

Name: _____

Final exam
266: Fi. Markets and Institutions
Spring 2014
Jon Faust

Directions:

You have 2 hours (120 min.) to do the exam unless other arrangements have been made.

You may write on the backs of the exam pages and request additional paper.

If your answer extends outside the space provided, you must label clearly where the additional portion is located.

NOTE: Some questions involve choice about which parts of the question you must complete. This is signified, e.g., by (Do 3 of 4). If you do more parts than required, we will grade the parts in order and then ignore any extras.

1 **(Do 6 of 7. 3 points each.) 3 points each.** Give a brief definition for the following terms.

1.1 Real interest rate

1.2 Credit default swap.

1.3 Dark pool

1.4 Underwriting (say, a bond IPO)

1.5 Operational risk

1.6 Bank reserves

1.7 Insurable interest

2 (**Do 7 of 8. 3 points each.**) Real world data. In the following questions, you may give approximate values. Be sure to state the units.

2.1 What has been the approximate highest **and** lowest level of short-term interest rates in U.S. over the past 50 years?

2.2 What is the approximate annual value of U.S. nominal GDP at present?

2.3 What is total credit market debt in the U.S. as a share of nominal GDP?

2.4 Economies with lower per capita income than the U.S. generally have [more][less] debt as a share of GDP than does the United States. (Choose one)

2.5 Of the 10 largest banks in the world by total assets, about how many are U.S. banks?

2.6 What is the approximate capitalization of stock markets worldwide? And the capitalization of U.S. stock markets?

2.7 While broad stock market indices rise or fall on any given day, over any given 20 year period, broad stock indices in major advanced economies have always increased. [true/false]

2.8 Stock markets in the U.S. and across Europe had fallen considerably from previous highs at the depth of the financial crisis. U.S. markets have bounced back more [rapidly][slowly] than the markets in major European economies. (Choose one)

3 (Do 4 of 5. 4 points each.) Some short answer questions.

3.1 Suppose you own stock in Putin Corp., and you are concerned that the price of this stock may fall sharply. Name and describe a standard order you could place with a broker in order to protect yourself from a sharp fall in price, while continuing to own the stock if the price does not fall.

3.2 Because of the Pension Benefit Guaranty Corporation, a defined benefit pension is a nearly risk free asset to an employee who has earned the pension. [true/false and explain]

3.3 What is meant by the term 'real exchange rate,' and what does the purchasing power parity theory say about real exchange rates?

3.4 Explain how a commercial bank might adjust its **asset holdings** if it decides that it faces too much liquidity risk.

3.5 Explain how higher financial leverage (all else equal) raises the risk of bankruptcy. Despite the fact that leverage raises the risk of bankruptcy, some firms choose high leverage. What incentive do firms have to use leverage?

4 (**Do all parts. 4 points each.**) Monetary policy.

4.1 What is the main monetary policymaking group of the U.S. Federal Reserve System? The members of the Federal Reserve Board of Governors vote on the FOMC. Who else votes?

4.2 What is meant by 'central bank independence'? Why have many Democracies chosen to adopt laws protecting and promoting this independence?

4.3 Explain how by controlling short-term interest rates, central banks affect longer-term interest rates. (Hint: we are asking about 'normal times' policy here.)

4.4 The Federal Reserve has recently been making large scale purchases of longer-term securities. Explain why the Fed thinks that this may stimulate the economy.

4.5 The 'lender of last resort' function of central banks is intended to allow central banks to bail out insolvent institutions. [true/false and explain]

5 **(Do all parts. 4 points each.)** Risk and its management.

5.1 You pay \$96 for a security promising \$100 in 1 year's time. With 25 percent probability, the security will default and pay nothing; otherwise it pays the full amount. What is your expected yield (in percent)?

5.2 The expected rate of return on the bond just described must, under standard reasoning such as that reflected in the CAPM, be higher than the risk free rate of return. [true/false and explain]

5.3 We generally think that as riskiness of borrowers increases, the market interest rate for loans increases. Explain how adverse selection may affect this relation and cause the loan market to cease to function.