

Sample Multiple-Choice Questions

Circle the letter of each correct answer.

- The M1 definition of money includes which of the following?
 - Currency
 - Demand deposits (checkable deposits)
 - Savings accounts and small time deposits
 - Eurodollars
 - I only
 - II only
 - III only
 - I and II only
 - II, III and IV only
- If the legal reserve requirement is 25 percent, the value of the simple deposit expansion multiplier is
 - 2.
 - 4.
 - 5.
 - 10.
 - 1.0.
- When money is used as a standard of value, a person is
 - earning more money than before.
 - purchasing a necessity.
 - making a financial transaction.
 - making price comparisons among products.
 - writing a check for groceries.
- Which of the following are true statements about the federal funds rate?
 - It is the same thing as the discount rate.
 - It is the interest rate that banks charge each other for short-term loans.
 - It is influenced by open market operations.
 - I only
 - II only
 - III only
 - I and II only
 - II and III only
- Suppose the Federal Reserve buys \$400,000 worth of securities from the securities dealers on the open market. If the reserve requirement is 20 percent and the banks hold no excess reserves, what will happen to the total money supply?
 - It will be unchanged.
 - It will contract by \$2,000,000.
 - It will contract by \$800,000.
 - It will expand by \$2,000,000.
 - It will expand by \$800,000.
- The money market is definitely in equilibrium in which of the following cases?
 - When velocity is constant
 - When the quantity of money demanded equals the quantity of money supplied
 - When the present value is equal to the interest rate
 - When the present value is greater than the interest rate
 - When the interest rate is equal to the price of bonds
- A commercial bank holds \$500,000 in demand deposit liabilities and \$120,000 in reserves. If the required reserve ratio is 20 percent, which of the following is the maximum amount by which this single commercial bank and the maximum amount by which the banking system can increase loans?

	Amount Created by Single Bank	Amount Created by Banking System
(A)	\$5,000	\$25,000
(B)	\$20,000	\$80,000
(C)	\$20,000	\$100,000
(D)	\$30,000	\$150,000
(E)	\$120,000	\$500,000

8. Which of the following does the Federal Reserve use most often to combat a recession?
- (A) Selling securities
 - (B) Buying securities
 - (C) Reducing the reserve requirement
 - (D) Increasing the discount rate
 - (E) Increasing the federal funds rate
9. To reduce inflation, the Federal Reserve could
- (A) expand the money supply in order to raise interest rates, which increases investment.
 - (B) expand the money supply in order to lower interest rates, which increases investment.
 - (C) contract the money supply in order to lower interest rates, which increases investment.
 - (D) contract the money supply in order to raise interest rates, which decreases investment.
 - (E) buy bonds and decrease the discount rate to encourage borrowing.
10. Reserves, the money supply and interest rates are most likely to change in which of the following ways when the Federal Reserve sells bonds?
- | Reserves | Money Supply | Interest Rates |
|--------------|--------------|----------------|
| (A) Increase | Increase | Increase |
| (B) Increase | Increase | Decrease |
| (C) Decrease | Increase | Decrease |
| (D) Decrease | Decrease | Increase |
| (E) Decrease | Decrease | Decrease |
11. Which of the following actions by the Federal Reserve will result in an increase in banks' excess reserves?
- (A) Buying bonds on the open market
 - (B) Selling bonds on the open market
 - (C) Increasing the discount rate
 - (D) Increasing the reserve requirement
 - (E) Increasing the federal funds rate
12. Aggregate demand and aggregate supply analysis suggests that, in the short run, an expansionary monetary policy will result in
- (A) a shift in the aggregate demand curve to the left.
 - (B) a shift in the aggregate supply curve to the left.
 - (C) an increase in real GDP without much inflation when the economy is on the horizontal portion of the aggregate supply curve.
 - (D) an increase in real GDP with high inflation when the economy is on the horizontal portion of the aggregate supply curve.
 - (E) an increase in real GDP and no inflation when the economy is on the vertical portion of the aggregate supply curve.
13. Which of the following combinations of monetary policy actions would definitely cause a decrease in aggregate demand?
- | Discount Rate | Open Market Operations | Reserve Requirement |
|---------------|------------------------|---------------------|
| (A) Decrease | Buy bonds | Decrease |
| (B) Decrease | Sell bonds | Decrease |
| (C) Increase | Buy bonds | Increase |
| (D) Increase | Sell bonds | Decrease |
| (E) Increase | Sell bonds | Increase |
14. Which of the following is most likely to increase the velocity of money?
- (A) Higher frequency of paychecks
 - (B) Decrease in the price level
 - (C) Decrease in interest rates
 - (D) Decrease in personal income
 - (E) Increase in the unemployment rate

15. Which of the following characteristics of money could be found in bars of gold?
- (A) Portability, uniformity and stability in value
 - (B) Portability and acceptability
 - (C) Uniformity, acceptability and stability in value
 - (D) Uniformity and durability
 - (E) Portability and stability in value
16. The real interest rate is simply stated as the
- (A) price of borrowed money in the future.
 - (B) inflation rate minus the CPI.
 - (C) nominal interest rate over time.
 - (D) nominal interest rate minus the expected inflation rate.
 - (E) nominal interest rate plus the expected inflation rate.
17. Vault cash and reserve accounts are similar in that each
- (A) earns no interest.
 - (B) provides for the bank's use of large amounts of cash.
 - (C) is maintained by the bank at a fixed percentage set by the Federal Reserve.
 - (D) is kept on account at the Federal Reserve Bank.
 - (E) is part of the money supply.
18. The neutrality of money refers to the situation where
- (A) money has not been the cause of war.
 - (B) increases in interest rates are matched by decreases in the price of bonds.
 - (C) increases in interest rates are matched by increases in the price of bonds.
 - (D) increases in the money supply eventually result in no change in real output.
 - (E) decreases in the money supply result in increases in the interest rate in the short run.
19. Expansionary monetary policy results in which of the following in the short run?
- I. The money supply increases.
 - II. The nominal interest rate decreases.
 - III. The real interest rate decreases.
 - IV. Bond prices decrease.
- (A) I and II only
 - (B) I, II and III only
 - (C) I, II and IV only
 - (D) III and IV only
 - (E) IV only
20. True statements about expansionary monetary policy in the long run include which of the following?
- I. Price level increases to match the increase in the money supply.
 - II. The nominal interest rate equals the real interest rate plus the expected inflation rate.
 - III. The real output level has not permanently increased.
- (A) I only
 - (B) II only
 - (C) III only
 - (D) I and II only
 - (E) I, II and III

Sample Short Free-Response Questions

- *1. The reserve requirement for the banking system is 20 percent. Currently Third National Bank has no excess reserves. Then Behroz deposits \$100 in her checking account at Third National.
- (A) Explain, without using a mathematical formula, why Behroz's deposit can lead to an increase in the money supply that is greater than \$100.

(B) Discuss two limitations of this process.

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2. The Federal Reserve has three primary tools to expand or contract the money supply.
- (A) List the three tools.

 - (B) Which tool does the Fed use most often?

 - (C) Explain why the Federal Reserve uses the tool you indicated in Question 2(B).
3. Milton Friedman has said, "Inflation is primarily a monetary phenomenon."
- (A) Describe the conditions under which an increase in the money supply would be inflationary.

 - (B) Use an aggregate supply and aggregate demand graph to show the conditions under which increases in the money supply are entirely inflationary.

4. Explain the statement that the Federal Reserve can “target” the size of the money supply or the interest rate, but not both.
5. Suppose the required reserve ratio is 0.20.
- (A) What would be the value of the deposit expansion multiplier? _____
- (B) Discuss why it is unlikely that a new deposit of \$1,000 to a checking account would result in the money supply fully increasing as indicated by the deposit expansion multiplier.
6. Banks can borrow reserves at either the federal funds rate or at the discount rate.
- (A) Define the federal funds rate.
- (B) Define the discount rate.
- (C) Under what conditions would banks borrow at the discount rate?

Sample Long Free-Response Questions

1. Suppose the economy is experiencing rising unemployment, slowing increases in real GDP and modest inflation. The Federal Reserve decides to follow an expansionary policy.
 - (A) Describe what this policy might include.

- (B) If the policy is effective, explain the short-run effect it would have on each of the following:
 - (i) Interest rates
 - (ii) Private investment
 - (iii) GDP
 - (iv) Employment

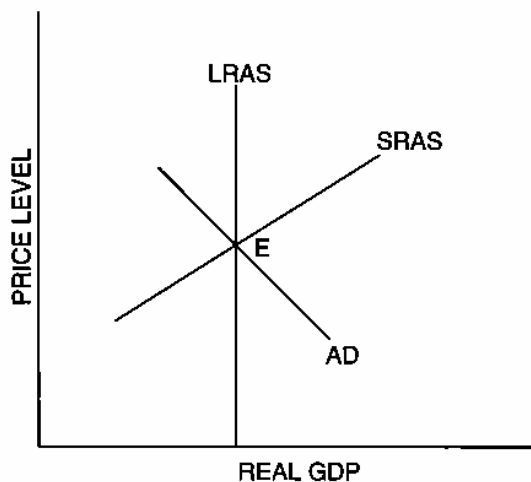
2. The Federal Reserve Board of Governors determines that it is currently appropriate to follow a contractionary policy.

(A) Use a correctly labeled aggregate demand and aggregate supply graph to illustrate the situation that would make this policy appropriate.

(B) Would the monetary policy be to increase or decrease the money supply? Explain.

- (C) Describe the policy the Federal Reserve is likely to take, and explain how its action achieves the goal of following a contractionary policy. Explain how the policy would affect each of the following:
- (i) Interest rates
 - (ii) Investment
 - (iii) Output
 - (iv) Price level
 - (v) Employment

3. Suppose the economy is at E in the graph below and the Federal Reserve decides to implement expansionary monetary policy to reduce the unemployment rate.



- (A) Explain the short-run effect of the expansionary policy on each of the following:

- (i) Nominal interest rates
- (ii) Real interest rates
- (iii) Output
- (iv) Price level
- (v) Employment

- (B) Explain the long-run effect of the expansionary policy on each of the following:

- (i) Output
- (ii) Price
- (iii) Employment
- (iv) Nominal interest rates
- (v) Real interest rates