

## ANSWER OUTLINE

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

**L. Tesfatsion/Fall 06**  
**28 September 2006**

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: FIRST 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 Mishkin Chapter 1, questions Q11-Q20 stress required materials related to Mishkin Chapter 2:Part A, questions Q21-Q30 stress required materials related to Mishkin Chapter 2:Part B, questions Q31-Q40 stress required materials related to Mishkin Chapter 3, questions Q41-Q45 stress required materials related to Mishkin Chapter 4:Part A (as covered in class), and Q46-Q50 focus on Web browse questions discussed in class that appeared in Q6 portions of the assigned Take-Home Exercises 1-4 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.** A TREND LINE is a measure of
- A.** the average magnitude of fluctuations in real GDP.
  - B B.** the average movement exhibited by the time series data for some variable.
  - C.** the average duration of business cycle expansions.
  - D.** the currently hottest fads among consumers.
- Q2.** A BUSINESS CYCLE is a record of the
- A.** duration of a company from its founding date to its dissolution date.
  - B B.** recurrent fluctuations that occur in time series data for key macro variables.
  - C.** seasonal changes that occur in the demand for a business's product.
  - D.** duration of a product, from introduction to obsolescence.
- Q3.** The U.S. government budget DEFICIT in 2005 measured the extent to which
- A.** the U.S. had to rely on foreign borrowing in 2005.
  - B.** U.S. government tax revenues exceeded U.S. government expenditures in 2005.
  - C C.** U.S. government expenditures exceeded U.S. government tax revenues in 2005.
  - D.** U.S. imports exceeded U.S. exports in 2005.
- Q4.** It is important for the U.S. to keep track of its EXCHANGE RATES with rest-of-the-world (ROW) countries because
- A.** these exchange rates have a direct effect on the cost of U.S. exports purchased by consumers residing within the U.S.
  - B.** these exchange rates are direct measures of the net volume of trade (exchange) between the U.S. and ROW.
  - C.** these exchange rates are direct measures of migration flows between the U.S. and ROW, which affects the U.S. labor supply.
  - D D.** these exchange rates have a direct effect on the cost of ROW imports purchased by consumers residing within the U.S.

- Q5.** The organization responsible for the conduct of monetary policy in the U.S. is the
- A.** Comptroller of the Currency.
  - B B.** Federal Reserve System (the “Fed”).
  - C.** Bureau of Monetary Affairs.
  - D.** U.S. Treasury.
- Q6.** A key DIFFERENCE between nominal GDP (gross domestic product) and real GDP for the U.S. is that
- A.** Nominal GDP includes production outside the borders of the U.S. whereas real GDP does not.
  - B.** Nominal GDP includes financial assets whereas real GDP includes only real assets.
  - C.** Nominal GDP is the initial measure of output and real GDP is the final revised measure of output.
  - D D.** Nominal GDP is not corrected for possible changes in prices whereas real GDP is corrected for possible changes in prices.
- Q7.** The AGGREGATE PRICE LEVEL P for an economy over some time period is \_\_\_\_\_ and the INFLATION RATE FOR P is \_\_\_\_\_.
- A.** the sum of prices for all final goods and services produced in the economy during this time period; the percent increase in P from one period to the next.
  - B.** the total value of all final goods and services produced in the economy during this time period; the percent change in P from one period to the next.
  - C.** the total value of all goods and services consumed in the economy during this time period; the percent increase in P from one period to the next.
  - D D.** a measure of the average price of goods and services produced in the economy during this time period; the percent change in P from one period to the next.
- Q8.** The U.S. economy was severely impacted in the 1970s by
- A.** strong debt deflation.
  - B B.** oil price shocks.
  - C.** the bursting of the dot.com bubble.
  - D.** a major financial crisis primarily hitting the Savings and Loan industry.

**Q9.** According to time series data presented in Mishkin (Chapter 1) and in class:

- A. U.S. stock prices rose dramatically between 1950 and 1999.
- B. U.S. interest rates fluctuated substantially during 1950-2005.
- C. The average U.S. inflation rate during 1950-2005 was approximately zero.
- D. All of the above.
- E E.** Only A and B.

**Q10.** According to time series data presented in Mishkin (Chaper 1) and in class:

- A. the supply of money (M2) is unrelated to the average price level.
- B. there is a strong positive correlation between the average price level and the money supply (M2) – that is, when one is increasing, the other tends to be increasing as well.
- C. a high average inflation rate is associated with a high average money growth rate, and vice versa.
- D. there is a strong negative correlation between the average price level and the money supply (M2) – that is, when one is increasing, the other tends to be decreasing.
- E E.** Only B and C are true.

**Q11.** By definition, money is a FINANCIAL ASSET because

- A. it is denominated in currency units.
- B B.** it is a claim against real assets.
- C. it is issued by the U.S. Treasury.
- D. it is a medium of exchange.

**Q12.** A key DISTINCTION between financial assets and real assets that helps to explain why financial markets are more heavily regulated is that financial assets

- A. are not durable assets.
- B B.** typically establish an ongoing contractual relationship between the current holder and the original issuer.
- C. have longer durability.
- D. generate returns to the holder.

**Q13.** A BOND newly issued by the U.S. government is \_\_\_\_ for the U.S. government and \_\_\_\_ for the buyer of the bond.

- A. a liability; an asset
- B. an asset; a liability
- C. real asset; a financial asset
- D. a financial asset; a real asset

**Q14.** A type of financial institution that plays a major role in the sale of securities in PRIMARY markets is

- A. a stock exchange.
- B. a dealer.
- C. an investment bank.
- D. a commercial bank.

**Q15.** Which of the following can be described as a SECONDARY market transaction:

- A. Merrill Lynch underwrites an initial public offering of shares for Dotcom Corp.
- B. You buy a share of Microsoft on the Nasdaq.
- C. Gateway Inc. buys commercial paper newly issued by Global Crossing Inc.
- D. You buy a Treasury bill in a U.S. Treasury auction.
- E. A venture capital firm supplies start-up funds to a new business.

**Q16.** Which of the following can be described as PRIMARY market transactions:

- A. A dealer helps the Fed sell some of its inventory of U.S. Treasury bonds in open market operations in order to regulate the Fed Funds rate.
- B. An investment banker facilitates the sale of newly issued corporate bonds.
- C. You buy shares of stock on the New York Stock Exchange.
- D. A broker facilitates the sale of a municipal bond from one household to another.

**Q17.** By definition, ways in which financial asset dealers DIFFER from financial intermediaries (FIs) include:

- A.** dealers do not engage in asset transformation.
- B.** dealers do not hold inventories of the financial assets in which they trade.
- C.** The most important source of profits for dealers is buying financial assets at low prices and then reselling these same assets at higher prices.
- D.** All of the above.
- E.** Only A and C above.

**Q18.** By definition, ways in which financial intermediaries (FIs) DIFFER from financial asset brokers include:

- A.** FIs engage in asset transformation.
- B.** FIs “make the market” for stocks and bonds by setting their purchase and sale prices.
- C.** the most important source of profits for FIs is commissions on sales.
- D.** FIs do not hold inventories of the financial assets in which they trade.

**Q19.** Which of the following markets are organized as OVER-THE-COUNTER markets:

- A.** The Nasdaq stock market
- B.** U.S. Treasury auctions.
- C.** The New York Stock Exchange.
- D.** All of the above.

**Q20.** Auction markets and over-the-counter (OTC) markets are DISTINGUISHED by the following characteristic(s):

- A.** Trades in auction markets are generally handled by dealers whereas trades in OTC markets are generally handled by brokers.
- B.** Trades in auction markets are conducted through a centralized facility whereas trades in OTC markets are not.
- C.** Auction markets only handle trades in equity instruments whereas OTC markets handle trades in both equity and debt instruments.
- D.** None of the above.

- Q21.** A BORROWER acquires \_\_\_\_ by \_\_\_\_.
- A. a stream of dividend payments; selling a newly issued equity instrument.
  - B B.** temporary additional purchasing power; issuing and selling a debt instrument.
  - C. additional net worth; buying a newly issued equity instrument.
  - D. liabilities; buying financial assets in secondary markets.
- Q22.** By definition, instances of DIRECT FINANCE include:
- A. You sell an IBM stock share to your classmate.
  - B. You take out a loan at the First National Bank.
  - C C.** You buy a newly issued share of Google.
  - D. You contribute to your company's pension fund.
- Q23.** By definition, instances of INDIRECT FINANCE include:
- A. The U.S. government buys commercial paper on a secondary market.
  - B B.** An insurance company makes a loan to a corporation.
  - C. You buy stock shares on the New York Stock Exchange.
  - D. The U.S. government buys commercial paper newly issued by a corporation.
  - E. None of the above.
- Q24.** Corporations acquire NEW funds when their stocks are sold \_\_\_\_.
- A. in money markets.
  - B. in secondary markets.
  - C. by financial intermediaries through mutual funds.
  - D D.** in primary markets.

**Q25.** Which of the following statements are TRUE?

- A. A bond is a debt instrument that promises to make payments for a specified period of time (i.e., over its maturity).
- B. Debt instruments with maturities greater than a year are traded in the capital market.
- C. The maturity of a debt instrument is the length of time to the debt instrument's expiration date.
- D D. All of the above statements are true.
- E. Only A and B are true.

**Q26.** Which of the following properties characterize CORPORATE DEBT SECURITIES:

- A. Corporate debt holders regularly participate in key management decisions of their corporate debt issuers.
- B B. In case of bankruptcy, corporate debt claims are paid before corporate equity claims.
- C. Corporate debt payments are conditional on the profits earned by the debt issuer except under conditions of duress.
- D. Only B and C above.

**Q27.** Which of the following properties characterize COMMON STOCK SHARES:

- A. If bankruptcy occurs, common stock holder claims are prior to bond holder claims.
- B B. Holders of a corporation's common stock shares have the right to vote their approval or disapproval of key corporate management decisions.
- C. By law, corporations must pay out their profits as dividends to their common stock holders.
- D. All of the above.
- E. Only A and B.

**Q28.** The presence of \_\_\_\_\_ in financial markets leads to adverse selection and moral hazard problems that interfere with the functioning of financial markets.

- A. free-riding
- B. default risk
- C C. asymmetric information
- D. noncollateralized risk
- E. costly state verification

- Q29.** The concept of moral hazard in markets for loans
- A.** refers to the high rejection rates faced by loan applicants.
  - B.** refers to the tendency of borrowers to have a high probability of default.
  - C.** refers to the negative effects on the quality of the pool of loan applicants when banks try to use a single interest rate to cover expected default costs.
  - D D.** refers to the incentive of borrowers to switch borrowed monies to riskier loan projects after their loan contracts are signed.
- Q30.** If bad credit risks are the ones who most actively seek out and receive loans from a financial intermediary due to specific features of its loan contracts, then the financial intermediary has
- A.** a free-riding problem.
  - B B.** an adverse selection problem.
  - C.** an interest rate risk problem.
  - D.** a moral hazard problem.
- Q31.** Economists define INCOME as
- A.** The market value of all assets owned at a point in time.
  - B.** Anything that is generally accepted in payment for goods and services and for the repayment of debts.
  - C C.** The flow of value accrued over some specified period of time.
  - D.** None of the above.
- Q32.** Which of the following statements is TRUE BY DEFINITION:
- A.** Money is any legally enforced medium of exchange.
  - B.** Money is anything that must be accepted in repayment of debts, as a matter of law.
  - C.** Money is paper currency plus coinage.
  - D D.** Money is anything generally accepted for the payment of goods and services and the repayment of debts.

- Q33.** As discussed in “Notes on Mishkin: Chapter 3,” TOKEN COINS are coins
- A A.** whose precious metal content is far below their face value.
  - B B.** decorated with pretty artwork.
  - C C.** that can be used to pay for subway rides.
  - D D.** not backed specifically by gold.
- Q34.** If the U.S. aggregate price level were to fall by half, then (all else equal) the domestic purchasing power of a U.S. dollar would be expected to
- A A.** more than double.
  - B B.** double.
  - C C.** rise but not double due to diminishing returns.
  - D D.** fall by half.
  - E E.** fall by more than half.
- Q35.** For an economy with exactly 101 goods, \_\_\_\_\_ prices are required to support exchange under a barter payment system while \_\_\_\_\_ prices are required to support exchange under a monetary payment system.
- A A.** 202; 101
  - B B.** 5050; 101
  - C C.** 10100; 101
  - D D.** 5050; 202
  - E E.** 10100; 202
- Q36.** The conversion of a barter economy to one that uses money
- A A.** increases efficiency by reducing the volume of trade.
  - B B.** increases efficiency by encouraging production specialization and division of labor.
  - C C.** increases efficiency by reducing adverse selection problems.
  - D D.** increases efficiency by reducing moral hazard problems.

**Q37.** The observed tendency for the form of money to evolve from commodity money to fiat money increases the fragility of money because

- A. fiat money can lose much of its value in hyperinflations.
- B. fiat money is unbacked, i.e., it is not collateralized by any commodity.
- C. fiat money can lose much of its value if people lose confidence in its general acceptability as a means of payment.
- D D. all of the above.
- E. only A and C.

**Q38.** Government monetary policy is the management by government of

- A. the extent of foreign borrowing.
- B. the balance of payments.
- C. the trade balance.
- D D. money and interest rates.

**Q39.** Checkable deposits in the U.S. satisfy the DEFINITION of money because

- A. federal regulations mandate that checks be accepted as a means of payment for goods and services.
- B B. checkable deposits are generally accepted as a means of payment for goods and services and for repayment of debts.
- C. checkable deposits are backed by federal guarantee.
- D. checkable deposits are legal tender.

**Q40.** When a person in the U.S. takes currency from a checkable deposit account and uses it to buy travelers checks, then

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

- Q41.** Under the terms of a COUPON BOND, the issuer agrees to pay the holder
- A.** a periodic fixed payment until the bond's maturity date, where the fixed payment includes both principal and interest.
  - B.** a periodic coupon payment until the bond's maturity date, plus the face value of the bond at the bond's maturity date.
  - C.** only one payment, the face value of the bond at the bond's maturity date.
  - D.** only one payment, the bond's coupon rate plus par value at the bond's maturity date.
- Q42.** Which of the following are instances of DISCOUNT BONDS:
- A.** Food stamps with detachable coupons.
  - B.** Residential mortgages.
  - C.** Treasury bills sold through Treasury auctions.
  - D.** Corporate bonds listed on the New York Stock Exchange.
- Q43.** The COUPON RATE on a coupon bond with a purchase price of \$80, a \$100 face value, annual coupon payments of \$10, and a 2-year maturity is defined to be
- A.** the coupon payment \$10 divided by the face value \$100.
  - B.** total coupon payments \$20 divided by the maturity 2.
  - C.** the coupon payment \$10 divided by the purchase price \$80.
  - D.** one coupon payment per year.
- Q44.** 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.** it provides an accurate assessment for future interest rate risk.
  - C.** it permits payment streams on different financial assets to be compared with each other in terms of a common unit of account.
  - D.** it provides an accurate assessment of an asset's real purchasing power.
  - E.** it provides a way to measure the current value of a financial asset without having to consider the timing and amount of future payments.

- Q45.** Letting “ \* ” denote multiplication, if the annual interest rate is 3 percent, then the PRESENT VALUE TODAY of a payment stream (\$50, \$30) with \$50 to be received at the end of the first year and \$30 to be received at the end of the second year is given by
- A.  $\$50 * (1 + 0.03) + \$30 * (1 + 0.03)^2$
  - B.  $\$50 / (1 + 0.03) + \$30 / (1 + 0.03)$
  - C C.  $\$50 / (1 + 0.03) + \$30 / (1 + 0.03)^2$
  - D.  $[\$50 + \$30] / (1 + 0.03)^2$
- Q46.** As discussed in class, the beginning of the modern U.S. financial system occurred around 1781 with the establishment of the Bank of North America in response to
- A. the sharp devaluation of United States Notes (greenbacks) through inflation.
  - B B. the need to finance military activities.
  - C. the end of the free banking period.
  - D. the collapse of the continental congress.
- Q47.** As seen in Exercise 2 (Q6), Stafford student loans
- A. currently have a default rate of about 20 percent.
  - B. are only offered to students with sufficient collateral.
  - C C. are either guaranteed by, or directly provided by, the U.S. federal government.
  - D. all of the above.
  - E. only B and C above.
- Q48.** As seen in Exercise 3 (Q6), the volatility of the return rate for the NASDAQ Composite stock index \_\_\_ the volatility of the return rate for the Dow Jones Industrial Average over 1985-2005 when measured by sample standard deviation.
- A. is somewhat less than
  - B B. exceeds
  - C. is the same as
  - D. is much less than

**Q49.** As discussed in the required reading “Measuring the Volatility of Stock Returns: Points to Ponder” for Exercise 3 (Q6), the measurement of the volatility of stock return rates is complicated by the fact that

- A.** stock return rate distributions appear to be highly asymmetric, implying the presence of information problems.
- B.** stock return rates are difficult to calculate due to lack of prompt reporting.
- C.** stock return rate distributions appear to have “thick tails”, implying that sample standard deviations do not converge to finite limits as the sample size increases.
- D.** stock prices have been steadily trending upward since 1950.

**Q50.** As seen in Exercise 4 (Q6), Alan Greenspan has used the “Free Banking Era” as evidence to support his contention that

- A.** regulations such as deposit insurance can result in bad unintended consequences (e.g. an increase in moral hazard problems).
- B.** strong federal regulations are essential for maintaining the stability of the U.S. banking sector.
- C.** bank chartering should be handled through legislative action rather than through incorporation law.
- D.** state regulation of banking is not necessary to ensure the stability of the U.S. banking sector.