Financial markets promote economic efficiency by
A) channeling funds from investors to savers.
B) creating inflation.
C) channeling funds from savers to investors.
D) reducing investment.

2. An increase in interest rates might _______ saving because more can be earned in interest income.
   A) encourage
   B) discourage
   C) disallow
   D) invalidate

3. A corporation acquires new funds only when its securities are sold in the
   A) secondary market by an investment bank.
   B) primary market by an investment bank.
   C) secondary market by a stock exchange broker.
   D) secondary market by a commercial bank.

4. Which of the following statement is WRONG about secondary market?
   A) Dealers and brokers facilitate trades in secondary market.
   B) Borrowing and lending happen in secondary market.
   C) The existence of secondary market helps increase liquidity in primary market.
   D) Secondary market is for resale of financial instruments.
5. Which of the following markets are organized as OVER-THE-COUNTER (OTC) markets:
   A) the New York Stock Exchange
   B) the secondary market for U.S. government bonds
   C) the Chicago Board of Trade (CBOT)
   D) All of the above.

6. The concept of diversification is captured by the statement
   A) don't look a gift horse in the mouth.
   B) don't put all your eggs in one basket.
   C) it never rains, but it pours.
   D) make hay while the sun shines.

7. Which of the following statements about Financial Intermediaries is WRONG?
   A) Financial Intermediaries is a bigger source of funds than financial markets in most countries.
   B) Financial Intermediaries reduce risks and lower transaction costs.
   C) Financial Intermediaries perform financial asset transformations.
   D) Financial Intermediaries provide the main channel for direct finance.

8. Which of the following statements are TRUE?
   A) A common stock is a claim on a corporation’s net income and assets.
   B) A debt instrument requires the issuer to pay the holder certain specified payments at regularly specified intervals until the maturity date is reached.
   C) A debt instrument is called “money market instrument” if its maturity is less than a year.
   D) All of the above are true

9. I deposit $100 in the U.S bank. Then, this deposit contract is a financial instrument that is issued by U.S. bank as a claim on ______ future income and asset, and is a _____ for me and a ___ for the U.S. bank.
   A) U.S. bank; financial asset; liability
   B) my; liability; financial asset
   C) my; financial asset; liability
   D) U.S. bank; real asset; financial asset

10. Which of the following is not a goal of financial regulation?
    A) Ensuring the soundness of the financial intermediaries
    B) Increase information in the financial system
    C) Prevent financial panics and ‘bank runs’
    D) Ensuring that investors never suffer losses

11. The organization responsible for the conduct of monetary policy in the United States is the
    A) Comptroller of the Currency.
B) U.S. Treasury.
C) Federal Reserve System (the Fed)
D) Bureau of Monetary Affairs

12. To an economist, ________ is anything that is generally accepted in payment for goods and services or in the repayment of debt.
   A) wealth
   B) income
   C) money
   D) credit

13. Which of the following statement best describe the value of ‘paper money’ such as a dollar bill?
   A) Value of paper money would not change in hyperinflation (extremely severe inflation).
   B) Value of paper money for me depends on whether other people accept it or not (think it is valuable or not).
   C) It has a direct use value just like commodity money (e.g. gold and silver).
   D) Value of paper money is guaranteed by bank

14. The conversion of a barter economy to one that uses money
   A) increases efficiency by reducing the need to exchange goods and services.
   B) increases efficiency by reducing the need to specialize.
   C) increases efficiency by reducing transactions costs.
   D) does not increase economic efficiency.

15. If there are three goods in a barter economy, then one needs to know ________ prices in order to exchange one good for another.
   A) 9
   B) 6
   C) 3
   D) 1

16. Which of the following is not included in the M1 measure of money but is included in the M2 measure of money?
   A) Currency
   B) Traveler's checks
   C) Demand deposits
   D) Small-denomination time deposits

17. Generally, the data initially reported by the Fed are
   A) not a reliable guide to the short-run behavior of the money supply.
   B) not a reliable guide to the long-run behavior of the money supply.
   C) a reliable guide to the short-run behavior of the money supply.
   D) usually underestimate the revised statistics.
18. A fixed-payment loan (for example, a home mortgage loan) has a loan value of $50,000, with annual fixed payments of $6,000 and a maturity of 20 years. By solving which of the following equations for \( i \) could we find yield to maturity for this loan?

A) \[ i \times 50,000 = 6,000 \times 20 \]

B) \[ 50,000 = \frac{6,000}{(1+i)} + \frac{6,000}{(1+i)^2} + \ldots + \frac{6,000+50,000}{(1+i)^{20}} \]

C) \[ 50,000 = \frac{6,000}{(1+i)} + \frac{6,000}{(1+i)^2} + \ldots + \frac{6,000}{(1+i)^{20}} \]

D) \[ \frac{50,000}{20} = \frac{6,000}{(1+i)} \]

19. If a security pays nothing next year and $121 the year after that, what is its yield to maturity if it sells for $100 now?

A) 9 percent  
B) 10 percent  
C) 11 percent  
D) 12 percent

**Question 20: Answer questions (a) through (c)**

Suppose you have $100 and want to decide which way to invest.

(a) Your bank offers you a deposit contract with a 0.1 interest rate for 3 year investment. How much would you get at the end of year 3?

**Answer:** \[ $100 \times (1+0.1)^3 \approx $133 \]

(b) Suppose there is a newly issued security with a 3-year maturity that promises to pay $100 at the end of year 3 and nothing else. Do you think it is a good deal to buy this security at a price $100? Why?

**Answer:** $100 in the future worth less then $100 now, it is not a good deal.

(c) If another security promises to pay $50 at the end of year 1 and $100 at the end of year 3, interest rate is 0.1, what is the present value of this debt instrument?

**Answer:**

\[ PV = \frac{50}{(1+0.1)} + \frac{100}{(1+0.1)^3} \approx 120.6 \]

**Questions 21: Choose to answer only one of the two questions below:**

1. From historical data we saw that the rate of money growth has declined before every recession. If recession is a bad thing, then why doesn’t the Fed just set a high money
supply growth all the time? (Hint, think about the relationship between a high money supply growth and inflation)

**Answer:**
An increase in money growth rate would normally result in higher inflation which is not desirable. You may list adverse effects of inflation on the economy and state that fight against inflation is as important as fight against recession.

2. Because of asymmetric information in a lending situation, we must deal with the problems of adverse selection and moral hazard. Define either adverse selection or moral hazard and explain how financial intermediaries can reduce these problems.

**Answer:**
Adverse selection is the asymmetric information problem that exists before the transaction occurs. For lenders, it is the difficulty in judging a good credit risk from a bad credit risk. Moral hazard is the asymmetric information problem that exists after the transaction occurs. For lenders, it is the difficulty in making sure the borrower uses the funds appropriately. Financial intermediaries can reduce adverse selection through intensive screening and can reduce moral hazard by monitoring the borrower.

**Question 22: Answer questions (a) through (c)**
Suppose you buy a 2-year bond with a face value of $1000, coupon payment is $50 per year,
(a) What’s coupon rate?
**Answer:** coupon rate = 50/1000 = 5%, same as yield to maturity.
(b) If the yield to maturity for this bond turns out to be 5%, what should the selling price be?
**Answer:** Since coupon rate equals yield to maturity, selling price should equal to face value, $1000. or:
$$ P = \frac{50}{(1+.05)} + \frac{1050}{(1+.05)^2} = $1000 $$
(c) One year later, the interest rate rise to 10%. If you need to sell this bond next year, what should the selling price be then?
**Answer:** price should equal to present value which is:
$$ P = \frac{1050}{(1+.1)} = $954.55 $$
(d) What’s your rate of return?
**Answer:**
$$ r = \frac{50 + 954.55 - 1000}{1000} = 0.455\% $$
(d) If expected inflation is 2%, the 10% nominal interest rate implies real interest rate to be what?
**Answer:**
$$ i_r = 10\% - 2\% = 8\% $$