ECO 301: Money and Banking
Instructor: Dr. James Murray.
Spring 2012
Practice Exam 2

Name: (20 points) ____________________

1. Homeowners selling their houses always know more about their houses than potential buyers.
   (a) (5 points) Describe the type of market failure this causes.
   (b) (5 points) What impact does this market failure have on the price of existing homes?
   (c) (5 points) What impact does this market failure have on the quality of existing homes?
2. Suppose a homeowner takes out a line-of-credit on his house (this is a second mortgage loan, using the real estate as collateral) and there are no restrictions on how the borrower spends the money.
   (a) (5 points) Is this a source of asymmetric information that occurs before or after the financial transaction takes place?
   (b) (5 points) Describe the type of market failure this causes.
   (c) (5 points) Describe the impact the asymmetric information has on the likelihood of repayment and the interest rate on the loan.
3. (10 points) Identify and explain three functions of financial markets.
4. (10 points) Identify and explain three ways financial institutions or financial markets attempt to limit adverse selection.
5. Answer the following questions concerning *liquidity risk*.
   (a) (5 points) Define liquidity risk.
   (b) (10 points) Explain three ways banks attempt to manage liquidity risk.
6. (5 points) Describe the difference between liquidity crisis and a solvency crisis.
7. (10 points) What is the dual mandate for the Federal Reserve? Describe the Federal Reserves macroeconomic policy goals associated with this type of policy.