

Econ 520 (Spring 2007)  
**Problems for Chapters 8-9**  
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**CHAPTER 8**

**1. Mishkin's Problems**

Mishkin, P.215, Questions and Problems, 2, 4, 6

**2. Multiple-Choice Problems**

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

1. 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) adverse selection.
  - B) moral hazard.
  - C) free-riding.
  - D) regulatory forbearance.
2. 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 adverse selection.
  - C) can be explained by government regulations that prohibit small firms from acquiring funds in securities markets.
  - D) can be explained by all of the above.
3. Solutions to the moral hazard problem include
  - A) monitoring and enforcement of restrictive covenants.
  - B) high net worth.
  - C) greater reliance on equity contracts and less on debt contracts.
  - D) all of the above.
  - E) only (a) and (b) of the above.

4. Financial intermediaries, particularly banks,
- A) play a greater role in moving funds to corporations than do securities markets.
  - B) overcome the free-rider problem by primarily making private loans, rather than purchasing securities that are traded in the open market.
  - C) are experts in the production of information about firms so that it can sort good risks from bad ones.
  - D) all of the above.
  - E) only (a) and (b) of the above.
5. 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) principal-agent
  - C) free-rider
  - D) debt deflation
6. Although restrictive covenants can reduce moral hazard, a problem with restrictive covenants is that
- A) borrowers may find loopholes that make the covenants ineffective.
  - B) they are costly to monitor and enforce.
  - C) too few resources may be devoted to monitoring and enforcing them, as debtholders free ride on others' monitoring and enforcement efforts.
  - D) all of the above.
  - E) only (a) and (b) of the above.
7. The concept of adverse selection helps to explain
- A) why direct finance is a more important source of business finance than is indirect finance.
  - B) why collateral is not a common feature of debt contracts.
  - C) why only large, well-established corporations have access to securities markets.
  - D) all of the above.
  - E) only (a) and (b) of the above.
  - F) only (b) and (c) of the above.

### 3. Short Answer/Essay Problems

(1) Explain how the separation of ownership and control in American corporations might lead to a principal-agent problem. Discuss the relation between debt contracts and the principal-agent problem.

## CHAPTER 9

### 1. Mishkin's Problems

Mishkin, P.245, Questions and Problems, 4, 8, 10

### 2. Multiple-Choice Problems

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

1. Banks face the problem of \_\_\_\_\_ in loan markets because bad risks are the ones most likely to seek bank loans.
  - A) adverse selection
  - B) moral hazard
  - C) free rider
  - D) securitization
2. When compared to banks with \_\_\_\_\_ net worth, banks with \_\_\_\_\_ net worth have fewer incentives to engage in risky activities.
  - A) high; low
  - B) high; high
  - C) low; high
  - D) low; low
3. When Jane Brown opens a bank account with \$1,000 check, Ms. Brown's bank \_\_\_\_\_ assets of \$1,000 and \_\_\_\_\_ liabilities of \$1,000.
  - A) gains; gains
  - B) gains; loses
  - C) loses; gains
  - D) loses; loses

4. Secondary reserves are so-called because
- A) they are not easily converted into cash, and are, therefore, of secondary importance to banking firms.
  - B) 50% of these assets count toward meeting required reserves.
  - C) they can be converted into cash with low transactions costs.
  - D) of none of the above.
5. A bank's commitment (for a specified future period of time) to provide a firm with loans up to a given amount at an interest rate that is tied to a market interest rate is called
- A) a line of credit.
  - B) credit rationing.
  - C) continuous dealings.
  - D) none of the above.
6. If a bank has more rate-sensitive assets than liabilities, then a (or an) \_\_\_\_\_ in interest rates will \_\_\_\_\_ bank profits.
- A) decline; not affect
  - B) increase; increase
  - C) increase; reduce
  - D) decline; increase
7. The \_\_\_\_\_ are the costs associated with deposit outflows, the \_\_\_\_\_ excess reserves banks will want to hold.
- A) higher; less
  - B) lower; more
  - C) higher; more
  - D) None of the above are true, since deposit outflows cannot be anticipated.