

Foundations of Finance, 8e (Keown/Martin/Petty)
Chapter 2 The Financial Markets and Interest Rates

Learning Objective 1

1) Common stock is considered a short-term security because it has no maturity date and a long-term security is one with a maturity date of more than one year.

Answer: FALSE

Diff: 1

Keywords: Long-term Capital

AACSB: Reflective thinking skills

2) Saving surplus units include individuals and governments, but not corporations.

Answer: FALSE

Diff: 1

Keywords: Capital Markets, Savings Surplus Units

AACSB: Reflective thinking skills

3) Individuals, corporations, and governments can be either savings deficit units or savings surplus units.

Answer: TRUE

Diff: 1

Keywords: Capital Markets, Savings Surplus Units, Savings Deficit

AACSB: Reflective thinking skills

4) A corporation needing cash sells securities to investors in the secondary market.

Answer: FALSE

Diff: 1

Keywords: Secondary Market

AACSB: Reflective thinking skills

5) Part of the U.S. Government's huge deficit is financed by foreign countries, such as China, which is a savings surplus unit.

Answer: TRUE

Diff: 1

Keywords: Capital Markets, Savings Surplus Units

AACSB: Dynamics of the global economy

6) Venture capitalists typically provide funds to high-risk start up companies but take no active role in their management.

Answer: FALSE

Diff: 1

Keywords: Venture Capitalist

AACSB: Reflective thinking skills

7) Seasoned secondary offerings occur in the secondary market.

Answer: FALSE

Diff: 1

Keywords: Seasoned Secondary Offering, Secondary Market

AACSB: Reflective thinking skills

8) Capital markets are all the financial institutions that help a business raise long-term capital.

Answer: TRUE

Diff: 1

Keywords: Capital Markets

AACSB: Reflective thinking skills

9) Transactions in the futures markets involve current payments for goods which will be delivered at some future agreed upon date.

Answer: FALSE

Diff: 1

Keywords: Futures Market

AACSB: Reflective thinking skills

10) Organized stock exchanges provide the benefits of a continuous market, fair security pricing, and helping businesses raise new capital.

Answer: TRUE

Diff: 1

Keywords: Organized Stock Exchanges

AACSB: Reflective thinking skills

11) On the basis of number of shares traded, more stocks are traded over the counter than on organized exchanges.

Answer: TRUE

Diff: 1

Keywords: Organized Stock Exchanges, Over-The-Counter Markets

AACSB: Reflective thinking skills

12) Stocks listed on the New York Stock Exchange must be traded exclusively on the NYSE in order to maintain the high standards set by the exchange.

Answer: FALSE

Diff: 1

Keywords: New York Stock Exchange

AACSB: Reflective thinking skills

13) One advantage of being listed on the NYSE is that all trades are made in an auction setting with face-to-face trading between individuals on the floor of the stock exchange.

Answer: FALSE

Diff: 1

Keywords: New York Stock Exchange, NYSE

AACSB: Reflective thinking skills

14) One advantage of organized stock exchanges is increased stock price volatility resulting from the efficient exchange of pricing information.

Answer: FALSE

Diff: 2

Keywords: Stock Exchange, Price Volatility

AACSB: Reflective thinking skills

15) Three ways that savings can be transferred through the financial markets to those in need of funds include direct transfers, indirect transfers using the investment banker, and indirect transfers using the financial intermediary.

Answer: TRUE

Diff: 1

Keywords: Capital Markets, Direct Transfer, Indirect Transfer

AACSB: Reflective thinking skills

16) Flotation costs are typically greater in the secondary market than in the primary market.

Answer: FALSE

Diff: 1

Keywords: Flotation Costs, Secondary Market, Primary Market

AACSB: Reflective thinking skills

17) Each purchase occurring in the secondary markets increases the total stock of financial assets that exist in the economy.

Answer: FALSE

Diff: 1

Keywords: Secondary Market

AACSB: Reflective thinking skills

18) The money market includes transactions in short-term financial instruments.

Answer: TRUE

Diff: 1

Keywords: Money Market

AACSB: Reflective thinking skills

19) Over-the-counter markets include all security markets, with the exception of organized exchanges.

Answer: TRUE

Diff: 1

Keywords: Over-the-counter Markets, Organized Exchanges

AACSB: Reflective thinking skills

20) For a firm to have its securities listed on an exchange, it must meet certain requirements. These usually include measures of profitability, size, market value, and public ownership.

Answer: TRUE

Diff: 1

Keywords: Stock Exchange, Listing Requirements

AACSB: Reflective thinking skills

21) The vast majority of corporate bond business takes place over the counter.

Answer: TRUE

Diff: 1

Keywords: Corporate Bonds, Over the Counter Markets

AACSB: Reflective thinking skills

22) Financial markets exist in order to allocate savings in the economy to the demanders of those savings.

Answer: TRUE

Diff: 1

Keywords: Financial Markets

AACSB: Reflective thinking skills

23) A seasoned equity offering is the sale of additional shares by a company whose shares are already publicly traded.

Answer: TRUE

Diff: 1

Keywords: Seasoned Equity Offering

AACSB: Reflective thinking skills

24) Primary market transactions cannot be undertaken in over the counter markets.

Answer: FALSE

Diff: 2

Keywords: Primary Market, Over the Counter Markets

AACSB: Reflective thinking skills

25) Financial intermediaries issue their own indirect securities and use the proceeds to purchase the direct securities of other economic units.

Answer: TRUE

Diff: 1

Keywords: Financial Intermediaries, Indirect Securities, Direct Securities

AACSB: Reflective thinking skills

26) Cash markets are often referred to as spot markets.

Answer: TRUE

Diff: 1

Keywords: Spot Markets, Cash Markets

AACSB: Reflective thinking skills

27) Which of the following statements is an example of a futures market transaction?

A) An investor purchases 100 shares of IBM hoping to sell it in two years for a profit

B) A company purchases an option to buy 1000 barrels of oil anytime between now and the end of the year.

C) A company agrees to purchase 1000 barrels of oil for delivery in six months at a price of \$70 per barrel.

D) An executive has a portion of his current year salary deferred until he retires.

Answer: C

Diff: 2

Keywords: Futures Market

AACSB: Analytic skills

28) General Electric (GE) has been a public company for many years with its common stock traded on the New York Stock Exchange. If GE decides to sell 500,000 shares of new common stock, the transaction will be describe as

A) an initial public offering.

B) a secondary market transaction because GE common stock has been trading for years.

C) a seasoned equity offering because GE has sold common stock before.

D) a money market transaction because GE raises new money to fund its business.

Answer: C

Diff: 2

Keywords: Seasoned Equity Offering

AACSB: Reflective thinking skills

29) Money market instruments include

- A) common stock.
- B) preferred stock.
- C) T-bonds.
- D) T-bills.

Answer: D

Diff: 1

Keywords: Money Market, T-bills

AACSB: Reflective thinking skills

30) ExxonMobil generates about \$50 billion in cash annually from its operations and invests about half of that on new exploration. Therefore, ExxonMobil is an example of a(n)

- A) savings surplus unit.
- B) savings deficit unit.
- C) investment banker.
- D) financial intermediary.

Answer: A

Diff: 1

Keywords: Capital Markets, Savings Surplus Units

AACSB: Reflective thinking skills

31) Three ways that savings can be transferred through the financial markets include all of the following EXCEPT

- A) direct transfer of funds.
- B) indirect transfer using the investment banker.
- C) indirect transfer using the venture capital firm.
- D) indirect transfer using the financial intermediary.

Answer: C

Diff: 1

Keywords: Capital Markets, Venture Capital Firm

AACSB: Reflective thinking skills

32) A wealthy private investor providing a direct transfer of funds is called

- A) a venture capitalist.
- B) an investment banker.
- C) a financial intermediary.
- D) an angel investor.

Answer: D

Diff: 1

Keywords: Capital Markets, Angel Investor

AACSB: Reflective thinking skills

33) Common examples of financial intermediaries include all of the following EXCEPT

- A) Venture Capital Firms.
- B) Life Insurance Companies.
- C) Pension Funds.
- D) Mutual Funds.

Answer: A

Diff: 1

Keywords: Capital Markets, Financial Intermediaries

AACSB: Reflective thinking skills

34) John calls his stockbroker and instructs him to purchase 100 shares of Microsoft Corporation common stock. This transaction occurs in the

- A) secondary market.
- B) primary market.
- C) credit market.
- D) futures market.

Answer: A

Diff: 1

Keywords: Secondary Market, Primary Market

AACSB: Reflective thinking skills

35) A life insurance company purchases \$1 billion of corporate bonds from premiums collected on its life insurance policies. Therefore

- A) the corporate bonds are indirect securities and the life insurance policies are direct securities.
- B) the corporate bonds are indirect securities and the life insurance policies are indirect securities.
- C) the corporate bonds are direct securities and the life insurance policies are indirect securities.
- D) the corporate bonds are direct securities and the life insurance policies are direct securities.

Answer: C

Diff: 2

Keywords: Direct Securities, Indirect Securities

AACSB: Analytic skills

36) General Motors raises money by selling a new issue of common stock. This transaction occurs in

- A) the secondary market.
- B) the capital market.
- C) the money market.
- D) the futures market.

Answer: B

Diff: 1

Keywords: Capital Markets

AACSB: Reflective thinking skills

37) Which of the following is an example of both a capital market and a primary market transaction?

- A) The U.S. Government sells 3-month Treasury Bills.
- B) Microsoft common stock owned by an individual investor is sold to another investor.
- C) Ford Motor Company sells a new issue of common stock to raise funds through a public offering.
- D) No transactions occur in both primary and capital markets at the same time.

Answer: C

Diff: 2

Keywords: Primary Market, Capital Market

AACSB: Analytic skills

38) All of the following securities are sold in money markets EXCEPT

- A) common stock.
- B) commercial paper.
- C) 3-month U.S. Treasury Bills.
- D) 6-month certificates of deposit.

Answer: A

Diff: 1

Keywords: Money Market, Commercial Paper, Treasury Bills

AACSB: Reflective thinking skills

39) Which of the following is an advantage of organized stock exchanges?

- A) increased stock price volatility
- B) screening companies to ensure only low risk stocks are sold
- C) providing a continuous market
- D) only profitable companies may issue new securities on an organized exchange

Answer: C

Diff: 1

Keywords: Organized Stock Exchanges, Continuous Market

AACSB: Reflective thinking skills

40) All of the following are benefits of organized stock exchanges EXCEPT

- A) increased stock price volatility.
- B) continuous markets.
- C) fair security prices.
- D) easier access to new capital for business expansion.

Answer: A

Diff: 1

Keywords: Stock Exchange, Price Volatility, Continuous Markets

AACSB: Reflective thinking skills

41) The stock market with the most stringent listing requirements is the

- A) New York Stock Exchange (NYSE).
- B) NASDAQ Stock Market.
- C) American Stock Exchange (AMEX).
- D) All organized exchanges have the same listing requirements in order to make trading fair for all investors.

Answer: A

Diff: 1

Keywords: Listing Requirements, NYSE, AMEX, NASDAQ

AACSB: Reflective thinking skills

42) Bill is a public accountant auditing Expo Corporation. Based on information in Expo's confidential records, Bill recommends the purchase of Expo stock to his brother.

- A) Bill is involved in insider trading prohibited by the SEC.
- B) Bill's brother has no direct connection to Expo Corporation and therefore his purchase of the stock is not prohibited by insider trading laws.
- C) Bill is not an insider because he is not an officer or employee of Expo Corporation
- D) If Bill told a non-relative who purchases Expo stock, no insider trading laws would be violated.

Answer: A

Diff: 2

Keywords: Insider Trading, SEC, Securities Regulation

AACSB: Analytic skills

43) Capital market instruments include

- A) negotiable certificates of deposit.
- B) corporate equities.
- C) commercial paper.
- D) Treasury bills.

Answer: B

Diff: 1

Keywords: Capital Markets

AACSB: Reflective thinking skills

44) An example of a primary market transaction is

- A) a new issue of common stock by AT&T.
- B) a sale of some outstanding common stock of AT&T by an investor.
- C) AT&T repurchasing its own stock from a stockholder.
- D) all of the above

Answer: A

Diff: 1

Keywords: Primary Market

AACSB: Reflective thinking skills

45) An example of a primary market transaction involving a money market security is

- A) a new issue of a security with a very short maturity.
- B) a new issue of a security with a very long maturity.
- C) the transfer of a previously-issued security with a very short maturity.
- D) the transfer of a previously-issued security with a very long maturity.

Answer: A

Diff: 2

Keywords: Primary Market, Money Market

AACSB: Reflective thinking skills

46) An example of a secondary market transaction involving a capital market security is

- A) a new issue of a security with a very short maturity.
- B) a new issue of a security with a very long maturity.
- C) the transfer of a previously-issued security with a very short maturity.
- D) the transfer of a previously-issued security with a very long maturity.

Answer: D

Diff: 2

Keywords: Secondary Market, Capital Market

AACSB: Reflective thinking skills

47) Financial intermediaries

- A) offer indirect securities.
- B) include the national and regional stock exchange.
- C) usually are underwriting syndicates.
- D) constitute the various secondary markets.

Answer: A

Diff: 1

Keywords: Financial Intermediaries

AACSB: Reflective thinking skills

48) The telecommunications system that provides a national information linkup among brokers and dealers operating in the over-the-counter market is called

- A) NCIS.
- B) NSQA.
- C) NASDAQ.
- D) NASQ.

Answer: C

Diff: 1

Keywords: NASDAQ, Over-the-Counter Market

AACSB: Reflective thinking skills

49) Which of the following statements is false?

- A) Brokers purchase securities for their own account.
- B) Most corporate bond trading takes place over the counter.
- C) Broker-dealers stand ready to buy and sell specific securities at selected prices.
- D) none of the above

Answer: A

Diff: 2

Keywords: Brokers, Broker-Dealers, Securities

AACSB: Analytic skills

50) Insurance companies invest in the "long-end" of the securities market by purchasing securities with longer maturities. In which of the following instruments would an insurance company be least likely to invest most of its assets?

- A) corporate stocks
- B) corporate bonds
- C) mortgages
- D) commercial paper

Answer: D

Diff: 2

Keywords: Money Market, Commercial Paper

AACSB: Analytic skills

51) Which of the following refers to all institutions and procedures that provide for transactions in short-term debt instruments generally issued by borrowers with very high credit ratings?

- A) capital market
- B) commercial banks
- C) money market
- D) stock market

Answer: C

Diff: 2

Keywords: Money Market

AACSB: Reflective thinking skills

52) Which of the following is NOT a benefit provided by the existence of organized security exchanges?

- A) providing a continuous market
- B) establishing and publicizing fair security prices
- C) helping businesses raise new capital
- D) standardization of all debt agreements

Answer: D

Diff: 2

Keywords: Organized Security Exchange

AACSB: Reflective thinking skills

53) In August 2004, Google first sold its common stock to the public at \$85 per share and raised \$1.76 billion. This is an examples of

- A) a primary market transaction.
- B) a secondary market transaction.
- C) a venture capital firm transaction.
- D) a money market transaction.

Answer: A

Diff: 1

Keywords: Primary Market, Capital Market

AACSB: Reflective thinking skills

54) Money market transactions include which of the following?

- A) any security that is paid for with cash
- B) 30-year U.S. Treasury bonds
- C) all securities paid for with the proceeds of a money market account
- D) securities that have a maturity of less than one year

Answer: D

Diff: 2

Keywords: Money Market

AACSB: Reflective thinking skills

55) Capital market transactions include which of the following?

- A) any security that is purchased from a brokerage firm that is well capitalized
- B) common stock of a public corporation
- C) all securities that are purchased in the open market
- D) U.S. Treasury bills

Answer: B

Diff: 2

Keywords: Capital Markets

AACSB: Reflective thinking skills

56) Prices of securities that are traded on the organized exchanges are determined by

- A) a "bid" and "ask" negotiation process amongst brokers who hold these securities in their own account.
- B) the Securities Exchange Commission.
- C) a continuous auction process reflecting the sentiments of buyers and sellers.
- D) the sellers of the securities.

Answer: C

Diff: 2

Keywords: Security Pricing, Continuous Auction Process, Organized Security Exchange

AACSB: Reflective thinking skills

57) Prices of securities that are traded in the Over-the-Counter Markets are determined by

- A) the Federal Trade Commission.
- B) a continuous modified auction process.
- C) the buyers of these securities.
- D) a "bid" and "ask" negotiation process of broker-dealers of these securities.

Answer: D

Diff: 2

Keywords: Over-the-Counter Market, Security Pricing, Negotiation Process

AACSB: Reflective thinking skills

58) The Securities and Exchange Commission (SEC)

- A) regulates only initial public offerings, or IPOs.
- B) regulates only primary market transactions to ensure investors are provided with adequate and accurate information on new securities.
- C) regulates both primary and secondary markets.
- D) regulates initial public offerings, but not seasoned equity offerings, in the primary market.

Answer: C

Diff: 1

Keywords: SEC, Securities and Exchange Commission, Regulation

AACSB: Reflective thinking skills

59) The New York Stock Exchange (NYSE) is

A) an automated electronic trading platform.

B) an auction market with face-to-face trading on the floor of the stock exchange in addition to automated, electronic trading.

C) a hybrid market, allowing for face-to-face trading on the floor of the stock exchange in addition to automated, electronic trading.

D) primarily a futures market.

Answer: C

Diff: 1

Keywords: New York Stock Exchange, NYSE

AACSB: Reflective thinking skills

Learning Objective 2

1) The difference between the price the corporation gets and the public offering price is called the broker-dealer spread.

Answer: FALSE

Diff: 1

Keywords: Investment Banker, Broker-Dealer, Spread

AACSB: Reflective thinking skills

2) The need for extensive regulation of investment banking firms is limited due to the highly competitive nature of that industry.

Answer: FALSE

Diff: 1

Keywords: Investment Banking, Concentration

AACSB: Reflective thinking skills

3) The investment banker performs three basic functions: (1) underwriting, (2) distributing, and (3) advising.

Answer: TRUE

Diff: 1

Keywords: Investment Banker

AACSB: Reflective thinking skills

4) The negotiated purchase is the most prevalent method of securities distribution in the private sector.

Answer: TRUE

Diff: 1

Keywords: Negotiated Purchase, Investment Banking

AACSB: Reflective thinking skills

5) When the corporation sells securities directly to the investment public without involving an investment banker, it is called a privileged subscription.

Answer: FALSE

Diff: 1

Keywords: Privileged Subscription, Investment Banking

AACSB: Reflective thinking skills

6) An investment banker assumes underwriting risk in both negotiated purchases and privileged subscriptions with standby agreements.

Answer: FALSE

Diff: 2

Keywords: Negotiated Purchase, Standby Agreements, Investment Banking

AACSB: Reflective thinking skills

7) Investment banking firms are prohibited from selling securities due to conflicts of interest.

Answer: FALSE

Diff: 1

Keywords: Investment Banker

AACSB: Reflective thinking skills

8) Transactions in common stock occur in the money market, due to the large amount of money involved in such transactions.

Answer: FALSE

Diff: 2

Keywords: Money Market, Common Stock

AACSB: Reflective thinking skills

9) The syndicate can be thought of as a wholesaler of securities and the dealer organization as a retailer of securities.

Answer: TRUE

Diff: 1

Keywords: Syndicate, Dealer Organization, Securities

AACSB: Reflective thinking skills

10) A group of investment bankers organized to distribute large securities issues is known as a syndicate.

Answer: TRUE

Diff: 1

Keywords: Syndicate, Investment Bankers

AACSB: Reflective thinking skills

11) It is common practice among the largest corporations to sell their securities directly to investors.

Answer: FALSE

Diff: 1

Keywords: Securities, Direct Placement

AACSB: Reflective thinking skills

12) The investment banker prefers to avoid a negotiated purchase because it tends to be the least profitable arrangement for the investment banker.

Answer: FALSE

Diff: 2

Keywords: Negotiated Purchase, Investment Banking

AACSB: Reflective thinking skills

13) The competitive bid purchase is largely confined to railroad, public utility, and municipal bond issues.

Answer: TRUE

Diff: 2

Keywords: Competitive Bid Purchase

AACSB: Reflective thinking skills

14) The bid price is the price that a dealer will pay for a security; the asked price is the price at which she will sell a security.

Answer: TRUE

Diff: 1

Keywords: Bid Price, Asked Price, Securities

AACSB: Reflective thinking skills

15) Because they occur in private, stricter regulations are placed on the private placement of securities.

Answer: FALSE

Diff: 2

Keywords: Private Placements, Securities

AACSB: Reflective thinking skills

16) The investment banking business is dominated by a few very large, stand-alone investment banking firms.

Answer: FALSE

Diff: 1

Keywords: Investment Banking

AACSB: Reflective thinking skills

17) Only individual investors participate in public offerings, while institutional investors participate in private placements.

Answer: FALSE

Diff: 1

Keywords: Public Offering, Private Placement

AACSB: Reflective thinking skills

18) Registration of securities by the SEC indicates to investors that the risk of those securities is reasonable.

Answer: FALSE

Diff: 2

Keywords: SEC, Registration of Securities

AACSB: Reflective thinking skills

19) Preferred stock is traded in the money market, while common stock is traded in the capital market.

Answer: FALSE

Diff: 1

Keywords: Money Markets, Capital Markets

AACSB: Reflective thinking skills

20) In a private placement, the securities are offered and sold to a limited number of investors.

Answer: TRUE

Diff: 1

Keywords: Private Placements, Securities

AACSB: Reflective thinking skills

21) The process of shelf-registration is beneficial to the issuing firm because it will reduce the time needed for the firm to take an issue to market.

Answer: TRUE

Diff: 1

Keywords: Shelf Registration, Securities

AACSB: Analytic skills

22) The provisions of the Sarbanes-Oxley Act of 2002, or SOX, apply to all U.S.-based corporations, as well as to foreign corporations conducting business in U.S. markets.

Answer: FALSE

Diff: 1

Keywords: Sarbanes-Oxley, SOX

AACSB: Reflective thinking skills

23) When a company repurchases its own common stock, it is likely that

A) the stock price will increase because the company views the stock as undervalued.

B) the stock price will decrease because the company is creating artificial demand for its stock.

C) the stock price will remain the same as this is simply an internal transaction.

D) the board of directors will be fired for incompetence.

Answer: A

Diff: 2

Keywords: Common Stock, Share Repurchase

AACSB: Analytic skills

24) Investment firms, such as Goldman Sachs, assist the transfer of capital by

A) facilitating indirect transfers from savers (investing public) to borrowers (corporations needing capital).

B) selling indirect securities to savers and using the funds to buy common stock for corporations needing funds.

C) selling direct securities.

D) selling common stock for corporate clients in the secondary market.

Answer: A

Diff: 1

Keywords: Investment Banker, Capital Transfer

AACSB: Reflective thinking skills

25) A corporation sells securities to an investment banking firm on January 1st. The next day an international oil crisis causes stock prices to drop dramatically. The corporation is immune from the drop in price of its stock due to which function of the investment banking firm?

- A) hedging
- B) distributing
- C) reinsurance
- D) underwriting

Answer: D

Diff: 2

Keywords: Investment Banker, Underwriting

AACSB: Reflective thinking skills

26) If a corporation wants a guarantee that all of its shares of stock will be sold, it should use which of the following distribution methods?

- A) competitive bid purchase
- B) privileged subscription with no standby agreement
- C) commission or best-efforts contract
- D) direct sale

Answer: A

Diff: 2

Keywords: Investment Banking, Competitive Bid Purchase

AACSB: Analytic skills

27) Reynolds, Inc. needs to raise \$5 million by selling common stock. Reynolds sells 1 million shares of stock at \$5 each to Goldman Sachs, who then is responsible for selling the shares to investors. This is an example of a

- A) privileged subscription.
- B) standby agreement.
- C) negotiated purchase.
- D) commission or best-efforts agreement.

Answer: C

Diff: 2

Keywords: Negotiated Purchase, Investment Banking

AACSB: Analytic skills

28) Spandra Electronics wants to raise money by selling stock. After talking to several investment banking firms, Spandra decides to hire Goldman Sachs to sell 5 million shares of its common stock. Goldman sells 4.5 million shares and returns the rest to Spandra. This is an example of

- A) a privileged subscription with a standby agreement.
- B) a commission or best-efforts agreement.
- C) a privileged subscription with a standby agreement.
- D) a competitive bid purchase.

Answer: B

Diff: 2

Keywords: Commission or Best-Efforts Agreement, Investment Banking

AACSB: Analytic skills

- 29) Activities of the investment banker include
- A) assuming the risk of selling a security issue.
 - B) selling new securities to the ultimate investors.
 - C) providing advice to firms issuing securities.
 - D) all of the above

Answer: D

Diff: 1

Keywords: Investment Banker

AACSB: Reflective thinking skills

- 30) The investment banker does NOT underwrite the securities to be issued in which of the following?
- A) initial public offering
 - B) primary market transaction
 - C) firm commitment
 - D) best efforts

Answer: D

Diff: 1

Keywords: Investment Banker, Underwriting, Best Efforts

AACSB: Reflective thinking skills

- 31) Which of the following relationships is true regarding the costs of issuing the following securities?
- A) common stock > bonds > preferred stock
 - B) preferred stock > common stock > bonds
 - C) bonds > common stock > preferred stock
 - D) common stock > preferred stock > bonds

Answer: D

Diff: 1

Keywords: Cost of Capital, Securities, Common Stock, Preferred Stock, Bonds

AACSB: Analytic skills

- 32) Which of the following statements about investment banking in the United States is MOST correct?
- A) Investing banking is dominated by a few, very large, stand-alone investment banking firms, such as Bear Stearns.
 - B) The investment banking industry is dominated by large banks that are also investment bankers.
 - C) The top five banks involved in investment banking account for less than 25% of the industry's total market share.
 - D) The investment banking industry became more competitive following the financial crisis in 2007 and 2008.

Answer: B

Diff: 1

Keywords: Investment Banking

AACSB: Analytic skills

33) The investment banker performs what three basic functions?

- A) underwriting, distributing, and regulating
- B) underwriting, advising, and price-pegging
- C) underwriting, distributing, and advising
- D) underwriting, distributing, and negotiating

Answer: C

Diff: 2

Keywords: Investment Banker

AACSB: Reflective thinking skills

34) When an investment banking firm "underwrites" an issue of securities, the firm is performing which of the following?

- A) agreeing to market the securities to investors for a fee
- B) giving legal advice to the firm that is issuing the securities
- C) offering to purchase the securities from the firm, thereby assuming the risk of resale to investors
- D) agreeing to provide insurance that the firm's securities will sell for a price that is established by the firm

Answer: C

Diff: 2

Keywords: Investment Banker, Underwriting

AACSB: Reflective thinking skills

35) Investment banking firms offer to facilitate the sale of securities to the public in a variety of ways. Which of the following methods guarantees the corporation with a pre-determined price for the securities?

- A) a best efforts basis
- B) a commission basis
- C) a competitive bid
- D) an underwriting

Answer: D

Diff: 2

Keywords: Investment Banker, Underwriting

AACSB: Reflective thinking skills

36) A "Dutch auction" was used by Google to raise money in 2004. A Dutch auction involves

- A) selling bonds in Europe.
- B) allowing investors to submit bids saying how many shares they'd like to buy and at what price.
- C) allowing investment banking firms to submit bids on how many shares they are willing to sell and at what price.
- D) hiring a Dutch firm to sell a company's securities at auction.

Answer: B

Diff: 1

Keywords: Dutch Auction, Google

AACSB: Reflective thinking skills

37) Commercial banks that also provide investment banking services are called

- A) conglomerate banks.
- B) multi-purpose banks.
- C) investment enhanced banks.
- D) universal banks.

Answer: D

Diff: 1

Keywords: Universal Banks, Investment Banking

AACSB: Reflective thinking skills

38) Which of the following statements concerning private placements is MOST correct?

- A) Private placements do not involve investment bankers.
- B) Although not selling the securities to the public, investment bankers may provide advice on the evaluation of prospective buyers and the terms of sale for private placements.
- C) Private placements are limited to stocks, not bonds.
- D) More than half of all private placements are sold to federal, state, or local governments or government agencies.

Answer: B

Diff: 1

Keywords: Private Placement, Investment Banking

AACSB: Analytic skills

39) Which of the following is an advantage of using private placements for debt?

- A) reduced costs from the elimination of the registration statement for the SEC, investment-banking underwriting fees and distribution costs
- B) lower interest costs
- C) fewer and less burdensome restrictive covenants
- D) the possibility of future SEC registration

Answer: A

Diff: 2

Keywords: Private Placement

AACSB: Reflective thinking skills

40) Which of the following statements is MOST correct concerning flotation costs?

- A) Flotation costs are the same for common stock, preferred stock and bonds because they reflect mainly printing costs and legal fees.
- B) Flotation costs are generally higher for bonds rather than stocks because the dollar amounts involved are much higher, allowing for economies of scale.
- C) Flotation costs as a percentage of gross proceeds increase as the size of the security issue increases.
- D) Flotation costs are higher for common stocks than for preferred stocks and bonds due to the higher level of risk associated with owning common stock.

Answer: D

Diff: 2

Keywords: Flotation Costs

AACSB: Analytic skills

- 41) Private placements are
- A) limited to debt securities.
 - B) limited to equity securities.
 - C) available for both debt and equity securities, but the market is dominated by equity issues.
 - D) especially appealing to new, small, and medium-sized companies.

Answer: D

Diff: 1

Keywords: Private Placement

AACSB: Reflective thinking skills

- 42) All of the following are typically advantages of private placements EXCEPT

- A) speed.
- B) reduced flotation costs.
- C) financial flexibility.
- D) the possibility of future SEC registration.

Answer: D

Diff: 1

Keywords: Private Placement

AACSB: Reflective thinking skills

- 43) Advantages of private placements do NOT include which of the following?

- A) more financing flexibility
- B) lower flotation costs
- C) investor protection through extensive regulation
- D) funds which are available more quickly than through a public offering

Answer: C

Diff: 1

Keywords: Private Placement

AACSB: Reflective thinking skills

- 44) Private placements usually have several advantages associated with them, but also tend to suffer from specific disadvantages. Which of the following is a disadvantage of a private placement when compared to other methods of selling new securities?

- A) strictly standardized features/terms
- B) higher interest costs
- C) reduced flotation costs
- D) avoidance of registration with the SEC

Answer: B

Diff: 2

Keywords: Private Placement

AACSB: Reflective thinking skills

45) Which of the following would NOT normally be considered a "flotation cost"?

- A) underwriter's spread
- B) dividends
- C) legal fees
- D) printing and engraving expenses

Answer: B

Diff: 2

Keywords: Flotation Costs

AACSB: Reflective thinking skills

46) The costs associated with issuing securities to the public can be high. Some types of securities have greater expenses associated with them than others. Which of the following is the most costly security to issue?

- A) common stock
- B) corporate bonds
- C) preferred stock
- D) all of the above

Answer: A

Diff: 2

Keywords: Flotation Costs

AACSB: Analytic skills

47) The Sarbanes-Oxley Act of 2002, in order to protect investors, requires a higher level of accountability for which of the following groups?

- A) corporate officers
- B) public accountants
- C) boards of directors
- D) all of the above

Answer: D

Diff: 1

Keywords: Sarbanes-Oxley Act of 2002

AACSB: Reflective thinking skills

48) The Sarbanes-Oxley Act of 2002 holds all of the following groups strictly accountable in a legal sense for any instances of misconduct EXCEPT

- A) company officers.
- B) outside members of the board of directors.
- C) lawyers.
- D) investors.

Answer: D

Diff: 1

Keywords: Sarbanes-Oxley Act of 2002

AACSB: Reflective thinking skills

49) The Sarbanes-Oxley Act, or SOX

- A) holds corporate advisors strictly accountable in a legal sense for any instances of misconduct.
- B) pretexts the interests of shareholders by providing greater protection against accounting fraud and financial misconduct.
- C) reduces the cost of financial reporting by standardizing reporting requirements.
- D) accomplishes both A and B.

Answer: D

Diff: 2

Keywords: Sarbanes-Oxley, SOX

AACSB: Reflective thinking skills

50) A commitment fee is

- A) an amount paid on the unused portion of a loan in a private placement.
- B) an amount paid by an investment banker to ensure the sale of securities.
- C) paid by investors to guarantee that a company will borrow from them.
- D) paid by bondholders to secure the right to convert bonds into common stock.

Answer: A

Diff: 1

Keywords: Commitment Fee, Private Debt Placements

AACSB: Reflective thinking skills

Learning Objective 3

1) Over time, there has been a high correlation between actual rates of return on securities and the securities' standard deviations of returns.

Answer: TRUE

Diff: 1

Keywords: Risk/Return Tradeoff, Standard Deviation, Actual Return

AACSB: Reflective thinking skills

2) The rate of return available on the next best investment alternative for the saver refers to the opportunity cost of funds.

Answer: TRUE

Diff: 1

Keywords: Opportunity Cost of Funds

AACSB: Reflective thinking skills

3) Investors expect to receive the highest returns from government-issued securities because the government will not default on securities that it has issued.

Answer: FALSE

Diff: 2

Keywords: Risk-Return Tradeoff

AACSB: Reflective thinking skills

4) The nominal interest rate is 7% and the expected inflation rate is 2%. Based on the Fisher effect, the real rate of interest is

- A) 5.0%.
- B) 6.86%.
- C) 5.1%.
- D) 4.9%.

Answer: D

Diff: 2

Keywords: Fisher Effect, Real Rate of Interest, Nominal Interest Rate

AACSB: Reflective thinking skills

5) A basis point is equal to

- A) one percent.
- B) one-tenth of one percent.
- C) one-hundredth of one percent.
- D) one-half of one percent.

Answer: C

Diff: 1

Keywords: Basis Point

AACSB: Reflective thinking skills

6) The prime lending rate is the base rate on

- A) mortgage loans.
- B) home equity loans.
- C) auto loans.
- D) corporate loans.

Answer: D

Diff: 1

Keywords: Prime Rate

AACSB: Reflective thinking skills

7) The real rate of return is the return earned above the

- A) default risk premium.
- B) risk-adjusted return.
- C) inflation risk premium.
- D) variability of returns measured by standard deviation.

Answer: C

Diff: 2

Keywords: Real Rate of Return, Inflation Risk Premium

AACSB: Reflective thinking skills

8) The risk premium would be greater for an investment in an oil and gas exploration in unproven fields than an investment in preferred stock because

- A) oil and gas exploration investments have a greater variability in possible returns.
- B) the preferred stock is more liquid.
- C) the inflation rate would vary more with oil and gas exploration investments.
- D) both A and B

Answer: D

Diff: 3

Keywords: Variability of Returns, Liquidity Premium, Risk Premium

AACSB: Analytic skills

9) What was the average annual rate of return on 3-month U.S. Treasury bills during the period 1987 to 2011?

- A) 2.15%
- B) 4.23%
- C) 3.85%
- D) 5.68%

Answer: C

Diff: 2

Keywords: U.S. Treasury Bills, Rate of Return

AACSB: Reflective thinking skills

10) What was the average annual rate of return on long-term government bonds (30-Year Treasury Bonds) during the period 1987 to 2011?

- A) 4.14%
- B) 5.88%
- C) 6.14%
- D) 7.82%

Answer: C

Diff: 2

Keywords: Long-term Government Bonds, Rate of Return

AACSB: Reflective thinking skills

11) What was the average annual rate of return on long-term corporate bonds during the period 1926 to 2011?

- A) 8.3%
- B) 6.5%
- C) 6.2%
- D) 7.00%

Answer: D

Diff: 2

Keywords: Long-term Government Bonds, Rate of Return

AACSB: Reflective thinking skills

12) What was the average annual rate of return on common stocks of small firms during the period 1926 to 2011?

- A) 15.4%
- B) 18.6%
- C) 11.9%
- D) 9.5%

Answer: C

Diff: 2

Keywords: Small Firm Common Stocks, Rate of Return

AACSB: Reflective thinking skills

13) Over the period 1926 to 2011 the standard deviation of returns has been the greatest for which of the following?

- A) treasury bills
- B) corporate bonds
- C) common stocks
- D) common stocks of small firms

Answer: D

Diff: 1

Keywords: Small Firm Common Stocks, Standard Deviation

AACSB: Reflective thinking skills

14) Which of the following represents the correct ordering of returns over the period 1926 to 2011 (from lowest to highest return)?

- A) Treasury bills, long-term corporate bonds, common stocks, small firm common stocks
- B) small firm common stocks, common stocks, long-term corporate bonds, Treasury bills
- C) Treasury bills, common stocks, long-term corporate bonds, small firm common stocks
- D) long-term corporate bonds, Treasury bills, common stocks, small firm common stocks

Answer: A

Diff: 2

Keywords: Rate of Return, Risk/Return Tradeoff

AACSB: Analytic skills

15) Which of the following represents the correct ordering of standard deviation of returns over the period 1926 to 2011 (from highest to lowest standard deviation of returns)?

- A) Treasury bills, long-term corporate bonds, common stocks, small firm common stocks
- B) small firm common stocks, common stocks, long-term corporate bonds, Treasury bills
- C) Treasury bills, common stocks, long-term corporate bonds, small firm common stocks
- D) Treasury bills, common stocks, small firm common stocks, long-term corporate bonds

Answer: B

Diff: 2

Keywords: Standard Deviation, Risk/Return Tradeoff

AACSB: Analytic skills

16) During the period 1987 to 2011, the average yield on 3-Month U.S. Treasury bills was 3.85%, the average inflation rate was 2.92%, the average yield on 30-year Treasury bonds was 6.14%, and the average return on 30-year AAA-Rated Corporate Bonds was 7.00%. The real risk-free short-term interest rate is

- A) 0.90%.
- B) 2.13%.
- C) 2.97%.
- D) 4.76%.

Answer: A

Diff: 2

Keywords: Real Risk-Free Interest Rate, Inflation Risk Premium

AACSB: Analytic skills

17) Which of the following securities will likely have the highest liquidity premium?

- A) U.S. Treasury Bond maturing in 2027
- B) BBB-rated corporate bond maturing in 2020 actively traded on a major exchange
- C) AAA-rated corporate bond maturing in 2015 not actively traded
- D) U.S. Treasury Bill

Answer: C

Diff: 2

Keywords: Liquidity Premium

AACSB: Analytic skills

18) Which of the following securities will likely have the highest default risk premium?

- A) U.S. Treasury Bond maturing in 2027
- B) BBB-rated corporate bond maturing in 2020 actively traded on a major exchange
- C) AAA-rated corporate bond maturing in 2015 not actively traded
- D) U.S. Treasury Bill

Answer: B

Diff: 2

Keywords: Default Risk Premium

AACSB: Reflective thinking skills

19) Suppose the following rates are averages for banks in your area: interest checking accounts pay 1%, savings accounts pay 2%, and one-year certificates of deposit pay 3%. All accounts are federally insured by the FDIC. The difference in rates can be explained mainly by

- A) liquidity premiums.
- B) default risk premiums.
- C) maturity premiums.
- D) inflation risk premiums.

Answer: A

Diff: 2

Keywords: Liquidity Premium

AACSB: Reflective thinking skills

20) Examine the securities below and identify the security with the highest liquidity premium, the highest default risk premium, and the highest maturity premium.

- a. 30-Year U.S. Government Treasury Bond maturing in 2025
- b. 25-Year BBB-rated Corporate Bond maturing in 2030, actively traded on the New York Exchange
- c. 10-Year AAA-rated Corporate Bond maturing in 2020, thinly traded on a regional exchange
- d. 3-Month U.S. Treasury Bill

Answer: The 10-Year AAA-rated Corporate Bond has the highest liquidity premium because it is not actively traded and may be difficult to turn into cash on short notice. The BBB-rated Corporate Bond has the highest default risk premium. The U.S. Government securities are virtually default risk free, and the other corporate bond is AAA-rated. The 25-Year BBB-rated Corporate Bond maturing in 2030 has the highest maturity premium. Although the Treasury Bond had a longer maturity when issued, currently the 25-Year BBB bond has the longest time left to maturity.

Diff: 2

Keywords: Risk Premium, Liquidity Premium, Maturity Premium

AACSB: Reflective thinking skills

Learning Objective 4

1) The term structure of interest rates usually indicates that longer terms to maturity have higher expected returns.

Answer: TRUE

Diff: 2

Keywords: Term Structure of Interest Rates

AACSB: Reflective thinking skills

2) In response to the banking crisis and economic collapse of 2007 and 2008, the U.S. government moved to increase interest rates in order to attract foreign capital seeking high returns in U.S. banks.

Answer: FALSE

Diff: 2

Keywords: Interest Rates, Term Structure

AACSB: Reflective thinking skills

3) A *liquidity-risk* premium is the additional return required by investors in longer-term securities to compensate them for the greater risk of price fluctuation on those securities caused by interest rate changes.

Answer: FALSE

Diff: 2

Keywords: Nominal Rate of Interest, Inflation Premium, Real Rate of Interest

AACSB: Reflective thinking skills

4) A *real interest rate* is the interest rate on a fixed-income security that has no risk in an economic environment of high inflation.

Answer: FALSE

Diff: 2

Keywords: Nominal Rate of Interest, Inflation Premium, Real Rate of Interest

AACSB: Reflective thinking skills

5) A *liquidity-risk premium* is the additional return required by investors for securities that cannot quickly be converted into cash at a reasonably predictable price.

Answer: TRUE

Diff: 1

Keywords: Nominal Rate of Return, Liquidity Premium

AACSB: Reflective thinking skills

6) Which of the following securities will likely have the highest maturity risk premium?

A) U.S. Treasury Bond maturing in 2027

B) BBB-rated corporate bond maturing in 2020 actively traded on a major exchange

C) AAA-rated corporate bond maturing in 2015 not actively traded

D) U.S. Treasury Bill

Answer: A

Diff: 2

Keywords: Maturity Risk Premium

AACSB: Analytic skills

7) The one-year interest rate is 4%. The interest rate for a two-year security is 6%. According to the unbiased expectations theory, the one-year interest rate one year from now must be equal to

A) 5.00%.

B) 8.00%.

C) 8.04%.

D) 10.00%.

Answer: C

Diff: 2

Keywords: Term Structure of Interest Rates, Unbiased Expectations

AACSB: Reflective thinking skills

8) The one-year interest rate is 4%. The interest rate for a two-year security is 6%. The one-year interest rate one year from now is 8.34%. According to the liquidity preference theory, the risk premium for the second one-year investment is

A) 0.50%.

B) 0.34%.

C) 0.30%.

D) 1.66%.

Answer: C

Diff: 3

Keywords: Term Structure of Interest Rates, Liquidity Preference Theory

AACSB: Reflective thinking skills

9) You are considering an investment in a U.S. Treasury bond but you are not sure what rate of interest it should pay. Assume that the real risk-free rate of interest is 1.0%; inflation is expected to be 1.5%; the maturity risk premium is 2.5%; and, the default risk premium for AAA-rated corporate bonds is 3.5%. What rate of interest should the U.S. Treasury bond pay?

- A) 8.5%
- B) 6.0%
- C) 5.0%
- D) 2.5%

Answer: C

Diff: 2

Keywords: Nominal Interest Rate, Real Rate, Inflation Premium, Maturity Risk Premium, Default Risk Premium

AACSB: Analytic skills

10) You are considering an investment in a AAA-rated U.S. corporate bond but you are not sure what rate of interest it should pay. Assume that the real risk-free rate of interest is 1.0%; inflation is expected to be 1.5%; the maturity risk premium is 2.5%; and, the default risk premium for AAA-rated corporate bonds is 3.5%. What rate of interest should the U.S. corporate bond pay?

- A) 8.5%
- B) 6.0%
- C) 5.0%
- D) 2.5%

Answer: A

Diff: 2

Keywords: Nominal Interest Rate, Real Rate, Inflation Premium, Maturity Risk Premium, Default Risk Premium

AACSB: Analytic skills

11) What is the term for a graphical representation of the relationship between interest rates and the maturities of debt securities?

- A) term curve
- B) maturity chart
- C) yield curve
- D) inflationary expectations

Answer: C

Diff: 2

Keywords: Yield Curve, Interest Rates

AACSB: Reflective thinking skills

12) Which of the following is NOT a valid theory that attempts to explain the shape of the term structure of interest rates?

- A) the unbiased expectations theory
- B) the liquidity preference theory
- C) the market segmentation theory
- D) the Fisher Effect theory

Answer: D

Diff: 2

Keywords: Expectations Theory, Liquidity Preference Theory, Market Segmentation Theory, Term Structure of Interest Rates

AACSB: Reflective thinking skills

- 13) A "normal" yield curve is
 A) downward sloping.
 B) downward sloping, then upward sloping.
 C) upward sloping.
 D) upward sloping, then downward sloping.

Answer: C

Diff: 2

Keywords: Normal Yield Curve

AACSB: Reflective thinking skills

- 14) Given the anticipated rate of inflation (i) of 1.7% and the real rate of interest (R) of 1.4%, find the nominal rate of interest (r).

Answer: Answer:

$$r = R + i + Ri$$

$$r = .014 + .017 + (.014)(.017)$$

$$r = .031 + .000238 = .031238$$

$$r = 3.12\%$$

Diff: 2

Keywords: Real Rate of Interest, Inflation Premium, Nominal Rate of Interest

AACSB: Analytic skills

- 15) Given the rate information in the table below, estimate the nominal rate for a AA-rated corporate bond. Assume a liquidity premium of 8 basis points. Identify as part of your answer the inflation risk premium, the default risk premium, the maturity premium, and the liquidity premium.

3-month T-bills	2.0%
30-year Treasury Bonds	5.0%
AA-rated Corp. Bonds	8.0%
Inflation Rate	1.0%

Answer: $k^* = 2.0\% - 1.0\% = 1.0\%$

IRP = 1.0%

DRP = 8.0% - 5.0% = 3.0%

MP = 5.0% - 2.0% = 3.0%

LP = .08% (given)

$K = 1.0\% + 1.0\% + 3.0\% + 3.0\% + .08\% = 8.08\%$

Diff: 3

Keywords: Nominal Interest Rate, IRP, DRP, MP, LP

AACSB: Analytic skills

- 16) An investor buys a 20-year BBB-rated corporate bond with a nominal annual rate of return of 10%. The average inflation rate is expected to be 2%. The default risk premium is expected to be 5% and the maturity premium is 4%. Calculate the real rate of interest.

Answer: $k_{rf} = k^* + IRP + (k^* \times IRP)$

$10\% = k^* + 2\% + (k^* \times 2\%)$

$8\% = 1.02 k^*$

$7.84\% = k^*$

Diff: 2

Keywords: Fisher Effect, Real Rate of Interest

AACSB: Analytic skills

17) The current rate of return on a one-year U.S. Government security is 3%. The rate of return on a two-year U.S. Government security is 5%. According to the expectations theory, what is the return on a one-year U.S. Government security purchased one year from today?

Answer: $\$1,000 \times 1.03 = \$1,030$ at the end of year one

$\$1,000 \times (1.05)^2 = \$1,102.50$ at the end of two years

$\$1,102.50 - \$1,030 = \$72.50$ interest needed in year 2

$\$72.50/\$1,030 = 7.04\%$

Diff: 3

Keywords: Expectations Theory, Term Structure of Interest Rates

AACSB: Analytic skills

18) The date today is January 1, 2010. A one-year security maturing on 1/1/11 yields 3%. A two-year security maturing on 1/1/12 yields 6%. A three-year security maturing on 1/1/13 yields 11%. Calculate the expected annual return on a two-year security beginning 1/1/11 and maturing on 1/1/13.

Answer: $\$1,000 \times (1.11)^3 = \$1,367.63$ at the end of three years (1/1/13)

$\$1,000 \times (1.03) = \$1,030$ at the end of one year (1/1/11)

$\$1,367.63 - \$1,030 = \$337.63$ to be earned on two-year security from 1/1/11 to 1/1/13

$\$1,030 \times (1 + k)^2 = \$1,367.63$

$k = (\$1,367.63/\$1,030)^{.5} - 1 = 15.23\%$

Diff: 2

Keywords: Expectations Theory, Term Structure of Interest Rates

AACSB: Analytic skills

19) If provided the nominal rate of interest (r) of 7.4% and the anticipated rate of inflation (i) of 4.5%, what is the real rate of interest (R)?

Answer: $r = R + i + Ri$

$.074 = R + .045 + (.045)(R)$

$.074 - .045 = 1.045R$

$.029 = 1.045R$

$R = .02775 = 2.78\%$

78%

Diff: 2

Keywords: Nominal Rate of Interest, Inflation Premium, Real Rate of Interest

AACSB: Analytic skills

20) Given the anticipated rate of inflation (i) of 2.13% and the real rate of interest (R) of 3.1%, find the nominal rate of interest (r).

Answer: $r = R + i + Ri$

$r = .031 + .0213 + (.031)(.0213)$

$r = .0523 + .0006603$

$r = .05296 = 5.3\%$

Diff: 2

Keywords: Inflation Premium, Real Rate of Interest, Nominal Rate of Interest

AACSB: Analytic skills

21) Which of the following premiums is NOT factored into the price of a long-term Treasury bond?

- A) a real risk-free interest rate
- B) a maturity premium
- C) a default-risk premium
- D) an inflation-risk premium

Answer: C

Diff: 1

Keywords: Nominal Rate of Interest, Inflation Premium, Real Rate of Interest

AACSB: Reflective thinking skills

22) The _____ is the premium to compensate for the price change expected to occur over the life of the bond or investment instrument.

- A) inflation-risk premium
- B) maturity premium
- C) real risk-free interest rate premium
- D) default-risk premium

Answer: A

Diff: 1

Keywords: Nominal Rate of Interest, Inflation Premium, Real Rate of Interest

AACSB: Reflective thinking skills

23) The yield curve in 2009 was very low, with short-term rates close to zero and long-term rates below 5 percent. What factors contributed to such low interest rates?

Answer: Answer: In response to the banking and economic crises, the U.S. Government undertook policies to reduce interest rates in an attempt to stimulate economic activity. In addition, the recession caused a decrease in the demand for borrowed funds, and investors, scared off by large declines in the stock market, moved money into safer U.S. Treasury securities. Increasing Treasury prices mean lower yields.

Diff: 2

Keywords: Economic Crises, Yield Curve, Term Structure of Interest Rates

AACSB: Reflective thinking skills