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Study Questions, The Fed and Money (Answers on next page)

1. Suppose that next week the Fed unexpectedly purchases a large number of Treasury bonds on the open market. Describe the possible effects of this purchase on interest rates, bond prices, and economic activity.
2. You buy a 60-day T-bill with a face value of \$10,000 for \$9950 on the primary market. What is your annualized yield if you hold the bill to its maturity.

1. This action increases bank reserves, lowering the Fed Funds rate. As a result, we would expect other interest rates to fall. When interest rates fall, price of existing bonds rise. We would expect economic activity to pick up, as lower borrowing costs result in more loans being granted to businesses and consumers, resulting in greater sales, requiring production to pick up to meet the higher demand.

2. Yield = $(10000-9950)/9950 \times 365/60 = .03057$, or 3.057%