Instructions. This homework is due at the beginning of Session 13. Please submit only one paper per group, via Blackboard. Please make sure that the printed output of your files is intelligible.

1. Read the enclosed article entitled “Why Are Banks Holding So Many Excess Reserves,” by Todd Keister and James McAndrews and then answer the following questions.

(a) Starting in the Fall in 2008, the Federal Reserve has purchased large quantities of financial assets on the open market. Briefly describe the process by which this policy resulted in an increase in the reserves held by banks at the Federal Reserve. In other words: how is it the case that the Fed’s purchase of an asset from a non–bank institution turns out to increase the level of reserves held by banks at the Fed itself? (25 points)

(b) Why was the increase in total reserves accompanied by a rise in excess reserves? Is such rise a signal of the banks’ reluctance to lend to non–financial institutions? (25 points)

(c) Many analysts claim that, unless the Federal Reserve reduces the amount of reserves by selling a large portion of its asset holdings, we are bound for a spike in inflation. Others disagree. Please, provide arguments in support of both claims. (25 points)

(d) Consider the scenario in which the economic recovery gains momentum. Everything else equal, do you expect that monetary aggregates such as M2 will increase? If yes, do you believe that the Federal Reserve should let it happen? To what extent? What policy instruments, if any, should the Fed employ? (25 points)