**Money & Banking**  
Review Questions for First Exam

**Instructions:** Read the questions carefully. Select the best answer to a question.

**True/False Questions**

1. When economists refer to the role of money as a store of value, they mean that the value of money falls only when the quantity of money in circulation falls.  **F**
2. The risk of owning a financial asset is equal to the interest received from ownership of the asset.  **F**
3. A decline in market interest rates reduces the discounted value of future principal payments.  **F**
4. Yield to maturity is the interest rate that equates the discounted value of all of a bond’s cash flows to its market price.  **T**
5. If market interest rates fall below the coupon rate of a bond, the bond’s price will fall.  **F**

**Multiple Choice Questions**

1. The problem of the double coincidence of wants refers to:  
   a. the insatiability of wants in a free economy.  
   b. poorly managed companies producing what consumers want only by coincidence.  
   c. **the necessity in a barter system of each trading partner wanting what the other has to trade.**  
   d. the likelihood that needs will not be the same as wants.
2. The financial system enables savers and investors to transfer risk to other parties willing to bear it. Savers and investors who take advantage of this fact:  
   a. often end up paying higher taxes.  
   b. do so by engaging in diversification.  
   c. **will typically earn a lower return than if they had not done so.**  
   d. do so exclusively through the banking system.
3. If you deposit $5,000 into a savings account that pays 10% interest, how much will you have in the account at the end of 7 years?  
   a. $5,500  
   b. $8,500  
   c. **$9,744**  
   d. $10,718
4. If the nominal interest rate on an investment is 10%, the tax rate is 25%, and the expected inflation rate is 5%, what is the real after-tax rate of return on this investment?  
   a. –2.5%  
   b. 1.25%  
   c. **2.50%**  
   d. 3.75%
5. Which of the following is most liquid?  
   a. A 10-year Fairfax County General Obligation Bond.  
   b. A 5-year General Motors Corporate Bond.  
   c. **A 10-year US Treasury Bond.**  
   d. A Share of General Motors Stock.
6. What price will a one-year discount bill trade for if it is currently priced to yield 5%?  
   a. $9,500.00  
   b. **$9,523.81**  
   c. $9,625.67  
   d. $10,500.00
7. Suppose Congress passes a law prohibiting mutual funds from holding corporate bonds in their portfolios. The likely result of this action will be to:
   a. increase the price of bonds and lower the rate of interest.
   b. increase the supply of loanable funds.
   c. increase the interest rate and lower the price of bonds.
   d. decrease the supply of loanable funds.

8. Wealth, properly understood, includes:
   a. money.
   b. goods and services
   c. goods, services, and money.
   d. none of the above.

9. Interest rate risk refers to the fact that:
   a. government bonds are considered a risk-free investment and are therefore unaffected by changes in market interest rates
   b. fluctuations in market interest rates can affect the interest payments of a bond.
   c. fluctuations in market interest rates can affect the price of a bond.
   d. fluctuations in market interest rates can affect the face or par value of a bond.

10. Susie’s contributions over the years to her retirement savings combined with the earnings those funds have generated over the years, total $250,000. Susie is now 65 and has a life expectancy of 80. Assuming her investments can continue to earn 6%, what is the maximum annual check Susie would receive if she were to completely exhaust her retirement funds by the time she reaches 80? (assume n=15).
    a. Susie can expect $11,585 each year from Social Security
    b. Susie can expect $25,741 each year from Social Security.
    c. Susie can expect $104,250 each year from Social Security.
    d. There is not enough information to answer this question.

Short answer problem(s)

At issuance, you purchase a 4% 10-year coupon bond when market interest rates are 5%. One year later, because market rates have risen further (this time, to 7%), you decide to sell your bond. If you have received one coupon payment, calculate your bond’s rate of return over your one-year holding period.

\[
P_0 = 40 \times 7.722 \text{ [Table D, n=10; i=5%]} = \$308.88
+ 1,000 \times 0.614 \text{ [Table B, n=10; i=5%]} = \$614.00
\]
\[
P_1 = 40 \times 6.515 \text{ [Table D, n=9; i=7%]} = \$260.60
+ 1,000 \times 0.544 \text{ [Table B, n=9; i=7%]} = \$544.00
\]
\[
ROR = \frac{C}{P_0} + \frac{P_1 - P_0}{P_0} = \frac{40}{922.88} + \left(\frac{804.60}{922.88} - 1\right) = 4.33\% + (-12.82\%) = -8.49\%
\]

You earned a negative 8.5% ROR on your investment under these conditions.