Problem 1

Questions 1, 2, 3, 6, 9, 12, 16, 20, and 21 (Applied Problems) from Chapter 1.

Solutions:

1. The interest rate on three-month Treasury bills fluctuates more than the other interest rates and is lower on average. The interest rate on Baa corporate bonds is higher on average than the other interest rates.

2. The lower price for a firm’s shares means that it can raise a smaller amount of funds, so investment in facilities and equipment will fall.

3. Higher stock prices mean that consumers wealth is higher, and they will be more likely to increase their spending.

6. The basic activity of banks is to accept deposits and make loans.

9. In the period from 2007 to 2011, both inflation and interest rates have generally trended downward compared to before that period.

12. No. It is true that people who borrow to purchase a house or a car are worse off because it costs them more to finance their purchase; however, savers benefit because they can earn higher interest rates on their savings.

16. It makes British goods more expensive relative to American goods. Thus American businesses will find it easier to sell their goods in the United States and abroad, and the demand for their
products will rise.

20. As the dollar becomes stronger (worth more) relative to a foreign currency, one dollar is equivalent to (can be exchanged for) more foreign currency. Thus for a given face value of bond holdings, a stronger dollar will yield more home currency to foreigners, so the asset will be worth more to foreign investors. Likewise, a weak dollar will lead to foreign bond holdings worth less to foreigners.

21. The best day is 4/25. At a rate of $1.6674/pound, you would have $119.95. The worst day is 4/7. At $1.961/pound, you would have $101.99, or a difference of $17.96.

**Problem 2**

Questions 1, 2, 3, 5, 7, 10, and 22 from Chapter 2.

**Solutions:**

1. Yes, I should take out the loan, because I will be better off as a result of doing so. My interest payment will be $4500 (90% of $5000), but as a result, I will earn an additional $10,000, so I will be ahead of the game by $5500. Since Larry's loan-sharking business can make some people better off, as in this example, loan sharking may have social benefits. (One argument against legalizing loan sharking, however, is that it is frequently a violent activity.)

2. Yes, because the absence of financial markets means that funds cannot be channeled to people who have the most productive use for them. Entrepreneurs then cannot acquire funds to set up businesses that would help the economy grow rapidly.

3. The share of Microsoft stock is an asset for its owner, because it entitles the owner to a share of the earnings and assets of Microsoft. The share is a liability for Microsoft, because it is a claim on its earnings and assets by the owner of the share.

5. This statement is false. Prices in secondary markets determine the prices that firms issuing securities receive in primary markets. In addition, secondary markets make securities more liquid and thus easier to sell in the primary markets. Therefore, secondary markets are, if anything, more important than primary markets.
7. Mortgages are loans to households or firms to purchase housing, land, or other real structures, where the structure or land itself serves as collateral for the loans. Mortgage-backed securities are bond-like debt instruments which are backed by a bundle of individual mortgages, whose interest and principal payments are collectively paid to the holders of the security. In other words, when an individual takes out a mortgage, that loan is bundled with other individual mortgages to create a composite debt instrument, which is then sold to investors.

10. Financial intermediaries benefit by carrying risk at relatively low transaction costs. Since higher risk assets on average earn a higher return, financial intermediaries can earn a profit on a diversified portfolio of risky assets. Individual investors benefit by earning returns on a pooled collection of assets issued by financial intermediaries at lower risk. Risk to individual investors is lowered through the pooling of assets by the financial intermediary.

22. During the financial panic, regulators were concerned that depositors worried their banks would fail, and that depositors (especially with accounts over $100,000) would pull money from banks, leaving cash-starved banks with even less cash to satisfy customer demands and day-to-day operations. This could create a contagious bank panic in which otherwise healthy banks would fail. Raising the insurance limit would reassure depositors that their money was safe in banks and prevent a bank panic, helping to stabilize the financial system.

Problem 3
Questions 2, and 3 from Chapter 3.

Solutions:

2. Even if he or she is a non-smoker, since the prisoner knows that others in the prison will accept cigarettes as a form of payment, they themselves would be willing to accept cigarettes as a form of payment. So, rather than prisoners having to barter and trade favors, cigarettes satisfy the double coincidence of wants in that both parties to a trade stand ready to use them to purchase goods or services.

3. Because the orchard owner likes only bananas but the banana grower doesn’t like apples, the banana grower will not want apples in exchange for his bananas, and they will not trade. Similarly, the chocolatier will not be willing to trade with the banana grower because she does not like bananas. The orchard owner will not trade with the chocolatier because he doesn’t like chocolate. Hence, in a barter economy, trade among these three people may well not take place, because in no case is there a double coincidence of wants. However, if money is introduced into the economy, the
orchard owner can sell his apples to the chocolatier and then use the money to buy bananas from the banana grower. Similarly, the banana grower can use the money he receives from the orchard owner to buy chocolate from the chocolatier, and the chocolatier can use the money to buy apples from the orchard owner. The result is that the need for a double coincidence of wants is eliminated, and everyone is better off because all three producers are now able to eat what they like best.