ECO 301: Money and Banking
Instructor: Dr. James Murray.
Spring 2012
Practice Exam 3

Name: (20 points) ______________________________

Directions: Provide descriptive answers to all of the following questions. When appropriate, complement your descriptions with graphical illustrations of the economic models relevant to your discussion.

1. Suppose the Federal Reserve Open Market Committee's latest meeting minutes indicate an uncertain outlook for the health of the economy which leads to an increase in the uncertainty regarding future monetary policy.

   (a) (10 points) Describe and illustrate the short-run impact on money market and goods market. What is the impact on the real interest rate, real GDP, and price level?

   (b) (10 points) Describe and illustrate the long-run effect on real GDP, price level, and real interest rate. How do these compare to the original levels, that is *before* the meeting minutes were released?

2. Suppose an economy has the following characteristics:

   - The required reserve ratio is 3%
   - Banks hold excess reserves equal to 2% of the total deposits.
   - Consumers and businesses hold currency levels equal to 10% of total deposits.
   - When real GDP increases, consumption expenditures increase by 95%.
   - When real GDP increases, imports increase by 5%.

   (a) (10 points) Suppose the Fed conducts an open market sale of $210 billion in government bonds. What is the change in money supply (compute a number)? Describe and illustrate the immediate impact on equilibrium real money balances and real interest rates.

   (b) (10 points) Will the change in interest rates in the previous problem cause aggregate expenditures to increase or decrease? What components of aggregate expenditures will change? Explain.

   (c) (10 points) Suppose the total change in aggregate expenditures you discussed in the previous question is equal to $154 billion. Compute the immediate change in real GDP.

3. (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?

4. Suppose the economy is producing at its potential when there is a drop in consumer confidence.

   (a) (10 points) Describe and illustrate the short-run effect on real GDP, price level, employment, and interest rate.

   (b) (10 points) Prescribe a monetary policy to bring real GDP to potential GDP and price level back to its original level. Describe and illustrate the effect on real GDP, price level, employment, and interest rate.