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EXAM ECONOMICS C NA004G 2018-11-15

MODULE: MONEY, BANKING AND FINANCIAL MARKETS NA004G
DELKURS: FINANSIELLA INSTITUTIONER OCH MARKNADER NA004G

Examiner: Barbro Widerstedt, tel 010–142 83 22

INSTRUCTIONS

This exam consists of 8 pages, including this cover sheet. Make sure that all pages are in your handout.

The exam comprises three sections (1) 40 multiple-choice questions (20 p), (2) 5 definitions (10p) and (3) 2 essay questions (20p) for a total of 50 points. In order to get a passing grade (E or above), you need to get at least 25 points.

- Answer multiple-choice questions on the provided answer sheet (page 8 of the exam). The answer sheet should be detached from the exam before handed in. Mark the answer sheet with your anonymization code. You may keep the rest of the exam when you leave the exam room.
- Definitions should be answered on one sheet. Mark the answer sheet of with your anonymization code.
- Essay questions should be answered on a separate sheet of paper. Do not answer more than one question on each sheet. Mark each sheet of paper with your anonymization code.

Read the questions carefully. You can choose to answer open questions in Swedish or in English.

INSTRUCTION FOR ESSAY QUESTIONS:

Your answers should be clear and legible. Keep your answers to the point and easy to follow. Long-winded answers with a complicated outline are difficult to follow and there is a high risk that you will contradict yourself. Generally 200-300 words (1-1½ page) is enough to answer the question if properly outlined.

Support graphical illustrations and mathematical formulas with an explanatory text where needed. Label axes in diagrams and explain abbreviations and symbols in illustrations and formulas.

Consider the outline of your answer. If answering the question requires and assumption not mentioned in the question, explicitly state your assumption. Your ability to discuss as well as give a plain and systematic formulation of the problem are part of marking and grading your exam.

GRADING

Course grades are marked on the following scale

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The grade F constitutes a failing grade and requires a new examination.

Passing grades on quizzes and participations points (max 15p) will adjust your starting points.

ALLOWED RESOURCES AND DEVICES

Dictionary, calculator

GOOD LUCK!
### SECTION 1: MULTIPLE CHOICE QUESTIONS

Answer the following Multiple choice questions on the provided answer sheet (page 8 of the exam).

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| 1  | Every financial market has the following characteristic.  
    A) It allows common stock to be traded.  
    B) It determines the level of interest rates.  
    C) It allows loans to be made.  
    D) It channels funds from lenders-savers to borrowers-spenders. |
| 2  | Financial markets improve economic welfare because  
    A) they channel funds from investors to savers.  
    B) they weed out inefficient firms.  
    C) they eliminate the need for indirect finance.  
    D) they allow consumers to time their purchase better. |
| 3  | The time and resources spent trying to exchange goods and services are examples of  
    A) transaction costs  
    B) barter costs  
    C) bargaining costs  
    D) contracting costs |
| 4  | Whatever a society uses as money, the distinguishing characteristic is that it must  
    A) contain gold.  
    B) be completely inflation proof.  
    C) be produced by the government.  
    D) be generally acceptable as payment for goods and services or in the repayment of debt. |
| 5  | What is the effect of recent financial innovation on Central Bank's job of conducting monetary policy  
    A) It makes the job easier, since the Fed no longer knows what to consider money.  
    B) It makes the job easier, since the Fed now knows what to consider money.  
    C) It makes the job more difficult, since the Fed no longer knows what to consider money.  
    D) It makes the job more difficult, since the Fed now knows what to consider money. |
| 6  | What happens to the present value of a payment if the date of the payment is pushed farther into the future?  
    A) The present value increases.  
    B) The present value decreases.  
    C) It has no effect on the present value.  
    D) It is irrelevant for the present value. |
| 7  | What is the present value of $500.00 to be paid in two years if the interest rate is 5 percent?  
    A) $453.51  
    B) $476.25  
    C) $500.00  
    D) $550.00 |
| 8  | The payments to the owner plus the change in a security's value expressed as a fraction of the security's purchase price is known as the  
    A) yield rate.  
    B) rate of return.  
    C) current yield.  
    D) yield to maturity. |
Which interest rate reflects the true cost of borrowing most accurately?
A) The real interest rate.
B) The discount rate.
C) The market interest rate.
D) The nominal interest rate.

During business cycle expansions when income and wealth are rising, the demand for bonds _______ and the demand curve shifts to the _______, everything else held constant.
A) rises; left
B) falls; right
C) rises; right
D) falls; left

When the interest rate changes,
A) the demand curve for bonds shifts to the left.
B) the supply curve for bonds shifts to the right.
C) the demand curve for bonds shifts to the right.
D) it is because either the demand or the supply curve has shifted.

In Keynes’s liquidity preference framework
A) an excess demand of bonds implies an excess demand for money.
B) an excess supply of bonds implies an excess demand for money.
C) the demand for money must equal the supply of bonds.
D) the demand for bonds must equal the supply of money.

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

If there is an excess supply of money
A) individuals sell bonds, causing the interest rate to fall.
B) individuals buy bonds, causing interest rates to rise.
C) individuals sell bonds, causing the interest rate to rise.
D) individuals buy bonds, causing interest rates to fall.

The figure above illustrates the effect of an increased rate of money supply growth at time period T₀. From the figure, one can conclude that the
A) liquidity effect is smaller than the expected inflation effect and interest rates adjust slowly to changes in expected inflation.
B) liquidity effect is larger than the expected inflation effect and interest rates adjust quickly to changes in expected inflation.
C) liquidity effect is smaller than the expected inflation effect and interest rates adjust quickly to changes in expected inflation.
D) liquidity effect is larger than the expected inflation effect and interest rates adjust slowly to changes in expected inflation.
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| 16 | The risk structure of interest rates is  
  A) the relationship among interest rates on bonds with different maturities.  
  B) the relationship among interest rates of different bonds with the same maturity.  
  C) the relationship among the term to maturity of different bonds.  
  D) the structure of how interest rates move over time.  
| 17 | Why are interest rates on Treasury securities not all the same?  
  A) They have different times to maturity.  
  B) They carry different risk.  
  C) They have differing tax characteristics.  
  D) They have differences in liquidity.  
| 18 | A change in perceived risk of a stock changes  
  A) the expected dividend growth rate.  
  B) the required rate of return.  
  C) the current dividend.  
  D) the expected sales price.  
| 19 | The view that expectations change relatively slowly over time in response to new information is known in economics as  
  A) rational expectations.  
  B) slow-response expectations.  
  C) adaptive expectations.  
  D) irrational expectations.  
| 20 | People have a strong incentive to form rational expectations because  
  A) it is costly to do so.  
  B) they are guaranteed of success in the stock market.  
  C) everyone wants to be rational.  
  D) it is costly not to do so.  
| 21 | Evidence in support of the efficient markets hypothesis includes  
  A) the small-firm effect.  
  B) excessive volatility.  
  C) the January effect.  
  D) the failure of technical analysis to outperform the market.  
| 22 | A borrower who takes out a loan usually has better information about the potential returns and risk of the investment projects he plans to undertake than does the lender. This inequality of information is called  
  A) moral hazard.  
  B) asymmetric information.  
  C) adverse selection.  
  D) noncollateralized risk.  
| 23 | The free-rider problem occurs because  
  A) it is never profitable to produce information.  
  B) people who pay for information use it freely.  
  C) information can never be sold at any price.  
  D) people who do not pay for information use it.  
| 24 | That only large, well-established corporations have access to securities markets  
  A) can be explained by government regulations that prohibit small firms from acquiring funds in securities markets.  
  B) explains why newer and smaller corporations rely so heavily on the new issues market for funds.  
  C) explains why indirect finance is such an important source of external funds for businesses.  
  D) can be explained by the problem of moral hazard.  

Managers may act in their own interest rather than in the interest of the stockholder-owners because the managers have less incentive to maximize profits than the stockholder-owners do. In this example

A) Managers are agents; stockholder-owners are principals.
B) Managers are principals; stockholder-owners are agents.
C) Managers and stockholder-owners are agents.
D) Managers and stockholder-owners are principals.

Although restrictive covenants can potentially reduce moral hazard, a problem with restrictive covenants is that

A) borrowers may find loopholes that make the covenants ineffective.
B) too many resources may be devoted to monitoring and enforcing them, as debtholders duplicate others’ monitoring and enforcement efforts.
C) they are inexpensive to monitor and enforce.
D) they reduce the value of the debt contract.

A problem faced by banks in loan markets is that bad credit risks are the ones most likely to seek bank loans. This is because of

A) intentional fraud
B) adverse selection
C) moral suasion
D) moral hazard

Off-balance sheet activities involving guarantees of securities and back-up credit lines

A) increase the risk a bank faces.
B) greatly reduce the risk a bank faces.
C) have no impact on the risk a bank faces.
D) slightly reduce the risk a bank faces.

Because of asymmetric information, the failure of one bank can lead to runs on other banks. This is the

A) moral hazard problem.
B) contagion effect.
C) adverse selection problem.
D) too-big-to-fail effect.

Regulators attempt to reduce the riskiness of banks’ asset portfolios by

A) encouraging banks to hold risky assets such as common stocks.
B) requiring collateral for all loans.
C) limiting the amount of loans in particular categories or to individual borrowers.
D) establishing a minimum interest rate floor that banks can earn on certain assets.

The practice of keeping high-risk assets on a bank’s books while removing low-risk assets with the same capital requirement is known as

A) a dual banking system.
B) regulatory arbitrage.
C) competition in laxity.
D) depositor supervision.

Purchases and sales of government securities by the Federal Reserve are called

A) open market operations.
B) swap transactions.
C) federal fund transfers.
D) discount loans.
When a primary dealer buys a government bond from the Federal Reserve, reserves in the banking system _______ and the monetary base _______, everything else held constant.

A) increase; increases
B) increase; decreases
C) decrease; increases
D) decrease; decreases

In the model of the money supply process, the depositor’s role in influencing the money supply is represented by

A) the currency holdings and borrowed reserve.
B) the market interest rate.
C) the currency holdings.
D) the currency holdings and excess reserve.

What happens as a result of an open market purchase by the Central bank?

A) The money multiplier increases, which increases the monetary base.
B) The money multiplier increases, which increases the money supply.
C) The monetary base increases, which increases the money supply.
D) The monetary base increases, which increases the money multiplier.

Which of the following monetary policy tools is more effective when the economy faces the interest rate zero-lower-bound problem?

A) the Fed’s liquidity provision
B) open market operation
C) discount policy
D) required reserve ratio

Inflation results in

A) ease of comparing prices over time.
B) difficulty interpreting relative price movements.
C) ease of planning for the future.
D) lower nominal interest rates.

Monetary policy is considered time-inconsistent because

A) policymakers are tempted to pursue discretionary policy that is more expansionary in the short run.
B) of the lag times associated with the implementation of monetary policy and its effect on the economy.
C) policymakers are tempted to pursue discretionary policy that is more contractionary in the short run.
D) of the lag times associated with the recognition of a potential economic problem and the implementation of monetary policy.

"The primary objective of the ECB’s monetary policy is to maintain price stability. This is the best contribution monetary policy can make to economic growth and job creation."

The mandate for the monetary policy goals that has been given to the European Central Bank is an example of a _______ mandate.

A) primary
B) dual
C) hierarchical
D) secondary
If the central bank targets a monetary aggregate, it is likely to lose control over the interest rate because
A) fluctuations in the consumption function.
B) fluctuations in the business cycle.
C) fluctuations in the demand for reserves.
D) bond values will tend to remain stable.

SECTION 2: DEFINITIONS OF KEY TERMS

Give a short (1-2 sentences) explanation of the following terms:
1. Liability management
2. Agency theory
3. Stress tests
4. Financial innovation
5. Money multiplier

SECTION 3: ESSAY QUESTIONS

Choose any two questions. If you answer all three, a random question will be left unmarked.

Your answer should be in the form of 200-300 word short essay. The answer should be complete and standalone: as an example you should define key terms used in your answer. You can use diagrams to support your argument if you wish. Start each essay on a new sheet of paper.

Q1

The term structure of interest rates for a particular type of bond is called a yield curve.

Explain how the yield curve can be used as an indicator of economic outcomes, and how to interpret the slope of the yield curve. There are three main theories that try to explain the slope of the yield curve, describe these theories and how well they explain the slope of the yield curve.

Q2

There is an ongoing debate on whether Central banks should try to "pop" asset-price bubbles. Describe the argument for and against popping asset price bubbles and discuss if, and in that case when, it is a good idea to pop the bubble. What policies can be used to pop asset price bubbles?

Q3

The Federal Reserve can use four conventional tools to conduct monetary policy. Which are these conventional tools of monetary policy and how do they work in regulating the money supply?

Also explain why conventional policy tools don't work in financial crisis and describe how non-interest-rate monetary tools can help stabilize the economy.
This sheet should be separated from the booklet and handed in as Question 1 on the cover sheet.

**ANSWER SHEET MULTIPLE CHOICE QUESTIONS (SECTION 1)**

Answer each question in the provided space.

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