Money and Banking **Prof. Yamin Ahmad**
ECON 354 **Summer 2009**

Quiz 3: The Stock Market, Efficient Markets Hypothesis; Central Banks and the Fed

Name______________________________________ **Id #** ____________________________

Instructions: Please mark the answers to the multiple choice questions on the exam paper in the space provided and turn the exam in at the end.

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

1) Using the one-period valuation model, assuming a year-end dividend of $0.11, an expected sales price of $110, and a required rate of return of 10%, the current price of the stock would be

A) $121.12. B) $100.00. C) $110.11. D) $100.10 E) $100.11

Answer: D

2) In the generalized dividend model, a future sales price far in the future does not affect the current stock price because

A) the stock may never be sold.
B) the company may suffer bankruptcy.
C) the sales price does not affect the current price.
D) the present value is almost zero.
E) the present value cannot be computed.

Answer: D

3) Using the Gordon growth model, a stock's price will increase if

A) the future sales price increases.
B) the dividend growth rate increases.
C) the required rate of return increases.
D) all of the above occur.
E) both A and B of the above.

Answer: B

4) Using the Gordon growth formula, if D_1 is $2.00, k_e is 12% or 0.12, and g is 10% or 0.10, then the current stock price is

A) $150. B) $20. C) $200. D) $50. E) $100.

Answer: E

5) If expectations of the future inflation rate are formed solely on the basis of a weighted average of past inflation rates, then economics would say that expectation formation is

A) adaptive. B) irrational.
C) rational. D) the result of none of the above.

Answer: A

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

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

Answer: B

7) According to the efficient markets hypothesis, the current price of a financial security:

A) fully reflects all available relevant information.
B) is determined by the highest successful bidder.
C) is the discounted net present value of future interest payments.
D) is a result of none of the above.

Answer: A

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

Answer: B

9) The small–firm effect refers to the

A) fact that small firms earn low returns after adjusting for risk.
B) abnormally high returns earned by small firms.
C) lower than average returns earned by small firms.
D) fact that small firms earn returns equal to large firms.
E) fact that small firms generally earn negative returns.

Answer: B

10) Evidence in support of the efficient markets hypothesis includes

A) the January effect.
B) the small–firm effect.
C) excessive volatility.
D) the failure of technical analysis to outperform the market.
E) all of the above.

Answer: D

11) If stock prices surge upwards after news breaks that a recession is over, then we can say that markets are:

A) Weak form efficient
B) Semi–Strong form effiicent
C) Strong Form Efficient
D) None of the above

Answer: A

12) A situation when an asset price differs from its fundamental value is a(n)
   A) inflation.
   B) random walk.
   C) deflation.
   D) efficient market.
   E) bubble.

Answer: E

13) American businesses get their external funds primarily from
   A) bonds and commercial paper issues.
   B) bank loans.
   C) other loans.
   D) stock issues.

Answer: B

14) The problem created by asymmetric information before the transaction occurs is called _____, while the problem created after the transaction occurs is called _____.
   A) free-riding; costly state verification
   B) costly state verification; free-riding
   C) adverse selection; moral hazard
   D) moral hazard; adverse selection

Answer: C

15) If bad credit risks are the ones who most actively seek loans and, therefore, receive them from financial intermediaries, then financial intermediaries face the problem of
   A) adverse selection.
   B) costly state verification.
   C) moral hazard.
   D) free-riding.

Answer: A

16) Because of the "lemons problem" the price a buyer of a used car pays is
   A) equal to the price of a lemon.
   B) greater than the price of a peach.
   C) less than the price of a lemon.
   D) between the price of a lemon and a peach.
   E) equal to the price of a peach.

Answer: D

17) Which of the following is an element of the Federal Reserve System?
   A) The Federal Reserve Banks
   B) The Board of Governors
   C) The FDIC
   D) Each of the above
   E) Only A and B of the above

Answer: E

18) The Federal Open Market Committee consists of
   A) the seven members of the Board of Governors and seven presidents of the regional Fed banks.
   B) the twelve regional Fed bank presidents and the chairman of the Board of Governors.
   C) the seven members of the Board of Governors and five presidents of the regional Fed banks.
   D) the five senior members of the seven-member Board of Governors.

Answer: C

19) Of the major central banks of the world, the most independent is

A) the European Central Bank.

B) the Bank of Japan.

C) the Federal Reserve System.

D) the Bank of Canada.

E) the Bank of England.

Answer: A

20) The Federal Reserve entity that determines monetary policy strategy is the

A) chairman of the Board of Governors.

B) Shadow Open Market Committee.

C) Board of Governors.

D) Federal Open Market Committee.

Answer: D