VERSION C ANSWER KEY – ANSWERS IN TEXT

ECONOMICS 353 **L. Tesfatsion/Fall 2011**

MIDTERM EXAM 2-VERSION C: 50 Questions (1 Point Each) **10 March 2011**

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 - VERSION C.

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. In his summary overview of the U.S. financial crisis of 2007-2009, Charles Jones (Ex 1 required reading) stresses that the growing percentage of ______ in the portfolios of financial institutions prior to 2007 resulted in a ______

A. stock shares; speculative bubble on stock share prices due to market psychology ("animal spirits").

B **B.** derivative financial instruments based on subprime residential mortgages; high level of systemic (aggregate) risk because the values of all of these assets depended on U.S. housing prices continuing to rise.

C. long-term government bonds; debt crisis due to the inability of the U.S. government to sell more bonds.

D. corporate commercial paper; moral hazard problem because the corporations were not being adequately monitored in order to detect and prevent undesirable behaviors that could increase default risk.

Q2. As discussed in the required readings for Ex 5 (Q6-Q8), key criticisms of the two "Government Sponsored Enterprises" (GSEs) Fannie Mae and Freddie Mac prior to their takeover by the U.S. government in 2008 included: _____

A. During the housing boom leading up to 2007, these GSEs lowered their standards for loan purchases in order to increase their share of the profits flowing from subprime mortgage lending.

B. The special credit lines these GSEs had with the U.S. Treasury gave them an unfair advantage relative to strictly private firms in the mortgage securities business.

C. It is estimated that the interest rates of residential mortgage borrowers were about 1/4% higher than they would have been in the absence of the GSEs.

D. All of the above.

E **E.** Only A and B above.

Q3. According to the bond market theory in Mishkin Chapter 5, all else equal, the Fed's decision to BUY $600 billion in long-term U.S. Treasury bonds from private-sector investors as part of its QE2 initiative should _____

A. lower the market price of these bonds, hence lower their yield-to-maturity.

B **B.** increase the market price of these bonds, hence lower their yield-to-maturity.

C. lower the market price of these bonds, hence increase their yield-to-maturity.

D. increase the market price of these bonds, hence increase their yield-to-maturity.

Q4. According to the required readings for Ex 7 (Q6-Q8), a SOCIAL GRAPH or (SOCIAL NETWORK) is ____

A. a model of a society's major transportation systems in which each key transportation hub is a node (point) and transport routes between hubs are indicated by lines linking their nodes.

B. a model of a society's major trade relationships in which each trader is a node (point) and goods exchanges between traders are represented by lines linking their nodes.

C. a model of a society's major kinship relationships in which each person is represented as a node (point) and the kin of a person are indicated by lines linking the person to his/her ancestors and descendants.

D D. a model of the social relationships among people in a society in which each person is represented as a node (point) and a social relationship between two people is indicated by a line linking their nodes.

Q5. Which of the following items WOULD be counted as part of U.S. Gross Domestic Product (GDP) in 2011: ____

A. your 2011 purchase of an Apple iPad 2 produced (manufactured) in China in 2011.

B B. the 2011 purchase by a British citizen of a battery produced in 2011 by Douglas Battery Inc. in North Carolina (U.S.) as a replacement battery for his Apple iPad 2.

C. Douglas Battery Inc.'s purchase in 2011 of plastic casings from the U.S. Plastic Corporation in Ohio (U.S.) for the production of its batteries for the Apple iPad 2.

D. your 2011 purchase of a battery produced in 2010 by Douglas Battery Inc. as a replacement battery for your Apple iPad 2.

Q6. The REAL GDP for an economy during any time period T is a measure of ____

A A. the size of the economy during T.

B. the growth of the economy during T.

C. the strength of the economy's currency during T.

D. the trade balance of the economy during T.

Q7. According to U.S. time series data presented in Mishkin (Chapter 1) and Empirical Data Packet #1, the ____ closely tracks short-term interest rates, such as the interest rate on 1-month Treasury bills.

A. interest rate on 15-year corporate bonds

B B. Federal funds rate

C. interest rate on 30-year mortgages

D. post-1980 growth rate of the money supply (M1)

Q8. As discussed in class in relation to Empirical Data Packet #2, a major concern of U.S. government policy makers is that over half of the U.S. Federal spending contributing to the current U.S. federal deficit _____

A. is in the form of questionable foreign aid.

B. is in the form of discretionary spending (i.e., spending that can be changed by Congressional appropriations bills, such as the budget for the Department of Defense)

C C. is in the form of mandatory spending (i.e., spending required by law, such as medicare, medicaid, and social security benefit entitlements).

D. has been shown to be due to corruption and inefficient management practices.

Q9. 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 D. dealers post bid and asked prices whereas brokers do not.

Q10. Types of FINANCIAL INTERMEDIARIES include _____

A. credit unions.

B. pension funds.

C. mutual funds.

D D. all of the above.

E. only A and B above.

Q11. A key type of financial player that underwrites corporate bonds in PRIMARY markets is _____

A. a savings and loan officer.

B B. an investment banker.

C. a commercial banker.

D. a specialized trader on a stock exchange.

E. a Securities and Exchange Commissioner.

Q12. Which of the following are SECONDARY markets: _____

- **A.** Auction markets conducted by the U.S. Treasury for U.S. Treasury bills.
- **B.** The New York Stock Exchange.
- **C.** The foreign exchange market.
- **D.** The over-the-counter market for U.S. government bonds
- **E E.** Only B, C, and D above

Q13. EQUITY instruments are traded in _____

- **A.** bond markets.
- **B B.** capital markets.
- **C.** money markets.
- **D.** commodities markets.

Q14. By definition, SECURITIES are financial assets _____

- **A.** that have been approved for sale by the Federal Reserve Board.
- **B.** whose earnings have been underwritten ("made secure") by some government agency.
- **C C.** that have been transformed into relatively liquid marketable assets by means of various legally enforceable guarantees.
- **D.** that have received at least a BBB rating under the Standard & Poor rating system.
- **E.** whose market value is derived from some underlying pool of financial assets that have been packaged together and sold in the form of shares.

Q15. Which of the following statements are TRUE: _____

- **A A.** The maturity of a financial asset is the length of time to the financial asset's expiration date.
- **B.** A U.S. Treasury bill has a maturity between one and ten years.
- **C.** A stock share has a maturity of one year.
- **D.** All of the above statements are true.
- **E.** Only A and B above.

Q16. By definition, instances of INDIRECT FINANCE include _____.

A. You loan your classmate $100 for one year at 3% interest.

B B. You take out a loan at the First National Bank.

C. You buy a newly issued share of Google.

D. You purchase a share of the McDonald Corporation on the New York Stock Exchange.

E. All of the above.

Q17. The main purpose of the disclosure requirements of the Securities and Exchange Commission (SEC) is _____

A. to prevent bank panics.

B B. to increase the information available to investors engaging in securities trades.

C. to improve the ability of monetary policy authorities to control the economy.

D. to insure investors in securities against financial losses.

E. to discourage investors from investing in securities.

Q18. If the U.S. aggregate price level were to DECREASE by 50%, then (all else equal) the real value of a dollar would _____

A A. double (increase by 100%).

B. decrease by 50 percent.

C. more than double.

D. increase by 50%.

E. none of the above.

Q19. The use of a pure barter system in place of a pure monetary payment system tends to DECREASE efficiency because _____

A. it encourages people to specialize in the production of goods for which they have a comparative advantage.

B. it increases the number of prices needed to support trading (assuming the economy has four or more tradeable goods).

C. it increases the need to rely on "double coincidence of wants".

D. all of the above.

E E. only B and C above.

Q20. Which of the following statements about FIAT MONEY are TRUE: _____

A. fiat money is backed, i.e., it is collateralized by some precious commodity.

B B. fiat money is legal tender – i.e., by law, citizens must accept it as repayment for debts.

C. fiat money must necessarily be issued by a government.

D. all of the above.

E. only B and C above.

Q21. Economists have no single precise MEASURE of money because _____

A. the money supply data supplied by private commercial banks is confidential information (not to be released publicly), by law.

B. the Federal Reserve System does not allow the public release of money supply data on the grounds that this release would encourage speculative trading.

C C. the "moneyness" (liquidity) of an asset is a matter of degree.

D. economists are sharply divided on ideological grounds about the definition of "money."

Q22. Which of the following financial assets ARE included in the M1 measure of the U.S. money supply: _____

A. checkable deposit accounts at banks.

B. currency.

C. money market mutual fund shares.

D. small-denomination time deposits.

E E. only A and B.

Q23. If a private U.S. investor BUYS a newly issued 30-year U.S. Treasury bond from the U.S. government in return for currency, then _____

A. M1 stays the same and M2 decreases.

B. M1 decreases and M2 stays the same.

C. M1 increases and M2 increases.

D D. M1 decreases and M2 decreases.

E. M1 increases and M2 decreases.

Q24. Under the terms of a COUPON BOND, the borrower agrees to pay the lender _____

A. a periodic fixed payment until a specified maturity date, where the fixed payment includes both principal and interest.

B. the face value of the bond plus principal, both at the maturity date.

C C. a periodic coupon payment until a specified maturity date, plus the face value of the bond at the maturity date.

D. only one payment, the face value of the bond at the maturity date.

Q25. Which of the following are COUPON BONDS:

A. Treasury bills.

B. 30-year residential mortgages.

C C. Treasury notes

D. All of the above

E. Only B and C above

Q26. 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 C. less; less

D. none of the above.

Q27. PRESENT VALUE is considered to be one of the most important concepts ever articulated in financial economics because _____

A. it measures the implicit discount rate used by the market to price assets.

B B. it permits payment streams on different financial assets to be compared with each other in terms of a common unit of account (current dollars).

C. it corrects for changes in real purchasing power due to price effects.

D. it provides an accurate assessment for future return rates.

E. it provides a simple way to measure the value of a financial asset solely in terms of its current (present) payments, ignoring future payments.

Q28. 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 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.

Q29. 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 E. Only A and B.

Q30. Consider a coupon bond with an annual coupon payment C = \$200, a face value F = \$4,000, and a maturity date 4/1/2014. Suppose you BUY this bond on 4/1/2011 for Pb = \$3,000 and you SELL it one year later on 4/1/2012 for \$2,900. Which of the following statements are TRUE for this transaction:

A. Your current yield is C/Pb.

B. Your return rate from 4/1/2011 to 4/1/2012 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 E. Only A and B are true.

Q31. Suppose you bought a bond B one year ago whose maturity date is one year from now. An INCREASE in B's yield-to-maturity TODAY then results in a _____ in B's return rate OVER THE PAST YEAR because it implies a _____ in B's market price today.

A. increase; decrease

B B. decrease; decrease

C. decrease; increase

D. increase; increase

Q32. Which of the following statements are TRUE:

A. Dealers handling secondary T-bond/note trades attempt to make profits by buying low and selling high.

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. For a coupon bond, the longer its maturity, the more closely its current yield approximates its yield to maturity.

D D. All of the above.

E. Only A and B.

Q33. Which statements below regarding BOND FINANCIAL PAGES reported in major newspapers such as the Wall Street Journal and the New York Times are TRUE: _____

A. For a Treasury bond or note, the asked price is typically higher than the bid price.

B. For a Treasury bill, the entry in the asked column is typically lower than the entry in the bid column because these entries are the discount yield (based on asked price) and the discount yield (based on bid price) that vary inversely with price.

C. Treasury bills, Treasury notes, and Treasury bonds are all lumped together for reporting purposes because they all take the form of discount bonds.

D. All of the above.

E E. Only A and B above.

Q34. 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 D. the Securities and Exchange Commission.

Q35. Which of the following situations would a rational person prefer to be in if he is PLANNING TO LEND:

A. The nominal interest rate is 4% and the expected inflation rate is 4%.

B. The nominal interest rate is 2% and the expected inflation rate is 4%.

C C. The nominal interest rate is 6% and the expected inflation rate is 3%

D. The nominal interest rate is 8% and the expected inflation rate is 6%.

Q36. Suppose the current nominal interest rate on bank deposit accounts is 2%, and the inflation rate over the coming year is expected to be 3%. Suppose you plan to store \$1000 in a hole in your back yard for the entire next year. Then, all else equal, the NOMINAL return rate you should expect to earn on this \$1000 over the coming year is _____ and the REAL return rate you should expect to earn on this \$1000 over the coming year is _____.

- **A.** 2%; 3%
- **B.** 3%; 2%
- **C** **C.** 0%; -3%
- **D.** -3%; 0%
- **E.** 2%; -3%

Q37. In a SECONDARY bond market, all else equal, the SUPPLY of bonds is higher at higher bond prices because ______.

- **A.** lenders anticipate they will receive higher interest payments.
- **B.** bond sellers anticipate that they will receive higher interest payments.
- **C.** borrowers anticipate that their interest payments will be higher.
- **D** **D.** bond sellers receive a higher return rate on each bond sold.

Q38. If bonds are in EXCESS DEMAND, then standard demand/supply theory predicts the current market price of these bonds is _____.

- **A** **A.** below equilibrium and will be bid upwards until demand equals supply.
- **B.** above equilibrium and will be bid downwards until supply is greater than demand.
- **C.** below equilibrium and will be bid upwards until demand is greater than supply.
- **D.** above equilibrium and will be bid downwards until demand equals supply.

Q39. Suppose 15-year bonds are newly issued today. Suppose something suddenly happens that causes lenders to expect a HIGHER yield to maturity on these bonds ONE YEAR FROM NOW. Then one would expect to see the lenders' demand curve for bonds today _____ because ______.

- **A** **A.** shift to the left; lenders expect a lower capital gain over the coming year.
- **B.** shift to the right; lenders expect a higher capital gain over the coming year.
- **C.** shift to the left; lenders expect a higher capital gain over the coming year.
- **D.** shift to the right; lenders expect a lower capital gain over the coming year.

Q40. Suppose that, in response to a speech today by Fed Chairman Ben Bernanke, people now expect the yield to maturity on U.S. Treasury bonds to DECREASE by the end of next year. The bond market theory in Mishkin Chapter 5 predicts (all else equal) that the most likely result today will be a _____ equilibrium bond price and _____ equilibrium quantity of bonds sold today.

A. higher; a lower

B. lower; a higher

C **C.** higher; a higher

D. lower; an ambiguous effect on the

Q41. 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 result today will be ____ in the equilibrium bond price and ____ in the equilibrium quantity of bonds sold.

A **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

Q42. 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 **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.

Q43. In the GENERALIZED STOCK VALUATION MODEL, the current price of a stock share is assumed to equal the discounted value of _____.

A **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.

Q44. 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 **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.

Q45 The U.S. financial crisis that began in August 2007 led to a downward revision in growth prospects for corporate profits (hence in the growth rate g of dividend payments) as well as increased worries about the riskiness of owning stock (hence an increase in the required return k_e on investment in equity). Given these two events, all else equal, the prediction of the GORDON GROWTH MODEL is _____

A. that stock prices will fluctuate more widely.

B. that stock prices will deviate from their fundamental values.

C. that stock prices will become harder to predict.

D **D.** that stock prices will fall.

E. that stock prices will have to rise in compensation.

Q46. 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 **D.** investors could be expecting future dividend payments and/or a future appreciation in the stock share price.

Q47. Expectations formed by taking a weighted average of past observations are known as ________.

A. perfect foresight expectations.

B **B.** adaptive expectations.

C. extrapolated expectations.

D. rational expectations.

Q48. 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 C. people make optimal use of their information when forming their expectations.

D. people are able to forecast things without error.

Q49. According to Mishkin Chapter 7, the EFFICIENT MARKETS HYPOTHESIS in its strongest form implies _______.

A. there is no adverse selection in financial markets.

B 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.

Q50. BEHAVIORAL FINANCE researchers stress that participants in financial markets _____.

A. should closely study the behavior of corporations for clues regarding the future movements of stock prices.

B. behave irrationally because they do not have sufficient training in financial economics.

C C. can exhibit "non-rational" group behaviors such as panics and flash selling.

D. behave irrationally because they do not have sufficient information about market fundamentals.

E. should closely study the behaviors of financial advisors for "insider" clues regarding the future movements of stock prices.