Homework 2

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Chapter 3

1. Credit unions are **made up of individuals who possess common bonds of association**.
    - B
2. Financial institutions include all of the following except **pawn shops**.
    - D
3. Which of the following institutions is not part of the modern banking system?
    - C – **Mutual Funds**
4. An open-end investment company that can issue an unlimited number of its shares to investors and use the pooled proceeds to purchase corporate and government securities is called a(n) **mutual fund**.
    - A
5. Commercial banks obtain the bulk of their loanable funds from **depositors**.
    - A
6. What is?
    1. Liquidity risk: **Likelihood that a bank will be unable to meet its depositor withdrawal demands and/or other liabilities when they are due**
    2. Credit risk: **The chance of nonpayment or delayed payment of interest or principal**
    3. Interest rate risk: **(1) reflects the possibility of changes or fluctuations in market values of fixed-rate debt instruments as market interest rates change over time; (2) variations in interest expense unrelated to sales or operating income arising from changes in the level of interest rates in the economy**
7. The following three one-year "discount" loans are available to you:

    Loan A: $120,000 at a 7 percent discount rate

    Loan B: $110,000 at a 6 percent discount rate

    Loan C: $130,000 at a 6.5 percent discount rate

    1. Determine the dollar amount of interest you would pay on each loan and indicate the amount of net proceeds each loan would provide. Which loan would provide you with the most upfront money when the loan takes place?
        - Loan A:

$$\begin{gathered} 120000 * .07 = 8400 \\ 120000 - 8400 = 111600 \end{gathered} \tag{1}$$

Loan B:

$$
\begin{aligned}
110000 * .06 &= 6600 \\
110000 - 6600 &= 103400
\end{aligned} \tag{2}
$$

Loan C:

$$
\begin{aligned}
130000 * .065 &= 8450 \\
130000 - 8450 &= 121550
\end{aligned} \tag{3}
$$

Loan C has the largest upfront value.

2. Calculate the percent interest rate or effective cost of each loan. Which one has the lowest cost?
   - Loan A: $\frac{8400}{111600} = 7.53\%$
     Loan B: $\frac{6600}{103400} = 6.38\%$
     Loan C: $\frac{8450}{121550} = 6.95\%$

     Loan B has the lowest cost.

8. What is Quantitative Easing (QE)? When has it been recently used and how?
   - Quantitative Easing is a nontraditional monetary policy designed to stimulate eco- nomic activity when conventional monetary policy methods are ineffective. Fed purchases financial assets from banks and other financial institutions with newly created money resulting in larger bank excess reserves and increased money supply and liquidity.
   - Quantitative Easing (QE1) was begun in late-2008 when the Fed began buying large amounts of mortgage-backed securities and Treasury securities from financial institutions. QE2 was initiated in 2010 and QE3 in 2012 in an effort to stimulate economic activity
9. Under the Federal Reserve Act of 1913, the number of Federal Reserve districts established is **12**.
   - C
10. The seven-member board of the Federal Reserve that sets monetary policy is called **the Federal Reserve Board of Governors**.
    - B
11. The chairman of the Federal Reserve System **is appointed by the President of the United States**.
    - D
12. The primary function of the Federal Reserve System is to **regulate the growth of the money supply**.
    - B
13. The Federal Reserve Banks are owned by **member banks of the Federal Reserve System**.
14. The Federal Open Market Committee **implements the most powerful and flexible monetary policy tool of the Fed** .
    - B
15. Open market operations **are used infrequently** .
    - A
16. The effect of an increase of required reserves by the Fed is **a decrease in loanable funds of depository institutions**.

- A

17. During the past several years **the discount rate has been lower than the prime rate**.
    - A
18. A basic policy instrument that the Fed uses to execute monetary policy is which of the following?
    - B – **changing the lending/discount rate**
19. The Fed controls the **money** supply.
    - C
20. The Fed discount rate is **the rate a bank must pay to borrow from the Fed**.
    - C
21. The interest rate that a bank must pay to borrow from its regional federal reserve bank is called **the Federal Discount Rate**.
    - C