

ANSWERS AT END

ECONOMICS 353

L. Tesfatsion/Fall 2011

EXERCISE 1: Eight Questions (8 Pts Total)

DUE: Tues., January 18, 12:40pm

****PLEASE NOTE: EXERCISES ARE DUE AT THE BEGINNING OF CLASS ON THE DUE DATE. LATE EXERCISES WILL NOT BE ACCEPTED AFTER DISCUSSION OF ANSWERS HAS BEGUN – NO EXCEPTIONS****

EXERCISE INSTRUCTIONS:

- (1) Please **fill in your name and student ID number** on Side 1 of your bubble sheet and write **353 Exercise 1** in the top margin of Side 1.
- (2) Use a number 2 pencil to **mark your answers** on Side 1 of the bubble sheet to the multiple-choice questions Q1 through Q8 below.
- (3) Each question is worth 1 point.

Q1 (1 point). According to class lectures on Mishkin (Chapter 1), a *business cycle* is a record of the _____.

- A. duration of a company from its founding date to its dissolution date.
- B. currently hottest trends in business product innovation.
- C. recurrent fluctuations that occur in time series data for key macro variables such as aggregate output.
- D. average duration of product cycles, from introduction to obsolescence.

Q2 (1 Point). According to class lectures on Mishkin (Chapter 1), an *interest rate* measures _____.

- A. the cost of borrowing, i.e., the price paid for the rental of funds.
- B. the payment to a stock holder.
- C. the face value of a debt instrument.
- D. the amount an investor is willing to pay to purchase a security in a securities market.

Q3 (1 Point). According to class lectures on Mishkin (Chapter 1), a government is currently running a BUDGET DEFICIT when _____.

- A. current government expenditures exceed the debt ceiling.
- B. current government tax revenues exceed current government expenditures.
- C. current government expenditures exceed current government tax revenues.
- D. bonds previously issued by the government are held by private-sector nationals or by foreign nationals.

Q4 (1 Point). According to class lectures on Mishkin (Chapter 1), assuming no major changes are made in U.S. federal tax rates and U.S. federal government expenditure commitments, the U.S. federal debt held by the public, as a percentage of gross domestic product (GDP), is expected to _____

- A. exhibit much greater fluctuations starting around 2025.
- B. rise rapidly starting around 2025.
- C. stay at a high but steady level starting around 2025.
- D. start to decline starting around 2025.

Q5 (1 Point). According to class lectures on Mishkin (Chapter 1), one likely reason for the increase in the inequality of wealth in the U.S. during 1983-2006 is the _____.

- A. dramatic decrease in the U.S. current account during this time period.
- B. dramatic increase in U.S. interest rates during this time period.
- C. dramatic overall increase in U.S. stock prices and housing prices during this time period.
- D. dramatic rise in the Euro/U.S.\$ exchange rate during this time period.

SEE THE FOLLOWING PAGE FOR Q6-Q8.

Q6-Q8: Questions on the Financial Crisis of 2007-2009

Use the following required course reading to answer questions Q6 through Q8 below:

** Charles I. Jones, “The Global Financial Crisis: Overview,” a 2009 Supplement to *Macroeconomics*, W.W. Norton, 2008. ON-LINE at www.econ.iastate.edu/classes/econ353/tesfatsion/CrisisOverview.Jones.pdf

Q6 (1 Point). Some commentators have blamed Federal Reserve Chairman Alan Greenspan (1987-2006) for keeping interest rates too low between 2002 and 2005, which in turn encouraged and permitted “subprime” borrowers with insufficient income and assets to take out residential home mortgages. However, Jones attributes these low interest rates in large part to ____.

- A. poor monetary policy choices by the National Bureau of Economic Research (NBER).
- B. the high personal saving rate of U.S. consumers.
- C. unusually low spending levels by the U.S. Federal government.
- D. a global saving glut resulting from developing country financial crises in the 1990s.

Q7 (1 Point). Jones lists several major shocks to the economy as proximate (near) causes of the U.S. financial crisis of 2007-2009. These shocks include ____.

- A. a sudden sharp *decline* in the Fed funds rate starting around mid-2006.
- B. a sudden sharp *decline* in housing prices starting around mid-2006.
- C. a sudden sharp *increase* in stock prices starting around mid-2006.
- D. a sudden sharp *fall* in the U.S. employment level starting around mid-2006.

Q8 (1 Point). Jones argues that an innovation known as _____, in combination with excessive subprime lending, made it difficult for investors to understand the riskiness of their portfolios and for regulators to understand the degree to which systemic (correlated) risk was increasing throughout the economy.

- A. *free riding*, i.e., the ability of some people to obtain information “for free” about the earnings prospects of financial assets by simply watching the investment choices of other people who have paid to obtain this information.
- B. *securitization*, i.e., the bundling together of large numbers of individual financial instruments (such as mortgages) followed by the slicing and dicing of these bundled instruments into different pieces for different types of investors.
- C. *junk bonds*, i.e., bonds with poor credit ratings due to their high risk of default that offer high yields in compensation for their riskiness.
- D. *moral hazard*, i.e., the possibility that a borrower will use his borrowed funds for riskier projects than the lender intended when the lender set the terms of the loan.

Multiple Choice Answers: Q1-C, Q2-A, Q3-C, Q4-B, Q5-C, Q6-D, Q7-B, Q8-B