Economics 470/570
Winter 2014
Midterm Exam 1

Answer each of the following questions (20 points each)

1. (a) Suppose that there are 10 individuals, each with $5,000 in savings that they would like to lend. Suppose also that there is someone who wants to take out a $50,000 loan. Use this example to show how pooling small deposits 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?

2. (a) Who is on the FOMC? What does the FOMC do? (b) How independent is the Fed? What factors contribute to independence? What factors work against independence?

3. (a) Suppose that the Fed sells a $10,000 T-Bill. Assuming that the required reserve ratio is 10% and that both currency holdings and excess reserves are zero, use t-accounts to illustrate the multiple deposit creation process. Use this to obtain the simple deposit multiplier. (b) Explain why the multiplier falls when people hold currency or when banks hold excess reserves.

4. (a) Explain why the demand curve for reserves slopes downward. (b) Suppose that the federal funds rate is at the lower bound, i.e. the supply of reserves is sufficiently large to put the equilibrium on the flat part of the reserve demand curve. Show graphically that the Fed can use either open market operations or the interest it pays on reserves to raise the federal funds rate and fight inflation. (c) Why might the Fed prefer to use changes in the interest on reserves rather than open market operations to fight inflation?

5. (a) What are the functions of money, i.e. why does money exist? Relative to a barter economy, what problems are overcome by the use of money? (b) To be useful as a medium of exchange, what properties should money have?