ECON UN3265: Money and Banking

Summer 2026 — Practice Quiz

Chapter 6 — Practice Quiz

How to use this quiz. These multiple-choice questions are based on the Chapter 6 practice problems on risk structure and term structure of interest rates. Work through them after the reading; the answer key is on the last page.

Questions

1. Which government bond should have a higher risk premium on its interest rates, a German bond with an S&P rating of AAA or an Italian bond with a rating of BBB? Why?

A) The German bond, because AAA ratings imply greater default risk.
B) The Italian bond, because a BBB rating implies a higher perceived probability of default.
C) Both should have the same risk premium because both are European government bonds.
D) Neither should have a risk premium because government bonds cannot default.

2. After the 2008-2009 crisis, the U.K. government rescued Lloyds Bank with capital injections and an ownership stake. How would this affect the yield and risk premium on Lloyds corporate debt?

A) Both the yield and the risk premium would likely rise because government support increases default risk.
B) Both the yield and the risk premium would likely fall because the rescue reduces expected default risk.
C) The yield would fall, but the risk premium would necessarily rise.
D) There would be no effect because corporate debt is unrelated to government policy.

3. Risk premiums on corporate bonds are usually anticyclical: they decrease during expansions and increase during recessions. Why?

A) During recessions, firms are more likely to default, so investors demand higher compensation for risk.
B) During expansions, firms become less liquid, so investors demand higher risk premiums.
C) During recessions, tax exemptions become more valuable, raising corporate bond prices.
D) Because central banks legally require corporate spreads to move opposite the business cycle.

4. TIPS are Treasury bonds whose principal is adjusted for inflation, but they are traded on a smaller scale than nominal U.S. Treasury bonds. What can you conclude about the liquidity premiums of TIPS versus nominal Treasury bonds?

A) TIPS likely have a higher liquidity premium because they are less liquid than nominal Treasuries.
B) TIPS likely have a lower liquidity premium because they are less frequently traded.
C) Both must have identical liquidity premiums because both are issued by the Treasury.
D) Nominal Treasuries have a higher liquidity premium because larger markets are always less liquid.

5. Predict what will happen to interest rates on a corporation's bonds if the federal government guarantees that it will pay creditors if the corporation goes bankrupt. What will happen to interest rates on Treasury securities?

A) Corporate bond rates rise, while Treasury rates fall.
B) Corporate bond rates fall because default risk falls; Treasury rates may rise slightly as demand shifts away from Treasuries and government liabilities increase.
C) Both corporate and Treasury rates fall by the same amount.
D) There is no effect on either market because guarantees are not priced by investors.

6. During 2008, the yield spread between three-month AA-rated financial commercial paper and three-month AA-rated nonfinancial commercial paper rose sharply. What explains this sudden increase?

A) Financial firms were perceived as much riskier during the crisis, so investors demanded a higher premium to hold their paper.

B) Nonfinancial firms suddenly became riskier than financial firms.

C) The maturity of financial commercial paper became much longer than three months.

D) The spread rose only because financial paper became tax-exempt.

7. In Germany, suppose North Rhine-Westphalia issues a tax-exempt bond for German investors. How would its interest rate compare with a non-tax-exempt bond issued by Baden-Wuerttemberg?

A) The tax-exempt bond would likely have a lower interest rate, other things equal, because investors value the tax benefit.

B) The tax-exempt bond would likely have a higher interest rate because tax exemption makes it riskier.

C) The two bonds must have identical rates because both are German state bonds.

D) The tax-exempt bond would trade only at zero interest.

8. According to the expectations theory of the term structure, is it better to invest in one-year bonds reinvested over two years than to invest in a two-year bond if one-year rates are expected to be the same in both years?

A) True, because rolling over one-year bonds must always earn more.

B) False, because the two strategies should have the same expected return under pure expectations theory.

C) True only if two-year bonds have no default risk.

D) Uncertain because expectations theory says nothing about returns across maturities.

9. If investors decide that 30-year bonds are no longer as desirable as before, what happens to the yield curve under expectations theory and segmented markets theory?

A) Under expectations theory, the yield curve necessarily becomes inverted; under segmented markets, it stays unchanged.

B) Under expectations theory, there is no direct effect unless expectations of future short rates change; under segmented markets, the 30-year yield rises and the long end steepens.

C) Both theories predict that all yields fall equally.

D) Both theories predict that only short-term rates rise.

10. Suppose one-, five-, and ten-year German government bond rates are -0.5%, -0.3%, and 0%. Hans chooses only one-year bonds, while Dietrich is indifferent between five- and ten-year bonds. How can this behavior be explained?

A) Hans expects short rates to rise enough to prefer rolling over one-year bonds, while Dietrich views the expected returns on five- and ten-year bonds as roughly equal after term premiums.

B) Hans must believe long-term bonds have no risk, while Dietrich must believe one-year bonds are illegal.

C) Hans and Dietrich must have identical expectations and identical preferred habitats.

D) The observed rates make one-year bonds strictly dominated for every investor.

11. If a yield curve is roughly flat at short and medium maturities but rises sharply at long maturities, what is the market predicting about future short-term rates and inflation?

A) Short-term rates are expected to stay about the same at first and rise later; this may indicate expectations of higher future inflation.

B) Short-term rates are expected to fall sharply at all horizons; inflation is expected to fall.

C) The market predicts no change in future short-term rates and no inflation risk.

D) The curve contains no information about future rates or inflation.

12. If a yield curve rises at first and then slopes downward at longer maturities, what is the market predicting about future short-term rates and inflation?

A) Short-term rates are expected to rise in the near term and fall later; this may suggest inflation is expected to rise first and then decline.

B) Short-term rates are expected to fall in the near term and rise later; inflation must accelerate permanently.

C) Short-term rates are expected to remain constant forever.

D) Only default risk is being predicted, not interest rates or inflation.

13. If the French government yield curve, on average, is flat, what would this say about liquidity or term premiums? Would you be more or less willing to accept the expectations theory?

A) It suggests term premiums are very large and positive, making pure expectations theory more convincing.

B) It suggests liquidity or term premiums are small on average, making the expectations theory more plausible.

C) It proves that short-term rates are expected to rise sharply.

D) It proves that investors do not care about maturity.

14. If expectations of future short-term interest rates in the Eurozone suddenly rise, what would happen to the slope of the yield curve?

A) The yield curve would become steeper, especially if current short rates do not rise by the same amount.

B) The yield curve would become flatter automatically.

C) Only the shortest-maturity yield would move, so the slope would fall.

D) There would be no effect on the yield curve.

15. In March 2009, the Federal Reserve announced it would purchase up to $300 billion of longer-term Treasury securities over six months. What effect might this policy have on the yield curve?

A) It would raise long-term Treasury yields and steepen the curve.

B) It would lower long-term Treasury yields by increasing demand for longer-term securities, likely flattening the yield curve.

C) It would affect only overnight rates, leaving the rest of the curve unchanged.

D) It would eliminate all risk premiums in corporate bond markets.

Answer Key

1. B 2. B 3. A 4. A 5. B 6. A 7. A 8. B 9. B 10. A 11. A 12. A 13. B 14. A 15. B