MULTIPLE CHOICE. Choose the one alternative that best completes the statement or answers the question.

1) U.S. government bonds have no default risk because A) the federal government can increase taxes to pay its obligations. B) they can be exchanged for silver at any time. C) they are backed by the full faith and credit of the federal government. D) they are backed with gold reserves.  

2) The spread between interest rates on low quality corporate bonds and U.S. government bonds A) did not change during the Great Depression. B) narrowed significantly during the Great Depression. C) widened significantly during the Great Depression. D) narrowed moderately during the Great Depression.  

3) Suppose you are holding a 5 percent coupon bond maturing in one year with a yield to maturity of 15 percent. If the interest rate on one-year bonds rises from 15 percent to 20 percent over the course of the year, what is the yearly return on the bond you are holding? A) 5 percent B) 10 percent C) 15 percent D) 20 percent  

4) A monetary expansion _______ stock prices due to a decrease in the _______ and an increase in the _______. everything else held constant. A) reduces; current dividend; expected rate of return B) increases; required rate of return; dividend growth rate C) reduces; future sales price; expected rate of return D) increases; required rate of return; future sales price  

5) The expectations theory and the segmented markets theory do not explain the facts very well, but they provide the groundwork for the most widely accepted theory of the term structure of interest rates, A) the Keynesian theory. B) liquidity premium theory. C) the asset market approach. D) separable markets theory.  

6) When the yield curve is flat or downward-sloping, it suggest that the economy is more likely to enter A) a recession. B) an expansion. C) a period of increasing output. D) a boom time.  

7) A situation in which the quantity of bonds supplied exceeds the quantity of bonds demanded is called a condition of excess supply; because people want to sell _______ bonds than others want to buy, the price of bonds will _______. A) more; rise B) more; fall C) fewer; rise D) fewer; fall  

8) Everything else held constant, if income tax rates were lowered, then A) the price of Treasury bonds would fall. B) the interest rate on Treasury bonds would rise. C) the interest rate on municipal bonds would fall. D) the interest rate on municipal bonds would rise.
9) Increased uncertainty resulting from the subprime crisis ______ the required return on investment in equity.
   A) had no impact on
   B) raised
   C) decreased
   D) lowered

10) As their relative riskiness ______, the expected return on corporate bonds ______ relative to the expected return on default-free bonds, everything else held constant.
    A) decreases; decreases
    B) increases; increases
    C) decreases; does not change
    D) increases; decreases

11) During a recession, the supply of bonds ______ and the supply curve shifts to the ______, everything else held constant.
    A) increases; left
    B) decreases; right
    C) increases; right
    D) decreases; left

12) If the expected path of 1-year interest rates over the next five years is 2 percent, 4 percent, 1 percent, 4 percent, and 3 percent, the expectations theory predicts that the bond with the lowest interest rate today is the one with a maturity of
    A) one year.
    B) two years.
    C) three years.
    D) four years.

13) Higher government deficits ______ the supply of bonds and shift the supply curve to the ______, everything else held constant.
    A) decrease; right
    B) increase; left
    C) increase; right
    D) decrease; left

14) If the amount payable in two years is $2420 for a simple loan at 10 percent interest, the loan amount is
    A) $1000.
    B) $1210.
    C) $2000.
    D) $2200.

15) In asset markets, an asset’s price is
    A) set equal to the highest price a seller will accept.
    B) set equal to the lowest price a seller is willing to accept.
    C) set equal to the highest price a buyer is willing to pay.
    D) set by the buyer willing to pay the highest price.

16) Recently the Federal Reserve announced that they would keep short-term interest rates low until late 2014. According to the Expectations Theory of interest rates, which of the following could we expect to happen?
    A) a rising 3-year interest rate
    B) a flatter yield curve
    C) a steeper yield curve
    D) a parallel shift in the yield curve

17) If market participants notice that a variable behaves differently now than in the past, then, according to rational expectations theory, we can expect market participants to
    A) give up trying to forecast this variable.
    B) begin to make systematic mistakes.
    C) no longer pay close attention to movements in this variable.
    D) change the way they form expectations about future values of the variable.
18) The major criticism of the view that expectations are formed adaptively is that
   A) it is easier to model adaptive expectations than it is to model rational expectations.
   B) adaptive expectations models have no predictive power.
   C) people are irrational and therefore never learn from past mistakes.
   D) this view ignores that people use more information than just past data to form their
       expectations.

19) Sara decides to lend Tom $5,000 for 3 years at 2% interest rate with all interest and principal due
    at the end of the 3 years. What is the total amount Tom must pay Sara 3 years into the future?
   A) 5222.02  B) 5278.43  C) 5306.04  D) 5999.99

20) If 1-year interest rates for the next three years are expected to be 4, 2, and 3 percent, and the
    3-year term premium is 1 percent, then the 3-year bond rate will be
   A) 1 percent.  B) 2 percent.  C) 3 percent.  D) 4 percent.

21) In the one-period valuation model, the value of a share of stock today depends upon
    A) only the present value of the future dividends.
    B) the present value of both dividends and the expected sales price.
    C) the future value of dividends and the actual sales price.
    D) the actual value of the dividends and expected sales price received in one year.

22) Sara decides to loan Tom $750 at an 8% interest rate for 3 years. She wants Tom to pay her back
    in 3 equal annual payments. What will be Tom's annual payments?
   A) $291.02  B) $210.22  C) $245.25  D) $201.56

23) If investors expect interest rates to fall significantly in the future, the yield curve will be inverted.
    This means that the yield curve has a ________ slope.
   A) steep upward  B) slight upward  C) downward  D) flat

24) Everything else held constant, when the inflation rate is expected to rise, interest rates will
    _______; this result has been termed the ________.
   A) rise; Keynes effect  B) fall; Keynes effect
   C) fall; Fisher effect  D) rise; Fisher effect

25) If a $5,000 coupon bond has a coupon rate of 13 percent, then the coupon payment every year is
    A) $13.  B) $130.  C) $650.  D) $1,300.

26) Which of the following $5,000 face-value securities has the highest to maturity?
   A) A 10 percent coupon bond selling for $5,000
   B) A 6 percent coupon bond selling for $5,500
   C) A 6 percent coupon bond selling for $5,000
   D) A 12 percent coupon bond selling for $4,500

27) Rational expectations forecast errors will on average be _______ and therefore _______ be
    predicted ahead of time.
   A) zero; cannot  B) negative; can
   C) positive; can  D) positive; cannot
28) If Greece defaults on their sovereign debt sometime in the near future, we should expect the interest rate on Irish government bonds to ________, and the interest rate on U.S. government bonds to ________.  
A) rise, fall  B) fall, fall  C) rise, rise  D) fall, rise

29) The yield to maturity for a discount bond is _______ related to the current bond price.  
A) not  B) directly  C) negatively  D) positively

30) During business cycle expansions when income and wealth are rising, the demand for bonds _______, and the demand curve shifts to the ______, everything else held constant.  
A) falls; right  B) rises; left  C) rises; right  D) falls; left

31) What is the return on a 5 percent coupon bond that initially sells for $1,000 and sells for $1,200 next year?  
A) 10 percent  B) 5 percent  C) 25 percent  D) ~5 percent

32) Municipal bonds have default risk, yet their interest rates are lower than the rates on default-free Treasury bonds. This suggests that  
A) Treasury bonds are not default-free.  
B) the benefit from the tax-exempt status of municipal bonds is less than their default risk.  
C) the benefit from the tax-exempt status of municipal bonds equals their default risk.  
D) the benefit from the tax-exempt status of municipal bonds exceeds their default risk.

33) Tom would like to borrow $450 from Sara today. In return, Tom has agreed to pay Sara $76.5 forever, but will never pay back the $450. (Assume they both live forever). What is Sara's yield to maturity?  
A) 14%  B) 12%  C) 17%  D) 20%

34) Corporate bonds are not as liquid as government bonds because  
A) the corporate bond rating must be calculated each time they are traded.  
B) corporate bonds cannot be resold.  
C) fewer corporate bonds for any one corporation are traded, making them more costly to sell.  
D) corporate bonds are not callable.

35) In September 2011, the Federal Reserve announced they would undertake "operation twist" whereby they would buy long-term bonds and sell short-term bonds. According to the Bond Market model, we should expect  
A) a steepening yield curve  
B) rising short-term and falling long-term interest rates.  
C) falling short-term and rising long-term interest rates  
D) an upward shift of the yield curve.

36) A consol paying $20 annually when the interest rate is 5 percent has a price of  
A) $100.  B) $200.  C) $400.  D) $800.

37) The value of any investment is found by computing the  
A) present value of all future liabilities.  B) future value of all future expenses.  
C) present value of all future sales.  D) present value of all future cash flows.
38) If during the past decade the average rate of monetary growth has been 5% and the average inflation rate has been 5%, everything else held constant, when the Federal Reserve announces that the new rate of monetary growth will be 10%, the adaptive expectation forecast of the inflation rate is
   A) 5%.       B) between 5 and 10%.
   C) 10%.       D) more than 10%.

39) Assume today's one-year interest rate is 0.10%, the three-year interest rate is 0.50%, and the three-year liquidity premium is 0.10%. According to the Liquidity Premium Theory, which of the following is a possible combination of future one-year interest rates?
   A) 0.60%, 0.60%       B) 0.20%, 0.30%       C) 0.10%, 0.10%       D) 0.50%, 0.60%

40) Assume Tom would like to borrow money from Sara for 3 years but can only afford $100 annual loan payments. If Sara agrees to lend money to Tom at an interest rate of 8%, how much money can Tom afford to borrow today?
   A) 301.60       B) 257.70       C) 295.18       D) 273.61

41) Assume UW Credit Union has a current capital-to-asset ratio of 9% and would like to maintain that ratio over the next year. Also assume the credit union's assets are expected to grow 10% over the next year. What is the credit union's required return on assets?
   A) 0.55%       B) 0.90%       C) 22.2%       D) 15.0%

42) The sum of the current yield and the rate of capital gain is called the
   A) pretuity yield.       B) discount yield.       C) par value.       D) rate of return.

43) The risk premium on corporate bonds reflects the fact that corporate bonds have a higher default risk and are
   A) less speculative than       B) less liquid than
   C) lower-yielding than       D) tax-exempt unlike

44) If a security pays $110 next year and $121 the year after that, what is its yield to maturity if it sells for $200?
   A) 9 percent       B) 10 percent       C) 11 percent       D) 12 percent

45) When the interest rate on a bond is
   A) above; demand; rise
   B) below; supply; fall
   C) above; demand; fall
   D) above; supply; rise

46) Everything else held constant, when bonds become less widely traded, and as a consequence the market becomes less liquid, the demand curve for bonds shifts to the
   A) right; rises
   B) left; rises
   C) left; falls
   D) right; falls

47) In the bond market, the market equilibrium shows the market-clearing
   A) interest rate; deposit
   B) interest rate; premium
   C) price; deposit
   D) price; interest rate
48) Which of the following is not a factor pushing down the 10-year interest rate in 2011?
   A) Euro-Zone debt crisis       B) A $1.3 trillion federal deficit
   C) QE-2                        D) A slowing economy

49) If a security pays $55 in one year and $133 in three years, its present value is $150 if the interest rate is
   A) 5 percent.      B) 10 percent.      C) 12.5 percent.      D) 15 percent.

50) According to the segmented markets theory of the term structure
   A) buyers of bonds do not prefer bonds of one maturity over another.
   B) buyers require an additional incentive to hold long-term bonds.
   C) the interest rate on long-term bonds will equal an average of short-term interest rates that people expect to occur over the life of the long-term bonds.
   D) interest rates on bonds of different maturities do not move together over time.
MULTIPLE CHOICE. Choose the one alternative that best completes the statement or answers the question.

1) Corporate bonds are not as liquid as government bonds because
   A) fewer corporate bonds for any one corporation are traded, making them more costly to sell.
   B) corporate bonds are not callable.
   C) corporate bonds cannot be resold.
   D) the corporate bond rating must be calculated each time they are traded.

2) If market participants notice that a variable behaves differently now than in the past, then, according to rational expectations theory, we can expect market participants to
   A) give up trying to forecast this variable.
   B) change the way they form expectations about future values of the variable.
   C) no longer pay close attention to movements in this variable.
   D) begin to make systematic mistakes.

3) According to the segmented markets theory of the term structure
   A) buyers require an additional incentive to hold long-term bonds.
   B) buyers of bonds do not prefer bonds of one maturity over another.
   C) the interest rate on long-term bonds will equal an average of short-term interest rates that people expect to occur over the life of the long-term bonds.
   D) interest rates on bonds of different maturities do not move together over time.

4) If investors expect interest rates to fall significantly in the future, the yield curve will be inverted. This means that the yield curve has a ________ slope.
   A) downward  B) flat  C) slight upward  D) steep upward

5) A monetary expansion ________ stock prices due to a decrease in the ________ and an increase in the ________ everything else held constant.
   A) increases; required rate of return; dividend growth rate
   B) reduces; current dividend; expected rate of return
   C) increases; required rate of return; future sales price
   D) reduces; future sales price; expected rate of return

6) Which of the following is not a factor pushing down the 10-year interest rate in 2011?
   A) A slowing economy  B) A $1.3 trillion federal deficit
   C) Euro-Zone debt crisis  D) QE-2

7) The sum of the current yield and the rate of capital gain is called the
   A) par value.  B) discount yield.  C) rate of return.  D) perpetuity yield.

8) The risk premium on corporate bonds reflects the fact that corporate bonds have a higher default risk and are ________ U.S. Treasury bonds.
   A) less speculative than  B) tax-exempt unlike
   C) lower-yielding than  D) less liquid than
9) The major criticism of the view that expectations are formed adaptively is that
   A) it is easier to model adaptive expectations than it is to model rational expectations.
   B) adaptive expectations models have no predictive power.
   C) this view ignores that people use more information than just past data to form their
      expectations.
   D) people are irrational and therefore never learn from past mistakes.

10) If the expected path of 1-year interest rates over the next five years is 2 percent, 4 percent, 1
    percent, 4 percent, and 3 percent, the expectations theory predicts that the bond with the lowest
    interest rate today is the one with a maturity of
    A) one year.          B) two years.          C) three years.          D) four years.

11) In the bond market, the market equilibrium shows the market-clearing _______ and
    market-clearing _______.
    A) price; interest rate          B) interest rate; deposit
    C) price; deposit                D) interest rate; premium

12) During a recession, the supply of bonds _______ and the supply curve shifts to the _______,
    everything else held constant.
    A) increases; left          B) decreases; right
    C) decreases; left          D) increases; right

13) Suppose you are holding a 5 percent coupon bond maturing in one year with a yield to maturity
    of 15 percent. If the interest rate on one-year bonds rises from 15 percent to 20 percent over the
    course of the year, what is the yearly return on the bond you are holding?
    A) 5 percent          B) 10 percent          C) 15 percent          D) 20 percent

14) Everything else held constant, when bonds become less widely traded, and as a consequence the
    market becomes less liquid, the demand curve for bonds shifts to the _______ and the interest
    rate _______.
    A) left; falls          B) right; rises
    C) left; rises          D) right; falls

15) Everything else held constant, if income tax rates were lowered, then
    A) the price of Treasury bonds would fall.
    B) the interest rate on municipal bonds would fall.
    C) the interest rate on Treasury bonds would rise.
    D) the interest rate on municipal bonds would rise.

16) The yield to maturity for a discount bond is _______ related to the current bond price.
    A) negatively          B) not          C) positively          D) directly

17) Rational expectations forecast errors will on average be _______ and therefore _______ be
    predicted ahead of time.
    A) positive;          B) positive; can
    C) zero; cannot       D) negative; cannot

18) In the one-period valuation model, the value of a share of stock today depends upon
    A) the present value of both dividends and the expected sales price.
    B) the actual value of the dividends and expected sales price received in one year.
    C) the future value of dividends and the actual sales price.
    D) only the present value of the future dividends.
19) If Greece defaults on their sovereign debt sometime in the near future, we should expect the interest rate on Irish government bonds to ________, and the interest rate on U.S. government bonds to ________.  
A) fall, rise  
B) fall, fall  
C) rise, rise  
D) rise, fall

20) The spread between interest rates on low quality corporate bonds and U.S. government bonds 
A) narrowed moderately during the Great Depression.  
B) did not change during the Great Depression.  
C) widened significantly during the Great Depression.  
D) narrowed significantly during the Great Depression.

21) In asset markets, an asset's price is  
A) set equal to the highest price a seller will accept.  
B) set equal to the lowest price a seller is willing to accept.  
C) set by the buyer willing to pay the highest price.  
D) set equal to the highest price a buyer is willing to pay.

22) The expectations theory and the segmented markets theory do not explain the facts very well, but they provide the groundwork for the most widely accepted theory of the term structure of interest rates, 
A) the Keynesian theory.  
B) separable markets theory.  
C) liquidity premium theory.  
D) the asset market approach.

23) Increased uncertainty resulting from the subprime crisis ________ the required return on investment in equity.  
A) lowered  
B) raised  
C) decreased  
D) had no impact on

24) Assume UW Credit Union has a current capital-to-asset ratio of 9% and would like to maintain that ratio over the next year. Also assume the credit union's assets are expected to grow 10% over the next year. What is the credit union's required return on assets?  
A) 22.2%  
B) 15.0%  
C) 0.55%  
D) 0.90%

25) U.S. government bonds have no default risk because  
A) they are backed with gold reserves.  
B) they are backed by the full faith and credit of the federal government.  
C) they can be exchanged for silver at any time.  
D) the federal government can increase taxes to pay its obligations.

26) Sara decides to loan Tom $750 at an 8% interest rate for 3 years. She wants Tom to pay her back in 3 equal annual payments. What will be Tom's annual payments?  
A) $201.56  
B) $210.22  
C) $245.25  
D) $291.02

27) If during the past decade the average rate of monetary growth has been 5% and the average inflation rate has been 5%, everything else held constant, when the Federal Reserve announces that the new rate of monetary growth will be 10%, the adaptive expectation forecast of the inflation rate is  
A) 5%.  
B) more than 10%.  
C) between 5 and 10%.  
D) 10%.
28) Recently the Federal Reserve announced that they would keep short-term interest rates low until late 2014. According to the Expectations Theory of interest rates, which of the following could we expect to happen?
   A) a steeper yield curve  
   B) a parallel shift in the yield curve  
   C) a rising 3-year interest rate  
   D) a flatter yield curve  

29) A situation in which the quantity of bonds supplied exceeds the quantity of bonds demanded is called a condition of excess supply; because people want to sell bonds than others want to buy, the price of bonds will _______.
   A) more; fall  
   B) more; rise  
   C) fewer; fall  
   D) fewer; rise  

30) Which of the following $5,000 face-value securities has the highest to maturity?
   A) A 6 percent coupon bond selling for $5,500  
   B) A 10 percent coupon bond selling for $5,000  
   C) A 12 percent coupon bond selling for $4,500  
   D) A 6 percent coupon bond selling for $5,000  

31) If 1-year interest rates for the next three years are expected to be 4, 2, and 3 percent, and the 3-year term premium is 1 percent, than the 3-year bond rate will be
   A) 1 percent.  
   B) 2 percent.  
   C) 3 percent.  
   D) 4 percent.  

32) If a $5,000 coupon bond has a coupon rate of 13 percent, then the coupon payment every year is
   A) $1,300.  
   B) $13.  
   C) $650.  
   D) $130.  

33) If a security pays $55 in one year and $133 in three years, its present value is $150 if the interest rate is
   A) 5 percent.  
   B) 10 percent.  
   C) 12.5 percent.  
   D) 15 percent.  

34) Tom would like to borrow $450 from Sara today. In return, Tom has agreed to pay Sara $76.5 forever, but will never pay back the $450. (Assume they both live forever). What is Sara's yield to maturity?
   A) 20%  
   B) 12%  
   C) 17%  
   D) 14%  

35) A consol paying $20 annually when the interest rate is 5 percent has a price of
   A) $100.  
   B) $200.  
   C) $400.  
   D) $800.  

36) Everything else held constant, when the inflation rate is expected to rise, interest rates will _______; this result has been termed the _______.
   A) fall; Fisher effect  
   B) rise; Keynes effect  
   C) fall; Keynes effect  
   D) rise; Fisher effect  

37) When the yield curve is flat or downward-sloping, it suggest that the economy is more likely to enter
   A) a recession.  
   B) a boom time.  
   C) an expansion.  
   D) a period of increasing output.  

38) If the amount payable in two years is $2420 for a simple loan at 10 percent interest, the loan amount is
   A) $1000.  
   B) $1210.  
   C) $2000.  
   D) $2200.
39) What is the return on a 5 percent coupon bond that initially sells for $1,000 and sells for $1,200 next year? 
   A) 5 percent       B) 25 percent       C) 10 percent       D) -5 percent

40) As their relative riskiness ________, the expected return on corporate bonds ________ relative to 
the expected return on default-free bonds, everything else held constant. 
   A) decreases; decreases        B) increases; decreases 
   C) decreases; does not change   D) increases; increases

41) In September 2011, the Federal Reserve announced they would undertake "operation twist" 
whereby they would buy long-term bonds and sell short-term bonds. According to the Bond 
Market model, we should expect 
   A) falling short-term and rising long-term interest rates 
   B) rising short-term and falling long-term interest rates. 
   C) an upward shift of the yield curve. 
   D) a steepening yield curve

42) When the interest rate on a bond is ________ the equilibrium interest rate, in the bond market 
there is excess ________ and the interest rate will ________. 
   A) below; supply; fall  B) above; demand; rise 
   C) above; supply; rise  D) above; demand; fall

43) If a security pays $110 next year and $121 the year after that, what is its yield to maturity if it 
sells for $700? 
   A) 9 percent       B) 10 percent       C) 11 percent       D) 12 percent

44) The value of any investment is found by computing the 
   A) present value of all future sales.  
   B) present value of all future cash flows. 
   C) present value of all future liabilities.  
   D) future value of all future expenses.

45) Municipal bonds have default risk, yet their interest rates are lower than the rates on 
default-free Treasury bonds. This suggests that 
   A) the benefit from the tax-exempt status of municipal bonds equals their default risk. 
   B) the benefit from the tax-exempt status of municipal bonds exceeds their default risk.  
   C) Treasury bonds are not default-free. 
   D) the benefit from the tax-exempt status of municipal bonds is less than their default risk.

46) Higher government deficits ________ the supply of bonds and shift the supply curve to the 
______ everything else held constant. 
   A) decrease; right       B) increase; right       C) increase; left       D) decrease; left

47) Sara decides to lend Tom $5,000 for 3 years at 2% interest rate with all interest and principal due 
at the end of the 3 years. What is the total amount Tom must pay Sara 3 years into the future? 
   A) 5222.02       B) 5999.99       C) 5278.43       D) 5306.04

48) Assume Tom would like to borrow money from Sara for 3 years but can only afford $100 annual 
loan payments. If Sara agrees to lend money to Tom at an interest rate of 8%, how much money 
can Tom afford to borrow today? 
   A) 301.60       B) 255.18       C) 273.61       D) 257.70
49) Assume today’s one-year interest rate is 0.10%, the three-year interest rate is 0.50%, and the three-year liquidity premium is 0.10%. According to the Liquidity Premium Theory, which of the following is a possible combination of future one-year interest rates?
   A) 0.50%, 0.60%  
   B) 0.10%, 0.10%  
   C) 0.60%, 0.60%  
   D) 0.20%, 0.30%

50) During business cycle expansions when income and wealth are rising, the demand for bonds ______ and the demand curve shifts to the ______, everything else held constant.
   A) rises; left  
   B) falls; right  
   C) falls; left  
   D) rises; right
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Exam 1

V-2
Econ 330 – Spring 2012: EXAM 1
Name _______________________
ID _______________________
Section Number _______________________

MULTIPLE CHOICE. Choose the one alternative that best completes the statement or answers the question.

1) When the interest rate on a bond is ______ the equilibrium interest rate, in the bond market there is excess ______ and the interest rate will ______.
   A) above; demand; fall
   B) below; supply; fall
   C) above; demand; rise
   D) above; supply; rise

2) The major criticism of the view that expectations are formed adaptively is that
   A) adaptive expectations models have no predictive power.
   B) it is easier to model adaptive expectations than it is to model rational expectations.
   C) this view ignores that people use more information than just past data to form their expectations.
   D) people are irrational and therefore never learn from past mistakes.

3) The value of any investment is found by computing the
   A) present value of all future liabilities.
   B) future value of all future expenses.
   C) present value of all future cash flows.
   D) present value of all future sales.

4) If a security pays $55 in one year and $133 in three years, its present value is $150 if the interest rate is
   A) 5 percent.
   B) 10 percent.
   C) 12.5 percent.
   D) 15 percent.

5) If 1-year interest rates for the next three years are expected to be 4, 2, and 3 percent, and the 3-year term premium is 1 percent, than the 3-year bond rate will be
   A) 1 percent.
   B) 2 percent.
   C) 3 percent.
   D) 4 percent.

6) If investors expect interest rates to fall significantly in the future, the yield curve will be inverted. This means that the yield curve has a ______ slope.
   A) flat
   B) slight upward
   C) steep upward
   D) downward

7) Increased uncertainty resulting from the subprime crisis ______ the required return on investment in equity.
   A) lowered
   B) had no impact on
   C) decreased
   D) raised

8) According to the segmented markets theory of the term structure
   A) the interest rate on long-term bonds will equal an average of short-term interest rates that people expect to occur over the life of the long-term bonds.
   B) buyers require an additional incentive to hold long-term bonds.
   C) buyers of bonds do not prefer bonds of one maturity over another.
   D) interest rates on bonds of different maturities do not move together over time.
9) Recently the Federal Reserve announced that they would keep short-term interest rates low until late 2014. According to the Expectations Theory of interest rates, which of the following could we expect to happen?
   A) a steeper yield curve   B) a rising 3-year interest rate
   C) a parallel shift in the yield curve   D) a flatter yield curve

10) Assume today's one-year interest rate is 0.10%, the three-year interest rate is 0.50%, and the three-year liquidity premium is 0.10%. According to the Liquidity Premium Theory, which of the following is a possible combination of future one-year interest rates?
   A) 0.50%, 0.60%   B) 0.60%, 0.60%   C) 0.20%, 0.30%   D) 0.10%, 0.10%

11) In asset markets, an asset's price is
   A) set equal to the lowest price a seller is willing to accept.
   B) set equal to the highest price a seller will accept.
   C) set equal to the highest price a buyer is willing to pay.
   D) set by the buyer willing to pay the highest price.

12) The risk premium on corporate bonds reflects the fact that corporate bonds have a higher default risk and are _______ U.S. Treasury bonds.
   A) less speculative than   B) less liquid than
   C) lower-yielding than   D) tax-exempt unlike

13) Which of the following is not a factor pushing down the 10-year interest rate in 2011?
   A) QE-2   B) A $1.3 trillion federal deficit
   C) Euro-Zone debt crisis   D) A slowing economy

14) Suppose you are holding a 5 percent coupon bond maturing in one year with a yield to maturity of 15 percent. If the interest rate on one-year bonds rises from 15 percent to 20 percent over the course of the year, what is the yearly return on the bond you are holding?
   A) 5 percent   B) 10 percent   C) 15 percent   D) 20 percent

15) In the bond market, the market equilibrium shows the market-clearing _______ and
    market-clearing _______.
    A) interest rate; premium   B) price; interest rate
    C) price; deposit   D) interest rate; deposit

16) Sara decides to loan Tom $750 at an 8% interest rate for 3 years. She wants Tom to pay her back in 3 equal annual payments. What will be Tom's annual payments?
   A) $291.02   B) $210.22   C) $245.25   D) $201.56

17) A monetary expansion _______ stock prices due to a decrease in the _______ and an increase in the _______, everything else held constant.
   A) increases; required rate of return; future sales price
   B) reduces; future sales price; expected rate of return
   C) increases; required rate of return; dividend growth rate
   D) reduces; current dividend; expected rate of return
18) Assume Tom would like to borrow money from Sara for 3 years but can only afford $100 annual loan payments. If Sara agrees to lend money to Tom at an interest rate of 8%, how much money can Tom afford to borrow today?
   A) 257.70          B) 273.61         C) 301.60         D) 295.18

19) Everything else held constant, when bonds become less widely traded, and as a consequence the market becomes less liquid, the demand curve for bonds shifts to the ______ and the interest rate _______.
   A) right; rises       B) left; rises        C) left; falls       D) right; falls

20) If a $5,000 coupon bond has a coupon rate of 13 percent, then the coupon payment every year is 20) _______
   A) $13.          B) $1,300.         C) $130.          D) $650.

21) During business cycle expansions when income and wealth are rising, the demand for bonds ______ and the demand curve shifts to the ______, everything else held constant.
   A) falls; right     B) rises; right    C) rises; left     D) falls; left

22) Higher government deficits ______ the supply of bonds and shift the supply curve to the ______, everything else held constant.
   A) decrease; left   B) increase; right C) decrease; right D) increase; left

23) Which of the following $5,000 face-value securities has the highest to maturity?
   A) A 6 percent coupon bond selling for $5,500
   B) A 6 percent coupon bond selling for $5,000
   C) A 12 percent coupon bond selling for $4,500
   D) A 10 percent coupon bond selling for $5,000

24) A situation in which the quantity of bonds supplied exceeds the quantity of bonds demanded is called a condition of excess supply; because people want to sell ______ bonds than others want to buy, the price of bonds will _______.
   A) fewer; rise      B) more; rise      C) more; fall      D) fewer; fall

25) If during the past decade the average rate of monetary growth has been 5% and the average inflation rate has been 5%, everything else held constant, when the Federal Reserve announces that the new rate of monetary growth will be 10%, the adaptive expectation forecast of the inflation rate is
   A) between 5 and 10%. B) more than 10%.
   C) 10%.                  D) 5%.

26) If the expected path of 1-year interest rates over the next five years is 2 percent, 4 percent, 1 percent, 4 percent, and 3 percent, the expectations theory predicts that the bond with the lowest interest rate today is the one with a maturity of
   A) one year.          B) two years.         C) three years.       D) four years.

27) Everything else held constant, when the inflation rate is expected to rise, interest rates will _______; this result has been termed the _______.
   A) rise; Keynes effect B) fall; Fisher effect
   C) rise; Fisher effect D) fall; Keynes effect

28) During a recession, the supply of bonds ______ and the supply curve shifts to the ______, everything else held constant.
   A) decreases; left    B) increases; left    C) decreases; right D) increases; right
29) If a security pays $110 next year and $121 the year after that, what is its yield to maturity if it sells for $200?
   A) 9 percent  B) 10 percent  C) 11 percent  D) 12 percent

30) Corporate bonds are not as liquid as government bonds because
   A) the corporate bond rating must be calculated each time they are traded.
   B) corporate bonds cannot be resold.
   C) corporate bonds are not callable.
   D) fewer corporate bonds for any one corporation are traded, making them more costly to sell.

31) If Greece defaults on their sovereign debt sometime in the near future, we should expect the interest rate on Irish government bonds to __________, and the interest rate on U.S. government bonds to __________.
   A) fall, rise  B) rise, fall  C) fall, fall  D) rise, rise

32) Assume UW Credit Union has a current capital-to-asset ratio of 9% and would like to maintain that ratio over the next year. Also assume the credit union's assets are expected to grow 10% over the next year. What is the credit union's required return on assets?
   A) 0.55%  B) 0.90%  C) 15.0%  D) 22.2%

33) Everything else held constant, if income tax rates were lowered, then
   A) the price of Treasury bonds would fall.
   B) the interest rate on Treasury bonds would rise.
   C) the interest rate on municipal bonds would rise.
   D) the interest rate on municipal bonds would fall.

34) A consol paying $20 annually when the interest rate is 5 percent has a price of
   A) $100.  B) $200.  C) $400.  D) $800.

35) In September 2011, the Federal Reserve announced they would undertake "operation twist" whereby they would buy long-term bonds and sell short-term bonds. According to the Bond Market model, we should expect
   A) an upward shift of the yield curve.
   B) a steepening yield curve
   C) falling short-term and rising long-term interest rates
   D) rising short-term and falling long-term interest rates.

36) The expectations theory and the segmented markets theory do not explain the facts very well, but they provide the groundwork for the most widely accepted theory of the term structure of interest rates,
   A) separable markets theory.  B) the asset market approach.
   C) the Keynesian theory.  D) liquidity premium theory.

37) The yield to maturity for a discount bond is _______ related to the current bond price.
   A) positively  B) negatively  C) directly  D) not
38) In the one-period valuation model, the value of a share of stock today depends upon  
   A) the present value of both dividends and the expected sales price.  
   B) the actual value of the dividends and expected sales price received in one year.  
   C) only the present value of the future dividends.  
   D) the future value of dividends and the actual sales price.

39) Rational expectations forecast errors will on average be _______ and therefore _______ be  
   predicted ahead of time.  
   A) negative; can  
   B) positive; can 
   C) zero; cannot  
   D) positive; cannot

40) If market participants notice that a variable behaves differently now than in the past, then,  
   according to rational expectations theory, we can expect market participants to  
   A) change the way they form expectations about future values of the variable.  
   B) no longer pay close attention to movements in this variable.  
   C) give up trying to forecast this variable.  
   D) begin to make systematic mistakes.

41) The spread between interest rates on low quality corporate bonds and U.S. government bonds  
   A) narrowed significantly during the Great Depression.  
   B) widened significantly during the Great Depression.  
   C) did not change during the Great Depression.  
   D) narrowed moderately during the Great Depression.

42) The sum of the current yield and the rate of capital gain is called the  
   A) par value.  
   B) pertuity yield. 
   C) discount yield.  
   D) rate of return.

43) When the yield curve is flat or downward-sloping, it suggest that the economy is more likely to  
   enter  
   A) an expansion.  
   B) a period of increasing output.  
   C) a boom time.  
   D) a recession.

44) If the amount payable in two years is $2420 for a simple loan at 10 percent interest, the loan  
   amount is  
   A) $1000.  
   B) $1210. 
   C) $2000.  
   D) $2200.

45) Sara decides to lend Tom $5,000 for 3 years at 2% interest rate with all interest and principal due  
   at the end of the 3 years. What is the total amount Tom must pay Sara 3 years into the future?  
   A) 5999.99  
   B) 5276.43 
   C) 5306.04  
   D) 5222.02

46) What is the return on a 5 percent coupon bond that initially sells for $1,000 and sells for $1,200  
   next year?  
   A) 25 percent  
   B) 5 percent  
   C) 10 percent  
   D) -5 percent

47) Municipal bonds have default risk, yet their interest rates are lower than the rates on  
   default-free Treasury bonds. This suggests that  
   A) the benefit from the tax-exempt status of municipal bonds is less than their default risk.  
   B) the benefit from the tax-exempt status of municipal bonds equals their default risk.  
   C) Treasury bonds are not default-free.  
   D) the benefit from the tax-exempt status of municipal bonds exceeds their default risk.
48) U.S. government bonds have no default risk because
   A) they can be exchanged for silver at any time.
   B) they are backed by the full faith and credit of the federal government.
   C) they are backed with gold reserves.
   D) the federal government can increase taxes to pay its obligations.

49) As their relative riskiness ______, the expected return on corporate bonds ______ relative to
   the expected return on default-free bonds, everything else held constant.
   A) decreases; decreases   B) decreases; does not change
   C) increases; increases   D) increases; decreases

50) Tom would like to borrow $450 from Sara today. In return, Tom has agreed to pay Sara $76.5
    forever, but will never pay back the $450. (Assume they both live forever). What is Sara's
    yield to maturity?
    A) 12%   B) 14%   C) 20%   D) 17%
1) A
2) C
3) C
4) B
5) D
6) D
7) D
8) D
9) D
10) A
11) D
12) B
13) B
14) C
15) B
16) A
17) C
18) A
19) B
20) D
21) B
22) B
23) C
24) C
25) D
26) A
27) C
28) A
29) B
30) D
31) B
32) B
33) C
34) C
35) D
36) D
37) B
38) A
39) C
40) A
41) B
42) D
43) D
44) C
45) C
46) A
47) D
48) D
49) D
50) D