

## Answer Outline

ECONOMICS 353 (SECTION 2)  
EXERCISE 13: 6 POINTS TOTAL

L. Tesfatsion/Spring 04  
DUE: Tuesday, April 27, 2:10pm

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

### EXERCISE INSTRUCTIONS:

- Please **fill in your name and student ID number** on Side 1 of your bubble sheet and write **353-2 Exercise 13** in the top margin of Side 1.
- Use a number 2 pencil to **mark your answers** on Side 1 of the bubble sheet to the first five questions Q1 through Q5, below, which are in multiple choice format.
- The sixth question Q6 is a Web Browse Exercise. Please put your **name and student ID number** at the top of your answer sheet for Q6 along with **353-2 Exercise 13** and **separately** hand in your answer sheet for Q6 in addition to your answer bubble sheet for questions Q1 through Q5.
- Each question Q1 through Q6 is worth 1 point.

**Q1.** Questionable practices by the Enron Corporation leading to severe moral hazard problems, large losses, and the ultimate bankruptcy of the company in December 2001 included

**A.** the reporting of substantial debt and financial transactions on its balance sheet in order to confuse auditors.

**\*\*B.** a lack of sufficient independence between Enron auditors and Enron company executives.

**C.** the frequent switching of auditing companies.

**D.** a rule that prevented auditors from owning Enron stock.

**Q2.** According to Mishkin, an important development that led to large losses for venture capitalists in the United States in the late 1990s was

**A.** a lack of venture capital funding.

**B.** free-rider problems arising from heavily reliance on the Internet.

**C.** a drying up of innovative ideas.

**\*\*D.** a surge of money into venture capital funds that reduced the ability of partners of venture capital firms to provide quality monitoring.

**E.** increased transactions costs leading to state verification problems.

- Q3.** According to Mishkin, key factors that can trigger financial crises include
- A.** sudden increases in uncertainty that discourage lenders
  - B.** sudden declines in corporate net worth that discourage lenders
  - C.** sudden increases in prices that cause debt deflation
  - D.** all of the above
  - \*\*E.** only A and B.
- Q4.** According to Mishkin, a key way in which U.S. financial crises have differed from financial crises in emerging and transition economies such as Mexico is that
- \*\*A.** speculative currency attacks (foreign exchange crises) have not played a dominant role in U.S. financial crises.
  - B.** U.S. regulators have not permitted insolvent financial institutions to stay in operation.
  - C.** U.S. financial crises tend to be of far shorter duration.
  - D.** U.S. financial crises have not resulted in substantial bank failures.
- Q5.** According to Mishkin, the Great Depression in the U.S. was triggered in part by
- A.** a balance of payments crisis.
  - \*\*B.** the pursuit of a tight monetary policy to curb excessive speculation in the stock market.
  - C.** a sharp rise in the aggregate price level.
  - D.** the failure of a major non-financial firm.
  - E.** all of the above

**Q6. (WEB BROWSE QUESTION)** This question concerns the microcredit movement in general and the Grameen Bank in particular. The key reference is “Notes on the Grameen Bank and the Microcredit Movement” available online at

<http://www.econ.iastate.edu/classes/econ353/tesfatsion/grameen.htm>

*Microcredit* is the extension of small start-up loans to entrepreneurs too poor to qualify for traditional bank loans because they lack collateral. The microcredit concept is attributed to Dr. Muhammad Yunus, who established the Grameen Bank microcredit project in Bangladesh in 1972.

As Mishkin stresses in Chapter 8, collateral requirements in loan contracts are a key way that traditional banks attempt to protect themselves against both adverse selection and moral hazard problems. This question asks you to consider the particular mechanisms used by the Grameen Bank instead of collateral in an attempt to prevent moral hazard problems.

**Part A: 1/2 Point** Discuss briefly (200 words maximum) the key ways in which the standard Grameen Bank loan process has been specifically designed to try to keep moral hazard problems from arising among Grameen Bank borrowers.

**Answer Outline for Part A:** The Grameen Bank (GB) borrower, typically a poor woman, is required to join a five-member group of GB borrowers from her local community so that her actions can be closely monitored by her peers. Specifically, she must attend weekly group meetings. During these group meetings, peer pressure is exerted to encourage “loan discipline” among the group as well as adherence to “sixteen decisions” about the conduct of one’s personal life. As an additional enforcement mechanism, a GB borrower’s continued access to GB credit is conditional on prompt loan repayment by *all* of her group members. Loans might be restructured by the GB (have their maturities extended) in emergency situations, but they are never forgiven. Consequently, a GB borrower defaulting on her loan payments due to laziness or inappropriate use of funds risks being publicly shamed in her community for a very long time.

**Part B: 1/2 Point** Discuss briefly (200 words maximum) whether, in your opinion, a microcredit program structured along the lines of the Grameen Bank could succeed in the United States. That is, do you believe that such a program could be viable in the United States over the long haul as a self-sufficient organization with no need to depend on outside funding (e.g., government support). Why or why not?

**Answer Outline for Part B:** Answers will vary by individual.

Several concerns about the long-run viability (financial self-sufficiency) of microcredit programs in general are discussed in “Notes on the Grameen Bank... .” These include a concern

about lack of adequate supervision of the GB by regulators, non-standard accounting practices, problems with borrowers “gaming” the system by acquiring multiple loans, and groups banding together to act as unions to force more lenient repayment terms rather than as peer pressure groups to enforce loan discipline. These concerns are dismissed as minor issues by Dr. Yunus.

As Borenstein (1995) argues (see “Notes on the Grameen Bank...,” p. 5), Bangladesh has a long tradition of self-employment, but few Americans work for themselves. Consequently, the stress by the GB strictly on loans for entrepreneurship might not be as effective in the U.S. as in Bangladesh. Two other problems might also arise specifically in the U.S. First, the GB lends primarily to women, which might be viewed as discriminatory. Second, the heavy GB emphasis on group peer pressure might be criticized as being too intrusive and “socialist.”