

## EE431: Economics of financial market and institutions

Semester 1/2017

### Practice questions (Some review questions in Mishkin)

---

---

1. Which of the following bonds would you prefer to be buying?
  - A) a \$10,000 face-value security with a 10 percent coupon selling for \$9,000
  - B) a \$10,000 face-value security with a 7 percent coupon selling for \$10,000
  - C) a \$10,000 face-value security with a 9 percent coupon selling for \$10,000
  - D) a \$10,000 face-value security with a 10 percent coupon selling for \$10,000
  
2. M1 money growth in the U.S. was about 15% in 2011 and 2012, and 10% in 2013. Over the same time period, the yield on 3-month Treasury bills was close to 0%. Given these high rates of money growth, why did interest rates stay so low, rather than increase? What does this say about the income, price-level, and expected-inflation effects?
  
3. Analyze the impact of the following situations on the market interest rate of Thailand.
  - a. Investors expect a persistent problem on Thai's deflation.
  - b. Market expects that FED will keep raising the FED fund rate over the next two FOMC meetings to come.
  - c. Several private listed companies are expected to be downgraded by a credit-rating agency.
  - d. Chinese economy would continue to have a slow growth due to the problem in Chinese financial sector.
  - e. Market expects that oil price is going to increase.
  - f. Thai government has decided to increase the size of budget deficit from 4% to 6%
  - g. The president of the United States announces in a press conference that he will fight the higher inflation rate with a new anti-inflation program. Predict what will happen to interest rates if the public believes him.
  - h. Predict what will happen to interest rates if the public suddenly expects a large increase in stock prices.
  - i. Predict what will happen to interest rates if prices in the bond market become more volatile.

- j. Would fiscal policymakers ever have reason to worry about potentially inflationary conditions? Why or why not?
4. In the aftermath of the global economic crisis that started to take hold in 2008, U.S. government budget deficits increased dramatically, yet interest rates on U.S. Treasury debt fell sharply and stayed low for quite some time. Does this make sense? Why or why not?
  5. Why do we observe in the data that bond rates of most OECD countries are lower than that of emerging market economy? Use the framework discussed in class to explain the phenomena.
  6. In his recent paper, Simon Gilchrist has found that 12-months lagged period of US credit spread, measured by the difference between BBB bond rate and 3-month US T-bills, negatively correlates with current payroll employment growth. In words, he found that an increase in credit spread is likely to *precede* a decline in employment activity. Use the analytical framework discussed in class to rationalize the empirical findings.
  7. (Moderate) The following is a list of prices for zero-coupon bonds of various maturities. Calculate the yields to maturity of each bond and the implied sequence of forward rates.

Maturity (Years)	Price of Bond
1	\$943.40
2	898.47
3	847.62
4	792.16

8. In the fall of 2008, AIG, the largest insurance company in the world at the time, was at risk of defaulting due to the severity of the global financial crisis. As a result, the U.S. government stepped in to support AIG with large capital injections and an ownership stake. How would this affect, if at all, the yield and risk premium on AIG corporate debt

9. Which of the following statements is TRUE?
- A) A liquid asset is one that can be quickly and cheaply converted into cash.
  - B) The demand for a bond declines when it becomes less liquid, decreasing the interest rate spread between it and relatively more liquid bonds.
  - C) The differences in bond interest rates reflect differences in default risk only.
  - D) The corporate bond market is the most liquid bond market.
10. Which of the following securities has the lowest interest rate?
- A) junk bonds
  - B) U.S. Treasury bonds
  - C) investment-grade bonds
  - D) corporate Baa bonds
11. During a "flight to quality"
- A) the spread between Treasury bonds and Baa bonds increases.
  - B) the spread between Treasury bonds and Baa bonds decreases.
  - C) the spread between Treasury bonds and Baa bonds is not affected.
  - D) the change in the spread between Treasury bonds and Baa bonds cannot be predicted.
12. If the interest rates on all bonds rise from 5 to 6 percent over the course of the year, which bond would you prefer to have been holding?
- A) a bond with one year to maturity
  - B) a bond with five years to maturity
  - C) a bond with ten years to maturity
  - D) a bond with twenty years to maturity
13. An equal decrease in all bond interest rates
- A) increases the price of a five-year bond more than the price of a ten-year bond.
  - B) increases the price of a ten-year bond more than the price of a five-year bond.
  - C) decreases the price of a five-year bond more than the price of a ten-year bond.
  - D) decreases the price of a ten-year bond more than the price of a five-year bond.