

## Answer Outline

ECONOMICS 353 (SECTION 2)  
EXERCISE 9: 6 POINTS TOTAL

L. Tesfatsion/Spring 04  
DUE: Tuesday, March 23, 2:10pm

**\*\*IMPORTANT REMINDER: LATE ASSIGNMENTS CANNOT BE ACCEPTED – NO EXCEPTIONS\*\***

### EXERCISE INSTRUCTIONS:

- (1) Please **fill in your name and student ID number** on Side 1 of your bubble sheet and write **353-2 Exercise 9** 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 six questions Q1 through Q6, below, which are all in multiple choice format.
- (3) Each question Q1 through Q6 is worth 1 point.

**Q1.** The view that expectations are formed from past experience as some kind of average over past observations, and hence change only slowly over time as past data change, is known as

- A. optimal statistical forecasting.
- \*\*B.** adaptive expectations.
- C. inertial statistical inference.
- D. rational expectations.
- E. risk aversion.

**Q2.** The view that expectations make optimal use of all available information, and hence are optimal forecasts, is known as

- A. adaptive expectations.
- B. optimal statistical decision theory.
- \*\*C.** rational expectations.
- D. optimal information theory.
- E. optimal adaptive inference.

- Q3.** The major criticism of the view that expectations are formed from past experience as some kind of average over past observations is that
- A. this view ignores transactions costs.
  - B. this view ignores computational difficulties.
  - C. such expectations would have no predictive power.
  - \*\*D.** many people use additional relevant sources of information to form their expectations.
  - E. people are irrational and do not learn from past mistakes.
- Q4.** According to rational expectations
- \*\*A.** people can change their expectations quickly when made aware of new relevant information.
  - B. because people make optimal use of all available information, their expectations will always be perfectly correct.
  - C. people adjust their expectations cautiously due to risk aversion.
  - D. all of the above are true statements.
  - E. only A and B are true statements.
- Q5.** According to the Efficient Market Hypothesis in the form presented by Mishkin on page 150 of his text, the current price of a stock share
- A. reflects the true (intrinsic) fundamental value of the stock share.
  - B. equals the present value of the stream of its future prices.
  - \*\*C.** fully reflects all available information.
  - D. is the optimal forecast of next period's price.
  - E. equals the present value of the stream of its future dividends.
- Q6.** An important implication of the Efficient Market Hypothesis is that stock market investors
- A. should act quickly to take advantage of "hot tips" in published reports by investment advisors.
  - B. should pay close attention to trends and patterns in past stock price data.
  - C. should not follow a "buy and hold" strategy since such an overly cautious approach will leave unexploited profit opportunities.
  - D. should never buy into a mutual fund, because such funds cannot consistently outperform the market.
  - \*\*E.** should not expect to be able to earn returns in the stock market that are persistently higher than the general market average.