

ECO 301: Money and Banking
Instructor: Dr. James Murray.
Spring 2010
Exam 2

Name: (20 points) _____

Directions: Work in groups of up to four people and answer the following questions. All papers will be collected, but only one member's paper will be randomly selected and graded and all members of the group will receive the same grade.

By signing below, you agree that the following work represents the efforts of everyone in the group, and you are willing to accept as your own grade for the group project the grade earned from this representation of your group's work. Every member must agree to these terms to earn a non-zero grade for this assignment.

_____ Signature Group Member 1	_____ Print Name	_____ Date
_____ Signature Group Member 2	_____ Print Name	_____ Date
_____ Signature Group Member 3	_____ Print Name	_____ Date
_____ Signature Group Member 4	_____ Print Name	_____ Date

1. (10 points) Suppose there is an improvement in financial technology that causes people to hold more of their assets in stocks and bonds, and less in money. Moreover, the financial technology causes people to hold most of their money in checking deposits, decreasing the amount they hold in currency. Illustrate and describe the impact of this new technology in the money market. What happens to the interest rate and quantity of money in equilibrium?

2. (10 points) Describe two ways in which the quantity of money supplied depends on the interest rate, assuming the Federal Reserve does not conduct any explicit change in policy.

3. Suppose the monetary supply is \$6.5 trillion, the required reserve ratio is 5%, the ratio of currency to deposits is 10%, and the fraction of deposits that banks hold in reserves over the legal requirement is 5%.

(a) (5 points) What is the monetary base?

(b) (5 points) How much money is held in currency?

(c) (5 points) How much money is held in deposits?

(d) (5 points) How much money is being held in reserves?

4. Using the same information as the previous question, suppose the Federal Reserve increased the required reserve ratio to 10%.

(a) (5 points) What will be the change in money supply?

(b) (5 points) All other things remaining equal, describe and illustrate the impact on interest rates.

5. (10 points) Which is larger, the M1 money multiplier, or the M2 money multiplier? Describe *intuitively* why this should be so (Intuitively means don't describe what is happening to an equation. Describe instead what is happening in the economy.)

6. (10 points) Suggest one weakness of the Federal Reserve System and suggest how the system might be changed for the better.

7. (10 points) The Federal Reserve currently follows a long term policy that promotes low, stable inflation. It has been suggested that a better policy would be to promote a long run average inflation rate of 0%. Suggest one argument for this change in policy, and one argument against it.