Chapter 8 Assignment

A 1. Which of the following statements is correct?
   a. Lenders buy bonds, and borrowers sell them.
   b. Long-term bonds usually pay a lower interest rate than do short-term bonds, because long-term bonds are riskier.
   c. Junk bonds refer to bonds that have been resold many times.
   d. Short-term bonds usually pay a lower interest rate than do long-term bonds, because short-term bonds are riskier.

B 2. In a CLOSED economy, national saving equals which of the following?
   a. income plus the sum of consumption and government expenditures
   b. income minus the sum of consumption and government expenditures
   c. GDP plus consumption expenditures
   d. GDP minus consumption expenditures

A 3. Suppose the current market interest rate for loanable funds is below the equilibrium level. Which of the following best describes this situation?
   a. There is a shortage of loanable funds
   b. There is a surplus of loanable funds
   c. There is a shortage of loanable funds
   d. There is a surplus of loanable funds

B 4. Suppose that Parliament were to introduce a new investment tax credit. What would happen in the market for loanable funds?
   a. The demand for loanable funds would shift left, and interest rates would fall.
   b. The demand for loanable funds would shift right, and interest rates would rise.
   c. The supply of loanable funds would shift left, and interest rates would rise.
   d. The supply of loanable funds would shift right, and interest rates would fall.

C 5. Suppose Canada increases its budget deficit. What effect would this have?
   a. Private saving would fall, and the supply of loanable funds would shift left.
   b. Investment would fall, and the demand for loanable funds would shift right.
   c. Public saving would fall, and the supply of loanable funds would shift left.
   d. Public saving would fall, and the supply of loanable funds would shift right.

C 6. Crowding out refers to which of the following?
a. an increase in national saving that occurs when government runs a deficit
b. a decrease in the real interest rate due to government borrowing
c. a reduction in investment spending resulting from government borrowing
d. a decrease in consumption spending resulting from government borrowing

C 7. Which of the following statements is true for a bank to be profitable?
a. The loans must cost more than the price of obtaining funds.
b. The loans must pay less interest than the total revenue from obtaining funds.
c. The loans must make more interest than the total cost of obtaining funds.
d. The loans must be less profitable than the total revenue from obtaining funds.

B 8. Large budget deficits are likely to do which of the following?
a. increase the nation's pool of saving
b. decrease the nation's pool of saving
c. have no impact on the nation's pool of saving
d. improve the nation's trade balance

A 9. Which of the following best describes the supply curve of loanable funds?
a. upward-sloping, reflecting the fact that savers need a higher rate of interest to coax them into lending more
b. downward-sloping, reflecting the fact that savers will increase their supply for loanable funds at lower rates of interest
c. upward-sloping, reflecting the fact that savers will increase their saving at lower rates of interest
d. downward-sloping, reflecting the fact that savers will decrease their saving at lower rates of interest

D 10. If the market for loanable funds is NOT in equilibrium, which of the following factors must change to bring it into equilibrium?
a. output
b. profits
c. the inflation rate
d. the interest rate

B 11. In the market for loanable funds, which of the following statements is true?
a. Higher interest rates discourage savings.
b. Lower interest rates encourage investment.
c. Lower interest rates make borrowers worse off.
d. Higher interest rates increase the demand for loanable funds.

A 12. Which of the following best describes the primary function of commercial banks?

a. Banks use people's deposits to make loans.
b. Banks issue mortgage loans.
c. Banks print and circulate money.
d. Banks have a positive impact on the economic system.

D 13. Suppose GDP last year in a closed economy was $2000, taxes were $100, government spending was $200, and consumption was $1200. What was national saving?

a. $1000
b. $800
c. $700
d. $600

C 14. Which of the following is correct?

a. Bondholders bear higher risk than stockholders.
b. Bondholders are issued owner shares of a corporation when they buy its bonds.
c. Stockholders enjoy the benefits of a company's profits.
d. If a company runs into financial difficulty, stockholders are paid what they are due before bondholders receive anything.

True or False?

F 15. Private savings is the tax revenue that the government has left after paying for its spending; and public savings is the income that households have left after paying for taxes and consumption.

F 16. A budget deficit is an excess of tax revenue over government spending; and a budget surplus is a shortfall of tax revenue from government spending.

F 17. A budget surplus decreases the supply of loanable funds, increases the interest rate, and stimulates investment.

T 18. The financial system is the group of institutions in the economy that help match one person's savings with another person's investment.

T 19. A mutual fund is an institution that sells shares to the public and uses the proceeds to buy a selection, or portfolio, of various types of stocks, bonds, or both stocks and bonds.

20. What are the basic differences between bonds and stocks?

Bond holder is a lender, shareholders are part owner of the company. when a corporation sell bonds to get money they're borrowing (debt finance), when corporations sell stock to raise money they're doing equity finance. Bonds pay interests payment while stocks pay dividens.

21. Identify each of the following acts as representing either saving or investment.

   a. Fred uses some of his income to buy government bonds.

      Saving

   b. Julie takes some of her income and buys mutual funds.

      Saving

   c. Alex purchases a new truck for his delivery business using borrowed funds.

      Investment

   d. Elaine uses some of her income to buy stock in a major corporation.

      Saving

   e. Henrietta hires a builder to construct a new home using borrowed funds.

      Investment

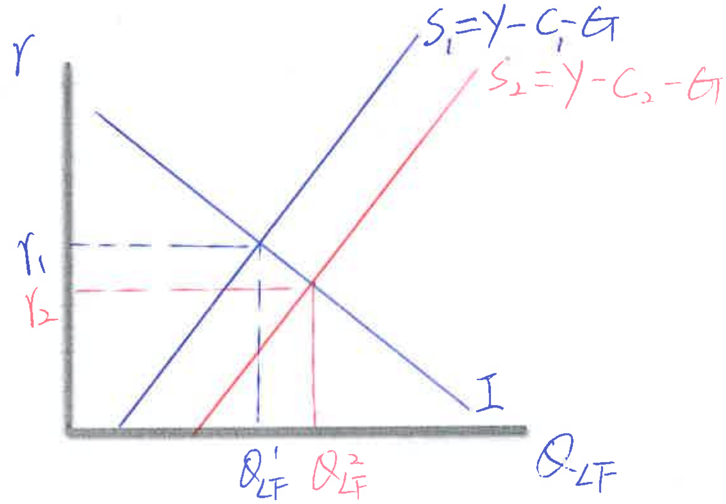
22. Explain why the demand for loanable funds slopes downward and the supply of loanable funds slopes upward.

Demand represents investment which is negatively related to real interest rate.
Supply represents savings which are positively related to real interest rate.

23. What is the primary function of banks? How do banks cover their costs?

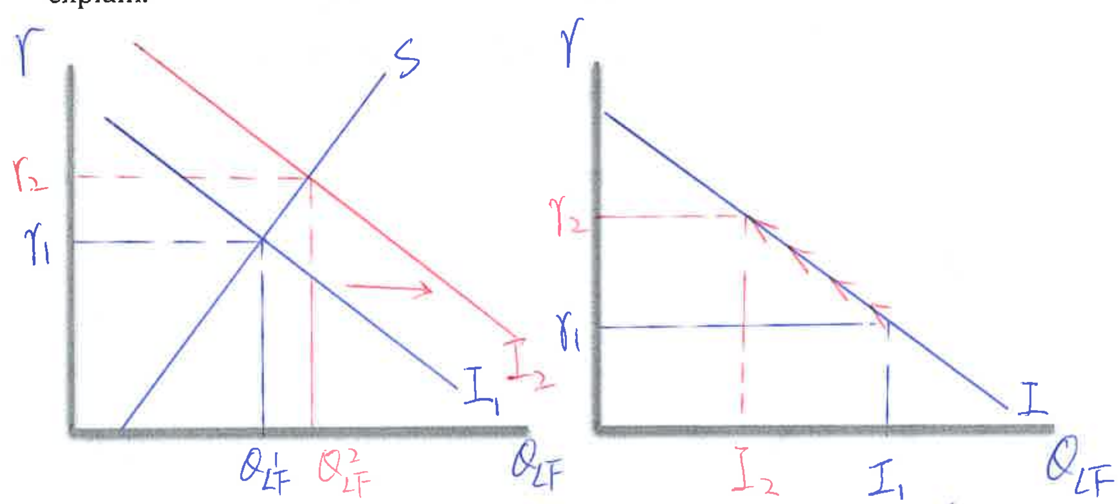
The primary function of banks is to take in deposits from whom has savings & direct them to those who want to borrow.
Banks cover their costs from the interest rate spread b/w borrower & lender. They also provide financial services & do investment to make profits.

24. Australia has recently implemented a national sales tax. If that country uses the proceeds from this tax to reduce income tax rates, what happens in the loanable funds market?



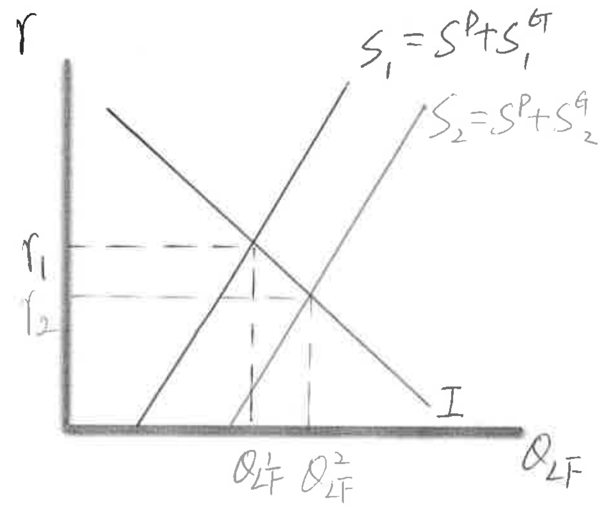
C↓ w/ the sales tax

25. The model of the market for loanable funds shows that an investment tax credit will cause interest rates to rise and investment to rise. Yet we also suppose that higher interest rates lead to lower investment. How can these two conclusions be reconciled? Show both on the diagrams below and explain.



Investment tax credit change investment spending at every level of interest rate, which shifts the I-curve to the right. ↑ in r however changes quantity of loanable funds demanded & thus causes a movement along the I-curve

26. Using a graph representing the market for loanable funds, show and explain what happens to interest rates and investment if a government goes from a deficit to a surplus.



$S^G \uparrow \rightarrow S \uparrow$
$\rightarrow r \downarrow$
$\rightarrow S \uparrow \& I \uparrow$

27. In a closed economy GDP = \$1300, private saving = \$125, government budget deficit = \$5, and government spending =\$15 (all numbers are in billions). Calculate national saving, taxes, and consumption.

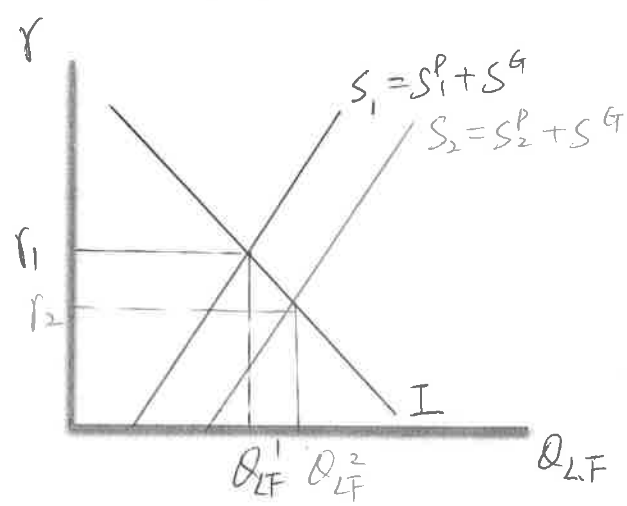
$S = S^P + S^G = 125 - 5 = \$120$

$S^G = T - G \Rightarrow T = S^G + G = -5 + 15 = \$10$

$S^P = Y - T - C \Rightarrow C = Y - T - S^P = 1300 - 10 - 125 = \$1165$

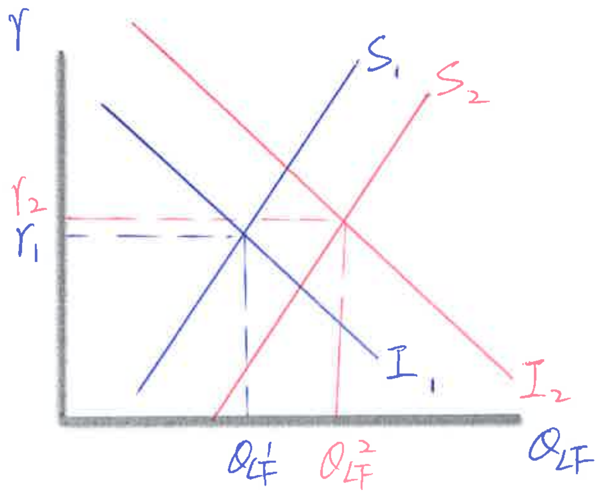
28. Consider a closed economy. Use the supply and demand for loanable funds model to predict the effects of the following events on interest rates and investment.

   a. The government introduces a tax credit for savings accounts of up to \$5000 per year.



$S^P \uparrow$
$S \uparrow$
$I \uparrow$
$r \downarrow$

b. The government introduces a tax credit for savings accounts of up to \$5000 per year, and at the same time it repeals an investment tax exemption provision.



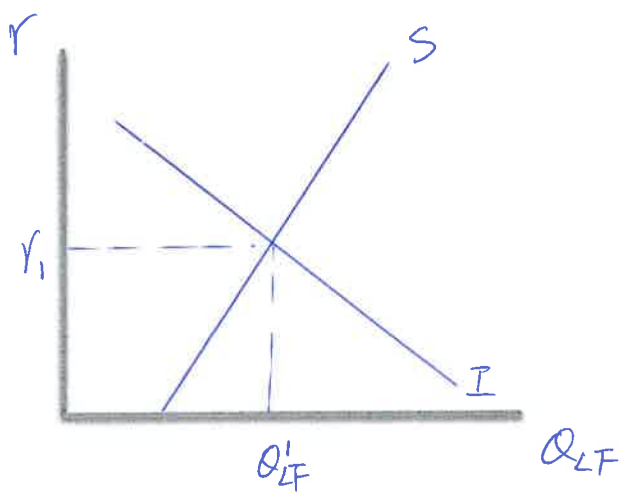
$S\uparrow$ & $I\uparrow$

$S\uparrow : r\downarrow , Q_{LF}\uparrow$

$I\uparrow : r\uparrow , Q_{LF}\uparrow$

$r?\quad Q_{LF}\uparrow$

c. The government raises the tax rates.



Nothing changes.

$$S = \underbrace{(T-G)}_{S^G} + \underbrace{(Y-T-C)}_{S^P}$$

$$= \cancel{tY} - G + Y - \cancel{tY} - C$$

$$= Y - C - G$$