

IFN 201 - International Financial Markets Study Questions 3

A. Multiple Choice Questions

1. Which factor shifts the supply of loanable funds to the right?
 - A) Higher inflation expectations
 - B) Decrease in household income
 - C) Increase in household savings rate ☒
 - D) Increase in government borrowing
2. When demand for loanable funds exceeds supply, interest rates will:
 - A) Fall
 - B) Remain constant
 - C) Increase ☒
 - D) Be unaffected
3. The “Crowding Out Effect” occurs when:
 - A) Firms borrow less due to higher interest rates caused by government borrowing ☒
 - B) Central Bank decreases policy rates
 - C) Inflation expectations decline
 - D) Private investment rises due to tax cuts
4. Which of the following is NOT a factor affecting investment demand?
 - A) Technological advancement
 - B) Institutional efficiency
 - C) Inflation expectation ☒
 - D) Government investment incentives
5. In the Fisher Equation, the nominal interest rate equals:
 - A) Real interest rate + expected inflation ☒
 - B) Real interest rate $\times$ expected inflation
 - C) Real interest rate – expected inflation
 - D) Only expected inflation
6. A normal (upward-sloping) yield curve usually indicates:
 - A) Economic slowdown
 - B) Expected decline in interest rates
 - C) Greater uncertainty about inflation in the long term ☒

D) Stable economic expectations

7. Under the Expectations Hypothesis, the long-term rate is:

- A) The sum of future short-term rates
- B) The average of expected future short-term rates ☒
- C) Always lower than short-term rates
- D) Determined only by inflation

8. If the Central Bank pursues expansionary monetary policy:

- A) Short-term interest rates rise
- B) Money supply decreases
- C) Credit contracts
- D) Short-term interest rates fall ☒

9. In an open economy, capital inflows cause:

- A) Interest rates to rise
- B) Interest rates to fall ☒
- C) Exchange rate to depreciate
- D) Borrowing costs to increase

10. Which Excel formula correctly computes the future value of £1000 at 8% for 3 years?

- A) =FV(8%, 3, 0, -1000)
- B) =FV(0.08, 3, 0, -1000) ☒
- C) =PV(0.08, 3, 0, -1000)
- D) =NPV(0.08, 3, 0, -1000)

11. Interest rates are determined by the equilibrium between:

- A) Exports and imports
- B) Supply of and demand for funds ☒
- C) Government spending and taxation
- D) Inflation and unemployment

12. When supply of funds exceeds demand, interest rates tend to:

- A) Increase
- B) Decrease ☒
- C) Remain constant
- D) Fluctuate randomly

13. When demand for funds exceeds supply, what happens?

- A) Interest rates fall
- B) Inflation decreases

- C) Interest rates rise ✓
- D) Liquidity increases

14. Which factor directly affects short-term interest rates through monetary policy?

- A) Inflation expectations
- B) Economic growth rate
- C) Central bank policies ✓
- D) Liquidity conditions

15. The 'price of money' in the economy refers to:

- A) Inflation
- B) Interest rate ✓
- C) Exchange rate
- D) Risk premium

16. A higher inflation expectation usually leads to:

- A) Lower nominal interest rates
- B) Higher nominal interest rates ✓
- C) Lower real interest rates
- D) Stable nominal interest rates

17. Which of the following describes a normal (upward-sloping) yield curve?

- A) Short-term rates exceed long-term rates
- B) Long-term rates exceed short-term rates ✓
- C) All maturities have equal rates
- D) Interest rates are negative

18. The liquidity premium explains why:

- A) Long-term assets are risk-free
- B) Long-term assets are less liquid and require higher returns ✓
- C) Short-term assets have higher yields
- D) Inflation decreases in the long run

19. Economic growth tends to:

- A) Decrease demand for funds
- B) Increase demand for funds and push interest rates up ✓
- C) Have no impact on interest rates
- D) Reduce inflation expectations

20. Risk premium refers to:

- A) The extra compensation lenders demand for uncertainty ✓
- B) The discount borrowers receive for early payment

- C) The government's tax on interest income
- D) The liquidity of long-term securities

B. True / False

1. The intersection of the supply and demand for loanable funds determines the equilibrium interest rate. → True
2. Higher household savings shift the demand curve for funds to the right. → False
3. Technological improvement reduces firms' willingness to borrow. → False
4. Higher inflation expectations usually increase nominal interest rates. → True
5. According to the Fisher Equation, nominal = real + inflation. → True
6. A flat yield curve signals economic expansion. → False
7. The Central Bank lowers policy rates to cool down inflation. → False
8. Crowding out occurs when government borrowing pushes out private investment. → True
9. The time value of money states that future money is more valuable than present money. → False
10. In an open economy, capital outflows can increase domestic interest rates. → True
11. Interest rates are set entirely by the central bank. → False
12. When supply exceeds demand, interest rates increase. → False
13. Inflation expectations are one of the key determinants of nominal interest rates. → True
14. Central bank policies mostly affect long-term interest rates. → False
15. A normal yield curve means long-term rates are higher than short-term rates. → True
16. Risk premium is unrelated to country risk. → False
17. Liquidity conditions affect how easily assets can be converted into cash. → True
18. Economic growth increases investment demand and can lead to higher interest rates. → True
19. When demand for funds exceeds supply, borrowing becomes cheaper. → False
20. The equilibrium interest rate balances savings and investment demand. → True

C. Problems with Detailed Solutions

1. £1000 is invested for 3 years at 8% annual interest. What is the future value?

Solution: $FV = PV (1 + i)^n = 1000 \times (1.08)^3 = £1,259.7$

2. Find the present value of £1,259 to be received in 3 years if the interest rate is 8%.

Solution: $PV = FV / (1 + i)^n = 1259 / (1.08)^3 = £1,000$

3. Investment cost £1000, cash inflows £400 for 3 years, $r = 10\%$. What is NPV?

Solution: $NPV = 400/(1.10) + 400/(1.10)^2 + 400/(1.10)^3 - 1000 = £-5.25 \approx 0$ (Break-even)

Interpretation: Near zero, investment breaks even.

4. If real interest rate = 4% and expected inflation = 6%, find nominal rate.

Solution: $i = r + \pi^e = 4\% + 6\% = 10\%$

5. Government deficit increases. What happens to the equilibrium interest rate?

Solution: Deficit $\uparrow \rightarrow$ D curve shifts right $\rightarrow$ Interest rate $\uparrow$

6. If short-term rates are 4% and long-term rates are 7%, what curve shape is it?

Solution: Normal (upward-sloping) yield curve

7. If foreign investors buy more Turkish bonds, what happens?

Solution: Capital inflows $\uparrow \rightarrow$ Supply of funds $\uparrow \rightarrow$ Interest rates $\downarrow \rightarrow$ Exchange rate appreciates

8. £5000 invested for 5 years at 6% interest. Find FV.

Solution: $FV = 5000(1.06)^5 = \text{£}6,691$

9. Future value = £2000, rate = 5%, time = 4 years. Find PV.

Solution: $PV = 2000 / (1.05)^4 = \text{£}1,646.7$

10. Use Excel to compute NPV for CFs £500, £600, £700; $r = 12\%$; cost = £1500.

Solution: $=NPV(0.12, 500, 600, 700) - 1500 = \text{£}-77.01 \rightarrow \text{Not profitable}$