ECONOMICS 353

MIDTERM EXAM 1: 50 Questions (1 Point Each)  28 September 2010

On side 1 of your bubble sheet, give your FIRST AND LAST NAME together with your STUDENT ID NUMBER. In the top margin of side 1 also write ECON 353: FIRST MIDTERM EXAM.

Answer all 50 questions below by marking answers on your answer bubble sheet using a number 2 pencil. Each question is worth 1 point. Read each question carefully before answering.

At the end of the exam, please turn in your answer bubble sheet and be prepared to show an official photo ID of yourself (e.g., student ID, driver’s license) if asked.

**Important Caution:** Do your own work, do not assist others in any way during the exam, and keep your eyes focused only on your own exam. USE OF ANY ELECTRONIC OR MECHANICAL DEVICE (E.G., CALCULATORS) DURING THE EXAM IS STRICTLY PROHIBITED. Any behavior to the contrary will be considered cheating and will not be tolerated. Cheating will result in an automatic F on the exam, and further sanctions may be applied in line with university policy.

**IF YOU THINK ANY QUESTIONS ARE UNCLEAR OR AMBIGUOUS:** Ask the instructor during the exam for clarification. If this does not resolve the issue, do the following:

1. Write your specific comments on the following pages along side the statement(s) of the question(s) about which you have concerns.

2. Indicate here the numbers of the questions you have commented on:

3. Write your name and student ID number where indicated below.

   STUDENT NAME_____________________

   STUDENT ID NUMBER_________________

4. At the end of the exam, give this exam question packet to the instructor for special handling.

Good Luck!
Q1. The U.S. economy was severely impacted in the 1970s by _____
   A. strong debt deflation.
   B. oil price shocks.
   C. the bursting of the dot.com bubble.
   D. a major financial crisis primarily hitting the Savings and Loan industry.

Q2. A BUSINESS CYCLE is a record of the ______
   A. duration of a company from its founding date to its dissolution date.
   B. recurrent fluctuations that occur in time series data for key macro variables such as real GDP.
   C. currently hottest trends in consumer purchases.
   D. average duration of product cycles, from introduction to obsolescence.

Q3. The AGGREGATE PRICE LEVEL for an economy over a specified time period is ________ and the INFLATION RATE is the ________.
   A. a measure of the total value of all goods and services sold in the economy during this time period; percent increase in this value from one period to the next.
   B. the sum of prices for all final goods and services produced in the economy during this time period; a measure of the extent to which the aggregate price level is high or low relative to its normal value.
   C. a measure of the total value of all goods and services consumed in the economy during this time period; percent change in this value from one period to the next.
   D. a measure of the average price of goods and services in the economy over this time period; percent change in the aggregate price level from one period to the next.

Q4. If current government expenditures are MORE than current tax revenues, then the government is said to be running ______
   A. a government budget deficit.
   B. a current account deficit.
   C. a capital account surplus.
   D. a government budget surplus.
Q5. The FEDERAL FUNDS RATE is the interest rate on ______

A. bonds issued by the Federal government.
B. loans made by the Federal Reserve System to banks.
C. overnight loans between banks of their deposits at the Federal Reserve.
D. loans made by banks to the Federal Reserve System.

Q6. According to time series data presented in Mishkin (Chaper 1) and in class, _____

A. the supply of money (M2) tends to fluctuate in the OPPOSITE direction of the aggregate price level (i.e. when one is increasing the other tends to be decreasing, and vice versa).
B. the supply of money (M2) tends to fluctuate INDEPENDENTLY of the aggregate price level because of its breadth.
C. the supply of money (M2) tends to fluctuate in the SAME direction as the aggregate price level (i.e. when one is increasing the other tends to be increasing, and vice versa)
D. a HIGH average inflation rate is associated with a LOW average money growth rate, and vice versa.

Q7. By definition (Mishkin Chapter 1, Appendix), the GROWTH RATE for any variable V from time period T-1 to time period T is given by ______

A. $100 \times \left[ V(T) - V(T - 1) \right]$
B. $100 \times \left[ V(T) + V(T - 1) \right]/2$
C. $100 \times \left[ V(T + 1)/V(T) \right]$
D. $100 \times \left[ V(T) - V(T - 1) \right]/V(T - 1)$

Q8. By definition (Mishkin Chapter 1, Appendix), the qualifier NOMINAL applied to U.S. Gross Domestic Product (GDP) implies that _____

A. the value of the GDP is measured in current prices.
B. the value of the GDP is measured in base-year prices.
C. the current value of the GDP is only approximate and will subsequently be revised when more data become available.
D. The value of the GDP excludes real (tangible) assets.
Q9. According to Mishkin, traditional economic theories regarding the U.S. Great Depression do not pay enough attention to ____

A. the role of government expenditures and tax policy.
B. financial aspects such as credit channels, stock markets, balance sheet conditions, etc.
C. foreign sector activities (exchange rate movements, balance of payments, etc.)
D. the role of government policy with regard to money and interest rates.

Q10. Many commentators believe that a primary causal factor triggering the recent Great Recession was ____

A. a “bubble” (unjustified sharp increase) in stock prices that then unexpectedly collapsed in 2007.
B. a “bubble” (unjustified sharp increase) in housing prices that then unexpectedly collapsed in 2007.
C. bank runs in the U.S. and the UK causing a collapse of investor confidence during 2008.
D. the decision by rating agencies to change their ratings on many collateralized debt obligations from AAA to junk status in 2008.

Q11. A key DISTINCTION between financial and real assets that helps to explain why financial asset trades are more heavily regulated than real asset trades is that financial assets ____

A. are not durable.
B. establish ongoing contractual relationships between original asset issuers and current asset holders.
C. have longer maturities than real assets and so are subject to the “maturity gap” problem.
D. are more readily bought and sold in secondary markets.

Q12. A key DISTINCTION between financial intermediaries (FIs) and dealers is ____

A. FIs are key players in auction markets whereas dealers are not.
B. dealers earn profits through commissions whereas FIs do not.
C. FIs engage in asset transformation whereas dealers do not.
D. FIs earn profits by buying low and selling high, whereas dealers do not.
Q13. Key DISTINCTIONS between a broker and a dealer include ____
   A. brokers posts bid and asked prices whereas dealers do not.
   B. brokers buy low and sell high whereas dealers sell low and buy high.
   C. brokers keep inventories of the assets they trade in whereas dealers do not.
   D. dealers post bid and asked prices whereas brokers do not.

Q14. Which of the following markets are organized as OVER-THE-COUNTER markets:
   A. The secondary market for U.S. government bonds
   B. U.S. Treasury auctions.
   C. The New York Stock Exchange.
   D. All of the above.
   E. Only A and B above.

Q15. A LENDER acquires ____ by ____.
   A. a contractually promised payment stream; buying a newly issued debt instrument.
   B. a contractually promised payment stream; issuing and selling a debt instrument.
   C. temporary additional purchasing power; issuing and selling a debt instrument.
   D. immediate loan principal (funds); buying a newly issued debt instrument.

Q16. A BOND newly issued by a corporation is ____ for the corporation and ____ for the buyer of the bond.
   A. a liability; an asset
   B. an asset; a liability
   C. real asset; a financial asset
   D. a financial asset; a real asset
Q17. Corporations acquire NEW funds when their stocks are sold ____

A. in money markets.
B. in secondary markets.
C. by financial intermediaries through mutual funds.
D. in primary markets.

Q18. Which of the following properties characterize COMMON STOCK SHARES:

A. If bankruptcy occurs, common stock holder claims are paid after preferred stock holder claims.
B. Holders of a corporation’s common stock shares have the right to vote their approval or disapproval of key corporate management decisions.
C. By law, corporations must pay out their profits as dividends to their common stock holders within a reasonable amount of time.
D. All of the above.
E. Only A and B.

Q19. The primary mission of Fannie Mae has been to create a liquid secondary market for home mortgages by

A. purchasing mortgages from lending institutions using funds obtained by issuing and selling its own debt instruments in capital markets.
B. standing ready as a lender of last resort for “subprime” individual home buyers in need of loans to buy homes.
C. devising innovative mortgage instruments (such as adjustable rate mortgages, or ARMs) that make it easier for individual home buyers to buy homes.
D. providing low-cost insurance to lending institutions to encourage lending to individual home buyers.

Q20. In recent months the interest rate on Treasury-indexed 1-Year ADJUSTABLE RATE MORTGAGES (ARMS) have been ____., a direct reflection of the ____.

A. highly volatile; discretionary policy actions of the Federal Reserve.
B. lower than average; high unemployment rate.
C. higher than average; volatile and uncertain interest rates on Treasury securities.
D. lower than average; lower-than-average interest rates on Treasury securities.
Q21. By definition, DIRECT FINANCE refers to ____

A. trades of financial assets enacted directly (immediately) in a spot market rather than in a forward market.
B. trades of financial assets enacted directly (face to face) between buyers and sellers.
C. instances of borrowing in which borrowers directly transact with their lenders.
D. instances of borrowing mediated directly by a financial intermediary.

Q22. By definition, instances of INDIRECT FINANCE include ____

A. You loan your classmate $100 for one year at 3% interest.
B. You take out a loan at the First National Bank.
C. You buy a newly issued share of Google.
D. You contribute money to a charity.
E. All of the above.

Q23. Which of the following properties are TRUE for DEBT securities:

A. Debt holders actively participate in the management of the affairs of debt issuers.
B. In case of bankruptcy, debt claims are paid before equity claims.
C. The size of the payment received by a debt holder in any given time period is independent of the profits earned by the debt issuer in this time period unless the debt issuer goes bankrupt.
D. All of the above.
E. Only B and C above.

Q24. If bad credit risks are the ones that most actively seek out and receive loans from a financial intermediary due to its loan contract provisions, then the financial intermediary has _______.

A. a free-rider problem.
B. an adverse selection problem.
C. a moral hazard problem.
D. a risk diversification problem.
Q25. Moral hazard is less of a problem for corporate debt holders than for stock owners because ____

A. debt holders typically are active participants in corporate management.
B. debt contracts have pre-set payment obligations not conditioned on issuer profits.
C. debt contracts always include legal restrictions on corporate management behavior.
D. all of the above.

Q26. Which of the following statements is TRUE BY DEFINITION:

A. Money is any legally enforced medium of exchange.
B. Money is anything that must be accepted in repayment of debts, as a matter of law.
C. Money is paper currency plus coinage.
D. Money is anything generally accepted in payment for goods and services and in repayment of debts, as a matter of social custom.

Q27. By definition, money is a FINANCIAL ASSET because ____

A. it is denominated in currency units.
B. it is a claim against real assets.
C. it is issued by the U.S. Treasury.
D. it is a medium of exchange.

Q28. By definition, a form of money is said to be LEGAL TENDER if ____

A. it is required by law to be accepted for repayment of debts.
B. the issuer has received a charter from government.
C. it is required by law to be accepted for the purchase of goods and services.
D. it is issued by a government.
Q29. By definition, a form of money is said to be FIAT if ____
   A. it is required by law to be accepted for the repayment of debts.
   B. it is required by law to be accepted for the purchase of goods and services.
   C. it is a paper money that is unbacked legal tender.
   D. it is token coinage issued by a government.

Q30. Legal tender in the U.S. consists of ____
   A. all paper money issued by the U.S. Treasury.
   B. all currency (coins and paper money) issued by the U.S. government.
   C. all coins minted by the U.S. Mint.
   D. any generally accepted means for repayment of legal debts.

Q31. By definition, EUROCURRENCIES are currencies that ____
   A. are pegged to the Euro.
   B. have been issued by a European country.
   C. are deposited in banks outside their country of issue.
   D. are issued by a home country but denominated in the currency of a foreign country and held as deposits in that foreign country.

Q32. The conversion of a barter economy to one that uses money ____
   A. decreases efficiency by reducing the volume of trade.
   B. increases efficiency by reducing double coincidence of wants problems.
   C. increases efficiency by discouraging specialization (division of labor).
   D. decreases efficiency by increasing the number of prices.
   E. both B and C above.
Q33. For an economy with exactly 8 goods, _____ prices are needed to support exchange under a barter payment system while _____ prices are needed to support exchange under a monetary payment system.

A. 56; 8  
B. 28; 16  
C. 56; 16  
D. 16; 8  
E. 28; 8

Q34. The M1 measure of money used in the U.S. _____

A. is a selection of financial assets judged best for controlling GDP growth.  
B. is a weighted aggregate (average) of all of the most widely held financial assets.  
C. is a selection of financial assets judged to be most liquid.  
D. is a weighted aggregate (average) of all financial assets acting to some degree as a medium of exchange.

Q35. In the U.S., MONETARY POLICY refers to _____

A. the management of money and interest rates.  
B. oversight of the printing and security of U.S. currency.  
C. insuring of bank deposits and imposition of restrictions on the assets banks can hold.  
D. oversight of the federal chartering of commercial banks and savings and loan associations.

Q36. In the U.S. monetary policy is conducted by _____

A. the Securities Supervision and Accountancy Board.  
B. the Federal Deposit Insurance Corporation.  
C. the Federal Reserve.  
D. the Securities and Exchange Commission.
Q37. Which of the following typically take the form of FIXED-PAYMENT LOANS:

A. Simple loans.
B. 30-year residential mortgages.
C. Newly issued corporate bonds.
D. All of the above.
E. Only A and B.

Q38. Which of the following are instances of DISCOUNT (ZERO COUPON) BONDS:

A. Simple loans.
B. 15-year residential mortgages.
C. Treasury bills.
D. Treasury strips.
E. Both C and D.

Q39. The COUPON RATE on a coupon bond with a purchase price of $80, a $100 face value, annual coupon payments of $10, and a 2-year maturity is defined to be _____

A. the coupon payment $10 divided by the face value $100.
B. total coupon payments $20 divided by the maturity 2.
C. the coupon payment $10 divided by the purchase price $80.
D. one coupon payment per year.

Q40. For a coupon bond, its purchase price is _____ than its face value if and only if its coupon rate is _____ than its yield to maturity.

A. greater; less
B. less; greater
C. less; less
D. none of the above.
Q41. Letting * denote multiplication, if the annual interest rate is 3%, the PRESENT VALUE of a payment stream ($50, $0, $0, $30) with $50 to be received at the end of the first year and $30 to be received at the end of the fourth year is _____

A. $50 \ast (1 + 0.03) + $30 \ast (1 + 0.03)^4$
B. $50/(0.03) + $30/(0.03)^4$
C. $50/(1 + 0.03) + $30/(1 + 0.03)^4$
D. $[50 \ast (1 + 0.03)] + [30 \ast (1 + 0.03)^4]/4$

Q42. The (ANNUAL) YIELD TO MATURITY on a 3-year COUPON BOND with a purchase price $450, a face value $500, and a 3-year coupon payment stream ($30,$40,$50) is the annual interest rate $i$ that, when used for discounting, yields _____

A. a present value for ($30,$40,$50) that is equal to $500.
B. a present value for ($30,$40,$550) that is equal to $450.
C. a present value for ($30,$40,$550) that is equal to $500.
D. a present value for ($30,$40,$50) that is equal to $450.

Q43. Smart investors need to understand the distinction between the YIELD TO MATURITY on a financial asset and its RETURN RATE because _____

A. the yield to maturity ignores capital gain or loss that might accrue to an investor who sells a financial asset prior to maturity.
B. the return rate for any given holding period takes into account capital gain or loss over the holding period as well as payments over the holding period.
C. the return rate calculated for a holding period less than the financial asset’s maturity fully takes into account all remaining payments until maturity.
D. All of the above.
E. Only A and B.

Q44. Consider a coupon bond with an annual coupon payment C = $100, a face value F = $3,000, and a maturity date 1/1/2014. Suppose you BUY this bond on 1/1/2011 for Pb = $2500 and you SELL it one year later on 1/1/2012 for $3050. Which of the following statements are TRUE for this transaction:

A. Your current yield is C/Pb.
B. Your return rate from 1/1/2011 to 1/1/2012 is your current yield plus the rate of your capital gain or loss.
C. Your return rate is MORE than your current yield.
D. All of the above are true.
E. Only A and B are true.
Q45. Letting \( i \) denote the yield to maturity on coupon bonds, which situation below should a rational LENDER prefer to be in if he is planning to purchase a newly issued coupon bond?

A. \( i = 2 \) percent and the expected inflation rate = -2 percent  
B. \( i = 12 \) percent and the expected inflation rate = 10 percent  
C. \( i = 8 \) percent and the expected inflation rate = 9 percent  
D. \( i = 6 \) percent and the expected inflation rate = 1 percent

Q46. Suppose you bought a bond B one year ago whose maturity date is one year from now. Let \( i \) denote the yield to maturity on B today. Then an INCREASE in \( i \) today results in a _____ in the return rate to B over the past year because it implies a _____ in the bond’s market price today.

A. increase; decrease  
B. increase; increase  
D. decrease; increase  
E. decrease; decrease

Q47. Interest and principal payments for TREASURY INFLATION PROTECTION SECURI-
TIES (TIPS) are adjusted for _____, which implies that _____.

A. changes in default risk; TIPS earn a constant real interest rate.  
B. changes in the inflation rate; TIPS can be bought and sold at a fixed (pegged) price.  
C. changes in the price level; the interest rate on TIPS provides a direct measure of the real interest rate.  
D. changes in the money supply; TIPS help government to ensure a balanced budget.

For the final three questions below, please refer to the bond table presented in Figure 1 on the final page of this packet.

Q48. Referring to the Treasury bonds and notes data presented in Figure 1, below, which of the following statements are TRUE:

A. These data support the claim that dealers handling secondary T-bond/note trades attempt to make profits by selling high and buying low.  
B. These data illustrate the fact that the coupon rate of a coupon bond is less than the yield to maturity for the bond if and only if the purchase price of the bond is less than the bond’s face value.  
C. These data illustrate the fact that Treasury bonds and notes all have maturities of one year or less.  
D. All of the above.  
E. Only A and B.
Q49. Referring to the Treasury bills data presented in Figure 1, below, which of the following statements are TRUE:

A. The coupon rates for the listed T-bills cannot be computed because the T-bill data do not report these coupon rates.
B. The BID and ASK columns for the T-bill data give discount yields using the price bid by buyers and the price asked by sellers, respectively.
C. Dealers had a negative profit margin (ask price less than bid price) for T-bills with maturity on Feb 02 06.
D. All of the above.
E. Only B and C.

Q50. Referring to the corporate bond data presented in Figure 1, below, which of the following statements are TRUE:

A. For Tyco International Group bonds, the latest purchase price (as of 1/12/2006) was greater than the face value.
B. These corporate bond data are in conflict with the claim that — for any given coupon bond — the price of the bond moves in the opposite direction to its yield.
C. These corporate bond data are consistent with the claim that longer-maturity corporate bonds entail greater interest rate risk.
D. All of the above.
E. Only A and C.
(a) Treasury bonds and notes

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<th>Chg.</th>
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(b) Treasury bills

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(c) New York Stock Exchange bonds

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<th>Est $ Vol (000's)</th>
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</tbody>
</table>


Volume represents total volume for each issue; price/yield data are for trades of $1 million or greater. *Estimated spreads, in basis points (100 basis points = one percentage point), over the 2, 3, 5, 10, or 30-year Treas bond. 2-year: 4.375 12/07; 3-year: 4.375 11/08; 5-year: 4.375 12/10; 10-year: 4.500 11/15; 30-year: 5.375 02/31. Comparable U.S. Treasury issue.

Source: MarketAxess Corporate BondTicker

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Figure 1: Wall Street Journal Bond Table (January 12, 2006)
Answers to Multiple Choice Questions

Q1-B,
Q2-B,
Q3-D,
Q4-A,
Q5-C,
Q6-C,
Q7-D,
Q8-A,
Q9-B,
Q10-B,

Q11-B,
Q12-C,
Q13-D,
Q14-A,
Q15-A,
Q16-A,
Q17-D,
Q18-E,
Q19-A,
Q20-D,

Q21-C,
Q22-B,
Q23-E,
Q24-B,
Q25-B,
Q26-D,
Q27-B,
Q28-A,
Q29-C,
Q30-B,

Q31-C,
Q32-B,
Q33-E,
Q34-C,
Q35-A,