**ECO 301: Money and Banking**
**Instructor: Dr. James Murray.**
**Spring 2013**
**Practice Exam 2**

**Name:** ______________________________

1. 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.

   (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) What components of aggregate expenditures change in response to the changes you described in the market for money? Explain.

   (c) (10 points) Describe and illustrate the impact on real GDP and price level.

2. (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?

3. 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.

4. (10 points) Identify and explain three ways financial institutions or financial markets attempt to limit adverse selection.

5. Answer the following questions concerning *liquidity risk*.

   (a) (5 points) Define liquidity risk.

   (b) (10 points) Explain three ways banks attempt to manage liquidity risk.

6. (5 points) Describe the difference between liquidity crisis and a solvency crisis.

7. (10 points) What is the dual mandate for the Federal Reserve? Describe the Federal Reserves macroeconomic policy goals associated with this type of policy.