Chapter 6
The Risk and Term Structure of Interest Rates

■ Multiple Choice

1) The risk structure of interest rates is
   (a) the structure of how interest rates move over time.
   (b) the relationship among interest rates of different bonds with the same maturity.
   (c) the relationship among the term to maturity of different bonds.
   (d) the relationship among interest rates on bonds with different maturities.

   Answer: B
   Question Status: Previous Edition

2) The risk that interest payments will not be made, or that the face value of a bond is not repaid when a bond matures is
   (a) interest rate risk.
   (b) inflation risk.
   (c) exchange rate risk.
   (d) default risk.
   (e) moral hazard.

   Answer: D
   Question Status: New

3) Default risk is the risk that
   (a) a bond issuer is unable to make interest payments.
   (b) a bond issuer is unable to make a profit.
   (c) a bond issuer is unable to pay the face value at maturity.
   (d) all of the above.
   (e) both (a) and (c) above.

   Answer: E
   Question Status: New

4) Bonds with no default risk are called
   (a) flower bonds.
   (b) no-risk bonds.
   (c) default-free bonds.
   (d) zero-risk bonds.

   Answer: C
   Question Status: Previous Edition

5) U.S. government bonds have no default risk because
(a) they are backed by the full faith and credit of the federal government.
(b) the federal government can increase taxes or even just print money to pay its obligations.
(c) they are backed with gold reserves.
(d) all of the above.
(e) of only (a) and (b) of the above.

Answer: B
Question Status: Previous Edition

6) The spread between the interest rates on bonds with default risk and default-free bonds is called the
(a) risk premium.
(b) junk margin.
(c) bond margin.
(d) default premium.

Answer: A
Question Status: Previous Edition

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) risk premium.
(c) capitalized risk.
(d) junk premium.

Answer: B
Question Status: Previous Edition

8) If the probability of a bond default increases because corporations begin to suffer large losses, then the default risk on corporate bonds will _____ and the expected return on these bonds will _____.
(a) decrease; increase
(b) decrease; decrease
(c) increase; increase
(d) increase; decrease

Answer: D
Question Status: Previous Edition

9) If a corporation begins to suffer large losses, then
(a) the default risk on the corporate bond will increase and the bond's return will become more uncertain, meaning the expected return on the corporate bond will fall.
(b) the default risk on the corporate bond will increase and the bond's return will become less uncertain, meaning the expected return on the corporate bond will fall.
(c) the default risk on the corporate bond will decrease and the bond's return will become less uncertain, meaning the expected return on the corporate bond will fall.
(d) the default risk on the corporate bond will decrease and the bond's return will become less uncertain, meaning the expected return on the corporate bond will rise.

Answer: A
Question Status: Previous Edition

10) If the possibility of a default increases because corporations begin to suffer losses, then the default risk on corporate bonds will _____, and the bonds' returns will become _____ uncertain, meaning that the expected return on these bonds will decrease.

(a) increase; less
(b) increase; more
(c) decrease; less
(d) decrease; more

Answer: B
Question Status: Previous Edition

11) The theory of asset demand predicts that as the possibility of a default on a corporate bond increases, the expected return on the bond _____ while its relative riskiness _____.

(a) rises; rises
(b) rises; falls
(c) falls; rises
(d) falls; falls

Answer: C
Question Status: Previous Edition

12) The theory of asset demand predicts that as the possibility of a default on a corporate bond decreases, the expected return on the bond _____ while its relative riskiness _____.

(a) rises; rises
(b) rises; falls
(c) falls; rises
(d) falls; falls

Answer: B
Question Status: Previous Edition

13) The theory of asset demand predicts that because the expected return on corporate bonds falls as their relative riskiness rises,

(a) the demand for corporate bonds will fall.
(b) the demand for corporate bonds will rise.
(c) the supply of corporate bonds will fall.
(d) the supply of corporate bonds will rise.

Answer: A
Question Status: Previous Edition

14) The theory of asset demand predicts that because the expected return on corporate bonds falls as their relative riskiness rises, the demand for corporate bonds will _____ and the demand for default-free bonds will _____.

(a) rise; rise
(b) rise; fall
(c) fall; rise
(d) fall; fall

Answer: C
Question Status: Previous Edition

15) Other things being equal, an increase in the default risk of corporate bonds shifts the demand curve for corporate bonds to the _____ and the demand curve for Treasury bonds to the _____.

(a) right; right
(b) right; left
(c) left; right
(d) left; left

Answer: C
Question Status: Study Guide

16) The theory of asset demand predicts that a increase in the expected return on corporate bonds due to a decline in relative riskiness causes

(a) a decline in the demand for default-free bonds.
(b) a decline in the supply of default-free bonds.
(c) an decrease in the demand of corporate bonds.
(d) an increase in the supply of corporate bonds.

Answer: A
Question Status: Previous Edition

17) The theory of asset demand predicts that a decline in the expected return on corporate bonds due to a rise in relative riskiness causes

(a) a decline in the demand for default-free bonds.
(b) an increase in the demand of corporate bonds.
(c) a decline in the demand for corporate bonds.
(d) a decline in the supply of corporate bonds.

Answer: C
Question Status: Previous Edition

18) The theory of asset demand predicts that a decline in the expected return on corporate bonds due to a rise in relative riskiness causes

(a) a decline in the demand for default-free bonds.
(b) an increase in the demand of default-free bonds.
(c) an increase in the demand for corporate bonds.
(d) none of the above.

Answer: B
Question Status: Previous Edition

19) An increase in the riskiness of corporate bonds will _____ the price of corporate bonds and _____ the price of Treasury bonds.

(a) increase; increase
(b) reduce; reduce
(c) reduce; increase
(d) increase; reduce
(e) increase; not affect

Answer: C
Question Status: New

20) A reduction in the riskiness of corporate bonds will _____ the price of corporate bonds and ____ the price of Treasury bonds.
(a) increase; increase
(b) reduce; reduce
(c) reduce; increase
(d) increase; reduce
(e) reduce; not affect
Answer: D
Question Status: New

21) An increase in the riskiness of corporate bonds will _____ the yield on corporate bonds and _____ the yield on Treasury securities.
(a) increase; increase
(b) reduce; reduce
(c) increase; reduce
(d) reduce; increase
(e) increase; not affect
Answer: C
Question Status: New

22) A reduction of the riskiness of corporate bonds will _____ the yield on corporate bonds and _____ the yield on Treasury securities.
(a) increase; increase
(b) reduce; reduce
(c) increase; reduce
(d) reduce; increase
(e) reduce; not affect
Answer: D
Question Status: New

23) Bonds with relatively low risk of default are called
(a) zero coupon bonds.
(b) junk bonds.
(c) investment grade bonds.
(d) none of the above.
Answer: C
Question Status: Previous Edition

24) Bonds with relatively high risk of default are called
(a) Brady bonds.
(b) junk bonds.
(c) zero coupon bonds.
(d) investment grade bonds.
Answer: B
Question Status: Previous Edition

25) Bonds with relatively low risk of default are called _____ securities and have a rating of Baa (or BBB) and above; bonds with ratings below Baa (or BBB) have a higher default risk and are called _____.

(a) investment grade; lower grade
(b) investment grade; junk bonds
(c) high quality; lower grade
(d) high quality; junk bonds

Answer: B
Question Status: Previous Edition

26) A risk premium is sometimes called a

(a) default premium.
(b) rating premium.
(c) liquidity premium.
(d) junk premium.

Answer: C
Question Status: Previous Edition

27) 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) the corporate bond rating must be calculated each time they are traded.
(c) corporate bonds are not callable.
(d) of all of the above.
(e) of only (a) and (b) of the above.

Answer: A
Question Status: Previous Edition

28) When the default risk in corporate bonds decreases, other things equal, the demand curve for corporate bonds shifts to the _____ and the demand curve for Treasury bonds shifts to the _____.

(a) right; right
(b) right; left
(c) left; left
(d) left; right

Answer: B
Question Status: Previous Edition

29) When the default risk in corporate bonds increases, other things equal, the demand curve for corporate bonds shifts to the _____ and the demand curve for Treasury bonds shifts to the _____.

(a) right; right
(b) right; left
(c) left; left
(d) left; right

Answer: D
Question Status: Previous Edition

30) An increase in default risk on corporate bonds _____ the demand for these bonds, but _____ the demand for default-free bonds.
(a) increases; lowers
(b) lowers; increases
(c) does not change; greatly increases
(d) moderately lowers; does not change

Answer: B
Question Status: Previous Edition

31) As default risk increases, the expected return on corporate bonds _____, and the return becomes _____ uncertain.
(a) increases; less
(b) increases; more
(c) decreases; less
(d) decreases; more

Answer: D
Question Status: Previous Edition

32) As their relative riskiness _____, the expected return on corporate bonds _____ relative to the expected return on default-free bonds.
(a) increases; increases
(b) increases; decreases
(c) decreases; decreases
(d) decreases; does not change
(e) increases; does not change

Answer: B
Question Status: Previous Edition

33) 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 more uncertain as default risk increases.
(d) As their relative riskiness increases, the expected return on corporate bonds decreases relative to the expected return on default-free bonds.
(e) All of the above are true statements.

Answer: E
Question Status: Previous Edition

34) Which of the following statements are true?
(a) A decrease 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) As their relative riskiness increases, the expected return on corporate bonds increases relative to the expected return on default-free bonds.

Answer: B
Question Status: Previous Edition

35) Which of the following statements are true?
(a) A decrease 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 increases as default risk increases.
(c) A corporate bond's return becomes more uncertain as default risk increases.
(d) As their relative riskiness increases, the expected return on corporate bonds increases relative to the expected return on default-free bonds.

Answer: C
Question Status: Previous Edition

36) Which of the following statements are true?
(a) An increase in default risk on corporate bonds decreases the demand for default-free bonds.
(b) The expected return on corporate bonds decreases as default risk decreases.
(c) A corporate bond's return becomes more uncertain as default risk decreases.
(d) As their relative riskiness increases, the expected return on corporate bonds decreases relative to the expected return on default-free bonds.

Answer: D
Question Status: Previous Edition

37) 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
Question Status: Previous Edition

38) Which of the following statements are true?
(a) A bond with default risk will always have a positive risk premium, and an increase in its default risk will raise the risk premium.
(b) The expected return on corporate bonds decreases as default risk decreases.
(c) A corporate bond's return becomes less uncertain as default risk increases.
(d) Only (a) and (b) of the above are true statements.

Answer: A
Question Status: Revised

39) Which of the following statements are true?
(a) The expected return on corporate bonds decreases as default risk increases.
(b) Two major investment advisory firms, Moody's Investor Service and Standard and Poor's Corporation, provide default risk information by rating the quality of corporate and municipal bonds.
(c) Bonds with low ratings have been dubbed junk bonds.
(d) All of the above are true statements.
(e) Only (a) and (b) of the above are true statements.

Answer: D
Question Status: Previous Edition

40) Which of the following long-term bonds currently has the lowest interest rate?
(a) Corporate Baa bonds
(b) U.S. Treasury bonds
(c) Corporate Aaa bonds
(d) Municipal bonds

Answer: D
Question Status: Previous Edition

41) Which of the following long-term bonds has the highest interest rate?
(a) Corporate Baa bonds
(b) U.S. Treasury bonds
(c) Corporate Aaa bonds
(d) Municipal bonds

Answer: A
Question Status: Previous Edition

42) Which of the following long-term bonds currently has the lowest interest rate?
(a) Corporate Aaa bonds
(b) U.S. Treasury bonds
(c) Corporate Aa bonds
(d) Corporate Baa bonds

Answer: B
Question Status: Previous Edition

43) Which of the following long-term bonds has the highest interest rate?
(a) Corporate Aaa bonds
(b) U.S. Treasury bonds
(c) Corporate Aa bonds
(d) Corporate Baa bonds

Answer: D
Question Status: Previous Edition

44) Which of the following short-term securities has the lowest interest rate?
(a) Banker's acceptances
(b) U.S. Treasury bills
(c) Negotiable certificates of deposit
(d) Commercial paper

Answer: B
Question Status: Previous Edition

45) Of the following long-term bonds, the one with the highest interest rate is
(a) corporate Baa bonds.
(b) U.S. Treasury bonds.
(c) municipal bonds.
(d) corporate Caa bonds.

Answer: D
Question Status: Study Guide

46) The bankruptcy of the Enron Corporation
(a) did not affect the corporate bond market.
(b) increased the perceived riskiness of Treasury securities.
(c) increased the perceived riskiness of municipal bonds.
(d) increased the Baa-Aaa spread.
(e) reduced the Baa-Aaa spread.

Answer: D
Question Status: New

47) The bankruptcy of the Enron Corporation increased the spread between Baa and Aaa rated bonds. This is due to
(a) a reduction in risk.
(b) a reduction in maturity.
(c) a flight to quality.
(d) a flight to liquidity.
(e) an increase in maturity

Answer: C
Question Status: New

48) During a "flight to quality"
(a) the spread between Aaa and Baa bonds increases.
(b) the spread between Aaa and Baa bonds decreases.
(c) the spread between Aaa and Baa bonds is not affected.
(d) the change in the spread between Aaa and Baa bonds cannot be predicted.
(e) junk bonds become more attractive to investors.

Answer: A
Question Status: New

49) The spread between interest rates on low quality corporate bonds and U.S. government bonds
(a) widened significantly during the Great Depression.
(b) narrowed significantly during the Great Depression.
(c) narrowed moderately during the Great Depression.
(d) did not change during the Great Depression.

Answer: A
Question Status: Previous Edition

50) Which of the following statements are true?
(a) A liquid asset is one that can be quickly and cheaply converted into cash.
(b) The demand for a bond declines when it becomes less liquid, increasing the interest rate spread between it and relatively more liquid bonds.
(c) The differences in bond interest rates reflect differences in both default risk and liquidity.
(d) All of the above are true statements.
(e) Only (a) and (b) are true statements.

Answer: D
Question Status: Previous Edition

51) Which of the following statements are true?
(a) A risk premium is sometimes mistakenly called a "liquidity premium."
(b) The demand for a bond declines when it becomes less liquid, increasing the interest rate spread between it and relatively more liquid bonds.
(c) The differences in bond interest rates reflect differences in both default risk and liquidity.
(d) Only (a) and (b) are true statements.
(e) Only (b) and (c) are true statements.

Answer: E
Question Status: Previous Edition

52) When the Treasury bond market becomes more liquid, other things equal, the demand curve for corporate bonds shifts to the _____ and the demand curve for Treasury bonds shifts to the _____.
(a) right; right
(b) right; left
(c) left; right
(d) left; left

Answer: C
Question Status: Previous Edition

53) A decrease in the liquidity of corporate bonds, other things being equal, shifts the demand curve for corporate bonds to the _____ and the demand curve for Treasury bonds shifts to the _____.
(a) right; right
(b) right; left
(c) left; left
(d) left; right

Answer: D
Question Status: Study Guide

54) The risk premium on corporate bonds becomes smaller if
(a) the riskiness of corporate bonds increases.
(b) the liquidity of corporate bonds increases.
(c) the liquidity of corporate bonds decreases.
(d) the riskiness of corporate bonds decreases.
(e) both (b) and (d) occur.
Answer: E
Question Status: Previous Edition

55) The risk premium on corporate bonds becomes smaller if
(a) the riskiness of corporate bonds increases.
(b) the liquidity of corporate bonds increases.
(c) the liquidity of corporate bonds decreases.
(d) both (a) and (c) occur.
Answer: B
Question Status: Previous Edition

56) The risk premium on corporate bonds rises when
(a) brokerage commissions fall in the corporate bond market.
(b) a flurry of major corporate bankruptcies occurs.
(c) the Treasury bond market becomes less liquid.
(d) any of the above occurs.
Answer: B
Question Status: Previous Edition

57) A decrease in the risk premium on corporate bonds results from
(a) a flurry of major corporate bankruptcies.
(b) an increase in Treasury bond liquidity.
(c) a decline in corporate bond brokerage commissions.
(d) all of the above.
(e) both (a) and (b) of the above.
Answer: C
Question Status: Study Guide

58) An increase in the liquidity of corporate bonds will _____ the price of corporate bonds and _____ the yield of Treasury bonds.
(a) increase; increase
(b) reduce; reduce
(c) increase; reduce
(d) reduce; increase
(e) increase; not affect
Answer: A
Question Status: New

59) A decrease in the liquidity of corporate bonds will _____ the price of corporate bonds and _____ the yield of Treasury bonds.

(a) increase; increase
(b) reduce; reduce
(c) increase; reduce
(d) reduce; increase
(e) reduce; not affect

Answer: B
Question Status: New

60) An increase in marginal tax rates would likely have the effect of _____ the demand for municipal bonds, and _____ the demand for U.S. government bonds.

(a) increasing; increasing
(b) increasing; decreasing
(c) decreasing; increasing
(d) decreasing; decreasing

Answer: B
Question Status: Previous Edition

61) A decrease in marginal tax rates would likely have the effect of _____ the demand for municipal bonds, and _____ the demand for U.S. government bonds.

(a) increasing; increasing
(b) increasing; decreasing
(c) decreasing; increasing
(d) decreasing; decreasing

Answer: C
Question Status: Previous Edition

62) Which of the following statements are true?

(a) Because coupon payments on municipal bonds are exempt from federal income tax, the expected after-tax return on them will be higher for individuals in higher income tax brackets.
(b) An increase in tax rates will increase the demand for municipal bonds, lowering their interest rates.
(c) Interest rates on municipal bonds will be lower than comparable bonds without the tax exemption.
(d) All of the above are true statements.
(e) Only (a) and (b) are true statements.

Answer: D
Question Status: Previous Edition

63) Which of the following statements are true?
(a) Because coupon payments on municipal bonds are exempt from federal income tax, the expected after-tax return on them will be higher for individuals in higher income tax brackets.
(b) An increase in tax rates will increase the demand for Treasury bonds, lowering their interest rates.
(c) Interest rates on municipal bonds will be higher than comparable bonds without the tax exemption.
(d) Only (a) and (b) are true statements.

Answer: A
Question Status: Previous Edition

64) Which of the following statements are true?
(a) An increase in tax rates will increase the demand for Treasury bonds, lowering their interest rates.
(b) Because the tax-exempt status of municipal bonds was of little benefit to bond holders when tax rates were low, they had higher interest rates than U.S. government bonds before World War II.
(c) Interest rates on municipal bonds will be higher than comparable bonds without the tax exemption.
(d) Only (a) and (b) are true statements.

Answer: B
Question Status: Previous Edition

65) The interest rate on municipal bonds falls relative to the interest rate on Treasury securities when
(a) there is a major default in the municipal bond market.
(b) income tax rates are raised.
(c) municipal bonds become less widely traded.
(d) corporate bonds become riskier.
(e) none of the above occur.

Answer: B
Question Status: Previous Edition

66) The interest rate on municipal bonds rises relative to the interest rate on Treasury securities when
(a) there is a major default in the corporate bond market.
(b) income tax rates are raised.
(c) municipal bonds become more widely traded.
(d) corporate bonds become riskier.
(e) income tax rates are lowered.

Answer: E
Question Status: Revised

67) Municipal bond interest rates increase relative to corporate bond interest rates when
(a) income taxes are increased.
(b) corporate bonds become riskier.
(c) Treasury securities become more widely traded.
(d) there is a major default in the municipal bond market.
(e) all of the above occur.
Answer: D
Question Status: Study Guide

68) If income tax rates were lowered, then
(a) the interest rate on municipal bonds would fall.
(b) the interest rate on Treasury bonds would rise.
(c) the interest rate on municipal bonds would rise.
(d) the price of Treasury bonds would fall.
Answer: C
Question Status: Previous Edition

69) If income tax rates were lowered, then
(a) the prices of municipal bonds would fall.
(b) the interest rate on municipal bonds would fall.
(c) the interest rate on Treasury bonds would rise.
(d) both (a) and (b) would occur.
Answer: A
Question Status: Previous Edition

70) If income tax rates were lowered, then
(a) the interest rate on municipal bonds would rise.
(b) the interest rate on Treasury bonds would fall.
(c) the interest rate on municipal bonds would fall.
(d) both (a) and (b) would occur.
(e) both (b) and (c) would occur.
Answer: D
Question Status: Previous Edition

71) If income tax rates were lowered, then
(a) the prices of municipal bonds would fall.
(b) the prices of Treasury bonds would rise.
(c) the interest rate on Treasury bonds would rise.
(d) both (a) and (b) would occur.
Answer: D
Question Status: Previous Edition

72) If income tax rates rise, then
(a) the interest rate on municipal bonds would fall.
(b) the interest rate on Treasury bonds would rise.
(c) the interest rate on municipal bonds would rise.
(d) both (a) and (b) would occur.
Answer: D
Question Status: Previous Edition

73) If income tax rates rise, then
(a) the prices of municipal bonds would fall.
(b) the interest rate on municipal bonds would fall.
(c) the interest rate on Treasury bonds would rise.
(d) both (a) and (b) would occur.
(e) both (b) and (c) would occur.
Answer: E
Question Status: Previous Edition

74) If income tax rates rise, then
(a) the interest rate on municipal bonds would rise.
(b) the interest rate on Treasury bonds would fall.
(c) the interest rate on municipal bonds would fall.
(d) both (a) and (b) would occur.
(e) both (b) and (c) would occur.
Answer: C
Question Status: Previous Edition

75) If income tax rates rise, then
(a) the prices of municipal bonds would fall.
(b) the prices of Treasury bonds would rise.
(c) the interest rate on Treasury bonds would rise.
(d) the interest rate on municipal bonds would rise.
Answer: C
Question Status: Previous Edition

76) Abolishing all taxes will
(a) increase the interest rate on corporate bonds.
(b) reduce the interest rate on municipal bonds.
(c) increase the interest rate on municipal bonds.
(d) not affect bond interest rates.
(e) both (a) and (b) of the above.
Answer: C
Question Status: Study Guide

77) Because of the substantial default risk of municipal bonds, their interest rates
(a) exceed the interest rates on default-free U.S. Treasury bonds, indicating that the default premium exceeds the tax advantages of municipal bonds.
(b) exceed the interest rates on default-free U.S. Treasury bonds, indicating that the default premium is less than the tax advantages of municipal bonds.
(c) are lower than the interest rates on default-free U.S. Treasury bonds, indicating that the default premium exceeds the tax advantages of municipal bonds.
(d) are lower than the interest rates on default-free U.S. Treasury bonds, indicating that the default premium is less than the tax advantages of municipal bonds.
(e) none of the above

Answer: D
Question Status: Study Guide

78) 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) the benefit from the tax-exempt status of municipal bonds exceeds their default risk.
(d) Treasury bonds are not default-free.
(e) both (c) and (d) above are correct.

Answer: C
Question Status: New

79) If the tax-exempt status of municipal bonds were eliminated, then
(a) the interest rates on municipal bonds would still be less than the interest rate on Treasury bonds.
(b) the interest rate on municipal bonds would equal the rate on Treasury bonds.
(c) the interest rate on municipal bonds would exceed the rate on Treasury bonds.
(d) the interest rates on municipal, Treasury, and corporate bonds would all increase.
(e) the interest rates on municipal, Treasury, and corporate bonds would all decrease.

Answer: C
Question Status: New

80) Interest rates on bonds of the same maturity will differ because of differences in
(a) liquidity.
(b) risk.
(c) income tax treatment.
(d) all of the above.
(e) only (a) and (b) of the above.

Answer: D
Question Status: Previous Edition

81) The differences among the various bond ratings reflect
(a) the bonds' relative default risks.
(b) the bonds' relative liquidity.
(c) the bond's relative tax treatment.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: D
Question Status: Revised

82) The risk structure of interest rates is explained by differences in
(a) the bonds' relative default risks.
(b) the bonds' relative liquidity.
(c) the bond's relative tax treatment.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: D
Question Status: Previous Edition

83) Three factors explain the risk structure of interest rates:
(a) liquidity, default risk, and the income tax treatment of a security.
(b) maturity, default risk, and the income tax treatment of a security.
(c) maturity, liquidity, and the income tax treatment of a security.
(d) maturity, default risk, and the liquidity of a security.
(e) maturity, default risk, and inflation.
Answer: A
Question Status: Study Guide

84) The term structure of interest rates is
(a) the relationship among interest rates of different bonds with the same maturity.
(b) the structure of how interest rates move over time.
(c) the relationship among the term to maturity of different bonds.
(d) the relationship among interest rates on bonds with different maturities.
Answer: D
Question Status: Previous Edition

85) A plot of the interest rates on default-free government bonds with different terms to maturity is called
(a) a risk-structure curve.
(b) a term-structure curve.
(c) a yield curve.
(d) an interest-rate curve.
Answer: C
Question Status: Previous Edition

86) The relationship among interest rates on bonds with identical default risk, but of different maturities is called the
(a) time-risk structure of interest rates.
(b) liquidity structure of interest rates.
(c) bond demand curve.
(d) yield curve.
Answer: D
Question Status: Previous Edition

87) Factors that influence interest rates on bonds include
(a) risk.
(b) liquidity.
(c) tax considerations.
(d) term to maturity.
(e) all of the above.
Answer: E
Question Status: Previous Edition

88) Yield curves can be classified as
(a) upward sloping.
(b) downward sloping.
(c) flat.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: D
Question Status: Previous Edition

89) Yield curves can be
(a) steeply upward sloping.
(b) moderately upward sloping.
(c) downward sloping.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: D
Question Status: Previous Edition

90) Typically, yield curves are
(a) gently upward sloping.
(b) gently downward sloping.
(c) flat.
(d) bowl shaped.
(e) mound shaped.
Answer: A
Question Status: Previous Edition

91) When yield curves are steeply upward sloping,
(a) long-term interest rates are above short-term interest rates.
(b) short-term interest rates are above long-term interest rates.
(c) short-term interest rates are about the same as long-term interest rates.
(d) medium-term interest rates are above both short-term and long-term interest rates.
(e) medium-term interest rates are below both short-term and long-term interest rates.
Answer: A
Question Status: Previous Edition

92) When yield curves are downward sloping,
(a) long-term interest rates are above short-term interest rates.
(b) short-term interest rates are above long-term interest rates.
(c) short-term interest rates are about the same as long-term interest rates.
(d) medium-term interest rates are above both short-term and long-term interest rates.
(e) medium-term interest rates are below both short-term and long-term interest rates.
Answer: B
Question Status: Previous Edition

93) When yield curves are flat,
(a) long-term interest rates are above short-term interest rates.
(b) short-term interest rates are above long-term interest rates.
(c) short-term interest rates are about the same as long-term interest rates.
(d) medium-term interest rates are above both short-term and long-term interest rates.
(e) medium-term interest rates are below both short-term and long-term interest rates.
Answer: C
Question Status: Previous Edition

94) An inverted yield curve
(a) slopes up.
(b) is flat.
(c) slopes down.
(d) has a U shape.
(e) has an inverted U shape.
Answer: C
Question Status: New

95) 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) buyers of bonds do not prefer bonds of one maturity over another.
(c) interest rates on bonds of different maturities move together over time.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: D
Question Status: Previous Edition

96) 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
Question Status: Previous Edition

97) 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) buyers of bonds do not prefer bonds of one maturity over another.
(d) all of the above.
(e) only (a) and (b) of the above.

Answer: D
Question Status: Previous Edition

98) 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
Question Status: Previous Edition

99) 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) yield curves should be as equally likely to slope downward as slope upward.
(d) all of the above.
(e) only (a) and (b) of the above.

Answer: D
Question Status: Previous Edition

100) 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) buyers of bonds do not prefer bonds of one maturity over another.
(c) yield curves should be as equally likely to slope downward as slope upward.
(d) all of the above.
(e) only (a) and (b) of the above.

Answer: D
Question Status: Previous Edition

101) 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) buyers of bonds do prefer short-term to long-term bonds.
(c) interest rates on bonds of different maturities do not move together over time.
(d) all of the above.

Answer: A
Question Status: Previous Edition

102) According to the expectations theory of the term structure
(a) the interest rate on long-term bonds will exceed the average of short-term interest rates that people expect to occur over the life of the long-term bonds, because of their preference for short-term securities.
(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: B
Question Status: Previous Edition

103) 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) 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
Question Status: Previous Edition

104) 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 remain relatively stable 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: A
Question Status: Previous Edition

105) According to the expectations theory of the term structure
(a) yield curves should be as equally likely to slope downward as slope upward.
(b) when the yield curve is steeply upward sloping, short-term interest rates are expected to rise in the future.
(c) when the yield curve is downward sloping, short-term interest rates are expected to remain relatively stable in the future.
(d) all of the above.
(e) only (a) and (b) of the above.

Answer: E
Question Status: Previous Edition

106) 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 are not expected to move together over time since buyers of bonds prefer short-term to long-term bonds.
(c) investors' strong preferences for short-term relative to long-term bonds explains why yield curves typically slope upward.
(d) all of the above.
(e) only (a) and (b) of the above.

Answer: A
Question Status: Previous Edition

107) 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) 6 percent.
(d) 7 percent.
(e) 8 percent.

Answer: C
Question Status: Previous Edition

108) If the expected path of 1-year interest rates over the next four years is 5 percent, 4 percent, 2 percent, and 1 percent, then the expectations theory predicts that today's interest rate on the four-year bond is

(a) 1 percent.
(b) 2 percent.
(c) 4 percent.
(d) none of the above.

Answer: D
Question Status: Previous Edition

109) If the expected path of 1-year interest rates over the next four years is 5 percent, 4 percent, 2 percent, and 1 percent, then the expectations theory predicts that today's interest rate on the four-year bond is

(a) 1 percent.
(b) 2 percent.
(c) 3 percent.
(d) 4 percent.
(e) 5 percent.

Answer: C
Question Status: Previous Edition

110) If the expected path of 1-year interest rates over the next five years is 1 percent, 2 percent, 3 percent, 4 percent, and 5 percent, the expectations theory predicts that the bond with the highest interest rate today is the one with a maturity of

(a) one year.
(b) two years.
(c) three years.
(d) four years.
(e) five years.

Answer: E
Question Status: Previous Edition

111) 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.

Answer: A
Question Status: Previous Edition

112) Over the next three years, the expected path of 1-year interest rates is 4, 1, and 1 percent. The expectations theory of the term structure predicts that the current interest rate on 3-year bond is
(a) 1 percent.
(b) 2 percent.
(c) 3 percent.
(d) 4 percent.
(e) 5 percent.

Answer: B
Question Status: Study Guide

113) 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 of bonds do not prefer bonds of one maturity over another.
(c) interest rates on bonds of different maturities do not move together over time.
(d) all of the above.

Answer: C
Question Status: Previous Edition

114) 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) 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.
(c) investors' strong preferences for short-term relative to long-term bonds explains why yield curves typically slope upward.
(d) all of the above.
(e) none of the above.

Answer: D
Question Status: Previous Edition

115) According to the segmented markets theory of the term structure
(a) bonds of one maturity are close substitutes for bonds of other maturities, therefore, interest rates on bonds of different maturities move together over time.
(b) the interest rate for each maturity bond is determined by supply and demand for that maturity bond.
(c) investors' strong preferences for short-term relative to long-term bonds explains why yield curves typically slope downward.
(d) all of the above.

Answer: B
Question Status: Previous Edition

116) 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) 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.
(c) investors' strong preferences for short-term relative to long-term bonds explains why yield curves typically slope downward.
(d) only (a) and (b) of the above.

Answer: D
Question Status: Previous Edition

117) 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 close substitutes for bonds of other maturities, therefore, interest rates on bonds of different maturities move together over time.
(d) all of the above.
(e) only (a) and (b) of the above.

Answer: E
Question Status: Previous Edition

118) The liquidity premium theory of the term structure
(a) indicates that today's long-term interest rate equals the average of short-term interest rates that people expect to occur over the life of the long-term bond.
(b) assumes that bonds of different maturities are perfect substitutes.
(c) suggests that markets for bonds of different maturities are completely separate because people have preferred habitats.
(d) does none of the above.

Answer: D
Question Status: Previous Edition

119) According to the liquidity premium 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 plus a term premium.
(b) buyers of bonds may prefer bonds of one maturity over another, yet interest rates on bonds of different maturities move together over time.
(c) even with a positive term premium, if future short-term interest rates are expected to fall significantly, then the yield curve will be downward sloping.
(d) all of the above.
(e) only (a) and (b) of the above.

Answer: D
Question Status: Previous Edition

120) According to the liquidity premium theory of the term structure
(a) because buyers of bonds may prefer bonds of one maturity over another, interest rates on bonds of different maturities do not move together over time.
(b) 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 plus a term premium.
(c) because of the positive term premium, the yield curve will not be observed to be downward sloping.
(d) all of the above.
(e) only (a) and (b) of the above.

Answer: B
Question Status: Previous Edition

121) 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
Question Status: New

122) If 1-year interest rates for the next four years are expected to be 4, 2, 3, and 3 percent, and the 4-year term premium is 1 percent, than the 4-year bond rate will be
(a) 1 percent.
(b) 2 percent.
(c) 3 percent.
(d) 4 percent.
(e) 5 percent.

Answer: D
Question Status: New

123) If 1-year interest rates for the next five years are expected to be 4, 2, 5, 4, and 5 percent, and the 5-year term premium is 1 percent, than the 5-year bond rate will be
(a) 1 percent.
(b) 2 percent.
(c) 3 percent.
(d) 4 percent.
(e) 5 percent.

Answer: E
Question Status: New

124) If 1-year interest rates for the next two years are expected to be 4 and 2 percent, and the 2-year term premium is 1 percent, than the 2-year bond rate will be
(a) 1 percent.
(b) 2 percent.
(c) 3 percent.
(d) 4 percent.
(e) 5 percent.

Answer: D
Question Status: New

125) If the yield curve is flat for short maturities and then slopes downward for longer maturities, the liquidity premium theory (assuming a mild preference for shorter-term bonds) indicates that the market is predicting.
(a) a rise in short-term interest rates in the near future and a decline further out in the future.
(b) constant short-term interest rates in the near future and a decline further out in the future.
(c) a decline in short-term interest rates in the near future and a rise further out in the future.
(d) a decline in short-term interest rates in the near future and an even steeper decline further out in the future.

Answer: D
Question Status: Previous Edition

126) If the yield curve slope is flat, the liquidity premium theory (assuming a mild preference for shorter-term bonds) indicates that the market is predicting
(a) a mild rise in short-term interest rates in the near future and a mild decline further out in the future.
(b) constant short-term interest rates in the near future and further out in the future.
(c) a mild decline in short-term interest rates in the near future and a continuing mild decline further out in the future.
(d) constant short-term interest rates in the near future and a mild decline further out in the future.

Answer: C
Question Status: Previous Edition

127) If the yield curve has a mild upward slope, the liquidity premium theory (assuming a mild preference for shorter-term bonds) indicates that the market is predicting
(a) a rise in short-term interest rates in the near future and a decline further out in the future.
(b) constant short-term interest rates in the near future and further out in the future.
(c) a decline in short-term interest rates in the near future and a rise further out in the future.
(d) a decline in short-term interest rates in the near future and an even steeper decline further out in the future.

Answer: B
Question Status: Previous Edition

128) According to the liquidity premium theory of the term structure
(a) when short-term interest rates are expected to rise in the future, the yield curve will be upward sloping.
(b) when short-term interest rates are expected to decline moderately in the future, the yield curve is likely to be flat.
(c) when short-term interest rates are expected to decline significantly in the future, the yield curve is likely to be downward sloping,
(d) all of the above.
(e) only (a) and (b) of the above.

Answer: D
Question Status: Previous Edition

129) According to the liquidity premium theory
(a) a steeply rising yield curve indicates that short-term interest rates are expected to remain unchanged in the future.
(b) a moderately rising yield curve indicates that short-term interest rates are not expected to change much in the future.
(c) a flat yield curve indicates that short-term interest rates are expected to rise moderately in the future.
(d) only (a) and (b) of the above are true.

Answer: B
Question Status: Previous Edition

130) According to the liquidity premium theory of the term structure
(a) when short-term interest rates are expected to rise in the future, the yield curve will be upward sloping.
(b) when short-term interest rates are expected to decline significantly in the future, the yield curve is likely to be downward sloping,
(c) when short-term interest rates are expected to remain unchanged 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: E
Question Status: Previous Edition

131) According to the liquidity premium theory of the term structure
(a) when short-term interest rates are expected to rise in the future, the yield curve will be steeply upward sloping.
(b) when short-term interest rates are expected to remain unchanged in the future, the yield curve is likely to be slightly 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
Question Status: Previous Edition

132) According to the liquidity premium theory of the term structure, a steeply upward sloping yield curve indicates that
(a) short-term interest rates are expected to rise in the future.
(b) short-term interest rates are expected to remain unchanged in the future.
(c) short-term interest rates are expected to decline moderately in the future.
(d) short-term interest rates are expected to decline sharply in the future.
Answer: A
Question Status: Previous Edition

133) According to the liquidity premium theory of the term structure, a slightly upward sloping yield curve indicates that
(a) short-term interest rates are expected to rise in the future.
(b) short-term interest rates are expected to remain unchanged in the future.
(c) short-term interest rates are expected to decline moderately in the future.
(d) short-term interest rates are expected to decline sharply in the future.
Answer: B
Question Status: Previous Edition

134) According to the liquidity premium theory of the term structure, a flat yield curve indicates that
(a) short-term interest rates are expected to rise in the future.
(b) short-term interest rates are expected to remain unchanged in the future.
(c) short-term interest rates are expected to decline moderately in the future.
(d) short-term interest rates are expected to decline sharply in the future.
Answer: C
Question Status: Previous Edition

135) According to the liquidity premium theory of the term structure, a downward sloping yield curve indicates that
(a) short-term interest rates are expected to rise in the future.
(b) short-term interest rates are expected to remain unchanged in the future.
(c) short-term interest rates are expected to decline moderately in the future.
(d) short-term interest rates are expected to decline sharply in the future.
Answer: D
Question Status: Previous Edition

136) According to the liquidity premium theory of the term structure, when the yield curve has its usual slope (gently upward sloping), the market expects
(a) short-term interest rates to stay near their current levels.
(b) short-term interest rates to rise sharply.
(c) short-term interest rates to drop sharply.
(d) none of the above.
Answer: A
Question Status: Previous Edition

137) According to the liquidity premium theory of the term structure, when the yield curve has its usual slope, the market expects
(a) short-term interest rates to stay near their current levels.
(b) short-term interest rates to rise sharply.
(c) short-term interest rates to drop sharply.
(d) none of the above.

Answer: A
Question Status: Previous Edition

138) According to the liquidity premium theory
(a) a steeply rising yield curve indicates that short-term interest rates are expected to rise in the future.
(b) a moderately rising yield curve indicates that short-term interest rates are not expected to change much in the future.
(c) a flat yield curve indicates that short-term interest rates are expected to fall moderately in the future.
(d) all of the above are true.
(e) only (a) and (b) of the true.

Answer: D
Question Status: Previous Edition

139) According to the liquidity premium theory
(a) a steeply rising yield curve indicates that short-term interest rates are expected to remain unchanged in the future.
(b) a moderately rising yield curve indicates that short-term interest rates are expected rise moderately in the future.
(c) a flat yield curve indicates that short-term interest rates are expected to rise moderately in the near future, then fall moderately in the distant future.
(d) a downward sloping yield curve indicates that short-term interest rates are expected to fall sharply in the future.

Answer: D
Question Status: Previous Edition

140) According to the liquidity premium theory of the term structure
(a) bonds of different maturities are substitutes, but investors can prefer one bond maturity over another.
(b) if yield curves are downward sloping, then short-term interest rates are expected to fall by so much that, even when the positive term premium is added, long-term rates fall below short-term rates.
(c) yield curves should never slope downward.
(d) both (a) and (b) of the above are true.
(e) both (a) and (c) of the above are true.

Answer: D
Question Status: Previous Edition

141) Which of the following theories of the term structure is (are) able to explain the fact that interest rates on bonds of different maturities tend to move together over time?

(a) The expectations theory
(b) The segmented markets theory
(c) The liquidity premium theory
(d) Both (a) and (b) of the above
(e) Both (a) and (c) of the above

Answer: E
Question Status: Previous Edition

142) Which of the following theories of the term structure are able to explain the fact that yield curves usually slope upward?

(a) The expectations theory
(b) The segmented markets theory
(c) The liquidity premium theory
(d) Both (b) and (c) of the above
(e) Both (a) and (c) of the above

Answer: D
Question Status: Previous Edition

143) Which of the following theories of the term structure are able to explain the fact that yield curves usually slope upward?

(a) The preferred habitat theory
(b) The segmented market theory
(c) The liquidity premium theory
(d) All of the above
(e) Both (a) and (c) of the above

Answer: D
Question Status: New

144) Which of the following theories of the term structure are able to explain the fact that interest rates on bonds of different maturities move together over time?

(a) The preferred habitat theory
(b) The expectations theory
(c) The liquidity premium theory
(d) All of the above
(e) Both (a) and (c) of the above

Answer: D
Question Status: New

145) Which of the following theories of the term structure are able to explain the fact that interest rates on bonds of different maturities move together over time?

(a) The preferred habitat theory
(b) The segmented market theory
(c) The liquidity premium theory
(d) All of the above
(e) Both (a) and (c) of the above

Answer: E
Question Status: New

146) Which of the following theories of the term structure is (are) able to explain all three empirical facts about the term structure?

(a) The expectations theory
(b) The segmented markets theory
(c) The preferred habitat theory
(d) All of the above
(e) Both (a) and (b) of the above

Answer: C
Question Status: New

147) The preferred habitat theory of the term structure is closely related to the

(a) expectations theory of the term structure.
(b) segmented markets theory of the term structure.
(c) liquidity premium theory of the term structure.
(d) the inverted yield curve theory of the term structure.
(e) risk premium theory of the term structure

Answer: C
Question Status: New

148) 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.

Answer: C
Question Status: Previous Edition

149) The _____ of the term structure of interest rates states that the interest rate on a long-term bond will equal the average of short-term interest rates that individuals expect to occur over the life of the long-term bond, and investors have no preference for short-term bonds relative to long-term bonds.
(a) segmented markets theory
(b) expectations theory
(c) liquidity premium theory
(d) separable markets theory

Answer: B
Question Status: Study Guide

150) When the yield curve is upward sloping,
(a) the expectations theory suggests that short-term interest rates are expected to rise.
(b) the expectations theory suggests that short-term interest rates are expected to fall.
(c) the segmented markets theory suggests that short-term interest rates are expected to fall.
(d) the liquidity premium theory suggests that short-term interest rates are expected to fall.

Answer: A
Question Status: Previous Edition

151) When the yield curve slopes down,
(a) the expectations theory suggests that short-term interest rates are expected to rise.
(b) the expectations theory suggests that short-term interest rates are expected to fall.
(c) the segmented markets theory suggests that short-term interest rates are expected to rise.
(d) the liquidity premium theory suggests that short-term interest rates are expected to rise.

Answer: B
Question Status: Previous Edition

152) In actual practice, short-term interest rates and long-term interest rates move together; this is the major shortcoming of the
(a) segmented markets theory.
(b) expectations theory.
(c) liquidity premium theory.
(d) separable markets theory.

Answer: A
Question Status: Revised

153) According to this theory of the term structure, bonds of different maturities are not substitutes for one another.
(a) Segmented markets theory
(b) Expectations theory
(c) Liquidity premium theory
(d) Separable markets theory

Answer: A
Question Status: Previous Edition

154) Since yield curves are usually upward sloping, the _____ indicates that, on average, people tend to prefer holding short-term bonds to long-term bonds.
(a) segmented markets theory
(b) expectations theory
(c) liquidity premium theory
(d) both (a) and (b) of the above
(e) both (a) and (c) of the above
Answer: E
Question Status: Previous Edition

155) It cannot explain the empirical fact that interest rates on bonds of different maturities tend to move together.
(a) Segmented markets theory
(b) Expectations theory
(c) Liquidity premium theory
(d) Both (a) and (b) of the above
(e) Both (a) and (c) of the above
Answer: A
Question Status: Previous Edition

156) The _____ of the term structure states the following: the interest rate on a long-term bond will equal an average of short-term interest rates expected to occur over the life of the long-term bond plus a term premium that responds to supply and demand conditions for that bond.
(a) segmented markets theory
(b) expectations theory
(c) liquidity premium theory
(d) both (a) and (b) of the above
(e) both (a) and (c) of the above
Answer: C
Question Status: Previous Edition

157) A particularly attractive feature of the _____ is that it tells you what the market is predicting about future short-term interest rates by just looking at the slope of the yield curve.
(a) segmented markets theory
(b) expectations theory
(c) liquidity premium theory
(d) both (a) and (b) of the above
Answer: C
Question Status: Previous Edition

158) Economists' attempts to explain the term structure of interest rates
(a) illustrate how economists modify theories to improve them when they are inconsistent with the empirical evidence.
(b) illustrate how economists continue to accept theories that fail to explain observed behavior of interest rate movements.
(c) prove that the real world is a special case that tends to get short shrift in theoretical models.
(d) have proved entirely unsatisfactory to date.

Answer: A
Question Status: Previous Edition

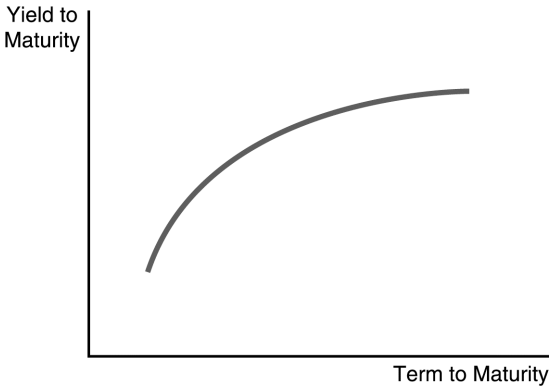


Figure 6-1

159) The steeply upward sloping yield curve in Figure 6-1 indicates that
(a) short-term interest rates are expected to rise in the future.
(b) short-term interest rates are expected to fall moderately in the future.
(c) short-term interest rates are expected to fall sharply in the future.
(d) short-term interest rates are expected to remain unchanged in the future.

Answer: A
Question Status: Previous Edition

160) The steeply upward sloping yield curve in Figure 6-1 indicates that _____ interest rates are expected to _____ in the future.
(a) short-term; rise
(b) short-term; fall moderately
(c) short-term; remain unchanged
(d) long-term; fall moderately
(e) long-term; remain unchanged

Answer: A
Question Status: Previous Edition

161) The U-shaped yield curve in Figure 6-2 indicates that
(a) short-term interest rates are expected to rise in the near term and fall later on.
(b) short-term interest rates are expected to fall moderately in the near-term and rise later on.
(c) short-term interest rates are expected to fall sharply in the near-term and rise later on.
(d) short-term interest rates are expected to remain unchanged in the near-term and rise later on.

Answer: C
Question Status: Previous Edition

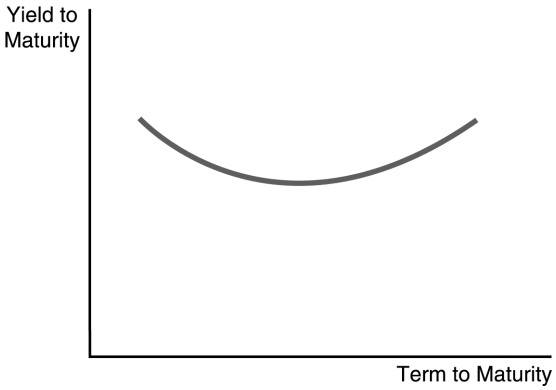


Figure 6-2

162) The U-shaped yield curve in Figure 6-2 indicates that short-term interest rates are expected to ____.
(a) rise in the near-term and fall later on
(b) fall sharply in the near-term and rise later on
(c) fall moderately in the near-term and rise later on
(d) remain unchanged in the near-term and rise later on

Answer: B
Question Status: Previous Edition

163) The U-shaped yield curve in Figure 6-2 indicates that
(a) inflation is expected to remain constant in the near-term and fall later on.
(b) inflation is expected to fall sharply in the near-term and rise later on.
(c) inflation is expected to rise moderately in the near-term and fall later on.
(d) inflation is expected to remain constant in the near-term and rise later on.

Answer: B
Question Status: Previous Edition

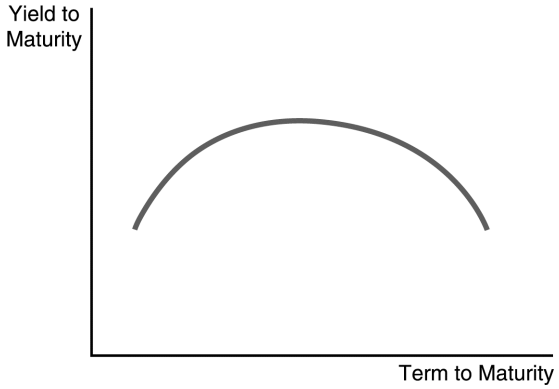


Figure 6-3

164) The inverted U-shaped yield curve in Figure 6-3 indicates that
(a) short-term interest rates are expected to rise in the near-term and fall later on.
(b) short-term interest rates are expected to fall moderately in the near-term and rise later on.
(c) short-term interest rates are expected to fall sharply in the near-term and rise later on.
(d) short-term interest rates are expected to remain unchanged in the near-term and fall later on.

Answer: A
Question Status: Previous Edition

165) The inverted U-shaped yield curve in Figure 6-3 indicates that
(a) inflation is expected to remain constant in the near-term and fall later on.
(b) inflation is expected to fall moderately in the near-term and rise later on.
(c) inflation is expected to rise moderately in the near-term and fall later on.
(d) inflation is expected to remain unchanged in the near-term and rise later on.

Answer: C
Question Status: Previous Edition

166) An inverted yield curve predicts that
(a) short-term interest rates are expected to rise in the future.
(b) short-term interest rates will rise and then fall in the future.
(c) short-term interest rates will remain unchanged in the future.
(d) short-term interest rates will fall in the future.
(e) short-term interest rates will fall and then rise in the future.

Answer: D
Question Status: New

167) When short-term interest rates are expected to fall in the future, the yield curve will
(a) slope up.
(b) be flat.
(c) be inverted.
(d) be an inverted U shape.
(e) have a W shape.

Answer: C
Question Status: New

■ Essay Questions

1) Explain the factors that determine the risk structure of interest rates. Explain how a change of each factor changes interest rates.

Answer: Default risk is the risk that interest or principal payments will not be made.

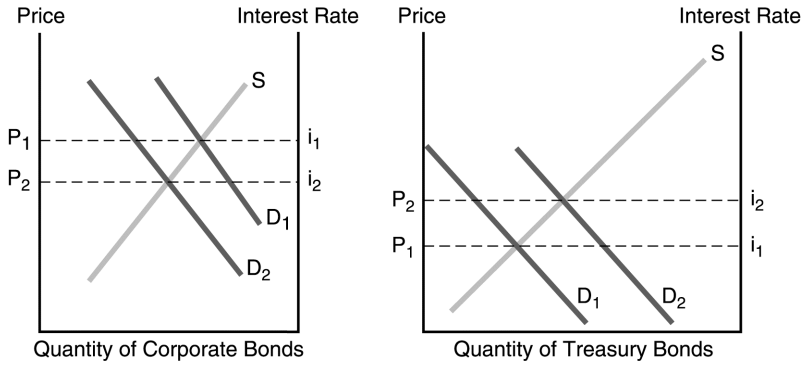
Liquidity is the ability to convert an asset to cash quickly and cheaply.

Tax-exempt bonds are more attractive to investors in high tax brackets.

An increase in default risk, a reduction in liquidity, and a tax cut increase interest rates on the affected assets. A reduction of default risk, an increase in liquidity, and a tax increase reduce interest rates on the affected assets.

2) Demonstrate graphically and explain how a reduction in default risk affects the demand or supply of corporate and Treasury bonds.

Answer:



A reduction of default risk increases the demand for corporate bonds and reduces the demand for Treasury bonds. Corporate bond prices rise and interest rates fall. Treasury bond prices fall and interest rates rise. In the graph, the price of corporate bonds after the decrease in default risk must still be above the new Treasury bond price, since corporate bonds are not free of default risk.

3) If over the next five years, the interest rates on 1-year bonds are expected to be 5, 7, 7, 6, and 5 percent, and the liquidity premium for five-year bonds is 1 percent. According to the expectations theory of the term structure, what is the rate on five-year bonds? According to the liquidity premium theory, what is the rate on five-year bonds? Explain the difference between the two answers.

Answer: The expectations theory predicts that the five-year interest rate is the average of five 1-year interest rates, which is 6 percent in this problem. The liquidity premium theory adds a term premium due to a preference for short-term bonds to the expectations theory. In this problem, the liquidity premium theory predicts a rate of 7 percent.

4) What empirical facts must a theory of the term structure explain? Discuss the three main theories of the term structure and how well each explains these facts.

Answer: The three facts are that rates of different maturities move together, that yield curves slope up when short rates are low and down when short rates are high, and that yield curves generally slope up.

The expectations theory is based on the assumption that bonds of different maturities are perfect substitutes, making long rates the average of expected short rates over the life of the long bond. This theory explains the first two facts, but not the third, since on average the yield curve is flat according to this theory.

The segmented markets theory rejects the substitutability of bonds of different maturities. Markets for different bonds are segmented. Since investors prefer short bonds, this theory explains why the yield curve slopes up, but not the first two facts.

The liquidity premium theory combines the expectations theory with the preference for short-term bonds. This theory explains all three facts.

5) What is the shape of the yield curve when short rates are expected to fall in the medium term, and then increase? Demonstrate this graphically.

Answer: The curve will have a U shape reflecting the expected fall and then increase.