Chapt 5

4. There are four possible effects of an increase in the money supply on interest rates: the liquidity effect, the income effect, the price-level effect, and the expected-inflation effect. The liquidity effect indicates that a rise in money supply growth will lead to a decline in interest rates; the other effects work in the opposite direction. The evidence seems to indicate that the inco[me,] price-level, and expected-inflation effects dominat[e the] liquidity effect such that an increase in money su[pply] growth leads to higher—rather than lower—inter[est] rates.

KEY TERMS

asset market approach, p. 99
demand curve, p. 96
excess demand, p. 98
excess supply, p. 98
expected return, p. 93
Fisher effect, p. 106
liquidity, p. 94
liquidity preference framework, p. 111
market equilibrium, p. 98
opportunity cost, p. 112
risk, p. 94
supply curve, p. 98
theory of asset demand, p. 95
wealth, p. 93

QUESTIONS AND PROBLEMS

Questions marked with an asterisk are answered at the end of the book in an appendix, "Answers to Selected Questions and Problems." Questions marked with a blue circle indicate the question is available in MyEconLab at www.myeconlab.com/mishkin.

1. Explain why you would be more or less willing to buy a share of Microsoft stock in the following situations:
   a. Your wealth falls.
   b. You expect the stock to appreciate in value.
   c. The bond market becomes more liquid.
   d. You expect gold to appreciate in value.
   e. Prices in the bond market become more volatile.

*2. Explain why you would be more or less willing to buy a house under the following circumstances:
   a. You just inherited $100,000.
   b. Real estate commissions fall from 6% of the sales price to 5% of the sales price.
   c. You expect Microsoft stock to double in value next year.
   d. Prices in the stock market become more volatile.
   e. You expect housing prices to fall.

3. Explain why you would be more or less willing to buy gold under the following circumstances:
   a. Gold again becomes acceptable as a medium of exchange.
   b. Prices in the gold market become more v[olatile.]
   c. You expect inflation to rise, and gold pric[es] move with the aggregate price level.
   d. You expect interest rates to rise.

*4. Explain why you would be more or less will[ing to] buy long-term AT&T bonds under the follo[wing] circumstances:
   a. Trading in these bonds increases, makin[g them] easier to sell.
   b. You expect a bear market in stocks (sto[ck prices are] expected to decline).
   c. Brokerage commissions on stocks fall.
   d. You expect interest rates to rise.
   e. Brokerage commissions on bonds fall.

5. What would happen to the demand for R[...] paintings if the stock market undergoes a [...]

Answer each question by drawing the appropri[ate supply] and demand diagrams.

*6. An important way in which the Federal R[eserve] decreases the money supply is by selling [...] public. Using a supply and demand anal[ysis,] show what effect this action has on inter[est rates.] Is your answer consistent with what you [would expect] to find with the liquidity preference fra[mework?]

Chapter 5

7. Using both the liquidity preference framework and the supply and demand for bonds framework, show why interest rates are procyclical (rising when the economy is expanding and falling during recessions).

8. Why should a rise in the price level (but not in expected inflation) cause interest rates to rise when the nominal money supply is fixed?

9. Find the "Credit Markets" column in the *Wall Street Journal*. Underline the statements in the column that explain bond price movements, and draw the appropriate supply and demand diagrams that support these statements.

10. What effect will a sudden increase in the volatility of gold prices have on interest rates?

*11. How might a sudden increase in people's expectations of future real estate prices affect interest rates?

12. Explain what effect a large federal deficit might have on interest rates.

*13. Using both the supply and demand for bonds and liquidity preference frameworks, show what the effect is on interest rates when the riskiness of bonds rises. Are the results the same in the two frameworks?

14. If the price level falls next year, remaining fixed thereafter, and the money supply is fixed, what is likely to happen to interest rates over the next two years? (*Hint:* Take account of both the price-level effect and the expected-inflation effect.)

*15. Will there be an effect on interest rates if brokerage commissions on stocks fall? Explain your answer.

Using Economic Analysis to Predict the Future

16. The president of the United States announces in a press conference that he will fight the higher inflation rate with a new anti-inflation program. Predict what will happen to interest rates if the public believes him.

*17. The chairman of the Fed announces that interest rates will rise sharply next year, and the market believes him. What will happen to today's interest rate on AT&T bonds, such as the $8\frac{1}{8}$s of 2022?

18. Predict what will happen to interest rates if the public suddenly expects a large increase in stock prices.

*19. Predict what will happen to interest rates if prices in the bond market become more volatile.

20. If the next chair of the Federal Reserve Board has a reputation for advocating an even slower rate of money growth than the current chair, what will happen to interest rates? Discuss the possible resulting situations.

WEB EXERCISES

1. One of the largest single influences on the level of interest rates is inflation. There are a number of sites that report inflation over time. Go to ftp://ftp.bls.gov/pub/special.requests/cpi/cpiai.txt and review the data available. Note that the last columns report various averages. Move these data into a spreadsheet using the method discussed in the Web exploration at the end of Chapter 1. What has the average rate of inflation been since 1950, 1960, 1970, 1980, and 1990? Which year had the lowest level of inflation? Which year had the highest level of inflation?

2. Increasing prices erode the purchasing power of the dollar. It is interesting to compute what goods would have cost at some point in the past after adjusting for inflation. Go to http://minneapolisfed.org/Research/data/us/calc/. What would a car that cost $22,000 today have cost the year that you were born?

3. One of the points made in this chapter is that inflation erodes investment returns. Go to www.moneychimp.com/articles/econ/inflation_calculator.htm and review how changes in inflation alter your real return. What happens to the difference between the adjusted value of an investment compared to its inflation-adjusted value as
   a. Inflation increases?
   b. The investment horizon lengthens?
   c. Expected returns increase?

Chapter 8

free-rider problem, p. 188
incentive-compatible, p. 196
initial public offering (IPO), p.200
insolvent, p. 210
net worth (equity capital), p. 191
principal–agent problem, p. 192
restrictive covenants, p. 184
secured debt, p. 184
spinning, p. 200
state-owned banks, p. 204
unsecured debt, p. 184
venture capital firm, p. 194

QUESTIONS AND PROBLEMS

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1. How can economies of scale help explain the existence of financial intermediaries?
*2. Describe two ways in which financial intermediaries help lower transaction costs in the economy.
3. Would moral hazard and adverse selection still arise in financial markets if information were not asymmetric? Explain.
*4. How do standard accounting principles help financial markets work more efficiently?
5. Do you think the lemons problem would be more severe for stocks traded on the New York Stock Exchange or those traded over-the-counter? Explain.
*6. Which firms are most likely to use bank financing rather than to issue bonds or stocks to finance their activities? Why?
7. How can the existence of asymmetric information provide a rationale for government regulation of financial markets?
*8. Would you be more willing to lend to a friend if she put all of her life savings into her business than you would if she had not done so? Why?
9. Rich people often worry that others will seek to marry them only for their money. Is this a problem of adverse selection?
*10. The more collateral there is backing a loan, the less the lender has to worry about adverse selection. Is this statement true, false, or uncertain? Explain your answer.
11. How does the free-rider problem aggravate adverse selection and moral hazard problems in financial markets?
*12. Explain how the separation of ownership and control in American corporations might lead to poor management.
13. Is a financial crisis more likely to occur when the economy is experiencing deflation or inflation? Explain.
*14. How can a stock market crash provoke a financial crisis?
15. How can a sharp rise in interest rates provoke a financial crisis?

WEB EXERCISES

1. In this chapter we discuss the lemons problem and its effect on the efficient functioning of a market. This theory was initially developed by George Akerlof. Go to www.nobel.se/economics/laureates/2001/public.html. This site reports that Akerlof, Spence, and Stiglitz were awarded the Nobel prize in economics in 2001 for their work. Read this report down through the section on George Akerlof. Summarize his research ideas in one page.
2. This chapter discusses how an understanding of adverse selection and moral hazard can help us better understand financial crises. The greatest financial crisis faced by the United States has been the Great Depression from 1929 to 1933. Go to www.amatecon.com/greatdepression.html. This site contains a brief discussion of the factors that led to the Great Depression. Write a one-page summary explaining how adverse selection and moral hazard contributed to the Great Depression.

Week 3: The Behavior of Interest Rates and An Economic Analysis of Financial St

Stocks, Bonds, and Interest Rates
Week 3 Discussion

Stock markets, including those within the United States and abroad, have experienced extreme volatility over the past year. Take a moment to do some quick research (online, newspapers, television, etc.) to familiarize yourself with the performance of stocks, bonds, and interest rates.

From reading the text (Chapter 5), what *should* be the response in the bond and interest rate markets given what is happening in stock markets? Is this the response that is actually occurring?

Post your response to the questions above.

Stocks, Bonds, and Interest Rates

Stocks, Bonds, and Interest Rates

Respond

Week 3: The Behavior of Interest Rates and An Economic Analysis of Financial St

Extra Credit Questions
(3 pts - equivalent to 10% of possible weekly points)

What do you think is the most important part of the Theory of Asset Demand? Why?

Participation in this discussion thread is not required. I will only post to acknowledge your response to the questions. You will receive credit based on your own original response.

Theory of Asset Demand

Post your own original response for credit.

Respond