Chapter 1

Why Study Money, Banking, and Financial Markets?

1.1 Why Study Financial Markets?

1) Financial markets promote economic efficiency by

A) channeling funds from investors to savers.

B) creating inflation.

C) channeling funds from savers to investors.

D) reducing investment.

Answer: C
Ques Status: Revised

2) Financial markets promote greater economic efficiency by channeling funds from ________ to ________.

A) investors; savers

B) borrowers; savers

C) savers; borrowers

D) savers; lenders

Answer: C
Ques Status: New

3) Well-functioning financial markets promote

A) inflation.

B) deflation.

C) unemployment.

D) growth.

Answer: D
Ques Status: Revised

4) Markets in which funds are transferred from those who have excess funds available to those who have a shortage of available funds are called

A) commodity markets.

B) fund-available markets.

C) derivative exchange markets.

D) financial markets.

Answer: D
Ques Status: Previous Edition

5) ________ markets transfer funds from people who have an excess of available funds to people who have a shortage.

A) Commodity

B) Fund–available

C) Financial

D) Derivative exchange

Answer: C
Ques Status: New

6) Poorly performing financial markets can be the cause of

A) wealth.

B) poverty.

C) financial stability.

D) financial expansion.

Answer: B
Ques Status: Revised

7) The bond markets are important because they are

A) easily the most widely followed financial markets in the United States.

B) the markets where foreign exchange rates are determined.

C) the markets where interest rates are determined.

D) the markets where all borrowers get their funds.

Answer: C
Ques Status: Revised

8) The price paid for the rental of borrowed funds (usually expressed as a percentage of the rental of $100 per year) is commonly referred to as the

A) inflation rate.

B) exchange rate.

C) interest rate.

D) aggregate price level.

Answer: C
Ques Status: Previous Edition

9) Compared to interest rates on long-term U.S. government bonds, interest rates on three-month Treasury bills fluctuate ________ and are ________ on average.

A) more; lower

B) less; lower

C) more; higher

D) less; higher

Answer: A
Ques Status: Previous Edition

10) The interest rate on Baa (medium quality) corporate bonds is ________, on average, than other interest rates, and the spread between it and other rates became ________ in the 1970s.

A) lower; smaller

B) lower; larger

C) higher; smaller

D) higher; larger

Answer: D
Ques Status: Previous Edition

11) Everything else held constant, a decline in interest rates will cause spending on housing to

A) fall.

B) remain unchanged.

C) either rise, fall, or remain the same.

D) rise.

Answer: D
Ques Status: Revised

12) An increase in interest rates might ________ saving because more can be earned in interest income.

A) encourage

B) discourage

C) disallow

D) invalidate

Answer: A
Ques Status: New

13) Everything else held constant, an increase in interest rates on student loans

A) increases the cost of a college education.

B) reduces the cost of a college education.

C) has no effect on educational costs.

D) increases costs for students with no loans.

Answer: A
Ques Status: Revised

14) High interest rates might cause a corporation to ________ building a new plant that would provide more jobs.

A) complete

B) consider

C) postpone

D) contemplate

Answer: C
Ques Status: New

15) The stock market is important because it is

A) where interest rates are determined.

B) the most widely followed financial market in the United States.

C) where foreign exchange rates are determined.

D) the market where most borrowers get their funds.

Answer: B
Ques Status: Revised

16) Stock prices since the 1950s have been

A) relatively stable trending upward at a steady pace.

B) relatively stable trending downward at a moderate rate.

C) extremely volatile.

D) unstable trending downward at a moderate rate.

Answer: C
Ques Status: Previous Edition

17) A rising stock market index due to higher share prices

A) increases people's wealth, but is unlikely to increase their willingness to spend.

B) increases people's wealth and as a result may increase their willingness to spend.

C) decreases the amount of funds that business firms can raise by selling newly–issued stock.

D) decreases people's wealth, but is unlikely to increase their willingness to spend.

Answer: B
Ques Status: Revised

18) When stock prices fall

A) an individual's wealth is not affected nor is their willingness to spend.

B) a business firm will be more likely to sell stock to finance investment spending.

C) an individual's wealth may decrease but their willingness to spend is not affected.

D) an individual's wealth may decrease and their willingness to spend may decrease.

Answer: D
Ques Status: New

19) Changes in stock prices

A) do not affect people's wealth and their willingness to spend

B) affect firms' decisions to sell stock to finance investment spending.

C) occur in regular patterns.

D) are unimportant to decision makers.

Answer: B
Ques Status: Revised

20) An increase in stock prices ________ the size of people's wealth and may ________ their willingness to spend, everything else held constant.

A) increases; increase

B) increases; decrease

C) decreases; increase

D) decreases; decrease

Answer: A
Ques Status: New

21) Fear of a major recession causes stock prices to fall, everything else held constant, which in turn causes consumer spending to

A) increase.

B) remain unchanged.

C) decrease.

D) cannot be determined.

Answer: C
Ques Status: Revised

22) A common stock is a claim on a corporation's

A) debt.

B) liabilities.

C) expenses.

D) earnings and assets.

Answer: D
Ques Status: Revised

23) On ________, October 19, 1987, the market experienced its worst one-day drop in its entire history with the DIJA falling by more than 500 points.

A) "Terrible Tuesday"

B) "Woeful Wednesday"

C) "Freaky Friday"

D) "Black Monday"

Answer: D
Ques Status: New

24) The decline in stock prices from 2000 through 2002

A) increased individuals' willingness to spend.

B) had no effect on individual spending.

C) reduced individuals' willingness to spend.

D) increased individual wealth.

Answer: C
Ques Status: Revised

25) The Dow reached a peak of over 11,000 before the collapse of the ________ bubble in 2000.

A) housing

B) manufacturing

C) high-tech

D) banking

Answer: C
Ques Status: New

26) The price of one country's currency in terms of another country's currency is called the

A) exchange rate.

B) interest rate.

C) Dow Jones industrial average.

D) prime rate.

Answer: A
Ques Status: Revised

27) The market where one currency is converted into another currency is called the ________ market.

A) stock

B) bond

C) derivatives

D) foreign exchange

Answer: D
Ques Status: New

28) Everything else constant, a stronger dollar will mean that

A) vacationing in England becomes more expensive.

B) vacationing in England becomes less expensive.

C) French cheese becomes more expensive.

D) Japanese cars become more expensive.

Answer: B
Ques Status: Previous Edition

29) Which of the following is most likely to result from a stronger dollar?

A) U.S. goods exported aboard will cost less in foreign countries, and so foreigners will buy more of them.

B) U.S. goods exported aboard will cost more in foreign countries and so foreigners will buy more of them.

C) U.S. goods exported abroad will cost more in foreign countries, and so foreigners will buy fewer of them.

D) Americans will purchase fewer foreign goods.

Answer: C
Ques Status: Previous Edition

30) Everything else held constant, a weaker dollar will likely hurt

A) textile exporters in South Carolina.

B) wheat farmers in Montana that sell domestically.

C) automobile manufacturers in Michigan that use domestically produced inputs.

D) furniture importers in California.

Answer: D
Ques Status: Revised

31) Everything else held constant, a stronger dollar benefits ________ and hurts ________.

A) American businesses; American consumers

B) American businesses; foreign businesses

C) American consumers; American businesses

D) foreign businesses; American consumers

Answer: C
Ques Status: Study Guide

32) From 1980 to early 1985 the dollar ________ in value, thereby benefiting American ________.

A) appreciated; consumers

B) appreciated, businesses

C) depreciated; consumers

D) depreciated, businesses

Answer: A
Ques Status: Previous Edition

33) From 1980 to 1985 the dollar appreciated relative to the British pound. Holding everything else constant, one would expect that, when compared to 1980,

A) fewer Britons traveled to the United States in 1985.

B) Britons imported more wine from California in 1985.

C) Americans exported more wheat to England in 1985.

D) more Britons traveled to the United States in 1985.

Answer: A
Ques Status: Previous Edition

34) When in 1985 a British pound cost approximately $1.30, a Shetland sweater that cost 100 British pounds would have cost $130. With a weaker dollar, the same Shetland sweater would have cost

A) less than $130.

B) more than $130.

C) $130, since the exchange rate does not affect the prices that American consumers pay for foreign goods.

D) $130, since the demand for Shetland sweaters will decrease to prevent an increase in price due to the stronger dollar.

Answer: B
Ques Status: Previous Edition

35) Everything else held constant, a decrease in the value of the dollar relative to all foreign currencies means that the price of foreign goods purchased by Americans

A) increases

B) decreases.

C) remains unchanged.

D) either increases, decreases, or remains unchanged.

Answer: A
Ques Status: Revised

36) American farmers who sell beef to Europe benefit most from

A) a decrease in the dollar price of euros.

B) an increase in the dollar price of euros.

C) a constant dollar price for euros.

D) a European ban on imports of American beef.

Answer: B
Ques Status: Revised

37) If the price of a euro (the European currency) increases from $1.00 to $1.10, then, everything else held constant,

A) a European vacation becomes less expensive.

B) a European vacation becomes more expensive.

C) the cost of a European vacation is not affected.

D) foreign travel becomes impossible.

Answer: B
Ques Status: Revised

38) Everything else held constant, Americans who love French wine benefit most from

A) a decrease in the dollar price of euros.

B) an increase in the dollar price of euros.

C) a constant dollar price for euros.

D) a ban on imports from Europe.

Answer: A
Ques Status: Revised

39) What is a stock? How do stocks affect the economy?

Answer: A stock represents a share of ownership of a corporation, or a claim on a firm's earnings/assets. Stocks are part of wealth, and changes in their value affect people's willingness to spend. Changes in stock prices affect a firm's ability to raise funds, and thus their investment.
Ques Status: Previous Edition

1.2 Why Study Banking and Financial Institutions?

1) Channeling funds from individuals with surplus funds to those desiring funds when the saver does not purchase the borrower's security is known as

A) barter.

B) redistribution.

C) financial intermediation.

D) taxation.

Answer: C
Ques Status: Revised

2) Banks are important to the study of money and the economy because they

A) channel funds from investors to savers.

B) have been a source of rapid financial innovation.

C) are the only important financial institution in the U.S. economy.

D) create inflation.

Answer: B
Ques Status: Revised

3) Economists group commercial banks, savings and loan associations, credit unions, mutual funds, mutual savings banks, insurance companies, pension funds, and finance companies together under the heading financial intermediaries. Financial intermediaries

A) provide a channel for linking those who want to save with those who want to invest.

B) produce nothing of value and are therefore a drain on society's resources.

C) can hurt the performance of the economy.

D) hold very little of the average American's wealth.

Answer: A
Ques Status: Revised

4) Banks, savings and loan associations, mutual savings banks, and credit unions

A) are no longer important players in financial intermediation.

B) since deregulation now provide services only to small depositors.

C) have been adept at innovating in response to changes in the regulatory environment.

D) produce nothing of value and are therefore a drain on society's resources.

Answer: C
Ques Status: Revised

5) Banks and other financial institutions engage in financial intermediation, which

A) can hurt the performance of the economy.

B) can benefit economic performance.

C) has no effect on economic performance.

D) involves borrowing from investors and lending to savers.

Answer: B
Ques Status: Revised

6) Financial institutions that accept deposits and make loans are called ________.

A) exchanges

B) banks

C) over-the-counter markets

D) finance companies

Answer: B
Ques Status: New

7) The financial intermediaries that the average person interacts with most frequently are ________.

A) exchanges

B) over-the-counter markets

C) finance companies

D) banks

Answer: D
Ques Status: New

8) Which of the following is not a financial institution?

A) a life insurance company

B) a pension fund

C) a credit union

D) a business college

Answer: D
Ques Status: New

9) The delivery of financial services electronically is called ________.

A) e-business

B) e-commerce

C) e-finance

D) e-possible

Answer: C
Ques Status: New

1.3 Why Study Money and Monetary Policy?

1) Money is defined as

A) bills of exchange.

B) anything that is generally accepted in payment for goods and services or in the repayment of debt.

C) a risk-free repository of spending power.

D) the unrecognized liability of governments.

Answer: B
Ques Status: Previous Edition

2) Evidence from the United States and other foreign countries indicates that

A) there is a strong positive association between inflation and growth rate of money over long periods of time.

B) there is little support for the assertion that "inflation is always and everywhere a monetary phenomenon."

C) countries with low monetary growth rates tend to experience higher rates of inflation, all else being constant.

D) money growth is clearly unrelated to inflation.

Answer: A
Ques Status: Previous Edition

3) The upward and downward movement of aggregate output produced in the economy is referred to as the ________.

A) roller coaster

B) see saw

C) business cycle

D) shock wave

Answer: C
Ques Status: New

4) Sustained downward movements in the business cycle are referred to as

A) inflation.

B) recessions.

C) economic recoveries.

D) expansions.

Answer: B
Ques Status: Previous Edition

5) Prior to all recessions since 1900, there has been a drop in

A) inflation.

B) the money stock.

C) the growth rate of the money stock.

D) interest rates.

Answer: C
Ques Status: Revised

6) Evidence from business cycle fluctuations in the United States indicates that

A) a negative relationship between money growth and general economic activity exists.

B) recessions have been preceded by declines in share prices on the stock exchange.

C) recessions have been preceded by dollar depreciation.

D) recessions have been preceded by a decline in the growth rate of money.

Answer: D
Ques Status: Previous Edition

7) A sharp increase in the growth of the money supply is likely followed by

A) a recession.

B) a depression.

C) an increase in the inflation rate.

D) no change in the economy.

Answer: C
Ques Status: Revised

8) It is true that inflation is a

A) continuous increase in the money supply.

B) continuous fall in prices.

C) decline in interest rates.

D) continually rising price level.

Answer: D
Ques Status: Revised

9) ________ theory relates changes in the quantity of money to changes in aggregate economic activity and the price level.

A) Monetary

B) Fiscal

C) Financial

D) Systemic

Answer: A
Ques Status: New

10) The management of money and interest rates is called ________ policy and is conducted by a nation's ________ bank.

A) monetary; superior

B) fiscal; superior

C) fiscal; central

D) monetary; central

Answer: D
Ques Status: New

11) The organization responsible for the conduct of monetary policy in the United States is the

A) Comptroller of the Currency.

B) U.S. Treasury.

C) Federal Reserve System.

D) Bureau of Monetary Affairs.

Answer: C
Ques Status: Previous Edition

12) Which of the following is a true statement?

A) Money or the money supply is defined as Federal Reserve notes.

B) The average price of goods and services in an economy is called the aggregate price level.

C) The inflation rate is measured as the rate of change in the federal government budget deficit.

D) The aggregate price level is measured as the rate of change in the inflation rate.

Answer: B
Ques Status: Revised

13) If ten years ago the prices of the items bought last month by the average consumer would have been much higher, then one can likely conclude that

A) the aggregate price level has declined during this ten–year period.

B) the average inflation rate for this ten–year period has been positive.

C) the average rate of money growth for this ten–year period has been positive.

D) the aggregate price level has risen during this ten–year period.

Answer: A
Ques Status: Revised

14) From 1950–2005 the price level in the United States increased more than ________.

A) twofold

B) threefold

C) sixfold

D) ninefold

Answer: C
Ques Status: New

15) One likely explanation for the relatively high rates of inflation experienced in many Latin American countries is the

A) relatively slow growth in the money supply in these countries.

B) relatively rapid growth in the money supply in these countries.

C) decline in the prices of basic commodities in these countries.

D) budget surpluses maintained in these countries.

Answer: B
Ques Status: Revised

16) Complete Milton Friedman's famous statement, "Inflation is always and everywhere a ________ phenomenon."

A) recessionary

B) discretionary

C) repressionary

D) monetary

Answer: D
Ques Status: Previous Edition

17) Countries that experience very high rates of inflation have

A) balanced budgets.

B) rapidly growing money supplies.

C) falling money supplies.

D) constant money supplies.

Answer: B
Ques Status: Revised

18) ________ policy involves decisions about government spending and taxation.

A) Monetary

B) Fiscal

C) Financial

D) Systemic

Answer: B
Ques Status: New

19) When tax revenues are greater than government expenditures, the government has a budget ________.

A) crisis

B) deficit

C) surplus

D) revision

Answer: C
Ques Status: New

20) Budgets deficits can be a concern because they might

A) ultimately lead to higher inflation.

B) lead to lower interest rates.

C) lead to a slower rate of money growth.

D) lead to higher bond prices.

Answer: A
Ques Status: Revised

21) Budget deficits are important because deficits

A) cause bank failures.

B) always cause interest rates to fall.

C) can result in higher rates of monetary growth.

D) always cause prices to fall.

Answer: C
Ques Status: Revised

22) Between 1950 and 1980 in the U.S., interest rates trended upward. During this same time period,

A) the rate of money growth declined.

B) the rate of money growth increased.

C) the government budget deficit (expressed as a percentage of GNP) trended downward.

D) the aggregate price level declined quite dramatically.

Answer: B
Ques Status: Previous Edition

23) What happens to economic growth and unemployment during a business cycle recession? What is the relationship between the money growth rate and a business cycle recession?

Answer: During a recession, output declines and unemployment increases. Prior to every recession in the U.S. the money growth rate has declined, however, not every decline is followed by a recession.
Ques Status: New

1.4 How We Will Study Money, Banking, and Financial Markets

1) There are no questions for section 1.4 How We Will Study Money, Banking, and Financial Markets

Answer: No Correct Answer Was Provided.

1.5 Concluding Remarks

1) There are no questions for section 1.5 Concluding Remarks

Answer: No Correct Answer Was Provided.

1.6 Appendix: Defining Aggregate Output, Income, the Price Level, and the Inflation Rate

1) The most comprehensive measure of aggregate output is

A) gross domestic product.

B) net national product.

C) the stock value of the industrial 500.

D) national income.

Answer: A
Ques Status: Previous Edition

2) Values measured using current prices are called ________ values.

A) nominal

B) real

C) inflated

D) aggregate

Answer: A
Ques Status: New

3) When the total value of final goods and services is calculated using current prices, the resulting measure is referred to as

A) real GDP.

B) the GDP deflator.

C) nominal GDP.

D) the index of leading indicators.

Answer: C
Ques Status: Previous Edition

4) GDP measured with constant prices is referred to as

A) real GDP.

B) nominal GDP.

C) the GDP deflator.

D) industrial production.

Answer: A
Ques Status: Previous Edition

5) If the aggregate price level at time t is denoted by Pt, the inflation rate from time t – 1 to t is defined as

A) $\pi_t = (P_t - P_{t-1})/P_{t-1}$.

B) $\pi_t = (P_{t+1} - P_{t-1})/P_{t-1}$.

C) $\pi_t = (P_{t+1} - P_t)/P_t$.

D) $\pi_t = (P_t - P_{t-1})/P_t$.

Answer: A
Ques Status: Previous Edition

6) The gross domestic product is the

A) the value of all wealth in an economy.

B) the value of all goods and services sold to other nations in a year.

C) the market value of all final goods and services produced in an economy in a year.

D) the market value of all intermediate goods and services produced in an economy in a year.

Answer: C
Ques Status: Revised

7) If an economy has aggregate output of $20 trillion, then aggregate income is

A) $10 trillion.

B) $20 trillion.

C) $30 trillion.

D) $40 trillion.

Answer: B
Ques Status: Revised

8) If your nominal income in 1996 was $50,000, and prices doubled between 1996 and 2002, to have the same real income, your nominal income in 2002 must be

A) $50,000.

B) $75,000.

C) $90,000.

D) $100,000.

Answer: D
Ques Status: Revised

9) If your nominal income in 1990 is $50,000, and prices increase by 50% between 1990 and 2000, then to have the same real income, your nominal income in 2000 must be

A) $50,000.

B) $75,000.

C) $100,000.

D) $150,000.

Answer: B
Ques Status: Revised

10) If nominal GDP in 2001 is $9 trillion, and 2001 real GDP in 1996 prices is $6 trillion, the GDP deflator price index is

A) 7.

B) 100.

C) 150.

D) 200.

Answer: C
Ques Status: Revised

11) If the price level increases from 200 in year 1 to 220 in year 2, the rate of inflation from year 1 to year 2 is

A) 20%.

B) 10%.

C) 11%.

D) 120%.

Answer: B
Ques Status: Revised

12) If real GDP grows from $10 trillion in 2002 to $10.5 trillion in 2003, the growth rate for real GDP is

A) 5%.

B) 10%.

C) 50%.

D) 0.5%.

Answer: A
Ques Status: Revised

13) If real GDP in 2002 is $10 trillion, and in 2003 real GDP is $9.5 trillion, then real GDP growth from 2002 to 2003 is

A) 0.5%.

B) 5%.

C) 0%.

D) –5%.

Answer: D
Ques Status: Revised

14) If the CPI is 120 in 1996 and 180 in 2002, then between 1996 and 2002, prices have increased by

A) 180%.

B) 80%.

C) 60%.

D) 50%.

Answer: D
Ques Status: Revised

15) If the CPI in 2004 is 200, and in 2005 the CPI is 180, the rate of inflation from 2004 to 2005 is

A) 20%.

B) 10%.

C) 0%.

D) –10%.

Answer: D
Ques Status: Revised

16) The measure of the aggregate price level that is most frequently reported in the media is the ________.

A) GDP deflator

B) producer price index

C) consumer price index

D) household price index

Answer: C
Ques Status: New

17) When prices are measured in terms of fixed (base–year) prices they are called ________ prices.

A) nominal

B) real

C) inflated

D) aggregate

Answer: B

Ques Status: New

Chapter 2

An Overview of the Financial System

2.1 Function of Financial Markets

1) Every financial market has the following characteristic:

A) It determines the level of interest rates.

B) It allows common stock to be traded.

C) It allows loans to be made.

D) It channels funds from lenders–savers to borrowers–spenders.

Answer: D
Ques Status: Previous Edition

2) Financial markets have the basic function of

A) getting people with funds to lend together with people who want to borrow funds.

B) assuring that the swings in the business cycle are less pronounced.

C) assuring that governments need never resort to printing money.

D) providing a risk–free repository of spending power.

Answer: A
Ques Status: Revised

3) Financial markets improve economic welfare because

A) they channel funds from investors to savers.

B) they allow consumers to time their purchase better.

C) they weed out inefficient firms.

D) eliminate the need for indirect finance.

Answer: B
Ques Status: Revised

4) Well–functioning financial markets

A) cause inflation.

B) eliminate the need for indirect finance.

C) cause financial crises.

D) produce an efficient allocation of capital.

Answer: D
Ques Status: Revised

5) A breakdown of financial markets can result in

A) financial stability.

B) rapid economic growth.

C) political instability.

D) stable prices.

Answer: C
Ques Status: Revised

6) Which of the following can be described as direct finance?

A) You take out a mortgage from your local bank.

B) You borrow $2500 from a friend.

C) You buy shares of common stock in the secondary market.

D) You buy shares in a mutual fund.

Answer: B
Ques Status: Revised

7) 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

A) $400.

B) $201.

C) $200.

D) $199.

Answer: B
Ques Status: Revised

8) You can borrow $5000 to finance a new business venture. This new venture will generate annual earnings of $251. The maximum interest rate that you would pay on the borrowed funds and still increase your income is

A) 25%.

B) 12.5%.

C) 10%.

D) 5%.

Answer: D
Ques Status: Revised

9) Which of the following can be described as involving direct finance?

A) A corporation issues new shares of stock.

B) People buy shares in a mutual fund.

C) A pension fund manager buys a short–term corporate security in the secondary market.

D) An insurance company buys shares of common stock in the over–the–counter markets.

Answer: A
Ques Status: Previous Edition

10) Which of the following can be described as involving direct finance?

A) A corporation takes out loans from a bank.

B) People buy shares in a mutual fund.

C) A corporation buys a short–term corporate security in a secondary market.

D) People buy shares of common stock in the primary markets.

Answer: D
Ques Status: Revised

11) Which of the following can be described as involving indirect finance?

A) You make a loan to your neighbor.

B) A corporation buys a share of common stock issued by another corporation in the primary market.

C) You buy a U.S. Treasury bill from the U.S. Treasury.

D) You make a deposit at a bank.

Answer: D
Ques Status: Revised

12) Which of the following can be described as involving indirect finance?

A) You make a loan to your neighbor.

B) You buy shares in a mutual fund.

C) You buy a U.S. Treasury bill from the U.S. Treasury.

D) A corporation buys a short–term security issued by another corporation in the primary market.

Answer: B
Ques Status: Revised

13) Securities are ________ for the person who buys them, but are ________ for the individual or firm that issues them.

A) assets; liabilities

B) liabilities; assets

C) negotiable; nonnegotiable

D) nonnegotiable; negotiable

Answer: A
Ques Status: Previous Edition

14) With ________ finance, borrowers obtain funds from lenders by selling them securities in the financial markets.

A) active

B) determined

C) indirect

D) direct

Answer: D
Ques Status: New

15) With direct finance funds are channeled through the financial market from the ________ directly to the ________.

A) savers, spenders

B) spenders, investors

C) borrowers, savers

D) investors, savers

Answer: A
Ques Status: New

16) Distinguish between direct finance and indirect finance. Which of these is the most important source of funds for corporations in the United States?

Answer: With direct finance, funds flow directly from the lender/saver to the borrower . With indirect finance, funds flow from the lender/saver to a financial intermediary who then channels the funds to the borrower/investor. Financial intermediaries (indirect finance) are the major source of funds for corporations in the U.S.
Ques Status: New

2.2 Structure of Financial Markets

1) Which of the following statements about the characteristics of debt and equity is false?

A) They can both be long-term financial instruments.

B) They can both be short-term financial instruments.

C) They both involve a claim on the issuer's income.

D) They both enable a corporation to raise funds.

Answer: B
Ques Status: Revised

2) Which of the following statements about the characteristics of debt and equities is true?

A) They can both be long-term financial instruments.

B) Bond holders are residual claimants.

C) The income from bonds is typically more variable than that from equities.

D) Bonds pay dividends.

Answer: A
Ques Status: Revised

3) Which of the following statements about financial markets and securities is true?

A) A bond is a long-term security that promises to make periodic payments called dividends to the firm's residual claimants.

B) A debt instrument is intermediate term if its maturity is less than one year.

C) A debt instrument is intermediate term if its maturity is ten years or longer.

D) The maturity of a debt instrument is the number of years (term) to that instrument's expiration date.

Answer: D
Ques Status: Revised

4) Forty or so dealers establish a "market" in these securities by standing ready to buy and sell them.

A) Secondary stocks

B) Surplus stocks

C) U.S. government bonds

D) Common stocks

Answer: C
Ques Status: Previous Edition

5) An important function of secondary markets is to

A) make it easier to sell financial instruments to raise funds.

B) raise funds for corporations through the sale of securities.

C) make it easier for governments to raise taxes.

D) create a market for newly constructed houses.

Answer: A
Ques Status: Revised

6) Secondary markets make financial instruments more

A) solid.

B) vapid.

C) liquid.

D) risky.

Answer: C
Ques Status: Revised

7) The higher a security's price in the secondary market the _________ funds a firm can raise by selling securities in the _________ market.

A) more; primary

B) more; secondary

C) less; primary

D) less; secondary

Answer: A
Ques Status: Revised

8) An important financial institution that assists in the initial sale of securities in the primary market is the

A) investment bank.

B) commercial bank.

C) stock exchange.

D) brokerage house.

Answer: A
Ques Status: Previous Edition

9) A corporation acquires new funds only when its securities are sold in the

A) primary market by an investment bank.

B) primary market by a stock exchange broker.

C) secondary market by a securities dealer.

D) secondary market by a commercial bank.

Answer: A
Ques Status: Previous Edition

10) A corporation acquires new funds only when its securities are sold in the

A) secondary market by an investment bank.

B) primary market by an investment bank.

C) secondary market by a stock exchange broker.

D) secondary market by a commercial bank.

Answer: B
Ques Status: Previous Edition

11) Which of the following statements about financial markets and securities is true?

A) Many common stocks are traded over-the-counter, although the largest corporations usually have their shares traded at organized stock exchanges such as the New York Stock Exchange.

B) As a corporation gets a share of the broker's commission, a corporation acquires new funds whenever its securities are sold.

C) Capital market securities are usually more widely traded than shorter-term securities and so tend to be more liquid.

D) Because of their short-terms to maturity, the prices of money market instruments tend to fluctuate wildly.

Answer: A
Ques Status: Revised

12) Equity holders are a corporation's ________. That means the corporation must pay all of its debt holders before it pays its equity holders.

A) debtors

B) brokers

C) residual claimants

D) underwriters

Answer: C
Ques Status: New

13) Which of the following is an example of an intermediate-term debt?

A) A thirty-year mortgage.

B) A sixty-month car loan.

C) A six month loan from a finance company.

D) A Treasury bond.

Answer: B
Ques Status: New

14) If the maturity of a debt instrument is less than one year, the debt is called ________.

A) short-term

B) intermediate-term

C) long-term

D) prima-term

Answer: A
Ques Status: New

15) Long-term debt has a maturity that is __________.

A) between one and ten years.

B) less than a year.

C) between five and ten years.

D) ten years or longer.

Answer: D
Ques Status: New

16) 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.

A) bonds

B) bills

C) notes

D) stock

Answer: D
Ques Status: New

17) A financial market in which previously issued securities can be resold is called a ________ market.

A) primary

B) secondary

C) tertiary

D) used securities

Answer: B
Ques Status: New

18) When an investment bank ________ securities, it guarantees a price for a corporation's securities and then sells them to the public.

A) underwrites

B) undertakes

C) overwrites

D) overtakes

Answer: A
Ques Status: New

19) ________ work in the secondary markets matching buyers with sellers of securities.

A) Dealers

B) Underwriters

C) Brokers

D) Claimants

Answer: C
Ques Status: New

20) A financial market in which only short-term debt instruments are traded is called the ________ market.

A) bond

B) money

C) capital

D) stock

Answer: B
Ques Status: New

21) Equity instruments are traded in the ________ market.

A) money

B) bond

C) capital

D) commodities

Answer: C
Ques Status: New

22) Corporations receive funds when their stock is sold in the primary market. Why do corporations pay attention to what is happening to their stock in the secondary market?

Answer: The existence of the secondary market makes their stock more liquid and the price in the secondary market sets the price that the corporation would receive if they choose to sell more stock in the primary market.
Ques Status: New

2.3 Financial Market Instruments

1) 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

A) commercial paper.

B) a negotiable certificate of deposit.

C) a banker' acceptance.

D) federal funds.

Answer: B
Ques Status: Previous Edition

2) Federal funds are

A) funds raised by the federal government in the bond market.

B) loans made by the Federal Reserve System to banks.

C) loans made by banks to the Federal Reserve System.

D) loans made by banks to each other.

Answer: D
Ques Status: Revised

3) Which of the following are short–term financial instruments?

A) A banker's acceptance.

B) A share of Walt Disney Corporation stock.

C) A Treasury note with a maturity of four years.

D) A residential mortgage.

Answer: A
Ques Status: Revised

4) Which of the following instruments are traded in a money market?

A) State and local government bonds.

B) U.S. Treasury bills.

C) Corporate bonds.

D) U.S. government agency securities.

Answer: B
Ques Status: Revised

5) Which of the following instruments are traded in a money market?

A) Bank commercial loans.

B) Banker's acceptances.

C) State and local government bonds.

D) Residential mortgages.

Answer: B
Ques Status: Previous Edition

6) Which of the following instruments is not traded in a money market?

A) Residential mortgages.

B) U.S. Treasury Bills.

C) Eurodollars.

D) Commercial paper.

Answer: A
Ques Status: Revised

7) Which of the following are long-term financial instruments?

A) A negotiable certificate of deposit.

B) A banker's acceptance.

C) A U.S. Treasury bond.

D) A U.S. Treasury bill.

Answer: C

Ques Status: Previous Edition

8) Which of the following instruments are traded in a capital market?

A) U.S. Government agency securities.

B) Negotiable bank CDs.

C) Repurchase agreements.

D) Banker's acceptances.

Answer: A

Ques Status: Revised

9) Which of the following instruments are traded in a capital market?

A) Corporate bonds.

B) U.S. Treasury bills.

C) Banker's acceptances.

D) Repurchase agreements.

Answer: A

Ques Status: Previous Edition

10) Which of the following are not traded in a capital market?

A) U.S. government agency securities.

B) State and local government bonds.

C) Repurchase agreements.

D) Corporate bonds.

Answer: C

Ques Status: New

11) 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.

A) premium

B) collateral

C) default

D) discount

Answer: D
Ques Status: New

12) U.S. Treasury bills are considered the safest of all money market instruments because there is no risk of ________.

A) defeat

B) default

C) desertion

D) demarkation

Answer: B
Ques Status: New

13) The money market instruments that were created to assist in carrying out international trade are called ________.

A) negotiable CDs.

B) banker's acceptances.

C) repurchase agreements.

D) federal funds.

Answer: B
Ques Status: New

14) Collateral is ________ the lender receives if the borrower does not pay back the loan.

A) a liability

B) an asset

C) a present

D) an offering

Answer: B
Ques Status: New

15) Bonds issued by state and local governments are called ________ bonds.

A) corporate

B) Treasury

C) municipal

D) commercial

Answer: C
Ques Status: New

2.4 Internationalization of Financial Markets

1) Bonds that are sold in a foreign country and are denominated in the country's currency in which they are sold are known as

A) foreign bonds.

B) Eurobonds.

C) equity bonds.

D) country bonds.

Answer: A
Ques Status: Previous Edition

2) Bonds that are sold in a foreign country and are denominated in a currency other than that of the country in which it is sold are known as

A) foreign bonds.

B) Eurobonds.

C) equity bonds.

D) country bonds.

Answer: B
Ques Status: Previous Edition

3) If Microsoft sells a bond in London and it is denominated in dollars, the bond is a ________.

A) Eurobond

B) foreign bond

C) British bond

D) currency bond

Answer: A
Ques Status: New

4) U.S. dollar deposits in foreign banks outside the U.S. or in foreign branches of U.S. banks are called ________.

A) Atlantic dollars

B) Eurodollars

C) foreign dollars

D) outside dollars

Answer: B
Ques Status: New

5) One reason for the extraordinary growth of foreign financial markets is

A) decreased trade.

B) lack of savings in foreign countries.

C) the recent introduction of the foreign bond.

D) deregulation of foreign financial markets.

Answer: D
Ques Status: New

2.5 Function of Financial Intermediaries: Indirect Finance

1) The process of indirect finance using financial intermediaries is called

A) direct lending.

B) financial intermediation.

C) resource allocation.

D) financial liquidation.

Answer: B
Ques Status: Revised

2) In the United States, loans from ________ are far ________ important for corporate finance than are securities markets.

A) government agencies; more

B) government agencies; less

C) financial intermediaries; more

D) financial intermediaries; less

Answer: C
Ques Status: Previous Edition

3) Economies of scale enable financial institutions to

A) reduce transactions costs.

B) avoid the asymmetric information problem.

C) avoid adverse selection problems.

D) reduce moral hazard.

Answer: A
Ques Status: Revised

4) An example of economies of scale in the provision of financial services is

A) investing in a diversified collection of assets.

B) providing depositors with a variety of savings certificates.

C) spreading the cost of borrowed funds over many customers.

D) spreading the cost of writing a standardized contract over many borrowers.

Answer: D
Ques Status: Revised

5) The process where financial intermediaries create and sell low-risk assets and use the proceeds to purchase riskier assets is known as

A) risk sharing.

B) risk aversion.

C) risk neutrality.

D) risk selling.

Answer: A
Ques Status: Revised

6) Reducing risk through the purchase of assets whose returns do not always move together is

A) diversification.

B) intermediation.

C) intervention.

D) discounting.

Answer: A
Ques Status: Revised

7) The concept of diversification is captured by the statement

A) don't look a gift horse in the mouth.

B) don't put all your eggs in one basket.

C) it never rains, but it pours.

D) make hay while the sun shines.

Answer: B
Ques Status: Revised

8) The process of asset transformation refers to the conversion of

A) safer assets into risky assets.

B) safer assets into safer liabilities.

C) risky assets into safer assets.

D) risky assets into risky liabilities.

Answer: C
Ques Status: Revised

9) Risk sharing is profitable for financial institutions due to

A) low transactions costs.

B) asymmetric information.

C) adverse selection.

D) moral hazard.

Answer: A
Ques Status: Revised

10) Typically, borrowers have superior information relative to lenders about the potential returns and risks associated with an investment project. The difference in information is called ________, and it creates the ________ problem.

A) adverse selection; moral hazard

B) asymmetric information; risk sharing

C) asymmetric information; adverse selection

D) adverse selection; risk sharing

Answer: C
Ques Status: Revised

11) 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
Ques Status: Previous Edition

12) 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
Ques Status: Previous Edition

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

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

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

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

D) the borrower's lack of good options for obtaining funds.

Answer: A
Ques Status: Revised

14) A professional baseball player may be contractually restricted from skiing. The team owner includes this clause in the player's contract to protect against

A) risk sharing.

B) moral hazard.

C) adverse selection.

D) regulatory circumvention.

Answer: B
Ques Status: Revised

15) An example of the problem of ________ is when a corporation uses the funds raised from selling bonds to fund corporate expansion to pay for Caribbean cruises for all of its employees and their families.

A) adverse selection

B) moral hazard

C) risk sharing

D) credit risk

Answer: B
Ques Status: Revised

16) In the early 1980s, a particular bank in Oklahoma developed a reputation of readily providing loans to borrowers for the purpose of exploring for oil deposits. Many of these loans were never repaid, because this bank failed to address the

A) adverse selection problem.

B) regulatory avoidance problem.

C) free-rider problem.

D) risk-sharing problem.

Answer: A
Ques Status: Revised

17) The countries that have made the least use of securities markets are ________ and ________; in these two countries finance from financial intermediaries has been almost ten times greater than that from securities markets.

A) Germany; Japan

B) Germany; Great Britain

C) Great Britain; Canada

D) Canada; Japan

Answer: A
Ques Status: Previous Edition

18) Although the dominance of ________ over ________ is clear in all countries, the relative importance of bond versus stock markets differs widely.

A) financial intermediaries; securities markets

B) financial intermediaries; government agencies

C) government agencies; financial intermediaries

D) government agencies; securities markets

Answer: A
Ques Status: Previous Edition

19) Studies of the major developed countries show that when businesses go looking for funds to finance their activities they usually obtain these funds from

A) government agencies.

B) equities markets.

C) financial intermediaries.

D) bond markets.

Answer: C
Ques Status: Previous Edition

20) Because there is an imbalance of information in a lending situation, we must deal with the problems of adverse selection and moral hazard. Define these terms and explain how financial intermediaries can reduce these problems.

Answer: Adverse selection is the asymmetric information problem that exists before the transaction occurs. For lenders, it is the difficulty in judging a good credit risk from a bad credit risk. Moral hazard is the asymmetric information problem that exists after the transaction occurs. For lenders, it is the difficulty in making sure the borrower uses the funds appropriately. Financial intermediaries can reduce adverse selection through intensive screening and can reduce moral hazard by monitoring the borrower.
Ques Status: New

2.6 Types of Financial Intermediaries

1) Which of the following financial intermediaries is not a depository institution?

A) A savings and loan association

B) A commercial bank

C) A credit union

D) A finance company

Answer: D
Ques Status: Revised

2) Which of the following is a contractual savings institution?

A) A life insurance company

B) A credit union

C) A savings and loan association

D) A mutual fund

Answer: A
Ques Status: Previous Edition

3) Contractual savings institutions include

A) mutual savings banks.

B) money market mutual funds.

C) commercial banks.

D) life insurance companies.

Answer: D
Ques Status: Revised

4) Which of the following are not contractual savings institutions?

A) Life insurance companies

B) Credit unions

C) Pension funds

D) State and local government retirement funds

Answer: B
Ques Status: Previous Edition

5) Financial institutions that accept deposits and make loans are called ________ institutions.

A) investment

B) contractual savings

C) depository

D) underwriting

Answer: C
Ques Status: New

6) Which of the following are investment intermediaries?

A) Life insurance companies

B) Mutual funds

C) Pension funds

D) State and local government retirement funds

Answer: B
Ques Status: Previous Edition

7) Which of the following is a depository institution?

A) A life insurance company

B) A credit union

C) A pension fund

D) A mutual fund

Answer: B
Ques Status: Previous Edition

8) Which of the following is a depository institution?

A) A life insurance company

B) A mutual savings bank

C) A pension fund

D) A finance company

Answer: B
Ques Status: Revised

9) Which of the following is not a contractual savings institution?

A) A life insurance company

B) A pension fund

C) A savings and loan association

D) A fire and casualty insurance company

Answer: C
Ques Status: Previous Edition

10) The primary assets of a mutual savings bank are

A) bonds.

B) mortgages.

C) commercial loans.

D) deposits.

Answer: B
Ques Status: Revised

11) The primary liabilities of a credit union are

A) bonds.

B) mortgages.

C) deposits.

D) commercial loans.

Answer: C
Ques Status: Revised

12) The primary assets of a pension fund are

A) money market instruments.

B) corporate bonds and stock.

C) consumer and business loans.

D) mortgages.

Answer: B
Ques Status: Previous Edition

13) The primary assets of a savings and loan association are

A) money market instruments.

B) corporate bonds and stock.

C) consumer and business loans.

D) mortgages.

Answer: D
Ques Status: Previous Edition

14) The primary assets of credit unions are

A) municipal bonds.

B) business loans.

C) consumer loans.

D) mortgages.

Answer: C
Ques Status: Previous Edition

15) The primary assets of a finance company are

A) municipal bonds.

B) corporate stocks and bonds.

C) consumer and business loans.

D) mortgages.

Answer: C
Ques Status: Previous Edition

16) The primary liabilities of a commercial bank are

A) bonds.

B) mortgages.

C) deposits.

D) commercial paper.

Answer: C
Ques Status: Previous Edition

17) The primary liabilities of depository institutions are

A) premiums from policies.

B) shares.

C) deposits.

D) bonds.

Answer: C
Ques Status: Revised

18) The primary assets of money market mutual funds are

A) stocks.

B) bonds.

C) money market instruments.

D) deposits.

Answer: C
Ques Status: Revised

19) Money market mutual fund shares function like

A) checking accounts that pay interest.

B) bonds.

C) stocks.

D) currency.

Answer: A
Ques Status: Revised

20) An important feature of money market mutual fund shares is

A) deposit insurance.

B) the ability to write checks against shareholdings.

C) the ability to borrow against shareholdings.

D) claims on shares of corporate stock.

Answer: B
Ques Status: Revised

21) Thrift institutions include

A) banks, mutual funds, and insurance companies.

B) savings and loan associations, mutual savings banks, and credit unions.

C) finance companies, mutual funds, and money market funds.

D) pension funds, mutual funds, and banks.

Answer: B
Ques Status: Revised

22) ________ institutions are financial intermediaries that acquire funds at periodic intervals on a contractual basis.

A) Investment

B) Contractual savings

C) Thrift

D) Depository

Answer: B
Ques Status: New

2.7 Regulation of the Financial System

1) Which of the following is not a goal of financial regulation?

A) Ensuring the soundness of the financial system

B) Reducing moral hazard

C) Reducing adverse selection

D) Ensuring that investors never suffer losses

Answer: D
Ques Status: Previous Edition

2) Savings and loan associations are regulated by the

A) Federal Reserve System.

B) Securities and Exchange Commission.

C) Office of the Comptroller of the Currency.

D) Office of Thrift Supervision.

Answer: D
Ques Status: Revised

3) Which of the following do not provide charters?

A) The Office of the Comptroller of the Currency

B) The Federal Reserve System

C) The National Credit Union Administration

D) State banking and insurance commissions

Answer: B
Ques Status: Previous Edition

4) The agency that was created to protect depositors after the banking failures of 1930–1933 is the

A) Federal Reserve System.

B) Federal Deposit Insurance Corporation.

C) Treasury Department.

D) Office of the Comptroller of the Currency.

Answer: B
Ques Status: Revised

5) An important restriction on bank activities that was repealed in 1999 was

A) the prohibition of the payment of interest on checking deposits.

B) restrictions on credit terms.

C) minimum down payments on loans to purchase securities.

D) separation of commercial banking from the securities industries.

Answer: D
Ques Status: Revised

6) A goal of the Securities and Exchange Commission is to reduce problems arising from

A) competition.

B) banking panics.

C) risk.

D) asymmetric information.

Answer: D
Ques Status: Revised

7) Asymmetric information is a universal problem. This would suggest that financial regulations

A) in industrial countries are an unqualified failure.

B) differ significantly around the world.

C) in industrialized nations are similar.

D) are unnecessary.

Answer: C
Ques Status: Revised

8) The purpose of the disclosure requirements of the Securities and Exchange Commission is to

A) increase the information available to investors.

B) prevent bank panics.

C) improve monetary control.

D) protect investors against financial losses.

Answer: A
Ques Status: Revised

9) The primary purpose of deposit insurance is to

A) improve the flow of information to investors.

B) prevent banking panics.

C) protect bank shareholders against losses.

D) protect bank employees from unemployment.

Answer: B

Ques Status: Revised

10) In order to reduce risk and increase the safety of financial institutions, commercial banks and other depository institutions are prohibited from

A) owning municipal bonds.

B) making real estate loans.

C) making personal loans.

D) owning common stock.

Answer: D

Ques Status: Revised

11) How do regulators help to ensure the soundness of financial intermediaries?

Answer: Regulators restrict who can set up a financial intermediary, conduct regular examinations, restrict assets, and provide insurance to help ensure the soundness of financial intermediaries.

Ques Status: New

Chapter 3

What Is Money?

3.1 Meaning of Money

1) Economists find no completely satisfactory way to measure money because

A) money supply statistics are a state secret.

B) the Federal Reserve does not employ or report different measures of the money supply.

C) the "moneyness" or liquidity of an asset is a matter of degree.

D) economists find disagreement interesting and refuse to agree for ideological reasons.

Answer: C
Ques Status: Previous Edition

2) To an economist, ________ is anything that is generally accepted in payment for goods and services or in the repayment of debt.

A) wealth

B) income

C) money

D) credit

Answer: C
Ques Status: New

3) Currency includes

A) paper money and coins.

B) paper money, coins, and checks.

C) paper money and checks.

D) paper money, coins, checks, and savings deposits.

Answer: A
Ques Status: Previous Edition

4) The difference between money and income is that

A) money is a flow and income is a stock.

B) money is a stock and income is a flow.

C) there is no difference—money and income are both stocks.

D) there is no difference—money and income are both flows.

Answer: B
Ques Status: Previous Edition

5) It is true that

A) income and wealth are both stocks.

B) money and income are both stocks.

C) income is a flow and wealth is a stock.

D) money and wealth are both flows.

Answer: C
Ques Status: Revised

6) An individual's annual salary is her

A) money.

B) income.

C) wealth.

D) liabilities.

Answer: B
Ques Status: Revised

7) A person's house is part of her

A) money.

B) income.

C) liabilities.

D) wealth.

Answer: D
Ques Status: Revised

8) Money is

A) anything that is generally accepted in payment for goods and services or in the repayment of debt.

B) a flow of earnings per unit of time.

C) the total collection of pieces of property that are a store of value.

D) always based on a precious metal like gold or silver.

Answer: A
Ques Status: Revised

9) Which of the following are true statements?

A) Wealth is a stock variable.

B) Money is a flow variable.

C) Income is a stock variable.

D) Wealth is a flow variable.

Answer: A
Ques Status: Revised

10) ________ is used to make purchases while ________ is the total collection of pieces of property that serve to store value.

A) Money; income

B) Wealth; income

C) Income; money

D) Money; wealth

Answer: D
Ques Status: New

11) ________ is a flow of earnings per unit of time.

A) Income

B) Money

C) Wealth

D) Currency

Answer: A
Ques Status: New

12) Which of the following statements uses the economists' definition of money?

A) I plan to earn a lot of money over the summer.

B) Betsy is rich—she has a lot of money.

C) I hope that I have enough money to buy my lunch today.

D) The job with New Company gave me the opportunity to earn more money.

Answer: C
Ques Status: New

3.2 Functions of Money

1) Of money's three functions, the one that distinguishes money from other assets is its function as a

A) store of value.

B) unit of account.

C) standard of deferred payment.

D) medium of exchange.

Answer: D
Ques Status: Previous Edition

2) If peanuts serve as a medium of exchange, a unit of account, and a store of value, then peanuts are

A) bank deposits.

B) reserves.

C) money.

D) loanable funds.

Answer: C
Ques Status: Revised

3) The conversion of a barter economy to one that uses money

A) increases efficiency by reducing the need to exchange goods and services.

B) increases efficiency by reducing the need to specialize.

C) increases efficiency by reducing transactions costs.

D) does not increase economic efficiency.

Answer: C
Ques Status: Previous Edition

4) When compared to exchange systems that rely on money, disadvantages of the barter system include:

A) the requirement of a double coincidence of wants.

B) lowering the cost of exchanging goods over time.

C) lowering the cost of exchange to those who would specialize.

D) encouraging specialization and the division of labor.

Answer: A
Ques Status: Revised

5) When economists say that money promotes ________, they mean that money encourages specialization and the division of labor.

A) bargaining

B) contracting

C) efficiency

D) greed

Answer: C
Ques Status: New

6) Which of the following statements best explains how the use of money in an economy increases economic efficiency?

A) Money increases economic efficiency because it is costless to produce.

B) Money increases economic efficiency because it discourages specialization.

C) Money increases economic efficiency because it decreases transactions costs.

D) Money cannot have an effect on economic efficiency.

Answer: C
Ques Status: Revised

7) For a commodity to function effectively as money it must be

A) easily standardized, making it easy to ascertain its value.

B) difficult to make change.

C) deteriorate quickly so that its supply does not become too large.

D) hard to carry around.

Answer: A
Ques Status: Revised

8) All but the most primitive societies use money as a medium of exchange, implying that

A) the use of money is economically efficient.

B) barter exchange is economically efficient.

C) barter exchange cannot work outside the family.

D) inflation is not a concern.

Answer: A
Ques Status: Revised

9) Whatever a society uses as money, the distinguishing characteristic is that it must

A) be completely inflation proof.

B) be generally acceptable as payment for goods and services or in the repayment of debt.

C) contain gold.

D) be produced by the government.

Answer: B
Ques Status: Previous Edition

10) ________ are the time and resources spent trying to exchange goods and services.

A) Bargaining costs.

B) Transaction costs.

C) Contracting costs.

D) Barter costs.

Answer: B
Ques Status: New

11) Compared to an economy that uses a medium of exchange, in a barter economy

A) transaction costs are higher.

B) transaction costs are lower.

C) liquidity costs are higher.

D) liquidity costs are lower.

Answer: A
Ques Status: Previous Edition

12) Money ________ transaction costs, allowing people to specialize in what they do best.

A) reduces

B) increases

C) enhances

D) eliminates

Answer: A
Ques Status: New

13) Kevin purchasing concert tickets with his debit card is an example of the ________ function of money.

A) medium of exchange

B) unit of account

C) store of value

D) specialization

Answer: A
Ques Status: New

14) When money prices are used to facilitate comparisons of value, money is said to function as a

A) unit of account.

B) medium of exchange.

C) store of value.

D) payments–system ruler.

Answer: A
Ques Status: Previous Edition

15) Because it is a unit of account, money

A) increases transaction costs.

B) reduces the number of prices that need to be calculated.

C) does not earn interest.

D) discourages specialization.

Answer: B
Ques Status: Revised

16) A problem with barter exchange when there are many goods is that in a barter system

A) transactions costs are minimized.

B) there exists a multiple number of prices for each good.

C) there is only one store of value.

D) exchange of services is impossible.

Answer: B
Ques Status: Revised

17) In a barter economy the number of prices in an economy with N goods is

A) $[N(N - 1)]/2$.

B) $N(N/2)$.

C) $2N$.

D) $N(N/2) - 1$.

Answer: A
Ques Status: Previous Edition

18) Dennis notices that jackets are on sale for $99. In this case money is functioning as a ________.

A) medium of exchange

B) unit of account

C) store of value

D) payments–system ruler

Answer: B
Ques Status: New

19) If there are five goods in a barter economy, one needs to know ten prices in order to exchange one good for another. If, however, there are ten goods in a barter economy, then one needs to know ________ prices in order to exchange one good for another.

A) 20

B) 25

C) 30

D) 45

Answer: D
Ques Status: Previous Edition

20) If there are four goods in a barter economy, then one needs to know ________ prices in order to exchange one good for another.

A) 8

B) 6

C) 5

D) 4

Answer: B
Ques Status: Previous Edition

21) Because it is a store of value, money

A) does not earn interest.

B) cannot be a durable asset.

C) must be currency.

D) is a way of saving for future purchases.

Answer: D
Ques Status: Revised

22) Patrick places his pocket change into his savings bank on his desk each evening. By his actions, Patrick indicates that he believes that money has a ________ function.

A) medium of exchange

B) unit of account

C) store of value

D) specialization

Answer: C
Ques Status: New

23) ________ is the relative ease and speed with which an asset can be converted into a medium of exchange.

A) Efficiency

B) Liquidity

C) Deflation

D) Specialization

Answer: B
Ques Status: New

24) Increasing transactions costs of selling an asset make the asset

A) more valuable.

B) more liquid.

C) less liquid.

D) more moneylike.

Answer: C
Ques Status: Revised

25) Of the following assets, the least liquid is

A) stocks.

B) traveler's checks.

C) checking deposits.

D) a house.

Answer: D
Ques Status: Revised

26) Ranking assets from most liquid to least liquid, the correct order is

A) savings bonds; house; currency.

B) currency; savings bonds; house.

C) currency; house; savings bonds.

D) house; savings bonds; currency.

Answer: B
Ques Status: Revised

27) People hold money even during inflationary episodes when other assets prove to be better stores of value. This can be explained by the fact that money is

A) extremely liquid.

B) a unique good for which there are no substitutes.

C) the only thing accepted in economic exchange.

D) backed by gold.

Answer: A
Ques Status: Revised

28) If the price level doubles, the value of money

A) doubles.

B) more than doubles, due to scale economies.

C) rises but does not double, due to diminishing returns.

D) falls by 50 percent.

Answer: D
Ques Status: Previous Edition

29) A fall in the level of prices

A) does not affect the value of money.

B) has an uncertain effect on the value of money.

C) increases the value of money.

D) reduces the value of money.

Answer: C
Ques Status: Revised

30) During hyperinflations,

A) the value of money rises rapidly.

B) money no longer functions as a good store of value and people may resort to barter transactions on a much larger scale.

C) middle–class savers benefit as prices rise.

D) money's value remains fixed to the price level; that is, if prices double so does the value of money.

Answer: B
Ques Status: Revised

31) Because inflation in Nicaragua in 1990 topped 13,000 percent, one can conclude that the Nicaraguan economy suffered from

A) deflation.

B) disinflation.

C) hyperinflation.

D) superdeflation.

Answer: C
Ques Status: Previous Edition

32) If merchants in the country Zed choose to close their doors, preferring to be stuck with rotting merchandise rather than worthless currency, then one can conclude that Zed is experiencing a

A) superdeflation.

B) hyperdeflation.

C) disinflation.

D) hyperinflation.

Answer: D
Ques Status: Previous Edition

33) Explain how cigarettes could be called "money" in prisoner-of-war camps of World War II.

Answer: The cigarettes performed the three functions of money. They served as the medium of exchange because individuals did exchange items for cigarettes. They served as a unit of account because prices were quoted in terms of the number of cigarettes required for the exchange. They served as a store of value because an individual would be willing to save their cigarettes even if they did not smoke because they believed that they could exchange the cigarettes for something that they did want at some time in the future.

Ques Status: New

3.3 Evolution of The Payments System

1) Compared to checks, paper currency and coins have the major drawbacks that they

A) are easily stolen.

B) are hard to counterfeit.

C) are not the most liquid assets.

D) must be backed by gold.

Answer: A

Ques Status: Revised

2) As the payments system evolves from barter to a monetary system,

A) commodity money is likely to precede the use of paper currency.

B) transaction costs increase.

C) the number of prices that need to be calculated increase rather dramatically.

D) specialization decreases.

Answer: A

Ques Status: Revised

3) A disadvantage of ________ is that it is very heavy and hard to transport from one place to another.

A) commodity money

B) fiat money

C) electronic money

D) paper money

Answer: A

Ques Status: New

4) Paper currency that has been declared legal tender but is not convertible into coins or precious metals is called ________ money.

A) commodity

B) fiat

C) electronic

D) funny

Answer: B
Ques Status: New

5) When paper currency is decreed by governments as legal tender, legally it must be ________.

A) paper currency backed by gold

B) a precious metal such as gold or silver

C) accepted as payment for debts

D) convertible into an electronic payment

Answer: C
Ques Status: New

6) The evolution of the payments system from barter to precious metals, then to fiat money, then to checks can best be understood as a consequence of

A) government regulations designed to improve the efficiency of the payments system.

B) government regulations designed to promote the safety of the payments system.

C) innovations that reduced the costs of exchanging goods and services.

D) competition among firms to make it easier for customers to purchase their products.

Answer: C
Ques Status: Revised

7) The evolution of the payments system from barter to precious metals, then to fiat money, then to checks can best be understood as a consequence of the fact that

A) paper is more costly to produce than precious metals.

B) precious metals were not generally acceptable.

C) precious metals were difficult to carry and transport.

D) paper money is less accepted than checks.

Answer: C
Ques Status: Revised

8) Which of the following sequences accurately describes the evolution of the payments system?

A) Barter, coins made of precious metals, paper currency, checks, electronic funds transfers

B) Barter, coins made of precious metals, checks, paper currency, electronic funds transfers

C) Barter, checks, paper currency, coins made of precious metals, electronic funds transfers

D) Barter, checks, paper currency, electronic funds transfers

Answer: A
Ques Status: Previous Edition

9) In explaining the evolution of money

A) government regulation is the most important factor.

B) commodity money, because it is valued more highly, tends to drive out paper money.

C) new forms of money evolve to lower transaction costs.

D) paper money is always backed by gold and therefore more desirable than checks.

Answer: C
Ques Status: Revised

10) During the past two decades an important characteristic of the modern payments system has been the rapidly increasing use of

A) checks and decreasing use of currency.

B) electronic fund transfers.

C) commodity monies.

D) fiat money.

Answer: B
Ques Status: Revised

11) Compared to an electronic payments system, a payments system based on checks has the major drawback that

A) checks are less costly to process.

B) checks take longer to process, meaning that it may take several days before the depositor can get her cash.

C) fraud may be more difficult to commit when paper receipts are eliminated.

D) legal liability is more clearly defined.

Answer: B
Ques Status: Revised

12) A smart card is the equivalent of

A) cash.

B) savings bonds.

C) savings deposits.

D) certificates of deposit.

Answer: A
Ques Status: Revised

13) Which of the following is not a form of e–money?

A) a debit card

B) a credit card

C) a stored–value card

D) a smart card

Answer: B
Ques Status: New

14) Which of the following reasons would not explain why electronic payments have been slow to displace the paper payments system?

A) expensive equipment is necessary to set up the system

B) security concerns

C) privacy concerns

D) transportation costs

Answer: D
Ques Status: New

15) What factors have slowed down the movement to a system where all payments are made electronically?

Answer: The equipment necessary to set up the system is expensive, security of the information, and privacy concerns are issues that need to be addressed before an electronic payments system will be widely accepted.
Ques Status: New

3.4 Measuring Money

1) Recent financial innovation makes the Federal Reserve's job of conducting monetary policy

A) easier, since the Fed now knows what to consider money.

B) more difficult, since the Fed now knows what to consider money.

C) easier, since the Fed no longer knows what to consider money.

D) more difficult, since the Fed no longer knows what to consider money.

Answer: D
Ques Status: Previous Edition

2) Defining money becomes ________ difficult as the pace of financial innovation ________.

A) less; quickens

B) more; quickens

C) more; slows

D) more; stops

Answer: B
Ques Status: Revised

3) ________ is the narrowest monetary aggregate that the Fed reports.

A) M0

B) M1

C) M2

D) M3

Answer: B
Ques Status: New

4) Which of the following is not included in the measure of M1?

A) NOW accounts.

B) Demand deposits.

C) Currency.

D) Savings deposits.

Answer: D
Ques Status: Previous Edition

5) The components of the U.S. M1 money supply are demand and checkable deposits plus

A) currency.

B) currency plus savings deposits.

C) currency plus travelers checks.

D) currency plus travelers checks plus money market deposits.

Answer: C
Ques Status: Previous Edition

6) The M1 measure of money includes

A) small denomination time deposits.

B) traveler's checks.

C) money market deposit accounts.

D) money market mutual fund shares.

Answer: B
Ques Status: Revised

7) The currency component includes paper money and coins held in ________.

A) bank vaults

B) ATMs

C) the hands of the nonbank public

D) the central bank

Answer: C
Ques Status: New

8) Which of the following is not included in the monetary aggregate M2?

A) Currency

B) Savings bonds

C) Traveler's checks

D) Checking deposits

Answer: B
Ques Status: Revised

9) Which of the following is included in M2 but not in M1?

A) NOW accounts

B) Demand deposits

C) Currency

D) Money market mutual fund shares (retail)

Answer: D
Ques Status: Revised

10) Which of the following is not included in the M1 measure of money but is included in the M2 measure of money?

A) Currency

B) Traveler's checks

C) Demand deposits

D) Small–denomination time deposits

Answer: D
Ques Status: Previous Edition

11) Which of the following is included in both M1 and M2?

A) Currency

B) Savings deposits

C) Small–denomination time deposits

D) Money market deposit accounts

Answer: A
Ques Status: Revised

12) Of the following, the largest is

A) money market deposit accounts.

B) demand deposits.

C) M1.

D) M2.

Answer: D
Ques Status: Revised

13) If an individual redeems a U.S. savings bond for currency

A) M1 stays the same and M2 decreases.

B) M1 increases and M2 increases.

C) M1 increases and M2 stays the same.

D) M1 stays the same and M2 stays the same.

Answer: B
Ques Status: Revised

14) If an individual moves money from a small–denomination time deposit to a demand deposit account,

A) M1 increases and M2 stays the same.

B) M1 stays the same and M2 increases.

C) M1 stays the same and M2 stays the same.

D) M1 increases and M2 decreases.

Answer: A
Ques Status: Previous Edition

15) If an individual moves money from a demand deposit account to a money market deposit account,

A) M1 decreases and M2 stays the same.

B) M1 stays the same and M2 increases.

C) M1 stays the same and M2 stays the same.

D) M1 increases and M2 decreases.

Answer: A
Ques Status: Previous Edition

16) If an individual moves money from a savings deposit account to a money market deposit account,

A) M1 decreases and M2 stays the same.

B) M1 stays the same and M2 increases.

C) M1 stays the same and M2 stays the same.

D) M1 increases and M2 decreases.

Answer: C
Ques Status: Previous Edition

17) If an individual moves money from currency to a demand deposit account,

A) M1 decreases and M2 stays the same.

B) M1 stays the same and M2 increases.

C) M1 stays the same and M2 stays the same.

D) M1 increases and M2 stays the same.

Answer: C
Ques Status: Previous Edition

18) If an individual moves money from a money market deposit account to currency,

A) M1 increases and M2 stays the same.

B) M1 stays the same and M2 increases.

C) M1 stays the same and M2 stays the same.

D) M1 increases and M2 decreases.

Answer: A
Ques Status: Previous Edition

19) Small–denomination time deposits refer to certificates of deposit with a denomination of less than ________.

A) $1,000

B) $10,000

C) $100,000

D) $1,000,000

Answer: C
Ques Status: New

20) The growth rates of monetary aggregates

A) follow one another exactly.

B) tend to move together in the short run but not in the long run.

C) are unrelated in the long run.

D) tend to move together in the long run but can diverge in the short run.

Answer: D
Ques Status: Revised

21) The decade during which the growth rates of monetary aggregates diverged the most is

A) the 1960s.

B) the 1970s.

C) the 1980s.

D) the 1990s.

Answer: D
Ques Status: Revised

22) Why are most of the U.S. dollars held outside of the United States?

Answer: Concern about high inflation eroding the value of their own currency causes many people in foreign countries to hold U.S. dollars as a hedge against inflation risk.
Ques Status: New

3.5 How Reliable Are the Money Data?

1) Generally, the data initially reported by the Fed are

A) not a reliable guide to the short-run behavior of the money supply.

B) not a reliable guide to the long-run behavior of the money supply.

C) a reliable guide to the short-run behavior of the money supply.

D) usually underestimate the revised statistics.

Answer: A
Ques Status: Revised

2) An examination of revised money supply statistics, when compared to the initial statistics, suggests that the initial statistics

A) are pretty good.

B) do not provide a good guide to short-run movements in the money supply.

C) provide a poor guide of monetary policy because they are usually underestimates of the revised statistics.

D) provide a good guide of monetary policy, though they are usually underestimates of the revised statistics.

Answer: B
Ques Status: Previous Edition

3) The Fed revises its estimates of the monetary aggregates, sometimes by large amounts, because

A) large depository institutions need only report their deposits infrequently.

B) weekly monetary data need to be adjusted for the "weekend effect."

C) monthly monetary data need to be adjusted for the "payday effect."

D) seasonal adjustments become more precise only as more data becomes available.

Answer: D
Ques Status: Revised

4) The Fed estimates initial monetary aggregate reports because ________ depository institutions report the amount of their deposits infrequently.

A) all

B) small

C) large

D) state

Answer: B
Ques Status: New

5) The increase in holiday spending is not the same every year causing the Fed's adjustment for ________ to be revised as more data becomes available.

A) seasonal variation

B) reporting discrepancy

C) market churning

D) transactions discrepancy

Answer: A
Ques Status: New

6) Which of the following statements accurately describes the two measures of the money supply?

A) The two measures do not move together, so they cannot be used interchangeably by policymakers.

B) The two measures' movements closely parallel each other, even on a month-to-month basis.

C) Short-run movements in the money supply are extremely reliable.

D) M2 is the narrowest measure the Fed reports.

Answer: A
Ques Status: Revised

Chapter 4

Understanding Interest Rates

4.1 Measuring Interest Rates

1) The concept of ________ is based on the common–sense notion that a dollar paid to you in the future is less valuable to you than a dollar today.

A) present value

B) future value

C) interest

D) deflation

Answer: A
Ques Status: Previous Edition

2) With an interest rate of 6 percent, the present value of $100 next year is approximately

A) $106.

B) $100.

C) $94.

D) $92.

Answer: C
Ques Status: Previous Edition

3) The present value of an expected future payment ________ as the interest rate increases.

A) falls

B) rises

C) is constant

D) is unaffected

Answer: A
Ques Status: New

4) If a security pays $55 in one year and $133 in three years, its present value is $150 if the interest rate is

A) 5 percent.

B) 10 percent.

C) 12.5 percent.

D) 15 percent.

Answer: B
Ques Status: Revised

5) An increase in the time to the promised future payment ________ the present value of the payment.

A) decreases

B) increases

C) has no effect on

D) is irrelevant to

Answer: A
Ques Status: New

6) To claim that a lottery winner who is to receive $1 million per year for twenty years has won $20 million ignores the concept of

A) face value.

B) par value.

C) deflation.

D) discounting the future.

Answer: D
Ques Status: Revised

7) The interest rate that equates the present value of payments received from a debt instrument with its value today is the

A) simple interest rate.

B) current yield.

C) yield to maturity.

D) real interest rate.

Answer: C
Ques Status: Revised

8) Economists consider the ________ to be the most accurate measure of interest rates.

A) simple interest rate.

B) current yield.

C) yield to maturity.

D) real interest rate.

Answer: C
Ques Status: Revised

9) If a security pays $110 next year and $121 the year after that, what is its yield to maturity if it sells for $200?

A) 9 percent

B) 10 percent

C) 11 percent

D) 12 percent

Answer: B
Ques Status: Previous Edition

10) A credit market instrument that provides the borrower with an amount of funds that must be repaid at the maturity date along with an interest payment is known as a

A) simple loan.

B) fixed–payment loan.

C) coupon bond.

D) discount bond.

Answer: A
Ques Status: Previous Edition

11) For simple loans, the simple interest rate is ________ the yield to maturity.

A) greater than

B) less than

C) equal to

D) not comparable to

Answer: C
Ques Status: Previous Edition

12) If the amount payable in two years is $2420 for a simple loan at 10 percent interest, the loan amount is

A) $1000.

B) $1210.

C) $2000.

D) $2200.

Answer: C
Ques Status: Revised

13) For a 3–year simple loan of $10,000 at 10 percent, the amount to be repaid is

A) $10,030.

B) $10,300.

C) $13,000.

D) $13,310.

Answer: D
Ques Status: Revised

14) If $22,050 is the amount payable in two years for a $20,000 simple loan made today, the interest rate is

A) 5 percent.

B) 10 percent.

C) 22 percent.

D) 25 percent.

Answer: A
Ques Status: Revised

15) A credit market instrument that requires the borrower to make the same payment every period until the maturity date is known as a

A) simple loan.

B) fixed–payment loan.

C) coupon bond.

D) discount bond.

Answer: B
Ques Status: Previous Edition

16) Which of the following are true of fixed payment loans?

A) The borrower repays both the principal and interest at the maturity date.

B) Installment loans and mortgages are frequently of the fixed payment type.

C) The borrower pays interest periodically and the principal at the maturity date.

D) Commercial loans to businesses are often of this type.

Answer: B
Ques Status: Revised

17) A fully amortized loan is another name for

A) a simple loan.

B) a fixed-payment loan.

C) a commercial loan.

D) an unsecured loan.

Answer: B
Ques Status: Previous Edition

18) A credit market instrument that pays the owner a fixed coupon payment every year until the maturity date and then repays the face value is called a

A) simple loan.

B) fixed-payment loan.

C) coupon bond.

D) discount bond.

Answer: C
Ques Status: Previous Edition

19) A ________ pays the owner a fixed coupon payment every year until the maturity date, when the ________ value is repaid.

A) coupon bond; discount

B) discount bond; discount

C) coupon bond; face

D) discount bond; face

Answer: C
Ques Status: Previous Edition

20) The ________ is the final amount that will be paid to the holder of a coupon bond.

A) discount value

B) coupon value

C) face value

D) present value

Answer: C
Ques Status: New

21) All of the following are examples of coupon bonds except

A) Corporate bonds

B) U.S. Treasury bills

C) U.S. Treasury notes

D) U.S. Treasury bonds

Answer: B
Ques Status: New

22) Which of the following are true for a coupon bond?

A) When the coupon bond is priced at its face value, the yield to maturity equals the coupon rate.

B) The price of a coupon bond and the yield to maturity are positively related.

C) The yield to maturity is greater than the coupon rate when the bond price is above the par value.

D) The yield is less than the coupon rate when the bond price is below the par value.

Answer: A
Ques Status: Revised

23) If a $5,000 coupon bond has a coupon rate of 13 percent, then the coupon payment every year is

A) $650.

B) $1,300.

C) $130.

D) $13.

Answer: A
Ques Status: Revised

24) An $8,000 coupon bond with a $400 coupon payment every year has a coupon rate of

A) 5 percent.

B) 8 percent.

C) 10 percent.

D) 40 percent.

Answer: A
Ques Status: Previous Edition

25) The price of a coupon bond and the yield to maturity are ________ related; that is, as the yield to maturity ________, the price of the bond ________.

A) positively; rises; rises

B) negatively; falls; falls

C) positively; rises; falls

D) negatively; rises; falls

Answer: D
Ques Status: New

26) A $10,000 8 percent coupon bond that sells for $10,000 has a yield to maturity of

A) 8 percent.

B) 10 percent.

C) 12 percent.

D) 14 percent.

Answer: A
Ques Status: Previous Edition

27) Which of the following $1,000 face–value securities has the highest yield to maturity?

A) A 5 percent coupon bond selling for $1,000

B) A 10 percent coupon bond selling for $1,000

C) A 12 percent coupon bond selling for $1,000

D) A 12 percent coupon bond selling for $1,100

Answer: C
Ques Status: Previous Edition

28) Which of the following $1,000 face–value securities has the highest yield to maturity?

A) A 5 percent coupon bond with a price of $600

B) A 5 percent coupon bond with a price of $800

C) A 5 percent coupon bond with a price of $1,000

D) A 5 percent coupon bond with a price of $1,200

Answer: A
Ques Status: Revised

29) Which of the following $1,000 face-value securities has the lowest yield to maturity?

A) A 5 percent coupon bond selling for $1,000

B) A 10 percent coupon bond selling for $1,000

C) A 15 percent coupon bond selling for $1,000

D) A 15 percent coupon bond selling for $900

Answer: A
Ques Status: Previous Edition

30) Which of the following $5,000 face-value securities has the highest to maturity?

A) A 6 percent coupon bond selling for $5,000

B) A 6 percent coupon bond selling for $5,500

C) A 10 percent coupon bond selling for $5,000

D) A 12 percent coupon bond selling for $4,500

Answer: D
Ques Status: Revised

31) The yield to maturity is ________ than the ________ rate when the bond price is ________ its face value.

A) greater; coupon; above

B) greater; coupon; below

C) greater; perpetuity; above

D) less; perpetuity; below

Answer: B
Ques Status: New

32) Which of the following bonds would you prefer to be buying?

A) A $10,000 face-value security with a 10 percent coupon selling for $9,000

B) A $10,000 face-value security with a 7 percent coupon selling for $10,000

C) A $10,000 face-value security with a 9 percent coupon selling for $10,000

D) A $10,000 face-value security with a 10 percent coupon selling for $10,000

Answer: A
Ques Status: Revised

33) The price of a consol equals the coupon payment

A) times the interest rate.

B) plus the interest rate.

C) minus the interest rate.

D) divided by the interest rate.

Answer: D
Ques Status: Revised

34) The interest rate on a consol equals the

A) price times the coupon payment.

B) price divided by the coupon payment.

C) coupon payment plus the price.

D) coupon payment divided by the price.

Answer: D
Ques Status: Revised

35) A consol paying $20 annually when the interest rate is 5 percent has a price of

A) $100.

B) $200.

C) $400.

D) $800.

Answer: C
Ques Status: Revised

36) If a consol has a price of $500 and an annual interest payment of $25, the interest rate is

A) 2.5 percent.

B) 5 percent.

C) 7.5 percent.

D) 10 percent.

Answer: B
Ques Status: Revised

37) A bond that is bought at a price below its face value and the face value is repaid at a maturity date is called a

A) simple loan.

B) fixed–payment loan.

C) coupon bond.

D) discount bond.

Answer: D
Ques Status: Previous Edition

38) A ________ is bought at a price below its face value, and the ________ value is repaid at the maturity date.

A) coupon bond; discount

B) discount bond; discount

C) coupon bond; face

D) discount bond; face

Answer: D
Ques Status: Previous Edition

39) A discount bond

A) pays the bondholder a fixed amount every period and the face value at maturity.

B) pays the bondholder the face value at maturity.

C) pays all interest and the face value at maturity.

D) pays the face value at maturity plus any capital gain.

Answer: B
Ques Status: Revised

40) Examples of discount bonds include

A) U.S. Treasury bills.

B) corporate bonds.

C) U.S. Treasury notes.

D) municipal bonds.

Answer: A
Ques Status: Revised

41) The yield to maturity for a one–year discount bond equals the increase in price over the year, divided by the

A) initial price.

B) face value.

C) interest rate.

D) coupon rate.

Answer: A
Ques Status: Revised

42) Which of the following are true for discount bonds?

A) A discount bond is bought at par.

B) The purchaser receives the face value of the bond at the maturity date.

C) U.S. Treasury bonds and notes are examples of discount bonds.

D) The purchaser receives the par value at maturity plus any capital gains.

Answer: B
Ques Status: Revised

43) If a $10,000 face–value discount bond maturing in one year is selling for $5,000, then its yield to maturity is

A) 5 percent.

B) 10 percent.

C) 50 percent.

D) 100 percent.

Answer: D
Ques Status: Previous Edition

44) If a $5,000 face–value discount bond maturing in one year is selling for $5,000, then its yield to maturity is

A) 0 percent.

B) 5 percent.

C) 10 percent.

D) 20 percent.

Answer: A
Ques Status: Previous Edition

45) A discount bond selling for $15,000 with a face value of $20,000 in one year has a yield to maturity of

A) 3 percent.

B) 20 percent.

C) 25 percent.

D) 33.3 percent.

Answer: D
Ques Status: Revised

46) In Japan in 1998, interest rates were negative for a short period of time because investors found it convenient to hold six–month bills as a store of value because

A) of the high inflation rate.

B) these bills sold at a discount from face value.

C) the bills were denominated in small amounts and could be stored electronically.

D) the bills were denominated in large amounts and could be stored electronically.

Answer: D
Ques Status: Revised

47) If the interest rate is 5%, what is the present value of a security that pays you $1, 050 next year and $1,102.50 two years from now? If this security sold for $2200, is the yield to maturity greater or less than 5%? Why?

Answer: $PV = \$1{,}050/(1. +.05) + \$1{,}102.50/(1 + 0.5)^2$
$PV = \$2{,}000$
If this security sold for $2200, the yield to maturity is less than 5%. The lower the interest rate the higher the present value.
Ques Status: New

4.2 Yield on a Discount Basis

1) Dealers in U.S. Treasury securities always refer to prices by quoting the

A) yield to maturity.

B) coupon rate.

C) current yield

D) yield on a discount basis.

Answer: D
Ques Status: Previous Edition

2) Which of the following are true of the yield on a discount basis as a measure of the interest rate?

A) It uses the percentage gain on the purchase price of the security, rather than the percentage gain on the face value of the security.

B) It puts the yield on the annual basis of a 360–day year.

C) It ignores the time to maturity.

D) It overstates the yield to maturity.

Answer: B
Ques Status: Revised

3) A problem with the yield on discount basis is that it ________ the yield to maturity, and this ________ increases, the ________ the maturity of the discount bond.

A) understates; understatement; longer

B) understates; understatement; shorter

C) overstates; overstatement; longer

D) overstates; overstatement; shorter

Answer: A
Ques Status: Revised

4) Dealers in T–bills make profits by selling T–bills at a ________ price than they pay for them, thus, the ________ discount yield should be lower than the ________ discount yield.

A) higher; bid; asked

B) higher; asked; bid

C) lower; bid; asked

D) lower; asked; bid

Answer: B
Ques Status: New

5) The yield on a discount basis of a 90–day, $1,000 Treasury bill selling for $950 is

A) 5 percent.

B) 10 percent.

C) 15 percent.

D) 20 percent.

Answer: D
Ques Status: Revised

6) The yield on a discount basis of a 180–day $1,000 Treasury bill selling for $900 is

A) 10 percent.

B) 20 percent.

C) 25 percent.

D) 40 percent.

Answer: B
Ques Status: Previous Edition

7) The yield to maturity on a $10,000 Treasury bill selling for $9,800 with 73 days to maturity is approximately

A) 2 percent.

B) 5 percent.

C) 10 percent.

D) 20 percent.

Answer: C
Ques Status: Revised

8) When referring to changes in yields, a basis point equals

A) 10 percent.

B) 1 percent.

C) 0.1 percent.

D) 0.01 percent.

Answer: D
Ques Status: Revised

9) To say that a yield increased by twenty basis points means the interest rate increased by

A) 20 percent.

B) 2 percent.

C) 0.2 percent.

D) 0.02 percent.

Answer: C
Ques Status: Revised

10) If the yield on Treasury bills falls from 5.27 percent to 5.22 percent, then the yield has

A) increased by 5 basis points.

B) increased by 0.5 basis point.

C) decreased by 0.5 basis point.

D) decreased by 5 basis points.

Answer: D
Ques Status: Revised

11) If the yield on Treasury bills increases from 6.34 percent to 6.44 percent, the yield has

A) increased by 0.01 basis point.

B) increased by 0.1 basis point.

C) increased by 1 basis point.

D) increased by 10 basis points.

Answer: D
Ques Status: Revised

12) You are considering alternative quotes, a one–year Treasury note with a yield to maturity of 4.5% and a one–year Treasury bill with a yield on a discount basis of 4.5%. Would these be equivalent? Why or why not?

Answer: No, these are not the same. The yield on a discount basis always understates true yield so the yield to maturity on the one–year Treasury bill is higher than the quoted value.
Ques Status: New

4.3 The Distinction Between Interest Rates and Returns

1) The ________ is defined as the payments to the owner plus the change in a security's value expressed as a fraction of the security's purchase price.

A) yield to maturity

B) current yield

C) rate of return

D) yield rate

Answer: C
Ques Status: New

2) What is the return on a 5 percent coupon bond that initially sells for $1,000 and sells for $1,200 next year?

A) 5 percent

B) 10 percent

C) –5 percent

D) 25 percent

Answer: D
Ques Status: Revised

3) What is the return on a 5 percent coupon bond that initially sells for $1,000 and sells for $900 next year?

A) 5 percent

B) 10 percent

C) –5 percent

D) –10 percent

Answer: C
Ques Status: Revised

4) The return on a 5 percent coupon bond that initially sells for $1,000 and sells for $950 next year is

A) –10 percent.

B) –5 percent.

C) 0 percent.

D) 5 percent.

Answer: C
Ques Status: Previous Edition

5) Suppose you are holding a 5 percent coupon bond maturing in one year with a yield to maturity of 15 percent. If the interest rate on one–year bonds rises from 15 percent to 20 percent over the course of the year, what is the yearly return on the bond you are holding?

A) 5 percent

B) 10 percent

C) 15 percent

D) 20 percent

Answer: C
Ques Status: Previous Edition

6) If the interest rates on all bonds rise from 5 to 6 percent over the course of the year, which bond would you prefer to have been holding?

A) A bond with one year to maturity

B) A bond with five years to maturity

C) A bond with ten years to maturity

D) A bond with twenty years to maturity

Answer: A
Ques Status: Previous Edition

7) An equal decrease in all bond interest rates

A) increases the price of a five–year bond more than the price of a ten–year bond.

B) increases the price of a ten–year bond more than the price of a five–year bond.

C) decreases the price of a five–year bond more than the price of a ten–year bond.

D) decreases the price of a ten–year bond more than the price of a five–year bond.

Answer: B
Ques Status: Revised

8) An equal increase in all bond interest rates

A) increases the return to all bond maturities by an equal amount.

B) decreases the return to all bond maturities by an equal amount.

C) has no effect on the returns to bonds.

D) decreases long–term bond returns more than short–term bond returns.

Answer: D
Ques Status: Previous Edition

9) Which of the following are true concerning the distinction between interest rates and returns?

A) The rate of return on a bond will not necessarily equal the interest rate on that bond.

B) The return can be expressed as the difference between the current yield and the rate of capital gains.

C) The rate of return will be greater than the interest rate when the price of the bond falls between time t and time t + 1.

D) The return can be expressed as the sum of the discount yield and the rate of capital gains.

Answer: A
Ques Status: Previous Edition

10) Which of the following are generally true of bonds?

A) The only bond whose return equals the initial yield to maturity is one whose time to maturity is the same as the holding period.

B) A rise in interest rates is associated with a fall in bond prices, resulting in capital gains on bonds whose terms to maturity are longer than the holding periods.

C) The longer a bond's maturity, the smaller is the size of the price change associated with an interest rate change.

D) Prices and returns for short–term bonds are more volatile than those for longer–term bonds.

Answer: A
Ques Status: Revised

11) Which of the following are generally true of all bonds?

A) The longer a bond's maturity, the greater is the rate of return that occurs as a result of the increase in the interest rate.

B) Even though a bond has a substantial initial interest rate, its return can turn out to be negative if interest rates rise.

C) Prices and returns for short–term bonds are more volatile than those for longer term bonds.

D) A fall in interest rates results in capital losses for bonds whose terms to maturity are longer than the holding period.

Answer: B
Ques Status: Revised

12) The riskiness of an asset's returns due to changes in interest rates is

A) exchange–rate risk.

B) price risk.

C) asset risk.

D) interest–rate risk.

Answer: D
Ques Status: Revised

13) Interest–rate risk is the riskiness of an asset's returns due to

A) interest–rate changes.

B) changes in the coupon rate.

C) default of the borrower.

D) changes in the asset's maturity.

Answer: A
Ques Status: Revised

14) Prices and returns for ________ bonds are more volatile than those for ________ bonds, everything else held constant.

A) long–term; long–term

B) long–term; short–term

C) short–term; long–term

D) short–term; short–term

Answer: B
Ques Status: Previous Edition

15) Your favorite uncle advises you to purchase long–term bonds because their interest rate is 10%. Should you follow his advice?

Answer: It depends on where you think interest rates are headed in the future. If you think interest rates will be going up, you should not follow your uncle's advice because you would then have to discount your bond if you needed to sell it before the maturity date. Long–term bonds have a greater interest–rate risk.
Ques Status: New

4.4 The Distinction Between Real and Nominal Interest Rates

1) The ________ states that the nominal interest rate equals the real interest rate plus the expected rate of inflation.

A) Fisher equation

B) Keynesian equation

C) Monetarist equation

D) Marshall equation

Answer: A
Ques Status: Previous Edition

2) The nominal interest rate minus the expected rate of inflation

A) defines the real interest rate.

B) is a less accurate measure of the incentives to borrow and lend than is the nominal interest rate.

C) is a less accurate indicator of the tightness of credit market conditions than is the nominal interest rate.

D) defines the discount rate.

Answer: A
Ques Status: Previous Edition

3) The ________ interest rate more accurately reflects the true cost of borrowing.

A) nominal

B) real

C) discount

D) market

Answer: B
Ques Status: New

4) If you expect the inflation rate to be 15 percent next year and a one–year bond has a yield to maturity of 7 percent, then the real interest rate on this bond is

A) 7 percent.

B) 22 percent.

C) –15 percent.

D) –8 percent.

Answer: D
Ques Status: Revised

5) When the ________ interest rate is low, there are greater incentives to ________ and fewer incentives to ________.

A) nominal; lend; borrow

B) real; lend; borrow

C) real; borrow; lend

D) market; lend; borrow

Answer: C
Ques Status: New

6) In which of the following situations would you prefer to be the lender?

A) The interest rate is 9 percent and the expected inflation rate is 7 percent.

B) The interest rate is 4 percent and the expected inflation rate is 1 percent.

C) The interest rate is 13 percent and the expected inflation rate is 15 percent.

D) The interest rate is 25 percent and the expected inflation rate is 50 percent.

Answer: B
Ques Status: Previous Edition

7) In which of the following situations would you prefer to be borrowing?

A) The interest rate is 9 percent and the expected inflation rate is 7 percent.

B) The interest rate is 4 percent and the expected inflation rate is 1 percent.

C) The interest rate is 13 percent and the expected inflation rate is 15 percent.

D) The interest rate is 25 percent and the expected inflation rate is 50 percent.

Answer: D
Ques Status: Previous Edition

8) If you expect the inflation rate to be 12 percent next year and a one–year bond has a yield to maturity of 7 percent, then the real interest rate on this bond is

A) –5 percent.

B) –2 percent.

C) 2 percent.

D) 12 percent.

Answer: A
Ques Status: Previous Edition

9) If you expect the inflation rate to be 4 percent next year and a one year bond has a yield to maturity of 7 percent, then the real interest rate on this bond is

A) –3 percent.

B) –2 percent.

C) 3 percent.

D) 7 percent.

Answer: C
Ques Status: Previous Edition

10) If the nominal rate of interest is 2 percent, and the expected inflation rate is –10 percent, the real rate of interest is

A) 2 percent.

B) 8 percent.

C) 10 percent.

D) 12 percent.

Answer: D
Ques Status: Revised

11) The interest rate on Treasury Inflation Protected Securities is a direct measure of

A) the real interest rate.

B) the nominal interest rate.

C) the rate of inflation.

D) the rate of deflation.

Answer: A
Ques Status: Revised

12) Assuming the same coupon rate and maturity length, the difference between the yield on a Treasury Inflation Protected Security and the yield on a nonindexed Treasury security provides insight into

A) the nominal interest rate.

B) the real interest rate.

C) the nominal exchange rate.

D) the expected inflation rate.

Answer: D
Ques Status: Revised

13) Assuming the same coupon rate and maturity length, when the interest rate on a Treasury Inflation Protected Security is 3 percent, and the yield on a nonindexed Treasury bond is 8 percent, the expected rate of inflation is

A) 3 percent.

B) 5 percent.

C) 8 percent.

D) 11 percent.

Answer: B
Ques Status: Revised

14) Would it make sense to buy a house when mortgage rates are 14% and expected inflation is 15%? Explain your answer.

Answer: Even though the nominal rate for the mortgage appears high, the real cost of borrowing the funds is –1%. Yes, under this circumstance it would be reasonable to make this purchase.
Ques Status: New

4.5 Web Appendix 1: Measuring Interest–Rate Risk: Duration

1) Duration is

A) an asset's term to maturity.

B) the time until the next interest payment for a coupon bond.

C) the average lifetime of a debt security's stream of payments.

D) the time between interest payments for a coupon bond.

Answer: C
Ques Status: Revised

2) Comparing a discount bond and a coupon bond with the same maturity,

A) the coupon bond has the greater effective maturity.

B) the discount bond has the greater effective maturity.

C) the effective maturity cannot be calculated for a coupon bond.

D) the effective maturity cannot be calculated for a discount bond.

Answer: B
Ques Status: Revised

3) The duration of a coupon bond increases

A) the longer is the bond's term to maturity.

B) when interest rates increase.

C) the higher the coupon rate on the bond.

D) the higher the bond price.

Answer: A
Ques Status: Revised

4) All else equal, the ________ the coupon rate on a bond, the ________ the bond's duration.

A) higher; longer

B) higher; shorter

C) lower; shorter

D) greater; longer

Answer: B
Ques Status: New

5) If a financial institution has 50% of its portfolio in a bond with a five–year duration and 50% of its portfolio in a bond with a seven–year duration, what is the duration of the portfolio?

A) 12 years

B) 7 years

C) 6 years

D) 5 years

Answer: C
Ques Status: New

6) An asset's interest rate risk ________ as the duration of the asset ________.

A) increases; decreases

B) decreases; decreases

C) decreases; increases

D) remains constant; increases

Answer: B
Ques Status: Revised

Chapter 5

The Behavior of Interest Rates

5.1 Determinants of Asset Demand

1) Of the four factors that influence asset demand, which factor will cause the demand for all assets to increase when it increases, everything else held constant?

A) wealth

B) expected returns

C) risk

D) liquidity

Answer: A
Ques Status: New

2) If wealth increases, the demand for stocks ________ and that of long-term bonds ________, everything else held constant.

A) increases; increases

B) increases; decreases

C) decreases; decreases

D) decreases; increases

Answer: A
Ques Status: Previous Edition

3) Everything else held constant, a decrease in wealth

A) increases the demand for stocks.

B) increases the demand for bonds.

C) reduces the demand for housing.

D) increases the demand for housing.

Answer: C
Ques Status: Revised

4) Everything else held constant, if the expected return on ABC stock rises from 5 to 10 percent and the expected return on CBS stock is unchanged, then the expected return of holding CBS stock ________ relative to ABC stock and the demand for CBS stock ________.

A) rises; rises

B) rises; falls

C) falls; rises

D) falls; falls

Answer: D
Ques Status: Revised

5) Everything else held constant, if the expected return on U.S. Treasury bonds falls from 10 to 5 percent and the expected return on GE stock rises from 7 to 8 percent, then the expected return of holding GE stock ________ relative to U.S. Treasury bonds and the demand for GE stock ________.

A) rises; rises

B) rises; falls

C) falls; rises

D) falls; falls

Answer: A
Ques Status: Revised

6) If housing prices are suddenly expected to shoot up, then, other things equal, the demand for houses will ________ and that of Treasury bills will ________.

A) increase; increase

B) increase; decrease

C) decrease; decrease

D) decrease; increase

Answer: B
Ques Status: Previous Edition

7) If stock prices are expected to drop dramatically, then, other things equal, the demand for stocks will ________ and that of Treasury bills will ________.

A) increase; increase

B) increase; decrease

C) decrease; decrease

D) decrease; increase

Answer: D
Ques Status: Previous Edition

8) Everything else held constant, if the expected return on RST stock declines from 12 to 9 percent and the expected return on XYZ stock declines from 8 to 7 percent, then the expected return of holding RST stock ________ relative to XYZ stock and demand for XYZ stock ________.

A) rises; rises

B) rises; falls

C) falls; rises

D) falls; falls

Answer: C
Ques Status: Revised

9) Everything else held constant, if the expected return on U.S. Treasury bonds falls from 8 to 7 percent and the expected return on corporate bonds falls from 10 to 8 percent, then the expected return of corporate bonds ________ relative to U.S. Treasury bonds and the demand for corporate bonds ________.

A) rises; rises

B) rises; falls

C) falls; rises

D) falls; falls

Answer: D
Ques Status: Revised

10) An increase in the expected rate of inflation will ________ the expected return on bonds relative to the that on ________ assets, everything else held constant.

A) reduce; financial

B) reduce; real

C) raise; financial

D) raise; real

Answer: B
Ques Status: Revised

11) If fluctuations in interest rates become smaller, then, other things equal, the demand for stocks ________ and the demand for long-term bonds ________.

A) increases; increases

B) increases; decreases

C) decreases; decreases

D) decreases; increases

Answer: D
Ques Status: Previous Edition

12) If the price of gold becomes less volatile, then, other things equal, the demand for stocks will ________ and the demand for antiques will ________.

A) increase; increase

B) increase; decrease

C) decrease; decrease

D) decrease; increase

Answer: C
Ques Status: Previous Edition

13) If brokerage commissions on bond sales decrease, then, other things equal, the demand for bonds will ________ and the demand for real estate will ________.

A) increase; increase

B) increase; decrease

C) decrease; decrease

D) decrease; increase

Answer: B
Ques Status: New

14) If gold becomes acceptable as a medium of exchange, the demand for gold will ________ and the demand for bonds will ________, everything else held constant.

A) decrease; decrease

B) decrease; increase

C) increase; increase

D) increase; decrease

Answer: D
Ques Status: New

15) The demand for Jackson Pollack paintings rises (holding everything else equal) when:

A) stocks become easier to sell.

B) people expect a boom in real estate prices.

C) Treasury securities become riskier.

D) people suddenly expect gold prices to rise.

Answer: C
Ques Status: Previous Edition

16) The demand for silver bullion decreases, other things equal, when

A) the gold market is suddenly expected to boom.

B) the market for silver bullion becomes more liquid.

C) wealth grows rapidly.

D) interest rates are expected to fall.

Answer: A
Ques Status: Revised

17) You would be less willing to purchase U.S. Treasury bonds, other things equal, if

A) you inherit $1 million from your Uncle Harry.

B) you expect interest rates to fall.

C) gold becomes more liquid.

D) stocks become easier to sell.

Answer: C
Ques Status: Revised

18) You would be more willing to buy AT&T bonds (holding everything else constant) if

A) the brokerage commissions on bond sales become cheaper.

B) interest rates are expected to rise.

C) you had suffered big losses in the stock market.

D) you expected jewelry to appreciate sharply in value.

Answer: A
Ques Status: Revised

19) Holding everything else constant,

A) if asset A's risk rises relative to that of alternative assets, the demand will increase for asset A.

B) the more liquid is asset A, relative to alternative assets, the greater will be the demand for asset A.

C) the lower the expected return to asset A relative to alternative assets, the greater will be the demand for asset A.

D) if wealth increases, demand for asset A increases and demand for alternative assets decreases.

Answer: B
Ques Status: Revised

20) The demand for gold bullion increases, other things equal, when

A) the market for silver bullion becomes more liquid.

B) interest rates are expected to rise.

C) interest rates are expected to fall.

D) real estate prices are expected to increase.

Answer: B
Ques Status: Revised

21) Everything else held constant, would an increase in volatility of stock prices have any impact on the demand for rare coins? Why or why not?

Answer: Yes, it would cause the demand for rare coins to increase. The increased volatility of stock prices means that there is relatively more risk in owning stock than there was previously and so the demand for an alternative asset, rare coins, would increase.
Ques Status: New

5.2 Supply and Demand in the Bond Market

1) The demand curve for bonds has the usual downward slope, indicating that at ________ prices of the bond, everything else equal, the ________ is higher.

A) higher; demand

B) higher; quantity demanded

C) lower; demand

D) lower; quantity demanded

Answer: D
Ques Status: Previous Edition

2) The supply curve for bonds has the usual upward slope, indicating that as the price ________, ceteris paribus, the ________ increases.

A) falls; supply

B) falls; quantity supplied

C) rises; supply

D) rises; quantity supplied

Answer: D
Ques Status: Previous Edition

3) In the bond market, the market−clearing ________ and market−clearing ________.

A) price; deposit

B) interest rate; deposit

C) price; interest rate

D) interest rate; premium

Answer: C
Ques Status: New

4) When the price of a bond is above the equilibrium price, there is an excess ________ bonds and price will ________.

A) demand for; rise

B) demand for; fall

C) supply of; fall

D) supply of; rise

Answer: C
Ques Status: Previous Edition

5) When the price of a bond is ________ the equilibrium price, there is an excess demand for bonds and price will ________.

A) above; rise

B) above; fall

C) below; fall

D) below; rise

Answer: D
Ques Status: Previous Edition

6) When the interest rate on a bond is above the equilibrium interest rate, in the bond market there is excess ________ and the interest rate will ________.

A) demand; rise

B) demand; fall

C) supply; fall

D) supply; rise

Answer: B
Ques Status: Previous Edition

7) When the interest rate on a bond is ________ the equilibrium interest rate, in the bond market there is excess ________ and the interest rate will ________.

A) above; demand; rise

B) above; demand; fall

C) below; supply; fall

D) above; supply; rise

Answer: B
Ques Status: Previous Edition

8) A situation in which the quantity of bonds supplied exceeds the quantity of bonds demanded is called a condition of excess supply; because people want to sell ________ bonds than others want to buy, the price of bonds will ________.

A) fewer; fall

B) fewer; rise

C) more; fall

D) more; rise

Answer: C
Ques Status: Previous Edition

9) If the price of bonds is set ________ the equilibrium price, the quantity of bonds demanded exceeds the quantity of bonds supplied, a condition called excess ________.

A) above; demand

B) above; supply

C) below; demand

D) below; supply

Answer: C
Ques Status: Previous Edition

5.3 Changes in Equilibrium Interest Rates

1) A movement along the bond demand or supply curve occurs when ________ changes.

A) bond price

B) income

C) wealth

D) expected return

Answer: A
Ques Status: New

2) When the price of a bond decreases, all else equal, the bond demand curve ________.

A) shifts right

B) shifts left

C) does not shift

D) inverts

Answer: C
Ques Status: New

3) Everything else held constant, when households save less, wealth and the demand for bonds ________ and the bond demand curve shifts ________.

A) increase; right

B) increase; left

C) decrease; right

D) decrease; left

Answer: D
Ques Status: New

4) Holding the expected return on bonds constant, an increase in the expected return on common stocks would ________ the demand for bonds, shifting the demand curve to the ________.

A) decrease; left

B) decrease; right

C) increase; left

D) increase; right

Answer: A
Ques Status: Previous Edition

5) Everything else held constant, if interest rates are expected to fall in the future, the demand for long–term bonds today ________ and the demand curve shifts to the ________.

A) rises; right

B) rises; left

C) falls; right

D) falls; left

Answer: A
Ques Status: Revised

6) Everything else held constant, an increase in expected inflation, lowers the expected return on ________ compared to ________ assets.

A) bonds; financial

B) bonds; real

C) physical; financial

D) physical; real

Answer: B
Ques Status: New

7) The reduction of brokerage commissions for trading common stocks that occurred in 1975 caused the demand for bonds to ________ and the demand curve to shift to the ________.

A) fall; right

B) fall, left

C) rise; right

D) rise; left

Answer: B
Ques Status: Previous Edition

8) Everything else held constant, when stock prices become less volatile, the demand curve for bonds shifts to the ________ and the interest rate ________.

A) right; rises

B) right; falls

C) left; falls

D) left; rises

Answer: D
Ques Status: Previous Edition

9) Everything else held constant, when stock prices become ________ volatile, the demand curve for bonds shifts to the ________ and the interest rate ________.

A) more; right; rises

B) more; right; falls

C) less; left; falls

D) less; left; does not change

Answer: B
Ques Status: Revised

10) Everything else held constant, an increase in the riskiness of bonds relative to alternative assets causes the demand for bonds to ________ and the demand curve to shift to the ________.

A) rise; right

B) rise; left

C) fall; right

D) fall; left

Answer: D
Ques Status: Revised

11) Everything else held constant, when bonds become less widely traded, and as a consequence the market becomes less liquid, the demand curve for bonds shifts to the ________ and the interest rate ________.

A) right; rises

B) right; falls

C) left; falls

D) left; rises

Answer: D
Ques Status: Revised

12) Everything else held constant, an increase in the liquidity of bonds results in a ________ in demand for bonds and the demand curve shifts to the ________.

A) rise; right

B) rise; left

C) fall; right

D) fall; left

Answer: A
Ques Status: Revised

13) Factors that decrease the demand for bonds include

A) an increase in the volatility of stock prices.

B) a decrease in the expected returns on stocks.

C) a decrease in the inflation rate.

D) a decrease in the riskiness of stocks.

Answer: D
Ques Status: Previous Edition

14) During business cycle expansions when income and wealth are rising, the demand for bonds ________ and the demand curve shifts to the ________, everything else held constant.

A) falls; right

B) falls; left

C) rises; right

D) rises; left

Answer: C
Ques Status: Revised

15) Factors that can cause the supply curve for bonds to shift to the right include

A) an expansion in overall economic activity.

B) a decrease in expected inflation.

C) a decrease in government deficits.

D) a business cycle recession.

Answer: A
Ques Status: Revised

16) During a recession, the supply of bonds ________ and the supply curve shifts to the ________, everything else held constant.

A) increases; left

B) increases; right

C) decreases; left

D) decreases; right

Answer: C
Ques Status: Revised

17) An increase in the expected inflation rate causes the supply of bonds to ________ and the supply curve to shift to the ________, everything else held constant.

A) increase; left

B) increase; right

C) decrease; left

D) decrease; right

Answer: B
Ques Status: Revised

18) When the expected inflation rate increases, the real cost of borrowing ________ and bond supply ________, everything else held constant.

A) increases; increases

B) increases; decreases

C) decreases; increases

D) decreases; decreases

Answer: C
Ques Status: New

19) Higher government deficits ________ the supply of bonds and shift the supply curve to the ________, everything else held constant.

A) increase; left

B) increase; right

C) decrease; left

D) decrease; right

Answer: B
Ques Status: Previous Edition

20) When the inflation rate is expected to increase, the ________ for bonds falls, while the ________ curve shifts to the right, everything else held constant.

A) demand; demand

B) demand; supply

C) supply; demand

D) supply; supply

Answer: B
Ques Status: Revised

21) Everything else held constant, when the inflation rate is expected to rise, interest rates will ________; this result has been termed the ________.

A) fall; Keynes effect

B) fall; Fisher effect

C) rise; Keynes effect

D) rise; Fisher effect

Answer: D
Ques Status: Revised

22) The economist Irving Fisher, after whom the Fisher effect is named, explained why interest rates ________ as the expected rate of inflation ________, everything else held constant.

A) rise; increases

B) rise; stabilizes

C) fall; stabilizes

D) fall; increases

Answer: A
Ques Status: Revised

23) Everything else held constant, during a business cycle expansion, the supply of bonds shifts to the ________ as businesses perceive more profitable investment opportunities, while the demand for bonds shifts to the ________ as a result of the increase in wealth generated by the economic expansion.

A) right; left

B) right; right

C) left; left

D) left; right

Answer: B
Ques Status: Revised

24) When the interest rate changes,

A) the demand curve for bonds shifts to the right.

B) the demand curve for bonds shifts to the left.

C) the supply curve for bonds shifts to the right.

D) it is because either the demand or the supply curve has shifted.

Answer: D
Ques Status: Previous Edition

25) When the interest rate falls, either the demand for bonds ________ or the supply of bonds ________.

A) increased; increased

B) increased; decreased

C) decreased; decreased

D) decreased; increased

Answer: B
Ques Status: Revised

26) A decrease in the brokerage commissions in the housing market from 6% to 5% of the sales price will shift the ________ curve for bonds to the ________, everything else held constant.

A) demand; right

B) demand; left

C) supply; right

D) supply; left

Answer: B
Ques Status: Revised

27) When rare coin prices become volatile, the ________ curve for bonds shifts to the ________, everything else held constant.

A) demand; right

B) demand; left

C) supply; right

D) supply; left

Answer: A
Ques Status: Revised

28) If people expect real estate prices to increase significantly, the ________ curve for bonds will shift to the ________, everything else held constant.

A) demand; right

B) demand; left

C) supply; left

D) supply; right

Answer: B
Ques Status: Revised

29) Everything else held constant, when prices in the art market become more uncertain,

A) the demand curve for bonds shifts to the left and the interest rate rises.

B) the demand curve for bonds shifts to the left and the interest rate falls.

C) the demand curve for bonds shifts to the right and the interest rate falls.

D) the supply curve for bonds shifts to the right and the interest rate falls.

Answer: C
Ques Status: Revised

30) When the government has a surplus, as occurred in the late 1990s, the ________ curve of bonds shifts to the ________, everything else held constant.

A) supply; right

B) supply; left

C) demand; right

D) demand; left

Answer: B
Ques Status: New

31) When the expected inflation rate increases, the demand for bonds ________, the supply of bonds ________, and the interest rate ________, everything else held constant.

A) increases; increases; rises

B) decreases; decreases; falls

C) increases; decreases; falls

D) decreases; increases; rises

Answer: D
Ques Status: Revised

32) When an economy grows out of a recession, normally the demand for bonds ________ and the supply of bonds ________, everything else held constant.

A) increases; increases

B) increases; decreases

C) decreases; decreases

D) decreases; increases

Answer: A
Ques Status: Revised

33) When the economy slips into a recession, normally the demand for bonds ________, the supply of bonds ________, and the interest rate ________, everything else held constant.

A) increases; increases; rises

B) decreases; decreases; falls

C) increases; decreases; falls

D) decreases; increases; rises

Answer: B
Ques Status: Revised

34) In the 1990s Japan had the lowest interest rates in the world due to a combination of

A) inflation and recession.

B) deflation and expansion.

C) inflation and expansion.

D) deflation and recession.

Answer: D
Ques Status: Revised

35) Deflation causes the demand for bonds to ________, the supply of bonds to ________, and bond prices to________, everything else held constant.

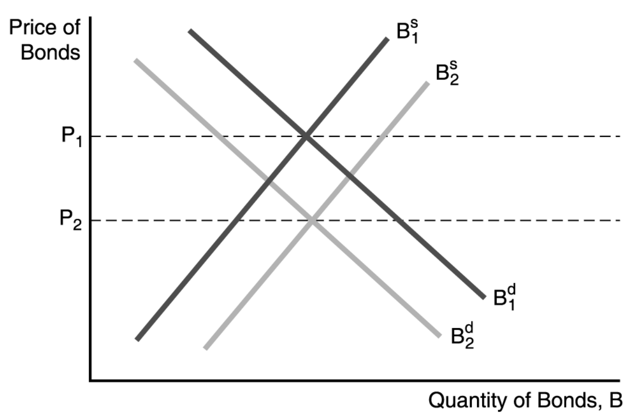
A) increase; increase; increase

B) increase; decrease; increase

C) decrease; increase; increase

D) decrease; decrease; increase

Answer: B
Ques Status: Revised



36) In the figure above, a factor that could cause the supply of bonds to shift to the right is:

A) a decrease in government budget deficits.

B) a decrease in expected inflation.

C) a recession.

D) a business cycle expansion.

Answer: D
Ques Status: Previous Edition

37) In the figure above, a factor that could cause the demand for bonds to decrease (shift to the left) is:

A) an increase in the expected return on bonds relative to other assets.

B) a decrease in the expected return on bonds relative to other assets.

C) an increase in wealth.

D) a reduction in the riskiness of bonds relative to other assets.

Answer: B
Ques Status: Previous Edition

38) In the figure above, the price of bonds would fall from P_1 to P_2

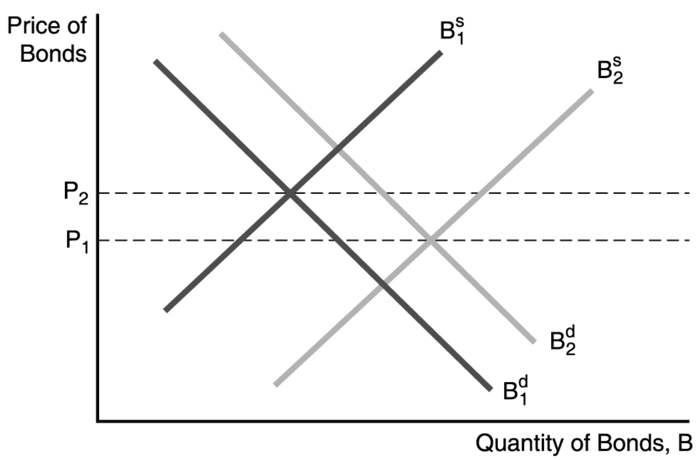
A) inflation is expected to increase in the future.

B) interest rates are expected to fall in the future.

C) the expected return on bonds relative to other assets is expected to increase in the future.

D) the riskiness of bonds falls relative to other assets.

Answer: A
Ques Status: Previous Edition



39) In the figure above, a factor that could cause the supply of bonds to increase (shift to the right) is:

A) a decrease in government budget deficits.

B) a decrease in expected inflation.

C) expectations of more profitable investment opportunities.

D) a business cycle recession.

Answer: C
Ques Status: Revised

40) In the figure above, a factor that could cause the demand for bonds to shift to the right is:

A) an increase in the riskiness of bonds relative to other assets.

B) an increase in the expected rate of inflation.

C) expectations of lower interest rates in the future.

D) a decrease in wealth.

Answer: C
Ques Status: Revised

41) In the figure above, the price of bonds would fall from P_2 to P_1 if

A) there is a business cycle recession.

B) there is a business cycle expansion.

C) inflation is expected to increase in the future.

D) inflation is expected to decrease in the future.

Answer: B
Ques Status: New

42) What is the impact on interest rates when the Federal Reserve decreases the money supply by selling bonds to the public?

Answer: Bond supply increases and the bond supply curve shifts to the right. The new equilibrium bond price is lower and thus interest rates will increase.
Ques Status: New

43) Use demand and supply analysis to explain why an expectation of Fed rate hikes would cause Treasury prices to fall.

Answer: The expected return on bonds would decrease relative to other assets resulting in a decrease in the demand for bonds. The leftward shift of the bond demand curve results in a new lower equilibrium price for bonds.
Ques Status: New

5.4 Supply and Demand in the Market for Money: The Liquidity Preference Framework

1) The bond supply and demand framework is easier to use when analyzing the effects of changes in ________, while the liquidity preference framework provides a simpler analysis of the effects from changes in income, the price level, and the supply of ________.

A) expected inflation; bonds

B) expected inflation; money

C) government budget deficits; bonds

D) government budget deficits; money

Answer: B
Ques Status: Revised

2) In his Liquidity Preference Framework, Keynes assumed that money has a zero rate of return; thus,

A) when interest rates rise, the expected return on money falls relative to the expected return on bonds, causing the demand for money to fall.

B) when interest rates rise, the expected return on money falls relative to the expected return on bonds, causing the demand for money to rise.

C) when interest rates fall, the expected return on money falls relative to the expected return on bonds, causing the demand for money to fall.

D) when interest rates fall, the expected return on money falls relative to the expected return on bonds, causing the demand for money to rise.

Answer: A
Ques Status: Previous Edition

3) In Keynes's liquidity preference framework, individuals are assumed to hold their wealth in two forms:

A) real assets and financial assets.

B) stocks and bonds.

C) money and bonds.

D) money and gold.

Answer: C
Ques Status: Previous Edition

4) Keynes assumed that money has ________ rate of return.

A) a positive

B) a negative

C) a zero

D) an increasing

Answer: C
Ques Status: New

5) In Keynes's liquidity preference framework, as the expected return on bonds increases (holding everything else unchanged), the expected return on money ________, causing the demand for ________ to fall.

A) falls; bonds

B) falls; money

C) rises; bonds

D) rises; money

Answer: B
Ques Status: Previous Edition

6) In Keynes's liquidity preference framework,

A) the demand for bonds must equal the supply of money.

B) the demand for money must equal the supply of bonds.

C) an excess demand of bonds implies an excess demand for money.

D) an excess supply of bonds implies an excess demand for money.

Answer: D
Ques Status: Previous Edition

7) The opportunity cost of holding money is

A) the level of income.

B) the price level.

C) the interest rate.

D) the discount rate.

Answer: C
Ques Status: Revised

8) If there is excess demand for money, there is

A) excess demand for bonds.

B) equilibrium in the bond market.

C) excess supply of bonds.

D) too much money.

Answer: C
Ques Status: Revised

9) An increase in the interest rate

A) increases the demand for money.

B) increases the quantity of money demanded.

C) decreases the demand for money.

D) decreases the quantity of money demanded.

Answer: D
Ques Status: Revised

10) If there is an excess supply of money

A) individuals sell bonds, causing the interest rate to rise.

B) individuals sell bonds, causing the interest rate to fall.

C) individuals buy bonds, causing interest rates to fall.

D) individuals buy bonds, causing interest rates to rise.

Answer: C
Ques Status: Revised

11) When the interest rate is above the equilibrium interest rate, there is an excess ________ money and the interest rate will ________.

A) demand for; rise

B) demand for; fall

C) supply of; fall

D) supply of; rise

Answer: C
Ques Status: Revised

12) In the market for money, an interest rate below equilibrium results in an excess ________ money and the interest rate will ________.

A) demand for; rise

B) demand for; fall

C) supply of; fall

D) supply of; rise

Answer: A
Ques Status: Revised

5.5 Changes in Equilibrium Interest Rates in the Liquidity Preference Framework

1) In the Keynesian liquidity preference framework, an increase in the interest rate causes the demand curve for money to ________, everything else held constant.

A) shift right

B) shift left

C) stay where it is

D) invert

Answer: C
Ques Status: New

2) A lower level of income causes the demand for money to ________ and the interest rate to ________, everything else held constant.

A) decrease; decrease

B) decrease; increase

C) increase; decrease

D) increase; increase

Answer: A
Ques Status: Revised

3) When real income ________, the demand curve for money shifts to the ________ and the interest rate ________, everything else held constant.

A) falls; right; rises

B) rises; right; rises

C) falls; left; rises

D) rises; left; rises

Answer: B
Ques Status: Revised

4) A business cycle expansion increases income, causing money demand to ________ and interest rates to ________, everything else held constant.

A) increase; increase

B) increase; decrease

C) decrease; decrease

D) decrease; increase

Answer: A
Ques Status: New

5) In the Keynesian liquidity preference framework, a rise in the price level causes the demand for money to ________ and the demand curve to shift to the ________, everything else held constant.

A) increase; left

B) increase; right

C) decrease; left

D) decrease; right

Answer: B
Ques Status: Revised

6) When the price level ________, the demand curve for money shifts to the ________ and the interest rate ________, everything else held constant.

A) falls; left; falls

B) rises; right; falls

C) falls; left; rises

D) rises; right; rises

Answer: D
Ques Status: Revised

7) A rise in the price level causes the demand for money to ________ and the interest rate to ________, everything else held constant.

A) decrease; decrease

B) decrease; increase

C) increase; decrease

D) increase; increase

Answer: D
Ques Status: Revised

8) A decline in the expected inflation rate causes the demand for money to ________ and the demand curve to shift to the ________, everything else held constant.

A) decrease; right

B) decrease; left

C) increase; right

D) increase; left

Answer: B
Ques Status: Revised

9) In the liquidity preference framework, a one-time increase in the money supply results in a price level effect. The maximum impact of the price level effect on interest rates occurs

A) at the moment the price level hits its peak (stops rising) because both the price level and expected inflation effects are at work.

B) immediately after the price level begins to rise, because both the price level and expected inflation effects are at work.

C) at the moment the expected inflation rate hits its peak.

D) at the moment the inflation rate hits it peak.

Answer: A
Ques Status: Revised

10) Interest rates increased continuously during the 1970s. The most likely explanation is

A) banking failures that reduced the money supply.

B) a rise in the level of income.

C) the repeated bouts of recession and expansion.

D) increasing expected rates of inflation.

Answer: D
Ques Status: Revised

11) When the Fed decreases the money stock, the money supply curve shifts to the ________ and the interest rate ________, everything else held constant.

A) right; rises

B) right; falls

C) left; falls

D) left; rises

Answer: D
Ques Status: Revised

12) When the Fed ________ the money stock, the money supply curve shifts to the ________ and the interest rate ________, everything else held constant.

A) decreases; right; rises

B) increases; right; falls

C) decreases; left; falls

D) increases; left; rises

Answer: B
Ques Status: Revised

13) When the price level falls, the ________ curve for nominal money ________, and interest rates ________, everything else held constant.

A) demand; decreases; fall

B) demand; increases; rise

C) supply; increases; rise

D) supply; decreases; fall

Answer: A
Ques Status: Revised

14) ________ in the money supply creates excess ________ money, causing interest rates to ________, everything else held constant.

A) a decrease; demand for; rise

B) an increase; demand for; fall

C) an increase; supply of; rise

D) a decrease; supply of; fall

Answer: A
Ques Status: Revised

15) ________ in the money supply creates excess demand for ________, causing interest rates to ________, everything else held constant.

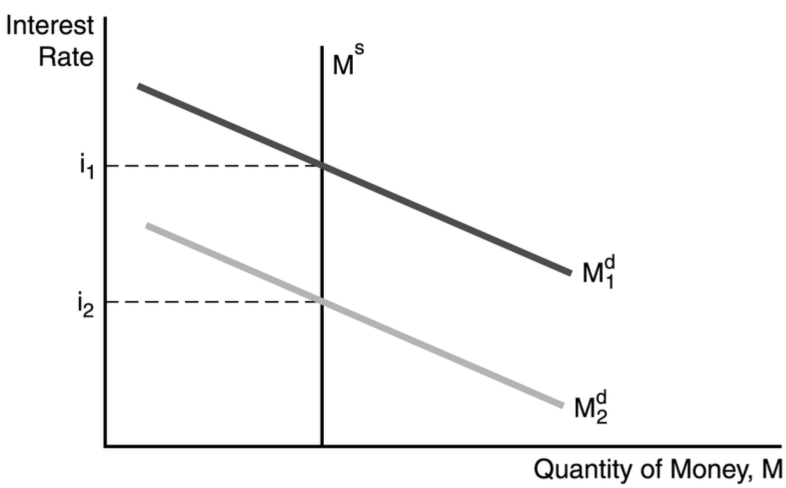
A) an increase; money; rise

B) an increase; bonds; fall

C) a decrease; bonds; rise

D) a decrease; money; fall

Answer: B
Ques Status: Revised



16) In the figure above, one factor not responsible for the decline in the demand for money is

A) a decline the price level.

B) a decline in income.

C) an increase in income.

D) a decline in the expected inflation rate.

Answer: C
Ques Status: Previous Edition

17) In the figure above, the decrease in the interest rate from i_1 to i_2 can be explained by

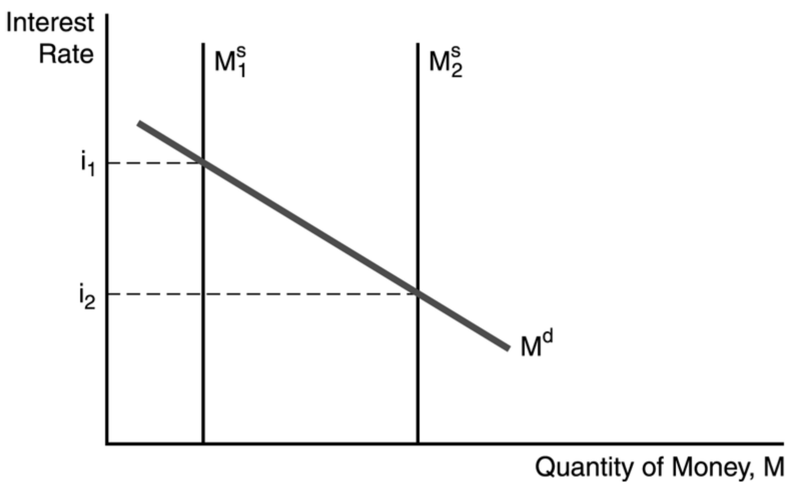
A) a decrease in money growth.

B) a decline in the expected price level.

C) an increase in income.

D) an increase in the expected price level.

Answer: B
Ques Status: Revised



18) In the figure above, the factor responsible for the decline in the interest rate is

A) a decline the price level.

B) a decline in income.

C) an increase in the money supply.

D) a decline in the expected inflation rate.

Answer: C
Ques Status: Previous Edition

19) In the figure above, the decrease in the interest rate from i_1 to i_2 can be explained by

A) a decrease in money growth.

B) an increase in money growth.

C) a decline in the expected price level.

D) an increase in income.

Answer: B
Ques Status: Revised

20) When the growth rate of the money supply increases, interest rates end up being permanently lower if

A) the liquidity effect is larger than the other effects.

B) there is fast adjustment of expected inflation.

C) there is slow adjustment of expected inflation.

D) the expected inflation effect is larger than the liquidity effect.

Answer: A
Ques Status: Previous Edition

21) When the growth rate of the money supply is increased, interest rates will fall immediately if the liquidity effect is ________ than the other money supply effects and there is ________ adjustment of expected inflation.

A) larger; fast

B) larger; slow

C) smaller; slow

D) smaller; fast

Answer: B
Ques Status: Previous Edition

22) If the Fed wants to permanently lower interest rates, then it should raise the rate of money growth if

A) there is fast adjustment of expected inflation.

B) there is slow adjustment of expected inflation.

C) the liquidity effect is smaller than the expected inflation effect.

D) the liquidity effect is larger than the other effects.

Answer: D
Ques Status: Previous Edition

23) Milton Friedman contends that it is entirely possible that when the money supply rises, interest rates may ________ if the ________ effect is more than offset by changes in income, the price level, and expected inflation.

A) fall; liquidity

B) fall; risk

C) rise; liquidity

D) rise; risk

Answer: C
Ques Status: Previous Edition

24) Of the four effects on interest rates from an increase in the money supply, the one that works in the opposite direction of the other three is the

A) liquidity effect.

B) income effect.

C) price level effect.

D) expected inflation effect.

Answer: A
Ques Status: Previous Edition

25) Of the four effects on interest rates from an increase in the money supply, the initial effect is, generally, the

A) income effect.

B) liquidity effect.

C) price level effect.

D) expected inflation effect.

Answer: B
Ques Status: Previous Edition

26) If the liquidity effect is smaller than the other effects, and the adjustment to expected inflation is slow, then the

A) interest rate will fall.

B) interest rate will rise.

C) interest rate will initially fall but eventually climb above the initial level in response to an increase in money growth.

D) interest rate will initially rise but eventually fall below the initial level in response to an increase in money growth.

Answer: C
Ques Status: Previous Edition

27) If the liquidity effect is smaller than the other effects, and the adjustment to expected inflation is immediate, then the

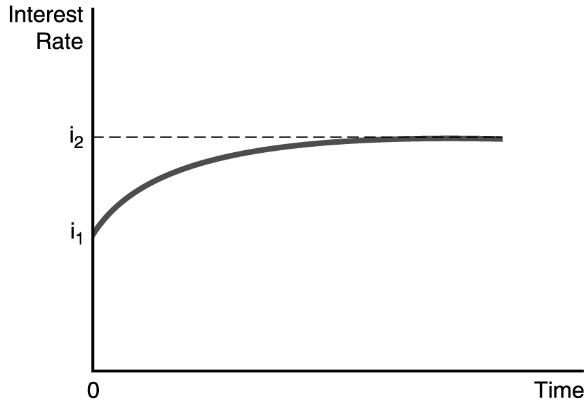
A) interest rate will fall.

B) interest rate will rise.

C) interest rate will fall immediately below the initial level when the money supply grows.

D) interest rate will rise immediately above the initial level when the money supply grows.

Answer: D
Ques Status: Previous Edition



28) In the figure above, illustrates the effect of an increased rate of money supply growth at time period 0. From the figure, one can conclude that the

A) liquidity effect is smaller than the expected inflation effect and interest rates adjust quickly to changes in expected inflation.

B) liquidity effect is larger than the expected inflation effect and interest rates adjust quickly to changes in expected inflation.

C) liquidity effect is larger than the expected inflation effect and interest rates adjust slowly to changes in expected inflation.

D) liquidity effect is smaller than the expected inflation effect and interest rates adjust slowly to changes in expected inflation.

Answer: A
Ques Status: Previous Edition

29) In the figure above, illustrates the effect of an increased rate of money supply growth at time period 0. From the figure, one can conclude that the

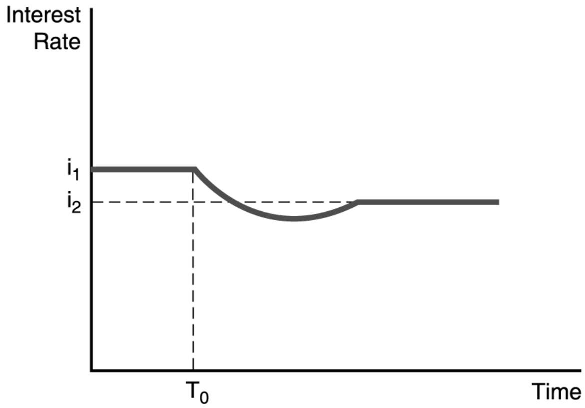
A) Fisher effect is dominated by the liquidity effect and interest rates adjust slowly to changes in expected inflation.

B) liquidity effect is dominated by the Fisher effect and interest rates adjust slowly to changes in expected inflation.

C) liquidity effect is dominated by the Fisher effect and interest rates adjust quickly to changes in expected inflation.

D) Fisher effect is smaller than the expected inflation effect and interest rates adjust quickly to changes in expected inflation.

Answer: C
Ques Status: Previous Edition



30) The figure above illustrates the effect of an increased rate of money supply growth at time period T_0. From the figure, one can conclude that the

A) liquidity effect is smaller than the expected inflation effect and interest rates adjust quickly to changes in expected inflation.

B) liquidity effect is larger than the expected inflation effect and interest rates adjust quickly to changes in expected inflation.

C) liquidity effect is larger than the expected inflation effect and interest rates adjust slowly to changes in expected inflation.

D) liquidity effect is smaller than the expected inflation effect and interest rates adjust slowly to changes in expected inflation.

Answer: C
Ques Status: Revised

31) The figure above illustrates the effect of an increased rate of money supply growth at time period T_0. From the figure, one can conclude that the

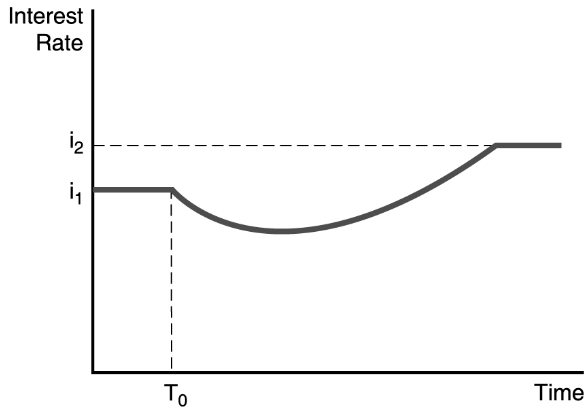
A) Fisher effect is dominated by the liquidity effect and interest rates adjust slowly to changes in expected inflation.

B) liquidity effect is dominated by the Fisher effect and interest rates adjust slowly to changes in expected inflation.

C) liquidity effect is dominated by the Fisher effect and interest rates adjust quickly to changes in expected inflation.

D) Fisher effect is smaller than the expected inflation effect and interest rates adjust quickly to changes in expected inflation.

Answer: A
Ques Status: Revised



32) The figure above illustrates the effect of an increased rate of money supply growth at time period T_0. From the figure, one can conclude that the

A) liquidity effect is smaller than the expected inflation effect and interest rates adjust quickly to changes in expected inflation.

B) liquidity effect is larger than the expected inflation effect and interest rates adjust quickly to changes in expected inflation.

C) liquidity effect is larger than the expected inflation effect and interest rates adjust slowly to changes in expected inflation.

D) liquidity effect is smaller than the expected inflation effect and interest rates adjust slowly to changes in expected inflation.

Answer: D
Ques Status: Revised

33) The figure above illustrates the effect of an increased rate of money supply growth at time period T_0. From the figure, one can conclude that the

A) Fisher effect is dominated by the liquidity effect and interest rates adjust slowly to changes in expected inflation

B) liquidity effect is dominated by the Fisher effect and interest rates adjust slowly to changes in expected inflation

C) liquidity effect is dominated by the Fisher effect and interest rates adjust quickly to changes in expected inflation

D) Fisher effect is smaller than the expected inflation effect and interest rates adjust quickly to changes in expected inflation

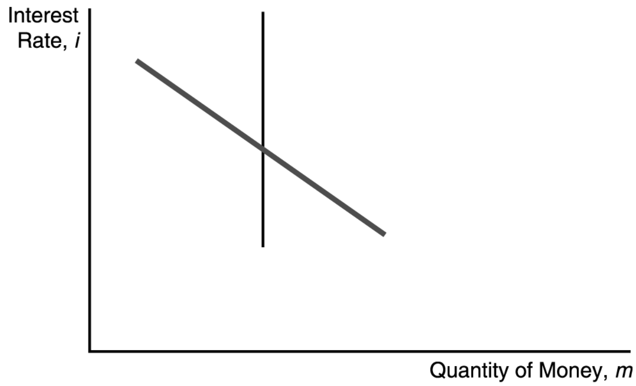
Answer: A
Ques Status: Revised

34) Using the liquidity preference framework, what will happen to interest rates if the Fed increases the money supply?

Answer: The Fed's actions shift the money supply curve to the right. The new equilibrium interest rate will be lower than it was previously.
Ques Status: New

35) Using the liquidity preference framework, show what happens to interest rates during a business cycle recession.

Answer: During a business cycle recession, income will fall. This causes the money demand curve to shift to the left. The resulting equilibrium will be at a lower interest rate.



Ques Status: New

5.6 Web Appendix 1: Models of Asset Pricing

1) The riskiness of an asset is measured by

A) the magnitude of its return.

B) the absolute value of any change in the asset's price.

C) the standard deviation of its return.

D) risk is impossible to measure.

Answer: C
Ques Status: Revised

2) A higher ________ means that an asset's return is more sensitive to changes in the value of the market portfolio.

A) alpha

B) beta

C) CAPM

D) APT

Answer: B
Ques Status: New

3) The riskiness of an asset that is unique to the particular asset is

A) systematic risk.

B) portfolio risk.

C) investment risk.

D) nonsystematic risk.

Answer: D
Ques Status: Revised

4) The risk of a well-diversified portfolio depends only on the ________ risk of the assets in the portfolio.

A) systematic

B) nonsystematic

C) portfolio

D) investment

Answer: A
Ques Status: New

5) In contrast to the CAPM , the APT assumes that there can be several sources of ________ that cannot be eliminated through diversification.

A) nonsystematic risk

B) systematic risk

C) credit risk

D) arbitrary risk

Answer: B
Ques Status: New

5.7 Web Appendix 2: Applying the Asset Market Approach to a Commodity Market: The Case of Gold

1) An increase in the expected inflation rate will ________ the ________ for gold, ________ its price, everything else held constant.

A) increase; demand; increasing

B) decrease; demand; decreasing

C) increase; supply; increasing

D) decrease; supply; increasing

Answer: A
Ques Status: Revised

2) A return to the gold standard, that is, using gold for money will ________ the ________ for gold, ________ its price, everything else held constant.
   A) increase; demand; increasing
   B) decrease; demand; decreasing
   C) increase; supply; increasing
   D) decrease; supply; increasing

   Answer: A
   Ques Status: Revised

3) Discovery of new gold in Alaska will ________ the ________ of gold, ________ its price, everything else held constant.
   A) increase; demand; increasing
   B) decrease; demand; decreasing
   C) decrease; supply; increasing
   D) increase; supply; decreasing

   Answer: D
   Ques Status: Revised

4) When gold prices become more volatile, the ________ curve for gold shifts to the ________; ________ the price of gold.
   A) supply; right; increasing
   B) supply; left; increasing
   C) demand; right; decreasing
   D) demand; left; decreasing

   Answer: D
   Ques Status: New

5.8 Web Appendix 3: Loanable Funds Framework

1) In the loanable funds framework, the ________ curve of bonds is equivalent to the ________ curve of loanable funds.
   A) demand; demand
   B) demand; supply
   C) supply; supply
   D) supply; equilibrium

   Answer: B
   Ques Status: New

2) In the loanable funds framework, the ________ is measured on the vertical axis.

A) price of bonds

B) interest rate

C) quantity of bonds

D) quantity of loanable funds

Answer: B

Ques Status: New

Chapter 6

The Risk and Term Structure of Interest Rates

6.1 Risk Structure of Interest Rates

1) The risk structure of interest rates is

A) the structure of how interest rates move over time.

B) the relationship among interest rates of different bonds with the same maturity.

C) the relationship among the term to maturity of different bonds.

D) the relationship among interest rates on bonds with different maturities.

Answer: B
Ques Status: Previous Edition

2) The risk that interest payments will not be made, or that the face value of a bond is not repaid when a bond matures is

A) interest rate risk.

B) inflation risk.

C) moral hazard.

D) default risk.

Answer: D
Ques Status: Revised

3) Bonds with no default risk are called

A) flower bonds.

B) no-risk bonds.

C) default-free bonds.

D) zero-risk bonds.

Answer: C
Ques Status: Previous Edition

4) Which of the following bonds are considered to be default-risk free?

A) municipal bonds

B) investment-grade bonds

C) U.S. Treasury bonds

D) junk bonds

Answer: C
Ques Status: New

5) U.S. government bonds have no default risk because

A) they are backed by the full faith and credit of the federal government.

B) the federal government can increase taxes to pay its obligations.

C) they are backed with gold reserves.

D) they can be exchanged for silver at any time.

Answer: B
Ques Status: Revised

6) The spread between the interest rates on bonds with default risk and default–free bonds is called the

A) risk premium.

B) junk margin.

C) bond margin.

D) default premium.

Answer: A
Ques Status: Previous Edition

7) If the probability of a bond default increases because corporations begin to suffer large losses, then the default risk on corporate bonds will ________ and the expected return on these bonds will ________, everything else held constant.

A) decrease; increase

B) decrease; decrease

C) increase; increase

D) increase; decrease

Answer: D
Ques Status: Revised

8) A bond with default risk will always have a ________ risk premium and an increase in its default risk will ________ the risk premium.

A) positive; raise

B) positive; lower

C) negative; raise

D) negative; lower

Answer: A
Ques Status: New

9) If a corporation begins to suffer large losses, then the default risk on the corporate bond will

A) increase and the bond's return will become more uncertain, meaning the expected return on the corporate bond will fall.

B) increase and the bond's return will become less uncertain, meaning the expected return on the corporate bond will fall.

C) decrease and the bond's return will become less uncertain, meaning the expected return on the corporate bond will fall.

D) decrease and the bond's return will become less uncertain, meaning the expected return on the corporate bond will rise.

Answer: A
Ques Status: Revised

10) If the possibility of a default increases because corporations begin to suffer losses, then the default risk on corporate bonds will ________, and the bonds' returns will become ________ uncertain, meaning that the expected return on these bonds will decrease, everything else held constant.

A) increase; less

B) increase; more

C) decrease; less

D) decrease; more

Answer: B
Ques Status: Revised

11) Other things being equal, an increase in the default risk of corporate bonds shifts the demand curve for corporate bonds to the ________ and the demand curve for Treasury bonds to the ________.

A) right; right

B) right; left

C) left; right

D) left; left

Answer: C
Ques Status: Previous Edition

12) An increase in the riskiness of corporate bonds will ________ the price of corporate bonds and ________ the price of Treasury bonds, everything else held constant.

A) increase; increase

B) reduce; reduce

C) reduce; increase

D) increase; reduce

Answer: C
Ques Status: Revised

13) An increase in the riskiness of corporate bonds will ________ the yield on corporate bonds and ________ the yield on Treasury securities, everything else held constant.

A) increase; increase

B) reduce; reduce

C) increase; reduce

D) reduce; increase

Answer: C
Ques Status: Revised

14) An increase in default risk on corporate bonds ________ the demand for these bonds, but ________ the demand for default-free bonds, everything else held constant.

A) increases; lowers

B) lowers; increases

C) does not change; greatly increases

D) moderately lowers; does not change

Answer: B
Ques Status: Previous Edition

15) As default risk increases, the expected return on corporate bonds ________, and the return becomes ________ uncertain, everything else held constant.

A) increases; less

B) increases; more

C) decreases; less

D) decreases; more

Answer: D
Ques Status: Revised

16) As their relative riskiness ________, the expected return on corporate bonds ________ relative to the expected return on default-free bonds, everything else held constant.

A) increases; increases

B) increases; decreases

C) decreases; decreases

D) decreases; does not change

Answer: B
Ques Status: Revised

17) Which of the following statements are true?

A) A decrease in default risk on corporate bonds lowers the demand for these bonds, but increases the demand for default-free bonds.

B) The expected return on corporate bonds decreases as default risk increases.

C) A corporate bond's return becomes less uncertain as default risk increases.

D) As their relative riskiness increases, the expected return on corporate bonds increases relative to the expected return on default-free bonds.

Answer: B
Ques Status: Previous Edition

18) Everything else held constant, if the federal government were to guarantee today that it will pay creditors if a corporation goes bankrupt in the future, the interest rate on corporate bonds will ________ and the interest rate on Treasury securities will ________.

A) increase; increase

B) increase; decrease

C) decrease; increase

D) decrease; decrease

Answer: C
Ques Status: New

19) Bonds with relatively high risk of default are called

A) Brady bonds.

B) junk bonds.

C) zero coupon bonds.

D) investment grade bonds.

Answer: B
Ques Status: Previous Edition

20) Bonds with relatively low risk of default are called ________ securities and have a rating of Baa (or BBB) and above; bonds with ratings below Baa (or BBB) have a higher default risk and are called ________.

A) investment grade; lower grade

B) investment grade; junk bonds

C) high quality; lower grade

D) high quality; junk bonds

Answer: B
Ques Status: Previous Edition

21) Which of the following bonds would have the highest default risk?

A) Municipal bonds

B) Investment-grade bonds

C) U.S. Treasury bonds

D) Junk bonds

Answer: D
Ques Status: New

22) Which of the following long-term bonds has the highest interest rate?

A) Corporate Baa bonds

B) U.S. Treasury bonds

C) Corporate Aaa bonds

D) Municipal bonds

Answer: A
Ques Status: Previous Edition

23) Which of the following short-term securities has the lowest interest rate?

A) Banker's acceptances

B) U.S. Treasury bills

C) Negotiable certificates of deposit

D) Commercial paper

Answer: B
Ques Status: Previous Edition

24) The bankruptcy of the Enron Corporation

A) did not affect the corporate bond market.

B) increased the perceived riskiness of Treasury securities.

C) reduced the Baa-Aaa spread.

D) increased the Baa-Aaa spread.

Answer: D
Ques Status: Revised

25) The bankruptcy of the Enron Corporation increased the spread between Baa and Aaa rated bonds. This is due to

A) a reduction in risk.

B) a reduction in maturity.

C) a flight to quality.

D) a flight to liquidity.

Answer: C
Ques Status: Revised

26) During a "flight to quality"

A) the spread between Aaa and Baa bonds increases.

B) the spread between Aaa and Baa bonds decreases.

C) the spread between Aaa and Baa bonds is not affected.

D) the change in the spread between Aaa and Baa bonds cannot be predicted.

Answer: A
Ques Status: Revised

27) If you have a very low tolerance for risk, which of the following bonds would you be least likely to hold in your portfolio?

A) a U.S. Treasury bond

B) a municipal bond

C) a corporate bond with a rating of Aaa

D) a corporate bond with a rating of Baa

Answer: D
Ques Status: New

28) The spread between interest rates on low quality corporate bonds and U.S. government bonds

A) widened significantly during the Great Depression.

B) narrowed significantly during the Great Depression.

C) narrowed moderately during the Great Depression.

D) did not change during the Great Depression.

Answer: A
Ques Status: Previous Edition

29) During the Great Depression years 1930–1933 there was a very high rate of business failures and defaults, we would expect the risk premium for ________ bonds to be very high.

A) U.S. Treasury

B) corporate Aaa

C) municipal

D) corporate Baa

Answer: D
Ques Status: New

30) Risk premiums on corporate bonds tend to ________ during business cycle expansions and ________ during recessions, everything else held constant.

A) increase; increase

B) increase; decrease

C) decrease; increase

D) decrease; decrease

Answer: C
Ques Status: New

31) Which of the following statements are true?

A) A liquid asset is one that can be quickly and cheaply converted into cash.

B) The demand for a bond declines when it becomes less liquid, decreasing the interest rate spread between it and relatively more liquid bonds.

C) The differences in bond interest rates reflect differences in default risk only.

D) The corporate bond market is the most liquid bond market.

Answer: A
Ques Status: Revised

32) Corporate bonds are not as liquid as government bonds because

A) fewer corporate bonds for any one corporation are traded, making them more costly to sell.

B) the corporate bond rating must be calculated each time they are traded.

C) corporate bonds are not callable.

D) corporate bonds cannot be resold.

Answer: A
Ques Status: Revised

33) When the Treasury bond market becomes more liquid, other things equal, the demand curve for corporate bonds shifts to the ________ and the demand curve for Treasury bonds shifts to the ________.

A) right; right

B) right; left

C) left; right

D) left; left

Answer: C
Ques Status: Previous Edition

34) A decrease in the liquidity of corporate bonds, other things being equal, shifts the demand curve for corporate bonds to the ________ and the demand curve for Treasury bonds shifts to the ________.

A) right; right

B) right; left

C) left; left

D) left; right

Answer: D
Ques Status: Previous Edition

35) An increase in the liquidity of corporate bonds will ________ the price of corporate bonds and ________ the yield of Treasury bonds, everything else held constant.

A) increase; increase

B) reduce; reduce

C) increase; reduce

D) reduce; increase

Answer: A
Ques Status: Revised

36) The risk premium on corporate bonds reflects the fact that corporate bonds have a higher default risk and are ________ U.S. Treasury bonds.

A) less liquid than

B) less speculative than

C) tax-exempt unlike

D) lower-yielding than

Answer: A
Ques Status: New

37) Everything else held constant, an increase in marginal tax rates would likely have the effect of ________ the demand for municipal bonds, and ________ the demand for U.S. government bonds.

A) increasing; increasing

B) increasing; decreasing

C) decreasing; increasing

D) decreasing; decreasing

Answer: B
Ques Status: Revised

38) Which of the following statements are true?

A) An increase in tax rates will increase the demand for Treasury bonds, lowering their interest rates.

B) Because the tax–exempt status of municipal bonds was of little benefit to bond holders when tax rates were low, they had higher interest rates than U.S. government bonds before World War II.

C) Interest rates on municipal bonds will be higher than comparable bonds without the tax exemption.

D) Because coupon payments on municipal bonds are exempt from federal income tax, the expected after–tax return on them will be higher for individuals in lower income tax brackets.

Answer: B
Ques Status: Revised

39) Everything else held constant, the interest rate on municipal bonds rises relative to the interest rate on Treasury securities when

A) income tax rates are lowered.

B) income tax rates are raised.

C) municipal bonds become more widely traded.

D) corporate bonds become riskier.

Answer: A
Ques Status: Revised

40) Everything else held constant, if income tax rates were lowered, then

A) the interest rate on municipal bonds would fall.

B) the interest rate on Treasury bonds would rise.

C) the interest rate on municipal bonds would rise.

D) the price of Treasury bonds would fall.

Answer: C
Ques Status: Revised

41) Everything else held constant, abolishing all taxes will

A) increase the interest rate on corporate bonds.

B) reduce the interest rate on municipal bonds.

C) increase the interest rate on municipal bonds.

D) increase the interest rate on Treasury bonds.

Answer: C
Ques Status: Revised

42) Municipal bonds have default risk, yet their interest rates are lower than the rates on default–free Treasury bonds. This suggests that

A) the benefit from the tax–exempt status of municipal bonds is less than their default risk.

B) the benefit from the tax–exempt status of municipal bonds equals their default risk.

C) the benefit from the tax–exempt status of municipal bonds exceeds their default risk.

D) Treasury bonds are not default–free.

Answer: C
Ques Status: Revised

43) Everything else held constant, if the tax–exempt status of municipal bonds were eliminated, then

A) the interest rates on municipal bonds would still be less than the interest rate on Treasury bonds.

B) the interest rate on municipal bonds would equal the rate on Treasury bonds.

C) the interest rate on municipal bonds would exceed the rate on Treasury bonds.

D) the interest rates on municipal, Treasury, and corporate bonds would all increase.

Answer: C
Ques Status: Revised

44) Which of the following statements is true?

A) State and local governments cannot default on their bonds.

B) Bonds issued by state and local governments are called municipal bonds.

C) All government issued bonds — local, state, and federal — are federal income tax exempt.

D) The coupon payment on municipal bonds is usually higher than the coupon payment on Treasury bonds.

Answer: B
Ques Status: New

45) Three factors explain the risk structure of interest rates:

A) liquidity, default risk, and the income tax treatment of a security.

B) maturity, default risk, and the income tax treatment of a security.

C) maturity, liquidity, and the income tax treatment of a security.

D) maturity, default risk, and the liquidity of a security.

Answer: A
Ques Status: Revised

46) The spread between the interest rates on Baa corporate bonds and U.S. government bonds is very large during the Great Depression years 1930–1933. Explain this difference using the bond supply and demand analysis.

Answer: During the Great Depression many businesses failed. The default risk for the corporate bond increased compared to the default–free Treasury bond. The demand for corporate bonds decreased while the demand for Treasury bonds increased resulting in a larger risk premium.
Ques Status: New

47) If the federal government where to raise the income tax rates, would this have any impact on a state's cost of borrowing funds? Explain.

Answer: Yes, if the federal government raises income tax rates, demand for municipal bonds which are federal income tax exempt would increase. This would lower the interest rate on the municipal bonds thus lowering the cost to the state of borrowing funds.
Ques Status: New

6.2 Term Structure of Interest Rates

1) The term structure of interest rates is

A) the relationship among interest rates of different bonds with the same maturity.

B) the structure of how interest rates move over time.

C) the relationship among the term to maturity of different bonds.

D) the relationship among interest rates on bonds with different maturities.

Answer: D
Ques Status: Previous Edition

2) A plot of the interest rates on default–free government bonds with different terms to maturity is called

A) a risk–structure curve.

B) a default–free curve.

C) a yield curve.

D) an interest–rate curve.

Answer: C
Ques Status: Revised

3) Differences in ________ explain why interest rates on Treasury securities are not all the same.

A) risk

B) liquidity

C) time to maturity

D) tax characteristics

Answer: C
Ques Status: New

4) Typically, yield curves are

A) gently upward sloping.

B) mound shaped.

C) flat.

D) bowl shaped.

Answer: A
Ques Status: Revised

5) When yield curves are steeply upward sloping,

A) long-term interest rates are above short-term interest rates.

B) short-term interest rates are above long-term interest rates.

C) short-term interest rates are about the same as long-term interest rates.

D) medium-term interest rates are above both short-term and long-term interest rates.

Answer: A
Ques Status: Revised

6) When yield curves are downward sloping,

A) long-term interest rates are above short-term interest rates.

B) short-term interest rates are above long-term interest rates.

C) short-term interest rates are about the same as long-term interest rates.

D) medium-term interest rates are above both short-term and long-term interest rates.

Answer: B
Ques Status: Revised

7) When yield curves are flat,

A) long–term interest rates are above short–term interest rates.

B) short–term interest rates are above long–term interest rates.

C) short–term interest rates are about the same as long–term interest rates.

D) medium–term interest rates are above both short–term and long–term interest rates.

Answer: C
Ques Status: Revised

8) An inverted yield curve

A) slopes up.

B) is flat.

C) slopes down.

D) has a U shape.

Answer: C
Ques Status: Revised

9) According to the expectations theory of the term structure

A) the interest rate on long–term bonds will exceed the average of short–term interest rates that people expect to occur over the life of the long–term bonds, because of their preference for short–term securities.

B) interest rates on bonds of different maturities move together over time.

C) buyers of bonds prefer short–term to long–term bonds.

D) buyers require an additional incentive to hold long–term bonds.

Answer: B
Ques Status: Revised

10) According to the expectations theory of the term structure

A) when the yield curve is steeply upward sloping, short–term interest rates are expected to remain relatively stable in the future.

B) when the yield curve is downward sloping, short–term interest rates are expected to remain relatively stable in the future.

C) investors have strong preferences for short–term relative to long–term bonds, explaining why yield curves typically slope upward.

D) yield curves should be equally likely to slope downward as slope upward.

Answer: D
Ques Status: Revised

11) If the expected path of one–year interest rates over the next five years is 4 percent, 5 percent, 7 percent, 8 percent, and 6 percent, then the expectations theory predicts that today's interest rate on the five–year bond is

A) 4 percent.

B) 5 percent.

C) 6 percent.

D) 7 percent.

Answer: C
Ques Status: Revised

12) If the expected path of 1–year interest rates over the next four years is 5 percent, 4 percent, 2 percent, and 1 percent, then the expectations theory predicts that today's interest rate on the four–year bond is

A) 1 percent.

B) 2 percent.

C) 3 percent.

D) 4 percent.

Answer: C
Ques Status: Revised

13) If the expected path of 1–year interest rates over the next five years is 1 percent, 2 percent, 3 percent, 4 percent, and 5 percent, the expectations theory predicts that the bond with the highest interest rate today is the one with a maturity of

A) two years.

B) three years.

C) four years.

D) five years.

Answer: D
Ques Status: Revised

14) If the expected path of 1–year interest rates over the next five years is 2 percent, 4 percent, 1 percent, 4 percent, and 3 percent, the expectations theory predicts that the bond with the lowest interest rate today is the one with a maturity of

A) one year.

B) two years.

C) three years.

D) four years.

Answer: A
Ques Status: Previous Edition

15) Over the next three years, the expected path of 1-year interest rates is 4, 1, and 1 percent. The expectations theory of the term structure predicts that the current interest rate on 3-year bond is

A) 1 percent.

B) 2 percent.

C) 3 percent.

D) 4 percent.

Answer: B
Ques Status: Revised

16) According to the segmented markets theory of the term structure

A) the interest rate on long-term bonds will equal an average of short-term interest rates that people expect to occur over the life of the long-term bonds.

B) buyers of bonds do not prefer bonds of one maturity over another.

C) interest rates on bonds of different maturities do not move together over time.

D) buyers require an additional incentive to hold long-term bonds.

Answer: C
Ques Status: Revised

17) According to the segmented markets theory of the term structure

A) bonds of one maturity are close substitutes for bonds of other maturities, therefore, interest rates on bonds of different maturities move together over time.

B) the interest rate for each maturity bond is determined by supply and demand for that maturity bond.

C) investors' strong preferences for short-term relative to long-term bonds explains why yield curves typically slope downward.

D) because of the positive term premium, the yield curve will not be observed to be downward-sloping.

Answer: B
Ques Status: Revised

18) According to the liquidity premium theory of the term structure

A) because buyers of bonds may prefer bonds of one maturity over another, interest rates on bonds of different maturities do not move together over time.

B) the interest rate on long-term bonds will equal an average of short-term interest rates that people expect to occur over the life of the long-term bonds plus a term premium.

C) because of the positive term premium, the yield curve will not be observed to be downward sloping.

D) the interest rate for each maturity bond is determined by supply and demand for that maturity bond.

Answer: B
Ques Status: Revised

19) According to the liquidity premium theory of the term structure

A) bonds of different maturities are not substitutes.

B) if yield curves are downward sloping, then short-term interest rates are expected to fall by so much that, even when the positive term premium is added, long-term rates fall below short-term rates.

C) yield curves should never slope downward.

D) interest rates on bonds of different maturities do not move together over time.

Answer: B
Ques Status: Revised

20) The additional incentive that the purchaser of a Treasury security requires to buy a long-term security rather than a short-term security is called the

A) risk premium.

B) term premium.

C) tax premium.

D) market premium.

Answer: B
Ques Status: New

21) If 1-year interest rates for the next three years are expected to be 4, 2, and 3 percent, and the 3-year term premium is 1 percent, than the 3-year bond rate will be

A) 1 percent.

B) 2 percent.

C) 3 percent.

D) 4 percent.

Answer: D
Ques Status: Revised

22) If 1–year interest rates for the next five years are expected to be 4, 2, 5, 4, and 5 percent, and the 5–year term premium is 1 percent, than the 5–year bond rate will be

A) 2 percent.

B) 3 percent.

C) 4 percent.

D) 5 percent.

Answer: D
Ques Status: Revised

23) If the yield curve is flat for short maturities and then slopes downward for longer maturities, the liquidity premium theory (assuming a mild preference for shorter–term bonds) indicates that the market is predicting.

A) a rise in short–term interest rates in the near future and a decline further out in the future.

B) constant short–term interest rates in the near future and a decline further out in the future.

C) a decline in short–term interest rates in the near future and a rise further out in the future.

D) a decline in short–term interest rates in the near future and an even steeper decline further out in the future.

Answer: D
Ques Status: Previous Edition

24) If the yield curve slope is flat, the liquidity premium theory (assuming a mild preference for shorter–term bonds) indicates that the market is predicting

A) a mild rise in short–term interest rates in the near future and a mild decline further out in the future.

B) constant short–term interest rates in the near future and further out in the future.

C) a mild decline in short–term interest rates in the near future and a continuing mild decline further out in the future.

D) constant short–term interest rates in the near future and a mild decline further out in the future.

Answer: C
Ques Status: Previous Edition

25) If the yield curve has a mild upward slope, the liquidity premium theory (assuming a mild preference for shorter–term bonds) indicates that the market is predicting

A) a rise in short–term interest rates in the near future and a decline further out in the future.

B) constant short–term interest rates in the near future and further out in the future.

C) a decline in short–term interest rates in the near future and a rise further out in the future.

D) a decline in short–term interest rates in the near future and an even steeper decline further out in the future.

Answer: B
Ques Status: Previous Edition

26) According to the liquidity premium theory of the term structure, a steeply upward sloping yield curve indicates that short–term interest rates are expected to

A) rise in the future.

B) remain unchanged in the future.

C) decline moderately in the future.

D) decline sharply in the future.

Answer: A
Ques Status: Revised

27) According to the liquidity premium theory of the term structure, a slightly upward sloping yield curve indicates that short–term interest rates are expected to

A) rise in the future.

B) remain unchanged in the future.

C) decline moderately in the future.

D) decline sharply in the future.

Answer: B
Ques Status: Revised

28) According to the liquidity premium theory of the term structure, a flat yield curve indicates that short–term interest rates are expected to

A) rise in the future.

B) remain unchanged in the future.

C) decline moderately in the future.

D) decline sharply in the future.

Answer: C
Ques Status: Revised

29) According to the liquidity premium theory of the term structure, a downward sloping yield curve indicates that short-term interest rates are expected to

A) rise in the future.

B) remain unchanged in the future.

C) decline moderately in the future.

D) decline sharply in the future.

Answer: D
Ques Status: Revised

30) The preferred habitat theory of the term structure is closely related to the

A) expectations theory of the term structure.

B) segmented markets theory of the term structure.

C) liquidity premium theory of the term structure.

D) the inverted yield curve theory of the term structure.

Answer: C
Ques Status: Revised

31) The expectations theory and the segmented markets theory do not explain the facts very well, but they provide the groundwork for the most widely accepted theory of the term structure of interest rates,

A) the Keynesian theory.

B) separable markets theory.

C) liquidity premium theory.

D) the asset market approach.

Answer: C
Ques Status: Previous Edition

32) The ________ of the term structure of interest rates states that the interest rate on a long-term bond will equal the average of short-term interest rates that individuals expect to occur over the life of the long-term bond, and investors have no preference for short-term bonds relative to long-term bonds.

A) segmented markets theory

B) expectations theory

C) liquidity premium theory

D) separable markets theory

Answer: B
Ques Status: Previous Edition

33) In actual practice, short–term interest rates and long–term interest rates usually move together; this is the major shortcoming of the

A) segmented markets theory.

B) expectations theory.

C) liquidity premium theory.

D) separable markets theory.

Answer: A
Ques Status: Revised

34) According to this theory of the term structure, bonds of different maturities are not substitutes for one another.

A) Segmented markets theory

B) Expectations theory

C) Liquidity premium theory

D) Separable markets theory

Answer: A
Ques Status: Previous Edition

35) The ________ of the term structure states the following: the interest rate on a long–term bond will equal an average of short–term interest rates expected to occur over the life of the long–term bond plus a term premium that responds to supply and demand conditions for that bond.

A) segmented markets theory

B) expectations theory

C) liquidity premium theory

D) separable markets theory

Answer: C
Ques Status: Revised

36) A particularly attractive feature of the ________ is that it tells you what the market is predicting about future short–term interest rates by just looking at the slope of the yield curve.

A) segmented markets theory

B) expectations theory

C) liquidity premium theory

D) separable markets theory

Answer: C
Ques Status: Revised

37) According to the liquidity premium theory, a yield curve that is flat means that

A) bond purchasers expect interest rates to rise in the future.

B) bond purchasers expect interest rates to stay the same.

C) bond purchasers expect interest rates to fall in the future.

D) the yield curve has nothing to do with expectations of bond purchasers.

Answer: C
Ques Status: New

38) Economists' attempts to explain the term structure of interest rates

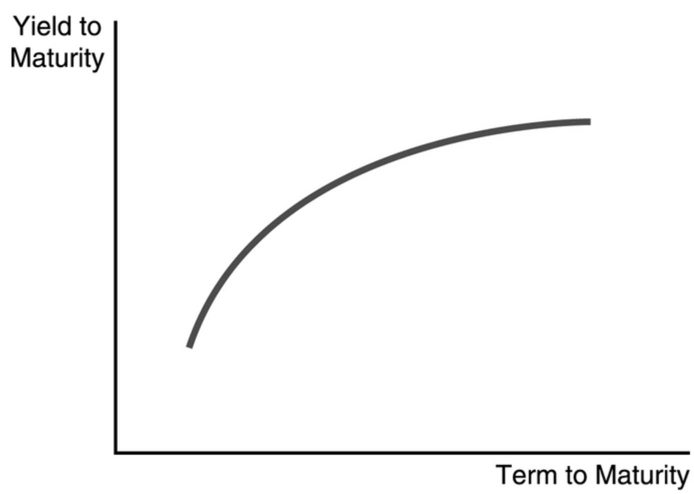
A) illustrate how economists modify theories to improve them when they are inconsistent with the empirical evidence.

B) illustrate how economists continue to accept theories that fail to explain observed behavior of interest rate movements.

C) prove that the real world is a special case that tends to get short shrift in theoretical models.

D) have proved entirely unsatisfactory to date.

Answer: A
Ques Status: Previous Edition



39) The steeply upward sloping yield curve in the figure above indicates that

A) short-term interest rates are expected to rise in the future.

B) short-term interest rates are expected to fall moderately in the future.

C) short-term interest rates are expected to fall sharply in the future.

D) short-term interest rates are expected to remain unchanged in the future.

Answer: A
Ques Status: Previous Edition

40) The steeply upward sloping yield curve in the figure above indicates that ________ interest rates are expected to ________ in the future.

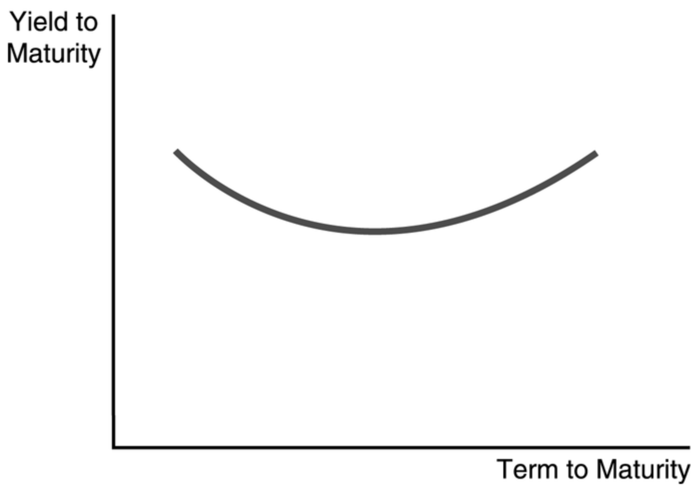
A) short–term; rise

B) short–term; fall moderately

C) short–term; remain unchanged

D) long–term; fall moderately

Answer: A
Ques Status: Revised



41) The U–shaped yield curve in the figure above indicates that short–term interest rates are expected to

A) rise in the near–term and fall later on.

B) fall sharply in the near–term and rise later on.

C) fall moderately in the near–term and rise later on.

D) remain unchanged in the near–term and rise later on.

Answer: B
Ques Status: Previous Edition

42) The U–shaped yield curve in the figure above indicates that the inflation rate is expected to

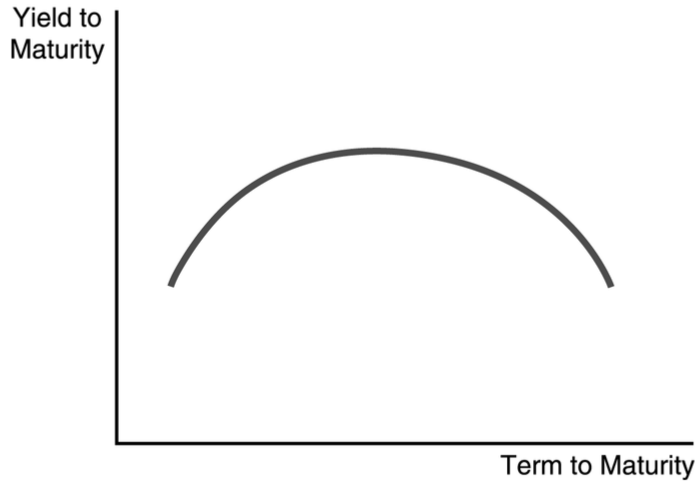
A) remain constant in the near–term and fall later on.

B) fall sharply in the near–term and rise later on.

C) rise moderately in the near–term and fall later on.

D) remain constant in the near–term and rise later on.

Answer: B
Ques Status: Revised



43) The inverted U–shaped yield curve in the figure above indicates that short–term interest rates are expected to

A) rise in the near–term and fall later on.

B) fall moderately in the near–term and rise later on.

C) fall sharply in the near–term and rise later on.

D) remain unchanged in the near–term and fall later on.

Answer: A
Ques Status: Revised

44) The inverted U–shaped yield curve in the figure above indicates that the inflation rate is expected to

A) remain constant in the near–term and fall later on.

B) fall moderately in the near–term and rise later on.

C) rise moderately in the near–term and fall later on.

D) remain unchanged in the near–term and rise later on.

Answer: C
Ques Status: Study Guide

45) An inverted yield curve predicts that short–term interest rates

A) are expected to rise in the future.

B) will rise and then fall in the future.

C) will remain unchanged in the future.

D) will fall in the future.

Answer: D
Ques Status: Revised

46) When short–term interest rates are expected to fall sharply in the future, the yield curve will

A) slope up.

B) be flat.

C) be inverted.

D) be an inverted U shape.

Answer: C
Ques Status: Revised

47) If investors expect interest rates to fall significantly in the future, the yield curve will be inverted. This means that the yield curve has a ________ slope.

A) steep upward

B) slight upward

C) flat

D) downward

Answer: D
Ques Status: New

48) If expectations of the inflation rate increase, what would you expect to happen to the shape of the yield curve? Why?

Answer: The yield curve should have a steep upward slope. Nominal interest rates will increase if the inflation rate increases, therefore, bond purchasers will require a higher term premium to hold the riskier long–term bond.
Ques Status: New

Chapter 7
The Stock Market, the Theory of Rational Expectations, and the Efficient Market Hypothesis

7.1 Computing the Price of Common Stock

1) Stockholders are residual claimants, meaning that they

A) have the first priority claim on all of a company's assets.

B) are liable for all of a company's debts.

C) will never share in a company's profits.

D) receive the remaining cash flow after all other claims are paid.

Answer: D
Ques Status: Revised

2) A stockholder's ownership of a company's stock gives her the right to

A) vote and be the primary claimant of all cash flows.

B) vote and be the residual claimant of all cash flows.

C) manage and assume responsibility for all liabilities.

D) vote and assume responsibility for all liabilities.

Answer: B
Ques Status: Revised

3) Periodic payments of net earnings to shareholders are known as

A) capital gains.

B) dividends.

C) profits.

D) interest.

Answer: B
Ques Status: Revised

4) The value of any investment is found by computing the

A) present value of all future sales.

B) present value of all future liabilities.

C) future value of all future expenses.

D) present value of all future cash flows.

Answer: D
Ques Status: Revised

5) In the one–period valuation model, the value of a share of stock depends upon

A) the present value of both dividends and the expected sales price.

B) only the present value of the future dividends.

C) the actual value of the dividends and expected sales price received in one year.

D) the future value of dividends and the actual sales price.

Answer: A
Ques Status: Revised

6) In the one–period valuation model, the current stock price increases if

A) the expected sales price increases.

B) the expected sales price falls.

C) the required return increases.

D) dividends are cut.

Answer: A
Ques Status: Revised

7) In the one–period valuation model, an increase in the required return

A) increases the expected sales price of a stock.

B) increases the current price of a stock.

C) reduces the expected sales price of a stock.

D) reduces the current price of a stock.

Answer: D
Ques Status: Revised

8) Using the one–period valuation model, assuming a year–end dividend of $0.11, an expected sales price of $110, and a required rate of return of 10%, the current price of the stock would be

A) $110.11.

B) $121.12.

C) $100.10.

D) $100.11

Answer: C
Ques Status: Revised

9) Using the one–period valuation model, assuming a year–end dividend of $1.00, an expected sales price of $100, and a required rate of return of 5%, the current price of the stock would be

A) $110.00.

B) $101.00.

C) $100.00.

D) $96.19.

Answer: D
Ques Status: Revised

10) In the generalized dividend model, if the expected sales price is in the distant future

A) it does not affect the stock price.

B) it is more important than dividends in determining a stock's price.

C) it is equally important with dividends in determining the stock's price.

D) it is less important than dividends but still affects a stock's price.

Answer: A
Ques Status: Revised

11) In the generalized dividend model, a future sales price far in the future does not affect the current stock price because

A) the present value cannot be computed.

B) the present value is almost zero.

C) the sales price does not affect the current price.

D) the stock may never be sold.

Answer: B
Ques Status: Revised

12) In the generalized dividend model, the current stock price is the sum of

A) the actual value of the future dividend stream.

B) the present value of the future dividend stream.

C) the present value of the future dividend stream plus the actual future sales price.

D) the present value of the future sales price.

Answer: B
Ques Status: Revised

13) Using the Gordon growth model, a stock's price will increase if

A) the dividend growth rate increases.

B) the growth rate of dividends falls.

C) the required rate of return rises.

D) the expected sales price rises.

Answer: A
Ques Status: Revised

14) In the Gordon growth model, a decrease in the required rate of return

A) increases the current stock price.

B) increases the future stock price.

C) reduces the future stock price.

D) reduces the current stock price.

Answer: A
Ques Status: Revised

15) Using the Gordon growth formula, if D_1 is \$2.00, k_e is 12% or 0.12, and g is 10% or 0.10, then the current stock price is

A) \$20.

B) \$50.

C) \$100.

D) \$150.

Answer: C
Ques Status: Revised

16) Using the Gordon growth formula, if D_1 is \$1.00, k_e is 10% or 0.10, and g is 5% or 0.05, then the current stock price is

A) \$10.

B) \$20.

C) \$30.

D) \$40.

Answer: B
Ques Status: Revised

17) One of the assumptions of the Gordon Growth Model is that dividends will continue growing at ________ rate.

A) an increasing

B) a fast

C) a constant

D) an escalating

Answer: C
Ques Status: New

18) In the Gordon Growth Model, the growth rate is assumed to be ________ the required return on equity.

A) greater than

B) equal to

C) less than

D) proportional to

Answer: C
Ques Status: New

19) You believe that a corporation's dividends will grow 5% on average into the foreseeable future. If the company's last dividend payment was $5 what should be the current price of the stock assuming a 12% required return?

Answer: Use the Gordon Growth Model.
$\$5(1 + .05)/(.12 - .05) = \$75$
Ques Status: New

20) What rights does ownership interest give stockholders?

Answer: Stockholders have the right to vote on issues brought before the stockholders, be the residual claimant , that is, receive a portion of any net earnings of the corporation, and the right to sell the stock.
Ques Status: New

7.2 How the Market Sets Stock Prices

1) In asset markets, an asset's price is

A) set equal to the highest price a seller will accept.

B) set equal to the highest price a buyer is willing to pay.

C) set equal to the lowest price a seller is willing to accept.

D) set by the buyer willing to pay the highest price.

Answer: D
Ques Status: Revised

2) New information about an asset can result in a decrease in the asset's price due to

A) an expected decrease in the level of future dividends.

B) a decrease in the required rate of return.

C) an expected increase in the dividend growth rate.

D) an expected increase in the future sales price.

Answer: A
Ques Status: Revised

3) Information plays an important role in asset pricing because it allows the buyer to more accurately judge ________.

A) liquidity

B) risk

C) capital

D) policy

Answer: B
Ques Status: New

4) A change in perceived risk of a stock changes

A) the expected dividend growth rate.

B) the expected sales price.

C) the required rate of return.

D) the current dividend.

Answer: C
Ques Status: Revised

5) A stock's price will fall if there is

A) a decrease in perceived risk.

B) an increase in the required rate of return.

C) an increase in the future sales price.

D) current dividends are high.

Answer: B
Ques Status: Revised

6) A monetary expansion ________ stock prices due to a decrease in the ________ and an increase in the ________, everything else held constant.

A) reduces; future sales price; expected rate of return

B) reduces; current dividend; expected rate of return

C) increases; required rate of return; future sales price

D) increases; required rate of return; dividend growth rate

Answer: D
Ques Status: Revised

7) Terrorist attacks on the United States caused

A) a decrease in stock prices due to lower expected growth and greater risk.

B) a decrease in stock prices due to lower expected dividend growth and reduced uncertainty.

C) an increase in stock prices due to an increased required return.

D) an increase in stock prices due to higher expected dividend growth.

Answer: A
Ques Status: Revised

8) Everything else held constant, an increase in uncertainty due to threat of war will

A) increase stock prices due to a higher required return.

B) depress stock prices due to a lower required return.

C) increase stock prices due to a lower required return.

D) depress stock prices due to a higher required return.

Answer: D
Ques Status: Revised

9) Dishonest corporate accounting procedures caused stock prices to

A) increase due to higher expected dividend growth and higher future sales price.

B) decrease due to lower expected dividend growth and lower required return.

C) decrease due to lower expected dividend growth and higher required return.

D) increase due to higher expected dividend growth and lower required return.

Answer: C
Ques Status: Revised

7.3 The Theory of Rational Expectations

1) Economists have focused more attention on the formation of expectations in recent years. This increase in interest can probably best be explained by the recognition that

A) expectations influence the behavior of participants in the economy and thus have a major impact on economic activity.

B) expectations influence only a few individuals, have little impact on the overall economy, but can have important effects on a few markets.

C) expectations influence many individuals, have little impact on the overall economy, but can have distributional effects.

D) models that ignore expectations have little predictive power, even in the short run.

Answer: A
Ques Status: Previous Edition

2) The view that expectations change relatively slowly over time in response to new information is known in economics as

A) rational expectations.

B) irrational expectations.

C) slow–response expectations.

D) adaptive expectations.

Answer: D
Ques Status: Previous Edition

3) If expectations of the future inflation rate are formed solely on the basis of a weighted average of past inflation rates, then economics would say that expectation formation is

A) irrational.

B) rational.

C) adaptive.

D) reasonable.

Answer: C
Ques Status: Revised

4) The major criticism of the view that expectations are formed adaptively is that

A) this view ignores that people use more information than just past data to form their expectations.

B) it is easier to model adaptive expectations than it is to model rational expectations.

C) adaptive expectations models have no predictive power.

D) people are irrational and therefore never learn from past mistakes.

Answer: A
Ques Status: Previous Edition

5) If expectations are formed adaptively, then people

A) use more information than just past data on a single variable to form their expectations of that variable.

B) often change their expectations quickly when faced with new information.

C) use only the information from past data on a single variable to form their expectations of that variable.

D) never change their expectations once they have been made.

Answer: C
Ques Status: Revised

6) In rational expectations theory, the term "optimal forecast" is essentially synonymous with

A) correct forecast.

B) the correct guess.

C) the actual outcome.

D) the best guess.

Answer: D
Ques Status: Previous Edition

7) If a forecast made using all available information is not perfectly accurate, then it is

A) still a rational expectation.

B) not a rational expectation.

C) an adaptive expectation.

D) a second–best expectation.

Answer: A
Ques Status: New

8) If additional information is not used when forming an optimal forecast because it is not available at that time, then expectations are

A) obviously formed irrationally.

B) still considered to be formed rationally.

C) formed adaptively.

D) formed equivalently.

Answer: B
Ques Status: Revised

9) An expectation may fail to be rational if

A) relevant information was not available at the time the forecast is made.

B) relevant information is available but ignored at the time the forecast is made.

C) information changes after the forecast is made.

D) information was available to insiders only.

Answer: B
Ques Status: New

10) According to rational expectations theory, forecast errors of expectations

A) are more likely to be negative than positive.

B) are more likely to be positive than negative.

C) tend to be persistently high or low.

D) are unpredictable.

Answer: D
Ques Status: Previous Edition

11) Rational expectations forecast errors will on average be ________ and therefore ________ be predicted ahead of time.

A) positive; can

B) positive; cannot

C) negative; can

D) zero; cannot

Answer: D
Ques Status: Revised

12) People have a strong incentive to form rational expectations because

A) they are guaranteed of success in the stock market.

B) it is costly not to do so.

C) it is costly to do so.

D) everyone wants to be rational.

Answer: B
Ques Status: Revised

13) If market participants notice that a variable behaves differently now than in the past, then, according to rational expectations theory, we can expect market participants to

A) change the way they form expectations about future values of the variable.

B) begin to make systematic mistakes.

C) no longer pay close attention to movements in this variable.

D) give up trying to forecast this variable.

Answer: A
Ques Status: Previous Edition

14) According to rational expectations,

A) expectations of inflation are viewed as being an average of past inflation rates.

B) expectations of inflation are viewed as being an average of expected future inflation rates.

C) expectations formation indicates that changes in expectations occur slowly over time as past data change.

D) expectations will not differ from optimal forecasts using all available information.

Answer: D
Ques Status: Previous Edition

15) During the past decade, the average rate of monetary growth has been 5%, and the average inflation rate has been 5%. Everything else held constant, if the Federal Reserve announces that the new rate of monetary growth will be 10%, the rational expectation forecast of the inflation rate will be

A) 5%.

B) between 5 and 10%.

C) less than 5%.

D) 10%.

E) more than 10%.

Answer: D
Ques Status: Previous Edition

16) Suppose Barbara looks out in the morning and sees a clear sky so decides that a picnic for lunch is a good idea. Last night the weather forecast included a 100% chance of rain by midday but Barbara does not watch the local news program. Is Barbara's prediction of good weather at lunchtime rational? Why or why not?

Answer: No, this prediction is not using rational expectations. Although Barbara based her guess on the information that was available to her at the time, additional information was readily available that could have been used to improve her prediction.
Ques Status: New

7.4 The Efficient Market Hypothesis: Rational Expectations in Financial Markets

1) The theory of rational expectations, when applied to financial markets, is known as

   A) monetarism.

   B) the efficient markets hypothesis.

   C) the theory of strict liability.

   D) the theory of impossibility.

   Answer: B
   Ques Status: Revised

2) Another way to state the efficient markets condition is: in an efficient market,

   A) unexploited profit opportunities will be quickly eliminated.

   B) unexploited profit opportunities will never exist.

   C) arbitrageurs guarantee that unexploited profit opportunities never exist.

   D) every financial market participant must be well informed about securities.

   Answer: A
   Ques Status: Revised

3) According to the efficient markets hypothesis, the current price of a financial security:

   A) is the discounted net present value of future interest payments.

   B) is determined by the highest successful bidder.

   C) fully reflects all available relevant information.

   D) is a result of none of the above.

   Answer: C
   Ques Status: Revised

4) According to the efficient markets hypothesis, the best strategy for betting on an athletic tournament, such as the NCAA basketball tournaments, is to

   A) randomly pick the winners in each round.

   B) watch as many games as possible on television so you are as well informed as the "experts."

   C) always select the underdog to win.

   D) select the highest seeded team to win each round.

   Answer: D
   Ques Status: Revised

5) If the optimal forecast of the return on a security exceeds the equilibrium return, then:

A) the market is inefficient.

B) no unexploited profit opportunities exist.

C) the market is in equilibrium.

D) the market is myopic.

Answer: A
Ques Status: Revised

6) The efficient markets hypothesis suggests that if an unexploited profit opportunity arises in an efficient market,

A) it will tend to go unnoticed for some time.

B) it will be quickly eliminated.

C) financial analysts are your best source of this information.

D) prices will reflect the unexploited profit opportunity.

Answer: B
Ques Status: Previous Edition

7) Financial markets quickly eliminate unexploited profit opportunities through changes in

A) dividend payments.

B) tax laws.

C) asset prices.

D) monetary policy.

Answer: C
Ques Status: Revised

8) The elimination of unexploited profit opportunities requires that ________ market participants be well informed.

A) all

B) a few

C) zero

D) many

Answer: B
Ques Status: New

9) If a corporation announces that it expects quarterly earnings to increase by 25% and it actually sees an increase of 22%, what should happen to the price of the corporation's stock if the efficient markets hypothesis holds, everything else held constant?

Answer: The stock's price should fall. The price had adjusted based on the statement of expected earnings. When the actual number turned out to be lower than expected, the stock price changes to reflect the additional information.
Ques Status: New

7.5 Evidence on the Efficient Market Hypothesis

1) If a mutual fund outperforms the market in one period, evidence suggests that this fund is

A) highly likely to consistently outperform the market in subsequent periods due to its superior investment strategy.

B) likely to under–perform the market in subsequent periods to average its overall returns.

C) not likely to consistently outperform the market in subsequent periods.

D) not likely to outperform the market in any subsequent period.

Answer: C
Ques Status: Revised

2) Studies of mutual fund performance indicate that mutual funds that outperformed the market in one time period usually

A) beat the market in the next time period.

B) beat the market in the next two subsequent time periods.

C) beat the market in the next three subsequent time periods.

D) do not beat the market in the next time period.

Answer: D
Ques Status: Previous Edition

3) The number and availability of discount brokers has grown rapidly since the mid–1970s. The efficient markets hypothesis predicts that people who use discount brokers

A) will likely earn lower returns than those who use full–service brokers.

B) will likely earn about the same as those who use full–service brokers, but will net more after brokerage commissions.

C) are going against evidence suggesting that full–service brokers can help outperform the market.

D) are likely to outperform the market by a wide margin.

Answer: B
Ques Status: Revised

4) Sometimes one observes that the price of a company's stock falls after the announcement of favorable earnings. This phenomenon is

A) clearly inconsistent with the efficient markets hypothesis.

B) consistent with the efficient markets hypothesis if the earnings were not as high as anticipated.

C) consistent with the efficient markets hypothesis if the earnings were not as low as anticipated.

D) consistent with the efficient markets hypothesis if the favorable earnings were expected.

Answer: B
Ques Status: Revised

5) You read a story in the newspaper announcing the proposed merger of Dell Computer and Gateway. The merger is expected to greatly increase Gateway's profitability. If you decide to invest in Gateway stock, you can expect to earn

A) above average returns since you will share in the higher profits.

B) above average returns since your stock price will definitely appreciate as higher profits are earned.

C) below average returns since computer makers have low profit rates.

D) a normal return since stock prices adjust to reflect expected changes in profitability almost immediately.

Answer: D
Ques Status: Revised

6) To say that stock prices follow a "random walk" is to argue that stock prices

A) rise, then fall, then rise again.

B) rise, then fall in a predictable fashion.

C) tend to follow trends.

D) cannot be predicted based on past trends.

Answer: D
Ques Status: Previous Edition

7) The efficient markets hypothesis predicts that stock prices follow a "random walk." The implication of this hypothesis for investing in stocks is

A) a "churning strategy" of buying and selling often to catch market swings.

B) turning over your stock portfolio each month, selecting stocks by throwing darts at the stock page.

C) a "buy and hold strategy" of holding stocks to avoid brokerage commissions.

D) following the advice of technical analysts.

Answer: C
Ques Status: Revised

8) Rules used to predict movements in stock prices based on past patterns are, according to the efficient markets hypothesis,

A) a waste of time.

B) profitably employed by all financial analysts.

C) the most efficient rules to employ.

D) consistent with the random walk hypothesis.

Answer: A
Ques Status: Previous Edition

9) Tests used to rate the performance of rules developed in technical analysis conclude that technical analysis

A) outperforms the overall market.

B) far outperforms the overall market, suggesting that stockbrokers provide valuable services.

C) does not outperform the overall market.

D) does not outperform the overall market, suggesting that stockbrokers do not provide services of any value.

Answer: C
Ques Status: Previous Edition

10) Which of the following accurately summarize the empirical evidence about technical analysis?

A) Technical analysts fare no better than other financial analysis—on average they do not outperform the market.

B) Technical analysts tend to outperform other financial analysis, but on average they nevertheless under-perform the market.

C) Technical analysts fare no better than other financial analysis, and like other financial analysts they outperform the market.

D) Technical analysts fare no better than other financial analysis, and like other financial analysts they under-perform the market.

Answer: A
Ques Status: Previous Edition

11) The small-firm effect refers to the

A) negative returns earned by small firms.

B) returns equal to large firms earned by small firms.

C) abnormally high returns earned by small firms.

D) low returns after adjusting for risk earned by small firms.

Answer: C
Ques Status: Revised

12) The January effect refers to the fact that

A) most stock market crashes have occurred in January.

B) stock prices tend to fall in January.

C) stock prices have historically experienced abnormal price increases in January.

D) the football team winning the Super Bowl accurately predicts the behavior of the stock market for the next year.

Answer: C
Ques Status: Revised

13) When a corporation announces a major decline in earnings, the stock price may initially decline significantly and then rise back to normal levels over the next few weeks. This impact is called ________.

A) the January effect

B) mean reversion

C) market overreaction

D) the small–firm effect

Answer: C
Ques Status: New

14) A phenomenon closely related to market overreaction is

A) the random walk.

B) the small–firm effect.

C) the January effect.

D) excessive volatility.

Answer: D
Ques Status: Revised

15) Excessive volatility refers to the fact that

A) stock returns display mean reversion.

B) stock prices can be slow to react to new information.

C) stock price tend to rise in the month of January.

D) stock prices fluctuate more than is justified by dividend fluctuations.

Answer: D
Ques Status: Revised

16) Mean reversion refers to the fact that

A) small firms have higher than average returns.

B) stocks that have had low returns in the past are more likely to do well in the future.

C) stock returns are high during the month of January.

D) stock prices fluctuate more than is justified by fundamentals.

Answer: B
Ques Status: Revised

17) Evidence in support of the efficient markets hypothesis includes

A) the failure of technical analysis to outperform the market.

B) the small–firm effect.

C) the January effect.

D) excessive volatility.

Answer: A
Ques Status: Revised

18) Evidence against market efficiency includes

A) failure of technical analysis to outperform the market.

B) the random walk behavior of stock prices.

C) the inability of mutual fund managers to consistently beat the market.

D) the January effect.

Answer: D
Ques Status: Revised

19) The efficient markets hypothesis suggests that allocating your funds in the financial markets on the advice of a financial analyst

A) will certainly mean higher returns than if you had made selections by throwing darts at the financial page.

B) will always mean lower returns than if you had made selections by throwing darts at the financial page.

C) is not likely to prove superior to a strategy of making selections by throwing darts at the financial page.

D) is good for the economy.

Answer: C
Ques Status: Previous Edition

20) According to the efficient markets hypothesis, purchasing the reports of financial analysts

A) is likely to increase one's returns by an average of 10%.

B) is likely to increase one's returns by about 3 to 5%.

C) is not likely to be an effective strategy for increasing financial returns.

D) is likely to increase one's returns by an average of about 2 to 3%.

Answer: C
Ques Status: Revised

21) Which of the following types of information most likely allows the exploitation of a profit opportunity?

A) Financial analysts' published recommendations

B) Technical analysis

C) Hot tips from a stockbroker

D) Insider information

Answer: D
Ques Status: Previous Edition

22) The advantage of a "buy–and–hold strategy" is that

A) net profits will tend to be higher because there will be fewer brokerage commissions.

B) losses will eventually be eliminated.

C) the longer a stock is held, the higher will be its price.

D) profits are guaranteed.

Answer: A
Ques Status: Revised

23) For small investors, the best way to pursue a "buy and hold" strategy is to

A) buy and sell individual stocks frequently.

B) buy no–load mutual funds with high management fees.

C) buy no–load mutual funds with low management fees.

D) buy load mutual funds.

Answer: C
Ques Status: Revised

24) The efficient markets hypothesis indicates that investors

A) can use the advice of technical analysts to outperform the market.

B) do better on average if they adopt a "buy and hold" strategy.

C) let too many unexploited profit opportunities go by if they adopt a "buy and hold" strategy.

D) do better if they purchase loaded mutual funds.

Answer: B
Ques Status: Revised

25) The efficient markets hypothesis suggests that investors

A) should purchase no-load mutual funds which have low management fees.

B) can use the advice of technical analysts to outperform the market.

C) let too many unexploited profit opportunities go by if they adopt a "buy and hold" strategy.

D) act on all "hot tips" they hear.

Answer: A
Ques Status: Revised

26) The tech stock crash of 2000 is evidence in support of

A) the efficient markets hypothesis.

B) a rational bubble.

C) rational expectations.

D) the small-firm effect.

Answer: B
Ques Status: Revised

27) A situation when an asset price differs from its fundamental value is

A) a random walk.

B) an inflation.

C) a deflation.

D) a bubble.

Answer: D
Ques Status: Revised

28) In a rational bubble, investors can have ________ expectations.

A) irrational

B) adaptive

C) rational

D) myopic

Answer: C
Ques Status: Revised

29) Your best friend calls and gives you the latest stock market "hot tip" that he heard at the health club. Should you act on this information? Why or why not?

Answer: No, if this information is readily available it will already be reflected in the stock price.
Ques Status: New

7.6 Evidence on Rational Expectations in Other Markets

1) Tests of rational expectations in markets other than financial markets required the use of survey data from market participants. One problem with using survey data is

A) it is not readily available.

B) the responses are not always reliable.

C) it leads to market churning.

D) it requires the use of a technical analyst.

Answer: B
Ques Status: New

2) Survey evidence may be a poor guide to market behavior because

A) a market's behavior may not be equally influenced by the expectations of all the survey participants.

B) survey questions are ambiguous.

C) the survey takers record answers however they want to.

D) the survey has too many participants.

Answer: A
Ques Status: New

3) Survey evidence does conclusively show that

A) people are always truthful when filling out a survey.

B) every participant in a market must react for the market price to change.

C) if the way a variable moves changes, the way expectations of this variable are formed will change also.

D) surveys are always reliable.

Answer: C
Ques Status: New

7.7 Behavioral Finance

1) ________ occurs when people are more unhappy when they suffer losses than they are happy when they achieve gains.

A) Loss fundamentals

B) Loss aversion

C) Loss leader

D) Loss cycle

Answer: B
Ques Status: New

2) Psychologists have found that people tend to be ________ in their own judgments.

A) underconfident

B) overconfident

C) indecisive

D) insecure

Answer: B
Ques Status: New

3) ________ and ________ may provide an explanation for stock market bubbles.

A) Overconfidence; social contagion

B) Underconfidence; social contagion

C) Overconfidence; social isolationism

D) Underconfidence; social isolationism

Answer: A
Ques Status: New

Chapter 8

An Economic Analysis of Financial Structure

8.1 Basic Facts About Financial Structure Throughout the World

1) American businesses get their external funds primarily from

A) bank loans.

B) bonds and commercial paper issues.

C) stock issues.

D) other loans.

Answer: A
Ques Status: Previous Edition

2) Of the sources of external funds for nonfinancial businesses in the United States, loans from banks and other financial intermediaries account for approximately ________ of the total.

A) 6%

B) 40%

C) 56%

D) 60%

Answer: C
Ques Status: Revised

3) Of the sources of external funds for nonfinancial businesses in the United States, corporate bonds and commercial paper account for approximately ________ of the total.

A) 5%

B) 10%

C) 32%

D) 50%

Answer: C
Ques Status: Revised

4) Of the following sources of external finance for American nonfinancial businesses, the least important is

A) loans from banks.

B) stocks.

C) bonds and commercial paper.

D) loans from other financial intermediaries.

Answer: B
Ques Status: Previous Edition

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

A) 2%

B) 11%

C) 20%

D) 40%

Answer: B
Ques Status: Revised

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

A) Stocks are a far more important source of finance than are bonds.

B) Stocks and bonds, combined, supply less than one-half of the external funds.

C) Financial intermediaries such as banks are the least important source of external funds for businesses.

D) Since 1970, more than half of the new issues of stock have been sold to American households.

Answer: B
Ques Status: Revised

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

A) Issuing marketable securities is the primary way that they finance their activities.

B) Bonds are the least important source of external funds to finance their activities.

C) Stocks are a relatively unimportant source of finance for their activities.

D) Selling bonds directly to the American household is a major source of funding for American businesses.

Answer: C
Ques Status: Revised

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

A) Marketable securities account for a larger share of external business financing in the United States than in most other countries.

B) Since 1970, most of the newly issued corporate bonds and commercial paper have been sold directly to American households.

C) Direct finance accounts for more than 50 percent of the external financing of American businesses.

D) Smaller businesses almost always raise funds by issuing marketable securities.

Answer: A
Ques Status: Revised

9) Nonfinancial businesses in Germany, Japan, and Canada raise most of their funds

A) by issuing stock.

B) by issuing bonds.

C) from nonbank loans.

D) from bank loans.

Answer: D
Ques Status: Revised

10) As a source of funds for nonfinancial businesses, stocks are relatively more important in

A) the United States.

B) Germany.

C) Japan.

D) Canada.

Answer: D
Ques Status: Revised

11) Regulation of the financial system

A) occurs only in the United States.

B) protects the jobs of employees of financial institutions.

C) protects the wealth of owners of financial institutions.

D) ensures the stability of the financial system.

Answer: D
Ques Status: Revised

12) One purpose of regulation of financial markets is to

A) limit the profits of financial institutions.

B) increase competition among financial institutions.

C) promote the provision of information to shareholders, depositors and the public.

D) guarantee that the maximum rates of interest are paid on deposits.

Answer: C
Ques Status: Revised

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

A) collateral.

B) points.

C) interest.

D) good faith money.

Answer: A
Ques Status: Previous Edition

14) Commercial and farm mortgages, in which property is pledged as collateral, account for

A) one-quarter of borrowing by nonfinancial businesses.

B) one-half of borrowing by nonfinancial businesses.

C) one-twentieth of borrowing by nonfinancial businesses.

D) two-thirds of borrowing by nonfinancial businesses.

Answer: A
Ques Status: Previous Edition

15) The predominant form of household debt is

A) consumer installment debt.

B) collateralized debt.

C) unsecured debt.

D) unrestricted debt.

Answer: B
Ques Status: Revised

16) Collateralized debt is also know as

A) unsecured debt.

B) secured debt.

C) unrestricted debt.

D) promissory debt.

Answer: B
Ques Status: Revised

17) Credit card debt is

A) secured debt.

B) unsecured debt.

C) restricted debt.

D) unrestricted debt.

Answer: B
Ques Status: Revised

18) If you default on your auto loan, your car will be repossessed because it has been pledged as ________ for the loan.

A) interest

B) collateral

C) dividend

D) commodity

Answer: B
Ques Status: New

19) A ________ is a provision that restricts or specifies certain activities that a borrower can engage in.

A) residual claimant

B) risk hedge

C) restrictive barrier

D) restrictive covenant

Answer: D
Ques Status: New

20) A clause in a mortgage loan contract requiring the borrower to purchase homeowner's insurance is an example of a

A) proscriptive covenant.

B) prescriptive covenant.

C) restrictive covenant.

D) constraint–imposed covenant.

Answer: C
Ques Status: Previous Edition

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

A) Stocks are the most important source of finance for American businesses.

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

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

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

Answer: A
Ques Status: Previous Edition

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

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

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

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

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

Answer: B
Ques Status: Previous Edition

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

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

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

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

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

Answer: C
Ques Status: Previous Edition

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

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

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

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

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

Answer: D
Ques Status: Previous Edition

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

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

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

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

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

Answer: C
Ques Status: Revised

8.2 Transaction Costs

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

A) adapt to continually changing government regulations.

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

C) reduce transaction costs.

D) cartelize the provision of financial services.

Answer: C
Ques Status: Previous Edition

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

A) discounting.

B) economies of scale.

C) economies of trade.

D) diversification.

Answer: B
Ques Status: Revised

3) Which of the following is not a benefit to an individual purchasing a mutual fund?

A) reduced risk

B) lower transactions costs

C) free–riding

D) diversification

Answer: C
Ques Status: New

4) Financial intermediaries develop ________ in things such as computer technology which allows them to lower transactions costs.

A) expertise

B) diversification

C) regulations

D) equity

Answer: A
Ques Status: New

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

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

8.3 Asymmetric Information: Adverse Selection and Moral Hazard

1) A borrower who takes out a loan usually has better information about the potential returns and risk of the investment projects he plans to undertake than does the lender. This inequality of information is called

A) moral hazard.

B) asymmetric information.

C) noncollateralized risk.

D) adverse selection.

Answer: B
Ques Status: Previous Edition

2) If bad credit risks are the ones who most actively seek loans and, therefore, receive them from financial intermediaries, then financial intermediaries face the problem of

A) moral hazard.

B) adverse selection.

C) free–riding.

D) costly state verification.

Answer: B
Ques Status: Previous Edition

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

A) adverse selection; moral hazard

B) moral hazard; adverse selection

C) costly state verification; free–riding

D) free–riding; costly state verification

Answer: A
Ques Status: Previous Edition

4) The presence of ________ in financial markets leads to adverse selection and moral hazard problems that interfere with the efficient functioning of financial markets.

A) noncollateralized risk

B) free–riding

C) asymmetric information

D) costly state verification

Answer: C
Ques Status: Previous Edition

5) The analysis of how asymmetric information problems affect economic behavior is called ________ theory.

A) uneven

B) parallel

C) principal

D) agency

Answer: D
Ques Status: New

8.4 The Lemons Problem: How Adverse Selection Influences Financial Structure

1) The "lemons problem" exists because of

A) transactions costs.

B) economies of scale.

C) rational expectations.

D) asymmetric information.

Answer: D
Ques Status: Revised

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

A) equal to the price of a lemon.

B) less than the price of a lemon.

C) equal to the price of a peach.

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

Answer: D
Ques Status: Revised

3) The free-rider problem occurs because

A) people who pay for information use it freely.

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

C) information can never be sold at any price.

D) it is never profitable to produce information.

Answer: B
Ques Status: Revised

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

A) free–rider; adverse selection

B) free–rider; moral hazard

C) principal–agent; adverse selection

D) principal–agent; moral hazard

Answer: A
Ques Status: Revised

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

A) transactions costs.

B) the need for diversification.

C) the adverse selection problem.

D) economies of scale.

Answer: C
Ques Status: Revised

6) A lesson of the Enron collapse is that government regulation

A) always fails.

B) can reduce but not eliminate asymmetric information.

C) increases the problem of asymmetric information.

D) should be reduced.

Answer: B
Ques Status: Revised

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

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

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

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

D) the lender's inability to restrict the borrower from changing his behavior once given a loan.

Answer: A
Ques Status: Revised

8) Because of the adverse selection problem,

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

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

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

D) lenders will write debt contracts that restrict certain activities of borrowers.

Answer: C
Ques Status: Previous Edition

9) In the United States, the government agency requiring that firms that sell securities in public markets adhere to standard accounting principles and disclose information about their sales, assets, and earnings is the

A) Federal Communications Commission.

B) Federal Trade Commission.

C) Securities and Exchange Commission.

D) Federal Reserve System.

Answer: C
Ques Status: Revised

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

A) have been afforded special government treatment, since used car dealers do not provide information that is valued by consumers of used cars.

B) are able to prevent potential competitors from free–riding off the information that they provide.

C) have failed to solve adverse selection problems in this market because "lemons" continue to be traded.

D) have solved the moral hazard problem by providing valuable information to their customers.

Answer: B
Ques Status: Revised

11) The concept of adverse selection helps to explain all of the following except

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

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

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

D) why the financial system is so heavily regulated.

Answer: C
Ques Status: Revised

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

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

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

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

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

Answer: A
Ques Status: Revised

13) The problem of adverse selection helps to explain

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

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

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

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

Answer: A
Ques Status: Revised

14) That only large, well–established corporations have access to securities markets

A) explains why indirect finance is such an important source of external funds for businesses.

B) can be explained by the problem of moral hazard.

C) can be explained by government regulations that prohibit small firms from acquiring funds in securities markets.

D) explains why newer and smaller corporations rely so heavily on the new issues market for funds.

Answer: A
Ques Status: Revised

15) The concept of adverse selection helps to explain

A) why collateral is not a common feature of many debt contracts.

B) why large, well–established corporations find it so difficult to borrow funds in securities markets.

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

D) why stocks are the most important source of external financing for businesses.

Answer: C
Ques Status: Revised

16) As information technology improves, the lending role of financial institutions such as banks should ________.

A) increase somewhat

B) decrease

C) stay the same

D) increase significantly

Answer: B
Ques Status: New

17) Net worth can perform a similar role to ________.

A) diversification

B) collateral

C) intermediation

D) economies of scale

Answer: B
Ques Status: New

18) How does collateral help to reduce the adverse selection problem in credit market?

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

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

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

A) principal–agent

B) adverse selection

C) free–rider

D) debt deflation

Answer: A
Ques Status: Previous Edition

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

A) principals; agents

B) principals; principals

C) agents; agents

D) agents; principals

Answer: D
Ques Status: Previous Edition

3) The principal–agent problem

A) occurs when managers have more incentive to maximize profits than the stockholders–owners do.

B) in financial markets helps to explain why equity is a relatively important source of finance for American business.

C) would not arise if the owners of the firm had complete information about the activities of the managers.

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

Answer: C
Ques Status: Revised

4) A problem for equity contracts is a particular type of ________ called the ________ problem.

A) adverse selection; principal–agent

B) moral hazard; principal–agent

C) adverse selection; free–rider

D) moral hazard; free–rider

Answer: B
Ques Status: Revised

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

A) the free–rider problem.

B) the adverse selection problem.

C) the principal–agent problem.

D) the "lemons problem."

Answer: C
Ques Status: Revised

6) Equity contracts

A) are claims to a share in the profits and assets of a business.

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

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

D) are not subject to the moral hazard problem.

Answer: A
Ques Status: Revised

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

A) laws that force firms to adhere to standard accounting principles.

B) light sentences for those who commit the fraud of hiding and stealing profits.

C) state verification subsidies.

D) state licensing restrictions.

Answer: A
Ques Status: Revised

8) One financial intermediary in our financial structure that helps to reduce the moral hazard from arising from the principal–agent problem is the

A) venture capital firm.

B) money market mutual fund.

C) pawn broker.

D) savings and loan association.

Answer: A
Ques Status: Previous Edition

9) A venture capital firm protects its equity investment from moral hazard through which of the following means?

A) It places people on the board of directors to better monitor the borrowing firm's activities.

B) It writes contracts that prohibit the sale of an equity investment to the venture capital firm.

C) It prohibits the borrowing firm from replacing its management.

D) It requires a 50% stake in the company.

Answer: A
Ques Status: Revised

10) Because information is scarce

A) helps explain why equity contracts are used so much more frequently to raise capital than are debt contracts.

B) monitoring managers gives rise to costly state verification.

C) government regulations, such as standard accounting principles, have no impact on problems such as moral hazard.

D) developing nations do not rely heavily on banks for business financing.

Answer: B
Ques Status: Revised

11) Debt contracts

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

B) have a higher cost of state verification than equity contracts..

C) are used less frequently to raise capital than are equity contracts.

D) never result in a loss for the lender.

Answer: A
Ques Status: Revised

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

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

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

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

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

Answer: A
Ques Status: Revised

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

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

8.6 How Moral Hazard Influences Financial Structure in Debt Markets

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

A) collateralizes the debt contract.

B) makes the debt contract incentive compatible.

C) state verifies the debt contract.

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

Answer: B
Ques Status: Revised

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

A) requiring the state to verify the debt contract.

B) collateralizing the debt contract.

C) making the debt contract incentive compatible.

D) giving the debt contract characteristics of equity contracts.

Answer: C
Ques Status: Previous Edition

3) A debt contract is incentive compatible

A) if the borrower has the incentive to behave in the way that the lender expects and desires, since doing otherwise jeopardizes the borrower's net worth in the business.

B) if the borrower's net worth is sufficiently low so that the lender's risk of moral hazard is significantly reduced.

C) if the debt contract is treated like an equity.

D) if the lender has the incentive to behave in the way that the borrower expects and desires.

Answer: A
Ques Status: Revised

4) Solutions to the moral hazard problem include

A) low net worth.

B) monitoring and enforcement of restrictive covenants.

C) greater reliance on equity contracts and less on debt contracts.

D) greater reliance on debt contracts than financial intermediaries.

Answer: B
Ques Status: Revised

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

A) limited-liability clauses.

B) risk insurance.

C) restrictive covenants.

D) illegal.

Answer: C
Ques Status: Revised

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

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

B) they are inexpensive to monitor and enforce.

C) too many resources may be devoted to monitoring and enforcing them, as debtholders duplicate others' monitoring and enforcement efforts.

D) they reduce the value of the debt contract.

Answer: A
Ques Status: Revised

7) A clause in a debt contract requiring that the borrower purchase insurance against loss of the asset financed with the loan is called a

   A) collateral–insurance clause.

   B) prescription covenant.

   C) restrictive covenant.

   D) proscription covenant.

   Answer: C
   Ques Status: Previous Edition

8) For restrictive covenants to help reduce the moral hazard problem they must be ________ by the lender.

   A) monitored and enforced

   B) written in all capitals

   C) easily changed

   D) impossible to remove

   Answer: A
   Ques Status: New

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

   A) the existence of the free–rider problem for traded securities helps to explain why banks play a predominant role in financing the activities of businesses.

   B) while free–rider problems limit the extent to which securities markets finance some business activities, nevertheless the majority of funds going to businesses are channeled through securities markets.

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

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

   Answer: A
   Ques Status: Previous Edition

10) Why does the free–rider problem occur in the debt market?

   Answer: Restrictive covenants can reduce moral hazard but they must be monitored and enforced to be effective. If bondholders know that other bondholders are monitoring and enforcing the restrictive covenants, they can free ride. Other bondholders will follow suit resulting in not enough resources devoted to monitoring and enforcing restrictive covenants.
   Ques Status: New

8.7 Conflicts of Interest

1) The presence of economies of scope may benefit financial institutions but may create potential costs from ________.

A) conflicts of interest

B) multiple profitable enterprises

C) economies of scale

D) unsecured debt

Answer: A
Ques Status: New

2) Because conflicts of interest increase asymmetric information problems

A) the economy will not operate as efficiently.

B) loans will not be made.

C) banks will not be able to make a profit.

D) the financial markets will operate more smoothly.

Answer: A
Ques Status: New

3) The practice of ________ is allocating initially underpriced initial public offerings to executives in companies the investment bank hopes to do underwriting business with in the future.

A) discounting

B) spinning

C) peppering

D) wiring

Answer: B
Ques Status: New

4) The Sarbanes–Oxley Act of 2002 increased supervisory oversight by

A) giving the FDIC the authority to review independent audits.

B) increasing the SEC's budget to supervise securities markets.

C) creating a new Department of Conflict Resolution.

D) reducing the penalties for obstruction of an official investigation.

Answer: B
Ques Status: New

5) The Global Legal Settlement of 2002 required investment banks to separate ________ and ________.

A) research; securities underwriting

B) deposits; securities underwriting

C) research; legal analysis

D) deposits; legal analysis

Answer: A
Ques Status: New

6) One reason financial systems in developing and transition countries are underdeveloped is

A) they have weak links to their governments.

B) they make loans only to nonprofit entities.

C) the legal system may be poor making it difficult to enforce restrictive covenants.

D) the accounting standards are too stringent for the banks to meet.

Answer: C
Ques Status: New

7) One reason China has been able to grow so rapidly even though its financial development is still in its early stages is

A) the high savings rate of around 40%.

B) the shift of labor to the agricultural sector.

C) the stringent enforcement of financial contracts.

D) the ease of obtaining high-quality information about creditors.

Answer: A
Ques Status: New

8.8 Financial Crises and Aggregate Economics Activity

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

A) declining interest rates.

B) unanticipated increases in the price level.

C) the deterioration in banks' balance sheets.

D) increases in bond prices.

Answer: C
Ques Status: Revised

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

A) increasing; increasing

B) increasing; decreasing

C) decreasing; decreasing

D) decreasing; increasing

Answer: B
Ques Status: Previous Edition

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

A) free–rider problem.

B) too–big–to–fail problem.

C) transactions cost problem.

D) asymmetric information problem.

Answer: D
Ques Status: Revised

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

A) a decline in international trade.

B) the losses of bank shareholders.

C) the losses of bank depositors.

D) a decline in lending for productive investment.

Answer: D
Ques Status: Revised

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

A) a sharp decline in interest rates.

B) a sharp stock market decline.

C) a sharp decline in bond values.

D) a strong improvement in banks' balance sheets.

Answer: B
Ques Status: Revised

6) If the anatomy of a financial crisis is thought of as a sequence of events, which of the following events would be least likely to be the initiating cause of the financial crisis?

A) Increase in interest rates

B) Bank panic

C) Stock market decline

D) Increase in uncertainty

Answer: B
Ques Status: Previous Edition

7) If the anatomy of a financial crisis is thought of as a sequence of events, which of the following events would be least likely to be the initiating cause of the financial crisis?

A) Increase in interest rates

B) Stock market decline

C) Unanticipated decline in price level

D) Increase in uncertainty

Answer: C
Ques Status: Previous Edition

8) The sequence of events in a U.S. financial crisis is ________ leading to ________ leading to ________.

A) debt deflation; increased interest rates; a bank panic

B) increased interest rates; a bank panic; debt deflation

C) a stock market decline; debt deflation; decreased economic activity

D) a bank panic; debt deflation; a stock market decline

Answer: B
Ques Status: Revised

9) Debt deflation occurs when

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

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

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

D) corporations pay back their loans before the scheduled maturity date.

Answer: A
Ques Status: Revised

10) A substantial decrease in the aggregate price level that reduces firms' net worth may stall a recovery from a recession. This process is called

A) debt deflation.

B) moral hazard.

C) insolvency.

D) illiquidity.

Answer: A
Ques Status: Revised

11) Adverse selection and moral hazard problems increased in magnitude during the early years of the Great Depression as

A) stock prices declined to 10% of their level in 1929.

B) banks recovered slowly.

C) the aggregate price level rose.

D) banks saw more lending opportunities.

Answer: A
Ques Status: Revised

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

A) debt deflation.

B) default on government debt.

C) stock price declines.

D) lower interest rates.

Answer: B
Ques Status: Revised

13) In recent years, a number of developing and transition countries have experienced financial crises, the most dramatic of which was the

A) Mexican crisis of 1994–1995.

B) Mexican crisis of 1988–1989.

C) Argentina crisis of 1995–1996.

D) Brazilian crisis of 1996–1997.

Answer: A
Ques Status: Previous Edition

14) An important factor leading up to the Mexican financial crisis of 1994–1995 was

A) the failure of the Mexican oil monopoly.

B) increasing loan losses at Mexican banks.

C) the ratification of the North American Free Trade Agreement.

D) the failure to ratify the North American Free Trade Agreement.

Answer: B
Ques Status: Previous Edition

15) Factors that led to worsening conditions in Mexico's 1994–1995 financial markets include

A) failure of the Mexican oil monopoly.

B) the ratification of the North American Free Trade Agreement.

C) increased uncertainty from political shocks.

D) decline in interest rates.

Answer: C
Ques Status: Revised

16) Factors that led to worsening financial market conditions in East Asia in 1997–1998 include

A) weak supervision by bank regulators.

B) a rise in interest rates abroad.

C) unanticipated increases in the price level.

D) increased uncertainty from political shocks.

Answer: A
Ques Status: Revised

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

A) rise in interest rates abroad.

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

C) deterioration of banks' balance sheets because of increasing loan losses.

D) stock market decline.

Answer: A
Ques Status: Revised

18) Argentina's financial crisis was due to

A) poor supervision of the banking system.

B) a lending boom prior to the crisis.

C) fiscal imbalances.

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

Answer: C
Ques Status: Revised

19) Factors likely to cause a financial crisis in emerging market countries include

A) fiscal imbalances.

B) decreases in foreign interest rates.

C) a foreign exchange crisis.

D) too strong oversight of the financial industry.

Answer: A
Ques Status: Revised

Chapter 9

Banking and the Management of Financial Institutions

9.1 The Bank Balance Sheet

1) Which of the following statements are true?

A) A bank's assets are its sources of funds.

B) A bank's liabilities are its uses of funds.

C) A bank's balance sheet shows that total assets equal total liabilities plus equity capital.

D) A bank's balance sheet indicates whether or not the bank is profitable.

Answer: C
Ques Status: Revised

2) Which of the following statements is false?

A) A bank's assets are its uses of funds.

B) A bank issues liabilities to acquire funds.

C) The bank's assets provide the bank with income.

D) Bank capital is recorded as an asset on the bank balance sheet.

Answer: D
Ques Status: Revised

3) Which of the following are reported as liabilities on a bank's balance sheet?

A) Reserves

B) Checkable deposits

C) Loans

D) Deposits with other banks

Answer: B
Ques Status: Previous Edition

4) Which of the following are reported as liabilities on a bank's balance sheet?

A) Discount loans

B) Reserves

C) U.S. Treasury securities

D) Loans

Answer: A
Ques Status: Revised

5) The share of checkable deposits in total bank liabilities has

A) expanded moderately over time.

B) expanded dramatically over time.

C) shrunk over time.

D) remained virtually unchanged since 1960.

Answer: C
Ques Status: Previous Edition

6) Which of the following statements is false?

A) Checkable deposits are usually the lowest cost source of bank funds.

B) Checkable deposits are the primary source of bank funds.

C) Checkable deposits are payable on demand.

D) Checkable deposits include NOW accounts.

Answer: B
Ques Status: Previous Edition

7) In recent years the interest paid on checkable and time deposits has accounted for around ________ of total bank operating expenses, while the costs involved in servicing accounts have been approximately ________ of operating expenses.

A) 45 percent; 55 percent

B) 55 percent; 4 percent

C) 25 percent; 50 percent

D) 50 percent; 30 percent

Answer: C
Ques Status: Revised

8) Which of the following statements are true?

A) Checkable deposits are payable on demand.

B) Checkable deposits do not include NOW accounts.

C) Checkable deposits are the primary source of bank funds.

D) Demand deposits are checkable deposits that pay interest.

Answer: A
Ques Status: Revised

9) Which of the following are transaction deposits?

A) Savings accounts

B) Small–denomination time deposits

C) Negotiable order of withdraw accounts

D) Certificates of deposit

Answer: C
Ques Status: Previous Edition

10) Which of the following is not a nontransaction deposit?

A) Savings accounts

B) Small–denomination time deposits

C) Negotiable order of withdrawal accounts

D) Certificate of deposit

Answer: C
Ques Status: Revised

11) Large–denomination CDs are ________, so that like a bond they can be resold in a ________ market before they mature.

A) nonnegotiable; secondary

B) nonnegotiable; primary

C) negotiable; secondary

D) negotiable; primary

Answer: C
Ques Status: Previous Edition

12) Because checking accounts are ________ liquid for the depositor than passbook savings, they earn ________ interest rates.

A) less; higher

B) less; lower

C) more; higher

D) more; lower

Answer: D
Ques Status: Previous Edition

13) Because ________ are less liquid for the depositor than ________, they earn higher interest rates.

A) money market deposit accounts; time deposits

B) checkable deposits; passbook savings

C) passbook savings; checkable deposits

D) passbook savings; time deposits

Answer: C
Ques Status: Previous Edition

14) Because ________ are less liquid for the depositor than ________, they earn higher interest rates.

A) passbook savings; time deposits

B) money market deposit accounts; time deposits

C) money market deposit accounts; passbook savings

D) time deposits; passbook savings

Answer: D
Ques Status: Previous Edition

15) Banks acquire the funds that they use to purchase income-earning assets from such sources as

A) cash items in the process of collection

B) savings accounts.

C) reserves.

D) deposits at other banks.

Answer: B
Ques Status: Revised

16) Bank loans from the Federal Reserve are called ________ and represent a ________ of funds.

A) discount loans; use

B) discount loans; source

C) fed funds; use

D) fed funds; source

Answer: B
Ques Status: Previous Edition

17) Which of the following is not a source of borrowings for a bank?

A) Federal funds

B) Eurodollars

C) Transaction deposits

D) Discount loans

Answer: C
Ques Status: New

18) Bank capital is equal to ________ minus ________.

A) total assets; total liabilities

B) total liabilities; total assets

C) total assets; total reserves

D) total liabilities; total borrowings

Answer: A
Ques Status: New

19) Bank capital is listed on the ________ side of the bank's balance sheet because it represents a ________ of funds.

A) liability; use

B) liability; source

C) asset; use

D) asset; source

Answer: B
Ques Status: Previous Edition

20) Bank reserves include

A) deposits at the Fed and short-term treasury securities.

B) vault cash and short-term Treasury securities.

C) vault cash and deposits at the Fed.

D) deposits at other banks and deposits at the Fed.

Answer: C
Ques Status: Revised

21) The fraction of checkable deposits that banks are required by regulation to hold are

A) excess reserves.

B) required reserves.

C) vault cash.

D) total reserves.

Answer: B
Ques Status: Revised

22) Which of the following are reported as assets on a bank's balance sheet?

A) Borrowings

B) Reserves

C) Savings deposits

D) Bank capital

Answer: B
Ques Status: Revised

23) Which of the following are not reported as assets on a bank's balance sheet?

A) Cash items in the process of collection

B) Deposits with other banks

C) U.S. Treasury securities

D) Checkable deposits

Answer: D
Ques Status: Previous Edition

24) Through correspondent banking, large banks provide services to small banks, including

A) loan guarantees.

B) foreign exchange transactions.

C) issuing stock.

D) debt reduction.

Answer: B
Ques Status: Revised

25) The largest percentage of banks' holdings of securities consist of

A) Treasury and government agency securities.

B) tax-exempt municipal securities.

C) state and local government securities.

D) corporate securities.

Answer: A
Ques Status: Revised

26) Which of the following bank assets is the most liquid?

A) Consumer loans

B) Reserves

C) Cash items in process of collection

D) U.S. government securities

Answer: B
Ques Status: Previous Edition

27) Secondary reserves include

A) deposits at Federal Reserve Banks.

B) deposits at other large banks.

C) short-term Treasury securities.

D) state and local government securities.

Answer: C
Ques Status: Revised

28) Because of their ________ liquidity, ________ U.S. government securities are called secondary reserves.

A) low; short-term

B) low; long-term

C) high; short-term

D) high; long-term

Answer: C
Ques Status: Previous Edition

29) Secondary reserves are so called because

A) they can be converted into cash with low transactions costs.

B) they are not easily converted into cash, and are, therefore, of secondary importance to banking firms.

C) 50% of these assets count toward meeting required reserves.

D) they rank second to bank vault cash in importance of bank holdings.

Answer: A
Ques Status: Revised

30) Banks' asset portfolios include state and local government securities because

A) their interest payments are tax deductible for federal income taxes.

B) banks consider them helpful in attracting accounts of Federal employees.

C) the Federal Reserve requires member banks to buy securities from state and local governments located within their respective Federal Reserve districts.

D) there is no default–risk with state and local government securities.

Answer: A
Ques Status: Revised

31) Bank's make their profits primarily by issuing ________.

A) equity

B) negotiable CDs

C) loans

D) NOW accounts

Answer: C
Ques Status: New

32) The most important category of assets on a bank's balance sheet is

A) discount loans.

B) securities.

C) loans.

D) cash items in the process of collection.

Answer: C
Ques Status: Previous Edition

9.2 Basic Banking

1) Banks earn profits by selling ________ with attractive combinations of liquidity, risk, and return, and using the proceeds to buy ________ with a different set of characteristics.

A) loans; deposits

B) securities; deposits

C) liabilities; assets

D) assets; liabilities

Answer: C
Ques Status: Previous Edition

2) In general, banks make profits by selling ________ liabilities and buying ________ assets.

A) long–term; shorter–term

B) short–term; longer–term

C) illiquid; liquid

D) risky; risk–free

Answer: B
Ques Status: Previous Edition

3) Asset transformation can be described as

A) borrowing long and lending short.

B) borrowing short and lending long.

C) borrowing and lending only for the short term.

D) borrowing and lending for the long term.

Answer: B
Ques Status: Revised

4) When a new depositor opens a checking account at the First National Bank, the bank's assets ________ and its liabilities ________.

A) increase; increase

B) increase; decrease

C) decrease; increase

D) decrease; decrease

Answer: A
Ques Status: Previous Edition

5) When Jane Brown writes a $100 check to her nephew (who lives in another state), Ms. Brown's bank ________ assets of $100 and ________ liabilities of $100.

A) gains; gains

B) gains; loses

C) loses; gains

D) loses; loses

Answer: D
Ques Status: Previous Edition

6) When you deposit a $50 bill in the Security Pacific National Bank,

A) its liabilities decrease by $50.

B) its assets increase by $50.

C) its reserves decrease by $50.

D) its cash items in the process of collection increase by $50.

Answer: B
Ques Status: Revised

7) When you deposit $50 in currency at Old National Bank,

A) its assets increase by less than $50 because of reserve requirements.

B) its reserves increase by less than $50 because of reserve requirements.

C) its liabilities increase by $50.

D) its liabilities decrease by $50.

Answer: C
Ques Status: Revised

8) Holding all else constant, when a bank receives the funds for a deposited check,

A) cash items in the process of collection fall by the amount of the check.

B) bank assets increase by the amount of the check.

C) bank liabilities decrease by the amount of the check.

D) bank reserves increase by the amount of required reserves.

Answer: A
Ques Status: Revised

9) When a $10 check written on the First National Bank of Chicago is deposited in an account at Citibank, then

A) the liabilities of the First National Bank increase by $10.

B) the reserves of the First National Bank increase by $ 10.

C) the liabilities of Citibank increase by $10.

D) the assets of Citibank fall by $10.

Answer: C
Ques Status: Previous Edition

10) When a $10 check written on the First National Bank of Chicago is deposited in an account at Citibank, then

A) the liabilities of the First National Bank decrease by $10.

B) the reserves of the First National Bank increase by $10.

C) the liabilities of Citibank decrease by $10.

D) the assets of Citibank decrease by $10.

Answer: A
Ques Status: Previous Edition

11) 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

A) the assets of First National rise by $50.

B) the assets of Chemical Bank rise by $50.

C) the reserves at First National fall by $50.

D) the liabilities at Chemical Bank rise by $50.

Answer: C
Ques Status: Previous Edition

12) When $1 million is deposited at a bank, the required reserve ratio is 20 percent, and the bank chooses not to hold any excess reserves but makes loans instead, then, in the bank's final balance sheet,

A) the assets at the bank increase by $800,000.

B) the liabilities of the bank increase by $1,000,000.

C) the liabilities of the bank increase by $800,000.

D) reserves increase by $160,000.

Answer: B
Ques Status: Previous Edition

13) When $1 million is deposited at a bank, the required reserve ratio is 20 percent, and the bank chooses not to make any loans but to hold excess reserves instead, then, in the bank's final balance sheet,

A) the assets at the bank increase by $1 million.

B) the liabilities of the bank decrease by $1 million.

C) reserves increase by $200,000.

D) liabilities increase by $200,000.

Answer: A
Ques Status: Revised

14) Using T–accounts show what happens to reserves at Security National Bank if one individual deposits $1000 in cash into her checking account and another individual withdraws $750 in cash from her checking account.

Answer: Security National Bank

Assets	Liabilities
Reserves +$250	Checkable deposits +$250

Ques Status: New

9.3 General Principles of Bank Management

1) Which of the following are primary concerns of the bank manager?

A) Maintaining sufficient reserves to minimize the cost to the bank of deposit outflows

B) Extending loans to borrowers who will pay low interest rates, but who are poor credit risks

C) Acquiring funds at a relatively high cost, so that profitable lending opportunities can be realized

D) Maintaining high levels of capital and thus maximizing the returns to the owners.

Answer: A
Ques Status: Revised

2) If a bank has $100,000 of checkable deposits, a required reserve ratio of 20 percent, and it holds $40,000 in reserves, then the maximum deposit outflow it can sustain without altering its balance sheet is

A) $30,000.

B) $25,000.

C) $20,000.

D) $10,000.

Answer: B
Ques Status: Revised

3) If a bank has $200,000 of checkable deposits, a required reserve ratio of 20 percent, and it holds $80,000 in reserves, then the maximum deposit outflow it can sustain without altering its balance sheet is

A) $50,000.

B) $40,000.

C) $30,000.

D) $25,000.

Answer: A
Ques Status: Revised

4) If a bank has $10 million of checkable deposits, a required reserve ratio of 10 percent, and it holds $2 million in reserves, then it will not have enough reserves to support a deposit outflow of

A) $1.2 million.

B) $1.1 million.

C) $1 million.

D) $900,000.

Answer: A
Ques Status: Revised

5) If a bank has excess reserves greater than the amount of a deposit outflow, the outflow will result in equal reductions in

A) deposits and reserves.

B) deposits and loans.

C) capital and reserves.

D) capital and loans.

Answer: A
Ques Status: Revised

6) A $5 million deposit outflow from a bank has the immediate effect of

A) reducing deposits and reserves by $5 million.

B) reducing deposits and loans by $5 million.

C) reducing deposits and securities by $5 million.

D) reducing deposits and capital by $5 million.

Answer: A
Ques Status: Revised

7) If, after a deposit outflow, a bank has a reserve deficiency of $ 3 million, it can meet its reserve requirements by

A) reducing deposits by $3 million.

B) increasing loans by $3 million.

C) selling $3 million of securities.

D) repaying its discount loans from the Fed.

Answer: C
Ques Status: Revised

8) A bank with insufficient reserves can increase its reserves by

A) lending federal funds.

B) calling in loans.

C) buying short-term Treasury securities.

D) buying municipal bonds.

Answer: B
Ques Status: Revised

9) Of the following, which would be the first choice for a bank facing a reserve deficiency.

A) call in loans.

B) borrow from the Fed.

C) sell securities.

D) borrow from other banks.

Answer: D
Ques Status: Revised

10) In general, banks would prefer to meet deposit outflows by ________ rather than ________.

A) selling loans; selling securities

B) selling loans; borrowing from the Fed

C) borrowing from the Fed; selling loans

D) "calling in" loans; selling securities

Answer: C
Ques Status: Previous Edition

11) ________ may antagonize customers and thus can be a very costly way of acquiring funds to meet an unexpected deposit outflow.

A) Selling securities

B) Selling loans

C) Calling in loans

D) Selling negotiable CDs

Answer: C
Ques Status: New

12) Bankers' concerns regarding the optimal mix of excess reserves, secondary reserves, borrowings from the Fed, and borrowings from other banks to deal with deposit outflows is an example of

A) liability management.

B) liquidity management.

C) managing interest rate risk.

D) managing credit risk.

Answer: B
Ques Status: Revised

13) Banks hold excess and secondary reserves to

A) reduce the interest-rate risk problem.

B) provide for deposit outflows.

C) satisfy margin requirements.

D) achieve higher earnings than they can with loans.

Answer: B
Ques Status: Revised

14) A bank will want to hold more excess reserves (everything else equal) when

A) it expects to have deposit inflows in the near future.

B) brokerage commissions on selling bonds increase.

C) the cost of selling loans falls.

D) the discount rate decreases.

Answer: B
Ques Status: Revised

15) As the costs associated with deposit outflows ________, the banks willingness to hold excess reserves will ________.

A) decrease; increase

B) increase; decrease

C) increase; increase

D) decrease; not be affected

Answer: C
Ques Status: Revised

16) Which of the following would a bank not hold as insurance against the highest cost of deposit outflow–bank failure?

A) excess reserves

B) secondary reserves

C) bank capital

D) mortgages

Answer: D
Ques Status: Previous Edition

17) Which of the following statements most accurately describes the task of bank asset management?

A) Banks seek the highest returns possible subject to minimizing risk and making adequate provisions for liquidity.

B) Banks seek to have the highest liquidity possible subject to earning a positive rate of return on their operations.

C) Banks seek to prevent bank failure at all cost; since a failed bank earns no profit, liquidity needs supersede the desire for profits.

D) Banks seek to acquire funds in the least costly way.

Answer: A
Ques Status: Revised

18) The goals of bank asset management include

A) maximizing risk.

B) minimizing liquidity

C) lending at high interest rates regardless of risk.

D) purchasing securities with high returns and low risk.

Answer: D
Ques Status: Revised

19) Banks that suffered significant losses in the 1980s made the mistake of

A) holding too many liquid assets.

B) minimizing default risk.

C) failing to diversify their loan portfolio.

D) holding only safe securities.

Answer: C
Ques Status: Revised

20) Which of the following has not resulted from more active liability management on the part of banks?

A) Increased bank holdings of cash items

B) Aggressive targeting of goals for asset growth by banks

C) Increased use of negotiable CDs to raise funds

D) An increased proportion of bank assets held in loans

Answer: A
Ques Status: Previous Edition

21) Banks that actively manage liabilities will most likely meet a reserve shortfall by

A) calling in loans.

B) borrowing federal funds.

C) selling municipal bonds.

D) seeking new deposits.

Answer: B
Ques Status: Revised

22) Modern liability management has resulted in

A) increased sales of certificates of deposits to raise funds.

B) increase importance of deposits as a source of funds.

C) reduced borrowing by banks in the overnight loan market.

D) failure by banks to coordinate management of assets and liabilities.

Answer: A
Ques Status: Revised

23) A bank failure occurs whenever

A) a bank cannot satisfy its obligations to pay its depositors and have enough reserves to meet its reserve requirements.

B) a bank suffers a large deposit outflow.

C) a bank has to call in a large volume of loans.

D) a bank is not allowed to borrow from the Fed.

Answer: A
Ques Status: Previous Edition

24) A bank is insolvent when

A) its liabilities exceed its assets.

B) its assets exceed its liabilities.

C) its capital exceeds its liabilities.

D) its assets increase in value.

Answer: A
Ques Status: Revised

25) Holding large amounts of bank capital helps prevent bank failures because

A) it means that the bank has a higher income.

B) it makes loans easier to sell.

C) it can be used to absorb the losses resulting from a deposit outflow.

D) it makes it easier to call in loans.

Answer: C
Ques Status: Previous Edition

26) Net profit after taxes per dollar of assets is a basic measure of bank profitability called

A) return on assets.

B) return on capital.

C) return on equity.

D) return on investment.

Answer: A
Ques Status: Previous Edition

27) Net profit after taxes per dollar of equity capital is a basic measure of bank profitability called

A) return on assets.

B) return on capital.

C) return on equity.

D) return on investment.

Answer: C
Ques Status: Previous Edition

28) The amount of assets per dollar of equity capital is called the

A) asset ratio.

B) equity ratio.

C) equity multiplier.

D) asset multiplier.

Answer: C
Ques Status: Revised

29) For a given return on assets, the lower is bank capital,

A) the lower is the return for the owners of the bank.

B) the higher is the return for the owners of the bank.

C) the lower is the credit risk for the owners of the bank.

D) the lower the possibility of bank failure.

Answer: B
Ques Status: Revised

30) In the absence of regulation, banks would probably hold

A) too much capital, reducing the efficiency of the payments system.

B) too much capital, reducing the profitability of banks.

C) too little capital.

D) too much capital, making it more difficult to obtain loans.

Answer: C
Ques Status: Revised

31) Conditions that likely contributed to a credit crunch in 1990–92 include:

A) a decrease in the equity multiplier caused by loan losses due to falling real estate prices.

B) regulated hikes in bank capital requirements.

C) falling interest rates that raised interest rate risk, causing banks to choose to hold more capital.

D) increases in reserve requirements.

Answer: B
Ques Status: Revised

32) Which of the following would not be a way to increase the return on equity?

A) Buy back bank stock

B) Pay higher dividends

C) Acquire new funds by selling negotiable CDs and increase assets with them

D) Sell more bank stock

Answer: D
Ques Status: New

33) If a bank needs to raise the amount of capital relative to assets, a bank manager might choose to

A) buy back bank stock.

B) pay higher dividends.

C) shrink the size of the bank.

D) sell securities the bank owns and put the funds into the reserve account.

Answer: C
Ques Status: New

34) Your bank has the following balance sheet:

Assets		Liabilities	
Reserves	$ 50 million	Checkable deposits	$200 million
Securities	50 million		
Loans	150 million	Bank capital	50 million

If the required reserve ratio is 10%, what actions should the bank manager take if there is an unexpected deposit outflow of $50 million?

Answer: After the deposit outflow, the bank will have a reserve shortfall of $15 million. The bank manager could try to borrow in the Federal Funds market, take out a discount loan from the Federal Reserve, sell $15 million of the securities the bank owns, sell off $15 million of the loans the bank owns , or lastly call–in $15 million of loans. All of the actions will be costly to the bank. The bank manager should try to acquire the funds with the least costly method.
Ques Status: New

9.4 Managing Credit Risk

1) Banks face the problem of ________ in loan markets because bad credit risks are the ones most likely to seek bank loans.

   A) adverse selection

   B) moral hazard

   C) moral suasion

   D) intentional fraud

   Answer: A
   Ques Status: Previous Edition

2) If borrowers with the most risky investment projects seek bank loans in higher proportion to those borrowers with the safest investment projects, banks are said to face the problem of

   A) adverse credit risk.

   B) adverse selection.

   C) moral hazard.

   D) lemon lenders.

   Answer: B
   Ques Status: Previous Edition

3) Because borrowers, once they have a loan, are more likely to invest in high–risk investment projects, banks face the

   A) adverse selection problem.

   B) lemon problem.

   C) adverse credit risk problem.

   D) moral hazard problem.

   Answer: D
   Ques Status: Previous Edition

4) In order to reduce the ________ problem in loan markets, bankers collect information from prospective borrowers to screen out the bad credit risks from the good ones.

   A) moral hazard

   B) adverse selection

   C) moral suasion

   D) adverse lending

   Answer: B
   Ques Status: New

5) In one sense ________ appears surprising since it means that the bank is not ________ its portfolio of loans and thus is exposing itself to more risk.

A) specialization in lending; diversifying

B) specialization in lending; rationing

C) credit rationing; diversifying

D) screening; rationing

Answer: A
Ques Status: Previous Edition

6) From the standpoint of ________, specialization in lending is surprising but makes perfect sense when one considers the ________ problem.

A) moral hazard; diversification

B) diversification; moral hazard

C) adverse selection; diversification

D) diversification; adverse selection

Answer: D
Ques Status: Previous Edition

7) Provisions in loan contracts that prohibit borrowers from engaging in specified risky activities are called

A) proscription bonds.

B) restrictive covenants.

C) due-on-sale clauses.

D) liens.

Answer: B
Ques Status: Previous Edition

8) Long-term customer relationships ________ the cost of information collection and make it easier to ________ credit risks.

A) reduce; screen

B) increase; screen

C) reduce; increase

D) increase; increase

Answer: A
Ques Status: New

9) Unanticipated moral hazard contingencies can be reduced by

A) screening.

B) long–term customer relationships.

C) specialization in lending.

D) credit rationing.

Answer: B
Ques Status: New

10) A bank's commitment to provide a firm with loans up to pre–specified limit at an interest rate that is tied to a market interest rate is called

A) an adjustable gap loan.

B) an adjustable portfolio loan.

C) loan commitment.

D) pre–credit loan line.

Answer: C
Ques Status: Previous Edition

11) A bank that wants to monitor the check payment practices of its commercial borrowers, so that moral hazard can be prevented, will require borrowers to

A) place a bank officer on their board of directors.

B) place a corporate officer on the bank's board of directors.

C) keep compensating balances in a checking account at the bank.

D) purchase the bank's CDs.

Answer: C
Ques Status: Revised

12) Of the following methods that banks might use to reduce moral hazard problems, the one not legally permitted in the United States is the

A) requirement that firms keep compensating balances at the banks from which they obtain their loans.

B) requirement that firms place on their board of directors an officer from the bank.

C) inclusion of restrictive covenants in loan contracts.

D) requirement that individuals provide detailed credit histories to bank loan officers.

Answer: B
Ques Status: Previous Edition

13) Property promised to the lender as compensation if the borrower defaults is called ________.

A) collateral

B) deductibles

C) restrictive covenants

D) contingencies

Answer: A
Ques Status: New

14) When a lender refuses to make a loan, although borrowers are willing to pay the stated interest rate or even a higher rate, the bank is said to engage in

A) coercive bargaining.

B) strategic holding out.

C) credit rationing.

D) collusive behavior.

Answer: C
Ques Status: Previous Edition

15) A Federal Reserve survey of bankers done in early 1991 revealed that depressed conditions in commercial real estate markets had prompted many banks simply to stop lending. This response to potential adverse selection problems is referred to as

A) screening.

B) monitoring.

C) specialized lending.

D) credit rationing.

Answer: D
Ques Status: Previous Edition

16) When banks offer borrowers smaller loans than they have requested, banks are said to

A) shave credit.

B) rediscount the loan.

C) raze credit.

D) ration credit.

Answer: D
Ques Status: Previous Edition

17) Credit risk management tools include:

A) deductibles.

B) collateral.

C) interest rate swaps.

D) duration analysis.

Answer: B
Ques Status: Revised

18) How can specializing in lending help to reduce the adverse selection problem in lending?

Answer: Reducing the adverse selection problem requires the banks to acquire information to screen bad credit risks from good credit risks. It is easier for banks to obtain information about local businesses. Also if the bank lends to firms in a few specific industries they will become more knowledgeable about those industries and a better judge of creditworthiness in those industries.
Ques Status: New

9.5 Managing Interest–Rate Risk

1) Risk that is related to the uncertainty about interest rate movements is called

A) default risk.

B) interest–rate risk.

C) the problem of moral hazard.

D) security risk.

Answer: B
Ques Status: Previous Edition

2) All else the same, if a bank's liabilities are more sensitive to interest rate fluctuations than are its assets, then ________ in interest rates will ________ bank profits.

A) an increase; increase

B) an increase; reduce

C) a decline; reduce

D) a decline; not affect

Answer: B
Ques Status: Previous Edition

3) If a bank has ________ rate–sensitive assets than liabilities, then ________ in interest rates will increase bank profits.

A) more; a decline

B) more; an increase

C) less; an increase

D) fewer; a surge

Answer: B
Ques Status: Previous Edition

4) If a bank has ________ rate–sensitive assets than liabilities, a ________ in interest rates will reduce bank profits, while a ________ in interest rates will raise bank profits.

A) more; rise; decline

B) more; decline; rise

C) fewer; decline; decline

D) fewer; rise; rise

Answer: B
Ques Status: Previous Edition

5) The difference of rate–sensitive liabilities and rate–sensitive assets is known as the

A) duration.

B) interest–sensitivity index.

C) rate–risk index.

D) gap.

Answer: D
Ques Status: Previous Edition

6) If the First National Bank has a gap equal to a negative $30 million, then a 5 percentage point increase in interest rates will cause profits to

A) increase by $15 million.

B) increase by $1.5 million.

C) decline by $15 million.

D) decline by $1.5 million.

Answer: D
Ques Status: Previous Edition

7) Measuring the sensitivity of bank profits to changes in interest rates by multiplying the gap times the change in the interest rate is called

A) basic duration analysis.

B) basic gap analysis.

C) interest–exposure analysis.

D) gap–exposure analysis.

Answer: B
Ques Status: Previous Edition

8) Measuring the sensitivity of bank profits to changes in interest rates by multiplying the gap for several maturity subintervals times the change in the interest rate is called

A) basic gap analysis.

B) the maturity bucket approach to gap analysis.

C) the segmented maturity approach to gap analysis.

D) the segmented maturity approach to interest–exposure analysis.

Answer: B
Ques Status: Revised

First National Bank

	Assets	**Liabilities**
Rate–sensitive	$20 million	$50 million
Fixed–rate	$80 million	$50 million

9) If interest rates rise by 5 percentage points, say, from 10 to 15%, bank profits (measured using gap analysis) will

A) decline by $0.5 million.

B) decline by $1.5 million.

C) decline by $2.5 million.

D) increase by $1.5 million.

Answer: B
Ques Status: Previous Edition

10) Assuming that the average duration of its assets is five years, while the average duration of its liabilities is three years, then a 5 percentage point increase in interest rates will cause the net worth of First National to decline by ________ of the total original asset value.

A) 5 percent

B) 10 percent

C) 15 percent

D) 25 percent

Answer: B
Ques Status: Revised

First National Bank

	Assets	Liabilities
Rate–sensitive	$40 million	$50 million
Fixed–rate	$60 million	$50 million

11) If interest rates rise by 5 percentage points, say from 10 to 15%, bank profits (measured using gap analysis) will

A) decline by $0.5 million.

B) decline by $1.5 million.

C) decline by $2.5 million.

D) increase by $2.0 million.

Answer: A
Ques Status: Previous Edition

12) Assuming that the average duration of its assets is four years, while the average duration of its liabilities is three years, then a 5 percentage point increase in interest rates will cause the net worth of First National to ________ by ________ of the total original asset value.

A) decline; 5 percent

B) decline; 10 percent

C) decline; 15 percent

D) increase; 20 percent

Answer: A
Ques Status: Previous Edition

13) Duration analysis involves comparing the average duration of the bank's ________ to the average duration of its ________.

A) securities portfolio; non–deposit liabilities

B) assets; liabilities

C) loan portfolio; deposit liabilities

D) assets; deposit liabilities

Answer: B
Ques Status: Revised

14) Because of an expected rise in interest rates in the future, a banker will likely

A) make long–term rather than short–term loans.

B) buy short–term rather than long–term bonds.

C) buy long–term rather than short–term bonds.

D) make either short or long–term loans; expectations of future interest rates are irrelevant.

Answer: B
Ques Status: Revised

15) If a banker expects interest rates to fall in the future, her best strategy for the present is

A) to increase the duration of the bank's liabilities.

B) to buy short-term bonds.

C) to sell long-term certificates of deposit.

D) to increase the duration of the bank's assets.

Answer: D
Ques Status: Revised

16) Bruce the Bank Manager can reduce interest rate risk by ________ the duration of the bank's assets to increase their rate sensitivity or, alternatively, ________ the duration of the bank's liabilities.

A) shortening; lengthening

B) shortening; shortening

C) lengthening; lengthening

D) lengthening; shortening

Answer: A
Ques Status: Previous Edition

17) Your bank has the following balance sheet

Assets		Liabilities	
Rate-sensitive	$100 million	Rate-sensitive	$75 million
Fixed-rate	100 million	Fixed-rate	125 million

What would happen to bank profits if the interest rates in the economy go down? Is there anything that you could do to keep your bank from being so vulnerable to interest rate movements?

Answer: The bank's profits would go down because it has more interest-rate sensitive assets than liabilities. In order to reduce interest-rate sensitivity, the bank manager could use financial derivatives such as interest-rate swaps, options, or futures. The bank manager could also try to adjust the balance sheet so that the bank's profits are not vulnerable to the movement of the interest rate.
Ques Status: New

9.6 Off–Balance–Sheet Activities

1) Examples of off–balance–sheet activities include

A) loan sales.

B) extending loans to depositors.

C) borrowing from other banks.

D) selling negotiable CDs.

Answer: A
Ques Status: Revised

2) All of the following are examples of off–balance sheet activities that generate fee income for banks except

A) foreign exchange trades.

B) guaranteeing debt securities.

C) back–up lines of credit.

D) selling negotiable CDs.

Answer: D
Ques Status: New

3) Which of the following is not an example of a backup line of credit?

A) loan commitments

B) overdraft privileges

C) standby letters of credit

D) mortgages

Answer: D
Ques Status: New

4) Off–balance sheet activities involving guarantees of securities and back–up credit lines

A) have no impact on the risk a bank faces.

B) greatly reduce the risk a bank faces.

C) increase the risk a bank faces.

D) slightly reduce the risk a bank faces.

Answer: C
Ques Status: New

5) When banks involved in trading activities attempt to outguess markets, they are

A) forecasting.

B) diversifying.

C) speculating.

D) engaging in riskless arbitrage.

Answer: C
Ques Status: Revised

6) Traders working for banks are subject to the

A) principal–agent problem.

B) free–rider problem.

C) double–jeopardy problem.

D) exchange–risk problem.

Answer: A
Ques Status: Revised

7) A reason why rogue traders have bankrupt their banks is due to

A) the separation of trading activities from the bookkeepers.

B) stringent supervision of trading activities by bank management.

C) accounting errors.

D) a failure to maintain proper internal controls.

Answer: D
Ques Status: Revised

8) The principal–agent problem that exists for bank trading activities can be reduced through

A) creation of internal controls that combine trading activities with bookkeeping.

B) creation of internal controls that separate trading activities from bookkeeping.

C) elimination of regulation of banking.

D) elimination of internal controls.

Answer: B
Ques Status: Revised

9) Banks develop statistical models to calculate their maximum loss over a given time period. This approach is known as the

A) stress–testing approach.

B) value–at–risk approach.

C) trading–loss approach.

D) doomsday approach.

Answer: B
Ques Status: Revised

10) When banks calculate the losses the institution would incur if an unusual combination of bad events happened, the bank is using the ________ approach.

A) stress–test

B) value–at–risk

C) trading–loss

D) maximum value

Answer: A
Ques Status: New

9.7 Web Appendix 1: Duration Gap Analysis

1) Assume a bank has $200 million of assets with a duration of 2.5, and $190 million of liabilities with a duration of 1.05. If interest rates increase from 5 percent to 6 percent, the net worth of the bank falls by

A) $1 million.

B) $2.4 million.

C) $3.6 million.

D) $4.8 million.

Answer: D
Ques Status: Revised

2) Assume a bank has $200 million of assets with a duration of 2.5, and $190 million of liabilities with a duration of 1.05. The duration gap for this bank is

A) 0.5 year.

B) 1 year.

C) 1.5 years.

D) 2 years.

Answer: C
Ques Status: Revised

3) If interest rates increase from 9 percent to 10 percent, a bank with a duration gap of 2 years would experience a decrease in its net worth of

A) 0.9 percent of its assets.

B) 0.9 percent of its liabilities.

C) 1.8 percent of its liabilities.

D) 1.8 percent of its assets.

Answer: D
Ques Status: Revised

9.8 Web Appendix 2: Measuring Bank Performance

1) When a bank suspects that a $1 million loan might prove to be bad debt that will have to be written off in the future the bank

A) can set aside $1 million of its earnings in its loan loss reserves account.

B) reduces its reported earnings by $1, even though it has not yet actually lost the $1 million.

C) reduces its assets immediately by $1 million, even though it has not yet lost the $1 million.

D) reduces its reserves by $1 million, so that they can use those funds later.

Answer: A
Ques Status: Revised

2) For banks,

A) return on assets exceeds return on equity.

B) return on assets equals return on equity.

C) return on equity exceeds return on assets.

D) return on equity is another name for net interest margin.

Answer: C
Ques Status: Revised

3) The quantity interest income minus interest expenses divided by assets is a measure of bank performance known as

A) operating income.

B) net interest margin.

C) return on assets.

D) return on equity.

Answer: B
Ques Status: Revised

Chapter 10

Banking Industry: Structure and Competition

10.1 Historical Development of the Banking System

1) The modern commercial banking system began in America when the

A) Bank of United States was chartered in New York in 1801.

B) Bank of North America was chartered in Philadelphia in 1782.

C) Bank of United States was chartered in Philadelphia in 1801.

D) Bank of North America was chartered in New York in 1782.

Answer: B
Ques Status: Previous Edition

2) A major controversy involving the banking industry in its early years was

A) whether banks should both accept deposits and make loans or whether these functions should be separated into different institutions.

B) whether the federal government or the states should charter banks.

C) what percent of deposits banks should hold as fractional reserves.

D) whether banks should be allowed to issue their own bank notes.

Answer: B
Ques Status: Previous Edition

3) The government institution that has responsibility for the amount of money and credit supplied in the economy as a whole is the

A) central bank.

B) commercial bank.

C) bank of settlement.

D) monetary fund.

Answer: A
Ques Status: Previous Edition

4) Because of the abuses by state banks and the clear need for a central bank to help the federal government raise funds during the War of 1812, Congress created the

A) Bank of United States in 1812.

B) Bank of North America in 1814.

C) Second Bank of the United States in 1816.

D) Second Bank of North America in 1815.

Answer: C
Ques Status: Previous Edition

5) The Second Bank of the United States was denied a new charter by

A) President Andrew Jackson.

B) Vice President John Calhoun.

C) President Benjamin Harrison.

D) President John Q. Adams.

Answer: A
Ques Status: Previous Edition

6) Currency circulated by banks that could be redeemed for gold was called ________.

A) junk bonds

B) banknotes

C) gold bills

D) state money

Answer: B
Ques Status: New

7) To eliminate the abuses of the state-chartered banks, the ________ created a new banking system of federally chartered banks, supervised by the ________.

A) National Bank Act of 1863; Office of the Comptroller of the Currency

B) Federal Reserve Act of 1863; Office of the Comptroller of the Currency

C) National Bank Act of 1863; Office of Thrift Supervision

D) Federal Reserve Act of 1863; Office of Thrift Supervision

Answer: A
Ques Status: Previous Edition

8) The belief that bank failures were regularly caused by fraud or the lack of sufficient bank capital explains, in part, the passage of

A) the National Bank Charter Amendments of 1918.

B) the Garn-St. Germain Act of 1982.

C) the National Bank Act of 1863.

D) Federal Reserve Act of 1913.

Answer: C
Ques Status: Revised

9) Before 1863,

A) federally–chartered banks had regulatory advantages not granted to state–chartered banks.

B) the number of federally–chartered banks grew at a much faster rate than at any other time since the end of the Civil War.

C) banks acquired funds by issuing bank notes.

D) banks were required to maintain 100% of their deposits as reserves.

Answer: C
Ques Status: Revised

10) Although the National Bank Act of 1863 was designed to eliminate state–chartered banks by imposing a prohibitive tax on banknotes, these banks have been able to stay in business by

A) issuing credit cards.

B) ignoring the regulations.

C) acquiring funds through deposits.

D) branching into other states.

Answer: C
Ques Status: Revised

11) The National Bank Act of 1863, and subsequent amendments to it,

A) created a banking system of state–chartered banks.

B) established the Office of the Comptroller of the Currency.

C) broadened the regulatory powers of the Federal Reserve.

D) created insurance on deposit accounts.

Answer: B
Ques Status: Revised

12) Which regulatory body charters national banks?

A) The Federal Reserve

B) The FDIC

C) The Comptroller of the Currency

D) The U.S. Treasury

Answer: C
Ques Status: Revised

13) The regulatory system that has evolved in the United States whereby banks are regulated at the state level, the national level, or both, is known as a

A) bilateral regulatory system.

B) tiered regulatory system.

C) two–tiered regulatory system.

D) dual banking system.

Answer: D
Ques Status: Previous Edition

14) Today the United States has a dual banking system in which banks supervised by the ________ and by the ________ operate side by side.

A) federal government; municipalities

B) state governments; municipalities

C) federal government; states

D) municipalities; states

Answer: C
Ques Status: Previous Edition

15) The U.S. banking system is considered to be a dual system because

A) banks offer both checking and savings accounts.

B) it actually includes both banks and thrift institutions.

C) it is regulated by both state and federal governments.

D) it was established before the Civil War, requiring separate regulatory bodies for the North and South.

Answer: C
Ques Status: Study Guide

16) The Federal Reserve Act of 1913 required that

A) state banks be subject to the same regulations as national banks.

B) national banks establish branches in the cities containing Federal Reserve banks.

C) national banks join the Federal Reserve System.

D) state banks could not join the Federal Reserve System.

Answer: C
Ques Status: Revised

17) The Federal Reserve Act required all ________ banks to become members of the Federal Reserve System, while ________ banks could choose to become members of the system.

A) state; national

B) state; municipal

C) national; state

D) national; municipal

Answer: C
Ques Status: Previous Edition

18) Probably the most significant factor explaining the drastic drop in the number of bank failures since the Great Depression has been

A) the creation of the FDIC.

B) rapid economic growth since 1941.

C) the employment of new procedures by the Federal Reserve.

D) better bank management.

Answer: A
Ques Status: Previous Edition

19) With the creation of the Federal Deposit Insurance Corporation, member banks of the Federal Reserve System ________ to purchase FDIC insurance for their depositors, while non-member commercial banks ________ to buy deposit insurance.

A) could choose; were required

B) could choose; were given the option

C) were required, could choose

D) were required; were required

Answer: C
Ques Status: Previous Edition

20) With the creation of the Federal Deposit Insurance Corporation,

A) member banks of the Federal Reserve System were given the option to purchase FDIC insurance for their depositors, while non-member commercial banks were required to buy deposit insurance.

B) member banks of the Federal Reserve System were required to purchase FDIC insurance for their depositors, while non-member commercial banks could choose to buy deposit insurance.

C) both member and non-member banks of the Federal Reserve System were required to purchase FDIC insurance for their depositors.

D) both member and non-member banks of the Federal Reserve System could choose, but were not required, to purchase FDIC insurance for their depositors.

Answer: B
Ques Status: Previous Edition

21) The Glass–Steagall Act, before its repeal in 1999, prohibited commercial banks from

A) issuing equity to finance bank expansion.

B) engaging in underwriting and dealing of corporate securities.

C) selling new issues of government securities.

D) purchasing any debt securities.

Answer: B
Ques Status: Previous Edition

22) The legislation that separated investment banking from commercial banking until its repeal in 1999 is known as the:

A) National Bank Act of 1863.

B) Federal Reserve Act of 1913.

C) Glass–Steagall Act.

D) McFadden Act.

Answer: C
Ques Status: Previous Edition

23) Which of the following statements concerning bank regulation in the United States are true?

A) The Office of the Comptroller of the Currency has the primary responsibility for state banks that are members of the Federal Reserve System.

B) The Federal Reserve and the state banking authorities jointly have responsibility for the 1000 state banks that are members of the Federal Reserve System.

C) The Office of the Comptroller of the Currency has sole regulatory responsibility over bank holding companies.

D) The state banking authorities have sole regulatory responsibility for all state banks.

Answer: B
Ques Status: Revised

24) Which bank regulatory agency has the sole regulatory authority over bank holding companies?

A) The FDIC

B) The Comptroller of the Currency

C) The FHLBS

D) The Federal Reserve System

Answer: D
Ques Status: Previous Edition

25) State banks that are not members of the Federal Reserve System are most likely to be examined by the

A) Federal Reserve System.

B) FDIC.

C) FHLBS.

D) Comptroller of the Currency.

Answer: B
Ques Status: Previous Edition

10.2 Financial Innovation and the Evolution of the Banking Industry

1) Financial innovations occur because of financial institutions search for ________.

A) profits

B) fame

C) stability

D) recognition

Answer: A
Ques Status: New

2) ________ is the process of researching and developing profitable new products and services by financial institutions.

A) Financial engineering

B) Financial manipulation

C) Customer manipulation

D) Customer engineering

Answer: A
Ques Status: New

3) The most significant change in the economic environment that changed the demand for financial products since 1970 has been

A) the aging of the baby-boomer generation.

B) the dramatic increase in the volatility of interest rates.

C) the dramatic increase in competition from foreign banks.

D) the deregulation of financial institutions.

Answer: B
Ques Status: Previous Edition

4) In the 1950s the interest rate on three-month Treasury bills fluctuated between 1 percent and 3.5 percent; in the 1980s it fluctuated between ________ percent and ________ percent.

   A) 5; 15

   B) 4; 11.5

   C) 4; 18

   D) 5; 10

   Answer: A
   Ques Status: Previous Edition

5) Uncertainty about interest-rate movements and returns is called ________.

   A) market potential

   B) interest-rate irregularities

   C) interest-rate risk

   D) financial creativity

   Answer: C
   Ques Status: New

6) Rising interest-rate risk

   A) increased the cost of financial innovation.

   B) increased the demand for financial innovation.

   C) reduced the cost of financial innovation.

   D) reduced the demand for financial innovation.

   Answer: B
   Ques Status: Previous Edition

7) Adjustable rate mortgages

   A) protect households against higher mortgage payments when interest rates rise.

   B) keep financial institutions' earnings high even when interest rates are falling.

   C) benefit homeowners when interest rates are falling.

   D) generally have higher initial interest rates than on conventional fixed-rate mortgages.

   Answer: C
   Ques Status: Revised

8) The agreement to provide a standardized commodity to a buyer on a specific date at a specific future price is

A) a put option.

B) a call option.

C) a futures contract.

D) a mortgage–backed security.

Answer: C
Ques Status: Revised

9) An instrument developed to help investors and institutions hedge interest–rate risk is

A) a put option.

B) a call option.

C) a financial derivative.

D) a mortgage–backed security.

Answer: C
Ques Status: Revised

10) Financial instruments whose payoffs are linked to previously issued securities are called ________.

A) grandfathered bonds

B) financial derivatives

C) hedge securities

D) reversible bonds

Answer: B
Ques Status: New

11) Both ________ and ________ were financial innovations that occurred because of interest rate risk volatility.

A) adjustable–rate mortgages; commercial paper

B) adjustable–rate mortgages; financial derivatives

C) sweep accounts; financial derivatives

D) sweep accounts; commercial paper

Answer: B
Ques Status: New

12) The most important source of the changes in supply conditions that stimulate financial innovation has been the

A) deregulation of financial institutions.

B) dramatic increase in the volatility of interest rates.

C) improvement in computer and telecommunications technology.

D) dramatic increase in competition from foreign banks.

Answer: C
Ques Status: Revised

13) New computer technology has

A) increased the cost of financial innovation.

B) increased the demand for financial innovation.

C) reduced the cost of financial innovation.

D) reduced the demand for financial innovation.

Answer: C
Ques Status: Previous Edition

14) Credit cards date back to

A) prior to the second World War.

B) just after the second World War.

C) the early 1950s.

D) the late 1950s.

Answer: A
Ques Status: Previous Edition

15) A firm issuing credit cards earns income from

A) loans it makes to credit card holders.

B) subsidies from the local governments.

C) payments made to it by manufacturers of the products sold in stores on credit card purchases.

D) sales of the card in foreign countries.

Answer: A
Ques Status: Revised

16) The entry of AT&T and GM into the credit card business is an indication of

A) government's efforts to deregulate the provision of financial services.

B) the rising profitability of credit card operations.

C) the reduction in costs of credit card operations since 1990.

D) the sale of unprofitable operations by Bank of America and Citicorp.

Answer: B
Ques Status: Previous Edition

17) A debit card differs from a credit card in that

A) a debit card is a loan while for a credit card purchase, payment is made immediately.

B) a debit card is a long-term loan while a credit card is a short-term loan.

C) a credit card is a loan while for a debit card purchase, payment is made immediately.

D) a credit card is a long-term loan while a debit card is a short-term loan.

Answer: C
Ques Status: Revised

18) Automated teller machines

A) are more costly to use than human tellers, so banks discourage their use by charging more for use of ATMs.

B) cost about the same to use as human tellers in banks, so banks discourage their use by charging more for use of ATMs.

C) cost less than human tellers, so banks may encourage their use by charging less for using ATMs.

D) cost nothing to use, so banks provide their services free of charge.

Answer: C
Ques Status: Revised

19) The declining cost of computer technology has made ________ a reality.

A) brick and mortar banking

B) commercial banking

C) virtual banking

D) investment banking

Answer: C
Ques Status: Revised

20) Bank customers perceive Internet banks as being

A) more secure than physical bank branches.

B) a better method for the purchase of long-term savings products.

C) better at keeping customer information private.

D) prone to many more technical problems.

Answer: D
Ques Status: Revised

21) A disadvantage of virtual banks (clicks) is that

A) their hours are more limited than physical banks.

B) they are less convenient than physical banks.

C) they are more costly to operate than physical banks.

D) customers worry about the security of on-line transactions.

Answer: D
Ques Status: Revised

22) So-called fallen angels differ from junk bonds in that

A) junk bonds refer to newly issued bonds with low credit ratings, whereas fallen angels refer to previously bonds that have had their credit ratings fall below Baa.

B) junk bonds refer to previously bonds that have had their credit ratings fall below Baa, whereas fallen angels refer to newly issued bonds with low credit ratings.

C) junk bonds have ratings below Baa, whereas fallen angels have ratings below C.

D) fallen angels have ratings below Baa, whereas junk bonds have ratings below C.

Answer: A
Ques Status: Previous Edition

23) Newly-issued high-yield bonds rated below investment grade by the bond-rating agencies are frequently referred to as

A) municipal bonds.

B) Yankee bonds.

C) "fallen angels."

D) junk bonds.

Answer: D
Ques Status: Previous Edition

24) In 1977, he pioneered the concept of selling new public issues of junk bonds for companies that had not yet achieved investment-grade status.

A) Michael Milken

B) Roger Milliken

C) Ivan Boskey

D) Carl Ichan

Answer: A
Ques Status: Previous Edition

25) The rapid growth of the commercial paper market since 1970 is due to

A) the fact that commercial paper has no default risk.

B) improved information technology making it easier to screen credit risks.

C) government regulation.

D) FDIC insurance for commercial paper.

Answer: B
Ques Status: Revised

26) The process of transforming otherwise illiquid financial assets into marketable capital market instruments is know as

A) securitization.

B) internationalization.

C) arbitrage.

D) program trading.

Answer: A
Ques Status: Revised

27) ________ is creating a marketable capital market instrument by bundling a portfolio of mortgage or auto loans.

A) diversification.

B) arbitrage.

C) computerization.

D) securitization.

Answer: D
Ques Status: Revised

28) The driving force behind the securitization of mortgages and automobile loans has been

A) the rising regulatory constraints on substitute financial instruments.

B) the desire of mortgage and auto lenders to exit this field of lending.

C) the improvement in computer technology.

D) the relaxation of regulatory restrictions on credit card operations.

Answer: C
Ques Status: Previous Edition

29) According to Edward Kane, because the banking industry is one of the most ________ industries in America, it is an industry in which ________ is especially likely to occur.

A) competitive; loophole mining

B) competitive; innovation

C) regulated; loophole mining

D) regulated; innovation

Answer: C
Ques Status: Previous Edition

30) Loophole mining refers to financial innovation designed to

A) hide transactions from the IRS.

B) conceal transactions from the SEC.

C) get around regulations.

D) conceal transactions from the Treasury Department.

Answer: C
Ques Status: Revised

31) Bank managers look on reserve requirements

A) as a tax on deposits.

B) as a subsidy on deposits.

C) as a subsidy on loans.

D) as a tax on loans.

Answer: A
Ques Status: Previous Edition

32) The cost of holding reserves to a bank equals

A) the interest paid on deposits times the amount of reserves.

B) the interest paid on deposits times the amount of deposits.

C) the interest earned on loans times the amount of loans.

D) the interest earned on loans times the amount on reserves.

Answer: D
Ques Status: Revised

33) Prior to 1980, the Fed set an interest rate ________ that is a maximum limit on the interest rate that could be paid on time deposits.

A) floor

B) ceiling

C) wall

D) window

Answer: B
Ques Status: New

34) The process in which people take their money out of financial institutions seeking higher interest rates is called

A) capital mobility.

B) loophole mining.

C) disintermediation.

D) deposit jumping.

Answer: C
Ques Status: Revised

35) Money market mutual funds

A) function as interest–earning checking accounts.

B) are legally deposits.

C) are subject to reserve requirements.

D) have an interest–rate ceiling.

Answer: A
Ques Status: Revised

36) In this type of arrangement, any balances above a certain amount in a corporation's checking account at the end of the business day are "removed" and invested in overnight securities that pay the corporation interest. This innovation is referred to as a

A) sweep account.

B) share draft account.

C) removed-repo account.

D) stockman account.

Answer: A
Ques Status: Previous Edition

37) Sweep accounts which were created to avoid reserve requirements became possible because of a change in ________.

A) demand conditions

B) supply conditions

C) government rules

D) bank mergers

Answer: B
Ques Status: New

38) Sweep accounts

A) have made reserve requirements nonbonding for many banks.

B) sweep funds out of deposit accounts into long-term securities.

C) enable banks to avoid paying interest to corporate customers.

D) reduce banks' assets.

Answer: A
Ques Status: Revised

39) Since 1974, commercial banks' importance as a source of funds for nonfinancial borrowers

A) has shrunk dramatically, from around 40 percent of total credit advanced to below 30 percent by 2005.

B) has shrunk dramatically, from around 70 percent of total credit advanced to below 50 percent by 2005.

C) has expanded dramatically, from around 50 percent of total credit advanced to above 70 percent by 2005.

D) has expanded dramatically, from around 30 percent of total credit advanced to above 50 percent by 2005.

Answer: A
Ques Status: Revised

40) Thrift institutions' importance as a source of funds for borrowers

A) has shrunk from around 40 percent of total credit advanced in the late 1970s to below 30 percent by 2005.

B) has shrunk from over 20 percent of total credit advanced in the late 1970s to below 6 percent by 2005.

C) has expanded dramatically, from around 15 percent of total credit advanced in the late 1970s to above 25 percent by 2005.

D) has expanded dramatically, from around 15 percent of total credit advanced in the late 1970s to above 30 percent by 2005.

Answer: B
Ques Status: Revised

41) Since 1980

A) bank profitability has declined.

B) banks have offset the decline in profits from traditional activities with increased income from off-balance-sheet activities.

C) banks have offset the decline in profits from off-balance-sheet activities with increased income from traditional activities.

D) bank profits have grown rapidly due to deregulation.

Answer: B
Ques Status: Revised

42) Financial innovation has caused

A) banks to suffer declines in their cost advantages in acquiring funds, although it has not caused a decline in income advantages.

B) banks to suffer a simultaneous decline of cost and income advantages.

C) banks to suffer declines in their income advantages in acquiring funds, although it has not caused a decline in cost advantages.

D) banks to achieve competitive advantages in both costs and income.

Answer: B
Ques Status: Previous Edition

43) Disintermediation resulted from

A) interest rate ceilings combine with inflation-driven increases in interest rates.

B) elimination of Regulation Q (the regulation imposing interest rate ceilings on bank deposits).

C) increases in federal income taxes.

D) reserve requirements.

Answer: A
Ques Status: Revised

44) The experience of disintermediation in the banking industry illustrates that

A) more regulation of financial markets may avoid such problems in the future.

B) banks are unable to remain competitive with other financial intermediaries.

C) consumers no longer desire the services that banks provide.

D) markets invent alternatives to costly regulations.

Answer: D
Ques Status: Revised

45) Banks responded to disintermediation by

A) supporting the elimination of interest rate regulations, enabling them to better compete for funds.

B) opposing the elimination of interest rate regulations, as this would increase their cost of funds.

C) demanding that interest rate regulations be imposed on money market mutual funds.

D) supporting the elimination of interest rate regulations, as this would reduce their cost of funds.

Answer: A
Ques Status: Revised

46) One factor contributing to the decline in cost advantages that banks once had is the

A) decline in the importance of checkable deposits from over 60 percent of banks' liabilities to under 15 percent today.

B) decline in the importance of savings deposits from over 60 percent of banks' liabilities to under 15 percent today.

C) decline in the importance of checkable deposits from over 40 percent of banks' liabilities to under 15 percent today.

D) decline in the importance of savings deposits from over 40 percent of banks' liabilities to under 20 percent today.

Answer: A
Ques Status: Previous Edition

47) The most important developments that have reduced banks' cost advantages in the past thirty years include:

A) the growth of the junk bond market.

B) the competition from money market mutual funds.

C) the growth of securitization.

D) the growth in the commercial paper market.

Answer: B
Ques Status: Revised

48) The most important developments that have reduced banks' income advantages in the past thirty years include:

A) the increase in off–balance sheet activities.

B) the growth of the junk bond market.

C) the elimination of Regulation Q ceilings.

D) the competition from money market mutual funds.

Answer: B
Ques Status: Revised

49) One factor contributing to the decline in income advantages that banks once had is the increased competition from the commercial paper market which has grown from ________ percent of commercial and industrial bank loans to over ________ percent today.

A) 10; 20

B) 5; 13

C) 10; 40

D) 5; 40

Answer: B
Ques Status: Revised

50) Banks have attempted to maintain adequate profit levels by

A) making fewer riskier loans, such as commercial real estate loans.

B) pursuing new off–balance–sheet activities.

C) increasing reserve deposits at the Fed.

D) decreasing capital accounts..

Answer: B
Ques Status: Revised

51) The decline in traditional banking internationally can be attributed to

A) increased regulation.

B) improved information technology.

C) increasing monopoly power of banks over depositors.

D) increased protection from competition.

Answer: B
Ques Status: Revised

52) Why did the interest rate volatility of the 1970s spur financial innovation?

Answer: Banks were very vulnerable to interest–rate risk in the mortgage loans. To protect themselves, banks began to issue adjustable–rate mortgages whose interest rate will increase along with market interest rates. Additionally financial derivatives were developed to help hedge against interest–rate risk.
Ques Status: New

10.3 Structure of the U.S. Commercial Banking Industry

1) The presence of so many commercial banks in the United States is most likely the result of

A) consumers' strong desire for dealing with only local banks.

B) adverse selection and moral hazard problems that give local banks a competitive advantage over larger banks.

C) prior regulations that restrict the ability of these financial institutions to open branches.

D) consumers' preference for state banks.

Answer: C
Ques Status: Revised

2) The McFadden Act of 1927

A) effectively prohibited banks from branching across state lines.

B) required that banks maintain bank capital equal to at least 6 percent of their assets.

C) effectively required that banks maintain a correspondent relationship with large money center banks.

D) separated the commercial banks and investment banks.

Answer: A
Ques Status: Revised

3) The legislation that effectively prohibited banks from branching across state lines and forced all national banks to conform to the branching regulations in the state in which they reside is the

A) McFadden Act.

B) National Bank Act.

C) Glass–Steagall Act.

D) Garn–St.Germain Act.

Answer: A
Ques Status: Previous Edition

4) As a result of restrictive banking regulations, the United States

A) has too few banks when compared to other industrialized countries.

B) has banks that are quite large relative to those in other countries.

C) has too many banks when compared to other industrialized countries.

D) has a few dominant banks that hold most of the assets in the industry.

Answer: C
Ques Status: Revised

5) The large number of banks in the United States is an indication of

A) vigorous competition within the banking industry.

B) lack of competition within the banking industry.

C) only efficient banks operating within the United States.

D) consumer preference for local banks.

Answer: B
Ques Status: Revised

6) Lack of competition in the United States banking industry can be attributed to

A) the fact that competition does not benefit consumers.

B) the fact that branching has eliminated competition.

C) recent legislation restricting competition.

D) nineteenth–century populist sentiment.

Answer: D
Ques Status: Revised

7) Which of the following is a true statement concerning bank holding companies?

A) Bank holding companies own few large banks.

B) Bank holding companies have experienced dramatic growth in the past three decades.

C) The McFadden Act has prevented bank holding companies from establishing branch banks.

D) Bank holding companies can own only banks.

Answer: B
Ques Status: Revised

8) Which of the following are true statements concerning shared electronic banking facilities?

A) Most courts and states have held that electronic bank facilities are not subject to branching restrictions.

B) If an electronic facility is paid for on a transaction fee basis, it is not considered a branch bank, and is therefore not subject to branching regulations.

C) McFadden Act restrictions do not apply to electronic facilities owned outright by banks.

D) Electronic banking facilities have no impact on the size of a bank's market.

Answer: B
Ques Status: Revised

9) A financial innovation that developed as a result of banks' avoidance of bank branching restrictions was ________.

A) money market mutual funds

B) commercial paper

C) junk bonds

D) bank holding companies

Answer: D
Ques Status: New

10) What financial innovations helped banks to get around the bank branching restrictions of the McFadden Act?

Answer: The introduction of the automated teller machine allowed a bank's customers to have access to funds from various locations not just the bank building and was not subject to the branching restrictions. Bank holding companies could own controlling interest in several banks and other companies related to banking.
Ques Status: New

10.4 Bank Consolidation and Nationwide Banking

1) The primary reason for the recent reduction in the number of banks is

A) bank failures.

B) re–regulation of banking.

C) restrictions on interstate branching.

D) mergers and acquisitions.

Answer: D
Ques Status: Revised

2) Bank holding companies that rival money center banks in size, but are not located in money center cities are

A) superregional banks.

B) bank clearing houses.

C) international banks.

D) local banks.

Answer: A
Ques Status: Revised

3) The ability to use one resource to provide different products and services is

A) economies of scale.

B) economies of scope.

C) diversification.

D) vertical integration.

Answer: B
Ques Status: Revised

4) The business term for economies of scope is

A) economies of scale.

B) diversification.

C) cooperation.

D) synergies.

Answer: D
Ques Status: Revised

5) The recent legislation that overturned the prohibition on interstate banking is

A) the McFadden Act.

B) the Gramm–Leach–Bliley Act.

C) the Glass–Steagall Act

D) the Riegle–Neal Act

Answer: D
Ques Status: Revised

6) The only country without a true national banking system in which banks have branches throughout the nation is

   A) Canada.

   B) France.

   C) Italy.

   D) the United States.

   Answer: D
   Ques Status: Previous Edition

7) Although it has a population about half that of the United States, Japan has

   A) many more banks.

   B) about 10 percent of the number of banks.

   C) about 5 percent of the number of banks.

   D) about 1 percent of the number of banks.

   Answer: D
   Ques Status: Revised

8) Experts predict that the future structure of the U.S. banking industry will have

   A) an increased number of banks.

   B) as few as ten banks.

   C) several thousand banks.

   D) a few hundred banks.

   Answer: C
   Ques Status: Revised

9) Bank consolidation will likely result in

   A) less competition.

   B) the elimination of community banks.

   C) increased competition.

   D) a shift in assets from larger banks to smaller banks.

   Answer: C
   Ques Status: Revised

10) Critics of nationwide banking fear

A) an elimination of community banks.

B) increased lending to small businesses.

C) cutthroat competition.

D) banks with economies of scale problems.

Answer: A
Ques Status: Revised

11) Nationwide banking will likely reduce bank failures due to

A) reduced competition.

B) reduced lending to small businesses.

C) diversification of loan portfolios across state lines.

D) elimination of community banks.

Answer: C
Ques Status: Revised

12) As the banking system in the United States evolves, it is expected that

A) the number and importance of small banks will increase.

B) the number and importance of large banks will decrease.

C) small banks will grow at the expense of large banks.

D) the number and importance of large banks will increase.

Answer: D
Ques Status: Revised

10.5 Separation of the Banking and Other Financial Service Industries

1) The legislation overturning the Glass–Steagall Act is

A) the McFadden Act.

B) the Gramm–Leach–Bliley Act.

C) the Garn–St. Germain Act

D) the Riegle–Neal Act.

Answer: B
Ques Status: Revised

2) Under the Gramm–Leach–Bliley Act states retain regulatory authority over ________.

A) bank holding companies

B) securities activities

C) insurance activities

D) bank subsidiaries engaged in securities underwriting

Answer: C
Ques Status: New

3) In a ________ banking system, commercial banks provide a full range of banking, securities, and insurance services, all within a single legal entity.

A) universal

B) severable

C) barrier–free

D) dividerless

Answer: A
Ques Status: Revised

4) In a ________ banking system, commercial banks engage in securities underwriting, but legal subsidiaries conduct the different activities. Also, banking and insurance are not typically undertaken together in this system.

A) universal

B) British–style universal

C) short–fence

D) compartmentalized

Answer: B
Ques Status: Revised

5) A major difference between the United States and Japanese banking systems is that

A) American banks are allowed to hold substantial equity stakes in commercial firms, whereas Japanese banks cannot.

B) Japanese banks are allowed to hold substantial equity stakes in commercial firms, whereas American banks cannot.

C) bank holding companies are illegal in the United States.

D) Japanese banks are usually organized as bank holding companies.

Answer: B
Ques Status: Revised

10.6 Thrift Industry: Regulation and Structure

1) The regulatory agency responsible for supervising savings and loans institutions is the

A) FSLIC.

B) Fed.

C) Comptroller of the Currency.

D) Federal Home Loan Bank System.

Answer: D
Ques Status: Previous Edition

2) Unlike banks, _____ have been allowed to branch statewide since 1980.

A) federally-chartered S&Ls

B) state-chartered S&Ls

C) financially troubled S&Ls

D) technically insolvent S&Ls

Answer: A
Ques Status: Previous Edition

3) Thrift institutions include

A) commercial banks.

B) brokerage firms

C) insurance companies.

D) mutual savings banks.

Answer: D
Ques Status: Revised

4) Mutual savings banks are owned by ___________.

A) shareholders

B) partners

C) depositors

D) foreign investors

Answer: C
Ques Status: New

5) An essential characteristic of credit unions is that

A) they are typically large.

B) branching across state lines is prohibited.

C) their lending is primarily for mortgage loans.

D) they are organized for individuals with a common bond.

Answer: D
Ques Status: Revised

6) ______________ are the only depository institutions that are tax–exempt.

A) Commercial banks

B) Savings and loans

C) Mutual savings banks

D) Credit unions

Answer: D
Ques Status: New

10.7 International Banking

1) The spectacular growth in international banking can be explained by

A) the rapid growth in international trade.

B) the 1988 Basel Agreement.

C) the desire for U.S. banks to escape burdensome domestic regulations.

D) the creation of the World Trade Organization.

Answer: A
Ques Status: Revised

2) What country is given credit for the birth of the Eurodollar market?

A) The United States

B) England

C) The Soviet Union

D) Japan

Answer: C
Ques Status: Previous Edition

3) Deposits in European banks denominated in dollars for the purpose of international transactions are known as

A) Eurodollars.

B) European Currency Units.

C) European Monetary Units.

D) International Monetary Units.

Answer: A
Ques Status: Previous Edition

4) The main center of the Eurodollar market is

A) London.

B) Basel.

C) Paris.

D) New York.

Answer: A
Ques Status: Previous Edition

5) Eurodollars are

A) dollar–dominated deposits held in banks outside the United States.

B) deposits held by U.S. banks in Europe.

C) deposits held by U.S. banks in foreign countries.

D) dollar–dominated deposits held in U.S. banks by Europeans.

Answer: A
Ques Status: Previous Edition

6) Reasons for holding Eurodollars include

A) the fact that Eurodollar deposits are insured by the FDIC.

B) the fact that dollars are widely used to conduct international transactions.

C) the fact that minimum transaction sizes are very low, making Eurodollars an attractive savings instrument for consumers.

D) the fact that Eurodollar deposits are heavily regulated.

Answer: B
Ques Status: Revised

7) An advantage to American banks from operating foreign branches is that Eurodollar deposits in offshore branches are

A) not subject to reserve requirements.

B) insured by the FDIC.

C) subject to extensive regulatory supervision.

D) all demand deposits that pay no interest.

Answer: A
Ques Status: Revised

8) U.S. banks have most of their branches in

A) Latin America, the Far East, the Caribbean, and London.

B) Latin America, the Middle East, the Caribbean, and London.

C) Mexico, the Middle East, the Caribbean, and London.

D) South America, the Middle East, the Caribbean, and Canada.

Answer: A
Ques Status: Previous Edition

9) A ________ is a subsidiary of a U.S. bank that is engaged primarily in international banking.

A) Edge Act corporation

B) Eurodollar agency

C) universal bank

D) McFadden corporation

Answer: A
Ques Status: New

10) ________ within the U.S. can make loans to foreigners but cannot make loans to domestic residents.

A) Edge Act corporations

B) International Banking Facilities

C) Universal banks

D) Euro banks

Answer: B
Ques Status: New

11) ________ of a foreign bank operates in the U.S. but cannot accept deposits from domestic residents.

A) An agency office

B) A universal corporation

C) A McFadden corporation

D) A Basel branch

Answer: A
Ques Status: New

12) Since the passage of the International Banking Act of 1978, the competitive advantage enjoyed by foreign banks has been

A) reduced.

B) mildly expanded.

C) completely eliminated.

D) greatly expanded.

Answer: A
Ques Status: Previous Edition

13) Discuss three ways in which U.S. banks can become involved in international banking.

Answer: United States banks could open a foreign branch of their bank. A U.S. bank holding company could purchase controlling interest in a foreign bank in a foreign country. A U.S. bank could open a Edge Act Corporation. A U.S. bank could open an International Banking Facility in the U.S. which accepts time deposits from foreigners and makes loans to foreigners in the U.S.
Ques Status: New

Chapter 11

Economic Analysis of Banking Regulation

11.1 Asymmetric Information and Banking Regulation

1) Depositors lack of information about the quality of bank assets can lead to ________.

A) bank panics

B) bank booms

C) sequencing

D) asset transformation

Answer: A
Ques Status: New

2) Although the FDIC was created to prevent bank failures, its existence encourages banks to

A) take too much risk.

B) hold too much capital.

C) open too many branches.

D) buy too much stock.

Answer: A
Ques Status: Previous Edition

3) The fact that banks operate on a "sequential service constraint" means that

A) all depositors share equally in the bank's funds during a crisis.

B) depositors arriving last are just as likely to receive their funds as those arriving first.

C) depositors arriving first have the best chance of withdrawing their funds.

D) banks randomly select the depositors who will receive all of their funds.

Answer: C
Ques Status: Revised

4) Depositors have a strong incentive to show up first to withdraw their funds during a bank crisis because banks operate on a

A) last–in, first–out constraint.

B) sequential service constraint.

C) double–coincidence of wants constraint.

D) everyone–shares–equally constraint.

Answer: B
Ques Status: Revised

5) Because of asymmetric information, the failure of one bank can lead to runs on other banks. This is the

A) too-big-to-fail effect.

B) moral hazard problem.

C) adverse selection problem.

D) contagion effect.

Answer: D
Ques Status: Revised

6) The contagion effect refers to the fact that

A) deposit insurance has eliminated the problem of bank failures.

B) bank runs involve only sound banks.

C) bank runs involve only insolvent banks.

D) the failure of one bank can hasten the failure of other banks.

Answer: D
Ques Status: Revised

7) During the boom years of the 1920s, bank failures were quite

A) uncommon, averaging less than 30 per year.

B) uncommon, averaging less than 100 per year.

C) common, averaging about 600 per year.

D) common, averaging about 1000 per year.

Answer: C
Ques Status: Previous Edition

8) A system of deposit insurance

A) attracts risk-taking entrepreneurs into the banking industry.

B) encourages bank managers to decrease risk.

C) increases the incentives of depositors to monitor the riskiness of their bank's asset portfolio.

D) increases the likelihood of bank runs.

Answer: A
Ques Status: Revised

9) The primary difference between the "payoff" and the "purchase and assumption" methods of handling failed banks is

A) that the FDIC guarantees all deposits, not just those under the $100,000 limit, when it uses the "payoff" method.

B) that the FDIC guarantees all deposits, not just those under the $100,000 limit, when it uses the "purchase and assumption" method.

C) that the FDIC is more likely to use the "payoff" method when the bank is large and it fears that depositor losses may spur business bankruptcies and other bank failures.

D) that the FDIC is more likely to use the purchase and assumption method for small institutions because it will be easier to find a purchaser for them compared to large institutions.

Answer: B
Ques Status: Revised

10) Deposit insurance has not worked well in countries with

A) a weak institutional environment.

B) strong supervision and regulation.

C) a tradition of the rule of law.

D) few opportunities for corruption.

Answer: A
Ques Status: Revised

11) When one party to a transaction has incentives to engage in activities detrimental to the other party, there exists a problem of

A) moral hazard.

B) split incentives.

C) ex ante shirking.

D) pre-contractual opportunism.

Answer: A
Ques Status: Previous Edition

12) Moral hazard is an important concern of insurance arrangements because the existence of insurance

A) provides increased incentives for risk taking.

B) is a hindrance to efficient risk taking.

C) causes the private cost of the insured activity to increase.

D) creates an adverse selection problem but no moral hazard problem.

Answer: A
Ques Status: Revised

13) When bad drivers line up to purchase collision insurance, automobile insurers are subject to the

A) moral hazard problem.

B) adverse selection problem.

C) assigned risk problem.

D) ill queue problem.

Answer: B
Ques Status: Previous Edition

14) Since depositors, like any lender, only receive fixed payments while the bank keeps any surplus profits, they face the ________ problem that banks may take on too ________ risk.

A) adverse selection; little

B) adverse selection; much

C) moral hazard; little

D) moral hazard; much

Answer: D
Ques Status: Previous Edition

15) The existence of deposit insurance can increase the likelihood that depositors will need deposit protection, as banks with deposit insurance

A) are likely to take on greater risks than they otherwise would.

B) are likely to be too conservative, reducing the probability of turning a profit.

C) are likely to regard deposits as an unattractive source of funds due to depositors' demands for safety.

D) are placed at a competitive disadvantage in acquiring funds.

Answer: A
Ques Status: Previous Edition

16) The government safety net creates ________ problem because risk-loving entrepreneurs might find banking an attractive industry.

A) an adverse selection

B) a moral hazard

C) a lemons

D) a revenue

Answer: A
Ques Status: New

17) If the FDIC decides that a bank is too big to fail, it will use the ________ method, effectively ensuring that ________ depositors will suffer losses.

A) payoff; large

B) payoff; no

C) purchase and assumption; large

D) purchase and assumption; no

Answer: D
Ques Status: Previous Edition

18) The result of the too-big-to-fail policy is that ________ banks will take on ________ risks, making bank failures more likely.

A) small; fewer

B) small; greater

C) big; fewer

D) big; greater

Answer: D
Ques Status: Previous Edition

19) A problem with the too-big-to-fail policy is that it ________ the incentives for ________ by big banks.

A) increases; moral hazard

B) decreases; moral hazard

C) decreases; adverse selection

D) increases; adverse selection

Answer: A
Ques Status: Revised

20) The too-big-to-fail policy

A) reduces moral hazard problems.

B) puts large banks at a competitive disadvantage in attracting large deposits.

C) treats large depositors of small banks inequitably when compared to depositors of large banks.

D) allows small banks to take on more risk than large banks.

Answer: C
Ques Status: Revised

21) In May 1991, the FDIC announced that it would sell the government's final 26% stake in Continental Illinois, ending government ownership of the bank that it had rescued in 1984. The FDIC took control of the bank, rather than liquidate it, because it believed that Continental Illinois

A) was a good investment opportunity for the government.

B) could be the Chicago branch of a new governmentally–owned interstate banking system.

C) was too big to fail.

D) would become the center of the new midwest region central bank system.

Answer: C
Ques Status: Revised

22) Federal deposit insurance covers deposits up to $100,000, but as part of a doctrine called "too–big–to–fail" the FDIC sometimes ends up covering all deposits to avoid disrupting the financial system. When the FDIC does this, it uses the

A) "payoff" method.

B) "purchase and assumption" method.

C) "inequity" method.

D) "Basel" method.

Answer: B
Ques Status: Revised

23) Because the ________ costs of bank failure are greater than bank's ________ costs, banks may hold assets that are too risky.

A) social; social

B) social; private

C) private; social

D) private; private

Answer: B
Ques Status: Previous Edition

24) Acquiring information on a bank's activities in order to determine a bank's risk is difficult for depositors and is another argument for government ________.

A) regulation

B) ownership

C) recall

D) forbearance

Answer: A
Ques Status: New

25) Regulators attempt to reduce the riskiness of banks' asset portfolios by

A) limiting the amount of loans in particular categories or to individual borrowers.

B) encouraging banks to hold risky assets such as common stocks.

C) establishing a minimum interest rate floor that banks can earn on certain assets.

D) requiring collateral for all loans.

Answer: A
Ques Status: Revised

26) A well-capitalized bank has ________ to lose if it fails and thus is ________ likely to pursue risky activities.

A) more; more

B) more; less

C) less; more

D) less; less

Answer: B
Ques Status: Revised

27) A bank failure is less likely to occur when

A) a bank holds less U.S. government securities.

B) a bank suffers large deposit outflows.

C) a bank holds fewer excess reserves.

D) a bank has more bank capital.

Answer: D
Ques Status: Revised

28) The leverage ratio is the ratio of a bank's

A) assets divided by its liabilities.

B) income divided by its assets.

C) capital divided by its total assets.

D) capital divided by its total liabilities.

Answer: C
Ques Status: Revised

29) To be considered well capitalized, a bank's leverage ratio must exceed ________.

A) 10%

B) 8%

C) 5%

D) 3%

Answer: C
Ques Status: New

30) Off–balance–sheet activities

A) generate fee income with no increase in risk.

B) increase bank risk but do not increase income.

C) generate fee income but increase a bank's risk.

D) generate fee income and reduce risk.

Answer: C
Ques Status: Revised

31) The increased integration of financial markets across countries and the need to make the playing field equal for banks from different countries led to the Basel agreement in June 1988 to

A) standardize bank capital requirements internationally.

B) reduce, across the board, bank capital requirements in all countries.

C) sever the link between risk and capital requirements.

D) eliminate bank capital requirements.

Answer: A
Ques Status: Revised

32) The Basel Accord requires banks to hold as capital an amount that is at least ________ of their risk–weighted assets.

A) 10%

B) 8%

C) 5%

D) 3%

Answer: B
Ques Status: New

33) Under the Basel Accord, assets and off–balance sheet activities were sorted according to ________ categories with each category assigned a different weight to reflect the amount of ________.

A) 2; adverse selection

B) 2; credit risk

C) 4; adverse selection

D) 4; credit risk

Answer: D
Ques Status: New

34) The practice of keeping high–risk assets on a bank's books while removing low–risk assets with the same capital requirement is know as

A) competition in laxity.

B) depositor supervision.

C) regulatory arbitrage.

D) a dual banking system.

Answer: C
Ques Status: Revised

35) Banks engage in regulatory arbitrage by

A) keeping high–risk assets on their books while removing low–risk assets with the same capital requirement.

B) keeping low–risk assets on their books while removing high–risk assets with the same capital requirement.

C) hiding risky assets from regulators.

D) buying risky assets from arbitrageurs.

Answer: A
Ques Status: Revised

36) Because banks engage in regulatory arbitrage, the Basel Accord on risk–based capital requirements may result in

A) reduced risk taking by banks.

B) reduced supervision of banks by regulators.

C) increased fraudulent behavior by banks.

D) increased risk taking by banks.

Answer: D
Ques Status: Revised

37) Overseeing who operates banks and how they are operated is called ________.

A) prudential supervision

B) hazard insurance

C) regulatory interference

D) loan loss reserves

Answer: A
Ques Status: New

38) The chartering process is especially designed to deal with the ________ problem, and regular bank examinations help to reduce the ________ problem.

A) adverse selection; adverse selection

B) adverse selection; moral hazard

C) moral hazard; adverse selection

D) moral hazard; moral hazard

Answer: B
Ques Status: Previous Edition

39) Banks will be examined at least once a year and given a CAMELS rating by examiners. The L stands for ________.

A) liabilities

B) liquidity

C) loans

D) leverage

Answer: B
Ques Status: New

40) The chartering process is similar to ________ potential borrowers and the restriction of risk assets by regulators is similar to ________ in private financial markets.

A) screening; restrictive covenants

B) screening; branching restrictions

C) identifying; branching restrictions

D) identifying; credit rationing

Answer: A
Ques Status: New

41) The federal agencies that examine banks include

A) the Federal Reserve System.

B) the Internal Revenue Service.

C) the SEC.

D) the U.S. Treasury.

Answer: A
Ques Status: Revised

42) Regular bank examinations and restrictions on asset holdings help to indirectly reduce the ________ problem because, given fewer opportunities to take on risk, risk-prone entrepreneurs will be discouraged from entering the banking industry.

A) moral hazard

B) adverse selection

C) ex post shirking

D) post-contractual opportunism.

Answer: B
Ques Status: Previous Edition

43) Banks are required to file ________ usually quarterly that list information on the bank's assets and liabilities, income and dividends, and so forth.

A) call reports

B) balance reports

C) regulatory sheets

D) examiner updates

Answer: A
Ques Status: New

44) The current supervisory practice toward risk management

A) focuses on the quality of a bank's balance sheet.

B) determines whether capital requirements have been met.

C) evaluates the soundness of a bank's risk-management process.

D) focuses on eliminating all risk.

Answer: C
Ques Status: Revised

45) Consumer protection legislation includes legislation to

A) reduce discrimination in credit markets.

B) require banks to make loans to everyone who applies.

C) reduce the amount of interest that bank's can charge on loans.

D) require banks to make periodic reports to the Better Business Bureau.

Answer: A
Ques Status: New

46) Competition between banks

A) encourages greater risk taking.

B) encourages conservative bank management.

C) increases bank profitability.

D) eliminates the need for government regulation.

Answer: A
Ques Status: Revised

47) Regulations that reduce competition between banks include

A) branching restrictions.

B) bank reserve requirements.

C) the dual system of granting bank charters.

D) interest-rate ceilings.

Answer: A
Ques Status: Revised

48) The Act that required separation of commercial and investment banking was

A) the Federal Reserve Act.

B) the Glass-Steagall Act.

C) the Bank Holding Company Act.

D) the Monetary Control Act.

Answer: B
Ques Status: Revised

49) The main motive behind the forces that have shaped the development of the current regulatory system has been the

A) desire to prevent monopolistic practices.

B) desire to ensure a sound banking system.

C) desire to create an interstate banking system.

D) desire to foster a highly competitive banking system.

Answer: B
Ques Status: Previous Edition

50) The government safety net creates both an adverse selection problem and a moral hazard problem. Explain.

Answer: The adverse selection problem occurs because risk–loving individuals might view the banking system as a wonderful opportunity to use other peoples' funds knowing that those funds are protected. The moral hazard problem comes about because depositors will not impose discipline on the banks since their funds are protected and the banks knowing this will be tempted to take on more risk than they would otherwise.
Ques Status: New

11.2 International Banking Regulation

1) Who has regulatory responsibility when a bank operates branches in many countries?

A) It is not always clear.

B) The WTO.

C) The U.S. Federal Reserve System.

D) The first country to submit an application.

Answer: A
Ques Status: New

2) The collapse of the Bank of Credit and Commerce International, BCCI, showed the difficulty of international banking regulation. BCCI operated in more than ________ countries and was supervised by the small country of ________.

A) 70, Luxemborg

B) 100, Monaco

C) 70, Monaco

D) 100, Luxemborg

Answer: A
Ques Status: New

3) Agreements such as the ________ are attempts to standardize international banking regulations.

A) Basel Accord

B) UN Bank Accord

C) GATT Accord

D) WTO Accord

Answer: A
Ques Status: New

4) The Basel Committee ruled that regulators in other countries can ________ the operations of a foreign bank if they believe that it lacks effective oversight.

A) restrict

B) encourage

C) renegotiate

D) enhance

Answer: A
Ques Status: New

5) Which of the following is not a reason bank regulation and supervision is difficult in real life?

A) Financial institutions have strong incentive to avoid existing regulations.

B) Unintended consequences may happen if details in the regulations are not precise.

C) Political pressure to ease the rules.

D) Financial institutions are not required to follow the rules.

Answer: D
Ques Status: New

11.3 The 1980s U.S. Savings and Loan and Banking Crisis: Why?

1) In the ten year period 1981–1990, 1202 commercial banks were closed, with a peak of 206 failures in 1989. This rate of failures was approximately ________ times greater than that in the period from 1934 to 1980.

A) two

B) three

C) five

D) ten

Answer: D
Ques Status: Revised

2) Moral hazard and adverse selection problems increased in prominence in the 1980s

A) as deregulation required savings and loans and mutual savings banks to be more cautious.

B) following a burst of financial innovation in the 1970s and early 1980s that produced new financial instruments and markets, thereby widening the scope for risk taking.

C) following a decrease in federal deposit insurance from $100,000 to $40,000.

D) as interest rates were sharply decreased to bring down inflation.

Answer: B
Ques Status: Revised

3) In the early stages of the 1980s banking crisis, financial institutions were especially harmed by

A) declining interest rates from late 1979 until 1981.

B) the severe recession in 1981–82.

C) the disinflation from mid 1980 to early 1983.

D) the increase in energy prices in the early 80s.

Answer: B
Ques Status: Revised

4) The Depository Institutions Deregulation and Monetary Control Act of 1980

A) approved NOW accounts nationwide.

B) restricted the use of ATS accounts.

C) imposed restrictive usury ceilings on large agricultural loans.

D) decreased deposit insurance from $100,000 to $40,000.

Answer: A
Ques Status: Revised

5) As a way of stemming the decline in the number of savings and loans and mutual savings banks, the Garn–St. Germain Act of 1982 allowed

A) MMCs.

B) MMMFs.

C) MMDAs.

D) NOWs.

Answer: C
Ques Status: Previous Edition

6) When regulators chose to allow insolvent S&Ls to continue to operate rather than to close them, they were pursuing a policy of ________.

A) regulatory forbearance

B) regulatory kindness

C) ostrich reasoning

D) ignorance reasoning

Answer: A
Ques Status: New

7) Although as many as half of the S&Ls in the U.S. had a negative net worth and were thus insolvent by the end of 1982, regulators adopted a policy of ________, which amounted to ________ capital requirements.

A) regulatory forbearance; raising

B) regulatory forbearance; lowering

C) regulatory agnosticism; raising

D) regulatory agnosticism; lowering

Answer: B
Ques Status: Previous Edition

8) The policy of ________ exacerbated ________ problems as savings and loans took on increasingly huge levels of risk on the slim chance of returning to solvency.

A) regulatory forbearance; moral hazard

B) regulatory forbearance; adverse hazard

C) regulatory agnosticism; moral hazard

D) regulatory agnosticism; adverse hazard

Answer: A
Ques Status: Previous Edition

9) Reasons regulators chose to follow regulatory forbearance rather than to close the insolvent S&Ls include all of the following except

A) they had insufficient funds to close all of the insolvent S&Ls.

B) they were friends with the S&L owners.

C) they hoped the problem would go away.

D) they did not have the authority to close the insolvent S&Ls.

Answer: D
Ques Status: New

10) Regulatory forbearance

A) meant delaying the closing of "zombie S&Ls" as their losses mounted during the 1980s.

B) had the advantage of benefiting healthy S&Ls at the expense of "zombie S&Ls", as insolvent institutions lost deposits to health institutions.

C) had the advantage of permitting many insolvent S&Ls the opportunity to return to profitability, saving the FSLIC billions of dollars.

D) increased adverse selection dramatically.

Answer: A
Ques Status: Revised

11) In 1987, Far West Savings & Loan Association, with a negative net worth of $290 million, persuaded the Federal Home Loan Bank of Seattle to lend the thrift more than $1 billion. This regulatory response to insolvency is an example of

A) loophole mining.

B) regulatory forbearance.

C) securitization.

D) regulatory agnosticism.

Answer: B
Ques Status: Revised

12) The major provisions of the Competitive Equality Banking Act of 1987 include

A) expanding the responsibilities of the FDIC, which is now the sole administrator of the federal deposit insurance system.

B) the establishment of the Resolution Trust Corporation to manage and resolve insolvent thrifts placed in conservatorship or receivership.

C) directing the Federal Home Loan Bank Board to continue to pursue regulatory forbearance.

D) prompt corrective action when a bank gets in trouble.

Answer: C
Ques Status: Revised

13) Responsibility for the high cost of the savings and loan bailout rests with

A) thrift regulators.

B) depositors.

C) politicians.

D) thrift officials.

Answer: C
Ques Status: Revised

14) How did the increase in the interest rates in the early 80s contribute to the S&L crisis?

Answer: The S&Ls suffered from an interest-rate risk problem. They had many fixed-rate mortgages with low interest rates. As interest rates in the economy began to climb, S&Ls began to lose profitability. Because of deregulation and financial innovation, it became possible for the S&Ls to undertake more risky ventures to try to regain their profitability. Many of them lacked expertise in judging credit risk in the new loan areas resulting in large losses.

Ques Status: New

11.4 Political Economy of the Saving and Loan Crisis

1) The S&L Crisis can be analyzed as a principal-agent problem. The agents in this case, the ________, did not have the same incentive to minimize cost to the economy as the principals, the ________.

A) politicians/regulators; taxpayers

B) taxpayers; politician/regulators

C) taxpayers; bank managers

D) bank managers; politicians/regulators

Answer: A

Ques Status: New

2) "Bureaucratic gambling" refers to

A) the strategy of thrift managers that they would not be audited by thrift regulators in the 1980s due to the relatively weak bureaucratic power of thrift regulators.

B) the risk that thrift regulators took in publicizing the plight of the S&L industry in the early 1980s.

C) the strategy adopted by thrift regulators of lowering capital requirements and pursuing regulatory forbearance in the 1980s in the hope that conditions in the S&L industry would improve.

D) the risk that regulators took in going to Congress to ask for additional funds.

Answer: C

Ques Status: Revised

3) Taxpayers were served poorly by thrift regulators in the 1980s. This poor performance cannot be explained by

A) regulators' desire to escape blame for poor performance, leading to a perverse strategy of "bureaucratic gambling."

B) regulators' incentives to accede to pressures imposed by politicians, who sought to keep regulators from imposing tough regulations on institutions that were major campaign contributors.

C) Congress's dogged determination to protect taxpayers from the unsound banking practices of managers at many of the nations savings and loans.

D) politicians strong incentives to act in their own interests rather than the interests of the taxpayers.

Answer: C
Ques Status: Revised

4) An analysis of the political economy of the savings and loan crisis helps one to understand

A) why politicians aided the efforts of thrift regulators, raising regulatory appropriations and encouraging closing of insolvent thrifts.

B) why thrift regulators were so quick to inform Congress of the problems that existed in the thrift industry.

C) why thrift regulators willingly acceded to pressures placed upon them by members of Congress.

D) why politicians listened so closely to the taxpayers they represented.

Answer: C
Ques Status: Revised

5) That several hundred S&Ls were not even examined once in the period January 1984 through June 1986 can be explained by

A) Congress's unwillingness to allocate the necessary funds to thrift regulators.

B) regulators' reluctance to find the specific problem thrifts that they knew existed.

C) prohibitions against easing regulatory restrictions against S&Ls as mandated in the Competitive Banking Equality Act.

D) Congress's unwillingness to listen to campaign contributors.

Answer: C
Ques Status: Revised

6) The bailout of the savings and loan industry was much delayed and, therefore, much more costly to taxpayers because

A) of regulators' initial attempts to downplay the seriousness of problems within the thrift industry.

B) politicians listened to the taxpayers rather than the S&L lobbyists.

C) Congress did not wait long enough for many of the problems in the thrift industry to correct themselves.

D) regulators could not be fired, therefore, they didn't care if they did a good job or not.

Answer: A
Ques Status: Revised

11.5 Savings and Loan Bailout: The Financial Institutions Reform, Recovery, and Enforcement Act of 1989

1) The Federal Home Loan Bank Board and the FSLIC, both of which failed in their regulatory tasks, were abolished by the

A) Competitive Equality Banking Act of 1987.

B) Financial Institutions Reform, Recovery and Enforcement Act of 1989.

C) Office of Thrift Supervision.

D) Office of the Comptroller of the Currency.

Answer: B
Ques Status: Previous Edition

2) The major provisions of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 include

A) reducing the regulatory responsibilities of the FDIC.

B) the establishment of the Resolution Trust Corporation to manage and resolve insolvent thrifts placed in conservatorship or receivership.

C) directing the Federal Home Loan Bank Board to continue to pursue regulatory forbearance.

D) encouraging the FDIC to take prompt corrective action.

Answer: B
Ques Status: Revised

3) Many economists were mildly critical of FIRREA because

A) it reduced the efficiency of financial intermediation in the United States.

B) it did little to deal with the underlying adverse selection and moral hazard problems created by deposit insurance.

C) it significantly reduced the powers of thrift regulators and made it more difficult to remove incompetent thrift managers.

D) it reduced the capital requirements on S&Ls.

Answer: B
Ques Status: Revised

11.6 Federal Deposit Insurance Corporation Improvement Act of 1991

1) The Federal Deposit Insurance Corporation Improvement Act of 1991

A) increased the FDIC's ability to borrow from the Treasury to deal with failed banks.

B) increased the FDIC's ability to use the too-big-to-fail doctrine.

C) eliminated governmentally-administered deposit insurance.

D) eliminated restrictions on nationwide banking.

Answer: A
Ques Status: Revised

2) The Federal Deposit Insurance Corporation Improvement Act of 1991

A) instructed the FDIC to come up with risk-based deposit insurance premiums.

B) expanded the FDIC's ability to use the "too-big-to-fail" policy.

C) instructed the FDIC to wait longer before intervening when a bank gets into trouble.

D) reduced the FDIC's ability to borrow from the Treasury.

Answer: A
Ques Status: Revised

3) The ability to use the too-big-to-fail policy was seriously curtained by the passage of the FDICIA. To use this action today, the FDIC must get approval of a two-thirds majority of both the Board of Governors of the Federal Reserve and the directors of the FDIC and also the approval of the ________.

A) Secretary of the Treasury

B) Senate Finance Committee Chairperson

C) President of the United States

D) Governor of the state in which the failed bank is located

Answer: A
Ques Status: New

11.7 Banking Crises Throughout the World

1) As in the United States, an important factor in the banking crises in Norway, Sweden, and Finland was the

A) financial liberalization that occurred in the 1980s.

B) decline in real interest rates that occurred in the 1980s.

C) high inflation that occurred in the 1980s.

D) sluggish economic growth that occurred in the 1980s.

Answer: A
Ques Status: Previous Edition

2) As in the United States, an important factor in the banking crises in Latin America was the

A) financial liberalization that occurred in the 1980s.

B) decline in real interest rates that occurred in the 1980s.

C) high inflation that occurred in the 1980s.

D) sluggish economic growth that occurred in the 1980s.

Answer: A
Ques Status: Previous Edition

3) When comparing the banking crisis in the United States to the crises in Latin America, cost to the taxpayers of the government bailouts was

A) higher in Latin American than in the United States.

B) higher in the United States than in Latin America.

C) about the same in both Latin America and the United States.

D) positive in Latin America but negative in the United States.

Answer: A
Ques Status: New

4) The Argentine banking crisis of 2001 resulted from Argentina's banks being required to

A) purchase large amounts of government debt.

B) pay back the value of failed loans.

C) make risky real estate loans.

D) make loans to only state-owned businesses.

Answer: A
Ques Status: New

5) The Japanese banking system went through a cycle of ________ in the 1990s similar to the one that occurred in the U.S. in the 1980s.

A) regulatory forbearance

B) policy antagonism

C) regulatory ignorance

D) policy renewal

Answer: A
Ques Status: New

6) China is trying to move its banking system from being strictly ________ owned by having them issue shares overseas.

A) state

B) domestic investor

C) depositor

D) domestic corporate

Answer: A
Ques Status: New

7) The evidence from banking crises in other countries indicates that

A) deposit insurance is to blame in each country.

B) a government safety net for depositors need not increase moral hazard.

C) regulatory forbearnace never leads to problems.

D) deregulation combined with poor regulatory supervision raises moral hazard incentives.

Answer: D
Ques Status: Revised

8) Banking crises have occurred throughout the world. What similarities do we find when we look at the different countries?

Answer: Financial deregulation with inadequate supervision can lead to increased moral hazard as banks take on more risk. Although deposit insurance was not necessarily a major factor in every country's bank crisis, there was always some kind of government safety net. The presence of the government safety net also leads to increased risk–taking from the banks.
Ques Status: New

11.8 Web Appendix 1: Evaluating FDICIA and Other Proposed Reforms of the Banking Regulatory System

1) A system of coinsurance would

A) eliminate deposit insurance.

B) reduce deposit insurance to $40,000.

C) limit deposit insurance to only a percentage of a deposit.

D) provide 100% deposit insurance for all deposits.

Answer: C
Ques Status: Revised

2) The idea of eliminating or reducing deposit insurance to increase incentives for uninsured depositors to monitor banks leads to a basic problem of

A) banks being unwilling to make loans.

B) banks subject to runs and a large number of failures.

C) increasing banks' incentives to assume high risk.

D) decreasing risk for depositors.

Answer: B
Ques Status: Revised

3) Big banks are not subject to enough discipline from uninsured depositors because of

A) regulatory forbearance.

B) bureaucratic gambling.

C) the too–big–to–fail policy.

D) the principal–agent problem.

Answer: C
Ques Status: Revised

4) With the prompt corrective action provision, regulators can no longer pursue a policy of ________.

A) regulatory forbearance

B) prudential supervision

C) regulatory expansion

D) compulsive supervision

Answer: A
Ques Status: New

5) Risk–based deposit insurance premiums

A) reduce moral hazard incentives.

B) encourage banks to hold less capital.

C) reduce the adverse selection problem for regulators.

D) will have no impact on the type of assets banks hold.

Answer: A
Ques Status: Revised

6) One suggestion for future consideration is ________ to improve the costly and complex current system of multiple agencies with overlapping jurisdictions.

A) regulatory consolidation

B) regulatory expansion

C) regulatory decrease

D) regulatory shrinkage

Answer: A
Ques Status: New

Chapter 12

Nonbank Finance

12.1 Insurance

1) The regulatory agency responsible for regulating the activities of life insurance companies is

A) the FDIC.

B) the Fed.

C) the FHLBS.

D) the appropriate state agency where the company is operating.

Answer: D
Ques Status: Revised

2) Which of the following is true of life insurance companies?

A) Typically the type of assets that life insurance companies hold are corporate bonds, commercial mortgages, and corporate stock.

B) The two typical forms of life insurance polices that are held can be classified as whole and variable life policies.

C) The major risk that life insurance companies face is that payouts to policy holders are very hard to predict.

D) Life insurance companies have suffered from wide spread failures.

Answer: A
Ques Status: Revised

3) Life insurance companies are regulated by state governments because

A) they have never experienced bankruptcy.

B) they have never experienced profitability.

C) they have never experienced widespread failures.

D) they hold only highly liquid assets.

Answer: C
Ques Status: Revised

4) The insurance industry's share of total financial intermediary assets fell because of

A) poor investment returns in the 1960s and 1970s.

B) widespread failures of life insurance companies.

C) federal regulations limiting the sale of life insurance.

D) unpredictability of payouts.

Answer: A
Ques Status: Revised

5) An example of permanent insurance is ________ insurance, and an example of temporary insurance is ________ insurance.

A) term; variable life

B) whole life; variable life

C) whole life; term

D) term; whole life

Answer: C
Ques Status: Revised

6) A contract requiring payment of an annual premium in exchange for the payment of a future stream of payments beginning at a specified age and continuing until death is

A) whole life insurance.

B) an annuity.

C) term life insurance.

D) variable life insurance.

E) universal life insurance.

Answer: B
Ques Status: Revised

7) The key factor causing life insurance companies to move into the management of pension funds was

A) the investment expertise of insurance companies.

B) a request for this change by managers of pension funds.

C) a change in state laws.

D) a change in federal legislation.

Answer: D
Ques Status: Revised

8) Property and casualty insurance companies hold the largest share of their assets in

A) long-term government bonds.

B) short-term government securities and commercial paper.

C) tax-exempt municipal bonds and U.S. government securities.

D) medium-term corporate bonds.

Answer: C
Ques Status: Previous Edition

9) Property and casualty insurance companies are organized

A) both as stock and mutual companies.

B) only as stock companies.

C) only as mutual companies.

D) primarily as cooperatives.

Answer: A
Ques Status: Previous Edition

10) Relative to life insurance companies, property and casualty insurance companies hold

A) more liquid assets.

B) more long-term government bonds.

C) more commercial mortgages.

D) fewer municipal bonds.

Answer: A
Ques Status: Previous Edition

11) Reinsurance allows ________ to reduce the risks of exposure by allocating a portion of the risk to ________ in exchange for a portion of the premium.

A) insurance companies; another insurance company

B) insurance companies; the insured

C) the insured; the insurance company

D) the insured; a bank

Answer: A
Ques Status: Revised

12) Insurance companies reduce risk exposure in exchange for a portion of their insurance premiums by obtaining

A) government loan guarantees.

B) federal insurance.

C) reinsurance.

D) bankers acceptances.

Answer: C
Ques Status: Revised

13) The specialty of Lloyd's of London is

A) annuities.

B) hedge funds.

C) mutual funds.

D) reinsurance.

Answer: D
Ques Status: Revised

14) In recent years, bank regulatory authorities have

A) encouraged banks to enter the insurance field.

B) discouraged banks from entering the insurance field.

C) asked Congress to write new legislation that would make it illegal for banks to enter the insurance field.

D) asked Congress to write new legislation that would make it legal for banks to enter the insurance field.

Answer: A
Ques Status: Revised

15) A Supreme Court ruling in March 1996 held that

A) state laws to prevent banks from selling insurance can be superseded by federal rulings from banking regulators that allow banks to sell insurance.

B) state laws to prevent banks from selling insurance cannot be superseded by federal rulings from banking regulators that allow banks to sell insurance.

C) state laws to prevent banks from selling insurance can be superseded only if Congress enacts legislation that allow banks to sell insurance.

D) state laws to prevent banks from selling insurance cannot be superseded by federal legislation.

Answer: A
Ques Status: Previous Edition

16) When those most likely to produce the outcome insured against are the ones who purchase insurance, insurance companies are said to face the problem of

A) fraudulent claims.

B) moral hazard.

C) adverse selection.

D) pecuniary purchases.

Answer: C
Ques Status: Previous Edition

17) Some automobile owners will drive faster knowing that they are covered by health and automobile insurance. This behavior creates the problem of

A) fraudulent claims.

B) moral hazard.

C) adverse selection.

D) pecuniary purchases.

Answer: B
Ques Status: Previous Edition

18) In the case of an insurance policy, ________ occurs when the existence of insurance encourages the insured party to take risks that increase the likelihood of an insurance payoff.

A) moral hazard

B) opportunism

C) adverse selection

D) shirking

Answer: A
Ques Status: Previous Edition

19) Adverse selection occurs when those ________ likely to get ________ insurance payoffs are the ones who want to purchase insurance the most.

A) least; large

B) least; small

C) most; large

D) most; small

Answer: C
Ques Status: Previous Edition

20) In the case of an insurance policy, ________ occurs when the existence of insurance encourages the insured party to take risks that increase the likelihood of an insurance payoff; ________ occurs when those most likely to get large insurance payoffs are the ones who want to purchase insurance the most.

A) moral hazard; insurance market discrimination

B) moral hazard; insurance segregation

C) moral hazard; adverse selection

D) adverse selection; moral hazard

Answer: C
Ques Status: Previous Edition

21) Insurance companies' attempts to minimize adverse selection explains which of the following insurance practices?

A) Prevention of fraud.

B) Risk–based premiums.

C) Restrictive provisions.

D) Deductibles.

Answer: B
Ques Status: Revised

22) A deductible reduces ________ in exactly the same way as ________.

A) moral hazard; coinsurance

B) adverse selection; restrictive provisions

C) moral hazard; cancellation of insurance

D) adverse selection; limits on the amount of insurance

Answer: A
Ques Status: New

23) Coinsurance reduces moral hazard in exactly the same way as

A) limits on insurance.

B) risk–based premiums.

C) deductibles.

D) restrictive provisions.

Answer: C
Ques Status: Revised

24) Charging risk–based insurance premiums is a time–honored principle of insurance management to reduce

A) moral hazard.

B) adverse selection.

C) free riding.

D) principal–agent problems.

Answer: B
Ques Status: Revised

25) Clauses in life insurance policies that eliminate death benefits if the insured person commits suicide is an example of a

A) restrictive provision.

B) restrictive covenant.

C) anti–fraud exclusion.

D) risk–based deductible.

Answer: A
Ques Status: Previous Edition

26) The higher the insurance coverage, the ________ the policyholder can gain from risky activities that make an insurance payoff ________ likely.

A) more; less

B) more; more

C) less; less

D) less; more

Answer: B
Ques Status: Previous Edition

27) Of the following financial intermediaries, which holds the least liquid assets?

A) Property and casualty insurance companies

B) Life insurance companies

C) Money market mutual funds

D) Commercial banks

Answer: B
Ques Status: Previous Edition

28) Explain the problems that necessitate insurance management, and three methods insurance companies use to address these problems. Identify the problem that each practice addresses.

Answer: Insurance companies face the problems of adverse selection and moral hazard. Adverse selection is the problem that the highest risk individuals will be the most likely to purchase insurance. Moral hazard is the problem that, once insured, individuals will engage in risky behavior that increase the probability that a claim will be paid. Insurance companies screen out good risk applicants from poor ones to reduce adverse selection. Risk–based premiums reduce adverse selection by charging higher premiums to higher risk individuals. Restrictive provisions reduce moral hazard by discouraging risky behavior. Investigation to prevent fraudulent claims also reduces moral hazard. Cancellation of insurance reduces moral hazard by discouraging risky activity. Deductibles and coinsurance require the insured to bear a portion of the cost of any claim, reducing moral hazard. Limiting the amount of insurance also reduces moral hazard.

Ques Status: Previous Edition

12.2 Pension Funds

1) From the end of 1970 to the end of 2005, pension funds' share of total financial intermediary assets increased from ________ percent to approximately ________ percent.

A) 13; 30

B) 10; 24

C) 10; 30

D) 13; 24

Answer: D

Ques Status: Revised

2) Vesting refers to

A) the length of time an insurance company has been in business.

B) the length of time that a person must be enrolled in a pension plan before being entitled to receive benefits.

C) the length of time until a CD matures.

D) the premium required under term insurance.

Answer: B

Ques Status: Previous Edition

3) A defined–benefit pension

A) determines benefits by contributions and their earnings.

B) fixes benefits in advance.

C) links benefits to investment performance.

D) fixes benefits paid out for a limited number of years.

Answer: B

Ques Status: Revised

4) If a pension fund has sufficient contributions and earnings to pay benefits, it is said to be

A) underfunded.

B) at par.

C) fully funded.

D) over par.

Answer: C
Ques Status: Revised

5) If a pension fund has insufficient contributions and earnings to pay benefits, it is said it be

A) underfunded.

B) at par.

C) fully funded.

D) under par.

Answer: A
Ques Status: Revised

6) Fraudulent practices and other abuses of private pension funds led Congress to enact the

A) FDIC Act.

B) Federal Reserve Act.

C) FHLBS.

D) Employee Retirement Income Security Act.

Answer: D
Ques Status: Previous Edition

7) The government corporation that insures pension benefits is

A) Fannie Mae.

B) Ginnie Mae.

C) Penny Benny.

D) Sallie Mae.

Answer: C
Ques Status: Revised

8) The Pension Benefit Guarantee Corporation performs a role similar to that of

A) the Federal Reserve System.

B) the Comptroller of the Currency.

C) the FDIC.

D) the Office of Thrift Supervision.

Answer: C
Ques Status: Previous Edition

9) Since Social Security benefits are paid from current contributions, the system is a

A) privatized system.

B) overfunded system.

C) "pay–as–you–go" system.

D) defined contribution system.

Answer: C
Ques Status: Revised

10) Privatization of Social Security involves

A) tax reductions.

B) benefit reductions.

C) increasing the retirement age.

D) investing portions of the trust fund in corporate securities.

Answer: D
Ques Status: Revised

11) Social Security is a

A) fully funded pension plan.

B) federally insured private pension plan.

C) government sponsored private pension plan.

D) "pay–as–you–go" system.

Answer: D
Ques Status: Previous Edition

12) Keough plans and IRAs are

A) individual pension plans.

B) government pension plans.

C) corporate pension plans.

D) public pension plans.

Answer: A
Ques Status: Previous Edition

13) Allowing individuals to manage a portion of their Social Security funds is

A) socialization.

B) privatization.

C) democratization.

D) regeneration.

Answer: B
Ques Status: Revised

14) Privatization of the Social Security system is being considered due to

A) the desire to reduce taxes.

B) demands to reduce the retirement age.

C) reduced life expectancy.

D) underfunding of the system.

Answer: D
Ques Status: Revised

15) Explain why the Social Security system faces problems. Discuss the possible solutions to these problems.

Answer: Social security faces problems because it is a pay–as–you–go system where benefits are not tied to contributions. This has resulted in substantial underfunding, which may be exacerbated by the retirement of the baby boomers.
Solutions include increases in taxes and benefit reductions, including additional increases in the retirement age. The other alternative is privatization. This could involve government purchases of corporate securities, shift of fund assets to private accounts that could be invested in corporate securities, or creation of new private accounts that could be invested in corporate securities, funded by increased taxes.
Ques Status: Revised

12.3 Finance Companies

1) Compared to commercial banks and thrift institutions, finance companies are

A) heavily regulated.

B) able to attract small depositors.

C) prevented from making relatively small loans.

D) virtually unregulated.

Answer: D
Ques Status: Previous Edition

2) The practice of factoring involves

A) the syndication of underwriting large security issues.

B) the selling of accounts receivable at a discount in return for cash.

C) breaking up large mutual funds into smaller funds.

D) spreading the risk of insurance through reinsurance.

Answer: B
Ques Status: Revised

3) Loans made to consumers by finance companies are typically

A) only for the purchase of cars or boats.

B) at interest rates below those charged by banks for the same type of loan.

C) at interest rates above those charged by banks for the same type of loan.

D) not made for less than $10,000.

Answer: C
Ques Status: Previous Edition

4) The General Motors Acceptance Company (GMAC) is a

A) sales finance company.

B) consumer finance company.

C) business finance company.

D) public finance company.

Answer: A
Ques Status: Revised

5) A person remodeling her house could obtain a loan from a

A) sales finance company.

B) consumer finance company.

C) business finance company.

D) public finance company.

Answer: B
Ques Status: Revised

12.4 Mutual Funds

1) Before 1970, mutual funds invested almost solely in

A) corporate bonds.

B) corporate common stocks.

C) United States government bonds.

D) municipal bonds and money market securities.

Answer: B
Ques Status: Revised

2) Mutual funds are primarily held by

A) financial institutions.

B) households.

C) nonfinancial businesses.

D) the Social Security trust fund.

Answer: B
Ques Status: Previous Edition

3) In 1980, only about ________ percent of households held mutual fund shares, while this number has risen to nearly ________ percent in recent years.

A) 3; 25

B) 4; 35

C) 6; 50

D) 8; 60

Answer: C
Ques Status: Previous Edition

4) Mutual funds that allow shares to be redeemed at any time at a price that is tied to the asset value of the fund are known as

A) close–end funds.

B) open–end funds.

C) asset–value funds.

D) redeemable funds.

Answer: B
Ques Status: Previous Edition

5) Mutual funds in which a fixed number of nonredeemable shares are sold at an initial offering and are then traded in the over–the–counter market, like shares of common stock, are called

A) open–end funds.

B) close–end funds.

C) OTC funds.

D) primary–issue funds.

Answer: B
Ques Status: Previous Edition

6) Most mutual funds are

A) no–load funds.

B) load funds.

C) large–load funds.

D) small–load funds.

Answer: A
Ques Status: Previous Edition

7) Which of the following was the fastest–growing financial intermediary of the 1970s?

A) Commercial banks

B) Credit unions

C) Finance companies

D) Money market mutual funds

Answer: D
Ques Status: Previous Edition

8) A sales commission is charged for the purchase of

A) no–load mutual funds.

B) load mutual funds.

C) sinking mutual funds.

D) syndicated funds.

Answer: B
Ques Status: Revised

9) Because the assets they offer individuals are virtually identical, banks face serious competition from

A) load mutual funds.

B) stock mutual funds.

C) closed–end mutual funds.

D) money market mutual funds.

Answer: D
Ques Status: Revised

10) In 1977, the assets in money market mutual funds was less than $4 billion; by 1980, assets had climbed to $50 billion and now stand at $1.28 trillion, or about ________ of the asset value of all mutual funds.

A) one–tenth

B) one–fourth

C) one–third

D) one–half

Answer: B
Ques Status: Revised

11) Several features distinguish hedge funds from traditional mutual funds, including:

A) Mutual funds have a minimum investment requirement of $1,000 or more; hedge funds have no minimum investment requirement.

B) Hedge funds typically charge investors large fees relative to mutual funds.

C) Hedge fund investors need not commit their money for than a few weeks at a time, explaining why they pay higher fees.

D) Hedge risky are significantly less risky relative to mutual funds.

Answer: B
Ques Status: Revised

12) Long–Term Capital got into trouble when it thought that the spread between prices on long–term Treasury bonds and long–term corporate bonds was too ________, and bet that this "anomaly" would disappear and the spread would ________.

A) high; narrow

B) low; widen

C) low; narrow

D) high; widen

Answer: A
Ques Status: Revised

13) Explain the factors that account for the large increase in market share experienced by mutual funds since 1980.

Answer: The growth of mutual funds is attributed to the stock market boom; the ability to invest in a variety of assets including bonds, foreign securities and specialized industries; the growing importance of pension plans that invest through mutual funds; and the growth of money market mutual funds as an alternative to bank deposits.
Ques Status: Previous Edition

12.5 Government Financial Intermediation

1) Of the three agencies that have been created to promote residential housing, the only one that is an entity of the U.S. government is

A) Fannie Mae.

B) Ginnie Mae.

C) Freddie Mac.

D) Sallie Mae.

Answer: B
Ques Status: Previous Edition

2) Concerns about Fannie Mae and Freddie Mac are based on

A) the large volume of debt that they hold.

B) their high capital–to–asset ratios.

C) the fact that they are government agencies.

D) their move to full privatization.

Answer: A
Ques Status: Revised

12.6 Securities Market Operations

1) When a corporation wishes to sell new securities, it usually employs

A) a takeover specialist.

B) a finance company.

C) an investment bank.

D) a commercial bank.

Answer: C
Ques Status: Revised

2) In financial markets an IPO is an

A) investment portfolio option.

B) initial public offering.

C) initial portfolio offering.

D) investment portfolio offering.

Answer: B
Ques Status: Revised

3) In financial markets, when a firm issuing new securities has previously issued securities, these securities are called

A) seasoned issues.

B) an initial public offering.

C) secondary issues.

D) investment–grade issues.

Answer: A
Ques Status: Revised

4) In financial markets, when a firm issues stock for the first time it is called an

A) investment portfolio option.

B) initial public offering.

C) initial portfolio offering.

D) investment portfolio offering.

Answer: B
Ques Status: Revised

5) IPOs have become very important in the U.S. economy because they are a major source of financing for

A) so-called "blue-chip" companies.

B) hedge funds.

C) internet companies.

D) mutual funds.

Answer: C
Ques Status: Previous Edition

6) Investment banks purchase new security issues in the hope of making a profit. This is the act of

A) reinsuring.

B) factoring.

C) syndicating.

D) underwriting.

Answer: D
Ques Status: Revised

7) ________ assume the risk of issuing a new stock in the hope of earning profits on its sale.

A) Stock brokers

B) Securities dealers

C) Underwriters

D) Stock speculators

E) Reinsurers

Answer: C
Ques Status: Revised

8) Brokers, in contrast to security dealers,

A) hold inventories of securities.

B) make their income through commissions.

C) make their living on the spread between the bid price and the asked price.

D) buy and sell securities at given prices.

Answer: B
Ques Status: Revised

9) ________ assist in the initial sale of securities in the primary market; ________ assist in the trading of securities in the secondary markets.

A) Investment banks; mutual funds

B) Commercial banks; mutual funds

C) Investment banks; securities brokers and dealers

D) Commercial banks; securities brokers and dealers

Answer: C
Ques Status: Revised

10) The federal agency that ensures that potential security purchasers are well informed is the

A) FCC.

B) FTC.

C) NRC.

D) SEC.

Answer: D
Ques Status: Revised

11) An innovation that blurred the distinction between brokerage firms and commercial banks was Merrill Lynch's development in 1977 of the

A) cash management account.

B) money market mutual fund.

C) individual retirement account.

D) discount brokerage.

Answer: A
Ques Status: Previous Edition

12) Elimination of minimum brokerage commission rates occurred because of

A) competition from banks.

B) demands of institution investors.

C) competition from foreign brokerage firms.

D) an action of the Securities and Exchange Commission.

Answer: D
Ques Status: Revised

Chapter 13

Financial Derivatives

13.1 Hedging

1) The payoffs for financial derivatives are linked to

A) securities that will be issued in the future.

B) the volatility of interest rates.

C) previously issued securities.

D) government regulations specifying allowable rates of return.

Answer: C
Ques Status: Revised

2) Which of the following is not a financial derivative?

A) Stock

B) Futures

C) Options

D) Forward contracts

Answer: A
Ques Status: Previous Edition

3) By hedging a portfolio, a bank manager

A) reduces interest–rate risk.

B) increases reinvestment risk.

C) increases exchange–rate risk.

D) increases the probability of gains.

Answer: A
Ques Status: Previous Edition

4) Hedging risk for a short position is accomplished by

A) taking a long position.

B) taking another short position.

C) taking additional long and short positions in equal amounts.

D) taking a neutral position.

Answer: A
Ques Status: Revised

5) Hedging risk for a long position is accomplished by

A) taking another long position.

B) taking a short position.

C) taking additional long and short positions in equal amounts.

D) taking a neutral position.

Answer: B
Ques Status: Revised

6) A contract that requires the investor to buy securities on a future date is called a

A) short contract.

B) long contract.

C) hedge.

D) cross.

Answer: B
Ques Status: Previous Edition

7) A long contract requires that the investor

A) sell securities in the future.

B) buy securities in the future.

C) hedge in the future.

D) close out his position in the future.

Answer: B
Ques Status: Previous Edition

8) A person who agrees to buy an asset at a future date has gone

A) long.

B) short.

C) back.

D) ahead.

Answer: A
Ques Status: Revised

9) A short contract requires that the investor

A) sell securities in the future.

B) buy securities in the future.

C) hedge in the future.

D) close out his position in the future.

Answer: A
Ques Status: Previous Edition

10) A contract that requires the investor to sell securities on a future date is called a

A) short contract.

B) long contract.

C) hedge.

D) micro hedge.

Answer: A
Ques Status: Previous Edition

13.2 Interest Rate Forward Contracts

1) To say that the forward market lacks liquidity means that

A) forward contracts usually result in losses.

B) forward contracts cannot be turned into cash.

C) it may be difficult to make the transaction.

D) forward contracts cannot be sold for cash.

Answer: C
Ques Status: Revised

2) The advantage of forward contracts over future contracts is that they

A) are standardized.

B) have lower default risk.

C) are more liquid.

D) are more flexible

Answer: D
Ques Status: Revised

13.3 Financial Futures Contracts and Markets

1) Forward contracts are of limited usefulness to financial institutions because

A) of default risk.

B) it is impossible to hedge risk.

C) they are relatively inflexible.

D) of interest–rate risk.

Answer: A
Ques Status: Revised

2) Futures contracts are regularly traded on the

A) Chicago Board of Trade.

B) New York Stock Exchange.

C) American Stock Exchange.

D) Chicago Board of Options Exchange.

Answer: A
Ques Status: Previous Edition

3) When interest rates fall, a bank that perfectly hedges its portfolio of Treasury securities in the futures market

A) suffers a loss.

B) experiences a gain.

C) has no change in its income.

D) may either gain, lose or see no change in its income.

Answer: C
Ques Status: Revised

4) Parties who have bought a futures contract and thereby agreed to ________ (take delivery of) the bonds are said to have taken a ________ position.

A) sell; short

B) buy; short

C) sell; long

D) buy; long

Answer: D
Ques Status: Previous Edition

5) Parties who have sold a futures contract and thereby agreed to ________ (deliver) the bonds are said to have taken a ________ position.

A) sell; short

B) buy; short

C) sell; long

D) buy; long

Answer: A
Ques Status: Previous Edition

6) By selling short a futures contract of $100,000 at a price of 115 you are agreeing to deliver

A) $100,000 face value securities for $115,000.

B) $115,000 face value securities for $110,000.

C) $100,000 face value securities for $100,000.

D) $115,000 face value securities for $115,000.

Answer: A
Ques Status: Previous Edition

7) By selling short a futures contract of $100,000 at a price of 96 you are agreeing to deliver

A) $100,000 face value securities for $104,167.

B) $96,000 face value securities for $100,000.

C) $100,000 face value securities for $96,000.

D) $96,000 face value securities for $104,167.

Answer: C
Ques Status: Previous Edition

8) By buying a long $100,000 futures contract for 115 you agree to pay

A) $100,000 for $115,000 face value bonds.

B) $115,000 for $100,000 face value bonds.

C) $86,956 for $100,000 face value bonds.

D) $86,956 for $115,000 face value bonds.

Answer: B
Ques Status: Previous Edition

9) On the expiration date of a futures contract, the price of the contract

A) always equals the purchase price of the contract.

B) always equals the average price over the life of the contract.

C) always equals the price of the underlying asset.

D) always equals the average of the purchase price and the price of the underlying asset.

Answer: C
Ques Status: Revised

10) The price of a futures contract at the expiration date of the contract

A) equals the price of the underlying asset.

B) equals the price of the counterparty.

C) equals the hedge position.

D) equals the value of the hedged asset.

Answer: A
Ques Status: Revised

11) Elimination of riskless profit opportunities in the futures market is

A) hedging.

B) arbitrage.

C) speculation.

D) underwriting.

Answer: B
Ques Status: Revised

12) If you purchase a $100,000 interest-rate futures contract for 110, and the price of the Treasury securities on the expiration date is 106

A) your profit is $4000.

B) your loss is $4000.

C) your profit is $6000.

D) your loss is $6000.

Answer: B
Ques Status: Revised

13) If you purchase a $100,000 interest–rate futures contract for 105, and the price of the Treasury securities on the expiration date is 108

A) your profit is $3000.

B) your loss is $3000.

C) your profit is $8000.

D) your loss is $8000.

Answer: A
Ques Status: Revised

14) If you sell a $100,000 interest–rate futures contract for 110, and the price of the Treasury securities on the expiration date is 106

A) your profit is $4000.

B) your loss is $4000.

C) your profit is $6000.

D) your loss is $6000.

Answer: A
Ques Status: Revised

15) If you sell a $100,000 interest–rate futures contract for 105, and the price of the Treasury securities on the expiration date is 108

A) your profit is $3000.

B) your loss is $3000.

C) your profit is $8000.

D) your loss is $8000.

Answer: B
Ques Status: Revised

16) If you sold a short contract on financial futures you hope interest rates

A) rise.

B) fall.

C) are stable.

D) fluctuate.

Answer: A
Ques Status: Revised

17) If you bought a long contract on financial futures you hope that interest rates

A) rise.

B) fall.

C) are stable.

D) fluctuate.

Answer: B
Ques Status: Revised

18) If you bought a long futures contract you hope that bond prices

A) rise.

B) fall.

C) are stable.

D) fluctuate.

Answer: A
Ques Status: Revised

19) If you sold a short futures contract you will hope that bond prices

A) rise.

B) fall.

C) are stable.

D) fluctuate.

Answer: B
Ques Status: Revised

20) To hedge the interest rate risk on $4 million of Treasury bonds with $100,000 futures contracts, you would need to purchase

A) 4 contracts.

B) 20 contracts.

C) 25 contracts.

D) 40 contracts.

Answer: D
Ques Status: Revised

21) If you sell twenty–five $100,000 futures contracts to hedge holdings of a Treasury security, the value of the Treasury securities you are holding is

A) $250,000.

B) $1,000,000.

C) $2,500,000.

D) $5,000,000.

Answer: C
Ques Status: Revised

22) Assume you are holding Treasury securities and have sold futures to hedge against interest–rate risk. If interest rates rise

A) the increase in the value of the securities equals the decrease in the value of the futures contracts.

B) the decrease in the value of the securities equals the increase in the value of the futures contracts.

C) both the securities and the futures contracts decrease in value.

D) both the securities and the futures contracts increase in value.

Answer: B
Ques Status: Revised

23) Assume you are holding Treasury securities and have sold futures to hedge against interest–rate risk. If interest rates fall

A) the increase in the value of the securities equals the decrease in the value of the futures contracts.

B) the decrease in the value of the securities equals the increase in the value of the futures contracts.

C) both the securities and the futures contracts decrease in value.

D) both the securities and the futures contracts increase in value.

Answer: A
Ques Status: Revised

24) When a financial institution hedges the interest–rate risk for a specific asset, the hedge is called a

A) macro hedge.

B) micro hedge.

C) cross hedge.

D) futures hedge.

Answer: B
Ques Status: Previous Edition

25) When the financial institution is hedging interest–rate risk on its overall portfolio, then the hedge is a

A) macro hedge.

B) micro hedge.

C) cross hedge.

D) futures hedge.

Answer: A
Ques Status: Previous Edition

26) The number of futures contracts outstanding is called

A) turnover.

B) volume.

C) float.

D) open interest.

Answer: D
Ques Status: Revised

27) Which of the following features of futures contracts were not designed to increase liquidity?

A) Standardized contracts

B) Traded up until maturity

C) Not tied to one specific type of bond

D) Marked to market daily

Answer: D
Ques Status: Previous Edition

28) Which of the following features of futures contracts were not designed to increase liquidity?

A) Standardized contracts

B) Traded up until maturity

C) Not tied to one specific type of bond

D) Can be closed with offsetting trade

Answer: D
Ques Status: Previous Edition

29) Futures differ from forwards because they are

A) used to hedge portfolios.

B) used to hedge individual securities.

C) used in both financial and foreign exchange markets.

D) a standardized contract.

Answer: D
Ques Status: Previous Edition

30) If a firm is due to be paid in euros in two months, to hedge against exchange–rate risk the firm should ________ foreign exchange futures ________.

A) sell; short

B) buy; long

C) sell; long

D) buy; short

Answer: A
Ques Status: Previous Edition

31) If a firm must pay for goods it has ordered with foreign currency, it can hedge its foreign exchange–rate risk by ________ foreign exchange futures ________.

A) selling; short

B) buying; long

C) buying; short

D) selling; long

Answer: B
Ques Status: Previous Edition

32) What is arbitrage? Explain why arbitrage drives the contract price of futures to the price of the underlying asset on the expiration date, for prices above and below the asset price.

Answer: Arbitrage is the riskless elimination of profit opportunities in futures markets. If the contract price is 111, and the asset price is 110, contracts will be sold at $111,000 and the asset purchased for $110,000. The bonds will be purchased at the market price and delivered to fulfill the contract, for a profit of $1000. This will continue until the contract price falls to equal the asset price. Similarly, if the contract price is 109, and the asset price is 110, everyone will buy the contract, and sell the bond for $110,000 after buying it for $109,000 on the market, for a profit, again, of $1,000. This activity will drive up the bond price and drive down the asset price until they are equal.
Ques Status: Previous Edition

33) Explain the margin requirement for financial futures and how marking to market affects the margin account.

Answer: Each contract requires a margin deposit of a specified amount. Each day futures contracts are marked to market. This means that each day the margin account is changed by the gain or loss of value of the contract. Assuming a contract price of 110, if the settlement (closing) price falls to 109, the $1000 loss is subtracted from the account and an additional $1000 must be added to the margin account. Conversely, a rise in the contract price to 111 means the $1000 profit is added to the account, increasing the value of the account above the required minimum.

Ques Status: Previous Edition

13.4 Options

1) Options are contracts that give the purchasers the

A) option to buy or sell an underlying asset.

B) obligation to buy or sell an underlying asset.

C) right to hold an underlying asset.

D) right to switch payment streams.

Answer: A

Ques Status: Revised

2) The price specified on an option at which the holder can buy or sell the underlying asset is called the

A) premium.

B) call.

C) strike price.

D) put.

Answer: C

Ques Status: Previous Edition

3) The seller of an option has the

A) right to buy or sell the underlying asset.

B) obligation to buy or sell the underlying asset.

C) ability to reduce transaction risk.

D) right to exchange one payment stream for another.

Answer: B

Ques Status: Revised

4) The seller of an option has the _________ to buy or sell the underlying asset while the purchaser of an option has the _________ to buy or sell the asset.

A) obligation; right

B) right; obligation

C) obligation; obligation

D) right; right

Answer: A
Ques Status: Previous Edition

5) The amount paid for an option is the

A) strike price.

B) premium.

C) discount.

D) yield.

Answer: B
Ques Status: Revised

6) An option that can be exercised at any time up to maturity is called a(n)

A) swap.

B) stock option.

C) European option.

D) American option.

Answer: D
Ques Status: Previous Edition

7) An option that can only be exercised at maturity is called a(n)

A) swap.

B) stock option.

C) European option.

D) American option.

Answer: C
Ques Status: Previous Edition

8) Options on individual stocks are referred to as

A) stock options.

B) futures options.

C) American options.

D) individual options.

Answer: A
Ques Status: Previous Edition

9) Options on futures contracts are referred to as

A) stock options.

B) futures options.

C) American options.

D) individual options.

Answer: B
Ques Status: Previous Edition

10) An option that gives the owner the right to buy a financial instrument at the exercise price within a specified period of time is a

A) call option.

B) put option.

C) American option.

D) European option.

Answer: A
Ques Status: Previous Edition

11) A call option gives the owner the

A) right to sell the underlying security.

B) obligation to sell the underlying security.

C) right to buy the underlying security.

D) obligation to buy the underlying security.

Answer: C
Ques Status: Revised

12) A call option gives the seller the

A) right to sell the underlying security.

B) obligation to sell the underlying security.

C) right to buy the underlying security.

D) obligation to buy the underlying security.

Answer: B
Ques Status: Revised

13) An option allowing the holder to buy an asset in the future is a

A) put option.

B) call option.

C) swap.

D) forward contract.

Answer: B
Ques Status: Revised

14) An option that gives the owner the right to sell a financial instrument at the exercise price within a specified period of time is a

A) call option.

B) put option.

C) American option.

D) European option.

Answer: B
Ques Status: Previous Edition

15) A put option gives the owner the

A) right to sell the underlying security.

B) obligation to sell the underlying security.

C) right to buy the underlying security.

D) obligation to buy the underlying security.

Answer: A
Ques Status: Revised

16) A put option gives the seller the

A) right to sell the underlying security.

B) obligation to sell the underlying security.

C) right to buy the underlying security.

D) obligation to buy the underlying security.

Answer: D
Ques Status: Revised

17) An option allowing the owner to sell an asset at a future date is a

A) put option.

B) call option.

C) futures contract.

D) forward contract.

Answer: A
Ques Status: Revised

18) If you buy a call option on Treasury futures at 115, and at expiration the market price is 110, the ________ will ________ exercised.

A) call; be

B) put; be

C) call; not be

D) put; not be

Answer: C
Ques Status: Revised

19) If you buy a call option on Treasury futures at 110, and at expiration the market price is 115, the ________ will ________ exercised.

A) call; be

B) put; be

C) call; not be

D) put; not be

Answer: A
Ques Status: Revised

20) If you buy a put option on Treasury futures at 115, and at expiration the market price is 110, the ________ will ________ exercised.

A) call; be

B) put; be

C) call; not be

D) put; not be

Answer: B
Ques Status: Revised

21) If you buy a put option on treasury futures at 110, and at expiration the market price is 115, the ________ will ________ exercised.

A) call; be

B) put; be

C) call; not be

D) put; not be

Answer: D
Ques Status: Revised

22) If, for a $1000 premium, you buy a $100,000 call option on bond futures with a strike price of 110, and at the expiration date the price is 114

A) your profit is $4000.

B) your loss is $4000.

C) your profit is $3000.

D) your loss is $3000.

Answer: C
Ques Status: Revised

23) If, for a $1000 premium, you buy a $100,000 call option on bond futures with a strike price of 114, and at the expiration date the price is 110

A) your profit is $1000.

B) your loss is $1000.

C) your profit is $3000.

D) your loss is $3000.

Answer: B
Ques Status: Revised

24) If, for a $1000 premium, you buy a $100,000 put option on bond futures with a strike price of 110, and at the expiration date the price is 114

A) your profit is $1000.

B) your loss is $1000.

C) your profit is $3000.

D) your loss is $3000.

Answer: B
Ques Status: Revised

25) If, for a $1000 premium, you buy a $100,000 put option on bond futures with a strike price of 114, and at the expiration date the price is 110

A) your profit is $4000.

B) your loss is $4000.

C) your profit is $3000.

D) your loss is $3000.

Answer: C
Ques Status: Revised

26) The main advantage of using options on futures contracts rather than the futures contracts themselves is that interest–rate risk is

A) controlled while preserving the possibility of gains.

B) controlled, while removing the possibility of losses.

C) not controlled, but the possibility of gains is preserved.

D) not controlled, but the possibility of gains is lost.

Answer: A
Ques Status: Revised

27) The main reason to buy an option on a futures contract rather than the futures contract itself is to

A) reduce transaction cost.

B) preserve the possibility for gains.

C) limit losses.

D) remove the possibility for gains.

Answer: B
Ques Status: Revised

28) The main disadvantage of hedging with futures contracts as compared to options on futures contracts is that futures

A) remove the possibility of gains.

B) increase the transactions cost.

C) are not as effective a hedge.

D) do not remove the possibility of losses.

Answer: A
Ques Status: Revised

29) If a bank manager wants to protect the bank against losses that would be incurred on its portfolio of treasury securities should interest rates rise, he could ________ options on financial futures.

A) buy put

B) buy call

C) sell put

D) sell call

Answer: A
Ques Status: Revised

30) Hedging by buying an option

A) limits gains.

B) limits losses.

C) limits gains and losses.

D) has no limit on option premiums.

Answer: B
Ques Status: Revised

31) All other things held constant, premiums on call options will increase when the

A) exercise price falls.

B) volatility of the underlying asset falls.

C) term to maturity decreases.

D) futures price increases.

Answer: A
Ques Status: Previous Edition

32) All other things held constant, premiums on options will increase when the

A) exercise price increases.

B) volatility of the underlying asset increases.

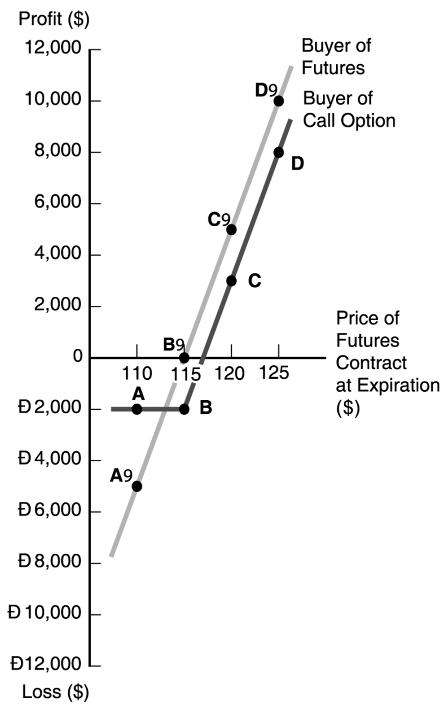
C) term to maturity decreases.

D) futures price increases.

Answer: B
Ques Status: Previous Edition

33) Show graphically and explain the profits and losses of buying futures relative to buying call options.

Answer: See figure below.



(a) Profit or loss for buyer of call option and buyer of futures

As shown in the graph, the profit–loss function for futures is linear. Both gains and losses grow linearly for each $1 change in the underlying security price at expiration. The profit curve for options is nonlinear. The loss is limited to the amount of the premium. Profits are a linear function of the asset price at expiration, but profits from options are always less than for futures by the amount of the premium. The key differences are that options losses are limited, while futures losses are not. Gains for futures and options are linear functions of the expiration price, but option profits are always less than futures profits by the amount of the premium.

Ques Status: Revised

13.5 Swaps

1) A tool for managing interest–rate risk that requires exchange of payment streams is a

A) futures contract.

B) forward contract.

C) swap.

D) micro hedge.

Answer: C
Ques Status: Revised

2) A financial contract that obligates one party to exchange a set of payments it owns for another set of payments owned by another party is called a

A) hedge.

B) call option.

C) put option.

D) swap.

Answer: D
Ques Status: Revised

3) A swap that involves the exchange of a set of payments in one currency for a set of payments in another currency is a(n)

A) interest–rate swap.

B) currency swap.

C) swaptions.

D) international swap.

Answer: B
Ques Status: Previous Edition

4) A swap that involves the exchange of one set of interest payments for another set of interest payments is called a(n)

A) interest rate swap.

B) currency swap.

C) swaptions.

D) international swap.

Answer: A
Ques Status: Previous Edition

5) A firm that sells goods to foreign countries on a regular basis can avoid exchange-rate risk by

A) buying stock options.

B) selling puts on financial futures.

C) selling a foreign exchange swap.

D) buying swaptions.

Answer: C
Ques Status: Previous Edition

6) The most common type of interest-rate swap is

A) the plain vanilla swap.

B) the basic swap.

C) the ordinary swap.

D) the notional swap.

Answer: A
Ques Status: Revised

7) If Second National Bank has more rate-sensitive assets than rate-sensitive liabilities, it can reduce interest-rate risk with a swap that requires Second National to

A) pay fixed rate while receiving floating rate.

B) receive fixed rate while paying floating rate.

C) both receive and pay fixed rate.

D) both receive and pay floating rate.

Answer: B
Ques Status: Previous Edition

8) If a bank has more rate-sensitive assets than rate-sensitive liabilities

A) it reduces interest rate risk by swapping rate-sensitive income for fixed rate income.

B) it reduces interest rate risk by swapping fixed rate income for rate-sensitive income.

C) it increases interest rate risk by swapping rate-sensitive income for fixed rate income.

D) it neutralizes interest rate risk by receiving and paying fixed-rate streams.

Answer: A
Ques Status: Revised

9) If Second National Bank has more rate–sensitive liabilities then rate–sensitive assets, it can reduce interest rate risk with a swap that requires Second National to

A) pay fixed rate while receiving floating rate.

B) receive fixed rate while paying floating rate.

C) both receive and pay fixed rate.

D) both receive and pay floating rate.

Answer: A
Ques Status: Previous Edition

10) One advantage of using swaps to eliminate interest–rate risk is that swaps

A) are less costly than futures.

B) are less costly than rearranging balance sheets.

C) are more liquid than futures.

D) have better accounting treatment than options.

Answer: B
Ques Status: Previous Edition

11) A advantage of using swaps to hedge interest–rate risk is that swaps

A) are less costly than futures.

B) can be written for long horizons.

C) are not subject to default risk.

D) are more liquid than futures.

Answer: B
Ques Status: Revised

13.6 Credit Derivatives

1) The credit derivative that, for a fee, gives the purchaser the right to receive profits that are tied either to the price of an underlying security or to an interest rate is called a

A) credit option.

B) credit swap.

C) credit–linked note.

D) credit default swap.

Answer: A
Ques Status: New

2) Suppose that Wells Fargo Home Mortgage sells $10 million worth of mortgage payments to GMAC in exchange for $10 million in auto loan payments. This type of transaction is called a

A) credit option.

B) credit swap.

C) credit-linked note.

D) credit default swap.

Answer: B
Ques Status: New

3) If one party pays a fixed fee on a regular basis in return for a contingent payment that is triggered by a downgrading of a firm's credit rating, that is called a

A) credit option.

B) credit swap.

C) credit-linked note.

D) credit default swap.

Answer: D
Ques Status: New

4) Suppose Ford Motor Company issues a 5% bond with a stipulation that if a national index of SUV sales drops by 10%, then Ford can decrease the coupon rate to 3%. This security is called a

A) credit option.

B) credit swap.

C) credit-linked note.

D) credit default swap.

Answer: C
Ques Status: New

Chapter 14

Conflicts of Interest in the Financial Industry

14.1 What are Conflicts of Interest and Why are They Important?

1) Conflicts of interest is a type of ________ problem that occurs when a person or institution has multiple objectives that are in conflict with each other.

A) moral hazard

B) adverse selection

C) risk sharing

D) spinning

Answer: A
Ques Status: New

2) A type of ________ problem that occurs when a person or institution has multiple objectives that conflict with each other is called ________.

A) moral hazard; conflicts of interest

B) adverse selection; conflicts of interest

C) moral hazard; spinning

D) adverse selection; spinning

Answer: A
Ques Status: New

3) When financial institutions are able to reduce the costs of information for each service they offer by applying the same information source to each service, we say that the financial institution is realizing ________.

A) economies of scope

B) economies of scale

C) increasing returns

D) diminishing marginal returns

Answer: A
Ques Status: New

4) Which of the following is an example of a bank realizing economies of scope?

A) The bank develops a standard mortgage loan application to make the process of loaning out mortgages easier.

B) The bank reduces costs of credit checking for the loan process by outsourcing the process to a specialist.

C) By using the information collected from a corporation, the bank can decide how easy it would be to sell bonds issued by the corporation to the public.

D) A bank in a rural area specializes in providing agricutural loans.

Answer: C
Ques Status: New

5) One problem with conflicts of interest is that they can reduce the ________ in financial markets, thereby increasing ________.

A) quantity of information; financial institutions' profits

B) quantity of information; asymmetric information

C) quality of information; asymmetric information

D) quality of information; financial institutions' profits

Answer: C
Ques Status: New

6) Describe what is meant by economies of scope and explain how financial institutions' realizing economies of scope has led to an increase in conflicts of interest.

Answer: Economies of scope is when firms can reduce costs by offering different products or services. For a financial institution, this usually takes the form of taking one information source and using it to provide a different array of services. This may lead to conflicts of interest because these services may have conflicting goals in which employees of different departments may conceal information or disseminate misleading information to financial markets.
Ques Status: New

14.2 Ethics and Conflicts of Interest

1) Not surprisingly, when financial institutions have consolidated more services under one roof, the amount of conflicts of interest has ________, which has led to ________ in unethical behavior.

A) increased; an increase

B) increased; a decrease

C) decreased; an increase

D) decreased; a decrease

Answer: A
Ques Status: New

14.3 Types of Conflicts of Interest

1) In investment banking, a conflict usually is present between the issuers of securities, who ________, and investors, who ________.

A) benefit from unbiased auditing; desire unbiased consulting

B) desire unbiased research; benefit from optimistic research

C) benefit from optimistic research; desire unbiased research

D) desire unbiased consulting; benefit from unbiased auditing

Answer: C
Ques Status: New

2) The incentive for analysts in investment banks to distort research increases when

A) revenues from brokerage commissions increase.

B) the potential revenues from underwriting greatly exceed brokerage commissions.

C) the potential brokerage commissions greatly exceed revenues from underwriting.

D) revenues from underwriting decrease.

Answer: B
Ques Status: New

3) When investment banks allocate shares of a popular but underpriced IPO to executives of other firms in order to attract their business, it is called ________.

A) spinning

B) a bribe

C) reputational activities

D) a kickback

Answer: A
Ques Status: New

4) The problem with spinning is that it may ________ the cost of capital to a firm and thus ________ the efficiency of the capital market.

A) increase; increase

B) increase; decrease

C) decrease; increase

D) decrease; decrease

Answer: B
Ques Status: New

5) Which of the following is not a conflict of interest in accounting firms?

A) The firm provides consulting as well as rating creditworthiness.

B) Auditors may be pressured to skew their opinions so the client will stay with the firm.

C) Auditors may be reluctant to criticize advice put into place by nonaudit personnel of the firm.

D) Auditors release an overly favorable audit in order to solicit business.

Answer: A
Ques Status: New

6) Advice on taxes, accounting or management information systems, and business strategies are commonly referred to as ________ services.

A) accounting audit

B) management advisory

C) seller

D) managing underwriter

Answer: B
Ques Status: New

7) Conflicts of interest arising from management advisory services brought down ________ in 2002.

A) Enron

B) WorldComm

C) Arthur Andersen

D) Global Crossing

Answer: C
Ques Status: New

8) Conflicts of interest may arise within the credit rating agencies because

A) the investors pay the credit agencies for ratings.

B) the issuers of debt securities pay the credit agencies for ratings.

C) the credit rating agencies provide auditing services to issuers of debt securities.

D) the credit rating agencies are involved in offering credit counseling to investors.

Answer: B
Ques Status: New

9) When the Glass-Steagall Act was repealed in 1999, potential conflicts of interest arose with

A) the development of universal banking.

B) the introduction of more credit-rating agencies.

C) accounting firms developing more comprehensive services.

D) investment analysis in investment banking.

Answer: A
Ques Status: New

10) Explain the type of conflicts of interest that can arise from the development of universal banking.

Answer: There are five main conflicts of interest:

1. The underwriting department would benefit from aggressive sales of a security to the customers of a bank where the customers would benefit from unbiased advice.

2. A bank manager may try to hard-sell an issuing's firms securities to the disadvantage of the bank customer or limit losses of an underperforming IPO to the bank's trust accounts.

3. A bank may push a bond issue of a firm with a high default risk to pay off a loan the bank has with the firm.

4. May grant favorable loan conditions to a firm in return for fees to perform underwriting activities.

5. May try to hard-sell the bank's insurance to its customers.

Ques Status: New

14.4 Can the Market Limit Exploitation of Conflicts of Interest?

1) Evidence suggests that credit-rating agencies ________ exploited conflicts of interest because ________.

A) have not; it would cause their ratings to lose credibility and thus have a lower value in the marketplace.

B) have not; they would have an increase in profits in the long-run.

C) have; it would cause their ratings to lose credibility and thus have a lower value in the marketplace.

D) have; they would have an increase in profits in the long-run.

Answer: A
Ques Status: New

2) Evidence suggests that the market ________ take into account the credibility of analyst's recommendations of IPO's that were underwritten at the analyst's investment bank because the performance of these recommendations was about 50% ________ compared to recommendations made by other analysts at different investment banks.

A) does; better

B) does; worse

C) does not; better

D) does not; worse

Answer: B
Ques Status: New

3) Reputation rents refer to

A) the profit earned by a firm when it captures economies of scope.

B) the costs associated with building credibility of a firm.

C) the profit earned soley based on the credibility of a firm.

D) the costs associated with the firm's achievement of economies of scale.

Answer: C
Ques Status: New

4) Explain how the market can reduce the incentive for credit-rating firms to take advantage of conflicts of interest.

Answer: If a credit-rating firm gives a higher than deserved rating to debt issuers, then the ratings from the firm will lose credibility. If that happens, then the ratings will have a lower value in the marketplace.
Ques Status: New

14.5 What has Been Done to Remedy Conflicts of Interest?

1) Which of the following is not a part of the Sarbanes-Oxley Act of 2002?

A) The establishment of a Public Company Accounting Oversight Board (PCAOB) to supervise accounting firms and thus insure that audits are independent and controlled for quality.

B) Increased penalties for white-collar crime and obstruction of official investigations.

C) Requires a CEO and CFO to certify that periodic financial statements and disclosers of the firm are accurate.

D) Requires investment banks to make public their analysts' recommendations.

Answer: D
Ques Status: New

2) Which policy measure increased the SEC budget to supervise securities markets?

A) Sarbanes–Oxley Act of 2002.

B) Global Legal Settlement of 2002.

C) Gramm–Leach–Bliley Act of 1999.

D) Riegle–Neal Act of 1994

Answer: A
Ques Status: New

3) Which policy measure makes it unlawful for a registered public accounting firm to provide any nonaudit service to a client contemporaneously with an impermissable audit?

A) Sarbanes–Oxley Act of 2002.

B) Global Legal Settlement of 2002.

C) Gramm–Leach–Bliley Act of 1999.

D) Riegle–Neal Act of 1994

Answer: A
Ques Status: New

4) Which policy measure increases the punishment for white–collar crime and obstruction of official investigations?

A) Sarbanes–Oxley Act of 2002.

B) Global Legal Settlement of 2002.

C) Gramm–Leach–Bliley Act of 1999.

D) Riegle–Neal Act of 1994

Answer: A
Ques Status: New

5) Which of the following is a part of the Global Legal Settlement of 2002?

A) The establishment of a Public Company Accounting Oversight Board (PCAOB) to supervise accounting firms and thus insure that audits are independent and controlled for quality.

B) Increased penalties for white–collar crime and obstruction of official investigations.

C) Requires a CEO and CFO to certify that periodic financial statements and disclosers of the firm are accurate.

D) Requires investment banks to make public their analysts' recommendations.

Answer: D
Ques Status: New

6) Which policy measure requires investment banks to sever the links between research and securities underwriting?

A) Sarbanes–Oxley Act of 2002.

B) Global Legal Settlement of 2002.

C) Gramm–Leach–Bliley Act of 1999.

D) Riegle–Neal Act of 1994

Answer: B
Ques Status: New

7) Which policy measure bans spinning?

A) Sarbanes–Oxley Act of 2002.

B) Global Legal Settlement of 2002.

C) Gramm–Leach–Bliley Act of 1999.

D) Riegle–Neal Act of 1994

Answer: B
Ques Status: New

8) Which policy measure requires investment banks to make public their analysts' recommendations?

A) Sarbanes–Oxley Act of 2002.

B) Global Legal Settlement of 2002.

C) Gramm–Leach–Bliley Act of 1999.

D) Riegle–Neal Act of 1994

Answer: B
Ques Status: New

14.6 A Framework for Evaluating Policies to Remedy Conflicts of Interest.

1) If a conflict of interest exists

A) it will always have serious adverse consequences.

B) it may not have a serious adverse consequences if the incentive to take advantage of the conflict is low.

C) the government needs to step in to pass legislation to remove the conflict.

D) there will not be serious adverse consequences, even if the incentive to take advantage of the conflict is low.

Answer: B
Ques Status: New

2) If the incentive to take advantage of a conflict of interest is high

   A) removing the economies of scope that created the conflict may induce higher costs because of the decrease in the flow of reliable information.

   B) then the government must step in to remove the conflict.

   C) the costs of non–action in removing the conflict will always be higher than the cost of removing the conflict.

   D) firms will always step in and work to remove the conflict.

Answer: A
Ques Status: New

3) If there isn't sufficient information available, then which of the following approaches to reduce conflicts of interest will have the lowest probability of working?

   A) Leave it to the market.

   B) Supervisory oversight.

   C) Separation of functions.

   D) Socialization of information production.

Answer: A
Ques Status: New

4) When the SEC requires companies to publicly release financial statements, which of the following remedies of conflicts of interest does this fall under?

   A) Leave it to the market.

   B) Regulate for transparency.

   C) Supervisory oversight.

   D) Separation of functions.

Answer: B
Ques Status: New

5) If firms have an incentive to hide information from mandatory disclosure because the information is proprietary, then which of the following remedies is the least intrusive way to overcome this incentive?

   A) Leave it to the market.

   B) Separation of functions.

   C) Supervisory oversight.

   D) Socialization of information production.

Answer: C
Ques Status: New

6) Under the Sarbanes–Oxley Act of 2002, the clause that makes it unlawful for a registered public accounting firm to provide any nonaudit service to a client contemporaneously with an impermissable audit is an example of which remedy of conflicts of interest?

A) Regulate for transparency.

B) Supervisory oversight.

C) Separation of functions.

D) Socialization of information production.

Answer: C
Ques Status: New

7) Of the remedies for conflicts of interest, which one is the most intrusive?

A) Regulate for transparency.

B) Separation of functions.

C) Supervisory oversight.

D) Socialization of information production.

Answer: D
Ques Status: New

8) Under the Global Legal Settlement of 2002, the provision that requires, for a period of five years, brokerage firms to contract with independent research firms to provide information to their customers is an example of

A) regulate for transparency.

B) supervisory oversight.

C) separation of functions.

D) socialization of information production.

Answer: D
Ques Status: New

9) Under the Global Legal Settlement of 2002, the provision that requires investment banking firms to make their analysts' recommendations public is an example of

A) regulate for transparency.

B) supervisory oversight.

C) separation of functions.

D) socialization of information production.

Answer: A
Ques Status: New

10) Under the Sarbanes–Oxley Act of 2002, the provision that established the PCAOB to supervise accounting firms is an example of

A) regulate for transparency.

B) supervisory oversight.

C) separation of functions.

D) socialization of information production.

Answer: B
Ques Status: New

11) Under the Sarbanes–Oxley Act of 2002, the provision that gives more funding to the SEC is an example of

A) regulate for transparency.

B) supervisory oversight.

C) separation of functions.

D) socialization of information production.

Answer: B
Ques Status: New

12) Under the Global Legal Settlement of 2002, the provision that requires investment banking firms to sever the link between underwriting and research is an example of

A) regulate for transparency.

B) supervisory oversight.

C) separation of functions.

D) socialization of information production.

Answer: C
Ques Status: New

Chapter 15

Structure of Central Banks and the Federal Reserve System

15.1 Origins of the Federal Reserve System

1) The First Bank of the United States

A) was disbanded in 1811 when its charter was not renewed.

B) had its charter renewal vetoed in 1832.

C) was fundamental in helping the Federal Government finance the War of 1812.

D) None of the above.

Answer: A
Ques Status: New

2) The Second Bank of the United States

A) was disbanded in 1811 when its charter was not renewed.

B) had its charter renewal vetoed in 1832.

C) is considered to be the primary cause of the bank panic of 1907.

D) None of the above.

Answer: B
Ques Status: New

3) The public's fear of centralized power and distrust of moneyed interests led to the demise of the first two experiments in central banking:

A) the First Bank of the United States and the Second Bank of the United States.

B) the First Bank of the United States and the Central Bank of the United States.

C) the First Central Bank of the United States and the Second Central Bank of the United States.

D) the First Bank of North America and the Second Bank of North America.

Answer: A
Ques Status: Revised

4) The financial panic of 1907 resulted in such widespread bank failures and substantial losses to depositors that the American public finally became convinced that

A) the First Bank of the United States had failed to serve as a lender of last resort.

B) the Second Bank of the United States had failed to serve as a lender of last resort.

C) the Federal Reserve System had failed to serve as a lender of last resort.

D) a central bank was needed to prevent future panics.

Answer: D
Ques Status: Previous Edition

5) What makes the Federal Reserve so unique compared to other central banks around the world is its

A) centralized structure.

B) decentralized structure.

C) regulatory functions.

D) monetary policy functions.

Answer: B
Ques Status: New

15.2 Structure of the Federal Reserve System

1) Which of the following is **NOT** an entity of the Federal Reserve System?

A) Federal Reserve Banks

B) The Comptroller of the Currency

C) The Board of Governors

D) The Federal Open Market Committee

Answer: B
Ques Status: Revised

2) Which of the following is an entity of the Federal Reserve System?

A) The U.S. Treasury Secretary

B) The FOMC

C) The Comptroller of the Currency

D) The FDIC

Answer: B
Ques Status: New

3) The three largest Federal Reserve banks (New York, Chicago, and San Francisco) combined hold more than ________ percent of the assets of the Federal Reserve System.

A) 25

B) 33

C) 50

D) 67

Answer: C
Ques Status: New

4) Each Federal Reserve bank has nine directors. Of these ________ are appointed by the member banks and ________ are appointed by the Board of Governors.

A) three; six

B) four; five

C) five; four

D) six; three

Answer: D
Ques Status: New

5) Member commercial banks have purchased stock in their district Fed banks; the dividend paid by that stock is limited by law to ________ percent annually.

A) four

B) five

C) six

D) eight

Answer: C
Ques Status: Revised

6) The Federal Reserve Bank of ________ plays a special role in the Federal Reserve System because it houses the open market desk.

A) Boston

B) New York

C) Chicago

D) San Francisco

Answer: B
Ques Status: New

7) The president from which Federal Reserve Bank always has a vote in the Federal Open Market Committee?

A) Philadelphia

B) Boston

C) San Francisco

D) New York

Answer: D
Ques Status: Previous Edition

8) An important function of the regional Federal Reserve Banks is

A) setting reserve requirements.

B) clearing checks.

C) determining monetary policy.

D) setting margin requirements.

Answer: B
Ques Status: Revised

9) Which of the following functions are not performed by any of the twelve regional Federal Reserve Banks?

A) Check clearing

B) Conducting economic research

C) Setting interest rates payable on time deposits

D) Issuing new currency

Answer: C
Ques Status: Previous Edition

10) All ________ are required to be members of the Fed.

A) state chartered banks

B) nationally chartered banks

C) banks with assets less than $100 million

D) banks with assets less than $500 million

Answer: B
Ques Status: Previous Edition

11) Of all commercial banks, about ________ percent belong to the Federal Reserve System.

A) 15

B) 20

C) 33

D) 50

Answer: C
Ques Status: Revised

12) Prior to 1980, member banks left the Federal Reserve System due to

A) the high cost of discount loans.

B) the high cost of required reserves.

C) a desire to avoid interest rate regulations.

D) a desire to avoid credit controls.

Answer: B
Ques Status: Revised

13) The Fed's support of the Depository Institutions Deregulation and Monetary Control Act of 1980 stemmed in part from its

A) concern over declining Fed membership.

B) belief that all banking regulations should be eliminated.

C) belief that interest rate ceilings were too high.

D) belief that depositors had to become more knowledgeable of banking operations.

Answer: A
Ques Status: Previous Edition

14) Banks subject to reserve requirements set by the Federal Reserve System include

A) only nationally chartered banks.

B) only banks with assets less than $100 million.

C) only banks with assets less than $500 million.

D) all banks whether or not they are members of the Federal Reserve System.

Answer: D
Ques Status: Revised

15) The Depository Institutions Deregulation and Monetary Control Act of 1980

A) established higher reserve requirements for nonmember than for member banks.

B) established higher reserve requirements for member than for nonmember banks.

C) abolished reserve requirements.

D) established uniform reserve requirements for all banks.

Answer: D
Ques Status: Revised

16) There are ________ members of the Board of Governors of the Federal Reserve System.

A) 5

B) 7

C) 12

D) 19

Answer: B
Ques Status: New

17) Members of the Board of Governors are

A) chosen by the Federal Reserve Bank presidents.

B) appointed by the newly elected president of the United States, as are cabinet positions.

C) appointed by the president of the United States and confirmed by the Senate as members resign.

D) never allowed to serve more than 7–year terms.

Answer: C
Ques Status: Previous Edition

18) Each governor on the Board of Governors can serve

A) only one nonrenewable fourteen–year term.

B) one full nonrenewable fourteen–year term plus part of another term.

C) only one nonrenewable eight–year term.

D) one full nonrenewable eight–year term plus part of another term.

Answer: B
Ques Status: New

19) The Chairman of the Board of Governors is chosen from among the seven governors and serves a ________ term.

A) one-year

B) two-year

C) four-year

D) eight-year

Answer: C
Ques Status: New

20) While the discount rate is "established" by the regional Federal Reserve Banks, in truth, the rate is determined by

A) Congress.

B) the president of the United States.

C) the Senate.

D) the Board of Governors.

Answer: D
Ques Status: Revised

21) Which of the following are duties of the Board of Governors of the Federal Reserve System?

A) Setting margin requirements, the fraction of the purchase price of the securities that has to be paid for with cash

B) Setting the maximum interest rates payable on certain types of time deposits under Regulation Q

C) Regulating credit with the approval of the president under the Credit Control Act of 1969

D) All governors advise the president of the United States on economics policy.

Answer: A
Ques Status: Revised

22) Which of the following are not current duties of the Board of Governors of the Federal Reserve System?

A) Setting margin requirements, the fraction of the purchase price of the securities that has to be paid for with cash

B) Setting the maximum interest rates payable on certain types of time deposits under Regulation Q

C) Approving the discount rate "established" by the Federal Reserve banks

D) Representing the United States in negotiations with foreign governments on economic matters

Answer: B
Ques Status: Revised

23) The Federal Open Market Committee usually meets ________ times a year.

A) four

B) six

C) eight

D) twelve

Answer: C
Ques Status: New

24) The Federal Reserve entity that makes decisions regarding the conduct of open market operations is the

A) Board of Governors.

B) chairman of the Board of Governors.

C) Federal Open Market Committee.

D) Open Market Advisory Council

Answer: C
Ques Status: Revised

25) The Federal Open Market Committee consists of the

A) five senior members of the seven-member Board of Governors.

B) seven members of the Board of Governors and seven presidents of the regional Fed banks.

C) seven members of the Board of Governors and five presidents of the regional Fed banks.

D) twelve regional Fed bank presidents and the chairman of the Board of Governors.

Answer: C
Ques Status: Revised

26) The majority of members of the Federal Open Market Committee are

A) Federal Reserve Bank presidents.

B) members of the Federal Advisory Council.

C) presidents of member banks.

D) the seven Federal Reserve governors.

Answer: D
Ques Status: Revised

27) Each Fed bank president attends FOMC meetings; although only ________ Fed bank presidents vote on policy, all ________ provide input.

A) three; ten

B) five; ten

C) three; twelve

D) five; twelve

Answer: D
Ques Status: Previous Edition

28) Although neither ________ nor the ________ are officially set by the Federal Open Market Committee, decisions concerning these policy tools are effectively made by the committee.

A) margin requirements; discount rate

B) margin requirements; federal funds rate

C) reserve requirements; discount rate

D) reserve requirements; federal funds rate

Answer: C
Ques Status: Previous Edition

29) The research document given to the Federal Open Market Committee that contains information on the state of the economy in each Federal Reserve district is called the

A) beige book.

B) green book.

C) blue book.

D) black book.

Answer: A
Ques Status: Revised

30) The research document given to the Federal Open Market Committee that contains the forecast of national economic variables for the next two years is called the

A) beige book.

B) green book.

C) blue book.

D) black book.

Answer: B
Ques Status: New

31) The research document given to the Federal Open Market Committee that contains forecasts of the money aggregates conditional on different monetary policy stances is called the

A) beige book.

B) green book.

C) blue book.

D) black book.

Answer: C
Ques Status: New

32) The Federal Open Market Committee's "balance of risks" is an assessment of whether, in the future, its primary concern will be

A) higher exchange rates or higher unemployment.

B) higher inflation or a stronger economy.

C) higher inflation or a weaker economy.

D) lower inflation or a stronger economy.

Answer: C
Ques Status: Revised

33) Why does the Federal Reserve Bank of New York play a special role within the Federal Reserve System?

Answer: The New York district contains the largest banks in the country. The New York Fed supervises and examines these banks to insure their soundness and the safety of the nation's financial system. The New York Fed conducts open market operations and foreign exchange transactions for the Fed and Treasury. The New York Fed belongs to the Bank for International Settlements, so its president and the chairman of the Board of Governors represent the U.S. at the monthly meetings of the world's central banks. The New York Fed president is the only president of a regional Fed who is a permanent voting member of the FOMC.
Ques Status: Previous Edition

34) Who are the voting members of the Federal Open Market Committee and why is this committee important? Where does the power lie within this committee?

Answer: The FOMC determines the monetary policy of the United States through its decisions about open market operations. It also effectively determines the discount rate and reserve requirements. The seven members of the Board of Governors, the president of the New York Fed, and four of the other eleven regional bank presidents are voting members on a rotating basis. Within the FOMC, the chairman of the Board of Governors wields the power.
Ques Status: Previous Edition

15.3 How Independent is the Fed?

1) Instrument independence is the ability of ________ to set monetary policy ________.

A) the central bank; goals

B) Congress; goals

C) Congress; instruments

D) the central bank; instruments

Answer: D
Ques Status: Revised

2) The ability of a central bank to set monetary policy instruments is

A) political independence.

B) goal independence.

C) policy independence.

D) instrument independence.

Answer: D
Ques Status: Revised

3) Goal independence is the ability of ________ to set monetary policy ________.

A) the central bank; goals

B) Congress; goals

C) Congress; instruments

D) the central bank; instruments

Answer: A
Ques Status: Revised

4) The ability of a central bank to set monetary policy goals is

A) political independence.

B) goal independence.

C) policy independence.

D) instrument independence.

Answer: B
Ques Status: Revised

5) Members of Congress are able to influence monetary policy, albeit indirectly, through their ability to

A) withhold appropriations from the Board of Governors.

B) withhold appropriations from the Federal Open Market Committee.

C) propose legislation that would force the Fed to submit budget requests to Congress, as must other government agencies.

D) instruct the General Accounting Office to audit the foreign exchange market functions of the Federal Reserve.

Answer: C
Ques Status: Revised

6) Explain two concepts of central bank independence. Is the Fed politically independent? Why do economists think central bank independence is important?

Answer: Instrument independence is the ability of the central bank to set its instruments, and goal independence is the ability of a central bank to set its goals. The Fed enjoys both types of independence. The Fed is largely independent of political pressure due to its earnings and the conditions of appointment of the Board of Governors and its chairman. However, some political pressure can be applied through the threat or enactment of legislation affecting the Fed. Independence is important because there is some evidence that independent central banks pursue lower rates of inflation without harming overall economic performance.
Ques Status: Previous Edition

15.4 Structure and Independence of the European Central Bank

1) Under the European System of Central Banks, the Executive Board is similar in structure to the ________ of the Federal Reserve System.

A) Board of Governors

B) Federal Open Market Committee

C) Federal Reserve Banks

D) Federal Advisory Council

Answer: A
Ques Status: New

2) Under the European System of Central Banks, the Governing Council is similar in structure to the ________ of the Federal Reserve System.

A) Board of Governors

B) Federal Open Market Committee

C) Federal Reserve Banks

D) Federal Advisory Council

Answer: B
Ques Status: New

3) Under the European System of Central Banks, the National Central Banks have the same role as the ________ of the Federal Reserve System.

A) Board of Governors

B) Federal Open Market Committee

C) Federal Reserve Banks

D) Federal Advisory Council

Answer: C
Ques Status: New

4) Members of the Executive Board of the European System of Central Banks are appointed to ________ year, nonrenewable terms.

A) four

B) eight

C) ten

D) fourteen

Answer: B
Ques Status: New

5) Which of the following statements comparing the European System of Central Banks and the Federal Reserve System is **TRUE?**

A) The budgets of the Federal Reserve Banks are controlled by the Board of Governors, while the National Central Banks control their own budgets and the budget of the European Central Bank.

B) The European Central Bank has similar power over the National Central Banks when compared to the level of power the Board of Governors has over the Federal Reserve Banks.

C) Just like the Federal Reserve System, monetary operations are centralized in the European System of Central Banks with the European Central Bank.

D) The European Central Bank's involvement in supervision and regulation of financial institutions is comparable to the Board of Governors' involvement.

Answer: A
Ques Status: New

6) The Governing Council usually meets ________ times a year.

A) four

B) six

C) eight

D) twelve

Answer: D
Ques Status: New

7) In the Governing Council, the decision of what policy to implement is made by

A) majority vote of the Executive Board members.

B) majority vote of the heads of the National Banks.

C) consensus.

D) majority vote of all members of the Governing Council.

Answer: C
Ques Status: New

8) As of the beginning of the year 2006, there are ________ countries that have representation on the Governing Council.

A) six

B) eight

C) ten

D) twelve

Answer: D
Ques Status: New

9) The central bank which is generally regarded as the most independent in the world because its charter cannot be changed by legislation is the

A) Bank of England.

B) Bank of Canada.

C) European Central Bank.

D) Bank of Japan.

Answer: C
Ques Status: Previous Edition

10) Explain the similarities and differences between the European System of Central Banks and the Federal Reserve System.

Answer: The similarities between the two are in their structure. The National Central Banks of the member countries of the Eurosystem have the same role as the Federal Reserve Banks in the Federal Reserve system. The Executive Board and the Governing Council of the Eurosystem resemble the Board of Governors and the Federal Open Market Committee of the Federal Reserve System, respectively. There are three major differences between the two. The first difference is concerning the control of the budgets. In the Fed, the Board of Governors controls the budgets of the Reserve Banks while in the Eurosystem, the National Banks control the budget of the European Central Bank. The second difference is the monetary operations of the Eurosystem are conducted by the National Banks, so they are not as centralized as the monetary operations in the Federal Reserve System. Finally, the European Central Bank is not involved in the supervision and regulation of the financial institutions in the euro zone while the Federal Reserve is involved with the regulation and supervision of the financial institutions in the United States.

Ques Status: New

15.5 Structure and independence of Other Foreign Central Banks

1) On paper, the Bank of Canada has ________ instrument independence and ________ goal independence when compared to the Federal Reserve System.

A) less; less

B) less; more

C) more; less

D) more; more

Answer: A

Ques Status: New

2) The oldest central bank, having been founded in 1694, is the

A) Bank of England.

B) Deutsche Bundesbank.

C) Bank of Japan.

D) Federal Reserve System.

Answer: A

Ques Status: Previous Edition

3) While legislation enacted in 1998 granted the Bank of Japan new powers and greater autonomy, its critics contend that its independence is

A) limited by the Ministry of Finance's veto power over a portion of its budget.

B) too great because it need not pursue a policy of price stability even if that is the popular will of the people.

C) too great since the Ministry of Finance no longer has veto power over the bank's budget.

D) limited since the Ministry of Finance can dismiss senior bank officials.

Answer: A
Ques Status: Revised

4) Regarding central bank independence,

A) the Fed is more independent than the European Central Bank.

B) the European Central Bank is more independent than the Fed.

C) the trend in industrialized nations has been to reduce central bank independence.

D) the Bank of England has the longest tradition of independence of any central bank in the world.

Answer: B
Ques Status: Revised

5) The trend in recent years is that more and more governments

A) have been granting greater independence to their central banks.

B) have been reducing the independence of their central banks to make them more accountable for poor economic performance.

C) have mandated that their central banks focus on controlling inflation.

D) have required their central banks to cooperate more with their Ministers of Finance.

Answer: A
Ques Status: Previous Edition

6) Which of the following statements about central bank structure and independence are true?

A) In recent years, with the exception of the Bank of England and the Bank of Japan, most countries have reduced the independence of their central banks, subjecting them to greater democratic control.

B) Before the Bank of England was granted greater independence, the Federal Reserve was the most independent of the world's central banks.

C) Both theory and experience suggest that more independent central banks produce better monetary policy.

D) While the European Central Bank is independent, it is not as independent as the Federal Reserve.

Answer: C
Ques Status: Revised

15.6 Explaining Central Bank Behavior

1) The theory of bureaucratic behavior suggests that the objective of a bureaucracy is to maximize

A) the public's welfare.

B) profits.

C) its own welfare.

D) conflict with the executive and legislative branches of government.

Answer: C
Ques Status: Previous Edition

2) The theory of bureaucratic behavior when applied to the Fed helps to explain why the Fed

A) is supportive of congressional attempts to limit the central bank's autonomy.

B) is so secretive about the conduct of future monetary policy.

C) sought less control over banks in the 1980s.

D) is willing to take on powerful groups that may threaten its autonomy.

Answer: B
Ques Status: Previous Edition

3) Compared to the Federal Reserve, the European Central Bank is less transparent because

A) the European Central Bank doesn't publicly release its inflation rate target for the European Monetary Union while the Federal Reserve publicly releases its inflation rate target for the United States.

B) the Federal Reserve holds a press conference after a policy meeting while the European Central Bank makes no public statement after its policy meetings.

C) the Federal Reserve publicly releases the minutes 3 weeks after the meetings while the European Central bank waits 20 years to publicly release its minutes.

D) the European Central Bank does not publicly release its economic forecasts while the Federal Reserve immediately releases its economic forecasts to the public.

Answer: C
Ques Status: New

4) What is the theory of bureaucratic behavior and how can it be used to explain the behavior of the Federal Reserve?

Answer: The theory of bureaucratic behavior concludes that the main objective of any bureaucracy is to maximize its own welfare, which is related to power and prestige. This can explain why the Federal Reserve has defended its autonomy, avoids conflict with Congress and the president, and its push to gain more control over banks.
Ques Status: New

15.7 Should the Fed be Independent?

1) The case for Federal Reserve independence does not include the idea that

A) political pressure would impart an inflationary bias to monetary policy.

B) a politically insulated Fed would be more concerned with long–run objectives and thus be a defender of a sound dollar and a stable price level.

C) policy is always performed better by an elite group such as the Fed.

D) a Federal Reserve under the control of Congress or the president might make the so–called political business cycle more pronounced.

Answer: C
Ques Status: Previous Edition

2) The political business cycle refers to the phenomenon that just before elections, politicians enact _________ policies. After the elections, the bad effects of these policies (for example, ________) have to be counteracted with ________ policies.

A) expansionary; higher unemployment; contractionary

B) expansionary; a higher inflation rate; contractionary

C) contractionary; higher unemployment; expansionary

D) contractionary; a higher inflation rate; expansionary

Answer: B
Ques Status: New

3) The strongest argument for an independent Federal Reserve rests on the view that subjecting the Fed to more political pressures would impart

A) an inflationary bias to monetary policy.

B) a deflationary bias to monetary policy.

C) a disinflationary bias to monetary policy.

D) a countercyclical bias to monetary policy.

Answer: A
Ques Status: Previous Edition

4) Critics of the current system of Fed independence contend that

A) the current system is undemocratic.

B) voters have too much say about monetary policy.

C) the president has too much control over monetary policy on a day–to–day basis.

D) the Board of Governors is held responsible for policy missteps.

Answer: A
Ques Status: Revised

5) Recent research indicates that inflation performance (low inflation) has been found to be best in countries with

A) the most independent central banks.

B) political control of monetary policy.

C) money financing of budget deficits.

D) a policy of always keeping interest rates low.

Answer: A
Ques Status: Revised

6) Make the case for and against an independent Federal Reserve.

Answer: Case for: 1. An independent Federal Reserve can shield the economy from the political business cycle, and it will be less likely to have an inflationary bias to monetary policy. 2. Control of the money supply is too important to leave to inexperienced politicians.

Case against: 1. It is undemocratic to have monetary policy be controlled by a small number of individuals that are not accountable. 2. In the past, an independent Fed has not used its freedom wisely. 3. Its independence may encourage it to pursue its own self-interest rather than the public's interest.
Ques Status: New

Chapter 16

Multiple Deposit Creation and the Money Supply Process

16.1 Four Players in the Money Supply Process

1) The government agency that oversees the banking system and is responsible for the conduct of monetary policy in the United States is

A) the Federal Reserve System.

B) the United States Treasury.

C) the U.S. Gold Commission.

D) the House of Representatives.

Answer: A
Ques Status: Revised

2) Individuals that lend funds to a bank by opening a checking account are called

A) policyholders.

B) partners.

C) depositors.

D) debt holders.

Answer: C
Ques Status: Revised

3) The four players in the money supply process include

A) banks, depositors, borrowers, and the U.S. Treasury.

B) banks, depositors, the central bank, and the U.S. Treasury.

C) banks, depositors, the central bank, and borrowers.

D) banks, borrowers, the central bank, and the U.S. Treasury.

Answer: C
Ques Status: Previous Edition

4) Of the four players in the money supply process, most observers agree that the most important player is

A) the United States Treasury.

B) the Federal Reserve System.

C) the FDIC.

D) the Office of Thrift Supervision.

Answer: B
Ques Status: Previous Edition

16.2 The Fed's Balance Sheet

1) Both ________ and ________ are Federal Reserve assets.

A) currency in circulation; reserves

B) currency in circulation; government securities

C) government securities; discount loans

D) government securities; reserves

Answer: C

Ques Status: Revised

2) The monetary liabilities of the Federal Reserve include

A) government securities and discount loans.

B) currency in circulation and reserves.

C) government securities and reserves.

D) currency in circulation and discount loans.

Answer: B

Ques Status: Revised

3) Both ________ and ________ are monetary liabilities of the Fed.

A) government securities; discount loans

B) currency in circulation; reserves

C) government securities; reserves

D) currency in circulation; discount loans

Answer: B

Ques Status: Revised

4) The sum of the Fed's monetary liabilities and the U.S. Treasury's monetary liabilities is called

A) the money supply.

B) currency in circulation.

C) bank reserves.

D) the monetary base.

Answer: D

Ques Status: Previous Edition

5) The monetary base consists of

A) currency in circulation and Federal Reserve notes.

B) currency in circulation and the U.S. Treasury's monetary liabilities.

C) currency in circulation and reserves.

D) reserves and Federal Reserve Notes.

Answer: C
Ques Status: Revised

6) Total reserves minus bank deposits with the Fed equals

A) vault cash.

B) excess reserves.

C) required reserves.

D) currency in circulation.

Answer: A
Ques Status: Revised

7) Reserves are equal to the sum of

A) required reserves and excess reserves.

B) required reserves and vault cash reserves.

C) excess reserves and vault cash reserves.

D) vault cash reserves and total reserves.

Answer: A
Ques Status: Revised

8) Total reserves are the sum of ________ and ________.

A) excess reserves; borrowed reserves.

B) required reserves; currency in circulation

C) vault cash; excess reserves

D) excess reserves; required reserves

Answer: D
Ques Status: Revised

9) Excess reserves are equal to

A) total reserves minus discount loans.

B) vault cash plus deposits with Federal Reserve banks minus required reserves.

C) vault cash minus required reserves.

D) deposits with the Fed minus vault cash plus required reserves.

Answer: B
Ques Status: Previous Edition

10) Total Reserves minus vault cash equals

A) bank deposits with the Fed.

B) excess reserves.

C) required reserves.

D) currency in circulation.

Answer: A
Ques Status: New

11) The amount of deposits that banks must hold in reserve is

A) excess reserves.

B) required reserves.

C) total reserves.

D) vault cash.

Answer: B
Ques Status: Revised

12) The percentage of deposits that banks must hold in reserve is the

A) excess reserve ratio.

B) required reserve ratio.

C) total reserve ratio.

D) currency ratio.

Answer: B
Ques Status: Revised

13) Suppose that from a new checkable deposit, First National Bank holds two million dollars in vault cash, eight million dollars on deposit with the Federal Reserve, and one million dollars in required reserves. Given this information, we can say First National Bank has ________ million dollars in excess reserves.

A) three

B) nine

C) ten

D) eleven

Answer: B
Ques Status: New

14) Suppose that from a new checkable deposit, First National Bank holds two million dollars in vault cash, eight million dollars on deposit with the Federal Reserve, and one million dollars in required reserves. Given this information, we can say First National Bank faces a required reserve ratio of ________ percent.

A) ten

B) twenty

C) eighty

D) ninety

Answer: A
Ques Status: New

15) Suppose that from a new checkable deposit, First National Bank holds two million dollars in vault cash, eight million dollars on deposit with the Federal Reserve, and nine million dollars in excess reserves. Given this information, we can say First National Bank has ________ million dollars in required reserves.

A) one

B) two

C) eight

D) ten

Answer: A
Ques Status: New

16) Suppose that from a new checkable deposit, First National Bank holds two million dollars in vault cash, eight million dollars on deposit with the Federal Reserve, and nine million dollars in excess reserves. Given this information, we can say First National Bank faces a required reserve ratio of ________ percent.

A) ten

B) twenty

C) eighty

D) ninety

Answer: A
Ques Status: New

17) Suppose that from a new checkable deposit, First National Bank holds eight million dollars on deposit with the Federal Reserve, one million dollars in required reserves, and faces a required reserve ratio of ten percent. Given this information, we can say First National Bank has ________ million dollars in excess reserves.

A) two

B) eight

C) nine

D) ten

Answer: C
Ques Status: New

18) Suppose that from a new checkable deposit, First National Bank holds eight million dollars on deposit with the Federal Reserve, one million dollars in required reserves, and faces a required reserve ratio of ten percent. Given this information, we can say First National Bank has ________ million dollars in vault cash.

A) two

B) eight

C) nine

D) ten

Answer: A
Ques Status: New

19) Suppose that from a new checkable deposit, First National Bank holds two million dollars in vault cash, nine million dollars in excess reserves, and faces a required reserve ratio of ten percent. Given this information, we can say First National Bank has ________ million dollars in required reserves.

A) one

B) two

C) eight

D) ten

Answer: A
Ques Status: New

20) Suppose that from a new checkable deposit, First National Bank holds two million dollars in vault cash, nine million dollars in excess reserves, and faces a required reserve ratio of ten percent. Given this information, we can say First National Bank has ________ million dollars on deposit with the Federal Reserve.

A) one

B) two

C) eight

D) ten

Answer: C
Ques Status: New

21) Suppose that from a new checkable deposit, First National Bank holds two million dollars in vault cash, one million dollars in required reserves, and faces a required reserve ratio of ten percent. Given this information, we can say First National Bank has ________ million dollars in excess reserves.

A) one

B) two

C) nine

D) ten

Answer: C
Ques Status: New

22) Suppose that from a new checkable deposit, First National Bank holds two million dollars in vault cash, one million dollars in required reserves, and faces a required reserve ratio of ten percent. Given this information, we can say First National Bank has ________ million dollars on deposit with the Federal Reserve.

A) one

B) two

C) eight

D) ten

Answer: C
Ques Status: New

23) Suppose that from a new checkable deposit, First National Bank holds eight million dollars on deposit with the Federal Reserve, nine million dollars in excess reserves, and faces a required reserve ratio of ten percent. Given this information, we can say First National Bank has ________ million dollars in required reserves.

A) one

B) two

C) nine

D) ten

Answer: A
Ques Status: New

24) Suppose that from a new checkable deposit, First National Bank holds eight million dollars on deposit with the Federal Reserve, nine million dollars in excess reserves, and faces a required reserve ratio of ten percent. Given this information, we can say First National Bank has ________ million dollars in vault cash.

A) one

B) two

C) nine

D) ten

Answer: B
Ques Status: New

25) The interest rate the Fed charges banks borrowing from the Fed is the

A) federal funds rate.

B) Treasury bill rate.

C) discount rate.

D) prime rate.

Answer: C
Ques Status: Revised

26) When banks borrow money from the Federal Reserve, these funds are called

A) federal funds.

B) discount loans.

C) federal loans.

D) Treasury funds.

Answer: B
Ques Status: New

27) ________ the Federal Reserve earn income while ________ the Federal Reserve cost nothing.

A) Currency in circulation by; assets of

B) Reserves of; assets of

C) Liabilities of; assets of

D) Assets of; liabilities of

Answer: D
Ques Status: New

16.3 Control of the Monetary Base

1) The monetary base minus currency in circulation equals

A) reserves.

B) the borrowed base.

C) the nonborrowed base.

D) discount loans.

Answer: A
Ques Status: Previous Edition

2) The monetary base minus reserves equals

A) currency in circulation.

B) the borrowed base.

C) the nonborrowed base.

D) discount loans.

Answer: A
Ques Status: New

3) High–powered money minus reserves equals

A) reserves.

B) currency in circulation.

C) the monetary base.

D) the nonborrowed base.

Answer: B
Ques Status: Revised

4) High–powered money minus currency in circulation equals

A) reserves.

B) the borrowed base.

C) the nonborrowed base.

D) discount loans.

Answer: A
Ques Status: New

5) Purchases and sales of government securities by the Federal Reserve are called

A) discount loans.

B) federal fund transfers.

C) open market operations.

D) swap transactions.

Answer: C
Ques Status: New

6) When the Federal Reserve purchases a government bond from a bank, reserves in the banking system ________ and the monetary base ________, everything else held constant.

A) increase; increases

B) increase; decreases

C) decrease; increases

D) decrease; decreases

Answer: A
Ques Status: Revised

7) When the Federal Reserve sells a government bond to a bank, reserves in the banking system ________ and the monetary base ________, everything else held constant.

A) increase; increases

B) increase; decreases

C) decrease; increases

D) decrease; decreases

Answer: D
Ques Status: New

8) When a bank sells a government bond to the Federal Reserve, reserves in the banking system ________ and the monetary base ________, everything else held constant.

A) increase; increases

B) increase; decreases

C) decrease; increases

D) decrease; decreases

Answer: A
Ques Status: New

9) When a bank buys a government bond from the Federal Reserve, reserves in the banking system ________ and the monetary base ________, everything else held constant.

A) increase; increases

B) increase; decreases

C) decrease; increases

D) decrease; decreases

Answer: D
Ques Status: New

10) When the Fed buys $100 worth of bonds from First National Bank, reserves in the banking system

A) increase by $100.

B) increase by more than $100.

C) decrease by $100.

D) decrease by more than $100.

Answer: A
Ques Status: Previous Edition

11) When the Fed sells $100 worth of bonds to First National Bank, reserves in the banking system

A) increase by $100.

B) increase by more than $100.

C) decrease by $100.

D) decrease by more than $100.

Answer: C
Ques Status: Previous Edition

12) If a person selling bonds to the Fed cashes the Fed's check, then reserves ________ and currency in circulation ________, everything else held constant.

A) remain unchanged; declines

B) remain unchanged; increases

C) decline; remains unchanged

D) increase; remains unchanged

Answer: B
Ques Status: Revised

13) The effect of an open market purchase on reserves differs depending on how the seller of the bonds keeps the proceeds. If the proceeds are kept in ________, the open market purchase has no effect on reserves; if the proceeds are kept as ________, reserves increase by the amount of the open market purchase.

A) deposits; deposits

B) deposits; currency

C) currency; deposits

D) currency; currency

Answer: C
Ques Status: Previous Edition

14) The effect of an open market purchase on reserves differs depending on how the seller of the bonds keeps the proceeds. If the proceeds are kept in currency, the open market purchase ________ reserves; if the proceeds are kept as deposits, the open market purchase ________ reserves.

A) has no effect on; has no effect on

B) has no effect on; increases

C) increases; has no effect on

D) decreases; increases

Answer: B
Ques Status: Previous Edition

15) When an individual sells a $100 bond to the Fed, she may either deposit the check she receives or cash it for currency. In both cases

A) reserves increase.

B) high–powered money increases.

C) reserves decrease.

D) high–powered money decreases.

Answer: B
Ques Status: Previous Edition

16) If a member of the nonbank public sells a government bond to the Federal Reserve in exchange for currency, the monetary base will ________, but ________.

A) remain unchanged; reserves will fall

B) remain unchanged; reserves will rise

C) rise; currency in circulation will remain unchanged

D) rise; reserves will remain unchanged

Answer: D
Ques Status: Revised

17) If a member of the nonbank public purchases a government bond from the Federal Reserve in exchange for currency, the monetary base will ________, but reserves will ________.

A) remain unchanged; rise

B) remain unchanged; fall

C) rise; remain unchanged

D) fall; remain unchanged

Answer: D
Ques Status: Revised

18) For which of the following is the change in reserves necessarily different from the change in the monetary base?

A) Open market purchases from a bank

B) Open market purchases from an individual who deposits the check in a bank

C) Open market purchases from an individual who cashes the check

D) Open market sale to a bank

Answer: C
Ques Status: Previous Edition

19) When a member of the nonbank public withdraws currency from her bank account,

A) both the monetary base and bank reserves fall.

B) both the monetary base and bank reserves rise.

C) the monetary base falls, but bank reserves remain unchanged.

D) bank reserves fall, but the monetary base remains unchanged.

Answer: D
Ques Status: Previous Edition

20) When a member of the nonbank public deposits currency into her bank account,

A) both the monetary base and bank reserves fall.

B) both the monetary base and bank reserves rise.

C) the monetary base falls, but bank reserves remain unchanged.

D) bank reserves rise, but the monetary base remains unchanged.

Answer: D
Ques Status: Previous Edition

21) When the Fed extends a $100 discount loan to the First National Bank, reserves in the banking system

A) increase by $100.

B) increase by more than $100.

C) decrease by $100.

D) decrease by more than $100.

Answer: A
Ques Status: Previous Edition

22) All else the same, when the Fed calls in a $100 discount loan previously extended to the First National Bank, reserves in the banking system

A) increase by $100.

B) increase by more than $100.

C) decrease by $100.

D) decrease by more than $100.

Answer: C
Ques Status: Previous Edition

23) When the Federal Reserve extends a discount loan to a bank, the monetary base ________ and reserves ________.

A) remains unchanged; decrease

B) remains unchanged; increase

C) increases; increase

D) increases; remain unchanged

Answer: C
Ques Status: Previous Edition

24) When the Federal Reserve calls in a discount loan from a bank, the monetary base ________ and reserves ________.

A) remains unchanged; decrease

B) remains unchanged; increase

C) decreases; decrease

D) decreases; remains unchanged

Answer: C
Ques Status: New

25) If the Fed decides to reduce bank reserves, it can

A) purchase government bonds.

B) extend discount loans to banks.

C) sell government bonds.

D) print more currency.

Answer: C
Ques Status: Revised

26) There are two ways in which the Fed can provide additional reserves to the banking system: it can ________ government bonds or it can ________ discount loans to commercial banks.

A) sell; extend

B) sell; call in

C) purchase; extend

D) purchase; call in

Answer: C
Ques Status: Previous Edition

27) A decrease in ________ leads to an equal ________ in the monetary base in the short run.

A) float; increase

B) float; decrease

C) Treasury deposits at the Fed; decrease

D) discount loans; increase

Answer: B
Ques Status: Revised

28) The monetary base declines when

A) the Fed extends discount loans.

B) Treasury deposits at the Fed decrease.

C) float increases.

D) the Fed sells securities.

Answer: D
Ques Status: Revised

29) An increase in ________ leads to an equal ________ in the monetary base in the short run.

A) float; decrease

B) float; increase

C) discount loans; decrease

D) Treasury deposits at the Fed; increase

Answer: B
Ques Status: Revised

30) A decrease in ________ leads to an equal ________ in the monetary base in the long run.

A) float; increase

B) float; decrease

C) securities; increase

D) securities; decrease

Answer: D
Ques Status: Revised

31) An increase in ________ leads to an equal ________ in the monetary base in the long run.

A) float; increase

B) float; decrease

C) securities; increase

D) securities; decrease

Answer: C
Ques Status: Revised

32) Suppose a person cashes his payroll check and holds all the funds in the form of currency. Everything else held constant, total reserves in the banking system _________ and the monetary base ________.

A) remain unchanged; increases

B) decrease; increases

C) decrease; remains unchanged

D) decrease; decreases

Answer: C
Ques Status: New

33) Suppose your payroll check is directly deposited to your checking account. Everything else held constant, total reserves in the banking system ________ and the monetary base ________.

A) remain unchanged; _remains unchanged

B) remain unchanged; increases

C) decrease; increases

D) decrease; decreases

Answer: A
Ques Status: New

34) Explain two ways by which the Federal Reserve System can increase the monetary base. Why is the effect of Federal Reserve actions on bank reserves less exact than the effect on the monetary base?

Answer: The Fed can increase the monetary base by purchasing government bonds and by extending discount loans. If the person selling the security chooses to keep the proceeds in currency, bank reserves do not increase. Because the Fed cannot control the distribution of the monetary base between reserves and currency, it has less control over reserves than the base.
Ques Status: Revised

16.4 Multiple Deposit Creation

1) When the Fed supplies the banking system with an extra dollar of reserves, deposits increase by more than one dollar—a process called

A) extra deposit creation.

B) multiple deposit creation.

C) expansionary deposit creation.

D) stimulative deposit creation.

Answer: B
Ques Status: Previous Edition

2) When the Fed supplies the banking system with an extra dollar of reserves, deposits ________ by ________ than one dollar—a process called multiple deposit creation.

A) increase; less

B) increase; more

C) decrease; less

D) decrease; more

Answer: B
Ques Status: Previous Edition

3) If the required reserve ratio is equal to 10 percent, a single bank can increase its loans up to a maximum amount equal to

A) its excess reserves.

B) 10 times its excess reserves.

C) 10 percent of its excess reserves.

D) its total reserves.

Answer: A
Ques Status: Previous Edition

4) In the simple deposit expansion model, if the Fed purchases $100 worth of bonds from a bank that previously had no excess reserves, the bank can now increase its loans by

A) $10.

B) $100.

C) $100 times the reciprocal of the required reserve ratio.

D) $100 times the required reserve ratio.

Answer: B
Ques Status: Previous Edition

5) In the simple deposit expansion model, if the Fed purchases $100 worth of bonds from a bank that previously had no excess reserves, deposits in the banking system can potentially increase by

A) $10.

B) $100.

C) $100 times the reciprocal of the required reserve ratio.

D) $100 times the required reserve ratio.

Answer: C
Ques Status: Revised

6) In the simple deposit expansion model, if the Fed extends a $100 discount loan to a bank that previously had no excess reserves, the bank can now increase its loans by

A) $10.

B) $100.

C) $100 times the reciprocal of the required reserve ratio.

D) $100 times the required reserve ratio.

Answer: B
Ques Status: Previous Edition

7) In the simple deposit expansion model, if the Fed extends a $100 discount loan to a bank that previously had no excess reserves, deposits in the banking system can potentially increase by

A) $10.

B) $100.

C) $100 times the reciprocal of the required reserve ratio.

D) $100 times the required reserve ratio.

Answer: C
Ques Status: Revised

8) The formula for the simple deposit multiplier can be expressed as

A) $\triangle R = \frac{1}{r} \times \triangle T$

B) $\triangle D = \frac{1}{r} \times \triangle R$

C) $\triangle r = \frac{1}{R} \times \triangle T$

D) $\triangle R = \frac{1}{r} \times \triangle D$

Answer: B
Ques Status: Revised

9) In the simple model of multiple deposit creation in which banks do not hold excess reserves, the increase in checkable deposits equals the product of the change in excess reserves and the

A) reciprocal of the excess reserve ratio.

B) simple deposit expansion multiplier.

C) reciprocal of the simple deposit multiplier.

D) discount rate.

Answer: B
Ques Status: Previous Edition

10) The simple deposit multiplier can be expressed as the ratio of the

A) change in reserves in the banking system divided by the change in deposits.

B) change in deposits divided by the change in reserves in the banking system.

C) required reserve ratio divided by the change in reserves in the banking system.

D) change in deposits divided by the required reserve ratio.

Answer: B
Ques Status: Revised

11) If reserves in the banking system increase by $100, then checkable deposits will increase by $1000 in the simple model of deposit creation when the required reserve ratio is

A) 0.01.

B) 0.10.

C) 0.05.

D) 0.20.

Answer: B
Ques Status: Previous Edition

12) If reserves in the banking system increase by $100, then checkable deposits will increase by $500 in the simple model of deposit creation when the required reserve ratio is

A) 0.01.

B) 0.10.

C) 0.05.

D) 0.20

Answer: D
Ques Status: Previous Edition

13) If the required reserve ratio is 10 percent, the simple deposit multiplier is

A) 5.0.

B) 2.5.

C) 100.0.

D) 10.0

Answer: D
Ques Status: Previous Edition

14) If the required reserve ratio is 15 percent, the simple deposit multiplier is

A) 15.0.

B) 1.5.

C) 6.67.

D) 3.33.

Answer: C
Ques Status: Revised

15) If the required reserve ratio is 20 percent, the simple deposit multiplier is

A) 5.0.

B) 2.5.

C) 4.0.

D) 10.0.

Answer: A
Ques Status: Previous Edition

16) If the required reserve ratio is 25 percent, the simple deposit multiplier is

A) 5.0.

B) 2.5.

C) 4.0.

D) 10.0.

Answer: C
Ques Status: Previous Edition

17) A simple deposit multiplier equal to one implies a required reserve ratio equal to

A) 100 percent.

B) 50 percent.

C) 25 percent.

D) 0 percent.

Answer: A
Ques Status: Previous Edition

18) A simple deposit multiplier equal to two implies a required reserve ratio equal to

A) 100 percent.

B) 50 percent.

C) 25 percent.

D) 0 percent.

Answer: B
Ques Status: Previous Edition

19) A simple deposit multiplier equal to four implies a required reserve ratio equal to

A) 100 percent.

B) 50 percent.

C) 25 percent.

D) 0 percent.

Answer: C
Ques Status: Previous Edition

20) In the simple deposit expansion model, if the banking system has excess reserves of $75, and the required reserve ratio is 20%, the potential expansion of checkable deposits is

A) $75.

B) $750.

C) $37.50.

D) $375.

Answer: D
Ques Status: Revised

21) In the simple deposit expansion model, if the required reserve ratio is 20 percent and the Fed increases reserves by $100, checkable deposits can potentially expand by

A) $100.

B) $250.

C) $500.

D) $1,000.

Answer: C
Ques Status: Revised

22) In the simple deposit expansion model, if the required reserve ratio is 10 percent and the Fed increases reserves by $100, checkable deposits can potentially expand by

A) $100.

B) $250.

C) $500.

D) $1,000.

Answer: D
Ques Status: Revised

23) In the simple deposit expansion model, an expansion in checkable deposits of $1,000 when the required reserve ratio is equal to 20 percent implies that the Fed

A) sold $200 in government bonds.

B) sold $500 in government bonds.

C) purchased $200 in government bonds.

D) purchased $500 in government bonds.

Answer: C
Ques Status: Previous Edition

24) In the simple deposit expansion model, an expansion in checkable deposits of $1,000 when the required reserve ratio is equal to 10 percent implies that the Fed

A) sold $1,000 in government bonds.

B) sold $100 in government bonds.

C) purchased $1000 in government bonds.

D) purchased $100 in government bonds.

Answer: D
Ques Status: Previous Edition

25) In the simple deposit expansion model, a decline in checkable deposits of $1,000 when the required reserve ratio is equal to 20 percent implies that the Fed

A) sold $200 in government bonds.

B) sold $500 in government bonds.

C) purchased $200 in government bonds.

D) purchased $500 in government bonds.

Answer: A
Ques Status: Previous Edition

26) In the simple deposit expansion model, a decline in checkable deposits of $1,000 when the required reserve ratio is equal to 10 percent implies that the Fed

A) sold $1,000 in government bonds.

B) sold $100 in government bonds.

C) purchased $1,000 in government bonds.

D) purchased $100 in government bonds.

Answer: B
Ques Status: Previous Edition

27) In the simple deposit expansion model, a decline in checkable deposits of $500 when the required reserve ratio is equal to 10 percent implies that the Fed

A) sold $500 in government bonds.

B) sold $50 in government bonds.

C) purchased $50 in government bonds.

D) purchased $500 in government bonds.

Answer: B
Ques Status: Previous Edition

28) In the simple deposit expansion model, a decline in checkable deposits of $500 when the required reserve ratio is equal to 20 percent implies that the Fed

A) sold $250 in government bonds.

B) sold $100 in government bonds.

C) sold $50 in government bonds.

D) purchased $100 in government bonds.

Answer: B
Ques Status: Previous Edition

29) If reserves in the banking system increase by $100, then checkable deposits will increase by $400 in the simple model of deposit creation when the required reserve ratio is

A) 0.01.

B) 0.10.

C) 0.20.

D) 0.25.

Answer: D
Ques Status: Previous Edition

30) If reserves in the banking system increase by $100, then checkable deposits will increase by $667 in the simple model of deposit creation when the required reserve ratio is

A) 0.01.

B) 0.05.

C) 0.15.

D) 0.20.

Answer: C
Ques Status: Previous Edition

31) If reserves in the banking system increase by $100, then checkable deposits will increase by $100 in the simple model of deposit creation when the required reserve ratio is

A) 0.01.

B) 0.10.

C) 0.20.

D) 1.00.

Answer: D
Ques Status: Previous Edition

32) If reserves in the banking system increase by $100, then checkable deposits will increase by $2,000 in the simple model of deposit creation when the required reserve ratio is

A) 0.01.

B) 0.05.

C) 0.10.

D) 0.20.

Answer: B
Ques Status: Previous Edition

33) If reserves in the banking system increase by $200, then checkable deposits will increase by $500 in the simple model of deposit creation when the required reserve ratio is

A) 0.04.

B) 0.25.

C) 0.40.

D) 0.50.

Answer: C
Ques Status: Previous Edition

34) If a bank has excess reserves of $10,000 and demand deposit liabilities of $80,000, and if the reserve requirement is 20 percent, then the bank has actual reserves of

A) $16,000.

B) $20,000.

C) $26,000.

D) $36,000.

Answer: C
Ques Status: Previous Edition

35) If a bank has excess reserves of $20,000 and demand deposit liabilities of $80,000, and if the reserve requirement is 20 percent, then the bank has total reserves of

A) $16,000.

B) $20,000.

C) $26,000.

D) $36,000.

Answer: D
Ques Status: Previous Edition

36) If a bank has excess reserves of $5,000 and demand deposit liabilities of $80,000, and if the reserve requirement is 20 percent, then the bank has actual reserves of

A) $11,000.

B) $20,000.

C) $21,000.

D) $26,000.

Answer: C
Ques Status: Previous Edition

37) If a bank has excess reserves of $15,000 and demand deposit liabilities of $80,000, and if the reserve requirement is 20 percent, then the bank has total reserves of

A) $11,000.

B) $21,000.

C) $31,000.

D) $41,000.

Answer: C
Ques Status: Previous Edition

38) If a bank has excess reserves of $4,000 and demand deposit liabilities of $100,000, and if the reserve requirement is 15 percent, then the bank has actual reserves of

A) $17,000.

B) $19,000.

C) $24,000.

D) $29,000.

Answer: B
Ques Status: Previous Edition

39) If a bank has excess reserves of $4,000 and demand deposit liabilities of $100,000, and if the reserve requirement is 10 percent, then the bank has actual reserves of

A) $14,000.

B) $19,000.

C) $24,000.

D) $29,000.

Answer: A
Ques Status: Previous Edition

40) If a bank has excess reserves of $7,000 and demand deposit liabilities of $100,000, and if the reserve requirement is 15 percent, then the bank has actual reserves of

A) $17,000.

B) $22,000.

C) $27,000.

D) $29,000.

Answer: B
Ques Status: Previous Edition

41) If a bank has excess reserves of $7,000 and demand deposit liabilities of $100,000, and if the reserve requirement is 10 percent, then the bank has actual reserves of

A) $14,000.

B) $17,000.

C) $22,000.

D) $27,000.

Answer: B
Ques Status: Previous Edition

42) A bank has excess reserves of $6,000 and demand deposit liabilities of $100,000 when the required reserve ratio is 20 percent. If the reserve ratio is raised to 25 percent, the bank's excess reserves will be

A) –$5,000.

B) –$1,000.

C) $1,000.

D) $5,000.

Answer: C
Ques Status: Previous Edition

43) A bank has excess reserves of $4,000 and demand deposit liabilities of $100,000 when the required reserve ratio is 20 percent. If the reserve ratio is raised to 25 percent, the bank's excess reserves will be

A) –$5,000.

B) –$1,000.

C) $1,000.

D) $5,000.

Answer: B
Ques Status: Previous Edition

44) A bank has excess reserves of $10,000 and demand deposit liabilities of $100,000 when the required reserve ratio is 20 percent. If the reserve ratio is raised to 25 percent, the bank's excess reserves will be

A) –$5,000.

B) –$1,000.

C) $1,000.

D) $5,000.

Answer: D
Ques Status: Previous Edition

45) A bank has no excess reserves and demand deposit liabilities of $100,000 when the required reserve ratio is 20 percent. If the reserve ratio is raised to 25 percent, the bank's excess reserves will now be

A) –$5,000.

B) –$1,000.

C) $1,000.

D) $5,000.

Answer: A
Ques Status: Previous Edition

46) A bank has excess reserves of $1,000 and demand deposit liabilities of $80,000 when the reserve requirement is 20 percent. If the reserve requirement is lowered to 10 percent, the bank's excess reserves will be

A) $1,000.

B) $8,000.

C) $9,000.

D) $17,000.

Answer: C
Ques Status: Previous Edition

47) A bank has excess reserves of $1,000 and demand deposit liabilities of $80,000 when the reserve requirement is 25 percent. If the reserve requirement is lowered to 20 percent, the bank's excess reserves will be

A) $1,000.

B) $5,000.

C) $8,000.

D) $9,000.

Answer: B
Ques Status: Previous Edition

48) Decisions by depositors to increase their holdings of ________, or of banks to hold ________ will result in a smaller expansion of deposits than the simple model predicts.

A) deposits; required reserves

B) deposits; excess reserves

C) currency; required reserves

D) currency; excess reserves

Answer: D
Ques Status: Previous Edition

49) Decisions by depositors to increase their holdings of ________, or of banks to hold excess reserves will result in a ________ expansion of deposits than the simple model predicts.

A) deposits; smaller

B) deposits; larger

C) currency; smaller

D) currency; larger

Answer: C
Ques Status: Previous Edition

50) Decisions by ________ about their holdings of currency and by ________ about their holdings of excess reserves affect the money supply.

A) borrowers; depositors

B) banks; depositors

C) depositors; borrowers

D) depositors; banks

Answer: D
Ques Status: Previous Edition

51) Assume that no banks hold excess reserves, and the public holds no currency. If a bank sells a $100 security to the Fed, explain what happens to this bank and two additional steps in the deposit expansion process, assuming a 10% reserve requirement. How much do deposits and loans increase for the banking system when the process is completed?

Answer: Bank A first changes a security for reserves, and then lends the reserves, creating loans. It receives $100 in reserves from the sale of securities. Since all of these reserve will be excess reserves (there was no change in checkable deposits), the bank will loan out all $100. The $100 will then be deposited into Bank B. This bank now has a change in reserves of $100, of which $90 is excess reserves. Bank B will loan out this $90, which will be deposited into Bank C. Bank C now has an increase in reserves of $90, $81 of which is excess reserves. Bank C will loan out this $81 dollars and the process will continue until there are no more excess reserves in the banking system.

For the banking system, both loans and deposits increase by $1000.
Ques Status: Revised

52) Explain two reasons why the Fed does not have complete control over the level of bank deposits and loans. Explain how a change in either factor affects the deposit expansion process.

Answer: The Fed does not completely control the level of bank deposits and loans because banks can hold excess reserves and the public can change its currency holdings. A change in either factor changes the deposit expansion process. An increase in either excess reserves or currency reduces the amount by which deposits and loans are increased.
Ques Status: Previous Edition

53) Explain why the simple deposit multiplier overstates the true deposit multiplier.

Answer: The simple model ignores the role banks and their customers play in the creation process. The bank's customers can decide to hold currency and the bank can decide to hold excess reserves. Both of these will restrict the banking system's ability to create deposits. Thus, the true multiplier is less than the prediction of the simple deposit multiplier.
Ques Status: New

16.5 Web Appendix: The Fed's Balance Sheet and the Monetary Base

1) Which is the most important category of Fed assets?

A) Securities

B) Discount loans

C) Gold and SDR certificates

D) Cash items in the process of collection

Answer: A
Ques Status: Previous Edition

2) The two most important categories of assets on the Fed's balance sheet are ________ and ________ because they earn interest.

A) discount loans; coins

B) securities; discount loans

C) gold; coins

D) cash items in the process of collection; SDR certificate accounts

Answer: B
Ques Status: Revised

3) The Fed's holdings of securities consist primarily of ________, but also in the past have included ________.

A) Treasury securities; bankers' acceptances

B) municipal securities; bankers' acceptances.

C) bankers' acceptances; Treasury securities.

D) Treasury securities; municipal securities.

Answer: A
Ques Status: Revised

4) The volume of loans that the Fed makes to banks is affected by the Fed's setting of the interest rate on these loans, called the

A) federal funds rate.

B) prime rate.

C) discount rate.

D) interbank rate.

Answer: C
Ques Status: Previous Edition

5) Special Drawing Rights (SDRs) are issued to governments by the ________ to settle international debts and have replaced ________ in international transactions.

A) Federal Reserve System; gold

B) Federal Reserve System; dollars

C) International Monetary Fund; gold

D) International Monetary Fund; dollars

Answer: C
Ques Status: Previous Edition

6) When the Treasury acquires gold or SDRs, it issues certificates to the ________, which are a claim on the gold or SDRs, and in turn is credited with deposit balances at the ________.

A) Federal Reserve System; Fed

B) Federal Reserve System; IMF

C) International Monetary Fund; Fed

D) International Monetary Fund; IMF

Answer: A
Ques Status: Previous Edition

7) Which of the following are not assets on the Fed's balance sheet?

A) Discount loans

B) U.S. Treasury deposits

C) Cash items in the process of collection

D) U.S. Treasury bills

Answer: B
Ques Status: Previous Edition

8) Which of the following are not assets on the Fed's balance sheet?

A) Securities

B) Discount loans

C) Cash items in the process of collection

D) Deferred availability cash items

Answer: D
Ques Status: Previous Edition

9) Which of the following are not liabilities on the Fed's balance sheet?

A) Discount loans

B) Bank deposits

C) Deferred availability cash items

D) U.S. Treasury deposits

Answer: A
Ques Status: Previous Edition

10) When the Fed purchases artwork to decorate the conference room at the Federal Reserve Bank of Kansas City,

A) reserves rise, but the monetary base falls.

B) reserves fall.

C) currency in circulation falls.

D) the monetary base rises.

Answer: D
Ques Status: Previous Edition

11) A Fed purchase of gold, SDRs, a deposit denominated in a foreign currency or any other asset is just an open market ________ of these assets, ________ the monetary base.

A) purchase; raising

B) sale; raising

C) purchase; lowering

D) sale; lowering

Answer: A
Ques Status: Revised

12) An increase in Treasury deposits at the Fed causes

A) the monetary base to increase.

B) the monetary base to decrease.

C) Fed assets to increase but has no effect on the monetary base.

D) Fed assets to decrease but has no effect on the monetary base.

Answer: B

Ques Status: Previous Edition

13) An increase in U.S. Treasury deposits at the Fed reduces both ________ and the ________.

A) reserves; monetary base

B) Fed liabilities; money multiplier

C) Fed assets; monetary base

D) Fed assets; money multiplier

Answer: A

Ques Status: Previous Edition

14) U.S. Treasury deposits at the Fed are ________ for the Fed but ________ for the Treasury. Thus an increase in U.S. Treasury deposits ________ the monetary base.

A) a liability; an asset; increases

B) a liability; an asset; decreases

C) an asset; a liability; increases

D) an asset; a liability; decreases

Answer: B

Ques Status: Revised

15) An increase in which of the following leads to a decline in the monetary base?

A) Float

B) Discount loans

C) Foreign deposits at the Fed

D) SDRs

Answer: C

Ques Status: Previous Edition

16) Suppose, while cleaning out its closets, a worker at the Federal Reserve bank branch in Memphis discovers a painting of Elvis (medium: acrylic on velvet) that used to grace the walls of the conference room. Suppose further that, at a public auction, the bank sells the painting for $19.95. This sale will cause ________ in the monetary base, everything else held constant.

A) an increase of $19.95

B) an increase of more than $19.95

C) a decrease of $19.95

D) a decrease of more than $19.95

Answer: C
Ques Status: New

17) Suppose the Bank of China permanently decreases its purchases of U.S. government bonds and, instead, holds more dollars on deposit at the Federal Reserve. Everything else held constant, a open market ________ would be the appropriate monetary policy action for the Fed to take to offset the expected ________ in the monetary base in the United States.

A) purchase; decrease

B) purchase; increase

C) sale; decrease

D) sale; increase

Answer: A
Ques Status: New

Chapter 17

Determinants of the Money Supply

17.1 The Money Supply Model and the Money Multiplier

1) Models describing the determination of the money supply and the Fed's role in this process normally focus on ________ rather than ________, since Fed actions have a more predictable effect on the former.

A) reserves; the monetary base

B) reserves; high-powered money

C) the monetary base; high-powered money

D) the monetary base; reserves

Answer: D
Ques Status: Previous Edition

2) The Fed can exert more precise control over ________ than it can over ________.

A) high-powered money; reserves

B) high-powered money; the monetary base

C) the monetary base; high-powered money

D) reserves; high-powered money

Answer: A
Ques Status: Previous Edition

3) The ratio that relates the change in the money supply to a given change in the monetary base is called the

A) money multiplier.

B) required reserve ratio.

C) deposit ratio.

D) discount rate.

Answer: A
Ques Status: Previous Edition

4) The formula linking the money supply to the monetary base is

A) M = m/MB.

B) M = m × MB.

C) m = M × MB.

D) MB = M × m.

E) M = m + MB.

Answer: B
Ques Status: Previous Edition

5) The variable that reflects the effect on the money supply of changes in factors other than the monetary base is the

A) currency–checkable deposits ratio.

B) required reserve ratio.

C) money multiplier.

D) nonborrowed base.

Answer: C
Ques Status: Previous Edition

6) An assumption in the model of the money supply process is that the desired levels of currency and excess reserves

A) are given as constants.

B) grow proportionally with checkable deposits.

C) grow proportionally with high–powered money.

D) grow proportionally over time.

Answer: B
Ques Status: New

7) The total amount of reserves in the banking system is equal to the ________ required reserves and excess reserves.

A) sum of

B) difference between

C) product of

D) ratio between

Answer: A
Ques Status: New

8) The total amount of required reserves in the banking system is equal to the ________ the required reserve ratio and checkable deposits.

A) sum of

B) difference between

C) product of

D) ratio between

Answer: C
Ques Status: New

9) Since the Federal Reserve sets the required reserve ratio to less than one, one dollar of reserves can support ________ of checkable deposits.

A) exactly one dollar

B) less than one dollar

C) more than one dollar

D) exactly twice the amount

Answer: C
Ques Status: New

10) The equation that shows the amount of the monetary base needed to support existing levels of checkable deposits, excess reserves, and currency is

A) $MB = (r \times D) + ER + C$.

B) $MB = (r + D) + ER + C$.

C) $MB = \frac{r}{D} + ER + C$.

D) $MB = (r \times D) - ER - C$.

Answer: A
Ques Status: Revised

11) An increase in the monetary base that goes into ________ is not multiplied, while an increase that goes into ________ is multiplied.

A) deposits; currency

B) excess reserves; currency

C) currency; excess reserves

D) currency; deposits

Answer: D
Ques Status: Revised

12) An increase in the monetary base that goes into currency is ________, while an increase that goes into deposits is ________.

A) multiplied; multiplied

B) not multiplied; multiplied

C) multiplied; not multiplied

D) not multiplied; not multiplied

Answer: B
Ques Status: Revised

13) If the Fed injects reserves into the banking system and they are held as excess reserves, then the money supply

A) increases by only the initial increase in reserves.

B) increases by only one–half the initial increase in reserves.

C) increases by a multiple of the initial increase in reserves.

D) does not change.

Answer: D
Ques Status: Previous Edition

14) If the Fed injects reserves into the banking system and they are held as excess reserves, then the monetary base ________ and the money supply ________.

A) remains unchanged; remains unchanged

B) remains unchanged; increases

C) increases; increases

D) increases; remains unchanged

Answer: D
Ques Status: Previous Edition

15) The formula that links checkable deposits to the monetary base is

A) $m = \frac{1}{r + e + c}$.

B) $M = \frac{1}{r + e + c}$.

C) $M = \frac{1 + c}{r + e + c}$.

D) $D = \frac{1}{r + e + c}$.

E) $D = \frac{1}{r + e + c} \times MB$.

Answer: E
Ques Status: Revised

16) The formula that links checkable deposits to the money supply is

A) $M = \frac{1 + c}{D}$.

B) $M = \frac{1}{1 + c} \times D$.

C) $D = \frac{1}{1 + c} \times M$.

D) $D = (1 + c) \times M$

Answer: C
Ques Status: New

17) The formula for the M1 money multiplier is

A) $m = (1 + c)/(r + e + c)$.

B) $M = 1/(r + e + c)$.

C) $M = (1 + c)/(r + e + c)$.

D) $m = [1/(r + e + c)] \times MB$.

Answer: A
Ques Status: Revised

18) If the required reserve ratio is 10 percent, currency in circulation is $400 billion, checkable deposits are $800 billion, and excess reserves total $0.8 billion, then the money supply is

A) $8000.

B) $1200.

C) $1200.8.

D) $8400.

Answer: B
Ques Status: Previous Edition

19) If the required reserve ratio is 10 percent, currency in circulation is $400 billion, checkable deposits are $800 billion, and excess reserves total $0.8 billion, then the M1 money multiplier is

A) 2.5.

B) 1.67.

C) 2.0.

D) 0.601.

Answer: A
Ques Status: Revised

20) If the required reserve ratio is 10 percent, currency in circulation is $400 billion, checkable deposits are $800 billion, and excess reserves total $0.8 billion, then the currency ratio is

A) 0.25.

B) 0.50.

C) 0.40.

D) 0.05.

Answer: B
Ques Status: Previous Edition

21) If the required reserve ratio is 10 percent, currency in circulation is $400 billion, checkable deposits are $800 billion, and excess reserves total $0.8 billion, then the excess reserves–checkable deposit ratio is

A) 0.001.

B) 0.10.

C) 0.01.

D) 0.05.

Answer: A
Ques Status: Previous Edition

22) If the required reserve ratio is 10 percent, currency in circulation is $400 billion, checkable deposits are $800 billion, and excess reserves total $0.8 billion, then the monetary base is

A) $480 billion.

B) $480.8 billion.

C) $80 billion.

D) $80.8 billion.

Answer: B
Ques Status: Previous Edition

23) If the required reserve ratio is 15 percent, currency in circulation is $400 billion, checkable deposits are $800 billion, and excess reserves total $0.8 billion, then the M1 money multiplier is

A) 2.5.

B) 1.67.

C) 2.3.

D) 0.651.

Answer: C
Ques Status: Revised

24) If the required reserve ratio is 5 percent, currency in circulation is $400 billion, checkable deposits are $800 billion, and excess reserves total $0.8 billion, then the M1 money multiplier is

A) 2.5.

B) 2.72.

C) 2.3.

D) 0.551.

Answer: B
Ques Status: Revised

25) If the required reserve ratio is 10 percent, currency in circulation is $400 billion, checkable deposits are $1000 billion, and excess reserves total $1 billion, then the money supply is

A) $10,000.

B) $4000.

C) $1400.

D) $10,400.

Answer: C
Ques Status: Previous Edition

26) If the required reserve ratio is 10 percent, currency in circulation is $400 billion, checkable deposits are $1000 billion, and excess reserves total $1 billion, then the M1 money multiplier is

A) 2.5.

B) 2.8.

C) 2.0.

D) 0.7.

Answer: B
Ques Status: Revised

27) If the required reserve ratio is 10 percent, currency in circulation is $400 billion, checkable deposits are $1000 billion, and excess reserves total $1 billion, then the currency ratio is

A) 0.25.

B) 0.50.

C) 0.40.

D) 0.05.

Answer: C
Ques Status: Previous Edition

28) If the required reserve ratio is 10 percent, currency in circulation is $400 billion, checkable deposits are $1000 billion, and excess reserves total $1 billion, then the excess reserves–checkable deposit ratio is

A) 0.01.

B) 0.10.

C) 0.001.

D) 0.05.

Answer: C
Ques Status: Previous Edition

29) If the required reserve ratio is 10 percent, currency in circulation is $400 billion, checkable deposits are $1000 billion, and excess reserves total $1 billion, then the monetary base is

A) $400 billion.

B) $401 billion.

C) $500 billion.

D) $501 billion.

Answer: D
Ques Status: Previous Edition

30) If the required reserve ratio is 15 percent, currency in circulation is $400 billion, checkable deposits are $1000 billion, and excess reserves total $1 billion, then the M1 money multiplier is

A) 2.54.

B) 2.67.

C) 2.35.

D) 0.551.

Answer: A
Ques Status: Revised

31) If the required reserve ratio is one–third, currency in circulation is $300 billion, and checkable deposits are $900 billion, then the money supply is

A) $2700.

B) $3000.

C) $1200.

D) $1800.

Answer: C
Ques Status: Previous Edition

32) If the required reserve ratio is one-third, currency in circulation is $300 billion, and checkable deposits are $900 billion, then the M1 money multiplier is

A) 2.5.

B) 2.8.

C) 2.0.

D) 0.67.

Answer: C
Ques Status: Revised

33) If the required reserve ratio is one-third, currency in circulation is $300 billion, and checkable deposits are $900 billion, then the currency ratio is

A) 0.25.

B) 0.33.

C) 0.67.

D) 0.375.

Answer: B
Ques Status: Previous Edition

34) If the required reserve ratio is one-third, currency in circulation is $300 billion, and checkable deposits are $900 billion, then the level of excess reserves in the banking system is

A) $300 billion.

B) $30 billion.

C) $3 billion.

D) 0.

Answer: D
Ques Status: Previous Edition

35) If the required reserve ratio is one-third, currency in circulation is $300 billion, and checkable deposits are $900 billion, then the monetary base is

A) $300 billion.

B) $600 billion.

C) $333 billion.

D) $667 billion.

Answer: B
Ques Status: Previous Edition

17.2 Factors That Determine the Money Multiplier

1) Everything else held constant, an increase in the required reserve ratio on checkable deposits will cause

A) the money supply to rise.

B) the money supply to remain constant.

C) the money supply to fall.

D) checkable deposits to rise.

Answer: C
Ques Status: Revised

2) Everything else held constant, a decrease in the required reserve ratio on checkable deposits will mean

A) a decrease in the money supply.

B) an increase in the money supply.

C) a decrease in checkable deposits.

D) an increase in discount loans.

Answer: B
Ques Status: Revised

3) Everything else hed constant, an increase in the required reserve ratio on checkable deposits causes the M1 money multiplier to _____ and the money supply to _____.

A) decrease; increase

B) increase; increase

C) decrease; decrease

D) increase; decrease

Answer: C
Ques Status: Revised

4) Everything else held constant, a decrease in the required reserve ratio on checkable deposits causes the M1 money multiplier to _____ and the money supply to _____.

A) decrease; increase

B) increase; increase

C) decrease; decrease

D) increase; decrease

Answer: B
Ques Status: Revised

5) Assuming initially that r = 10%, c = 40%, and e = 0, an increase in r to 15% causes the M1 money multiplier to _____, everything else held constant.

A) increase from 2.55 to 2.8

B) decrease from 2.8 to 2.55

C) increase from 1.82 to 2

D) decrease from 2 to 1.82

Answer: B
Ques Status: Revised

6) Assuming initially that r = 10%, c = 40%, and e = 0, a decrease in r to 5% causes the M1 money multiplier to _____, everything else held constant.

A) increase from 2.8 to 3.11

B) decrease from 3.11 to 2.8

C) increase from 2 to 2.22

D) decrease from 2.22 to 2

Answer: A
Ques Status: Revised

7) Everything else held constant, an increase in the currency–checkable deposit ratio will mean

A) an increase in currency in circulation and an increase in the money supply.

B) an increase in money supply but no change in reserves.

C) a decrease in the money supply.

D) an increase in currency in circulation but no change in the money supply.

Answer: C
Ques Status: Revised

8) Everything else held constant, a decrease in the currency–checkable deposit ratio will mean

A) an increase in currency in circulation and an increase in the money supply.

B) an increase in money supply.

C) a decrease in the money supply.

D) an increase in currency in circulation but no change in the money supply.

Answer: B
Ques Status: Revised

9) Everything else held constant, an increase in the currency ratio causes the M1 money multiplier to _____ and the money supply to _____.

A) decrease; increase

B) increase; decrease

C) decrease; decrease

D) increase; increase

Answer: C
Ques Status: Revised

10) Everything else held constant, a decrease in the currency ratio causes the M1 money multiplier to _____ and the money supply to _____.

A) decrease; increase

B) increase; increase

C) decrease; decrease

D) increase; decrease

Answer: B
Ques Status: Revised

11) Assuming initially that r = 10%, c = 40%, and e = 0, an increase in c to 50% causes the M1 money multiplier to _____, everything else held constant.

A) increase from 2.5 to 2.8

B) decrease from 2.8 to 2.5

C) increase from 2.33 to 2.8

D) decrease from 2.8 to 2.33

Answer: B
Ques Status: Revised

12) Assuming initially that r = 10%, c = 40%, and e = 0, an decrease in c to 30% causes the M1 money multiplier to _____, everything else held constant.

A) increase from 2.8 to 3.25

B) decrease from 3.25 to 2.8

C) increase from 2.8 to 3.5

D) decrease from 3.5 to 2.8

Answer: A
Ques Status: Revised

13) Every thing else held constant, a decrease in the excess reserves ratio causes the M1 money multiplier to _____ and the money supply to _____.

A) decrease; increase

B) increase; increase

C) decrease; decrease

D) increase; decrease

Answer: B
Ques Status: Revised

14) Everything else held constant, an increase in the excess reserves ratio causes the M1 money multiplier to _____ and the money supply to _____.

A) decrease; increase

B) increase; increase

C) decrease; decrease

D) increase; decrease

Answer: C
Ques Status: Revised

15) Assuming initially that r = 15%, c = 40%, and e = 5%, a decrease in e to 0% causes the M1 money multiplier to _____, everything else held constant.

A) increase from 2.33 to 2.55

B) decrease from 2.55 to 2.33

C) increase from 1.67 to 1.82

D) decrease from 1.82 to 1.67

Answer: A
Ques Status: Revised

16) Assuming initially that r = 15%, c = 40%, and e = 5%, an increase in e to 10% causes the M1 money multiplier to _____, everything else held constant.

A) increase from 2.15 to 2.33

B) decrease from 2.33 to 2.15

C) increase from 1.54 to 1.67

D) decrease from 1.67 to 1.54

Answer: B
Ques Status: Revised

17) The excess reserves ratio is _____ related to expected deposit outflows, and is _____ related to the market interest rate.

A) negatively; negatively

B) negatively; positively

C) positively; negatively

D) positively; positively

Answer: C
Ques Status: Previous Edition

18) The money supply is _____ related to expected deposit outflows, and is _____ related to the market interest rate.

A) negatively; negatively

B) negatively; positively

C) positively; negatively

D) positively; positively

Answer: B
Ques Status: Previous Edition

19) The money multiplier is

A) negatively related to high–powered money.

B) positively related to the excess reserves ratio.

C) negatively related to the required reserve ratio.

D) positively related to holdings of excess reserves.

Answer: C
Ques Status: Previous Edition

20) What factors determine a bank's holdings of excess reserves? How does a change in each factor affect excess reserves, the money multiplier, and the money supply?

Answer: An increase in market interest rates reduces excess reserves because banks profit from increased lending. An increase in expected deposit outflows increases excess reserves. An increase in interest rates reduces excess reserves, increasing the multiplier and the money supply. An increase in expected outflows increases excess reserves, reducing the multiplier and the money supply.
Ques Status: Previous Edition

21) Explain two developments in recent years that have led to the decreasing importance of reserve requirements in determining the money multiplier and the money supply.

Answer: The first is the sweep account. Sweep accounts are two accounts tied together, usually a checking account and a money market fund account. At the end of each business day, balances over a certain amount in the checking account are swept into the MMF account. This has led to lower checking account balances and less required reserves, since reserve requirements are only applied to checkable deposit accounts.

The second is the increased availability of ATMs. Banks have found that they need more cash to supply the increased number of ATMs. Hence, this increased vault cash means that banks are holding more excess reserves. A change in the reserve requirements will not alter banks' behavior, as long as the change is less than the extra vault cash now held by banks.

Ques Status: New

17.3 Additional Factors That Determine the Money Supply

1) The Fed does not tightly control the monetary base because it does not completely control

A) open market purchases.

B) open market sales.

C) borrowed reserves.

D) the discount rate.

Answer: C

Ques Status: Revised

2) Subtracting borrowed reserves from the monetary base obtains

A) reserves.

B) high–powered money.

C) the nonborrowed monetary base.

D) the borrowed monetary base.

Answer: C

Ques Status: Revised

3) The relationship between borrowed reserves, the nonborrowed monetary base, and the monetary base is

A) $MB = MB_n - BR$.

B) $BR = MB_n - MB$.

C) $BR = MB - MB_n$.

D) $MB = BR - MB_n$.

Answer: C

Ques Status: Revised

4) Recognizing the distinction between borrowed reserves and the nonborrowed monetary base, the money supply model is specified as

A) $M = m \times (MB_n - BR)$.

B) $M = m \times (MB_n + BR)$.

C) $M = m + (MB_n - BR)$.

D) $M = m - (MB_n + BR)$.

Answer: B
Ques Status: Revised

5) An increase in the nonborrowed monetary base, everything else held constant, will cause:

A) the money supply to fall.

B) the money supply to rise.

C) no change in the money supply.

D) demand deposits to fall.

Answer: B
Ques Status: Revised

6) The money supply is ________ related to the nonborrowed monetary base, and ________ related to the level of borrowed reserves.

A) positively; negatively

B) negatively; not

C) positively; positively

D) negatively; negatively

Answer: C
Ques Status: Revised

7) The amount of borrowed reserves is ________ related to the discount rate, and is ________ related to the market interest rate.

A) negatively; negatively

B) negatively; positively

C) positively; negatively

D) positively; positively

Answer: B
Ques Status: Revised

8) A ________ in market interest rates relative to the discount rate will cause discount borrowing to ________.

A) fall; increase

B) rise; decrease

C) rise; increase

D) fall; remain unchanged

Answer: C
Ques Status: Revised

9) Explain the complete formula for the M1 money supply, and explain how changes in required reserves, excess reserves, the currency ratio, the nonborrowed base, and borrowed reserves affect the money supply.

Answer: The formula is $M = \frac{1 + c}{r + c + e} \times (MB_n + BR)$. The formula indicates that the money supply is the product of the multiplier times the base. Increases in any of the multiplier components, required reserves, r; excess reserves, e; or the currency ratio, c; reduce the multiplier and the money supply. Increases in the nonborrowed base and borrowed reserves both increase the base and the money supply.
Ques Status: Revised

17.4 Overview of the Money Supply Process

1) In the model of the money supply process, the Federal Reserve's role in influencing the money supply is represented by

A) both the required reserve ratio and the market interest rate.

B) the required reserve ratio, nonborrowed reserves, borrowed reserves, and the market interest rate.

C) only borrowed reserves.

D) only nonborrowed reserves.

Answer: B
Ques Status: New

2) In the model of the money supply process, the depositor's role in influencing the money supply is represented by

A) only the currency ratio.

B) both the currency ratio and excess reserve ratio.

C) the currency ratio, excess reserve ratio, and the market interest rate.

D) only the market interest rate.

Answer: C
Ques Status: New

3) In the model of the money supply process, the bank's role in influencing the money supply process is represented by

A) only the excess reserve ratio.

B) both the excess reserve ratio and the market interest rate.

C) only the currency ratio.

D) only borrowed reserves.

Answer: B
Ques Status: New

4) In the model of the money supply process, borrowers from banks' role in influencing the money supply is represented by

A) only market interest rates.

B) both the excess reserve ratio and the market interest rate.

C) only the currency ratio.

D) both borrowed reserves and the market interest rate.

Answer: A
Ques Status: New

5) All else constant, a rise in market interest rates leads to a

A) rise in excess reserves and a rise in the money supply.

B) rise in borrowed reserves and a rise in the money supply.

C) fall in excess reserves and a fall in the money supply.

D) fall in borrowed reserves and a rise in the money supply.

Answer: B
Ques Status: Revised

6) Over the long run the primary determinant of movements in the money supply is the

A) currency ratio.

B) excess reserves ratio.

C) required reserve ratio.

D) nonborrowed base.

Answer: D
Ques Status: Revised

7) Over short time periods, changes in the ________ can have a major impact on the money supply.

A) currency ratio

B) excess reserve ratio

C) required reserve ratio

D) borrowed base

Answer: A
Ques Status: New

8) During the bank panics of the Great Depression the currency ratio

A) increased sharply.

B) decreased sharply.

C) increased slightly.

D) decreased slightly.

Answer: A
Ques Status: Revised

9) During the bank panics of the Great Depression the excess reserve ratio

A) increased sharply.

B) decreased sharply.

C) increased slightly.

D) decreased slightly.

Answer: A
Ques Status: New

10) In the early 1930s, the currency ratio rose, as did the level of excess reserves. Money supply analysis predicts that, everything else held constant, the money supply should have

A) risen.

B) fallen.

C) remain unchanged.

D) either risen, fallen, or remain unchanged

Answer: B
Ques Status: Revised

11) The monetary base increased by 20% during the contraction of 1929–1933, but the money supply fell by 25%. Explain why this occurred. How can the money supply fall when the base increases?

Answer: The banking crisis caused the public to fear for the safety of their deposits, increasing both the currency ratio and bank holdings of excess reserves in anticipation of deposit outflows. Both of these changes reduce the money multiplier and the money supply. In this case, the fall in the multiplier due to increases of currency and excess reserves more than offset the increase in the base, causing the money supply to fall.

Ques Status: Previous Edition

17.5 Appendix: The M2 Money Multiplier

1) The equation that represents M2 in the model of the money supply process is

A) M2 = C + D

B) M2 = C + D + T − MMF

C) M2 = C + D − T + MMF

D) M2 = C + D + T + MMF

Answer: D

Ques Status: New

2) In the model of the money supply process for M2, the relationship between checkable deposits and the M2 money supply is represented by

A) $D = \frac{1}{1 + c + t + mm} \times M2$

B) $D = (1 + c + t + mm) \times M2$

C) $M2 = \frac{1}{r + c + t + mm} \times D$

D) $M2 = \frac{r + c + t + mm}{D}$

Answer: A

Ques Status: New

3) The M2 money supply is represented by

A) $M2 = \frac{1 + c + t + mm}{r + e + c} \times MB$

B) $M2 = \frac{1 + c + t + mm}{r + e + c} \times \frac{1}{MB}$

C) $MB = \frac{1 + c + t + mm}{r + e + c} \times M2$

D) $MB = \frac{r + e + c}{1 + c + t + mm} \times \frac{1}{M2}$

Answer: A

Ques Status: New

4) The M2 money multiplier is

A) negatively related to high–powered money.

B) positively related to the time deposit ratio.

C) positively related to the required reserve ratio.

D) positively related to the excess reserves ratio.

Answer: B
Ques Status: Previous Edition

5) Everything else held constant, an increase in the currency ratio will mean ________ in the M2 money multiplier and ________ in the M2 money supply.

A) an increase; an increase

B) an increase; a decrease

C) a decrease; an increase

D) a decrease; a decrease

Answer: D
Ques Status: Revised

6) Everything else held constant, a decrease in the currency ratio will mean ________ in the M1 money multiplier and ________ in the M2 money multiplier.

A) an increase; an increase

B) an increase; a decrease

C) a decrease; an increase

D) a decrease; a decrease

Answer: A
Ques Status: Revised

7) Everything else held constant, an increase in the required reserve ratio will mean ________ in the M2 money multiplier and ________ in the M2 money supply.

A) an increase; an increase

B) an increase; a decrease

C) a decrease; an increase

D) a decrease; a decrease

Answer: D
Ques Status: Revised

8) Everything else held constant, an increase in the required reserve ratio will result in ________ in M1 and ________ in M2.

A) an increase; an increase

B) an increase; a decrease

C) a decrease; an increase

D) a decrease; a decrease

Answer: D
Ques Status: Revised

9) Everything else held constant, an increase in the time deposit ratio will mean ________ in the M2 money multiplier and ________ in the M2 money supply.

A) an increase; an increase

B) an increase; a decrease

C) a decrease; an increase

D) a decrease; a decrease

Answer: A
Ques Status: Revised

10) Everything else held constant, an increase in the time deposit ratio will result in ________ in the M1 money multiplier and ________ in the M2 money multiplier.

A) an increase; an increase

B) no change; an increase

C) a decrease; a decrease

D) no change; a decrease

Answer: B
Ques Status: Revised

11) 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.

A) an increase; an increase

B) an increase; a decrease

C) a decrease; an increase

D) a decrease; a decrease

Answer: A
Ques Status: Revised

12) Everything else held constant, an increase in the money market fund ratio will result in ________ in the M1 money multiplier and ________ in the M2 money multiplier.

A) an increase; an increase

B) no change; an increase

C) a decrease; a decrease

D) no change; a decrease

Answer: B
Ques Status: Revised

13) Everything else held constant, an increase in the excess reserve ratio will mean ________ in the M2 money multiplier and ________ in the M2 money supply.

A) an increase; an increase

B) an increase; a decrease

C) a decrease; an increase

D) a decrease; a decrease

Answer: D
Ques Status: New

14) Everything else held constant, an increase in the excess reserve ratio will mean ________ in the M1 money multiplier and ________ in the M2 money multiplier.

A) an increase; an increase

B) no change; an increase

C) a decrease; a decrease

D) no change; a decrease

Answer: C
Ques Status: New

17.6 Web Appendix: Explaining the Behavior of the Currency Ratio

1) Factors causing an increase in currency holdings include

A) an increase in the interest rates paid on checkable deposits.

B) an increase in the cost of acquiring currency.

C) a decrease in bank panics.

D) an increase in illegal activity.

Answer: D
Ques Status: Revised

2) Part of the increase in currency holdings in the 1960s and 1970s can be attributed to

A) increases in income tax rates.

B) the switch from progressive to proportional income taxes.

C) the adoption of regressive taxes.

D) bracket creep due to inflation and progressive income taxes.

Answer: D
Ques Status: Revised

3) Everything else held constant, an increase in wealth will cause the holdings of checkable deposits to the holdings of currency to ________ and the currency ratio will ________.

A) increase; increase

B) increase; decrease

C) decrease; increase

D) decrease; decrease

Answer: B
Ques Status: New

4) Everything else held constant, an increase in the interest rate paid on checkable deposits will cause ________ in the amount of checkable deposits held relative to currency holdings and ________ in the currency ratio.

A) an increase; an increase

B) an increase; a decrease

C) a decrease; an increase

D) a decrease; a decrease

Answer: B
Ques Status: New

5) The increase in the availability of ATM's has caused the cost of acquiring currency to ________ which will cause the currency ratio to ________, everything else held constant.

A) increase; increase

B) increase; decrease

C) decrease; increase

D) decrease; decrease

Answer: C
Ques Status: New

6) The steepest increase in the currency ratio since 1892 occurred during

A) World War II.

B) the Great Depression.

C) the interwar years.

D) the past twenty years.

Answer: B
Ques Status: Revised

7) The factor accounting for the steepest rise in the currency ratio since 1892 is

A) taxes.

B) bank panics.

C) illegal activity.

D) an increase in wealth.

Answer: B
Ques Status: Revised

8) The increase in the currency ratio during World War II was due to

A) bank panics.

B) a drop in the rate of interest paid on checking deposits.

C) the spread of ATMs.

D) high taxes and illegal activities.

Answer: D
Ques Status: Revised

Chapter 18

Tools of Monetary Policy

18.1 The Market for Reserves and the Federal Funds Rate

1) The Fed uses three policy tools to manipulate the money supply: ________, which affect reserves and the monetary base; changes in ________, which affect the monetary base; and changes in ________, which affect the money multiplier.

A) open market operations; borrowed reserves; margin requirements

B) open market operations; borrowed reserves; reserve requirements

C) borrowed reserves; open market operations; margin requirements

D) borrowed reserves; open market operations; reserve requirements

Answer: B
Ques Status: Revised

2) The Fed uses three policy tools to manipulate the money supply: open market operations, which affect the ________; changes in borrowed reserves, which affect the ________; and changes in reserve requirements, which affect the ________.

A) money multiplier; monetary base; monetary base

B) monetary base; money multiplier; monetary base

C) monetary base; monetary base; money multiplier

D) money multiplier; money multiplier; monetary base

Answer: C
Ques Status: Previous Edition

3) The interest rate charged on overnight loans of reserves between banks is the

A) prime rate.

B) discount rate.

C) federal funds rate.

D) Treasury bill rate.

Answer: C
Ques Status: Revised

4) The primary indicator of the Fed's stance on monetary policy is

A) the discount rate.

B) the federal funds rate.

C) the growth rate of the monetary base.

D) the growth rate of M2.

Answer: B
Ques Status: Revised

5) The quantity of reserves demanded equals

A) required reserves plus borrowed reserves.

B) excess reserves plus borrowed reserves.

C) required reserves plus excess reserves.

D) total reserves minus excess reserves.

Answer: C
Ques Status: Revised

6) The quantity of reserves demanded rises when the

A) discount rate rises.

B) discount rate falls.

C) federal funds rate rises.

D) federal funds rate falls.

Answer: D
Ques Status: Revised

7) The opportunity cost of holding excess reserves is

A) the discount rate.

B) the prime rate.

C) the Treasury bill rate.

D) the federal funds rate.

Answer: D
Ques Status: Revised

8) The quantity of reserves supplied equals

A) nonborrowed reserves minus borrowed reserves.

B) nonborrowed reserves plus borrowed reserves.

C) required reserves plus borrowed reserves.

D) total reserves minus required reserves.

Answer: B
Ques Status: New

9) In the market for reserves, when the federal funds interest rate is below the discount rate, the supply curve of reserves is

A) vertical.

B) horizontal.

C) positively sloped.

D) negatively sloped.

Answer: A
Ques Status: Revised

10) When the federal funds rate equals the discount rate

A) the supply curve of reserves is vertical.

B) the supply curve of reserves is horizontal.

C) the demand curve for reserves is vertical.

D) the demand curve for reserves is horizontal.

Answer: B
Ques Status: Revised

11) In the market for reserves, an open market ________ the supply of reserves, raising the federal funds interest rate, everything else held constant.

A) sale decreases

B) sale increases

C) purchase increases

D) purchase decreases

Answer: A
Ques Status: Revised

12) In the market for reserves, an open market purchase ________ the ________ of reserves which causes the federal funds rate to fall, everything else held constant.

A) increases; supply

B) increases; demand

C) decreases; supply

D) decreases; demand

Answer: A
Ques Status: New

13) Suppose on any given day there is an excess demand of reserves in the federal funds market. If the Federal Reserve wishes to keep the federal funds rate at its current level, then the appropriate action for the Federal Reserve to take is a ________ open market ________, everything else held constant.

A) defensive; sale

B) defensive; purchase

C) dynamic; sale

D) dynamic; purchase

Answer: B
Ques Status: New

14) In the market for reserves, an open market purchase ________ the supply of reserves and causes the federal funds interest rate to ________, everything else held constant.

A) decreases; fall

B) increases; fall

C) increases; rise

D) decreases; rise

Answer: B
Ques Status: Revised

15) Suppose on any given day the prevailing equilibrium federal funds rate is above the Federal Reserve's federal funds target rate. If the Federal Reserve wishes for the federal funds rate to be at their target level, then the appropriate action for the Federal Reserve to take is a ________ open market ________, everything else held constant.

A) defensive; sale

B) defensive; purchase

C) dynamic; sale

D) dynamic; purchase

Answer: D
Ques Status: New

16) In the market for reserves, an open market sale ________ the supply of reserves causing the federal funds rate to ________, everything else held constant.

A) decreases; decrease

B) increases; decrease

C) increases; increase

D) decreases; increase

Answer: D
Ques Status: Revised

17) Suppose on any given day there is an excess supply of reserves in the federal funds market. If the Federal Reserve wishes to keep the federal funds rate at its current level, then the appropriate action for the Federal Reserve to take is a ________ open market ________, everything else held constant.

A) defensive; sale

B) defensive; purchase

C) dynamic; sale

D) dynamic; purchase

Answer: A
Ques Status: New

18) Suppose on any given day the prevailing equilibrium federal funds rate is below the Federal Reserve's federal funds target rate. If the Federal Reserve wishes for the federal funds rate to be at their target level, then the appropriate action for the Federal Reserve to take is a ________ open market ________, everything else held constant.

A) defensive; sale

B) defensive; purchase

C) dynamic; sale

D) dynamic; purchase

Answer: C
Ques Status: New

19) In the market for reserves, an open market sale ________ the ________ of reserves, causing the federal funds rate to increase, everything else held constant.

A) increases; supply

B) increases; demand

C) decreases; supply

D) decreases; demand

Answer: C
Ques Status: New

20) In the market for reserves, a lower discount rate

A) decreases the supply of reserves.

B) increases the supply of reserves.

C) lengthens the vertical section of the supply curve of reserves.

D) shortens the vertical section of the supply curve of reserves.

Answer: D
Ques Status: Revised

21) Everything else held constant, in the market for reserves, when the federal funds rate is 3%, lowering the discount rate from 5% to 4%

A) lowers the federal funds rate.

B) raises the federal funds rate

C) has no effect on the federal funds rate.

D) has an indeterminate effect on the federal funds rate.

Answer: C
Ques Status: Revised

22) Everything else held constant, in the market for reserves, when the federal funds rate is 5%, lowering the discount rate from 5% to 4%

A) lowers the federal funds rate.

B) raises the federal funds rate.

C) has no effect on the federal funds rate.

D) has an indeterminate effect on the federal funds rate.

Answer: A
Ques Status: Revised

23) Everything else held constant, in the market for reserves, when the federal funds rate is 3%, raising the discount rate from 5% to 6%

A) lowers the federal funds rate.

B) raises the federal funds rate.

C) has no effect on the federal funds rate.

D) has an indeterminate effect on the federal funds rate.

Answer: C
Ques Status: Revised

24) Everything else held constant, in the market for reserves, when the federal funds rate equals the discount rate, lowering the discount rate

A) increases the federal funds rate.

B) lowers the federal funds rate.

C) has no effect on the federal funds rate.

D) has an indeterminate effect of the federal funds rate.

Answer: B
Ques Status: Revised

25) Everything else held constant, in the market for reserves, when the demand for federal funds intersects the reserve supply curve along the horizontal section, increasing the discount rate

A) increases the federal funds rate.

B) lowers the federal funds rate.

C) has no effect on the federal funds rate.

D) has an indeterminate effect of the federal funds rate.

Answer: A
Ques Status: Revised

26) Everything else held constant, in the market for reserves, when the demand for federal funds intersects the reserve supply curve on the vertical section, increasing the discount rate

A) increases the federal funds rate.

B) lowers the federal funds rate.

C) has no effect on the federal funds rate.

D) has an indeterminate effect on the federal funds rate.

Answer: C
Ques Status: Revised

27) Everything else held constant, in the market for reserves, increases in the discount rate affect the federal funds rate

A) when the funds rate is below the discount rate.

B) when the funds rate equals the discount rate.

C) when the demand for federal funds intersects the vertical section of the reserve supply curve.

D) when the demand for federal funds equals zero.

Answer: B
Ques Status: Revised

28) The Federal Reserve usually keeps the discount rate

A) above the target federal funds rate.

B) equal to the target federal funds rate.

C) below the target federal funds rate.

D) equal to zero.

Answer: A
Ques Status: Revised

29) Everything else held constant, the vertical section of the supply curve of reserves is shortened when the

A) discount rate increases.

B) discount rate decreases.

C) federal funds rate rises.

D) federal funds rate falls.

Answer: B
Ques Status: Revised

30) Everything else held constant, the vertical section of the supply curve of reserves is lengthened when the

A) discount rate increases.

B) discount rate decreases.

C) federal funds rate rises.

D) federal funds rate falls.

Answer: A
Ques Status: New

31) In the market for reserves, an increase in the reserve requirement ________ the demand for reserves, ________ the federal funds rate, everything else held constant.

A) decreases; lowering

B) increases; lowering

C) increases; raising

D) decreases; raising

Answer: C
Ques Status: Revised

32) In the market for reserves, a ________ in the reserve requirement ________ the demand for reserves, raising the federal funds interest rate, everything else held constant.

A) rise; decreases

B) rise; increases

C) decline; increases

D) decline; decreases

Answer: B
Ques Status: Revised

33) In the market for reserves, a ________ in the reserve requirement increases the demand for reserves, ________ the federal funds interest rate, everything else held constant.

A) rise; lowering

B) decline; raising

C) decline; lowering

D) rise; raising

Answer: D
Ques Status: Revised

34) In the market for reserves, an increase in the reserve requirement ________ the demand of reserves and causes the federal funds interest rate to ________, everything else held constant.

A) decreases; fall

B) increases; fall

C) increases; rise

D) decreases; rise

Answer: C
Ques Status: Revised

35) In the market for reserves, an increase in the reserve requirement ________ the ________ for reserves and causes the federal funds interest rate to rise, everything else held constant.

A) decreases; demand

B) increases; demand

C) increases; supply

D) decreases; supply

Answer: B
Ques Status: Revised

36) In the market for reserves, a ________ in the reserve requirement ________ the demand for reserves, lowering the federal funds interest rate, everything else held constant.

A) rise; decreases

B) rise; increases

C) decline; increases

D) decline; decreases

Answer: D
Ques Status: Revised

37) In the market for reserves, a ________ in the reserve requirement decreases the demand for reserves, ________ the federal funds interest rate, everything else held constant.

A) rise; lowering

B) decline; raising

C) decline; lowering

D) rise; raising

Answer: C
Ques Status: Revised

38) In the market for reserves, a decline in the reserve requirement ________ the ________ curve of reserves and causes the federal funds interest rate to fall, everything else held constant.

A) decreases; demand

B) increases; demand

C) increases; supply

D) decreases; supply

Answer: A
Ques Status: Revised

39) In the market for reserves, a decline in the reserve requirement ________ the demand of reserves, ________ the federal funds rate, everything else held constant.

A) decreases; lowering

B) increases; lowering

C) increases; raising

D) decreases; raising

Answer: A
Ques Status: Revised

40) Suppose, at a given federal funds rate, there is an excess demand for reserves in the federal funds market. If the Fed wants the federal funds rate to stay at that level, then it should undertake an open market ________ of bonds, everything else held constant. If the Fed does nothing, however, the federal funds rate will ________.

A) sale; increase

B) purchase; increase

C) sale; decrease

D) purchase; decrease

Answer: B
Ques Status: New

41) Suppose, at a given federal funds rate, there is an excess supply of reserves in the federal funds market. If the Fed wants the federal funds rate to stay at that level, then it should undertake an open market ________ of bonds, everything else held constant. If the Fed does nothing, however, the federal funds rate will ________.

A) sale; increase

B) purchase; ncrease

C) sale; ecrease

D) purchase; decrease

Answer: C
Ques Status: New

42) Explain the Fed's three tools of monetary policy and how each is used to change the money supply. Does each tool affect the monetary base or the money multiplier?

Answer: The three tools are open market operations, the purchase and sale of government securities; discount policy, controlling the price and quantity of discount loans to banks; and reserve requirements, setting the percentage of deposits that banks must hold in reserve. Open market operations and the discount rate affect the monetary base, and reserve requirements affect the money multiplier.
Ques Status: Previous Edition

43) State whether the following statement is true or false **AND** explain why: "A decrease in the discount rate will always cause a decrease in the federal reserve funds rate."

Answer: False. Since the discount rate is set above the federal funds rate, a decrease in the discount rate will only cause a decrease in the federal funds rate if the discount rate is decreased below the original federal funds rate level. If the decrease in the discount rate is such that the new rate is still above the federal funds rate, then the federal funds rate does not change, everything else held constant.
Ques Status: New

18.2 Open Market Operations

1) ________ are the most important monetary policy tool because they are the primary determinant of changes in the ________, the main source of fluctuations in the money supply.

A) Open market operations; monetary base

B) Open market operations; money multiplier

C) Changes in reserve requirements; monetary base

D) Changes in reserve requirements; money multiplier

Answer: A
Ques Status: Revised

2) Open market purchases raise the ________ thereby raising the ________.

A) money multiplier; money supply

B) money multiplier; monetary base

C) monetary base; money supply

D) monetary base; money multiplier

Answer: C
Ques Status: Previous Edition

3) Open market purchases ________ reserves and the monetary base thereby ________ the money supply.

A) raise; lowering

B) raise; raising

C) lower; lowering

D) lower; raising

Answer: B
Ques Status: Previous Edition

4) Open market sales shrink ________ thereby lowering ________.

A) the money multiplier; the money supply

B) the money multiplier; reserves and the monetary base

C) reserves and the monetary base; the money supply

D) the money base; the money multiplier

Answer: C
Ques Status: Previous Edition

5) Open market sales ________ reserves and the monetary base thereby ________ the money supply.

A) raise; lowering

B) raise; raising

C) lower; lowering

D) lower; raising

Answer: C
Ques Status: Previous Edition

6) The two types of open market operations are

A) offensive and defensive.

B) dynamic and reactionary.

C) active and passive.

D) dynamic and defensive.

Answer: D
Ques Status: Revised

7) There are two types of open market operations: ________ open market operations are intended to change the level of reserves and the monetary base, and ________ open market operations are intended to offset movements in other factors that affect the monetary base.

A) defensive; dynamic

B) defensive; static

C) dynamic; defensive

D) dynamic; static

Answer: C
Ques Status: Previous Edition

8) Open market operations intended to offset movements in noncontrollable factors (such as float) that affect reserves and the monetary base are called

A) defensive open market operations.

B) dynamic open market operations.

C) offensive open market operations.

D) reactionary open market operations.

Answer: A
Ques Status: Previous Edition

9) When the Federal Reserve engages in a repurchase agreement to offset a withdrawal of Treasury funds from the Federal Reserve, the open market operation is said to be

A) defensive.

B) offensive.

C) dynamic.

D) reactionary.

Answer: A
Ques Status: Previous Edition

10) The Federal Open Market Committee makes the Fed's decisions on the purchase or sale of government securities, but these purchases or sales are executed by the Federal Reserve Bank of

A) Chicago.

B) Boston.

C) New York.

D) San Francisco.

Answer: C
Ques Status: Previous Edition

11) The actual execution of open market operations is done at

A) the Board of Governors in Washington, D.C.

B) the Federal Reserve Bank of New York.

C) the Federal Reserve Bank of Philadelphia.

D) the Federal Reserve Bank of Boston.

Answer: B
Ques Status: Previous Edition

12) If float is predicted to decrease because of unseasonably good weather, the manager of the trading desk at the Federal Reserve Bank of New York will likely conduct a ________ open market ________ of securities.

A) defensive; sale

B) defensive; purchase

C) dynamic; sale

D) dynamic; purchase

Answer: B
Ques Status: Previous Edition

13) When bad storms slow the check–clearing process, float tends to ________ causing the Fed to initiate defensive open market ________.

A) decrease; sales

B) decrease; purchases

C) increase; sales

D) increase; purchases

Answer: C
Ques Status: Previous Edition

14) When good weather speeds the check–clearing process, float tends to ________ causing the Fed to initiate defensive open market ________.

A) decrease; sales

B) decrease; purchases

C) increase; sales

D) increase; purchases

Answer: B
Ques Status: Previous Edition

15) When bad storms slow the check–clearing process, float tends to ________ causing the Fed to initiate ________ open market ________.

A) decrease; defensive; sales

B) decrease; dynamic; purchases

C) increase; defensive; sales

D) increase; dynamic; purchases

Answer: C
Ques Status: Previous Edition

16) When good weather speeds the check–clearing process, float tends to ________ causing the Fed to initiate ________ open market ________.

A) decrease; defensive; sales

B) decrease; dynamic; sales

C) decrease; defensive; purchases

D) increase; dynamic; purchases

Answer: C
Ques Status: Revised

17) If float is predicted to increase because of bad weather, the manager of the trading desk at the New York Fed bank will likely conduct ________ open market operations to ________ reserves.

A) defensive; inject

B) defensive; drain

C) dynamic; inject

D) dynamic; drain

Answer: B
Ques Status: Previous Edition

18) If float is predicted to decrease because of good weather, the manager of the trading desk at the New York Fed bank will likely conduct ________ open market operations to ________ reserves.

A) defensive; inject

B) defensive; drain

C) dynamic; inject

D) dynamic; drain

Answer: A
Ques Status: Previous Edition

19) If Treasury deposits at the Fed are predicted to increase, the manager of the trading desk at the New York Fed bank will likely conduct ________ open market operations to ________ reserves.

A) defensive; inject

B) defensive; drain

C) dynamic; inject

D) dynamic; drain

Answer: A
Ques Status: Previous Edition

20) If Treasury deposits at the Fed are predicted to ________, the manager of the trading desk at the New York Fed bank will likely conduct ________ open market operations to ________ reserves.

A) increase; defensive; inject

B) decrease; defensive; drain

C) increase; dynamic; inject

D) decrease; dynamic; drain

Answer: A
Ques Status: Previous Edition

21) If Treasury deposits at the Fed are predicted to fall, the manager of the trading desk at the New York Fed bank will likely conduct ________ open market operations to ________ reserves.

A) defensive; inject

B) defensive; drain

C) dynamic; inject

D) dynamic; drain

Answer: B
Ques Status: Previous Edition

22) If Treasury deposits at the Fed are predicted to ________, the manager of the trading desk at the New York Fed bank will likely conduct ________ open market operations to ________ reserves.

A) rise; defensive; drain

B) fall; defensive; drain

C) rise; dynamic; inject

D) fall; dynamic; drain

Answer: B
Ques Status: Previous Edition

23) If the Fed expects currency holdings to rise, it conducts open market ________ to offset the expected ________ in reserves.

A) purchases; increase

B) purchases; decrease

C) sales; increase

D) sales; decrease

Answer: B
Ques Status: Revised

24) If the Fed expects currency holdings to fall, it conducts open market ________ to offset the expected ________ in reserves.

A) purchases; increase

B) purchases; decrease

C) sales; increase

D) sales; decrease

Answer: C
Ques Status: Revised

25) If the banking system has a large amount of reserves, many banks will have excess reserves to lend and the federal funds rate will probably ________; if the level of reserves is low, few banks will have excess reserves to lend and the federal funds rate will probably ________.

A) fall; fall

B) fall; rise

C) rise; fall

D) rise; rise

Answer: B
Ques Status: Previous Edition

26) The Federal Reserve will engage in a repurchase agreement when it wants to ________ reserves ________ in the banking system.

A) increase; permanently

B) increase; temporarily

C) decrease; temporarily

D) decrease; permanently

Answer: B
Ques Status: Previous Edition

27) If the Fed wants to temporarily inject reserves into the banking system, it will engage in

A) a repurchase agreement.

B) a matched sale–purchase transaction.

C) reverse repurchase agreement.

D) an open market sale.

Answer: A
Ques Status: Revised

28) The Fed can offset the effects of an increase in float by engaging in

A) a repurchase agreement.

B) a matched sale–purchase transaction.

C) an interest rate swap.

D) an open market purchase.

Answer: B
Ques Status: Revised

29) The Federal Reserve will engage in a matched sale–purchase transaction when it wants to ________ reserves ________ in the banking system.

A) increase; permanently

B) increase; temporarily

C) decrease; temporarily

D) decrease; permanently

Answer: C
Ques Status: Previous Edition

30) Explain dynamic and defensive open market operations. What is the purpose of each type? Describe two situations when defensive open market operations are used. How are defensive open market operations typically conducted?

Answer: Dynamic OMOs are used to permanently change the monetary base and money supply. Defensive operations are used to offset temporary changes in the monetary base and/or money supply. Defensive operations are used to offset float, shifts in Treasury balances into or out of the Fed, and temporary changes in currency. Defensive purchases are typically conducted by using repurchase agreements, while reverse repos or matched sale–purchase transactions are used to conduct defensive open market sales.
Ques Status: Previous Edition

18.3 Discount Policy

1) Discount policy affects the money supply by affecting the volume of ________ and the ________.

A) excess reserves; monetary base

B) borrowed reserves; monetary base

C) excess reserves; money multiplier

D) borrowed reserves; money multiplier

Answer: B
Ques Status: Revised

2) The discount rate is

A) the interest rate the Fed charges on loans to banks.

B) the price the Fed pays for government securities.

C) the interest rate that banks charge their most preferred customers.

D) the price banks pay the Fed for government securities.

Answer: A
Ques Status: Previous Edition

3) The most common type of discount lending that the Fed extends to banks is called

A) seasonal credit.

B) secondary credit.

C) primary credit.

D) installment credit.

Answer: C
Ques Status: Revised

4) The most common type of discount lending, ________ credit loans, are intended to help healthy banks with short-term liquidity problems that often result from temporary deposit outflows.

A) secondary

B) primary

C) temporary

D) seasonal

Answer: B
Ques Status: Revised

5) When the Fed acts as a lender of last resort, the type of lending it provides is

A) primary credit.

B) seasonal credit.

C) secondary credit.

D) installment credit.

Answer: C
Ques Status: Revised

6) The Fed's discount lending is of three types: ________ is the most common category; ________ is given to a limited number of banks in vacation and agricultural areas; ________ is given to banks that have experienced severe liquidity problems.

A) seasonal credit; secondary credit; primary credit

B) secondary credit; seasonal credit; primary credit

C) primary credit; seasonal credit; secondary credit

D) seasonal credit; primary credit; secondary credit

Answer: C
Ques Status: Revised

7) The discount rate is ________ kept ________ the federal funds rate.

A) always; below

B) typically; below

C) typically; equal to

D) typically; above

Answer: D
Ques Status: Revised

8) The discount rate refers to the interest rate on

A) primary credit.

B) secondary credit.

C) seasonal credit.

D) federal funds.

Answer: A
Ques Status: New

9) The interest rate on secondary credit is set ________ basis points ________ the primary credit rate.

A) 100; above

B) 100; below

C) 50; above

D) 50; below

Answer: C
Ques Status: Revised

10) The interest rate for primary credit is set ________ basis points ________ the federal funds rate.

A) 50; below

B) 100; above

C) 100; below

D) 50; above

Answer: B
Ques Status: Revised

11) The interest rate on seasonal credit equals

A) the federal funds rate.

B) the primary credit rate.

C) the secondary credit rate.

D) an average of the federal funds rate and rates on certificates of deposits.

Answer: D
Ques Status: Revised

12) The Fed is considering eliminating

A) primary credit lending.

B) secondary credit lending.

C) seasonal credit lending.

D) its lender of last resort function.

Answer: C
Ques Status: Revised

13) At its inception, the Federal Reserve was intended to be

A) the Treasury's banker.

B) the issuer of government debt.

C) a lender-of-last-resort.

D) a regulator of bank holding companies.

Answer: C
Ques Status: Previous Edition

14) Much of the credit for prevention of a financial market meltdown after "Black Monday" (October 19, 1987) must be given to the Federal Reserve System and its chairman

A) Paul Volker.

B) Alan Blinder.

C) Arthur Burns.

D) Alan Greenspan.

Answer: D
Ques Status: Previous Edition

15) A financial panic was averted in October 1987 following "Black Monday" when the Fed announced that

A) it was lowering the discount rate.

B) it would provide discount loans to any bank that would make loans to the security industry.

C) it stood ready to purchase common stocks to prevent a further slide in stock prices.

D) it was raising the discount rate.

Answer: B
Ques Status: Revised

16) The Fed's lender-of-last-resort function

A) has proven to be ineffective.

B) cannot prevent runs by large depositors.

C) is no longer necessary due to FDIC insurance.

D) creates a moral hazard problem.

Answer: D
Ques Status: Revised

17) The most important advantage of discount policy is that the Fed can use it to

A) precisely control the monetary base.

B) perform its role as lender of last resort.

C) control the money supply.

D) punish banks that have deficient reserves.

Answer: B
Ques Status: Previous Edition

18.4 Reserve Requirements

1) An increase in ________ reduces the money supply since it causes the ________ to fall.

A) reserve requirements; monetary base

B) reserve requirements; money multiplier

C) margin requirements; monetary base

D) margin requirements; money multiplier

Answer: B
Ques Status: Previous Edition

2) A decrease in ________ increases the money supply since it causes the ________ to rise.

A) reserve requirements; monetary base

B) reserve requirements; money multiplier

C) margin requirements; monetary base

D) margin requirements; money multiplier

Answer: B
Ques Status: Previous Edition

3) The Federal Reserve has had the authority to vary reserve requirements since the

A) 1920's.

B) 1930's.

C) 1940's.

D) 1950's.

Answer: B
Ques Status: New

4) Since 1980, ________ are subject to reserve requirements.

A) only commercial banks

B) only the member institutions of the Federal Reserve

C) only nationally chartered depository institutions

D) all depository institutions

Answer: D
Ques Status: New

5) Funds held in ________ are subject to reserve requirements.

A) all checkable deposits

B) all checkable and time deposits

C) all checkable, time, and money market fund deposits

D) all time deposits

Answer: A
Ques Status: New

6) The policy tool of changing reserve requirements is

A) the most widely used.

B) the preferred tool from the bank's perspective.

C) no longer used.

D) still used, even with its disadvantanges.

Answer: C
Ques Status: New

7) In the channel–corridor system

A) control of the overnight interest rate is impossible.

B) reserve requirements are essential for monetary control.

C) the overnight rate always equals the Lombard rate.

D) monetary control can be exercised with no required reserves.

Answer: D
Ques Status: Revised

18.5 Monetary Policy Tools of the European Central Bank

1) The European System of Central Banks signals the stance of its monetary policy by setting a target for the

A) federal funds rate.

B) overnight cash rate.

C) lombard rate.

D) reserve rate.

Answer: B
Ques Status: New

2) When the European System of Central Banks uses main refinancing operations, it is similar to the Federal Reserve using

A) dynamic open market operations.

B) defensive open market operations.

C) discount policy.

D) reserve requirements.

Answer: B
Ques Status: New

3) When the European System of Central Banks uses long–term refinancing operations, it is similar to the Federal Reserve using

A) dynamic open market operations.

B) defensive open market operations.

C) discount policy.

D) reserve requirements.

Answer: A
Ques Status: New

4) The equivalent to the Federal Reserve's discount rate in the European System of Central Banks is the

A) federal funds rate.

B) marginal lending rate.

C) deposit facility rate.

D) lombard rate.

Answer: B
Ques Status: New

5) The Federal Reserve ________ pay interest on reserves held on deposit. The European System of Central Banks ________ pay interest on reserves held on deposit.

A) does; does

B) does; does not

C) does not; does

D) does not; does not

Answer: C
Ques Status: New

6) Since the European Central Bank ________ interest on reserves, banks have a ________ cost of complying with reserve requirements when compared to banks complying with the reserve requirements of the Federal Reserve.

A) pays; lower

B) pays; higher

C) does not pay; lower

D) does not pay; higher

Answer: A
Ques Status: New

Chapter 19

What Should Central Banks Do?
Monetary Policy Goals, Strategy, and Tactics

19.1 The Price Stability Goal and the Nominal Anchor

1) The most common definition that central bankers use for price stability is

A) low and stable deflation.

B) an inflation rate of zero percent.

C) high and stable inflation.

D) low and stable inflation.

Answer: D
Ques Status: New

2) Price stability is desirable because

A) inflation creates uncertainty, making it difficult to plan for the future.

B) everyone is better off when prices are stable.

C) price stability increases the profitability of the Fed.

D) it guarantees full employment.

Answer: A
Ques Status: Previous Edition

3) Inflation results in

A) ease of planning for the future.

B) ease of comparing prices over time.

C) lower nominal interest rates.

D) difficulty interpreting relative price movements.

Answer: D
Ques Status: Revised

4) Economists believe that countries recently suffering hyperinflation have experienced

A) reduced growth.

B) increased growth.

C) reduced prices.

D) lower interest rates.

Answer: A
Ques Status: Revised

5) A nominal variable, such as the inflation rate or the money supply, which ties down the price level to achieve price stability is called ________ anchor.

A) a nominal

B) a real

C) an operating

D) an intermediate

Answer: A
Ques Status: New

6) A central feature of monetary policy strategies in all countries is the use of a nominal variable that monetary policymakers use as an intermediate target to achieve an ultimate goal such as price stability. Such a variable is called a nominal

A) anchor.

B) benchmark.

C) tether.

D) guideline.

Answer: A
Ques Status: Previous Edition

7) A central feature of monetary policy strategies in all countries is the use of a nominal anchor, which is a nominal variable that monetary policymakers use as an

A) operating target, such as the federal funds interest rate.

B) intermediate target, such as the federal funds interest rate.

C) intermediate target to achieve an ultimate goal such as price stability.

D) operating target to achieve an ultimate goal such as exchange rate stability.

Answer: C
Ques Status: Previous Edition

8) A nominal anchor promotes price stability by

A) outlawing inflation.

B) stabilizing interest rates.

C) keeping inflation expectations low.

D) keeping economic growth low.

Answer: C
Ques Status: Revised

9) Monetary policy is considered time–inconsistent because

A) of the lag times associated with the implementation of monetary policy and its effect on the economy.

B) policymakers are tempted to pursue discretionary policy that is more contractionary in the short run.

C) policymakers are tempted to pursue discretionary policy that is more expansionary in the short run.

D) of the lag times associated with the recognition of a potential economic problem and the implementation of monetary policy.

Answer: C
Ques Status: New

10) 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.

A) inflation rate

B) unemployment rate

C) interest rate

D) foreign exchange rate

Answer: A
Ques Status: New

11) The theory that monetary policy conducted on a discretionary, day–by–day basis leads to poor long–run outcomes is referred to as the

A) adverse selection problem.

B) moral hazard problem.

C) time–inconsistency problem.

D) nominal–anchor problem.

Answer: C
Ques Status: Previous Edition

12) The ________ problem of discretionary policy arises because economic behavior is influenced by what firms and people expect the monetary authorities to do in the future.

A) moral hazard

B) time–inconsistency

C) nominal–anchor

D) rational–expectation

Answer: B
Ques Status: Previous Edition

13) If the central bank pursues a monetary policy that is more expansionary than what firms and people expect, then the central bank must be trying to

A) boost output in the short run.

B) constrain output in the short run.

C) constrain prices.

D) boost prices in the short run.

Answer: A
Ques Status: Previous Edition

14) The time–inconsistency problem in monetary policy can occur when the central bank conducts policy

A) using a nominal anchor.

B) using a strict and inflexible rule.

C) on a discretionary, day–by–day basis.

D) using a flexible, discretionary rule.

Answer: C
Ques Status: Revised

15) Explain the time–inconsistency problem. What is the likely outcome of discretionary policy? What are the solutions to the time–inconsistency problem?

Answer: With policy discretion, policymakers have an incentive to attempt to increase output by pursuing expansionary policies once expectations are set. The problem is that this policy results not in higher output, but in higher actual and expected inflation. The solution is to adopt a rule to constrain discretion. Nominal anchors can provide the necessary constraint on discretionary behavior.
Ques Status: Previous Edition

19.2 Other Goals of Monetary Policy

1) Even if the Fed could completely control the money supply, monetary policy would have critics because

A) the Fed is asked to achieve many goals, some of which are incompatible with others.

B) the Fed's goals do not include high employment, making labor unions a critic of the Fed.

C) the Fed's primary goal is exchange rate stability, causing it to ignore domestic economic conditions.

D) it is required to keep Treasury security prices high.

Answer: A
Ques Status: Revised

2) High unemployment is undesirable because it

A) results in a loss of output.

B) always increases inflation.

C) always increases interest rates.

D) reduces idle resources.

Answer: A
Ques Status: Revised

3) When workers voluntarily leave work while they look for better jobs, the resulting unemployment is called

A) structural unemployment.

B) frictional unemployment.

C) cyclical unemployment.

D) underemployment.

Answer: B
Ques Status: Previous Edition

4) Unemployment resulting from a mismatch of workers' skills and job requirements is called

A) frictional unemployment.

B) structural unemployment.

C) seasonal unemployment.

D) cyclical unemployment.

Answer: B
Ques Status: Revised

5) The goal for high employment should seek a level of unemployment at which the demand for labor equals the supply of labor. Economists call this level of unemployment the

A) frictional level of unemployment.

B) structural level of unemployment.

C) natural rate level of unemployment.

D) Keynesian rate level of unemployment.

Answer: C
Ques Status: Previous Edition

6) Supply–side economic policies seek to

A) raise interest rates through contractionary monetary policy.

B) increase federal government expenditures.

C) increase consumption expenditures by increasing taxes.

D) increase saving and investment using tax incentives.

Answer: D
Ques Status: Revised

7) The Federal Reserve System was created to

A) make it easier to finance budget deficits.

B) promote financial market stability.

C) lower the unemployment rate.

D) promote rapid economic growth.

Answer: B
Ques Status: Revised

8) Having interest rate stability

A) allows for less uncertainty about future planning.

B) leads to demands to curtail the Fed's power.

C) guarantees full employment.

D) leads to problems in financial markets.

Answer: A
Ques Status: Revised

19.3 Should Price Stability Be The Primary Goal of Monetary Policy?

1) Which set of goals can, at times, conflict in the short run?

A) High employment and economic growth.

B) Interest rate stability and financial market stability.

C) High employment and price level stability.

D) Exchange rate stability and financial market stability.

Answer: C
Ques Status: Revised

2) The primary goal of the European Central Bank is

A) price stability.

B) exchange rate stability.

C) interest rate stability.

D) high employment.

Answer: A
Ques Status: Revised

3) The mandate for the monetary policy goals that has been given to the European Central Bank is an example of a ________ mandate.

A) primary

B) dual

C) secondary

D) hierarchical

Answer: D
Ques Status: New

4) The mandate for the monetary policy goals that has been given to the Federal Reserve System is an example of a ________ mandate.

A) primary

B) dual

C) secondary

D) hierarchical

Answer: B
Ques Status: New

5) Either a dual or hierarchial mandate is acceptable as long as ________ is the primary goal in the ________.

A) price stability; short run

B) price stability; long run

C) reducing business–cycle fluctuations; short run

D) reducing business–cycle fluctuations; long run

Answer: B
Ques Status: New

19.4 Monetary Targeting

1) Under monetary targeting, a central bank announces an annual growth rate target for ________.

A) a monetary aggregate

B) a reserve aggregate

C) the monetary base

D) GDP

Answer: A
Ques Status: New

2) During the years 1979 to 1982, the Federal Reserve's announced policy was monetary targeting. During this time period the Federal Reserve

A) hit all of their monetary targets.

B) did not hit any of their monetary targets because it is believed that controlling the money supply was not the intent of the Federal Reserve.

C) did not hit any of their monetary targets because they were unrealistic.

D) hit about half of their monetary targets.

Answer: B
Ques Status: New

3) Compared to the United States, Japan's experience with monetary targeting performed

A) better with regard to the inflation rate and output fluctuations.

B) worse with regard to the inflation rate and output fluctuations.

C) better with regard to the inflation rate, but worse with regard to output fluctuations.

D) worse with regard to the inflation rate, but better with regard to output fluctuations.

Answer: A
Ques Status: New

4) One of the factors that contributed to the success German policymakers had using a monetary targeting type policy was that

A) they used a rigid target for the money growth rate.

B) they implemented policy so their inflation rate goal was met in the short run.

C) the money target was flexible to allow the Bundesbank to concentrate on other goals as needed.

D) they rarely communicated the intentions of policy to the public in order to keep the public from panicking.

Answer: C
Ques Status: New

5) Which of the following is an advantage to money targeting?

A) There is an immediate signal on the achievement of the target.

B) It does not rely on a stable money–inflation relationship.

C) It implies lack of transparency.

D) It implies smaller output fluctuations.

Answer: A
Ques Status: New

6) Which of the following is a disadvantage to monetary targeting?

A) It relies on a stable money–inflation relationship.

B) There is a delayed signal about the achievement of a target.

C) It implies larger ouput fluctuations.

D) It implies a lack of transparency.

Answer: A
Ques Status: New

7) If the relationship between the monetary aggregate and the goal variable is weak, then

A) monetary aggregate targeting is superior to exchange–rate targeting.

B) monetary aggregate targeting is superior to inflation targeting.

C) inflation targeting is superior to exchange–rate targeting.

D) monetary aggregate targeting will not work.

Answer: D
Ques Status: Revised

8) The monetary policy strategy that provides an immediate signal on target achievement is

A) exchange–rate targeting.

B) monetary targeting.

C) inflation targeting.

D) the implicit nominal anchor.

Answer: B
Ques Status: Revised

9) The monetary policy strategy that relies on a stable money–income relationship is

A) exchange–rate targeting.

B) monetary targeting.

C) inflation targeting.

D) the implicit nominal anchor.

Answer: B
Ques Status: Revised

19.5 Inflation Targeting

1) The type of monetary policy that is used in Canada, New Zealand, and the United Kingdom is

A) monetary targeting.

B) inflation targeting.

C) targeting with an implicit nominal anchor.

D) interest–rate targeting.

Answer: B
Ques Status: New

2) Which of the following is not an element of inflation targeting?

A) A public announcement of medium–term numerical targets for inflation

B) An institutional commitment to price stability as the primary long–run goal

C) An information–inclusive approach in which only monetary aggregates are used in making decisions about monetary policy

D) Increased accountability of the central bank for attaining its inflation objectives

Answer: C
Ques Status: New

3) The first country to adopt inflation targeting was

A) the United Kingdom.

B) Canada.

C) New Zealand.

D) Australia.

Answer: C
Ques Status: New

4) In both New Zealand and Canada, what has happened to the unemployment rate since the countries adopted inflation targeting?

A) The unemployment rate increased sharply.

B) The unemployment rate remained constant.

C) The unemployment rate has declined substantially after a sharp increase.

D) The unemployment rate declined sharply immediately after the inflation targets were adopted.

Answer: C
Ques Status: New

5) Which of the following is not an advantage of inflation targeting?

A) There is simplicity and clarity of the target.

B) Inflation targeting does not rely on a stable money–inflation relationship.

C) There is an immediate signal on the achievement of the target.

D) Inflation targeting reduces the effects of inflation shocks.

Answer: C
Ques Status: New

6) Which of the following is not a disadvantage to inflation targeting?

A) There is a delayed signal about achievement of the target.

B) Inflation targets could impose a rigid rule on policymakers.

C) There is potential for larger output fluctuations.

D) There is a lack of transparency.

Answer: D
Ques Status: New

7) The decision by inflation targeters to choose inflation targets ________ zero reflects the concern of monetary policymakers that particularly ________ inflation can have substantial negative effects on real economic activity.

A) below; high

B) below; low

C) above; high

D) above; low

Answer: D
Ques Status: Previous Edition

8) Inflation targets can increase the central bank's flexibility in responding to declines in aggregate spending. Declines in aggregate ________ that cause the inflation rate to fall below the floor of the target range will automatically stimulate the central bank to ________ monetary policy without fearing that this action will trigger a rise in inflation expectations.

A) demand: tighten

B) demand; loosen

C) supply; tighten

D) supply; loosen

Answer: B
Ques Status: Previous Edition

9) Explain what inflation targeting is. What are the advantages and disadvantages of this type of monetary policy strategy?

Answer: There are five main elements to inflation targeting: 1. a public announcement of a medium–term target for the inflation rate; 2. a commitment to price stability as the primary long–term goal of policy; 3. many variables are used in making decisions about policy moves; 4. increased transparency about policy strategy with the public; 5. the central bank has increased accountability for attaining policy goals.

The advantages of inflation targeting include: 1. the simplicity and clarity of a numerical target for the inflation rate; 2. does not rely on a stable money–inflation relationship; 3. there is increased accountability of the central bank; 4. reduces the effects of inflationary shocks.

The disadvantages of inflation targeting include: 1. there is a delayed signal about the achievement of the target; 2. it could lead to a rigid rule where the only focus is the inflation rate (has not happened in practice); 3. if sole focus is the inflation rate, larger output fluctuations can occur (has not happened in practice).
Ques Status: New

19.6 Monetary Policy with an Implicit Nominal Anchor

1) The type of monetary policy regime that the Federal Reserve has been following in recent years can best be described as

A) monetary targeting.

B) inflation targeting.

C) policy with an implicit nominal anchor.

D) exchange–rate targeting.

Answer: C
Ques Status: New

2) Estimates suggest that, in the United States economy, it takes just over ________ for monetary policy to affect output and just over ________ for monetary policy to affect the inflation rate.

A) 1 year; 2 years

B) 2 years; 1 year

C) 1 year; 6 months

D) 6 months; 1 year

Answer: A
Ques Status: New

3) Which of the following is an advantage of using an implicit nominal anchor for monetary policy?

A) It does not rely on the money–inflation relationship.

B) It is simplistic and has clarity.

C) There is increased accountability of central bankers.

D) There is an immediate signal if the target has been achieved.

Answer: A
Ques Status: New

4) Which of the following is not a disadvantage of using an implicit nominal anchor for monetary policy?

A) There is low transparency of policy.

B) There is low accountability for central bankers.

C) This type of policy relies on the policy–makers in charge.

D) It relies on a stable money–inflation relationship.

Answer: D
Ques Status: New

5) When compared to the Fed's ________ anchor approach, ________ targeting can make the institutional framework for the conduct of monetary policy more consistent with democratic principles.

A) nominal; inflation

B) implicit; monetary

C) nominal; monetary

D) implicit; inflation

Answer: D
Ques Status: Previous Edition

6) The monetary policy strategy that suffers a lack of transparency is

A) exchange-rate targeting.

B) monetary targeting.

C) inflation targeting.

D) the implicit nominal anchor.

Answer: D
Ques Status: Revised

7) The monetary policy strategy that provides the least accountability is

A) exchange-rate targeting.

B) monetary targeting.

C) inflation targeting.

D) the implicit nominal anchor.

Answer: D
Ques Status: Revised

8) Explain the type of monetary policy strategy that the Federal Reserve has used in recent years. What are the advantages and disadvantages to this type of strategy?

Answer: The Federal Reserve doesn't use an explicit nominal anchor such as a monetary aggregate or the inflation rate. Its strategy revolves around using an implict nominal anchor in the form of an overriding concern to control inflation in the long run. This involves forward-looking behavior and "pre-emptive strikes" by policy actions to prevent inflation. This forward-looking behavior is necessary because of the long time lags between monetary policy action and its impact on inflation.

The advantages of this policy strategy include: 1. it doesn't rely on a stable money-inflation relationship; 2. the demonstrated success it had in the United States.

The disadvantages of this policy strategy include: 1. there is a lack of transparency; 2. its success depends on the individuals in charge of policy; 3. there is low accountability of the central bank.
Ques Status: New

19.7 Tactics: Choosing the Policy Instrument

1) Which of the following is not an operating instrument?

A) Nonborrowed reserves

B) Monetary base

C) Federal funds interest rate

D) Discount rate

Answer: D
Ques Status: Revised

2) Which of the following is a potential operating instrument for the central bank?

A) The monetary base

B) The M1 money supply

C) Nominal GDP

D) The discount rate

Answer: A
Ques Status: Revised

3) Due to the lack of timely data for the price level and economic growth, the Fed's strategy

A) targets the exchange rate, since the Fed can control this variable.

B) targets the price of gold, since it is closely related to economic activity.

C) uses an intermediate target, such as an interest rate.

D) stabilizes the consumer price index, since the Fed can control the CPI.

Answer: C
Ques Status: Revised

4) If the central bank targets a monetary aggregate, it is likely to lose control over the interest rate because

A) of fluctuations in the demand for reserves.

B) of fluctuations in the consumption function.

C) bond values will tend to remain stable.

D) of fluctuations in the business cycle.

Answer: A
Ques Status: Revised

5) If the Fed pursues a strategy of targeting an interest rate when fluctuations in money demand are prevalent,

A) fluctuations of nonborrowed reserves will be small.

B) fluctuations of nonborrowed reserves will be large.

C) the Fed will probably quickly abandon this policy, as it did in the 1960s.

D) the Fed will probably quickly abandon this policy, as it did in the 1950s.

Answer: B
Ques Status: Revised

6) Fluctuations in the demand for reserves cause the Fed to lose control over a monetary aggregate if the Fed targets

A) a monetary aggregate.

B) the monetary base.

C) an interest rate.

D) nominal GDP.

Answer: C
Ques Status: Revised

7) Interest rates are difficult to measure because

A) data on them are not available in a timely manner.

B) real interest rates depend on the hard–to–determine expected inflation rate.

C) they fluctuate too often to be accurate.

D) they cannot be controlled by the Fed.

Answer: B
Ques Status: Revised

8) Which of the following criteria need not be satisfied for choosing an intermediate target?

A) The variable must be measurable.

B) The variable must be controllable.

C) The variable must be predictable.

D) The variable must be transportable.

Answer: D
Ques Status: Previous Edition

9) Which of the following is not a requirement in selecting an intermediate target?

A) Measurability

B) Controllability

C) Flexibility

D) Predictability

Answer: C
Ques Status: Previous Edition

10) When it comes to choosing an policy instrument, both the ________ rate and ________ aggregates are measured accurately and are available daily with almost no delay.

A) three–month T–bill; monetary

B) three–month T–bill; reserve

C) federal funds; monetary

D) federal funds; reserve

Answer: D
Ques Status: Revised

11) If the desired intermediate target is an interest rate, then the preferred policy instrument will be a(n) ________ variable like the ________.

A) interest rate; three–month T–bill rate

B) interest rate; federal funds rate

C) monetary aggregate; monetary base

D) monetary aggregate; nonborrowed base

Answer: B
Ques Status: Revised

12) If the desired intermediate target is a monetary aggregate, then the preferred policy instrument will be a(n) ________ variable like the ________.

A) interest rate; three–month T–bill rate

B) interest rate; federal funds rate

C) reserve aggregate; monetary base

D) reserve aggregate; narrow money supply M1

Answer: C
Ques Status: Revised

13) If the desired intermediate target is a monetary aggregate, which of the following would be the most preferred policy instrument?

A) The federal funds rate

B) The 90–day T–bill rate

C) The 180–day T–bill rate

D) The monetary base

Answer: D
Ques Status: Revised

14) If the desired intermediate target is an interest rate, the preferred policy instrument would be

A) the federal funds rate.

B) the monetary base.

C) nonborrowed reserves.

D) borrowed reserves.

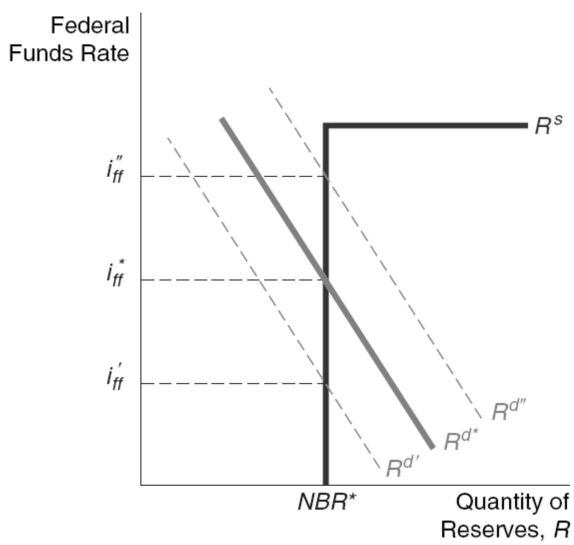
E) the discount rate.

Answer: A

Ques Status: Revised

15) Explain and demonstrate graphically how targeting nonborrowed reserves can result in federal funds rate instability.

Answer: See figure below.

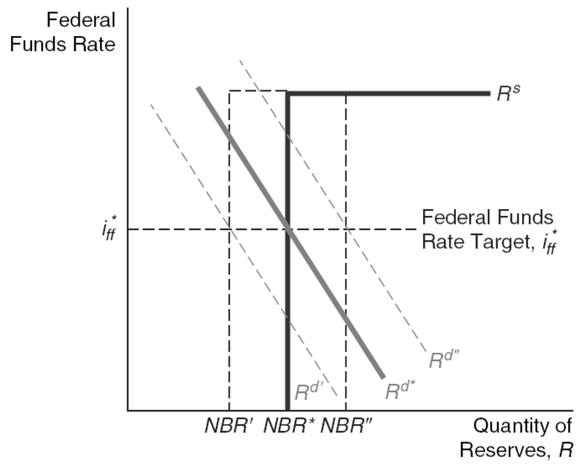


When nonborrowed reserves are held constant, increases in the demand for reserves result in the federal funds rate increasing and decreases in the demand for nonborrowed reserves result in the federal funds rate declining. Since fluctuations in demand do not cause monetary policy actions, the result is the federal funds rate will fluctuate (assuming the equilibrium federal funds rate is below the discount rate).

Ques Status: Revised

16) Explain and demonstrate graphically how targeting the federal funds rate can result in fluctuations in nonborrowed reserves.

Answer: See figure below.



With a federal funds rate target, fluctuations in demand for reserves require similar changes in the nonborrowed reserves to keep the federal funds rate constant.

Ques Status: Revised

19.8 The Taylor Rule, NAIRU and the Philips Curve

1) According to the Taylor rule, the Fed should raise the federal funds interest rate when inflation ________ the Fed's inflation target or when real GDP ________ the Fed's output target.

A) rises above; drops below

B) drops below; drops below

C) rises above; rises above

D) drops below; rises above

Answer: C

Ques Status: Revised

2) Using Taylor's rule, when the equilibrium real federal funds rate is 3 percent, the positive output gap is 2 percent, the target inflation rate is 1 percent, and the actual inflation rate is 2 percent, the nominal federal funds rate target should be

A) 5 percent.

B) 5.5 percent.

C) 6 percent.

D) 6.5 percent.

Answer: D

Ques Status: Revised

3) Using Taylor's rule, when the equilibrium real federal funds rate is 2 percent, there is no output gap, the actual inflation rate is zero, and the target inflation rate is 2 percent, the nominal federal funds rate should be

A) 0 percent.

B) 1 percent.

C) 2 percent.

D) 3 percent.

Answer: B
Ques Status: Revised

4) The rate of inflation tends to remain constant when

A) the unemployment rate is above the NAIRU.

B) the unemployment rate equals the NAIRU.

C) the unemployment rate is below the NAIRU.

D) the unemployment rate increases faster than the NAIRU increases.

Answer: B
Ques Status: Revised

5) The rate of inflation increases when

A) the unemployment rate equals the NAIRU.

B) the unemployment rate exceeds the NAIRU.

C) the unemployment rate is less than the NAIRU.

D) the unemployment rate increases faster than the NAIRU increases.

Answer: C
Ques Status: Revised

6) Explain the Taylor rule, including the formula for setting the federal funds rate target, and the components of the formula. If the Fed were to use this rule, how many goals would it use to set monetary policy?

Answer: The Taylor rule specifies that the target federal fund rates should be set to equal the equilibrium real federal funds rate, plus the rate of inflation (for the Fisher effect), plus one-half times the output gap, plus one-half times the inflation gap. The formula is

Federal funds rate target = equilibrium real federal funds rate + inflation rate + $\frac{1}{2}$ (output gap) + $\frac{1}{2}$ (inflation gap)

The output gap is the percentage deviation of real GDP from potential full-employment real GDP. The inflation gap is the difference between actual inflation and the central bank's target rate of inflation. The equilibrium real federal funds rate is the real rate consistent with full employment in the long run. The inflation rate is the actual rate of inflation. The Taylor rule sets the federal funds rate recognizing the goals of low inflation and full employment (or equilibrium long-run economic growth).

Ques Status: Previous Edition

19.9 Appendix: Fed Policy Procedures: Historical Perspective

1) In its earliest years, the Federal Reserve's guiding principle for the conduct of monetary policy was known as the

A) real bills doctrine.

B) liberal liquidity doctrine.

C) free reserves doctrine.

D) quantity theory of money.

Answer: A

Ques Status: Revised

2) The guiding principle for the conduct of monetary policy that held that as long as loans were being made for "productive" purposes, then providing reserves to the banking system to make these loans would not be inflationary became known as the

A) free reserves doctrine.

B) Benjamin Strong doctrine.

C) efficient liquidity doctrine.

D) real bills doctrine.

Answer: D

Ques Status: Previous Edition

3) The real bills doctrine was the guiding principle for the conduct of monetary policy during the

A) 1910s.

B) 1940s.

C) 1950s.

D) 1960s.

Answer: A
Ques Status: Previous Edition

4) The Fed accidentally discovered open market operations in the early

A) 1920s.

B) 1910s.

C) 1900s.

D) 1890s.

Answer: A
Ques Status: Previous Edition

5) The Fed accidentally discovered open market operations when

A) it came to the rescue of failing banks in the early 1930s, and found that its purchases of bank loans injected reserves into the banking system.

B) it purchased securities for income following the 1920–1921 recession.

C) it attempted to slow inflation in 1919 by selling securities and found that its sales drained reserves from the banking system.

D) it reinterpreted a key provision of the Federal Reserve Act.

Answer: B
Ques Status: Previous Edition

6) The Fed's mistakes of the early 1930s were compounded by its decision to

A) raise reserve requirements in 1936–1937.

B) lower reserve requirements in 1936–1937.

C) raise the monetary base in 1936–1937.

D) lower the monetary base in 1936–1937.

Answer: A
Ques Status: Revised

7) During World War II, whenever interest rates would ________ and the price of bonds would begin to ________, the Fed would make open market purchases.

A) rise; rise

B) rise; fall

C) fall; rise

D) fall; fall

Answer: B
Ques Status: Previous Edition

8) During World War II, whenever interest rates would rise and the price of bonds would begin to fall, the Fed would

A) lower reserve requirements.

B) raise reserve requirements.

C) make open market purchases of government securities.

D) make open market sales of government securities.

Answer: C
Ques Status: Previous Edition

9) During World War II, the Fed in effect relinquished its control of monetary policy through its policy of

A) continually lowering reserve requirements.

B) continually raising reserve requirements.

C) pegging interest rates.

D) targeting free reserves.

Answer: C
Ques Status: Previous Edition

10) The Fed was committed to keeping interest rates low to assist Treasury financing of budget deficits

A) only during World War I.

B) during the Great Depression.

C) during World War I and World War II.

D) throughout the entire existence of the Fed.

Answer: C
Ques Status: Revised

11) The Fed–Treasury Accord of March 1951 provided the Fed greater freedom to

A) let interest rates increase.

B) let unemployment increase.

C) let inflation accelerate.

D) let exchange rates increase.

Answer: A
Ques Status: Revised

12) During the 1950s, the Fed targeted

A) M1.

B) M2.

C) the monetary base.

D) money market conditions.

Answer: D
Ques Status: Revised

13) During the 1950s, Fed monetary policy targeted

A) the monetary base.

B) the exchange rate.

C) discount loans.

D) interest rates.

Answer: D
Ques Status: Revised

14) Targeting interest rates can be procyclical because

A) an increase in income increases interest rates, causing the Fed to buy bonds, increasing the monetary base and money supply, leading to further increases in income.

B) an increase in interest rates increases income, causing the Fed to buy bonds, increasing the monetary base and money supply, leading to further increases in income.

C) an increase in the monetary base increases the money supply, causing the Fed to buy bonds, increasing the monetary base and money supply, leading to further increases in income.

D) an increase in income increases the monetary base and money supply, causing the Fed to buy bonds to increase interest rates and income.

Answer: A
Ques Status: Revised

15) High inflation can spiral out of control when

A) expected inflation increases nominal interest rates, causing the Fed to buy bonds, increasing the money supply and further increasing inflation.

B) expected inflation decreases nominal interest rates, causing the Fed to buy bonds, increasing the money supply and further increasing inflation.

C) expected inflation increases nominal interest rates, causing the Fed to sell bonds, increasing the money supply and further increasing inflation.

D) expected inflation decreases nominal interest rates, causing the Fed to sell bonds, increasing the money supply and further increasing inflation.

Answer: A
Ques Status: Revised

16) In practice, the Fed's policy of targeting money market conditions in the 1960s proved to be

A) countercyclical, helping to stabilize the economy.

B) procyclical, destabilizing the economy.

C) procyclical, helping to stabilize the economy.

D) countercyclical, destabilizing the economy.

Answer: B
Ques Status: Previous Edition

17) In practice, the Fed's policy of targeting ________ in the 1960s proved to be ________, destabilizing the economy.

A) money market conditions; countercyclical

B) money market conditions; procyclical

C) monetary aggregates; countercyclical

D) monetary aggregates; procyclical

Answer: B
Ques Status: Previous Edition

18) Although the Fed professed employment of a monetary aggregate targeting strategy during the 1970s, its behavior suggests that it emphasized

A) free–reserve targeting.

B) interest–rate targeting.

C) a real–bills doctrine.

D) price–index targeting.

Answer: B
Ques Status: Previous Edition

19) Although the Fed professed employment of ________ targeting during the 1970s, its behavior suggests that it emphasized ________ targeting.

A) free–reserve; interest–rate

B) interest–rate; monetary aggregate

C) monetary aggregate; interest–rate

D) free reserve; monetary aggregate

Answer: C
Ques Status: Revised

20) The Fed's use of the federal funds rate as an operating target in the 1970s resulted in

A) countercyclical monetary policy.

B) too slow growth in M1 throughout the decade.

C) procyclical monetary policy.

D) too rapid growth in M1 throughout the decade.

Answer: C
Ques Status: Revised

21) The Fed's use of the ________ as an operating target in the 1970s resulted in ________ monetary policy.

A) federal funds rate; countercyclical

B) federal funds rate; procyclical

C) M1 money supply; countercyclical

D) M1 money supply; procyclical

Answer: B
Ques Status: Revised

22) In the 1970s, the Fed selected an interest rate as an operating target rather than a reserve aggregate primarily because it

A) had no interest in targeting a monetary aggregate, as evidenced by its unwillingness to target a reserve aggregate.

B) was still very concerned with achieving interest rate stability.

C) was committed to targeting free reserves.

D) was committed to the real bills doctrine.

Answer: B
Ques Status: Previous Edition

23) The Fed operating procedures employed between 1979 and 1982 resulted in ________ swings in the federal funds rate and ________ swings in the M1 growth rate.

A) increased; increased

B) increased; decreased

C) decreased; decreased

D) decreased; increased

Answer: A
Ques Status: Previous Edition

24) The fluctuations in both money supply growth and the federal funds rate during 1979–1982 suggest that the Fed

A) had shifted to borrowed reserves as an operating target.

B) had shifted to total reserves as an operating target.

C) had shifted to the monetary base as an operating target.

D) never intended to target monetary aggregates.

Answer: D
Ques Status: Previous Edition

25) The Fed's failure to exercise effective control over the money supply during the 1979–1982 period

A) proves that such control is not possible.

B) resulted because forces outside of its control removed the link between open market operations and the money supply.

C) occurred despite evidence of a strong link between open market operations and the money supply.

D) stems from the Treasury–Federal Reserve Accord.

Answer: C
Ques Status: Previous Edition

26) Large fluctuations in money supply growth and smaller fluctuations in the federal funds rate between October 1982 and the early 1990s indicate that the Fed had shifted to ________ as an operating target.

A) borrowed reserves

B) nonborrowed reserves

C) excess reserves

D) required reserves

Answer: A
Ques Status: Previous Edition

27) The strengthening of the dollar between 1980 and 1985 contributed to a ________ in American competitiveness, putting pressure on the Fed to pursue a more ________ monetary policy.

A) decrease; contractionary

B) increase; expansionary

C) increase; contractionary

D) decrease; expansionary

Answer: D
Ques Status: Revised

28) A borrowed reserves target is ________ because increases in income ________ interest rates and discount loans, causing the Fed to ________ the monetary base, everything else held constant.

A) procyclical; increase; increase

B) countercyclical; increase; increase

C) procyclical; reduce; reduce

D) countercyclical; reduce; reduce

Answer: A
Ques Status: Revised

29) Fed policy since the early 1990s indicates that it is pursuing a policy of targeting the

A) monetary base.

B) money supply.

C) federal funds interest rate.

D) exchange rate.

Answer: C
Ques Status: Previous Edition

30) Since the early 1990s, the Fed has conducted monetary policy by setting a target for the

A) level of borrowed reserves.

B) monetary base.

C) federal funds rate.

D) inflation rate.

Answer: C
Ques Status: Revised

31) The Fed can engage in preemptive strikes against a rise in inflation by ________ the federal funds interest rate; it can act preemptively against negative demand shocks by ________ the federal funds interest rate.

A) raising; lowering

B) raising; raising

C) lowering; lowering

D) lowering; raising

Answer: A
Ques Status: Previous Edition

32) International policy coordination refers to

A) central banks in major nations acting without regard to the global consequences of their policies.

B) central banks in major nations pursuing only domestic objectives.

C) central banks adopting policies in pursuit of joint objectives.

D) central banks all adopting identical policies.

Answer: C
Ques Status: Revised

Chapter 20

The Foreign Exchange Market

20.1 Foreign Exchange Market

1) The exchange rate is

A) the price of one currency relative to gold.

B) the value of a currency relative to inflation.

C) the change in the value of money over time.

D) the price of one currency relative to another.

Answer: D
Ques Status: Revised

2) Exchange rates are determined in

A) the money market.

B) the foreign exchange market.

C) the stock market.

D) the capital market.

Answer: B
Ques Status: Revised

3) Although foreign exchange market trades are said to involve the buying and selling of currencies, most trades involve the buying and selling of

A) bank deposits denominated in different currencies.

B) SDRs.

C) gold.

D) ECUs.

Answer: A
Ques Status: Previous Edition

4) The immediate (two–day) exchange of one currency for another is a

A) forward transaction.

B) spot transaction.

C) money transaction.

D) exchange transaction.

Answer: B
Ques Status: Revised

5) An agreement to exchange dollar bank deposits for euro bank deposits in one month is a

A) spot transaction.

B) future transaction.

C) forward transaction.

D) deposit transaction.

Answer: C
Ques Status: Revised

6) Today 1 euro can be purchased for $1.10. This is the

A) spot exchange rate.

B) forward exchange rate.

C) fixed exchange rate.

D) financial exchange rate.

Answer: A
Ques Status: Revised

7) In an agreement to exchange dollars for euros in three months at a price of $0.90 per euro, the price is the

A) spot exchange rate.

B) money exchange rate.

C) forward exchange rate.

D) fixed exchange rate.

Answer: C
Ques Status: Revised

8) When the value of the British pound changes from $1.25 to $1.50, the pound has ________ and the U.S. dollar has ________.

A) appreciated; appreciated

B) depreciated; appreciated

C) appreciated; depreciated

D) depreciated; depreciated

Answer: C
Ques Status: Revised

9) When the value of the British pound changes from \$1.50 to \$1.25, then the pound has ________ and the U.S. dollar has ________.

A) appreciated; appreciated

B) depreciated; appreciated

C) appreciated; depreciated

D) depreciated; depreciated

Answer: B
Ques Status: Revised

10) When the value of the dollar changes from £0.5 to £0.75, then the British pound has ________ and the U.S. dollar has ________.

A) appreciated; appreciated

B) depreciated; appreciated

C) appreciated; depreciated

D) depreciated; depreciated

Answer: B
Ques Status: Revised

11) When the value of the dollar changes from £0.75 to £0.5, then the British pound has ________ and the U.S. dollar has ________.

A) appreciated; appreciated

B) depreciated; appreciated

C) appreciated; depreciated

D) depreciated; depreciated

Answer: C
Ques Status: Revised

12) When the exchange rate for the Mexican peso changes from 9 pesos to the U.S. dollar to 10 pesos to the U.S. dollar, then the Mexican peso has ________ and the U.S. dollar has ________.

A) appreciated; appreciated

B) depreciated; appreciated

C) appreciated; depreciated

D) depreciated; depreciated

Answer: B
Ques Status: Revised

13) When the exchange rate for the Mexican peso changes from 10 pesos to the U.S dollar to 9 pesos to the U.S. dollar, then the Mexican peso has ________ and the U.S. dollar has ________.

A) appreciated; appreciated

B) depreciated; appreciated

C) appreciated; depreciated

D) depreciated; depreciated

Answer: C
Ques Status: Revised

14) On April 7, 2006, one U.S. dollar traded on the foreign exchange market for about 0.83 euros. Therefore, one euro would have purchased about ________ U.S. dollars.

A) 0.83

B) 1.00

C) 1.20

D) 1.83

Answer: C
Ques Status: Revised

15) On April 7, 2006, one U.S. dollar traded on the foreign exchange market for about 44.5 Indian rupees. Thus, one Indian rupee would have purchased about ________ U.S. dollars.

A) 0.02

B) 1.20

C) 7.00

D) 44.5

Answer: A
Ques Status: Revised

16) On April 7, 2006, one U.S. dollar traded on the foreign exchange market for about 1.30 Swiss francs. Therefore, one Swiss franc would have purchased about ________ U.S. dollars.

A) 0.30

B) 0.77

C) 1.30

D) 3.10

Answer: B
Ques Status: Revised

17) On April 7, 2006, one U.S. dollar traded on the foreign exchange market for about 2.86 Romanian new lei. Therefore, one Romanian new lei would have purchased about ________ U.S. dollars.

A) 0.35

B) 1.86

C) 2.86

D) 3.35

Answer: A
Ques Status: Revised

18) If the U.S. dollar appreciates from 1.25 Swiss franc per U.S. dollar to 1.5 francs per dollar, then the franc depreciates from ________ U.S. dollars per franc to ________ U.S. dollars per franc.

A) 0.80; 0.67

B) 0.67; 0.80

C) 0.50; 0.33

D) 0.33; 0.50

Answer: A
Ques Status: New

19) If the British pound appreciates from $0.50 per pound to $0.75 per pound, the U.S. dollar depreciates from ________ per dollar to ________ per dollar.

A) £2; £2.5

B) £2; £1.33

C) £2; £1.5

D) £2; £1.25

Answer: B
Ques Status: Revised

20) If the Japanese yen appreciates from $0.01 per yen to $0.02 per yen, the U.S. dollar depreciates from ________ per dollar to ________ per dollar.

A) 100¥; 50¥

B) 10¥; 5¥

C) 5¥; 10¥

D) 50¥; 100¥

Answer: A
Ques Status: Revised

21) If the dollar appreciates from 1.5 Brazilian reals per dollar to 2.0 reals per dollar, the real depreciates from ________ per real to ________ per real.

A) $0.67; $0.50

B) $0.33; $0.50

C) $0.75; $0.50

D) $0.50; $0.67

E) $0.50; $0.75

Answer: A
Ques Status: Revised

22) When the exchange rate for the British pound changes from $1.80 per pound to $1.60 per pound, then, holding everything else constant, the pound has ________ and ________ expensive.

A) appreciated; British cars sold in the United States become more

B) appreciated; British cars sold in the United States become less

C) depreciated; American wheat sold in Britain becomes more

D) depreciated; American wheat sold in Britain becomes less

Answer: C
Ques Status: Revised

23) If the dollar depreciates relative to the Swiss franc

A) Swiss chocolate will become cheaper in the United States.

B) American computers will become more expensive in Switzerland.

C) Swiss chocolate will become more expensive in the United States.

D) Swiss computers will become cheaper in the United States.

Answer: C
Ques Status: Previous Edition

24) Everything else held constant, when a country's currency appreciates, the country's goods abroad become ________ expensive and foreign goods in that country become ________ expensive.

A) more; less

B) more; more

C) less; less

D) less; more

Answer: A
Ques Status: Revised

25) Everything else held constant, when a country's currency depreciates, its goods abroad become ________ expensive while foreign goods in that country become ________ expensive.

A) more; less

B) more; more

C) less; less

D) less; more

Answer: D
Ques Status: Revised

20.2 Exchange Rates in the Long Run

1) According to the law of one price, if the price of Colombian coffee is 100 Colombian pesos per pound and the price of Brazilian coffee is 4 Brazilian reals per pound, then the exchange rate between the Colombian peso and the Brazilian reals is:

A) 40 pesos per real.

B) 100 pesos per real.

C) 25 pesos per real.

D) 0.4 pesos per real.

Answer: C
Ques Status: Revised

2) The starting point for understanding how exchange rates are determined is a simple idea called ________, which states: if two countries produce an identical good, the price of the good should be the same throughout the world no matter which country produces it.

A) Gresham's law

B) the law of one price

C) purchasing power parity

D) arbitrage

Answer: B
Ques Status: Previous Edition

3) The ________ states that exchange rates between any two currencies will adjust to reflect changes in the price levels of the two countries.

A) theory of purchasing power parity

B) law of one price

C) theory of money neutrality

D) quantity theory of money

Answer: A
Ques Status: Previous Edition

4) The theory of PPP suggests that if one country's price level rises relative to another's, its currency should

A) depreciate.

B) appreciate.

C) float.

D) do none of the above.

Answer: A
Ques Status: Previous Edition

5) The theory of PPP suggests that if one country's price level falls relative to another's, its currency should

A) depreciate.

B) appreciate.

C) float.

D) do none of the above.

Answer: B
Ques Status: Previous Edition

6) The theory of PPP suggests that if one country's price level rises relative to another's, its currency should

A) depreciate in the long run.

B) appreciate in the long run.

C) depreciate in the short run.

D) appreciate in the short run.

Answer: A
Ques Status: Revised

7) The theory of PPP suggests that if one country's price level falls relative to another's, its currency should

A) depreciate in the long run.

B) appreciate in the long run.

C) appreciate in the short run.

D) depreciate in the short run.

Answer: B
Ques Status: Previous Edition

8) The theory of purchasing power parity cannot fully explain exchange rate movements because

A) all goods are identical even if produced in different countries.

B) monetary policy differs across countries.

C) some goods are not traded between countries.

D) fiscal policy differs across countries.

Answer: C
Ques Status: Previous Edition

9) The theory of purchasing power parity states that exchange rates between any two currencies will adjust to reflect changes in

A) the trade balances of the two countries.

B) the current account balances of the two countries.

C) fiscal policies of the two countries.

D) the price levels of the two countries.

Answer: D
Ques Status: Previous Edition

10) In the long run, a rise in a country's price level (relative to the foreign price level) causes its currency to ________, while a fall in the country's relative price level causes its currency to ________.

A) appreciate; appreciate

B) appreciate; depreciate

C) depreciate; appreciate

D) depreciate; depreciate

Answer: C
Ques Status: Previous Edition

11) If the 2005 inflation rate in Canada is 4 percent, and the inflation rate in Mexico is 2 percent, then the theory of purchasing power parity predicts that, during 2005, the value of the Canadian dollar in terms of Mexican pesos will

A) rise by 6 percent.

B) rise by 2 percent.

C) fall by 6 percent.

D) fall by 2 percent.

Answer: D
Ques Status: Revised

12) Assume that the following are the predicted inflation rates in these countries for the year: 2% for the United States, 3% for Canada; 4% for Mexico, and 5% for Brazil. According to the purchasing power parity and everything else held constant, which of the following would we expect to happen?

A) The Brazilian real will depreciate against the U.S. dollar.

B) The Mexican peso will depreciate against the Brazilian real.

C) The Canadian dollar will depreciate against the Mexican peso.

D) The U.S. dollar will depreciate against the Canadian dollar.

Answer: A
Ques Status: New

13) According to the purchasing power parity theory, a rise in the United States price level of 5 percent, and a rise in the Mexican price level of 6 percent cause

A) the dollar to appreciate 1 percent relative to the peso.

B) the dollar to depreciate 1 percent relative to the peso.

C) the dollar to depreciate 5 percent relative to the peso.

D) the dollar to appreciate 5 percent relative to the peso.

Answer: A
Ques Status: Revised

14) Higher tariffs and quotas cause a country's currency to ________ in the ________ run, everything else held constant.

A) depreciate; short

B) appreciate; short

C) depreciate; long

D) appreciate; long

Answer: D
Ques Status: Revised

15) Lower tariffs and quotas cause a country's currency to ________ in the ________ run, everything else held constant.

A) depreciate; short

B) appreciate; short

C) depreciate; long

D) appreciate; long

Answer: C
Ques Status: Revised

16) Anything that increases the demand for foreign goods relative to domestic goods tends to ________ the domestic currency because domestic goods will only continue to sell well if the value of the domestic currency is ________, everything else held constant.

A) depreciate; lower

B) depreciate; higher

C) appreciate; lower

D) appreciate; higher

Answer: A
Ques Status: Revised

17) Everything else held constant, increased demand for a country's ________ causes its currency to appreciate in the long run, while increased demand for ________ causes its currency to depreciate.

A) imports; imports

B) imports; exports

C) exports; imports

D) exports; exports

Answer: C
Ques Status: Revised

18) Everything else held constant, increased demand for a country's exports causes its currency to ________ in the long run, while increased demand for imports causes its currency to ________

A) appreciate; appreciate

B) appreciate; depreciate

C) depreciate; appreciate

D) depreciate; depreciate

Answer: B
Ques Status: Revised

19) Everything else held constant, if a factor increases the demand for ________ goods relative to ________ goods, the domestic currency will appreciate.

A) foreign; domestic

B) foreign; foreign

C) domestic; domestic

D) domestic; foreign

Answer: D
Ques Status: Revised

20) Everything else held constant, if a factor decreases the demand for ________ goods relative to ________ goods, the domestic currency will depreciate.

A) foreign; domestic

B) foreign; foreign

C) domestic; domestic

D) domestic; foreign

Answer: D
Ques Status: Revised

21) An increase in productivity in a country will cause its currency to ________ because it can produce goods at a ________ price, everything else held constant.

A) depreciate; lower

B) appreciate; lower

C) depreciate; higher

D) appreciate; higher

Answer: B
Ques Status: Revised

22) If, in retaliation for "unfair" trade practices, Congress imposes a 30 percent tariff on Japanese DVD recorders, but at the same time, U.S. demand for Japanese goods increases, then, in the long run, ________, everything else held constant

A) the Japanese yen should appreciate relative to the U.S. dollar

B) the Japanese yen should depreciate relative to the U.S. dollar

C) there is no effect on the Japanese yen relative to the U.S. dollar

D) the Japanese yen could appreciate, depreciate or remain constant relative to the U.S. dollar

Answer: D
Ques Status: Revised

23) If the U.S. Congress imposes a quota on imports of Japanese cars due to claims of "unfair" trade practices, and Japanese demand for American exports increases at the same time, then, in the long run ________, everything else held constant.

A) the Japanese yen will appreciate relative to the U.S. dollar

B) the Japanese yen will depreciate relative to the U.S. dollar

C) the Japanese yen will either appreciate, depreciate or remain constant against the U.S. dollar

D) there will be no effect on the Japanese yen relative to the U.S. dollar

Answer: B
Ques Status: Revised

24) If the inflation rate in the United States is higher than that in Mexico and productivity is growing at a slower rate in the United States than in Mexico, then, in the long run, ________, everything else held constant.

A) the Mexican peso will appreciate relative to the U.S. dollar

B) the Mexican peso will depreciate relative to the U.S. dollar

C) the Mexican peso will either appreciate, depreciate, or remain constant relative to the U.S. dollar

D) there will be no effect on the Mexican peso relative to the U.S. dollar

Answer: A
Ques Status: Revised

25) If the Brazilian demand for American exports rises at the same time that U.S. productivity rises relative to Brazilian productivity, then, in the long run, ________, everything else held constant.

A) the Brazilian real will appreciate relative to the U.S. dollar

B) the Brazilian real will depreciate relative to the U.S. dollar

C) the Brazilian real will either appreciate, depreciate, or remain constant relative to the U.S. dollar

D) there is no effect on the Brazilian real relative to the U.S. dollar

Answer: B
Ques Status: Revised

26) Explain the law of one price and the theory of purchasing power parity. Why doesn't purchasing power parity explain all exchange rate movements? What factors determine long-run exchange rates?

Answer: With no trade barriers and low transport costs, the law of one price states that the price of traded goods should be the same in all countries. The purchasing power parity theory extends the law of one price to total economies. PPP states that exchange rates should adjust to reflect changes in the price levels between two countries. PPP may fail to fully explain exchange rates because goods are not identical, and price levels include traded and nontraded goods and services. Long-run exchange rates are determined by domestic price levels relative to foreign price levels, trade barriers, import and export demand, and productivity.
Ques Status: Revised

20.3 Exchange Rates in the Short Run

1) The theory of asset demand suggests that the most important factor affecting the demand for domestic and foreign assets is

A) the level of trade and capital flows.

B) the expected return on these assets relative to one another.

C) the liquidity of these assets relative to one another.

D) the riskiness of these assets relative to one another.

Answer: B
Ques Status: Revised

2) The ________ suggests that the most important factor affecting the demand for domestic and foreign assets is the expected return on domestic assets relative to foreign assets.

A) theory of asset demand

B) law of one price

C) interest parity condition

D) theory of foreign capital mobility

Answer: A
Ques Status: Revised

3) The theory of asset demand suggests that the most important factor affecting the demand for domestic and foreign assets is the ________ on these assets relative to one another.

A) interest rate

B) risk

C) expected return

D) liquidity

Answer: C
Ques Status: Revised

4) The condition that states that the domestic interest rate equals the foreign interest rate minus the expected appreciation of the domestic currency is called

A) the purchasing power parity condition.

B) the interest parity condition.

C) money neutrality.

D) the theory of foreign capital mobility.

Answer: B
Ques Status: Previous Edition

5) As the relative expected return on dollar assets increases, foreigners will want to hold more ________ assets and less ________ assets, everything else held constant.

A) foreign; foreign

B) foreign; dollar

C) dollar; foreign

D) dollar; dollar

Answer: C
Ques Status: Revised

6) When Americans or foreigners expect the return on ________ assets to be high relative to the return on ________ assets, there is a higher demand for dollar assets and a correspondingly lower demand for foreign assets.

A) dollar; dollar

B) dollar; foreign

C) foreign; dollar

D) foreign; foreign

Answer: B
Ques Status: Revised

7) When Americans or foreigners expect the return on ________ assets to be high relative to the return on ________ assets, there is a ________ demand for dollar assets, everything else held constant.

A) dollar; foreign; constant

B) dollar; foreign; higher

C) foreign; dollar; higher

D) foreign; dollar; constant

Answer: B
Ques Status: Revised

8) When Americans or foreigners expect the return on dollar assets to be high relative to the return on foreign assets, there is a ________ demand for dollar assets and a correspondingly ________ demand for ________ foreign assets.

A) higher; higher

B) higher; lower

C) lower; higher

D) lower; lower

Answer: B
Ques Status: Revised

9) If the interest rate is 7 percent on euro–denominated assets and 5 percent on dollar–denominated assets, and if the dollar is expected to appreciate at a 4 percent rate, for Francois the Frenchman the expected rate of return on dollar–denominated assets is

A) 11 percent.

B) 9 percent.

C) 5 percent.

D) 3 percent.

E) 1 percent.

Answer: B
Ques Status: Revised

10) If the interest rate is 7 percent on euro–denominated assets and 5 percent on dollar–denominated assets, and if the dollar is expected to appreciate at a 4 percent rate, the expected return on ________–denominated assets in ________ percent.

A) dollar; euros is 3

B) euro; dollars is 1

C) dollar; euros is 1

D) euro; dollars is 3

Answer: D
Ques Status: Revised

11) If the interest rate on euro–denominated assets is 13 percent and it is 15 percent on peso–denominated assets, and if the euro is expected to appreciate at a 4 percent rate, for Manuel the Mexican the expected rate of return on euro–denominated assets is

A) 11 percent.

B) 13 percent.

C) 17 percent.

D) 19 percent.

Answer: C
Ques Status: Revised

12) If the interest rate on euro–denominated assets is 13 percent and it is 15 percent on peso–denominated assets, and if the euro is expected to appreciate at a 4 percent rate, for Francois the Frenchman the expected rate of return on peso–denominated assets is

A) 11 percent.

B) 15 percent.

C) 17 percent.

D) 19 percent.

Answer: A
Ques Status: Revised

13) With a 10 percent interest rate on dollar deposits, and an expected appreciation of 7 percent over the coming year, the expected return on dollar deposits in terms of the foreign currency is

A) 3 percent.

B) 10 percent.

C) 13.5 percent.

D) 17 percent.

Answer: D
Ques Status: Revised

14) With a 10 percent interest rate on dollar deposits, and an expected appreciation of 7 percent over the coming year, the expected return on dollar deposits in terms of the dollar is

A) 3 percent.

B) 10 percent.

C) 13.5 percent.

D) 17 percent.

Answer: B
Ques Status: Revised

15) The expected return on dollar deposits in terms of foreign currency can be written as the ________ of the interest rate on dollar deposits and the expected appreciation of the dollar.

A) product

B) ratio

C) sum

D) difference

Answer: C
Ques Status: Revised

16) In a world with few impediments to capital mobility, the domestic interest rate equals the sum of the foreign interest rate and the expected depreciation of the domestic currency, a situation known as the

A) interest parity condition.

B) purchasing power parity condition.

C) exchange rate parity condition.

D) foreign asset parity condition.

Answer: A
Ques Status: Previous Edition

17) According to the interest parity condition, if the domestic interest rate is 12 percent and the foreign interest rate is 10 percent, then the expected ________ of the foreign currency must be ________ percent.

A) appreciation; 4

B) appreciation; 2

C) depreciation; 2

D) depreciation; 4

Answer: B
Ques Status: Revised

18) According to the interest parity condition, if the domestic interest rate is 10 percent and the foreign interest rate is 12 percent, then the expected ________ of the foreign currency must be ________ percent.

A) appreciation; 4

B) appreciation; 2

C) depreciation; 2

D) depreciation; 4

Answer: C
Ques Status: Revised

19) Everything else held constant, when the current value of the domestic currency increases, the ________ domestic assets ________.

A) demand for; increases

B) quantity demanded of; increases

C) demand for; decreases

D) quantity demanded of; decreases

Answer: D
Ques Status: New

20) Everything else held constant, when the current value of the domestic exchange rate increases, the ________ of domestic assets ________.

A) quantity supplied; does not change

B) supply; decreases

C) quantity supplied; increases

D) supply; increases

Answer: A
Ques Status: New

21) Explain the interest parity condition. What key assumption underlies this condition? What factors affect the returns on domestic and foreign assets?

Answer: The interest parity condition states that returns on domestic and foreign assets will be equal. The key assumption for this condition is capital mobility. The return on domestic assets is equal to the domestic interest rate. The return on foreign assets is equal to the foreign interest rate minus the expected rate of appreciation of the domestic currency.
Ques Status: Previous Edition

20.4 Explaining Changes in Exchange Rates

1) An increase in the domestic interest rate causes the demand for domestic assets to ________ and the domestic currency to ________, everything else held constant.

A) increase; appreciate

B) increase; depreciate

C) decrease; appreciate

D) decrease; depreciate

Answer: A
Ques Status: New

2) An increase in the domestic interest rate causes the demand for domestic assets to shift to the ________ and the domestic currency to ________, everything else held constant.

A) right; appreciate

B) right; depreciate

C) left; appreciate

D) left; depreciate

Answer: A
Ques Status: New

3) A decrease in the domestic interest rate causes the demand for domestic assets to ________ and the domestic currency to ________, everything else held constant.

A) increase; appreciate

B) increase; depreciate

C) decrease; appreciate

D) decrease; depreciate

Answer: D
Ques Status: New

4) A decrease in the domestic interest rate causes the demand for domestic assets to shift to the ________ and the domestic currency to ________, everything else held constant.

A) right; appreciate

B) right; depreciate

C) left; appreciate

D) left; depreciate

Answer: D
Ques Status: New

5) ________ in the domestic interest rate causes the demand for domestic assets to increase and the domestic currency to ________, everything else held constant.

A) An increase; appreciate

B) An increase; depreciate

C) A decrease; appreciate

D) A decrease; depreciate

Answer: A
Ques Status: New

6) ________ in the domestic interest rate causes the demand for domestic assets to shift to the right and the domestic currency to ________, everything else held constant.

A) An increase; appreciate

B) An increase; depreciate

C) A decrease; appreciate

D) A decrease; depreciate

Answer: A
Ques Status: New

7) ________ in the domestic interest rate causes the demand for domestic assets to decrease and the domestic currency to ________, everything else held constant.

A) An increase; appreciate

B) An increase; depreciate

C) A decrease; appreciate

D) A decrease; depreciate

Answer: D
Ques Status: New

8) ________ in the domestic interest rate causes the demand for domestic assets to shift to the left and the domestic currency to ________, everything else held constant.

A) An increase; appreciate

B) An increase; depreciate

C) A decrease; appreciate

D) A decrease; depreciate

Answer: D
Ques Status: New

9) ________ in the domestic interest rate causes the demand for domestic assets to ________ and the domestic currency to appreciate, everything else held constant.

A) An increase; increase

B) An increase; decrease

C) A decrease; increase

D) A decrease; decrease

Answer: A
Ques Status: New

10) ________ in the domestic interest rate causes the demand for domestic assets to shift to the ________ and the domestic currency to appreciate, everything else held constant.

A) An increase; right

B) An increase; left

C) A decrease; right

D) A decrease; left

Answer: A
Ques Status: New

11) ________ in the domestic interest rate causes the demand for domestic assets to ________ and the domestic currency to depreciate, everything else held constant.

A) An increase; increase

B) An increase; decrease

C) A decrease; increase

D) A decrease; decrease

Answer: D
Ques Status: New

12) ________ in the domestic interest rate causes the demand for domestic assets to shift to the ________ and the domestic currency to depreciate, everything else held constant.

A) An increase; right

B) An increase; left

C) A decrease; right

D) A decrease; left

Answer: D
Ques Status: New

13) Suppose that the Federal Reserve enacts expansionary policy. Everything else held constant, this will cause the demand for U.S. assets to ________ and the U.S. dollar to ________.

A) increase; appreciate

B) decrease; appreciate

C) increase; depreciate

D) decrease; depreciate

Answer: D
Ques Status: New

14) Suppose that the Federal Reserve conducts an open market sale. Everything else held constant, this will cause the demand for U.S. assets to ________ and the U.S. dollar will ________.

A) increase; appreciate

B) increase; depreciate

C) decrease; appreciate

D) decrease; depreciate

Answer: A
Ques Status: New

15) An increase in the foreign interest rate causes the demand for domestic assets to ________ and the domestic currency to ________, everything else held constant.

A) increase; appreciate

B) increase; depreciate

C) decrease; appreciate

D) decrease; depreciate

Answer: D
Ques Status: New

16) An increase in the foreign interest rate causes the demand for domestic assets to shift to the ________ and the domestic currency to ________, everything else held constant.

A) right; appreciate

B) right; depreciate

C) left; appreciate

D) left; depreciate

Answer: D
Ques Status: New

17) A decrease in the foreign interest rate causes the demand for domestic assets to ________ and the domestic currency to ________, everything else held constant.

A) increase; appreciate

B) increase; depreciate

C) decrease; appreciate

D) decrease; depreciate

Answer: A
Ques Status: New

18) A decrease in the foreign interest rate causes the demand for domestic assets to shift to the ________ and the domestic currency to ________, everything else held constant.

A) right; appreciate

B) right; depreciate

C) left; appreciate

D) left; depreciate

Answer: A
Ques Status: New

19) ________ in the foreign interest rate causes the demand for domestic assets to increase and the domestic currency to ________, everything else held constant.

A) An increase; appreciate

B) An increase; depreciate

C) A decrease; appreciate

D) A decrease; depreciate

Answer: C
Ques Status: New

20) ________ in the foreign interest rate causes the demand for domestic assets to shift to the right and the domestic currency to ________, everything else held constant.

A) An increase; appreciate

B) An increase; depreciate

C) A decrease; appreciate

D) A decrease; depreciate

Answer: C
Ques Status: New

21) ________ in the foreign interest rate causes the demand for domestic assets to decrease and the domestic currency to ________, everything else held constant.

A) An increase; appreciate

B) An increase; depreciate

C) A decrease; appreciate

D) A decrease; depreciate

Answer: B
Ques Status: New

22) ________ in the foreign interest rate causes the demand for domestic assets to shift to the left and the domestic currency to ________, everything else held constant.

A) An increase; appreciate

B) An increase; depreciate

C) A decrease; appreciate

D) A decrease; depreciate

Answer: B
Ques Status: New

23) ________ in the foreign interest rate causes the demand for domestic assets to ________ and the domestic currency to appreciate, everything else held constant.

A) An increase; increase

B) An increase; decrease

C) A decrease; increase

D) A decrease; decrease

Answer: C
Ques Status: New

24) ________ in the foreign interest rate causes the demand for domestic assets to shift to the ________ and the domestic currency to appreciate, everything else held constant.

A) An increase; right

B) An increase; left

C) A decrease; right

D) A decrease; left

Answer: C
Ques Status: New

25) ________ in the foreign interest rate causes the demand for domestic assets to ________ and the domestic currency to depreciate, everything else held constant.

A) An increase; increase

B) An increase; decrease

C) A decrease; increase

D) A decrease; decrease

Answer: B
Ques Status: New

26) ________ in the foreign interest rate causes the demand for domestic assets to shift to the ________ and the domestic currency to depreciate, everything else held constant.

A) An increase; right

B) An increase; left

C) A decrease; right

D) A decrease; left

Answer: B
Ques Status: New

27) Suppose that the European Central Bank enacts expansionary policy. Everything else held constant, this will cause the demand for U.S. assets to ________ and the U.S. dollar to ________.

A) increase; appreciate

B) decrease; appreciate

C) increase; depreciate

D) decrease; depreciate

Answer: A
Ques Status: New

28) Suppose that the European Central Bank conducts a main refinancing sale. Everything else held constant, this would cause the demand for U.S. assets to ________ and the U.S. dollar will ________.

A) increase; appreciate

B) increase; depreciate

C) decrease; appreciate

D) decrease; depreciate

Answer: D
Ques Status: New

29) An increase in the expected future domestic exchange rate causes the demand for domestic assets to ________ and the domestic currency to ________, everything else held constant.

A) increase; appreciate

B) increase; depreciate

C) decrease; appreciate

D) decrease; depreciate

Answer: A
Ques Status: New

30) An increase in the expected future domestic exchange rate causes the demand for domestic assets to shift to the ________ and the domestic currency to ________, everything else held constant.

A) right; appreciate

B) right; depreciate

C) left; appreciate

D) left; depreciate

Answer: A
Ques Status: New

31) A decrease in the expected future domestic exchange rate causes the demand for domestic assets to ________ and the domestic currency to ________, everything else held constant.

A) increase; appreciate

B) increase; depreciate

C) decrease; appreciate

D) decrease; depreciate

Answer: D
Ques Status: New

32) A decrease in the expected future domestic exchange rate causes the demand for domestic assets to shift to the ________ and the domestic currency to ________, everything else held constant.

A) right; appreciate

B) right; depreciate

C) left; appreciate

D) left; depreciate

Answer: D
Ques Status: New

33) ________ in the expected future domestic exchange rate causes the demand for domestic assets to increase and the domestic currency to ________, everything else held constant.

A) An increase; appreciate

B) An increase; depreciate

C) A decrease; appreciate

D) A decrease; depreciate

Answer: A
Ques Status: New

34) ________ in the expected future domestic exchange rate causes the demand for domestic assets to shift to the right and the domestic currency to ________, everything else held constant.

A) An increase; appreciate

B) An increase; depreciate

C) A decrease; appreciate

D) A decrease; depreciate

Answer: A
Ques Status: New

35) ________ in the expected future domestic exchange rate causes the demand for domestic assets to decrease and the domestic currency to ________, everything else held constant.

A) An increase; appreciate

B) An increase; depreciate

C) A decrease; appreciate

D) A decrease; depreciate

Answer: D
Ques Status: New

36) ________ in the expected future domestic exchange rate causes the demand for domestic assets to shift to the left and the domestic currency to ________, everything else held constant.

A) An increase; appreciate

B) An increase; depreciate

C) A decrease; appreciate

D) A decrease; depreciate

Answer: D
Ques Status: New

37) ________ in the expected future domestic exchange rate causes the demand for domestic assets to ________ and the domestic currency to appreciate, everything else held constant.

A) An increase; increase

B) An increase; decrease

C) A decrease; increase

D) A decrease; decrease

Answer: A
Ques Status: New

38) ________ in the expected future domestic exchange rate causes the demand for domestic assets to shift to the ________ and the domestic currency to appreciate, everything else held constant.

A) An increase; right

B) An increase; left

C) A decrease; right

D) A decrease; left

Answer: A
Ques Status: New

39) ________ in the expected future domestic exchange rate causes the demand for domestic assets to ________ and the domestic currency to depreciate, everything else held constant.

A) An increase; increase

B) An increase; decrease

C) A decrease; increase

D) A decrease; decrease

Answer: D
Ques Status: New

40) ________ in the expected future domestic exchange rate causes the demand for domestic assets to shift to the ________ and the domestic currency to depreciate, everything else held constant.

A) An increase; right

B) An increase; left

C) A decrease; right

D) A decrease; left

Answer: D
Ques Status: New

41) Suppose the Federal Reserve releases a policy statement today which leads people to believe that the Fed will be enacting expansionary monetary policy in the near future. Everything else held constant, the release of this statement would immediately cause the demand for U.S. assets to ________ and the U.S. dollar to ________.

A) increase; appreciate

B) decrease; appreciate

C) increase; depreciate

D) decrease; depreciate

Answer: D
Ques Status: New

42) Suppose a report was released today that showed the Euro–Zone inflation rate is running above the European Central Bank's inflation rate target. This leads people to expect that the European Central Bank will enact contractionary policy in the near future. Everything else held constant, the release of this report would immediately cause the demand for U.S. assets to ________ and the U.S. dollar will ________.

A) increase; appreciate

B) increase; depreciate

C) decrease; appreciate

D) decrease; depreciate

Answer: A
Ques Status: New

43) Suppose that the latest Consumer Price Index (CPI) release shows a higher inflation rate in the U.S. than was expected. Everything else held constant, the release of the CPI report would immediately cause the demand for U.S. assets to ________ and the U.S. dollar would ________.

A) increase; appreciate

B) increase; depreciate

C) decrease; appreciate

D) decrease; depreciate

Answer: D
Ques Status: New

44) In the long run, a one-time percentage increase in the money supply is matched by the same one-time percentage rise in the price level, leaving unchanged the real money supply and ________. This proposition is called money ________.

A) other economic variables such as interest rates; neutrality

B) the nominal exchange rate; neutrality

C) all other economic variables such as interest rates; illusion

D) the nominal exchange rate; illusion

Answer: A
Ques Status: Revised

45) Money neutrality means that in the long run the domestic interest rate remains unchanged from an increase in the money supply, implying that the fall in the exchange rate is greater in the ________ run than in the ________ run, a phenomenon called exchange rate overshooting.

A) short; short

B) short; long

C) long; short

D) long; long

Answer: B
Ques Status: Revised

46) Evidence from the United States during the period 1973-2002 indicates that the value of the dollar and the measure of the ________ interest rate rose and fell together.

A) real

B) nominal

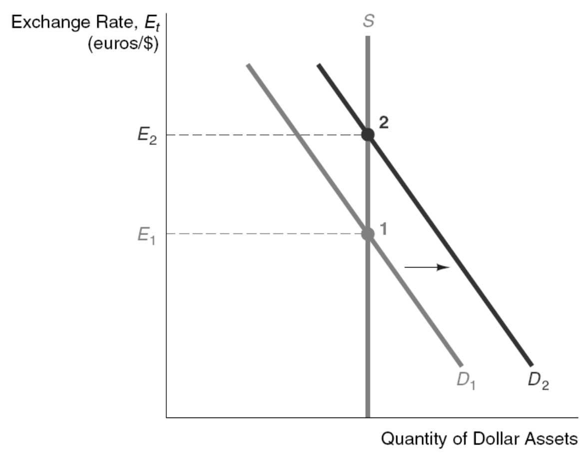
C) expected

D) actual

Answer: A
Ques Status: Revised

47) Explain and show graphically the effect of an increase in the expected future exchange rate on the equilibrium exchange rate, everything else held constant.

Answer: See figure below.

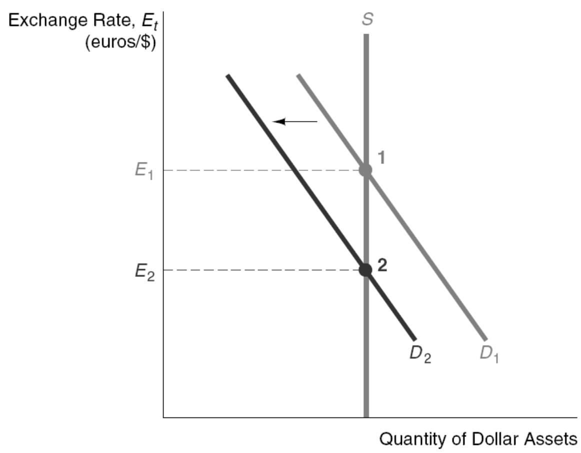


When the expected future exchange rate increases, the relative expected return on the domestic assets increases. This will cause the demand for domestic assets to increase and the current value of the exchange rate will appreciate.

Ques Status: Revised

48) Explain and show graphically the effect of an increase in the expected inflation rate on the equilibrium exchange rate, everything else held constant.

Answer: See figure below.



When the expected inflation rate increases, the relative expected return on domestic assets is affected two ways. First, through the Fisher effect, the domestic nominal interest rate will increase the expected return on domestic assets. Second, through purchasing power parity, the future value of the domestic exchange rate will decline which will decrease the expected return on domestic assets. Since it is generally believed that the effect of the change in the expected future value of the domestic exchange rate is larger than the Fisher effect, the net effect is a lower expected return on domestic assets. This will decrease the demand for domestic assets, which will cause the current value of the domestic exchange rate to depreciate.

Ques Status: Revised

Chapter 21

The International Financial System

21.1 Intervention in the Foreign Exchange Market

1) A central bank ________ of domestic currency and corresponding ________ of foreign assets in the foreign exchange market leads to an equal decline in its international reserves and the monetary base, everything else held constant.

   A) sale; purchase

   B) sale; sale

   C) purchase; sale

   D) purchase; purchase

   Answer: C
   Ques Status: Revised

2) A central bank ________ of domestic currency and corresponding ________ of foreign assets in the foreign exchange market leads to an equal increase in its international reserves and the monetary base, everything else held constant.

   A) sale; purchase

   B) sale; sale

   C) purchase; sale

   D) purchase; purchase

   Answer: A
   Ques Status: Revised

3) Suppose that the Bank of Japan buys U.S. dollar assets with yen–denominated assets. Everything else held constant, this transaction will cause ________ in the foreign assets held by the Federal Reserve and ________ in the U.S. monetary base.

   A) an increase; an increase

   B) an increase; a decrease

   C) a decrease; an increase

   D) a decrease; a decrease

   Answer: A
   Ques Status: New

4) Suppose that the Bank of Japan buys yen-denominated assets with U.S. dollar assets. Everything else held constant, this transaction will cause ________ in the foreign assets held by the Federal Reserve and ________ in the U.S. monetary base.

A) an increase; an increase

B) an increase; a decrease

C) a decrease; an increase

D) a decrease; a decrease

Answer: D
Ques Status: New

5) When the central bank allows the purchase or sale of domestic currency to have an effect on the monetary base, it is called

A) an unsterilized foreign exchange intervention.

B) a sterilized foreign exchange intervention.

C) an exchange rate feedback rule.

D) a money neutral foreign exchange intervention.

Answer: A
Ques Status: Previous Edition

6) A foreign exchange intervention with an offsetting open market operation that leaves the monetary base unchanged is called

A) an unsterilized foreign exchange intervention.

B) a sterilized foreign exchange intervention.

C) an exchange rate feedback rule.

D) a money neutral foreign exchange intervention.

Answer: B
Ques Status: Previous Edition

7) Everything else held constant, if a central bank makes an unsterilized purchase of foreign assets, then the domestic money supply will ________ and the domestic currency will ________.

A) increase; appreciate

B) increase; depreciate

C) decrease; appreciate

D) decrease; depreciate

Answer: B
Ques Status: New

8) Everything else held constant, if a central bank makes an unsterilized ________ of foreign assets, then the domestic money supply will increase and the domestic currency will ________.

A) purchase; appreciate

B) purchase; depreciate

C) sale; appreciate

D) sale; depreciate

Answer: B
Ques Status: New

9) Everything else held constant, if a central bank makes an unsterilized ________ of foreign assets, then the domestic money supply will ________ and the domestic currency will appreciate.

A) purchase; increase

B) purchase; decrease

C) sale; increase

D) sale; decrease

Answer: D
Ques Status: New

10) Everything else held constant, if a central bank makes an unsterilized sale of foreign assets, then the domestic money supply will ________ and the domestic currency will ________.

A) increase; appreciate

B) increase; depreciate

C) decrease; appreciate

D) decrease; depreciate

Answer: C
Ques Status: New

11) Everything else held constant, if a central bank makes an unsterilized ________ of foreign assets, then the domestic money supply will decrease and the domestic currency will ________.

A) purchase; appreciate

B) purchase; depreciate

C) sale; appreciate

D) sale; depreciate

Answer: C
Ques Status: New

12) Everything else held constant, if a central bank makes an unsterilized ________ of foreign assets, then the domestic money supply will ________ and the domestic currency will depreciate.

A) purchase; increase

B) purchase; decrease

C) sale; increase

D) sale; decrease

Answer: A
Ques Status: New

13) Everything else held constant, if a central bank makes a sterilized purchase of foreign assets, then the domestic currency will ________.

A) appreciate

B) depreciate

C) either appreciate, depreciate, or remain constant

D) not be affected

Answer: D
Ques Status: New

14) Because sterilized interventions mean offsetting open market operations, there is no impact on the monetary base and the money supply, and therefore a sterilized intervention

A) causes the exchange rate to overshoot in the short run.

B) causes the exchange rate to undershoot in the short run.

C) causes the exchange rate to depreciate in the short run, but has no effect on the exchange rate in the long run.

D) has no effect on the exchange rate.

Answer: D
Ques Status: Previous Edition

15) Everything else held constant, if a central bank makes a sterilized sale of foreign assets, then the domestic currency will ________.

A) appreciate

B) depreciate

C) either appreciate, depreciate, or remain constant

D) not be affected

Answer: D
Ques Status: New

16) If the United States has a current account deficit with England of $1 million, and the Bank of England sells $1 million worth of pounds in the foreign exchange market, then England ________ $1 million of international reserves and its monetary base ________ by $1 million.

A) gains; rises

B) gains; falls

C) loses; rises

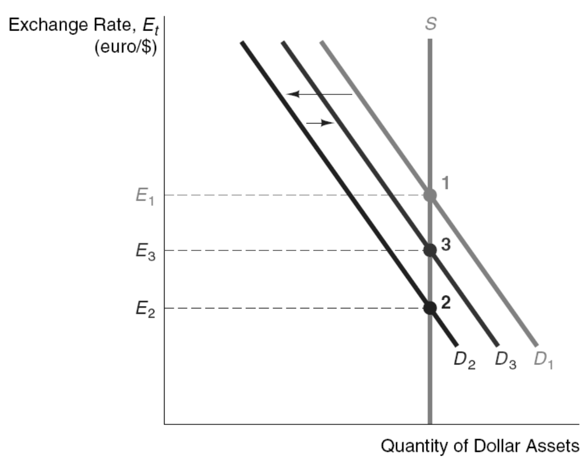
D) loses; falls

Answer: A

Ques Status: Revised

17) Explain and demonstrate graphically how an unsterilized purchase of foreign assets leads to overshooting of the exchange rate, and describe the long-run behavior of the exchange rate, everything else held constant.

Answer: See figure below.



A purchase of foreign assets increases the monetary base and money supply, increasing the price level and decreasing the expected appreciation of the domestic currency. In the short run, this decreased expected appreciation of the domestic currency along with the lower domestic interest rate will decrease the relative expected return on domestic assets causing the domestic currency to depreciate. Over the long run, as the domestic interest rate starts to increase, the domestic currency will start to appreciate, but (assuming money neutrality) will still be at a lower value compared to the starting value.

Ques Status: Revised

21.2 Balance of Payments

1) The difference between merchandise exports and imports is called the ________ balance.

A) current account

B) capital account

C) official reserve transactions

D) trade

Answer: D
Ques Status: Revised

2) The account that shows international transactions involving currently produced goods and services is called the

A) trade balance.

B) current account.

C) balance of payments.

D) capital account.

Answer: B
Ques Status: Previous Edition

3) The account that shows international transactions involving financial transactions (stocks, bonds, bank loans, etc.) is called the

A) trade balance.

B) current account.

C) balance of payments.

D) capital account.

Answer: D
Ques Status: New

4) Which of the following does not appear in the current account part of the balance of payments?

A) A loan of $1 million from Chase Manhattan bank to Brazil.

B) Foreign aid to El Salvador.

C) An Air France ticket bought by an American.

D) Income earned by General Motors from its plants abroad.

Answer: A
Ques Status: Revised

5) Of the following, the one that appears in the current account of the balance of payments is

A) an Italian investor's purchase of IBM stock.

B) income earned by U.S. subsidiaries of Barclay's Bank of London.

C) a loan by a Swiss bank to an American corporation.

D) a purchase of a British Treasury bond by the Fed.

Answer: B
Ques Status: Revised

6) Capital ________ are American purchases of foreign assets, and capital ________ are foreign purchases of American assets.

A) inflows; outflows

B) inflows; inflows

C) outflows; outflows

D) outflows; inflows

Answer: D
Ques Status: Previous Edition

7) Which of the following appears in the capital account part of the balance of payments?

A) A gift to an American from his English aunt.

B) A purchase by the Honda corporation of a U.S. Treasury bill.

C) A purchase by the Bank of England of a U.S. Treasury bill.

D) Income earned by the Honda corporation on its automobile plant in Ohio.

Answer: B
Ques Status: Revised

8) The net amount of international reserves that move between governments to finance international transactions is called the ________ balance.

A) capital account

B) current account

C) trade

D) official reserve transactions

Answer: D
Ques Status: New

9) If the current account balance shows a surplus, and the capital account also shows a surplus, then the official reserve transactions balance

A) must be positive.

B) must be negative.

C) must best be zero.

D) can either be positive, negative, or zero.

Answer: A
Ques Status: Revised

10) A current account surplus indicates that America is ________ its claims on foreign wealth, while a deficit indicates that this country is ________ its claims on foreign wealth.

A) reducing; reducing

B) reducing; increasing

C) increasing; reducing

D) increasing; increasing

Answer: C
Ques Status: Previous Edition

11) Because it provides some indication of what is happening to U.S. claims on foreign wealth and the demand for imports and exports, the ________ is closely followed by economists wanting information on the future movement of exchange rates.

A) trade balance

B) capital account

C) current account balance

D) statistical discrepancy

Answer: C
Ques Status: Previous Edition

12) Economists closely follow the current account balance because they believe it can provide information on the future movement of

A) interest rates.

B) gold flows.

C) exchange rates.

D) special drawing rights.

Answer: C
Ques Status: Previous Edition

21.3 Exchange Rate Regimes in the International Financial System

1) Under a gold standard in which one dollar could be turned in to the U.S. Treasury and exchanged for 1/20th of an ounce of gold and one German mark could be exchanged for 1/100th of an ounce of gold, an exchange rate of ________ marks to the dollar would stimulate a flow of gold from the United States to Germany.

A) 7

B) 6

C) 5

D) 4

Answer: D
Ques Status: Previous Edition

2) When gold production was low in the 1870s and 1880s, the money supply grew ________ causing ________.

A) rapidly; inflation

B) rapidly; disinflation

C) slowly; deflation

D) slowly; disinflation

Answer: C
Ques Status: Previous Edition

3) The fixed exchange rate regime established at a meeting in New Hampshire in 1944 has been known as the

A) General Agreement on Tariffs and Trade.

B) Bretton Woods system.

C) International Settlement Fund.

D) Balance of Payments Compliance Accord.

Answer: B
Ques Status: Previous Edition

4) Under the Bretton Woods system, the organization assigned the task of making loans to countries that were experiencing balance of payments difficulties is known as the

A) World Bank.

B) International Development Association.

C) International Monetary Fund.

D) Federal Reserve System.

Answer: C
Ques Status: Previous Edition

5) The Bretton Woods agreement created the ________, which was given the task of promoting the growth of world trade by setting rules for the maintenance of fixed exchange rates and by making loans to countries that were experiencing balance of payments difficulties.

A) IMF

B) World Bank

C) Central Settlements Bank

D) Bank of International Settlements

Answer: A
Ques Status: Revised

6) The World Bank is an international organization that:

A) promotes the growth of trade by setting rules for how tariffs and quotas are set by countries.

B) makes loans to countries to finance projects such as dams and roads.

C) makes loans to countries with balance of payment difficulties.

D) helps developing countries that have been having difficulties in repaying their loans to come to terms with lenders in the West.

Answer: B
Ques Status: Previous Edition

7) Under the Bretton Woods system, the United States was designated as the

A) reserve–currency country.

B) fixed–rate country.

C) par–standard country.

D) dollar–standard country.

Answer: A
Ques Status: Previous Edition

8) Under a fixed exchange rate regime, if the domestic currency is initially ________, that is, ________ par, the central bank must intervene to sell the domestic currency by purchasing foreign assets.

A) overvalued; below

B) overvalued; above

C) undervalued; below

D) undervalued; above

Answer: D
Ques Status: Previous Edition

9) Under a fixed exchange rate regime, if the domestic currency is initially undervalued, that is, above par, the central bank must intervene to sell the ________ currency by purchasing ________ assets.

A) domestic; foreign

B) domestic; domestic

C) foreign; foreign

D) foreign; domestic

Answer: A
Ques Status: Revised

10) Under a fixed exchange rate regime, if the domestic currency is initially ________, that is, ________ par, the central bank must intervene to purchase the domestic currency by selling foreign assets.

A) overvalued; below

B) overvalued; above

C) undervalued; below

D) undervalued; above

Answer: A
Ques Status: Previous Edition

11) Under a fixed exchange rate regime, if the domestic currency is initially overvalued, that is, below par, the central bank must intervene to purchase the ________ currency by selling ________ assets.

A) domestic; foreign

B) domestic; domestic

C) foreign; foreign

D) foreign; domestic

Answer: A
Ques Status: Previous Edition

12) Under a fixed exchange rate regime, if a central bank must intervene to purchase the ________ currency by selling ________ assets, then, like an open market sale, this action reduces the monetary base and the money supply, causing the interest rate on domestic assets to rise.

A) domestic; foreign

B) domestic; domestic

C) foreign; foreign

D) foreign; domestic

Answer: A
Ques Status: Previous Edition

13) Under a fixed exchange rate regime, if a central bank must intervene to purchase the domestic currency by selling foreign assets, then, like an open market sale, this action ________ the monetary base and the money supply, causing the interest rate on domestic assets to ________.

A) increases; rise

B) increases; fall

C) reduces; rise

D) reduces; fall

Answer: C
Ques Status: Previous Edition

14) When the domestic currency is initially overvalued in a fixed exchange rate regime, the central bank must intervene in the foreign exchange market to ________ the domestic currency, thereby allowing the money supply to ________.

A) purchase; decline

B) sell; decline

C) purchase; increase

D) sell; increase

Answer: A
Ques Status: Revised

15) When the domestic currency is initially undervalued in a fixed exchange rate regime, the central bank must intervene in the foreign exchange market to ________ the domestic currency, thereby allowing the money supply to ________.

A) purchase; decline

B) sell; decline

C) purchase; increase

D) sell; increase

Answer: D
Ques Status: Revised

16) Under a fixed exchange rate regime, if a country has an overvalued exchange rate, then its central bank's attempt to keep its currency from ________ will result in a ________ of international reserves.

A) depreciating; gain

B) depreciating; loss

C) appreciating; gain

D) appreciating; loss

Answer: B
Ques Status: Previous Edition

17) Under a fixed exchange rate regime, if a country has an ________ exchange rate, then its central bank's attempt to keep its currency from depreciating will result in a ________ of international reserves.

A) undervalued; gain

B) undervalued; loss

C) overvalued; gain

D) overvalued; loss

Answer: D
Ques Status: Previous Edition

18) Under a fixed exchange rate regime, if a country has an undervalued exchange rate, then its central bank's attempt to keep its currency from________ will result in a ________ of international reserves.

A) depreciating; gain

B) depreciating; loss

C) appreciating; gain

D) appreciating; loss

Answer: C
Ques Status: Revised

19) Under a fixed exchange rate regime, if a country has an ________ exchange rate, then its central bank's attempt to keep its currency from appreciating will result in a ________ of international reserves.

A) undervalued; gain

B) undervalued; loss

C) overvalued; gain

D) overvalued; loss

Answer: A
Ques Status: Revised

20) Under a fixed exchange rate regime, if a country's central bank runs out of international reserves, it cannot keep its currency from

A) depreciating.

B) appreciating.

C) deflating.

D) inflating.

Answer: A
Ques Status: Previous Edition

21) Under a fixed exchange rate regime, a country that depletes its international reserves in an attempt to keep its currency from ________ will be forced to ________ its currency.

A) depreciating; revalue

B) depreciating; devalue

C) appreciating; revalue

D) appreciating; devalue

Answer: B
Ques Status: Revised

22) Under a fixed exchange rate regime, a central bank that does not want to acquire international reserves to keep its currency from ________ will decide to ________ its currency.

A) depreciating; revalue

B) depreciating; devalue

C) appreciating; revalue

D) appreciating; devalue

Answer: C
Ques Status: Revised

23) Under a fixed exchange rate system, countries that ran large, persistent balance of payments deficits would ________ international reserves, thereby pressuring them into ________ their exchange rate.

A) gain; devaluing

B) gain; revaluing

C) lose; devaluing

D) lose; revaluing

Answer: C
Ques Status: Previous Edition

24) Under a fixed exchange rate system, countries that ran large, persistent balance of payments surpluses would ________ international reserves, thereby pressuring them into ________ their exchange rate.

A) gain; devaluing

B) gain; revaluing

C) lose; devaluing

D) lose; revaluing

Answer: B
Ques Status: Revised

25) A balance of payments ________ is associated with a loss of international reserves, while a balance of payments ________ is associated with a gain.

A) surplus; surplus

B) surplus; deficit

C) deficit; surplus

D) deficit; deficit

Answer: C
Ques Status: Previous Edition

26) A balance of payments deficit is associated with a ________ of international reserves, while a balance of payments surplus is associated with a ________.

A) loss; loss

B) loss; gain

C) gain; loss

D) gain; gain

Answer: B
Ques Status: Previous Edition

27) To keep from running out of international reserves under the Bretton Woods system, a country had to implement ________ monetary policy to ________ its currency.

A) expansionary; strengthen

B) expansionary; weaken

C) contractionary; strengthen

D) contractionary; weaken

Answer: C
Ques Status: Previous Edition

28) Under the Bretton Woods system, when a country adopted an expansionary monetary policy, thereby causing a balance of payments ________, the country would eventually be forced to implement ________ monetary policy.

A) deficit; expansionary

B) deficit; contractionary

C) surplus; expansionary

D) surplus; contractionary

Answer: B
Ques Status: Previous Edition

29) Because the United States was the reserve–currency country under the Bretton Woods system, it could run large balance of payments ________ without ________ significant amounts of international reserves.

A) deficits; losing

B) deficits; gaining

C) surpluses; losing

D) surpluses; gaining

Answer: A
Ques Status: Previous Edition

30) The Bretton Woods system was one in which central banks

A) bought and sold their own currencies to keep their exchange rates fixed.

B) agreed not to intervene in the foreign exchange market to maintain a fixed exchange rate regime that had existed prior to World War I.

C) agreed to limit domestic money growth to the average of the five largest industrial nations.

D) agreed to limit domestic money growth to the average of the seven largest industrial nations.

Answer: A
Ques Status: Previous Edition

31) The Bretton Woods system broke down in the early 1970s for all but one of the following reasons:

A) deficit countries losing international reserves were not willing to devalue their currencies.

B) surplus countries were not willing to revalue their currencies upwards.

C) surplus countries were not willing to pursue more expansionary policies.

D) the United States had been pursuing an inflationary monetary policy to reduce domestic unemployment.

Answer: A
Ques Status: Revised

32) To maintain fixed exchange rates when countries had balance of payments deficits and were losing international reserves, the ________ would loan ________ countries international reserves contributed by other members.

A) IMF; deficit

B) IMF; surplus

C) World Bank; deficit

D) World Bank; surplus

Answer: A
Ques Status: Revised

33) Under the Bretton Woods system, the IMF could encourage ________ countries to pursue ________ monetary policies that would strengthen their currency or eliminate their balance of payment deficits.

A) surplus; expansionary

B) surplus; contractionary

C) deficit; expansionary

D) deficit; contractionary

Answer: D
Ques Status: Previous Edition

34) Under the Bretton Woods system, the IMF could encourage deficit countries to pursue contractionary monetary policies that would ________ their currency or eliminate their balance of payment ________.

A) strengthen; surpluses

B) strengthen; deficits

C) weaken; surpluses

D) weaken; deficits

Answer: B
Ques Status: Previous Edition

35) A weakness of the Bretton Woods system was that the ________ had no way to force surplus countries to either revalue their exchange rates upwards or pursue more expansionary policies.

A) IMF

B) World Bank

C) European Exchange Rate Mechanism (ERM)

D) Bank of International Settlements

Answer: A
Ques Status: Revised

36) Under the Bretton Woods system, a country running a balance of payments deficit ________ international reserves, and had to implement ________ monetary policy to strengthen its currency.

A) lost; expansionary

B) lost; contractionary

C) gained; expansionary

D) gained; contractionary

Answer: B
Ques Status: Previous Edition

37) Under the Bretton Woods system, a country running a balance of payments ________ lost international reserves, and had to implement ________ monetary policy to strengthen its currency.

A) surplus; expansionary

B) surplus; contractionary

C) deficit; expansionary

D) deficit; contractionary

Answer: D
Ques Status: Previous Edition

38) Under the Bretton Woods system, a country running a balance of payments surplus ________ international reserves, and had to implement ________ monetary policy to weaken its currency.

A) lost; expansionary

B) lost; contractionary

C) gained; expansionary

D) gained; contractionary

Answer: C
Ques Status: Previous Edition

39) Under the Bretton Woods system, if IMF loans were insufficient to prevent ________ of a currency, then the country was allowed to devalue its currency by setting a new, ________ exchange rate.

A) depreciation; lower

B) depreciation; higher

C) appreciation; lower

D) appreciation; higher

Answer: A
Ques Status: Previous Edition

40) As a result of its power to dictate loan terms to borrowing countries (under the Bretton Woods system), the IMF could encourage ________ countries to pursue ________ monetary policies that would strengthen their currency or eliminate their balance of payments deficits.

A) surplus; contractionary

B) surplus; expansionary

C) deficit; contractionary

D) deficit; expansionary

Answer: C
Ques Status: Previous Edition

41) Because central banks have not been willing to give up their option of intervening in the foreign exchange market, the current international financial system can best be described as a

A) variable-pegged exchange rate system.

B) moving-pegged exchange rate system.

C) hybrid of a fixed exchange rate and flexible exchange rate system.

D) flexible-exchange, dollar-pegged exchange rate system.

Answer: C
Ques Status: Previous Edition

42) The current international financial system is a managed float exchange rate system because

A) exchange rates fluctuate in response to, but are not determined solely by, market forces.

B) some countries keep their currencies pegged to the dollar, which is not allowed to fluctuate.

C) all countries allow their exchange rates to fluctuate in response to market forces.

D) all countries peg their currencies to the dollar which is allowed to fluctuate in response to market forces.

Answer: A
Ques Status: Previous Edition

43) Policymakers in a country with a balance of payments surplus may not want to see their country's currency appreciate because this would

A) hurt consumers in their country by making foreign goods more expensive.

B) hurt domestic businesses by making foreign goods cheaper in their country.

C) increase inflation in their country.

D) decrease the wealth of the country.

Answer: B
Ques Status: Revised

44) Under the current managed float exchange rate regime, countries with balance of payments deficits frequently do not want to see their currencies depreciate because it makes ________ goods more expensive for ________ consumers and can stimulate inflation.

A) foreign; foreign

B) foreign; domestic

C) domestic; foreign

D) domestic; domestic

Answer: B
Ques Status: Previous Edition

45) Countries with surpluses in their balance of payments frequently do not want to see their currencies ________ because it makes their goods ________ expensive abroad.

A) appreciated; less

B) appreciate; more

C) depreciated; less

D) depreciate; more

Answer: B
Ques Status: Previous Edition

46) Countries with balance of payments deficits do not want to see their currencies ________ because it makes foreign goods ________ expensive for domestic consumers.

A) appreciate; less

B) appreciate; more

C) depreciate; less

D) depreciate; more

Answer: D
Ques Status: Previous Edition

47) Under the current managed float exchange rate regime, countries with ________ in their balance of payments frequently do not want to see their currencies ________ because it makes their goods more expensive abroad and foreign goods cheaper in their countries.

A) surpluses; depreciate

B) deficits; depreciate

C) surpluses; appreciate

D) deficits; appreciate

Answer: C
Ques Status: Previous Edition

48) Under the current managed float exchange rate regime; countries with surpluses in their balance of payments frequently do not want to see their currencies appreciate because it makes their goods ________ expensive abroad and foreign goods ________ in their countries.

A) more; cheaper

B) more; costlier

C) less; cheaper

D) less; costlier

Answer: A
Ques Status: Previous Edition

49) Under the current managed float exchange rate regime, countries with balance of payments ________ frequently do not want to see their currencies ________ because it makes foreign goods more expensive for domestic consumers and can stimulate inflation.

A) surpluses; depreciate

B) deficits; depreciate

C) surpluses; appreciate

D) deficits; appreciate

Answer: B
Ques Status: Previous Edition

50) Which of the following is true?

A) Special drawing rights are loans to countries made by the IMF.

B) Changes in the quantity of special drawing rights are tied to changes in the quantity of gold.

C) Special drawing rights are a paper substitute for gold.

D) Special drawing rights are not held as international reserves.

Answer: C
Ques Status: Previous Edition

51) An ECU was

A) a paper substitute for gold issued by the IMF.

B) a loan by European countries to the IMF.

C) a paper currency issued by the European Common Market.

D) a monetary unit created by the European Monetary System.

Answer: D
Ques Status: Previous Edition

52) Under the Exchange Rate Mechanism of the European Monetary System, when the British pound depreciated below its lower limit against the German mark, the Bank of England was required to buy ________ and sell ________, thereby ________ international reserves.

A) pounds; marks; losing

B) pounds; marks; gaining

C) marks; pounds; gaining

D) marks; pounds; losing

Answer: A
Ques Status: Previous Edition

53) Under the Exchange Rate Mechanism of the European Monetary System, when the British pound depreciated below its lower limit against the German mark, the German central bank was required to buy ________ and sell ________, thereby ________ international reserves.

A) pounds; marks; losing

B) pounds; marks; gaining

C) marks; pounds; gaining

D) marks; pounds; losing

Answer: B
Ques Status: Previous Edition

54) Under the Exchange Rate Mechanism of the European Monetary System, when the German mark depreciated below its lower limit against the British pound, the Bank of England was required to buy ________ and sell ________, thereby ________ international reserves.

A) pounds; marks; losing

B) pounds; marks; gaining

C) marks; pounds; gaining

D) marks; pounds; losing

Answer: C
Ques Status: Previous Edition

55) Under the Exchange Rate Mechanism of the European Monetary System, when the German mark depreciated below its lower limit against the British pound, the German central bank was required to buy _____ and sell _____, thereby _____ international reserves.

A) pounds; marks; losing

B) pounds; marks; gaining

C) marks; pounds; gaining

D) marks; pounds; losing

Answer: D
Ques Status: Revised

56) In September 1992, the Bundesbank attempted to keep the mark from appreciating relative to the British pound, but it failed because participants in the foreign exchange market came to expect the

A) appreciation of the mark.

B) depreciation of the mark.

C) revaluation of the dollar.

D) end of the Exchange Rate Mechanism.

Answer: A
Ques Status: Revised

57) The East Asia currency crisis in 1997 started in

A) Japan.

B) Thailand.

C) South Korea.

D) Philippines.

Answer: B

Ques Status: Previous Edition

58) Between May and July 1997, concerns about the large current account deficit in Thailand and the weakness in the Thai financial system caused speculators to suspect that Thailand might be forced to

A) devalue its currency.

B) sell baht to prop up its value.

C) buy dollars to prop up the baht.

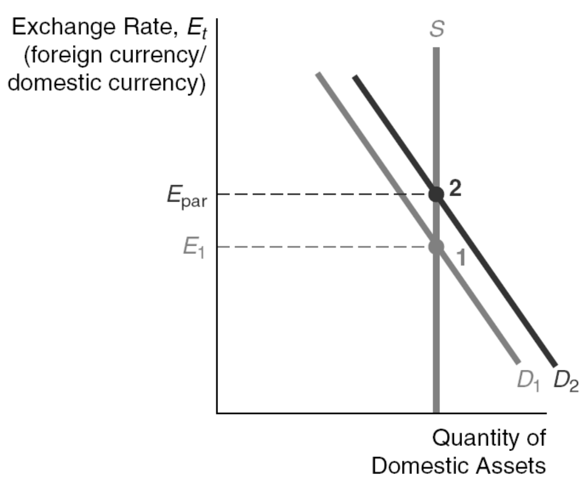
D) impose capital controls.

Answer: A

Ques Status: Previous Edition

59) Explain and demonstrate graphically the situation of an overvalued exchange rate in a fixed exchange rate system. What alternative policies are available to eliminate the overvaluation of the exchange rate?

Answer: See the figure below.



The par value is above the equilibrium value, resulting in overvaluation of the exchange rate. One approach is to pursue contractionary monetary policies, raising interest rates and increasing the demand for domestic assets. This process continues until equilibrium at par value is restored. Another alternative is for the central bank to purchase domestic currency by selling foreign assets.

Ques Status: Revised

60) Assume that a fixed exchange rate is overvalued. Describe the situation of a speculative crisis against this currency. What can the central bank do to defend the currency? Why might the alternative of devaluation be preferable?

Answer: When the speculative attack begins, the expected depreciation of the domestic currency increases substantially, decreasing the demand for domestic assets. Contrationary monetary policy is needed to increase domestic interest rates enough to defend the currency. The cost to the central bank in terms of the costs of intervention and the contractionary effect on the economy may make devaluation preferable.
Ques Status: Revised

21.4 Capital Controls

1) A capital ________ can promote financial instability in an emerging–market country because it is what forces a country to ________ its currency.

A) inflow; devalue

B) inflow; revalue

C) outflow; devalue

D) outflow; revalue

Answer: C
Ques Status: Previous Edition

2) A capital ________ can promote financial instability in an emerging–market country because it can lead to a lending boom and excessive risk–taking on the part of banks, which helps trigger a ________.

A) inflow; financial crisis

B) inflow; currency devaluation

C) outflow; financial crisis

D) outflow; currency devaluation

Answer: A
Ques Status: Previous Edition

3) A case for capital inflow controls can be made because capital inflows

A) can cause a lending boom and lead to excessive risk taking.

B) never finance productive investments.

C) always finance productive investments.

D) are less likely to cause financial crises than regulation of banking activities.

Answer: A
Ques Status: Revised

4) Which of the following is not a disadvantage of controls on capital outflows?

A) The controls may lead to excessive risk taking by the domestic banks.

B) They are seldom effective during a crisis.

C) Capital flight may increase after they are put in place.

D) Controls often lead to an increase in government corruption.

Answer: A
Ques Status: New

21.5 The Role of the IMF

1) In the 1990s this agency has acted like an international lender of last resort to cope with financial instability.

A) World Bank

B) European Central Bank

C) IMF

D) International Bank for Reconstruction and Development

Answer: C
Ques Status: Previous Edition

2) An international lender of last resort creates a serious ________ problem because depositors and other creditors of banking institutions expect that they will be protected if a crisis occurs.

A) moral hazard

B) adverse selection

C) public choice

D) strategic choice

Answer: A
Ques Status: Previous Edition

3) An international lender of last resort creates a serious moral hazard problem because ________ and other ________ of banking institutions expect that they will be protected if a crisis occurs.

A) depositors; debtors

B) depositors; creditors

C) borrowers; debtors

D) borrowers; creditors

Answer: B
Ques Status: Previous Edition

4) Critics of the IMF contend that its lending in the Mexican crisis, which was used to bail out foreign ________, set the stage for the ________ crisis because these ________ expected to be bailed out if things went wrong.

   A) lenders; East Asian; borrowers

   B) lenders; East Asian; lenders

   C) borrowers; Russian; borrowers

   D) borrowers; Russian; lenders

   Answer: B
   Ques Status: Previous Edition

5) Critics of the IMF contend that its lending in the ________ crisis, which was used to bail out foreign lenders, set the stage for the ________ crisis because these lenders expected to be bailed out if things went wrong and thus provided funds that were used to fuel excessive risk taking.

   A) Russian; Mexican

   B) Russian; East Asian

   C) Mexican; Russian

   D) Mexican; East Asian

   Answer: D
   Ques Status: Previous Edition

6) An advantage of an international lender of last resort is its ability to prevent ________, in which a successful speculative attack on one currency leads to attacks on others; its disadvantage is the problem of ________ if creditors expect to be protected if a crisis occurs.

   A) contagion; moral hazard

   B) contagion; adverse selection

   C) currency virus; moral hazard

   D) currency virus; adverse selection

   Answer: A
   Ques Status: Previous Edition

21.6 International Considerations and Monetary Policy

1) In the early 1970s, the U.S. ran large balance of payments ________, causing an ________ dollar and an ________ German mark.

   A) deficits; undervalued; overvalued

   B) deficits; overvalued; undervalued

   C) surpluses; undervalued; overvalued

   D) surpluses; overvalued; undervalued

   Answer: B
   Ques Status: Previous Edition

2) In response to the overvalued dollar in the early 1970s, the German Bundesbank bought ________ and sold ________ to keep the exchange rate fixed, gaining international reserves.

A) marks; dollars

B) marks; pounds

C) dollars; marks

D) dollars; pounds

Answer: C
Ques Status: Revised

3) In response to the overvalued dollar in the early 1970s, the German Bundesbank bought dollars and sold marks to keep the exchange rate fixed, gaining international reserves. The huge purchase of international reserves meant that the German monetary base began to ________, leading to ________ growth in the German money supply.

A) decline; sluggish

B) decline; rapid

C) grow; sluggish

D) grow; rapid

Answer: D
Ques Status: Revised

4) The German central bank gained international reserves in the early 1970s because it sold ________ to prevent mark ________.

A) marks; appreciation

B) dollars; appreciation

C) marks; depreciation

D) dollars; depreciation

Answer: A
Ques Status: Revised

5) Since the abandonment of the Bretton Woods system, balance of payments considerations have become ________ important, and exchange rate considerations ________ important in the conduct of monetary policy.

A) more; less

B) more; more

C) less; less

D) less; more

Answer: D
Ques Status: Previous Edition

6) If a central bank does not want to see its currency fall in value, it may pursue ________ monetary policy to ________ the domestic interest rate, thereby strengthening its currency.

A) expansionary; raise

B) contractionary; raise

C) expansionary; lower

D) contractionary; lower

Answer: B
Ques Status: Previous Edition

7) If a central bank does not want to see its currency ________ in value, it may pursue contractionary monetary policy to raise the domestic interest rate, thereby ________ its currency.

A) fall; strengthening

B) fall; weakening

C) rise; strengthening

D) rise; weakening

Answer: A
Ques Status: Previous Edition

8) If a central bank does not want to see its currency rise in value, it may pursue ________ monetary policy to ________ the domestic interest rate, thereby weakening its currency.

A) expansionary; raise

B) contractionary; raise

C) expansionary; lower

D) contractionary; lower

Answer: C
Ques Status: Previous Edition

9) If a central bank does not want to see its currency ________ in value, it may pursue expansionary monetary policy to lower the domestic interest rate, thereby ________ its currency.

A) fall; strengthening

B) fall; weakening

C) rise; strengthening

D) rise; weakening

Answer: D
Ques Status: Previous Edition

10) If a central bank does not want to allow the domestic currency to appreciate, it will ________ international reserves by selling its currency, thereby ________ the monetary base and increasing the risk of higher inflation.

A) lose; decreasing

B) lose; increasing

C) acquire; decreasing

D) acquire; increasing

Answer: D
Ques Status: Previous Edition

11) If a central bank does not want to allow the domestic currency to depreciate, it will ________ international reserves by purchasing its currency, thereby ________ the monetary base and increasing the risk of higher unemployment.

A) lose; decreasing

B) lose; increasing

C) acquire; decreasing

D) acquire; increasing

Answer: A
Ques Status: Previous Edition

12) A central bank's attempt to prevent an appreciation of its currency can stimulate domestic inflation if the ________ of its currency leads to ________ international reserves which ________ the monetary base.

A) purchase; higher; increases

B) purchase; lower; decreases

C) sale; lower; decreases

D) sale; higher; increases

Answer: D
Ques Status: Previous Edition

13) A central bank's attempt to prevent an appreciation of its currency can stimulate domestic inflation if the ________ of foreign currencies leads to ________ international reserves which ________ the monetary base.

A) purchase; higher; increases

B) purchase; lower; decreases

C) sale; lower; decreases

D) sale; higher; increases

Answer: A
Ques Status: Previous Edition

21.7 To Peg or not to Peg: Exchange–Rate Targeting as an Alternative Monetary Policy Strategy

1) A monetary policy strategy that uses a fixed exchange rate regime that ties the value of a currency to the currency of a large, low inflation country is called ________ targeting.

A) exchange–rate

B) currency

C) monetary

D) inflation

Answer: A
Ques Status: New

2) Under an exchange–rate targeting rule for monetary policy, a crawling peg

A) fixes the value of the domestic currency to a commodity such as gold.

B) fixes the value of the domestic currency to that of a large, low–inflation country.

C) allows the domestic currency to depreciate at a steady rate so that inflation in the pegging country can be higher than that of the anchor country.

D) allows the domestic currency to depreciate at a steady rate so that inflation in the pegging country can be lower than that of the anchor country.

Answer: C
Ques Status: Revised

3) An advantage to exchange–rate targeting is it helps keep inflation under control by tying the inflation rate for ________ traded goods to what is found in the ________ country.

A) domestically; anchor

B) domestically, domestic

C) internationally; anchor

D) internationally; domestic

Answer: C
Ques Status: New

4) Exchange–rate targeting allows a central bank to ________, thus this will ________ the probability of policy developing a time–inconsistency problem.

A) be governed by a policy rule; decrease

B) follow discretionary policy; decrease

C) be governed by a policy rule; increase

D) follow discretionary policy; increase

Answer: A
Ques Status: New

5) Which of the following is not an advantage to exchange–rate targeting?

A) It provides a strong nominal anchor to keep inflation under control.

B) It provides an automatic rule for policy to help avoid the time–inconsistency problem.

C) It is simple and clear so that the public can easily understand it.

D) It increases the accountability of policymakers.

Answer: D
Ques Status: New

6) Under exchange–rate targeting, the central bank in the targeting country ________ lose the ability to pursue its own independent monetary policy and any shocks to the anchor country is ________ transmitted to the targeting country.

A) does; directly

B) does not; directly

C) does; not directly

D) does not; not directly

Answer: A
Ques Status: New

7) Both France and the United Kingdom successfully used exchange–rate targeting to lower inflation in the late 1980s and early 1990s by tying the value of their currencies to the

A) U.S. dollar.

B) German mark.

C) Swiss franc.

D) Euro.

Answer: B
Ques Status: Previous Edition

8) Which of the following is not a disadvantage of exchange–rate targeting?

A) It relies on a stable money–inflation relationship.

B) The targeting country gives up an independent monetary policy.

C) The targeting country is left open for a speculative attack.

D) It can weaken the accountability of policymakers.

Answer: A
Ques Status: New

9) Two reasons for industrialized countries to adopt an exchange-rate targeting regime are if the country ________ conduct successful monetary policy on their own, and if the country wants to ________ integration of the domestic economy with its neighbors.

A) cannot; encourage

B) cannot; discourage

C) can; encourage

D) can; discourage

Answer: A
Ques Status: New

10) An emerging market country that successfully used exchange-rate targeting to lower its inflation from above 100 percent in 1988 to below 10 percent in 1994 (before devaluation) was

A) Thailand.

B) Mexico.

C) Philippines.

D) Indonesia.

Answer: B
Ques Status: Previous Edition

11) Because many emerging market countries have not developed the political or monetary institutions that allow the successful use of discretionary monetary policy,

A) they have little to gain from pegging their exchange rate to an anchor country like the U.S. or Germany.

B) they have little to gain from using a nominal anchor, because it would mean a monetary policy that is overly expansionary.

C) they have very little to gain from an independent monetary policy, but a lot to lose.

D) they would be better off giving their central bankers the independence to use discretion, rather than take their discretion away through any nominal anchor.

Answer: C
Ques Status: Previous Edition

12) Emerging market countries are in effect between a rock and a hard place because

A) they would be wise to adopt the monetary policy of the United States by pegging their currencies to the dollar, but this policy leaves them open to speculative attacks.

B) to avoid speculative attacks on their currencies they must peg their exchange rates to an anchor country, but this means giving central bankers in these countries too much discretion.

C) to avoid speculative attacks on their currencies they must peg their exchange rates to an anchor country, but this means giving central bankers in these countries too little discretion.

D) by adopting the monetary policy of the anchor country through an exchange rate peg, these countries allow for too little monetary expansion and thereby sacrifice economic growth for price stability.

Answer: A
Ques Status: Previous Edition

13) When a domestic currency is completely backed by a foreign currency and the note–issuing authority establishes a fixed exchange rate to this foreign currency, then the country is said to have

A) created a currency board.

B) undergone dollarization.

C) adopted a managed exchange system.

D) adopted an exchange rate monetary system.

Answer: A
Ques Status: New

14) When a country forgoes its own currency and starts using another country's currency as its own, we say that this country has

A) created a currency board.

B) undergone dollarization.

C) adopted a managed exchange system.

D) adopted an exchange rate monetary system.

Answer: A
Ques Status: New

15) The revenue a government gains from issuing money is

A) interest.

B) rent.

C) seignorage.

D) the national dividend.

E) the inflation tax.

Answer: C
Ques Status: Previous Edition

16) A country that dollarizes

A) maximizes its seignorage.

B) earns the same amount of seignorage as it would with a currency board.

C) earns the same amount of seignorage as it would with exchange-rate targeting.

D) eliminates its seignorage.

E) must pay seignorage to other governments to use their currency.

Answer: D
Ques Status: Previous Edition

17) The seignorage for a government is greater for ________ than for ________.

A) dollarization; a currency board

B) dollarization; exchange-rate targeting

C) dollarization; monetary targeting

D) dollarization; inflation targeting

E) exchange-rate targeting; dollarization

Answer: E
Ques Status: Previous Edition

18) Exchange-rate targeting is not an option for the United States because

A) the United States is already dollarized.

B) the United States is too large.

C) the Fed has adopted a monetary targeting strategy.

D) the Fed has adopted an inflation targeting strategy.

Answer: B
Ques Status: Revised

19) The monetary policy strategy that provides an automatic rule for the conduct of monetary policy is

A) exchange–rate targeting.

B) monetary targeting.

C) inflation targeting.

D) the implicit nominal anchor.

Answer: A
Ques Status: Revised

20) The monetary policy strategy that does not allow the policy to focus on domestic considerations is

A) exchange–rate targeting.

B) monetary targeting.

C) inflation targeting.

D) the implicit nominal anchor.

Answer: A
Ques Status: Revised

21) The monetary policy strategy that results in the loss of an independent monetary policy is

A) exchange–rate targeting.

B) monetary targeting.

C) inflation targeting.

D) the implicit nominal anchor.

Answer: A
Ques Status: Revised

22) The monetary policy strategy that directly ties down the price of internationally traded goods is

A) exchange–rate targeting.

B) monetary targeting.

C) inflation targeting.

D) the implicit nominal anchor.

Answer: A
Ques Status: Revised

23) Explain an additional disadvantage for a country undergoing dollarization compared to a currency board or other exchange–rate targeting regimes.

Answer: The additional disadvantage to dollarization is that the government loses seignorage. Seignorage is the income that a government earns by issuing its own currency.
Ques Status: New

24) Explain the 1992 crisis that led to the breakdown of the European Union's Exchange Rate Mechanism. What disadvantages of exchange–rate targeting were exhibited during this crisis?

Answer: The 1992 crisis began with Germany raising interest rates in 1990 to stem inflationary pressures from reunification. This demand shock was immediately transmitted to the other nations in the exchange–rate mechanism. Thus, these countries did not have independent monetary policies and were subject to shocks from the anchor country. This gave rise to the second problem. Speculators bet that these other countries would not want the increased unemployment resulting from the tight monetary policy. Betting that their commitment was weak, speculators bet against these currencies, and a number were forced to devalue or drop out of the ERM. The disadvantages illustrated by this are the lack of independent policy subjecting member nations to shocks from the anchor nation, and the possibility of speculative attacks when commitment is felt to be weak.

Ques Status: Previous Edition

Chapter 22

The Demand for Money

22.1 Quantity Theory of Money

1) The quantity theory of money is a theory of how

A) the money supply is determined.

B) interest rates are determined.

C) the nominal value of aggregate income is determined.

D) the real value of aggregate income is determined.

Answer: C
Ques Status: Revised

2) Because the quantity theory of money tells us how much money is held for a given amount of aggregate income, it is also a theory of

A) interest–rate determination.

B) the demand for money.

C) exchange–rate determination.

D) the demand for assets.

Answer: B
Ques Status: Revised

3) The average number of times that a dollar is spent in buying the total amount of final goods and services produced during a given time period is known as

A) gross national product.

B) the spending multiplier.

C) the money multiplier.

D) velocity.

Answer: D
Ques Status: Previous Edition

4) The velocity of money is

A) the average number of times that a dollar is spent in buying the total amount of final goods and services.

B) the ratio of the money stock to high-powered money.

C) the ratio of the money stock to interest rates.

D) the average number of times a dollar is spent in buying financial assets.

Answer: A
Ques Status: Revised

5) If the money supply is $500 and nominal income is $3,000, the velocity of money is

A) 1/60.

B) 1/6.

C) 6.

D) 60.

Answer: C
Ques Status: Revised

6) If the money supply is $600 and nominal income is $3,000, the velocity of money is

A) 1/50.

B) 1/5.

C) 5.

D) 50.

Answer: C
Ques Status: Revised

7) If the money supply is $500 and nominal income is $4,000, the velocity of money is

A) 1/20.

B) 1/8.

C) 8.

D) 20.

Answer: C
Ques Status: Revised

8) If the money supply is $600 and nominal income is $3,600, the velocity of money is

A) 1/60.

B) 1/6.

C) 6.

D) 60.

Answer: C
Ques Status: Revised

9) If nominal GDP is $10 trillion, and the money supply is $2 trillion, velocity is

A) 0.2.

B) 5.

C) 10.

D) 20.

Answer: B
Ques Status: Revised

10) If nominal GDP is $8 trillion, and the money supply is $2 trillion, velocity is

A) 0.25.

B) 4.

C) 8.

D) 16.

Answer: B
Ques Status: Revised

11) If nominal GDP is $10 trillion, and velocity is 10, the money supply is

A) $1 trillion.

B) $5 trillion.

C) $10 trillion.

D) $100 trillion.

Answer: A
Ques Status: Revised

12) If the money supply is $2 trillion and velocity is 5, then nominal GDP is

A) $1 trillion.

B) $2 trillion.

C) $5 trillion.

D) $10 trillion.

Answer: D
Ques Status: Revised

13) If the money supply is $20 trillion and velocity is 2, then nominal GDP is

A) $2 trillion.

B) $10 trillion.

C) $20 trillion.

D) $40 trillion.

Answer: D
Ques Status: Revised

14) Velocity is defined as

A) P + M + Y.

B) (P × M)/Y.

C) (Y × M)/P.

D) (P × Y)/M.

Answer: D
Ques Status: Revised

15) The velocity of money is defined as

A) real GDP divided by the money supply.

B) nominal GDP divided by the money supply.

C) real GDP times the money supply.

D) nominal GDP times the money supply.

Answer: B
Ques Status: Revised

16) The equation of exchange states that the quantity of money multiplied by the number of times this money is spent in a given year must equal

A) nominal income.

B) real income.

C) real gross national product.

D) velocity.

Answer: A
Ques Status: Previous Edition

17) In the equation of exchange, the concept that provides the link between M and PY is called

A) the velocity of money.

B) aggregate demand.

C) aggregate supply.

D) the money multiplier.

Answer: A
Ques Status: Previous Edition

18) The equation of exchange is

A) $M \times P = V \times Y$.

B) $M + V = P + Y$.

C) $M + Y = V + P$.

D) $M \times V = P \times Y$.

Answer: D
Ques Status: Revised

19) Irving Fisher took the view that the institutional features of the economy which affect velocity change _____ over time so that velocity will be fairly _____ in the short run.

A) rapidly; erratic

B) rapidly; stable

C) slowly; stable

D) slowly; erratic

Answer: C
Ques Status: Previous Edition

20) In Irving Fisher's quantity theory of money, velocity was determined by

A) interest rates.

B) real GDP.

C) the institutions in an economy that affect individuals' transactions.

D) the price level.

Answer: C
Ques Status: Revised

21) The classical economists' conclusion that nominal income is determined by movements in the money supply rested on their belief that _____ could be treated as _____ in the short run.

A) velocity; constant

B) velocity; variable

C) money; constant

D) money; variable

Answer: A
Ques Status: Previous Edition

22) The view that velocity is constant in the short run transforms the equation of exchange into the quantity theory of money. According to the quantity theory of money, when the money supply doubles

A) velocity falls by 50 percent.

B) velocity doubles.

C) nominal incomes falls by 50 percent.

D) nominal income doubles.

Answer: D
Ques Status: Previous Edition

23) Cutting the money supply by one-third is predicted by the quantity theory of money to cause

A) a sharp decline in real output of one-third in the short run, and a fall in the price level by one-third in the long run.

B) a decline in real output by one-third.

C) a decline in output by one-sixth, and a decline in the price level of one-sixth.

D) a decline in the price level by one-third.

Answer: D
Ques Status: Revised

24) The classical economists believed that if the quantity of money doubled,

A) output would double.

B) prices would fall.

C) prices would double.

D) prices would remain constant.

Answer: C
Ques Status: Previous Edition

25) The classical economists' contention that prices double when the money supply doubles is predicated on the belief that in the short run velocity is _____ and real GDP is _____.

A) constant; constant

B) constant; variable

C) variable; variable

D) variable; constant

Answer: A
Ques Status: Previous Edition

26) For the classical economists, the quantity theory of money provided an explanation of movements in the price level. Movements in the price level result

A) solely from changes in the quantity of money.

B) primarily from changes in the quantity of money.

C) only partially from changes in the quantity of money.

D) from changes in factors other than the quantity of money.

Answer: A
Ques Status: Previous Edition

27) If initially the money supply is $1 trillion, velocity is 5, the price level is 1, and real GDP is $5 trillion, an increase in the money supply to $2 trillion

A) increases real GDP to $10 trillion.

B) causes velocity to fall to 2.5.

C) increases the price level to 2.

D) increases the price level to 2 and velocity to 10.

Answer: C
Ques Status: Revised

28) If initially the money supply is $2 trillion, velocity is 5, the price level is 2, and real GDP is $5 trillion, a fall in the money supply to $1 trillion

A) reduces real GDP to $2.5 trillion.

B) causes velocity to rise to 10.

C) decreases the price level to 1.

D) decreases the price level to 1 and decreases velocity to 2.5.

Answer: C
Ques Status: Revised

29) According to the quantity theory of money demand,

A) an increase in interest rates will cause the demand for money to fall.

B) a decrease in interest rates will cause the demand for money to increase.

C) interest rates have no effect on the demand for money.

D) an increase in money will cause the demand for money to fall.

Answer: C
Ques Status: Previous Edition

30) Fisher's quantity theory of money suggests that the demand for money is purely a function of _____ , and _____ no effect on the demand for money.

A) income; interest rates have

B) interest rates; income has

C) government spending; interest rates have

D) expectations; income has

Answer: A
Ques Status: Revised

31) _____ quantity theory of money suggests that the demand for money is purely a function of income, and interest rates have no effect on the demand for money.

A) Keynes's

B) Fisher's

C) Friedman's

D) Tobin's

Answer: B
Ques Status: Previous Edition

32) Irving Fisher's view that velocity is fairly constant in the short run transforms the equation of exchange into the

A) Friedman's theory of income determination.

B) quantity theory of money.

C) Keynesian theory of income determination.

D) monetary theory of income determination.

Answer: B
Ques Status: Previous Edition

22.2 Is Velocity a Constant?

1) The empirical evidence regarding the velocity of money indicates that velocity tends to be _____; that is, velocity _____ when economic activity contracts.

A) procyclical; declines

B) countercyclical; declines

C) countercyclical; increases

D) procyclical; increases

Answer: A
Ques Status: Revised

2) Evidence since 1915 indicates that velocity has

A) grown at a fairly constant rate, even in the short run.

B) fluctuated too much in the short run to be viewed as a constant.

C) trended downward since 1950 due to technological and financial innovations.

D) remained fairly constant in the short run, but tends to slowly increase.

Answer: B
Ques Status: Revised

3) In the 20th century, velocity

A) has been quite stable over periods as long as a decade.

B) has grown at a constant rate.

C) has been quite volatile.

D) has been quite stable over short, two year periods.

Answer: C
Ques Status: Revised

4) Velocity, over the business cycle, tends to

A) rise during economic contractions.

B) fall during economic expansions.

C) stay constant.

D) fall during economic contractions.

Answer: D
Ques Status: Previous Edition

5) Until the Great Depression, economists did not recognize that velocity

A) increases during severe economic contractions.

B) declines during severe economic contractions.

C) declines during rapid economic expansions, since money growth fails to keep pace.

D) fails to decline during economic contractions.

Answer: B
Ques Status: Previous Edition

22.3 Keynes's Liquidity Preference Theory

1) The Keynesian theory of money demand emphasizes the importance of

A) a constant velocity.

B) irrational behavior on the part of some economic agents.

C) interest rates on the demand for money.

D) expectations.

Answer: C
Ques Status: Revised

2) Keynes hypothesized that the transactions component of money demand was primarily determined by the level of

A) interest rates.

B) velocity.

C) income.

D) stock market prices.

Answer: C
Ques Status: Revised

3) Keynes argued that the transactions component of the demand for money was primarily determined by the level of people's _____, which he believed were proportional to _____.

A) transactions; income

B) transactions; age

C) incomes; wealth

D) incomes; age

Answer: A
Ques Status: Previous Edition

4) Keynes hypothesized that the precautionary component of money demand was primarily determined by the level of

A) interest rates.

B) velocity.

C) income.

D) stock market prices.

Answer: C
Ques Status: Revised

5) Keynes argued that the precautionary component of the demand for money was primarily determined by the level of people's _____, which he believed were proportional to _____.

A) incomes; wealth

B) incomes; age

C) transactions; income

D) transactions; age

Answer: C
Ques Status: Previous Edition

6) The demand for money as a cushion against unexpected contingencies is called the

A) transactions motive.

B) precautionary motive.

C) insurance motive.

D) speculative motive.

Answer: B
Ques Status: Previous Edition

7) Keynes hypothesized that the speculative component of money demand was primarily determined by the level of

A) interest rates.

B) velocity.

C) income.

D) stock market prices.

Answer: A
Ques Status: Revised

8) The speculative motive for holding money is closely tied to what function of money?

A) Store of wealth.

B) Unit of account.

C) Medium of exchange.

D) Standard of deferred payment.

Answer: A
Ques Status: Revised

9) Of the three motives for holding money suggested by Keynes, which did he believe to be the most sensitive to interest rates?

A) The transactions motive.

B) The precautionary motive.

C) The speculative motive.

D) The altruistic motive.

Answer: C
Ques Status: Revised

10) Because Keynes assumed that the expected return on money was zero, he argued that people would

A) never hold money.

B) never hold money as a store of wealth.

C) hold money as a store of wealth when the expected return on bonds was negative.

D) hold money as a store of wealth only when forced to by government policy.

Answer: C
Ques Status: Revised

11) The Keynesian theory of money demand predicts that people will increase their money holdings if they believe that

A) interest rates are about to fall.

B) bond prices are about to rise.

C) expected inflation is about to fall.

D) bond prices are about to fall.

Answer: D
Ques Status: Revised

12) If people expect nominal interest rates to be higher in the future, the expected return to bonds _____, and the demand for money _____.

A) rises; increases

B) rises; decreases

C) falls; increases

D) falls; decreases

Answer: C
Ques Status: Previous Edition

13) If people expect nominal interest rates to be lower in the future, the expected return to bonds _____, and the demand for money _____.

A) increases; increases

B) increases; decreases

C) decreases; increases

D) decreases; decreases

Answer: B
Ques Status: Previous Edition

14) Keynes argued that when interest rates were low relative to some normal value, people would expect bond prices to _____ so the quantity of money demanded would _____.

A) increase; increase

B) increase; decrease

C) decrease; increase

D) decrease; decrease

Answer: C
Ques Status: Previous Edition

15) Keynes argued that when interest rates were high relative to some normal value, people would expect bond prices to _____ , so the quantity of money demanded would _____.

A) increase; increase

B) increase; decrease

C) decrease; decrease

D) decrease; increase

Answer: B
Ques Status: Revised

16) According to Keynes's theory of liquidity preference, velocity increases when

A) income increases.

B) wealth increases.

C) brokerage commissions increase.

D) interest rates increase.

Answer: D
Ques Status: Revised

17) Keynes's theory of the demand for money implies that velocity is

A) not constant but fluctuates with movements in interest rates.

B) not constant but fluctuates with movements in the price level.

C) not constant but fluctuates with movements in the time of year.

D) a constant.

Answer: A
Ques Status: Revised

18) Because interest rates have substantial fluctuations, the _____ theory of the demand for money indicates that velocity has substantial fluctuations as well.

A) classical

B) Cambridge

C) liquidity preference

D) Pigouvian

Answer: C
Ques Status: Previous Edition

19) Keynes's liquidity preference theory indicates that the demand for money

A) is purely a function of income, and interest rates have no effect on the demand for money.

B) is purely a function of interest rates, and income has no effect on the demand for money.

C) is a function of both income and interest rates.

D) is a function of both government spending and income.

Answer: C
Ques Status: Previous Edition

20) Keynes's theory of the demand for money is consistent with

A) countercyclical movements in velocity.

B) a constant velocity.

C) procyclical movements in velocity.

D) a relatively stable velocity.

Answer: C
Ques Status: Revised

21) Keynes's theory of the demand for money is consistent with _____ movements in _____.

A) countercyclical; velocity

B) procyclical; velocity

C) countercyclical; expectations

D) procyclical; expectations

Answer: B
Ques Status: Revised

22) Keynes's model of the demand for money suggests that velocity is

A) constant.

B) positively related to interest rates.

C) negatively related to interest rates.

D) positively related to bond values.

Answer: B
Ques Status: Revised

23) Keynes's liquidity preference theory indicates that the demand for money is

A) constant.

B) positively related to interest rates.

C) negatively related to interest rates.

D) negatively related to bond values.

Answer: C
Ques Status: Revised

24) Keynes's model of the demand for money suggests that velocity is _____ related to _____.

A) positively; interest rates

B) negatively; interest rates

C) positively; bond values

D) positively; stock prices

Answer: A
Ques Status: Previous Edition

25) Keynes's liquidity preference theory indicates that the demand for money is _____ related to _____.

A) negatively; interest rates

B) positively; interest rates

C) negatively; income

D) negatively; wealth

Answer: A
Ques Status: Previous Edition

26) The Keynesian demand for real balances can be expressed as

A) $M^d = f(i,Y)$.

B) $M^d/P = f(i)$.

C) $M^d/P = f(Y)$.

D) $M^d/P = f(i,Y)$.

Answer: D
Ques Status: Revised

27) Explain the Keynesian theory of money demand. What motives did Keynes think determined money demand? What are the two reasons why Keynes thought velocity could not be treated as a constant?

Answer: Keynes believed the demand for money depended on income and interest rates. Money was held to facilitate normal transactions and as a precaution for unexpected transactions. For both of these motives, money demand depended on income. People also held money as an asset, for speculative purposes. The speculative motive depends on income and interest rates. People hold more money for speculative purposes when they expect bond prices to fall, generating a negative return on bonds. Since money demand varies with interest rates, velocity changes when interest rates change. Also, since money demand depends upon expectations about future interest rates, unstable expectations can make money demand, and thus velocity, unstable.

Ques Status: Previous Edition

22.4 Further Developments in the Keynesian Approach

1) The Baumol–Tobin analysis suggests that

A) velocity is relatively constant.

B) the transactions component of the demand for money is negatively related to the level of interest rates.

C) the speculative motive is nonexistent.

D) velocity is unrelated to the transactions motive.

Answer: B

Ques Status: Revised

2) The Baumol–Tobin analysis suggests that an increase in the brokerage fee for buying and selling bonds will cause the demand for money to ________ and the demand for bonds to ________.

A) increase; increase

B) increase; decrease

C) decrease; increase

D) decrease; decrease

Answer: B

Ques Status: Previous Edition

3) The Baumol–Tobin analysis suggests that a decrease in the brokerage fee for buying and selling bonds will cause the demand for money to _____ and the demand for bonds to _____.

A) increase; increase

B) increase; decrease

C) decrease; decrease

D) decrease; increase

Answer: D

Ques Status: Previous Edition

4) In the Baumol–Tobin analysis of transactions demand for money, either an increase in _____ or a decrease in _____ increases money demand.

   A) income; interest rate

   B) interest rates; brokerage fees

   C) brokerage fees; income

   D) interest rate; income

   Answer: A
   Ques Status: Revised

5) In the Baumol–Tobin analysis of the demand for money, either an increase in _____ or an increase in _____ increases money demand.

   A) income; interest rates

   B) brokerage fees; interest rates

   C) interest rates; the price level

   D) brokerage fees; income

   Answer: D
   Ques Status: Revised

6) In the Baumol–Tobin analysis of transactions demand, scale economies imply that an increase in real income increases the quantity of money demanded ______, while an increase in the price level increases the quantity of money demanded ______.

   A) proportionately; less than proportionately

   B) more than proportionately; proportionately

   C) less than proportionately; proportionately

   D) proportionately; more than proportionately

   Answer: C
   Ques Status: Revised

7) Tobin's model of the speculative demand for money improves on Keynes's analysis by showing that

   A) the speculative demand for money is interest insensitive.

   B) the transactions demand for money is interest insensitive.

   C) people will hold a diversified portfolio.

   D) people will hold money or bonds but not both.

   Answer: C
   Ques Status: Previous Edition

8) Tobin's model of the speculative demand for money shows that people hold money as a store of wealth as a way of

A) reducing risk.

B) reducing income.

C) avoiding taxes.

D) reducing transactions cost.

Answer: A
Ques Status: Revised

9) Tobin's model of the speculative demand for money shows that people hold money as a _____ as a way of reducing _____.

A) medium of exchange; transaction costs

B) medium of exchange; risk

C) store of wealth; transaction costs

D) store of wealth; risk

Answer: D
Ques Status: Previous Edition

10) Tobin's model of the speculative demand for money shows that people can reduce their ____ by _____ their asset holdings.

A) wealth; diversifying

B) risk; specializing

C) return; diversifying

D) risk; diversifying

Answer: D
Ques Status: Revised

11) Because Treasury bills pay a higher return than money and have no risk

A) the transactions demand for money may be zero.

B) the precautionary demand for money may be zero.

C) the speculative demand for money may be zero.

D) all three of the above motives for holding money will be zero.

Answer: C
Ques Status: Revised

12) The speculative demand for money may not exist because

A) banks now pay interest on some types of checkable deposits.

B) there are alternative riskless assets paying higher returns than the return on money.

C) the transactions demand can be shown to depend on interest rates.

D) government regulations have eliminated risk in the financial markets.

Answer: B
Ques Status: Revised

13) What factors determine the demand for money in the Baumol–Tobin analysis of transactions demand for money? How does a change in each factor affect the quantity of money demanded?

Answer: The factors are real income, the price level, interest rates, and the brokerage cost of shifting between money and bonds. Increases in real income increase money demand less than proportionately, since the model predicts scale economies in transactions demand. Increases in prices increase money demand proportionately, since the demand is for real balances. The quantity of money demanded varies inversely with interest rates, since interest is the opportunity cost of holding money. The brokerage fee is the cost of converting other assets (bonds) into money. An increase in this cost increases money demand.
Ques Status: Previous Edition

22.5 Friedman's Modern Quantity Theory of Money

1) Friedman's argument that competition among banks will tend to keep the difference between the return on bonds and money relatively constant implies that changes in _____ will have _____ on the demand for money.

A) interest rates; a big impact

B) income; a big impact

C) income; little effect

D) interest rates; little effect

Answer: D
Ques Status: Revised

2) Since the elimination of interest rate ceilings on deposits, the implicit interest rate on money more closely approaches bond interest rates. This suggests that changes in interest rates will

A) have a larger impact on money demand.

B) have a smaller impact on money demand.

C) no longer affect the speculative demand for money.

D) no longer affect the transactions demand for money.

Answer: B
Ques Status: Revised

3) According to Milton Friedman, the demand for money is insensitive to interest rates because

A) the demand for money is insensitive to changes in the opportunity cost of holding money.

B) competition among banks keeps the opportunity cost of holding money relatively constant.

C) people base their investment decisions on expected profits, not interest rates.

D) transactions are not subject to scale economies as wealth increases.

Answer: B
Ques Status: Revised

4) In Friedman's modern quantity theory, velocity depends upon the ratio of

A) money to prices.

B) actual to permanent income.

C) interest rates to actual income.

D) prices to interest rates.

Answer: B
Ques Status: Revised

5) In Friedman's modern quantity theory, velocity is procyclical because

A) money demand depends on permanent income, which is more stable than actual income.

B) money demand depends on actual income, which is more stable than permanent income.

C) velocity depends upon interest rates, which are stable over the business cycle.

D) velocity depends upon interest rates, which move procyclically.

Answer: A
Ques Status: Revised

6) In Friedman's modern quantity theory, the implied formula for velocity is

A) $V = M^d/f(i)$.

B) $V = Y/f(Y_p)$.

C) $V = f(Y_p)/Y$.

D) $V = Y/f(i)$.

Answer: B
Ques Status: Revised

7) According to Milton Friedman, income declines relative to permanent income during a business cycle contraction, causing the demand for money relative to actual income to increase, thereby causing velocity to

A) rise.

B) decline.

C) remain unchanged, since velocity depends only on interest rates.

D) decline, provided that interest rates increase when the economy contracts.

Answer: B
Ques Status: Revised

8) What factors determine money demand in Friedman's modern quantity theory? How does each affect money demand? What determines velocity in Friedman's theory? What effect do interest rates have on velocity?

Answer: In Friedman's theory, increases in permanent income increase money demand. Increases in the returns on bonds relative to money and the returns on equities relative to money decrease money demand. Increases in the returns on goods relative to the return on money, which is the expected rate of inflation relative to the return on money, decrease money demand. Velocity is determined by the ratio of actual to permanent income. As actual income increases in an expansion, permanent income increases less rapidly, so money demand increases less rapidly than income, and velocity rises (and vice versa for contractions). Interest rates do not affect velocity in Friedman's theory, since the relative returns on money and other assets are predicted to remain relatively constant.
Ques Status: Previous Edition

22.6 Distinguishing Between the Friedman and Keynesian Theories

1) According to Milton Friedman, income rises relative to permanent income during a business cycle expansion, causing the demand for money relative to actual income to decrease, thereby causing velocity to

A) rise.

B) decline.

C) remain unchanged, since velocity depends only on interest rates.

D) decline, provided that interest rates increase when the economy contracts.

Answer: A
Ques Status: Revised

2) A central question in monetary theory is whether or to what extent the quantity of money demanded is affected by changes in

A) the price level.

B) inflation.

C) income.

D) interest rates.

Answer: D
Ques Status: Previous Edition

3) If interest rates do not affect the demand for money, then velocity is _____ likely to be _____.

A) more; stable

B) more; unstable

C) more; procyclical

D) less; stable

Answer: A
Ques Status: Previous Edition

4) True or False: The more sensitive is the demand for money to interest rates, the more unpredictable velocity will be.

Answer: TRUE
Ques Status: Revised

5) The more sensitive is the demand for money to interest rates, the _____ unpredictable velocity will be, and the link between the money supply and aggregate spending will be _____ clear.

A) more; more

B) more; less

C) less; more

D) less; less

Answer: B
Ques Status: Previous Edition

22.7 Empirical Evidence on the Demand for Money

1) The evidence on the interest sensitivity of the demand for money suggests that the demand for money is ________ to interest rates, and there is ________ evidence that a liquidity trap exists.

A) sensitive; substantial

B) sensitive; little

C) insensitive; substantial

D) insensitive; little

Answer: B
Ques Status: Previous Edition

2) In the liquidity trap a small change in interest rates produces ________ change in the quantity of money demanded.

A) a small

B) no

C) a proportionate

D) a very large

Answer: D
Ques Status: Revised

3) In a liquidity trap, monetary policy has ________ effect on aggregate spending because a change in the money supply has ________ effect on interest rates.

A) no; no

B) no; a large

C) no; a small

D) a large; a large

Answer: A
Ques Status: Revised

4) In the liquidity trap, monetary policy

A) has a large impact on interest rates.

B) has a small impact on interest rates.

C) has no impact on interest rates.

D) has a proportionate impact on interest rates.

Answer: C
Ques Status: Revised

5) In the liquidity trap, the money demand curve

A) is horizontal.

B) is vertical.

C) is negatively sloped.

D) is positively sloped.

Answer: A
Ques Status: Revised

6) The reason that economists are so interested in the stability of velocity is because if the demand for money is not stable, then steady growth of the money supply

A) is going to promote price stability at the expense of low unemployment.

B) is going to promote low unemployment at the expense of price stability.

C) is an ineffective way to conduct monetary policy.

D) can still be used to conduct monetary policy if the goal is price stability.

Answer: C
Ques Status: Revised

7) Describe what the liquidity trap is. Explain how it can be problematic for monetary policymakers.

Answer: The liquidity trap describes the situation in which the demand for money is ultrasensitive to changes in interest rates (i.e., the money demand curve is infinitely elastic). In this case, monetary policy has no direct effect on aggregate spending because a change in the money supply will not effect interest rates.
Ques Status: New

22.8 Web Appendix 1: A Mathematical Treatment of the Baumol–Tobin and Tobin Mean–Variance Models

1) The absence of money illusion means that

A) as real income doubles, the demand for money doubles.

B) as interest rates double, the demand for money doubles.

C) as the money supply doubles, the demand for money doubles.

D) as the price level doubles, the demand for money doubles.

Answer: D
Ques Status: Revised

2) If there are economies of scale in the transactions demand for money, as income increases, money demand

A) increases proportionately.

B) increases less than proportionately.

C) increases more than proportionately.

D) does not change.

Answer: B
Ques Status: Revised

3) Comparing Tobin's model of the speculative demand for money with Keynesian speculative demand

A) both models imply that individuals hold only money or only bonds.

B) the Keynesian model implies individuals diversify their asset holdings, while the Tobin model predicts that individuals hold only money or only bonds.

C) the Tobin model implies individuals diversify their asset holdings, while the Keynesian model predicts that individuals hold only money or only bonds.

D) both models imply that individuals diversify their asset holdings.

Answer: C
Ques Status: Revised

4) In the Baumol–Tobin model, given that total costs for an individual equals $\frac{bT_0}{C} + \frac{iC}{2}$, where T_0 = monthly income, b = brokerage costs, and C = amount raised from each bond transaction, derive the so–called square root rule.

Answer: An individual will minimize their costs. Thus, the optimal level of C is found as follows:

$$COSTS = \frac{bT_0}{C} + \frac{iC}{2}$$

$$\frac{dCOSTS}{dC} = \frac{-bT_0}{C^2} + \frac{i}{2} = 0$$

$$C^* = \sqrt{\frac{2bT_0}{i}}$$

Since money demand is the average desired holdings of cash balances, C/2:

$$M^d = \frac{1}{2}\sqrt{\frac{2bT_0}{i}} = \sqrt{\frac{bT_0}{2i}}$$

The last expression is the square root rule.
Ques Status: New

22.9 Web Appendix 2: Empirical Evidence on the Demand for Money

1) In one of the earliest studies on the link between interest rates and money demand using United States data, James Tobin concluded that the demand for money is

A) sensitive to interest rates.

B) not sensitive to interest rates.

C) not sensitive to changes in income.

D) not sensitive to changes in bond values.

Answer: A
Ques Status: Previous Edition

2) Starting in 1974, the conventional M1 money demand function began to

A) severely underpredict the demand for money.

B) severely overpredict the demand for money.

C) predict more precisely the demand for money.

D) do none of the above.

Answer: B
Ques Status: Previous Edition

3) Starting in 1974, the conventional M1 money demand function began to severely ________ the demand for money. Stephen Goldfeld labeled this phenomenon "the case of the missing ________."

A) underpredict; velocity

B) overpredict; velocity

C) underpredict; money

D) overpredict; money

Answer: D
Ques Status: Previous Edition

4) Conventional money demand functions tended to ________ money demand in the middle and late 1970s, and ________ velocity beginning in 1982.

A) overpredict; overpredict

B) overpredict; underpredict

C) underpredict; overpredict

D) underpredict; underpredict

Answer: A
Ques Status: Previous Edition

5) Researchers at the Federal Reserve found that M2 money demand functions performed ________ in the 1980s, with M2 velocity moving ________ with the opportunity cost of holding M2.

A) poorly; erratically

B) poorly; closely

C) well; erratically

D) well; closely

Answer: D
Ques Status: Previous Edition

6) In the early 1990s, M2 growth underwent a dramatic ________, which some researchers believe ________ be explained by traditional money demand functions.

A) surge; cannot

B) surge; can

C) slowdown; cannot

D) slowdown; can

Answer: C
Ques Status: Previous Edition

7) In the late 1990s, M2 velocity ________, suggesting a ________ normal relationship between M2 and macroeconomic variables.

A) stabilized; less

B) stabilized; more

C) slowed; less

D) slowed; more

Answer: B
Ques Status: Previous Edition

Chapter 23

Aggregate Demand and Supply Analysis

23.1 Aggregate Demand

1) The aggregate demand curve is the total quantity of an economy's

A) intermediate goods demanded at all price levels.

B) intermediate goods demanded at a particular price level.

C) final goods and services demanded at a particular price level.

D) final goods and services demanded at different price levels.

Answer: D
Ques Status: Revised

2) The total quantity of an economy's final goods and services demanded at different price levels is

A) the aggregate supply curve.

B) the aggregate demand curve.

C) the Phillips curve.

D) the aggregate expenditure function.

Answer: B
Ques Status: Revised

3) According to the quantity theory of money, changes in the money supply are

A) unrelated to changes in the price level.

B) unrelated to changes in inflation.

C) unrelated to shifts in the aggregate demand curve.

D) the primary source of changes in aggregate spending.

Answer: D
Ques Status: Revised

4) The quantity theory of money concludes that changes in aggregate spending are primarily determined by changes in

A) government spending and taxes.

B) the velocity of money.

C) interest rates.

D) the money supply.

Answer: D
Ques Status: Revised

5) The average number of times per year that a dollar is spent on final goods and services is called

A) velocity.

B) acceleration.

C) the equation of exchange.

D) nominal output.

Answer: A
Ques Status: Revised

6) Suppose nominal GDP is equal to $200 trillion and the money supply equals $50 trillion. In this case, the velocity of money is equal to ________.

A) 1

B) 2

C) 4

D) 5

Answer: C
Ques Status: New

7) Suppose real GDP is equal to $100 trillion, the money supply is equal to $50 trillion and the price level is equal to 2. In this case, the velocity of money is equal to ________.

A) 1

B) 2

C) 4

D) 5

Answer: C
Ques Status: New

8) The quantity theory of money is derived from

A) the concept of velocity.

B) the Keynesian monetary transmission mechanism.

C) the equation of exchange.

D) the money supply.

Answer: C
Ques Status: Revised

9) As approached through the quantity theory of money, aggregate demand is derived from

A) the equation of exchange.

B) its three component parts: consumer expenditure, investment spending, and government spending.

C) its four component parts: consumer expenditure, investment spending, government spending, and net exports.

D) the spending multiplier.

Answer: A
Ques Status: Revised

10) The aggregate demand curve slopes downward because a decrease in the price level means ________ in the real money supply and therefore a ________ level of real spending.

A) an increase; higher

B) an increase; lower

C) a decrease; lower

D) a decrease; higher

Answer: A
Ques Status: Revised

11) According to the quantity theory of money approach to aggregate demand, an increase in the money supply, other things equal, ________ aggregate ________.

A) increases; demand

B) decreases; demand

C) decreases; supply

D) increases; supply

Answer: A
Ques Status: Revised

12) According to the quantity theory of money approach to aggregate demand, a decrease in the money supply, other things equal, ________ aggregate ________.

A) increases; demand

B) decreases; demand

C) decreases; supply

D) increases; supply

Answer: B
Ques Status: Revised

13) One way to derive aggregate demand is by looking at its four component parts, which are:

A) consumer expenditures, planned investment spending, government spending, and net exports.

B) consumer expenditures, actual investment spending, government spending, and net exports.

C) consumer expenditures, planned investment spending, government spending, and gross exports.

D) consumer expenditures, planned investment spending, government spending, and taxes.

Answer: A
Ques Status: Revised

14) By analyzing aggregate demand through its component parts, we can conclude that, everything else held constant, a decline in the price level causes

A) a decline in the real money supply, an increase in interest rates, a decline in investment spending, and a decline in aggregate output demand.

B) a decline in the real money supply, a decline in interest rates, an increase in investment spending, and an increase in aggregate output demand.

C) an increase in the real money supply, a decline in interest rates, an increase in investment spending, and an increase in aggregate output demand.

D) an increase in the real money supply, an increase in interest rates, a decline in investment spending, and a decline in aggregate output demand.

Answer: C
Ques Status: Revised

15) By looking at aggregate demand via its component parts, we can conclude that the aggregate demand curve is downward sloping because

A) a lower price level, holding the nominal quantity of money constant, leads to a larger quantity of money in real terms, causes the interest rate to fall, and stimulates planned investment spending.

B) a lower price level, holding the nominal quantity of money constant, leads to a larger quantity of money in nominal terms, causes the interest rate to rise, and stimulates planned investment spending.

C) a higher price level, holding the nominal quantity of money constant, leads to a larger quantity of money in real terms, causes the interest rate to fall, and stimulates planned investment spending.

D) a higher price level, holding the nominal quantity of money constant, leads to a smaller quantity of money in real terms, causes the interest rate to fall, and stimulates planned investment spending.

Answer: A
Ques Status: Revised

16) By looking at aggregate demand through its component parts, we can conclude that a ________ price level ________ the real quantity of money, ________ higher spending.

A) lower; expands; encouraging

B) higher; contracts; encouraging

C) lower; contracts; discouraging

D) higher; expands; encouraging

Answer: A
Ques Status: Revised

17) By analyzing aggregate demand via its component parts, we can conclude that changes in the money supply

A) have no effect on aggregate demand.

B) affect aggregate demand in the opposite direction of the change in government spending.

C) affect aggregate demand in the same direction as the change in government spending.

D) affect the quantity of aggregate output demand.

Answer: C
Ques Status: Revised

18) An increase in government spending, other things equal, ________ aggregate ________.

A) increases; demand

B) decreases; demand

C) decreases; supply

D) increases; supply

Answer: A
Ques Status: Revised

19) A decrease in government spending, other things equal, ________ aggregate ________.

A) increases; demand

B) decreases; demand

C) decreases; supply

D) increases; supply

Answer: B
Ques Status: Revised

20) A decrease in net taxes, other things equal, ________ aggregate ________.

A) increases; demand

B) decreases; demand

C) decreases; supply

D) increases; supply

Answer: A
Ques Status: Revised

21) An increase in net taxes, other things equal, ________ aggregate ________.

A) increases; demand

B) decreases; demand

C) decreases; supply

D) increases; supply

Answer: B
Ques Status: Revised

22) Everything else held constant, a balanced budget increase in government spending (that is, an increase in government spending that is matched by an identical increase in net taxes) will

A) increase aggregate demand, but not by as much if just government spending increases.

B) increase aggregate demand by more than if just government spending increases.

C) will not affect aggregate demand.

D) decrease aggregate demand.

Answer: A
Ques Status: New

23) An increase in net exports, other things equal, ________ aggregate ________.

A) increases; demand

B) decreases; demand

C) decreases; supply

D) increases; supply

Answer: A
Ques Status: Revised

24) A decrease in net exports, other things equal, ________ aggregate ________.

A) increases; demand

B) decreases; demand

C) decreases; supply

D) increases; supply

Answer: B
Ques Status: Revised

25) Everything else held constant, an increase in planned investment expenditure ________ aggregate ________.

A) increases; demand

B) decreases; demand

C) decreases; supply

D) increases; supply

Answer: A
Ques Status: New

26) Everything else held constant, a decrease in planned investment expenditure ________ aggregate ________.

A) increases; demand

B) decreases; demand

C) decreases; supply

D) increases; supply

Answer: B
Ques Status: New

27) Everything else held constant, aggregate demand increases when

A) taxes are cut.

B) government spending is reduced.

C) animal spirits decrease.

D) the money supply is reduced.

Answer: A
Ques Status: Revised

28) Everything else held constant, aggregate demand increases when

A) net exports decrease.

B) taxes increase.

C) planned investment spending increases.

D) the money supply decreases.

Answer: C
Ques Status: Revised

29) Everything else held constant, which of the following does not cause aggregate demand to increase?

A) An increase in net exports.

B) An increase in government spending.

C) An increase in taxes.

D) An increase in consumer optimism.

Answer: C
Ques Status: Revised

30) Explain through the component parts of aggregate demand why the aggregate demand curve slopes down with respect to the price level. Be sure to discuss two channels through which changes in prices affect demand.

Answer: A fall in the price level increases the real value of a fixed nominal money supply. This increase in the real money supply lowers interest rates. Lower rates increase investment, thereby increasing aggregate demand. Lower interest rates also cause depreciation of the domestic currency, increasing net exports and aggregate demand.
Ques Status: Revised

23.2 Aggregate Supply

1) The aggregate supply curve is the total quantity of

A) raw materials offered for sale at different prices.

B) final goods and services offered for sale at the current price level.

C) final goods and services offered for sale at different price levels.

D) intermediate and final goods and service offered for sale at different price levels.

Answer: C
Ques Status: Revised

2) The aggregate supply curve shows the relationship between

A) the level of inputs and aggregate output.

B) the price level and the level of inputs.

C) the wage rate and the level of employment.

D) the price level and the level of aggregate output supplied.

Answer: D
Ques Status: Previous Edition

3) The long-run rate of unemployment to which an economy always gravitates is the

A) normal rate of unemployment.

B) natural rate of unemployment.

C) neutral rate of unemployment.

D) inflationary rate of unemployment.

Answer: B
Ques Status: Revised

4) The long-run aggregate supply curve is

A) a vertical line through the non-inflationary rate of output.

B) a vertical line through the current level of output.

C) a vertical line through the natural rate level of output.

D) a horizontal line through the current level of output.

Answer: C
Ques Status: Previous Edition

5) The long-run aggregate supply curve is a vertical line passing through

A) the natural rate of output.

B) the natural-rate price level.

C) the actual rate of unemployment.

D) the expected rate of inflation.

Answer: A
Ques Status: Revised

6) The short–run aggregate supply curve is upward sloping because in the short run, costs of many factors that go into producing goods and services are ________, meaning that the price for a unit of output will ________ relative to input prices and the profit per unit will rise.

A) fixed; rise

B) fixed; fall

C) flexible; rise

D) flexible; fall

Answer: A
Ques Status: Revised

7) The positively sloped short–run aggregate supply curve reflects the assumption that factor prices are

A) more flexible than output prices.

B) less flexible than output prices.

C) fixed in the long run.

D) perfectly flexible in both the short run and the long run.

Answer: B
Ques Status: Revised

8) Everything else held constant, an increase in the cost of production ________ aggregate ________.

A) increases; demand

B) decreases; demand

C) increases; supply

D) decreases; supply

Answer: D
Ques Status: Revised

9) Everything else held constant, a decrease in the cost of production ________ aggregate ________.

A) increases; demand

B) decreases; demand

C) increases; supply

D) decreases; supply

Answer: C
Ques Status: Revised

10) Everything else held constant, when output is ________ the natural rate level, wages will begin to ________, increasing short-run aggregate supply.

A) above; fall

B) above; rise

C) below; fall

D) below; rise

Answer: C
Ques Status: Revised

11) Everything else held constant, when output is ________ the natural rate level, wages will begin to ________, decreasing short-run aggregate supply.

A) above; fall

B) above; rise

C) below; fall

D) below; rise

Answer: B
Ques Status: Revised

12) Everything else held constant, when actual output exceeds the natural rate of output ________ aggregate supply ________.

A) short-run; decreases

B) short-run; increases

C) long-run; increases

D) long-run; decreases

Answer: A
Ques Status: Revised

13) If workers demand and receive higher real wages (a successful wage push), the cost of production ________ and the short-run aggregate supply curve shifts ________.

A) rises; leftward

B) rises; rightward

C) falls; leftward

D) falls; rightward

Answer: A
Ques Status: Revised

14) Everything else held constant, if workers expect an increase in the price level, ________ aggregate supply ________.

A) long-run; increases

B) long-run; decreases

C) short-run; decreases

D) short-run; increases

Answer: C
Ques Status: Revised

15) Everything else held constant, a change in workers' expectations about the aggregate price level will cause ________ to change.

A) aggregate demand

B) short-run aggregate supply

C) the production function

D) long-run aggregate supply

Answer: B
Ques Status: Revised

16) A decrease in the availability of raw materials that increases the price level is called a ________ shock

A) negative demand

B) positive demand

C) negative supply

D) positive supply

Answer: C
Ques Status: Revised

17) A negative supply shock causes ________ to ________.

A) aggregate demand; increase

B) aggregate demand; decrease

C) short-run aggregate supply; decrease

D) short-run aggregate supply; increase

Answer: C
Ques Status: Revised

18) A positive supply shock causes ________ to ________.

A) aggregate demand; increase

B) aggregate demand; decrease

C) short-run aggregate supply; decrease

D) short-run aggregate supply; increase

Answer: D
Ques Status: Revised

19) Which of the following increases aggregate supply in the short-run, everything else held constant?

A) An increase in the price of crude oil.

B) A successful wage push by workers.

C) Expectations of a higher aggregate price level.

D) A technological improvement that increases worker productivity.

Answer: D
Ques Status: Revised

23.3 Equilibrium in Aggregate Supply and Demand Analysis

1) The fact that an economy always returns to the natural rate level of output is known as

A) the excess demand hypothesis.

B) the price-adjustment mechanism.

C) the self-correcting mechanism.

D) the natural rate of unemployment.

Answer: C
Ques Status: Revised

2) Assuming the economy is starting at the natural rate of output and everything else held constant, the effect of ________ in aggregate ________ is a rise in both the price level and output in the short-run, but in the long-run the only effect is a rise in the price level.

A) a decrease; supply

B) a decrease; demand

C) an increase; supply

D) an increase; demand

Answer: D
Ques Status: Revised

3) The aggregate demand–aggregate supply framework indicates that the long–run effect of a _________ in the money supply is an increase in _________, everything else held constant.

A) fall; aggregate output

B) fall; the price level

C) rise; aggregate output

D) rise; the price level

Answer: D
Ques Status: Revised

4) Suppose the economy is producing at the natural rate of output. Everything else held constant, the development of a new, more productive technology will cause ________ in the unemployment rate and ________ in the aggregate price level in the short run.

A) an increase; an increase

B) a decrease; a decrease

C) a decrease; an increase

D) no change; no change

Answer: B
Ques Status: New

5) Suppose the economy is producing at the natural rate of output. Assuming a fixed natural rate of output and everything else held constant, the development of a new, more productive technology will cause ________ in the unemployment rate and ________ the aggregate price level in the long run.

A) an increase; an increase

B) a decrease; a decrease

C) a decrease; an increase

D) no change; no change

Answer: D
Ques Status: New

6) Suppose the economy is producing at the natural rate of output. An increase in consumer and business confidence will cause ________ in real GDP and ________ in the aggregate price level in the short run, everything else held constant.

A) an increase; an increase

B) a decrease; a decrease

C) no change; an increase

D) no change; a decrease

Answer: A
Ques Status: New

7) Suppose the economy is producing at the natural rate of output. An increase in consumer and business confidence will cause ________ in real GDP and ________ in the aggregate price level in the long run, everything else held constant.

A) an increase; an increase

B) a decrease; a decrease

C) no change; an increase

D) no change; a decrease

Answer: C
Ques Status: New

8) Suppose the economy is producing at the natural rate of output. A decrease in consumer and business confidence will cause ________ in real GDP and ________ in the aggregate price level in the short run, everything else held constant.

A) an increase; an increase

B) a decrease; a decrease

C) no change; an increase

D) no change; a decrease

Answer: B
Ques Status: New

9) Suppose the economy is producing at the natural rate of output. A decrease in consumer and business confidence will cause ________ in real GDP and ________ in the aggregate price level in the long run, everything else held constant.

A) an increase; an increase

B) a decrease; a decrease

C) no change; an increase

D) no change; a decrease

Answer: D
Ques Status: New

10) Suppose the economy is producing at the natural rate of output. An open market purchase of bonds by the Fed will cause ________ in real GDP and ________ in the aggregate price level in the short run, everything else held constant.

A) an increase; an increase

B) a decrease; a decrease

C) no change; an increase

D) no change; a decrease

Answer: A
Ques Status: New

11) Suppose the economy is producing at the natural rate of output. An open market purchase of bonds by the Fed will cause ________ in real GDP and ________ in the aggregate price level in the long run, everything else held constant.

A) an increase; an increase

B) a decrease; a decrease

C) no change; an increase

D) no change; a decrease

Answer: C
Ques Status: New

12) Suppose the economy is producing at the natural rate of output. An open market sale of bonds by the Fed will cause ________ in real GDP and ________ in the aggregate price level in the short run, everything else held constant.

A) an increase; an increase

B) a decrease; a decrease

C) no change; an increase

D) no change; a decrease

Answer: B
Ques Status: New

13) Suppose the economy is producing at the natural rate of output. An open market sale of bonds by the Fed will cause ________ in real GDP and ________ in the aggregate price level in the long run, everything else held constant.

A) an increase; an increase

B) a decrease; a decrease

C) no change; an increase

D) no change; a decrease

Answer: D
Ques Status: New

14) Suppose the U.S. economy is producing at the natural rate of output. A depreciation of the U.S. dollar will cause ________ in real GDP and ________ in the aggregate price level in the short run, everything else held constant. (Assume the depreciation causes no effects in the supply side of the economy.)

A) an increase; an increase

B) a decrease; a decrease

C) no change; an increase

D) no change; a decrease

Answer: A
Ques Status: New

15) Suppose the U.S. economy is producing at the natural rate of output. A depreciation of the U.S. dollar will cause ________ in real GDP and ________ in the aggregate price level in the long run, everything else held constant. (Assume the depreciation causes no effects in the supply side of the economy.)

A) an increase; an increase

B) a decrease; a decrease

C) no change; an increase

D) no change; a decrease

Answer: C
Ques Status: New

16) Suppose the U.S. economy is producing at the natural rate of output. An appreciation of the U.S. dollar will cause ________ in real GDP and ________ in the aggregate price level in the short run, everything else held constant. (Assume the appreciation causes no effects in the supply side of the economy.)

A) an increase; an increase

B) a decrease; a decrease

C) no change; an increase

D) no change; a decrease

Answer: B
Ques Status: New

17) Suppose the U.S. economy is producing at the natural rate of output. An appreciation of the U.S. dollar will cause ________ in real GDP and ________ in the aggregate price level in the long run, everything else held constant. (Assume the appreciation causes no effects in the supply side of the economy.)

A) an increase; an increase

B) a decrease; a decrease

C) no change; an increase

D) no change; a decrease

Answer: D
Ques Status: New

18) Suppose the economy is producing below the natural rate of output and the government is suffering from large budget deficits. To deal with the deficit problem, suppose the government takes a policy action to reduce the size of the deficits. This policy action will cause ________ in the unemployment rate and ________ in the aggregate price level in the short run, everything else held constant.

A) an increase; an increase

B) a decrease; a decrease

C) a decrease; an increase

D) an increase; a decrease

Answer: D
Ques Status: New

19) Suppose the economy is producing at the natural rate of output and the government passes legislation that severely restricts a company's ability to reduce production costs via outsourcing. Everything else held constant, this policy action will cause ________ in the unemployment rate and ________ in the aggregate price level in the short run.

A) an increase; an increase

B) a decrease; a decrease

C) a decrease; an increase

D) no change; no change

Answer: A
Ques Status: New

20) Suppose the U.S. economy is operating at potential output. A negative supply shock that is accommodated by an open market purchase by the Federal Reserve will cause ________ in real GDP and ________ in the aggregate price level in the long run, everything else held constant.

A) no change; an increase

B) no change; a decrease

C) an increase; an increase

D) a decrease; a decrease

Answer: A
Ques Status: Revised

21) A theory of aggregate economic fluctuations called real business cycle theory holds that

A) changes in the real money supply are the only demand shocks that affect the natural rate of output.

B) aggregate demand shocks do affect the natural rate of output.

C) aggregate supply shocks do affect the natural rate of output.

D) changes in net exports are the only demand shocks that affect the natural rate of output.

Answer: C
Ques Status: Previous Edition

22) This theory views shocks to tastes (workers' willingness to work, for example) and technology (productivity) as the major driving forces behind short–run fluctuations in the business cycle because these shocks lead to substantial short–run fluctuations in the natural rate of output.

A) The natural rate hypothesis

B) Hysteresis

C) Real business cycle theory

D) The Phillips curve model

Answer: C
Ques Status: Previous Edition

23) Because shifts in aggregate demand are not viewed as being particularly important to aggregate output fluctuations, they do not see much need for activist policy to eliminate high unemployment. "They" refers to proponents of

A) the natural rate hypothesis.

B) monetarism.

C) the Phillips curve model.

D) real business cycle theory.

Answer: D
Ques Status: Previous Edition

24) A group of economists believe that the natural rate of output is affected by aggregate ________ shocks. They contend that the natural rate level of unemployment and output are subject to ________, a departure from full employment levels as a result of past high unemployment.

A) supply; hysterisis

B) supply; systerisis

C) demand; hysterisis

D) demand; systerisis

Answer: C
Ques Status: Previous Edition

25) A reduction of aggregate demand may raise the natural rate of unemployment above the full employment level, meaning that the self–correcting mechanism will only be able to return the economy to the natural rate level of output and unemployment—not to the full employment levels. Such a view is consistent with

A) monetarism.

B) hysterisis.

C) Keynesianism.

D) real business cycle theory.

Answer: B
Ques Status: Previous Edition

26) According to aggregate demand and supply analysis, America's involvement in the Vietnam War had the effect of

A) increasing aggregate output, lowering unemployment, and raising the price level.

B) decreasing aggregate output, lowering unemployment, and lowering the price level.

C) increasing aggregate output, raising unemployment, and raising the price level.

D) decreasing aggregate output, raising unemployment, and lowering the price level.

Answer: A
Ques Status: Revised

27) According to aggregate demand and supply analysis, the negative supply shocks of 1973–1975 and 1978–1980 had the effect of

A) increasing aggregate output, lowering unemployment, and raising the price level.

B) decreasing aggregate output, raising unemployment, and raising the price level.

C) increasing aggregate output, raising unemployment, and raising the price level.

D) decreasing aggregate output, raising unemployment, and lowering the price level.

Answer: B
Ques Status: Revised

28) According to aggregate demand and supply analysis, the favorable supply shock of 1995–1999 had the effect of

A) increasing aggregate output, lowering unemployment, and raising inflation.

B) decreasing aggregate output, raising unemployment, and raising inflation.

C) increasing aggregate output, lowering unemployment, and lowering inflation.

D) decreasing aggregate output, raising unemployment, and lowering inflation.

Answer: C
Ques Status: Revised

29) According to aggregate demand and supply analysis, the negative demand shock of 2000–2004 had the effect of

A) increasing aggregate output, lowering unemployment, and raising inflation.

B) decreasing aggregate output, raising unemployment, and raising inflation.

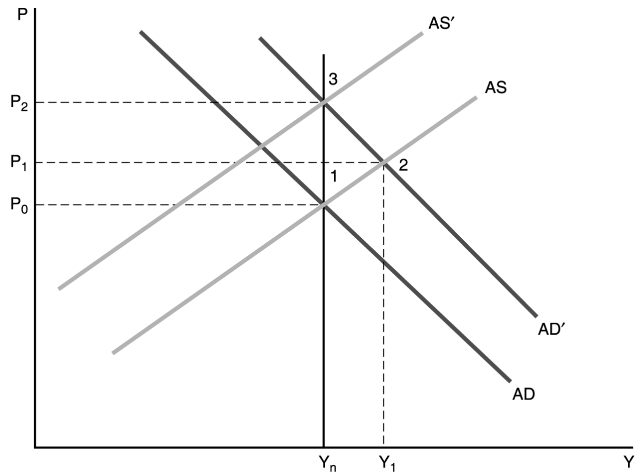
C) increasing aggregate output, lowering unemployment, and lowering inflation.

D) decreasing aggregate output, raising unemployment, and lowering inflation.

Answer: D
Ques Status: New

30) Using the aggregate demand–aggregate supply model, explain and demonstrate graphically the short–run and log–run effects of an increase in the money supply.

Answer: See figure below.

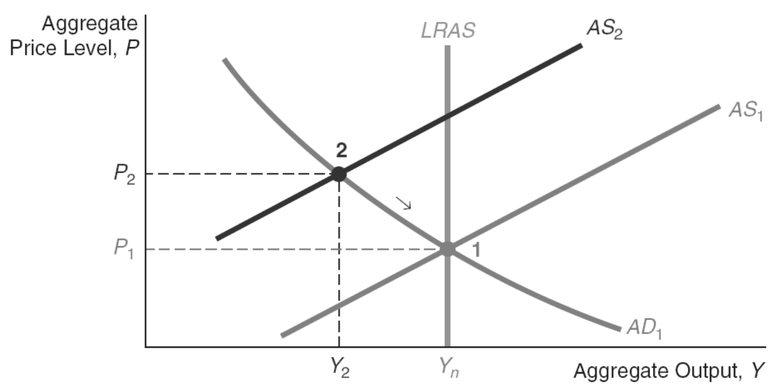


An increase in the money supply increases aggregate demand, from AD_1 to AD_2. The economy moves from point 1 to point 1'. In the short run both the price level and real output increase. In the long run, wages adjust, decreasing short–run aggregate supply, to AS_2, raising prices further and reducing real output until the economy returns to the natural level of output. The long–run result is to only increase the price level. The path is from 1 to 1' to 2.

Ques Status: Revised

31) Explain and demonstrate graphically the effects of a negative supply shock in both the short–run and long–run.

Answer: See figure below.



The supply shock decreases short–run aggregate supply from AS_1 to AS_2, reducing real output and raising the price level, or from points 1 to 2 in the graph. In the long run, the supply curve eventually adjusts back to the original position as wages fall. The economy adjusts from 2 back to 1.

Ques Status: Revised

23.4 Web Appendix: Aggregate Supply and the Phillips Curve

1) The Phillips curve indicates that when the labor market is ________, production costs will ________ and aggregate supply increases.

A) easy; rise

B) easy; fall

C) tight; fall

D) tight; rise

Answer: B
Ques Status: Revised

2) The Phillips curve indicates that when the labor market is ________, production costs will ________ and aggregate supply decreases.

A) easy; rise

B) easy; fall

C) tight; fall

D) tight; rise

Answer: D
Ques Status: Revised

3) The expectations–augmented Phillips curve implies that as expected inflation increases, nominal wages ________ to prevent real wages from ________.

A) fall; rising

B) fall; falling

C) rise; falling

D) rise; rising

Answer: C
Ques Status: Previous Edition

4) The Lucas supply function indicates that deviations of unemployment from the natural rate level respond to

A) any increase in aggregate demand.

B) unanticipated inflation.

C) a supply shock.

D) expected changes in inflation.

Answer: B
Ques Status: Revised

Chapter 24

Transmission Mechanisms of Monetary Policy: The Evidence

24.1 Framework for Evaluating Empirical Evidence

1) Evidence that examines whether one variable has an effect on another by simply looking directly at the relationship between the two variables is

A) reduced–form evidence.

B) organizational–model evidence.

C) direct–model evidence.

D) structural–model evidence.

Answer: A
Ques Status: Previous Edition

2) Evidence that is based on a variable having its effect on another variable through channels rather than a direct effect is known as

A) indirect–model evidence.

B) organizational–model evidence.

C) reduced–form evidence.

D) structural–model evidence.

Answer: D
Ques Status: Previous Edition

3) On the evening news you hear of a scientific study that directly links premature births to cigarette smoking. This is an example of

A) direct–model evidence.

B) informed voter–model evidence.

C) structural–model evidence.

D) reduced–form evidence.

Answer: D
Ques Status: Previous Edition

4) The monetarist–Keynesian debate on the importance of monetary policy is unresolved because monetarists and Keynesians focus on two different types of evidence that generate conflicting conclusions. Monetarists tend to focus on

A) structural–model evidence, while Keynesians focus on reduced–form evidence.

B) reduced–form evidence, while Keynesians focus on structural–model evidence.

C) reduced–form evidence, while Keynesians focus on direct–model evidence.

D) structural–model evidence, while Keynesians focus on direct–model evidence.

Answer: B
Ques Status: Previous Edition

5) The channels through which monetary policy affects economic activity are called the ________ of monetary policy.

A) transmission mechanisms

B) flow mechanisms

C) distribution mechanisms

D) allocational mechanisms

Answer: A
Ques Status: Revised

6) A model that is composed of many equations that show the channels through which monetary and fiscal policy affect aggregate output and spending is called a

A) reduced–form model.

B) median–voter model.

C) informed median–voter model.

D) structural model.

Answer: D
Ques Status: Previous Edition

7) Monetarists directly study the link between money and economic activity using

A) structural models.

B) reduced–form models.

C) scientific models.

D) experimental models.

Answer: B
Ques Status: Revised

8) The monetarist reduced–form evidence does not specify the working of the economy and thus is considered to be a

A) scientific model.

B) open model.

C) black box.

D) black hole.

Answer: C
Ques Status: Revised

9) Which of the following is not an advantage of a correctly specified structural model?

A) Structural models may help us to more accurately predict the effect that monetary policy has on economic activity.

B) A structural model provides more pieces of evidence about monetary policy's effect on economic activity.

C) Structural models may allow economists to more accurately predict the impact institutional changes have on the link between monetary policy and income.

D) A structural model imposes no restrictions on the way monetary policy affects the economy.

Answer: D
Ques Status: Revised

10) Predicting the impact of institutional change on the effectiveness of monetary policy is best done with a

A) structural model.

B) reduced–form model.

C) black–box model.

D) scientific model.

Answer: A
Ques Status: Revised

11) The monetarists complained that early Keynesian structural models tended to ignore the impact of monetary policy changes on

A) interest rates.

B) investment spending.

C) consumption spending.

D) capital goods spending.

Answer: C
Ques Status: Previous Edition

12) Monetarists contend that the channels of monetary influence in Keynesian structural models are too ________ defined, ________ the importance of monetary policy.

A) broadly; exaggerating

B) broadly; understating

C) narrowly; understating

D) narrowly; exaggerating

Answer: C
Ques Status: Previous Edition

13) Monetarists claim that ________ models ignore important transmission mechanisms and therefore ________ the importance of the effects of monetary policy on the economy.

A) structural; overstate

B) reduced–form; overstate

C) reduced–form; understate

D) structural; understate

Answer: D
Ques Status: Revised

14) Monetarists assert that monetary policy may affect aggregate demand through

A) only an interest rate channel.

B) only an exchange rate channel.

C) only two channels: interest rates and exchange rates.

D) many channels.

Answer: D
Ques Status: Previous Edition

15) If the particular channels through which changes in the money supply affect aggregate income are diverse and continually changing, the best evidence of monetary policy's effect is likely to come from

A) reduced–form models.

B) structural models.

C) median–voter models.

D) indirect models.

Answer: A
Ques Status: Previous Edition

16) Monetarists' preference for reduced–form models is based on their belief that

A) reverse causation is a problem.

B) structural models may understate money's effect on economic activity.

C) money supply changes are always endogenous.

D) monetary policy affects only investment spending.

Answer: B
Ques Status: Revised

17) When Keynesians argue that "correlation does not necessarily imply causation," they are probably criticizing

A) structural–model evidence.

B) reduced–form evidence.

C) indirect–model evidence.

D) black–box evidence.

Answer: B
Ques Status: Revised

18) Reverse causation between money and aggregate output is likely to be a problem when a central bank targets

A) a monetary aggregate.

B) an interest rate.

C) the exchange rate.

D) the inflation rate.

Answer: B
Ques Status: Revised

19) With regard to aggregate demand, early Keynesians tended to believe that

A) monetary policy mattered most.

B) monetary policy was all that mattered.

C) monetary policy mattered.

D) monetary policy did not matter.

Answer: D
Ques Status: Previous Edition

20) The ________ held the view that monetary policy does not matter at all for movements in aggregate output.

A) new Keynesian economists

B) early Keynesians

C) early monetarists

D) early classical economists

Answer: B
Ques Status: Previous Edition

21) Early Keynesians felt that ________ policy was ________, so they stressed the importance of ________ policy.

A) fiscal; ineffective; monetary

B) monetary; ineffective; fiscal

C) monetary; potent; monetary

D) fiscal; too potent; monetary

Answer: B
Ques Status: Revised

22) Early Keynesians believed that ________ interest rates during the Great Depression indicated that monetary policy had been ________.

A) high; contractionary

B) high; expansionary

C) low; contractionary

D) low; expansionary

Answer: D
Ques Status: Previous Edition

23) Early Keynesians viewed monetary policy as influencing aggregate demand solely through its impact on ________ interest rates, which, in turn, affect ________ spending.

A) nominal; consumer

B) nominal; investment

C) real; consumer

D) real; investment

Answer: B
Ques Status: Previous Edition

24) Early Keynesians believed that ________ interest rates during the Great Depression indicated that monetary policy was ________.

A) high; easy

B) high; tight

C) low; easy

D) low; tight

Answer: C
Ques Status: Previous Edition

25) Early Keynesians believed that low ________ during the Great Depression indicated that ________ policy was easy.

A) money growth; fiscal

B) money growth; monetary

C) interest rates; fiscal

D) interest rates; monetary

Answer: D
Ques Status: Previous Edition

26) Early Keynesians concluded that changes in monetary policy had no impact on aggregate output because early empirical studies found no linkage between movements in ________ and ________.

A) nominal interest rates; investment spending

B) real interest rates; investment spending

C) money supply; aggregate output

D) investment spending; aggregate output

Answer: A
Ques Status: Previous Edition

27) In response to the early Keynesians, monetarists contended that

A) monetary policy during the Great Depression was not easy.

B) bank failures during the Great Depression were not the cause of the decline in the money supply.

C) evidence from the Great Depression demonstrated the ineffectiveness of monetary policy.

D) there is a weak link between interest rates and investment spending.

Answer: A
Ques Status: Revised

28) Milton Friedman and Anna Schwartz showed that monetary policy during the Great Depression had

A) been quite inflationary.

B) never been more contractionary.

C) been more expansionary than in the 1920s.

D) been essentially neutral.

Answer: B
Ques Status: Previous Edition

29) By the standard of low-grade bonds, interest rates were ________ and monetary policy was ________ during the Great Depression.

A) low; tight

B) low; easy

C) high; tight

D) high; easy

Answer: C
Ques Status: Revised

30) During the Great Depression, real interest rates

A) rose to unprecedentedly high levels.

B) rose only slightly above the long-run trend.

C) fell to unprecedentedly low levels.

D) fell only slightly below the long-run trend.

Answer: A
Ques Status: Previous Edition

31) Movements of ________ interest rates indicate that, contrary to the early Keynesians' beliefs, monetary policy was ________ during the Great Depression.

A) nominal; tight

B) nominal; easy

C) real; tight

D) real; easy

Answer: C
Ques Status: Previous Edition

32) Movements of real interest rates indicate that, contrary to the early Keynesians' beliefs, ________ policy was ________ during the Great Depression.

A) fiscal; tight

B) fiscal; easy

C) monetary; tight

D) monetary; easy

Answer: C
Ques Status: Previous Edition

33) Periods of price deflation, such as the Great Depression, are characterized by

A) low nominal rates but high real rates of interest.

B) low nominal and real interest rates.

C) real rates of interest lower than the nominal rate of interest.

D) high nominal and real rates of interest.

Answer: A
Ques Status: Revised

34) Monetarists contend that

A) monetary policy affects aggregate demand solely through investment.

B) monetary policy may affect aggregate demand through many channels.

C) a weak link between nominal interest rates and investment spending implies monetary policy ineffectiveness.

D) monetary policy affects aggregate demand solely through consumption.

Answer: B
Ques Status: Previous Edition

35) In the early 1960s, monetarists used reduced–form timing, statistical, and historical evidence to show that

A) fiscal policy had a strong impact on economic activity.

B) monetary policy had a strong impact on economic activity.

C) monetary policy had a weak impact on economic activity.

D) neither monetary nor fiscal policy had a strong impact on economic activity.

Answer: B
Ques Status: Revised

36) In a study published in 1963, Milton Friedman and Anna Schwartz found that in every business cycle they studied over nearly a hundred–year period, the growth rate of the ________ decreased before ________ decreased.

A) money supply; interest rates

B) money supply; output

C) budget deficit; interest rates

D) budget deficit; output

Answer: B
Ques Status: Previous Edition

37) Friedman and Schwartz found that the rate of money growth fell prior to business cycle downturns in

A) about three out of every four instances.

B) four out of every five instances.

C) about two out of every three instances.

D) every instance studied.

Answer: D
Ques Status: Previous Edition

38) In a study published in 1963, Milton Friedman and Anna Schwartz found that in every business cycle they studied over nearly a hundred–year period,

A) the growth rate of the money supply decreased before output decreased.

B) interest rates decreased before output decreased.

C) the growth rate of federal government spending decreased before output decreased.

D) the growth rate of state and local government spending decreased before output decreased.

Answer: A
Ques Status: Previous Edition

39) Timing evidence is valid only if it is known that the first event is

A) endogenous.

B) exogenous.

C) a leading indicator of the second event.

D) a lagging indicator of the second event.

Answer: B
Ques Status: Revised

40) Because ________ evidence is of a ________ nature, there is always the possibility of reverse causation, in which output growth causes money growth.

A) historical; structural

B) statistical; structural

C) timing; structural

D) timing; reduced–form

Answer: D
Ques Status: Previous Edition

41) If the movements of the level of the money supply and real output are perfectly coordinated the growth rate of money

A) will lead the level of real output.

B) will move in synchronization with the level of real output.

C) will lag the level of real output.

D) can either lead or lag the level of real output.

Answer: A
Ques Status: Revised

42) The monetarist statistical evidence examines the correlations between both ________ and ________ with ________.

A) money; aggregate spending; the unemployment rate

B) money; autonomous expenditures; the unemployment rate

C) money; consumption spending; aggregate spending

D) money; autonomous expenditures; aggregate spending

Answer: D
Ques Status: Revised

43) A criticism of the monetarist autonomous spending variable is that

A) some types of autonomous spending do not affect aggregate demand.

B) some types of autonomous spending affect aggregate demand before the spending occurs. Some types of autonomous spending affect aggregate demand when they occur.

C) some types of autonomous spending affect aggregate demand only long after they occur.

D) Keynesians do not think that autonomous spending affects aggregate demand.

Answer: B
Ques Status: New

44) One of the best examples of an episode in which a change in monetary policy appears to have been an exogenous event is

A) the increase in reserve requirements in 1936–1937.

B) the decrease in reserve requirements in 1936–1937.

C) the decrease in reserve requirements in 1818–1819.

D) the increase in reserve requirements in 1818–1819.

Answer: A
Ques Status: Revised

45) The monetarist position on the importance of monetary policy is probably best supported by

A) timing evidence.

B) statistical evidence.

C) historical evidence.

D) structural evidence.

Answer: C
Ques Status: Previous Edition

46) The monetarist _________ evidence in which declines in money growth are followed by recessions provides the strongest support for their position that monetary policy matters.

A) statistical

B) historical

C) timing

D) structural

Answer: B
Ques Status: Revised

47) As a result of recent empirical research, there has been a convergence of Keynesian and monetarist opinion to the view that

A) money is all that matters.

B) money does matter.

C) money does not matter.

D) fiscal policy is all that matters.

Answer: B
Ques Status: Previous Edition

48) Real business cycle theorists are critical of monetarist reduced–form evidence because they believe

A) money is the most important cause of changes in aggregate demand.

B) there is reverse causation from the business cycle to money.

C) there is reverse causation from money to the business cycle.

D) business cycles do not exist.

Answer: B
Ques Status: Revised

49) Real business cycle theory states that the most important cause of business cycles is

A) shocks to the money supply.

B) interest rate shocks.

C) Federal Reserve policy decisions.

D) shocks to tastes and technology.

Answer: D
Ques Status: Revised

24.2 Transmission Mechanisms of Monetary Policy

1) Economic theory suggests that ________ interest rates are ____ important than ________ interest rates in explaining investment behavior.

A) nominal; more; real

B) real; less; nominal

C) real; more; nominal

D) market; more; real

Answer: C
Ques Status: Revised

2) According to the traditional interest–rate channel, expansionary monetary policy lowers the real interest rate, thereby raising expenditure on

A) business fixed investment.

B) government expenditure.

C) consumer nondurables.

D) net exports

Answer: A
Ques Status: Revised

3) The monetary transmission mechanism that links monetary policy to GDP through real interest rates and investment spending is called the

A) traditional interest-rate channel.

B) Tobins' q theory.

C) wealth effects.

D) cash flow channel.

Answer: A
Ques Status: New

4) If the aggregate price level adjusts slowly over time, then an expansionary monetary policy lowers

A) only the short-term nominal interest rate.

B) only the short-term real interest rate.

C) both the short-term nominal and real interest rates.

D) the short-term nominal, the short-term real, and the long-term real interest rates.

Answer: D
Ques Status: Previous Edition

5) If monetary policy can influence __________ prices and conditions in _________ markets, then it can affect spending through channels other than the traditional interest-rate channel.

A) asset; labor

B) asset; credit

C) commodity; labor

D) commodity; credit

Answer: B
Ques Status: Previous Edition

6) An expansionary monetary policy lowers the real interest rate, causing the domestic currency to _________, thereby _________ net exports.

A) appreciate; raising

B) appreciate; lowering

C) depreciate; raising

D) depreciate; lowering

Answer: C
Ques Status: Previous Edition

7) An expansionary monetary policy increases net exports by

A) lowering nominal interest rates and decreasing the value of the dollar.

B) lowering real interest rates and decreasing the value of the dollar.

C) raising nominal interest rates and increasing the value of the dollar.

D) raising real interest rates and increasing the value of the dollar.

Answer: B
Ques Status: Revised

8) A contractionary monetary policy raises the real interest rate, causing the domestic currency to _________, thereby _________ net exports.

A) appreciate; raising

B) appreciate; lowering

C) depreciate; raising

D) depreciate; lowering

Answer: B
Ques Status: Previous Edition

9) A contractionary monetary policy decreases net exports by

A) lowering real interest rates and decreasing the value of the dollar.

B) lowering real interest rates and increasing the value of the dollar.

C) raising nominal interest rates and increasing the value of the dollar.

D) raising real interest rates and increasing the value of the dollar.

Answer: D
Ques Status: Revised

10) Tobin's q is defined as

A) market value of firms times replacement cost of capital.

B) market value of firms minus replacement cost of capital.

C) market value of firms plus replacement cost of capital.

D) market value of firms divided by replacement cost of capital.

Answer: D
Ques Status: Previous Edition

11) Tobin's q is defined as

A) the market value of firms divided by the replacement cost of capital.

B) the market value of firms less the replacement cost of capital.

C) the replacement cost of capital divided by the new cost of capital.

D) the replacement cost of capital divided by the market value of firms.

Answer: A
Ques Status: Previous Edition

12) Tobin's q theory suggests that monetary policy may affect investment spending through its impact on

A) stock prices.

B) interest rates.

C) bond prices.

D) cash flow.

Answer: A
Ques Status: Revised

13) In the late 1990s, the stock market bubble ________ the value of Tobin's q, and caused ________ in business equipment.

A) increased; underinvestment

B) increased; overinvestment

C) decreased; underinvestment

D) decreased; overinvestment

Answer: B
Ques Status: Revised

14) The deflation of the stock market bubble of the late 1990s likely resulted in

A) a collapse of business investment spending.

B) a collapse of federal government spending.

C) a collapse of housing investment.

D) a surge in net exports.

Answer: A
Ques Status: Revised

15) During the Great Depression, Tobin's q

A) rose dramatically, as did real interest rates.

B) fell to unprecedentedly low levels.

C) stayed fairly constant, in contrast to most other economic measures.

D) rose only slightly, in spite of Hoover's attempts to prop it up.

Answer: B
Ques Status: Previous Edition

16) According to Tobin's q theory, ________ policy can affect ________ spending through its effect on the prices of common stock.

A) fiscal; consumption

B) fiscal; investment

C) monetary; consumption

D) monetary; investment

Answer: D
Ques Status: Previous Edition

17) According to Tobin's q theory, when q is ________, firms will not purchase new investment goods because the market value of firms is ________ relative to the cost of capital.

A) low; low

B) low; high

C) high; low

D) high; high

Answer: A
Ques Status: Previous Edition

18) According to Tobin's q theory, if q is ________, new plant and equipment capital is ________ relative to the market value of business firms, so companies can buy a lot of new investment goods with only a ________ issue of stock.

A) high; dear; large

B) high; cheap; large

C) high; cheap; small

D) low; cheap; large

E) low; cheap; small

Answer: C
Ques Status: Previous Edition

19) According to Tobin's q theory, when equity prices are low the market price of existing capital is ________ relative to new capital, so expenditure on fixed investment is ________.

A) cheap; low

B) dear ; low

C) cheap; high

D) dear; high

Answer: A
Ques Status: Revised

20) According to Tobin's q theory, when equity prices are high the market price of existing capital is ________ relative to new capital, so expenditure on fixed investment is ________.

A) cheap; low

B) dear ; low

C) cheap; high

D) dear; high

Answer: D
Ques Status: Revised

21) Franco Modigliani has found that an expansionary monetary policy can cause stock market prices to ________ and consumption to ________.

A) increase; increase

B) increase; decrease

C) decrease; decrease

D) decrease; increase

Answer: A
Ques Status: Previous Edition

22) The sharp drop in housing purchases in 1966 and 1969, when market interest rates rose above Regulation Q ceilings, is consistent with the

A) bank lending channel.

B) traditional interest-rate channel.

C) cash flow channel.

D) balance sheet channel.

Answer: A
Ques Status: Revised

23) A rise in stock prices ________ the net worth of firms and so leads to ________ investment spending because of the reduction in moral hazard.

A) raises; higher

B) raises; lower

C) reduces; higher

D) reduces; lower

Answer: A
Ques Status: Previous Edition

24) Because of the presence of asymmetric information problems in credit markets, an expansionary monetary policy causes a ________ in net worth, which ________ the adverse selection problem, thereby _________ increased lending to finance investment spending.

A) decline; increases; encouraging

B) rise; increases; discouraging

C) rise; reduces; encouraging

D) decline; reduces; discouraging

Answer: C
Ques Status: Revised

25) Due to asymmetric information in credit markets, monetary policy may affect economic activity through the balance sheet channel, where an increase in the money supply

A) raises stock prices, lowering the cost of new capital relative to firms' market value, thus increasing investment spending.

B) raises firms' net worth, decreasing adverse selection and moral hazard problems, thus increasing banks' willingness to lend to finance investment spending.

C) raises the level of bank reserves, deposits, and bank loans, thereby raising spending by those individuals who do not have access to credit markets.

D) lowers the value of the dollar, increasing net exports and aggregate demand.

Answer: B
Ques Status: Revised

26) An expansionary monetary policy raises firms' cash flows by

A) lowering real interest rates.

B) lowering nominal interest rates.

C) raising real interest rates.

D) raising nominal interest rates.

Answer: B
Ques Status: Revised

27) If a contractionary monetary policy lowers the price level by more than expected, it raises the real value of consumer debt. This reduces consumer expenditure through

A) the bank lending channel.

B) Tobin's q.

C) the traditional interest–rate channel.

D) the household liquidity effect.

Answer: D
Ques Status: Revised

28) An expansionary monetary policy may cause asset prices to rise, thereby reducing the likelihood of financial distress and causing consumer durable and housing expenditures to rise. This monetary transmission mechanism is referred to as

A) the household liquidity effect.

B) the wealth effect.

C) Tobin's q theory.

D) the cash flow effect.

Answer: A
Ques Status: Previous Edition

29) According to the household liquidity effect, an expansionary monetary policy causes a __________ in the value of households' financial assets, causing consumer durable expenditure to _________.

A) decline; rise

B) rise; rise

C) rise; fall

D) decline; fall

Answer: B
Ques Status: Previous Edition

30) According to the household liquidity effect, higher stock prices lead to increased consumption expenditures because consumers

A) feel more secure about their financial position.

B) want to sell stocks and spend the proceeds before stock prices fall.

C) believe that their wages will increase due to increased profitability of firms.

D) can now afford more expensive imports.

Answer: A
Ques Status: Revised

31) Corporate scandals involving Enron and Arthur Andersen reduced investment and aggregate spending because these scandals

A) forced the Fed to raise interest rates.

B) caused appreciation of the dollar.

C) worsened adverse selection and moral hazard.

D) caused bank failures.

Answer: C
Ques Status: Revised

32) In a period of deflation, when there is a declining price level, ________ nominal interest rates do not necessarily indicate that the cost of borrowing is ____ or that monetary policy is easy.

A) low; low

B) low; high

C) high; low

D) high; high

Answer: A
Ques Status: Previous Edition

33) In a period of deflation, when there is a declining price level, low nominal interest rates do not necessarily indicate that the cost of borrowing is ____ or that monetary policy is ________.

A) low; tight

B) low; easy

C) high; tight

D) high; easy

Answer: B
Ques Status: Previous Edition

34) Explain the traditional interest–rate channel for expansionary monetary policy. Explain how a tight monetary policy affects the economy through this channel.

Answer: In the traditional channel, a monetary expansion reduces real interest rates, lowering the cost of capital and increasing investment spending. The increase in investment increases aggregate demand. A monetary contraction has the opposite effect, raising real interest rates, lowering investment and aggregate spending.
Ques Status: Previous Edition

35) Explain how expansionary and contractionary monetary policies affect aggregate demand through the exchange rate channel.

Answer: An expansionary monetary policy reduces real interest rates, causing depreciation of the domestic currency. This depreciation increases net exports and aggregate spending. A monetary contraction increases real interest rates, causing appreciation of the domestic currency, reducing net exports and aggregate spending.
Ques Status: Previous Edition

36) Discuss three channels by which monetary policy affects stock prices and aggregate spending.

Answer: The answer should include three of the following:
In Tobin's q theory, a monetary expansion increases stock prices, increasing the value of the firm relative to the cost of new capital. This stimulates investment in new capital goods, which in turn increases aggregate spending.
A monetary expansion increases stock prices, increasing wealth and stimulating consumption and aggregate spending.
Expansionary monetary policy increases equity prices. This improves firms' balance sheets, reducing adverse selection and moral hazard and increasing lending for investment, which increases aggregate spending.
In the household liquidity effect, the increase in equity prices due to a monetary expansion improves consumer balance sheets, reducing the probability of financial distress, and increasing consumer spending on durable goods and housing.
Ques Status: Previous Edition

24.3 Lessons for Monetary Policy

1) Analysis of the transmission mechanisms of monetary policy provides four basic lessons for a central bank's conduct of monetary policy. These lessons include:

A) Rising interest rates indicate a tightening of monetary policy, whereas falling interest rates indicate an easing of monetary policy.

B) Monetary policy can be highly effective in reviving a weak economy even if short-term interest rates are already near zero.

C) Avoiding fluctuations in the level of unemployment is an important objective of monetary policy, thus providing a rationale for interest-rate stability as the primary long-run goal for monetary policy.

D) Other asset prices beside those on short-term debt instruments do not contain important information about the stance of monetary policy because they are not important elements in various monetary policy transmission mechanisms.

Answer: B
Ques Status: Revised

2) Analysis of the transmission mechanisms of monetary policy provides four basic lessons for a central bank's conduct of monetary policy. Which of the following is not one of these lessons?

A) Rising interest rates indicate a tightening of monetary policy, whereas falling interest rates indicate an easing of monetary policy.

B) Monetary policy can be highly effective in reviving a weak economy even if short-term interest rates are already near zero.

C) Avoiding unanticipated fluctuations in the price level is an important objective of monetary policy, thus providing a rationale for price stability as the primary long-run goal for monetary policy.

D) Other asset prices beside those on short-term debt instruments do not contain important information about the stance of monetary policy because they are important elements in various monetary policy transmission mechanisms.

Answer: A
Ques Status: Revised

3) In the late 1990s and early 2000s, the Japanese economy has experienced

A) easy monetary policy as indicated by falling nominal interest rates.

B) easy monetary policy as indicated by short-term interest rates near zero.

C) tight monetary policy as indicated by falling asset prices.

D) tight monetary policy as indicated by short-term interest rates near zero.

Answer: C
Ques Status: Revised

4) Recent Japanese experience has been characterized by tight monetary policy, as indicated by

A) falling interest rates.

B) short-term interest rates near zero.

C) falling asset prices.

D) low real interest rates.

Answer: C
Ques Status: Revised

Chapter 25

Money and Inflation

25.1 Money and Inflation: Evidence

1) The condition of a continually rising price level is defined as

A) stagflation.

B) stagnation.

C) disinflation.

D) inflation.

Answer: D
Ques Status: Previous Edition

2) The economist who proposed that, "Inflation is always and everywhere a monetary phenomenon" was

A) John Maynard Keynes.

B) John R. Hicks.

C) Milton Friedman.

D) Franco Modigliani.

Answer: C
Ques Status: Previous Edition

3) Complete Milton Friedman's famous proposition: "Inflation is always and everywhere a ________ phenomenon."

A) monetary

B) political

C) policy

D) budgetary

Answer: A
Ques Status: Previous Edition

4) At first cut, the simple solution to fighting inflation is

A) reducing the growth rate of the money supply.

B) limiting the number of terms that politicians can serve in elective office.

C) returning the economy to barter by prohibiting the use of fiat money.

D) to impose price controls on businesses that attempt to raise prices.

Answer: A
Ques Status: Previous Edition

5) "How do we prevent the inflationary fire from igniting again and stop the roller coaster ride in the inflation rate of the last 40 years?" Milton Friedman's famous proposition suggests the simple solution:

A) reduce the number of terms that politicians are allowed to serve.

B) reduce the growth rate of the money supply.

C) reduce the marginal tax rate on low-income wage earners.

D) increase the marginal tax rates on businesses that hike prices in excess of 5 percent per year.

Answer: B
Ques Status: Revised

6) Milton Friedman's proposition concerning the cause of inflation implies a simple solution to the inflation problem:

A) reduce government budget deficits.

B) limit the ability of fiscal policymakers to bring pressure to bear on the monetary authority.

C) limit the number of terms that politicians are allowed to serve.

D) reduce the growth rate of the money supply.

Answer: D
Ques Status: Previous Edition

7) Milton Friedman's proposition that inflation is always and everywhere a monetary phenomenon holds only if

A) government budget deficits do not rise continually.

B) the unemployment rate does not rise continually.

C) the price level rises continually.

D) the United States does not experience more than one negative supply shock per decade.

Answer: C
Ques Status: Previous Edition

8) Inflation occurs whenever

A) the price level rises.

B) the money supply increases.

C) the price level rises continuously over a period of time.

D) the price level falls continuously over a period of time.

Answer: C
Ques Status: Revised

9) Evidence strongly supports the view that countries with high inflation also have

A) the lowest nominal interest rates.

B) the highest rates of money growth.

C) the smallest budget deficits.

D) the lowest interest rates.

Answer: B
Ques Status: Previous Edition

10) Countries with the highest inflation rates are likely to have

A) the highest rates of money growth.

B) small budget deficits relative to GDP.

C) the lowest interest rates.

D) nonaccomodating monetary policy.

Answer: A
Ques Status: Revised

11) The proposition that inflation is the result of a high rate of money growth is

A) not supported by evidence from the German hyperinflation.

B) held only by sociologists and is no longer believed by economists.

C) supported by evidence from inflationary episodes throughout the world.

D) largely a political fabrication designed to make the Fed a scapegoat for poor fiscal policy.

Answer: C
Ques Status: Previous Edition

12) Which of the following would provide the strongest evidence that rapid money growth is the driving force behind inflation?

A) An endogenous increase in the money supply that preceded the onset of inflation.

B) An exogenous increase in the money supply that preceded the onset of inflation.

C) An endogenous increase in the money supply that lagged the onset of inflation.

D) An exogenous increase in the money supply that lagged the onset of inflation.

Answer: B
Ques Status: Revised

13) The German hyperinflation of the 1920s supports the proposition that excessive monetary growth causes inflation and not the other way around since the increase in monetary growth appears to have been

A) unintentional.

B) intentional.

C) endogenous.

D) exogenous.

Answer: D
Ques Status: Revised

14) The German hyperinflation of 1921–1923 provides important support for the view that high money growth results when

A) the government sets an employment target that is too high.

B) the government expands the money supply to finance its expenditures.

C) the government raises taxes to finance its expenditures.

D) the government sells bonds to the public.

Answer: B
Ques Status: Previous Edition

15) Evidence for Latin American countries over the ten–year period 1989–1999 indicates that

A) in every case in which a country's inflation rate is extremely high for any sustained period of time, its rate of money growth is extremely high.

B) a country can experience high inflation for a sustained period of time without an increase in its rate of money growth.

C) a country can experience a significant increase in its money supply for a sustained period of time without an increase in its rate of inflation.

D) there seems to be no relation between the rate of money growth and the inflation rate over this time period.

Answer: A
Ques Status: Revised

25.2 Meaning of Inflation

1) A one–time increase in the price level

A) is rarely reported by the news media as inflation, but is nevertheless considered to be inflation by economists.

B) is regularly reported by the news media as inflation, but is not considered to be inflation by economists.

C) is rarely reported by the news media as inflation because it is not considered to be inflation by economists.

D) is regularly reported by the news media as inflation because it is considered to be inflation by economists.

Answer: B
Ques Status: Previous Edition

2) When inflation is defined to be a condition of a continually rising price level, ________ economists agree with Milton Friedman's proposition that inflation is a monetary phenomenon.

A) no

B) very few

C) about half of practicing

D) almost all

Answer: D
Ques Status: Revised

25.3 Views of Inflation

1) According to aggregate demand and supply analysis, inflation is caused by

A) supply shocks.

B) expansionary fiscal policies.

C) expansionary monetary policies.

D) rising prices.

Answer: C
Ques Status: Revised

2) According to aggregate demand and supply analysis, a continually increasing money supply causes a ________ in aggregate demand, everything else held constant.

A) continual increase

B) continual decrease

C) one-time increase

D) one-time decrease

Answer: A
Ques Status: Revised

3) According to aggregate demand and supply analysis of inflation and with everything else held constant, a continually increasing money supply causes

A) aggregate demand to increase along a stationary aggregate supply curve, leading to continually increasing aggregate output and prices.

B) aggregate supply to decrease along a stationary aggregate demand curve, leading to continually contracting aggregate output and prices.

C) aggregate demand to increase continually as aggregate supply decreases continually, leading to higher and higher price levels.

D) aggregate demand to decrease continually as aggregate supply increases continually, leading to higher and higher price levels.

Answer: C
Ques Status: Revised

4) Aggregate demand and supply analysis conclude that continuously growing ________ will cause the price level to rise continually, thus generating an inflation.

A) money supply

B) government spending

C) interest rates

D) consumer expenditure

Answer: A
Ques Status: Revised

5) According to aggregate demand and supply analysis and with everything else held constant, a continuous increase in the money supply causes

A) the price level to increase, but has no lasting effect on the inflation rate.

B) the price level to fall.

C) inflation.

D) output to increase, but leaves the price level and inflation unchanged.

Answer: C
Ques Status: Revised

6) According to aggregate demand and supply analysis, an increase in government spending will cause aggregate demand to ________, causing output to ________ , everything else held constant.

A) increase; fall

B) increase; rise

C) decrease; fall

D) decrease; rise

Answer: B
Ques Status: Revised

7) Aggregate demand and supply analysis indicates that negative supply shocks

A) decrease the price level, but cannot decrease the inflation rate.

B) increase the price level, but cannot increase the inflation rate.

C) increase both the price level and the inflation rate.

D) decrease both the price level and the inflation rate.

Answer: B
Ques Status: Revised

8) Suppose that the economy is at the natural rate of output. In the absence of accommodating policy and everything else held constant, the net result of a negative supply shock is that

A) the economy returns to full employment at the initial price level.

B) the economy returns to full employment at a higher price level.

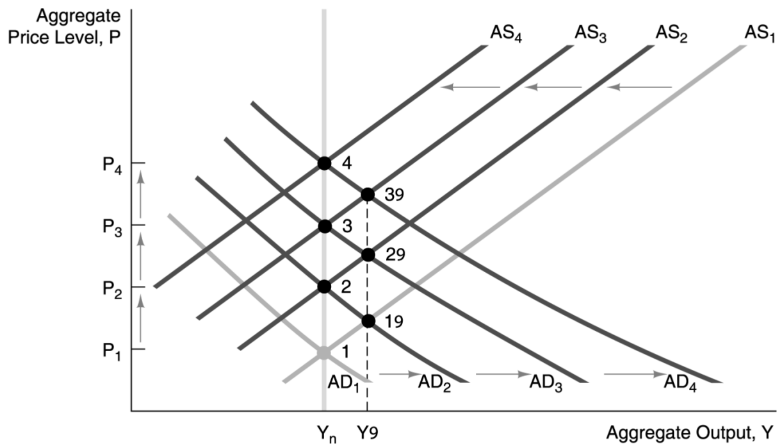
C) the economy returns to full employment at a lower price level.

D) aggregate output increases above the natural rate level, but only temporarily.

Answer: A
Ques Status: Revised

9) Explain and show graphically why continuous monetary growth is needed to generate inflation. Describe how the inflation process is generated.

Answer: See figure below.



Only continuous monetary growth can cause continuous increases in aggregate demand of the sort needed to generate inflation. Other factors can increase demand and the price level, but none can increase demand continuously. In the graph, the monetary expansion increases AD. The increase in output above the natural rate increases wages and decreases AS. Monetary expansion increases AD repeatedly, and wages continue to adjust upward.

Ques Status: Revised

10) Suppose that the economy is at the natural rate of output. Explain how a positive supply shock, followed by a more restrictive monetary policy, allows policymakers a painless way to reduce inflation.

Answer: The positive supply shock increases aggregate supply, exerting downward pressure on prices. Policymakers can now reduce demand to further reduce inflationary pressure without reducing output below the natural rate.

Ques Status: Revised

25.4 Origins of Inflationary Monetary Policy

1) To say that inflation is a monetary phenomenon seems to beg the question:

A) Why does inflationary monetary policy occur?

B) Why do politicians seek reelection?

C) Why is the Fed independent?

D) Why does the U.S. Treasury print so much money?

Answer: A

Ques Status: Previous Edition

2) The combination of a successful wage push by workers and the government's commitment to high employment leads to

A) demand–pull inflation.

B) supply–side inflation.

C) supply–shock inflation.

D) cost–push inflation.

Answer: D
Ques Status: Previous Edition

3) If the Fed responds by increasing the money supply in response to a successful wage push by workers, monetary policy is said to be

A) accomplishing.

B) nonaccommodating.

C) nonaccomplishing.

D) accommodating.

Answer: D
Ques Status: Previous Edition

4) If workers do not believe that policymakers are serious about fighting inflation, they are most likely to push for higher wages, which will ________ aggregate ________ and lead to unemployment or inflation or both, everything else held constant.

A) decrease; demand

B) increase; demand

C) decrease; supply

D) increase; supply

Answer: C
Ques Status: Revised

5) Workers will have greater incentives to push for higher wages when government policymakers place greater concern on ________ than ________ and are thus ________ likely to adopt accommodative policies.

A) inflation; unemployment; less

B) inflation; unemployment; more

C) unemployment; inflation; less

D) unemployment; inflation; more

Answer: D
Ques Status: Revised

6) In the absence of an accommodating monetary policy, a push by workers to get higher wages will cause

A) cost–push inflation.

B) demand–pull inflation.

C) higher unemployment.

D) a lower price level.

Answer: C
Ques Status: Revised

7) If workers believe that government policymakers will increase aggregate demand to avoid a politically unpopular increase in unemployment when workers demand higher wages, then workers will not fear higher unemployment and their wage demands will result in

A) demand–pull inflation.

B) hyperinflation.

C) deflation.

D) cost–push inflation.

Answer: D
Ques Status: Revised

8) If policymakers set a target for unemployment that is too low because it is less than the natural rate of unemployment, this can set the stage for a higher rate of money growth and

A) cost–push inflation.

B) demand–pull inflation.

C) cost–pull inflation.

D) demand–push inflation.

Answer: B
Ques Status: Previous Edition

9) Theoretically, one can distinguish a demand–pull inflation from a cost–push inflation by comparing

A) how fast prices rise relative to wages.

B) the unemployment rate with its natural rate level.

C) when prices rise relative to wages.

D) government debt to real GDP.

Answer: B
Ques Status: Revised

10) Demand–pull inflation can result when

A) policymakers set an unemployment target that is too high.

B) a persistent budget deficit is financed by selling bonds to the public.

C) a persistent budget deficit is financed by selling bonds to the central bank.

D) workers get numerous wage increases.

Answer: C
Ques Status: Revised

11) Which of the following is least likely to lead to inflationary monetary policy?

A) Rising unemployment

B) Expanding federal budget deficits

C) Declining oil prices

D) Conflict in the Middle East

Answer: C
Ques Status: Previous Edition

12) Which of the following is most likely to lead to inflationary monetary policy?

A) Declining oil prices

B) Resolution of conflict in the Middle East

C) The enactment of a free–trade agreement with Mexico

D) Rising unemployment

Answer: D
Ques Status: Previous Edition

13) Which of the following is most likely to lead to inflationary monetary policy?

A) Declining oil prices

B) Resolution of conflict in the Middle East

C) The enactment of a free–trade agreement with Mexico

D) Rising government budget deficits

Answer: D
Ques Status: Previous Edition

14) Methods of financing government spending are described by an expression called the government budget constraint, which states the following:

A) the government budget deficit must equal the sum of the change in the monetary base and the change in government bonds held by the public.

B) the government budget deficit must equal the difference between the change in the monetary base and the change in government bonds held by the public.

C) the government budget deficit must equal the difference between the change in the monetary base and the change in government bonds held by the Fed.

D) the government budget deficit must equal the difference between the change in the monetary base and the change in government bonds held by the Treasury.

Answer: A
Ques Status: Previous Edition

15) Methods of financing government spending are described by an expression called the government budget constraint, which states the following:

A) DEFICIT = (G – T) = ΔMB + ΔBONDS.

B) DEFICIT = (G – T) = ΔMB – ΔBONDS.

C) DEFICIT = (G – T) = ΔBONDS – ΔMB.

D) DEFICIT = (G – T) = ΔMB/ΔBONDS.

Answer: A
Ques Status: Previous Edition

16) If the government finances its spending by issuing debt to the public, the monetary base will ___________ and the money supply will ___________.

A) increase; increase

B) increase; decrease

C) decrease; increase

D) not change; not change

Answer: D
Ques Status: Revised

17) If the government finances its spending by selling bonds to the central bank, the monetary base will ___________ and the money supply will ___________.

A) increase; increase

B) increase; decrease

C) decrease; decrease

D) not change; not change

Answer: A
Ques Status: Previous Edition

18) Financing government spending with taxes

A) causes both reserves and the monetary base to rise.

B) causes both reserves and the monetary base to decline.

C) causes reserves to rise, but the monetary base to decline.

D) has no net effect on the monetary base.

Answer: D
Ques Status: Previous Edition

19) Financing government spending by selling bonds to the public, which pays for the bonds with currency,

A) leads to a permanent decline in the monetary base.

B) leads to a permanent increase in the monetary base.

C) leads to a temporary increase in the monetary base.

D) has no net effect on the monetary base.

Answer: D
Ques Status: Previous Edition

20) The financing of government spending by issuing debt

A) causes both reserves and the monetary base to rise.

B) causes both reserves and the monetary base to decline.

C) causes reserves to rise, but the monetary base to decline.

D) has no net effect on the monetary base.

Answer: D
Ques Status: Previous Edition

21) The finance of government spending through a Treasury sale of bonds which are then purchased by the Fed

A) causes both reserves and the monetary base to rise.

B) causes both reserves and the monetary base to decline.

C) causes reserves to rise, but the monetary base to decline.

D) has no net effect on the monetary base.

Answer: A
Ques Status: Previous Edition

22) This method of financing government spending is frequently called printing money because high–powered money (the monetary base) is created in the process.

A) Financing government spending with taxes.

B) The finance of government spending through a Treasury sale of bonds that are then purchased by the Fed.

C) Financing government spending by selling bonds to the public, which pays for the bonds with currency.

D) Financing government spending by selling bonds to the public, which pays for the bonds with checks.

Answer: B
Ques Status: Revised

23) Only when budget deficits are financed by money creation does the increased government spending lead to ________ in the ________.

A) a decrease; monetary base

B) an increase; monetary base

C) a decrease; money multiplier

D) an increase; money multiplier

Answer: B
Ques Status: Revised

24) If the deficit is financed by selling bonds to the ________, the money supply will ________, increasing aggregate demand, and leading to a rise in the price level.

A) public; rise

B) public; fall

C) central bank; rise

D) central bank; fall

Answer: C
Ques Status: Revised

25) If the deficit is financed by selling bonds to the ________, the money supply will ________, causing aggregate demand to ________.

A) public; rise; increase

B) public; fall; decrease

C) central bank; rise; increase

D) central bank; fall; decrease

Answer: C
Ques Status: Revised

26) Kayla, an economist, is interested in knowing if government deficits have been a factor in explaining rapid money growth in her country in the past twenty years. What ratio should Kayla examine?

A) The ratio of money to the monetary base

B) The ratio of currency to demand deposits

C) The ratio of money to government debt

D) The ratio of government debt to GDP

Answer: D
Ques Status: Previous Edition

27) If an economist were interested in testing whether government budget deficits had been the cause of excessive monetary growth for a country for the period 1950–2000, she would examine the behavior of

A) the ratio of government spending to GDP.

B) the money supply–to–monetary–base ratio.

C) interest rates.

D) the government debt–to–GDP ratio.

Answer: D
Ques Status: Revised

28) Evidence from episodes of hyperinflation indicates that

A) wage–push demands have been the ultimate source of inflationary monetary policies.

B) supply shocks have been the ultimate source of inflationary monetary policies.

C) huge government budget deficits have been the ultimate source of inflationary monetary policies.

D) there is no common source of inflationary monetary policies.

Answer: C
Ques Status: Previous Edition

29) Analysis of episodes of hyperinflation indicate that the rapid money growth leading to the inflation is the result of

A) governments financing massive budget deficits by printing money.

B) central banks' attempts to peg interest rates.

C) central banks' attempts to peg exchange rates.

D) increases in taxes.

Answer: A
Ques Status: Revised

30) Although the U.S. has a well-developed government bond market and has experienced relatively small budget deficits relative to GDP, deficits can be inflationary if

A) deficits put upward pressure on interest rates, and the Fed attempts to keep interest rates from rising.

B) deficits put upward pressure on interest rates, and fiscal authorities raise taxes in an attempt to keep interest rates from rising.

C) the Fed refuses to purchase government bonds.

D) the world's supply of gold expands because of new gold discoveries.

Answer: A
Ques Status: Previous Edition

31) Moderate deficits, such as those experienced by the United States in the last decade, present an inflationary problem if

A) they put upward pressure on interest rates, and the Fed has a goal of preventing high interest rates.

B) they put upward pressure on interest rates, and the Fed has a goal of preventing interest rates from falling too low.

C) the Fed responds by reducing the growth of high-powered money.

D) the Fed cuts money growth to offset the expansionary fiscal effects.

Answer: A
Ques Status: Previous Edition

32) If moderate deficits put ________ pressure on interest rates, the Fed may ________ bonds, leading to an increase in high-powered money.

A) upward; sell

B) upward; buy

C) downward; sell

D) downward; buy

Answer: B
Ques Status: Previous Edition

33) If moderate deficits put upward pressure on interest rates, the Fed may ________ bonds, leading to a ________ in high-powered money.

A) sell; fall

B) buy; fall

C) sell; rise

D) buy; rise

Answer: D
Ques Status: Previous Edition

34) If the Fed pursues a policy goal of

A) preventing high interest rates, and deficits cause interest rates to rise, then deficits will lead to money creation.

B) preventing high inflation, and deficits cause inflation to rise, then deficits will lead to money creation.

C) preventing high bond prices, and deficits cause bond prices to rise, then deficits will lead to money creation.

D) preventing high stock prices, and deficits cause stock prices to rise, then deficits will lead to money creation.

Answer: A
Ques Status: Previous Edition

35) Proponents of Ricardian Equivalence reject the view that deficits

A) cause the monetary base to decrease.

B) cause the monetary base to increase.

C) have no effect on the monetary base.

D) cannot be inflationary, even when financed by tax hikes.

Answer: B
Ques Status: Revised

36) According to economists who believe in Ricardian Equivalence, when the government runs a deficit and issues bonds,

A) the public recognizes that it will be subject to higher taxes in the future in order to pay off these bonds.

B) the public works less to avoid these future taxes, causing the demand for bonds to decrease.

C) the Fed must purchase bonds to keep the interest rate from rising.

D) the Fed must sell bonds to keep the interest rate from rising.

Answer: A
Ques Status: Revised

37) Evidence from the time period 1960–1980 indicates that inflation in the United States resulted from

A) an employment target that was set too high.

B) the government's inability to sell bonds to the Fed.

C) an expansion in the money supply to finance federal government expenditures.

D) the excessive sale of government bonds to the public.

Answer: A
Ques Status: Previous Edition

38) Because policies in the United States were too expansionary from 1965 through 1973, the U.S. suffered

A) demand–pull inflation.

B) cost–push inflation, as workers sought higher wages in order to keep up with inflation.

C) both demand–pull and cost–push inflation.

D) neither demand–pull nor cost–push inflation.

Answer: A
Ques Status: Revised

39) In the period 1965 through the 1970s, policymakers pursued ________ policies in order to achieve ________.

A) expansionary; high employment

B) expansionary; low inflation

C) contractionary; high employment

D) contractionary; low inflation

Answer: A
Ques Status: Revised

25.5 Activist/Nonactivist Policy Debate

1) If aggregate output is below the natural rate level, advocates of activist policy would recommend that the government

A) do nothing.

B) try to eliminate the high unemployment by attempting to shift the aggregate supply curve to the right.

C) try to eliminate the high unemployment by attempting to shift the aggregate demand curve to the right.

D) try to eliminate the high unemployment by attempting to shift the aggregate demand curve to the left.

Answer: C
Ques Status: Previous Edition

2) If aggregate output is below the natural rate level, advocates of nonactivist policy would recommend that the government

A) do nothing.

B) try to eliminate the high unemployment by attempting to shift the aggregate supply curve to the right.

C) try to eliminate the high unemployment by attempting to shift the aggregate demand curve to the right.

D) try to eliminate the high unemployment by attempting to shift the aggregate demand curve to the left.

Answer: A
Ques Status: Previous Edition

3) The time that it takes for an activist policy to actually influence economic activity is called the

A) implementation lag.

B) effectiveness lag.

C) recognition lag.

D) legislative lag.

Answer: B
Ques Status: Previous Edition

4) The time it takes for policymakers to change policy instruments once they have decided on a new policy is called the

A) implementation lag.

B) effectiveness lag.

C) legislative lag.

D) recognition lag.

Answer: A
Ques Status: Previous Edition

5) The time it takes for a policy to have an impact on the economy, once it has been implemented, is called the

A) implementation lag.

B) effectiveness lag.

C) legislative lag.

D) data lag.

E) inside lag.

Answer: B
Ques Status: Previous Edition

6) The ________ lag is the time it takes for policymakers to obtain the data that tell them what is happening to the economy, while the ________ lag is the time it takes for policymakers to be sure of what the data are signaling about the future course of the economy.

A) data; recognition

B) recognition; data

C) data; implementation

D) implementation; recognition

Answer: A
Ques Status: Previous Edition

7) The ________ lag is the time it takes for policymakers to be sure of what the data are signaling about the future course of the economy, while the ________ lag represents the time it takes to pass legislation to implement a particular (fiscal) policy.

A) data; recognition

B) recognition; legislative

C) data; legislative

D) implementation; legislative

Answer: B
Ques Status: Revised

8) The ________ lag represents the time it takes to pass legislation to implement a particular (fiscal) policy, while the ________ lag is the time it takes for policymakers to change policy instruments once they have decided on the new policy.

A) legislative; effectiveness

B) legislative; recognition

C) legislative; implementation

D) implementation; legislative

Answer: C
Ques Status: Revised

9) The ________ lag is the time it takes for policymakers to change policy instruments once they have decided on the new policy, while the ________ lag is the time it takes for the policy to actually have an impact on the economy.

A) recognition; implementation

B) legislative; effectiveness

C) implementation; recognition

D) implementation; effectiveness

Answer: D
Ques Status: Previous Edition

10) The ________ lag is the time it takes for policymakers to obtain the information that tells them what is happening to the economy, while the ________ lag represents the time it takes to implement a particular fiscal policy.

A) data; legislative

B) recognition; data

C) data; implementation

D) recognition; legislative

Answer: A
Ques Status: Previous Edition

11) The ________ lag is the time it takes for policymakers to be sure of what the information is signaling about the future course of the economy, while the ________ lag is the time it takes for policymakers to change policy instruments once they have decided on the new policy.

A) recognition; implementation

B) recognition; legislative

C) data; legislative

D) data; implementation

Answer: A
Ques Status: Previous Edition

12) Of the five time lags that prevent an activist policy from returning aggregate output to full employment instantaneously, two do not slow the effectiveness of monetary policy—the

A) implementation and effectiveness lags.

B) legislative and effectiveness lags.

C) legislative and implementation lags.

D) recognition and effectiveness lags.

Answer: C
Ques Status: Previous Edition

13) Activists usually view ________ policy as having a shorter effectiveness lag than ________ policy, but there is substantial uncertainty about how long this lag is.

A) fiscal; incomes

B) fiscal; monetary

C) monetary; incomes

D) monetary; fiscal

Answer: B
Ques Status: Revised

14) Activists usually view ________ policy as having a longer effectiveness lag than ________ policy, but there is substantial uncertainty about how long this lag is.

A) fiscal; incomes

B) fiscal; monetary

C) monetary; incomes

D) monetary; fiscal

Answer: D
Ques Status: Revised

15) Economists usually view ________ policy as having a shorter implementation lag than ________ policy, but there is substantial uncertainty about how long this lag is.

A) fiscal; incomes

B) fiscal; monetary

C) monetary; incomes

D) monetary; fiscal

Answer: D
Ques Status: Previous Edition

16) Economists usually view ________ policy as having a longer implementation lag than ________ policy, but there is substantial uncertainty about how long this lag is.

A) fiscal; incomes

B) fiscal; monetary

C) monetary; incomes

D) monetary; fiscal

Answer: B
Ques Status: Previous Edition

17) If output adjusts ________ to the natural rate level, and if time lags between policy actions and changes in aggregate output are relatively ________, then the case for activist policy is strengthened.

A) slowly; short

B) slowly; long

C) quickly; short

D) quickly; long

Answer: A
Ques Status: Previous Edition

18) If output adjusts ________ to the natural rate level, and if time lags between policy actions and changes in aggregate output are relatively ________, then the case for activist policy is weakened.

A) slowly; short

B) slowly; long

C) quickly; short

D) quickly; long

Answer: D
Ques Status: Previous Edition

19) Nonactivists contend that an activist policy of shifting the aggregate ________ curve will be costly because it produces ________ volatility in both the price level and output.

A) supply; less

B) supply; more

C) demand; less

D) demand; more

Answer: D
Ques Status: Previous Edition

20) Some economists contend that a policy of shifting the aggregate demand curve will be costly because it produces more volatility in both the price level and output. These economists likely

A) activist policy.

B) discretionary policy.

C) demand-management policy.

D) nonactivist policy.

Answer: D
Ques Status: Previous Edition

21) The existence of lags prevents the instantaneous adjustment of the economy to policies changing aggregate demand, thereby strengthening the case for

A) activist policy.

B) nonactivist policy.

C) discretionary policy.

D) demand-management policy.

Answer: B
Ques Status: Previous Edition

22) Which of the following views are consistent with the case for nonactivist macroeconomic policy?

A) Even with time lags, activist policy moves the economy to full employment before the economy's self-correcting mechanism would.

B) The wage and price adjustment process being extremely slow, a nonactivist policy results in a large loss of output.

C) Workers will come to expect expansionary policies whenever the economy moves below full employment.

D) An activist, accommodating policy of shifting the aggregate demand curve will produce less volatility in both the price level and output due to the short time it takes to shift aggregate demand.

Answer: C
Ques Status: Revised

23) If expectations about policy affect how wages are set, then the case for a(n) ________ policy is much stronger.

A) activist

B) nonactivist

C) interventionist

D) stabilization

Answer: B
Ques Status: Previous Edition

24) Nonactivists emphasize the importance of a constant money growth rate rule more than the balanced-budget amendment or restrictions on union power because

A) they regard excessive money growth as the cause of inflation.

B) they believe that excessive government spending, not excessive monetary growth, is the cause of inflation.

C) they believe that while unions cause inflation, they are too politically powerful to deal with.

D) they regard high tax rates as the cause of inflation.

Answer: A
Ques Status: Revised

25) Nonactivists contend that a policy of shifting the aggregate demand curve will be costly because it produces more volatility in both the price level and output. Thus they favor

A) a policy of variable money supply growth.

B) discretionary policy.

C) demand–management policy.

D) a constant–money–growth–rate rule.

Answer: D
Ques Status: Revised

26) A credible, nonaccommodating policy rule has the ________ that it makes a cost–push by workers ________ likely and thus helps to reduce the output loss from controlling inflation.

A) advantage; less

B) advantage; more

C) disadvantage; less

D) disadvantage; more

Answer: A
Ques Status: Previous Edition

27) Suppose the economy is at the natural rate of output. Explain how a tax increase reduces demand and increases unemployment. Why is the speed of the adjustment of wages and/or the role of expectations important in this situation?

Answer: The tax increase decreases aggregate demand. Output falls below the natural rate, increasing unemployment. If wages are slow to adjust, the economy remains below the natural rate for a long time, but adjustment back to the natural rate is rapid if wages adjust quickly or if expectations lead to rapid adjustment of wages.
Ques Status: Revised