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. in 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