EC 370 **Name:** _____
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Chapter 4 - Part III - Practice **UO ID:** _____

QUESTION 1

In which of the following situations would benefit you most as a borrower? In which of the following situations would benefit you most as a lender?

(1) The interest rate is 9 percent and the expected inflation rate is 7 percent.

(2) The interest rate is 4 percent and the expected inflation rate is 1 percent.

(3) The interest rate is 13 percent and the expected inflation rate is 15 percent.

(4) The interest rate is 25 percent and the expected inflation rate is 50 percent.

QUESTION 2

Suppose that you want to take out a loan and that your local bank wants to charge you an annual real interest rate equal to 3%. Assuming that the annualized expected rate of inflation over the life of the bond is 1%, determine the nominal interest rate that the bank will charge you. What happens if, over the life of the loan, actual inflation is 0.5%?

QUESTION 3

Mortgages are loans to households to purchase houses. If mortgage rates rise from 5% to 10%, but the expected rate of increase in housing prices rises from 2% to 9%. Are people more or less likely to buy houses? Why?

QUESTION 4

Consider four coupon bonds with the same face value of $100 and the same coupon rate of 10%. These bonds are held for one year. Assume interest rate **increase** from 10% to 12% in the next year. Complete the following table.

Bond No.	Initial Years to Maturity	Initial Current Yield	Price next year	Rate of Capital Gain	Rate of Return
#1	20	10%		-14.73%	
#2	10	10%			-0.66%
#3	5	10%			
#4	1	10%			

QUESTION 5

If the interest rates on all bonds rise from 5 to 6 percent over the course of the year, which bond would you prefer to have been holding?

(a) a bond with ten years to maturity;

(b) a bond with five years to maturity;

(c) a bond with twenty years to maturity;

(d) a bond with one year to maturity.

QUESTION 6

Indicate TRUE or FALSE for the following statement.

(1) The longer a bond's maturity, the greater is the rate of return that occurs as a result of the increase in the interest rate.

(2) Even though a bond has a substantial initial interest rate, its return can turn out to be negative if interest rates rise.

(3) Prices and returns for short-term bonds are more volatile than those for longer term bonds.

(4) A fall in interest rates results in capital losses for bonds whose terms to maturity are longer than the holding period.

(5) The rate of return on a bond will not necessarily equal the interest rate on that bond.

(6) The rate of return will be greater than the interest rate when the price of the bond falls during the holding period.

(7) The return can be expressed as the difference between the current yield and the rate of capital gains.

(8) With a zero-coupon bond, the return on the bond is equal to the rate of capital gain.