Money and Banking **Prof. Yamin Ahmad**
ECON 354 **Summer 2009**

Quiz 2: The Bond Market and the Term Structure of Interest Rates

Name_____________________________________ **Id #** ________________________

Instructions: Please mark the answers to the multiple choice questions on the exam paper in the space provided and turn the exam in at the end.

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

1) Holding everything else constant,
   - A) if asset A's risk rises relative to that of alternative assets, the demand for asset A will fall.
   - B) the more liquid asset A, relative to alternative assets, the greater will be the demand for asset A.
   - C) the lower the expected return to asset A relative to alternative assets, the greater will be the demand for asset A.
   - D) all of the above.
   - E) only A and B of the above.

   Answer: E

2) When the expected inflation rate decreases, the demand for bonds _____, the supply of bonds _____, and the interest rate ______.
   - A) increases; decreases; falls
   - B) decreases; increases; rises
   - C) increases; increases; rises
   - D) decreases; decreases; falls

   Answer: A

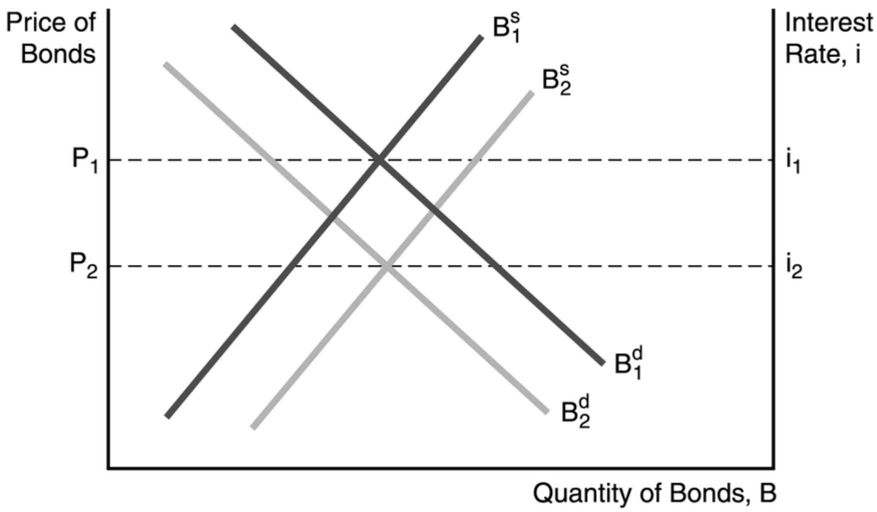

Figure 5–1

3) In Figure 5–1, the most likely cause of the increase in the equilibrium interest rate from i_1 to i_2 is

A) a sharp decline in the growth rate of the money supply.
B) an expected decrease in the government budget deficit.
C) an expected increase in the government budget deficit.
D) a combination of both A and C of the above.

Answer: C

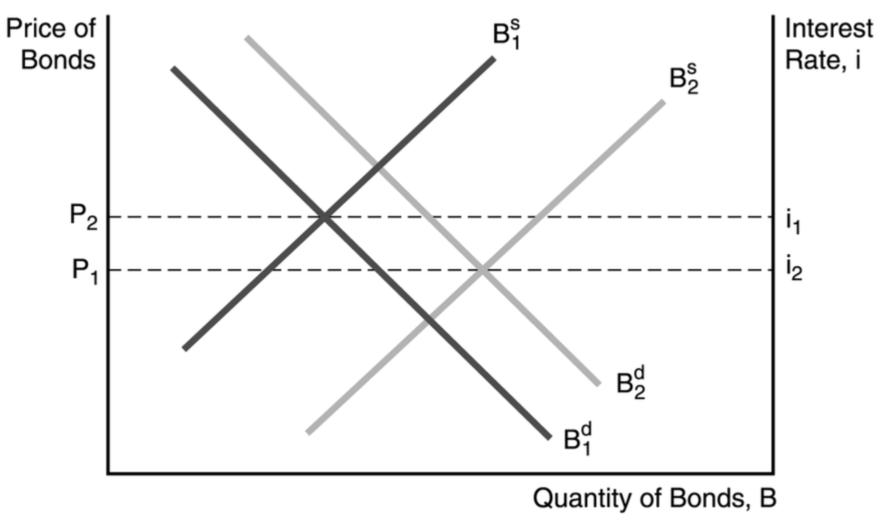

Figure 5–2

4) In Figure 5–2, one factor that would not have caused the demand for bonds to increase (shift to the right) is

A) an increase in the expected return on bonds relative to other assets.
B) an increase in wealth.
C) a decrease in the expected return on bonds relative to other assets.
D) a reduction in the riskiness of bonds relative to other assets.

Answer: C

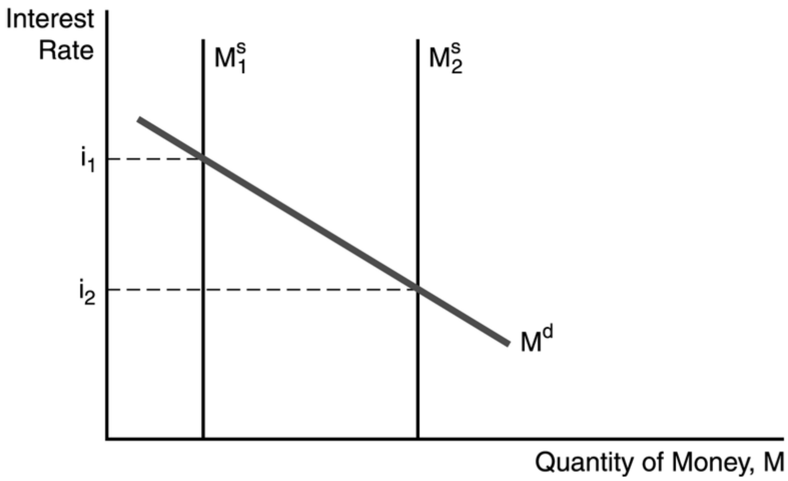

Figure 5-4

5) In Figure 5-4, the factor responsible for the decline in the interest rate is

A) a decline in the expected inflation rate.
B) a decline the price level.
C) an increase in the money supply.
D) a decline in income.

Answer: C

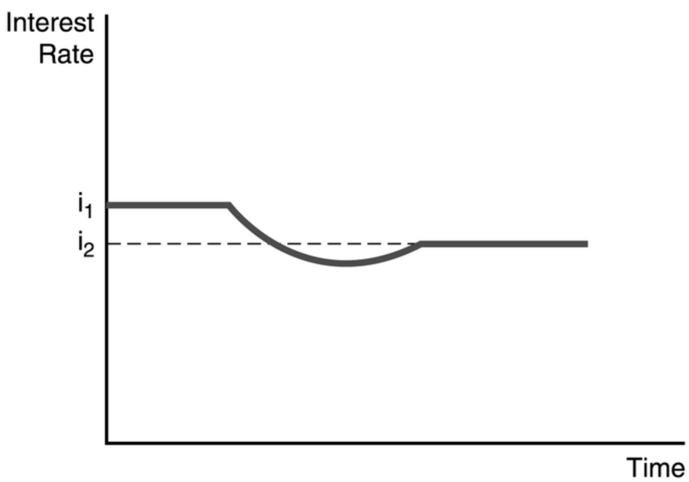

Figure 5-6

6) Figure 5-6 illustrates the effect of an increased rate of money supply growth. From the figure, one can conclude that the

A) liquidity effect is dominated by the Fisher effect and interest rates adjust quickly to changes in expected inflation.
B) Fisher effect is dominated by the liquidity effect and interest rates adjust slowly to changes in expected inflation.
C) Fisher effect is smaller than the expected inflation effect and interest rates adjust quickly to changes in expected inflation.
D) liquidity effect is dominated by the Fisher effect and interest rates adjust slowly to changes in expected inflation.

Answer: B

7) The spread between the interest rates on default–free bonds and those with a positive default risk is called the
A) default premium. B) junk premium. C) risk premium. D) capitalized risk.

Answer: C

8) Which of the following statements are true?
A) An increase in default risk on corporate bonds lowers the demand for these bonds, but increases the demand for default–free bonds.
B) The expected return on corporate bonds decreases as default risk increases.
C) A corporate bond's return becomes less uncertain as default risk increases.
D) Only A and B of the above are true statements.
E) Only A and C of the above are true statements.

Answer: D

9) Interest rates on bonds of the same maturity will differ because of differences in
A) risk.
B) income tax treatment.
C) liquidity.
D) all of the above.
E) only A and B of the above.

Answer: D

10) According to the expectations 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) interest rates on bonds of different maturities move together over time.
C) buyers of bonds prefer short–term to long–term bonds.
D) all of the above.
E) only A and B of the above.

Answer: E

11) According to the expectations theory of the term structure
A) when the yield curve is steeply upward sloping, short–term interest rates are expected to rise in the future.
B) when the yield curve is downward sloping, short–term interest rates are expected to decline in the future.
C) investors have strong preferences for short–term relative to long–term bonds, explaining why yield curves typically slope upward.
D) all of the above.
E) only A and B of the above.

Answer: E

12) If the expected path of one–year interest rates over the next five years is 4 percent, 5 percent, 7 percent, 8 percent, and 6 percent, then the expectations theory predicts that today's interest rate on the five–year bond is
A) 4 percent. B) 5 percent. C) 8 percent. D) 6 percent. E) 7 percent.

Answer: D

13) According to the segmented markets theory of the term structure
- A) the interest rate for each maturity bond is determined by supply and demand for that maturity bond.
- B) investors' strong preferences for short–term relative to long–term bonds explains why yield curves typically slope upward.
- C) bonds of one maturity are not substitutes for bonds of other maturities, therefore, interest rates on bonds of different maturities do not move together over time.
- D) all of the above.
- E) none of the above.

Answer: D

14) 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. E) 5 percent.

Answer: D

15) According to the liquidity premium theory of the term structure
- A) when short–term interest rates are expected to decline significantly in the future, the yield curve is likely to be downward sloping,
- B) when short–term interest rates are expected to rise in the future, the yield curve will be upward sloping.
- C) when short–term interest rates are expected to decline moderately in the future, the yield curve is likely to be flat.
- D) all of the above.
- E) only A and B of the above.

Answer: D