

ANSWER OUTLINE – Multiple Choice Answers at End

ECONOMICS 353

L. Tesfatsion/Fall 2010

EXERCISE 8: Six Questions (8 Pts Total)

DUE: Tuesday, November 9, 2:10pm

****IMPORTANT REMINDER: LATE ASSIGNMENTS WILL NOT BE ACCEPTED
– NO EXCEPTIONS****

EXERCISE INSTRUCTIONS:

- (1) Please **fill in your name and student ID number** on Side 1 of your bubble sheet and write **353 Exercise 8** in the top margin of Side 1.
- (2) The first six multiple-choice questions Q1-Q5 focus on basic topics from Mishkin Chapter 8. The remaining question Q6 asks you to summarize and comment on the financial market implications of the “lemons problem” researched by Nobel Laureate George Akerloff and discussed by Mishkin in the main Chapter 8 text and in web exercise 1 at the end of Chapter 8.
- (3) Use a number 2 pencil to **mark your answers** to Q1-Q5 on Side 1 of your bubble sheet. Turn in this bubble sheet at the beginning of class on the due date. Separately turn in an answer sheet for Q6, being sure to put your name and student ID number in the top margin.
- (4) Each question Q1 through Q5 is worth 1 point, and Q6 is worth 3 points.

Q1 (1 point). The largest source of EXTERNAL FINANCE for U.S. businesses is _____.

- A. stocks
- B. bonds
- C. bank and nonbank loans
- D. venture capital firms
- E. retained earnings

Q2 (1 Point). During 1970-2000, in which country below did firms use DIRECT FINANCE for external financing to the greatest degree when compared to the firms of the other listed countries?

- A. United States
- B. Germany
- C. Japan
- D. Canada

Q3 (1 Point). The TRANSACTIONS COSTS associated with a loan contract refer to _____

- A. the principal plus interest payments of the borrower under the loan contract.
- B. the costs of bringing together borrowers and lenders and preparing the loan contract.
- C. the costs of reducing asymmetric information problems associated with the loan contract.
- D. all of the above.

Q4 (1 Point). The following tools help solve ADVERSE SELECTION PROBLEMS in financial markets:

- A. private production and sale of credit ratings for individuals and firms
- B. government regulation to increase information to investors
- C. use of financial intermediaries that specialize in the gathering of information about would-be borrowers
- D. inclusion of collateral requirements in loan contracts as a quality signal
- E. all of the above

Q5 (1 Point). Which of the following is NOT a tool used by corporations to reduce PRINCIPAL-AGENT PROBLEMS.

- A. Stockholders engage in costly state verification by auditing an observing management.
- B. Venture capital firms provide funds to new firms in exchange for equity and membership on the board of directors.
- C. Firms issue equity instead of debt because principal-agent problems are smaller with equity.
- D. Governments regulate firms by imposing standard accounting principles and punishing fraud.

Q6 (3 Points Total).

Q6.A (1.5 Points) Carry out Web Exercise 1 in Mishkin Chapter 8, pages 191-192. Specifically, *in your own words*, provide a brief but careful summarization of the key ideas of Nobel prize winner George Akerlof on the “lemons problem” as set out at the following web reference: www.nobel.se/economics/laureates/2001/public.html

Answer Outline for Q6.A: Any clear organized summary (in your own words) of the key ideas of Akerlof from the reading above will be accepted for full credit.

Q6.B (1.5 Points) *In your own words*, provide a brief but careful summarization of Mishkin’s Chapter 8 discussion of the importance of the “lemons problem” for the efficient functioning of financial markets.

Answer Outline for Q6.B: Any clear organized summary (in your own words) of the Mishkin Chapter 8 discussion of the importance of the “lemons problem” for the efficient functioning of financial markets will be accepted for full credit.

Answers to Multiple Choice Questions: Q1-C, Q2-A, Q3-B, Q4-E, Q5-C