2. The following is the balance sheet of First Superior Bank.

Assets		Liabilities and Equity	
Reserves	$200	Demand deposits	$2,000
Loans	$1,800	Equity (net worth)	$0

Assume that the required reserve ratio is 10 percent.

(a) What is the dollar value of new loans that First Superior Bank can make? Explain.

(b) Mr. Smith deposits $100 of cash in a demand deposit account in First Superior Bank. Calculate the maximum amount of new loans that First Superior Bank can now make.

(c) As a result of Mr. Smith's $100 cash deposit, calculate the maximum change over time in each of the following in the banking system.

  (i) Loans

  (ii) Demand deposits

(d) As a result of Mr. Smith's $100 cash deposit, calculate the maximum change over time in the money supply.

(e) Provide one reason why the actual change in money supply can be smaller than the maximum change you identified in part (d).

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3. The following table shows the number of donuts or cupcakes that John and Erica can each produce in one day.

	Donuts	Cupcakes
John	200	100
Erica	150	50

(a) Who has the absolute advantage in producing donuts? Explain.

(b) Who has the comparative advantage in producing donuts? Explain.

(c) Assume that John and Erica decide to specialize according to their comparative advantages and that one cupcake is exchanged for four donuts.

  (i) Indicate whether or not specialization and trade are beneficial to John.

  (ii) Indicate whether or not specialization and trade are beneficial to Erica.

(d) Assume that Erica discovers a new cupcake production technique that will increase her daily production of cupcakes only. Using donuts on the horizontal axis, draw a correctly labeled production possibilities curve for Erica, before and after the technology change in cupcake production.

STOP

END OF EXAM

Question 2

6 points (1+1+2+1+1)

(a) 1 point:
- One point is earned for stating that new loans are zero because the bank has no excess reserves (or because the bank is already fully loaned up).

(b) 1 point:
- One point is earned for correctly calculating the maximum amount of new loans that First Superior Bank can make as $90 (= $100 x (1 − 0.10)).

(c) 2 points:
- One point is earned for correctly calculating the maximum change over time in loans in the banking system as $900 (= $90 × 10).
- One point is earned for correctly calculating the maximum change over time in demand deposits in the banking system as $1,000 (= $100 × 10).

(d) 1 point:
- One point is earned for correctly calculating the maximum change over time in the money supply in the banking system as $900 (= $90 × 10).

(e) 1 point:
- One point is earned for stating that the money supply can be smaller than the maximum change identified when the public holds more money and /or banks hold more excess reserves.