you may igore question 8,9 and 10.

HE2002 Practice Questions
Ch14 and Ch16

1. Assume that the current one-year rate is 5% and the two-year rate is 7%. Given this information, the one-year rate expected one year from now is
A) 5%.
B) 6%.
C) 7%.
D) 9%.
E) 12%.

2. Suppose the current one-year interest rate is 4%, and financial markets expect the one-year interest rate next year to be 8%. Given this information, the yield to maturity on a two-year bond will be approximately
A) 4%.
B) 6%.
C) 8%.
D) 12%.
E) none of these

3. Suppose the current one-year interest rate is 4%. Also assume that financial markets expect the one-year interest rate next year to be 5%, and expect the one-year rate to be 6% the year after that. Given this information, the yield to maturity on a three-year bond will be approximately
A) 4%.
B) 5%.
C) 6%.
D) 15%.

4. Suppose the yield curve is initially horizontal. Suppose the current one-year interest rate increases by 4% while the expected future one-year interest rate does not change. Which of the following will tend to occur?
A) i_{2t} will increase by 4%
B) i_{2t} will increase by 2%
C) i_{2t} will increase by less than 2%
D) i_{2t} will decrease by 2%

5. A consol bond promises to pay $1000 each year, forever, starting next year. If the nominal interest rate is 5%, the present discounted value of this consol is
A) $900.00.
B) $995.00.
C) $2,500.00.
D) $20,000.00.
E) $25,000.00.

6. The length of time over which a bond promises to make payments to the holder is called which of the following?
A) the term structure of interest rates
B) the face value

C) the yield to maturity
D) the holding period
E) none of these

7. For this question, assume that one-year and two-year bonds have the same risk; therefore, you can ignore risk here. Assuming that there is arbitrage between one-year bonds and two-year bonds, we know that the expected rate of return on two-year bonds
A) will equal the expected rate of return from holding a one-year bond for one year.
B) will equal the expected rate of return from holding a one-year bond for two years.
C) will be larger than the expected rate of return from holding a one-year bond for one year.
D) will be smaller than the expected rate of return from holding a one-year bond for one year.
E) will be exactly half the rate of return on one-year bonds.

8. An upward-sloping yield curve suggests that financial market participants expect short-term interest rates will
A) rise in the future.
B) fall in the future.
C) be unstable in the future.
D) not change in the future.
E) be equal to zero in the future.

9. Suppose financial market participants expect short-term rates in the future to be less than current short-term interest rates. Given this information, we would expect
A) an upward sloping yield curve.
B) a downward sloping yield curve.
C) an upward shifting yield curve.
D) a downward shifting yield curve.
E) a horizontal yield curve.

10. Suppose that financial market participants expect that the central bank will pursue a monetary expansion in the future. Also assume that the yield curve is initially upward sloping. Given this information, we would expect which of the following to occur?
A) The yield curve will become steeper.
B) i_{2t} will increase.
C) i_{2t} will decrease.
D) The yield curve will become downward sloping.

11. Assume that the current one-year rate is 3% and the two-year rate is 5%. Given this information, the one-year rate expected one year from now is
A) 5%.
B) 6%.
C) 7%.
D) 9%.
E) 12%.

12. Suppose the current one-year interest rate is 3%, and financial markets expect the one-year interest rate next year to be 5%. Given this information, the yield to maturity on a two-year bond will be approximately
A) 4%.
B) 6%.

C) 8%.
D) 12%.
E) none of these

13. The fundamental value of a share of stock is equal to which of the following?
A) the sum of expected dividends
B) the present value of expected dividends
C) the sum of coupon payments
D) the present value of coupon payments
E) the present value of the expected yield

14. A share of stock will pay a dividend of $25 in one year, and will be sold for an expected price of $500 at that time. If the current one-year interest rate is 5%, the current price of the stock will be approximately equal to
A) $100.
B) $475.
C) $500.
D) $525.
E) none of these

15. Suppose the central bank implements a monetary contraction that is fully expected by financial market participants. Given this information, we would expect
A) stock prices to rise.
B) stock prices to fall.
C) stock prices to remain unchanged.
D) an ambiguous effect on stock prices.
E) stock prices to fall and the interest rate to rise.

16. Suppose the central bank implements a monetary expansion that is *not* fully anticipated by financial markets. Given this information, we would expect
A) stock prices to rise.
B) stock prices to fall.
C) stock prices to remain unchanged.
D) an ambiguous effect on stock prices.
E) none of these

17. Suppose policy makers implement a fiscal expansion that is *not* fully anticipated by financial market participants. We know that this will
A) always cause stock prices to fall.
B) always cause stock prices to rise.
C) tend to cause stock prices to rise if the LM curve is very flat.
D) tend to cause stock prices to rise if the LM curve is vertical.

18. Suppose policy makers implement an unexpected fiscal expansion. Further assume that monetary policy is expected to keep interest rates constant in response to this unexpected fiscal expansion. Given this information, we would expect that
A) stock prices will rise.
B) stock prices will remain constant.
C) this policy will have an ambiguous effect on stock prices.
D) the effect on stock prices will depend on the slope of the IS curve.

19. Which of the following represents a stock's fundamental value?
A) the price the stock would sell at in the midst of a rational bubble
B) the price the stock would sell at if the interest rate were zero
C) the present value of its expected future dividend payments
D) the simple sum of its future dividend payments
E) none of these

20. An expected reduction in the money supply will tend to cause
A) an increase in stock prices.
B) a reduction in stock prices.
C) no change in stock prices.
D) an ambiguous effect on stock prices.

21. An expected increase in the money supply will tend to cause
A) an increase in stock prices.
B) a reduction in stock prices.
C) no change in stock prices.
D) an ambiguous effect on stock prices.

22. An expected tax cut will tend to cause
A) an increase in stock prices.
B) a reduction in stock prices.
C) no change in stock prices.
D) an ambiguous effect on stock prices.

23. An unexpected reduction in the money supply will tend to cause
A) an increase in stock prices.
B) a reduction in stock prices.
C) no change in stock prices.
D) an ambiguous effect on stock prices.

24. An unexpected increase in the money supply will tend to cause
A) an increase in stock prices.
B) a reduction in stock prices.
C) no change in stock prices.
D) an ambiguous effect on stock prices.

25. Suppose households unexpectedly increase consumption. Which of the following will occur as a result of this unexpected increase in consumption?
A) an increase in stock prices
B) a reduction in stock prices
C) no change in stock prices
D) an ambiguous effect on stock prices

26. A share of stock will pay a dividend of $20 in one year, and will be sold for an expected price of $500 at that time. If the current one-year interest rate is 5%, the current price of the stock will be approximately equal to
A) $100.
B) $495.

C) $500.
D) $525.
E) none of these

27. Changes in future expected interest rates can affect current consumption. Suppose individuals expect future interest rates to decrease. Consumption will change as a result of this lower expected future interest rate because of its effects on which of the following?
A) human wealth
B) the value of stocks
C) the value of bonds
D) all of these
E) none of these

28. Which of the following will *not* cause aggregate private spending to increase?
A) an increase in expected future real interest rates
B) an increase in government spending
C) a reduction in future taxes
D) all of these
E) none of these

29. Which of the following will cause aggregate private spending to decrease?
A) a reduction in government spending
B) an increase in expected future interest rates
C) an increase in expected future taxes
D) all of these
E) none of these

30. The IS curve shifts to the left where there is
A) a reduction in current taxes.
B) an increase in expected future taxes.
C) an increase in expected future output.
D) all of these
E) none of these

31. Suppose individuals now believe that there will be a future tax cut. This reduction in expected future taxes will cause which of the following to occur in the current period?
A) the LM curve to shift down
B) the LM curve to shift up
C) the IS curve to shift rightward
D) the IS curve to shift leftward
E) none of these

32. Suppose individuals now believe that there will be an increase in the future expected interest rate. This increase in the expected future interest rate will cause which of the following to occur in the current period?
A) an upward shift of the LM curve
B) a leftward shift of the IS curve
C) the IS curve to become flatter
D) the LM curve to become steeper

E) none of these

33. Suppose there is a fiscal expansion in the current period. This fiscal expansion will tend to cause a smaller increase in current output when
A) an increase in current output causes an increase in expected future output.
B) an increase in the current interest rate causes expectations of expansionary monetary policy in the future.
C) an increase in the current interest rate causes an increase in expected future interest rates.
D) none of these
E) all of these

34. Which of the following will *not* cause aggregate private spending to decrease?
A) a reduction in expected future real interest rates
B) a reduction in government spending
C) an increase in future taxes
D) all of these
E) none of these

35. Which of the following will cause aggregate private spending to increase?
A) an increase in government spending
B) a reduction in expected future interest rates
C) a reduction in expected future taxes
D) all of these
E) none of these

36. The IS curve shifts to the right where there is
A) an increase in current taxes.
B) a reduction in expected future taxes.
C) a reduction in expected future output.
D) all of these
E) none of these

37. Suppose individuals now believe that there will be a future tax increase. This increase in expected future taxes will cause which of the following to occur in the current period?
A) the LM curve to shift down
B) the LM curve to shift up
C) the IS curve to shift rightward
D) the IS curve to shift leftward
E) none of these

38. Suppose there is a reduction in expected future output. This will cause which of the following to occur?
A) the IS curve to shift left in the current period
B) the IS curve to shift right in the current period
C) the LM curve to shift up in the current period
D) the LM curve to shift down in the current period

39. Suppose there is a reduction in the expected future interest rate. This will cause which of the following to occur?

A) the IS curve to shift left in the current period
B) the IS curve to shift right in the current period
C) the LM curve to shift up in the current period
D) the LM curve to shift down in the current period

40. Which of the following will cause the LM curve to shift up?
A) an increase in the expected future interest rate
B) an increase in current income
C) an increase in expected future taxes
D) all of these
E) none of these

41. A change in which of the following will have a direct effect on the amount of money individuals wish to hold in the current period?
A) the current nominal interest rate
B) the current real interest rate
C) the expected future nominal interest rate
D) the expected future real interest rate
E) all of these

42. A reduction in which of the following variables will cause an increase in the amount of money individuals wish to hold in the current period?
A) current income
B) the current nominal interest rate
C) the current real interest rate
D) expected future income
E) all of these

43. Suppose individuals expect that interest rates will increase in the future. Also assume that the Fed wants to prevent any change in current output. Given this goal of the Fed, the Fed should implement a policy in the current period that
A) shifts the IS curve rightward.
B) shifts the IS curve leftward.
C) shifts the IS curve leftward and the LM curve upward.
D) shifts the LM curve upward.
E) shifts the LM curve downward.

44. A change in which of the following variables will cause a shift of the IS curve in the current period?
A) the current interest rate
B) current output
C) current taxes
D) all of these
E) none of these

45. The IS curve becomes steeper when
A) government spending is relatively small.
B) the income tax rate in the current period is relatively small.
C) current changes in the real interest rate cause large changes in current real output.
D) changes in the current real interest rate cause small changes in current demand.

E) none of these

46. Suppose the central bank reduces the money supply. This monetary contraction will always cause a greater reduction in output when it is accompanied by
A) an increase in expected future taxes.
B) an increase in expected future interest rates.
C) a reduction in expected future output.
D) all of these
E) none of these

47. Suppose individuals expect that interest rates will decrease in the future. Also assume that the Fed wants to prevent any change in current output. Given this goal of the Fed, the Fed should implement a policy in the current period that
A) shifts the IS curve rightward.
B) shifts the IS curve leftward.
C) shifts the IS curve leftward and the LM curve upward.
D) shifts the LM curve upward.
E) shifts the LM curve downward.

48. Suppose the Fed reduces the money supply in the current period with no other policy change implemented or anticipated. This policy action will cause which of the following shifts in the IS and/or LM curves in the current period?
A) IS left; LM up
B) IS right; LM up
C) no shift in IS; LM up
D) IS left; LM down
E) IS right; LM down

49. Suppose policy makers pass a budget that reduces the budget deficit. A deficit reduction package such as this has a greater chance of increasing current output when
A) the policy is front-loaded.
B) financial markets believe that taxes will not increase in the future.
C) financial markets believe the Fed will lower interest rates in the future.
D) all of these
E) none of these

50. Suppose there is an increase in expected future output. This will cause which of the following to occur?
A) the IS curve to shift left in the current period
B) the IS curve to shift right in the current period
C) the LM curve to shift up in the current period
D) the LM curve to shift down in the current period

51. Suppose there is a simultaneous reduction in expected future output and reduction in the future expected interest rate. This will cause which of the following to occur?
A) the IS curve to shift left in the current period
B) the IS curve to shift right in the current period
C) the LM curve to shift up in the current period
D) the LM curve to shift down in the current period
E) an ambiguous effect on the position of the IS curve in the current period

52. Suppose there is an increase in the expected future interest rate. This will cause which of the following to occur?
A) the IS curve to shift left in the current period
B) the IS curve to shift right in the current period
C) the LM curve to shift up in the current period
D) the LM curve to shift down in the current period

53. Suppose there is a simultaneous reduction in the expected future interest rate and increase in future expected output. This will cause which of the following to occur?

A) the IS curve to shift left in the current period
B) the IS curve to shift right in the current period
C) the LM curve to shift up in the current period
D) the LM curve to shift down in the current period
E) an ambiguous effect on the position of the IS curve in the current period

54. Suppose there is an increase in expected future taxes. This will cause which of the following to occur?
A) the IS curve to shift left in the current period
B) the IS curve to shift right in the current period
C) the LM curve to shift up in the current period
D) the LM curve to shift down in the current period

55. Suppose there is a reduction in expected future taxes. This will cause which of the following to occur?
A) the IS curve to shift left in the current period
B) the IS curve to shift right in the current period
C) the LM curve to shift up in the current period
D) the LM curve to shift down in the current period

56. When answering this question, assume individuals consider only the short-run effects of changes in future variables when forming expectations of future output and future interest rates. Suppose policy makers announce a reduction in future government spending. Which of the following will occur as a result of this expected reduction in government spending?
A) a reduction in the expected future interest rate and no change in expected future output
B) a reduction in the expected future interest rate and an increase in expected future output
C) a reduction in the expected future interest rate and an ambiguous effect on expected future output
D) none of these

57. When answering this question, assume individuals consider only the medium-run effects of changes in future variables when forming expectations of future output and future interest rates. Suppose policy makers announce a reduction in future government spending. Which of the following will occur as a result of this expected reduction in government spending?
A) a reduction in the expected future interest rate and no change in expected future output
B) a reduction in the expected future interest rate and an increase in expected future output
C) a reduction in the expected future interest rate and a reduction in expected future output
D) a reduction in the expected future interest rate and an ambiguous effect on expected future output

58. Assume individuals consider only the long run effects of changes in future macro variables when forming expectations of future output and future interest rates. Suppose policy makers announce a reduction in future government spending, given this information, individuals will expect

A) a reduction in the expected future interest rate and no change in expected future output.

B) a reduction in the expected future interest rate and an increase in expected future output.

C) a reduction in the expected future interest rate and a reduction in expected future output.

D) a reduction in the expected future interest rate and an ambiguous effect on expected future output.

59. Suppose government announces increases in both current and future government spending, given this information, in which of the following cases will output in the current period be more likely to increase?

A) Individuals consider only the short run effects of changes in future macro variables when forming expectations of future output and future interest rates.

B) Individuals consider only the medium run effects of changes in future macro variables when forming expectations of future output and future interest rates.

C) Individuals consider only the long run effects of changes in future macro variables when forming expectations of future output and future interest rates.

D) Individuals consider both medium and long term effects

60. Suppose government announces increases in both current and future government spending, given this information, in which of the following cases will output in the current period be more likely to decrease?

A) Individuals consider only the short run effects of changes in future macro variables when forming expectations of future output and future interest rates.

B) Individuals consider only the medium run effects of changes in future macro variables when forming expectations of future output and future interest rates.

C) Individuals consider only the long run effects of changes in future macro variables when forming expectations of future output and future interest rates.

D) Individuals consider both medium and long term effects.