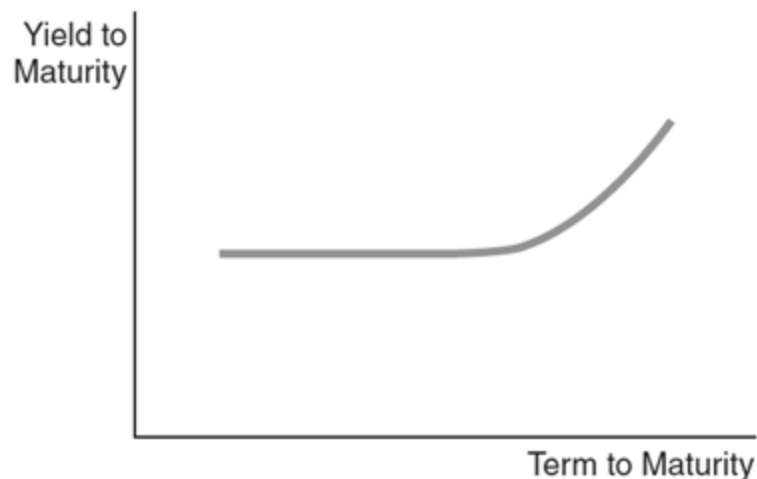


Review questions

EE431 Semester 1/2017

These are some conceptual questions that might be worth attempting. They all are helpful in terms of getting your concept checked. Use this material at your own risk. (No solution will be provided.)

1. “According to the expectations theory of the term structure, it is better to invest in one-year bonds, reinvested over two years, than to invest in a two-year bond if interest rates on one-year bonds are expected to be the same in both years.” Is this statement true, false, or uncertain?
2. If bond investors decide that 30-year bonds are no longer as desirable an investment as they were previously, predict what will happen to the yield curve, assuming (a) the expectations theory of the term structure holds; and (b) the segmented markets theory of the term structure holds.
3. If a yield curve looks like the one shown in the figure below, what is the market predicting about the movement of future short-term interest rates? What might the yield curve indicate about the market’s predictions for the inflation rate in the future?



4. Following a policy meeting on March 19, 2009, the Federal Reserve made an announcement that it would purchase up to \$300 billion of longer-term Treasury securities over the following six months. What effect might this policy have on the yield curve?
5. The table below shows current and expected future one-year interest rates, as well as current interest rates on multiyear bonds. Use the table to calculate the liquidity

premium for each multiyear bond.

Time to maturity	Multiyear Bond Rate (Current quotes)
1	2%
2	4%
3	5%
4	7%
5	10%

Year	Expected future One-Year Bond Rate
1	2%
2	5%
3	7%
4	8%
5	10%

6. Explain why you would be more or less willing to buy a share of Microsoft stock in the following situations:
- (a) Your wealth falls.
 - (b) You expect the stock to appreciate in value.
 - (c) The bond market becomes more liquid.
 - (d) You expect gold to appreciate in value.
 - (e) Prices in the bond market become more volatile.
7. Some economists think that central banks should try to prick bubbles in the stock market before they get out of hand and cause later damage when they burst. How

can monetary policy be used to prick a market bubble? Explain using the Gordon growth model.

8. How can economies of scale help explain the existence of financial intermediaries?
9. Would you be more willing to lend to a friend if she had put all of her life savings into her business than you would be if she had not done so? Why?
10. Gustavo is a young doctor who lives in a country with a relatively inefficient legal and financial system. When Gustavo applied for a mortgage, he found that banks usually required collateral for up to 300% of the amount of the loan. Explain why banks might require that much collateral in such a financial system. Comment on the consequences of such a system for economic growth.
11. Consider the balance sheet of the following two banks: A and B.

Bank A

Assets		Liabilities	
Reserves	\$75 million	Deposits	\$500 million
Loans	\$525 million	Bank capital	\$100 million

Bank B

Assets		Liabilities	
Reserves	\$100 million	Deposits	\$500 million
Loans	\$500 million	Bank capital	\$100 million

If both banks suffer a deposit outflow of \$50 million with a required reserve ratio on deposits of 10%, what actions should the two banks take? Discuss about all possible options that they might choose, and synthesize that which bank would be likely facing more difficulty in dealing with the outflow? Why?

12. If a bank is falling short of meeting its capital requirements by \$1 million, what three things can it do to rectify the situation?
13. Why do equity holders care more about ROE than about ROA?

14. Suppose you are the manager of a bank whose \$100 billion of assets have an average duration of four years and whose \$90 billion of liabilities have an average duration of six years. Conduct a duration analysis for the bank, and show what will happen to the net worth of the bank if interest rates rise by 2 percentage points. What actions could you take to reduce the bank's interest-rate risk?
 15. Suppose you are the manager of a bank that has \$15 million of fixed-rate assets, \$30 million of rate-sensitive assets, \$25 million of fixed-rate liabilities, and \$20 million of rate-sensitive liabilities. Conduct a gap analysis for the bank, and show what will happen to bank profits if interest rates rise by 5 percentage points. What actions could you take to reduce the bank's interest-rate risk?
 16. Why might more competition in financial markets be a bad idea? Would restrictions on competition be a better idea? Why or why not?
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