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

1) Sometimes one observes that the price of a company’s stock falls after the announcement of favorable earnings. This phenomenon is
   A) consistent with the efficient markets hypothesis if the earnings were not as low as anticipated.
   B) clearly inconsistent with the efficient markets hypothesis.
   C) consistent with the efficient markets hypothesis if the favorable earnings were expected.
   D) consistent with the efficient markets hypothesis if the earnings were not as high as anticipated.

2) 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) give up trying to forecast this variable.
   B) change the way they form expectations about future values of the variable.
   C) begin to make systematic mistakes.
   D) no longer pay close attention to movements in this variable.

3) 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 reduce the value of the debt contract.
   C) too many resources may be devoted to monitoring and enforcing them, as debtholders duplicate others’ monitoring and enforcement efforts.
   D) they are inexpensive to monitor and enforce.

4) If expectations are formed rationally, then individuals
   A) have forecast errors that are persistently low.
   B) use only the information from past data on a single variable to form their forecast.
   C) will have a forecast that is 100% accurate all of the time.
   D) change their forecast when faced with new information.

5) A financial crisis occurs when an increase in asymmetric information from a disruption in the financial system
   A) increases economic activity.
   B) reduces uncertainty in the economy and increases market efficiency.
   C) causes severe adverse selection and moral hazard problems that make financial markets incapable of channeling funds efficiently.
   D) allows for a more efficient use of funds.

6) The reduction in transactions costs per dollar of investment as the size of transactions increases is
   A) discounting.
   B) diversification.
   C) economies of scale.
   D) economies of trade.

7) 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) free-riding; costly state verification
   D) costly state verification; free-riding
8) Large-denomination CDs are ________, so that like a bond they can be resold in a ________ market before they mature.
   A) nonnegotiable; primary       B) negotiable; primary
   C) nonnegotiable; secondary     D) negotiable; secondary

9) Of the four sources of external funding for nonfinancial businesses, the least often used in the U.S. is
   A) nonbank loans.       B) bank loans.       C) stock.       D) bonds.

10) The free-rider problem occurs because
    A) information can never be sold at any price.
    B) people who pay for information use it freely.
    C) people who do not pay for information use it.
    D) it is never profitable to produce information.

11) Which of the following statements concerning external sources of financing for nonfinancial businesses in the United States are true?
    A) Stocks and bonds, combined, supply less than one-half of the external funds.
    B) Stocks are a far more important source of finance than are bonds.
    C) Since 1970, more than half of the new issues of stock have been sold to American households.
    D) Financial intermediaries are the least important source of external funds for businesses.

12) The originate–to–distribute business model has a serious ________ problem since the mortgage broker has little incentive to make sure that the mortgagor is a good credit risk.
    A) collateralized debt       B) principal-agent
    C) democratization of credit D) debt deflation

13) A possible sequence for the three stages of a financial crisis in an advanced economy might be ________ leads to ________ leads to ________.
    A) unanticipated decline in price level; banking crises; increase in interest rates
    B) asset price declines; banking crises; unanticipated decline in price level
    C) banking crises; increase in uncertainty; increase in interest rates
    D) banking crises; increase in interest rates; unanticipated decline in price level

14) 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.

15) 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) illiquidity.       D) insolvency.

16) Since they require less monitoring of firms, ________ contracts are used more frequently than ________ contracts to raise capital.
    A) equity; stock       B) equity; debt       C) debt; loan       D) debt; equity
17) Collateralized debt is also known as
   A) unsecured debt.       B) promissory debt.
   C) unrestricted debt.    D) secured debt.

18) 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) people are irrational and therefore never learn from past mistakes.
   D) adaptive expectations models have no predictive power.

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

20) 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) $100.10.       C) $100.11       D) $121.12.

21) Because of the adverse selection problem,
    A) lenders are reluctant to make loans that are not secured by collateral.
    B) lenders will write debt contracts that restrict certain activities of borrowers.
    C) good credit risks are more likely to seek loans causing lenders to make a disproportionate amount of loans to good credit risks.
    D) lenders may refuse loans to individuals with high net worth, because of their greater proclivity to "skip town."

22) A credit boom can lead to a(n) ______ such as we saw in the tech stock market in the late 1990s.
    A) asset-price bubble       B) decrease in moral hazard
    C) liability war            D) decline in lending

23) The Enron and Tyco scandals are an example of
    A) the principal-agent problem.       B) the free-rider problem.
    C) the adverse selection problem.     D) the "lemons problem."

24) Psychologists have found that people tend to be ______ in their own judgments.
    A) overconfident       B) indecisive       C) underconfident       D) insecure

25) Financial innovations that emerged after 2000 in the mortgage markets included all of the following except
    A) subprime mortgages.       B) Alt-A mortgages.
    C) adjustable-rate mortgages.       D) mortgage-backed securities.

26) A stock's price will fall if there is
    A) an increase in the future sales price.       B) an increase in the required rate of return.
    C) a decrease in perceived risk.       D) current dividends are high.
27) The efficient markets hypothesis implies that prices in the stock market
   A) are unpredictable.
   B) are more likely to go up than down.
   C) always undervalue the true assets of a corporation.
   D) follow a definite pattern.

28) Periodic payments of net earnings to shareholders are known as
   A) profits. B) capital gains. C) interest. D) dividends.

29) 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.

30) 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) inclusion of restrictive covenants in loan contracts.
   B) requirement that individuals provide detailed credit histories to bank loan officers.
   C) requirement that firms keep compensating balances at the banks from which they obtain their loans.
   D) requirement that firms place on their board of directors an officer from the bank.

31) An unanticipated decline in the price level increases the burden of debt on borrowing firms but does not raise the real value of borrowing firms' assets. The result is
   A) an increase in the real net worth of the borrowing firm.
   B) an increase in lending.
   C) that adverse selection and moral hazard problems are reduced.
   D) that net worth in real terms declines.

32) One reason financial systems in developing and transition countries are underdeveloped is
   A) the accounting standards are too stringent for the banks to meet.
   B) they have weak links to their governments.
   C) they make loans only to nonprofit entities.
   D) the legal system may be poor making it difficult to enforce restrictive covenants.

33) Information plays an important role in asset pricing because it allows the buyer to more accurately judge

34) Using the Gordon growth model, if $D_1$ is $.50, $k_e$ is 7%, and $g$ is 5%, then the present value of the stock is
   A) $46.73. B) $2.50. C) $25. D) $50.

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

36) If you default on your auto loan, your car will be repossessed because it has been pledged as
   A) commodity B) dividend C) collateral D) interest
37) A _______ is a provision that restricts or specifies certain activities that a borrower can engage in.
   A) restrictive barrier       B) risk hedge
   C) restrictive covenant      D) residual claimant

38) A serious consequence of a financial crisis is
   A) financial globalization.  B) financial engineering.
   C) an increase in asset prices. D) a contraction in economic activity.

39) The "lemons problem" exists because of
   A) economies of scale.    B) transactions costs.
   C) asymmetric information. D) rational expectations.

40) In a bank panic, the source of contagion is the
   A) asymmetric information problem. B) free-rider problem.

41) Analysis of adverse selection indicates that financial intermediaries, especially banks,
   A) despite their success in overcoming free-rider problems, nevertheless play a minor role in moving funds to corporations.
   B) must buy securities from corporations to diversify the risk that results from holding non-tradable loans.
   C) 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.
   D) 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.

42) Another way to state the efficient markets condition is: in an efficient market,
   A) unexploited profit opportunities will be quickly eliminated.
   B) every financial market participant must be well informed about securities.
   C) arbitragers guarantee that unexploited profit opportunities never exist.
   D) unexploited profit opportunities will never exist.

43) In emerging market countries, many firms have debt denominated in foreign currency like the dollar or yen. A depreciation of the domestic currency
   A) results in increases in the firm’s indebtedness in domestic currency terms, even though the value of their assets remains unchanged.
   B) strengthens their balance sheet in terms of the domestic currency.
   C) results in an increase in the value of the firm’s assets.
   D) means that the firm does not owe as much on their foreign debt.

44) A conflict of interest can occur for accounting firms when the firms both
   A) provide nonaudit services and tax advice.
   B) monitor data and underwrite securities.
   C) provide auditing services and nonaudit consulting services.
   D) enter data and record data.
45) Mortgage brokers often did not make a strong effort to evaluate whether the borrower could pay off the loan. This created a
A) decrease in the demand for houses. B) decline in mortgage applications. C) call to deregulate the industry. D) severe adverse selection problem.

46) Financial intermediaries’ low transaction costs allow them to provide _______ services that make it easier for customers to conduct transactions.
A) transcendental B) equitable C) conduction D) liquidity

47) A problem for equity contracts is a particular type of _______ called the _______ problem.
A) adverse selection; free-rider B) moral hazard; principal-agent C) adverse selection; principal-agent D) moral hazard; free-rider

48) Nonfinancial businesses in Germany, Japan, and Canada raise most of their funds
A) from bank loans. B) from nonbank loans. C) by issuing stock. D) by issuing bonds.

49) In the generalized dividend model, the current stock price is the sum of
A) the present value of the future dividend stream. B) the actual value of the future dividend stream. C) the present value of the future sales price. D) the present value of the future dividend stream plus the actual future sales price.

50) If a market participant believes that a stock price is irrationally high, they may try to borrow stock from brokers to sell in the market and then make a profit by buying the stock back again after the stock falls in price. This practice is called
A) undermining. B) long marketing. C) double dealing. D) short selling.
Answer Key
Testname: ECON3303_EXAM3_SUMMER_2016

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