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

1) If income tax rates rise, then
   A) the interest rate on Treasury bonds would fall.
   B) the interest rate on municipal bonds would rise.
   C) the interest rate on municipal bonds would fall.
   D) both A and B would occur.
   E) both B and C would occur.

2) 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

3) It cannot explain the empirical fact that interest rates on bonds of different maturities tend to move together.
   A) Liquidity premium theory
   B) Segmented markets theory
   C) Expectations theory
   D) Both A and B of the above
   E) Both A and C of the above

4) A reduction in the riskiness of corporate bonds will _____ the price of corporate bonds and ____ the price of Treasury bonds.
   A) reduce; not affect
   B) increase; increase
   C) reduce; increase
   D) reduce; reduce
   E) increase; reduce

5) Of the following long-term bonds, the one with the highest interest rate is
   A) corporate Caa bonds.
   B) municipal bonds.
   C) corporate Baa bonds.
   D) U.S. Treasury bonds.
6) An increase in default risk on corporate bonds _____ the demand for these bonds, but _____ the demand for default-free bonds.
   A) increases; lowers
   B) moderately lowers; does not change
   C) lowers; increases
   D) does not change; greatly increases

7) U.S. government bonds have no default risk because
   A) they are backed by the full faith and credit of the federal government.
   B) they are backed with gold reserves.
   C) the federal government can increase taxes or even just print money to pay its obligations.
   D) all of the above.
   E) of only A and B of the above.

8) When yield curves are downward sloping,
   A) short-term interest rates are above long-term interest rates.
   B) short-term interest rates are about the same as long-term interest rates.
   C) medium-term interest rates are above both short-term and long-term interest rates.
   D) long-term interest rates are above short-term interest rates.
   E) medium-term interest rates are below both short-term and long-term interest rates.

9) The inverted U-shaped yield curve in Figure 6–3 indicates that
   A) short-term interest rates are expected to remain unchanged in the near-term and fall later on.
   B) short-term interest rates are expected to fall sharply in the near-term and rise later on.
   C) short-term interest rates are expected to fall moderately in the near-term and rise later on.
   D) short-term interest rates are expected to rise in the near-term and fall later on.
10) 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 rise sharply.
   B) short-term interest rates to drop sharply.
   C) short-term interest rates to stay near their current levels.
   D) none of the above.

11) The risk premium on corporate bonds rises when
   A) a flurry of major corporate bankruptcies occurs.
   B) the Treasury bond market becomes less liquid.
   C) brokerage commissions fall in the corporate bond market.
   D) any of the above occurs.

12) 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) four years.  D) three years.

13) The steeply upward sloping yield curve in Figure 6-1 indicates that _____ interest rates are expected to _____ in the future.
   A) long-term; remain unchanged
   B) short-term; fall moderately
   C) long-term; fall moderately
   D) short-term; remain unchanged
   E) short-term; rise
14) 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) falls; falls  B) falls; rises  C) rises; rises  D) rises; falls

15) 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, then the 2-year bond rate will be
   A) 1 percent.  B) 2 percent.  C) 3 percent.  D) 4 percent.  E) 5 percent.
Answer Key
Testname: PRACTICE_CH6

1) C
2) E
3) B
4) E
5) A
6) C
7) B
8) A
9) D
10) C
11) A
12) A
13) E
14) D
15) D