

# Econ 121 Money and Banking

## Problem Set 2

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1. Using both the liquidity preference framework and the supply and demand for bonds framework, show why interest rates are procyclical (rising when the economy is expanding and falling during recessions).
2. Use either bond supply and demand analysis or liquidity preference framework to predict how each of the following events would affect the interest rate. Explain your answer..
  - (a) An increase in the riskiness of bonds.
  - (b) A sudden increase in the volatility of gold prices.
  - (c) A large federal deficit.
  - (d) Brokerage commissions on stocks fall.
3. An important way in which the Federal Reserve decreases the money supply is by selling bonds to the public. Using a supply and demand analysis for bonds, show what effect this action has on interest rates. Is your answer consistent with what you would expect to find with the liquidity preference framework?
4. If the income tax exemptions on municipal bonds were abolished, what would happen to the interest rates on these bonds? What effect would the change have on interest rates on U.S. Treasury securities?