Econ 353: Money, Banking and Financial Markets
Problem Set 1

1. Markets in which funds are transferred from those who have excess funds available to those who have a shortage of available funds are called
   A) commodity markets.
   B) fund-available markets.
   C) derivative exchange markets.
   **D) financial markets.**

2. Evidence from the United States and other foreign countries indicates that
   **A) there is a strong positive association between inflation and growth rate of money over long periods of time.**
   B) there is little support for the assertion that "inflation is always and everywhere a monetary phenomenon."
   C) countries with low monetary growth rates tend to experience higher rates of inflation, all else being constant.
   D) money growth is clearly unrelated to inflation.

3. The management of money and interest rates is called ________ policy and is conducted by a nation's ________ bank -- the Federal Reserve Bank.
   A) monetary; superior
   B) fiscal; superior
   C) fiscal; central
   **D) monetary; central**

4. The bond markets are important because they are
   A) easily the most widely followed financial markets in the United States.
   B) the markets where foreign exchange rates are determined.
   C) **the markets where interest rates are determined.**
   D) the markets where all borrowers get their funds.

5. An important financial institution that assists in the initial sale of securities in the primary market is the
   A) investment bank.
   B) commercial bank.
   C) stock exchange.
   D) brokerage house.

6. Economies of scale enable financial institutions to
   A) reduce transactions costs.
   B) avoid the asymmetric information problem.
   C) avoid adverse selection problems.
   D) reduce moral hazard.
7. Typically, borrowers have superior information relative to lenders about the potential returns and risks associated with an investment project. The difference in information is called ________, and it creates the ________ problem.
   A) adverse selection; moral hazard
   B) asymmetric information; risk sharing
   C) asymmetric information; adverse selection
   D) adverse selection; risk sharing

8. Securities are ________ for the person who buys them, but are ________ for the individual or firm that issues them.
   A) assets; liabilities
   B) liabilities; assets
   C) negotiable; nonnegotiable
   D) nonnegotiable; negotiable

9. The primary purpose of deposit insurance is to
   A) improve the flow of information to investors.
   B) prevent banking panics.
   C) protect bank shareholders against losses.
   D) protect bank employees from unemployment.

10. Corporations receive funds when their stock is sold in the primary market. Why do corporations pay attention to what is happening to their stock in the secondary market?
    **Answer:**
    The existence of the secondary market makes their stock more liquid and the price in the secondary market sets the price that the corporation would receive if they choose to sell more stock in the primary market.

11. What are the two types of asymmetric information in financial markets and how can financial intermediaries solve those 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.