

Chapter 2

Practice Problems

MULTIPLE CHOICE. Choose the one alternative that best completes the statement or answers the question.

- 1) Assume that you borrow \$2000 at 10% annual interest to finance a new business project. For this loan to be profitable, the minimum amount this project must generate in annual earnings is 1) _____
A) \$400. B) \$201. C) \$200. D) \$199.
- 2) Which of the following can be described as direct finance? 2) _____
A) You take out a mortgage from your local bank.
B) You buy shares in a mutual fund.
C) You buy shares of common stock in the secondary market.
D) You borrow \$2500 from a friend.
- 3) Well-functioning financial markets 3) _____
A) eliminate the need for indirect finance. B) cause inflation.
C) produce an efficient allocation of capital. D) cause financial crises.
- 4) Every financial market has the following characteristic: 4) _____
A) It determines the level of interest rates.
B) It allows loans to be made.
C) It allows common stock to be traded.
D) It channels funds from lenders-savers to borrowers-spenders.
- 5) When I purchase _____, I own a portion of a firm and have the right to vote on issues important to the firm and to elect its directors. 5) _____
A) stock B) notes C) bonds D) bills
- 6) Long-term debt has a maturity that is 6) _____
A) between five and ten years. B) between one and ten years.
C) ten years or longer. D) less than a year.
- 7) If the maturity of a debt instrument is less than one year, the debt is called 7) _____
A) prima-term. B) long-term.
C) short-term. D) intermediate-term.
- 8) Which of the following benefit directly from any increase in the corporation's profitability? 8) _____
A) a bond holder B) a T-bill holder
C) a shareholder D) a commercial paper holder
- 9) When an investment bank _____ securities, it guarantees a price for a corporation's securities and then sells them to the public. 9) _____
A) underwrites B) overwrites C) overtakes D) undertakes
- 10) A financial market in which previously issued securities can be resold is called a _____ market. 10) _____
A) secondary B) primary C) tertiary D) used securities

- 11) A corporation acquires new funds only when its securities are sold in the _____ 11) _____
 A) primary market by an investment bank.
 B) secondary market by a stock exchange broker.
 C) secondary market by a commercial bank.
 D) secondary market by an investment bank.
- 12) A liquid asset is _____ 12) _____
 A) a share of an ocean resort.
 B) always sold in an over-the-counter market.
 C) difficult to resell.
 D) an asset that can easily and quickly be sold to raise cash.
- 13) Equity instruments are traded in the _____ market. 13) _____
 A) money B) capital C) commodities D) bond
- 14) A financial market in which only short-term debt instruments are traded is called the _____ 14) _____
 market.
 A) stock B) bond C) capital D) money
- 15) Prices of money market instruments undergo the least price fluctuations because of _____ 15) _____
 A) the price ceiling imposed by government regulators.
 B) the lack of competition in the market.
 C) the heavy regulations in the industry.
 D) the short terms to maturity for the securities.
- 16) Equity of U.S. companies can be purchased by _____ 16) _____
 A) foreign citizens only. B) U.S. citizens only.
 C) U.S. mutual funds only. D) U.S. citizens and foreign citizens.
- 17) Bonds that are sold in a foreign country and are denominated in a currency other than that of the 17) _____
 country in which it is sold are known as
 A) foreign bonds. B) country bonds. C) Eurobonds. D) equity bonds.
- 18) Bonds that are sold in a foreign country and are denominated in the country's currency in which 18) _____
 they are sold are known as
 A) equity bonds. B) Eurobonds. C) foreign bonds. D) country bonds.
- 19) U.S. dollar deposits in foreign banks outside the U.S. or in foreign branches of U.S. banks are called 19) _____
 A) Atlantic dollars. B) foreign dollars.
 C) Eurodollars. D) outside dollars.
- 20) In the United States, loans from _____ are far _____ important for corporate finance than are 20) _____
 securities markets.
 A) financial intermediaries; less B) government agencies; more
 C) government agencies; less D) financial intermediaries; more
- 21) The process of indirect finance using financial intermediaries is called _____ 21) _____
 A) direct lending. B) resource allocation.
 C) financial liquidation. D) financial intermediation.

- 22) Financial institutions that accept deposits and make loans are called _____ institutions. 22) _____
 A) contractual savings B) depository
 C) investment D) underwriting
- 23) Which of the following is a depository institution? 23) _____
 A) A mutual fund B) A life insurance company
 C) A credit union D) A pension fund
- 24) The primary liabilities of a commercial bank are 24) _____
 A) deposits. B) mortgages.
 C) commercial paper. D) bonds.
- 25) Which of the following is a contractual savings institution? 25) _____
 A) A mutual fund B) A life insurance company
 C) A credit union D) A savings and loan association
- 26) Money market mutual fund shares function like 26) _____
 A) currency. B) bonds.
 C) checking accounts that pay interest. D) stocks.
- 27) An investment bank helps _____ issue securities. 27) _____
 A) foreign governments B) the SEC
 C) a corporation D) the United States government
- 28) Which of the following is not a goal of financial regulation? 28) _____
 A) Reducing adverse selection
 B) Ensuring the soundness of the financial system
 C) Ensuring that investors never suffer losses
 D) Reducing moral hazard
- 29) Increasing the amount of information available to investors helps to reduce the problems of _____ and _____ in the financial markets. 29) _____
 A) adverse selection; risk sharing B) moral hazard; transactions costs
 C) adverse selection; economies of scale D) adverse selection; moral hazard
- 30) U.S. Treasury bills pay no interest but are sold at a _____. That is, you will pay a lower purchase price than the amount you receive at maturity. 30) _____
 A) collateral B) premium C) default D) discount
- 31) U.S. Treasury bills are considered the safest of all money market instruments because there is almost no risk of _____ 31) _____
 A) default. B) desertion. C) demarcation. D) defeat.
- 32) A debt instrument sold by a bank to its depositors that pays annual interest of a given amount and at maturity pays back the original purchase price is called 32) _____
 A) federal funds. B) a negotiable certificate of deposit.
 C) a municipal bond. D) commercial paper.

- 33) A short-term debt instrument issued by well-known corporations is called _____ 33) _____
 A) commercial mortgages. B) corporate bonds.
 C) municipal bonds. D) commercial paper.
- 34) _____ are short-term loans in which Treasury bills serve as collateral. 34) _____
 A) Federal funds B) U.S. government agency securities
 C) Repurchase agreements D) Negotiable certificates of deposit
- 35) Collateral is _____ the lender receives if the borrower does not pay back the loan. 35) _____
 A) an offering B) an asset C) a present D) a liability
- 36) Federal funds are 36) _____
 A) loans made by banks to each other.
 B) loans made by banks to the Federal Reserve System.
 C) loans made by the Federal Reserve System to banks.
 D) funds raised by the federal government in the bond market.
- 37) The British Banker's Association average of interbank rates for dollar deposits in the London market is called the 37) _____
 A) federal funds rate. B) prime rate.
 C) Libor rate. D) Treasury Bill rate.
- 38) Which of the following are short-term financial instruments? 38) _____
 A) A residential mortgage
 B) A Treasury note with a maturity of four years
 C) A share of Walt Disney Corporation stock
 D) A repurchase agreement
- 39) Which of the following instruments are traded in a money market? 39) _____
 A) U.S. Treasury bills B) Corporate bonds
 C) U.S. government agency securities D) State and local government bonds
- 40) Which of the following instruments are traded in a money market? 40) _____
 A) Residential mortgages B) Commercial paper
 C) Bank commercial loans D) State and local government bonds
- 41) Which of the following instruments is not traded in a money market? 41) _____
 A) Residential mortgages B) Commercial paper
 C) U.S. Treasury Bills D) Negotiable bank certificates of deposit
- 42) Bonds issued by state and local governments are called _____ bonds. 42) _____
 A) corporate B) Treasury C) commercial D) municipal
- 43) Equity and debt instruments with maturities greater than one year are called _____ market instruments. 43) _____
 A) money B) capital C) federal D) benchmark
- 44) Which of the following is a long-term financial instrument? 44) _____
 A) A U.S. Treasury bond B) A U.S. Treasury bill
 C) A repurchase agreement D) A negotiable certificate of deposit

- 45) Which of the following instruments are traded in a capital market? 45) _____
 A) Negotiable bank CDs B) U.S. Government agency securities
 C) Repurchase agreements D) U.S. Treasury bills
- 46) Which of the following instruments are traded in a capital market? 46) _____
 A) Negotiable bank CDs B) Corporate bonds
 C) Repurchase agreements D) U.S. Treasury bills
- 47) Which of the following are not traded in a capital market? 47) _____
 A) Corporate bonds B) U.S. government agency securities
 C) State and local government bonds D) Repurchase agreements
- 48) The most liquid securities traded in the capital market are 48) _____
 A) mortgage-backed securities. B) municipal bonds.
 C) corporate bonds. D) U.S. Treasury bonds.
- 49) Bonds that are sold in a foreign country and are denominated in a currency other than that of the 49) _____
 country in which it is sold are known as
 A) country bonds. B) foreign bonds. C) equity bonds. D) Eurobonds.
- 50) Conflicts of interest are a type of _____ problem that can happen when an institution provides 50) _____
 multiple services.
 A) moral hazard B) free-riding
 C) adverse selection D) discounting
- 51) The primary assets of a finance company are 51) _____
 A) municipal bonds. B) consumer and business loans.
 C) corporate stocks and bonds. D) mortgages.
- 52) Savings and loan associations are regulated by the 52) _____
 A) Office of Thrift Supervision. B) Federal Reserve System.
 C) Securities and Exchange Commission. D) Office of the Comptroller of the Currency.
- 53) When compared to exchange systems that rely on money, disadvantages of the barter system 53) _____
 include:
 A) lowering the cost of exchange to those who would specialize.
 B) the requirement of a double coincidence of wants.
 C) encouraging specialization and the division of labor.
 D) lowering the cost of exchanging goods over time.
- 54) If the interest rates on all bonds rise from 5 to 6 percent over the course of the year, which bond 54) _____
 would you prefer to have been holding?
 A) A bond with twenty years to maturity B) A bond with one year to maturity
 C) A bond with five years to maturity D) A bond with ten years to maturity
- 55) The global financial crisis lead to a decline in stock prices because 55) _____
 A) higher current dividends.
 B) higher expected future stock prices.
 C) of a lowered expected dividend growth rate.
 D) of a lowered required return on investment in equity.

- 56) Although debt contracts require less monitoring than equity contracts, debt contracts are still subject to _____ since borrowers have an incentive to take on more risk than the lender would like. 56) _____
 A) agency theory B) the "lemons" problem
 C) moral hazard D) diversification
- 57) The economic hardship resulting from a financial crises is severe, however, there are also social consequences such as 57) _____
 A) currency devaluations. B) loss of output.
 C) difficulty getting a loan. D) increased crime.
- 58) When you deposit \$50 in your account at First National Bank and a \$100 check you have written on this account is cashed at Chemical Bank, then 58) _____
 A) the reserves at First National fall by \$50.
 B) the assets of First National rise by \$50.
 C) the liabilities at Chemical Bank rise by \$50.
 D) the assets of Chemical Bank rise by \$50.
- 59) Depositors have a strong incentive to show up first to withdraw their funds during a bank crisis because banks operate on a 59) _____
 A) last-in, first-out constraint. B) everyone-shares-equally constraint.
 C) double-coincidence of wants constraint. D) sequential service constraint.
- 60) Allowing bank branching across state lines gives banks greater ability to coordinate bank operations. This makes it easier for them to receive the benefits of 60) _____
 A) economies of scale. B) interest-rate irregularities.
 C) the dual banking system. D) disintermediation.
- 61) Which of the followings is a duty of the Board of Governors of the Federal Reserve System? 61) _____
 A) All governors advise the president of the United States on economic policy.
 B) Regulating credit with the approval of the president under the Credit Control Act of 1969.
 C) Setting the maximum interest rates payable on certain types of time deposits under Regulation Q.
 D) Setting margin requirements, the fraction of the purchase price of the securities that has to be paid for with cash.
- 62) Everything else held constant, an increase in the money market fund ratio will mean _____ in the M2 money multiplier and _____ in the M2 money supply. 62) _____
 A) a decrease; a decrease B) an increase; a decrease
 C) an increase; an increase D) a decrease; an increase
- 63) The time-inconsistency problem with monetary policy tells us that, if policymakers use discretionary policy, there is a higher probability that the _____ will be higher, compared to policy makers following a behavior rule. 63) _____
 A) interest rate B) foreign exchange rate
 C) unemployment rate D) inflation rate

- 64) When the effects of the global financial crisis started to spread more quickly throughout the rest of the world, the U.S. dollar _____ because demand for U.S. assets _____. 64) _____
- A) depreciated; increased
 - B) depreciated; decreased
 - C) appreciated; decreased
 - D) appreciated; increased
- 65) The United States chooses to have _____ and _____ and therefore, cannot have a fixed exchange rate at the same time. 65) _____
- A) capital control, an independent monetary policy
 - B) free capital mobility, an independent monetary policy
 - C) capital control, no control of monetary policy
 - D) free capital mobility, no control of monetary policy

Answer Key

Testname: UNTITLED1

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

Answer Key

Testname: UNTITLED1

- 51) B
- 52) A
- 53) B
- 54) B
- 55) C
- 56) C
- 57) D
- 58) A
- 59) D
- 60) A
- 61) D
- 62) C
- 63) D
- 64) D
- 65) B