Financial Markets and Institutions 7th edition Saunders Test Bank

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Financial Markets and Institutions, 7e **(Saunders)**
Chapter 2 Determinants of Interest Rates

1) The real risk-free rate is the increment to purchasing power that the lender earns in order to induce him or her to forego current consumption.

2) If you earn 0.5 percent a month in your bank account, this would be the same as earning a 6 percent annual interest rate with annual compounding.

3) Simple interest calculations assume that interest earned is never reinvested.

4) An investor earned a 5 percent nominal risk-free rate over the year. However, over the year, prices increased by 2 percent. The investor's real risk-free rate was less than his nominal rate of return.

5) Earning a 5 percent interest rate with annual compounding is better than earning a 4.95 percent interest rate with semiannual compounding.

6) For any positive interest rate the present value of a given annuity will be less than the sum of the cash flows, and the future value of the same annuity will be greater than the sum of the cash flows.

7) With a zero interest rate both the present value and the future value of an N payment annuity would equal $N \times$ payment.

8) Households generally supply more funds to the markets as their income and wealth increase, *ceteris paribus*.

9) An increase in the perceived riskiness of investments would cause a movement up along the supply curve.

10) An increase in the marginal tax rates for all U.S. taxpayers would probably result in reduced supply of funds by households.

11) When the quantity of a financial security supplied or demanded changes at every given interest rate in response to a change in a factor, this causes a shift in the supply or demand curve.

12) An improvement in economic conditions would likely shift the supply curve down and to the right and shift the demand curve for funds up and to the right.

13) The risk that a security cannot be sold at a predictable price with low transaction costs at short notice is called liquidity risk.

14) Convertible bonds will normally have lower promised yields than straight bonds of similar terms and quality.

15) We expect liquidity premiums to move inversely with interest rate volatility.

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16) Everything else equal, the interest rate required on a callable bond will be less than the interest rate on a convertible bond.

17) The term structure of interest rates is the relationship between interest rates on bonds similar in terms except for maturity.

18) The unbiased expectations hypothesis of the term structure posits that long-term interest rates are unrelated to expected future short-term rates.

19) The traditional liquidity premium theory states that long-term interest rates are greater than the average of current and expected future short-term interest rates.

20) According to the market segmentation theory, short-term investors will not normally switch to intermediate- or long-term investments.

21) According to the liquidity premium theory, investors preferring long-term bonds over short-term bonds would require lower liquidity premium.

22) As the liquidity of corporate bonds decrease, the risk premium required on those bonds decrease as well.

23) An increase in interest rates increases the demand loanable funds.

24) A higher level of wealth causes the demand for loanable funds to increase and interest rates to fall.

25) An investment pays $400 in one year, *X* amount of dollars in two years, and $500 in three years. The total present value of all the cash flows (including *X*) is equal to $1,500. If i is 6 percent, what is *X*?
A) $702.83
B) $822.41
C) $789.70
D) $749.67
E) $600.00

26) An insurance company is trying to sell you a retirement annuity. The annuity will give you 20 payments with the first payment in 12 years when you retire. The insurance firm is asking you to pay $50,000 today. If this is a fair deal, what must the payment amount be (to the dollar) if the interest rate is 8 percent?
A) $5,093
B) $12,824
C) $9,472
D) $11,874
E) $10,422

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27) Suppose you can save $2,000 per year for the next ten years in an account earning 7 percent per year. How much will you have at the end of the tenth year if you make the first deposit today?
A) $34,187.75
B) $29,567.20
C) $31,217.36
D) $27,364.15
E) $18,364.25

28) An annuity and an annuity due with the same number of payments have the same future value if r = 10%. Which one has the higher payment?
A) They both must have the same payment since the future values are the same.
B) There is no way to tell which has the higher payment.
C) An annuity and an annuity due cannot have the same future value.
D) The annuity has the higher payment.
E) The annuity due has the higher payment.

29) You go to the *Wall Street Journal* and notice that yields on almost all corporate and Treasury bonds have decreased. The yield decreases may be explained by which one of the following?
A) A decrease in U.S. inflationary expectations
B) Newly expected decline in the value of the dollar
C) An increase in current and expected future returns of real corporate investments
D) Decreased Japanese purchases of U.S. Treasury bills/bonds
E) Increases in the U.S. government budget deficit

30) YIELD CURVE FOR ZERO COUPON BONDS RATED AA

Maturity	YTM	Maturity	YTM	Maturity	YTM
1 year	8.00%	7year	9.15%	13year	10.45 %
2 year	8.11%	8year	9.25%	14year	10.65 %
3 year	8.20%	9year	9.35%	15year	10.75 %
4 year	8.50%	10year	9.47%	16year	10.95 %
5 year	8.75%	11year	9.52%	17year	11.00 %
6 year	8.85%	12year	9.77%	18year	11.25 %

Assume that there are no liquidity premiums.

To the nearest basis point, what is the expected interest rate on a four-year maturity AA zero coupon bond purchased six years from today?
A) 10.41 percent
B) 10.05 percent
C) 9.16 percent
D) 10.56 percent
E) 9.96 percent

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31) YIELD CURVE FOR ZERO COUPON BONDS RATED AA

Maturity	YTM	Maturity	YTM	Maturity	YTM
1 year	8.00%	7year	9.15%	13year	10.45 %
2 year	8.11%	8year	9.25%	14year	10.65 %
3 year	8.20%	9year	9.35%	15year	10.75 %
4 year	8.50%	10year	9.47%	16year	10.95 %
5 year	8.75%	11year	9.52%	17year	11.00 %
6 year	8.85%	12year	9.77%	18year	11.25 %

Assume that there are no liquidity premiums.

You just bought a 15-year maturity Xerox corporate bond rated AA with a 0 percent coupon. You expect to sell the bond in eight years. Find the expected interest rate at the time of sale (watch out for rounding error).
A) 13.92 percent
B) 11.00 percent
C) 8.85 percent
D) 12.49 percent
E) 12.80 percent

32) According to the liquidity premium theory of interest rates,
A) long-term spot rates are higher than the average of current and expected future short-term rates.
B) investors prefer certain maturities and will not normally switch out of those maturities.
C) investors are indifferent between different maturities if the long-term spot rates are equal to the average of current and expected future short-term rates.
D) the term structure must always be upward sloping.
E) long-term spot rates are totally unrelated to expectations of future short-term rates.

33) Of the following, the most likely effect of an increase in income tax rates would be to
A) decrease the savings rate.
B) decrease the supply of loanable funds.
C) increase interest rates.
D) all of these choices are correct.

34) Upon graduating from college this year, you expect to earn $25,000 per year. If you get your MBA, in one year you can expect to start at $35,000 per year. Over the year, inflation is expected to be 5 percent. In today's dollars, how much additional (less) money will you make from getting your MBA (to the nearest dollar) in your first year?
A) −$2,462
B) $8,333
C) $8,750
D) $9,524
E) $10,000

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35) Investment A pays 8 percent simple interest for 10 years. Investment B pays 7.75 percent compound interest for 10 years. Both require an initial $10,000 investment. The future value of A minus the future value of B is equal to _____ (to the nearest penny).
A) $2,500.00
B) −$2,500.00
C) $1,643.32
D) $3,094.67
E) −$3,094.67

36) You buy a car for $38,000. You agree to a 60-month loan with a monthly interest rate of 0.55 percent. What is your required monthly payment?
A) $634.24
B) $745.29
C) $605.54
D) $764.07
E) None of these choices are correct.

37) You want to have $5 million when you retire in 40 years. You believe you can earn 9 percent per year on your investment. How much must you invest each year to achieve your goal when you retire? (Ignore all taxes.)
A) $10,412
B) $11,619
C) $14,798
D) $15,295
E) None of these choices are correct.

38) An investor wants to be able to buy 4 percent more goods and services in the future in order to induce her to invest today. During the investment period prices are expected to rise by 2 percent. Which statement(s) below is/are true?

I. 4 percent is the desired real risk-free interest rate.
II. 6 percent is the approximate nominal rate of interest required.
III. 2 percent is the expected inflation rate over the period.

A) I only
B) II only
C) III only
D) I and II only
E) I, II, and III are true.

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39) Classify each of the following in terms of their effect on interest rates (increase or decrease):

I. Perceived risk of financial securities increases.
II. Near term spending needs decrease.
III. Future profitability of real investments increases.

A) I increases: II increases: III increases
B) I increases: II decreases: III decreases
C) I decreases: II increases: III increases
D) I decreases; II decreases; III decreases
E) None of these choices are correct.

40) Classify each of the following in terms of their effect on interest rates (increase or decrease):

I. Covenants on borrowing become more restrictive.
II. The Federal Reserve increases the money supply.
III. Total household wealth increases.

A) I increases; II increases; III increases
B) I increases; II decreases; III decreases
C) I decreases; II increases; III increases
D) I decreases; II decreases; III decreases
E) None of these choices are correct.

41) Inflation causes the demand curve for loanable funds to shift to the _____ and causes the supply curve to shift to the _____.
A) right; right
B) right; left
C) left; left
D) left; right

42) An individual actually earned a 4 percent nominal return last year. Prices went up by 3 percent over the year. Given that the investment income was subject to a federal tax rate of 28 percent and a state and local tax rate of 6 percent, what was the investor's actual real after-tax rate of return?
A) −0.36 percent
B) 0.66 percent
C) 0.72 percent
D) 1.45 percent
E) 2.64 percent

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43) A 15-payment annual annuity has its first payment in nine years. If the payment amount is $1,400 and the interest rate is 7 percent, what is the most you should be willing to pay today for this investment?
A) $5,825.11
B) $12,751.08
C) $6,416.67
D) $7,421.24
E) $6,935.74

44) Which of the following would normally be expected to result in an increase in the supply of funds, all else equal?

I. The perceived riskiness of all investments decreases.
II. Expected inflation increases.
III. Current income and wealth levels increase.
IV. Near term spending needs of households increase as energy costs rise.

A) I and III only
B) II and III only
C) II, III, and IV only
D) I and IV only
E) I, II, III, and IV

45) An investor requires a 3 percent increase in purchasing power in order to induce her to lend. She expects inflation to be 2 percent next year. The nominal rate she must charge is about
A) 3 percent.
B) 2 percent.
C) 1 percent.
D) 5 percent.
E) 7 percent.

46) The term structure of interest rates is upward sloping for all bond types. A certain AAA-rated non-callable 10-year corporate bond has been issued at a 6.15 percent promised yield. Which one of the following bonds probably has a higher promised yield?
A) A similar quality municipal bond
B) A non-callable AAA-rated corporate bond with a five-year maturity
C) A callable AAA-rated corporate bond with a 15-year maturity
D) A non-callable AAA-rated convertible corporate bond with a 10-year maturity
E) All of these choices are correct.

47) Which of the following bond types pays interest that is exempt from federal taxation?
A) Municipal bonds
B) Corporate bonds
C) Treasury bonds
D) Convertible bonds
E) Municipal bonds and Treasury bonds

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48) The relationship between maturity and yield to maturity is called the _____.
A) loan covenant
B) term structure
C) bond indenture
D) Fisher effect
E) DRP structure

49) According to the unbiased expectations theory,
A) markets are segmented and buyers stay in their own segment.
B) liquidity premiums are negative and time varying.
C) the term structure will most often be upward sloping.
D) the long-term spot rate is an average of the current and expected future short-term interest rates.
E) forward rates are less than the expected future spot rates.

50) Suppose that the current one-year Treasury-bill rate is 3.15 percent and the expected one-year rate 12 months from now is 4.25 percent. According to the unbiased expectations theory, what should be the current rate for a two-year Treasury security?
A) 3.70 percent
B) 4.15 percent
C) 2.36 percent
D) 4.74 percent
E) 5.50 percent

51) Suppose you borrow $15,000 and then repay the loan by making 12 monthly payments of $1,297.92 each. What rate will you be quoted on the loan?

52) What is the loanable funds theory of interest rates?

53) What is the difference between the expected real interest rate and the real risk-free interest rate actually earned?

54) Can the actual real rate of interest be negative? When? Can the expected real rate be negative?

55) In October 1987 stock prices fell 22 percent in one day and bond rates fell also. Use the loanable funds theory to explain what happened.

56) A foreign investor placing money in dollar-denominated assets desires a 4 percent real rate of return. Global inflation is running about 3 percent, and the dollar is expected to decline against her home currency by 1.5 percent over the investment period. What is her minimum required rate of return? Explain.

57) Would you expect the demand curve for businesses to be steeper than the demand curve for funds by the federal government? Explain.

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58) Who are the major suppliers and demanders of funds in the United States and what is their typical position?

59) According to current projections, Social Security and other entitlement programs will soon be severely underfunded. If the government decides to cut social security benefits to future retirees and raise Social Security taxes on all workers, what will probably happen to the supply of funds available to the capital markets? What will be the effect on interest rates?

60) The one-year spot rate is currently 4 percent; the one-year spot rate one year from now will be 3 percent; and the one-year spot rate two years from now will be 6 percent. Under the unbiased expectations theory, what must today's three-year spot rate be? Suppose the three-year spot rate is actually 3.75 percent, how could you take advantage of this? Explain.

61) Explain the logic of the liquidity premium theory of the term structure.

62) Explain the market segmentation theory of the term structure.

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Financial Markets and Institutions, 7e **(Saunders)**
Chapter 2 Determinants of Interest Rates

1) The real risk-free rate is the increment to purchasing power that the lender earns in order to induce him or her to forego current consumption.

Answer: TRUE
Difficulty: 2 Medium
Topic: Determinants of Interest Rates for Individual Securities
Bloom's: Understand
AACSB: Reflective Thinking
Learning Goal: 02-06 Know what specific factors determine interest rates.
Accessibility: Keyboard Navigation

2) If you earn 0.5 percent a month in your bank account, this would be the same as earning a 6 percent annual interest rate with annual compounding.

Answer: FALSE
Difficulty: 2 Medium
Topic: Time Value of Money and Interest Rates
Bloom's: Understand
AACSB: Reflective Thinking
Learning Goal: 02-09 Understand how interest rates are used to determine present and future values.
Accessibility: Keyboard Navigation

3) Simple interest calculations assume that interest earned is never reinvested.

Answer: TRUE
Difficulty: 1 Easy
Topic: Determinants of Interest Rates for Individual Securities
Bloom's: Remember
AACSB: Reflective Thinking
Learning Goal: 02-06 Know what specific factors determine interest rates.
Accessibility: Keyboard Navigation

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4) An investor earned a 5 percent nominal risk-free rate over the year. However, over the year, prices increased by 2 percent. The investor's real risk-free rate was less than his nominal rate of return.

Answer: TRUE
Difficulty: 1 Easy
Topic: Time Value of Money and Interest Rates
Bloom's: Analyze; Apply
AACSB: Reflective Thinking; Analytical Thinking
Learning Goal: 02-09 Understand how interest rates are used to determine present and future values.
Accessibility: Keyboard Navigation

5) Earning a 5 percent interest rate with annual compounding is better than earning a 4.95 percent interest rate with semiannual compounding.

Answer: FALSE
Difficulty: 3 Hard
Topic: Time Value of Money and Interest Rates
Bloom's: Understand
AACSB: Reflective Thinking
Learning Goal: 02-09 Understand how interest rates are used to determine present and future values.
Accessibility: Keyboard Navigation

6) For any positive interest rate the present value of a given annuity will be less than the sum of the cash flows, and the future value of the same annuity will be greater than the sum of the cash flows.

Answer: TRUE
Difficulty: 2 Medium
Topic: Time Value of Money and Interest Rates
Bloom's: Understand
AACSB: Reflective Thinking
Learning Goal: 02-09 Understand how interest rates are used to determine present and future values.
Accessibility: Keyboard Navigation

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7) With a zero interest rate both the present value and the future value of an *N* payment annuity would equal *N* × payment.

Answer: TRUE
Difficulty: 2 Medium
Topic: Time Value of Money and Interest Rates
Bloom's: Remember
AACSB: Reflective Thinking
Learning Goal: 02-09 Understand how interest rates are used to determine present and future values.
Accessibility: Keyboard Navigation

8) Households generally supply more funds to the markets as their income and wealth increase, *ceteris paribus*.

Answer: TRUE
Difficulty: 1 Easy
Topic: Loanable Funds Theory
Bloom's: Understand; Remember
AACSB: Reflective Thinking
Learning Goal: 02-01 Know who the main suppliers of loanable funds are.
Accessibility: Keyboard Navigation

9) An increase in the perceived riskiness of investments would cause a movement up along the supply curve.

Answer: FALSE
Difficulty: 2 Medium
Topic: Loanable Funds Theory
Bloom's: Understand
AACSB: Reflective Thinking
Learning Goal: 02-01 Know who the main suppliers of loanable funds are.; 02-03 Understand how equilibrium interest rates are determined.; 02-04 Examine factors that cause the supply and demand curves for loanable funds to shift.
Accessibility: Keyboard Navigation

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10) An increase in the marginal tax rates for all U.S. taxpayers would probably result in reduced supply of funds by households.

Answer: TRUE
Difficulty: 1 Easy
Topic: Loanable Funds Theory
Bloom's: Understand
AACSB: Reflective Thinking
Learning Goal: 02-01 Know who the main suppliers of loanable funds are.; 02-03 Understand how equilibrium interest rates are determined.; 02-04 Examine factors that cause the supply and demand curves for loanable funds to shift.
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11) When the quantity of a financial security supplied or demanded changes at every given interest rate in response to a change in a factor, this causes a shift in the supply or demand curve.

Answer: TRUE
Difficulty: 2 Medium
Topic: Loanable Funds Theory
Bloom's: Understand
AACSB: Reflective Thinking
Learning Goal: 02-03 Understand how equilibrium interest rates are determined.; 02-04 Examine factors that cause the supply and demand curves for loanable funds to shift.
Accessibility: Keyboard Navigation

12) An improvement in economic conditions would likely shift the supply curve down and to the right and shift the demand curve for funds up and to the right.

Answer: TRUE
Difficulty: 2 Medium
Topic: Loanable Funds Theory
Bloom's: Understand
AACSB: Reflective Thinking
Learning Goal: 02-01 Know who the main suppliers of loanable funds are.; 02-03 Understand how equilibrium interest rates are determined.; 02-04 Examine factors that cause the supply and demand curves for loanable funds to shift.
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13) The risk that a security cannot be sold at a predictable price with low transaction costs at short notice is called liquidity risk.

Answer: TRUE
Difficulty: 1 Easy
Topic: Determinants of Interest Rates for Individual Securities
Bloom's: Remember
AACSB: Reflective Thinking
Learning Goal: 02-06 Know what specific factors determine interest rates.
Accessibility: Keyboard Navigation

14) Convertible bonds will normally have lower promised yields than straight bonds of similar terms and quality.

Answer: TRUE
Difficulty: 2 Medium
Topic: Determinants of Interest Rates for Individual Securities
Bloom's: Evaluate
AACSB: Reflective Thinking
Learning Goal: 02-06 Know what specific factors determine interest rates.
Accessibility: Keyboard Navigation

15) We expect liquidity premiums to move inversely with interest rate volatility.

Answer: FALSE
Difficulty: 3 Hard
Topic: Determinants of Interest Rates for Individual Securities
Bloom's: Understand
AACSB: Reflective Thinking
Learning Goal: 02-06 Know what specific factors determine interest rates.
Accessibility: Keyboard Navigation

16) Everything else equal, the interest rate required on a callable bond will be less than the interest rate on a convertible bond.

Answer: FALSE
Difficulty: 1 Easy
Topic: Determinants of Interest Rates for Individual Securities
Bloom's: Understand
AACSB: Reflective Thinking
Learning Goal: 02-06 Know what specific factors determine interest rates.
Accessibility: Keyboard Navigation

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17) The term structure of interest rates is the relationship between interest rates on bonds similar in terms except for maturity.

Answer: TRUE
Difficulty: 1 Easy
Topic: Term Structure of Interest Rates
Bloom's: Remember
AACSB: Reflective Thinking
Learning Goal: 02-07 Examine the different theories explaining the term structure of interest rates.
Accessibility: Keyboard Navigation

18) The unbiased expectations hypothesis of the term structure posits that long-term interest rates are unrelated to expected future short-term rates.

Answer: FALSE
Difficulty: 2 Medium
Topic: Term Structure of Interest Rates
Bloom's: Remember
AACSB: Reflective Thinking
Learning Goal: 02-07 Examine the different theories explaining the term structure of interest rates.
Accessibility: Keyboard Navigation

19) The traditional liquidity premium theory states that long-term interest rates are greater than the average of current and expected future short-term interest rates.

Answer: TRUE
Difficulty: 2 Medium
Topic: Term Structure of Interest Rates
Bloom's: Remember
AACSB: Reflective Thinking
Learning Goal: 02-07 Examine the different theories explaining the term structure of interest rates.
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20) According to the market segmentation theory, short-term investors will not normally switch to intermediate- or long-term investments.

Answer: TRUE
Difficulty: 1 Easy
Topic: Term Structure of Interest Rates
Bloom's: Remember
AACSB: Reflective Thinking
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21) According to the liquidity premium theory, investors preferring long-term bonds over short-term bonds would require lower liquidity premium.

Answer: FALSE
Difficulty: 1 Easy
Topic: Term Structure of Interest Rates
Bloom's: Remember
AACSB: Reflective Thinking
Learning Goal: 02-07 Examine the different theories explaining the term structure of interest rates.
Accessibility: Keyboard Navigation

22) As the liquidity of corporate bonds decrease, the risk premium required on those bonds decrease as well.

Answer: FALSE
Difficulty: 1 Easy
Topic: Determinants of Interest Rates for Individual Securities
Bloom's: Remember
AACSB: Reflective Thinking
Learning Goal: 02-06 Know what specific factors determine interest rates.
Accessibility: Keyboard Navigation

23) An increase in interest rates increases the demand loanable funds.

Answer: FALSE
Difficulty: 1 Easy
Topic: Loanable Funds Theory
Bloom's: Remember
AACSB: Reflective Thinking
Learning Goal: 02-02 Know who the main demanders of loanable funds are.
Accessibility: Keyboard Navigation

24) A higher level of wealth causes the demand for loanable funds to increase and interest rates to fall.

Answer: FALSE
Difficulty: 1 Easy
Topic: Loanable Funds Theory
Bloom's: Remember
AACSB: Reflective Thinking
Learning Goal: 02-04 Examine factors that cause the supply and demand curves for loanable funds to shift.
Accessibility: Keyboard Navigation

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25) An investment pays $400 in one year, *X* amount of dollars in two years, and $500 in three years. The total present value of all the cash flows (including *X*) is equal to $1,500. If i is 6 percent, what is *X*?
A) $702.83
B) $822.41
C) $789.70
D) $749.67
E) $600.00

Answer: C
Explanation: $X = [1{,}500 - (400/1.06) - (500/1.06^3)] \times 1.06^2$
Difficulty: 3 Hard
Topic: Time Value of Money and Interest Rates
Bloom's: Analyze; Apply
AACSB: Analytical Thinking
Learning Goal: 02-09 Understand how interest rates are used to determine present and future values.
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26) An insurance company is trying to sell you a retirement annuity. The annuity will give you 20 payments with the first payment in 12 years when you retire. The insurance firm is asking you to pay $50,000 today. If this is a fair deal, what must the payment amount be (to the dollar) if the interest rate is 8 percent?
A) $5,093
B) $12,824
C) $9,472
D) $11,874
E) $10,422

Answer: D
Explanation: $\$50{,}000 \times 1.08^{11} = \text{Pmt} \times \text{PVIFA}\ (8\%, 20\ \text{yrs.})$
Difficulty: 3 Hard
Topic: Time Value of Money and Interest Rates
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B) $29,567.20
C) $31,217.36
D) $27,364.15
E) $18,364.25

Answer: B
Explanation: FV = $2,000{[(1 + 0.07)^{10} − 1]/0. 07}(1 + 0.07) = $29,567.20 With a financial calculator set the payments at Begin mode, BGN, since the savings are happening at the beginning of the interest earning periods then, N = 10, I = 7, PV = 0, PMT = −2,000, then compute FV = $29,567.20.
Difficulty: 3 Hard
Topic: Time Value of Money and Interest Rates
Bloom's: Understand
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28) An annuity and an annuity due with the same number of payments have the same future value if r = 10%. Which one has the higher payment?
A) They both must have the same payment since the future values are the same.
B) There is no way to tell which has the higher payment.
C) An annuity and an annuity due cannot have the same future value.
D) The annuity has the higher payment.
E) The annuity due has the higher payment.

Answer: D
Difficulty: 3 Hard
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29) You go to the *Wall Street Journal* and notice that yields on almost all corporate and Treasury bonds have decreased. The yield decreases may be explained by which one of the following?
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B) Newly expected decline in the value of the dollar
C) An increase in current and expected future returns of real corporate investments
D) Decreased Japanese purchases of U.S. Treasury bills/bonds
E) Increases in the U.S. government budget deficit

Answer: A
Difficulty: 2 Medium
Topic: Determinants of Interest Rates for Individual Securities
Bloom's: Analyze; Evaluate
AACSB: Reflective Thinking
Learning Goal: 02-06 Know what specific factors determine interest rates.
Accessibility: Keyboard Navigation

30) YIELD CURVE FOR ZERO COUPON BONDS RATED AA

Maturity	YTM	Maturity	YTM	Maturity	YTM
1 year	8.00%	7year	9.15%	13year	10.45 %
2 year	8.11%	8year	9.25%	14year	10.65 %
3 year	8.20%	9year	9.35%	15year	10.75 %
4 year	8.50%	10year	9.47%	16year	10.95 %
5 year	8.75%	11year	9.52%	17year	11.00 %
6 year	8.85%	12year	9.77%	18year	11.25 %

Assume that there are no liquidity premiums.

To the nearest basis point, what is the expected interest rate on a four-year maturity AA zero coupon bond purchased six years from today?
A) 10.41 percent
B) 10.05 percent
C) 9.16 percent
D) 10.56 percent
E) 9.96 percent

Answer: A
Explanation: $((1.0947^{10}/1.0885^{6}))^{(1/4)} - 1$
Difficulty: 3 Hard
Topic: Forecasting Interest Rates
Bloom's: Analyze; Apply
AACSB: Analytical Thinking
Learning Goal: 02-08 Understand how forward rates of interest can be derived from the term structure of interest rates.
Accessibility: Keyboard Navigation

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31) YIELD CURVE FOR ZERO COUPON BONDS RATED AA

Maturity	YTM	Maturity	YTM	Maturity	YTM
1 year	8.00%	7year	9.15%	13year	10.45 %
2 year	8.11%	8year	9.25%	14year	10.65 %
3 year	8.20%	9year	9.35%	15year	10.75 %
4 year	8.50%	10year	9.47%	16year	10.95 %
5 year	8.75%	11year	9.52%	17year	11.00 %
6 year	8.85%	12year	9.77%	18year	11.25 %

Assume that there are no liquidity premiums.

You just bought a 15-year maturity Xerox corporate bond rated AA with a 0 percent coupon. You expect to sell the bond in eight years. Find the expected interest rate at the time of sale (watch out for rounding error).
A) 13.92 percent
B) 11.00 percent
C) 8.85 percent
D) 12.49 percent
E) 12.80 percent

Answer: D
Explanation: $((1.1075^{15}/1.0925^{8}))^{(1/7)} - 1$
Difficulty: 3 Hard
Topic: Forecasting Interest Rates
Bloom's: Analyze; Apply
AACSB: Analytical Thinking
Learning Goal: 02-08 Understand how forward rates of interest can be derived from the term structure of interest rates.
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32) According to the liquidity premium theory of interest rates,
A) long-term spot rates are higher than the average of current and expected future short-term rates.
B) investors prefer certain maturities and will not normally switch out of those maturities.
C) investors are indifferent between different maturities if the long-term spot rates are equal to the average of current and expected future short-term rates.
D) the term structure must always be upward sloping.
E) long-term spot rates are totally unrelated to expectations of future short-term rates.

Answer: A
Difficulty: 3 Hard
Topic: Term Structure of Interest Rates
Bloom's: Understand
AACSB: Reflective Thinking
Learning Goal: 02-07 Examine the different theories explaining the term structure of interest rates.
Accessibility: Keyboard Navigation

33) Of the following, the most likely effect of an increase in income tax rates would be to
A) decrease the savings rate.
B) decrease the supply of loanable funds.
C) increase interest rates.
D) all of these choices are correct.

Answer: D
Difficulty: 2 Medium
Topic: Loanable Funds Theory
Bloom's: Understand
AACSB: Reflective Thinking
Learning Goal: 02-04 Examine factors that cause the supply and demand curves for loanable funds to shift.
Accessibility: Keyboard Navigation

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34) Upon graduating from college this year, you expect to earn $25,000 per year. If you get your MBA, in one year you can expect to start at $35,000 per year. Over the year, inflation is expected to be 5 percent. In today's dollars, how much additional (less) money will you make from getting your MBA (to the nearest dollar) in your first year?
A) −$2,462
B) $8,333
C) $8,750
D) $9,524
E) $10,000

Answer: B
Explanation: (35,000/1.05) − 25,000
Difficulty: 3 Hard
Topic: Time Value of Money and Interest Rates
Bloom's: Analyze; Apply
AACSB: Reflective Thinking; Analytical Thinking
Learning Goal: 02-09 Understand how interest rates are used to determine present and future values.
Accessibility: Keyboard Navigation

35) Investment A pays 8 percent simple interest for 10 years. Investment B pays 7.75 percent compound interest for 10 years. Both require an initial $10,000 investment. The future value of A minus the future value of B is equal to _____ (to the nearest penny).
A) $2,500.00
B) −$2,500.00
C) $1,643.32
D) $3,094.67
E) −$3,094.67

Answer: E
Explanation: $[10{,}000 + (800 \times 10)] - [10{,}000 \times 1.0775^{10}]$
Difficulty: 3 Hard
Topic: Time Value of Money and Interest Rates
Bloom's: Analyze; Apply
AACSB: Analytical Thinking
Learning Goal: 02-09 Understand how interest rates are used to determine present and future values.
Accessibility: Keyboard Navigation

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36) You buy a car for $38,000. You agree to a 60-month loan with a monthly interest rate of 0.55 percent. What is your required monthly payment?
A) $634.24
B) $745.29
C) $605.54
D) $764.07
E) None of these choices are correct.

Answer: B
Explanation: Pmt = 38,000/PVIFA (i = 0.55%, n = 60)
Difficulty: 2 Medium
Topic: Time Value of Money and Interest Rates
Bloom's: Analyze; Apply
AACSB: Analytical Thinking
Learning Goal: 02-09 Understand how interest rates are used to determine present and future values.
Accessibility: Keyboard Navigation

37) You want to have $5 million when you retire in 40 years. You believe you can earn 9 percent per year on your investment. How much must you invest each year to achieve your goal when you retire? (Ignore all taxes.)
A) $10,412
B) $11,619
C) $14,798
D) $15,295
E) None of these choices are correct.

Answer: C
Explanation: $5 million/[$((1.09)^{40} - 1)/0.09$]
Difficulty: 1 Easy
Topic: Time Value of Money and Interest Rates
Bloom's: Analyze; Apply
AACSB: Reflective Thinking; Analytical Thinking
Learning Goal: 02-09 Understand how interest rates are used to determine present and future values.
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38) An investor wants to be able to buy 4 percent more goods and services in the future in order to induce her to invest today. During the investment period prices are expected to rise by 2 percent. Which statement(s) below is/are true?

I. 4 percent is the desired real risk-free interest rate.
II. 6 percent is the approximate nominal rate of interest required.
III. 2 percent is the expected inflation rate over the period.

A) I only
B) II only
C) III only
D) I and II only
E) I, II, and III are true.

Answer: E
Difficulty: 2 Medium
Topic: Determinants of Interest Rates for Individual Securities
Bloom's: Analyze; Apply
AACSB: Reflective Thinking; Analytical Thinking
Learning Goal: 02-06 Know what specific factors determine interest rates.
Accessibility: Keyboard Navigation

39) Classify each of the following in terms of their effect on interest rates (increase or decrease):

I. Perceived risk of financial securities increases.
II. Near term spending needs decrease.
III. Future profitability of real investments increases.

A) I increases: II increases: III increases
B) I increases: II decreases: III decreases
C) I decreases: II increases: III increases
D) I decreases; II decreases; III decreases
E) None of these choices are correct.

Answer: E
Difficulty: 3 Hard
Topic: Loanable Funds Theory
Bloom's: Understand; Analyze
AACSB: Reflective Thinking; Analytical Thinking
Learning Goal: 02-03 Understand how equilibrium interest rates are determined.; 02-04 Examine factors that cause the supply and demand curves for loanable funds to shift.; 02-02 Know who the main demanders of loanable funds are.
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40) Classify each of the following in terms of their effect on interest rates (increase or decrease):

I. Covenants on borrowing become more restrictive.
II. The Federal Reserve increases the money supply.
III. Total household wealth increases.

A) I increases; II increases; III increases
B) I increases; II decreases; III decreases
C) I decreases; II increases; III increases
D) I decreases; II decreases; III decreases
E) None of these choices are correct.

Answer: D
Difficulty: 3 Hard
Topic: Loanable Funds Theory
Bloom's: Understand; Analyze
AACSB: Reflective Thinking; Analytical Thinking
Learning Goal: 02-01 Know who the main suppliers of loanable funds are.; 02-03 Understand how equilibrium interest rates are determined.; 02-04 Examine factors that cause the supply and demand curves for loanable funds to shift.; 02-02 Know who the main demanders of loanable funds are.
Accessibility: Keyboard Navigation

41) Inflation causes the demand curve for loanable funds to shift to the _____ and causes the supply curve to shift to the _____.
A) right; right
B) right; left
C) left; left
D) left; right

Answer: B
Difficulty: 3 Hard
Topic: Loanable Funds Theory
Bloom's: Understand; Analyze
AACSB: Reflective Thinking; Analytical Thinking
Learning Goal: 02-01 Know who the main suppliers of loanable funds are.; 02-03 Understand how equilibrium interest rates are determined.; 02-04 Examine factors that cause the supply and demand curves for loanable funds to shift.; 02-02 Know who the main demanders of loanable funds are.
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42) An individual actually earned a 4 percent nominal return last year. Prices went up by 3 percent over the year. Given that the investment income was subject to a federal tax rate of 28 percent and a state and local tax rate of 6 percent, what was the investor's actual real after-tax rate of return?
A) −0.36 percent
B) 0.66 percent
C) 0.72 percent
D) 1.45 percent
E) 2.64 percent

Answer: A
Explanation: $\{0.04 \times [1 - (0.28 + 0.06)]\} - 0.03$
Difficulty: 3 Hard
Topic: Determinants of Interest Rates for Individual Securities
Bloom's: Analyze; Apply
AACSB: Analytical Thinking
Learning Goal: 02-06 Know what specific factors determine interest rates.
Accessibility: Keyboard Navigation

43) A 15-payment annual annuity has its first payment in nine years. If the payment amount is $1,400 and the interest rate is 7 percent, what is the most you should be willing to pay today for this investment?
A) $5,825.11
B) $12,751.08
C) $6,416.67
D) $7,421.24
E) $6,935.74

Answer: D
Explanation: $PV0 = \$1,400 \times \{[1 - 1.07^{-15}]/0.07\}/1.07^{8}$
Difficulty: 3 Hard
Topic: Time Value of Money and Interest Rates
Bloom's: Analyze; Apply
AACSB: Analytical Thinking
Learning Goal: 02-09 Understand how interest rates are used to determine present and future values.
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44) Which of the following would normally be expected to result in an increase in the supply of funds, all else equal?

I. The perceived riskiness of all investments decreases.
II. Expected inflation increases.
III. Current income and wealth levels increase.
IV. Near term spending needs of households increase as energy costs rise.

A) I and III only
B) II and III only
C) II, III, and IV only
D) I and IV only
E) I, II, III, and IV

Answer: A
Difficulty: 2 Medium
Topic: Loanable Funds Theory
Bloom's: Understand; Analyze
AACSB: Reflective Thinking; Analytical Thinking
Learning Goal: 02-01 Know who the main suppliers of loanable funds are.; 02-03 Understand how equilibrium interest rates are determined.; 02-04 Examine factors that cause the supply and demand curves for loanable funds to shift.
Accessibility: Keyboard Navigation

45) An investor requires a 3 percent increase in purchasing power in order to induce her to lend. She expects inflation to be 2 percent next year. The nominal rate she must charge is about
A) 3 percent.
B) 2 percent.
C) 1 percent.
D) 5 percent.
E) 7 percent.

Answer: D
Difficulty: 1 Easy
Topic: Determinants of Interest Rates for Individual Securities
Bloom's: Analyze; Apply
AACSB: Analytical Thinking
Learning Goal: 02-06 Know what specific factors determine interest rates.
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46) The term structure of interest rates is upward sloping for all bond types. A certain AAA-rated non-callable 10-year corporate bond has been issued at a 6.15 percent promised yield. Which one of the following bonds probably has a higher promised yield?
A) A similar quality municipal bond
B) A non-callable AAA-rated corporate bond with a five-year maturity
C) A callable AAA-rated corporate bond with a 15-year maturity
D) A non-callable AAA-rated convertible corporate bond with a 10-year maturity
E) All of these choices are correct.

Answer: C
Difficulty: 3 Hard
Topic: Term Structure of Interest Rates
Bloom's: Understand
AACSB: Reflective Thinking
Learning Goal: 02-07 Examine the different theories explaining the term structure of interest rates.
Accessibility: Keyboard Navigation

47) Which of the following bond types pays interest that is exempt from federal taxation?
A) Municipal bonds
B) Corporate bonds
C) Treasury bonds
D) Convertible bonds
E) Municipal bonds and Treasury bonds

Answer: A
Difficulty: 2 Medium
Topic: Determinants of Interest Rates for Individual Securities
Bloom's: Remember
AACSB: Reflective Thinking
Learning Goal: 02-06 Know what specific factors determine interest rates.
Accessibility: Keyboard Navigation

48) The relationship between maturity and yield to maturity is called the _____.
A) loan covenant
B) term structure
C) bond indenture
D) Fisher effect
E) DRP structure

Answer: B
Difficulty: 1 Easy
Topic: Determinants of Interest Rates for Individual Securities
Bloom's: Remember
AACSB: Reflective Thinking
Learning Goal: 02-06 Know what specific factors determine interest rates.
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49) According to the unbiased expectations theory,
A) markets are segmented and buyers stay in their own segment.
B) liquidity premiums are negative and time varying.
C) the term structure will most often be upward sloping.
D) the long-term spot rate is an average of the current and expected future short-term interest rates.
E) forward rates are less than the expected future spot rates.

Answer: D
Difficulty: 1 Easy
Topic: Term Structure of Interest Rates
Bloom's: Remember
AACSB: Reflective Thinking
Learning Goal: 02-07 Examine the different theories explaining the term structure of interest rates.
Accessibility: Keyboard Navigation

50) Suppose that the current one-year Treasury-bill rate is 3.15 percent and the expected one-year rate 12 months from now is 4.25 percent. According to the unbiased expectations theory, what should be the current rate for a two-year Treasury security?
A) 3.70 percent
B) 4.15 percent
C) 2.36 percent
D) 4.74 percent
E) 5.50 percent

Answer: A
Explanation: ${}_1R_2 = [(1 + .0315)(1 + .0425)]^{0.5} - 1 = 3.698\%$ which is 3.70% rounded.
Difficulty: 3 Hard
Topic: Term Structure of Interest Rates
Bloom's: Analyze; Apply
AACSB: Analytical Thinking
Learning Goal: 02-07 Examine the different theories explaining the term structure of interest rates.
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51) Suppose you borrow $15,000 and then repay the loan by making 12 monthly payments of $1,297.92 each. What rate will you be quoted on the loan?

Answer: The interest rate is the solution to the following:
$PV = PMT \times [(1 - (1 + r)^{-N})/r]$ or $\$15{,}000 = \$1{,}297.92 \times [(1 - (1 + r)^{-12})/r]$
r = 0.5836 % per month

You will be quoted the monthly rate times 12 or $0.5836\% \times 12 = 7.00\%$. The effective annual rate is then found as $1.005836^{12} - 1 = 7.23\%$.
Difficulty: 2 Medium
Topic: Time Value of Money and Interest Rates
Bloom's: Analyze; Apply
AACSB: Analytical Thinking
Learning Goal: 02-09 Understand how interest rates are used to determine present and future values.
Accessibility: Keyboard Navigation

52) What is the loanable funds theory of interest rates?

Answer: The level of interest rates in the economy is set by economic agents' willingness to make funds available to capital markets and borrowers' demand for funds in the capital markets at various interest rates. The interest rate where the supply of funds matches demand for funds is the equilibrium interest rate.
Difficulty: 1 Easy
Topic: Term Structure of Interest Rates
Bloom's: Understand
AACSB: Reflective Thinking
Learning Goal: 02-07 Examine the different theories explaining the term structure of interest rates.
Accessibility: Keyboard Navigation

53) What is the difference between the expected real interest rate and the real risk-free interest rate actually earned?

Answer: The expected real rate of interest is the nominal rate minus the expected inflation rate. The actual (or realized) real rate is the nominal rate of interest (absent default) minus the actual rate of inflation.
Difficulty: 1 Easy
Topic: Determinants of Interest Rates for Individual Securities
Bloom's: Understand
AACSB: Reflective Thinking
Learning Goal: 02-06 Know what specific factors determine interest rates.
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54) Can the actual real rate of interest be negative? When? Can the expected real rate be negative?

Answer: The actual real rate can be negative when actual inflation is greater than the nominal rate of interest. The expected real rate normally must be positive because investors build into the nominal rate a premium for expected inflation. However, recently in Japan, expected real rates have been negative on bank accounts and have still attracted funds. Investors in this case are willing to pay a (small) storage premium to banks for the convenience and safe keeping that bank accounts provide.
Difficulty: 2 Medium
Topic: Determinants of Interest Rates for Individual Securities
Bloom's: Analyze; Evaluate
AACSB: Reflective Thinking; Analytical Thinking
Learning Goal: 02-06 Know what specific factors determine interest rates.
Accessibility: Keyboard Navigation

55) In October 1987 stock prices fell 22 percent in one day and bond rates fell also. Use the loanable funds theory to explain what happened.

Answer: The worsening of perceived future economic conditions and a likely increase in risk premiums on equities caused a so-called "flight to quality." Reduced supply of funds in stock markets caused falling prices and, as the money moved into bonds, the increased supply of funds available for borrowing pushed bond rates down.
Difficulty: 1 Easy
Topic: Loanable Funds Theory
Bloom's: Analyze; Evaluate
AACSB: Reflective Thinking; Analytical Thinking
Learning Goal: 02-01 Know who the main suppliers of loanable funds are.; 02-03 Understand how equilibrium interest rates are determined.; 02-04 Examine factors that cause the supply and demand curves for loanable funds to shift.
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56) A foreign investor placing money in dollar-denominated assets desires a 4 percent real rate of return. Global inflation is running about 3 percent, and the dollar is expected to decline against her home currency by 1.5 percent over the investment period. What is her minimum required rate of return? Explain.

Answer: Approximately 4% + 3% + 1.5% = 8.5%
She would have to earn an additional 3 percent to cover the rising cost of goods and services and an additional 1.5 percent to cover the loss in value of her dollars, since the dollars she will get back will buy fewer units of her home currency. All this is needed in order to preserve a 4 percent increase in real purchasing power in her home country.
Difficulty: 2 Medium
Topic: Determinants of Interest Rates for Individual Securities
Bloom's: Analyze; Apply; Evaluate
AACSB: Reflective Thinking; Analytical Thinking
Learning Goal: 02-06 Know what specific factors determine interest rates.
Accessibility: Keyboard Navigation

57) Would you expect the demand curve for businesses to be steeper than the demand curve for funds by the federal government? Explain.

Answer: Because businesses have a profit motive and the federal government does not, we would expect business demand for funds to be more sensitive to the interest rate than the federal government demand. Hence, the demand for funds by businesses would exhibit a flatter curve (more elastic) than the demand by the government (less elastic).
Difficulty: 2 Medium
Topic: Loanable Funds Theory
Bloom's: Evaluate
AACSB: Reflective Thinking
Learning Goal: 02-02 Know who the main demanders of loanable funds are.
Accessibility: Keyboard Navigation

58) Who are the major suppliers and demanders of funds in the United States and what is their typical position?

Answer: Households; net suppliers
Business; net demander
Government; net demander
Foreign; net suppliers
Difficulty: 1 Easy
Topic: Loanable Funds Theory
Bloom's: Understand
AACSB: Reflective Thinking
Learning Goal: 02-01 Know who the main suppliers of loanable funds are.; 02-02 Know who the main demanders of loanable funds are.
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59) According to current projections, Social Security and other entitlement programs will soon be severely underfunded. If the government decides to cut social security benefits to future retirees and raise Social Security taxes on all workers, what will probably happen to the supply of funds available to the capital markets? What will be the effect on interest rates?

Answer: Cutting future benefits should encourage additional savings by the working public to fund their retirement. This should lead to an increase in the supply of funds available. Raising taxes, on the other hand, may curtail savings because of the reduction of income. This would reduce the supply of funds available. The net effect on interest rates is indeterminate.
Difficulty: 1 Easy
Topic: Loanable Funds Theory
Bloom's: Evaluate; Create
AACSB: Reflective Thinking
Learning Goal: 02-01 Know who the main suppliers of loanable funds are.; 02-03 Understand how equilibrium interest rates are determined.; 02-04 Examine factors that cause the supply and demand curves for loanable funds to shift.
Accessibility: Keyboard Navigation

60) The one-year spot rate is currently 4 percent; the one-year spot rate one year from now will be 3 percent; and the one-year spot rate two years from now will be 6 percent. Under the unbiased expectations theory, what must today's three-year spot rate be? Suppose the three-year spot rate is actually 3.75 percent, how could you take advantage of this? Explain.

Answer: Under the unbiased expectations theory, the three-year spot rate should equal the geometric average of the three one-year rates to prevent arbitrage $[(1.04 \times 1.03 \times 1.06)^{1/3} - 1] = 4.3259\%$. If the three-year spot is actually 3.75 percent, one should borrow any given amount, say $1,000, for the full three years at the three-year rate of 3.75 percent and simultaneously invest the money for one year at 4 percent, and then roll the investment over in one year and earn 3 percent in the second year and then finally roll the investment over one final time and earn 6 percent in year three. Your average annual investment return is 4.3259 percent and the annual borrowing rate is 3.75 percent. You net the difference without using any of your own money.
Difficulty: 2 Medium
Topic: Term Structure of Interest Rates
Bloom's: Analyze; Apply; Evaluate
AACSB: Reflective Thinking; Analytical Thinking
Learning Goal: 02-07 Examine the different theories explaining the term structure of interest rates.
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61) Explain the logic of the liquidity premium theory of the term structure.

Answer: Securities with different maturities are not perfect substitutes so the unbiased expectations theory does not strictly hold. In particular, there is a preference for shorter-term holdings. Thus, to induce investors to invest long-term, a premium interest rate over what could be earned by investing short-term and rolling the investment over must be offered.
Difficulty: 2 Medium
Topic: Term Structure of Interest Rates
Bloom's: Understand
AACSB: Reflective Thinking
Learning Goal: 02-07 Examine the different theories explaining the term structure of interest rates.
Accessibility: Keyboard Navigation

62) Explain the market segmentation theory of the term structure.

Answer: This argument is actually a more extreme version of the liquidity premium argument. Not only are different maturity securities not perfect substitutes, broadly speaking, they are not substitutes at all, and one cannot imply that supply and demand conditions in one maturity segment affect supply and demand conditions in another segment. Banks are usually hypothesized as short-term investors and pension funds and life insurers are cast in the role of long-term investors. Both are myopic in that they ignore yields outside of their normal sector. No explanation of why other less myopic investors do not enter the market to exploit un-arbitraged advantages among rate differentials is put forth. Presumably, in innovative capital markets, participants would not leave profit opportunities unexploited.
Difficulty: 2 Medium
Topic: Term Structure of Interest Rates
Bloom's: Understand
AACSB: Reflective Thinking
Learning Goal: 02-07 Examine the different theories explaining the term structure of interest rates.
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