Financial Institutions Markets and Money 12th edition Kidwell Test Bank

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CHAPTER 2

TRUE/FALSE QUESTIONS

(F) 1. Deposits should expand when reserve requirements increase.

(F) 2. The Fed's most commonly used tool is reserve requirements.

(T) 3. Federal Reserve regulations affect many nonbank institutions.

(T) 4. Depository institutions create money when they lend or invest excess reserves.

(T) 5. The Federal Open Market Committee basically establishes our nation's monetary policy.

(T) 6. A primary function of the Fed is economic stabilization via control of the money supply.

(F) 8. The Federal Reserve is independently funded and thus immune to any political pressure.

(F) 9. In the check-clearing system DACI usually exceeds CIPC, creating Fed float.

(T) 10. A decrease in Federal Reserve float decreases member bank reserves.

(F) 11. Currency is an asset of the Federal Reserve Banks.

(F) 12. A decrease in reserve requirements increases the total level of member bank reserves.

(F) 13. An increase in the money supply does not affect the supply of loanable funds.

(F) 14. Open market purchases by the Fed reduce total reserves in the banking system.

(T) 15. Monetary policy is a highly partisan issue.

(T) 16. The Fed can change the level of member bank reserves as well as reserve requirements.

(T) 17. The first impact of monetary policy upon depository institutions is via excess reserves.

(F) 18. Deposits should expand when the Fed sells securities.

(F) 19. The Discount Rate provides the Fed with direct control on the money supply.

(T) 20. The Federal Reserve is this nation's first permanent central bank.

(F) 21. The Federal Reserve System replaced the National Banking system.

(F) 22. Congress has no oversight of the Fed.

(F) 23. Excess reserve balances pay interest; required reserve balances do not.

(T) 24. Open Market Operations are the primary tool of monetary policy today.

(T) 25. The TARP program allowed the government to purchase troubled loans from banks during and after the financial crisis.

(T) 26. As the Fed expands the monetary base, bank loans and investments should expand also.

(T) 27. Though decentralized in geography, today’s Fed is highly centralized in power structure.

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(T) 28. There are 12 Federal Reserve District banks today.

(F) 29. The “monetary base” comprises the Fed’s most important assets.

(T) 30. The Federal Reserve Bank of New York is the “headquarters” of open market operations.

(F) 31. The Federal Reserve was created in 1933 as a result of the Great Depression.

(F) 32. Reserve requirements apply only to member banks in Federal Reserve System.

(T) 33. The most important new power granted to the Fed by the Dodd-Frank Act was to expand its power to manage systemic risk.

(T) 34. All national banks must join the Federal Reserve System.

(T) 35. Quantitative easing consists of the Fed buying bonds even when interest rates are low.

(F) 36. Excess reserves cost a depository institution nothing to maintain.

(F) 37. The monetary base comprises currency in circulation and checks not yet cleared.

(T) 38. A major asset of the Federal Reserve is U.S. Treasury securities, and the major liability is currency outside banks.

(T) 39. The seven members of the Board of Governors of the Federal Reserve System serve 14 year nonrenewable terms. Each Board member is appointed by the President and confirmed by the Senate.

(F) 40. The current chair of the Federal Reserve is Ben Bernanke.

(F) 41. If the FOMC wished to slow down economic growth and slow growth in the price level, they could issue a policy directive to the Federal Reserve Board Trading desk to purchase U.S. government securities.

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MULTIPLE-CHOICE QUESTIONS

(b) 1. Federal Reserve profitability
- a. was negative from 2006 through 2008.
- b. increased dramatically after 2009.
- c. has fallen since the financial crisis.
- d. fell every year after 2009.

(d) 2. Which of the following can be associated with the original objectives of the Fed?
- a. coordinate an efficient payments mechanism.
- b. provide an elastic money supply.
- c. serve as lender of last resort.
- d. all of the above

(a) 3. The primary responsibility of the Federal Open Market Committee (FOMC) is to
- a. set monetary policy
- b. supervise and examine member banks.
- c. guarantee excess reserves to National Banks.
- d. enforce margin requirements

Use this data to answer questions 4-6:
Total Reserves $80,000,000; Reserve Requirement 5%; Total Deposits $700,000,000.

(b) 4. Using the data above, the level of excess reserves is
- a. $ 4,000,000
- b. $ 45,000,000
- c. $ 70,000,000
- d. not ascertainable

(d) 5. The data above exemplify
- a. an arguable underutilization of resources, at least for the moment
- b. an excess reserve position
- c. a likelihood that loans and deposits will expand
- d. all of the above

(a) 6. The data above could indicate
- a. banks lack loan demand.
- b. the Fed should raise reserve requirements.
- c. the Fed should increase the interest rate paid on reserves.
- d. banks should have higher capital requirements.

(b) 7. The asset of Federal Reserve banks associated with open market operations is
- a. Federal Reserve notes.
- b. U.S. government securities.
- c. loans to member banks.
- d. float.

(c) 8. The Treasury draws most of its checks upon
- a. the Comptroller of the Currency.
- b. national banks.
- c. Federal Reserve banks.
- d. its own required reserves

(d) 9. For what purposes do depository institutions keep deposits in the Federal Reserve banks?

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a. for clearing checks
b. to satisfy reserve requirements
c. to earn interest
d. all of the above

(a) 10. Federal Reserve notes held in bank vaults are the liability or obligation of
a. the Fed.
b. the Treasury.
c. the bank.
d. none of the above

(b) 11. Federal Reserve float
a. is the "lag time" required for monetary policy to take effect
b. represents a net extension of credit by the Fed, which increases bank reserves.
c. represents a net liability of the Fed.
d. is DACI minus CIPC.

(a) 12. When the New York Fed sells Treasury securities to a securities dealer
a. depository institutions deposits in the Fed decrease.
b. depository institutions deposits in the Fed increase.
c. interest rates will fall.
d. bank lending will rise.

(c) 13. Which Fed action *directly* increases total reserves in the banking system?
a. Lowering the Discount Rate
b. Lowering the target Fed Funds rate
c. Buying U.S. Government securities on the open market
d. None of the above

(a) 14. To increase the money supply immediately but just slightly, the Fed would most likely
a. Buy securities on the open market
b. Lower the Discount Rate
c. Lower reserve requirements
d. Any of the above would be suitable for this purpose.

(d) 15. Reserve requirements apply to
a. National banks
b. State banks
c. Savings-and-loan associations
d. All of the above

(c) 16. The least used tool of monetary policy by the Fed is
a. changing the discount rate.
b. open market operations.
c. adjusting reserve requirements.
d. changing the Federal Funds target rate.

(b) 17. The 12 Federal Reserve Banks are
a. Important and autonomous components of a "decentralized central bank."
b. Important components of the Fed, but no longer very autonomous.
c. Neither important nor autonomous.
d. All permanently voting members of the FOMC.

(b) 18. From 2008 to 2015 the Federal Reserve asset that declined the most on a percentage basis was

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a. gold certificates.
b. U.S. government and agency securities
c. mortgage backed securities.
d. CIPC.

(d) 19. Which of the following is in the correct chronological order?
a. Second Bank of the United States, Federal Reserve Act, Crash of 1907
b. Crash of 1907, Federal Reserve Act, National Banking Acts
c. First Bank of the United States, Crash of 1907, National Banking Acts
d. Second Bank of the United States, National Banking Acts, Federal Reserve Act

(c) 20. From 2008 to 2015 the Federal Reserve asset that increased the most on a percentage basis was
a. gold certificates.
b. U.S. government and agency securities
c. mortgage backed securities.
d. CIPC.

(c) 21. The Fed's non-monetary or regulatory powers do NOT include
a. Margin requirements
b. Interest rate disclosures on deposits
c. Investigation and prosecution of counterfeiting
d. Bank holding companies

(d) 22. Which of the following was a responsibility of the early Federal Reserve System?
a. to control the money supply
b. to safeguard the national payment system
c. to establish a more rigorous bank supervisory system
d. all of the above

(c) 23. The Federal Reserve System established
a. a system for federal chartering of banks.
b. a system for controlling bank note issuance.
c. a source of liquidity for the banking system.
d. the beginning of demand deposit accounts.

(b) 24. Increases in the Fed's assets
a. decrease the monetary base
b. increase the monetary base
c. have no effect on the monetary base.
d. none of the above

(d) 25. Which of the following can be associated with the modern objectives of the Fed?
a. coordinate an efficient payments mechanism.
b. provide an elastic money supply.
c. regulate the financial system.
d. all of the above.

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(b) 26. Reforms and regulatory changes in U.S. financial institutions are best associated with:
a. international events affecting U.S. financial institutions.
b. periods of severe economic and financial problems in the U.S. economy.
c. voters changing the majority party in Congress.
d. recommendations of presidential commissions.

(b) 27. Excess reserves are equal to
a. required reserves – total reserves
b. total reserves – required reserves
c. nonborrowed reserves – borrowed reserves
d. total reserves – discounted reserves

(d) 28. There are _____ members of the Federal Reserve Board of Governors, _____ members of the Federal Open Market Committee, and _____ Federal Reserve Banks.
a. 12; 7; 12
b. 7; 14; 12
c. 14; 12; 12
d. 7; 12; 12

(c) 29. All of the following are locations of Federal Reserve Banks except
a. San Francisco
b. Dallas
c. Washington, DC
d. Kansas City

(b) 30. The Fed began paying interest on reserves in
a. 2007
b. 2008
c. 2009
d. 2010

(b) 31. The Discount Window
a. allows banks to borrow and lend to each other.
b. relates to the Fed's "lender of last resort" function
c. is a relatively recent innovation in the design of the Federal Reserve System
d. is available only during emergencies

(c) 32. The Fed's most important duty is to
a. regulate national banks
b. print currency
c. establish the nation's monetary policy
d. stimulate the economy

(a) 33. The major asset of the Federal Reserve is
a. The U.S. Treasury securities
b. Depository institution reserves
c. Currency outside banks
d. Vault cash of commercial banks
e. Gold and foreign exchange

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(b) 34. The Fed changes reserve requirements from 10% to 7%, thereby creating $900 million in excess reserves. The total change in deposits (with no drains) would be
a. $3,000 million
b. $12,857 million
c. $13,652 million
d. $15,795 million

(b) 35. Nationally chartered banks receive chartering and merger approval from the
a. Federal Deposit Insurance Corporation
b. Office of Comptroller of the Currency
c. Federal Reserve System
d. Office of Thrift Supervision

(a) 36. The fed funds rate is the rate that
a. Banks charge each other on loans of excess reserves
b. Banks charge to lend foreign exchange to customers
c. The Federal Reserve charges on emergency loans to commercial banks
d. Banks charge for loans to corporate customers

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ESSAY QUESTIONS

1. Explain why the Federal Reserve is less "independent" than it appears to be.

   Answer: What Congress creates, Congress can modify or destroy. Congress has from time to time established guidelines or objectives for the Fed (e.g. Humphrey-Hawkins, 1978). The Fed remains independent because most politicians want it that way. They mostly agree that monetary policy is not a partisan issue. An independent Fed can also absorb blame if the economy falters, and take necessary but unpopular steps to combat various economic ills. If Congress should change its mind, the Fed's independence could vanish at the stroke of a pen.

2. Compare and contrast the "tools of monetary policy" in terms of their relative usefulness.

   Answer: The discount rate and reserve requirements are both original design features of the Fed; open market operations have evolved as the FOMC has evolved. The discount rate was originally a direct control of the cost of funds to member banks; today it is more of a signal of the Fed's intent, as relatively few institutions borrow at the Window. Reserve requirements have always been a direct control on the ultimate expansion of deposits and loans, but changing them affects the banking system so dramatically that the Fed cannot use them for the "fine tuning" it prefers. Open market operations affect reserve levels directly, immediately, and dollar-for-dollar. Their flexibility and precision make them the most useful—and thus the most important—tool. In 2008 the Fed began paying interest on reserves held at the Fed. This policy tool was added to give the Fed more flexibility in impacting the amount of reserves that flow through the economy. For instance the Fed can increase the rate earned on reserves to quickly slow bank lending if inflation is increasing.

3. How has the power structure of the Fed changed since 1913?

   Answer: The Fed has centralized as the U.S. has evolved from a confederation of regional economies to a truly national economy. The 12 Federal Reserve Banks, once largely autonomous in their respective regional districts, remain operationally important but have lost their authority to set monetary policy. They are a minority (5 votes out of 12) on the FOMC, which sets U.S. monetary policy under ultimate control of the Board of Governors.

4. Assume the Fed pays $1000 for a government bond on the open market. With a 5% reserve requirement, what is the theoretical ultimate addition to the money supply, and why?

   Answer: With a 5% required reserve ratio, the theoretical loan/deposit expansion from the $1000 injection of new reserves, is 1000/.05 or $20,000. An open market purchase creates new excess reserves. Depository institutions, if they are profit maximizers, will lend or sell any excess reserves, expanding assets and deposits until any reserves are again absorbed as required reserves.

5. Why is changing the discount rate not a viable tool for conducting monetary policy?

   Answer: Changes to the discount rate will affect the money supply only if depository institutions choose to "go to the Window". Regulators closely scrutinize Window borrowing, so it is not a first or regular choice for raising liquidity. Most borrowing at the Window that does take place is short-term, so the ultimate effect on the money supply is hard to predict.

6. What are margin requirements, and why do they exist?

   Answer: After 1929 stock market crash, the Fed was empowered to regulate buying of securities "on margin" (i.e. with borrowed money). Margin requirements determine how much

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of the securities' value can be used as collateral. The Fed uses these regulations to deter the use of borrowed money to finance speculation in the capital markets.

7. What are the bodies of the Federal Reserve System?

Answer: The Federal Reserve System consists of
a. Board of Governors;
b. Federal Reserve Banks and Branches over the country;
c. The Federal Open Market Committee

8. What is the relationship between central bank independence and inflation?

Answer: Countries that have more independent central banks tend to have lower amounts of inflation. See Exhibit 2.7 for instance. This is because independence reduces the temptation to create more money to finance deficit spending by central governments. Excessive money creation can be inflationary.

9. How has the Fed's balance sheet changed since 2008? Why have these changes occurred and what are their implications?

Answer: The Fed's balance sheet has grown dramatically due to quantitative easing (purchasing bonds by creating money). The Fed has purchased large quantities of mortgage backed securities so this component has grown dramatically and thereby reduced the percentage of Fed investments in Treasuries. The Fed's balance sheet is also riskier than it was in the past. It has increased Fed profitability dramatically (the profits are remitted to the Treasury), but this could change if the mortgage backed securities default. So for the first time the Fed's balance sheet faces substantial credit risk.

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