Chapter 5  
The Behavior of Interest Rates

5.1 Determinants of Asset Demand

1) Of the four factors that influence asset demand, which factor will cause the demand for all assets to increase when it increases, everything else held constant?
   A) wealth
   B) expected returns
   C) risk
   D) liquidity

Answer: A  
_Ques Status: New_

2) If wealth increases, the demand for stocks ______ and that of long-term bonds ______, everything else held constant.
   A) increases; increases
   B) increases; decreases
   C) decreases; decreases
   D) decreases; increases

Answer: A  
_Ques Status: Previous Edition_

3) Everything else held constant, a decrease in wealth
   A) increases the demand for stocks.
   B) increases the demand for bonds.
   C) reduces the demand for housing.
   D) increases the demand for housing.

Answer: C  
_Ques Status: Revised_
4) Everything else held constant, if the expected return on ABC stock rises from 5 to 10 percent and the expected return on CBS stock is unchanged, then the expected return of holding CBS stock ______ relative to ABC stock and the demand for CBS stock ______.

   A) rises; rises
   B) rises; falls
   C) falls; rises
   D) falls; falls

   Answer: D

Ques Status: Revised

5) Everything else held constant, if the expected return on U.S. Treasury bonds falls from 10 to 5 percent and the expected return on GE stock rises from 7 to 8 percent, then the expected return of holding GE stock ______ relative to U.S. Treasury bonds and the demand for GE stock ______.

   A) rises; rises
   B) rises; falls
   C) falls; rises
   D) falls; falls

   Answer: A

Ques Status: Revised

6) If housing prices are suddenly expected to shoot up, then, other things equal, the demand for houses will ______ and that of Treasury bills will ______.

   A) increase; increase
   B) increase; decrease
   C) decrease; decrease
   D) decrease; increase

   Answer: B

Ques Status: Previous Edition

7) If stock prices are expected to drop dramatically, then, other things equal, the demand for stocks will ______ and that of Treasury bills will ______.

   A) increase; increase
   B) increase; decrease
   C) decrease; decrease
   D) decrease; increase

   Answer: D

Ques Status: Previous Edition
8) Everything else held constant, if the expected return on RST stock declines from 12 to 9 percent and the expected return on XYZ stock declines from 8 to 7 percent, then the expected return of holding RST stock ______ relative to XYZ stock and demand for XYZ stock ______.

A) rises; rises
B) rises; falls
C) falls; rises
D) falls; falls

Answer: C  
Ques Status: Revised

9) Everything else held constant, if the expected return on U.S. Treasury bonds falls from 8 to 7 percent and the expected return on corporate bonds falls from 10 to 8 percent, then the expected return of corporate bonds ______ relative to U.S. Treasury bonds and the demand for corporate bonds ______.

A) rises; rises
B) rises; falls
C) falls; rises
D) falls; falls

Answer: D  
Ques Status: Revised

10) An increase in the expected rate of inflation will ______ the expected return on bonds relative to the that on ______ assets, everything else held constant.

A) reduce; financial
B) reduce; real
C) raise; financial
D) raise; real

Answer: B  
Ques Status: Revised

11) If fluctuations in interest rates become smaller, then, other things equal, the demand for stocks ______ and the demand for long-term bonds ______.

A) increases; increases
B) increases; decreases
C) decreases; decreases
D) decreases; increases

Answer: D  
Ques Status: Previous Edition
12) If the price of gold becomes less volatile, then, other things equal, the demand for stocks will _______ and the demand for antiques will _______.
   A) increase; increase
   B) increase; decrease
   C) decrease; decrease
   D) decrease; increase

   Answer: C
   Ques Status: Previous Edition

13) If brokerage commissions on bond sales decrease, then, other things equal, the demand for bonds will _______ and the demand for real estate will _______.
   A) increase; increase
   B) increase; decrease
   C) decrease; decrease
   D) decrease; increase

   Answer: B
   Ques Status: New

14) If gold becomes acceptable as a medium of exchange, the demand for gold will _______ and the demand for bonds will _______, everything else held constant.
   A) decrease; decrease
   B) decrease; increase
   C) increase; increase
   D) increase; decrease

   Answer: D
   Ques Status: New

15) The demand for Jackson Pollack paintings rises (holding everything else equal) when:
   A) stocks become easier to sell.
   B) people expect a boom in real estate prices.
   C) Treasury securities become riskier.
   D) people suddenly expect gold prices to rise.

   Answer: C
   Ques Status: Previous Edition
16) The demand for silver bullion decreases, other things equal, when
   A) the gold market is suddenly expected to boom.
   B) the market for silver bullion becomes more liquid.
   C) wealth grows rapidly.
   D) interest rates are expected to fall.

   Answer: A
   Ques Status: Revised

17) You would be less willing to purchase U.S. Treasury bonds, other things equal, if
   A) you inherit $1 million from your Uncle Harry.
   B) you expect interest rates to fall.
   C) gold becomes more liquid.
   D) stocks become easier to sell.

   Answer: C
   Ques Status: Revised

18) You would be more willing to buy AT&T bonds (holding everything else constant) if
   A) the brokerage commissions on bond sales become cheaper.
   B) interest rates are expected to rise.
   C) you had suffered big losses in the stock market.
   D) you expected jewelry to appreciate sharply in value.

   Answer: A
   Ques Status: Revised

19) Holding everything else constant,
   A) if asset A's risk rises relative to that of alternative assets, the demand will increase for asset A.
   B) the more liquid is asset A, relative to alternative assets, the greater will be the demand for asset A.
   C) the lower the expected return to asset A relative to alternative assets, the greater will be the demand for asset A.
   D) if wealth increases, demand for asset A increases and demand for alternative assets decreases.

   Answer: B
   Ques Status: Revised
20) The demand for gold bullion increases, other things equal, when
   A) the market for silver bullion becomes more liquid.
   B) interest rates are expected to rise.
   C) interest rates are expected to fall.
   D) real estate prices are expected to increase.

Answer: B  
*Ques Status: Revised*

21) Everything else held constant, would an increase in volatility of stock prices have any impact on the demand for rare coins? Why or why not?

Answer: Yes, it would cause the demand for rare coins to increase. The increased volatility of stock prices means that there is relatively more risk in owning stock than there was previously and so the demand for an alternative asset, rare coins, would increase.  
*Ques Status: New*

### 5.2 Supply and Demand in the Bond Market

1) The demand curve for bonds has the usual downward slope, indicating that at _______ prices of the bond, everything else equal, the _______ is higher.
   A) higher; demand
   B) higher; quantity demanded
   C) lower; demand
   D) lower; quantity demanded

Answer: D  
*Ques Status: Previous Edition*

2) The supply curve for bonds has the usual upward slope, indicating that as the price _______, ceteris paribus, the _______ increases.
   A) falls; supply
   B) falls; quantity supplied
   C) rises; supply
   D) rises; quantity supplied

Answer: D  
*Ques Status: Previous Edition*
3) In the bond market, the market equilibrium shows the market-clearing _______ and market-clearing _______.
   A) price; deposit
   B) interest rate; deposit
   C) price; interest rate
   D) interest rate; premium

   Answer: C
   Ques Status: New

4) When the price of a bond is above the equilibrium price, there is an excess _______ bonds and price will _______.
   A) demand for; rise
   B) demand for; fall
   C) supply of; fall
   D) supply of; rise

   Answer: C
   Ques Status: Previous Edition

5) When the price of a bond is _______ the equilibrium price, there is an excess demand for bonds and price will _______.
   A) above; rise
   B) above; fall
   C) below; fall
   D) below; rise

   Answer: D
   Ques Status: Previous Edition

6) When the interest rate on a bond is above the equilibrium interest rate, in the bond market there is excess _______ and the interest rate will _______.
   A) demand; rise
   B) demand; fall
   C) supply; fall
   D) supply; rise

   Answer: B
   Ques Status: Previous Edition
7) When the interest rate on a bond is _______ the equilibrium interest rate, in the bond market there is excess _______ and the interest rate will _______.
   A) above; demand; rise
   B) above; demand; fall
   C) below; supply; fall
   D) above; supply; rise

Answer: B

8) A situation in which the quantity of bonds supplied exceeds the quantity of bonds demanded is called a condition of excess supply; because people want to sell _______ bonds than others want to buy, the price of bonds will _______.
   A) fewer; fall
   B) fewer; rise
   C) more; fall
   D) more; rise

Answer: C

9) If the price of bonds is set _______ the equilibrium price, the quantity of bonds demanded exceeds the quantity of bonds supplied, a condition called excess _______.
   A) above; demand
   B) above; supply
   C) below; demand
   D) below; supply

Answer: C

5.3 Changes in Equilibrium Interest Rates

1) A movement along the bond demand or supply curve occurs when _______ changes.
   A) bond price
   B) income
   C) wealth
   D) expected return

Answer: A
2) When the price of a bond decreases, all else equal, the bond demand curve _______.
   A) shifts right
   B) shifts left
   C) does not shift
   D) inverts
   Answer: C  
   Ques Status: New

3) Everything else held constant, when households save less, wealth and the demand for bonds _______ and the bond demand curve shifts _______.
   A) increase; right
   B) increase; left
   C) decrease; right
   D) decrease; left
   Answer: D  
   Ques Status: New

4) Holding the expected return on bonds constant, an increase in the expected return on common stocks would _______ the demand for bonds, shifting the demand curve to the _______.
   A) decrease; left
   B) decrease; right
   C) increase; left
   D) increase; right
   Answer: A  
   Ques Status: Previous Edition

5) Everything else held constant, if interest rates are expected to fall in the future, the demand for long-term bonds today _______ and the demand curve shifts to the _______.
   A) rises; right
   B) rises; left
   C) falls; right
   D) falls; left
   Answer: A  
   Ques Status: Revised
6) Everything else held constant, an increase in expected inflation, lowers the expected return on _______ compared to _______ assets.
   A) bonds; financial
   B) bonds; real
   C) physical; financial
   D) physical; real
   Answer: B
   Ques Status: New

7) The reduction of brokerage commissions for trading common stocks that occurred in 1975 caused the demand for bonds to _______ and the demand curve to shift to the _______.
   A) fall; right
   B) fall, left
   C) rise; right
   D) rise; left
   Answer: B
   Ques Status: Previous Edition

8) Everything else held constant, when stock prices become less volatile, the demand curve for bonds shifts to the _______ and the interest rate _______.
   A) right; rises
   B) right; falls
   C) left; falls
   D) left; rises
   Answer: D
   Ques Status: Previous Edition

9) Everything else held constant, when stock prices become _______ volatile, the demand curve for bonds shifts to the _______ and the interest rate _______.
   A) more; right; rises
   B) more; right; falls
   C) less; left; falls
   D) less; left; does not change
   Answer: B
   Ques Status: Revised
10) Everything else held constant, an increase in the riskiness of bonds relative to alternative assets causes the demand for bonds to _______ and the demand curve to shift to the _______.

A) rise; right  
B) rise; left  
C) fall; right  
D) fall; left  

Answer: D

Ques Status: Revised

11) Everything else held constant, when bonds become less widely traded, and as a consequence the market becomes less liquid, the demand curve for bonds shifts to the _______ and the interest rate _______.

A) right; rises  
B) right; falls  
C) left; falls  
D) left; rises  

Answer: D

Ques Status: Revised

12) Everything else held constant, an increase in the liquidity of bonds results in a _______ in demand for bonds and the demand curve shifts to the _______.

A) rise; right  
B) rise; left  
C) fall; right  
D) fall; left  

Answer: A

Ques Status: Revised

13) Factors that decrease the demand for bonds include

A) an increase in the volatility of stock prices.  
B) a decrease in the expected returns on stocks.  
C) a decrease in the inflation rate.  
D) a decrease in the riskiness of stocks.  

Answer: D

Ques Status: Previous Edition
14) During business cycle expansions when income and wealth are rising, the demand for bonds ________ and the demand curve shifts to the ________, everything else held constant.
   A) falls; right
   B) falls; left
   C) rises; right
   D) rises; left
   Answer: C
   Ques Status: Revised

15) Factors that can cause the supply curve for bonds to shift to the right include
   A) an expansion in overall economic activity.
   B) a decrease in expected inflation.
   C) a decrease in government deficits.
   D) a business cycle recession.
   Answer: A
   Ques Status: Revised

16) During a recession, the supply of bonds ________ and the supply curve shifts to the ________, everything else held constant.
   A) increases; left
   B) increases; right
   C) decreases; left
   D) decreases; right
   Answer: C
   Ques Status: Revised

17) An increase in the expected inflation rate causes the supply of bonds to ________ and the supply curve to shift to the ________, everything else held constant.
   A) increase; left
   B) increase; right
   C) decrease; left
   D) decrease; right
   Answer: B
   Ques Status: Revised
18) When the expected inflation rate increases, the real cost of borrowing _______ and bond supply _______, everything else held constant.
   A) increases; increases
   B) increases; decreases
   C) decreases; increases
   D) decreases; decreases

   Answer: C
   
19) Higher government deficits _______ the supply of bonds and shift the supply curve to the _______, everything else held constant.
   A) increase; left
   B) increase; right
   C) decrease; left
   D) decrease; right

   Answer: B

20) When the inflation rate is expected to increase, the _______ for bonds falls, while the _______ curve shifts to the right, everything else held constant.
   A) demand; demand
   B) demand; supply
   C) supply; demand
   D) supply; supply

   Answer: B

21) Everything else held constant, when the inflation rate is expected to rise, interest rates will _______; this result has been termed the _______.
   A) fall; Keynes effect
   B) fall; Fisher effect
   C) rise; Keynes effect
   D) rise; Fisher effect

   Answer: D
22) The economist Irving Fisher, after whom the Fisher effect is named, explained why interest rates _______ as the expected rate of inflation _______, everything else held constant.
   A) rise; increases
   B) rise; stabilizes
   C) fall; stabilizes
   D) fall; increases

   Answer: A
   Ques Status: Revised

23) Everything else held constant, during a business cycle expansion, the supply of bonds shifts to the _______ as businesses perceive more profitable investment opportunities, while the demand for bonds shifts to the _______ as a result of the increase in wealth generated by the economic expansion.
   A) right; left
   B) right; right
   C) left; left
   D) left; right

   Answer: B
   Ques Status: Revised

24) When the interest rate changes,
   A) the demand curve for bonds shifts to the right.
   B) the demand curve for bonds shifts to the left.
   C) the supply curve for bonds shifts to the right.
   D) it is because either the demand or the supply curve has shifted.

   Answer: D
   Ques Status: Previous Edition

25) When the interest rate falls, either the demand for bonds _______ or the supply of bonds _______.
   A) increased; increased
   B) increased; decreased
   C) decreased; decreased
   D) decreased; increased

   Answer: B
   Ques Status: Revised
26) A decrease in the brokerage commissions in the housing market from 6% to 5% of the sales price will shift the ________ curve for bonds to the ________, everything else held constant.
   A) demand; right
   B) demand; left
   C) supply; right
   D) supply; left

   Answer: B
   Ques Status: Revised

27) When rare coin prices become volatile, the ________ curve for bonds shifts to the ________, everything else held constant.
   A) demand; right
   B) demand; left
   C) supply; right
   D) supply; left

   Answer: A
   Ques Status: Revised

28) If people expect real estate prices to increase significantly, the ________ curve for bonds will shift to the ________, everything else held constant.
   A) demand; right
   B) demand; left
   C) supply; left
   D) supply; right

   Answer: B
   Ques Status: Revised

29) Everything else held constant, when prices in the art market become more uncertain,
   A) the demand curve for bonds shifts to the left and the interest rate rises.
   B) the demand curve for bonds shifts to the left and the interest rate falls.
   C) the demand curve for bonds shifts to the right and the interest rate falls.
   D) the supply curve for bonds shifts to the right and the interest rate falls.

   Answer: C
   Ques Status: Revised
30) When the government has a surplus, as occurred in the late 1990s, the _______ curve of bonds shifts to the _______, everything else held constant.
   A) supply; right
   B) supply; left
   C) demand; right
   D) demand; left
   Answer: B
   Ques Status: New

31) When the expected inflation rate increases, the demand for bonds _______, the supply of bonds _______, and the interest rate _______, everything else held constant.
   A) increases; increases; rises
   B) decreases; decreases; falls
   C) increases; decreases; falls
   D) decreases; increases; rises
   Answer: D
   Ques Status: Revised

32) When an economy grows out of a recession, normally the demand for bonds _______ and the supply of bonds ________, everything else held constant.
   A) increases; increases
   B) increases; decreases
   C) decreases; decreases
   D) decreases; increases
   Answer: A
   Ques Status: Revised

33) When the economy slips into a recession, normally the demand for bonds ________, the supply of bonds ________, and the interest rate ________, everything else held constant.
   A) increases; increases; rises
   B) decreases; decreases; falls
   C) increases; decreases; falls
   D) decreases; increases; rises
   Answer: B
   Ques Status: Revised
34) In the 1990s Japan had the lowest interest rates in the world due to a combination of
   A) inflation and recession.
   B) deflation and expansion.
   C) inflation and expansion.
   D) deflation and recession.

Answer: D
Ques Status: Revised

35) Deflation causes the demand for bonds to _______, the supply of bonds to _______, and bond prices to_______, everything else held constant.
   A) increase; increase; increase
   B) increase; decrease; increase
   C) decrease; increase; increase
   D) decrease; decrease; increase

Answer: B
Ques Status: Revised

36) In the figure above, a factor that could cause the supply of bonds to shift to the right is:
   A) a decrease in government budget deficits.
   B) a decrease in expected inflation.
   C) a recession.
   D) a business cycle expansion.

Answer: D
Ques Status: Previous Edition
37) In the figure above, a factor that could cause the demand for bonds to decrease (shift to the left) is:
   A) an increase in the expected return on bonds relative to other assets.
   B) a decrease in the expected return on bonds relative to other assets.
   C) an increase in wealth.
   D) a reduction in the riskiness of bonds relative to other assets.

   Answer: B

38) In the figure above, the price of bonds would fall from P₁ to P₂
   A) inflation is expected to increase in the future.
   B) interest rates are expected to fall in the future.
   C) the expected return on bonds relative to other assets is expected to increase in the future.
   D) the riskiness of bonds falls relative to other assets.

   Answer: A

39) In the figure above, a factor that could cause the supply of bonds to increase (shift to the right) is:
   A) a decrease in government budget deficits.
   B) a decrease in expected inflation.
   C) expectations of more profitable investment opportunities.
   D) a business cycle recession.

   Answer: C
40) In the figure above, a factor that could cause the demand for bonds to shift to the right is:

A) an increase in the riskiness of bonds relative to other assets.
B) an increase in the expected rate of inflation.
C) expectations of lower interest rates in the future.
D) a decrease in wealth.

Answer: C

41) In the figure above, the price of bonds would fall from \( P_2 \) to \( P_1 \) if

A) there is a business cycle recession.
B) there is a business cycle expansion.
C) inflation is expected to increase in the future.
D) inflation is expected to decrease in the future.

Answer: B

42) What is the impact on interest rates when the Federal Reserve decreases the money supply by selling bonds to the public?

Answer: Bond supply increases and the bond supply curve shifts to the right. The new equilibrium bond price is lower and thus interest rates will increase.

43) Use demand and supply analysis to explain why an expectation of Fed rate hikes would cause Treasury prices to fall.

Answer: The expected return on bonds would decrease relative to other assets resulting in a decrease in the demand for bonds. The leftward shift of the bond demand curve results in a new lower equilibrium price for bonds.

5.4 Supply and Demand in the Market for Money: The Liquidity Preference Framework

1) The bond supply and demand framework is easier to use when analyzing the effects of changes in ________, while the liquidity preference framework provides a simpler analysis of the effects from changes in income, the price level, and the supply of ________.

A) expected inflation; bonds
B) expected inflation; money
C) government budget deficits; bonds
D) government budget deficits; money

Answer: B
2) In his Liquidity Preference Framework, Keynes assumed that money has a zero rate of return; thus,

A) when interest rates rise, the expected return on money falls relative to the expected return on bonds, causing the demand for money to fall.

B) when interest rates rise, the expected return on money falls relative to the expected return on bonds, causing the demand for money to rise.

C) when interest rates fall, the expected return on money falls relative to the expected return on bonds, causing the demand for money to fall.

D) when interest rates fall, the expected return on money falls relative to the expected return on bonds, causing the demand for money to rise.

Answer: A

3) In Keynes's liquidity preference framework, individuals are assumed to hold their wealth in two forms:

A) real assets and financial assets.
B) stocks and bonds.
C) money and bonds.
D) money and gold.

Answer: C

4) Keynes assumed that money has ______ rate of return.

A) a positive
B) a negative
C) a zero
D) an increasing

Answer: C

5) In Keynes's liquidity preference framework, as the expected return on bonds increases (holding everything else unchanged), the expected return on money ______, causing the demand for ______ to fall.

A) falls; bonds
B) falls; money
C) rises; bonds
D) rises; money

Answer: B
6) In Keynes's liquidity preference framework,
   A) the demand for bonds must equal the supply of money.
   B) the demand for money must equal the supply of bonds.
   C) an excess demand of bonds implies an excess demand for money.
   D) an excess supply of bonds implies an excess demand for money.

   Answer: D  
   Ques Status: Previous Edition

7) The opportunity cost of holding money is
   A) the level of income.
   B) the price level.
   C) the interest rate.
   D) the discount rate.

   Answer: C  
   Ques Status: Revised

8) If there is excess demand for money, there is
   A) excess demand for bonds.
   B) equilibrium in the bond market.
   C) excess supply of bonds.
   D) too much money.

   Answer: C  
   Ques Status: Revised

9) An increase in the interest rate
   A) increases the demand for money.
   B) increases the quantity of money demanded.
   C) decreases the demand for money.
   D) decreases the quantity of money demanded.

   Answer: D  
   Ques Status: Revised
10) If there is an excess supply of money
   A) individuals sell bonds, causing the interest rate to rise.
   B) individuals sell bonds, causing the interest rate to fall.
   C) individuals buy bonds, causing interest rates to fall.
   D) individuals buy bonds, causing interest rates to rise.

   Answer: C

11) When the interest rate is above the equilibrium interest rate, there is an excess ______ money and the interest rate will ______.
    A) demand for; rise
    B) demand for; fall
    C) supply of; fall
    D) supply of; rise

   Answer: C

12) In the market for money, an interest rate below equilibrium results in an excess ______ money and the interest rate will ______.
    A) demand for; rise
    B) demand for; fall
    C) supply of; fall
    D) supply of; rise

   Answer: A

5.5 Changes in Equilibrium Interest Rates in the Liquidity Preference Framework

1) In the Keynesian liquidity preference framework, an increase in the interest rate causes the demand curve for money to ______, everything else held constant.
   A) shift right
   B) shift left
   C) stay where it is
   D) invert

   Answer: C
2) A lower level of income causes the demand for money to ______ and the interest rate to ______, everything else held constant.
   A) decrease; decrease
   B) decrease; increase
   C) increase; decrease
   D) increase; increase

   Answer: A
   Ques Status: Revised

3) When real income ______, the demand curve for money shifts to the ______ and the interest rate ______, everything else held constant.
   A) falls; right; rises
   B) rises; right; rises
   C) falls; left; rises
   D) rises; left; rises

   Answer: B
   Ques Status: Revised

4) A business cycle expansion increases income, causing money demand to ______ and interest rates to ______, everything else held constant.
   A) increase; increase
   B) increase; decrease
   C) decrease; decrease
   D) decrease; increase

   Answer: A
   Ques Status: New

5) In the Keynesian liquidity preference framework, a rise in the price level causes the demand for money to ______ and the demand curve to shift to the ______, everything else held constant.
   A) increase; left
   B) increase; right
   C) decrease; left
   D) decrease; right

   Answer: B
   Ques Status: Revised
6) When the price level ______, the demand curve for money shifts to the ______ and the interest rate ______, everything else held constant.
   A) falls; left; falls
   B) rises; right; falls
   C) falls; left; rises
   D) rises; right; rises
   Answer: D
   Ques Status: Revised

7) A rise in the price level causes the demand for money to ______ and the interest rate to ______, everything else held constant.
   A) decrease; decrease
   B) decrease; increase
   C) increase; decrease
   D) increase; increase
   Answer: D
   Ques Status: Revised

8) A decline in the expected inflation rate causes the demand for money to ______ and the demand curve to shift to the ______, everything else held constant.
   A) decrease; right
   B) decrease; left
   C) increase; right
   D) increase; left
   Answer: B
   Ques Status: Revised

9) In the liquidity preference framework, a one-time increase in the money supply results in a price level effect. The maximum impact of the price level effect on interest rates occurs
   A) at the moment the price level hits its peak (stops rising) because both the price level and expected inflation effects are at work.
   B) immediately after the price level begins to rise, because both the price level and expected inflation effects are at work.
   C) at the moment the expected inflation rate hits its peak.
   D) at the moment the inflation rate hits it peak.
   Answer: A
   Ques Status: Revised
10) Interest rates increased continuously during the 1970s. The most likely explanation is
   A) banking failures that reduced the money supply.
   B) a rise in the level of income.
   C) the repeated bouts of recession and expansion.
   D) increasing expected rates of inflation.

   Answer: D

Ques Status: Revised

11) When the Fed decreases the money stock, the money supply curve shifts to the ______ and
the interest rate ______, everything else held constant.
   A) right; rises
   B) right; falls
   C) left; falls
   D) left; rises

   Answer: D

Ques Status: Revised

12) When the Fed ______ the money stock, the money supply curve shifts to the ______ and
the interest rate ______, everything else held constant.
   A) decreases; right; rises
   B) increases; right; falls
   C) decreases; left; falls
   D) increases; left; rises

   Answer: B

Ques Status: Revised

13) When the price level falls, the ______ curve for nominal money ______, and interest rates
_______, everything else held constant.
   A) demand; decreases; fall
   B) demand; increases; rise
   C) supply; increases; rise
   D) supply; decreases; fall

   Answer: A

Ques Status: Revised
14) _______ in the money supply creates excess _______ money, causing interest rates to _______, everything else held constant.
   A) a decrease; demand for; rise
   B) an increase; demand for; fall
   C) an increase; supply of; rise
   D) a decrease; supply of; fall

   Answer: A
   Ques Status: Revised

15) _______ in the money supply creates excess demand for _______, causing interest rates to _______, everything else held constant.
   A) an increase; money; rise
   B) an increase; bonds; fall
   C) a decrease; bonds; rise
   D) a decrease; money; fall

   Answer: B
   Ques Status: Revised

16) In the figure above, one factor not responsible for the decline in the demand for money is
   A) a decline the price level.
   B) a decline in income.
   C) an increase in income.
   D) a decline in the expected inflation rate.

   Answer: C
   Ques Status: Previous Edition
17) In the figure above, the decrease in the interest rate from $i_1$ to $i_2$ can be explained by

A) a decrease in money growth. 
B) a decline in the expected price level. 
C) an increase in income. 
D) an increase in the expected price level. 

Answer: B

**Ques Status:** Revised

18) In the figure above, the factor responsible for the decline in the interest rate is

A) a decline the price level. 
B) a decline in income. 
C) an increase in the money supply. 
D) a decline in the expected inflation rate. 

Answer: C

**Ques Status:** Previous Edition

19) In the figure above, the decrease in the interest rate from $i_1$ to $i_2$ can be explained by

A) a decrease in money growth. 
B) an increase in money growth. 
C) a decline in the expected price level. 
D) an increase in income. 

Answer: B

**Ques Status:** Revised
20) When the growth rate of the money supply increases, interest rates end up being permanently lower if
   
   A) the liquidity effect is larger than the other effects.
   B) there is fast adjustment of expected inflation.
   C) there is slow adjustment of expected inflation.
   D) the expected inflation effect is larger than the liquidity effect.

   Answer: A
   Ques Status: Previous Edition

21) When the growth rate of the money supply is increased, interest rates will fall immediately if the liquidity effect is ________ than the other money supply effects and there is ________ adjustment of expected inflation.

   A) larger; fast
   B) larger; slow
   C) smaller; slow
   D) smaller; fast

   Answer: B
   Ques Status: Previous Edition

22) If the Fed wants to permanently lower interest rates, then it should raise the rate of money growth if

   A) there is fast adjustment of expected inflation.
   B) there is slow adjustment of expected inflation.
   C) the liquidity effect is smaller than the expected inflation effect.
   D) the liquidity effect is larger than the other effects.

   Answer: D
   Ques Status: Previous Edition

23) Milton Friedman contends that it is entirely possible that when the money supply rises, interest rates may ________ if the ________ effect is more than offset by changes in income, the price level, and expected inflation.

   A) fall; liquidity
   B) fall; risk
   C) rise; liquidity
   D) rise; risk

   Answer: C
   Ques Status: Previous Edition
24) Of the four effects on interest rates from an increase in the money supply, the one that works in the opposite direction of the other three is the

A) liquidity effect.
B) income effect.
C) price level effect.
D) expected inflation effect.

Answer: A

25) Of the four effects on interest rates from an increase in the money supply, the initial effect is, generally, the

A) income effect.
B) liquidity effect.
C) price level effect.
D) expected inflation effect.

Answer: B

26) If the liquidity effect is smaller than the other effects, and the adjustment to expected inflation is slow, then the

A) interest rate will fall.
B) interest rate will rise.
C) interest rate will initially fall but eventually climb above the initial level in response to an increase in money growth.
D) interest rate will initially rise but eventually fall below the initial level in response to an increase in money growth.

Answer: C

27) If the liquidity effect is smaller than the other effects, and the adjustment to expected inflation is immediate, then the

A) interest rate will fall.
B) interest rate will rise.
C) interest rate will fall immediately below the initial level when the money supply grows.
D) interest rate will rise immediately above the initial level when the money supply grows.

Answer: D
28) In the figure above, illustrates the effect of an increased rate of money supply growth at time period 0. From the figure, one can conclude that the

A) liquidity effect is smaller than the expected inflation effect and interest rates adjust quickly to changes in expected inflation.

B) liquidity effect is larger than the expected inflation effect and interest rates adjust quickly to changes in expected inflation.

C) liquidity effect is larger than the expected inflation effect and interest rates adjust slowly to changes in expected inflation.

D) liquidity effect is smaller than the expected inflation effect and interest rates adjust slowly to changes in expected inflation.

Answer: A

Ques Status: Previous Edition

29) In the figure above, illustrates the effect of an increased rate of money supply growth at time period 0. From the figure, one can conclude that the

A) Fisher effect is dominated by the liquidity effect and interest rates adjust slowly to changes in expected inflation.

B) liquidity effect is dominated by the Fisher effect and interest rates adjust slowly to changes in expected inflation.

C) liquidity effect is dominated by the Fisher effect and interest rates adjust quickly to changes in expected inflation.

D) Fisher effect is smaller than the expected inflation effect and interest rates adjust quickly to changes in expected inflation.

Answer: C

Ques Status: Previous Edition
30) The figure above illustrates the effect of an increased rate of money supply growth at time period $T_0$. From the figure, one can conclude that the

A) liquidity effect is smaller than the expected inflation effect and interest rates adjust quickly to changes in expected inflation.

B) liquidity effect is larger than the expected inflation effect and interest rates adjust quickly to changes in expected inflation.

C) liquidity effect is larger than the expected inflation effect and interest rates adjust slowly to changes in expected inflation.

D) liquidity effect is smaller than the expected inflation effect and interest rates adjust slowly to changes in expected inflation.

Answer: C

Ques Status: Revised

31) The figure above illustrates the effect of an increased rate of money supply growth at time period $T_0$. From the figure, one can conclude that the

A) Fisher effect is dominated by the liquidity effect and interest rates adjust slowly to changes in expected inflation.

B) liquidity effect is dominated by the Fisher effect and interest rates adjust slowly to changes in expected inflation.

C) liquidity effect is dominated by the Fisher effect and interest rates adjust quickly to changes in expected inflation.

D) Fisher effect is smaller than the expected inflation effect and interest rates adjust quickly to changes in expected inflation.

Answer: A

Ques Status: Revised
32) The figure above illustrates the effect of an increased rate of money supply growth at time period $T_0$. From the figure, one can conclude that the

A) liquidity effect is smaller than the expected inflation effect and interest rates adjust quickly to changes in expected inflation.

B) liquidity effect is larger than the expected inflation effect and interest rates adjust quickly to changes in expected inflation.

C) liquidity effect is larger than the expected inflation effect and interest rates adjust slowly to changes in expected inflation.

D) liquidity effect is smaller than the expected inflation effect and interest rates adjust slowly to changes in expected inflation.

Answer: D

Ques Status: Revised

33) The figure above illustrates the effect of an increased rate of money supply growth at time period $T_0$. From the figure, one can conclude that the

A) Fisher effect is dominated by the liquidity effect and interest rates adjust slowly to changes in expected inflation

B) liquidity effect is dominated by the Fisher effect and interest rates adjust slowly to changes in expected inflation

C) liquidity effect is dominated by the Fisher effect and interest rates adjust quickly to changes in expected inflation

D) Fisher effect is smaller than the expected inflation effect and interest rates adjust quickly to changes in expected inflation

Answer: A

Ques Status: Revised

34) Using the liquidity preference framework, what will happen to interest rates if the Fed increases the money supply?

Answer: The Fed's actions shift the money supply curve to the right. The new equilibrium interest rate will be lower than it was previously.

Ques Status: New
35) Using the liquidity preference framework, show what happens to interest rates during a business cycle recession.

Answer: During a business cycle recession, income will fall. This causes the money demand curve to shift to the left. The resulting equilibrium will be at a lower interest rate.

5.6 Web Appendix 1: Models of Asset Pricing

1) The riskiness of an asset is measured by
   A) the magnitude of its return.
   B) the absolute value of any change in the asset’s price.
   C) the standard deviation of its return.
   D) risk is impossible to measure.

   Answer: C

2) A higher ______ means that an asset’s return is more sensitive to changes in the value of the market portfolio.

   A) alpha
   B) beta
   C) CAPM
   D) APT

   Answer: B
3) The riskiness of an asset that is unique to the particular asset is
   A) systematic risk.
   B) portfolio risk.
   C) investment risk.
   D) nonsystematic risk.

   Answer: D
   Ques Status: Revised

4) The risk of a well-diversified portfolio depends only on the ________ risk of the assets in the portfolio.
   A) systematic
   B) nonsystematic
   C) portfolio
   D) investment

   Answer: A
   Ques Status: New

5) In contrast to the CAPM, the APT assumes that there can be several sources of ________ that cannot be eliminated through diversification.
   A) nonsystematic risk
   B) systematic risk
   C) credit risk
   D) arbitrary risk

   Answer: B
   Ques Status: New

5.7 Web Appendix 2: Applying the Asset Market Approach to a Commodity Market: The Case of Gold

1) An increase in the expected inflation rate will ________ the ________ for gold, ________ its price, everything else held constant.
   A) increase; demand; increasing
   B) decrease; demand; decreasing
   C) increase; supply; increasing
   D) decrease; supply; increasing

   Answer: A
   Ques Status: Revised
2) A return to the gold standard, that is, using gold for money will _______ the _______ for gold, _______ its price, everything else held constant.
   A) increase; demand; increasing
   B) decrease; demand; decreasing
   C) increase; supply; increasing
   D) decrease; supply; increasing

   Answer: A

Ques Status: Revised

3) Discovery of new gold in Alaska will _______ the _______ of gold, _______ its price, everything else held constant.
   A) increase; demand; increasing
   B) decrease; demand; decreasing
   C) decrease; supply; increasing
   D) increase; supply; decreasing

   Answer: D

Ques Status: Revised

4) When gold prices become more volatile, the _______ curve for gold shifts to the _______; _______ the price of gold.
   A) supply; right; increasing
   B) supply; left; increasing
   C) demand; right; decreasing
   D) demand; left; decreasing

   Answer: D

Ques Status: New

5.8 Web Appendix 3: Loanable Funds Framework

1) In the loanable funds framework, the _______ curve of bonds is equivalent to the _______ curve of loanable funds.
   A) demand; demand
   B) demand; supply
   C) supply; supply
   D) supply; equilibrium

   Answer: B

Ques Status: New
2) In the loanable funds framework, the _______ is measured on the vertical axis.

- A) price of bonds
- B) interest rate
- C) quantity of bonds
- D) quantity of loanable funds

Answer: B

Ques Status: New