

Answer Outline

ECONOMICS 353 (SECTION 2)
EXERCISE 7: 6 POINTS TOTAL

L. Tesfatsion/Spring 04
DUE: Tuesday, March 2, 2:10pm

****IMPORTANT REMINDER: LATE ASSIGNMENTS CANNOT BE ACCEPTED – NO EXCEPTIONS****

EXERCISE INSTRUCTIONS:

- (1) Please **fill in your name and student ID number** on Side 1 of your bubble sheet and write **353-2 Exercise 7** 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 first five questions Q1 through Q6, below, which are all in multiple choice format. Each question Q1 through Q6 is worth 1 point.

Q1. If there currently is an EXCESS SUPPLY of Treasury bonds, then the theory in Mishkin Chapter 5 predicts that (all else equal) the current price of Treasury bonds is ____ than the equilibrium price and hence will _____.

A. higher; be bid upwards until demand equals supply

****B.** higher; be bid downwards until demand equals supply

C. lower; be bid upwards until demand equals supply

D. lower; be bid downwards until demand equals supply

E. none of the above

Q2. Key factors that are likely to cause the SUPPLY curve for bonds to shift RIGHT (more bonds supplied for each bond price P) include

A. higher government deficits.

B. an increase in the expected inflation rate.

C. an increase in the expected profitability of physical capital investment

****D.** all of the above

E. only A and B

Q3. The bankruptcy of the Enron Corporation caused jitters among investors regarding the credibility of accountants' reports testifying to the financial soundness of corporations. A plausible outcome of such a shock, at least in the short run, would be _____ in the demand for corporate bonds, most likely due to _____.

- A. an increase; increased moral hazard associated with corporate bonds
- B. an increase; increased interest rate risk associated with corporate bonds
- **C.** a decrease; an increased fear of payment default on corporate bonds
- D. a decrease; increased adverse selection associated with corporate bonds
- E. a decrease; individual investors replacing their corporate bonds by stock shares from these same corporations

Q4. A bond market is said to be in EQUILIBRIUM when

- A. the government is neither buying nor selling bonds at the current price level for bonds (i.e., the government is not intervening in the market).
- **B.** the demand for bonds equals the supply of bonds at the current price level for bonds.
- C. the price of bonds is falling (if there is an excess supply of bonds) or rising (if there is an excess demand for bonds).
- D. the government has attained its Federal funds rate target level at its current level of open market operations (bond purchases or sales).
- E. none of the above

Q5. If people revise DOWNWARD their expectations of the future yield to maturity on bonds, the theory in Mishkin Chapter 5 predicts that (all else equal) the current DEMAND curve for bonds will shift to the _____ because _____.

- **A.** right; lenders will foresee an increase in their capital gains
- B. left; borrowers will foresee higher real interest payments
- C. right; borrowers will foresee lower real interest payments
- D. left; lenders will foresee a decrease in their capital gains
- E. none of the above

Q6 ON FOLLOWING PAGE.

Q6. Suppose the U.S. Treasury bond market is currently in equilibrium. Suddenly the Fed Chairman, Alan Greenspan, announces that he expects that the inflation rate from this year to the next will be HIGHER than previously anticipated. Then the analysis in Mishkin Chapter 5 predicts that (all else equal) the effect on the market for newly issued U.S. Treasury bonds today will be that the EQUILIBRIUM PRICE of U.S. Treasury bonds will ____ and the EQUILIBRIUM QUANTITY of U.S. Treasury bonds purchased will _____.

- A. either increase or decrease; definitely decrease.
- **B.** definitely decrease; either increase or decrease.
- C. definitely decrease; definitely increase.
- D. definitely increase; either increase or decrease.
- E. none of the above