Chapter 15 & 16

1. The primary indicator of the Fed's stance on monetary policy is

A) the discount rate.
B) the federal funds rate.
C) the growth rate of the monetary base.
D) the growth rate of M2.

Answer: B

2. The opportunity cost of holding excess reserves is the federal funds rate

A) minus the discount rate.
B) plus the discount rate.
C) plus the interest rate paid on excess reserves.
D) minus the interest rate paid on excess reserves.

Answer: D

3. The quantity of reserves supplied equals

A) nonborrowed reserves minus borrowed reserves.
B) nonborrowed reserves plus borrowed reserves.
C) required reserves plus borrowed reserves.
D) total reserves minus required reserves.

Answer: B

4. In the market for reserves, if the federal funds rate is above the interest rate paid on excess reserves, an open market purchase _____ the supply of reserves and causes the federal funds interest rate to _____, everything else held constant.

A) decreases; fall
B) increases; fall
C) increases; rise
D) decreases; rise

Answer: B

5. In the market for reserves, if the federal funds rate is above the interest rate paid on excess reserves, an open market sale _____ the supply of reserves causing the federal funds rate to _____, everything else held constant.

A) decreases; decrease
B) increases; decrease
C) increases; increase
D) decreases; increase

Answer: D

6. In the market for reserves, a lower discount rate

A) decreases the supply of reserves.
B) increases the supply of reserves.
C) lengthens the vertical section of the supply curve of reserves.
D) shortens the vertical section of the supply curve of reserves.

Answer: D

7. In the market for reserves, a lower interest rate paid on excess reserves

A) decreases the supply of reserves.
B) increases the supply of reserves.
C) decreases the effective floor for the federal funds rate.
D) increases the effective floor for the federal funds rate.

Answer: C

8. Everything else held constant, in the market for reserves, when the federal funds rate is 1%, increasing the interest rate paid on excess reserves from 1% to 2%

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.

Answer: B

9. Everything else held constant, in the market for reserves, when the federal funds rate equals the discount rate, lowering the discount rate

A) increases the federal funds rate.
B) lowers the federal funds rate.
C) has no effect on the federal funds rate.
D) has an indeterminate effect of the federal funds rate.

Answer: B

10. Everything else held constant, the vertical section of the supply curve of reserves is shortened when the

A) discount rate increases.
B) discount rate decreases.
C) federal funds rate rises.
D) federal funds rate falls.

Answer: B

11. In the market for reserves, if the federal funds rate is between the discount rate and the interest rate paid on excess reserves, a _____ in the reserve requirement _____ the demand for reserves, raising the federal funds interest rate, everything else held constant.

A) rise; decreases
B) rise; increases
C) decline; increases
D) decline; decreases

Answer: B

12. In the market for reserves, if the federal funds rate is between the discount rate and the interest rate paid on excess reserves, a _____ in the reserve requirement decreases the demand for reserves, _____ the federal funds interest rate, everything else held constant.

A) rise; lowering
B) decline; raising
C) decline; lowering
D) rise; raising

Answer: C

13. Explain the Fed's three tools of monetary policy and how each is used to change the money supply. Does each tool affect the monetary base or the money multiplier?

Answer: The three tools are open market operations, the purchase and sale of government securities; discount policy, controlling the price and quantity of discount loans to banks; and reserve requirements, setting the percentage of deposits that banks must hold in reserve. Open market operations and the discount rate affect the monetary base, and reserve requirements affect the money multiplier.

14. _____ are the most important monetary policy tool because they are the primary determinant of changes in the _____, the main source of fluctuations in the money supply.

A) Open market operations; monetary base
B) Open market operations; money multiplier
C) Changes in reserve requirements; monetary base
D) Changes in reserve requirements; money multiplier

Answer: A

15. Open market sales shrink _____ thereby lowering _____.

A) the money multiplier; the money supply
B) the money multiplier; reserves and the monetary base
C) reserves and the monetary base; the money supply
D) the money base; the money multiplier

Answer: C

16. There are two types of open market operations: _____ open market operations are intended to change the level of reserves and the monetary base, and _____ open market operations are intended to offset movements in other factors that affect the monetary base.

A) defensive; dynamic
B) defensive; static
C) dynamic; defensive
D) dynamic; static

Answer: C

17. When the Federal Reserve engages in a repurchase agreement to offset a withdrawal of Treasury funds from the Federal Reserve, the open market operation is said to be

A) defensive.
B) offensive.
C) dynamic.
D) reactionary.

Answer: A

18. If the Fed wants to temporarily inject reserves into the banking system, it will engage in

A) a repurchase agreement.
B) a matched sale-purchase transaction.
C) a reverse repurchase agreement.
D) an open market sale.
Answer: A

19. Suppose on any given day there is an excess demand of reserves in the federal funds market. If the Federal Reserve wishes to keep the federal funds rate at its current 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; sale
D) dynamic; purchase

Answer: B

20. 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; sale
D) dynamic; purchase

Answer: D

21. The most common type of discount lending that the Fed extends to banks is called

A) seasonal credit.
B) secondary credit.

C) primary credit.
D) installment credit.

Answer: C

22. The most common type of discount lending, _____ credit loans, are intended to help healthy banks with short-term liquidity problems that often result from temporary deposit outflows.

A) secondary
B) primary
C) temporary
D) seasonal

Answer: B

23. The Fed prefers that _____ so that _____.

A) banks borrow reserves from each other; banks can monitor each other for credit risk
B) banks borrow reserves from each other; the Fed can monitor banks for credit risk
C) banks borrow reserves from the Fed; banks can monitor each other for credit risk
D) banks borrow reserves from the Fed; the Fed can monitor banks for credit risk

Answer: A

24. The Fed's lender-of-last-resort function

A) has proven to be ineffective.
B) cannot prevent runs by large depositors.
C) is no longer necessary due to FDIC insurance.
D) creates a moral hazard problem.

Answer: D

25. The most important advantage of discount policy is that the Fed can use it to

A) precisely control the monetary base.
B) perform its role as lender of last resort.
C) control the money supply.
D) punish banks that have deficient reserves.

Answer: B

26. From before the financial crisis began in September of 2007 to when the crisis was over at the end of 2009, amount of Federal Reserve assets rose, leading to

A) a huge increase in the monetary base.
B) a huge expansion of the money supply.
C) an economic expansion.
D) a high inflation.

Answer: A

27. The purpose of the commitment by the Fed to keep the federal funds rate at zero for a long period of time is to

A) lower the long term interest rates.
B) lower the short term interest rates.
C) increase the long term interest rates.
D) increase the short term interest rates.

Answer: A

28. A nominal variable, such as the inflation rate or the money supply, which ties down the price level to achieve price stability is called _____ anchor.

A) a nominal
B) a real
C) an operating
D) an intermediate

Answer: A

29. Explain the time-inconsistency problem.

What is the likely outcome of discretionary policy? What are the solutions to the time-inconsistency problem?

Answer: With policy discretion, policymakers have an incentive to attempt to increase output by pursuing expansionary policies once expectations are set. The problem is that this policy results not in higher output, but in higher actual and expected inflation. The solution is to adopt a rule to constrain discretion. Nominal anchors can provide the necessary constraint on discretionary behavior.

30. Even if the Fed could completely control the money supply, monetary policy would have critics because

A) the Fed is asked to achieve many goals, some of which are incompatible with others.
B) the Fed's goals do not include high employment, making labor unions a critic of the Fed.
C) the Fed's primary goal is exchange rate stability, causing it to ignore domestic economic conditions.
D) it is required to keep Treasury security prices high.

Answer: A

31. The type of monetary policy regime that the Federal Reserve has followed From the 1980s up until the time Ben Bernanke became chair of the Federal Reserve in 2006 can best be described as

A) monetary targeting.
B) inflation targeting.
C) policy with an implicit nominal anchor.
D) exchange-rate targeting.

Answer: C

32. Which of the following is NOT an operating instrument?

A) non-borrowed reserves
B) monetary base
C) federal funds interest rate
D) discount rate

Answer: D

33. Due to the lack of timely data for the price level and economic growth, the Fed's strategy

A) targets the exchange rate, since the Fed can control this variable.
B) targets the price of gold, since it is closely related to economic activity.
C) uses an intermediate target, such as an interest rate.
D) stabilizes the consumer price index, since the Fed can control the CPI.

Answer: C

34. Since the early 1990s, the Fed has conducted monetary policy by setting a target for the

A) level of borrowed reserves.
B) monetary base.
C) federal funds rate.
D) inflation rate.

Answer: C

35. The Fed can engage in preemptive strikes against a rise in inflation by _____ the federal funds interest rate; it can act preemptively against negative demand shocks by _____ the federal funds interest rate.

A) raising; lowering
B) raising; raising
C) lowering; lowering

D) lowering; raising

Answer: A

36. The money supply in an economy equals

A) monetary base plus money multiplier.
B) monetary base divided by money multiplier.
C) money multiplier divided by monetary base.
D) money multiplier multiplied by monetary base.

ANSWER: D

37. The main asset on the Federal Reserve's balance sheet is

A) discount loans.
B) securities.
C) monetary base.
D) capital.

ANSWER: B

38. The main liability on the Federal Reserve's balance sheet is
A) discount loans.
B) securities.
C) the monetary base.
D) capital.

ANSWER: C

39. Consider a bank that has $10 million as reserves, $5million as securities, and $100 million as transaction accounts. If a customer, who is a government securities dealer, sells $2 million in securities to the Fed

A) the bank's transaction accounts reduce to $98 million.
B) the bank's securities reduce by $4 million.
C) the bank's reserves increase to $12 million.
D) the bank's loans reduce by $2 million.

ANSWER: C

40. The money multiplier equals
A) the money supply divided by the monetary base.
B) currency held by the non-bank public plus banks' reserves.
C) currency held by the non-bank public plus transaction accounts.
D) M2 divided by M1.

ANSWER: A

41. M1 money multiplier equals

A) (transaction accounts + currency) ÷ monetary base
B) (transaction accounts - currency) ÷ monetary base
C) (transaction accounts + currency) × monetary base
D) (transaction accounts - currency) × monetary base

ANSWER: A

42. M2 money multiplier equals

A) (non-transaction accounts + money market funds) ÷ monetary base
B) (M1 + non-transaction accounts - money market funds) × reserves
C) (M2 - money market funds) ÷ excess reserves
D) (M1 + non-transaction accounts + money market funds) ÷ monetary base

ANSWER: D

43. If the excess reserves held by banks increase, the money multiplier is likely to
A) rise.

B) fall.
C) remain unchanged.
D) rise at first, then decline later.

ANSWER: B

44. The Fed undertakes defensive open-market operations

A) when it wants to change fiscal policy.
B) because of seasonal effects or to offset a temporary change in money demand.
C) to offset a permanent change in money demand.
D) when it wants to change monetary policy.

ANSWER: B

45. A bank in poor condition may take out a loan under close Fed scrutiny. Such a loan is known as

A) a secondary credit discount loan.
B) a haircut.
C) a covenant.
D) a primary credit discount loan.

ANSWER: A

46. The amount of non-borrowed reserves equals

A) the monetary base plus the amount of discount loans.
B) the amount of reserves plus the amount of discount loans.
C) the amount of reserves minus the sum of the amount of discount loans and currency.
D) the monetary base minus the sum of the amount of discount loans and currency.

ANSWER: D

47. An increase in the amount of discount loans by the Fed

A) increases the money supply by an amount equal to the increase in the loans times the multiplier.
B) decreases the money supply by an amount equal to the increase in the loans times the multiplier.
C) decreases the money supply by an amount greater than the increase in the loans times the multiplier.
D) increases the money supply by an amount lower than the increase in the loans times the multiplier.

ANSWER: A

48. A _____is a situation in which additions to an economy's monetary base do not lead to an increase in the economy's money supply or decline in the interest rate.

A) liquidity trap
B) recession
C) financial crisis
D) credit crunch

ANSWER: A

49. Which of the following is true of an economy that has hit the zero lower bound?

A) The money supply in the economy increases rapidly as additions are made to the monetary base.
B) Any increase in its monetary base is exactly offset by a decline in its money multipliers.
C) Any short-term bond would provide a return that is much lower than the return from holding cash.
D) The economy's interest rates decline when there is an increase in the monetary base.

ANSWER: B

50. Since the 2008 financial crisis, what has happened to the M1 and M2 multipliers?

ANSWER: As banks began holding a large number of excess reserves, the M1 and M2 multipliers fell sharply. They have remained low since then. If banks continue to hold high levels of excess reserves, the multipliers are likely to remain low.

51. Discuss the effectiveness of a monetary policy in an economy in which banks are indifferent between holding bonds and holding cash as reserves.

ANSWER: This economy is at the zero lower bound, and may be in a liquidity trap. Any increase in the economy's monetary base would end up held as excess reserves by banks. The money multiplier would decline, just offsetting the increase in the monetary base, and the money supply would remain unchanged. Therefore, a monetary policy to increase money supply is ineffective in an economy that is at the zero lower bound.

52. The supply curve of reserves in an economy is horizontal when

A) the federal funds rate is greater than the seasonal credit discount rate.
B) the federal funds rate is less than the secondary credit discount rate.
C) the federal funds rate equals the primary credit discount rate.
D) the federal funds rate is less than the primary credit discount rate.

ANSWER: C

53. Which of the following is true of an economy in a liquidity trap?

A) The money supply in the economy increases rapidly as additions are made to the monetary base.
B) The economy's nominal short-term interest rates become close to zero.
C) The banks in the economy do not hold any reserves.
D) The economy's interest rates decline when there is an increase in the monetary base.

ANSWER: B