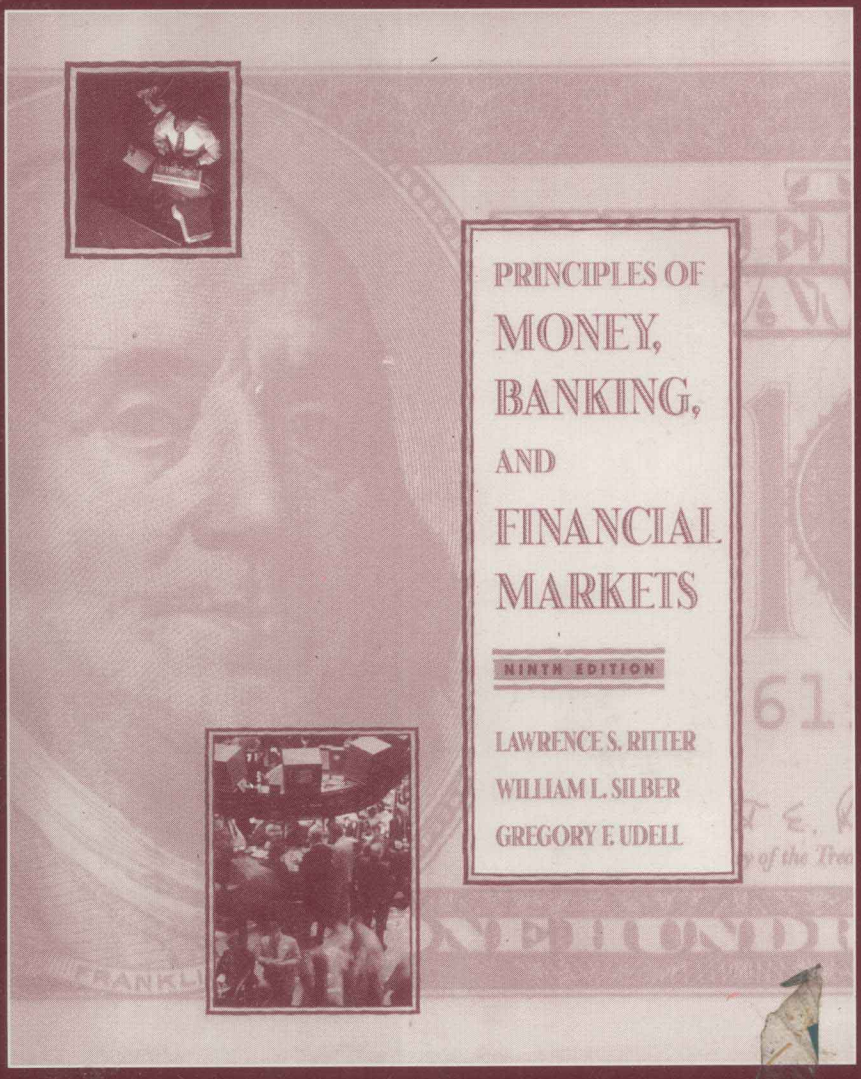
INSTRUCTOR'S MANUAL/TEST BANK

to accompany

Principles of Money, Banking, and Financial Markets

Ninth Edition



Scott Bloom

Instructor's Manual and Test Bank

to accompany

Ritter/Silber/Udell
Principles of Money, Banking, and Financial Markets
Ninth Edition

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ADDISON-WESLEY

An imprint of Addison Wesley Longman, Inc.

Reading, Massachusetts • Menlo Park, California • New York
Harlow, England • Don Mills, Ontario • Sydney
Mexico City • Madrid • Amsterdam

Instructor's Manual/Test Bank to accompany Ritter/Silber/Udell, *Principles of Money, Banking, and Financial Markets,* Ninth Edition

ISBN: 0-673-97756-0

12345678910-VG-0100999897

PREFACE

This *Instructor's Manual With Test Bank* is designed to accompany the ninth edition of Ritter, Silber, and Udell's *Principles of Money, Banking, and Financial Markets*. It was initially prepared by Jon Harkness of Northwestern University to accompany the first edition of the textbook. The second and third editions were prepared by Lawrence Ritter of New York University and Gabriel Hawawini of INSEAD-Paris. Gabriel Hawawini and Paul Warner did the fourth, fifth, and sixth editions. Paul Warner prepared the seventh edition and was joined by David Griffiths for the eighth. This ninth edition was revised by Scott Bloom of North Dakota State University.

You should choose the optimal way of using this book. It may be especially useful to less experienced teachers of Money and Banking and those who are not specialists in the field, saving them time in preparing exams, quizzes, and written assignments.

The Instructor's Manual provides for Chapters 2 through 30 of the textbook the following five items:

1. TEACHING. This is not a rehash of the chapter, but some very practical tips on teaching it, drawn from my eighteen years of doing Money and Banking. Included are suggestions on what parts of the chapter to cut when time is short, how you might extend the chapter's coverage — and the risks involved, and the sticky points that have caused students particular trouble.

2. DISCUSSION QUESTIONS. They can be tossed out during the lecture to stimulate discussion, or can be hoarded as an extra source of essay questions. A very brief idea about a possible answer appears in brackets following each question; it is usually not near to being a comprehensive answer. Many of these questions do not have a single correct answer and are meant to spark a round of "on one hand...then on the other hand...."

3. ANSWERS TO QUESTIONS IN TEXT. These answer the end-of-chapter questions in Ritter, Silber, and Udell.

4. ANSWERS TO STUDY GUIDE ESSAY QUESTIONS AND PROBLEMS. An unusual feature of the *Study Guide* (which I also revised) is that many of its "Essay Questions and Problems" are *not* answered in the back, if the answer is to be found directly in the textbook. This is designed to get students actively involved in a close rereading of the text. But now for the first time, the Instructor's Manual includes these answers, for those (hopefully conscientious) students who come knocking at your office door.

5. ESSAY QUESTIONS. These can do double duty as class discussion questions. Many can be fully answered in just a few sentences. A "compressed" answer appears in italics directly following the question.

The Test Bank provides multiple-choice questions of three types: factual, interpretive, and analytical. They are at three difficulty levels: 1-easy, 2-moderate, and 3-difficult. These questions are also available on Addison-Wesley's *TestMaster* software.

No question of any type in this book duplicates a question in the current *Study Guide*.

I will be glad to hear from you with any opinions or suggestions. Good luck with your course.

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Chapter 2
The Role of Money in the Macroeconomy

TEACHING

This chapter introduces the basic definitions, functions, and macroeconomic significance of money. Students are likely to be familiar with these concepts from a principles course. However, they probably need continual reminding about the difference between money and income. By discussing how an economy would operate without money, the chapter highlights the asset role that money plays. The concept of liquidity and its link to the various measures of money should be emphasized. The fact that liquidity is a continuum and that the divisions among the definitions of money are arbitrary should be stressed, especially as economists are increasingly using the M2 over the M1 definition of money.

The role of money in allocating resources across time is introduced. The discussion is in the spirit of a preview and should get students to start thinking about the nature and role of financial intermediaries.

Next come brief introductory remarks about the money creation process. Students are reacquainted with the idea the money is not backed by a tangible good such as gold. It should be emphasized that money creation takes place as the result of natural profit-maximizing decisions carried out by depository institutions.

A discussion of hyperinflation examples is interesting to the students and useful in establishing the importance of public confidence in the working of a modern monetary system.

As a preview of future chapters it may be useful to discuss what has happened to the velocity of M1 in recent years, why it happened, and the consequences of velocity instability for the Federal Reserve.

DISCUSSION QUESTIONS

1. Credit cards and travelers' checks are widely accepted as a medium of exchange. Should they be considered part of the money supply?

   [Travelers' checks are in M1. There are many reasons to exclude credit cards from money definitions; perhaps the most compelling is the statistical difficulty of counting them. Remember: money is a *statistic*.]

2. Is money necessary in an advanced economy? Are there alternative means of carrying out transactions and allocating resources over time?
   [It is hard to imagine a realistic alternative. And if money were to somehow vanish, would we not eventually contrive one? Think of the money that appear when an economy enters a hyperinflation.]

3. Is it necessary to have something of value backing up money? What stands behind money in the United States?
   [Nothing but confidence it its acceptability.]

4. What happens when a person has too much money? What about when an economy has too much money?
   [How would the extent of economic freedom and the development of the financial marketplace affect the answer?]

5. Is it possible to have inflation without monetary expansion in the short run? What about the long run?
   [Yes, in the short run. And even in the long run, money growth at or below the growth of natural GDP is noninflationary.]

ANSWERS TO QUESTIONS IN TEXT

1. M1 is the best measure of the money supply for the medium of exchange role. M1 contains currency and demand deposits, the assets generally acceptable as means of payment.

2. A good medium of exchange must be generally acceptable in trade. In addition, the medium of exchange should have minimal uncertainty over its value in trade and be a good store of value. Finally, it should be divisible so that it can serve as a unit of account.

3. The value of money is determined by its purchasing power. If the price level rises, the value of money declines because the purchasing power of each monetary unit is reduced.

4. The introduction of money permits separation of the act of investment from the act of saving. The channeling of funds from savers to investors through financial markets better allocates resources to the creation of new productive facilities.

5. No, the money supply is linked to the GDP via velocity. A central determinant of the effectiveness of monetary policy is the predictability and stability of velocity.

6. More money does not always lead to inflation: velocity can fall and output can rise. In the long run inflation cannot continue without increases in the money supply.

7. If it costs $20,000 a year to go to college now, it will cost $40,000 if the price level doubles. In real terms, however, there would be no change.

8. A breakdown of a country's institutional structure, perhaps a revolution, is likely with hyperinflation. However, gradual inflation is unlikely to cause the fundamental changes of which Lenin spoke.

ANSWERS TO STUDY GUIDE ESSAY QUESTIONS AND PROBLEMS

1. a. medium of exchange, store of value, unit of account
   b. A rapid inflation makes money a poor store of value, therefore crippling its ability to be a medium of exchange.

2. a. See Table 2 in the textbook.
   b. M2 and M3 bring increasingly illiquid assets into the money definition.

3. b. Millions of small savers delegate their lending decisions to experts at evaluating investment opportunities.
   c. Hyperinflation is never impossible.

4. a. the rate of real GDP growth, the unemployment rate, and the rate of inflation
   b. high real GDP growth and low unemployment, to the extent that they are consistent with low inflation
   c. One policy that is widely agreed on is modest and predictable growth in the money supply.

5. a. large enough to allow full employment, but not so large as to fuel a rapid inflation along with it
   b. changes in the money growth rate designed to moderate the swings of the business cycle
   c. Money growth should be compared to growth of full employment real GDP.

6. a. The ratio of GDP to the money supply is the "velocity of money."
   b. With an unpredictable velocity we cannot know how a given money growth rate translates to a GDP growth rate.
   c. it refers to what was just discussed: an unpredictable velocity

8. a. if it is equal to or less than the contemporaneous increase in full-employment real GDP.
   b. Once again, it depends on how full-employment real GDP is rising.

ESSAY QUESTIONS

1. Describe the characteristics an asset must possess in order to serve as a medium of exchange. Which of these is most important for the operation of the economy? *[The characteristics are: general acceptability in trade (medium of exchange), high degree of certainty of value (store of value), and divisibility (unit of account). Being a medium of exchange is most crucial.]*

2. Is it possible for a nonmonetary economy to save and invest? How does money improve how resources are allocated over time? *[Yes, it is possible to save and invest under barter, but it is highly inefficient. The saver and investor must be the same person. Saving occurs as real assets are acquired, so consumption must be less than income. Money allows for the separation of saving and investment decisions. This increases specialization and expands economic growth.]*

3. What is the "right" amount of money in an economic system? Who makes this decision, and how can that amount ever be achieved? *[There should be enough money to employ all resources and not enough to cause inflation. The Federal Reserve sets monetary policy, which is a vital determinant of the money supply.]*

4. Describe how changes in the money supply affect GDP. When might this be inflationary? *[Changes in the money supply affect people's liquidity, which then affects their spending on goods and assets. This is more likely to be inflationary the closer is the economy to full-employment.]*

5. Define the velocity of money. What determines velocity? How are changes in velocity related to inflation? *[Velocity is (GDP/money supply), determined by the public's relative preference for money versus other assets. Rising velocity can be a short-run source of inflation.]*

6. What happens to money and velocity during hyperinflation? What happens to the economy? Cite some historical examples. *[The money supply increases tremendously fast, followed by hyperinflation. Velocity rises toward infinity as people lose all confidence in money. Barter reemerges. Examples include Germany in 1923, Hungary in 1946, and Bolivia in the mid-1980s.]*

Chapter 3
Financial Instruments, Markets, and Institutions

TEACHING

A general overview of financial markets and financial intermediation is provided. Specific financial instruments such as stocks, bonds, mortgages and futures contracts are described in limited detail. Students interested in further details should be told that they will follow.

The advantages associated with financial intermediation are discussed, followed by an industry-by-industry introduction of intermediaries.

This is all straightforward and students usually enjoy learning the categories into which they can put things they have heard about. It is a good chapter to combine with current events.

DISCUSSION QUESTIONS

1. "Financial intermediaries are just middlemen. Borrowers and lenders would be better off if they were cut out of the process." What do you think?
   [transactions costs, diversification, information]

2. What future expectations of the economy would encourage you to buy stocks? Bonds?
   [prospects for profits, expected future interest rate]

3. Why are honesty and trust in handling financial market transactions likely to win out in the long run?
   [competition among financial firms]

4. Under what conditions would financial disintermediation increase? Under what conditions would disintermediation be advisable?
   [consider Regulation Q in the 1960s and 1970s]

5. Is there any reason to prefer opening an account with a bank over a savings-and-loan or vice versa. What should be your deciding factors?
   [so long as they are both insured, look at the variety of the deposits and services]

ANSWERS TO QUESTIONS IN TEXT

1. Direct finance is the flow of funds from saver-lenders directly to borrower-spenders through financial markets. Indirect finance is the flow of funds from saver-lenders to borrower-spenders indirectly through financial intermediaries. Primary securities are liabilities issued by borrower-spenders. Saver-lenders are the source of funds. Borrower-spenders are the ultimate users of funds.

2. The function of financial markets is to serve as a conduit through which all who do not spend all their income can make those excess funds available to those who want to spend more than their income.

3. "Interest" on a zero takes the form of a rise in its market price as it approaches maturity (just as in the case of a coupon-less Treasury bill).

4. reducing transactions and information costs and the ability to (indirectly) hold a vastly diversified portfolio.

5. Financial intermediaries facilitate the flow of funds from saver-lenders to borrower-spenders, which finances much of our capital investment. But how can we say that government can improve upon private market decisions here or has the wisdom to actually improve matters?

ANSWERS TO STUDY GUIDE ESSAY QUESTIONS AND PROBLEMS

1. There is jointly profitable contact between savers and borrowers in financial markets, both directly and indirectly, via financial intermediaries. Inefficiencies in financial markets would impede the flow of funds from savers to borrowers and slow the growth of the economy.

2. a. They promise to repay precise dollar amounts at previously specified times, usually to a finite maturity. (This involves only one payment in the case of a zero-coupon bond.) They are usually of much higher denomination than shares of stock.
   b. Common stock represents a permanent share of ownership in the issuing firm and entitles the holder to part of the firm's earnings. The firm's management decides how much of the earnings are to be retained internally and how much are to be paid out as dividends, so many dollars per share.
   c. Stock is riskier because a drop or suspected drop in the issuer's profit can greatly affect the stock's market price and dividend payout. Also, by law bondholders must be completely repaid before any stockholder can receive dividends.
   d. A preferred stock is an equity and a convertible bond is a debt instrument.

3. a. original maturities of more than one year
   b. stocks, issued by corporations and held by individuals, firms, and nondeposit financial institutions, residential mortgages issued by homeowners and held by savings-and-loans and commercial banks; bonds, issued by corporations and governments and held by corporations, governments, individuals, and financial institutions
   c. Stocks and bonds have active trading, residential and commercial mortgages moderate trading, and one particular capital market instrument, U.S. savings bonds, are forbidden by law to be traded. Lower trading frequently denotes a lower liquidity.

4. a. original maturities of one year or less
   b. Virtually every entity in the economy is a money market participant.
   c. Treasury bills, issued by the U.S. government and held by individuals and financial institutions; commercial paper, issued by large corporations and bank holding companies and held by financial institutions; negotiable CDs issued by banks and held by corporations and financial institutions

6. a. Financial intermediaries are conduits for the flow of funds between the saver-lender and the borrower-spender. They gather and repackage the funds of savers into big chunks for borrowers.
   b. Financial intermediaries lower interest rates as they lend much more cost-effectively than the individual savers; promote economic growth, which depends on the flow of funds; increase financial market efficiency; increase the velocity of money as savers are able to hold many non-money assets issued by the intermediaries in exchange for their funds.

ESSAY QUESTIONS

1. What are the similarities and differences in stocks and bonds? *[Both are securities which are a source of funds for a corporation and a claim to future streams of payment. Stocks are ownership shares with infinite maturity, while most bonds have a finite maturity. Bonds make fixed-dollar commitments, where with stocks you never know.]*

2. Describe the similarities and differences in futures and options contracts. *[Both are derivatives representing a contract by two parties regarding a third asset. Options contracts separate rights and obligations.]*

3. What is the primary difference between the money market and the capital market? Give three examples of financial instruments in each. *[The money market is for short-term borrowing (commercial paper, T-bills, certificates of deposit), and the capital market for long-term borrowing or selling ownership (stocks, bonds, mortgages).]*

4. How can the profits of financial intermediaries be justified? In general terms, what are they selling to saver-lenders? *[They provide an efficient way of transferring funds. The primary services they offer is expertise in evaluating creditor risk and risk reduction through pooling. They also allow the savers the option of maintaining liquidity while saving.]*

5. How do portfolios of life insurance and property and casualty insurance companies differ? Do they require different investment strategies? *[The portfolios of life insurance companies are much more concentrated in the capital market. Property and casualty companies have a much greater need for liquidity, due to the greater uncertainty of their obligations.]*

Chapter 4
Interest Rate Measurement and Behavior

TEACHING

Interest-rate calculations are the initial focus. Students with only a vague understanding of interest-rate mechanics will benefit greatly from this material. The inverse relationship between bond prices and yields, a legendary source of student confusion, is explained, along with the notion of capital gains and losses.

Although the mechanics of interest-rate calculation are fairly straightforward, students must work problems to hammer it in. Such problems can be found in the *Study Guide*.

Next comes the basics of interest rate determination. It is especially helpful for students with a weak or distant Principles background, but it may confuse students who were shown only the Keynesian approach via liquidity preference. Care should be taken to emphasize that interest rates are here being viewed as the cost of credit (rather than the Keynesian view of their being the opportunity cost of holding money) and therefore are determined by the supply of and demand for loanable funds.

DISCUSSION QUESTIONS

1. Is the risk of capital losses irrelevant if a person plans to hold a bond until maturity?
   [Plans sometimes need to be changed.]

2. Why would anyone buy a bond that does not make interest payments?
   [capital gains, plus the relatively low purchase price]

3. If you expect interest rates to fall, should you buy long- or short-term bonds?
   [long, for a greater price appreciation]

4. Interest rates were much higher in the late 1970s than the mid 1990s. Was credit more expensive back then?
   [not when you differentiate nominal versus real]

5. What would happen to the equilibrium level of interest rates if: A. borrowing for home building increased? B. a new highway program gets underway? C. foreign creditors lose confidence in the U.S.? D. the Fed raises reserve requirements?
   [in all cases, interest rates rise *ceteris paribus*]

ANSWERS TO QUESTIONS IN TEXT

1. The yield to maturity is higher because it takes account of the capital gain.

2. Zero-coupon bonds sell for less because they make no interest payments. The investor's return is simply the difference between the price she paid and the price she gets for selling it or holding it to maturity (the face value).

3. Yes, bond prices and interest rates are inversely related due to mathematics.

4. The real interest rate reflects the gain in purchasing power savers are rewarded with. It is a return over and above the depreciation of the purchasing power of a dollar due to inflation.

5. Falling interest rates mean capital gains for fixed-rate assets, larger the longer the maturity of the asset.

6. see the first two figures in the chapter

7. The demand for loanable funds can cause the equilibrium interest rate to rise if business, government, or household borrowing increases. Increased profit expectations, increased government deficits, or expectations of higher consumer incomes will also raise interest rates, as well as reduction in the supply of loanable funds.

8. An increase in inflationary expectations shifts the demand for loanable funds to the right, as borrowers perceive a reduction in real rates, and the supply of loanable funds to the left, as lenders want to be compensated for inflation.

9. Interest rates tend to rise during cyclical expansions and fall during recessions, although this may superimposed on a longer-term upward or downward trend in rates.

10. This is too broad a statement. There are may kinds of stock, many kinds of bonds, many kinds of risk, and many asset-holding strategies.

ESSAY QUESTIONS

1. Assume a saver deposits $500 for two years in a bank account that pays 10 percent interest. What is the simple interest over two years? What would it be if the account were compounded annually? Why the difference? *[Simple interest is $100; with annual compounding it is $105 because interest is paid the second year on the first year's interest.]*

2. Define the coupon rate on bonds. Is it a meaningful measure of the return on the bond? Is there a more accurate measure? *[The coupon rate is the bond's (coupon payment/face price). It is usually not an accurate measure of return. Yield to maturity is much more acceptable because it captures the capital gain or loss. Return also provides a more accurate measure.]*

3. "Returns were much higher in the 1970s than now because the interest rates were much higher." True or false? *[False, since it does not take into account the much higher inflation of the 1970s and thus a* real *rate at that time similar to ours now.]*

4. Using the loanable funds market diagram, demonstrate the effects of the following: A. a decrease in the saving rate; B. an increase in business investment spending; C. a reduction in the federal deficit; D. a rise in inflationary expectations. *[A. supply shifts left and the equilibrium rate rises; B. demand shifts right and the equilibrium rate rises; C. demand shifts left and the equilibrium rate falls; D. demand shifts right while supply shifts left and the equilibrium rate rises.]*

5. Why do interest rates tend to rise during economic expansions and fall during recessions? *[During expansions borrowers increase their demand for loanable funds, inflationary expectations tend to rise, and the Fed eventually starts reducing loanable funds supply. All this goes in reverse during the recession.]*