1) American businesses get their external funds primarily from

A) stock issues.
B) bank loans.
C) bonds and commercial paper issues.
D) other loans.

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

A) Stocks and bonds, combined, supply less than one–half of the external funds.
B) Financial intermediaries such as banks are the most important source of external funds.
C) Bonds are a far more important source of finance than are stocks.
D) All of the above.
E) Only A and B of the above.

3) 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 least important source of external funds for businesses.
B) Stocks are a far more important source of finance than are bonds.
C) Stocks and bonds, combined, supply less than one–half of the external funds.
D) All of the above.

4) Relative to the situation in the United States, nonfinancial businesses in Germany and Japan raise more of their funds from

A) new bonds issues.
B) new stock issues.
C) new commercial paper issues.
D) bank loans.
E) both A and B of the above.

5) The purpose of regulation of financial markets is to

A) increase competition among financial institutions.
B) limit the profits of financial institutions.
C) guarantee that the maximum rates of interest are paid on deposits.
D) promote the provision of information to shareholders, depositors and the public.
E) do all of the above.

6) Property that is pledged to the lender in the event that a borrower cannot make his or her debt payment is called

A) points.
B) collateral.
C) interest.
D) good faith money.

7) 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.

8) 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) Banks are the most important source of external funds to finance businesses.

C) Issuing marketable securities is not the primary way businesses finance their operations.

D) 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.

9) 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) 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) Issuing marketable securities is the primary way businesses finance their operations.

D) Banks are the most important source of external funds to finance businesses.

10) 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) Banks are the most important source of external funds to finance businesses.

D) Collateral is a prevalent feature of debt contracts for households, but not business since they have many alternative sources for funds.

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

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.

12) The benefits financial intermediaries provide their customers include

A) reduced transactions costs.

B) increased diversification.

C) reduced risk.

D) all of the above.

E) only B and C of the above.

13) Mutual funds lower transactions costs and provide individual investors the benefit of

A) economies of scale.

B) diversification.

C) reduced risk.

D) all of the above.

E) both A and C of the above.

14) The reduction in transactions costs per dollar of investment as the size of transactions increases is

A) diversification.

B) economies of scale.

C) discounting.

D) economies of trade.

E) both A and B of the above.

15) 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) noncollateralized risk.

C) asymmetric information.

D) adverse selection.

16) 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) free–riding.

B) costly state verification.

C) moral hazard.

D) adverse selection.

17) The problem created by asymmetric information before the transaction occurs is called _____, while the problem created after the transaction occurs is called _____.

A) free–riding; costly state verification

B) moral hazard; adverse selection

C) costly state verification; free–riding

D) adverse selection; moral hazard

18) The "lemons problem" is a term used to describe the

A) principal–agent problem.

B) moral hazard problem.

C) adverse selection problem.

D) free–rider problem.

E) both A and B of the above.

19) Because of the "lemons problem" the price a buyer of a used car pays is

A) less than the price of a lemon.

B) between the price of a lemon and a peach.

C) greater than the price of a peach.

D) equal to the price of a peach.

E) equal to the price of a lemon.

20) The free–rider problem occurs because

A) people who pay for information do not pay the full cost of producing the information.

B) people who pay for information use it freely.

C) people who do not pay for information use it.

D) information can never be sold at any price.

E) it is never profitable to produce information.

21) The _____ problem helps to explain why the private production and sale of information cannot eliminate _____.

A) principal–agent; incentive compatibility

B) free–rider; moral hazard

C) principal–agent; adverse selection

D) principal–agent; moral hazard

E) free–rider; adverse selection

22) Government regulations require publicly traded firms to provide information, reducing

A) the adverse selection problem.

B) the need for diversification.

C) transactions costs.

D) all of the above.

E) both A and C of the above.

23) A lesson of the Enron collapse is that

A) government regulation increases the problem of asymmetric information.

B) better government regulation can eliminate the problem of asymmetric information.

C) government regulation can reduce but not eliminate asymmetric information.

D) government regulation always fails.

E) government regulation should be reduced.

24) Adverse selection is a problem associated with equity and debt contracts arising from

A) the borrower's lack of incentive to seek a loan for highly risky investments.

B) the lender's relative lack of information about the borrower's potential returns and risks of his investment activities.

C) the lender's inability to legally require sufficient collateral to cover a 100% loss if the borrower defaults.

D) none of the above.

25) Because of the adverse selection problem,

A) lenders may refuse loans to individuals with high net worth, because of their greater proclivity to "skip town."

B) lenders are reluctant to make loans that are not secured by collateral.

C) good credit risks are more likely to seek loans causing lenders to make a disproportionate amount of loans to good credit risks.

D) all of the above.

26) Because of the adverse selection problem,

A) lenders may refuse loans to individuals with low net worth.

B) lenders may choose to lend only to those who "do not need the money."

C) lenders typically require collateral before making a loan.

D) all of the above.

27) Because of the moral hazard problem,

A) lenders will choose to write complicated contracts, prohibiting the borrowers from using the loan proceeds for unauthorized purposes.

B) lenders will more readily lend to borrowers with high net worth.

C) lenders may demand positions on the board of directors of the firms that they provide with financing.

D) all of the above.

28) 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.

29) That most used cars are sold by intermediaries (i.e., used car dealers) provides evidence that these intermediaries

A) are able to prevent others from free-riding off the information that they provide.

B) provide information that is valued by consumers of used cars.

C) help solve the adverse selection problem.

D) do all of the above.

30) Financial intermediaries, particularly banks,

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

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

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

D) all of the above.

E) only A and B of the above.

31) 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.

32) 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) 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.

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

D) all of the above.

E) only A and B of the above.

33) The problem of adverse selection helps to explain

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

B) which firms are more likely to obtain funds from banks and other financial intermediaries, rather than from 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.

34) 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.

35) 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 financial markets are among the most heavily regulated sectors of the economy.

D) all of the above.

E) only A and B of the above.

36) The principal-agent problem arises because

A) monitoring agents' activities is costly.

B) principals have incentives to free-ride off the monitoring expenditures of other principals.

C) agents have more information about their activities than do the principals.

D) of all of the above.

E) of only A and B of the above.

37) 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) debt deflation D) free-rider

38) 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) agents; agents

B) principals; agents

C) agents; principals

D) principals; principals

39) 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.

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

A) the adverse selection problem.

B) the free–rider problem.

C) the principal–agent problem.

D) the "lemons problem."

E) the "too–big–to–fail" problem.

41) Equity contracts

A) are used much more frequently to raise capital than are debt contracts.

B) have the advantage over debt contracts of a lower costly state verification.

C) are agreements by the borrowers to pay lenders fixed dollar amounts at periodic intervals.

D) are not subject to the moral hazard problem.

E) are none of the above.

42) 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.

43) 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.

44) 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.

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

A) state verifies the debt contract.

B) makes the debt contract incentive compatible.

C) collateralizes the debt contract.

D) does none of the above.

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

A) requiring the state to verify the debt contract.

B) giving the debt contract characteristics of equity contracts.

C) making the debt contract incentive compatible.

D) collateralizing the debt contract.

47) 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.

48) Professional athletes often have contract clauses prohibiting risky activities such as skiing and motorcycle riding. These clauses are

A) illegal.

B) risk insurance.

C) limited–liability clauses.

D) restrictive covenants.

E) all of the above.

49) Although restrictive covenants can potentially reduce moral hazard, a problem with restrictive covenants is that

A) too few resources may be devoted to monitoring and enforcing them, as debtholders free-ride on others' monitoring and enforcement efforts.

B) borrowers may find loopholes that make the covenants ineffective.

C) they are costly to monitor and enforce.

D) all of the above.

E) only A and B of the above.

50) A key finding of the economic analysis of financial structure is that

A) 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.

B) economists do not have a very good explanation for why securities markets are so heavily regulated.

C) 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.

D) given the great extent to which securities markets are regulated, free-rider problems are not of significant economic consequence in these markets.

51) Financial systems in developing and transition countries face several difficulties that keep them from operating efficiently, including:

A) 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.

B) poorly developed legal systems that make it extremely difficult for lenders to enforce restrictive covenants.

C) under-developed regulatory systems that retard the provision of adequate information to the marketplace.

D) all of the above.

52) A reason that many developing and transition economies remain poor is

A) overly stringent accounting standards.

B) nationalization of banks.

C) excessive government regulation of financial markets.

D) lack of government direction in the allocation of credit.

E) all of the above.

53) Some of the problems that cause financial repression in developing and transition economies include

A) poor legal systems.

B) strong accounting standards.

C) excessive government regulation.

D) private ownership of banks.

E) all of the above.

54) Financial crises

A) frequently lead to sharp contractions in economic activity.

B) occur when adverse selection and moral hazard problems in financial markets become more significant.

C) are major disruptions in financial markets that are characterized by sharp declines in asset prices and the failures of many financial and nonfinancial firms.

D) all of the above.

E) only A and B of the above.

55) Factors that lead to worsening conditions in financial markets include

A) declining stock prices.

B) increases in interest rates.

C) increasing uncertainty in financial markets.

D) all of the above.

E) only A and B of the above.

56) Factors that lead to worsening conditions in financial markets include

A) declining stock prices.

B) increases in bond prices.

C) declining interest rates.

D) all of the above.

57) Factors that lead to worsening conditions in financial markets include:

A) bankers' lack of expertise in screening and monitoring borrowers.

B) weak supervision by bank regulators.

C) the deterioration in banks' balance sheets.

D) all of the above.

E) only B and C of the above.

58) Most financial crises in the United States have begun with

A) a sharp rise in interest rates.

B) an increase in uncertainty resulting from the failure of a major firm.

C) a steep stock market decline.

D) all of the above.

E) only A and B of the above.

59) Debt deflation occurs when

A) lenders reduce their lending due to declining stock prices (equity deflation) that lowers the value of collateral.

B) rising interest rates worsen adverse selection and moral hazard problems.

C) an economic downturn causes the price level to fall and a deterioration in firms' net worth because of the increased burden of indebtedness.

D) none of the above.

60) 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) moral hazard.

B) insolvency.

C) debt deflation.

D) adverse selection.

E) illiquidity.

61) In emerging economies such as Argentina, government fiscal imbalances may cause fears of

A) debt deflation.

B) default on government debt.

C) a fall in the value of foreign currency.

D) lower interest rates.

E) stock price declines.

62) 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.

63) Factors that led 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) all of the above.

E) only A and B of the above.

64) In both the Mexican and East Asian financial crises in the mid – to late 1990s, important factors leading up to the crises include

A) lack of expertise in screening and monitoring borrowers at banking institutions.

B) an increased in indebtedness due to depreciation of their currencies.

C) weak supervision of banks by regulators.

D) all of the above.

E) only A and B of the above.

65) Argentina's financial crisis was due to

A) poor supervision of the banking system.

B) fiscal imbalances.

C) a lending boom prior to the crisis.

D) all of the above.

E) both A and C of the above.

66) Factors contributing to Argentina's financial crisis include

A) a decline in stock prices.

B) a rise in interest rates abroad.

C) fiscal imbalances.

D) all of the above.

E) both A and B of the above.

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

A) a sharp decline in bond values.

B) a sharp stock market decline.

C) a sharp decline in interest rates.

D) all of the above.

1) B
2) D
3) C
4) D
5) D
6) B
7) A
8) A
9) C
10) D
11) E
12) D
13) D
14) B
15) C
16) D
17) D
18) C
19) B
20) C
21) E
22) A
23) C
24) B
25) B
26) D
27) D
28) E
29) D
30) D
31) D
32) A
33) D
34) E
35) D
36) D
37) A
38) C
39) B
40) C
41) E
42) E
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67) B