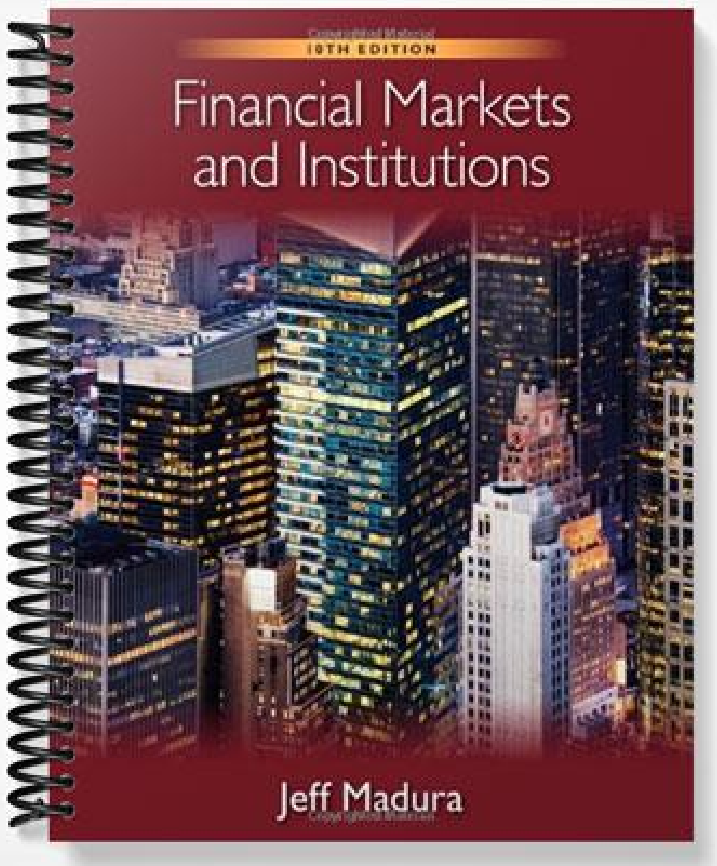
TEST BANK


10TH EDITION
Financial Markets
and Institutions
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Chapter 2—Determination of Interest Rates

1. According to the loanable funds theory, market interest rates are determined by the factors that control the supply of and demand for loanable funds.
   a. True
   b. False

   ANS: T PTS: 1

2. The level of installment debt as a percentage of disposable income is generally ____ during recessionary periods.
   a. higher
   b. lower
   c. zero
   d. negative

   ANS: B PTS: 1

3. At any given point in time, households would demand a ____ quantity of loanable funds at ____ rates of interest.
   a. greater; higher
   b. greater; lower
   c. smaller; lower
   d. none of the above

   ANS: B PTS: 1

4. Businesses demand loanable funds to
   a. finance installment debt.
   b. subsidize other companies.
   c. invest in fixed and short-term assets.
   d. none of the above

   ANS: C PTS: 1

5. The required return to implement a given business project will be ____ if interest rates are lower. This implies that businesses will demand a ____ quantity of loanable funds when interest rates are lower.
   a. greater; lower
   b. lower; greater
   c. lower; lower
   d. greater; greater

   ANS: B PTS: 1

6. If interest rates are ____, ____ projects will have positive NPVs.
   a. higher; more
   b. lower; more
   c. lower; no
   d. none of the above

   ANS: B PTS: 1

7. The demand for funds resulting from business investment in short-term assets is ____ related to the number of projects implemented, and is therefore ____ related to the interest rate.
   a. inversely; positively

b. positively; inversely
c. inversely; inversely
d. positively; positively

ANS: B PTS: 1

8. If economic conditions become less favorable, then:
a. expected cash flows on various projects will increase.
b. more proposed projects will have expected returns greater than the hurdle rate.
c. there would be additional acceptable business projects.
d. there would be a decreased demand by business for loanable funds.

ANS: D PTS: 1

9. As a result of more favorable economic conditions, there is a(n) ____ demand for loanable funds, causing an ____ shift in the demand curve.
a. decreased; inward
b. decreased; outward
c. increased; outward
d. increased; inward

ANS: C PTS: 1

10. The federal government demand for loanable funds is ____. If the budget deficit was expected to increase, the federal government demand for loanable funds would ____.
a. interest elastic; decrease
b. interest elastic; increase
c. interest inelastic; increase
d. interest inelastic; decrease

ANS: C PTS: 1

11. Other things being equal, foreign governments and corporations would demand ____ U.S. funds if their local interest rates were lower than U.S. rates. Therefore, for a given set of foreign interest rates, foreign demand for U.S. funds is ____ related to U.S. interest rates.
a. less; inversely
b. more; positively
c. less; positively
d. more; inversely

ANS: A PTS: 1

12. For a given set of foreign interest rates, the quantity of U.S. loanable funds demanded by foreign governments or firms will be ____ U.S. interest rates.
a. positively related to
b. inversely related to
c. unrelated to
d. none of the above

ANS: B PTS: 1

13. The quantity of loanable funds supplied is normally
a. highly interest elastic.
b. more interest elastic than the demand for loanable funds.
c. less interest elastic than the demand for loanable funds.
d. equally interest elastic as the demand for loanable funds.

e. A and B

ANS: C PTS: 1

14. The ____ sector is the largest supplier of loanable funds.
a. household
b. government
c. business
d. none of the above

ANS: A PTS: 1

15. The supply of loanable funds in the U.S. is partly determined by the monetary policy implemented by the Federal Reserve System.
a. True
b. False

ANS: T PTS: 1

16. If a strong economy allows for a large ____ in households income, the supply curve will shift ____.
a. decrease; outward
b. increase; inward
c. increase; outward
d. none of the above

ANS: C PTS: 1

17. The equilibrium interest rate
a. equates the aggregate demand for funds with the aggregate supply of loanable funds.
b. equates the elasticity of the aggregate demand and supply for loanable funds.
c. decreases as the aggregate supply of loanable funds decreases.
d. increases as the aggregate demand for loanable funds decreases.

ANS: A PTS: 1

18. The equilibrium interest rate should
a. fall when the aggregate supply funds exceeds aggregate demand for funds.
b. rise when the aggregate supply of funds exceeds aggregate demand for funds.
c. fall when the aggregate demand for funds exceeds aggregate supply of funds.
d. rise when aggregate demand for funds equals aggregate supply of funds.
e. B and C

ANS: A PTS: 1

19. Which of the following is likely to cause a decrease in the equilibrium U.S. interest rate, other things being equal?
a. a decrease in savings by foreign savers
b. an increase in inflation
c. pessimistic economic projections that cause businesses to reduce expansion plans
d. a decrease in savings by U.S. households

ANS: C PTS: 1

20. The Fisher effect states that the
a. nominal interest rate equals the expected inflation rate plus the real rate of interest.
b. nominal interest rate equals the real rate of interest minus the expected inflation rate.

c. real rate of interest equals the nominal interest rate plus the expected inflation rate.
d. expected inflation rate equals the nominal interest rate plus the real rate of interest.

ANS: A PTS: 1

21. If the real interest rate was negative for a period of time, then
a. inflation is expected to exceed the nominal interest rate in the future.
b. inflation is expected to be less than the nominal interest rate in the future.
c. actual inflation was less than the nominal interest rate.
d. actual inflation was greater than the nominal interest rate.

ANS: D PTS: 1

22. If inflation is expected to decrease, then
a. savers will provide less funds at the existing equilibrium interest rate.
b. the equilibrium interest rate will increase.
c. the equilibrium interest rate will decrease.
d. borrowers will demand more funds at the existing equilibrium interest rate.

ANS: C PTS: 1

23. If inflation turns out to be lower than expected
a. savers benefit.
b. borrowers benefit while savers are not affected.
c. savers and borrowers are equally affected.
d. savers are adversely affected but borrowers benefit.

ANS: A PTS: 1

24. If the economy weakens, there is ____ pressure on interest rates. If the Federal Reserve increases the money supply there is ____ pressure on interest rates (assume that inflationary expectations are not affected).
a. upward; upward
b. upward; downward
c. downward; upward
d. downward; downward

ANS: D PTS: 1

25. What is the basis of the relationship between the Fisher effect and the loanable funds theory?
a. the saver's desire to maintain the existing real rate of interest
b. the borrower's desire to achieve a positive real rate of interest
c. the saver's desire to achieve a negative real rate of interest
d. B and C

ANS: A PTS: 1

26. Assume that foreign investors who have invested in U.S. securities decide to decrease their holdings of U.S. securities and to instead increase their holdings of securities in their own countries. This should cause the supply of loanable funds in the United States to ____ and should place ____ pressure on U.S. interest rates.
a. decrease; upward
b. decrease; downward
c. increase; downward
d. increase; upward

ANS: A PTS: 1

27. Assume that foreign investors who have invested in U.S. securities decide to increase their holdings of U.S. securities. This should cause the supply of loanable funds in the United States to ____ and should place ____ pressure on U.S. interest rates.
    a. decrease; upward
    b. decrease; downward
    c. increase; downward
    d. increase; upward

ANS: C PTS: 1

28. If the federal government needs to borrow additional funds, this borrowing reflects a(n) ____ in the supply of loanable funds, and a(n) ____ in the demand for loanable funds.
    a. increase; no change
    b. decrease; no change
    c. no change; increase
    d. no change; decrease

ANS: C PTS: 1

29. If the federal government reduces its budget deficit, this causes a(n) ____ in the supply of loanable funds, and a(n) ____ in the demand for loanable funds.
    a. increase; no change
    b. decrease; no change
    c. no change; increase
    d. no change; decrease

ANS: D PTS: 1

30. Due to expectations of higher inflation in the future, we would typically expect the supply of loanable funds to ____ and the demand for loanable funds to ____.
    a. increase; decrease
    b. increase; increase
    c. decrease; increase
    d. decrease; decrease

ANS: C PTS: 1

31. Due to expectations of lower inflation in the future, we would typically expect the supply of loanable funds to ____ and the demand for loanable funds to ____.
    a. increase; decrease
    b. increase; increase
    c. decrease; increase
    d. decrease; decrease

ANS: A PTS: 1

32. If the real interest rate is expected by a particular person to become negative, then the purchasing power of his or her savings would be ____, as the inflation rate is expected to be ____ the existing nominal interest rate.
    a. decreasing; less than
    b. decreasing; greater than
    c. increasing; greater than
    d. increasing; less than

ANS: B PTS: 1

33. If economic expansion is expected to increase, then demand for loanable funds should ____ and interest rates should ____.
a. increase; increase
b. increase; decrease
c. decrease; decrease
d. decrease; increase

ANS: A PTS: 1

34. If economic expansion is expected to decrease, the demand for loanable funds should ____ and interest rates should ____.
a. increase; increase
b. increase; decrease
c. decrease; decrease
d. decrease; increase

ANS: C PTS: 1

35. If the real interest rate was stable over time, this would suggest that there is ____ relationship between inflation and nominal interest rate movements.
a. a positive
b. an inverse
c. no
d. an uncertain (cannot be determined from information above)

ANS: A PTS: 1

36. If inflation and nominal interest rates move more closely together over time than they did in earlier periods, this would ____ the volatility of the real interest rate movements over time.
a. increase
b. decrease
c. have an effect, which cannot be determined with above information, on
d. have no effect on

ANS: B PTS: 1

37. Canada and the U.S. are major trading partners. If Canada experiences a major increase in economic growth, it could place ____ pressure on Canadian interest rates and ____ pressure on U.S. interest rates.
a. upward; upward
b. upward; downward
c. downward; downward
d. downward; upward

ANS: A PTS: 1

38. If investors shift funds from stocks into bank deposits, this ____ the supply of loanable funds, and places ____ pressure on interest rates.
a. increases; upward
b. increases; downward
c. decreases; downward
d. decreases; upward

ANS: B PTS: 1

39. When Japanese interest rates rise, and if exchange rate expectations remain unchanged, the most likely effect is that the supply of loanable funds provided by Japanese investors to the United States will ____, and the U.S. interest rates will ____.
    a. increase; increase
    b. increase; decrease
    c. decrease; decrease
    d. decrease; increase

    ANS: D PTS: 1

40. Which of the following will probably not result in an increase in the business demand for loanable funds?
    a. an increase in positive net present value (NPV) projects
    b. a reduction in interest rates on business loans
    c. a recession
    d. none of the above

    ANS: C PTS: 1

41. If the aggregate demand for loanable funds increases without a corresponding ____ in aggregate supply, there will be a ____ of loanable funds.
    a. increase; surplus
    b. increase; shortage
    c. decrease; surplus
    d. decrease; shortage

    ANS: B PTS: 1

42. A ____ federal government deficit increases the quantity of loanable funds demanded at any prevailing interest rate, causing an ____ shift in the demand schedule.
    a. higher; inward
    b. higher; outward
    c. lower; outward
    d. none of the above

    ANS: B PTS: 1

43. Which of the following is not true regarding foreign interest rates?
    a. The large flow of funds between countries causes interest rates in any given country to become more susceptible to interest rate movements in other countries.
    b. The expectations of a strong dollar should cause a flow of funds to the U.S.
    c. An increase in a foreign country's interest rates will encourage investors in that country to invest their funds in other countries.
    d. All of the above are true regarding foreign interest rates.

    ANS: C PTS: 1

44. Which of the following is least likely to affect household demand for loanable funds?
    a. a decrease in tax rates
    b. an increase in interest rates
    c. a reduction in positive net present value (NPV) projects available
    d. All of the above are equally likely to affect household demand for loanable funds.

    ANS: C PTS: 1

45. Which of the following statements is incorrect?
   a. The Fed's monetary policy is intended to control the economic conditions in the U.S.
   b. The Fed's monetary policy affects the supply of loanable funds, which affects interest rates.
   c. By influencing interest rates, the Fed is able to influence the amount of money that corporations and households are willing to borrow and spend.
   d. All of the statements above are true.

   ANS: D PTS: 1

46. At any point in time, households and businesses demand a greater quantity of loanable funds at lower rates of interest.
   a. True
   b. False

   ANS: T PTS: 1

47. The business demand for funds resulting from short-term investments is inversely related to the number of projects implemented and inversely related to the interest rate.
   a. True
   b. False

   ANS: F PTS: 1

48. Other things being equal, a smaller quantity of U.S. funds would be demanded by foreign governments and corporations if their domestic interest rates were high relative to U.S. rates.
   a. True
   b. False

   ANS: F PTS: 1

49. If foreign interest rates fall, foreign firms and governments would likely reduce their demand for U.S. funds.
   a. True
   b. False

   ANS: T PTS: 1

50. Since the aggregate demand for loanable funds is the sum of the quantities demanded by the separate sectors, and since most of these sectors are likely to demand a larger quantity of funds at lower interest rates (other things being equal), the aggregate demand for loanable funds is positively related to interest rates at any point in time.
   a. True
   b. False

   ANS: F PTS: 1

51. In general, suppliers of loanable funds are willing to supply more funds if the interest rate is higher.
   a. True
   b. False

   ANS: T PTS: 1

52. If the aggregate demand for loanable funds increases without a corresponding increase in aggregate supply, there will be a surplus of loanable funds.
a. True
b. False

ANS: F PTS: 1

53. The relationship between interest rates and expected inflation is often referred to as the loanable funds theory.
a. True
b. False

ANS: F PTS: 1

54. According to the Fisher effect, if the real interest rate is zero, the nominal interest rate must be equal to the expected inflation rate.
a. True
b. False

ANS: T PTS: 1

55. To forecast interest rates using the Fisher effect, the real interest rate for an upcoming period can be forecasted by subtracting the expected inflation rate over that period from the nominal interest rate quoted for that period.
a. True
b. False

ANS: T PTS: 1

56. According to the Fisher effect, when the inflation rate is lower than anticipated, the real interest rate is relatively low.
a. True
b. False

ANS: F PTS: 1

57. Forecasters should consider future plans for corporate expansion and the future state of the economy when forecasting business demand for loanable funds.
a. True
b. False

ANS: T PTS: 1

58. The ____ suggests that the market interest rate is determined by factors that control the supply of and demand for loanable funds.
a. Fisher effect
b. loanable funds theory
c. real interest rate
d. none of the above

ANS: B PTS: 1

59. Which of the following will probably not result in an increase in the business demand for loanable funds?

a. an increase in positive net present value (NPV) projects
b. a reduction in interest rates on business loans
c. a recession
d. All of the above will result in an increase in the business demand for loanable funds.

ANS: C PTS: 1

60. Other things being equal, a ____ quantity of U.S. funds would be demanded by foreign governments and corporations if their domestic interest rates were ____ relative to U.S. rates.
a. smaller; high
b. larger; high
c. larger; low
d. none of the above

ANS: B PTS: 1

61. The federal government demand for funds is said to be interest inelastic, or ____ to interest rates.
a. sensitive
b. insensitive
c. relatively sensitive as compared to other sectors
d. none of the above

ANS: B PTS: 1

62. If the aggregate demand for loanable funds increases without a corresponding ____ in aggregate supply, there will be a ____ of loanable funds.
a. increase; surplus
b. increase; shortage
c. decrease; surplus
d. decrease; shortage

ANS: B PTS: 1

63. The expected impact of an increased expansion by businesses is an ____ shift in the demand schedule and ____ in the supply schedule.
a. inward; an inward shift
b. inward; an outward shift
c. outward; an inward shift
d. outward; no obvious change

ANS: D PTS: 1

64. Which of the following is a valid representation of the Fisher effect?
a. $i = E(INF) + i_R$
b. $i_R = E(INF) + i$
c. $E(INF) = i + i_R$
d. none of the above

ANS: A PTS: 1

65. The real interest rate can be forecasted by subtracting the ____ from the ____ for that period.
a. nominal interest rate; expected inflation rate
b. prime rate; nominal interest rate
c. expected inflation rate; nominal interest rate
d. prime rate; expected inflation rate

ANS: C PTS: 1

66. According to the Fisher effect, expectations of higher inflation cause savers to require a ____ on savings.
   a. higher nominal interest rate
   b. higher real interest rate
   c. lower nominal interest rate
   d. lower real interest rate

ANS: A PTS: 1

67. A ____ federal government deficit increases the quantity of loanable funds demanded at any prevailing interest rate, causing an ____ shift in the demand schedule.
   a. higher; inward
   b. higher; outward
   c. lower; outward
   d. none of the above

ANS: B PTS: 1