Econ 353: Problem Set 2 Solution

1. You would be less willing to purchase U.S. Treasury bonds, other things equal, if
   A) you inherit $1 million from your Uncle Harry.
   B) you expect interest rates to fall in the future.
   C) gold becomes more liquid.
   D) stock prices become more volatile (i.e. stocks become more risky)

2. The supply curve for bonds has the usual upward slope, indicating that as the
   price ________, ceteris paribus, the ________ increases.
   A) falls; supply
   B) falls; quantity supplied
   C) rises; supply
   D) rises; quantity supplied

3. When the price of a bond is above the equilibrium price, there is an excess
   ________ bonds and price will ________.
   A) demand for; rise
   B) demand for; fall
   C) supply of; fall
   D) supply of; rise

4. A movement along the bond demand or supply curve occurs when ________ changes.
   A) bond price
   B) income
   C) wealth
   D) expected return

5. In the figure above, a factor that could cause the demand for bonds to decrease is:
   A) an increase in the expected return on bonds relative to other assets.
   B) a decrease in the expected return on bonds relative to other assets.
   C) an increase in wealth.
   D) a reduction in the riskiness of bonds relative to other assets.
6. In his Liquidity Preference Framework, Keynes assumed that money has a zero rate of return; thus,
   A) when interest rates rise, the expected return on money falls relative to the expected return on bonds, causing the demand for money to fall.
   B) when interest rates rise, the expected return on money falls relative to the expected return on bonds, causing the demand for money to rise.
   C) when interest rates fall, the expected return on money falls relative to the expected return on bonds, causing the demand for money to fall.
   D) when interest rates fall, the expected return on money falls relative to the expected return on bonds, causing the demand for money to rise.

7. The opportunity cost of holding money is
   A) the level of income.
   B) the price level.
   C) the interest rate.
   D) the discount rate.

8. When the price level ________, the demand curve for money shifts to the ________ and the interest rate ________, everything else held constant.
   A) falls; left; falls
   B) rises; right; falls
   C) falls; left; rises
   D) rises; right; rises

9. When the growth rate of the money supply increases, interest rates end up being permanently lower if
   A) the liquidity effect is larger than the other effects.
   B) there is fast adjustment of expected inflation.
   C) there is slow adjustment of expected inflation.
   D) the expected inflation effect is larger than the liquidity effect.

10. Other things being equal, an increase in the default risk of corporate bonds shifts the demand curve for corporate bonds to the ________ and the demand curve for Treasury bonds to the ________.
    A) right; right
    B) right; left
    C) left; right
    D) left; left

11. (a) risk-return tradeoff basically says in an efficient market, if you want to earn higher rate of return, you need to bear more risks; if you want to avoid risk, then you could only earn lower rate of return.
    (b) $E(R_A) = 0.3*0.5+(-0.2)*0.5 = 0.05$; $E(R_B) = 0.2*0.4+0*0.6 = 0.08$
        $\text{Var}(R_A) = 0.5*(0.3-0.05)^2 + 0.5*(-0.2-0.05)^2 = 0.0625$; $s.d(R_A) = 0.25$
        $\text{Var}(R_B) = 0.4*(0.2-0.08)^2 + 0.6*(0-0.08)^2 = 0.0096$; $s.d(R_B) = 0.098$
    (c) stock B is more attractive, higher rate of return and lower risk. In an efficient market, no one would hold stock A, stock A would not be traded in an efficient market.