True/False Questions: Determine whether the statement is true or false.

1. Economists define money as currency in circulation plus reserves. **FALSE**

2. Present value calculations allow us to compare assets with differing time dimensions. **TRUE**

3. In the market for loanable funds, the "buyer" is the borrower. **TRUE**

4. The nominal rate of interest can be thought of as the sum of the real rate plus the expected rate of inflation. **TRUE**

5. The law of one price says the same tradeable goods will sell for the same price in different markets—allowing for differences in transportation costs. **TRUE**

6. Short-selling causes a stock's price to fall faster and farther than if the practice were banned. **FALSE**

7. Interest rates and bond prices tend to move together in the same direction in the long run. **FALSE**

8. Banks never hold excess reserves because if they did, they would forego earning interest on those funds. **FALSE**

9. Alan Greenspan heads the Federal Reserve’s Open Market Committee. **TRUE**

10. The Federal Reserve was created in response to the Great Depression. **FALSE**

Multiple Choice Questions: Select the best answer among the available alternatives. By process of elimination, you may be able to eliminate some answers as implausible.

11. In the United States monetary policy is carried out by
   a. the Federal Reserve System.
   b. Congress.
   c. the President.
   d. Congress and the President acting together.

12. Which of the following is an example of a barter transaction?
   a. An individual pays her electric bill with a check.
   b. An individual pays her electric bill with currency.
   c. An individual provides three light bulbs to her neighbor in exchange for two gallons of milk.
   d. An individual deposits three twenty-dollar bills in her checking account.

13. Deflation refers to
   a. a sustained fall in the general level of prices.
   b. a reduction in the quantity of money and credit relative to other goods.
   c. a sustained loss in purchasing power.
   d. the losses that result when debtors go bankrupt.

14. Which of the following statements is true about M3?
   a. Its total value is smaller than that of M2.
   b. Apart from those assets also included in M1 it includes no assets that offer check-writing features.
   c. Its total value is more than four times as large as M2.
   d. It includes large-denomination time deposits.

15. The determinants of the portfolio allocation decision are:
   a. Risk and return.
   b. Income (wealth), risk, return, and information costs.
   c. Income (wealth), risk, return, information costs, and liquidity.
   d. Income (wealth), risk, return, information costs, liquidity, and time preference.
16. What is the monthly payment for a 12%, 24-month used car loan if you borrow $6,000?
   a. $250.01
   b. $262.24
   c. $282.44
   d. $302.87

17. A two-year discount note is currently priced at $9,325; therefore, it currently yields:
   a. 3.56%
   b. 3.62%
   c. 6.75%
   d. 7.24%

18. If, while you are holding a coupon bond, the interest rates on other similar bonds fall, you know that
   a. the coupon payments on your bond will fall.
   b. the market price of your bond will rise.
   c. the market price of your bond will fall.
   d. the par value of your bond will rise.

19. Assets with greater risk
   a. Usually go unsold relative to those with lower risk.
   b. are generally tax-free to compensate for the increased risk.
   c. Tend to have higher yields to compensate for the increased risk.
   d. Are avoided by rational people.

20. Assets with greater liquidity
   a. also have greater returns.
   b. are generally tax-free.
   c. help savers smooth spending over time.
   d. are avoided by rational people.

21. The flight to quality during the early years of the Great Depression resulted in
   a. the yield on government securities being pushed close to zero.
   b. a decline in the spread between medium-quality corporate bonds and long-term Treasury
      securities.
   c. a fall in the commercial paper rate relative to the T-bill rate.
   d. a decline in the price of T-bills.

22. The term structure of interest rates is usually defined with respect to yields on
   a. Corporate bonds
   b. Commercial paper
   c. U.S. Treasury securities
   d. Municipal bonds

23. A put option is said to be in the money if
   a. it is written on a Treasury bill or other money-market asset.
   b. it has increased in price since it was first written.
   c. the price of the underlying asset is currently less than the strike price.
   d. the price of the underlying asset is currently less than the strike price plus the option premium.

24. The adverse selection problem in financial markets creates a profit opportunity because
   a. it opens a gap between the cost of short-term funds and the cost of long-term funds.
   b. savers are willing to pay for information about the quality of potential borrowers.
   c. it results in the value of a company's stock being well below the value of the company's assets.
   d. it makes bond-financed projects cheaper than stock-financed projects.
25. The moral hazard problem in financial markets
   a. Is difficult if not impossible to solve.
   b. Results in inefficient pricing of financial assets.
   c. Is a type of information cost that is often surmounted by having the borrower pledge assets as collateral.
   d. All of the above.

26. Money market mutual funds
   a. hold portfolios of stocks.
   b. hold portfolios of short-term assets.
   c. are always load funds.
   d. hold only U.S. Treasury securities.

27. Which of the following represented the largest asset on the balance sheet of U.S. banks in 2004?
   a. Checkable deposits
   b. Loans
   c. Non-transaction deposits
   d. US Government obligations

28. The interest rate on unsecured loans between banks is called the
   a. discount rate.
   b. repurchase rate.
   c. T-bill rate.
   d. federal funds rate.

29. If you deposit a $50 check in the bank, before the check has cleared, the change in your bank's balance sheet will be
   a. a $50 increase in reserves and a $50 increase in checkable deposits.
   b. a $50 increase in cash items in the process of collection and a $50 increase in reserves.
   c. a $50 increase in cash items in the process of collection and a $50 increase in checkable deposits.
   d. a $50 increase in cash and a $50 increase in checkable deposits.

30. The US was on a gold standard from
   a. Its founding to 1836.
   b. From 1836 to the present
   c. From 1836 to 1861 and again from 1879 to 1933
   d. From 1900 to 1933.

31. A bank run involves
   a. a failure by a bank to get the maximum return on its investments
   b. large numbers of depositors withdrawing their deposits in a short period of time.
   c. a bank being forced into receivership.
   d. fraud on the part of a bank's management.

32. When households and businesses substitute Treasury bills, commercial paper, and repurchase agreements for short-term bank deposits in their portfolios, they are
   a. sacrificing liquidity for return.
   b. sacrificing return for liquidity.
   c. increasing both their liquidity and return.
   d. decreasing both their liquidity and return.

33. The Consumer Price Index (CPI) in the previous year was 125, and this year the CPI was 132. If the average rate of time preference is 3%, what should the nominal rate of interest equal?
   a. 2.6%
   b. 3.0%
   c. 8.6%
   d. 10.0%.
34. Reserves equal
   a. deposits with the Fed plus holdings of U.S. government securities.
   b. currency in circulation plus vault cash.
   c. deposits with the Fed plus vault cash.
   d. currency outstanding plus currency in circulation.

35. Why do banks avoid holding excess reserves?
   a. The Fed levies a 10% penalty on any reserves held above the required level.
   b. The Fed does not pay interest on reserves.
   c. Savers are often reluctant to place their deposits with banks that hold excess reserves.
   d. The Office of the Comptroller of the Currency monitors excess reserves more closely than any other bank asset.

36. Suppose your first job after graduation pays $32,000/year and that your banker says you can devote no more than 33% of your gross monthly salary toward the monthly payments on a 30-year mortgage. If current mortgage interest rates are 6%, what is the maximum amount you can borrow for a house? (For n=360, the Annuity PV Factor is 166.792, and the PV Factor for a Sum is 6.023.)
   a. $132,000.
   b. $148,278.
   c. $192,722.
   d. Cannot be determined without knowing your after tax income.

37. During the reserve maintenance period, University Bank & Trust Co. has transactions deposits of $145 million. Under the current 3-tier reserve rule, how much must University hold in reserve?
   a. $10.96 million
   b. $14.50 million
   c. $14.20 million
   d. Cannot be determined without information on the currency-to-deposit ratio

38. Suppose that the banking system currently has no excess reserves and that a bank in the system receives a deposit into a checking account of $20,000 in new currency. Under current reserve requirements, and assuming all subsequent deposits are placed in accounts requiring reserves, what is the maximum amount of deposits the entire fractional reserve banking system can create?
   a. $100,000
   b. $160,000
   c. $180,000
   d. $200,000

39. If ordinary citizens hold one dollar in currency for every dollar of transactions accounts, and banks hold reserves equivalent to 7.5% of transactions accounts, what is the level of the precise money (or deposit) multiplier?
   a. 0.925 times
   b. 1.075 times
   c. 1.860 times
   d. 13.333 times

40. Items in the process of collection are generated by
   a. open market operations.
   b. discount loans.
   c. the Fed’s check-clearing role.
   d. spending by the Treasury from its Fed accounts.

41. If the Treasury buys $5 million in gold, the monetary base will
   a. fall by $5 million.
   b. rise by $5 million.
   c. rise by $5 million times the money multiplier.
   d. be unchanged because we are no longer on a gold standard.
42. Who organized the first Bank of the United States?
   a. Alexander Hamilton
   b. George Washington
   c. Andrew Jackson
   d. Woodrow Wilson

43. The main argument against Fed independence is that
   a. in a democracy elected officials should make public policy.
   b. monetary and fiscal policy would be easier to coordinate if the Fed were not independent.
   c. the Fed has proven irresponsible on many occasions.
   d. congressional control of the Fed was tried during the 1960s and it worked well.

44. What is the principal means by which the Fed attempts to change the monetary base?
   a. Discount loans
   b. Open market operations
   c. Changes in the required reserve ratio
   d. Moral suasion

45. The Federal Reserve implements monetary policy in the US because
   a. The Fed has better information than market participants.
   b. The Fed has the interests of the banking public at heart at all times.
   c. Bankers are the best-qualified people to administer monetary policy.
   d. The majority opinion in Congress wants it that way.

46. The quantity of M1 demanded tends to vary inversely with market interest rates because
   a. higher market interest rates lead the public to demand more money to make investments with.
   b. high interest rates discourage investments in fixed capital.
   c. market interest rates represent the opportunity cost of holding M1.
   d. high interest rates encourage banks to make more loans.

47. The main reason the Fed cannot control the real interest rate is that
   a. M1 fluctuates too widely to allow interest rates to be easily controlled.
   b. M2 fluctuates too widely to allow interest rates to be easily controlled.
   c. it cannot control individual rates of time preference.
   d. the real interest rate is mainly determined by the relative solvency of banks.

48. Inflation is
   a. the result of chronic federal budget deficits.
   b. the result of the slowdown in the growth rate of aggregate supply since 1973.
   c. caused by excess wage demands of unionized workers.
   d. a monetary phenomenon.

49. Deposit insurance
   a. stops runs on banks completely.
   b. encourages banks to hold excess reserves
   c. encourages depositor vigilance about bank safety and soundness.
   d. encourages banks to engage in riskier lending practices than without it.

50. When inflation is higher than expected, it redistributes wealth from
   a. employers to employees under nominal wage contracts.
   b. borrowers to lenders.
   c. lenders to borrowers.
   d. the federal government to taxpayers.

**NOTE:** You should also be able to solve problems such as: (a) rate of return on a bond; (b) graphing of bond purchases/sales in the US Govt bond market or foreign exchange market; (c) basic measures in bank analysis; and (d) calculate the precise deposit multiplier.