

CHAPTER 2

- 2-1. The price of a bond:
- a. is related to nothing. It is arbitrarily set by the corporation's Treasurer and Board of Director based on their need for profit the day the bonds are issued.
 - b.*** is inversely related to the market-required yield
 - c. is not a reflection of the market as a whole
 - d. increases (higher yields) and leads to an increase in the quantity demanded
- 2-2. The Equation of Exchange (Irving Fisher) is:
- a.*** $MV = PT$
 - b. $MP = VT$
 - c. $MT = PV$
 - d. none of the above
- 2-3. Velocity of circulation refers to:
- a. how fast the average person spends his paycheck
 - b. how fast the current interest rate doubles
 - c.*** the average number of times one dollar turns over in one year
 - d. the total annual dollar transactions divided by the current interest rate
- 2-4. In the equation of exchange:
- a. M = marginal revenue, V = velocity of trade. P = price level, T = trade value
 - b. M = money, V = volume of trade, P = price level, T = Time value of money
 - c. M = market yield, V = variability of circumstances, P = population growth, T time value of money
 - d.*** M = money supply, T = velocity of circulation, P = general price level, T = volume of trade
- 2-5. Other things being equal, the greater the rate of growth of money:
- a. the better off we are
 - b.*** the greater the rate of inflation
 - c. the higher the standard of living for the general population
 - d. the higher the poverty level

2-6. Economists agree:

- a. inflation stops growing after it reaches double digits
- b. inflation cannot continue year after year
- c.*** inflation, especially if it is consistent year after year, creates expectations of future inflation
- d. inflation doesn't play an important role in the determination of market interest rates

2-7. The line of causation: of money > inflation > interest rate mechanism is:

- a.*** money, economy, inflation, inflationary expectation, credit markets, interest rates
- b. interest rate, credit markets, inflationary expectations, inflation, economy, money
- c. inflationary expectations, inflation, economy, interest rate
- d. credit market, inflationary expectations, interest rate

2-8. Liquidity, income, and price-anticipation effects:

- a.*** are related to the money supply increase
- b. are related to the interest rate increase
- c. are related to the bond market increases
- d. operate autonomously in the market and are not related to each other

2-9. The liquidity effect:

- a. refers to the initial short-term effect of a decrease in the money supply when interest rates rise
- b.*** refers to the initial short-run effect of an increase in the money supply on interest rates
- c. decreases the amount of excess cash individuals hold when interest rates drop
- d. has no effect on the demand for bonds

2-10. The income effect comes into play when:

- a. the lower levels of income cause an increase in the demand for credit
- b. the lower levels of income cause a decrease in the demand for credit
- c.*** the higher levels of income cause an increase in the demand for credit
- d. the higher levels of income cause a decrease in the demand for credit

2-11. The price-anticipation effect on interest rates:

- a.* reflects the decrease in the supply of credit as a result of future expected inflation
- b. reflects the increase in the supply of credit as a result of future expected inflation
- c. reflects the decrease in the supply of credit as a result of future expected inflation rate
- d. reflects the increase in the supply of credit on inflation and future expected inflation

2-12. Risk characteristics of securities include:

- a. future growth, default, risk and callability
- b. bond rate, marketability, future growth, maturity
- c.* default, callability, marketability and maturity
- d. future growth, bond rate, default, and callability

2-13. Default risk:

- a.* is the risk the bond issuer will be unable to pay the interest and principal on the obligation
- b. means a high percentage yield (11% or higher)
- c. with a 11.3% yield on a bond means that there is little risk involved in paying back the principal and interest
- d. means that the interest rate can be low because the risk is high

2-14. Non-callable bonds:

- a. have a callability risk attached to them
- b. are less desirable than callable bonds
- c. can be called prior to maturity if holders are given a 120-day notice
- d.* will have a lower yield than identical callable bonds

2-15. Interest rate risk is best described by:

- a. the risk of choosing the wrong interest rate
- b. the risk of having a bond that may not trade in a liquid market
- c.* values of bonds with longer maturities change more than those with shorter maturities when interest rates change
- d. longer-term bonds are priced higher to yield more than shorter-term bonds

- 2-16. Market segmentation:
- a.* means there are two (or more) markets for securities of different maturities
 - b. is based on the long-term market
 - c. is based on the short-term market
 - d. includes the pension fund for long-term investments but not short-term investments
- 2-17. In the absence of inflationary expectation, the _____ would equal the real rate.
- a. callability risk rate
 - b. purchasing power risk rate
 - c. yield curve rate
 - d.* risk-free rate
- 2-18. The interest rate on a default - free bond would be the same as the real rate when:
- a.* inflationary expectations are zero
 - b. it is at its lowest of all time and remains constant
 - c. it is at its highest
 - d. there is a balanced budget
- 2-19. The following security is generally considered to have no default risk:
- a. EBM corporation
 - b. Orange County, California
 - c.* U.S. Treasury securities
 - d. State of New York general revenue bonds
- 2-20. The risk associated with the possibility that a bond issuer could legally repurchase outstanding bonds at their face value is called:
- a.* callability risk
 - b. default risk
 - c. purchasing power risk
 - d. maturity risk
- 2-21. The following asset likely has the highest liquidity risk:
- a. U.S. Treasury security
 - b. stock in EBM
 - c.* personal residence
 - d. this textbook

- 2-22 The rate of return on a municipal bond comparable to a non-municipal bond with a yield of ten per cent will be:
- a. 5% for all investors
 - b*** 6% for investors in the 40% tax bracket
 - b. 4% for investors in the 40% tax bracket
 - c. 10% for all investors