Review for Final Exam
Money, Banking and Financial Markets

1. What are the benefits to monetary policy rules? What are some of the problems?

2. Give an example of a passive monetary rule. Give an example of an active monetary rule.

3. Explain the recession of 1981 using a properly labeled graph of the Phillips curve. Do the same using the AD/AS model (goods market).

4. Assume that households desire to hold currency outside the banking system in a fixed proportion of their holdings of demand deposits. We can illustrate this relationship by:

\[ C = \{C/D\} \cdot D \]

Banks also hold excess reserves which are a fraction of demand deposits. This relationship is given by:

\[ ER = \{ER/D\} \cdot D \]

There are no traveler's checks and all deposits are demand deposits. Given the above information give an equation describing M1 (\( M1 = C + D \)).

5. What are the Federal Reserve determinants of the money supply? What are the banking system determinants of the money supply? What are the public determinants of the money supply? Think about the equation describing M1 to help answer this question.

6. We discussed how changes in the money supply alters the interest rate. However, interest is not paid in the money market, but in other markets. Explain how an increase in money supply will alter the interest rate. Use the bond market or the loanable funds market in your answer.

7. Explain why the Fed must decide to target interest rate or the money supply but cannot target both. Show this in a graph. Explain why the Fed must decide to target either the price level or real output but cannot target both. Show this in the appropriate graph. Explain why the Fed must decide to target either the rate of inflation or the unemployment rate but cannot target both. Show this in the appropriate graph.

8. What are the three main policy instruments of the Federal Reserve? How would the Fed use each of the three policy instruments if it wanted to increase GDP? Give a detailed explanation of how each of the three policy tools of the Fed alters GDP. Be sure to show you understand each step.

9. The Fed has fewer possible goals in the LR than in the SR. Why is this? Explain. Show this graphically.

10. Briefly explain how an increase in the probability of bank failures would alter the behavior of households. What would this do to the money supply? Briefly explain how the fear of an increase in deposit withdrawals would alter the behavior of banks. What would this do to the money supply?

11. According to most economists, what must be occurring if a country is experiencing high rates of inflation?
12. In a properly labeled graph of the Phillips Curve, show how the Fed’s desire to keep the UR below the natural rate would lead to high inflation. Be sure you can explain movements between SR and LR equilibrium.

13. In a properly labeled graph of the Goods Market, show how labor’s demand for higher wages accompanied by accommodating policy at the Fed would lead to high inflation. Be sure you can explain movements between SR and LR equilibrium.

14. Show the equation that describes a government’s budget constraint. Use it to show how high deficits can lead to high money growth.

15. Explain the difference between monetization of the debt and the direct printing of money. Does the US engage in either of these? If so, which?

16. Periods of hyperinflation helped put two leaders in power that ultimately lead to disastrous results for their countries. Who are these leaders?

17. Show how deficits combined with interest rate targeting by the Fed can lead to high inflation.