

## ANSWERS AT END

ECONOMICS 353

L. Tesfatsion/Spring Semester 2011

EXERCISE 3: Eight Questions (8 Pts Total)

DUE: Tues., February 1, 12:40pm

**\*\*PLEASE NOTE: EXERCISES ARE DUE AT THE BEGINNING OF CLASS ON THE DUE DATE. LATE EXERCISES WILL NOT BE ACCEPTED AFTER DISCUSSION OF ANSWERS HAS BEGUN – NO EXCEPTIONS\*\***

### EXERCISE INSTRUCTIONS:

- (1) Please **fill in your name and student ID number** on Side 1 of your bubble sheet and write **353 Exercise 3** in the top margin of Side 1.
- (2) Use a number 2 pencil to **mark your answers** on Side 1 of the bubble sheet to the multiple-choice questions Q1 through Q8 below.
- (3) Each question is worth 1 point. Questions Q1 through Q5 can be answered using required course materials for Mishkin Chapter 2:Part B. Questions Q5 through Q8 on “irrational exuberance” in U.S. stock markets leading up to the 2007-2009 financial crisis can be answered using the accompanying link to an online reading.

**Q1 (1 point).** A new incidence of BORROWING occurs whenever \_\_\_\_\_.

- A. the current owner of a financial asset sells this asset to someone else.
- B. a newly issued security is purchased by a party different from the issuer.
- C. a household receives funds from a bank under the terms of a new residential mortgage contract
- D. all of the above
- E. only B and C above

**Q2 (1 Point).** An example of DIRECT FINANCE is \_\_\_\_\_.

- A. China (PRC) sells some of its holdings of U.S. Treasury bonds in the U.S. government bond market
- B. You acquire a residential mortgage from Midwestern Bank
- C. Jipu.com sells newly issued stock shares in an initial public offering (IPO)
- D. You buy shares of Intel on the Nasdaq stock market.

**Q3 (1 Point).** Which of the following are SECONDARY markets.

- A. U.S. Treasury bill auctions conducted by the U.S. Treasury
- B. The Nasdaq stock market
- C. The U.S. government bond market conducted through dealers
- D. All of the above
- E. Only B and C

**Q4 ( 1 Point).** Suppose a person has a chance to use \$100 to buy either a debt instrument issued by Dewey, Cheetum, and Howe (DCAH) Corporation or common stock shares issued by DCAH. Specify which of the following statements is FALSE: \_\_\_\_\_.

- A. If DCAH remains solvent, the DCAH debt instrument holders will receive a known stream of payments as determined by their debt contracts.
- B. Purchasing the DCAH common stock shares is risky even if DCAH remains solvent, because the return rate obtained by holders of DCAH common stock shares depends on uncertain future share prices and dividend payouts.
- C. Purchasing the DCAH common stock shares is risky because, if DCAH goes bankrupt, the claims of DCAH debt instrument holders have first priority.
- D. In order to obtain higher net earnings, an investor should definitely choose the DCAH debt instrument over the DCAH common stock shares.

**Q5 (1 Point).** 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 is said to have \_\_\_\_\_.

- A. an adverse selection problem
- B. a free-riding problem
- C. a risk pooling problem
- D. a moral hazard problem
- E. a direct finance problem

**SEE THE FOLLOWING PAGE FOR Q6-Q8.**

**Q6-Q8: Questions on “irrational exuberance” in the U.S. stock market leading up to the 2007-2009 financial crisis.** Please use the following required online reading to answer Q6-Q8 below.

\*\* [1] Excerpts (Preface, Chapter 1) from Robert J. Shiller, *Irrational Exuberance*, Princeton University Press, Second Edition, 2005.

[www.econ.iastate.edu/classes/econ353/tesfatsion/IrrationalExuberanceExcerpts.RShiller2005.pdf](http://www.econ.iastate.edu/classes/econ353/tesfatsion/IrrationalExuberanceExcerpts.RShiller2005.pdf)

**Q6 (1 Point).** According to Ref.[1], the expression “IRRATIONAL EXUBERANCE” first used in 1996 by Alan Greenspan (then-chairman of the Federal Reserve Board) has become a useful term for describing \_\_\_\_.

- A. the unreasonable optimism of inexperienced young investors first entering into stock market transactions.
- B. the ill-informed trading activities of “technical” stock investors who do not adhere to the efficient market hypothesis.
- C. a situation in which market prices have been bid up to unusually high and unsustainable levels under the influence of market psychology.
- D. the poorly-timed trading activities of traders who do not sufficiently understand and participate in ongoing market trends regarding the purchases and sales of particular stocks.

**Q7 (1 Point).** The PRICE-EARNINGS RATIO depicted in Fig. 1.3 in Ref.[1] is calculated for each January of each year as the ratio of \_\_\_\_.

- A. the base-year U.S. aggregate price level to U.S. gross national income
- B. the real (inflation-corrected) S&P Composite Stock Price Index to U.S. gross domestic product
- C. The base-year U.S. aggregate price level to a moving average of real S&P Composite earnings
- D. the real (inflation-corrected) S&P Composite Stock Price Index to a moving average of real S&P Composite earnings

**Q8 (1 Point).** As depicted in Fig. 1.3 of Ref.[1], on March 24, 2000 the PRICE-EARNINGS RATIO for the stocks represented in the S&P Composite Index reached an historically high level of 47.2. According to Ref.[1], this historically high level was PRIMARILY a reflection of \_\_\_\_\_.

- A.** the extraordinary surge during 1982-2000 in labor productivity for the U.S. corporations whose stocks were included in the S&P Composite Index
- B.** the extraordinary increase during 1982-2000 in the prices of the stocks included in the S&P Composite Index, a speculative bubble driven strongly by market psychology (“animal spirits”)
- C.** the extraordinary change during 1982-2000 in dividend earnings for the stocks included in the S&P Stock Index
- D.** the extraordinary decline in the interest rate on long-term government bonds during 1982-2000
- E.** the extraordinary increase in the net earnings of the corporations whose stocks were included in the S&P Composite Index, due to fundamental changes in the U.S. economy (e.g., the surge in Internet usage)

**Multiple Choice Answers: Q1-E, Q2-C, Q3-E, Q4-D, Q5-A, Q6-C, Q7-D, Q8-B**