EC1B5 | Chapter 10

Credit Markets

Additional Practice Questions:

Book Question 4

Many kinds of loans, like student loans and mortgages, can be taken out at either a fixed or variable rate. A fixed rate loan allows the borrower to pay the same nominal interest rate for the entire lifetime of the loan, while a variable rate loan may experience changes in in the nominal interest rate as the rate that banks charge each other for overnight loans changes. For this problem, assume that this variable nominal interest rate adjusts such that the associated real interest rate remains constant over time.

a. In the first year, inflation is 2.75 percent and the nominal interest rate for both the fixed and variable rate loans is 5 percent. What is the real interest rate for the fixed rate loan? What about for the variable rate loan?

b. In the second year, inflation rises to 3 percent. Calculate the nominal and real interest rates for the fixed rate and the variable rate loans described in part a.

c. What happens if the inflation rate falls? Could a borrower end up facing a much higher real interest rate with a variable rate loan? With a fixed rate loan?

d. Suppose you are deciding between a fixed rate and a variable rate loan and that you dislike risk (variability) in the real interest rate you pay. Should you opt for a fixed rate or a variable rate loan? Are there any reasons for a borrower to dislike variability in the nominal interest rate rather than the real interest rate she faces?

Book Question 5

Explain how the equilibrium real interest rate and the equilibrium quantity of credit would change in each of the following scenarios and illustrate your answer with a well-labeled graph of the credit market.

a. As the real estate market recovers from the 2007 – 2009 financial crisis, households begin to buy more houses and condominiums, and they apply for more mortgages to enable those purchases.

b. Congress agrees to a large tax cut which increases the level of the government deficit.

c. Households begin to fear that a growing pandemic may cause them to lose their jobs and they increase their savings for a rainy day.

d. Businesses become more optimistic about the future of the economy and decide to distribute more of their earnings as dividends to their shareholders.

Book Question 8

If you have studied microeconomics, you may recall a concept called "moral hazard." Moral hazard occurs when an economic agent is incentivized to take risks because some (or all) of the losses that might result will be borne by other economic agents. Discuss how federal deposit insurance, administered by the FDIC as described in the chapter, might lead to moral hazard.

Book Question 11

The sharpest one-day percentage decline in the Dow Jones Industrial Average (DJIA) took place on October 19, 1987. The DJIA fell 23 percent on this one day. Foreign exchange markets and other asset markets also exhibit large fluctuations on a daily basis. Based on the information given in this chapter, discuss some factors that could explain why asset prices fluctuate.