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

1) A major disruption in financial markets characterized by sharp declines in asset prices and firm failures is called a

2) A financial crisis occurs when an increase in asymmetric information from a disruption in the financial system
   A) causes severe adverse selection and moral hazard problems that make financial markets incapable of channeling funds efficiently.
   B) reduces uncertainty in the economy and increases market efficiency.
   C) increases economic activity.
   D) allows for a more efficient use of funds.

3) A bank panic can lead to a severe contraction in economic activity due to
   A) the losses of bank shareholders.
   B) the losses of bank depositors.
   C) a decline in international trade.
   D) a decline in lending for productive investment.

4) When the value of loans begins to drop, the net worth of financial institutions falls causing them to cut back on lending in a process called

5) If uncertainty about banks’ health causes depositors to begin to withdraw their funds from banks, the country experiences a(n)
   A) financial recovery.
   B) reduction of the adverse selection and moral hazard problems.
   C) increase in information available to investors.
   D) banking crisis.

6) ________ is a process of bundling together smaller loans (like mortgages) into standard debt securities.
   A) Securitization  B) Distribution  C) Debt deflation  D) Origination

7) Mortgage brokers often did not make a strong effort to evaluate whether the borrower could pay off the loan. This created a
   A) severe adverse selection problem.  B) decline in mortgage applications.
   C) decrease in the demand for houses.  D) call to deregulate the industry.

8) The originate-to-distribute business model has a serious ________ problem since the mortgage broker has little incentive to make sure that the mortgagee is a good credit risk.
   A) collateralized debt  B) debt deflation
   C) democratization of credit  D) principal-agent
9) The two key factors that trigger speculative attacks on emerging market currencies are
A) low interest rates abroad and severe fiscal imbalances.
B) deterioration in bank balance sheets and low interest rates abroad.
C) deterioration in bank balance sheets and severe fiscal imbalances.
D) low interest rates abroad and rising asset prices.

10) Factors that led to worsening conditions in Mexico’s 1994–1995 financial markets include
A) decline in interest rates.
B) increased uncertainty from political shocks.
C) failure of the Mexican oil monopoly.
D) the ratification of the North American Free Trade Agreement.

11) Which of the following are reported as liabilities on a bank’s balance sheet?
A) Loans
B) Reserves
C) Deposits with other banks
D) Checkable deposits

12) Bank loans from the Federal Reserve are called _______ and represent a _______ of funds.
A) discount loans; source
B) fed funds; use
C) discount loans; use
D) fed funds; source

13) Bank capital is equal to _______ minus _______.
A) total assets; total liabilities
B) total liabilities; total borrowings
C) total assets; total reserves
D) total liabilities; total assets

14) Bank reserves include
A) deposits at the Fed and short-term treasury securities.
B) deposits at other banks and deposits at the Fed.
C) vault cash and deposits at the Fed.
D) vault cash and short-term Treasury securities.

15) Bank’s make their profits primarily by issuing _______.
A) negotiable CDs
B) NOW accounts
C) equity
D) loans

16) In general, banks make profits by selling _______ liabilities and buying _______ assets.
A) illiquid; liquid
B) short-term; longer-term
C) risky; risk-free
D) long-term; shorter-term

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

18) If a bank has $100,000 of checkable deposits, a required reserve ratio of 20 percent, and it holds $40,000 in reserves, then the maximum deposit outflow it can sustain without altering its balance sheet is
A) $10,000.
B) $30,000.
C) $20,000.
D) $25,000.
19) If a bank has excess reserves greater than the amount of a deposit outflow, the outflow will result in equal reductions in
A) deposits and reserves.  
B) deposits and loans.  
C) capital and loans.  
D) capital and reserves.

20) Of the following, which would be the first choice for a bank facing a reserve deficiency?
A) Sell securities  
B) Borrow from the Fed  
C) Borrow from other banks  
D) Call in loans

21) The goals of bank asset management include
A) minimizing liquidity.  
B) maximizing risk.  
C) lending at high interest rates regardless of risk.  
D) purchasing securities with high returns and low risk.

22) Which of the following would a bank not hold as insurance against the highest cost of deposit outflow–bank failure?
A) Secondary reserves  
B) Excess reserves  
C) Mortgages  
D) Bank capital

23) Holding large amounts of bank capital helps prevent bank failures because
A) it makes it easier to call in loans.  
B) it can be used to absorb the losses resulting from bad loans.  
C) it means that the bank has a higher income.  
D) it makes loans easier to sell.

24) Bank capital has both benefits and costs for the bank owners. Higher bank capital ______ the likelihood of bankruptcy, but higher bank capital ______ the return on equity for a given return on assets.
A) increases; increases  
B) increases; reduces  
C) reduces; reduces  
D) reduces; increases

25) Because borrowers, once they have a loan, are more likely to invest in high-risk investment projects, banks face the
A) adverse selection problem.  
B) adverse credit risk problem.  
C) lemon problem.  
D) moral hazard problem.

26) From the standpoint of _______, specialization in lending is surprising but makes perfect sense when one considers the ______ problem.
A) diversification; adverse selection  
B) diversification; moral hazard  
C) moral hazard; diversification  
D) adverse selection; diversification

27) To reduce moral hazard problems, banks include restrictive covenants in loan contracts. In order for these restrictive covenants to be effective, banks must also
A) be willing to rewrite the contract if the borrower cannot comply with the restrictions.  
B) be prepared to extend the deadline when the borrower needs more time to comply.  
C) trust the borrower to do the right thing.  
D) monitor and enforce them.
28) Property promised to the lender as compensation if the borrower defaults is called _______. 28) _____
   A) collateral B) contingencies
   C) restrictive covenants D) deductibles

29) All else the same, if a bank’s liabilities are more sensitive to interest rate fluctuations than are its assets, then _______ in interest rates will _______ bank profits.
   A) a decline; not affect
   B) an increase; increase
   C) an increase; reduce
   D) a decline; reduce

First National Bank

<table>
<thead>
<tr>
<th>Rate-sensitive</th>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>$40 million</td>
<td></td>
<td>$50 million</td>
</tr>
<tr>
<td>Fixed-rate</td>
<td>$60 million</td>
<td>$50 million</td>
</tr>
</tbody>
</table>

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

31) A reason why rogue traders have bankrupt their banks is due to
   A) a failure to maintain proper internal controls.
   B) the separation of trading activities from the bookkeepers.
   C) accounting errors.
   D) stringent supervision of trading activities by bank management.

32) The fact that banks operate on a “sequential service constraint” means that
   A) all depositors share equally in the bank’s funds during a crisis.
   B) depositors arriving first have the best chance of withdrawing their funds.
   C) depositors arriving last are just as likely to receive their funds as those arriving first.
   D) banks randomly select the depositors who will receive all of their funds.

33) The contagion effect refers to the fact that
   A) bank runs involve only sound banks.
   B) the failure of one bank can hasten the failure of other banks.
   C) bank runs involve only insolvent banks.
   D) deposit insurance has eliminated the problem of bank failures.

34) A system of deposit insurance
   A) increases the incentives of depositors to monitor the riskiness of their bank's asset portfolio.
   B) increases the likelihood of bank runs.
   C) attracts risk-taking entrepreneurs into the banking industry.
   D) encourages bank managers to decrease risk.

35) The result of the too-big-to-fail policy is that _______ banks will take on _______ risks, making bank failures more likely.
   A) small; greater
   B) small; fewer
   C) big; greater
   D) big; fewer
36) Under the Basel Accord, assets and off-balance sheet activities were sorted according to _______ categories with each category assigned a different weight to reflect the amount of _______.
   A) 2; credit risk                      B) 2; adverse selection
   C) 4; adverse selection               D) 4; credit risk

37) Regular bank examinations and restrictions on asset holdings help to indirectly reduce the _______ problem because, given fewer opportunities to take on risk, risk-prone entrepreneurs will be discouraged from entering the banking industry.
   A) post-contractual opportunism       B) moral hazard
   C) ex post shirking                   D) adverse selection

38) The evidence from banking crises in other countries indicates that
   A) regulatory forbearance never leads to problems.
   B) a government safety net for depositors need not increase moral hazard.
   C) deregulation combined with poor regulatory supervision raises moral hazard incentives.
   D) deposit insurance is to blame in each country.

39) Currency circulated by banks that could be redeemed for gold was called _______.
   A) gold bills                         B) state money
   C) banknotes                         D) junk bonds

40) Although the National Bank Act of 1863 was designed to eliminate state-chartered banks by imposing a prohibitive tax on banknotes, these banks have been able to stay in business by
   A) acquiring funds through deposits.
   B) branching into other states.
   C) issuing credit cards.
   D) ignoring the regulations.

41) The regulatory system that has evolved in the United States whereby banks are regulated at the state level, the national level, or both, is known as a
   A) dual banking system.                B) two-tiered regulatory system.
   C) bilateral regulatory system.       D) tiered regulatory system.

42) The Glass-Steagall Act, before its repeal in 1999, prohibited commercial banks from
   A) issuing equity to finance bank expansion.
   B) selling new issues of government securities.
   C) engaging in underwriting and dealing of corporate securities.
   D) purchasing any debt securities.

43) Financial innovations occur because of financial institutions search for _______.
   A) recognition                         B) profits
   C) stability                          D) fame

44) Both _______ and _______ were financial innovations that occurred because of interest rate risk volatility.
   A) sweep accounts; financial derivatives
   B) adjustable-rate mortgages; commercial paper
   C) sweep accounts; commercial paper
   D) adjustable-rate mortgages; financial derivatives
45) Loophole mining refers to financial innovation designed to
A) conceal transactions from the SEC.
B) conceal transactions from the Treasury Department.
C) get around regulations.
D) hide transactions from the IRS.

46) A financial innovation that developed as a result of banks avoidance of bank branching restrictions was _______.
A) money market mutual funds  B) commercial paper
C) bank holding companies  D) junk bonds

47) Price stability is desirable because
A) everyone is better off when prices are stable.
B) it guarantees full employment.
C) inflation creates uncertainty, making it difficult to plan for the future.
D) price stability increases the profitability of the Fed.

48) A central feature of monetary policy strategies in all countries is the use of a nominal variable that monetary policymakers use as an intermediate target to achieve an ultimate goal such as price stability. Such a variable is called a nominal

49) The theory that monetary policy conducted on a discretionary, day–by–day basis leads to poor long–run outcomes is referred to as the

50) The primary goal of the European Central Bank is
A) interest rate stability.  B) price stability.
C) exchange rate stability.  D) high employment.

51) The financial panic of 1907 resulted in such widespread bank failures and substantial losses to depositors that the American public finally became convinced that
A) the Second Bank of the United States had failed to serve as a lender of last resort.
B) the First Bank of the United States had failed to serve as a lender of last resort.
C) the Federal Reserve System had failed to serve as a lender of last resort.
D) a central bank was needed to prevent future panics.

52) The public’s fear of centralized power and distrust of moneyed interests led to the demise of the first two experiments in central banking:
A) the First Central Bank of the United States and the Second Central Bank of the United States.
B) the First Bank of the United States and the Central Bank of the United States.
C) the First Bank of North America and the Second Bank of North America.
D) the First Bank of the United States and the Second Bank of the United States.
53) What makes the Federal Reserve so unique compared to other central banks around the world is its
   A) regulatory functions.  B) decentralized structure.
   C) centralized structure.  D) monetary policy functions.

54) Which of the following is NOT an entity of the Federal Reserve System?
   A) The Board of Governors  B) The Comptroller of the Currency
   C) The Federal Open Market Committee  D) Federal Reserve Banks

55) An important function of the regional Federal Reserve Banks is
   A) determining monetary policy.  B) setting reserve requirements.
   C) clearing checks.  D) setting margin requirements.

56) There are _______ members of the Board of Governors of the Federal Reserve System.
   A) 5  B) 7  C) 12  D) 19

57) The Federal Reserve entity that makes decisions regarding the conduct of open market operations is the
   A) Open Market Advisory Council  B) chairman of the Board of Governors.
   C) Federal Open Market Committee.  D) Board of Governors.

58) Each Fed bank president attends FOMC meetings; although only _______ Fed bank presidents vote on policy, all _______ provide input.
   A) three; ten  B) five; twelve  C) three; twelve  D) five; ten

59) The central bank which is generally regarded as the most independent in the world because its charter cannot be changed by legislation is the

60) The trend in recent years is that more and more governments
   A) have required their central banks to cooperate more with their Ministers of Finance.
   B) have been granting greater independence to their central banks.
   C) have mandated that their central banks focus on controlling inflation.
   D) have been reducing the independence of their central banks to make them more accountable for poor economic performance.

61) The theory of bureaucratic behavior suggests that the objective of a bureaucracy is to maximize
   A) its own welfare.  B) the public’s welfare.
   C) profits.  D) conflict with the executive and legislative branches of government.
62) The political business cycle refers to the phenomenon that just before elections, politicians enact _______ policies. After the elections, the bad effects of these policies (for example, _______) have to be counteracted with _______ policies.

   A) contractionary; higher unemployment; expansionary
   B) contractionary; a higher inflation rate; expansionary
   C) expansionary; higher unemployment; contractionary
   D) expansionary; a higher inflation rate; contractionary

63) Recent research indicates that inflation performance (low inflation) has been found to be best in countries with

   A) the most independent central banks.
   B) money financing of budget deficits.
   C) a policy of always keeping interest rates low.
   D) political control of monetary policy.

64) The government agency that oversees the banking system and is responsible for the conduct of monetary policy in the United States is

   A) the House of Representatives.  B) the U.S. Gold Commission.
   C) the United States Treasury.  D) the Federal Reserve System.

65) The monetary liabilities of the Federal Reserve include

   A) currency in circulation and reserves.
   B) government securities and reserves.
   C) government securities and discount loans.
   D) currency in circulation and discount loans.

66) The monetary base minus currency in circulation equals

   A) the borrowed base.  B) discount loans.
   C) the nonborrowed base.  D) reserves.

67) When a bank sells a government bond to the Federal Reserve, reserves in the banking system _______ and the monetary base _______, everything else held constant.

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

68) When the Fed sells $100 worth of bonds to First National Bank, reserves in the banking system

   A) increase by $100.  B) decrease by more than $100.
   C) decrease by $100.  D) increase by more than $100.

69) 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; deposits  B) deposits; currency
   C) currency; currency  D) deposits; deposits
70) 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) purchase; call in   B) sell; call in
   C) sell; extend       D) purchase; extend

71) Suppose a person cashes his payroll check and holds all the funds in the form of currency. Everything else held constant, total reserves in the banking system _______ and the monetary base _______.
   A) decrease; remains unchanged   B) decrease; increases
   C) remain unchanged; increases   D) decrease; decreases

72) In the simple deposit expansion model, if the Fed purchases $100 worth of bonds from a bank that previously had no excess reserves, deposits in the banking system can potentially increase by
   A) $10.   B) $100.
   C) $100 times the reciprocal of the required reserve ratio.   D) $100 times the required reserve ratio.

73) If the required reserve ratio is 10 percent, the simple deposit multiplier is
   A) 5.0.   B) 2.5.   C) 10.0   D) 100.0.

74) In the simple deposit expansion model, an expansion 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.

75) If reserves in the banking system increase by $200, then checkable deposits will increase by $500 in the simple model of deposit creation when the required reserve ratio is
   A) 0.04.   B) 0.25.   C) 0.40.   D) 0.50.

76) The Fed can exert more precise control over _______ than it can over _______.
   A) the monetary base; high-powered money
   B) high-powered money; the monetary base
   C) high-powered money; reserves
   D) reserves; high-powered money

77) Since the Federal Reserve sets the required reserve ratio to less than one, one dollar of reserves can support _______ of checkable deposits.
   A) exactly twice the amount   B) more than one dollar
   C) exactly one dollar         D) less than one dollar

78) If the Fed injects reserves into the banking system and they are held as excess reserves, then the money supply
   A) increases by a multiple of the initial increase in reserves.
   B) does not change.
   C) increases by only one-half the initial increase in reserves.
   D) increases by only the initial increase in reserves.
79) The formula for the M1 money multiplier is
   A) \[ m = \frac{1 + c}{r + e + c}. \]
   B) \[ m = \frac{1}{r + e + c}. \]
   C) \[ M = \frac{1 + c}{r + e + c}. \]
   D) \[ M = \frac{1}{r + e + c}. \]

80) 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 M1 money multiplier is
   A) 2.8.  
   B) 2.5.  
   C) 2.0.  
   D) 0.7.

81) Everything else held constant, a decrease in the currency ratio causes the M1 money multiplier to _______ and the money supply to _______.
   A) decrease; decrease  
   B) increase; decrease  
   C) increase; increase  
   D) decrease; increase

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

83) The opportunity cost of holding excess reserves is the federal funds rate _______.
   A) minus the interest rate paid on excess reserves  
   B) plus the discount rate  
   C) minus the discount rate  
   D) plus the interest rate paid on excess reserves

84) In the market for reserves, if the federal funds rate is above the interest rate paid on excess reserves, an open market purchase _______ the _______ of reserves which causes the federal funds rate to fall, everything else held constant.
   A) decreases; supply  
   B) increases; demand  
   C) decreases; demand  
   D) increases; supply

85) Suppose on any given day there is an excess supply 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 _______.
   A) defensive; sale  
   B) dynamic; purchase  
   C) dynamic; sale  
   D) defensive; purchase

86) When good weather speeds the check-clearing process, float tends to _______ causing the Fed to initiate _______ open market _______.
   A) decrease; defensive; sales  
   B) decrease; dynamic; sales  
   C) increase; dynamic; purchases  
   D) decrease; defensive; purchases

87) If the consumption function is expressed as \( C = a + mpc \times YD \), then "a" represents
   A) disposable income.  
   B) autonomous consumer expenditure.  
   C) the expenditure multiplier.  
   D) the marginal propensity to consume.
88) If actual output is less than equilibrium output, firms will _______ output to keep from _______ inventories.
   A) increase; accumulating  B) increase; depletin
g   C) decrease; accumulating  D) decrease; depletin

Situation 20-1
Assume a closed economy with no government. Suppose that autonomous consumption equals $400, planned investment equals $500, and the mpc equals 0.9.

89) Using the information contained in Situation 20-1, if autonomous consumption increases by $100, then equilibrium aggregate output will change by
   A) -$1,000.  B) -$100.  C) $100.  D) $1,000.

90) The money market is in equilibrium _______.
   A) at only one point on the LM curve  B) at any point on the IS curve
   C) at any point on the LM curve  D) only at the intersection of the IS and LM curves

91) As interest rates rise, the opportunity cost of holding money _______ and the demand for money _______.
   A) rises; rises  B) falls; rises  C) rises; falls  D) falls; falls

92) When the IS and LM curves are combined in the same diagram, the intersection of the two curves determines the equilibrium level of _______ as well as the _______.
   A) money supply; price level  B) aggregate output; price level
   C) consumer expenditures; interest rate  D) aggregate output; interest rate

93) If the economy is on the LM curve, but is to the left of the IS curve, aggregate output will _______ and the interest rate will _______.
   A) fall; fall  B) fall; rise  C) rise; rise  D) rise; fall

94) A decline in taxes _______ consumer expenditure and shifts the _______ curve to the _______, everything else held constant.
   A) lowers; IS; left  B) lowers; LM; left
   C) raises; IS; right  D) raises; LM; right

95) Which of the following does not shift the IS curve?
   A) A fall in the interest rate.
   B) An increase in government spending.
   C) A decline in government spending.
   D) An increase in autonomous consumption.

96) If the Federal Reserve conducts open market _______, the money supply _______, shifting the LM curve to the left, everything else held constant.
   A) sales; increases  B) purchases; decreases
   C) purchases; increases  D) sales; decreases
97) A decrease in the quantity of money supplied shifts the money supply curve to the _______ and the LM curve to the _______, everything else held constant.
   A) right; left     B) right; right     C) left; right     D) left; left

ESSAY. Write your answer in the space provided or on a separate sheet of paper.

98) Assume that the domestic economy is initially in internal equilibrium (where IS and LM intersect) but that there is a balance of payments surplus. If the central bank has committed to a fixed exchange rate policy, analyze the adjustment of the external balance to the BP surplus using the IS-LM-BP model.
Answer Key
Testname: EXAM2_FALL_2012

1) D
2) A
3) D
4) D
5) D
6) A
7) A
8) D
9) C
10) B
11) D
12) A
13) A
14) C
15) D
16) B
17) B
18) D
19) A
20) C
21) D
22) C
23) B
24) C
25) D
26) A
27) D
28) A
29) C
30) D
31) A
32) B
33) B
34) C
35) C
36) D
37) D
38) C
39) C
40) A
41) A
42) C
43) B
44) D
45) C
46) C
47) C
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72) C
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79) A
80) A
81) C
82) A
83) A
84) D
85) A
86) D
87) B
88) B
89) D
90) C
91) C
92) D
93) C
94) C
95) A
96) D
97) D
98)
At point A the economy is in internal equilibrium but the BP is in surplus. A balance of payments (BP) surplus leads to a domestic appreciation. But the central bank is committed to the fixed exchange rate and so must intervene by selling dollars either in the forex market or by buying bonds in the domestic economy. In either case this will expand the domestic money supply causing the LM curve to shift rightward. This process will continue until the new internal/external balance is achieved at point B.