ECON 4100: Monetary Economics **Mid-term exam**
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Questions 1 – 15 are multiple choice; circle the best answer. Questions 16 – 20 are short answer; give a brief answer in the space provided. Each question is worth 5 points.

1. Because of the 'coincidence of wants' problem
   a. barter exchange is not possible.
   b. primitive traders established 'trading posts' and relied on indirect barter.
   c. government's were impelled to create money.
   d. buyers and sellers must want the same things for trade to take place.

2. US Federal Reserve notes, a liability of the U.S. central bank, are a form of __________ money and __________ money.
   a. fiat, base
   b. commodity, base
   c. fiat, credit
   d. commodity, credit

3. According to Radford, cigarettes served as a *unit of account* in World War II prisoner-of-war camps. This means that
   a. cigarettes were generally accepted in exchange throughout the camp.
   b. cigarettes were used as a store of value.
   c. prices of other goods were quoted in terms of cigarettes.
   d. cigarettes were generally not consumed in the camps.

4. Suppose that we estimate that the nominal stock of money rises by 6% over the year, while the rate of inflation is 3% over the same period. During this period, the rate of growth of the real money supply has been
   a. –2% .
   b. 2%.
   c. –3%.
   d. 3%.
   e. none of the above.

5. Which of the following events will cause the price level to fall in a country under a gold standard?
   a. The discovery of a new technology that reduces the cost of mining gold.
   b. An increase in the demand for real money balances (but only in the short-run).
   c. A decrease in the gold reserve-ratio (k).
   d. An increase in goods exported abroad.
   e. None of the above.

6. In the long-run, what would we expect to happen to a gold standard economy's price level (P) and nominal stock of money (M) if the monetary authority increases its gold reserve ratio?
   a. P will decrease and M will increase.
   b. Both P and M will decrease proportionately.
   c. Both P and M will remain the same.
   d. P will not change, but M will increase.
   e. P will decrease, but M will not change.

7. Suppose that under a bimetallic monetary system the market price of gold in units of silver falls significantly below the mint ratio as defined by the government. Which of the following will likely result?
   a. Gold will be driven out of circulation as money.
   b. Silver will be driven out of circulation as money.

c. Silver will be exchanged at a premium (i.e. a silver dollar could buy more than a gold dollar).
d. Both (b) and (c) could result.

8. Under bimetallism,
   a. it is not possible for Gresham's Law to hold.
   b. there is typically no single unit of account.
   c. the money supply can be set arbitrarily by the central bank (or government mint).
   d. the rate of exchange between two metals is fixed by the monetary authorities.

9. In a system of fractional reserve banking with many competing banks
   a. the money stock can expand beyond the value of the underlying commodity money.
   b. banks are susceptible to panics and runs.
   c. inter-bank note redemption will prevent inflationary over-expansion of the money supply.
   d. both (b) and (c) are likely to occur.
   e. all of the above are likely to occur.

10. Clearinghouses
    a. promote the use of multi-lateral note clearing instead of net-clearing of notes.
    b. tend to increase the costs of inter-bank note redemption.
    c. can only function properly in a commodity money system.
    d. can act as a 'lender of last resort.'

11. The classical view of the 'lender of last resort' function of central banks
    a. is that central banks should lend to healthy banks in need of liquidity, but at a 'penalty' rate.
    b. is an important component of the proposals of the Free Banking school.
    c. is applicable only under a commodity money system.
    d. was originally espoused by Milton Friedman.

12. At its origin, and for most of its history until the early-20th century, the Bank of England issued banknotes that were fully redeemable in gold. However, the Bank was forced to suspend convertibility from _______ to _______ because of its needs for war finance.
    a. 1694 to 1711
    b. 1833 to 1844
    c. 1821 to 1844
    d. 1797 to 1821

13. The US Coinage Act of 1873
    a. eliminated the free coinage of silver in the US.
    b. raised the gold-silver mint ratio, so that gold in effect replaced silver as money in the US.
    c. legalized the issue of US government notes, or "Greenbacks."
    d. did none of the above.

14. If the current price of a multi-period coupon bond is greater than its face value,
    a. its yield to maturity will be less than the coupon rate.
    b. its rate of return will be less than the coupon rate.
    c. its yield to maturity will be greater than the coupon rate.
    d. its rate of return will be greater than the coupon rate.

15. If a borrower fails to pay back his loan from you because he lost the funds gambling in Las Vegas instead of financing his new software company, you have fallen prey to the
    a. adverse selection problem of financial transactions.
    b. debt-deflation problem of financial transactions.
    c. moral hazard problem of financial transactions.
    d. coincidence of wants problem of financial transactions.

16. How does a medium of exchange arise from ‘indirect barter?’

17. What happened to prices in Radford’s POW camp when there was a cigarette delivery? Why?

18. The purchasing power of gold rose in the US from 1870 to 1900. During this period, what must have happened to the overall price level in the US?

19. Gresham’s Law is often taken to mean that “bad money drives out good money.” Provide a more precise description of the law in terms of mint and market prices.

20. What is the *real* yield to maturity on a one-year discount bond that sells for $1,000 and has a face value of $1,100, if the expected inflation rate over the year is 7%?

Answers

1. b
2. a
3. c
4. d
5. b
6. c
7. d
8. d
9. e
10. d
11. a
12. d
13. a
14. a
15. c
16. When people accept a good in exchange not because they want it, but because they perceive that others will want it, they engage in indirect barter. When a single item becomes pervasively used in indirect barter, money, or a general medium of exchange, has evolved.
17. Because cigarettes were a commodity money in the POW camps, a cigarette delivery was tantamount to an increase in the supply of money. According to our model of commodity money, this would shift the stock of money curve to the right, driving down purchasing power (or relative price) of cigarettes, which is the same thing as an increase in overall prices of goods.
18. Because the US economy was on a gold standard during this period, so that the nominal price of gold was fixed, the price level would have decreased during this time.
19. Gresham's law: money that is overvalued at mint prices, and therefore undervalued at market prices, will tend to drive money that is undervalued at the mint and overvalued in the market out of circulation.
20. 3%