Chapter 8
An Economic Analysis of Financial Structure

**Multiple Choice**

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
Question Status: Previous Edition

2) American businesses get their external funds primarily from
(a) common stock issues.
(b) bonds and commercial paper issues.
(c) government loans.
(d) none of the above.
Answer: D
Question Status: Previous Edition

3) Which of the following is the primary source of external funds used by American businesses to finance their activities?
(a) Stock
(b) Bonds and commercial paper
(c) Bank loans
(d) Other loans
Answer: C
Question Status: Previous Edition

4) 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) 55%
(d) 60%
Answer: C
Question Status: Revised
5) 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) 35%
(d) 50%
Answer: C
Question Status: Revised

6) 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
Question Status: Revised

7) Of the following sources of external finance for American nonfinancial businesses, the most important is

(a) loans from banks.
(b) stocks.
(c) bonds and commercial paper.
(d) loans from other financial intermediaries.
Answer: A
Question Status: Revised

8) Of the sources of external funds for nonfinancial businesses in the United States, stocks account for approximately _____ of the total.

(a) 2%
(b) 9%
(c) 20%
(d) 40%
Answer: B
Question Status: Revised

9) In the mid- to late 1980s, American corporations

(a) repurchased such large numbers of shares that stock issues were a negative source of corporate finance in that period.
(b) took advantage of an especially strong stock market to issue record numbers of new shares in that period.
(c) generally abandoned corporate bond and commercial paper markets to concentrate on new stock issues.
(d) have done both (b) and (c) of the above.
Answer: A
Question Status: Revised
10) Which of the following statements concerning external sources of financing for nonfinancial businesses in the United States are true?
   (a) Bonds are a far more important source of finance than are stocks.
   (b) Stocks and bonds, combined, supply less than one-half of the external funds.
   (c) Financial intermediaries such as banks are the most important source of external funds.
   (d) All of the above.
   (e) Only (a) and (b) of the above.
   Answer: D
   Question Status: Revised

11) 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) All of the above.
   Answer: B
   Question Status: Revised

12) Which of the following statements concerning external sources of financing for nonfinancial businesses in the United States are true?
   (a) Bonds are a far more important source of finance than are stocks.
   (b) Stocks and bonds, combined, supply more than one-half of the external funds.
   (c) Financial intermediaries such as banks are a relatively unimportant source of external funds.
   (d) Only (a) and (b) of the above.
   Answer: A
   Question Status: Revised

13) Which of the following statements concerning external sources of financing for nonfinancial businesses in the United States are true?
   (a) Financial intermediaries such as banks are the most important source of external funds.
   (b) Bonds are a far more important source of finance than are stocks.
   (c) Stocks and bonds, combined, supply less than one-fifth of the external funds.
   (d) Only (a) and (b) of the above.
   (e) Only (a) and (c) of the above.
   Answer: D
   Question Status: Revised
14) Which of the following statements concerning external sources of financing for nonfinancial businesses in the United States are true?
   (a) In the mid- to late 1980s, American corporations in the aggregate did not issue shares to finance their activities.
   (b) Issuing marketable securities is not the primary way businesses finance their operations.
   (c) Indirect finance is many times more important than direct finance as a source of external funds.
   (d) All of the above.
   Answer: D
   Question Status: Previous Edition

15) Which of the following statements concerning external sources of financing for nonfinancial businesses in the United States are true?
   (a) In the mid- to late 1980s, American corporations in the aggregate did not issue shares to finance their activities.
   (b) Issuing marketable securities is the primary way businesses finance their operations.
   (c) Direct finance is twice as important as indirect finance as a source of external funds to business.
   (d) Direct finance is fifty percent more important than indirect finance as a source of external funds to business.
   Answer: A
   Question Status: Previous Edition

16) Which of the following statements concerning external sources of financing for nonfinancial businesses in the United States are true?
   (a) Banks are the second most important source of external funds to finance their activities.
   (b) Stocks are the most important source of external funds to finance their activities.
   (c) Indirect finance is many times more important than direct finance as a source of external funds.
   (d) All of the above.
   Answer: C
   Question Status: Previous Edition

17) 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) All of the above.
   Answer: C
   Question Status: Previous Edition
18) Which of the following statements concerning external sources of financing for nonfinancial businesses in the United States are true?  
(a) Neither stocks nor marketable securities are the primary source of external funds to finance their activities.  
(b) Stocks were a negative source of corporate finance in the mid- to late 1980s.  
(c) Indirect finance is many times more important than direct finance as a source of external funds.  
(d) All of the above.  
(e) Only (a) and (c) of the above.  
Answer: D  
Question Status: Revised

19) Which of the following statements concerning external sources of financing for nonfinancial businesses in the United States are true?  
(a) Combined, both stocks and marketable debt securities are the primary source of external funds to finance their activities.  
(b) Stocks were a negative source of corporate finance in the mid- to late 1980s.  
(c) Stocks have been the primary source of corporate finance in recent years.  
(d) Only (a) and (b) of the above.  
(e) Only (a) and (c) of the above.  
Answer: B  
Question Status: Revised

20) 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, less than 5% of newly issued corporate bonds and commercial paper have been sold directly to American households.  
(c) The stock market accounted for a sizeable fraction of the financing of American businesses in the 1970-1985 period.  
(d) All of the above.  
(e) Only (a) and (b) of the above.  
Answer: E  
Question Status: Revised

21) Which of the following are true statements concerning financial structure in the United States?  
(a) The stock market accounted for only a very small fraction of the financing of American businesses in the 1970-1985 period.  
(b) In the mid- to late 1980s, American corporations on average did not issued shares to finance their activities.  
(c) Corporations have repurchased large numbers of shares so that the stock market actually has been a negative source of corporate finance in the mid- to late 1980s.  
(d) All of the above are true statements.  
Answer: D  
Question Status: Revised
22) Which of the following are true statements concerning financial structure in the United States?
(a) Issuing marketable securities is not the primary way businesses finance their operations.
(b) Bonds are a far more important source of finance than are stocks in the United States.
(c) Together, bonds and stocks supply less than one-half of the external funds that corporations use to finance their activities.
(d) All of the above are true statements.
Answer: D
Question Status: Revised

23) With regard to external sources of financing for nonfinancial businesses in the United States, which of the following are accurate statements?
(a) Direct finance is used in less than 5% of the external financing of American businesses.
(b) Only large, well-established corporations have access to securities markets to finance their activities.
(c) Bank loans in the United States provide over four times more financing of corporate activities than do stock markets.
(d) All of the above.
(e) Only (a) and (b) of the above.
Answer: D
Question Status: Revised

24) With regard to external sources of financing for nonfinancial businesses in the United States, which of the following are accurate statements?
(a) Smaller businesses that are not well-established almost never raise funds by issuing marketable securities.
(b) Because well-established corporations are dominant financial market participants, their issues of marketable securities are the single most important source of funds to finance businesses.
(c) Direct finance is accounts for more than 50 percent of the external financing of American businesses.
(d) Both (a) and (b) of the above.
Answer: A
Question Status: Previous Edition

25) Nonfinancial businesses in Germany and Japan
(a) raise most of their funds by issuing stock.
(b) raise most of their funds by issuing bonds.
(c) raise most of their funds from nonbank loans.
(d) raise most of their funds from bank loans.
(e) raise most of their funds by issuing commercial paper.
Answer: D
Question Status: New
26) Relative to the situation in the United States, nonfinancial businesses in Germany and Japan raise more of their funds from
   (a) new stock issues.
   (b) new bonds issues.
   (c) new commercial paper issues.
   (d) bank loans.
   (e) both (a) and (b) of the above.
   Answer: D
   Question Status: New

27) As a source of funds for nonfinancial businesses, stocks are relatively more important in
   (a) the United States.
   (b) Germany.
   (c) Japan.
   (d) both (a) and (c) of the above.
   (e) both (b) and (c) of the above.
   Answer: A
   Question Status: New

28) As a source of funds for nonfinancial businesses, banks are relatively the least important source in
   (a) Germany.
   (b) Japan.
   (c) the United States.
   (d) both (a) and (b) of the above.
   (e) both (b) and (c) of the above.
   Answer: C
   Question Status: New

29) 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.
   (e) does all of the above.
   Answer: D
   Question Status: New

30) The 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.
   (e) do all of the above.
   Answer: C
   Question Status: New
31) 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
   Question Status: Previous Edition

32) Collateral is
   (a) a prevalent feature of debt contracts for households.
   (b) a prevalent feature of debt contracts for business.
   (c) is property that is pledged to the lender if a borrower cannot make his or her debt payments.
   (d) all of the above.
   (e) only (a) and (c) of the above.
   Answer: D
   Question Status: Previous Edition

33) 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
   Question Status: Previous Edition

34) Poor people have difficulty getting loans because
   (a) they typically have little collateral.
   (b) they are more likely to be dishonest.
   (c) they are less likely to benefit from access to financial markets.
   (d) all of the above.
   (e) of none of the above.
   Answer: A
   Question Status: Previous Edition

35) The predominant form of household debt is
   (a) consumer installment debt.
   (b) collateralized debt.
   (c) unsecured debt.
   (d) none of the above.
   Answer: B
   Question Status: Revised
36) Collateralized debt is also known as
(a) unsecured debt.
(b) secured debt.
(c) unrestricted debt.
(d) restricted debt.
(e) promissory debt.
Answer: B
Question Status: New

37) Credit card debt is
(a) secured debt.
(b) unsecured debt.
(c) restricted debt.
(d) unrestricted debt.
(e) both (b) and (d) of the above.
Answer: B
Question Status: New

38) A clause in a mortgage loan contract requiring the borrower to purchase homeowner’s insurance is an example of a
(a) restrictive covenant.
(b) collusive agreement between mortgage lenders and insurance companies.
(c) both (a) and (b) of the above.
(d) neither (a) and (b) of the above.
Answer: A
Question Status: Previous Edition

39) 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
Question Status: Previous Edition

40) 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
Question Status: Previous Edition
41) 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
Question Status: Previous Edition

42) 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
Question Status: Previous Edition

43) 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
Question Status: Previous Edition

44) 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) Collateral is a prevalent feature of debt contracts for both households and business.
(d) Debt contracts are typically extremely complicated legal documents that place substantial restrictions on the behavior of the borrower.
(e) 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.

Answer: E
Question Status: Previous Edition
45) Financial intermediaries provide their customers with
(a) reduced transactions costs.
(b) increased diversification and reduced risk.
(c) greater liquidity.
(d) all of the above.
(e) only (b) and (c) of the above.
Answer: D

46) The benefits financial intermediaries provide their customers include
(a) increased diversification.
(b) reduced risk.
(c) reduced transactions costs.
(d) all of the above.
(e) only (b) and (c) of the above.
Answer: D

47) 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

48) Mutual funds lower transactions costs and provide individual investors the benefit of
(a) reduced risk.
(b) diversification.
(c) economies of scale.
(d) all of the above.
(e) both (a) and (c) of the above.
Answer: D

49) 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.
(e) both (a) and (b) of the above.
Answer: B
50) 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
   Question Status: Previous Edition

51) 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
   Question Status: Previous Edition

52) 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
   Question Status: Previous Edition

53) 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
   Question Status: Previous Edition

54) The “lemons problem” is a term used to describe the
   (a) moral hazard problem.
   (b) adverse selection problem.
   (c) free-rider problem.
   (d) principal-agent problem.
   (e) both (a) and (b) of the above.
   Answer: B
   Question Status: Study Guide
55) 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) greater than the price of a peach.
   (e) between the price of a lemon and a peach.
   Answer: E
   Question Status: New

56) The “lemons problem” exists because of
   (a) transactions costs.
   (b) economies of scale.
   (c) regulation.
   (d) asymmetric information.
   (e) rational expectations.
   Answer: D
   Question Status: New

57) 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) people who pay for information do not pay the full cost of producing the information.
   (e) it is never profitable to produce information.
   Answer: B
   Question Status: New

58) 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
   (e) principal-agent; incentive compatibility
   Answer: A
   Question Status: Study Guide

59) Government regulations require publicly traded firms to provide information, reducing
   (a) transactions costs.
   (b) the need for diversification.
   (c) the adverse selection problem.
   (d) all of the above.
   (e) both (a) and (c) of the above.
   Answer: C
   Question Status: New
60) A lesson of the Enron collapse is that
(a) government regulation always fails.
(b) government regulation can reduce but not eliminate asymmetric information.
(c) government regulation increases the problem of asymmetric information.
(d) government regulation should be reduced.
(e) better government regulation can eliminate the problem of asymmetric information.
Answer: B

61) 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) none of the above.
Answer: A

62) Because of the adverse selection problem,
(a) lenders may make a disproportionate amount of loans to bad credit risks.
(b) lenders may refuse loans to individuals with low net worth.
(c) lenders are reluctant to make loans that are not secured by collateral.
(d) all of the above.
Answer: D

63) 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) all of the above.
Answer: C

64) Because of the adverse selection problem,
(a) lenders may choose to lend only to those who “do not need the money.”
(b) lenders typically require collateral before making a loan.
(c) lenders may refuse loans to individuals with low net worth.
(d) all of the above.
Answer: D
65) Due to the problem of adverse selection, lenders
   (a) may refuse to lend to individuals with high net worth.
   (b) may lend only to those “who do not need the money.”
   (c) may be reluctant to make loans not secured by collateral.
   (d) all of the above.
   (e) only (b) and (c) of the above.
   Answer: E
   Question Status: Study Guide

66) Because of the moral hazard problem,
   (a) lenders may demand positions on the board of directors of the firms that they provide with
       financing.
   (b) lenders will choose to write complicated contracts, prohibiting the borrowers from using the
       loan proceeds for unauthorized purposes.
   (c) lenders will more readily lend to borrowers with high net worth.
   (d) all of the above.
   (e) only (a) and (b) of the above.
   Answer: D
   Question Status: Previous Edition

67) Because of the moral hazard problem,
   (a) lenders will write debt contracts that restrict certain activities of borrowers.
   (b) debt contracts are used more frequently to raise capital than are equity contracts.
   (c) lenders are more willing to lend to borrowers with low net worth.
   (d) all of the above.
   (e) only (a) and (b) of the above.
   Answer: E
   Question Status: Revised

68) Because of the moral hazard problem,
   (a) lenders will write debt contracts that restrict certain activities of borrowers.
   (b) lenders will more readily lend to borrowers with high net worth.
   (c) debt contracts are used less frequently to raise capital than are equity contracts.
   (d) all of the above.
   (e) only (a) and (b) of the above.
   Answer: E
   Question Status: Previous Edition

69) 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) U.S. Treasury Department.
    (e) Federal Reserve System.
    Answer: C
    Question Status: Previous Edition
70) The fact that used car dealers (intermediaries) sell most used cars is evidence that these dealers (intermediaries)
  (a) profit by becoming experts, able to determine whether a car is a lemon or a peach.
  (b) help solve the adverse selection problem.
  (c) are unable to prevent purchasers from free-riding off the information they provide.
  (d) do all of the above.
  (e) do only (a) and (b) of the above.
Answer: E
Question Status: Study Guide

71) That most used cars are sold by intermediaries (i.e., used car dealers) provides evidence that these intermediaries
  (a) provide information that is valued by consumers of used cars.
  (b) are able to prevent others from free-riding off the information that they provide.
  (c) help solve the adverse selection problem.
  (d) do all of the above.
Answer: D
Question Status: Previous Edition

72) 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) do all of the above.
Answer: B
Question Status: Previous Edition

73) That most used cars are sold by intermediaries (i.e., used car dealers) provides evidence that these intermediaries
  (a) provide information that is valued by consumers of used cars.
  (b) are able to prevent others from free-riding off the information that they provide.
  (c) can profit by becoming experts in determining whether an automobile is a good car or a lemon.
  (d) do all of the above.
Answer: D
Question Status: Previous Edition
74) Financial intermediaries, particularly banks,

(a) are experts in the production of information about firms so that they can sort good risks from bad ones.

(b) overcome the free-rider problem by primarily making private loans, rather than purchasing securities that are traded in the open market.

(c) play a greater role in moving funds to corporations than do securities markets.

(d) all of the above.

(e) only (a) and (b) of the above.

Answer: D

Question Status: Previous Edition

75) The concept of adverse selection helps to explain

(a) which 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) only (a) and (b) of the above.

(e) only (a) and (c) of the above.

Answer: D

Question Status: Previous Edition

76) Analysis of adverse selection indicates that financial intermediaries in general, and banks in particular because they hold a large fraction of non-traded loans,

(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) play a greater role in moving funds to corporations than do securities markets as a result of their ability to overcome the free-rider problem.

(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) all of the above.

(e) only (a) and (b) of the above.

Answer: E

Question Status: Revised

77) 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) all of the above.

(e) only (a) and (b) of the above.

Answer: A

Question Status: Revised
78) Analysis of adverse selection indicates that financial intermediaries, especially banks,
(a) do a rather poor job of overcoming adverse selection problems, helping to explain why direct
finance is a more important source of business finance than is indirect finance.
(b) do a rather good job of overcoming adverse selection problems, helping to explain why indirect
finance is a more important source of business finance than is direct finance.
(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) do only (a) and (c) of the above.
Answer: B
Question Status: Revised

79) Analysis of adverse selection indicates that financial intermediaries in general, and banks in
particular because they hold a large fraction of non-traded loans,
(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) play a greater role in moving funds to corporations than do securities markets as a result of their
ability to overcome the free-rider problem.
(c) provide newer and smaller firms with a greater proportion of their external funding requirements
than they do to larger, well-established firms.
(d) do all of the above.
(e) do only (a) and (b) of the above.
Answer: D
Question Status: Revised

80) Analysis of adverse selection indicates that financial intermediaries
(a) overcome free-rider problems by holding non-traded loans.
(b) must buy securities from corporations to diversify the risk that results from holding non-tradable
loans.
(c) have not been very successful in dealing with adverse selection problems in financial markets.
(d) do all of the above.
(e) do only (a) and (b) of the above.
Answer: A
Question Status: Revised

81) The problem of adverse selection helps to explain
(a) why banks prefer to make loans secured by collateral.
(b) why banks have a comparative advantage in raising funds for American businesses.
(c) why borrowers are willing to offer collateral to secure their promises to repay loans.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: D
Question Status: Previous Edition
82) The problem of adverse selection helps to explain:
   (a) which firms are more likely to obtain funds from banks and other financial intermediaries, rather than from securities markets.
   (b) why indirect finance is more important than direct finance as a source of business finance.
   (c) why collateral is an important feature of debt contracts.
   (d) all of the above.
   (e) only (a) and (b) of the above.
   Answer: D
   Question Status: Previous Edition

83) The problem of adverse selection helps to explain:
   (a) which 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) only (a) and (b) of the above.
   Answer: A
   Question Status: Previous Edition

84) 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 adverse selection.
   (c) can be explained by government regulations that prohibit small firms from acquiring funds in securities markets.
   (d) can be explained by all of the above.
   (e) can be explained by only (a) and (b) of the above.
   Answer: E
   Question Status: Previous Edition

85) The fact that the largest, most established corporations are the most likely to raise funds by issuing securities is know as
   (a) the “too-big-to-fail” hypothesis.
   (b) the “only those that don’t need the money can borrow” hypothesis.
   (c) the efficient markets hypothesis.
   (d) the pecking order hypothesis.
   (e) the “larger is better” hypothesis.
   Answer: D
   Question Status: New

86) The concept of adverse selection helps to explain:
   (a) why financial markets are among the most heavily regulated sectors of the economy.
   (b) why only large, well-established corporations have access to securities markets.
   (c) why collateral is an important feature of debt contracts.
   (d) all of the above.
   (e) only (a) and (b) of the above.
   Answer: D
   Question Status: Previous Edition
87) The concept of adverse selection helps to explain
(a) why only large, well-established corporations have access to securities markets.
(b) why collateral is an important feature of debt contracts.
(c) why direct finance is a more important source of business finance than is indirect finance.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: E

88) 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) all of the above.
Answer: C

89) The concept of adverse selection helps to explain
(a) which firms are more likely to obtain funds from banks and other financial intermediaries, rather than from the securities markets.
(b) why collateral is not a common feature of many debt contracts.
(c) why large, well-established corporations find it so difficult to borrow funds in securities markets.
(d) all of the above.
Answer: A

90) The principal-agent problem arises because
(a) agents have more information about their activities than do the principals.
(b) monitoring agents’ activities is costly.
(c) principals have incentives to free-ride off the monitoring expenditures of other principals.
(d) of all of the above.
(e) of only (a) and (b) of the above.
Answer: D

91) 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
92) Moral hazard in equity contracts is known as the _____ problem because the manager of the firm may shirk his responsibility to maximize profits for the shareholders.
(a) adverse selection
(b) free-rider
(c) principal-agent
(d) debt deflation
Answer: C
Question Status: Previous Edition

93) 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
Question Status: Previous Edition

94) The principal-agent problem
(a) occurs when managers have less incentive to maximize profits than the stockholders-owners do.
(b) would not arise if the owners of the firm had complete information about the activities of the managers.
(c) in financial markets helps to explain why equity is not a relatively important source of finance for American business.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: D
Question Status: Previous Edition

95) The principal-agent problem
(a) occurs when managers have more incentive to maximize profits than the stockholders-owners do.
(b) would not arise if the owners of the firm had complete information about the activities of the managers.
(c) in financial markets helps to explain why equity is a relatively important source of finance for American business.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: B
Question Status: Previous Edition
96) The principal-agent problem
(a) arises because principals have incentives to free-ride off of the monitoring expenditures of other
principals.
(b) arises because principals find it difficult and costly to monitor agents’ activities.
(c) arises because agents’ incentives are not always compatible with those of the principals.
(d) arises because of all of the above.
(e) arises because of only (a) and (b) of the above.
Answer: D
Question Status: Study Guide

97) A problem for equity contracts is a particular example of _________ called the _____ problem.
(a) adverse selection; principal-agent
(b) moral hazard; principal-agent
(c) adverse selection; free-rider
(d) moral hazard; free-rider
(e) moral hazard; costly state verification
Answer: B
Question Status: Study Guide

98) 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 “too-big-to-fail” problem.
(e) the “lemons problem.”
Answer: C
Question Status: New

99) Equity contracts
(a) are agreements by the borrowers to pay lenders fixed dollar amounts at periodic intervals.
(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.
(e) are none of the above.
Answer: E
Question Status: Study Guide

100) Government regulations designed to reduce the moral hazard problem include
(a) laws that force firms to adhere to standard accounting principles.
(b) stiff criminal penalties for those who commit fraud.
(c) state verification subsidies.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: E
Question Status: Previous Edition
101) 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
Question Status: Previous Edition

102) 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 anyone but the venture capital firm.
(c) It prohibits the borrowing firm from replacing its management.
(d) It does both (a) and (b) of the above.
(e) It does both (a) and (c) of the above.
Answer: D
Question Status: Previous Edition

103) Because information is scarce,
(a) equity contracts are less desirable than debt contracts, explaining, in part, why equity is not a more important element in our financial structure.
(b) monitoring managers gives rise to costly state verification.
(c) government regulations, such as standard accounting principles, can help reduce moral hazard.
(d) all of the above are true.
(e) only (a) and (b) of the above are true.
Answer: D
Question Status: Previous Edition

104) Because information is scarce
(a) helps explain why debt contracts are used so much more frequently to raise capital than are equity contracts.
(b) monitoring managers gives rise to costly state verification.
(c) government regulations, such as standard accounting principles, can help reduce moral hazard.
(d) all of the above are true.
(e) only (a) and (b) of the above are true.
Answer: D
Question Status: Previous Edition
105) 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, can help reduce moral hazard.
    (d) all of the above are true.
    (e) only (b) and (c) of the above are true.
Answer: E
Question Status: Previous Edition

106) Debt contracts
    (a) are agreements by the borrowers to pay the lenders fixed dollar amounts at periodic intervals.
    (b) have the advantage over equity contracts of a lower cost of state verification.
    (c) are used much more frequently to raise capital than are equity contracts.
    (d) all of the above.
    (e) only (a) and (b) of the above.
Answer: D
Question Status: Previous Edition

107) Debt contracts
    (a) are agreements by the borrowers to pay the lenders fixed dollar amounts at periodic intervals.
    (b) have the advantage over equity contracts of a lower cost of state verification.
    (c) are used less frequently to raise capital than are equity contracts.
    (d) all of the above.
    (e) only (a) and (b) of the above.
Answer: E
Question Status: Previous Edition

108) 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 greater 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) of all of the above.
    (e) of both (a) and (b) of the above.
Answer: E
Question Status: Previous Edition

109) Solutions to the moral hazard problem include
    (a) high net worth.
    (b) monitoring and enforcement of restrictive covenants.
    (c) greater reliance on equity contracts and less on debt contracts.
    (d) all of the above.
    (e) only (a) and (b) of the above.
Answer: E
Question Status: Previous Edition
110) Solutions to the moral hazard problem include
   (a) high net worth.
   (b) monitoring and enforcement of restrictive covenants.
   (c) greater reliance on debt contracts and less on equity contracts.
   (d) all of the above.
   (e) only (a) and (b) of the above.
   Answer: D
   Question Status: Previous Edition

111) 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) does none of the above.
   Answer: B
   Question Status: Previous Edition

112) 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
   Question Status: Previous Edition

113) A debt contract is said to be incentive compatible if
   (a) the borrower’s net worth reduces the probability of moral hazard.
   (b) restrictive covenants limit the type of activities that can be undertaken by the borrower.
   (c) both (a) and (b) of the above occur.
   (d) neither (a) nor (b) of the above occur.
   Answer: A
   Question Status: Previous Edition

114) 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 high so that the lender’s risk of moral hazard is
   significantly reduced.
   (c) if the debt contract is treated like an equity.
   (d) if both (a) and (b) of the above occur.
   Answer: D
   Question Status: Previous Edition
115) 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.
(e) all of the above.
Answer: C
Question Status: New

116) Which of the following are accurate statements concerning the role that restrictive covenants play in reducing moral hazard in financial markets?
(a) Covenants reduce moral hazard by restricting borrowers’ undesirable behavior.
(b) Covenants require that borrowers keep collateral in good condition.
(c) Covenants require that borrowers maintain high net worth.
(d) All of the above.
(e) Only (a) and (b) of the above.
Answer: D
Question Status: Previous Edition

117) Which of the following are accurate statements concerning the role that restrictive covenants play in reducing moral hazard in financial markets?
(a) Covenants reduce moral hazard by restricting borrowers’ undesirable behavior.
(b) Covenants require that borrowers keep collateral in good condition.
(c) Covenants require periodic accounting statements and income reports.
(d) All of the above.
(e) Only (a) and (b) of the above.
Answer: D
Question Status: Previous Edition

118) 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 costly to monitor and enforce.
(c) too few resources may be devoted to monitoring and enforcing them, as debtholders free-ride on others’ monitoring and enforcement efforts.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: D
Question Status: Previous Edition
119) 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 costly 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) all of the above.
   (e) only (a) and (b) of the above.
   Answer: E
   Question Status: Previous Edition

120) 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
   Question Status: Previous Edition

121) Financial intermediaries and, particularly, banks have the ability to avoid the free-rider problem as long as they primarily
   (a) make private loans.
   (b) acquire a diversified portfolio of stocks.
   (c) buy junk bonds.
   (d) do a balanced combination of (a) and (b) of the above.
   Answer: A
   Question Status: Previous Edition

122) 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
   Question Status: Previous Edition
123) One reason why developing and transition countries experience low rates of growth is that their financial systems are under-developed, a situation referred to as
(a) stunted financial markets.
(b) development hazard.
(c) financial repression.
(d) adverse financial development.
(e) financial regression.
Answer: C
Question Status: Previous Edition

124) Financial systems in developing and transition countries face several difficulties that keep them from operating efficiently, including:
(a) under-developed regulatory systems that retard the provision of adequate information to the marketplace.
(b) poorly developed legal systems that make it extremely difficult for lenders to enforce restrictive covenants.
(c) self-serving governments that use their financial systems to direct credit to favored sectors of the economy by setting interest rates at artificially low levels.
(d) all of the above.
Answer: D
Question Status: Previous Edition

125) Governments in developing and transition countries sometimes adopt policies that retard the efficient operation of their financial systems. These actions include policies that
(a) prevent lenders from foreclosing on borrowers with political clout.
(b) nationalize banks and direct credit to politically favored borrowers.
(c) make it costly to collect payments and collateral from defaulting debtors.
(d) all of the above.
Answer: D
Question Status: Previous Edition

126) A reason that many developing and transition economies remain poor is
(a) excessive government regulation of financial markets.
(b) overly stringent accounting standards.
(c) lack of government direction in the allocation of credit.
(d) nationalization of banks.
(e) all of the above.
Answer: D
Question Status: New
127) Some of the problems that cause financial repression in developing and transition economies include
(a) poor legal systems.
(b) strong accounting standards.
(c) private ownership of banks.
(d) excessive government regulation.
(e) all of the above.
Answer: A
Question Status: New

128) Financial crises
(a) are major disruptions in financial markets that are characterized by sharp declines in asset prices and the failures of many financial and nonfinancial firms.
(b) occur when adverse selection and moral hazard problems in financial markets become more significant.
(c) frequently lead to sharp contractions in economic activity.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: D
Question Status: Previous Edition

129) Factors that lead to worsening conditions in financial markets include
(a) increases in interest rates.
(b) declining stock prices.
(c) increasing uncertainty in financial markets.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: D
Question Status: Previous Edition

130) Factors that lead to worsening conditions in financial markets include
(a) increases in interest rates.
(b) declining stock prices.
(c) unanticipated increases in the price level.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: E
Question Status: Previous Edition

131) 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) only (a) and (c) of the above.
(e) only (b) and (c) of the above.
Answer: C
Question Status: Previous Edition
132) Factors that lead to worsening conditions in financial markets include
(a) increases in bond prices.
(b) declining stock prices.
(c) declining interest rates.
(d) all of the above.
Answer: B
Question Status: Previous Edition

133) Factors that lead to worsening conditions in financial markets include
(a) declining bond prices.
(b) declining stock prices.
(c) unanticipated increases in the price level.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: E
Question Status: Previous Edition

134) Factors that lead to worsening conditions in financial markets include:
(a) weak supervision by bank regulators.
(b) bankers’ lack of expertise in screening and monitoring borrowers.
(c) the deterioration in banks’ balance sheets.
(d) all of the above.
(e) only (b) and (c) of the above.
Answer: D
Question Status: Previous Edition

135) Factors that lead to worsening conditions in financial markets include
(a) bankers’ lack of expertise in screening and monitoring borrowers.
(b) declining stock prices.
(c) declining interest rates.
(d) only (a) and (b) of the above.
(e) only (b) and (c) of the above.
Answer: D
Question Status: Previous Edition

136) Factors that lead to worsening conditions in financial markets include
(a) weak supervision by bank regulators.
(b) bankers’ lack of expertise in screening and monitoring borrowers.
(c) unanticipated increases in the price level.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: E
Question Status: Previous Edition
137) 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
   Question Status: Previous Edition

138) In a bank panic
   (a) the source of contagion is the free-rider problem.
   (b) the source of contagion is the too-big-to-fail problem.
   (c) the source of contagion is the transactions cost problem.
   (d) the source of contagion is a regulatory problem.
   (e) the source of contagion is the asymmetric information problem.
   Answer: E
   Question Status: New

139) A bank panic can lead to a severe contraction in economic activity due to
   (a) the loss of jobs in banking.
   (b) the losses of bank shareholders.
   (c) the losses of bank depositors.
   (d) a decline in lending for productive investment.
   (e) a decline in international trade.
   Answer: D
   Question Status: New

140) Most financial crises in the United States have begun with
   (a) a sharp rise in interest rates.
   (b) a steep stock market decline.
   (c) an increase in uncertainty resulting from the failure of a major firm.
   (d) all of the above.
   (e) only (a) and (b) of the above.
   Answer: D
   Question Status: Previous Edition

141) Most financial crises in the United States have begun with
   (a) a steep stock market decline.
   (b) an increase in uncertainty resulting from the failure of a major firm.
   (c) a steep decline in interest rates.
   (d) all of the above.
   (e) only (a) and (b) of the above.
   Answer: E
   Question Status: Previous Edition
142) Most major financial crises in the United States have begun with
(a) a sharp rise in interest rates.
(b) a sharp stock market decline.
(c) an increase in financial market uncertainty resulting from the failure of either a major financial
or nonfinancial firm.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: D
Question Status: Previous Edition

143) 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) all of the above.
Answer: B
Question Status: Previous Edition

144) 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
Question Status: Previous Edition

145) 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
Question Status: Previous Edition

146) 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) decreased economic activity; debt deflation; a bank panic
(c) a stock market decline; debt deflation; decreased economic activity
(d) a bank panic; debt deflation; a stock market decline
(e) increased interest rates; a bank panic; debt deflation
Answer: E
Question Status: New
147) 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) none of the above.

Answer: A
Question Status: Previous Edition

148) Recovery from a recession can be cut off by a substantial decrease in the aggregate price level that reduces firms’ net worth. This process is called

(a) adverse selection.
(b) moral hazard.
(c) insolvency.
(d) illiquidity.
(e) debt deflation.

Answer: E
Question Status: Study Guide

149) 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 failed.
(c) the aggregate price level declined.
(d) a result of all of the above.
(e) a result of (a) and (b) of the above.

Answer: D
Question Status: Previous Edition

150) 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 failed.
(c) the aggregate price level rose.
(d) a result of all of the above.
(e) a result of (a) and (b) of the above.

Answer: E
Question Status: Previous Edition
151) 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.
(e) a fall in the value of foreign currency.
Answer: B
Question Status: New

152) In emerging economies, government fiscal imbalances can lead to
(a) default on the government debt.
(b) a foreign exchange crisis.
(c) an expansion of bank lending.
(d) all of the above.
(e) both (a) and (b) of the above.
Answer: E
Question Status: New

153) In recent years, a number of developing and transition countries have experienced financial crises, the most dramatic of which was the
(c) Argentina crisis of 1995-1996.
(d) Brazilian crisis of 1996-1997.
Answer: A
Question Status: Previous Edition

154) 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
Question Status: Previous Edition

155) Factors that led to worsening conditions in Mexico’s 1994-1995 financial markets include
(a) weak supervision by bank regulators.
(b) bankers’ lack of expertise in screening and monitoring borrowers.
(c) unanticipated increases in the price level.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: E
Question Status: Previous Edition
156) Factors that led to worsening conditions in Mexico’s 1994-1995 financial markets include
   (a) weak supervision by bank regulators.
   (b) bankers’ lack of expertise in screening and monitoring borrowers.
   (c) deterioration of banks’ balance sheets because of increasing loan losses.
   (d) all of the above.
   (e) only (a) and (b) of the above.
   Answer: D
   Question Status: Previous Edition

157) Factors that led to worsening conditions in Mexico’s 1994-1995 financial markets include
   (a) rise in interest rates abroad.
   (b) bankers’ lack of expertise in screening and monitoring borrowers.
   (c) unanticipated increases in the price level.
   (d) all of the above.
   (e) only (a) and (b) of the above.
   Answer: E
   Question Status: Revised

158) 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) all of the above.
   (e) only (a) and (b) of the above.
   Answer: C
   Question Status: Revised

159) Factors that led to worsening 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) all of the above.
   (e) only (a) and (b) of the above.
   Answer: A
   Question Status: Previous Edition

160) Factors that led to worsening conditions in East Asia in 1997-1998 include
   (a) weak supervision by bank regulators.
   (b) bankers’ lack of expertise in screening and monitoring borrowers.
   (c) deterioration of banks’ balance sheets because of increasing loan losses.
   (d) all of the above.
   (e) only (a) and (b) of the above.
   Answer: D
   Question Status: Previous Edition
161) Factors that led 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) unanticipated increases in the price level.
(d) only (a) and (b) of the above.
(e) only (a) and (c) of the above.
Answer: B
Question Status: Previous Edition

162) Factors that led to worsening financial market conditions in East Asia in 1997-1998 include
(a) bankruptcy of large firms in South Korea and Thailand.
(b) the ratification of the East Asia Free Trade Agreement.
(c) bankers’ lack of expertise in screening and monitoring borrowers
(d) only (a) and (b) of the above
(e) only (a) and (c) of the above.
Answer: E
Question Status: Previous Edition

163) 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) all of the above.
(e) only (a) and (b) of the above.
Answer: A
Question Status: Previous Edition

164) 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) deterioration of banks’ balance sheets because of increasing loan losses.
(b) bankers’ lack of expertise in screening and monitoring borrowers.
(c) weak supervision by bank regulators.
(d) none of the above.
(e) only (a) and (b) of the above.
Answer: D
Question Status: Previous Edition

165) In both the Mexican and East Asian financial crises in the mid- to late 1990s, important factors leading up to the crises include
(a) an increased in indebtedness due to depreciation of their currencies.
(b) weak supervision of banks by regulators.
(c) lack of expertise in screening and monitoring borrowers at banking institutions.
(d) all of the above.
(e) only (a) and (b) of the above.
Answer: D
Question Status: Study Guide
166) 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) all of the above.
(e) both (a) and (c) of the above.
Answer: C
Question Status: New

167) Factors contributing to Argentina’s financial crisis include
(a) fiscal imbalances.
(b) a rise in interest rates abroad.
(c) a decline in stock prices.
(d) all of the above.
(e) both (a) and (b) of the above.
Answer: D
Question Status: New

168) Factors likely to cause a financial crisis in emerging market countries include
(a) fiscal imbalances.
(b) increases in foreign interest rates.
(c) a foreign exchange crisis.
(d) all of the above.
(e) both (a) and (b) of the above.
Answer: E
Question Status: New

Essay Questions

1) Explain the problem of asymmetric information, adverse selection and moral hazard, and why these problems are important for the financial system.
Answer: Asymmetric information is an imbalance of information between two parties to a contract. In financial markets, lenders know less about a borrower’s planned use of the lender’s funds than does the lender. The problem of adverse selection arises when the least qualified individuals are more likely to apply for loans. This is a problem that exists prior to making a loan. Moral hazard is a problem that exists after a loan has been made. This is the problem that the borrower will take excessive risks, or behave in ways that jeopardize repayment of a loan. These problems exist for all financial contracts.
2) Explain the “lemons problem” as it applies to the used-car market. Why does this problem exist? How does this market resolve this problem?

Answer: The lemons problem exists because of asymmetric information. Buyers of used cars do not know if cars are lemons (bad) or peaches (good). The market price will be an average of the price of a lemon and a peach. Because of this, owners of lemons are more likely to sell their cars, an example of adverse selection. The resolution to this problem is that dealers (intermediaries) sell most used cars. Dealers specialize in the production of information about used cars. They can use this information to provide guarantees, or develop a reputation for selling quality cars. Dealers help solve the adverse selection problem in the used car market.

3) How do restrictive covenants reduce moral hazard in debt contracts?

Answer: Restrictive covenants keep borrowers from taking excessive risks. Restrictive covenants can encourage desirable behavior, such as buying insurance to repay the loan in case of death of the borrower, and maintaining high net worth. Covenants encourage the borrower to keep collateral valuable, including purchasing insurance to protect assets against risk of loss. Covenants require borrowers to provide information about activities, including accounting and income reports. This reduces moral hazard.

4) Are stocks an important source of funds for nonfinancial corporations in the United States? Why or why not?

Answer: Stocks are not an important source of funds for financing businesses. This is primarily due to the principal-agent problem, a type of moral hazard. Agents (managers) may not have the same incentive as principals (owners). Agents may sacrifice profits to provide themselves with various personal benefits. Monitoring managers’ (agents’) behavior is costly. This is costly state verification. Thus, moral hazard is the reason stocks are not an important source of funds for businesses.