

File: c02; Chapter 2: The Financial System and the Level of Interest Rates

Format: True/False

Learning Objective: LO 1

Level of Difficulty: Easy

1. The role of the financial system is to gather money from people and businesses that have funds to invest and to channel money to those that need it.
A) True
B) False
Ans: A

Format: True/False

Learning Objective: LO 1

Level of Difficulty: Easy

2. The financial system is nothing more than a collection of financial markets.
A) True
B) False
Ans: B

Format: True/False

Learning Objective: LO 1

Level of Difficulty: Easy

3. Without a financial market, purchasing a house would require a cash purchase.
A) True
B) False
Ans: A

Format: True/False

Learning Objective: LO 1

Level of Difficulty: Easy

4. Governments are the principal lender-savers in the economy.
A) True
B) False
Ans: B

Format: True/False

Learning Objective: LO 1

Level of Difficulty: Medium

5. Businesses are the principal borrower-spenders in the economy.
A) True
B) False
Ans: A

Format: True/False

Learning Objective: LO 1

Level of Difficulty: Easy

6. Direct financial markets could be broadly labeled as wholesale markets for funding.

A) True
B) False

Ans: A

Format: True/False

Learning Objective: LO 2

Level of Difficulty: Medium

7. A privately held corporation securing a loan from its regional commercial bank is an example of a direct market transaction.

A) True
B) False

Ans: B

Format: True/False

Learning Objective: LO 2

Level of Difficulty: Medium

8. The law that barred commercial banks from investment banking activities is the Financial Services Modernization Act of 1999.

A) True
B) False

Ans: B

Format: True/False

Learning Objective: LO 2

Level of Difficulty: Easy

9. Today, large money center banks in U.S have been allowed back into the investment business.

A) True
B) False

Ans: A

Format: True/False

Learning Objective: LO 3

Level of Difficulty: Easy

10. A primary market is any financial market in which owners of outstanding securities can resell them to other investors.

A) True
B) False

Ans: B

Format: True/False

Learning Objective: LO 3

Level of Difficulty: Easy

11. The vast preponderance of securities sales on the New York Stock Exchange are secondary market transactions.
- A) True
 - B) False
- Ans: A

Format: True/False

Learning Objective: LO 3

Level of Difficulty: Medium

12. The existence of an active secondary market for a security will help enhance the price for a security in the primary market.
- A) True
 - B) False
- Ans: A

Format: True/False

Learning Objective: LO 3

Level of Difficulty: Medium

13. The downside to a private placement transaction is that it does not require the fees and expenses associated with an SEC registration.
- A) True
 - B) False
- Ans: B

Format: True/False

Learning Objective: LO 3

Level of Difficulty: Easy

14. Brokers are market specialists who do not bear risk of ownership of securities.
- A) True
 - B) False
- Ans: A

Format: True/False

Learning Objective: LO 3

Level of Difficulty: Easy

15. The term *money market* reflects the idea that the instruments traded in the money market are highly marketable and easily converted into cash.
- A) True
 - B) False
- Ans: A

Format: True/False

Learning Objective: LO 5

Level of Difficulty: Medium

16. Equities are generally traded in the capital market.

A) True
B) False

Ans: A

Format: True/False

Learning Objective: LO 5

Level of Difficulty: Easy

17. Most individuals use indirect financing to fund their needs..

A) True
B) False

Ans: A

Format: True/False

Learning Objective: LO 5

Level of Difficulty: Medium

18. Business finance companies obtain the majority of their funds by selling equity.

A) True
B) False

Ans: B

Format: True/False

Learning Objective: LO 6

Level of Difficulty: Medium

19. The nominal rate of interest is the rate of interest that is adjusted for inflation.

A) True
B) False

Ans: B

Format: True/False

Learning Objective: LO 6

Level of Difficulty: Medium

20. Real rates of interest are perfectly observable.

A) True
B) False

Ans: B

Format: True/False

Learning Objective: LO 6

Level of Difficulty: Medium

21. It is impossible for the nominal rate of interest to be below the real rate of interest.

A) True
B) False

Ans: B

Format: Multiple Choice

Learning Objective: LO 1

Level of Difficulty: Medium

22. An economy with a large flow of funds requires

A) a lot of gold reserves.
B) a frictionless market.
C) an efficient financial system.
D) all of the above.

Ans: C

Format: Multiple Choice

Learning Objective: LO 1

Level of Difficulty: Easy

23. Financial markets and financial institutions are both part of

A) the U.S. Treasury.
B) the financial system.
C) the SEC.
D) none of the above.

Ans: B

Format: Multiple Choice

Learning Objective: LO 1

Level of Difficulty: Medium

24. Savings by _____ is the origin of much of the money that funds large business loans in an economy.

A) consumers
B) the U.S. government
C) small businesses
D) none of the above

Ans: A

Format: Multiple Choice

Learning Objective: LO 1

Level of Difficulty: Easy

25. A financial system's primary concern is funneling money from
- A) wealthy individuals to individuals.
 - B) lender-savers to borrower-spenders
 - C) borrower-spenders to lender-savers
 - D) the government to wealthy individuals
- Ans: B

Format: Multiple Choice

Learning Objective: LO 1

Level of Difficulty: Easy

26. _____ are the principal lender-savers in the economy.
- A) Households
 - B) Investment banks
 - C) State governments
 - D) Businesses
- Ans: A

Format: Multiple Choice

Learning Objective: LO 1

Level of Difficulty: Easy

27. An important function of the financial system is
- A) to direct money to the best investment opportunities in the economy.
 - B) to allow the federal government to view all financial transactions.
 - C) to help state governments to coordinate state tax levies.
 - D) all of the above.
- Ans: A

Format: Multiple Choice

Learning Objective: LO 1

Level of Difficulty: Easy

28. Direct financing occurs when
- A) a lender-savers borrows directly from a borrower-spenders.
 - B) a borrower-spenders borrows directly from a lender-savers.
 - C) an lender-savers borrows from the federal government.
 - D) a borrower-spenders borrows from the federal government.
- Ans: B

Format: Multiple Choice

Learning Objective: LO 2

Level of Difficulty: Easy

29. Which of the following is a major participant in the direct financial market?

- A) Large corporations
- B) Wealthy individuals
- C) Investment banks
- D) All of the above.

Ans: D

Format: Multiple Choice

Learning Objective: LO 2

Level of Difficulty: Easy

30. The major players in the direct financial markets are

- A) investment banks.
- B) money center banks.
- C) regional banks.
- D) both a and b.

Ans: D

Format: Multiple Choice

Learning Objective: LO 2

Level of Difficulty: Easy

31. What is the generally recognized minimum denominated transaction in the direct financial markets?

- A) \$10,000
- B) \$100,000
- C) \$1,000,000
- D) \$10,000,000

Ans: C

Format: Multiple Choice

Learning Objective: LO 2

Level of Difficulty: Easy

32. Which law is responsible for rolling back many of the rules against commercial banks offering investment banking activities?

- A) The Securities Act of 1933
- B) The Securities Exchange Act of 1934
- C) The Glass-Steagall Act of 1933
- D) The Financial Services Modernization Act of 1999

Ans: D

Format: Multiple Choice

Learning Objective: LO 2

Level of Difficulty: Easy

33. Which of the following is a process by which investment bankers purchase new securities directly from the issuing company and resell them to the public?

A) Agency marketing
B) Underwriting
C) Distribution
D) Private placement

Ans: B

Format: Multiple Choice

Learning Objective: LO 3

Level of Difficulty: Easy

34. Stocks that are traded in the _____ are typically those of smaller and lesser known firms.

A) National Stock Exchange
B) New York Stock Exchange
C) American Stock Exchange
D) over-the-counter

Ans: D

Format: Multiple Choice

Learning Objective: LO 3

Level of Difficulty: Easy

35. The financial market where a new security is sold for the first time is

A) a primary market.
B) a secondary market.
C) an indirect market.
D) none of the above.

Ans: A

Format: Multiple Choice

Learning Objective: LO 3

Level of Difficulty: Medium

36. Secondary financial markets are similar to

A) direct auction markets.
B) new-car markets.
C) used-car markets.
D) all of the above.

Ans: C

Format: Multiple Choice

Learning Objective: LO 3

Level of Difficulty: Easy

37. If you just purchased a share of IBM through a New York Stock Exchange-based transaction, you participated in
- A) a primary market transaction.
 - B) a secondary market transaction.
 - C) a futures market transaction.
 - D) none of the above.

Ans: B

Format: Multiple Choice

Learning Objective: LO 3

Level of Difficulty: Easy

38. The ease with which a security can be sold and converted into cash is called
- A) convertibility.
 - B) book value.
 - C) marketability.
 - D) none of the above.

Ans: C

Format: Multiple Choice

Learning Objective: LO 3

Level of Difficulty: Medium

39. The presence of a financial market increases the marketability of a financial security by
- A) essentially insuring the price of the security.
 - B) reducing the transaction costs for selling the security.
 - C) guaranteeing the accuracy of information produced by the issuer of the security.
 - D) none of the above.

Ans: B

Format: Multiple Choice

Learning Objective: LO 3

Level of Difficulty: Easy

40. One of the main services offered by investment banks to companies is
- A) helping companies sell new debt or equity issues in the security markets.
 - B) making loans to companies.
 - C) taking deposits from companies.
 - D) all of the above.

Ans: A

Format: Multiple Choice

Learning Objective: LO 3

Level of Difficulty: Easy

41. The NYSE is an example of
- A) an over-the-counter market exchange.
 - B) an organized exchange.
 - C) a commodities exchange.
 - D) all of the above.
- Ans: B

Format: Multiple Choice

Learning Objective: LO 3

Level of Difficulty: Medium

42. Which of the following markets has no physical location?
- A) A futures exchange
 - B) An over-the-counter market
 - C) An auction market
 - D) None of the above
- Ans: B

Format: Multiple Choice

Learning Objective: LO 3

Level of Difficulty: Medium

43. A highly liquid financial instrument with a maturity of 90 days would be traded in
- A) the money market.
 - B) the bond market.
 - C) the stock market.
 - D) none of the above.
- Ans: A

Format: Multiple Choice

Learning Objective: LO 3

Level of Difficulty: Easy

44. Money market instruments are generally issued by
- A) firms in dire need of cash to maintain their credit rating.
 - B) firms of the highest credit rating.
 - C) firms of the lower credit ratings.
 - D) all of the above.
- Ans: B

Format: Multiple Choice

Learning Objective: LO 3

Level of Difficulty: Medium

45. The term *money market* came about because
- A) firms that issue securities in this market are in dire need of cash.
 - B) it is a market where stocks are converted into money.
 - C) the securities traded in this market are a close substitute for cash.
 - D) none of the above.
- Ans: C

Format: Multiple Choice

Learning Objective: LO 3

Level of Difficulty: Medium

46. If a firm needs to adjust its liquidity position, then it would participate in
- A) the money market.
 - B) the bond market.
 - C) the stock market.
 - D) all of the above.
- Ans: A

Format: Multiple Choice

Learning Objective: LO 3

Level of Difficulty: Easy

47. If a firm needs to finance a new corporate headquarters building, then it would most likely seek the funds in the
- A) money market.
 - B) capital market.
 - C) futures market.
 - D) all of the above.
- Ans: B

Format: Multiple Choice

Learning Objective: LO 3

Level of Difficulty: Medium

48. The most common reason that corporate firms use the futures and options markets is
- A) to hedge risk.
 - B) to take risk.
 - C) to make deposits.
 - D) none of the above.
- Ans: A

Format: Multiple Choice

Learning Objective: LO 4

Level of Difficulty: Medium

49. Which of the following theories states that security prices reflect all public information, but not all private information?
- A) Weak-form efficiency
 - B) Semistrong-form efficiency
 - C) Strong-form efficiency
 - D) Nominal-form efficiency

Ans: B

Format: Multiple Choice

Learning Objective: LO 4

Level of Difficulty: Medium

50. Which of the following theories states that security prices reflect all information, whether public or private?
- A) Weak-form efficiency
 - B) Semistrong-form efficiency
 - C) Strong-form efficiency
 - D) Nominal-form efficiency

Ans: C

Format: Multiple Choice

Learning Objective: LO 5

Level of Difficulty: Easy

51. If your firm primarily borrows from commercial banks, then it primarily accesses the capital markets through
- A) direct financing.
 - B) indirect financing.
 - C) a legal loophole that allows all commercial banks the ability to underwrite securities.
 - D) none of the above.

Ans: B

Format: Multiple Choice

Learning Objective: LO 5

Level of Difficulty: Medium

52. The process of converting financial securities with one set of characteristics into securities with another set of characteristics is called
- A) financial bundling.
 - B) financial intermediation.
 - C) financial disintermediation.
 - D) none of the above.

Ans: B

Format: Multiple Choice

Learning Objective: LO 5

Level of Difficulty: Easy

53. A line of credit to a corporation is like _____ to an individual.

A) a term loan
B) a bond
C) a credit card
D) none of the above

Ans: C

Format: Multiple Choice

Learning Objective: LO 5

Level of Difficulty: Medium

54. Which of the following is a primary investment vehicle for the funds in which life insurance companies must invest?

A) CDs
B) Stocks
C) Long-term corporate bonds
D) Both b and c

Ans: D

Format: Multiple Choice

Learning Objective: LO 5

Level of Difficulty: Easy

55. Casualty insurance companies sell

A) protection against loss of income in the event of the death of the insured.
B) protection against loss of property from fire, theft, accidents, and other predictable causes.
C) protection against a loss of pension revenue for retirees.
D) all of the above.

Ans: B

Format: Multiple Choice

Learning Objective: LO 5

Level of Difficulty: Medium

56. Which of the following would not make up a major proportion of a pension fund investment portfolio?

A) Commercial paper
B) Long-term corporate bonds
C) Stocks
D) None of the above

Ans: A

Format: Multiple Choice

Learning Objective: LO 5

Level of Difficulty: Easy

57. A mutual fund is an example of

- A) a line of credit.
- B) an endowment fund.
- C) an investment fund.
- D) a pension fund.

Ans: C

Format: Multiple Choice

Learning Objective: LO 5

Level of Difficulty: Medium

58. If a small business opts not to borrow from a commercial bank, then what will probably be its next best alternative?

- A) An insurance company
- B) A pension
- C) An investment fund
- D) A finance company

Ans: D

Format: Multiple Choice

Learning Objective: LO 6

Level of Difficulty: Easy

59. The price of borrowing money is called

- A) inflation.
- B) return.
- C) interest.
- D) all of the above.

Ans: C

Format: Multiple Choice

Learning Objective: LO 6

Level of Difficulty: Medium

60. The nominal rate of interest is made up of

- A) the real rate of interest.
- B) compensation for inflation.
- C) a commodity cross-index return.
- D) both a and b above.

Ans: D

Format: Multiple Choice

Learning Objective: LO 6

Level of Difficulty: Medium

61. The real rate of return can be justified, at a basic level, by
- A) compensation for inflation.
 - B) compensation for deferring consumption.
 - C) compensation for the level of international borrowing.
 - D) all of the above.
- Ans: B

Format: Multiple Choice

Learning Objective: LO 6

Level of Difficulty: Medium

62. If you are a borrower, which would you prefer to occur during the life of your loan?
- A) A level of inflation that is higher than that anticipated at the outset of the loan.
 - B) A level of inflation that is lower than that anticipated at the outset of the loan.
 - C) A level of inflation that is exactly as anticipated at the outset of the loan.
 - D) No inflation at all
- Ans: A

Format: Multiple Choice

Learning Objective: LO 6

Level of Difficulty: Medium

63. If inflation is anticipated to be 5 percent during the next year, while the real rate of interest for a one-year loan is 5 percent, then what should the nominal rate of interest be for a risk-free one-year loan?
- A) 5 percent
 - B) 10 percent
 - C) 25 percent
 - D) None of the above
- Ans: B

Format: Multiple Choice

Learning Objective: LO 6

Level of Difficulty: Medium

64. The general level of interest rates tends to follow
- A) deflation.
 - B) the business cycle.
 - C) the default cycle.
 - D) all of the above.
- Ans: B

Format: Multiple Choice

Learning Objective: LO 6

Level of Difficulty: Medium

65. During an economic expansion, we would expect

- A) interest rates to increase.
- B) interest rates to decrease.
- C) interest rates to remain the same.
- D) the price of money to decrease.

Ans: A

Format: Multiple Choice

Learning Objective: LO 6

Level of Difficulty: Medium

66. In the United States, the real rate of interest has historically been around

- A) 1 percent.
- B) 3 percent.
- C) 5 percent.
- D) 7 percent.

Ans: B

Format: Multiple Choice

Learning Objective: LO 6

Level of Difficulty: Medium

67. If the supply of loanable funds decreases relative to the demand for those funds, then we would expect

- A) interest rates to remain unchanged.
- B) interest rates to increase.
- C) interest rates to decrease.
- D) the price of money to remain unchanged.

Ans: B

Format: Multiple Choice

Learning Objective: LO 6

Level of Difficulty: Medium

68. If a firm sells common stock to the public for the very first time, it is known as _____.

- A) an underwriting
- B) an initial public offering
- C) a financial intermediation
- D) an origination

Ans: B

Format: Essay

Level of Difficulty: Medium

Learning Objective: LO 3

69. Explain why secondary markets are so important to businesses that need to raise capital?

Ans: Secondary markets provide liquidity to the buyers of securities. They facilitate the sale of securities because they enable investors to buy and sell securities as frequently as they want. Secondary markets are important to corporations because investors are willing to pay higher prices for securities in primary markets if the securities have active secondary markets. This lowers the cost of capital for the corporations that issue securities.