Whitman College
Econ 407
Exam 1
October 5, 2012

Write all answers in your blue book. Explain all of your answers. The exam ends at 12:10.

1. (15pts) Consider the conclusions in the Financial Crisis Inquiry Commission's January 2011 report. According to the report, why didn't the instinct for self-preservation in financial firms "shield them from fatal risk-taking"?

2. (10pts) Consider the speech "Lessons from the Financial Crisis: Canada in Comparative Perspective" given in February 2011 by Nicholas Le Pan, Superintendent of Financial Institutions for Canada from 2001 to 2006. What core principle of banking regulation does Mr. Le Pan find most important? Why is this principle so important?

3. (a) (5) Define money.

(b) (5) Define representative money.

(c) (5pts) Consider the history of money in the United States. What items have circulated as representative money in the U.S.?

4. Consider Adam Smith's "Of the Origin and Use of Money."

(a) (5pts) According to Smith, what made it "necessary…to affix a public stamp upon certain quantities of such particular metal, as were in those countries commonly made use of to purchase goods"?

(b) (5pts) What, according to Smith, was the motivation for princes and sovereign states to have "diminished the real quantity of metal, which had been originally contained in their coins"?

(c) (5pts) How, according to Smith, did debasement of coins affect individuals?

5. (10pts) Consider "Deflating the Case for Zero Inflation" (1990), by Rao Aiyagari.
Why did "recent repeated failures by the federal government to contain the deficit" concern Aiyagari?

Consider the information below on nominal yields to maturity for debt issued by the United States Treasury on October 2, 2006. Use this information to answer **Questions 6 and 7**.

Treasury Yield Curve Rates

Date	1 Mo	1 Yr	2 Yr	3 Yr	5 Yr	7 Yr	10 Yr	20 Yr	30 Yr
10/2/06	4.67%	4.90%	4.66%	4.59%	4.56%	4.57%	4.62%	4.83%	4.76%

6. (15pts) Use the yield curve rates for October 2, 2006 and the Pure Expectations Theory of the term structure of interest rates to forecast the nominal yield to maturity on a one year Treasury bill offered October 2, 2007. Show all of your work.

7. In the October 3, 2006 *Wall Street Journal* article **"Reading the Bond Market's Tea Leaves to Deduce What's Ahead"** (p. R21) WSJ reporter Gregory Zuckerman asked fund manager Liard Landmann "Do you expect an economic downturn?" Mr. Landmann replied :

> "We definitely expect a slowdown. All the factors are in place for that. Monetary policy works with a lag so the Fed's interest-rate increases of the past two years are poised to weigh on the economy. There's a housing slowdown, and the consumer is not in a position to provide stimulus to the economy, because the consumer is leveraged…."

When Mr. Zuckerman followed up with the question "How big an economic slowdown do you foresee?" Mr. Landmann's reply included:

> "That likely will depend on whether the housing market is just slowing down or if there will be a catastrophe. It will all come down to whether the aggressive products in the mortgage market of the past few years cause a rash of defaults among homeowners."

(a) (10pts) Under the Pure Expectations Theory of the term structure of interest rates, does the October 2, 2006 yield curve provide evidence supporting a forecast of an economic slowdown to come? Explain your answer.

(b) (5pts) Why do economists look at yield curves when we want to "deduce what's ahead?"

When Mr. Zuckerman asked fund manger Tad Rivelle about his management strategy for the past year, Mr. Rivelle replied:

> **"**The housing market started to see signs of stress in the fall of last year, and what the Fed did was continue on the course of action that [it] communicated clearly: staying on the tightening bandwagon until sentiment changed on housing and there was a reappraisal of risk among speculators. We took the Fed at its word and we were cautious, [emphasizing short-term bonds, which tend to fall less in value when interest rates rise].

(c) (5pts) Explain why short-term bonds "fall less in value when interest rates rise."