Student: ____________________ **Date:** ____________________	**Instructor:** Josue Cox **Course:** Summer 2020: ECON-UA 231 - Money & Banking	**Assignment:** Problem Set 2

1. Why are deposit insurance and other types of government safety nets important to the health of the economy?

   - (selected) **A. Deposit insurance and other government safety nets help to eliminate a contagion effect.**
   - B. Deposit insurance and other types of government safety nets eliminate the adverse selection problem.
   - C. Government safety nets were designed to weaken the shadow banking system.
   - D. Deposit insurance prevents depositors from withdrawing their funds and thus eliminates runs on banks.

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2. If casualty insurance companies provided fire insurance without any restrictions, what kind of moral hazard[1] problem might result?

   - A. With no restrictions, individuals would likely engage in less risk-taking behaviour with this type of insurance
   - B. High-risk customers (for example, fireworks manufacturers) would seek this type of insurance
   - C. Insurance premiums would likely be lower with no need for deductibles
   - (selected) **D. Customers would take less preventive care in avoiding fire risk with this type of insurance**

1: Definition

Moral hazard

The risk that one party to a transaction will engage in behaviour that is undesirable from the other party's point of view.

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3. Do you think that eliminating or limiting the amount of deposit insurance would be a good idea? Explain your answer.

- **A.** It is a good idea. Eliminating or limiting the amount of deposit insurance would help reduce the moral hazard of excessive risk taking on the part of banks. Moreover, it would make bank failures and panics less likely.
- **B. It is not a good idea. Eliminating or limiting the amount of deposit insurance would help reduce the moral hazard of excessive risk taking on the part of banks. It would, however, make bank failures and panics more likely.**
- **C.** It is not a good idea. Eliminating or limiting the amount of deposit insurance would help increase the moral hazard of excessive risk taking on the part of banks. It would, however, make bank failures and panics more likely.
- **D.** It is a good idea. Eliminating or limiting the amount of deposit insurance would help increase the moral hazard of excessive risk taking on the part of banks. Moreover, it would make bank failures and panics less likely.

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4. How could higher deposit insurance premiums for banks with riskier assets benefit the economy?

- **A. Risk-based premiums would help mitigate the moral hazard problem; however, it is difficult to monitor the degree of risk in bank assets because often only the bank making the loans knows how risky they are**
- **B.** Risk-based premiums would help mitigate the adverse selection problem; however, it is difficult to monitor the degree of risk in bank assets because often only the bank making the loans knows how risky they are
- **C.** Risk-based premiums would eliminate the moral hazard problem. Furthermore, since the technology exists to accurately estimate the riskiness of bank assets, implementing this policy could significantly benefit the economy
- **D.** Risk-based premiums would eliminate the adverse selection problem. Furthermore, since the technology exists to accurately estimate the riskiness of bank assets, implementing this policy could significantly benefit the economy

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5. What are the costs and benefits of a too-big-to-fail policy?

- **A.** The benefit is shareholders of common stock in big banks are better protected against losing money; however, the cost is that it increases the incentive for adverse selection by big banks
- **B.** **The benefit is that it makes bank panics less likely; however, the cost is that it increases the incentive for moral hazard by big banks**
- **C.** The benefit is shareholders of common stock in big banks are better protected against losing money; however, the cost is that it increases the incentive for moral hazard by big banks
- **D.** The benefit is that it makes bank panics less likely; however, the cost is that it increases the incentive for adverse selection by big banks

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6. Consider a failing bank. If the FDIC uses the payoff method[2], a deposit of $330,000 is worth $ **297,000** . *(Round your response to the nearest whole number.)*

If the FDIC uses the purchase and assumption method[3], a deposit of $330,000 is worth $ **330,000** . *(Round your response to the nearest whole number.)*

Which method is more costly to taxpayers?

- **A.** The payoff method.
- **B.** **The purchase and assumption method.**
- **C.** Both methods are equally costly to taxpayers.

2: Definition

Payoff Method

One of two primary methods the FDIC uses to handle failed banks. In the *payoff method*, the FDIC allows the bank to fail and pays off deposits up to the $250,000 insurance limit (with funds acquired from the insurance premiums paid by the banks who have bought FDIC insurance).

3: Definition

Purchase and Assumption Method

One of two primary methods the FDIC uses to handle failed banks. In the *purchase and assumption method*, the FDIC reorganizes the bank, typically by finding a willing merger partner who assumes all of the failed bank's liabilities so that no depositor or other creditor loses a penny.

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7. Why does the existence of deposit insurance increase the likelihood that depositors will need deposit protection?

- **A.** Insured banks tend to be too conservative, reducing the profitability of the bank
- **B.** With increased deposit protection, depositors are likely to withdraw large amounts of funds from their accounts
- **C.** **Insured banks tend to pursue greater risks than they otherwise would**
- **D.** Insured banks tend to regard deposits as an unattractive source of funds due to depositor demands for safety

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8. Give one example each of moral hazard[4] and adverse selection[5] in private insurance arrangements.

- **A.** Leaving your car unlocked with the keys in it is an example of adverse selection, while a person with poor health seeking health insurance is an example of moral hazard
- **B.** An insurance company that sells a policy with inflated premiums is an example of adverse selection, while an insurance company that intentionally selects high-risk clients is an example of moral hazard
- **C.** **Leaving your car unlocked with the keys in it is an example of moral hazard, while a person with poor health seeking health insurance is an example of adverse selection**
- **D.** An insurance company that sells a policy with inflated premiums is an example of moral hazard, while an insurance company that intentionally selects high-risk clients is an example of adverse selection

4: Definition

Moral hazard

The risk that one party to a transaction will engage in behaviour that is undesirable from the other party's point of view.

5: Definition

Adverse selection

The problem created by asymmetric information *before* a transaction occurs: The people who are the most undesirable from the other party's point of view are the ones who are most likely to want to engage in the financial transaction.

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9. If a bank becomes insolvent and the FDIC reorganizes the bank by finding a willing merger partner, the FDIC resolved this insolvency problem through the

(1) ____________ .

It is (2) ____________ for the taxpayer if the FDIC resolves an insolvent institution by the "payoff method".

(1)
- ○ CAMELS method
- ◉ **purchase and assumption method**
- ○ payoff method
- ○ safety net method

(2)
- ○ about the same cost
- ◉ **usually cheaper**
- ○ typically more costly

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10. Which of the following is true of a banking system with deposit insurance?

- ○ **A.** Depositors are more likely to collect information about the quality of the bank's loans.
- ○ **B.** The moral hazard problem in banking is reduced.
- ◉ **C. Depositors are less likely to withdraw their money in the event of a crisis.**
- ○ **D.** Depositors are less likely to deposit their money in a bank.

In order to limit the moral hazard incentives for banks to engage in the excessively risky behavior encouraged by deposit insurance,

- ○ **A.** the government should be able to monitor the actions of the depositors.
- ○ **B.** there must be only a few large banks.
- ○ **C.** banks should pay a premium for the deposit insurance.
- ◉ **D. a strong, institutional environment must be in place.**

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11. Suppose Universal Bank holds $100 million in assets, which are composed of the following:

Required Reserves:	$10 million
Excess Reserves:	$ 5 million
Mortgage Loans:	$20 million
Corporate Bonds:	$15 million
Stocks:	$25 million
Commodities:	$25 million

Do you think it is a good idea for Universal Bank to hold stocks, corporate bonds, and commodities as assets?

- ○ **A.** Yes, as these types of assets surely provide the bank with extra profits.
- ◉ **B. No, as these types of assets are relatively high risk, and there is a threat of insolvency.**

If the housing market suddenly crashed, Universal Bank would be better off with (1) ____________ accounting system.

If the price of commodities suddenly increased sharply, Universal Bank would be better off with (2) ____________ accounting system.

What do your previous answers tell you about the tradeoffs between the two accounting systems? *(Check all that apply.)*

- ☐ **A.** The historical-cost system provides a more accurate picture of a bank's capital position.
- ☑ **B. Mark-to-market rules generally provide a more accurate picture of a bank's capital position.**
- ☐ **C.** Mark-to-market rules increase the value of collateral in downturns.
- ☑ **D. Using historical-cost can provide more capital stability for banks during downturns.**

(1) ◉ **the historical-cost**
○ a mark-to-market

(2) ○ the historical-cost
◉ **a mark-to-market**

12. Why might more competition in financial markets be bad?

- A. It would be more difficult for the FDIC to use the purchase-and-assumption method to handle failed banks.
- **B. There would be greater incentive for financial firms to take on greater risk.**
- C. There would be a higher probability of a contagion effect during economic downturns.
- D. More funds would be spent on regulations to monitor financial institutions.

Would restrictions on competition be better?

- **A. No, restrictions would decrease the efficiency of banking institutions.**
- B. No, restrictions would result in lower fees to consumers and therefore lower profits for banks.
- C. Yes, restrictions may increase the efficiency of banking institutions.
- D. Yes, restrictions would decrease the incentive for risk by financial markets and therefore increase bank profits.

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13. Oldhat Financial starts its first day of operations with $11 million in capital. A total of $135 million in checkable deposits are received. The bank makes a $25 million commercial loan and another $50 million in mortgages, with the following terms: 200 standard 30-year, fixed-rate mortgages with a nominal annual rate of 5.25%, each for $250,000. Assume that required reserves are 8%.

Complete the bank's balance sheet provided below. *(Round your responses to the nearest whole number.)*

Assets				Liabilities			
Required reserves	$	**11**	million	Checkable deposits	$	**135**	million
Excess reserves	$	**60**	million	Bank capital	$	**11**	million
Loans	$	**75**	million				

The leverage ratio is **7.53** %, and the bank is (1) ________. *(Round your response to two decimal places.)*

The risk-weighted assets after Oldhat's first day are $ **50** million. *(Round your response to the nearest whole number.)*

The risk-weighted capital ratio after Oldhat's first day is **22.00** %. *(Round your response to two decimal places.)*

(1)
- in a dire capital position
- **well capitalized**

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14. Oldhat Financial starts its first day of operations with $10 million in capital. A total of $140 million in checkable deposits are received. The bank makes a $20 million commercial loan and another $40 million in mortgages, with the following terms: 200 standard 30-year, fixed-rate mortgages with a nominal annual rate of 5.25%, each for $200,000. Assume that required reserves are 8%. The bank's balance sheet is shown below:

Assets			**Liabilities**	
Required reserves	$11	million	Checkable deposits	$140 million
Excess reserves	$79	million	Bank capital	$10 million
Loans	$60	million		

Early the next day the bank invests $35 million of its excess reserves in commercial loans. Later that day, terrible news hits the mortgage markets, and mortgage rates jump to 13%, implying a present value of its current mortgage holdings of $99,838 per mortgage. Bank regulators force Oldhat to sell its mortgages to recognize the fair market value.

What does Oldhat's balance sheet look like? *(Round your responses to the nearest whole number. Use a minus sign to enter negative numbers.)*

Fill in the blanks in the actual balance sheet as it would look after the sale:

Assets				**Liabilities**			
Required reserves	$	**11**	million	Checkable deposits	$	**140**	million
Excess reserves	$	**64**	million	Bank capital	$	**−10**	million
Loans	$	**55**	million				

The bank is now (1) ______________.

(1) ◯ well capitalized
◉ **in a dire capital position**

15. Consider a bank with the following balance sheet:

Assets			Liabilities	
Required reserves	$10	million	Checkable deposits	$120 million
Excess reserves	$17	million	Bank capital	− $13 million
Loans	$80	million		

Assume that required reserves are 8%. In order to avoid insolvency, regulators decide to provide the bank with $22 million in bank capital. Assume that bad news about mortgages is featured in the local newspaper, causing a bank run. As a result, $25 million in deposits is withdrawn.

Show the effects of the capital injection and bank run on the balance sheet. *(Round your responses to the nearest whole number.)*

Assets			Liabilities	
Required reserves	$ **8**	million	Checkable deposits	$ **95** million
Excess reserves	$ **16**	million	Bank capital	$ **9** million
Loans	$ **80**	million		

Was the capital injection enough to stabilize the bank?

The bank now has a capital ratio of **8.7** %, and the bank is (1) ________. *(Round your response to one decimal place.)*

If the bank regulators decide that the bank needs a capital ratio of 10% to prevent further runs on the bank, how much of an additional capital injection is required to reach the 10% capital ratio?

Bank regulators need to inject an additional $ **1.6** million to reach the 10% capital ratio. *(Round your response to one decimal place.)*

(1) ○ in a dire capital position
◉ **well capitalized**

16. Which agency has regulatory responsibility when a bank operates in many different countries?

○ **A.** The International Monetary Fund.
○ **B.** The Bank of International Settlements.
○ **C.** The U.S. Federal Reserve System.
◉ **D. It is not always clear.**

17. Which of the following is a main provision of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989?

- **A. The establishment of the Resolution Trust Corporation to manage and resolve insolvent thrifts.**
- B. Encouraging the FDIC to take prompt corrective action.
- C. Reducing the regulatory responsibilities of the FDIC.
- D. Directing the Federal Home Loan Bank Board to continue to pursue regulatory forbearance.

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18. A bank's capital-to-asset ratio is also known as its (1) ____________.

Regulators impose capital requirements on banks because a low capital-to-asset ratio dramatically

- **A. increases a bank's moral hazard.**
- B. decreases a bank's rate of return on equity.
- C. increases a bank's adverse selection.
- D. increases a bank's CAMELS rating.

(1)
- equity ratio
- liability ratio
- profit ratio
- **leverage ratio**

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19. Banking laws in the first half of 1900's were passed to

- A. increase bank competition and increased efficiency in banking.
- **B. reduce bank competition and reduced efficiency in banking.**
- C. reduce bank competition and increased efficiency in banking.
- D. increase bank competition and reduced efficiency in banking.

Many countries agreed to the requirements of the financial treaty known as the Basel Accord because they wanted to standardize

- **A. bank capital requirements across international boundaries.**
- B. deposit insurance across international boundaries.
- C. bank examinations across international boundaries.
- D. branching restrictions across international boundaries.

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20. (1) ____________ requires financial firms to value assets at what they would sell for in the market.

A major flaw of the mark-to-market accounting is that

- A. banks may not want to reveal their assets.
- B. it requires a certain amount of assets to be a viable measure.
- C. it is costly to measure the pricing of the market.
- **D. the price of an asset sold at a time of financial distress or a bubble does not reflect its fundamental value.**

(1)
- Value-at-risk accounting
- Stress test accounting
- **Mark-to-market accounting**

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21. Suppose the Fed pays no interest on bank reserves. For every $3000 in deposits, how much do banks lose in forgone interest due to the reserve requirement (after rounding to the nearest two decimal place) if the reserve requirement is 11% and the rate at which banks lend is 7%?

- A. 330
- B. 231
- **C. 23.1**
- D. 210

If the interest rate on the loans increases, then the opportunity cost of the reserves (1) ____________.

(1)
- remains the same
- **rises**
- declines

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22. How does the emergence of interest-rate risk help explain financial innovation?

- A. It decreases the demand for new financial innovation because these products are often risky.
- B. It increases profits for financial institutions and thus increases the supply of new financial instruments.
- C. It allows financial institutions to avoid the limits set on the interest rate paid on time deposits.
- **D. It increases the demand for financial products and services that could reduce that risk.**

How does the emergence of interest-rate risk help explain financial innovation?

An increase in interest-rate risk (1) ______________ the demand for financial innovation.

(1)
- decreases
- **increases**
- does not change

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23. “If inflation had not risen in the 1960s and 1970s, the banking industry might be healthier today.” Is this statement true, false, or uncertain? Explain your answer.

- A. False. Higher inflation helped raise interest rates, which helped the banking industry. Problems in the U.S. banking system are primarily due to financial innovation.
- **B. True. Higher inflation helped raise interest rates, which caused the disintermediation process to occur and helped create money market mutual funds.**
- C. False. Higher inflation helped raise interest rates, which helped the banking industry. Problems in the U.S. banking system are primarily due to the abolishment of Regulation Q.
- D. True. Higher inflation helped raise interest rates, which caused the disintermediation process to occur and prompted the reinstatement of Regulation Q and NOW accounts.

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24. How do sweep accounts and money market mutual funds allow banks to avoid reserve requirements?

- **A. Although they function as interest-earning deposits, these accounts are not legally deposits and so are not subject to reserve requirements.**
- B. Because these accounts pay a return that is slightly below the Regulation Q ceiling, they are not subject to reserve requirements.
- C. Because banks are able to "sweep" funds from these accounts into other transaction accounts, they are able to avoid reserve requirements.
- D. Reserve requirements on any interest bearing account cannot be avoided because they are mandated by the Federal Reserve System.

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25. Why is loophole mining so prevalent in the banking industry in the United States?

- **A.** By engaging in loophole mining, banks can limit financial innovation and thus increase their profits.
- **B.** Banks engage in loophole mining in order to protect their depositors from the risks of regulatory constraints.
- **C.** Because banks are heavily regulated, loopholes are always written into new legislation.
- **D. Banks engage in loophole mining in order to avoid regulatory constraints that restrict their ability to earn profits.**

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26. Why have banks been losing cost advantages in acquiring funds in recent years?

- **A. The increased cost of funds from higher interest rates and the abolishment of Regulation Q.**
- **B.** The reinstatement of Regulation Q and the appearance of NOW accounts significantly increased disintermediation.
- **C.** Foreign banks have been able to tap a large pool of domestic savings, thereby lowering their cost of funds relative to American banks.
- **D.** Both A and C are correct.
- **E.** All of the above are correct.

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27. Prior to 2008, the Fed did not pay interest on bank reserves. If banks charged 10% on loans and the required reserve ratio was 11%, then for every $1500 in deposits, the amount that banks lost in forgone interest (opportunity cost) because of reserve requirements is $ **16.50** . *(Round your response to the nearest two decimal place.)*

Without any interest in reserves, if the interest rate is equal to 5% and the reserve ratio is 15%, then the foregone interest per $500 in deposits, when rounded to the nearest two decimal place, is

- **A. $3.75**
- **B.** $75.
- **C.** $50.
- **D.** $25.

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28. 'The commercial banking industry in Canada is less competitive than the commercial banking industry in the United States because in Canada only a few large banks dominate the industry, while in the United States there are around 6,500 commercial banks.' Is this statement true or false? Explain your answer.

- **A.** True. The reason for the large number of US banks is regulations that promote competition such as branching restrictions
- **B.** False. It is not true that the industry is dominated by a few large firms; thus, based on the Herfindahl-Hirschman Index, the banking industry in Canada is just as competitive as in the United States
- **C. False. The reason for the large number of US banks is anticompetitive regulations such as branching restrictions**
- **D.** True. The banking industry is less competitive in Canada than in the United States because Canada has a national banking system, i.e., owned and operated by the government

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29. Which of the following is *not* a reason for the dramatic increase in the number of bank holding companies[6]?

- **A. Bank holding companies can monopolise the market for banking services in a given region**
- **B.** Bank holding companies can provide leasing, credit card services, and servicing of loans in other states
- **C.** Bank holding companies can circumvent branching restrictions because they can own a controlling interest in several banks even if branching is not permitted
- **D.** Bank holding companies can engage in other activities related to banking, which can be highly profitable

6: Definition

Bank holding companies

Companies that own one or more banks.

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30. The presence of so many commercial banks in the United States is most likely the result of:

- **A.** consumers' desire to deal with local banks only
- **B.** consumer preferences for federally chartered banks
- **C. previous restrictions on branch banking**
- **D.** asymmetric information problems that give local banks a competitive advantage over larger banks

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31. The McFadden Act of 1927:

- **A. prohibited banks from branching across state lines.**
- B. required that all banks seek deposit insurance.
- C. required that banks maintain bank capital equal to at least 6 percent of their assets.
- D. separated commercial banks and investment banks.

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32. As a result of strict banking regulations, the United States has:

- A. a few dominant banks that hold most of the assets in the banking industry
- **B. many more smaller banks when compared to other industrialised countries**
- C. too few banks when compared to other industrialised countries
- D. banks that are quite large relative to those in other industrialised countries

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33. According to the text, there are about

- A. 10,000 commercial banks in the United States.
- **B. 5,700 commercial banks in the United States.**
- C. 15,000 commercial banks in the United States.
- D. 5,000 commercial banks in the United States.

Most industries in the United States have (1) ____________ firms than the commercial banking industry.

(1)
- more
- about the same
- **fewer**

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34. The large number of banks in the United States

- **A.** are roughly equal to the number of banks in most developed countries.
- **B.** is evidence that the banking system in the United States is very competitive.
- **C.** are likely to substantially grow in number over the next few decades.
- **D.** **resulted from restrictive branching laws.**

Historically in the United States, branching laws have been most restrictive in the (1) ____________.

(1)
- Northeast
- Southeast
- **Midwest**
- Southwest

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35. Unlike commercial banks, savings and loans, and mutual savings banks, credit unions did not have restrictions on locating branches in other states. Why, then, are credit unions typically smaller than the other depository institutions?

- **A.** **Credit unions are small because members usually share a common employer or have ties to a particular organization.**
- **B.** To maintain their tax-exempt status, credit unions must remain smaller than other depository institutions.
- **C.** Credit unions are small because they operate under diseconomies of scale.
- **D.** The National Credit Union Association (NCUA) regulates the size of credit unions.

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36. Thrift institutions include:

- **A.** commercial banks
- **B.** **mutual savings banks**
- **C.** insurance companies
- **D.** brokerage firms

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37. What is a primary characteristic of credit unions?

- **A.** Lending is primarily in the form of mortgage loans for credit unions
- **B.** Credit unions are typically large
- **C.** Branching across state lines is prohibited in credit unions
- **D. Credit unions are organised around a group of individuals that belong to a common institution**

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38. Which of the following is the only depository institution to maintain a tax-exempt status?

- **A.** Savings and loan associations
- **B.** Mutual savings banks
- **C. Credit unions**
- **D.** Commercial banks

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39. Which of the following statements about savings and loans is not true?

- **A.** Savings and loans have historically been subject to less restrictive branching laws than banks.
- **B.** Savings and loans are supervised by the Office of Thrift Supervision.
- **C. There are more savings and loans than banks.**
- **D.** Savings and loans have deposit insurance.

Compared to banks, credit unions

- **A.** usually lend to commercial enterprises.
- **B.** have no deposit insurance.
- **C. have customers that share some common bond such as employment.**
- **D.** tend to be larger.

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40. What is the major difference between banking systems in the United States and Japan?

- **A.** Japanese banks are not allowed to hold substantial equity stakes in commercial firms, whereas American banks can.
- **B.** Japanese banks are usually organized as bank holding companies.
- **C.** Bank holding companies are illegal in the United States.
- **D.** **American banks are not allowed to hold substantial equity stakes in commercial firms, whereas Japanese banks can.**

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41. Which of the following is associated with asymmetric information in a financial crisis?

- **A.** Moral hazard could occur when only borrowers know if the funds will be used to finance high-risk activities.
- **B.** Adverse selection can occur if lenders must select from a pool of bad credit risks.
- **C.** There is a lack of information about one or more of the parties involved in a transaction.
- **D.** **All of the above are correct.**

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42. Which of the following statements is true of financial frictions?

- **A.** Financial frictions help avoid the problem of adverse selection in financial transactions.
- **B.** Financial frictions are a set of conditions that prevents financial markets from undertaking high-risk investment.
- **C.** Financial frictions help avoid the problem of moral hazard in financial markets.
- **D.** **Financial frictions are a set of conditions that prevents financial markets from effectively assigning funds to the best investment opportunities.**

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43. A well-functioning financial system:

- **A.** acts as a barrier to efficient allocation of capital.
- **B.** causes financial frictions to increase in an economy.
- **C.** creates unpredictable market disruptions.
- **D.** **solves asymmetric information problems.**

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44. A financial crisis occurs when:

- **A.** there are predictable market disruptions.
- **B. a particularly large disruption to information flows occurs in financial markets.**
- **C.** financial frictions decrease sharply.
- **D.** capital is allocated to its most productive uses.

45.
An increase in adverse selection and moral hazard in credit markets (1) ____________ bank lending.

Financial crises

- **A.** occur when financial frictions decrease sharply.
- **B. occur when information flows in financial markets experience a particularly large disruption.**
- **C.** is followed by an economic boom.
- **D.** often begin with financial liberalization or innovation

(1)
- does not affect
- **tends to decrease**
- tends to increase

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46. How can a bursting of an asset-price bubble in the stock market trigger a financial crisis[7]?

- **A.** A reduction in asset prices causes borrowing firms to have less to lose so they are willing to take on additional risk
- **B.** A reduction in asset prices causes a serious deterioration in borrowing firms' balance sheets
- **C.** A reduction in asset prices causes lenders to become more cautious and reduce the amount of loans they make
- **D. All of the above are correct**

7: Definition

Financial crisis

A financial crisis occurs when information flows in financial markets experience a particularly large disruption, with the result that financial frictions increase sharply and financial markets stop functioning.

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47. How does an unanticipated decline in the price level cause a drop in lending?

- (selected) **A. A decline in the price level raises the real value of borrowing firms' liabilities while lowering the firms' real net worth**
- **B.** A decline in the price level lowers the nominal value of loan contracts that have already been made
- **C.** A decline in the price level reduces the moral hazard associated with borrowing firms
- **D.** A decline in the price level does not affect lending

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48. What is a credit spread?

- **A.** The difference between the net worth of a borrower and the amount of the loan the borrower would like to secure.
- **B.** The difference between a borrower's credit score and the score of the most credit-worthy borrower.
- (selected) **C. The difference between interest rates on loans to households and businesses and interest rates on completely safe assets such as U.S. Treasury bonds.**
- **D.** The difference between the interest rate on corporate bonds with different maturities.

Why do credit spreads rise during financial crises?

- (selected) **A. Credit spreads rise because asymmetric information problems increase, making it more difficult to judge the risk of potential borrowers.**
- **B.** Credit spreads rise because the government becomes the only institution that is able to lend money to borrowers.
- **C.** Credit spreads rise because depositors with productive investment opportunities withdraw their funds from banks, which creates an incentive to lend to borrowers with riskier investment opportunities.
- **D.** None of the above are correct.

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49. What role does weak financial regulation and supervision play in causing financial crises?

- **A.** It helps establish tighter rules and regulations for lending activities.
- **B.** It reduces the risk that financial institutions will make bad loans.
- (selected) **C. It allows financial institutions a better opportunity to engage in excessive risk-taking behavior.**
- **D.** It creates higher interest rates, as government expenditures will tend to increase.

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50. The seeds of a financial crisis are often sown when an economy eliminates restrictions on financial markets and institutions, an event known as

(1) ____________.

With higher losses on loans, financial institutions undergo (2) ____________, the process of cutting back their lending to borrower-spenders.

(1)
- ◉ **financial liberalization**
- ○ financial frictions
- ○ financial innovation
- ○ credit boom

(2)
- ○ debt deflation
- ○ credit boom
- ◉ **deleveraging**
- ○ credit risking

51. When a fire sale occurs,

- ○ **A.** adverse selection and moral hazard are reduced.
- ◉ **B. banks may become insolvent.**
- ○ **C.** financial frictions are low.
- ○ **D.** uncertainty is reduced.

Which of the following does not cause a reduction in the net worth of the borrowing firm in a loan market?

- ◉ **A. an unanticipated increase in the price level that reduces the value of the firm's liabilities**
- ○ **B.** a decline in the stock market that drops the value of the firm
- ○ **C.** an unanticipated decline in the value of the domestic currency when the firm's debt is denominated in terms of a foreign currency
- ○ **D.** asset write-downs on the firm's balance sheet

52. Which of the following is unlikely to cause a reduction in lending?

- A. a decline in the stock market
- B. a bank panic
- **C. a decrease in interest rates**
- D. an unanticipated decline in the price level

(1) ______________ is a loan to someone with less-than-excellent credit.

(1)
- Credit boom
- Collateralized Debt
- **Subprime mortgage**
- Financial liberalization

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53. Which of the following is true of securitization?

- A. It is a process that drives the prices of financial instruments above their fundamental economic values.
- **B. It is a process that converts a series of financial instruments into marketable securities.**
- C. It is a process that converts high-risk financial instruments into default-free financial instruments.

Was the process of securitization solely responsible for the Great Recession of 2007-2009? (1) ______________

Which of the following factors apart from securitization was responsible for the Great Recession of 2007-2009?

- A. A sudden rise in equity prices.
- **B. An increase in funds lent to subprime borrowers.**
- C. An increase in the federal funds rate.

(1)
- **No**
- Yes

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54. Which of the following statements are likely to be in favor of the idea that the Fed was responsible for the housing price bubble in the mid-2000s in the United States? *(Select all that apply.)*

- [x] **A. The Fed set the federal funds rate at an extremely low level.**
- [ ] **B.** Capital inflows from India and China coupled with no attractive investment opportunities.
- [x] **C. The Fed was not stringent enough in regulating and monitoring financial intermediaries.**
- [ ] **D.** Lowering of lending standards.

Which of the following statements is likely to contradict the idea that the Fed was responsible for the housing price bubble of the mid-2000s in the United States? *(Select all that apply.)*

- [ ] **A.** The Fed was not stringent enough in regulating and monitoring financial intermediaries.
- [ ] **B.** The Fed set the federal funds rate at an extremely low level.
- [x] **C. Lowering of lending standards.**
- [x] **D. Capital inflows from India and China coupled with no attractive investment opportunities.**

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55. Identify the similarities between the United States' experiences during the Great Depression and the financial crisis of 2007-2009. *(Check all that apply.)*

- [ ] **A.** Both episodes resulted in significant declines in GDP and a significant increase in unemployment of 25%.
- [ ] **B.** A bank panic occurred during both episodes.
- [x] **C. Credit spreads widened and the availability of credit declined during both episodes.**
- [ ] **D.** The source of the asset − price increase was the same for both episodes.
- [x] **E. Both episodes were preceded by sharp increases in asset prices.**

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56. Which of the following did *not* help prevent the financial crisis of 2007-2009 from becoming a depression?

- ○ **A.** The use of nonconventional policy by the Federal Reserve to create term auction facilities.
- ○ **B.** The creation of new programs, such as lending to investment banks and purchasing commercial paper, by the Federal Reserve.
- ◉ **C. The purchase of stock and ownership takeovers of troubled banks by the Federal Reserve.**
- ○ **D.** The Federal Reserve's use of monetary policy to lower the federal funds rate target.

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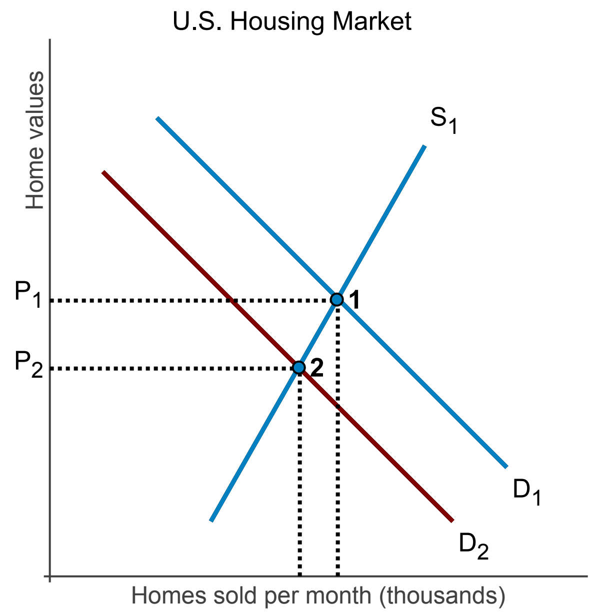
57. Housing prices boomed from 2002 to 2006, and then prices started to decline in 2006, falling by more than 30%, which led to defaults by subprime mortgage holders. [8]

Effect	
A	Subprime borrowers found the value of the house fell below the amount of the mortgage
B	Defaults on houses declined during this period
C	Banks began to restrict the availability of credit to households

Which of the effects listed above may have helped trigger the subprime financial crisis starting in 2007?

- ○ **A.** B and C.
- ○ **B.** A and B.
- ◉ **C.** **A and C.**
- ○ **D.** A, B, and C.

8: More Info



When the housing price bubble burst, demand for housing decreased dramatically, causing home values to fall precipitously.

58. Choose the components of the *shadow banking system*. *(Check all that apply.)*

- [ ] **A.** Commercial banks.
- [x] **B.** **Hedge funds.**
- [x] **C.** **Investment banks.**
- [x] **D.** **Money market funds.**
- [ ] **E.** Savings and loan associations.

Why is the shadow banking system an important part of the 2007-2009 financial crisis?

- ○ **A.** An increase of funding from the shadow banking system resulted in a decrease in the issuance of CDOs, increasing the severity of adverse selection and moral hazard problems.
- ◉ **B.** **A decrease of funding from the shadow banking system caused a restriction of lending and a decline in economic activity.**
- ○ **C.** A large amount of funds flowed through the shadow banking system, which increased interest rates and fueled some of the housing bubble.
- ○ **D.** The shadow banking system was able to take on significantly less risk than other financial firms, preventing the economy from losses.

---

59. Why is it a good idea for macroprudential policies to require countercyclical capital requirements?

- ○ **A.** This type of policy increases capital requirements during economic downturns to prevent bank failures.
- ○ **B.** This type of policy allows for the use of the most appropriate accounting system to evaluate bank capital reserves.
- ○ **C.** Macroprudential policies with countercyclical capital requirements always help to solve adverse selection problems.
- ◉ **D.** **This type of policy reduces lending and helps to mitigate credit bubbles during economic booms.**

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60. How does the process of financial innovation impact the effectiveness of macroprudential regulation?

- **A.** With financial innovation and the new financial instruments created, legislation has increased, which has made financial regulation more difficult.
- **B.** Because financial innovations are constantly changing, they tend to reduce the efficiency of the financial system.
- **C. It may be difficult for regulators to understand how new financial innovations will impact the overall financial system, as these innovations may often be mismanaged or misunderstood.**
- **D.** As new financial innovations arise, regulators are better able to understand their impact on the financial system and thus may prevent a future bank crisis.

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61. Why were consumer protection provisions included in the Dodd-Frank bill, a bill designed to strengthen the financial system?

- **A.** Consumer protection will prevent financial institutions from engaging in excessive risk taking.
- **B.** By limiting banks' proprietary trading, it will protect consumer interests.
- **C. Consumer protection will avert future financial problems in the housing market.**
- **D.** Consumer protection provisions will simplify the loan process for consumers.

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62. Why is it important for the U.S. government to have resolution authority?

- **A.** Resolution authority gives the government the authority to increase the level of deposit insurance if necessary.
- **B.** It provides that banks cannot engage in high-risk trading when receiving the benefits of federal deposit insurance.
- **C.** Resolution authority solves asymmetric information problems and thus prevents a contagion effect.
- **D. Resolution authority allows the government to quickly takeover a failing firm.**

---

63. The primary reason for the creation of the Federal Reserve System[9] was:

- A. to create a single central bank similar to the Bank of England.
- B. to stabilize short-term interest rates.
- **C. to reduce or eliminate future bank panics.**
- D. to eliminate state-chartered banks.

9: Definition

Federal Reserve System (The Fed)
The central banking authority responsible for monetary policy in the United States.

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64. Why was the Federal Reserve System set up with twelve regional Federal Reserve banks rather than one central bank, as in other countries?

- A. By creating twelve regional banks, writers of the Federal Reserve Act could ensure that finances from all parts of the country would flow through the Federal Reserve System.
- B. With twelve regional banks, the Federal Reserve could easily influence politics in all parts of the United States.
- **C. The writers of the Federal Reserve Act wanted to ensure the Fed's power was not centralized in a single location.**
- D. With twelve regional banks, employees of the Federal Reserve could quickly and easily get to a monetary crisis point anywhere in the United States.

---

65. Which of the following is *not* part of the checks and balances of the Federal Reserve System[10]?

- A. The Fed's independence from the federal government and the setting up of the Federal Reserve banks as incorporated institutions.
- B. The ability of the twelve regional banks to affect discount policy.
- C. The provision for three types of directors to district banks (A, B, and C) that would represent different groups (professional bankers, business people, and the public).
- **D. The requirement that all depository institutions keep deposits at the Fed.**

10: Definition

Federal Reserve System (The Fed)
The central banking authority responsible for monetary policy in the United States.

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66. Which of the following entities in the Federal Reserve System[11] controls the discount rate[12]?

- A. The Federal Advisory Council
- B. The FDIC
- **C. The Board of Governors**
- D. Member commercial banks

Which of the following entities in the Federal Reserve System sets reserve requirements?

- A. Member commercial banks
- B. The FDIC
- C. The Federal Advisory Council
- **D. The Board of Governors**

Which of the following entities in the Federal Reserve System directs open market operations[13]?

- **A. The FOMC**
- B. The Board of Governors
- C. Member commercial banks
- D. The Federal Advisory Council

11: Definition

Federal Reserve System (The Fed)

The central banking authority responsible for monetary policy in the United States.

12: Definition

Discount rate

The interest rate that the Federal Reserve charges banks on discount loans.

13: Definition

Open market operations

The Fed's buying or selling of bonds in the open market.

67. The Board of Governors of the Federal Reserve System:

- ○ **A.** establishes, within limits, reserve requirements.
- ○ **B.** effectively sets the discount rate.
- ○ **C.** sets margin requirements.
- ○ **D.** Only A and B are correct.
- ◉ **E. All of the above are correct.**

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68. Although neither _____ nor the _____ is officially set by the Federal Open Market Committee[14], decisions concerning these policy tools are effectively made by the committee.

- ◉ **A. reserve requirements; discount rate**
- ○ **B.** reserve requirements; federal funds rate
- ○ **C.** margin requirements; discount rate
- ○ **D.** margin requirements; federal funds rate

14: Definition

Federal Open Market Committee (FOMC)

The committee that makes decisions regarding the conduct of open market operations; composed of the seven members of the Board of Governors of the Federal Reserve System, the president of the Federal Reserve Bank of New York, and the presidents of four other Federal Reserve banks on a rotating basis.

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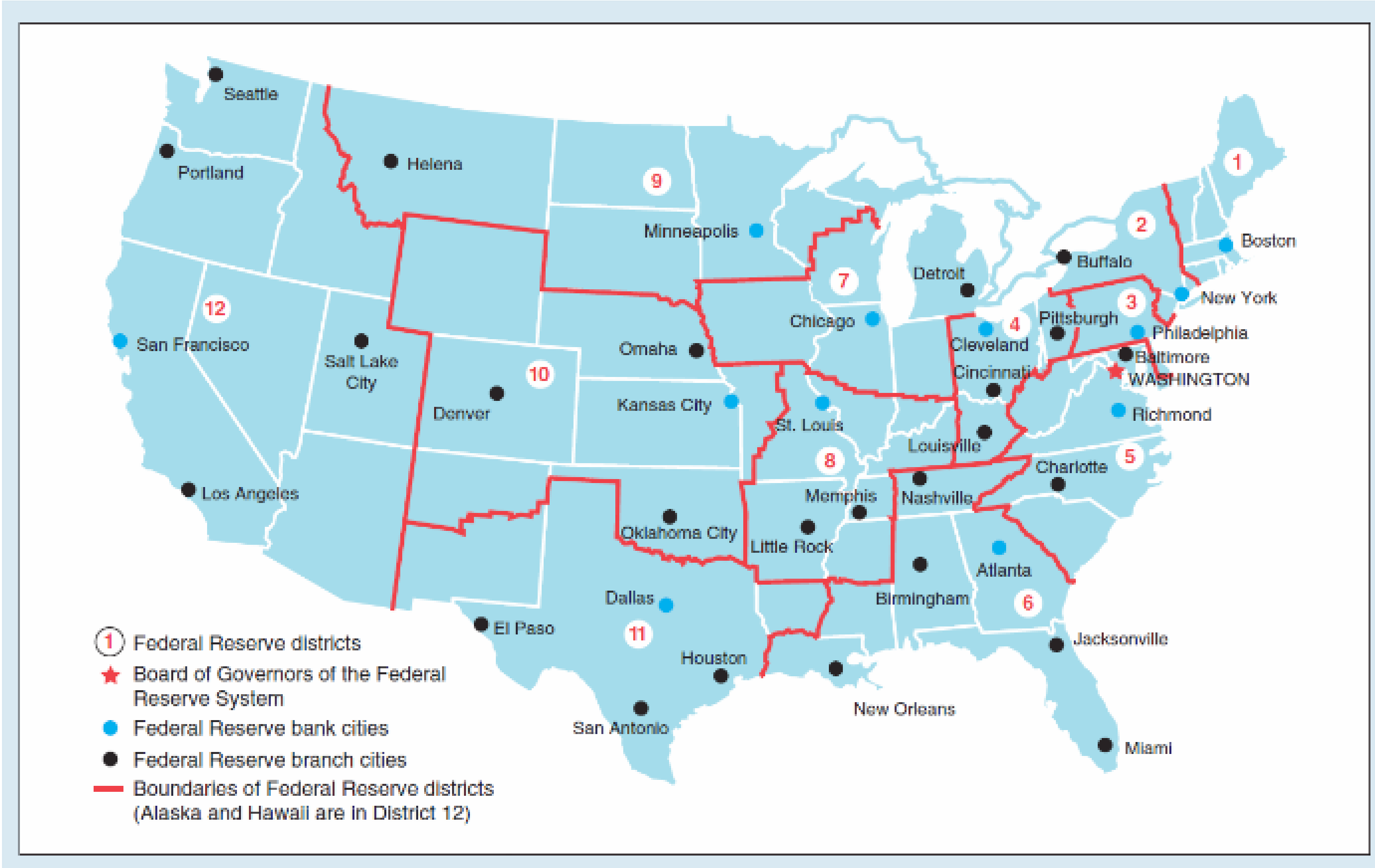
69. The Federal Reserve System include the following except the

- ○ **A.** Federal Open Market Committee.
- ○ **B.** Federal Advisory Council.
- ◉ **C. U.S. Treasury.**
- ○ **D.** member commercial banks.

The policy tools of the Fed are the following except

- ○ **A.** open market operations.
- ○ **B.** the discount rate.
- ◉ **C. bond creation.**
- ○ **D.** reserve requirements.

70.



Referring to the figure about the Federal Reserve System above, we find that

- ◯ **A.** there is a main Federal Reserve Bank in Denver.
- ◉ **B. there are 12 federal reserve bank cities.**
- ◯ **C.** there are no branches aside from the main Federal Reserve bank in district 12.
- ◯ **D.** all districts have more than one Federal Reserve bank branch.

Each Federal Reserve district has (1) __________ main Federal Reserve bank/banks.

(1) ◯ three
◉ **one**
◯ two

71. How does the Federal Reserve have a high degree of instrument independence?

- (selected) **A. The Federal Reserve can choose any method it wants in order to achieve a given set of policy objectives.**
- **B.** The Federal Reserve can contract with independent experts to choose the appropriate fiscal instruments.
- **C.** The Federal Reserve is able to set the goals of monetary policy.
- **D.** The Federal Reserve is not subject to the influence of Congress.

If the Federal Reserve has a specific mandate from Congress to achieve "maximum employment and low, stable prices," then how does the Fed have goal independence?

- **A.** The Fed can choose any method it wants in order to achieve the assigned goal.
- (selected) **B. The Fed is free to interpret exactly what these objectives mean.**
- **C.** The Fed is free to discuss the assigned goals with Congress.
- **D.** The Fed is able to change its goals frequently.

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72. Advocates of Fed independence fear that subjecting the Fed to direct presidential or congressional control would:

- **A.** impart an inflationary bias to monetary policy.
- **B.** force monetary authorities to sacrifice the long-run objective of price stability.
- **C.** make the so-called political business cycle less pronounced.
- (selected) **D. Only A and B are correct.**
- **E.** All of the above are correct.

---

73. 'The independence of the Fed has meant that it takes the long view and not the short view.' Assume this statement is correct and answer the following questions.

The Fed's personnel are not directly affected by the outcome of the next election; therefore, it has some level of independence: (1) ________

The Fed can still be influenced by political pressure: (2) ________

The Fed's lack of accountability may make the Fed more irresponsible: (3) ________

The members of the board generally cannot be reappointed to their position; they do not need to do favours in order to keep their job in the future. (4) ________

(1) ◉ **True** ○ False

(2) ○ True ◉ **False**

(3) ○ True ◉ **False**

(4) ◉ **True** ○ False

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74. Eliminating the Fed's independence might lead to a more pronounced political business cycle because a politically exposed Fed would be more concerned with:

◉ **A. short-run objectives and thus be more likely to engage in expansionary policies designed to lower unemployment and interest rates before an election.**

○ **B.** long-run objectives and thus be more likely to engage in expansionary policies designed to lower unemployment and interest rates before an election.

○ **C.** short-run objectives and thus be a defender of a sound dollar and a stable price level.

○ **D.** long-run objectives and thus be a defender of a sound dollar and a stable price level.

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75. Critics of Fed independence argue that:

◉ **A. it is undemocratic to have monetary policy controlled by an elite group responsible to no one**

○ **B.** the Fed, since it does not face a binding budget constraint, spends too much of its earnings

○ **C.** an independent Fed conducts monetary policy with a consistent inflationary bias

○ **D.** Only A and B are correct