ECON UN3265: Money and Banking

Summer 2026 — Practice Quiz

Chapter 7 — Practice Quiz

How to use this quiz. These multiple-choice questions are based on selected Chapter 7 practice questions and applied problems on stock valuation, rational expectations, and the efficient market hypothesis. Work through them after the reading; the answer key is on the last page.

Questions

1. What are the two main sources of cash flows for a stockholder, and how do they compare with bond cash flows?

A) Coupon payments and principal repayment; these are usually less uncertain for stocks than for bonds.
B) Dividends and the future sale price; these are harder to estimate than bond payments, so stocks are generally more volatile.
C) Only dividends; stockholders never receive cash from selling shares.
D) Only capital gains; dividends are not part of stock valuation.

2. Suppose the Reserve Bank of Australia is worried that the stock market is near bubble territory while growth is positive and inflation is above 3%. What policy is most consistent with this concern, and what would the Gordon growth model predict for stock prices?

A) It should lower the base rate; the required return falls, so stock prices fall.
B) It should increase the base rate; the required return rises, so stock prices fall.
C) It should increase the base rate; dividend growth must rise one-for-one, so stock prices rise.
D) It should do nothing because interest rates have no role in stock valuation.

3. If monetary policy becomes more transparent about the future course of interest rates, how will stock prices be affected, if at all?

A) Stock prices should adjust more smoothly to expected future rates, because expected policy is incorporated earlier and surprises are reduced.
B) Stock prices must permanently rise because transparency eliminates all risk.
C) Stock prices must permanently fall because transparency makes dividends illegal.
D) Stock prices cannot be affected because interest rates do not enter present-value formulas.

4. Francesco forecasts future stock prices using all available information. On the day he announces the forecast, a major competitor unexpectedly announces a plan to buy another bank and reshape the Italian banking industry. Would Francesco's forecast still be considered optimal?

A) Yes, because a forecast is optimal forever once it uses the information available at the time it was made.
B) No, because once new relevant information arrives, an optimal forecast should be revised to incorporate it.
C) Yes, because mergers by competitors can never affect stock prices.
D) No, because forecasts are optimal only when they are perfectly accurate ex post.

5. Luigi misjudges a football match whenever Cristiano Ronaldo is not playing, but Ronaldo misses only one match per year, so Luigi is almost always accurate. Are Luigi's expectations rational?

A) Yes, because rational expectations require forecasts to be correct most of the time.
B) Yes, because rare events can be ignored completely.

C) No, because his errors are systematic and predictable when Ronaldo is absent.

D) No, because rational expectations require perfect accuracy in every match.

6. If the public expected a corporation to lose $5 per share this quarter but it actually loses $4, what does the efficient market hypothesis predict will happen to the stock price when the $4 loss is announced?

A) The stock price should fall because any loss is bad news.

B) The stock price should rise because the loss is smaller than expected.

C) The stock price should not move because earnings announcements never matter.

D) The stock price should become zero because the firm reported a loss.

7. Hans expects the price of Volkswagen to decrease by 10% in the next month. Is Hans a person with rational expectations?

A) Yes, because rational expectations can include any expected price change, no matter how predictable.

B) Probably not, if this expected decline is based on available information, because the price should already adjust today until expected returns are normal.

C) Yes, because rational investors always expect negative returns.

D) No, because stock prices are legally required to rise each month.

8. Suppose that in every last week of November stock prices go up by an average of 3%. Would this constitute evidence in favor of or against the efficient market hypothesis?

A) Against it, because a predictable seasonal return pattern would appear to create abnormal profit opportunities.

B) In favor of it, because efficient markets require the same 3% gain every year.

C) Neither, because stock prices in November are not part of financial markets.

D) In favor of it, because predictable profits are the definition of efficiency.

9. "An efficient market is one in which no one ever profits from having better information than the rest of the market participants." Is this statement true, false, or uncertain?

A) True, because efficient markets eliminate all profits from private information.

B) False, because better or private information can generate profits; efficiency mainly says that available information is quickly reflected in prices.

C) True, because efficient markets mean all investors have identical information.

D) Uncertain, because efficient markets are unrelated to information.

10. If higher money growth is associated with higher future inflation, and announced money growth is extremely high but still less than the market expected, what should happen to long-term bond prices?

A) They should fall because any high money growth announcement raises expected inflation relative to expectations.

B) They should rise because the announcement is less inflationary than expected, lowering expected future interest rates relative to prior market expectations.

C) They should not change because bond prices never respond to inflation news.

D) They should become zero because money growth is high.

11. Altin can invest in mutual fund A with double the management fee of fund B, because fund A claims it can consistently outperform the market and has outperformed in the last two years. If the efficient market hypothesis holds, which fund should he choose?

A) Fund A, because two years of outperformance guarantees future outperformance.

B) Fund B, because past outperformance does not reliably predict future abnormal returns, and the lower fee is valuable.

C) Fund A, because high fees are proof of better analysts.

D) Either fund, because fees do not affect investor returns.

12. How could the late-1990s stock market boom and subsequent crash be described as a bubble while still adhering to the efficient market hypothesis?

A) Prices could reflect available information and rational expectations at the time, including high expected future growth or resale values, even if the crash was not predictable ex ante.
B) The efficient market hypothesis says stock prices are always equal to zero during bubbles.
C) A crash proves that all investors knew the exact date of the crash in advance.
D) It cannot be reconciled in any way, because any price decline automatically disproves market efficiency.

13. Why might the efficient market hypothesis be less likely to hold when fundamentals suggest stocks should be at a lower level?

A) Short-selling limits, arbitrage risk, investor optimism, or coordination problems can prevent informed traders from quickly pushing prices down to fundamentals.
B) Fundamentals are never relevant to stock prices.
C) Investors are legally prohibited from buying undervalued stocks.
D) Lower fundamentals always make arbitrage costless and riskless.

14. Compute the price of a share of stock that pays a $1 dividend in one year and is expected to sell for $20 in one year, assuming a required return of 15%.

A) $17.39
B) $18.26
C) $20.00
D) $21.00

15. A firm's dividends are expected to grow at 7% forever. The last dividend was $3, and the required return is 18%. What is the current stock price?

A) $16.67
B) $25.00
C) $29.18
D) $42.86

Answer Key

1. B 2. B 3. A 4. B 5. C 6. B 7. B 8. A 9. B 10. B 11. B 12. A 13. A 14. B 15. C