

Final Exam

Name _____

Id # _____

Instructions: There are 30 questions on this exam. Please circle the correct solution on the exam paper and fill in the relevant bubble on the scantron sheet. In addition please complete the survey at the back prior to turning in the exam. Good luck and have a great summer!

MULTIPLE CHOICE. Choose the one alternative that best completes the statement or answers the question.

- 1) When the growth rate of the money supply decreases, interest rates end up being permanently lower if
- A) the liquidity effect is larger than the other effects.
 - B) there is fast adjustment of expected inflation.
 - C) there is slow adjustment of expected inflation.
 - D) the expected inflation effect is larger than the liquidity effect.

Answer: D

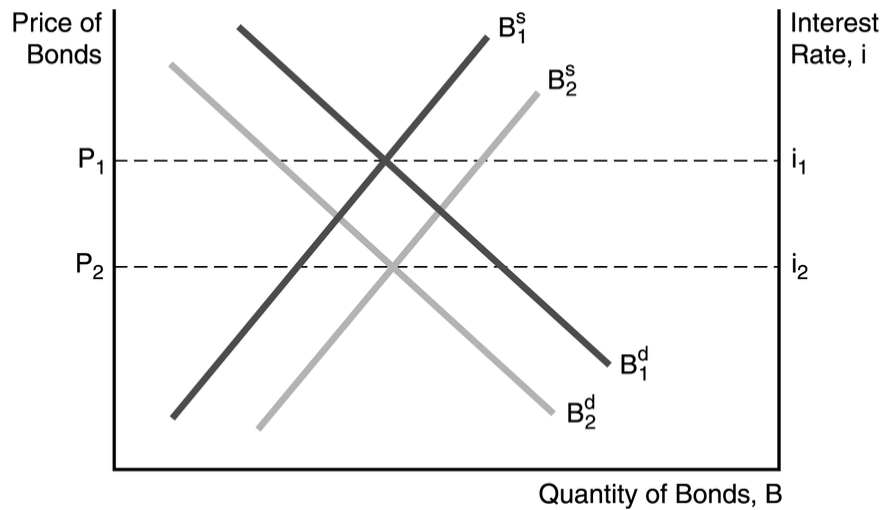


Figure 1

2) In the figure above, factors that could cause the supply of bonds to increase (shift to the right) include:

- A) an increase in government budget deficits.
- B) expectations of more profitable investment opportunities.
- C) an increase in expected inflation.
- D) all of the above.
- E) only B and C of the above.

Answer: D

3) In Figure 1 above, one factor that would not have caused the demand for bonds to decrease (shift to the left) is

- A) an increase in the riskiness of bonds relative to other assets.
- B) an increase in the expected return on bonds relative to other assets.
- C) a decrease in the expected return on bonds relative to other assets.
- D) a decrease in wealth.

Answer: B

4) In an expanding economy with growing wealth, the demand for bonds _____ and the demand curve for bonds shifts to the _____.

- A) rises; right
- B) rises; left
- C) falls; right
- D) falls; left

Answer: A

- 5) According to the liquidity premium theory of the term structure
- A) bonds of different maturities are substitutes, but investors can prefer one bond maturity over another.
 - B) if yield curves are downward sloping, then short-term interest rates are expected to fall by so much that, even when the positive term premium is added, long-term rates fall below short-term rates.
 - C) yield curves should never slope downward.
 - D) both A and B of the above are true.
 - E) both A and C of the above are true.

Answer: D

- 6) The preferred habitat theory of the term structure is closely related to the
- A) the inverted yield curve theory of the term structure.
 - B) liquidity premium theory of the term structure.
 - C) risk premium theory of the term structure
 - D) segmented markets theory of the term structure.
 - E) expectations theory of the term structure.

Answer: B

- 7) According to the expectations theory of the term structure
- A) when the yield curve is downward sloping, short-term interest rates are expected to remain relatively stable in the future.
 - B) investors have strong preferences for short-term relative to long-term bonds, explaining why yield curves typically slope upward.
 - C) when the yield curve is steeply upward sloping, short-term interest rates are expected to rise in the future.
 - D) all of the above.
 - E) only A and B of the above.

Answer: C

- 8) If the expected path of one-year interest rates over the next five years is 4 percent, 5 percent, 7 percent, 8 percent, and 6 percent, then the expectations theory predicts that today's interest rate on the five-year bond is
- A) 4 percent. B) 5 percent. C) 8 percent. D) 6 percent. E) 7 percent.

Answer: D

- 9) When the Treasury bond market becomes more liquid, other things equal, the demand curve for corporate bonds shifts to the _____ and the demand curve for Treasury bonds shifts to the _____.
- A) right; left B) right; right C) left; left D) left; right

Answer: D

10) In the Gordon growth model, a decrease in the required rate of return

- A) increases the current stock price.
- B) reduces the future stock price.
- C) reduces the current stock price.
- D) increases the future stock price.
- E) has no effect on stock prices.

Answer: A

11) During the past decade, the average rate of monetary growth has been 5%, and the average inflation rate has been 5%. If the Federal Reserve announces that the new rate of monetary growth will be 10%, the rational expectation forecast of inflation will be

- A) 10%.
- B) between 5 and 10%.
- C) 5%.
- D) more than 10%.
- E) less than 5%.

Answer: A

12) An increase in uncertainty due to threat of war will

- A) depress stock prices due to a higher required return.
- B) increase stock prices due to a lower required return.
- C) depress stock prices due to a lower required return.
- D) not affect stock prices.
- E) increase stock prices due to a higher required return.

Answer: A

13) Rational expectations forecast errors will on average be _____ and therefore _____ be predicted ahead of time.

- A) zero; can
- B) positive; cannot
- C) positive; can
- D) zero; cannot
- E) negative; can

Answer: D

- 14) In Keynes's liquidity preference framework,
- A) the demand for money must equal the supply of bonds.
 - B) an excess supply of bonds implies an excess supply of money.
 - C) the demand for bonds must equal the supply of money.
 - D) all of the above.
 - E) none of the above.

Answer: E

- 15) A risk premium is sometimes called a
- A) liquidity premium.
 - B) rating premium.
 - C) default premium.
 - D) junk premium.

Answer: A

- 16) If the expected path of 1-year interest rates over the next five years is 2 percent, 4 percent, 1 percent, 4 percent, and 3 percent, the expectations theory predicts that the bond with the lowest interest rate today is the one with a maturity of
- A) three years.
 - B) one year.
 - C) four years.
 - D) two years.

Answer: B

- 17) In Keynes's liquidity preference framework, individuals are assumed to hold their wealth in two forms:
- A) money and gold.
 - B) real assets and financial assets.
 - C) stocks and bonds.
 - D) money and bonds.

Answer: D

- 18) Using the Gordon growth model, a stock's price will increase if
- A) the expected sales price rises.
 - B) the dividend growth rate increases.
 - C) the growth rate of dividends falls.
 - D) dividends are reduced.
 - E) the required rate of return rises.

Answer: B

- 19) If the expected return on CBS stock rises from 5 to 10 percent and the expected return on NBC stock rises from 12 to 18 percent, then the expected return of holding CBS stock _____ relative to NBC stock and the demand for CBS stock _____.
- A) rises; rises
 - B) rises; falls
 - C) falls; rises
 - D) falls; falls

Answer: D

20) Suppose that people formed expectations of inflation as follows:

$$\pi^e = 0.5\pi_t + 0.25\pi_{t-1} + 0.25(y_t - y_f)$$

where y_f is the full employment level of output. This type of expectations formation can be described as being

- A) rational expectations
- B) bounded rationality
- C) adaptive expectations
- D) none of the above

Answer: C

21) Using the one-period valuation model, assuming a year-end dividend of \$1.00, an expected sales price of \$100, and a required rate of return of 10%, the current price of the stock would be

- A) \$91.00
- B) \$91.82
- C) \$90.91
- D) \$101.00
- E) \$92.00

Answer: B

22) Using the Gordon growth formula, if the current stock price is \$25, k_E is 12% or 0.12, and g is 10% or 0.10, then D_1 is

- A) \$0.50.
- B) \$1.25.
- C) \$0.75.
- D) \$0.25.
- E) \$1.00

Answer: A

23) Economists have focused more attention on the formation of expectations in recent years. This increase in interest can probably best be explained by the recognition that

- A) expectations influence the behavior of participants in the economy and thus have a major impact on economic activity.
- B) expectations influence only a few individuals, have little impact on the overall economy, but can have important effects on a few markets.
- C) models that ignore expectations have little predictive power, even in the short run.
- D) expectations influence many individuals, have little impact on the overall economy, but can have distributional effects.

Answer: A

24) The efficient markets hypothesis

- A) is an application of rational expectations to the pricing of financial securities.
- B) holds that the expected return on a security equals the equilibrium return.
- C) is based on the assumption that prices of securities fully reflect all available information.
- D) holds that all of the above are true.
- E) holds that only A and B of the above are true.

Answer: D

25) If the optimal forecast of the return on a security exceeds the equilibrium return, then:

- A) the market is inefficient.
- B) an unexploited profit opportunity exists.
- C) the market is in equilibrium.
- D) only A and B of the above are true.
- E) only B and C of the above are true.

Answer: D

26) Suppose that you hear that the Fed revised its inflation forecast downwards (i.e. they are predicting less inflation) and observed that stock prices rose as a result. This would indicate that markets were

- A) semi-strong form efficient
- B) weak form efficient
- C) strong form efficient
- D) all of the above
- E) none of the above

Answer: B

27) You read a story in the newspaper announcing the proposed merger of Dell Computer and Gateway. The merger is expected to greatly increase Gateway's profitability. If you decide to invest in Gateway stock, you can expect to earn

- A) above average returns since your stock price will definitely appreciate as higher profits are earned.
- B) below average returns since computer makers have low profit rates.
- C) a normal return since stock prices adjust to reflect expected changes in profitability almost immediately.
- D) above average returns since you will share in the higher profits.
- E) none of the above.

Answer: C

28) To say that stock prices follow a "random walk" is to argue that

- A) stock prices rise, then fall, then rise again.
- B) stock prices rise, then fall in a predictable fashion.
- C) stock prices cannot be predicted based on past trends.
- D) stock prices tend to follow trends.

Answer: C

29) Evidence against market efficiency includes

- A) the random walk behavior of stock prices.
- B) the inability of mutual fund managers to consistently beat the market.
- C) failure of technical analysis to outperform the market.
- D) the January effect.
- E) all of the above.

Answer: D

30) A situation when an asset price differs from its fundamental value is a(n)

- A) inflation.
- B) deflation.
- C) efficient market.
- D) random walk.
- E) bubble.

Answer: E