funds rate.

9) There are two ways in which the Fed can provide additional reserves to the banking system: it can _______ government bonds or it can _______ discount loans to commercial banks.
   A) sell; extend  B) sell; call in
   C) purchase; call in  D) purchase; extend

10) If the required reserve ratio is 10 percent, currency in circulation is $400 billion, checkable deposits are $1000 billion, and excess reserves total $1 billion, then the monetary base is
   A) $400 billion.  B) $401 billion.
   C) $500 billion.  D) $501 billion.

11) If a bank has _______ rate-sensitive assets than liabilities, a _______ in interest rates will reduce bank profits, while a _______ in interest rates will raise bank profits.
    A) more; decline; rise  B) more; rise; decline
    C) fewer; decline; decline  D) fewer; rise; rise

12) When you deposit a $50 bill in the Security Pacific National Bank,
    A) its cash items in the process of collection increase by $50.
    B) its liabilities decrease by $50.
    C) its reserves decrease by $50.
    D) its assets increase by $50.

13) Suppose that from a new checkable deposit, First National Bank holds eight million dollars on deposit with the Federal Reserve, nine million dollars in excess reserves, and faces a required reserve ratio of ten percent. Given this information, we can say First National Bank has _______ million dollars in vault cash.
    A) one  B) two  C) nine  D) ten

14) The sum of the Fed’s monetary liabilities and the U.S. Treasury’s monetary liabilities is called
    A) bank reserves.  B) currency in circulation.
    C) the monetary base.  D) the money supply.

15) High-powered money minus currency in circulation equals
    A) the borrowed base.  B) reserves.
    C) the nonborrowed base.  D) discount loans.

16) A bank with insufficient reserves can increase its reserves by
    A) calling in loans.
    B) buying municipal bonds.
    C) buying short-term Treasury securities.
    D) lending federal funds.
17) If the required reserve ratio is equal to 10 percent, a single bank can increase its loans up to a maximum amount equal to
   A) its excess reserves.
   B) its total reserves.
   C) 10 times its excess reserves.
   D) 10 percent of its excess reserves.

18) All else the same, when the Fed calls in a $100 discount loan previously extended to the First National Bank, reserves in the banking system
   A) decrease by more than $100.
   B) decrease by $100.
   C) increase by $100.
   D) increase by more than $100.

19) If float is predicted to decrease because of unseasonably good weather, the manager of the trading desk at the Federal Reserve Bank of New York will likely conduct a _______ open market _______ of securities.
   A) defensive; purchase
   B) dynamic; sale
   C) dynamic; purchase
   D) defensive; sale

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

21) Assuming initially that \( r = 10\% \), \( c = 40\% \), and \( e = 0 \), an increase in \( r \) to 15% causes the M1 money multiplier to _____, everything else held constant.
   A) increase from 2.55 to 2.8
   B) decrease from 2 to 1.82
   C) decrease from 2.8 to 2.55
   D) increase from 1.82 to 2

22) The goal for high employment should seek a level of unemployment at which the demand for labor equals the supply of labor. Economists call this level of unemployment the
   A) structural level of unemployment.
   B) Keynesian rate level of unemployment.
   C) natural rate level of unemployment.
   D) frictional level of unemployment.

23) 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.

24) In the market for reserves, when the federal funds interest rate is below the discount rate, the supply curve of reserves is
   A) negatively sloped.
   B) horizontal.
   C) vertical.
   D) positively sloped.
25) Suppose on any given day the prevailing equilibrium federal funds rate is above the Federal Reserve's federal funds target rate. If the Federal Reserve wishes for the federal funds rate to be at their target level, then the appropriate action for the Federal Reserve to take is a _______ open market _______ , everything else held constant.
   A) defensive; sale
   B) defensive; purchase
   C) dynamic; purchase
   D) dynamic; sale

26) The effect of an open market purchase on reserves differs depending on how the seller of the bonds keeps the proceeds. If the proceeds are kept in _______, the open market purchase has no effect on reserves; if the proceeds are kept as _______, reserves increase by the amount of the open market purchase.
   A) currency; currency
   B) deposits; deposits
   C) currency; deposits
   D) deposits; currency

27) If the First National Bank has a gap equal to a negative $30 million, then a 5 percentage point increase in interest rates will cause profits to
   A) decline by $1.5 million.
   B) increase by $1.5 million.
   C) increase by $15 million.
   D) decline by $15 million.

28) If reserves in the banking system increase by $100, then checkable deposits will increase by $1000 in the simple model of deposit creation when the required reserve ratio is
   A) 0.10.
   B) 0.20.
   C) 0.01.
   D) 0.05.

First National Bank

<table>
<thead>
<tr>
<th></th>
<th>Assets</th>
<th>Liabilities</th>
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</thead>
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<tr>
<td>Rate-sensitive</td>
<td>$40 million</td>
<td>$50 million</td>
</tr>
<tr>
<td>Fixed-rate</td>
<td>$60 million</td>
<td>$50 million</td>
</tr>
</tbody>
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29) Assuming that the average duration of its assets is four years, while the average duration of its liabilities is three years, then a 5 percentage point increase in interest rates will cause the net worth of First National to _______ by _______ of the total original asset value.
   A) decline; 10 percent
   B) increase; 20 percent
   C) decline; 5 percent
   D) decline; 15 percent

30) If interest rates rise by 5 percentage points, say from 10 to 15%, bank profits (measured using gap analysis) will
   A) decline by $0.5 million.
   B) decline by $2.5 million.
   C) decline by $1.5 million.
   D) increase by $2.0 million.

31) The actual execution of open market operations is done at
   A) the Federal Reserve Bank of New York.
   B) the Federal Reserve Bank of Boston.
   C) the Federal Reserve Bank of Philadelphia.
   D) the Board of Governors in Washington, D.C.
32) Both ______ and ______ are Federal Reserve assets.
   A) currency in circulation; government securities
   B) currency in circulation; reserves
   C) government securities; reserves
   D) government securities; discount loans

33) If, after a deposit outflow, a bank has a reserve deficiency of $3 million, it can meet its reserve requirements by
   A) increasing loans by $3 million.
   B) selling $3 million of securities.
   C) reducing deposits by $3 million.
   D) repaying its discount loans from the Fed.

34) The formula for the simple deposit multiplier can be expressed as
   A) \[ \frac{1}{r} \times \Delta R \]
   B) \[ \frac{1}{R} \times \Delta T \]
   C) \[ \frac{1}{r} \times \Delta T \]
   D) \[ \frac{1}{R} \times \Delta D \]

35) If a banker expects interest rates to fall in the future, her best strategy for the present is
   A) to increase the duration of the bank's assets.
   B) to increase the duration of the bank's liabilities.
   C) to buy short-term bonds.
   D) to sell long-term certificates of deposit.

36) Duration analysis involves comparing the average duration of the bank's ______ to the average duration of its ______.
   A) assets; liabilities
   B) loan portfolio; deposit liabilities
   C) securities portfolio; non-deposit liabilities
   D) assets; deposit liabilities

37) The most common definition that central bankers use for price stability is
   A) high and stable inflation.
   B) low and stable inflation.
   C) an inflation rate of zero percent.
   D) low and stable deflation.

38) Property promised to the lender as compensation if the borrower defaults is called ______.
   A) deductibles
   B) contingencies
   C) restrictive covenants
   D) collateral

39) 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) $8400.
   C) $1200.
   D) $1200.8.
40) The formula for the M1 money multiplier is
   A) \( M = (1 + c)/(r + e + c) \). \hspace{1cm} B) \( m = [1/(r + e + c)] \times MB \).
   C) \( m = (1 + c)/(r + e + c) \). \hspace{1cm} D) \( M = 1/(r + e + c) \).

41) The excess reserves ratio is ______ related to expected deposit outflows,
   and is ______ related to the market interest rate.
   A) negatively; positively \hspace{1cm} B) positively; negatively
   C) positively; positively \hspace{1cm} D) negatively; negatively

42) If a bank has $10 million of checkable deposits, a required reserve ratio
    of 10 percent, and it holds $2 million in reserves, then it will not have
    enough reserves to support a deposit outflow of
    A) $1.2 million. \hspace{1cm} B) $1.1 million.
    C) $1 million. \hspace{1cm} D) $900,000.

43) In order to reduce the ______ problem in loan markets, bankers collect
    information from prospective borrowers to screen out the bad credit
    risks from the good ones.
    A) moral suasion \hspace{1cm} B) moral hazard
    C) adverse lending \hspace{1cm} D) adverse selection

44) Recognizing the distinction between borrowed reserves and the
    nonborrowed monetary base, the money supply model is specified as
    A) \( M = m + (MB_n - BR) \). \hspace{1cm} B) \( M = m \times (MB_n - BR) \).
    C) \( M = m - (MB_n + BR) \). \hspace{1cm} D) \( M = m \times (MB_n + BR) \).

45) The ______ problem of discretionary policy arises because economic
    behavior is influenced by what firms and people expect the monetary
    authorities to do in the future.
    A) nominal-anchor \hspace{1cm} B) moral hazard
    C) time-inconsistency \hspace{1cm} D) rational-expectation

46) The four players in the money supply process include
    A) banks, borrowers, the central bank, and the U.S. Treasury.
    B) banks, depositors, the central bank, and the U.S. Treasury.
    C) banks, depositors, borrowers, and the U.S. Treasury.
    D) banks, depositors, the central bank, and borrowers.

47) Bankers’ concerns regarding the optimal mix of excess reserves,
    secondary reserves, borrowings from the Fed, and borrowings from
    other banks to deal with deposit outflows is an example of
    A) managing interest rate risk. \hspace{1cm} B) liability management.
    C) liquidity management. \hspace{1cm} D) managing credit risk.

48) The difference of rate-sensitive liabilities and rate-sensitive assets is
    known as the
    A) gap. \hspace{1cm} B) interest-sensitivity index.
    C) duration. \hspace{1cm} D) rate-risk index.
49) When $1 million is deposited at a bank, the required reserve ratio is 20 percent, and the bank chooses not to hold any excess reserves but makes loans instead, then, in the bank's final balance sheet, 
   A) reserves increase by $160,000.
   B) the liabilities of the bank increase by $800,000.
   C) the liabilities of the bank increase by $1,000,000.
   D) the assets at the bank increase by $800,000.

50) The Fed uses three policy tools to manipulate the money supply: open market operations, which affect the ______; changes in borrowed reserves, which affect the ______; and changes in reserve requirements, which affect the ______.
   A) monetary base; monetary base; money multiplier
   B) monetary base; money multiplier; monetary base
   C) money multiplier; monetary base; monetary base
   D) money multiplier; money multiplier; monetary base
Answer key for Midterm 2 (Spring 2010)

1. D
2. A
3. A
4. B
5. A
6. D
7. A
8. B
9. D
10. D
11. A
12. D
13. B
14. C
15. B
16. A
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18. B
19. A
20. D
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34. A
35. A
36. A
37. B
38. D
39. C
40. C
41. B
42. A
43. D
44. D
45. C
46. D
47. C
48. A
49. C
50. A