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

1) The name economists give the process by which stockholders gather information by frequent monitoring of the firm’s activities is
   A) the free-rider problem.  
   B) costly avoidance.  
   C) costly state verification. 
   D) debt intermediation.  

2) Debt deflation occurs when
   A) corporations pay back their loans before the scheduled maturity date.  
   B) lenders reduce their lending due to declining stock prices (equity deflation) that lowers the value of collateral.  
   C) rising interest rates worsen adverse selection and moral hazard problems.  
   D) an economic downturn causes the price level to fall and a deterioration in firms’ net worth because of the increased burden of indebtedness.  

3) People have a strong incentive to form rational expectations because
   A) it is costly to do so.  
   B) it is costly not to do so.  
   C) everyone wants to be rational.  
   D) they are guaranteed of success in the stock market.  

4) The principal-agent problem
   A) would not arise if the owners of the firm had complete information about the activities of the managers.  
   B) explains why direct finance is more important than indirect finance as a source of business finance.  
   C) in financial markets helps to explain why equity is a relatively important source of finance for American business.  
   D) occurs when managers have more incentive to maximize profits than the stockholders-owners do.  

5) A ______ pays out cash flows from subprime mortgage-backed securities in different tranches, with the highest-rated tranche paying out first, while lower ones paid out less if there were losses on the mortgage-backed securities.
   A) Negotiable CD  
   B) Collateralized debt obligation (CDO)  
   C) Discount bond  
   D) Adjustable-rate mortgage  

6) All of the following might create problems from financial liberalization in emerging countries except
   A) limits on risk-taking.  
   B) lenders failure to monitor borrowers.  
   C) lax government supervision of banks.  
   D) ineffective screening of borrowers.  

7) Of the following sources of external finance for American nonfinancial businesses, the least important is
   A) bonds and commercial paper.  
   B) stocks.  
   C) loans from other financial intermediaries.  
   D) loans from banks.
8) 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) proscription covenant.  B) prescription covenant.
   C) restrictive covenant.  D) collateral-insurance clause.

9) In the one-period valuation model, an increase in the required return on investments in equity
   A) increases the expected sales price of a stock.
   B) reduces the current price of a stock.
   C) increases the current price of a stock.
   D) reduces the expected sales price of a stock.

10) ________ means people are more unhappy when they suffer losses than they are happy when they achieve gains.
    A) Loss leader  B) Loss cycle
    C) Loss fundamentals  D) Loss aversion

11) 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.

12) 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) adverse selection  B) free-rider
    C) principal-agent  D) debt deflation

13) Which of the following types of information most likely allows the exploitation of a profit opportunity?
    A) Insider information  B) Hot tips from a stockbroker
    C) Technical analysis  D) Financial analystsʹ published recommendations

14) A venture capital firm protects its equity investment from moral hazard through which of the following means?
    A) It writes contracts that prohibit the sale of an equity investment to the venture capital firm.
    B) It requires a 50% stake in the company.
    C) It places people on the board of directors to better monitor the borrowing firm’s activities.
    D) It prohibits the borrowing firm from replacing its management.

15) A change in perceived risk of a stock changes
    A) the required rate of return.  B) the expected dividend growth rate.
    C) the expected sales price.  D) the current dividend.

16) The ________ problem helps to explain why the private production and sale of information cannot eliminate ________:
    A) principal-agent; moral hazard  B) free-rider; adverse selection
    C) free-rider; moral hazard  D) principal-agent; adverse selection
17) 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.

18) A monetary expansion _______ stock prices due to a decrease in the _______ and an increase in the _______. everything else held constant.
A) increases; required rate of return; dividend growth rate
B) reduces; future sales price; expected rate of return
C) increases; required rate of return; future sales price
D) reduces; current dividend; expected rate of return

19) If uncertainty about banks' health causes depositors to begin to withdraw their funds from banks, the country experiences a(n)
A) reduction of the adverse selection and moral hazard problems.
B) banking crisis.
C) financial recovery.
D) increase in information available to investors.

20) Using the Gordon growth formula, if D1 is $1.00, ke is 10% or 0.10, and g is 5% or 0.05, then the current stock price is

21) Using the Gordon growth model, if D1 is $.50, ke is 7%, and g is 5%, then the current price of the stock is
A) $2.50. B) $50. C) $46.73. D) $25.

22) Severe fiscal imbalances can directly trigger a currency crisis since
A) the government may stop printing money.
B) the currency must surely increase in value.
C) investors fear that the government may not be able to pay back the debt and so begin to sell domestic currency.
D) the government may have to cut back on spending.

23) When financial institutions go on a lending spree and expand their lending at a rapid pace they are participating in a
A) market race. B) deleveraging. C) credit bust. D) credit boom.

24) 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

25) A major disruption in financial markets characterized by sharp declines in asset prices and firm failures is called a
A) free–rider problem. B) "lemons" problem.
C) fiscal imbalance. D) financial crisis.
26) 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 favorable earnings were expected.
   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 earnings were not as high as anticipated.

27) The value of any investment is found by computing the
   A) future value of all future expenses.  B) present value of all future liabilities.
   C) present value of all future sales.   D) present value of all future cash flows.

28) Increased uncertainty resulting from the global financial crisis
   _______ the required return on investment in equity.
   A) decreased  B) lowered  C) had no impact on  D) raised

29) Government regulations require publicly traded firms to provide information, reducing
   A) the need for diversification.  B) economies of scale.
   C) the adverse selection problem.  D) transactions costs.

30) If a forecast is made using all available information, then economists say that the expectation formation is

31) The global financial crisis lead to a decline in stock prices because
   A) higher expected future stock prices.
   B) higher current dividends.
   C) of a lowered expected dividend growth rate.
   D) of a lowered required return on investment in equity.

32) The efficient markets hypothesis suggests that if an unexploited profit opportunity arises in an efficient market,
   A) it will be quickly eliminated.
   B) financial analysts are your best source of this information.
   C) it will tend to go unnoticed for some time.
   D) prices will reflect the unexploited profit opportunity.

33) According to the efficient markets hypothesis, purchasing the reports of financial analysts
   A) is not likely to be an effective strategy for increasing financial returns.
   B) is likely to increase one’s returns by about 3 to 5%.
   C) is likely to increase one’s returns by an average of 10%.
   D) is likely to increase one’s returns by an average of about 2 to 3%.

34) The problem created by asymmetric information before the transaction occurs is called _______,
    while the problem created after the transaction occurs is called _______.
    A) moral hazard; adverse selection  B) costly state verification; free-riding
    C) adverse selection; moral hazard  D) free-riding; costly state verification
35) A possible sequence for the three stages of a financial crisis in an advanced economy might be ______ leads to ______ leads to ______.

A) banking crises; increase in interest rates; unanticipated decline in price level
B) asset price declines; banking crises; unanticipated decline in price level
C) unanticipated decline in price level; banking crises; increase in interest rates
D) banking crises; increase in uncertainty; increase in interest rates

36) The efficient markets hypothesis implies that prices in the stock market

A) follow a definite pattern.
B) always undervalue the true assets of a corporation.
C) are more likely to go up than down.
D) are unpredictable.

37) In the generalized dividend model, a future sales price far in the future does not affect the current stock price because

A) the sales price does not affect the current price.
B) the present value cannot be computed.
C) the stock may never be sold.
D) the present value is almost zero.

38) The current structure of financial markets can be best understood as the result of attempts by financial market participants to

A) cartelize the provision of financial services.
B) reduce transaction costs.
C) adapt to continually changing government regulations.
D) deal with the great number of small firms in the United States.

39) The growth of the subprime mortgage market led to

A) decreased demand for houses as the less credit-worthy borrowers could not obtain residential mortgages.
B) increased demand for houses and helped fuel the boom in housing prices.
C) a decrease in home ownership as investors chose other assets over housing.
D) a decline in the housing industry because of higher default risk.

40) For restrictive covenants to help reduce the moral hazard problem they must be ______ by the lender.

A) impossible to remove
B) easily changed
C) monitored and enforced
D) written in all capitals

41) A feature of debt markets in emerging-market countries is that debt contracts are typically

A) intermediate term.
B) perpetual.
C) long term.
D) very short term.

42) Net worth can perform a similar role to

A) intermediation.
B) economies of scale.
C) collateral.
D) diversification.

43) A serious consequence of a financial crisis is

A) a contraction in economic activity.
B) financial globalization.
C) financial engineering.
D) an increase in asset prices.
44) If you default on your auto loan, your car will be repossessed because it has been pledged as _______ for the loan.
   A) collateral  B) dividend  C) commodity  D) interest

45) In a one-period valuation model, a decrease in the required return on investments in equity causes (n) _______ in the _______ price of a stock.
   A) increase; current  B) increase; expected sales
   C) decrease; current  D) decrease; expected sales

46) The advantage of a "buy-and-hold strategy" is that
   A) profits are guaranteed.
   B) net profits will tend to be higher because there will be fewer brokerage commissions.
   C) the longer a stock is held, the higher will be its price.
   D) losses will eventually be eliminated.

47) The efficient markets hypothesis indicates that investors
   A) let too many unexploited profit opportunities go by if they adopt a "buy and hold" strategy.
   B) do better if they purchase loaded mutual funds.
   C) do better on average if they adopt a "buy and hold" strategy.
   D) can use the advice of technical analysts to outperform the market.

48) When financial intermediaries deleverage, firms cannot fund investment opportunities resulting in
   A) a call for government regulation.  B) a contraction of economic activity.
   C) an economic boom.  D) an increased opportunity for growth.

49) In the one-period valuation model, the value of a share of stock today depends upon
   A) the future value of dividends and the actual sales price.
   B) the actual value of the dividends and expected sales price received in one year.
   C) the present value of both the dividends and the expected sales price.
   D) only the present value of the future dividends.

50) In emerging market countries, the deterioration in bank’s balance sheets has more _______ effects on lending and economic activity than in advanced countries.
   A) advancing  B) positive  C) negative  D) affirming
Answer Key
Testname: ECON3303_EXAM3_SUMMER_2015

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