

Fall, 2018
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EXAMINATION #3

Instructions: On your opscan form, mark your ID NUMBER, your NAME, and the number of the seat (e.g. G2) where you are actually sitting. Since a wrong answer has the same impact on your score as no answer, you should answer every question. Please also turn in this question sheet, after writing your NAME and SEAT NUMBER below. If you have any questions, ask now, not after the exam is over! There are 40 questions and 3 bonus questions. Each question is worth 2.5 points.

Name:

Seat that you are actually occupying:

1. Which investment project is most likely to be attractive if interest rates are high?

- (A) Highway.
- (B) Shrimp farm.
- (C) Private school.
- (D) Container ship.
- (E) Nuclear power plant.
- (AB) Automobile assembly plant.

2. If interest rates rise and corporate earnings are expected to fall, then we expect *bond* prices:

- (A) To fall.
- (B) To rise.
- (C) The implications are ambiguous.

3. If interest rates rise and corporate earnings are expected to fall, then we expect *stock* prices:

- (A) To fall.
- (B) To rise.
- (C) The implications are ambiguous.

4. If Ford reports a big increase in profits, but its stock price does not move quickly, then this likely indicates:

- (A) The earnings increase was expected.
- (B) Ford's stock price is not based on its earnings.
- (C) The stock price will increase as the market digests the news.
- (D) The earnings represented accounting instead of economic profits.

5. Which of the following are primary factors that determine a stock's price, according to the theory of efficient markets? (Mark all that apply.)

- (A) Interest rates.
- (B) The firm's profits.
- (C) The size of the firm.
- (D) The dividend that it pays to shareholders.
- (E) Whether the stock's price trend is up or down.

6. Which of the following usually has the greatest effect on saving and investment decisions?

- (A) Inflation rate.
- (B) Real interest rate.
- (C) Nominal interest rate.

7. Technical" investing refers to making decisions based on:

- (A) Price patterns.
- (B) Intrinsic value.
- (C) Extrinsic value.
- (D) Fundamental value.
- (E) Quantitative data only
- (AB) All of the above.

8. The real interest rate is negative:

- (A) When inflation is negative (i.e., deflation).
- (B) When inflation exceeds the nominal interest rate.
- (C) When the nominal interest rate exceeds inflation.
- (D) Never.

9. Which physical properties of gold contribute to its value (mark all that apply)?

- (A) Color.
- (B) Malleability.
- (C) Electrical conductivity.
- (D) Resistance to corrosion.
- (E) High strength to weight.

For the purpose of serving as a medium of exchange, and based on the discussion in class, which asset:

10. Is most widely accepted?

- (A) Gold.
- (B) Dollars.
- (C) Bitcoin.

11. Has the longest historical acceptance of value?

- (A) Gold.
- (B) Dollars.
- (C) Bitcoin.

12. Has the most support from the legal system?

- (A) Gold.
- (B) Dollars.
- (C) Bitcoin.

13. Has the fewest close substitutes?

- (A) Gold.
- (B) Dollars.
- (C) Bitcoin.

14. The most historical price stability?

- (A) Gold.
- (B) Dollars.
- (C) Bitcoin.

15. Is especially practical for hiding large transactions?

- (A) Gold.
- (B) Dollars.
- (C) Bitcoin.

16. If the yield on a bond is 4%, and the expected inflation rate is 1%, then the bond earns a real interest rate of:

- (A) -3%.
- (B) 1%
- (C) 2%
- (D) 3%
- (E) 4%
- (AB) 5%.

17. Which asset's market price can be explained only as a blend of intrinsic and extrinsic value?

- (A) Gold.
- (B) Dollars.
- (C) Bitcoin.
- (D) Shares of IBM.

18. Which interest rates tend to fluctuate more (i.e., show more up and down variation)?

- (A) Real rates
- (B) Nominal rates.
- (C) They fluctuate to an approximately equal extent.

19. According to the theory of efficient financial markets, an investment manager who has historically outperformed the market index for stocks of similar risk is most likely to _____ that index in the future.

- (A) underperform
- (B) continue to outperform
- (C) match (neither underperform nor outperform)

20. When calculating the intrinsic value of a bond, the interest rate used in the calculation is:

- (A) The bond's yield.
- (B) The yield on the Treasury bond of equal maturity.
- (C) The rate of return on assets with similar properties.
- (D) Whatever interest rate makes the intrinsic value equal to the bond's market price.

21. If the intrinsic value of a stock exceeds its market price, then it is reasonable to conclude:

- (A) The stock pays a low dividend.
- (B) The stock pays a high dividend.
- (C) The stock has a low level of risk.
- (D) The stock has a high level of risk.
- (E) The market is undervaluing the stock.
- (AB) The market is overvaluing the stock.

22. If the theory of efficient financial markets is true, then it has what implication?

- (A) On average, small investors earn higher rates of return than large investors.
- (B) On average, large investors earn higher rates of return than small investors.
- (C) The only kind of stock portfolio that can systematically earn a higher rate of return than the stock market as a whole is one that is riskier than average.
- (D) The only kind of stock portfolio that can systematically earn a higher rate of return than the stock market as a whole is one that emphasizes stocks that pay high dividends.

23. Financial markets are *efficient* if:

- (A) Every investor is small relative to the market.
- (B) The rate of return on investment is maximized.
- (C) The quantity supplied of each asset equals the quantity demanded.
- (D) Trading in those markets helps some investors without hurting any investors.
- (E) The market price of each asset equals its intrinsic value, based upon all available information.

24. The U.S. government provides legal support for the dollars in what ways? (Mark all that apply.)

- (A) Backs dollars by gold.
- (B) Requires taxes to be paid in dollars.
- (C) Makes dollars difficult to counterfeit.
- (D) Places legal limits on how many dollars the Fed can issue.
- (E) Bans use of cryptocurrencies for a wide range of transactions.

25. In the 20th century, the government stopped the rising use of _____ by banning their use for most transactions.

- (A) Bitcoins.
- (B) Casino tokens.
- (C) Postage stamps.
- (D) Housing vouchers.
- (E) Privately minted silver coins.

26. As shown in class, which country experienced such a severe hyperinflation that it issued \$10 trillion notes?

- (A) India.
- (B) Russia.
- (C) Greece.
- (D) Mexico.
- (E) Zimbabwe.
- (AB) Bangladesh.

27. Most economists believe that the surest way to make money in the stock market is to:

- (A) Buy a highly-rated stock fund.
- (B) Buy stocks that pay high dividends.
- (C) Buy stocks that have a low price/earnings ratio.
- (D) Use the "technical" approach to portfolio selection.
- (E) Buy stocks that are moving up and sell stocks that are moving down.
- (AB) Discover information that affects the value of a stock before anyone else discovers it.

28. The theory of efficient markets predicts that stock prices _____ and studies of the data mostly _____ confirm that prediction.

- (A) follow a random walk; do.
- (B) exhibit persistent trends; do.
- (C) follow a random walk; do not.
- (D) exhibit persistent trends; do not.

29. What is required for free entry (mark all that apply)?

- (A) Every seller is small relative to the market.
- (B) Sellers and potential entrants have the same long run costs.
- (C) Sellers and potential entrants have the same long run access to markets.
- (D) None of these conditions is required.

30. When market interest rates change, what changes for a typical corporate bond? (Mark all that apply.)

- (A) The maturity date.
- (B) The price of the bond.
- (C) The principal that a corporation returns when the bond matures.
- (D) The interest payments that a corporation pays on the bond before maturity.
- (E) None of these things change.

31. If the auction price of a one-year \$1,000 Treasury bill is \$813, then the yield is closest to:

- | | |
|----------|-----------|
| (A) 16%. | (AB) 21%. |
| (B) 17%. | (AC) 22%. |
| (C) 18%. | (AD) 23%. |
| (D) 19%. | (AE) 24%. |
| (E) 20%. | (BC) 25%. |

32. Suppose the Treasury auctions a \$5,000 bond that matures in *two* years, has an annualized yield of 11% and makes no interest payments. Then the the auction price of the bond is closest to:

- | | |
|---------------|---------------|
| (A) \$4,000. | (AC) \$4,300. |
| (B) \$4,050. | (AD) \$4,350. |
| (C) \$4,100. | (AE) \$4,400. |
| (D) \$4,150. | (BC) \$4,450. |
| (E) \$4,200. | (BD) \$4,500. |
| (AB) \$4,250. | (BE) \$4,550. |

33. If the bonds of corporation A pay a higher interest rate than the bonds of corporation B, consistently over several years, the safest conclusion is that:

- (A) Corporation A is larger.
- (B) Corporation B is larger.
- (C) Corporation A is more likely to go bankrupt.
- (D) Corporation B is more likely to go bankrupt.
- (E) The financial markets are not in equilibrium.

34. One source of risk in buying a longer term bond is that _____ could lead to an unexpected loss if _____.

- (A) early redemption; yields fall.
- (B) early redemption; yields rise.
- (C) holding the bond until maturity; yields fall.
- (D) holding the bond until maturity; yields rise.

35. Suppose that the market supply curve can be described by the equation $Q_s = 6P - 4$ and market demand can be described by the equation $Q_d = 77 - 3P$, where P is the market price. Then, in equilibrium, the equilibrium price in this market is closest to:

- (A) 1. (AB) 6.
- (B) 2. (AC) 7.
- (C) 3. (AD) 8.
- (D) 4. (AE) 9.
- (E) 5. (BC) 10.

36. Economics ____ a science because ____:

- (A) Is; it has its own Nobel prize.
- (B) Is; it uses mathematical models.
- (C) Is; it makes predictions and tests them.
- (D) Is not; economists can never agree on a single theory.
- (E) Is not; most economists have never been inside a laboratory.
- (AB) Is not; economic behavior often deviates from scientific principles.

For the next four questions, assume that game consoles and video games are complements. If tariffs increase the cost of producing game consoles, then what happens?

37. In the market for game consoles:

- (A) Supply increases.
- (B) Supply decreases.
- (C) Demand increases.
- (D) Demand decreases.

Based on the events in the console market:

38. What happens to the demand curve for video games?

- (A) It shifts left.
- (B) It shifts right.
- (C) There is no clear shift.

39. What happens to the supply curve for video games?

- (A) It shifts left.
- (B) It shifts right.
- (C) There is no clear shift.

40. What happens to the price of video games?

- (A) It increases.
- (B) It decreases.
- (C) It does not change.
- (D) It could increase or decrease, depending on the size of the tariffs relative to the price of video games.

BONUS QUESTIONS

41. According to Mark Twain, Cecil Rhodes got rich with the help of a:

- (A) Dog.
- (B) Shark.
- (C) Horse.
- (D) Monkey.
- (E) Elephant.
- (AB) Bacterium.

42. If the Fed wants to achieve the lowest possible real interest rate, to stimulate the economy, and its only tool is manipulation of the nominal interest rate, which cannot go below zero, then, thinking only of this goal, the best situation for the Fed is:

- (A) High inflation.
- (B) Low inflation.
- (C) Zero inflation.
- (D) Negative inflation.

43. Salvator Mundi is a portrayal of:

- (A) Jesus.
- (B) A bowl of fruit.
- (C) A bowl of pasta.
- (D) Heaven and hell.
- (E) An Italian aristocrat.
- (AB) A scene from Greek mythology.