

Macroeconomics, 8e, Global Edition (Blanchard)
Chapter 14: Financial Markets and Expectations

14.1 Expected Present Discounted Values

- 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) Which of the following bonds (of equal maturity) would have the largest risk premium?
 - A) U.S. government bonds
 - B) German government bonds
 - C) the bonds of a financially stable corporation, like IBM
 - D) Bonds rated AAA by Moody's
 - E) junk bonds

5) Suppose there is a decrease in the short-term interest rate. Give this reduction in the current short-term interest rate, which of the following will most likely occur?

- A) The long-term interest rate will increase.
- B) The long-term interest rate will remain the same.
- C) The long-term interest rate will decrease by more than the short-term rate.
- D) The long-term interest rate will decrease by the same amount as the short-term rate.
- E) The long-term interest rate will decrease, but by less than the short-term rate.

6) Which of the following statements about indexed bonds is correct?

- A) They were relatively recently introduced in the United States.
- B) They exist in England.
- C) They have a nominal interest rate that rises when the inflation rate rises.
- D) all of these
- E) none of these

7) Which of the following best explains why the long-term interest rate will generally change by less than 1% when the short-term interest rate changes by 1%?

- A) The mathematical calculations are more difficult for analysts in the case of long-term bonds.
- B) Long-term rates are always lower than short-term rates, so there is less room for them to change.
- C) Financial market participants will not expect this increase in the short-term interest rate to persist fully in the future.
- D) Financial markets are often affected by bubbles and fads.
- E) none of these

8) 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%

- 9) 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.

14.2 Bond Prices and Bond Yields

1) 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

2) A "junk bond" is a bond with a

- A) low yield to maturity.
- B) value of zero.
- C) low face value, but high coupon rate.
- D) high default risk.
- E) very low maturity.

3) A bond has a face value of \$10,000, a price of \$12,000, and coupon payments of \$2000 for two years. The coupon rate of this bond is

- A) 10%.
- B) 16.7%.
- C) 20%.
- D) 30%.
- E) none of these

- 4) A discount bond is a bond
- A) with no coupon payments.
 - B) where the price of the bond is greater than its face value.
 - C) where the interest rate is zero.
 - D) where the face value is zero.
 - E) that never matures.
- 5) 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.
- 6) A bond has a face value of \$1,000, a price of \$1,200, and coupon payments of \$100 for two years. The "current yield" of this bond is
- A) 8.33%.
 - B) 10%.
 - C) 12%.
 - D) 83%.
 - E) none of these
- 7) 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.

8) 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.

9) Which of the following represents the ratio of coupon payments to the face value of a bond?

- A) the interest rate
- B) the discount rate
- C) the coupon rate
- D) the risk premium
- E) the current yield

10) Suppose a bond promises to make a single payment at maturity. These types of bond are called

- A) junk bonds.
- B) indexed bonds.
- C) corporate bonds.
- D) discount bonds.
- E) constant maturity bonds.

11) Assume that the one-year interest rate is on the vertical axis of the IS-LM model and that the yield curve is initially upward sloping. Suppose that financial market participants expect that the central bank will pursue a monetary contraction in the future. Given this information, we would expect which of the following to occur?

- A) The yield curve will become steeper.
- B) The yield curve will become flatter.
- C) The yield curve will become horizontal.
- D) The yield curve will become downward sloping.

12) 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.

13) Suppose that financial market participants now expect a future tax increase in one year. 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.

14) Suppose that financial market participants now expect a future tax cut and 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) The yield curve will become flatter.
- C) The yield curve will become horizontal.
- D) The yield curve will become downward sloping.

15) A bond has a face value of \$10,000, a price of \$12,000, and coupon payments of \$2000 for two years. The current yield of this bond is

- A) 10%.
- B) 16.7%.
- C) 20%.
- D) 30%.
- E) none of these

- 16) 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%.
- 17) 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
- 18) Which of the following represents the ratio of coupon payments to the price of a bond?
- A) the interest rate
 - B) the discount rate
 - C) the coupon rate
 - D) the risk premium
 - E) the current yield
- 19) The yield curve is
- A) the term structure of interest rates.
 - B) yield of a bond.
 - C) maturity.
 - D) all of these
- 20) Bonds with relatively high risk of default are called
- A) Brady bonds.
 - B) junk bonds.
 - C) zero coupon bonds.
 - D) investment grade bonds.

- 21) Junk bonds, bonds with a low bond rating, are also known as
- A) high-yield bonds.
 - B) investment grade bonds.
 - C) high quality bonds.
 - D) zero-coupon bonds.

14.3 The Stock Market and Movements in Stock Prices

- 1) Equity finance is represented by which of the following?
- A) when a firm borrows money from banks
 - B) when a firm sells bonds
 - C) when a firm sells shares of stock
 - D) when a firm draws down retained earnings
 - E) when a firm sells off part of its capital stock
- 2) Among the following, which is the broadest measure of stock prices in the United States?
- A) Dow Jones Index
 - B) FT index
 - C) Nikkei Index
 - D) Term Structure Index
 - E) Standard and Poor's 500 Composite Index
- 3) 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
- 4) 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
- 5) For this question, assume that there is perfect arbitrage in the stock market. Given this assumption, economists believe that
- A) movements in stock prices can be easily predicted.

- B) movements in stock prices are largely unpredictable.
- C) most stocks will diverge from their fundamental value.
- D) stocks will generally earn a lower rate of return than bonds.
- E) the rate of return on stocks will be equal to the rate of return on bonds.

6) 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.

7) 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

8) 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.

9) 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.

10) 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

11) Which of the following does *not* represent a form of debt finance?

- A) bonds
- B) loans
- C) stock
- D) all of these

12) Which of the following represents a form of equity finance?

- A) stock
- B) loans
- C) bonds
- D) all of these
- E) none of these

13) Which of the following variables would *not* influence the ex-dividend price of a share of stock at time t ?

- A) $i_1^e_{t+1}$
- B) $i_1^e_t$
- C) $\$D^e_{t+1}$
- D) none of these

14) 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.

15) 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.

16) 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.

17) An expected tax increase 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.

18) 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.

19) 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.

20) 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

21) Suppose households unexpectedly decrease consumption. Which of the following will occur as a result of this unexpected reduction 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

22) Suppose there are two types of bonds (one-year bonds and two-year bonds) and that the yield curve is initially upward sloping in period t . Note: For this question assume that: (1) expected inflation is zero; and (2) the relevant interest rate on the vertical axis of the IS-LM model is the one-year interest rate. Based on our understanding of the IS-LM model, of the yield curve and of financial markets, we know with certainty that an announcement in period t of a partially unexpected future *increase* in taxes (to be implemented in period $t + 1$) will have which of the following effects?

- A) stock prices will increase in period t
- B) stock prices will fall in period t
- C) the yield curve will become steeper in period t
- D) none of these

23) For this question, assume that the Fed is expected to respond to any event by keeping the interest rate constant (i.e., equal to its initial level). An unexpected tax increase will cause

- A) stock prices to fall.
- B) stock prices to rise.
- C) no change in stock prices.
- D) an ambiguous effect on stock prices.

24) For this question, assume that the Fed is expected to respond to any event by keeping the interest rate constant (i.e., equal to its initial level). An unexpected tax cut will cause

- A) stock prices to fall.
- B) stock prices to rise.
- C) no change in stock prices.
- D) an ambiguous effect on stock prices.

25) For this question, assume that the Fed is expected to respond to any event by keeping output constant (i.e., equal to its initial level). An unexpected increase in taxes will cause

- A) stock prices to fall.
- B) stock prices to rise.
- C) no change in stock prices.
- D) an ambiguous effect on stock prices.

26) For this question, assume that the Fed is expected to respond to any event by keeping output constant (i.e., equal to its initial level). An unexpected increase in government spending will cause

- A) stock prices to fall.
- B) stock prices to rise.
- C) no change in stock prices.
- D) an ambiguous effect on stock prices.

27) As the LM curve becomes steeper, an unexpected increase in consumer confidence

- A) will cause a relatively large increase in output and relatively large increase in the interest rate.
- B) will cause a relatively small increase in output and relatively small increase in the interest rate.
- C) is more likely to cause stock prices to rise.
- D) is more likely to cause stock prices to fall.

28) As the LM curve becomes steeper, an unexpected decrease in consumer confidence

- A) will cause a relatively large increase in output and relatively large increase in the interest rate.
- B) will cause a relatively small increase in output and relatively small increase in the interest rate.
- C) is more likely to cause stock prices to rise.
- D) is more likely to cause stock prices to fall.

29) 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

