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

Name: ______________________________

1. Suppose an economy has the following characteristics:
   - The required reserve ratio is 5%
   - Banks hold excess reserves equal to 3% of the total deposits.
   - Consumers and businesses hold currency levels equal to 2% of total deposits.

2. Suppose the Fed conducts an open market sale of $150 billion in government bonds.

   (a) (5 points) Compute the change in money supply.

   (b) (5 points) Compute the change in deposits.

   (c) (5 points) Compute the change in total reserves.

   (d) (5 points) Describe and illustrate the immediate impact on equilibrium real money balances and real interest rates.

3. (10 points) Suppose there is an improvement in financial technology that causes people to hold more of their financial assets in stocks and bonds, and less in money. Moreover, suppose financial technology improvements cause people to hold most of their money in checking deposits and less in currency. Illustrate and describe the impact of improvement in technology in the money market. What happens to the interest rate and quantity of money in equilibrium?

4. A financial institution's variable-rate gap (or simply *gap*) is the difference between the dollar value of the financial institution's variable-rate assets and the dollar value of its variable-rate liabilities.

   (a) (10 points) Do most banks have a positive or negative gap? Include in your explanation a description of banks most significant assets and liabilities.

   (b) (10 points) Describe the impact of an increase in interest rates on a bank with a gap as you describe in part (a).

5. (10 points) Define liquidity risk and explain three ways banks attempt to manage it.

6. (10 points) Describe the difference between liquidity crisis and a solvency crisis.

7. (10 points) Identify and explain three ways financial institutions or financial markets attempt to limit adverse selection.

8. (10 points) Describe using the money multiplier how money supply may change in response to an increase in the spread between short-term interest rates on risk free assets and long-term interest rates on borrowed funds to consumers and businesses.

9. (10 points) Describe moral hazard behavior in the financial and banking industry and two ways that financial firms manage that risk.

10. (10 points) Describe financial market contagion and two ways the government attempts to prevent it.