Masters Macroeconomics Fall 2015

Short Questions Due: 7 October

1. Why are most of us comfortable holding money in the form of bank deposits even though banks only hold a small fraction of their deposits in the form of reserves?

2. Explain why, in a world with no deposit insurance, prospective depositors would look very carefully at a bank's capital (or its owners' equity) before depositing their money in the bank. If deposits are fully insured, do depositors still have the same incentive to monitor bank capital? Who does have such an incentive?

3. Mankiw presents the following formula for the relationship between the amount of money in circulation (*M*) and the monetary base issued by the central bank (*B*):

$$M = \frac{cr+1}{cr+rr} \times B.$$

Use this formula to explain what would happen to the money supply if banks increased the fraction of deposits that they wish to hold as reserves and the central bank did not change the monetary base. If the central bank was aware that this was happening, how should they change the base to keep the money supply stable?

4. Why does the demand for money depend on the nominal interest rate rather than the real interest rate?