

Answer Outline

ECONOMICS 353 (SECTION 2)
EXERCISE 12: 6 POINTS TOTAL

L. Tesfatsion/Spring 04
DUE: Tuesday, April 20, 2:10pm

****IMPORTANT REMINDER: LATE ASSIGNMENTS CANNOT BE ACCEPTED – NO EXCEPTIONS****

EXERCISE INSTRUCTIONS:

- (1) Please **fill in your name and student ID number** on Side 1 of your bubble sheet and write **353-2 Exercise 12** in the top margin of Side 1.
- (2) Use a number 2 pencil to **mark your answers** on Side 1 of the bubble sheet to the six questions Q1 through Q6, below, which are all in multiple choice format.
- (3) Each question Q1 through Q6 is worth 1 point. Questions Q1 through Q4 are from Mishkin Chapter 8 (Part A) and questions Q5 and Q6 are from Mishkin Chapter 8 (Part B).

Q1. MORAL HAZARD problems can arise with newly issued securities because of

- A.** the security purchasers' lack of detailed information about the current financial situation (e.g., default risk) of the security issuer.
- B.** the possibility that other investors will be able to gain information costlessly by observing the actions of security purchasers.
- **C.** the inability of security purchasers to monitor fully the future behavior of security issuers.
- D.** the time-varying nature of investors' preferences for asset holdings.

Q2. Banks are generally BETTER able than securities dealers to prevent information problems (moral hazard and adverse selection) because

- A.** most bank loans are private (not traded on an open market), so banks can profitably gather information about borrowers without worrying about free-rider problems.
- B.** banks can force borrowers to signal their true "type" (high or low risk) by putting special restrictions in loan contracts (e.g., collateral requirements).
- C.** bank loans are regulated by the Securities and Exchange Commission (SEC).
- D.** all of the above.
- **E.** only A and B above.

IMPORTANT: Correction for Q3 below: EITHER B OR C constitutes an acceptable answer to Q3 for the reasons detailed in my email sent to all Econ 353 students on Friday, April 23.

- Q3.** Owners of corporate BONDS generally face FEWER moral hazard problems than owners of corporate STOCK SHARES because
- A. corporate bond owners generally are active participants in corporate management.
 - **B.** corporate bonds have pre-set payment obligations that are not dependent on corporate profit performance (except in extreme conditions such as bankruptcy).
 - **C.** corporate bonds typically include strong covenants restricting corporate management behavior.
 - D. all of the above.
- Q4.** The separation of ownership and control in corporations can lead to higher risk for ____ because of ____.
- A. corporate managers; low salaries
 - **B.** corporate shareholders; principal-agent problems
 - C. tax-payers; adverse selection problems.
 - D. employees; free-rider problems.
- Q5.** The “economic development” of a country refers to improvements in ____ that permit a higher standard of living for its people.
- **A.** the infrastructure, organization, and governance of its economy
 - B. its balance of payments
 - C. its unemployment rate
 - D. the size of its GDP
 - E. none of the above
- Q6.** Mishkin (Chapter 8) argues that financial crises arise when disruptions to the financial system (from whatever source) _____, so that financial markets are unable to channel funds from savers to investors.
- A. lead to a weakening of the legal system,
 - B. lead to divergencies from standard accounting practices,
 - C. result in inadequate or inappropriate government regulation,
 - **D.** result in a large surge in adverse selection and moral hazard problems,
 - E. lead to the nationalization of financial institutions,