

ANSWER OUTLINE

ECONOMICS 353

MIDTERM EXAM 2: 50 Questions (1 Point Each)

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1 November 2007

Please write on side 1 of your answer bubble sheet your FIRST AND LAST NAME together with your STUDENT ID NUMBER, and write ECON 353: SECOND MIDTERM EXAM on the top margin of side 1. Answer all 50 questions below by marking answers on your answer bubble sheet using a number 2 pencil **ONLY**. Each question is worth 1 point. Read each question carefully before answering.

Questions Q1-Q10 stress required materials related to the FIRST midterm exam, questions Q11-Q19 stress required materials related to Mishkin Chapter 4:Part B, questions Q20-Q25 stress required materials related to Mishkin Chapter 5, questions Q26-Q31 stress required materials related to Mishkin Chapter 7:Part A, questions Q32-Q37 stress required materials related to Mishkin Chapter 7:Part B, questions Q38-Q44 stress required materials related to Mishkin Chapter 17, and Q45-Q50 focus on Web browse questions discussed in class that appeared in the web browse portions of the assigned take-home exercises and/or in the lists of Key In-Class Discussion Questions for each Mishkin chapter.

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.

****OPPORTUNITY TO COMMENT ON QUESTIONS:**** If you wish to comment on a question you believe is unclear or ambiguous, please 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.

Q1. By definition, a REAL value is

- A.** a value measured in actual as opposed to predicted prices.
- B.** the average value of a quantity over time.
- C** **C.** a value corrected for changes in prices.
- D.** the actual sales price of an item as opposed to its advertised value.

Q2. The U.S. GDP DEFLATOR for year 2007 is a measure of

- A** **A.** the average dollar price of the goods and services included in U.S. GDP in 2007.
- B.** the inflation-adjusted value of the U.S. nominal GDP level in 2007.
- C.** the average price of all consumption goods sold in the U.S. in 2007
- D.** the value of a basic basket of goods and services bought by a typical U.S. urban household in 2007.

Q3. According to time series data presented in Mishkin (Chapter 1) and in class (Economagic charts):

- A.** U.S. stock prices increased dramatically between 1980 and 1999.
- B.** the U.S. inflation rate has been persistently positive since 1960.
- C.** the U.S. government budget has been in deficit for much of the time since 1960.
- D** **D.** All of the above.
- E.** None of the above.

Q4. Which of the following markets are organized as OVER-THE-COUNTER markets:

- A.** the New York Stock Exchange
- B.** the Chicago Board of Trade (CBOT)
- C** **C.** the Foreign Exchange Market
- D.** All of the above.
- E.** None of the above

Q5. The _____ conducts INITIAL PUBLIC OFFERINGS of U.S. government securities through _____.

- A.** New York Stock Exchange; advertisement of dealer bid/ask quotes in newspaper bond tables.
- B.** Security Exchange Commission; an over-the-counter market.
- C** **C.** U.S. Treasury; auction markets.
- D.** Federal Reserve System (the “Fed”); open-market operations.

Q6. By definition, instances of INDIRECT FINANCE include the following types of situations:

- A.** Last National Bank buys commercial paper in a secondary market.
- B** **B.** An insurance company uses premiums received from its policy holders to purchase stock shares newly issued by Scamaday Inc.
- C.** You buy euros on the Foreign Exchange Market for a future planned European vacation.
- D.** The Fed engages in an open-market operation in which it buys back U.S. Treasury bonds from the U.S. private sector.
- E.** None of the above.

Q7. Which of the following statements is TRUE BY DEFINITION:

- A.** Legal tender is any unbacked paper currency that is legally enforced as a medium of exchange.
- B.** Legal tender is any money whose supply is legally monopolized by a government.
- C.** Legal tender is anything generally accepted for the payment of goods and services and for the repayment of debts.
- D** **D.** Legal tender is anything that must be accepted in repayment of debts, as a matter of law.

Q8. As stressed in class discussions of Mishkin Chapter 3, open-market operations are

- A.** the normal way the Federal Reserve Board attempts to manipulate and control the money supply and short-term interest rates.
- B.** sales and purchases of government bonds to and from the private sector by the Federal Reserve Board.
- C.** open auctions conducted by the Federal Reserve Board to sell newly issued government bonds.
- D.** changes in the Federal Funds Rate implemented by the Federal Reserve Board through revised borrowing contracts with banks.
- E** **E.** both A and B.

Q9. If U.S. citizens sell some of their U.S. Treasury bond holdings and subsequently use their bond sale receipts to purchase money market mutual fund shares, then

- A. M1 and M2 both stay the same.
- B. M1 increases and M2 stays the same.
- C **C.** M1 stays the same and M2 increases.
- D. M1 and M2 both increase.
- E. none of the above.

Q10. All else equal, if the time of receipt of a future \$100 payment is delayed, the present value of this payment ____.

- A. is not affected.
- B. increases.
- C **C.** decreases.
- D. could increase or decrease.

Q11. If a coupon bond with an \$8000 face value and a 5 year maturity has a \$400 coupon payment and a purchase price of \$10,000, then the CURRENT YIELD is

- A **A.** 4 percent
- B. 5 percent
- C. 8 percent
- D. 10 percent
- E. 20 percent

Q12. The ____ on an asset over a holding period is defined as the payments to the owner over the holding period plus the change in the asset's value over the holding period expressed as a fraction of the asset's purchase price.

- A. yield to maturity
- B **B.** return rate
- C. current yield
- D. capital gains (or losses)
- E. profit

Q13. Letting i denote the yield to maturity on coupon bonds, which situation below should a rational investor prefer to be in if he is planning to be a LENDER?

- 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

Q14. A key DISTINCTION between the YIELD TO MATURITY and the RETURN RATE on a financial asset is

- A. the yield to maturity assumes a financial asset will be held to maturity, whereas the return rate can be calculated for any holding period.
- B. the yield to maturity ignores capital gains or losses that might accrue to an investor who sells a financial asset prior to its maturity, whereas the return rate does not.
- C. the return rate corrects for changes in prices (purchasing power) whereas the yield to maturity does not.
- D**. all of the above.

E E. Only A and B above.

Q15. Consider a coupon bond with an annual coupon payment $C = \$100$, a face value $F = \$3,000$, and a maturity date January 1, 2012. Suppose you BUY this bond on January 1, 2007 for \$2500 and you SELL it on January 1, 2008 for \$3000. Which of the following statements are TRUE for this bond:

- A. Your (annual) current yield is 0.04 (1/25).
- B. Your return rate 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.

Q16. Suppose a consol bond pays \$1.00 at 11:59 P.M. on December 31 of each year in perpetuity. Suppose you purchase the consol bond for \$100 at midnight on December 31, 2007, and you sell it for \$109 at midnight on December 31, 2008. Suppose the inflation rate during 2007 is 4 percent. Then your NOMINAL return rate on the consol bond for 2007 would be ____ and your REAL return rate on the consol bond for 2007 would be ____.

- A. 9 percent; 13 percent
- B**. 10 percent; 6 percent
- C. 10 percent; 14 percent
- D. 1 percent; 5 percent
- E. 9 percent; 5 percent

Q17 (1 point). Let B denote a bond whose maturity date is $T+1$, and let $i(T)$ denote the yield to maturity on B at time T . Then an INCREASE in $i(T)$ at time T results in a _____ in the return rate to B over the holding period from $T-1$ to T because it implies a _____ in the sale price of the bond at time T .

- A. increase; decrease
- B. increase; increase
- C. decrease; increase
- D** D. decrease; decrease

Q18. INTEREST RATE RISK is the risk faced by _____ in the form of _____.

- A. a person contemplating a bond purchase; fluctuations in the real interest rate on bonds.
- B** B. a person who has already bought a bond; uncertainty regarding fluctuations in the bond's yield to maturity during the holding period.
- C. a person who has issued and sold a bond; fluctuations in the interest payments the bond issuer will have to make to the bond purchaser.
- D. a person who is contemplating the issue and sale of a bond; fluctuations in the nominal interest rate on bonds.

Q19. The U.S. TREASURY STRIPS seen reported in bond tables in major newspapers

- A. are a major financial innovation introduced by Merrill Lynch in 1982.
- B. were designed to help monetary policy makers have a way of measuring the real interest rate.
- C. are formed by separating ("stripping") coupon bonds into several separate zero-coupon bonds, one for the face value payment and one for each coupon payment.
- D. all of the above.
- E** E. only A and C.

Q20. The DEMAND CURVE for bonds in a PRIMARY bond market describes

- A. the planned bond sales of lenders at each price.
- B** B. the planned bond purchases of lenders at each price.
- C. the planned bond sales of borrowers at each price.
- D. the planned bond purchases of borrowers at each price.

Q21. Key factors that are likely to cause the SUPPLY curve for bonds to shift RIGHT (more bonds supplied for each bond price P) include

- A. higher government deficits.
- B. an increase in the expected profitability of capital investment
- C. a decrease in the expected inflation rate.
- D. all of the above
- E. only A and B.

Q22. Key factors that are likely to cause the DEMAND curve for bonds to shift RIGHT (more bonds demanded for each bond price P) include

- A. an increase in the expected inflation rate.
- B. a decrease in default risk
- C. an increase in the expected profitability of capital investment.
- D. all of the above.
- E. only A and C.

Q23. When the price of bonds is ABOVE the equilibrium price level, then there is an _____ bonds and the price of bonds can be expected to _____.

- A. excess demand for; fall
- B. excess supply of; fall
- C. excess demand for; rise
- D. excess supply of; rise

Q24. If the Fed Chairman Ben Bernanke suddenly makes a credible announcement that the YIELD TO MATURITY on bonds will be LOWER a year from now than previously expected, the theory in Mishkin Chapter 5 predicts (all else equal) that this will lead people to _____ because _____.

- A. demand fewer bonds today; they now expect a lower bond price a year from now, leading to lower expected capital gains.
- B. supply more bonds today; they now expect lower bond price a year from now, leading to higher expected capital gains.
- C. supply more bonds today; they now expect a higher bond price a year from now, leading to lower expected capital gains.
- D. demand more bonds today; they now expect a higher bond price a year from now, leading to higher expected capital gains.

Q25 (1 Point). If the Fed Chairman Ben Bernanke suddenly makes a credible announcement today that the INFLATION RATE will be LOWER a year from now than previously expected, the theory in Mishkin Chapter 5 predicts (all else equal) that this should lead in today's bond market to ____ in the equilibrium price of bonds and ____ in the equilibrium quantity of bonds sold.

- A** A. a definite rise; an ambiguous change
- B. an ambiguous change; a definite rise
- C. a definite fall; an ambiguous change
- D. a definite fall; a definite rise
- E. a definite rise; a definite fall

Q26. Major DIFFERENCES between the Nasdaq stock market and the New York Stock Exchange (NYSE) Euronext stock market include:

- A.** the Nasdaq is structured as an over-the-counter market while the NYSE Euronext is not.
- B. the Nasdaq permits electronic trading while the NYSE Euronext does not.
- C. the Nasdaq is heavily tilted towards technology stocks while the NYSE Euronext is not.
- D. all of the above.
- E** E. Only A and C.

Q27. BEHAVIORAL finance supports the view that

- A.** stock prices are largely determined by the effects of the behavior of company managers on fundamental company financial conditions.
- B. stock prices are strongly affected by group behavioral factors such as fads and the spread of rumors.
- C. stock prices often exhibit price bubbles.
- D. all of the above.
- E** E. both B and C.

Q28. According to the FUNDAMENTAL view of stock valuation, the primary determinant of the share price of a company's stock is

- A.** the general public consensus regarding the current profitability of the company.
- B. the profitability of the company over its past history.
- C** C. the expected future profitability of the company.
- D. the expected default risk associated with the company.

Q29 (1 Point). By definition, a PRICE BUBBLE is said to exist on an asset if

- A. the price of the asset exhibits high volatility over time.
- B. the price of the asset differs from the discounted value of the asset's expected future payments.
- C. the price of the asset has sharply increased over the past few periods and is now suddenly in sharp decline.
- D. the current price of the asset is higher than the average current asset price.

Q30. In the absence of a price bubble, the GENERALIZED DIVIDEND (VALUATION) MODEL described by Mishkin (Chapter 7) predicts that the share price of a stock will be equal to

- A. the discounted value of the expected future dividend payments to the shareholder.
- B. next period's expected dividend payment divided by the required return on equity net of the dividend growth rate.
- C. the expected future revenues (per shareholder) of the issuing corporation.
- D. the present value of expected future profits (per shareholder) of the issuing corporation.

Q31. The Gordon Growth Model predicts the price of a stock share will DECREASE if

- A. its dividend growth rate DECREASES.
- B. its current dividend DECREASES.
- C. its required return on equity DECREASES.
- D. all of the above.

E. only A and B.

Q32. The theory of RATIONAL EXPECTATIONS assumes that

- A. the forecasts of rational people are always correct.
- B. rational people cautiously adjust their expectations in small incremental steps as new information becomes available to them.
- C. rational people form their price expectations as optimal weighted averages of past price observations.
- D. rational people make optimal use of whatever information they have in forming their expectations.

Q33. In its strongest form (as presented in Mishkin Chapter 7), the EFFICIENT MARKET HYPOTHESIS implies

- A. stock share prices continually adjust to ensure market equilibrium (demand equals supply).
- B. the price of each stock share equals the discounted value of its expected future dividend payments.
- C. all investors have (strong form) rational expectations.
- D. all of the above.
- E. only B and C.

Q34. In its strongest form (as presented in Mishkin Chapter 7), the EFFICIENT MARKET HYPOTHESIS implies that

- A. there are no price bubbles on stock shares.
- B. security prices never fall in response to good news.
- C. published reports of financial analysts are crucially important for investors to acquire and study carefully.
- D. buy and hold is NOT a rational investment strategy.
- E. all of the above.

Q35. Early evidence in FAVOR of the Efficient Market Hypothesis included

- A. evidence that stock prices reflected all insider information even if not available to the public at large.
- B. evidence that announcements confirming previously anticipated events resulted in substantial movements in stock prices.
- C. evidence that technical analysis (predicting future prices on the basis of past price patterns) was unable to persistently beat the market.
- D. evidence that all price bubbles were rational.

Q36. Later evidence (“anomalies”) UNFAVORABLE to the Efficient Market Hypothesis included

- A. evidence that insider trading based on information not available to the public at large could be profitable.
- B. evidence that technical analysis (predicting future prices on the basis of past price patterns) was unable to persistently beat the market.
- C. evidence that stock prices could fall after the receipt of good news.
- D. evidence of excessive fluctuation in stock market prices relative to the fluctuations in their dividend payment streams.

Q37. In financial economics, an ARBITRAGE OPPORTUNITY is said to exist if

- A.** regulators are able to increase social welfare by suitably applied rules and regulations.
- B.** a conflict arising between traders can be resolved by an arbitration process.
- C** **C.** starting from nothing, people are able to engage in a sequence of transactions from which they can earn positive profits for sure.
- D.** investors have a chance to increase their profits by investing in projects with high expected returns.

Q38. The assumption that people exploit all available profit opportunities is frequently used in financial economics to derive conditions for prediction purposes. Examples of such conditions include:

- A.** bond market equilibrium (demand=supply) for prediction of movements in bond prices and quantities of bonds bought and sold.
- B.** purchasing power parity for prediction of movements in exchange rates and inflation rates.
- C.** interest parity for prediction of movements in exchange rates and interest rates.
- D** **D.** all of the above.
- E.** only B and C.

Q39. If the euro-U.S.\$ nominal exchange rate changes from 0.80 euros per U.S.\$ to 1.43 euros per U.S.\$, then

- A.** the euro has appreciated and the U.S.\$ has depreciated
- B.** the euro has appreciated and the U.S.\$ has appreciated
- C** **C.** the euro has depreciated and the U.S.\$ has appreciated
- D.** the euro has depreciated and the U.S.\$ has depreciated

Q40. In a two-country world divided between HC and ROW, in order to OFFSET an APPRECIATION of HC currency, the HC central bank could ____ HC currency in the Foreign Exchange Market, which would tend to shift ____.

- A** **A.** sell; the supply curve for HC currency to the right
- B.** sell; the demand curve for HC currency to the right
- C.** buy; the demand curve for HC currency to the right
- D.** sell; the supply curve for HC currency to the left
- E.** buy; the demand curve for HC currency to the left

Q41. Given a world divided between HC and ROW, the HC REAL EXCHANGE RATE measures

- A A.** the price of HC output in terms of ROW output (a goods-for-goods price).
- B.** the difference in inflation rates between ROW and HC.
- C.** the relative size of net exports in the ROW versus the HC.
- D.** the relative amount of currency in the ROW versus the HC.

Q42. Given a world divided between HC and ROW, the PURCHASING POWER PARITY (PPP) CONDITION asserts

- A.** the HC and ROW have the same aggregate price levels.
- B.** the HC and ROW have the same inflation rates.
- C C.** the HC real exchange rate is equal to one.
- D.** the HC nominal exchange rate equals the ROW nominal exchange rate.

Q43. The basic motivation for the PURCHASING POWER PARITY (PPP) CONDITION is that, in equilibrium, there should be no opportunities for arbitrage ____.

- A.** through currency swaps between HC and ROW.
- B.** through financial asset trades between HC and ROW.
- C.** through HC speculative investment in ROW stocks.
- D D.** through trades in goods and services between HC and ROW.

Q44. Given a world divided between HC and ROW, INTEREST PARITY asserts that ____.

- A.** interest rates in the HC and ROW are equalized by the profit-seeking activities of HC and ROW investors.
- B.** the HC savings rate must equal the ROW savings rate.
- C.** the demand and supply for HC bonds are equalized by the profit-seeking activities of HC and ROW lenders.
- D D.** the expected returns on HC and ROW deposit accounts are equalized by the profit-seeking activities of HC and ROW investors.

Q45. As covered in class discussions of Ex 2 (Q6), the CME Group formed in 2007 as a merger of the Chicago Board of Trade and the Chicago Mercantile Exchange specializes in part in *futures contracts*, which are

- A. contractual agreements to engage in spot trades at specified future dates.
- B. contractual agreements to sell agricultural commodities such as corn, oats, and soybeans at regular future intervals (e.g., after each yearly harvest).
- C. standardized transferable contracts that require delivery of a specified item at a specified price on a specified future date.
- D. speculative purchases of financial assets that offer the chance to earn high future returns at high risk.

Q46. As covered in class discussions of Exercise 3 (Q6), the Federal Deposit Insurance Corporation (FDIC) provides up to \$100,000 insurance per depositor per FDIC-insured bank. SUPPORTERS of this policy have argued

- A. it might increase the incentives of depositors to monitor the lending and investment activities of their banks, thus lessening moral hazard problems.
- B. it might decrease the need for banks to monitor the spending habits of their depositors, thus lessening transactions costs.
- C. it might increase the confidence of depositors in the safety of their deposits, thus lessening the chances of a bank panic.
- D. it might encourage banks to refrain from high risk lending, thus reducing adverse selection problems.

Q47. As discussed in class (Exercise 4, Q6), the holders of subprime mortgages are currently in serious trouble in the U.S. as a result of

- A. the persistently sharp rise in the price of new housing over the past year.
- B. a sharp rise in subprime mortgage payment delinquencies.
- C. a sharp rise in subprime mortgage payments in accordance with adjustable rate mortgage features.
- D. deceptive advertising by borrowers.

Q48. As discussed in class, behavioral financial economists such as Robert Shiller believe that a primary cause of the current subprime mortgage crisis is

- A. financial deregulation leading to increased moral hazard problems.
- B. irrational bank lending to unqualified borrowers.
- C. irrational exuberance that led to a price bubble on new housing starting around 1998 and bursting in 2005.
- D. the dot.com bubble burst in 2000.

Q49. As covered in class discussions of Exercise 5 (Q6), the “student loan scandal” uncovered this past Spring that has promoted corrective actions by the U.S. Congress is the fact that

- A. there is a very high default rate on student loans.
- B. some universities appear to have received “kick-backs” from private student loan providers for promoting the services of these loan providers to students.
- C. student loans are routinely forgiven, which has created a moral hazard problem.
- D. preferred treatment is given to participants in military service.

Q50. As detailed in the required Mishkin Chapter 1 reading “Measuring the Volatility of Stock Returns” (also required for Exercise 7), the volatility of a stock price P_t is typically measured quantitatively by calculating

- A. the frequency with which P_t moves up and down over short time periods.
- B. the sample standard deviation for the “stock return rate” $R_t = [\ln(P_{t+1}) - \ln(P_t)]$ over past time periods t , where \ln denotes “natural logarithm”.
- C. the average size of the fluctuations in P_t over past time periods t .
- D. the trend line exhibited by a time series plot of the “stock return rate” $R_t = [\ln(P_{t+1}) - \ln(P_t)]$ over past time periods t , where \ln denotes “natural logarithm”.