ANSWER OUTLINE

ECONOMICS 353 **L. Tesfatsion/Fall 07**
MIDTERM EXAM 1: 50 Questions (1 Point Each) **27 September 2007**

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-Q21 stress required materials related to Mishkin Chapter 2:Part A, questions Q22-Q31 stress required materials related to Mishkin Chapter 2:Part B, questions Q32-Q40 stress required materials related to Mishkin Chapter 3, questions Q41-Q45 stress required materials related to Mishkin Chapter 4:Part A, 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. By definition, a NOMINAL value is

A. a value measured in base year prices.

B **B.** a value measured in current prices.

C. the average value of a quantity over time.

D. the advertised value of an item as opposed to its actual sales price.

Q2 (1 point). According to Mishkin (Chapter 1), *NOMINAL* GROSS DOMESTIC PRODUCT (GDP) can be a misleading measure of economic well-being since it does not correct for ____

A **A.** changes in prices.

B. changes in production occuring outside the borders of the country.

C. changes in foreign exchange rates.

D. changes in wealth.

Q3 (1 Point). As shown by data presented in class (source: www.economagic.com), the U.S. INFLATION RATE since 1952

A. has steadily trended downward (evidence of a "New Economy").

B. has steadily trended upward (evidence of a "twin deficit" problem).

C **C.** has remained positive (indicating a persistent increase in prices).

D. has fluctuated around its "natural rate" level of 0 percent.

Q4. By definition, a GOVERNMENT BUDGET SURPLUS measures the extent to which

A. a country is lending to foreign countries.

B **B.** government tax revenues exceed government expenditures.

C. government expenditures exceed government tax revenues.

D. imports exceed exports.

Q5 (1 Point). According to Mishkin (Chapter 1), ANNUAL U.S. GOVERNMENT EXPENDITURES during 1950 to 2005 have

A A. typically been higher than annual U.S. government tax revenues.

B. typically been lower than annual U.S. government tax revenues.

C. stayed approximately equal to annual U.S. government tax revenues.

D. persistently fluctuated around (above and below) annual U.S. government tax revenues.

Q6. The U.S. CONSUMER PRICE INDEX (CPI) for year 2007 is a measure of

A. the average dollar price of the goods and services included in U.S. GDP in 2007.

B. the inflation-adjusted value of the U.S. nominal GDP level in 2007.

C. the average price of all consumption goods sold in the U.S. in 2007

D D. the value of a basic basket of goods and services bought by a typical U.S. urban household in 2007.

Q7. All else equal, when the U.S. dollar DEPRECIATES in value against the euro (as it has been doing over the recent past),

A. the U.S. is unquestionably made better off.

B B. U.S. goods exported to euro-using countries become cheaper for these countries to buy.

C. U.S. goods exported to euro-using countries become more expensive for these countries to buy.

D. the U.S. is unquestionably made worse off.

Q8. The ______ is a major participant in the initial public offering of U.S. government securities.

A. Comptroller of the Currency.

B. Federal Reserve System (the "Fed").

C. Bureau of Monetary Affairs.

D D. U.S. Treasury.

Q9. The U.S. economy was strongly impacted in the late 1990s by

A. strong debt deflation.

B. oil price shocks.

C C. the bursting of the dot.com bubble.

D. a major financial crisis primarily hitting the Savings and Loan industry.

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

A. U.S. stock prices fluctuated dramatically up and down between 1980 and 1999.

B. U.S. interest rates have persistently increased during 1950-2007.

C. the U.S unemployment rate has persistently declined during 1990-2007.

D. All of the above.

E E. None of the above.

Q11. By definition, a mortgage contract is a FINANCIAL ASSET because

A. its payments are denominated in currency units.

B. it is typically drawn up by a bank.

C C. it is a claim against real assets.

D. it is sold in financial markets.

Q12. Debt instruments (e.g., bonds) are _______ for the issuer and _______ for the purchaser.

A. puts; calls

B. primary assets; secondary assets

C. assets; liabilities

D. illiquid assets; liquid assets

E E. liabilities; assets

Q13. A type of financial player that has a major role in ensuring the sale of corporate bonds in PRIMARY markets is

A. a specialized trader on a stock exchange.

B. a commercial banker.

C C. an investment banker.

D. a savings and loan officer.

E. a Securities and Exchange Commissioner.

Q14. Key ways in which a broker DIFFERS from a dealer include:

A. Brokers take positions in the financial assets they trade.

B B. Brokers make profits by charging commissions to users of their services.

C. Brokers facilitate financial asset trades.

D. all of the above.

E. none of the above.

Q15. By definition, ways in which dealers in financial assets 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 E. Only A and C above.

Q16. By definition, ways in which financial intermediaries (FIs) DIFFER from brokers of financial assets include:

A A. FIs engage in asset transformation.

B. FIs "make the market" for bonds and stocks by publicly posting their purchase and sale prices.

C. the most important source of profits for FIs is commissions on sales.

D. FIs do not maintain inventories of the financial assets in which they trade.

Q17. Which of the following can be described as a SECONDARY market transaction:

- **A** **A.** You buy a share of Wells Fargo Group from the New York Stock Exchange.
- **B.** You acquire a mortgage from Scamway Bank.
- **C.** You buy a Treasury bill in a U.S. Treasury auction.
- **D.** You supply start-up funds for your uncle's new business.

Q18. Auction markets and over-the-counter (OTC) markets are DISTINGUISHED by the following characteristic(s):

- **A.** Auction markets only handle trades in financial assets whereas OTC markets handle trades in both financial and real assets.
- **B** **B.** Trades in auction markets are conducted through a centralized facility whereas trades in OTC markets are not.
- **C.** Auction market trades are handled exclusively through face-to-face floor/street trading whereas OTC markets rely exclusively on electronic exchanges.
- **D.** None of the above.

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

- **A.** the New York Stock Exchange
- **B** **B.** the secondary market for U.S. government bonds
- **C.** the Chicago Board of Trade (CBOT)
- **D.** All of the above.

Q20. Financial market structure is generally tailored to the type of item being bought and sold. For example, a basic reason why one might be surprised to see a retail stock share store in Ames with displayed stock shares for sale is that

- **A.** stock shares must be sold (by law) only through securities markets.
- **B.** the purchase of a stock share requires detailed contractual arrangements too complicated for retail outlets to handle.
- **C** **C.** directly viewing and handling stock shares is not very informative about the underlying value of the stock.
- **D.** the purchase and sale of stock shares involves high transaction costs.

Q21. Financial intermediaries typically purchase financial assets with long maturities while at the same time selling financial assets with short maturities, resulting in what is known as

A. a bid-ask spread.

B B. a maturity gap.

C. risk pooling.

D. risk spreading.

Q22. By definition, instances of DIRECT FINANCE include:

A. You sell a Treasury bill to your classmate.

B. You get a loan from a finance company.

C C. You buy a municipal bond newly issued by the Ames City government to build a pool.

D. You buy shares in a mutual bond fund.

Q23. By definition, instances of INDIRECT FINANCE include:

A. A money market mutual fund buys commercial paper on a secondary market.

B B. A pension fund uses employee contributions to purchase newly issued subprime mortgages.

C. You buy stock shares on the New York Stock Exchange.

D. The U.S. government buys back government bonds held by the private sector.

E. None of the above.

Q24. Corporations aquire NEW funds when their stocks are sold ____.

A. in the New York Stock Exchange.

B. in a foreign stock exchange such as the London Stock Exchange.

C C. by investment bankers in a primary market.

D. all of the above.

E. only A and B.

Q25. A LENDER acquires ____ by _____.

A. an entitlement to a stream of dividends; selling a newly issued equity instrument.

B. additional wealth; selling a newly issued debt instrument.

C. temporary additional purchasing power; buying a newly issued equity instrument.

D D. an entitlement to a stream of payments; buying a newly issued debt instrument.

Q26. Which of the following statements are TRUE?

A. The maturity of a debt instrument is the length of time to the debt instrument's expiration date.

B. A debt instrument requires the issuer to pay the holder certain specified payments at regularly specified intervals until the maturity date is reached.

C. A debt instrument is called "short term" if its maturity is less than a year.

D D. All of the above are true

Q27. Which of the following statements about COMMON STOCK SHARES issued by corporations are true?

A. Common stock shares are equity (ownership) claims on the net income and assets of the issuing corporation.

B. Common stock shares are entitlements to a share of corporate profits through a stream of dividend payments.

C. Owners of common stock shares are entitled to vote on various aspects of corporate management.

D. All of the above.

E E. Only A and C above.

Q28. A EUROBOND is

A. a bond issued by a European country.

B B. an international bond denominated in a currency other than that of the country in which it is sold.

C. a bond sold in Europe.

D. a bond denominated in euros.

Q29. Which of the following describes a MONEY MARKET transaction:

A **A.** A dealer helps the Fed sell some of its inventory of 6-month U.S. Treasury bills in open market operations in order to regulate the Fed Funds rate.

B. An investment banker facilitates the sale of newly issued 30-year corporate bonds.

C. You buy shares of stock on the New York Stock Exchange.

D. A broker facilitates the sale of a 5-year municipal bond from one household to another.

Q30. ______ in financial markets leads to adverse selection and moral hazard problems that interfere with the functioning of financial markets.

A. Interest-rate risk

B. Transactions costs

C **C.** Asymmetric information

D. Free-riding

E. Risk-sharing

Q31. Moral hazard arises in financial markets

A. before the sale of a financial asset, when the buyer of the financial asset has difficulty assessing the quality of the financial asset he is interested in purchasing.

B **B.** after the sale of a financial asset, when the buyer of the financial asset finds it difficult to monitor the behavior of the seller after the purchase is made.

C. during the sale of a financial asset, when buyers with "market power" are able to force sellers to accept a low price.

D. during the sale of a financial asset, when sellers with "market power" are able to force buyers to pay a high price.

Q32. Economists define a person's WEALTH to be

A **A.** the total value of all of the assets currently possessed by the person.

B. everything the person possesses that is generally accepted in payment for goods and services and for the repayment of debts.

C. the flow of value accruing to the person over some specified period of time.

D. none of the above.

Q33. Economists define MONEY as

- **A.** The market value of all financial and real assets owned at a point in time.
- B **B.** Anything that is generally accepted in payment for goods and services and for the repayment of debts.
- **C.** The flow of value accrued over some specified period of time.
- **D.** None of the above.

Q34. Which of the following statements is TRUE BY DEFINITION:

- **A.** Legal tender is any legally enforced medium of exchange.
- B **B.** Legal tender is anything that must be accepted in repayment of debts, as a matter of law.
- **C.** Legal tender is paper currency plus coinage.
- **D.** Legal tender is anything generally accepted for the payment of goods and services and for the repayment of debts.

Q35. As discussed in "Notes on Mishkin: Chapter 3," COMMODITY MONEY is

- **A.** money used specifically to buy commodities.
- B **B.** any commodity (economic good) that is used as money.
- **C.** any money that is backed (collaterized) by a commodity.
- **D.** any money that accommodates trades in commodities.

Q36. The observed tendency for the form of money to evolve from commodity money to fiat money increases the fragility of money because, unlike commodity money,

- **A.** fiat money can become worthless if people lose confidence in its general acceptability as a medium of exchange for whatever reason.
- **B.** the value of fiat money is determined by government.
- **C.** fiat money can become worthless in situations of hyperinflation.
- **D.** all of the above.
- E **E.** only A and C.

Q37. For an economy with exactly 10 goods, _____ prices are minimally required to support exchange under a barter payment system while _____ prices are minimally required to support exchange under a monetary payment system.

A. 20; 10

B. 90; 20

C C. 45; 10

D. 90; 10

E. 45; 20

Q38. As stressed in class discussions of Mishkin Chapter 3, the normal way the Federal Reserve Board (the "Fed") attempts to manipulate and control the money supply and short-term interest rates is through

A. adjustments of the interest rate the Fed charges member banks for borrowed funds.

B B. open-market operations.

C. periodic updates of the weights used to calculate the money supply and key interest rate indices.

D. printing money as necessary to liquify the economy in response to adverse shocks.

Q39. During inflation

A. the purchasing power of money falls.

B. sellers of debt instruments benefit as the real value of their payment obligations falls.

C. buyers of debt instruments benefit as the real value of their payment receipts rises.

D. only A and C.

E E. only A and B.

Q40. If the Federal Reserve purchases government bonds from private U.S. citizens who subsequently deposit their bond sale receipts in small-denomination time deposit accounts, then

A. M1 increases and M2 stays the same.

B B. M1 stays the same and M2 increases.

C. M1 and M2 both increase.

D. M1 and M2 both stay the same.

E. none of the above.

Q41. Which of the following statements are TRUE:

A. For fixed-rate mortgages, the borrower pays the lender a periodic fixed payment through the bond's maturity date.

B. Risk-averse borrowers tend to prefer adjustable-rate mortgages (ARMs) to fixed-rate mortgages due to lower guaranteed interest payments for the life of the loan.

C. When market interest rates go up, people with ARMs tend to face a higher risk of default and foreclosure than people with fixed-rate mortgages.

D. All of the above.

E E. Only A and C.

Q42. Which of the following statements are TRUE for coupon bonds?

A. The owner of the coupon bond receives a coupon payment every payment period through the maturity date, at which time the face value is also paid.

B. U.S. Treasury bonds and notes are examples of coupon bonds.

C. Corporate bonds typically take the form of coupon bonds.

D D. All of the above

E. Only A and B above

Q43. The COUPON RATE on a coupon bond with a purchase price of $50, a $80 face value, annual coupon payments of $10, and a 4-year maturity is defined to be

A. total coupon payments $40 divided by the maturity 4.

B. the coupon payment $10 divided by the purchase price $50.

C C. the coupon payment $10 divided by the face value $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 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. If a newly issued security with a 3-year maturity and a \$500 sale price promises to pay \$300 at the end of year 1 and \$600 at the end of year 3, then (letting * denote multiplication) its yield to maturity i is found by solving which of the following equations for i:

A. $i = [\$300 + \$600 - \$500]/3$

B B. $\$500 = \$300/(1+i) + \$600/(1+i)^3$

C. $\$500 = \$300 * (1+i) + \$600 * (1+i)^3$

E. $\$500 = \$300/(1+i)^2 + \$600/(1+i)^3$

Q46. As detailed in the required Mishkin Chapter 1 reading "Measuring the Volatility of Stock Returns," the volatility of a stock index S_t is typically measured quantitatively by calculating

A. the frequency with which S_t moves up and down over short time periods.

B B. the sample standard deviation for the "stock return rate" $R_t = [\ln(S_{t+1}) - \ln(S_t)]$ over past time periods t, where ln denotes "natural logarithm".

C. the average size of the fluctuations in S_t over past time periods t.

D. the trend line exhibited by a time series plot of the "stock return rate" $R_t = [\ln(S_{t+1}) - \ln(S_t)]$ over past time periods t, where ln denotes "natural logarithm".

Q47. As covered in class discussions of Ex 2 (Q6), the CME Group formed in 2007 as a merger of the Chicago Board of Trade and the Chicago Mercantile Exchange is

A. an auction primarily engaged in floor trading of agricultural commodities and other real assets.

B. an electronic stock exchange heavily tilted towards technology stocks.

C C. one of the largest and most diverse futures and options exchanges in the world.

D. an over-the-counter market handling U.S. import/export mercantile trades with the rest of the world.

Q48. As discussed in class (key in-class discussion question for Mishkin Chapter 3), financial problems experienced by the thirteen colonies during the American Revolution subsequently led to the beginnings of the modern U.S. financial system with the

A. issuing of "greenbacks" by the U.S. Treasury in 1776.

B. establishment of the Federal Reserve System in 1783.

C C. chartering of the Bank of North America in 1782 and the first issue of state bank notes.

D. establishment of a dual banking system (chartering of U.S. national banks as well as state banks) in 1776.

Q49. As covered in class discussions of Exercise 3 (Q6), the Federal Deposit Insurance Corporation (FDIC) provides up to \$100, 000 insurance per depositor per FDIC-insured bank. Critics of this policy have argued

A **A.** it might lessen the incentives of depositors to monitor the lending and investment activities of their banks, thus leading to moral hazard problems.

B. it might lessen the incentives of banks to monitor the spending habits of their depositors, thus leading to moral hazard problems.

C. it might encourage higher-risk depositors to become clients of the bank, thus leading to adverse selection problems.

D. it might lessen the incentives of banks to refrain from high risk lending, thus leading to adverse selection problems.

Q50. As covered in class discussions of Exercise 4 (Q6), possible explanations for the current subprime mortgage crisis include

A. the current sharp increase in housing prices that is putting housing out of reach of low-income households.

B. overly confident borrowers not properly understanding the risks they were assuming in the loan contracts they were signing.

C. use of deceptive advertising practices to attract borrowers to high-risk "adjustable rate mortgages" (ARMs).

D. all of the above.

E **E.** only B and C above.