EXERCISE 6: Six Questions (8 Points Total)  DUE: Tues, October 10, 2006, 2:10pm

**IMPORTANT REMINDER: LATE ASSIGNMENTS WILL NOT 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-Ex6 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 Q5, below, which are in multiple choice format.

3. The sixth question Q6 is a Web Exercise that asks you to consider a controversy that has arisen regarding the mortgage refinance company Fannie Mae and an alleged price bubble in the U.S. housing market. Please put your name and student ID number at the top of your print-out sheet for Q6 along with 353-Ex6:Q6 and separately hand in your answer sheet for Q6 in addition to your answer bubble sheet for questions Q1 through Q5.

4. Each question Q1 through Q5 is worth 1 point, and Q6 is worth 3 points.

Q1 (1 Point). If a 10-year $5,000 coupon bond (i.e., a coupon bond with a $5000 face value and a 10 year maturity) has a coupon rate of 10 percent and a purchase price of $4,000, then the COUPON PAYMENT is

A. $600
B. $500
C. $400
D. $300

Q2 (1 point). If a coupon bond with an $8000 face value and a 7 year maturity has a $400 coupon payment and a purchase price of $10,000, then the CURRENT YIELD is

A. 7 percent
B. 6 percent
C. 5 percent
D. 4 percent
E. none of the above
Q3 (1 Point). Letting $i$ denote the yield to maturity on coupon bonds, which of the following situations should a rational BORROWER prefer to be in if he is planning to raise funds through the issue of new coupon bonds?

A. $i = 25\%$ and the expected inflation rate = $20\%$
B. $i = 13\%$ and the expected inflation rate = $11\%$
C. $i = 6\%$ and the expected inflation rate = $2\%$
D. $i = 1\%$ and the expected inflation rate = $-2\%$

Q4 (1 Point). As detailed in Mishkin (Chapter 4), the interest rate on Treasury Inflation Protected Securities (TIPS) is a direct measure of ____ because interest and principal payments on TIPS are ____.

A. a nominal interest rate; denominated in current U.S. dollars.
B. the inflation rate; adjusted for cost of living increases.
C. a real interest rate; adjusted for changes in the price level.
D. the return on gold collectibles; collateralized by gold.

Q5 (1 Point). Smart investors need to understand the distinction between the YIELD TO MATURITY on a financial asset and its RETURN RATE (equivalently, its rate of return) because

A. the yield to maturity assumes a financial asset will be held to maturity, whereas the return rate can be calculated for any holding period.
B. the yield to maturity ignores capital gain or loss that might accrue to an investor who sells a financial asset prior to its maturity.
C. the yield to maturity ignores all payments received on a financial asset other than capital gain or loss whereas the return rate takes all payments into account.
D. all of the above
E. only A and B.

SEE THE FOLLOWING PAGE FOR
Q6: WEB EXERCISE
Q6: Web Exercise (3 Points Total): Fannie Mae and the U.S. Housing Bubble Controversy

Key On-Line References:


NOTE: Please prepare your answer to Q6 on a separate answer sheet with “Econ 353-Ex6:Q6” at the top of the sheet. Turn in your answer sheet for Q6 together with your bubble sheet answers for Q1 through Q5 – but please do not staple or otherwise attach the bubble sheet to your Q6 answer sheet.

Housing is a critical component of household wealth thought to have an important influence on household spending, and the residential construction industry is an important source of jobs (real estate agents, appraisers, lumber mills, specialty contractors, building material suppliers, credit and finance companies, and architects, to name a few.) Consequently, the price of housing is a closely watched economic indicator.

In recent years charges have been leveled at the mortgage refinance company Fannie Mae that it has contributed to the building up of a massive bubble in housing prices in the U.S. that is now in the process of collapsing. This question asks you to explore this issue.

PART A (1 Point): Dean Baker (ref.[2]) outlines several types of evidence that he claims support his contention the U.S. economy experienced an extended housing price bubble starting in 2001, and other types of evidence he claims support his contention that this bubble at the time of his article (June 2006) was in the process of collapsing. Define what is meant by a price bubble, and briefly describe three distinct types of evidence cited by Baker in support of his contention of a collapsing housing price bubble that you judge to be most convincing (or least unconvincing!).

PART B (1 Point): Give a brief but careful description of the mortgage refinance company “Fannie Mae,” including its date of establishment, the extent to which it is a public or private company, and what specific type of business it engages in (i.e. what does a “mortgage refinance company” actually do?)

PART C (1 Point): Some commentators have blamed Fannie Mae for contributing to the run-up of housing prices, and many of these same commentators are now expressing concerns that Fannie Mae could suffer huge losses in the event of a collapse in housing prices. Briefly but carefully explain the nature of these concerns.