**CAFER SELLI**

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**ECON 212 – Principles of Economics II**

**Problem Set 5**

**LONG QUESTIONS:**

**1)** Why is the FED’s role as lender of last resort an important function of the FED?

Because credit becomes unavailable, the entire real economy can stagnate. The Fed's role as lender of last resort is vital. If no one else would, the Fed can use loans and monetary policy to bridge the short-term credit gap.

**2)** What role did liquidity play in the financial crisis in 2008? What caused this lack of liquidity?

Financial institutions had enough assets to satisfy their long-term responsibilities, but not enough liquidity or assets that could be transformed quickly into cash to cover their short-term obligations. The illiquidity was caused by their failure to sell their assets quickly enough at nonfire sale pricing.

**3)** How can a debt that is too high lead to an even higher debt?

Bondholders may demand a risk premium, resulting in increased interest rates, interest payments, deficits, and debt.

**4)** List three ways in which individual debt differs from government debt.

1. The government lives forever; people don't.  
2. Government owes much of its debt to itself, which is debt owed to its own citizens.  
3. The government can print money to pay its debt; people can't.

**5)** What are the two ways government can finance a budget deficit?

The government finances its deficits by:

1. Selling bonds to private individuals and to the central bank.

2.. Selling bonds to the central bank.

**MULTIPLE CHOICE QUESTIONS:**

**1)** If you invest $100 in a stock, borrowing 90 percent of the $100 at 10 percent interest, and the stock price rises by 20 percent, what is the return on your investment? **(B)**

A) 90%

B) 110%

C) 120%

D) 130%

**2)** What is leveraging?

**A) The practice of buying an asset with borrowed money.**

B) The human tendency to follow the crowd.

C) A system under which the federal government promises to reimburse an individual for any losses due to bank failure.

D) The policy of buying a wide range of financial assets from banks and other financial institutions in order to stimulate the economy.

**3)** What is herding?

A) The practice of buying an asset with borrowed money.

**B) The human tendency to follow the crowd.**

C) A system under which the federal government promises to reimburse an individual for any losses due to bank failure.

D) The policy of buying a wide range of financial assets from banks and other financial institutions in order to stimulate the economy.

**4)** What are the unconventional monetary policies?

**A) Quantitative easing, Operation twist, Precommitment policy**

B) The Law of Diminishing Control, Deposit insurance, Glass-Steagall Act

C) Leverage, Herding, Mortgage-backed securities

D) Efficient market hypothesis, Quantitative easing, The Law of Diminishing Control

**5)** Inflation is 10 percent. Debt is $2 trillion. The nominal deficit is $300 billion. Calculate the real deficit or surplus.

A) $100 billion real deficit

B) $300 billion real deficit

C) $100 billion real surplus

D) $300 billion real surplus

**6)** Inflation is 15 percent. Debt is $2 trillion. Nominal deficit is $220 billion. Calculate the real deficit or surplus. **(C)**

A) $80 billion real deficit

B) $220 billion real deficit

C) $80 billion real surplus

D) $220 billion real surplus

**7)** Inflation is −4 percent. Debt is $500 billion. Nominal deficit is $30 billion. Calculate the real deficit or surplus.

A) $10 billion real deficit

B) $30 billion real deficit

C) $10 billion real surplus

D) $30 billion real surplus

**8)** Inflation is 2 percent. Debt is $1 trillion. Nominal deficit is $50 billion. Calculate the real deficit or surplus.

A) $30 billion real deficit

B) $50 billion real deficit

C) $30 billion real surplus

D) $50 billion real surplus

**9)** What is the structural deficit?

A) Part of the deficit that exists because the economy is operating below its potential level of output.

B) Nominal deficit adjusted for inflation.

C) Part of the budget deficit that would exist even if the economy were at its potential level of output.

D) Accumulated deficits minus accumulated surpluses.

**10)** Which one is the definition of surplus?

A) a shortfall of revenues under payments

B) an excess of revenues over payments.

C) the difference between expenditures and receipts.

D) government debt owed to individuals in foreign countries