Economics 470/570 **Name: ______________________________**
Fall 2011
Midterm Exam 1

Part I - Definitions. Define each of the following (4 points each, 20 points total).

1. Fiat money
2. Discount window
3. Federal funds rate
4. Moral hazard
5. FOMC

Part II. Answer each of the following questions (16 points each, 80 points total).

1. (a) Describe the structure of Federal Reserve districts and Federal Reserve district banks. (b) Describe the major functions of Federal Reserve district banks.

2. (a) Suppose that there are 10 individuals, each with $10,000 in savings that they would like to lend. Suppose there are also 100 different people who want to take out $1,000 loans. Assuming an expected default rate of 10%, use this example to show how pooling risk through financial intermediation can increase the efficiency of financial markets. (b) Besides pooling risk, pooling small deposits, and pooling over time, what else do financial intermediaries do to increase the efficiency of financial markets?

3. (a) How independent is the Fed? What factors contribute to independence? What factors work against independence? (b) Discuss arguments for and against the independence of the Fed.

4. (a) What is adverse selection? Give an example of adverse selection in financial markets. (b) How can the adverse selection problem be overcome?

5. (a) Suppose that the Fed injects $1,000 in reserves into the banking system. Assuming that the required reserve ratio is 10% and that both excess reserves and currency holdings are zero, use t-accounts to illustrate the multiple deposit creation process. Use this result to obtain the simple deposit multiplier. (b) Explain intuitively how the multiplier changes if banks hold excess reserves.