

ANSWERS AT END

ECONOMICS 353

L. Tesfatsion/Spring Semester 2011

EXERCISE 6: Eight Questions (8 Pts Total)

DUE: Tues., March 1, 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****

- (1) Please **fill in your name and student ID number** on Side 1 of your red bubble sheet and write **353 Exercise 6** in the top margin of Side 1. (Red bubble sheets will be handed out in class each Tuesday and can also be obtained from the Econ Undergraduate Office in 174 Heady during normal business hours M-F.)
- (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. Questions Q1-Q5 can be answered using required course materials for Mishkin Chapter 4:Part B (pp. 80-89) and Mishkin Chapter 5. Questions Q6-Q8 on “What’s the Scoop on Quantitative Easing (QE2)?” can be answered using the accompanying links to online readings.

Q1. Let i denote the average yield to maturity on coupon bonds. In which of the following situations should you prefer to be in if you are **PLANNING TO BORROW** though coupon bond transactions?

- A. $i = 2$ percent and the expected inflation rate = -1 percent
- B. $i = 7$ percent and the expected inflation rate = 3 percent
- C. $i = 13$ percent and the expected inflation rate = 11 percent
- D. $i = 25$ percent and the expected inflation rate = 20 percent

Q2. Smart investors need to understand the **DISTINCTION** between the yield to maturity (YTM) on a financial asset and its return rate because _____

- A. many investors end up having to sell financial assets prior to their maturity.
- B. the yield to maturity assumes the asset will be held to maturity, whereas the return rate can be calculated for any holding period.
- C. the yield to maturity ignores capital gain or loss that might accrue to an investor who sells a financial asset prior to maturity.
- D. the return rate for any given holding period takes into account capital gain or loss over the holding period as well as payments received over the holding period.
- E. all of the above.

Q3 (1 point). If there currently is an EXCESS SUPPLY of Ames municipal bonds, then the theory in Mishkin Chapter 5 predicts that (all else equal) the current price of these bonds is _____ the equilibrium price level and hence will _____.

- A. above; be bid upwards until demand equals supply
- B. above; be bid downwards until demand equals supply
- C. below; be bid upwards until demand equals supply
- D. below; be bid downwards until demand equals supply

Q4 (1 point). If a sudden DECREASE occurs today (Feb 22, 2011) in the future yield to maturity that borrowers and lenders EXPECT will hold for bonds in January of 2012, then (all else remaining equal) one would expect to see _____ in the demand for bonds today because of _____.

- A. an increase; a higher expected capital gain from Jan 2012 to Jan 2013
- B. a decrease; a lower expected capital gain from today through Jan 2012
- C. an increase; a higher expected capital gain from today through Jan 2012
- D. a decrease; a lower expected capital gain from Jan 2012 to Jan 2013
- E. none of the above

Q5 (1 point). If the market for U.S. Treasury bonds is currently in a demand=supply equilibrium, and suddenly Fed Chairman Ben Bernanke announces that he has good reason to believe that NEXT YEAR the inflation rate will be LOWER than currently anticipated, then the analysis in Mishkin Chapter 5 predicts that (all else equal) the equilibrium price of U.S. Treasury bonds today will _____ and the equilibrium quantity of these bonds sold today will _____.

- A. rise; rise
- B. fall; fall
- C. fall; rise
- D. either rise or fall (effect is theoretically ambiguous); rise
- E. rise; either rise or fall (effect is theoretically ambiguous)

SEE THE FOLLOWING PAGE FOR Q6-Q8.

Q6-Q8: “What’s the Scoop on Quantitative Easing (QE2)?” Please use the following required (**) online readings to answer Q6-Q8 below.

** [1] “Open Market Operations,” Wikipedia, accessed Feb 22, 2011.

http://en.wikipedia.org/wiki/Open_market_operations

** [2] “Quantitative Easing,” New York Times, December 14, 2010.

www.econ.iastate.edu/classes/econ353/tesfatsion/QuantitativeEasing.NYTDec2010.pdf

** [3] Ben S. Bernanke, “What the Fed did and why: Supporting the recovery and sustaining price stability,” The Washington Post, Nov 4, 2010.

www.econ.iastate.edu/classes/econ353/tesfatsion/BernankeQE2.Nov2010.pdf

** [4] Deborah Lynn Blumberg, “Despite Dissent, QE2 Sails On,” Barron’s, Feb 12, 2011.

www.econ.iastate.edu/classes/econ353/tesfatsion/QE2SailsOn.Barrons.12Feb2011.pdf

Q6 (1 Point). According to Ref.[1], an OPEN-MARKET OPERATION in the U.S. is when the Federal Reserve attempts to ____

- A. lower longer-term U.S. interest rates by increasing the U.S. money supply through purchases of longer-term securities from the private sector.
- B. influence the federal funds rate and other short-term U.S. interest rates by changing the U.S. money supply through the purchase of government securities from (or sale of government securities to) the private sector.
- C. increase longer-term U.S. interest rates by increasing the U.S. money supply through sales of longer-term securities to the private sector.
- D. increase holdings of short-term securities in the U.S. economy through increases in the U.S. money supply.

Q7 (1 Point). According to Refs.[2-3], QUANTITATIVE EASING (QE) by the Fed is when the Fed attempts to ____

- A. lower longer-term U.S. interest rates by increasing the U.S. money supply through purchases of longer-term securities from the private sector.
- B. influence the federal funds rate and other short-term U.S. interest rates by changing the U.S. money supply through the purchase of government securities from (or sale of government securities to) the private sector.
- C. increase longer-term U.S. interest rates by increasing the U.S. money supply through sales of longer-term securities to the private sector.
- D. increase holdings of short-term securities in the U.S. economy through increases in the U.S. money supply.

Q8 (1 Point). According to Refs.[2-3], a SECOND round of quantitative easing (QE2) is being undertaken to ____; but, according to Ref.[4], critics of QE2 worry that QE2 ____

- A. lower short-term interest rates; will increase the U.S. debt.
- B. raise long-term interest rates; will increase the foreclosure rate on home mortgages.
- C. keep inflation low; could tip the U.S. economy into deflation.
- D. reduce high unemployment; will increase inflation.

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