Chapter 8
An Economic Analysis of Financial Structure

8.1 Basic Facts About Financial Structure Throughout the World

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

Answer: A
Ques Status: Previous Edition

2) Of the sources of external funds for nonfinancial businesses in the United States, loans from banks and other financial intermediaries account for approximately ______ of the total.
   A) 6%
   B) 40%
   C) 56%
   D) 60%

Answer: C
Ques Status: Revised

3) Of the sources of external funds for nonfinancial businesses in the United States, corporate bonds and commercial paper account for approximately ______ of the total.
   A) 5%
   B) 10%
   C) 32%
   D) 50%

Answer: C
Ques Status: Revised

4) Of the following sources of external finance for American nonfinancial businesses, the least important is
   A) loans from banks.
   B) stocks.
   C) bonds and commercial paper.
   D) loans from other financial intermediaries.

Answer: B
Ques Status: Previous Edition
5) Of the sources of external funds for nonfinancial businesses in the United States, stocks account for approximately ________ of the total.

   A) 2%
   B) 11%
   C) 20%
   D) 40%

Answer: B
Ques Status: Revised

6) Which of the following statements concerning external sources of financing for nonfinancial businesses in the United States are true?

   A) Stocks are a far more important source of finance than are bonds.
   B) Stocks and bonds, combined, supply less than one-half of the external funds.
   C) Financial intermediaries such as banks are the least important source of external funds for businesses.
   D) Since 1970, more than half of the new issues of stock have been sold to American households.

Answer: B
Ques Status: Revised

7) Which of the following statements concerning external sources of financing for nonfinancial businesses in the United States are true?

   A) Issuing marketable securities is the primary way that they finance their activities.
   B) Bonds are the least important source of external funds to finance their activities.
   C) Stocks are a relatively unimportant source of finance for their activities.
   D) Selling bonds directly to the American household is a major source of funding for American businesses.

Answer: C
Ques Status: Revised

8) With regard to external sources of financing for nonfinancial businesses in the United States, which of the following are accurate statements?

   A) Marketable securities account for a larger share of external business financing in the United States than in most other countries.
   B) Since 1970, most of the newly issued corporate bonds and commercial paper have been sold directly to American households.
   C) Direct finance accounts for more than 50 percent of the external financing of American businesses.
   D) Smaller businesses almost always raise funds by issuing marketable securities.

Answer: A
Ques Status: Revised
9) Nonfinancial businesses in Germany, Japan, and Canada raise most of their funds
   A) by issuing stock.
   B) by issuing bonds.
   C) from nonbank loans.
   D) from bank loans.

   Answer: D
   Ques Status: Revised

10) As a source of funds for nonfinancial businesses, stocks are relatively more important in
    A) the United States.
    B) Germany.
    C) Japan.
    D) Canada.

    Answer: D
    Ques Status: Revised

11) Regulation of the financial system
    A) occurs only in the United States.
    B) protects the jobs of employees of financial institutions.
    C) protects the wealth of owners of financial institutions.
    D) ensures the stability of the financial system.

    Answer: D
    Ques Status: Revised

12) One purpose of regulation of financial markets is to
    A) limit the profits of financial institutions.
    B) increase competition among financial institutions.
    C) promote the provision of information to shareholders, depositors and the public.
    D) guarantee that the maximum rates of interest are paid on deposits.

    Answer: C
    Ques Status: Revised
13) Property that is pledged to the lender in the event that a borrower cannot make his or her debt payment is called
   A) collateral.
   B) points.
   C) interest.
   D) good faith money.
   Answer: A
   Ques Status: Previous Edition

14) Commercial and farm mortgages, in which property is pledged as collateral, account for
   A) one-quarter of borrowing by nonfinancial businesses.
   B) one-half of borrowing by nonfinancial businesses.
   C) one-twentieth of borrowing by nonfinancial businesses.
   D) two-thirds of borrowing by nonfinancial businesses.
   Answer: A
   Ques Status: Previous Edition

15) The predominant form of household debt is
   A) consumer installment debt.
   B) collateralized debt.
   C) unsecured debt.
   D) unrestricted debt.
   Answer: B
   Ques Status: Revised

16) Collateralized debt is also know as
   A) unsecured debt.
   B) secured debt.
   C) unrestricted debt.
   D) promissory debt.
   Answer: B
   Ques Status: Revised
17) Credit card debt is
   A) secured debt.
   B) unsecured debt.
   C) restricted debt.
   D) unrestricted debt.
   
   Answer: B
   Ques Status: Revised

18) If you default on your auto loan, your car will be repossessed because it has been pledged as ______ for the loan.
   
   A) interest
   B) collateral
   C) dividend
   D) commodity
   
   Answer: B
   Ques Status: New

19) A ______ is a provision that restricts or specifies certain activities that a borrower can engage in.
   
   A) residual claimant
   B) risk hedge
   C) restrictive barrier
   D) restrictive covenant
   
   Answer: D
   Ques Status: New

20) A clause in a mortgage loan contract requiring the borrower to purchase homeowner's insurance is an example of a
   
   A) proscriptive covenant.
   B) prescriptive covenant.
   C) restrictive covenant.
   D) constraint-imposed covenant.
   
   Answer: C
   Ques Status: Previous Edition
21) Which of the following is not one of the eight basic puzzles about financial structure?

A) Stocks are the most important source of finance for American businesses.
B) Issuing marketable securities is not the primary way businesses finance their operations.
C) Indirect finance, which involves the activities of financial intermediaries, is many times more important than direct finance, in which businesses raise funds directly from lenders in financial markets.
D) Banks are the most important source of external funds to finance businesses.

Answer: A
Ques Status: Previous Edition

22) Which of the following is not one of the eight basic puzzles about financial structure?

A) The financial system is among the most heavily regulated sectors of the economy.
B) Issuing marketable securities is the primary way businesses finance their operations.
C) Indirect finance, which involves the activities of financial intermediaries, is many times more important than direct finance, in which businesses raise funds directly from lenders in financial markets.
D) Banks are the most important source of external funds to finance businesses.

Answer: B
Ques Status: Previous Edition

23) Which of the following is not one of the eight basic puzzles about financial structure?

A) Only large, well-established corporations have access to securities markets to finance their activities.
B) Indirect finance, which involves the activities of financial intermediaries, is many times more important than direct finance, in which businesses raise funds directly from lenders in financial markets.
C) Collateral is a prevalent feature of debt contracts for households, but not business since they have many alternative sources for funds.
D) Banks are the most important source of external funds to finance businesses.

Answer: C
Ques Status: Previous Edition
24) Which of the following is not one of the eight basic puzzles about financial structure?

A) Debt contracts are typically extremely complicated legal documents that place substantial restrictions on the behavior of the borrower.

B) Indirect finance, which involves the activities of financial intermediaries, is many times more important than direct finance, in which businesses raise funds directly from lenders in financial markets.

C) Collateral is a prevalent feature of debt contracts for both households and business.

D) New security issues are the most important source of external funds to finance businesses.

Answer: D

25) Which of the following is not one of the eight basic puzzles about financial structure?

A) The financial system is among the most heavily regulated sectors of the economy.

B) Only large, well-established corporations have access to securities markets to finance their activities.

C) Direct finance, in which businesses raise funds directly from lenders in financial markets, is many times more important than indirect finance, which involves the activities of financial intermediaries.

D) Debt contracts are typically extremely complicated legal documents that place substantial restrictions on the behavior of the borrower.

Answer: C

8.2 Transaction Costs

1) The current structure of financial markets can be best understood as the result of attempts by financial market participants to

A) adapt to continually changing government regulations.

B) deal with the great number of small firms in the United States.

C) reduce transaction costs.

D) cartelize the provision of financial services.

Answer: C
2) The reduction in transactions costs per dollar of investment as the size of transactions increases is
   A) discounting.
   B) economies of scale.
   C) economies of trade.
   D) diversification.

   Answer: B
   Ques Status: Revised

3) Which of the following is not a benefit to an individual purchasing a mutual fund?
   A) reduced risk
   B) lower transactions costs
   C) free-riding
   D) diversification

   Answer: C
   Ques Status: New

4) Financial intermediaries develop _______ in things such as computer technology which allows them to lower transactions costs.
   A) expertise
   B) diversification
   C) regulations
   D) equity

   Answer: A
   Ques Status: New

5) How does a mutual fund lower transactions costs through economies of scale?

   Answer: The mutual fund takes the funds of the individuals who have purchased shares and uses them to purchase bonds or stocks. Because the mutual fund will be purchasing large blocks of stocks or bonds they will be able to obtain them at lower transactions costs than the individual purchases of smaller amounts could.

   Ques Status: New
8.3 Asymmetric Information: Adverse Selection and Moral Hazard

1) A borrower who takes out a loan usually has better information about the potential returns and risk of the investment projects he plans to undertake than does the lender. This inequality of information is called
   A) moral hazard.
   B) asymmetric information.
   C) noncollateralized risk.
   D) adverse selection.

   Answer: B

2) 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) moral hazard.
   B) adverse selection.
   C) free-riding.
   D) costly state verification.

   Answer: B

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

   Answer: A

4) The presence of ________ in financial markets leads to adverse selection and moral hazard problems that interfere with the efficient functioning of financial markets.
   A) noncollateralized risk
   B) free-riding
   C) asymmetric information
   D) costly state verification

   Answer: C
5) The analysis of how asymmetric information problems affect economic behavior is called _______ theory.
   A) uneven
   B) parallel
   C) principal
   D) agency

Answer: D
Ques Status: New

8.4 The Lemons Problem: How Adverse Selection Influences Financial Structure

1) The "lemons problem" exists because of
   A) transactions costs.
   B) economies of scale.
   C) rational expectations.
   D) asymmetric information.

Answer: D
Ques Status: Revised

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

Answer: D
Ques Status: Revised

3) The free-rider problem occurs because
   A) people who pay for information use it freely.
   B) people who do not pay for information use it.
   C) information can never be sold at any price.
   D) it is never profitable to produce information.

Answer: B
Ques Status: Revised
4) The ______ problem helps to explain why the private production and sale of information cannot eliminate ______.
   A) free-rider; adverse selection
   B) free-rider; moral hazard
   C) principal-agent; adverse selection
   D) principal-agent; moral hazard

   Answer: A
   Ques Status: Revised

5) Government regulations require publicly traded firms to provide information, reducing
   A) transactions costs.
   B) the need for diversification.
   C) the adverse selection problem.
   D) economies of scale.

   Answer: C
   Ques Status: Revised

6) A lesson of the Enron collapse is that government regulation
   A) always fails.
   B) can reduce but not eliminate asymmetric information.
   C) increases the problem of asymmetric information.
   D) should be reduced.

   Answer: B
   Ques Status: Revised

7) Adverse selection is a problem associated with equity and debt contracts arising from
   A) the lender’s relative lack of information about the borrower’s potential returns and risks of his investment activities.
   B) the lender’s inability to legally require sufficient collateral to cover a 100% loss if the borrower defaults.
   C) the borrower’s lack of incentive to seek a loan for highly risky investments.
   D) the lender’s inability to restrict the borrower from changing his behavior once given a loan.

   Answer: A
   Ques Status: Revised
8) Because of the adverse selection problem,
   A) good credit risks are more likely to seek loans causing lenders to make a
disproportionate amount of loans to good credit risks.
   B) lenders may refuse loans to individuals with high net worth, because of their greater
proclivity to "skip town."
   C) lenders are reluctant to make loans that are not secured by collateral.
   D) lenders will write debt contracts that restrict certain activities of borrowers.

Answer: C

Ques Status: Previous Edition

9) In the United States, the government agency requiring that firms that sell securities in public
markets adhere to standard accounting principles and disclose information about their sales,
assets, and earnings is the
   A) Federal Communications Commission.
   B) Federal Trade Commission.
   C) Securities and Exchange Commission.
   D) Federal Reserve System.

Answer: C

Ques Status: Revised

10) That most used cars are sold by intermediaries (i.e., used car dealers) provides evidence that
these intermediaries
   A) have been afforded special government treatment, since used car dealers do not provide
information that is valued by consumers of used cars.
   B) are able to prevent potential competitors from free-riding off the information that they
provide.
   C) have failed to solve adverse selection problems in this market because "lemons" continue
to be traded.
   D) have solved the moral hazard problem by providing valuable information to their
customers.

Answer: B

Ques Status: Revised
11) The concept of adverse selection helps to explain all of the following except

A) why firms are more likely to obtain funds from banks and other financial intermediaries, rather than from the securities markets.

B) why indirect finance is more important than direct finance as a source of business finance.

C) why direct finance is more important than indirect finance as a source of business finance.

D) why the financial system is so heavily regulated.

Answer: C  
Ques Status: Revised

12) Analysis of adverse selection indicates that financial intermediaries, especially banks,

A) have advantages in overcoming the free-rider problem, helping to explain why indirect finance is a more important source of business finance than is direct finance.

B) despite their success in overcoming free-rider problems, nevertheless play a minor role in moving funds to corporations.

C) provide better-known and larger corporations a higher percentage of their external funds than they do to newer and smaller corporations which rely to a greater extent on the new issues market for funds.

D) must buy securities from corporations to diversify the risk that results from holding non-tradable loans.

Answer: A  
Ques Status: Revised

13) The problem of adverse selection helps to explain

A) why firms are more likely to obtain funds from banks and other financial intermediaries, rather than from securities markets.

B) why collateral is an important feature of consumer, but not business, debt contracts.

C) why direct finance is more important than indirect finance as a source of business finance.

D) why lenders refuse loans to individuals with high net worth.

Answer: A  
Ques Status: Revised
14) That only large, well-established corporations have access to securities markets
   A) explains why indirect finance is such an important source of external funds for businesses.
   B) can be explained by the problem of moral hazard.
   C) can be explained by government regulations that prohibit small firms from acquiring funds in securities markets.
   D) explains why newer and smaller corporations rely so heavily on the new issues market for funds.

Answer: A
Ques Status: Revised

15) The concept of adverse selection helps to explain
   A) why collateral is not a common feature of many debt contracts.
   B) why large, well-established corporations find it so difficult to borrow funds in securities markets.
   C) why financial markets are among the most heavily regulated sectors of the economy.
   D) why stocks are the most important source of external financing for businesses.

Answer: C
Ques Status: Revised

16) As information technology improves, the lending role of financial institutions such as banks should _______.
   A) increase somewhat
   B) decrease
   C) stay the same
   D) increase significantly

Answer: B
Ques Status: New

17) Net worth can perform a similar role to _______.
   A) diversification
   B) collateral
   C) intermediation
   D) economies of scale

Answer: B
Ques Status: New
18) How does collateral help to reduce the adverse selection problem in credit market?

Answer: Collateral is property that is promised to the lender if the borrower defaults thus reducing the lender’s losses. Lenders are more willing to make loans when there is collateral that can be sold if the borrower defaults.

Ques Status: New

8.5 How Moral Hazard Affects the Choice Between Debt and Equity Contracts

1) Moral hazard in equity contracts is known as the _______ problem because the manager of the firm has fewer incentives to maximize profits than the stockholders might ideally prefer.

A) principal-agent
B) adverse selection
C) free-rider
D) debt deflation

Answer: A  
Ques Status: Previous Edition

2) Because managers (_______) have less incentive to maximize profits than the stockholders—owners (_______) do, stockholders find it costly to monitor managers; thus, they are reluctant to purchase equities.

A) principals; agents
B) principals; principals
C) agents; agents
D) agents; principals

Answer: D  
Ques Status: Previous Edition

3) The principal-agent problem

A) occurs when managers have more incentive to maximize profits than the stockholders—owners do.
B) in financial markets helps to explain why equity is a relatively important source of finance for American business.
C) would not arise if the owners of the firm had complete information about the activities of the managers.
D) explains why direct finance is more important than indirect finance as a source of business finance.

Answer: C  
Ques Status: Revised
4) A problem for equity contracts is a particular type of ______, called the ______ problem.

   A) adverse selection; principal–agent
   B) moral hazard; principal–agent
   C) adverse selection; free–rider
   D) moral hazard; free–rider

   Answer: B
   Ques Status: Revised

5) The recent Enron and Tyco scandals are an example of

   A) the free–rider problem.
   B) the adverse selection problem.
   C) the principal–agent problem.
   D) the "lemons problem."

   Answer: C
   Ques Status: Revised

6) Equity contracts

   A) are claims to a share in the profits and assets of a business.
   B) have the advantage over debt contracts of a lower costly state verification.
   C) are used much more frequently to raise capital than are debt contracts.
   D) are not subject to the moral hazard problem.

   Answer: A
   Ques Status: Revised

7) Government regulations designed to reduce the moral hazard problem include

   A) laws that force firms to adhere to standard accounting principles.
   B) light sentences for those who commit the fraud of hiding and stealing profits.
   C) state verification subsidies.
   D) state licensing restrictions.

   Answer: A
   Ques Status: Revised
8) One financial intermediary in our financial structure that helps to reduce the moral hazard from arising from the principal–agent problem is the
   A) venture capital firm.
   B) money market mutual fund.
   C) pawn broker.
   D) savings and loan association.

Answer: A

9) A venture capital firm protects its equity investment from moral hazard through which of the following means?
   A) It places people on the board of directors to better monitor the borrowing firm’s activities.
   B) It writes contracts that prohibit the sale of an equity investment to the venture capital firm.
   C) It prohibits the borrowing firm from replacing its management.
   D) It requires a 50% stake in the company.

Answer: A

10) Because information is scarce
    A) helps explain why equity contracts are used so much more frequently to raise capital than are debt contracts.
    B) monitoring managers gives rise to costly state verification.
    C) government regulations, such as standard accounting principles, have no impact on problems such as moral hazard.
    D) developing nations do not rely heavily on banks for business financing.

Answer: B

11) Debt contracts
    A) are agreements by the borrowers to pay the lenders fixed dollar amounts at periodic intervals.
    B) have a higher cost of state verification than equity contracts.
    C) are used less frequently to raise capital than are equity contracts.
    D) never result in a loss for the lender.

Answer: A
12) Equity contracts account for a small fraction of external funds raised by American businesses because

A) costly state verification makes the equity contract less desirable than the debt contract.

B) of the reduced scope for moral hazard problems under equity contracts, as compared to debt contracts.

C) equity contracts do not permit borrowing firms to raise additional funds by issuing debt.

D) there is no moral hazard problem when using a debt contract.

Answer: A

Ques Status: Revised

13) Explain the principal-agent problem as it pertains to equity contracts.

Answer: The principals are the stockholders who own most of the equity. The agents are the managers of the firm who generally own only a small portion of the firm. The problem occurs because the agents may not have as much incentive to profit maximize as the stockholders.

Ques Status: New

8.6 How Moral Hazard Influences Financial Structure in Debt Markets

1) One way of describing the solution that high net worth provides to the moral hazard problem is to say that it

A) collateralizes the debt contract.

B) makes the debt contract incentive compatible.

C) state verifies the debt contract.

D) removes all of the risk in the debt contract.

Answer: B

Ques Status: Revised

2) High net worth helps to diminish the problem of moral hazard problem by

A) requiring the state to verify the debt contract.

B) collateralizing the debt contract.

C) making the debt contract incentive compatible.

D) giving the debt contract characteristics of equity contracts.

Answer: C

Ques Status: Previous Edition
3) A debt contract is incentive compatible
   A) if the borrower has the incentive to behave in the way that the lender expects and desires, since doing otherwise jeopardizes the borrower’s net worth in the business.
   B) if the borrower’s net worth is sufficiently low so that the lender’s risk of moral hazard is significantly reduced.
   C) if the debt contract is treated like an equity.
   D) if the lender has the incentive to behave in the way that the borrower expects and desires.

   Answer: A
   *Ques Status: Revised*

4) Solutions to the moral hazard problem include
   A) low net worth.
   B) monitoring and enforcement of restrictive covenants.
   C) greater reliance on equity contracts and less on debt contracts.
   D) greater reliance on debt contracts than financial intermediaries.

   Answer: B
   *Ques Status: Revised*

5) Professional athletes often have contract clauses prohibiting risky activities such as skiing and motorcycle riding. These clauses are
   A) limited-liability clauses.
   B) risk insurance.
   C) restrictive covenants.
   D) illegal.

   Answer: C
   *Ques Status: Revised*

6) Although restrictive covenants can potentially reduce moral hazard, a problem with restrictive covenants is that
   A) borrowers may find loopholes that make the covenants ineffective.
   B) they are inexpensive to monitor and enforce.
   C) too many resources may be devoted to monitoring and enforcing them, as debtholders duplicate others’ monitoring and enforcement efforts.
   D) they reduce the value of the debt contract.

   Answer: A
   *Ques Status: Revised*
7) A clause in a debt contract requiring that the borrower purchase insurance against loss of the asset financed with the loan is called a
   A) collateral-insurance clause.
   B) prescription covenant.
   C) restrictive covenant.
   D) proscription covenant.
   Answer: C  
   Ques Status: Previous Edition

8) For restrictive covenants to help reduce the moral hazard problem they must be _______ by the lender.
   A) monitored and enforced
   B) written in all capitals
   C) easily changed
   D) impossible to remove
   Answer: A  
   Ques Status: New

9) A key finding of the economic analysis of financial structure is that
   A) the existence of the free-rider problem for traded securities helps to explain why banks play a predominant role in financing the activities of businesses.
   B) while free-rider problems limit the extent to which securities markets finance some business activities, nevertheless the majority of funds going to businesses are channeled through securities markets.
   C) given the great extent to which securities markets are regulated, free-rider problems are not of significant economic consequence in these markets.
   D) economists do not have a very good explanation for why securities markets are so heavily regulated.
   Answer: A  
   Ques Status: Previous Edition

10) Why does the free-rider problem occur in the debt market?
    Answer: Restrictive covenants can reduce moral hazard but they must be monitored and enforced to be effective. If bondholders know that other bondholders are monitoring and enforcing the restrictive covenants, they can free ride. Other bondholders will follow suit resulting in not enough resources devoted to monitoring and enforcing restrictive covenants.  
    Ques Status: New
8.7 Conflicts of Interest

1) The presence of economies of scope may benefit financial institutions but may create potential costs from ________.
   - A) conflicts of interest
   - B) multiple profitable enterprises
   - C) economies of scale
   - D) unsecured debt

   Answer: A
   Ques Status: New

2) Because conflicts of interest increase asymmetric information problems
   - A) the economy will not operate as efficiently.
   - B) loans will not be made.
   - C) banks will not be able to make a profit.
   - D) the financial markets will operate more smoothly.

   Answer: A
   Ques Status: New

3) The practice of ________ is allocating initially underpriced initial public offerings to executives in companies the investment bank hopes to do underwriting business with in the future.
   - A) discounting
   - B) spinning
   - C) peppering
   - D) wiring

   Answer: B
   Ques Status: New

4) The Sarbanes–Oxley Act of 2002 increased supervisory oversight by
   - A) giving the FDIC the authority to review independent audits.
   - B) increasing the SEC’s budget to supervise securities markets.
   - C) creating a new Department of Conflict Resolution.
   - D) reducing the penalties for obstruction of an official investigation.

   Answer: B
   Ques Status: New
5) The Global Legal Settlement of 2002 required investment banks to separate _______ and _______.
   A) research; securities underwriting
   B) deposits; securities underwriting
   C) research; legal analysis
   D) deposits; legal analysis

Answer: A
Ques Status: New

6) One reason financial systems in developing and transition countries are underdeveloped is
   A) they have weak links to their governments.
   B) they make loans only to nonprofit entities.
   C) the legal system may be poor making it difficult to enforce restrictive covenants.
   D) the accounting standards are too stringent for the banks to meet.

Answer: C
Ques Status: New

7) One reason China has been able to grow so rapidly even though its financial development is still in its early stages is
   A) the high savings rate of around 40%.
   B) the shift of labor to the agricultural sector.
   C) the stringent enforcement of financial contracts.
   D) the ease of obtaining high-quality information about creditors.

Answer: A
Ques Status: New

8.8 Financial Crises and Aggregate Economics Activity

1) Factors that lead to worsening conditions in financial markets include:
   A) declining interest rates.
   B) unanticipated increases in the price level.
   C) the deterioration in banks’ balance sheets.
   D) increases in bond prices.

Answer: C
Ques Status: Revised
2) In addition to having a direct effect on increasing adverse selection problems, increases in interest rates also promote financial crises by ________ firms’ and households’ interest payments, thereby ________ their cash flow.

A) increasing; increasing  
B) increasing; decreasing  
C) decreasing; decreasing  
D) decreasing; increasing

Answer: B

Ques Status: Previous Edition

3) In a bank panic the source of contagion is the

A) free-rider problem.  
B) too-big-to-fail problem.  
C) transactions cost problem.  
D) asymmetric information problem.

Answer: D

Ques Status: Revised

4) A bank panic can lead to a severe contraction in economic activity due to

A) a decline in international trade.  
B) the losses of bank shareholders.  
C) the losses of bank depositors.  
D) a decline in lending for productive investment.

Answer: D

Ques Status: Revised

5) Most major financial crises in the United States have begun with

A) a sharp decline in interest rates.  
B) a sharp stock market decline.  
C) a sharp decline in bond values.  
D) a strong improvement in banks’ balance sheets.

Answer: B

Ques Status: Revised
6) If the anatomy of a financial crisis is thought of as a sequence of events, which of the following events would be least likely to be the initiating cause of the financial crisis?
   A) Increase in interest rates
   B) Bank panic
   C) Stock market decline
   D) Increase in uncertainty

   Answer: B
   Ques Status: Previous Edition

7) If the anatomy of a financial crisis is thought of as a sequence of events, which of the following events would be least likely to be the initiating cause of the financial crisis?
   A) Increase in interest rates
   B) Stock market decline
   C) Unanticipated decline in price level
   D) Increase in uncertainty

   Answer: C
   Ques Status: Previous Edition

8) The sequence of events in a U.S. financial crisis is ______ leading to ______ leading to ______.
   A) debt deflation; increased interest rates; a bank panic
   B) increased interest rates; a bank panic; debt deflation
   C) a stock market decline; debt deflation; decreased economic activity
   D) a bank panic; debt deflation; a stock market decline

   Answer: B
   Ques Status: Revised

9) Debt deflation occurs when
   A) an economic downturn causes the price level to fall and a deterioration in firms' net worth because of the increased burden of indebtedness.
   B) rising interest rates worsen adverse selection and moral hazard problems.
   C) lenders reduce their lending due to declining stock prices (equity deflation) that lowers the value of collateral.
   D) corporations pay back their loans before the scheduled maturity date.

   Answer: A
   Ques Status: Revised
10) A substantial decrease in the aggregate price level that reduces firms’ net worth may stall a recovery from a recession. This process is called
   A) debt deflation.
   B) moral hazard.
   C) insolvency.
   D) illiquidity.
   Answer: A
   Ques Status: Revised

11) Adverse selection and moral hazard problems increased in magnitude during the early years of the Great Depression as
   A) stock prices declined to 10% of their level in 1929.
   B) banks recovered slowly.
   C) the aggregate price level rose.
   D) banks saw more lending opportunities.
   Answer: A
   Ques Status: Revised

12) In emerging economies such as Argentina, government fiscal imbalances may cause fears of
   A) debt deflation.
   B) default on government debt.
   C) stock price declines.
   D) lower interest rates.
   Answer: B
   Ques Status: Revised

13) In recent years, a number of developing and transition countries have experienced financial crises, the most dramatic of which was the
   Answer: A
   Ques Status: Previous Edition
14) An important factor leading up to the Mexican financial crisis of 1994–1995 was
   A) the failure of the Mexican oil monopoly.
   B) increasing loan losses at Mexican banks.
   C) the ratification of the North American Free Trade Agreement.
   D) the failure to ratify the North American Free Trade Agreement.

   Answer: B
   Ques Status: Previous Edition

15) Factors that led to worsening conditions in Mexico’s 1994–1995 financial markets include
   A) failure of the Mexican oil monopoly.
   B) the ratification of the North American Free Trade Agreement.
   C) increased uncertainty from political shocks.
   D) decline in interest rates.

   Answer: C
   Ques Status: Revised

16) Factors that led to worsening financial market conditions in East Asia in 1997–1998 include
   A) weak supervision by bank regulators.
   B) a rise in interest rates abroad.
   C) unanticipated increases in the price level.
   D) increased uncertainty from political shocks.

   Answer: A
   Ques Status: Revised

17) Factors that led to worsening conditions in Mexico’s 1994–1995 financial markets, but did not
    lead to worsening financial market conditions in East Asia in 1997–1998 include

   A) rise in interest rates abroad.
   B) bankers’ lack of expertise in screening and monitoring borrowers.
   C) deterioration of banks’ balance sheets because of increasing loan losses.
   D) stock market decline.

   Answer: A
   Ques Status: Revised
18) Argentina’s financial crisis was due to
   A) poor supervision of the banking system.
   B) a lending boom prior to the crisis.
   C) fiscal imbalances.
   D) lack of expertise in screening and monitoring borrowers at banking institutions.

   Answer: C  
   Ques Status: Revised

19) Factors likely to cause a financial crisis in emerging market countries include
   A) fiscal imbalances.
   B) decreases in foreign interest rates.
   C) a foreign exchange crisis.
   D) too strong oversight of the financial industry.

   Answer: A  
   Ques Status: Revised