Money and Banking Version 3 0 3rd edition Wright Test Bank

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Chapter 2: The Financial System

Test Bank

True/False

1) Capital refers to the short term financing needs of firms.
(False, easy, section 3)

2) The quantity of financial assets as a percentage of GDP for the United States is less than it was 50 years ago.
(False, easy, section 6)

3) The quantity of assets in commercial banks as a ratio to all the assets held by financial institutions in the United States is less than it was 50 years ago.
(True, easy, section 6)

4) The Great Inflation took place during the 1970s.
(True, easy, section 8)

5) A positive net present value project is any project that will earn money in the future.
(False, medium, section 2)

6) It is easier for banks to achieve minimum efficient scale than for individuals.
(True, easy, section 2)

7) If you saved to buy a car, you would be using external finance.
(False, easy, section 2)

8) A security that pays $100 after 1 year and $500 after 3 years is an example of a derivative.
(False, medium, section 5)

9) All financial transactions involve intermediaries.
(False, easy, section 6)

10) A mortgage is an asset of a bank and a liability of a homeowner.
(True, easy, section 6)

11) The “too-big-to-fail” policy has not been invoked since the Great Depression.
(False, medium, section 8)

12) When a pension fund buys stock on the NYSE, it is using a secondary market.
(True, easy, section 5)

13) When an investor buys stock on E-trade, she is using a primary market.
(False, easy, section 5)

14) Total assets of commercial and savings institutions have increased over the past 50 years.
(True, medium, section 6)

15) Mutual fund assets as a fraction of financial assets in the United States have increased over the past 50 years.
(True, medium, section 6)

16) GDP is the value of all final goods and services over a given period of time.
(True, easy, section 6)

17) GDP is the value of all imported goods and services over a given period of time.
(False, easy, section 6)

18) GDP is the value of all intermediate and final goods over a given period of time.
(False, medium, section 6)

19) Assets in savings institutions have continually decreased as a fraction of financial assets in the United States over the past 50 years.
(False, hard, section 6)

20) An insurance premium is the amount paid to the insured on the expiry of the insurance contract.
(False, medium, section 6)

21) Bankers never make mistakes.
(False, super-easy, section 1)

22) Every loan involves financial intermediation.
(False, easy, section 6)

23) Equities are ownership stakes that entitle owners to a portion of the profits.
(True, easy, section 4)

24) Hybrid instruments are part debt and part equity or convertible from one into the other.
(True, easy, section 4)

25) High Frequency Trading accounts for one-third of all U.S. trading volume.
(False, easy, section 5)

26) Electronic Communication Networks (ECNs) are not as popular today as they once were.

(False, easy, section 5)

27) If you do not have a car payment on your car, your car is an asset.
(True, easy, section 6)

28) More than 10 billion shares are traded daily.
(True, easy, section 6)

29) An acquisition occurs when two companies combine into one.
(False, easy, section 5)

30) The terms *financial securities* and *financial instruments* can be used interchangeably.
(True, easy, section 4)

Multiple Choice

1) When a corporation forgoes paying a dividend to expand its business, it is engaging in
   a) internal finance.
   b) external finance.
   c) both of the above.
   d) neither of the above.
(a, easy, section 2)

2) When Nikki mortgages her home, she is engaged in
   a) internal finance.
   b) external finance.
   c) both of the above.
   d) neither of the above.
(b, easy, section 2)

3) Which of the following is an example of direct finance?
   a) A home buyer takes a mortgage.
   b) You borrow money from a friend for lunch.
   c) Your parents buy life insurance.
   d) All of the above.
(b, easy, section 5)

4) Which of the following does not involve a financial intermediary?
   a) a credit card purchase
   b) buying stock online
   c) buying renter's insurance
   d) all of the above
(d, easy, section 6)

5) When Google issued stock to raise money, it was engaged in
   a) internal finance.

b) external finance.
c) both of the above.
d) neither of the above.
(b, easy, section 2)

6) The problem for lenders, that highest risk borrowers tend to be the most eager to take loans, is an example of
a) adverse selection.
b) moral hazard.
c) both of the above.
d) neither of the above.
(a, easy, section 3)

7) The problem for lenders, that a borrower has the incentive to take chances once the loan is made, is an example of
a) adverse selection.
b) moral hazard.
c) both of the above.
d) neither of the above.
(b, easy, section 3)

8) The tendency of people with renter's insurance to leave the apartment door unlocked is an example of a(n) _____ problem for insurance companies.
a) adverse selection
b) moral hazard
c) both of the above
d) neither of the above
(b, easy, section 3)

9) People with few valuables won't want property insurance. This is an example of a(n) _____ problem for insurance companies.
a) adverse selection
b) moral hazard
c) both of the above
d) neither of the above
(a, easy, section 3)

10) Banks might be more efficient than individual lenders due to
a) returns to scale.
b) expertise in accounting tasks.
c) expertise in advertising to borrowers.
d) all of the above.
(d, easy, section 2)

11) Banks might be more efficient than individual lenders due to
a) returns to scale.

b) their access to the stock market.
c) increasing returns on capital.
d) all of the above.
(a, easy, section 2)

12) Which of the following is a decentralized market?
a) NYSE
b) CBOT
c) OTC market
d) All of the above
(c, medium, section 5)

13) Which of the following is a centralized market?
a) NYSE
b) CBOT
c) FTSE
d) All of the above
(d, medium, section 5)

14) Mutual funds provide
a) diversification to small stock market investors.
b) expertise in insurance contracts.
c) home loans.
d) none of the above.
(a, easy, section 6)

15) Which of the following regularly hold stock portfolios?
a) pension funds
b) brokers
c) mutual funds
d) all of the above
(d, easy, section 6)

16) Which of the following is NOT a financial intermediary?
a) mutual fund
b) pension fund
c) insurance company
d) all of the above
(d, easy, section 6)

17) Which of the following is NOT a financial intermediary?
a) mutual fund
b) auction house
c) insurance company
d) all of the above
(b, easy, section 6)

18) The value of a wheat futures contract is based on the expected price of wheat, so it is an example of a(n)

a) stock.
b) derivative.
c) option.
d) none of the above.

(b, easy, section 5)

19) When U.S. Steel issues commercial paper (for short term borrowing), it is accessing

a) financial intermediaries.
b) the OTC market.
c) the bond market.
d) none of the above.

(a, easy, section 6)

20) Joanna decides to buy a U.S. government bond instead of stock in a technology firm that has just gone public (issued stock for the first time). She is primarily concerned with

a) risk.
b) return.
c) liquidity.
d) none of the above.

(a, easy, section 6)

21) The primary source of funds for an insurance company is

a) loans.
b) premiums.
c) deposits.
d) none of the above.

(b, easy, section 6)

22) Investors in collectible musical instruments must have a high tolerance for low

a) return.
b) risk.
c) liquidity.
d) none of the above.

(c, easy, section 6)

23) Investors in fine art must have a high tolerance for

a) low return.
b) high inflation.
c) low liquidity.
d) all of the above.

(c, medium, section 6)

24) Investors in lottery tickets must have a high tolerance for high

a) return.
b) risk.
c) liquidity.
d) all of the above.
(b, easy, section 6)

25) The Great Inflation took place during the
a) 1950s.
b) 1960s.
c) 1970s.
d) 1980s.
(c, easy, section 6)

26) Nonnegotiable shares are those that:
a) trade at a fixed price on the stock exchange.
b) cannot be issued in a primary market.
c) cannot be transferred to third parties.
d) cannot be changed to cash.
(c, easy, section 6)

27) Credit card companies are required to disclose the APR (annual percentage rate) giving a standard measure of borrowing costs. This is an example of
a) a transparency regulation.
b) *ceteris paribus*.
c) monetary policy.
d) all of the above.
(a, easy, section 8)

28) Which of the following is NOT a financial regulator?
a) FDIC
b) FBI
c) SEC
d) All of the above
(b, easy section 8)

29) Which of the following is a financial regulator?
a) MLB
b) CIA
c) CFTC
d) All of the above (c, super-easy, section 8)

30) Which of the following does NOT regulate banks?
a) SEC
b) FDIC
c) Federal Reserve
d) All of the above

(a, medium, section 8)

31) Which of the following does NOT regulate stock markets?
   a) SEC
   b) FDIC
   c) NYSE
   d) All of the above
(b, medium, section 8)

32) Which of the following is NOT considered one of the major types of financial instruments?
   a) debt
   b) equity
   c) capital
   d) hybrid
(c, easy, section 4)

33) Which of the following is a hybrid financial instrument?
   a) Treasury bond
   b) convertible bond
   c) a share of common stock
   d) certificate of deposit
(b, medium, section 4)

34) Makers can include:
   a) individuals.
   b) governments.
   c) businesses.
   d) all of the above.
(d, easy, section 4)

35) An investor's primary concerns are usually:
   a) risk
   b) return
   c) liquidity
   d) all of the above.
(d, easy, section 7)

36) Which of the following contributed to the reversal of financial globalization?
   a) the creation of the Bretton Woods arrangement
   b) the beginning of the Civil War
   c) the increase of the gold standard
   d) all of the above
(a, easy, section 5)

Short Answer

1) What is the minimum efficient scale of the business?

Minimum efficient scale is the smallest size a business can be while still remaining profitable.
(easy, section 2)

2) What is the difference between liquidity and capital financing requirements for a firm?
Liquidity financing is for short term needs while capital requirements are for long term projects.
(easy, section 3)

3) Drivers with theft insurance are less likely to lock their car. Explain the type of asymmetric information problem this represents for insurance companies.

Drivers behave in undesirable ways after they have obtained insurance, so this is a moral hazard problem.
(medium, section 3)

4) When a borrower uses a loan to buy lottery tickets, what type of asymmetric information problem does this represent for the lender? Explain briefly.

Borrowers behave in undesirable ways after the loan is made, so this is a moral hazard problem.
(medium, section 3)

5) Healthy people are less likely to buy medical insurance. Explain what type of asymmetric information problem this represents for the insurance company.

People who the insurance company would like to insure opt out before any agreement can be made, so this is an adverse selection problem.
(medium, section 3)

6) Samantha's restaurant just burned down, destroying all of her net worth, and she wants a loan to rebuild. Explain what type of asymmetric information problem this represents for the bank.

Samantha has no net worth and is high risk so she needs money. High-risk people requesting loans constitute an adverse selection problem, since the problem arises before the loan has been made.
(medium, section 3)

7) What are the two types of asymmetric information and what is the difference between them?

The two types are adverse selection and moral hazard. Adverse selection problems arise before an agreement or contract is made, while moral hazard problems arise after.
(medium, section 3)

8) The recent bailout of AIG by the Federal Reserve and the Treasury Department is an example of what regulatory policy?

Too-big-to-fail
(easy, section 8)

9) What is a direct placement of corporate bonds?

A direct placement occurs when a financial institution arranges for recently issued bonds to be purchased by another institution.
(easy, section 5)

10) Why are mutual funds necessary, now that investors can buy stocks and bonds via online trading services?

Small investors might not have enough money to form a sufficiently diversified portfolio, but they can buy a share of a mutual fund that has exposure to many stocks.
(medium, section 6)

11) What does "*ceteris paribus*" mean?

This phrase means *"all else equal."*
(easy, section 7)

12) Why are some banking regulations aimed at limiting competition?

Excessive competition can lead to excessive risk-taking by banks.
(medium, section 8)

13) What is the difference between debt and equity?

Debt instruments, such as bonds, indicate a lender-borrower relationship in which the borrower promises to pay a fixed sum and interest to the lender at a specific date or over some period of time. Equity instruments, such as stocks, represent an ownership stake in which the holder of the instrument receives some portion of the issuer's profits.
(easy, section 4)

14) How have financial systems contributed to material progress and technological breakthroughs?

Financial systems link borrowers such as inventors, entrepreneurs, and other economic agents with limited resources to lenders or savers who have excess funds. (easy, section 2)