

Mid Semester Exam (Answer Key and Explanations)

Course: Money and Banking

Course Code: ECO 223

Total points: 30

Weightage towards final grade: 30%

Date: 11/06/2023

Time: 2:30 PM - 4:30 PM

Name: _____ Roll No. _____

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|---------|-----------------|---|
| 1. (B) | 12. (C) | 20. $\% \Delta M + \% \Delta V - \% \Delta Y$ |
| 2. (C) | 13. (A) | 21. ₹37509 (Units compulsory) |
| 3. (D) | 14. (C) | 22. 0.75% |
| 4. (D) | 15. (A) | Section II |
| 5. (A) | Section I | Total: _____ |
| 6. (D) | Total: _____ | 23. (C) |
| 7. (C) | 16. $e + r > 1$ | 24. (C) |
| 8. (D) | 17. (E) | 25. (A) |
| 9. (D) | 18. Segmented | 26. Inventories |
| 10. (C) | Markets | Section III |
| 11. (B) | 19. (D) | Total: _____ |

Section I

1. There are two **main** reasons why banks hold reserves. Which of these is not one of them?

- (A) To meet mandated reserve requirements
- (B) For emergencies when loans are not repaid
- (C) To meet obligations to a depositor
- (D) At no point during the course did we answer this properly.

Answer. The answer is (B). This is directly in your slides, and it not one of the two primary reasons.

2. As per the slides and book, bank securities are made up of

- (A) Debt instruments and stocks (B) Primarily stocks
- (C) Only debt instruments. (D) Primarily debt instruments with some stock

Answer. (C). As we have read in class, banks cannot hold stocks. This is again from your slides.

3. “The manager must decide the amount of capital the bank should maintain and then acquire the needed capital”. This is known as

- (A) Hedging capital (B) Capital Management Problem.
- (C) Capital shortfall prevention (D) None of these.

Answer. (D). It is Capital Adequacy Management.

4. *The options to this will seem vague but you will know the answer if you have studied.*

Some banks (especially more local ones) do not diversify its portfolio of loans as it has better knowledge and experience in lending to a particular type of borrower (we talked about agricultural loans in class). In the context of our class, this is especially helpful in

- (A) Capturing a specific market (B) Avoiding competition with bigger banks
- (C) Establishing more personal relations with certain borrowers.
- (D) Better understanding of the creditworthiness of a given borrower.

Answer. (D). This is explained in the section on managing credit risk.

5. From the perspective of a bank, “Short term securities” are

- (A) Rate-sensitive assets (B) Rate-sensitive liabilities
- (C) Assets but not rate-sensitive. (D) None of the above

Answer. (A). You can just refer to the slides. Again, taken directly.

6. Which of these “Accounts for different degrees of rate sensitivity”

- (A) Basic gap analysis. (B) Maturity Bucket Approach.
- (C) Advanced gap analysis. (D) None of the above.

Answer. (D). This is standardized gap analysis.

7. The **most important** addition by Keynes to the existing QTM with regards to money demand was

- (A) Transactions demand for money. (B) Precautionary demand for money.
- (C) Speculative demand for money. (D) Something else.

Answer. (C). He also talked about precautionary money demand but it was not the factor that was the key addition that drove his theory (discussed in class during the QTM lecture)

8. Ceteris paribus, when $BR \uparrow$, Money Supply decreases. The reason is

- (A) Less multiple deposit expansion (B) More multiple deposit expansion
(C) Less loans and deposit creation (D) More MB for deposit creation.

Answer. (D). From a table in your slides.

9. If $i_{or} = i_{ff}$, an open market sale

- (A) Does not affect i_{ff} (B) Increases i_{ff} (C) May decrease i_{ff}
(D) May increase i_{ff} .

Answer. (D). It depends on how much the supply curve shifts to the left.

10. Investor overconfidence and social contagion leading to stock market bubbles are studied in

- (A) Irrational investor theory. (B) The theory of cognitive investment.
(C) Behavioural finance. (D) None of the above

Answer. (C). These are behavioural factors. One can include loss aversion too.

11. _____ lowers the probability that a loan will be repaid due to post contractual risks taken by a borrower

- (A) Adverse Selection. (B) Moral Hazard. (C) The Lemons Problem.
(D) Something else.

Answer. (B). By definition. One of the question from pre mid-sem.

12. A nominal anchor is like a _____ rule

- (A) Price (B) Production (C) Behaviour. (D) Legal.

Answer. (C). Sentence lifted verbatim from slides.

13. In the context of GDP, factors of production include

- (A) Land (B) Revenue (C) Rent (D) None of the above.

Answer. (A). The three factors are land, labour and capital.

14. Which of these measures is particularly important both in “real” and “nominal” terms

- (A) GDP (PPP). (B) GDP (per capita) (C) Foreign Exchange Rate.
(D) Nothing is particularly important in nominal terms

Answer. (C). We discussed this a bit in class.

15. Other things held constant, an increase in domestic productivity leads to

- (A) $E^* \uparrow$ (B) $E^* \downarrow$ (C) E^* doesn't depend on domestic production much.
(D) Need more information.

Answer. (A). From a table in your slides.

Section II

16. If m is a function of c , e and r . Show the condition for which m is increasing in c (answer can also be always or never). *Answer.* $m = \frac{1+c}{r+e+c}$. To know the effect of c , take derivative.

$$\frac{\partial m}{\partial c} = \frac{e+r-1}{(r+e+c)^2}$$

This is greater than 0 iff $e+r > 1$.

17. The statistical measure that helps us understand how well a portfolio is diversified is

- (A) Variance (B) Mean (C) Skewness (D) Kurtosis (E) Correlation

Answer. The answer is correlation. The less correlated assets are, the less likely they are to be hurt by the same shock.

18. Bonds identical in every other way except their maturities are not substitutes at all.

This is the _____ Theory. *Answer.* Segmented markets theory. by definition. The only reason this was a medium hard question was because it was in the pre-midsem syllabus.

19. When comparing year t to year $t + 1$, an increase in prices leads to

- (A) Increased nominal GDP (B) Decreased real GDP.
(C) No change in real GDP (D) Can't say for sure.

Answer. (D). The question does not say ceteris paribus (or other things held constant), implying that production could have increased or decreased too.

20. If velocity of money V were not constant in the short run, $\pi =$ _____. *Answer.*

$\% \Delta M + \% \Delta V - \% \Delta Y$. This is from the slides.

21. $\Delta R = ₹12003$, $rr = 32\%$. Find ΔD accurately rounded off to the closest integer (not rounded up or rounded down, rounded off). *Answer.* ₹37509. Just divide.

22. In Gordon's growth model, if $P_0 = ₹2000$, $D_1 = ₹10$, $k_e = 3g$, $k_e =$ _____ %.

Answer. 0.75%. Use the Gordon growth model formula.

Section III

23. We discussed some things about models in economics the other day. In an economic model, what would you call a “parameter”

- (A) A component of the model that is endogenously determined.
- (B) A component of the model that depends on the choice variable.
- (C) A component of the model that cannot be affected by any decision maker within the model.
- (D) A state variable (as opposed to a choice variable).

Answer. (C). Parameters are “given” in the model and no decision maker can affect it within the model. Another word often used is “exogenously” given.

24. Hypothetically, if a country did not engage in any import or export of goods and services as it was truly self sufficient (and was absolutely certain that they would never have to), would exchange rate still matter? (Exclude tourism as well. Who would want to leave such a lovely place even for a holiday?)

- (A) Quite simply, no.
- (B) Yes, but there isn’t a solid reason related to economics for various reasons related to politics and international relations.
- (C) Yes, and for important economics related reasons.
- (D) No, but a government would still treat it as an indicator of economic health.

Answer. (C). Even if you have no clue, the answer is obviously going to be (C). The reason is people can still choose to invest in other countries (financial assets). This is not import/export of goods and services.

25. In class I referred to a term often used in economics: “costly signals”. In a financial markets, where information asymmetries are seen everywhere, a costly signal can sometimes help in

(A) Screening (B) Cheap Talk (Also an economics term I have used in class).

(C) Better understanding interest rates. (D) Time-consistent decisions

Answer. (A). Costly signals (like a degree or a guarantee) help with screening. Cheap talk are like costless signals (an ad saying we are the best in the world).

26. A car company has manufactures the chassis of 50 cars when it is time to calculate GDP. The chassis is not yet a car, but will be by the next production cycle. In the measurement of production (GDP), this is known as _____. (I am asking for a specific term, do not a broader one like C , I or G).

Answer. Inventories. This is from the GDP chapter.

Rough Work
