

ANSWER OUTLINE – ANSWERS AT END

ECONOMICS 353
MIDTERM EXAM 2: 50 Questions (1 Point Each)

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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: SECOND 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 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.
- Q2.** 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.
- Q3.** 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.
- Q4.** Which of the following markets are organized as OVER-THE-COUNTER markets:
- A. The Foreign Exchange Market
 - B. U.S. Treasury auctions.
 - C. The New York Stock Exchange.
 - D. All of the above.
 - E. Only A and B above.

- Q5.** 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.
- Q6.** 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.
- Q7.** 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.
- Q8.** 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.

- Q9.** 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.
- Q10.** 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.
- Q11.** For an economy with exactly 10 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. 90; 10
 - B. 45; 20
 - C. 90; 20
 - D. 20; 10
 - E. 45; 10
- Q12.** Which of the following typically take the form of FIXED-PAYMENT LOANS:
- A. Discount bonds
 - B. 30-year residential mortgages.
 - C. Treasury notes
 - D. All of the above
 - E. Only A and B above

- Q13.** 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.
- Q14.** 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,\$100) is the annual interest rate i that, when used for discounting, yields _____.
- A. a present value for (\$30,\$40,\$100) that is equal to \$500.
 - B. a present value for (\$30,\$40,\$600) that is equal to \$450.
 - C. a present value for (\$30,\$40,\$600) that is equal to \$500.
 - D. a present value for (\$30,\$40,\$100) that is equal to \$450.
- Q15.** 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.
- Q16.** Consider a coupon bond with an annual coupon payment $C = \$200$, a face value $F = \$4,000$, and a maturity date 1/1/2014. Suppose you BUY this bond on 1/1/2011 for $P_b = \$3000$ and you SELL it one year later on 1/1/2012 for \$3100. Which of the following statements are TRUE for this transaction:
- A. Your current yield is C/P_b .
 - 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.

- Q17.** 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
- Q18.** Which of the following statements are TRUE:
- A. Dealers handling secondary T-bond/note trades attempt to make profits by selling high and buying low.
 - B. 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. By definition, Treasury bonds and notes all have maturities of one year or less.
 - D. All of the above.
 - E. Only A and B.
- Q19.** The U.S. government agency that regulates security markets to ensure participants adhere to standard accounting principles and properly disclose information is _____
- A. the Securities Supervision and Accountancy Board.
 - B. the Federal Deposit Insurance Corporation.
 - C. the Federal Reserve.
 - D. the Securities and Exchange Commission.
- Q20.** Which of the following situations would a rational BORROWER prefer to be in:
- A. The nominal interest rate is 4 percent and the expected inflation rate is 4 percent.
 - B. The nominal interest rate is 2 percent and the expected inflation rate is 4 percent.
 - C. The nominal interest rate is 6 percent and the expected inflation rate is 3 percent
 - D. The nominal interest rate is 8 percent and the expected inflation rate is 6 percent.

- Q21.** In a SECONDARY BOND MARKET the ____ supply of bonds increases at HIGHER bond prices because ____.
- A. lenders'; the lenders anticipate they will receive higher interest payments.
 - B. sellers'; the sellers anticipate that they will receive higher interest payments.
 - C. borrowers'; the borrowers anticipate that their interest payments will be higher.
 - D. sellers'; the sellers receive a higher return rate on each bond sold.
- Q22.** If bonds are in EXCESS SUPPLY, then standard demand/supply theory predicts the current price of these bonds is ____.
- A. below equilibrium and will be bid upwards until demand equals supply.
 - B. above equilibrium and will be bid downwards until supply exceeds demand.
 - C. below equilibrium and will be bid upwards until demand exceeds supply.
 - D. above equilibrium and will be bid downwards until demand equals supply.
- Q23.** Suppose 15-year bonds are newly issued today. Suppose something suddenly happens that leads lenders today to have LOWER expectations concerning what the yield to maturity for these bonds will be ONE YEAR FROM NOW. Then one would expect to see the lenders' demand for bonds today ____ because they have ____.
- A. decrease; a lower expected capital gain over the coming year.
 - B. increase; a higher expected capital gain over the coming year.
 - C. decrease; a higher expected capital gain over the coming year.
 - D. increase; a lower expected capital gain over the coming year.
- Q24.** Suppose that, in response to a speech today by Fed Chairman Ben Bernanke, people now expect the INTEREST RATE (YTM) on bonds to INCREASE by the end of next year. The bond market theory presented in Mishkin Chapter 5 predicts (all else equal) that the most likely effect of this higher expected interest rate next year on the current bond market will be ____ equilibrium bond price and a ____ equilibrium quantity of bonds sold.
- A. a higher; lower
 - B. a lower; higher
 - C. an ambiguous effect on the; lower
 - D. a lower; lower

- Q25.** Suppose 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 bond market theory in Mishkin Chapter 5 predicts (all else equal) that the most likely effect of this lower expected inflation rate next year on the current bond market will be ____ in the equilibrium bond price and ____ in the equilibrium quantity of bonds sold.
- A. a rise; an ambiguous (uncertain) change
 - B. an ambiguous (uncertain) change; a rise
 - C. a fall; an ambiguous (uncertain) change
 - D. a fall; a rise
 - E. a rise; a fall
- Q26.** In the ONE-PERIOD VALUATION MODEL FOR STOCK SHARES, the current price of a stock share is assumed to equal the discounted value of _____.
- A. all future dividend payments to the shareholder
 - B. next period's dividend payment plus next period's expected share price.
 - C. next period's dividend payment to the shareholder.
 - D. next period's expected share price.
- Q27.** In the GENERALIZED STOCK VALUATION MODEL, the current price of a stock share is assumed to equal the discounted value of _____.
- A. all future dividend payments to the shareholder.
 - B. next period's dividend payment discounted by the required return on equity net of the dividend growth rate.
 - C. the future revenues of the issuing corporation.
 - D. the future profits of the issuing corporation.
- Q28.** By definition, a PRICE BUBBLE is said to exist for a stock if _____.
- A. the share price of the stock exhibits high volatility over time.
 - B. the current share price of the stock differs from the discounted value of its stream of future expected dividend payments.
 - C. the share price of the stock has sharply increased over the past few periods and is now suddenly in sharp decline.
 - D. the current share price of the stock is higher than the average current share price of all stocks.

- Q29.** If a corporation with a positive share price has not paid out any dividends to date, this indicates _____.
- A. the fundamental view of stock price determination is definitely refuted.
 - B. the behavioral finance view of stock price determination is definitely refuted.
 - C. the share price is a “price bubble” that will definitely burst soon.
 - D. investors could be expecting future dividend payments and/or a future appreciation in the stock share price.
- Q30.** Expectations formed by taking a weighted average of past observations are known as _____.
- A. perfect foresight expectations.
 - B. adaptive expectations.
 - C. extrapolated expectations.
 - D. rational expectations.
- Q31.** The key assumption characterizing RATIONAL EXPECTATIONS is that _____.
- A. people do not make sudden changes in their expectations.
 - B. people do not make use of past observations because these observations are out-of-date.
 - C. people make optimal use of their information when forming their expectations.
 - D. people are able to forecast things without error.
- Q32.** In its strongest form, the EFFICIENT MARKETS HYPOTHESIS implies _____.
- A. there is no adverse selection in financial markets.
 - B. the price of each stock share equals its fundamental value, i.e., the discounted value of its future dividend payments.
 - C. the prices of securities cannot exhibit sudden large changes.
 - D. technical analysis is the preferred mode for determining financial investments.

NOTE: Unless otherwise indicated, the questions below that are based on Mishkin Chapters 20-21 assume a two-country world consisting of HC (home country) and ROW (rest-of-the-world).

Q33. Multiplying an amount V of HC currency by the HC NOMINAL EXCHANGE RATE E _____.

- A. corrects V for changes in the HC price level.
- B. transforms V into an amount $V \cdot E$ of ROW currency.
- C. corrects V for changes in the HC inflation rate.
- D. transforms V into pure quantity terms

Q34. The HC REAL EXCHANGE RATE E_r measures _____.

- 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.

Q35. In 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. 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.

Q36. The basic motivation for the PURCHASING POWER PARITY (PPP) CONDITION is that, in equilibrium, there should be no opportunities for arbitrage arising from _____.

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

- Q37.** The PURCHASING POWER PARITY (PPP) CONDITION asserts _____.
- A. the GDP deflator P for the HC equals the GDP deflator P_{ROW} for ROW.
 - B. the HC and ROW have the same inflation rates.
 - C. the HC real exchange rate is equal to one.
 - D. the HC nominal exchange rate equals the ROW nominal exchange rate.
- Q38.** In order for the PPP CONDITION to reduce to a straightforward application of the Law of One Price, which of the following conditions need to hold?
- A. HC and ROW must produce the same bundle of goods and services.
 - B. Information about availability and prices of goods and services must be freely available to everyone in the HC and ROW, and there must not be any trade barriers between the HC and ROW.
 - C. The GDP deflator P for the HC and the GDP deflator P_{ROW} for ROW must equal each other over time.
 - D. All of the above.
 - E. Only A and B above.
- Q39.** The INTEREST PARITY CONDITION assumes that investors carefully consider _____.
- A. the risk of default for HC versus ROW deposit accounts.
 - B. the interest rate risk for HC versus ROW deposit accounts.
 - C. the possible gains or losses due to exchange rate movements while they are holding HC versus ROW deposit accounts.
 - D. the moral hazard risk associated with HC versus ROW deposit accounts.
- Q40.** Suppose the nominal interest rate in ROW is 7 percent. Suppose the HC nominal exchange rate is expected to DEPRECIATE by 3 percent. Then the INTEREST PARITY CONDITION predicts that the nominal interest rate in the HC should be _____.
- A. -4 percent
 - B. -10 percent.
 - C. 4 percent
 - D. 10 percent.

- Q41.** The HC CURRENT ACCOUNT CA keeps track of _____.
- A. net payments received by HC from ROW through financial asset trades.
 - B. HC net exports + net factor payments to the HC + net transfer payments to the HC
 - C. net payments received by HC from ROW through trades of pre-existing real assets.
 - D. net payments received by HC from ROW through reserve currency transactions.
- Q42.** Which item(s) below would be directly entered as items in the HC CURRENT ACCOUNT:
- A. A ROW citizen's purchase of HC Treasury bonds.
 - B. Foreign aid to ROW.
 - C. Purchases by ROW of cigars newly produced within the HC.
 - D. Interest payments received by HC holders of a ROW bond issue.
 - E. All but A.
- Q43.** An HC CURRENT ACCOUNT _____ indicates that ROW is INCREASING its net claims on HC assets because the HC is _____.
- A. deficit; a net lender to ROW.
 - B. surplus; a net borrower from ROW.
 - C. deficit; a net borrower from ROW.
 - D. surplus; a net lender to ROW.
- Q44.** Which of the following would directly INCREASE the size of the U.S. CURRENT ACCOUNT DEFICIT?
- A. A decline in U.S. household net interest income on U.S.-issued government bonds.
 - B. An increase in the amount of labor services purchased from Mexico.
 - C. An increase in foreign aid from the U.S. to Yemen.
 - D. All of the above.
 - E. Only B and C above.

NOTE: Questions Q45, Q46, and Q47 have been removed because they rely on older (now out of date) accounting conventions for the treatment of financial and secondary physical asset transactions in the U.S. Balance of Payments accounts.

- Q48.** The stock market index thought to be most representative of the U.S. stock market as a whole is the Standard & Poor's 500 Index because it is based on the common stocks of _____.
- A. the 500 largest "blue chip" U.S. companies
 - B. 500 high tech U.S. companies of varying sizes
 - C. 500 industrial, transportation, utility, and financial companies
 - D. 500 of the most profitable industrial companies

Q49. Europe has undergone major structural changes over the past 20 years. These changes include _____.

A. The creation of the *European Union (EU)*, an organization of European countries working gradually to unite European countries economically and politically.

B. The creation of a single *European Central Bank (ECB)* to replace the central banks of the EU member countries that have adopted the euro as their only legal-tender currency.

C. The creation of a single *European Political Region (EPR)* whose member countries have agreed to adopt a single constitution and a single governing Parliamentary body.

D. all of the above.

E E. only A and B above.

Q50. Currently one of the main purposes of the INTERNATIONAL MONETARY FUND (IMF) is _____.

A. to make loans to emerging countries for economic development purposes.

B B. to make loans to countries experiencing balance of payments problems.

C. to make loans to poor countries who lack collateral.

D. to make loans to countries experiencing government budget deficits.

Answers to Multiple Choice Questions

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

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

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

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

Q36-D,
Q37-C,
Q38-E,
Q39-C,
Q40-D,

Q41-B,
Q42-E,
Q43-C,
Q44-E,
Q45-A,
Q46-D,
Q47-B,
Q48-C,
Q49-E,
Q50-B