ECO 301: Money and Banking **Name:** ____________________

Practice Exam 2, Fall 2022
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Multiple choice: Choose the best response to each prompt.

1. Which of the following leads to a reallocation of wealth away from lenders toward borrowers?
   (a) Unexpected deflation
   (b) Increases in real GDP
   (c) Decrease in bond prices
   (d) Unexpected inflation

2. Which of the following is a potential goal for monetary policy consistent with the Fed's primary goals of maximum employment and price stability?
   (a) Open market operation stability
   (b) Stability in reserves
   (c) Interest rate stability
   (d) Stability in the monetary base

3. Which monetary policy tool increases money supply?
   (a) Quantitative easing
   (b) Decrease in the discount rate
   (c) Increase in the federal funds rate
   (d) Open market sale of bonds

4. What is the term used for when the Fed issues statements about the likely conduct for future monetary policy.
   (a) Forward guidance
   (b) Discount agreement
   (c) Money policy testimony
   (d) Taylor rule

5. Which of the following leads to a decrease in the demand for reserves?
   (a) Overnight reverse repurchase agreement
   (b) Increase in the required reserve ratio
   (c) Decrease in financial market volatility
   (d) Quantitative easiing

6. Which of the following describes the demand curve for reserves in the Federal Funds Market?
    (a) As the discount rate increases, the quantity of reserves demanded decreases.
    (b) As the federal funds rate decreases, the quantity of reserves demanded increases.
    (c) As the federal funds rate increases, the quantity of reserves demand increases.
    (d) As the Fed increases the money supply, the quantity of reserves decreases.

7. Which of the following results in an increase in the equilibrium federal funds rate?
    (a) Decrease in the interest rate on reserves.
    (b) A decrease in the amount of reserves that banks choose to hold.
    (c) Open market operation to deecrease in the money supply
    (d) Quantitative easing

8. Which of the following is true regarding the typical risk associated with a long-term U.S. government bonds?
    (a) There is a risk the government will change the interest payments made on the bond.
    (b) There is a risk of default.
    (c) There is a risk of making losses on bonds held and then sold on the secondary market.
    (d) All of these are risks of holding government bonds.

9. What is a debt instrument that makes fixed regular payments of interest and principal until a specified maturity date?
    (a) Fixed-payment loan
    (b) Coupon bond
    (c) Securitized bond
    (d) Discount bond

10. Which of the following would lead to an increase in the present value of a series of fixed future cash flows?
    (a) Increase in the interest rate
    (b) Decrease in the interest rate
    (c) Decrease in the discount rate
    (d) Decrease in the coupon rate

11. Suppose you have a fixed-payment loan with monthly payments. What is the impact of choosing a new fixed-payment loan of the same amount, at the same interest rate, but with a longer term until maturity?

    (a) Increase the total amount paid in interest

    (b) Increase the amount paid in principal.

    (c) All of these happen with a longer term on a fixed-payment loan.

    (d) Increase the monthly payment

12. What is the average return that will be earned on a bond purchased for a given price and held to maturity?

    (a) Interest on asset rate

    (b) Discount rate

    (c) Coupon rate

    (d) Yield to maturity

13. What happens to bond prices in secondary markets when there is a decrease in the interest rate, all other things remaining constant?

    (a) Bond prices may increase or decrease depending on whether bonds were undervalued or overvalued.

    (b) Bond prices do not change

    (c) Bond prices increase

    (d) Bond prices decrease

14. Which of the following creates a potential of making capital losses from buying and selling bonds?

    (a) Increase in inflation rate

    (b) Increase in the depreciation rate

    (c) Decrease in interest rates

    (d) Increase in interest rates

15. Which of the following is true regarding a risk averse financial investor?

    (a) A risk averse financial investor has accepts a lower return for greater risk.

    (b) A risk averse financial investor has a lower demand for bonds than a risk loving financial investor.

    (c) A risk averse financial investor requires a higher expected average return for a financial investment that has a greater possibility of losing value.

    (d) A risk averse financial investor avoids all risks associated with making financial investments.

16. Which of the following causes an increase in demand for a financial asset?

    (a) Greater amount of time and costs to get accurate information on the likely return and risks associated with the financial asset.

    (b) Less risk of loss associated with a financial asset.

    (c) Increase in the supply of an asset.

    (d) Less liquidity for a financial asset.

17. Which of the following is idiosyncratic risk?

    (a) Risk that is common to all assets of a certain type.

    (b) Market risk

    (c) Risk that decreases in economic expansions and increases in economic recessions.

    (d) Risk that is unique to a particular asset that is not necessarily true of the market as a whole.

18. What action is *not* part of the supply of bonds?

    (a) A financial firm selling a bond on the secondary market.

    (b) A corporation issuing new debt.

    (c) The Fed making an open market sale of bonds.

    (d) Banks increasing their reserves and investing less in government and corporate bonds.

19. Suppose there is a decrease in bond market liquidity. What will be the equilibrium impact in the bond market?

    (a) Bond supply will shift to the left, and prices of bonds and interest rates will increase.

    (b) Bond demand will shift to the left, price of bonds will decrease and interest rates will increase.

    (c) Bond demand will shift to the left, price of bonds and interest rates will decrease.

    (d) Bond supply will shift to the left, price of bonds will increase, and interest rates will decrease.

20. Suppose there is an increase in uncertainty for future interest rates. What will happen in the market for bonds?

    (a) There will be greater default risk, and therefore less supply of bonds.

    (b) There will be greater capital gains risk, and therefore less supply of bonds.

    (c) There will be greater capital gains risk, and therefore less demand for bonds.

    (d) There will be less paid in interest, and therefore less demand for bonds.

21. Suppose businesses have a positive outlook for future sales and profitability. What will be the impact on the market for bonds?

    (a) Increase in the demand of bonds leading to an increase in the price of bonds and a decrease in interest rates.

    (b) Decrease in the supply of bonds leading to an increase in the price of bonds and a decrease in interest rates.

    (c) Increase in the supply of bonds leading to a decrease in the price of bonds and an increase in interest rates.

    (d) No change in the market for bonds.

22. Which of the following is true regarding the money supply curve?

    (a) The central bank makes a decision on how much money to supply

    (b) Banks decide how much money to supply

    (c) Businesses and individuals supply money by making purchases

    (d) Businesses supply money by paying wages in labor markets

23. Suppose the central bank conducts an open market purchase of bonds. What is the impact on the market for money?

    (a) Increase in equilibrium interest rate

    (b) Decrease in the equilibrium quantity of money

    (c) Decrease in equilibrium inflation rate

    (d) Decrease in equilibrium interest rate

24. Suppose there is an increase in income. Which of the following will happen?

    (a) Money demand shifts to the left and equilbrium interest rates increase.

    (b) Money demand shifts to the right and equilbrium interest rates increase.

    (c) Money supply shifts to the right and equilibrium interest rates increase.

    (d) Money supply shifts to the right and equilibrium interest rates decrease.

25. Which of the following monetary policies may reduce capital gains/loss risk in the bond market?

    (a) Paying interest on reserves

    (b) Making reverse repurchase agreements

    (c) Forward guidance

    (d) Making open market sales of bonds

Short-answer and problem-solving questions: Provide written answers to each question in the space provided.

26. (6 points) Suppose the Federal Reserve conducts and open market purchase of bonds. Describe and illustrate the impact on reserves and the federal funds rate, using the supply and demand model for reserves.

27. (6 points) Suppose the Federal Reserve increases the interest rate that it pays banks for reserves they hold. Describe and illustrate the impact on reserves and the federal funds rate, using the supply and demand model for reserves.

28. (6 points) Suppose banks decide to hold a smaller portion of their deposits on reserve as a precautionary measure. What defensive open market operation should the Fed conduct to assure that the equilibrium federal funds rate does not change. Use the model for supply and demand for reserves to describe and illustrate the impact of both the change in behavior by banks and the impact of the defensive open market operation.

29. (6 points) Suppose you have an unsubsidized student loan in the amount of \$50,000. You must start making monthly payments on the loan in 24 months, and monthly payments will continue for 10 years. Suppose the interest rate is 7.2%, compounded monthly. Compute the monthly payment amount. To show your work, show the equation for the present value calculation that includes numbers for the numbers in the equation except for the monthly payment, which you will solve for.

30. (6 points) Suppose a 10-year discount bond with a face value of \$1,000 is sold for \$675. Compute the yield to maturity for the discount bond. Show your work.

31. (6 points) Suppose a coupon bond on the secondary market has a face value of \$1,000, makes one payment per year, has an annual coupon rate of 5%, and has 6 years until maturity. Suppose the average market interest rate expected over the next four years is 6%. Use this interest rate to compute the present value of this bond.

32. (6 points) Suppose businesses have a pessimistic outlook, expecting sales and profits to decline over the short to medium term. Describe and illustrate the impact on the market for bonds. What is the equilibrium impact on the price of bonds, interest rate on bonds, and quantity of borrowing?

33. (6 points) Suppose the Fed conducts an open market sale of bonds. Describe and illustrate the impact on the market for bonds. What is the equilibrium impact on the price of bonds and interest rate on bonds?