

Econ 353 Money, Banking, and Financial Institutions
Spring 2006

Midterm Exam 1

Name _____

- The duration of the exam is 1 hour 20 minutes.
- The exam consists of 10 problems and it is worth 100 points.
- Please write in the space provided. If necessary, write on the back of the page.
- Please ask me if you have any questions.
- To receive full credit you have to carefully explain all your answers and show all your work.

General advice: If you get stuck in the early parts of a problem, do not stop there. You can receive substantial partial credit by explaining how you would solve the rest of problem if you had the necessary answers from its previous parts.

1. (20 points) Determine whether each of the statements below is True or False:

Money is defined as the combined income of all individuals in the country.

Evidence from the United States and other foreign countries indicates that countries with low monetary growth rates tend to experience higher rates of inflation, all else being constant.

Monetary aggregate M1 is the most commonly used measure of money because it has been found to be the best predictor of inflation.

Of money's three functions, the one that distinguishes money from other assets is its function as a store of value.

The main problem with barter exchange is that barter requires standardization of the goods exchanged.

M0 is the narrowest measure of money.

7. (10 points) Suppose that you have \$100 to invest and there are two projects that you can invest your money into. The returns on each of these projects are unrelated to each other. The returns on Project A depend on oil prices in the following manner:

Project A:

Oil Prices	Probability	Return
High	0.2	20%
Average	0.6	10%
Low	0.2	0

The returns on Project B depend on amount of snow fall in New-York's Central Park in the following manner:

Project B:

Amount of snow	Probability	Return
High	0.2	18%
Average	0.6	10%
Low	0.2	2%

- (a) You consider two investment strategies: either invest all your \$100 in Project A or invest all your \$100 in Project B. For each of these strategies compute the expected return and variance of the returns. If you are risk averse, which one you would choose?

- (b) Propose an investment strategy that can offer the same expected return but lower variance of returns.

8. (10 points) What are the three functions of money? Imagine two countries, one that uses music CDs as money, and the other that uses provolone cheese as money. Discuss the advantages and disadvantages of each of these two goods in their role as money?

9. (10 points) Name three factors that shift demand for bonds to the right.

10. (10 points) During President Reagan's administration, his supporters argued that higher real interest rates were the result of policies increasing the profitability of investment. Reagan's critics argued that the high interest rates were the result of high budget deficits. Demonstrate graphically and explain how increased profitability of investments and increased deficits affect bond prices and interest rates. Based on your graphs, is there merit to either viewpoint?