DEPARTMENT OF ECONOMICS AND FINANCE
College of Management and Economics

ECON*3960 – Money, Credit and the Financial System

Winter 2018 - Midterm #2 – Version 1

INSTRUCTOR: E. Adomait

NAME: ANSWER KEY ID#: ____________

Question:

1. ______
2. ______
3. ______
4. ______

Total: ______

1) Write a brief essay on some aspect of the 2008 Financial Crisis.

2 points for a clear, precise thesis

6 points for facts

2 points for writing

2) Give a significant difference and significant similarity between the following pairs of terms. Use point form.

a) Office of the Superintendent of Financial Institutions and Ontario Securities Commission

Similarity:

2 Regulatory Bodies of financial institutions

Difference:

OSFI → federal, Banks, near banks
OSC → provincial, capital markets

b) Money market and Bond Market

Similarity:

2 money & Bonds → debt, or store of value, asset

Difference:

money - short liquid
Bonds → longer less liquid

c) M1 and M1+

Similarity:

2 Definition of money

Difference:

M1 Chartered Banks
M1+ includes credit unions, caisse populaire etc

d) Bassel Accords and Capital Requirements:

Similarity:

2 Financial Risk

Difference:

International agreement of cap requirements are one of 3 pillars

e) CAMELS and VaR

Similarity:

2 measures of risk

Difference:

CAMELS → Multifaceted

VaR → Value at Risk → prob of a bad → $ loss

3) You are given the following information

The one year T-Bill sells for $991, the 2 year bond with a 4% coupon sells for $1019 and the 20 year Canada bond with a 5% coupon sells for $1000.

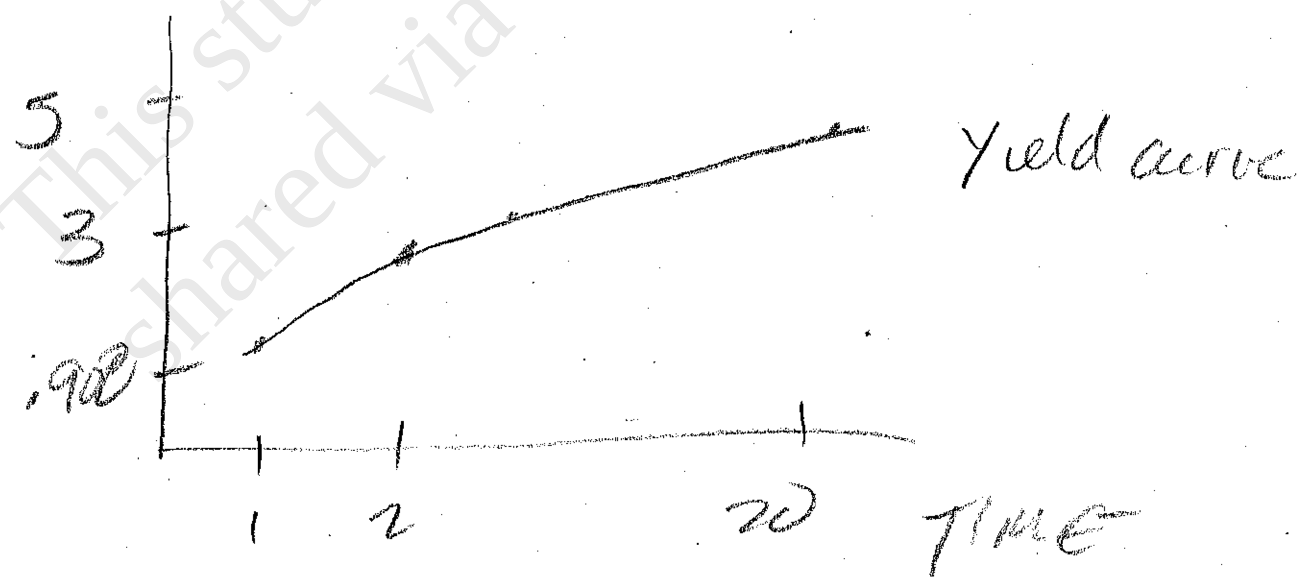
a) Draw the yield curve

1yr $1+i = \frac{1000}{991} = 1.00908$ or .908%

2yr $\$1019 = \frac{40}{i}\left(1 - \frac{1}{(1+i)^2}\right) + \frac{1000}{(1+i)^2}$

approx $= \dfrac{40 + (1000-1019)/2}{\frac{1019+1000}{2}} \sim 3\%$

20yr $i = 5\%$ sold at par



b) Use the expectations theory to predict next year's one year interest rate.

2

$$i_2^e = \frac{(1+i_2)^2}{(1+i_1)} - 1 = \frac{(1.03)^2}{(1.00908)^1} - 1 = \frac{1.0609}{1.00908} - 1$$

$$= 5.14\%$$

cheat approx

2yr	3%	3%	= 6%
1yr	.908%	5.09	= 6%

Use this get .5 or 1

Next the 1yr rate is expected to rise.

c) Explain how segmented markets can also explain this curve and why?

each market has its own S/D & equilibrium

Short market have higher prices

longer have lower prices

~~2~~ 1

d) What does this shape predict about the economy in the future and why?

The economy is improving → long rates are up due to ↑ in Bond sale

~~1~~ 2 Firms are going into debt because of future profits

4. The banking system is fraught with moral hazard. Explain the problem and the solutions to this issue if it is between,

a) Banks and their clients:

clients behave badly with money.
→ monitoring and restrictive covenants
↳ examples

5

b) Regulators and Financial institutions:

Banks behave badly ⇒ risky

regulate & monitor (OSFI)
↳ capital ↳ supervisory
Basel

5