CHAPTER 2

TRUE/FALSE QUESTIONS

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

(F) 2. The Fed's most influential 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 is a direct control on the money supply.

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

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

(F) 22. Congress is powerless over 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.

(F) 25. A Fed governor has a lifetime appointment.

(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.

(T) 28. Reserve requirements are not considered a viable tool of monetary policy.

(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.

(T) 31. No two Governors may be from the same Federal Reserve District.

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

(F) 33. The Chairman of the Fed is highly visible, but not very powerful.

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

(T) 35. Margin requirements are an important regulatory power of the Fed.

(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. The major asset of the Federal Reserve is the 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 Federal Reserve is Joe Biden.

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

MULTIPLE-CHOICE QUESTIONS

(b) 1. Number of Federal Reserve Governors plus size of FOMC less number of Federal Reserve banks equals:
- a. 9.
- b. 7.
- c. 14.
- d. 12.

(d) 2. Which of the following can be associated with 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 near-term likelihood that loans and deposits will expand
- d. all of the above

(a) 6. The data above could exemplify a direct, immediate effect of any of the following *except*
- a. an open market sale by the Fed
- b. a lowering of reserve requirements by the Fed
- c. a new loan at the Discount Window by the Fed
- d. an open market purchase by the Fed

(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?
- a. for clearing checks
- b. to satisfy reserve requirements
- c. to earn interest
- d. a and b

(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.

(d) 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. the deposit balance of the security dealer in its bank decreases.
d. both a and c above.

(a) 13. Which Fed action does NOT *directly* increase total reserves in the banking system?
a. Lowering the Discount Rate
b. Lowering reserve requirements
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

(d) 16. The Fed's primary tools of monetary policy include all the following except
a. changing the discount rate.
b. open market operations.
c. adjusting reserve requirements.
d. changes in the Federal Funds 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. The purchase of government securities by the Fed will
a. decrease the money supply.
b. increase security prices.
c. increase interest rates.
d. decrease credit availability.

(d) 19. Which of the following is in the correct historical 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

(d) 20. The Fed's most visible monetary tool is probably
a. open market operations.
b. change in reserve requirements.
c. Reg Z.
d. discount rate policy

(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.

(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. voter changing the majority party in Congress.
- d. recommendations of presidential commissions.

(b) 27. Who among the following does NOT have a permanent vote on the FOMC?
- a. President, Federal Reserve Bank of New York
- b. Chairman, Board of Governors
- c. President, Federal Reserve Bank of Los Angeles
- d. Members of the Board of Governors

(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. An increase in Federal Reserve float
- a. decreases bank reserve deposits in the Fed.
- b. increases bank reserve deposits in the Fed.
- c. has no impact upon bank reserves deposits in the Fed.
- d. reduces the net loan granted by the Fed to member banks.

(b) 31. The Discount Window
- a. is a common way for depository institutions to raise loanable funds
- 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

(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

(b) 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

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.

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 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