

Student: _____

1. The financial system may be thought of as the mechanism through which loanable funds reach borrowers.
True False
2. Transactions in the financial markets generally involve the exchange of money for financial claims.
True False
3. A financial asset is a claim against the income or wealth of a business firm, household or unit of government.
True False
4. Financial assets are sought after, according to the text, because they serve as a store of value and generally provide a continuing stream of services to their owners.
True False
5. Any asset held by a business firm, government or household that is also recorded as a liability or claim on some other economic unit's balance sheet is a financial asset.
True False
6. The net worth account of any economic unit (i.e., business firm, household or unit of government) represents its accumulated savings.
True False
7. Internal financing consists of drawing upon current income and accumulated savings to fund the acquisition of assets.
True False
8. According to the text, externally generated funds are the most important source of funds to acquire assets for most businesses and households.
True False
9. One of the most important contributions of the global financial system to our daily lives is in permitting businesses, households and governments to adjust their financial position from that of net borrower (DBU) to net lender (SBU) and back again, smoothly and efficiently.
True False
10. The so-called "leverage effect" refers to boosting earnings through the use of debt whose cost is less than the earnings generated by the borrowed funds.
True False
11. The act of borrowing simultaneously gives rise to an equal volume of financial liabilities incurred.
True False
12. For each sector of the economy the volume of financial assets held must be equal to the volume of financial liabilities incurred.
True False
13. Real assets are necessarily matched by an equal volume of financial claims held somewhere in the financial system.
True False

14. The amount of lending in a closed financial system must always equal the amount of borrowing in that system. In a closed economy the total value of all real assets must equal the amount of borrowing in that system.
True False
15. Society can increase its wealth only by saving.
True False
16. A deficit-budget unit is a net borrower of funds from the financial marketplace; that is $DD < DFA$.
True False
17. A surplus-budget unit is a net lender of funds to the financial marketplace; that is, $DFA > DD$.
True False
18. The business sector is typically a net borrower of funds in the financial marketplace.
True False
19. The household sector is typically a net lender of funds in the financial marketplace.
True False
20. From day to day and week to week businesses, governments and households typically fluctuate from a deficit-budget position to a surplus-budget position and back again.
True False
21. Money's role as a standard of value means that it is usually the only financial asset which virtually every business, household and unit of government will accept in payment for goods and services.
True False
22. *Fiat money* consists of gold and silver coins whose precious metal content has been reduced, depreciating the value of the coin, by government order.
True False
23. Money's role as a medium of exchange frees buyers and sellers of goods and services from the need to have an exact coincidence of wants in terms of quality, quantity, time and location.
True False
24. The fact that money is the only "perfectly liquid asset" refers to the fact that it is the only asset that need not be converted into any other form before being spent.
True False
25. Purchasing stocks and bonds through a broker is an example of indirect finance.
True False
26. *Indirect finance* requires that ultimate lenders (surplus-budget units) and ultimate borrowers (deficit-budget units) have a coincidence of wants in terms of the amount, form and terms of loan.
True False
27. In *semi-direct finance* secondary securities are created.
True False
28. One of the most important contributions of security brokers and dealers is to facilitate the development and growth of secondary markets.
True False
29. The *hedging principle* refers to risk reduction by approximately matching the maturities of assets held with the maturities of liabilities taken on.
True False
30. During periods of disintermediation the *total* flow of credit through the financial system is reduced.
True False

31. Measured by total assets the most important financial institution is the insurance company.
True False
32. Commercial banks are contractual institutions.
True False
33. Savings banks are classified as investment institutions.
True False
34. Real estate investment trusts are among the largest financial intermediaries.
True False
35. The essential role of financial markets is to convert savings into investments.
True False
36. Society as a whole is better off by the mere creation of financial assets and liabilities.
True False
37. Every financial asset represents the lending or investing of money transferred from one economic unit to another.
True False
38. An example of a net lender is an economic unit which purchases U.S. Treasury Bills.
True False
39. A benefit of a financial system is the ability of economic units to adjust their financial positions smoothly and efficiently.
True False
40. It is not possible for an economic unit to be a lender and a borrower simultaneously.
True False
41. It is necessary for a monetary unit to have an intrinsic value as a commodity to be accepted as a medium of exchange.
True False
42. An advantage of indirect finance is that secondary securities are attractive to a limited portion of the population.
True False
43. The "hedging principle" involves attempting to match maturity of assets held to liabilities taken on.
True False
44. The financial asset which entitles its holder to a share of a business corporation's net earnings but carries no voting privileges is known as an *indenture*.
True False
45. Passbook savings accounts and U.S. Savings Bonds are examples of negotiable debt securities.
True False
46. A marketable corporate note would be a negotiable debt instrument.
True False
47. By definition financial assets provide a continuing stream of services to their owner.
True False
48. Financial assets are *fungible*, which means they can easily be transported from one location to another.
True False

49. Financial assets usually have a high commodity value.
True False
50. A new form of *disintermediation* in recent years has involved some banks and savings and loans selling off their capital by purchasing large quantities of new loans in an attempt to bolster their revenues, according to the text.
True False
51. The recent trend in which some of the best loan customers of banks and other financial intermediaries have chosen instead to raise the loanable funds they need directly from the open market is actually a new form of indirect finance or reintermediation.
True False
52. Recent trends in disintermediation have tended to increase the relative importance of banks within the global financial system.
True False
53. Due to recent deregulation, service innovations and lower average interest rates today's financial intermediaries face less uncertainty today than in the past regarding their funds sources and funds costs.
True False
54. A corporation that decides to turn down a loan from a bank and borrow instead in the open market has switched from semi-direct finance to direct finance, according to the textbook.
True False
55. Insurance companies and pension funds must adhere to the prudent man rule when making stock selections.
True False
56. Disintermediation occurs when a bank sells loans to raise funds.
True False
57. Corporations depend on banks and other financial institutions to meet their credit needs more today than they did in the past.
True False
58. When a corporation pools credit receivables and uses them as collateral for the sale of bonds it is engaged in semi-direct finance.
True False
59. Brokers take a position in the securities they trade while dealers do not.
True False
60. The M1 definition of the U. S. money supply includes small time and savings deposits.
True False
61. The sum of all U.S. currency and coin held by the public, travelers checks, NOW accounts and automatic funds transfer services represents the M2Z definition of the U.S. money supply.
True False
62. The M2 measure of the U.S. money supply includes currency and coin held by the public.
True False
63. The M1 definition of the U.S. money supply views money primarily as a medium of exchange.
True False
64. The M2 and M3 definitions of the U.S. money supply reflect mainly money's role as a store of value.
True False

65. Short-term borrowings in the money market are included in the M1 definition of the U.S. money supply.
True False
66. A derivative is so called because its value is derived from an underlying asset.
True False
67. Swaps, futures and options all represent a class of financial assets called derivatives.
True False
68. In a *security-dominated* financial system, adequate collateral is required by most banks when issuing loans.
True False
69. Much of the disintermediation experienced by modern financial intermediaries has occurred due to financial innovation within the global financial system.
True False
70. One of the most serious management problems encountered by financial intermediaries today is disintermediation – the loss of funds from a financial intermediary to direct or semidirect finance.
True False
71. In describing the entire financial system, the total of all financial liabilities outstanding should equal the sum of all financial assets held.
True False
72. Countries with more fully developed financial systems usually grow faster and have a higher standard of living.
True False
73. Compared to other nations and regions of the world the United States is considered a relatively safe haven for money.
True False
74. Within the United States financial system the largest borrower of money in 2006 was the federal government.
True False
75. Within the United States financial system the largest borrower of money in 2006 was the local and state governments.
True False
76. Within the United States financial system the largest borrower of money in 2006 were individuals, borrowing \$950 billion.
True False
77. Within the United States financial system the largest borrower of money in 2006 were nonfinancial businesses at \$88 billion.
True False
78. The largest borrowers of money in descending order in 2006 were first, individuals, second, the federal government and third, the local and state governments.
True False
79. Today, relative to check writing volume, electronic payments are declining.
True False
80. The monetary unit, which is used for the in country currency, in China is the yuan
True False

81. The monetary unit, which is used for the in country currency, in China is the yen
True False
82. That euro is used as the home country monetary unit in Japan.
True False
83. Both Canada and the United States use a monetary unit, which is used for the home country currency is called the dollar.
True False
84. M2Z is a money measure close to the transactions demand for money.
True False
85. Money serves as a "store of value" which is a reserve for future purchasing power.
True False
86. Direct finance is the technique when borrower and lender meet each other and exchange funds for financial assets without the help of a third-party.
True False
87. In the United States, banks hold approximately one quarter of the total resources of all US financial institutions, which in 2006 was \$9.5 trillion.
True False
88. Money market funds held in US financial institutions went from zero in 1970 to just over \$5 trillion in 2006.
True False
89. Disintermediation may reverse itself, with funds flowing back into the perceived safer instruments of financial intermediaries, a process called re-intermediation.
True False
90. Disintermediation may reverse itself, with funds flowing back into the perceived safer instruments of financial intermediaries, a process called re-intermediation.
True False
91. The largest borrowers of money in descending order in 2006 were first, Corporations, second, the federal government and third, the local and state governments.
True False
92. Today, relative to check writing volume, electronic payments are increasing.
True False
93. The M2 measure of the U.S. money supply includes currency and coin held by the corporations.
True False
94. Purchasing stocks and bonds through a broker is an example of direct finance.
True False
95. Long-term borrowings in the money market are included in the M1 definition of the U.S. money supply.
True False
96. Which one of the following is not a financial asset?
A. Bank loan
B. Common stock
C. Corporate Bond
D. Insurance policy
E. Checking account
F. All of the above are examples of financial assets

97. There is a term missing from the identity shown below: Expenditures out of Current Income - Current Income Receipts = Change in Holdings of Debt and Equity During the Current Period - _____. Which of the terms shown below correctly completes the identity above?
- A. Change in holdings of real and financial assets during the current period
 - B. Change in holdings of real assets during the current period
 - C. Change in holdings of financial assets during the current period
 - D. Change in net worth during the current period
 - E. None of the above
98. The inequality statement $E > R$ and $DD > DFA$, according to your text, describes a:
- A. Deficit-budget unit
 - B. Surplus-budget unit
 - C. Net lender of funds
 - D. Balanced-budget unit
 - E. None of the above
99. The inequality statement $R > E$ and $DFA > DD$, according to your text, describes a:
- A. Deficit-budget unit
 - B. Net borrower of funds
 - C. Surplus-budget unit
 - D. Balanced-budget unit
 - E. None of the above
100. The government sector in the economy usually is a:
- A. Balanced-budget sector
 - B. Surplus-budget sector
 - C. Deficit-budget sector
 - D. Financially neutral sector
 - E. None of the above
101. The household sector in the economy usually is a:
- A. Balanced-budget sector
 - B. Surplus-budget sector
 - C. Deficit-budget sector
 - D. Financially neutral sector
 - E. None of the above
102. The business sector in the economy usually is a:
- A. Balanced-budget sector
 - B. Surplus-budget sector
 - C. Deficit-budget sector
 - D. Financially neutral sector
 - E. None of the above
103. The text notes that a liquid asset must possess all of the following characteristics except one. Which item listed below is not necessarily true for a liquid asset?
- A. Price stability
 - B. Ready marketability
 - C. Reversibility
 - D. Divisibility
 - E. All of the above are necessary characteristics of a liquid asset
104. According to the text, the secondary securities issued by financial intermediaries include all of the following items except one. Which is not normally a secondary security?
- A. Checking accounts
 - B. Insurance policies
 - C. Retirement plans
 - D. Savings deposits
 - E. Corporate bonds

105. For the most part secondary securities issued by financial intermediaries share all of the following characteristics except one. Identify which one.
- A. Low risk
 - B. Long maturity
 - C. Small denominations
 - D. Liquidity
 - E. Convenience
106. According to the text, the most important financial asset in the economy is:
- A. Money
 - B. Common stock
 - C. Mortgages
 - D. Savings deposits in banks and credit unions
 - E. Government bonds
107. The fact that money is an asset which virtually every business, household, unit of government will accept in payment for goods and services describes money's role as a:
- A. Perfectly liquid asset
 - B. Standard of value
 - C. Store of value
 - D. Medium of exchange
 - E. None of the above
108. The fact that money always has a constant price in terms of itself (i.e., a dollar always exchanges for a dollar) refers to money's role as a:
- A. Medium of exchange
 - B. Standard of value
 - C. Store of value
 - D. Perfectly liquid asset
 - E. None of the above
109. Which of the following items is an example of fiat money?
- A. A twenty-dollar bill
 - B. Wampum
 - C. Gold coins minted by the government
 - D. Silver dollars
 - E. Credit card
110. Money's role as a store of value is reduced or made less effective by:
- A. Greater use of barter
 - B. Taxation
 - C. Declining prices for goods and services
 - D. Rising prices for goods and services
 - E. None of the above
111. Borrowing money from the bank is an example of:
- A. Indirect finance
 - B. Direct finance
 - C. Semi-direct finance
 - D. Internal finance
 - E. None of the above
112. Postponing purchases, selling of existing assets, borrowing or issuance of new stock are alternatives available for a lack of:
- A. External funds
 - B. Financial assets
 - C. Real assets
 - D. Internal funds
 - E. None of the above

113. Portfolio choices made by financial institutions are affected by which of the following factors?
- A. Relative rates of return expected on various uses of funds
 - B. Relative risk attached to different sources and uses of funds
 - C. Cost of incoming funds
 - D. Maturity and volatility of incoming funds
 - E. All of the above
114. The withdrawal of funds from a financial intermediary by ultimate lenders (savers) and the lending of those funds to ultimate borrowers is called:
- A. Diversification
 - B. Indirect finance
 - C. Disintermediation
 - D. Internal finance
 - E. None of the above
115. Disintermediation is most likely to occur during periods of:
- A. High and rapidly rising interest rates
 - B. High consumption and low saving
 - C. High, but stable interest rates
 - D. Rapid inflation, while interest rates remain relatively low
 - E. None of the above
116. Internal financing is characterized by:
- A. Use of financial assets to acquire real assets
 - B. Transfer of accumulated savings between economic units
 - C. Use of current income and accumulated savings to acquire assets
 - D. Issuance of stock by a business to raise capital
 - E. None of the above
117. For a closed financial system, the sum total of financial assets equals:
- A. Total financial liabilities
 - B. Total real assets
 - C. Total assets
 - D. Net worth plus liabilities
 - E. Total net worth
118. An increased quantity of real assets leads to:
- A. An increased quantity of goods and services
 - B. An increased volume of financial assets
 - C. An increased volume of liabilities
 - D. A more efficient financial system
 - E. An increased net worth for business
119. Current expenditures greater than current receipts characterizes a:
- A. Surplus budget unit
 - B. Classical theory of interest
 - C. A financial intermediary
 - D. The hedging principle
 - E. Deficit budget unit
120. Savings accounts at banks and shares in money market mutual funds are:
- A. Financial assets but not liabilities
 - B. Debts giving rise to financial assets
 - C. Real assets
 - D. Equal to total financial assets in a financial system
 - E. None of the above

121. The most important financial asset is money. A disadvantage of holding money is:
- A. It has no intrinsic value as a commodity
 - B. It is a medium of exchange
 - C. It tends to have a low rate of return
 - D. It ceases to be a medium of exchange
 - E. It is the only perfectly liquid asset
122. Direct, indirect and semi-direct finance are:
- A. Methods of funds transfer
 - B. Types of financial systems
 - C. Internal financing methods
 - D. Secondary securities
 - E. None of the above
123. Secondary securities issued by financial intermediaries are characterized by:
- A. Low risk of default
 - B. Small denominations
 - C. Liquidity
 - D. All of the above
 - E. None of the above
124. A checking account would be classified, according to the text, as a kind of ____.
- A. Money
 - B. Equity
 - C. Debt security
 - D. Real asset
 - E. None of the above
125. U.S. savings bonds would be an example of what kind of financial asset (as defined in the textbook)?
- A. Money
 - B. Equities
 - C. Negotiable debt
 - D. Nonnegotiable debt
 - E. None of the above
126. Financial assets are _____, meaning they can be easily changed in form and substituted for other assets. The term that correctly fills in the blank above is:
- A. Fungible
 - B. Reversible
 - C. Liquid
 - D. Depreciable
 - E. None of the above
127. Which of the following statements about financial assets is usually not true?
- A. Serve as a store of value
 - B. Cannot be depreciated
 - C. Physical condition or form important in determining their value
 - D. Little or not value as a commodity
 - E. Easily stored and transported
128. According to the textbook, a new form of disintermediation has appeared in recent years in which:
- A. Financial intermediaries sell off some of their loans in order to raise new capital
 - B. Financial intermediaries develop new types of deposits not previously available and thereby add to their capital base
 - C. Some of the best borrowing customers of financial intermediaries have recently chosen to raise funds directly from the open market
 - D. A and C are both correct
 - E. None of the above

129. According to the text, insurance companies are classified as:
- A. Depository institutions
 - B. Contractual institutions
 - C. Investment institutions
 - D. Finance companies
 - E. None of the above
130. According to the text, pension funds are classified as:
- A. Depository institutions
 - B. Contractual institutions
 - C. Investment institutions
 - D. Investment mutuals
 - E. None of the above
131. Investment companies (sometimes called mutual funds) are classified as, according to the textbook:
- A. Depository institutions
 - B. Contractual institutions
 - C. Investment institutions
 - D. Stock savings institutions
 - E. None of the above
132. According to the textbook, money market funds are classified as:
- A. Depository institutions
 - B. Contractual institutions
 - C. Investment institutions
 - D. Common stock investment companies
 - E. None of the above
133. According to the textbook, savings and loan associations are classified as:
- A. Depository institutions
 - B. Contractual institutions
 - C. Investment institutions
 - D. Short-term intermediaries
 - E. None of the above
134. Savings banks are classified as one of the following types of financial institutions. Which one?
- A. Commercial banking firms
 - B. Credit Unions
 - C. Contractual institutions
 - D. Investment institutions
 - E. None of the above
135. Credit unions are classified as what type of financial institution, according to the textbook?
- A. Depository institutions
 - B. Contractual institutions
 - C. Investment institutions
 - D. Stockholder-owned savings institutions
 - E. None of the above
136. ITT decides to use receivables as collateral for debt it issues rather than borrow from the bank. This is an example of:
- A. Asset reduction
 - B. Arbitrage
 - C. Hedging
 - D. Indirect finance
 - E. Disintermediation

137. A _____ executes the sell order, while a _____ may buy the securities from the seller.
- A. Arbitrageur, speculator
 - B. Dealer, speculator
 - C. Arbitrageur, broker
 - D. Broker, dealer
 - E. Dealer, broker
138. _____ are subject to the risk of loss if securities decline in value.
- A. Dealers
 - B. Hedgers
 - C. Borrowers
 - D. Brokers
 - E. Liability managers
139. The prudent person rule:
- A. Limits the amount of borrowing a financial institution can do to a fixed percentage of liabilities.
 - B. . limits the amount of lending a financial institution can do to a fixed percentage of liabilities
 - C. Sets the minimum quality of security an institution can buy based on that which an informed and careful investor would do
 - D. Sets the maximum quality security an institution can sell based on that which an informed careful investor would do
 - E. None of the above
140. Disintermediation _____ the dependence of corporations and individuals on financial institutions.
- A. Increases
 - B. Reduces
 - C. Has no effect on
 - D. The effect depends on the level of interest rates
 - E. None of the above
141. The sum of all U.S. currency and coin held by the public, NOW accounts and Automatic Transfer Services at all commercial banks, credit unions and thrift institutions is which definition of the U.S. money supply?
- A. M1
 - B. M2
 - C. MZ2
 - D. L
 - E. None of the above
142. The smallest measure of the U.S. money supply that includes small savings and time deposits (under \$100,000 each in amount) is known as:
- A. M1
 - B. M2
 - C. MZ2
 - D. L
 - E. None of the above
143. The smallest measure of the U.S. money supply that includes large (\$100,000 +) size time deposits is known as:
- A. M1
 - B. M2
 - C. MZ2
 - D. L
 - E. None of the above

144. The definition of the U.S. money supply that views money primarily as a medium of exchange is:
- A. M1
 - B. M2
 - C. MZ2
 - D. L
 - E. None of the above
145. On January 1, 1999, a new currency joined the world financial system. This currency is:
- A. The Eurodollar
 - B. The Gold Standard
 - C. The Euro
 - D. The Euro Yen
146. Suppose the GDP deflator index has a base period of 100 in 1990 and by the year 2001 the deflator had an index value of 135. What was the percentage increase in this nation's price level?
- A. 35
 - B. 13.5
 - C. 135
 - D. 1.35
 - E. None of the above
147. Suppose the GDP deflator index has a base period of 100 in 1990 and by the year 2001 the deflator had an index value of 135. What was the percentage change in the purchasing power of this nation's currency?
- A. Increased by 35 percent
 - B. Decreased by 26 percent
 - C. Increased by 135 percent
 - D. Decreased by 74 percent
 - E. None of the above
148. Inflation
- A. Refers to a rise in the average price level of all goods and services
 - B. Is the opposite of deflation
 - C. Can be measured by the Gross Domestic Product (GDP) index
 - D. A and B only
 - E. A, B and C
149. A net lender of funds is the
- A. Federal Reserve
 - B. Balanced-budget unit
 - C. Surplus-budget unit
 - D. Deficit-budget unit
 - E. None of the above
150. For the entire financial system, the total of all financial assets held must equal
- A. All outstanding financial liabilities
 - B. The Gross domestic product
 - C. All outstanding financial claims
 - D. \$13 trillion
 - E. Both A and C
151. Nations with more fully developed financial systems
- A. Tend to grow faster
 - B. Have a higher standard of living
 - C. Have a higher cost of capital
 - D. A and B
 - E. None of the above

152. The financial system
- A. Lowers barriers for external financing
 - B. Lowers the cost of capital
 - C. Raises economic growth
 - D. Raises the standard of living
 - E. All of the above
153. In a given time period, if expenditures exceed income, then it will be necessary to
- A. Put additional money into savings
 - B. Take money from savings
 - C. Borrow money
 - D. B and C
 - E. None of the above
154. In a given time period, if income exceeds expenditures, then
- A. There is additional discretionary income
 - B. Money can be added to savings
 - C. Any debt outstanding can be reduced
 - D. There's more money than expenses
 - E. All of the above
155. In 2006, the major sector of the economy that was the largest net lender of funds was
- A. Households
 - B. Nonfinancial business firms
 - C. International sector
 - D. Federal government
 - E. State and local government
156. The biggest borrowers in 2006 were
- A. Pension funds
 - B. Individuals
 - C. Governments (local, state and federal)
 - D. Households
 - E. A and B
157. The biggest borrowers in 2006, in descending order were
- A. Individuals, federal government, local and state government
 - B. Federal government, local and state government, nonfinancial businesses
 - C. Nonfinancial businesses, federal government, individuals
 - D. Federal government, nonfinancial businesses, local and state government
 - E. None of the above
158. In the year 2006, the federal government sold assets of around \$14 billion and then borrowed almost
- A. \$635 billion
 - B. \$450 billion
 - C. \$100 billion
 - D. \$950 billion
 - E. \$22 billion
159. In 2006 the value of M1 was close to
- A. \$50 trillion
 - B. \$1.4 trillion
 - C. \$15 trillion
 - D. \$72 billion
 - E. None of the above

160. The value of M2 in 2006 was just over
- A. \$6.8 trillion
 - B. \$10 trillion
 - C. \$68 billion
 - D. \$12.2 trillion
 - E. None of the above
161. Between 1960 and 2006, the cost of living index, which measures the prices of consumer goods, increased
- A. More than three times
 - B. More than five times
 - C. More than two times
 - D. More than eight times
 - E. More than 10 times
162. Between the 1982-84 base period and 2006, the cost of living index, which measures the prices of consumer goods, increased
- A. 100 to 200
 - B. 100 to 150
 - C. 200 to 300
 - D. 100 to 300
 - E. 0 to 100
163. In the United States, banks hold approximately one quarter of the total resources of all US financial institutions, which in 2006 was
- A. \$9.5 trillion
 - B. \$14.5 trillion
 - C. \$72 trillion
 - D. \$10 billion
 - E. None of the above
164. Money market funds held in US financial institutions went from zero in 1970 to just over \$_____ in 2006.
- A. \$100 billion
 - B. \$1 trillion
 - C. \$2 trillion
 - D. \$10 trillion
 - E. \$500 billion
165. Disintermediation may reverse itself, with funds flowing back into the perceived safer instruments of financial intermediaries, a process called
- A. Reversal
 - B. Intermediation
 - C. Either reversal or intermediation
 - D. Reintermediation
 - E. None of the above
166. The importance of financial intermediaries as well as their growth has been reduced in recent years by
- A. FDIC
 - B. The Federal Reserve
 - C. Industrial loan companies (ILC)
 - D. New forms of disintermediation
 - E. C and D

167. Without adequate investor protection and rules those in need of capital tend to develop strong relationships with
- A. Brokers
 - B. Dealers
 - C. The banks
 - D. FDIC
 - E. The federal government
168. Countries that are developing market-dominated financial systems include
- A. China and Japan
 - B. China and the United States
 - C. Canada and the United States
 - D. Great Britain and the United States
 - E. Germany and the United States
169. A trademark of market-dominated financial systems
- A. Higher returns for Savers
 - B. Increased competition among lenders
 - C. More funds available to loan
 - D. A and B
 - E. A., B and C
170. A difference between a financial broker and a financial dealer is that
- A. A dealer also purchases the seller securities in the hopes of making a profit on their sale to the buyer
 - B. A broker also purchases the seller securities in the hopes of making a profit on their sale to the buyer
 - C. A dealer must have a college degree in finance
 - D. A broker must have a college degree in finance
 - E. None of the above
171. Direct finance is the technique when borrower and lender meet each other and exchange funds for financial assets
- A. Without the help of a third-party
 - B. With the help of a third-party
 - C. With the help of a bank
 - D. With the help of the savings-and-loan
 - E. All of the above
172. In the United States financial system M2Z is a
- A. Money measure
 - B. Close to the transactions demand for money
 - C. Developed by the St. Louis Federal Reserve Bank
 - D. Was over \$6.9 trillion in 2006
 - E. All of the above
173. Which one of the following is not a financial asset?
- A. Bank loan
 - B. Common stock
 - C. Land
 - D. Insurance policy
 - E. Checking account
 - F. All of the above are examples of financial assets
174. The smallest measure of the U.S. money supply that includes large (\$100,000 +) size time deposits is known as:
- A. M1
 - B. M2
 - C. M0
 - D. L
 - E. None of the above

175. The importance of financial intermediaries as well as their growth has been reduced in recent years by
- A. FDIC
 - B. The Federal Reserve
 - C. Foreign banks
 - D. New forms of disintermediation
 - E. C and D
176. The prudent person rule:
- A. Limits the amount of borrowing a financial institution can do to a fixed percentage of liabilities
 - B. Limits the amount of lending a financial institution can do to a fixed percentage of liabilities
 - C. Sets the maximum quality of security an institution can buy based on that which an informed and careful investor would do
 - D. Sets the maximum quality security an institution can sell based on that which an informed careful investor would do
 - E. None of the above
177. Company or business assets are different from financial in that they are __, which is a method of matching the useful life to the revenues generated. The term that correctly fills in the blank above is:
- A. Fungus
 - B. Reversible
 - C. Liquid
 - D. Depreciable
 - E. None of the above

178. Choose the definition or descriptive phrase on the right that best describes the term on the left.

1. Total Real Assets	Definitions or Descriptive Phrases	—
		—
2. Indirect Finance	Claims against the wealth or income of economic units.	—
		—
3. Liability	Reserve of future purchasing power.	—
		—
4. Fungible	Accumulated savings.	—
		—
5. Investment Institutions	Purchases of assets funded out of current income and accumulated savings.	—
		—
6. Primary Securities	Issuing securities to raise funds.	—
		—
7. Direct Finance	Always matched in amount by a financial asset held by some other unit.	—
		—
8. Depository Intermediaries	Must equal net worth of all units in the economy	—
		—
9. Internal Financing	Must equal volume of net investment in the economy.	—
		—
10. Deficit-Budget Unit	Current expenditures exceed current income receipts.	—
		—
11. External Financing	Net lender of funds.	—
		—
12. Households	Change in debt and equity securities issued equals change in holdings of financial assets during the current period.	—
		—
13. Net Worth	Perfectly liquid assets.	—
		—
14. Disintermediation	Borrowing money from a friend.	—
		—
15. Store of Value	Using brokers and dealers to aid in marketing securities.	—
		—
16. Net Savings	Results in creation of secondary securities	—
		—
17. Terms	Issued by financial intermediaries to ultimate lenders.	—
		—
18. Semi-Direct Finance	IOUs accepted by financial intermediaries from borrowers.	—
		—
19. Surplus-Budget Unit	Matching of maturities of assets and liabilities	—
		—

20. Equities	Advantage enjoyed by larger intermediaries.	__
		__
21. Economies of Scale	Withdrawal of funds by ultimate lenders.	__
		__
22. Secondary Securities	Attract funds by offering deposit accounts to the public.	__
		__
23. Financial Assets	Attract funds by offering legal contracts to protect the saver from risk.	__
		__
24. Contractual Intermediaries	Include money market funds, real estate investment trusts and investment companies.	__
		__
25. Balanced-Budget Unit	Certificates evidencing ownership of a business corporation.	__
		__
26. Hedging Principle	Principal surplus-budget sector in the economy.	__
		__
27. Money	Characteristics of a financial asset that permit it to be easily changed in form and substituted for other assets.	__
		__

179. What is the difference between *internal finance* and *external finance*?

• To acquire assets, households and business firms may use current income and accumulated savings – *internal financing*.

- An economic unit may also raise funds by issuing financial liabilities (debt) or stock (equities), provided that a buyer can be found – *external financing*.

180. What exactly is the relationship between the process of creating financial assets and liabilities and the acts of saving and investment? Why is that relationship important to your financial and economic well-being?
- For the balance sheet of any economic unit, Total assets = Total liabilities + Net worth, where total assets = real assets + financial assets
 - For the whole economy and financial system, Total financial assets = Total liabilities
 - So, for the economy as a whole, Total real assets = Total net worth (i.e., accumulated savings)
 - So, society increases its wealth only by saving and increasing the quantity of its real assets (investment), for these assets enable the economy to produce more goods and services in the future.
 - However, the financial system provides the essential channel necessary for the creation and exchange of financial assets between savers and borrowers so that real assets can be acquired.
 - Without that channel for savings, the total volume of investment in the economy will be greatly reduced and society's scarce resources will be allocated less efficiently than is possible with a system of financial markets. Growth in society's income, employment and standard of living will be seriously impaired without a vibrant global financial system at work.

181. What do the following terms mean? *Deficit-budget unit (DBU)*? *Surplus-budget unit (SBU)*? *Balanced-budget unit (BBU)*? Why are these concepts important?
- Economists John Gurley and Edward Shaw (1960) pointed out that each business firm, household or unit of government active in the financial system must conform to:
 $R - E = DFA - DD$
where R = Current income receipts
E = Current expenditures
DFA = Change in holdings of financial assets
DD = Change in debt and equity outstanding
 - So, for any given period of time, the individual economic unit falls into one of three groups:

182. Deficit-budget unit (DBU): $E > R$, $DD > DFA$ (i.e. net borrower of funds)
Surplus-budget unit (SBU): $R > E$, $DFA > DD$ (i.e. net lender of funds)
Balanced-budget unit (BBU): $R = E$, $DD = DFA$ (i.e. neither net lender nor net borrower)
- These concepts are important because it enables us to understand how the global financial system permits businesses, households and governments to adjust their financial position from that of net borrower (DBU) to net lender (SBU) and back again, smoothly and efficiently.

183. Explain what *money* is. What are its principal functions or roles within the system of money and capital markets? Within the economy?

- Any financial asset that is generally accepted in payment for the purchases of goods and services is a form of money. Examples include currency and checking accounts.
- Money is a true financial asset, because all forms of money in use today are claims against some institution, public or private.
- Within the system of money and capital markets, all financial assets are valued in terms of money and flows of funds between lenders and borrowers occur through the medium of money.
- Within the economy,

Money serves as a *standard of value* (or *unit of account*) for all goods and services.

Money serves as a *medium of exchange*, such that buyers and sellers no longer need to have an exact coincidence of wants in terms of quality, quantity, time and location.

Money serves as a *store of value* – a reserve of future purchasing power – although the value of money can experience marked fluctuations.

Money functions as the only perfectly *liquid* asset. It exhibits price stability, ready marketability and reversibility.

184. Can you distinguish between inflation and deflation? What do they have to do with money, if anything?

- *Inflation* refers to a rise in the average price level of all goods and services.
- The opposite of inflation is *deflation*, where the average level of prices for goods and services actually declines.
- Inflation lowers the value or purchasing power of money and is a special problem in the financial markets because it can damage the value of financial contracts.

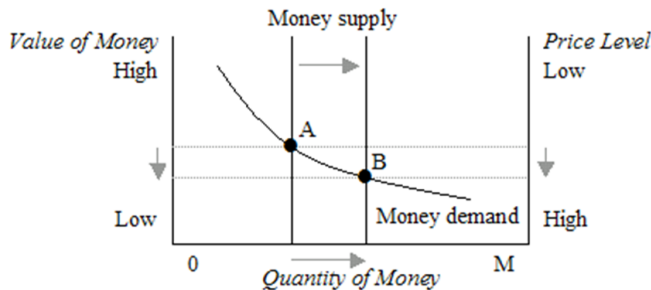
185.- When the central bank increases the supply of money, the money supply curve shifts as shown in the diagram above. The value of money then decreases (i.e. the price level increases – inflation occurs) so that supply and demand can reach a balance. The equilibrium moves from point A to point B.

- Hence, when monetary growth exceeds the amount needed to support sustainable growth in economic activity (an upward shift in the money demand curve), prices will rise.

Would you expect to find a relationship between money supply growth and inflation or deflation? What kind of relationship would you expect to prevail?

- Yes, there is a relationship.

- The *quantity theory of money* is a theory asserting that the quantity of money available determines the price level and that the growth rate in the quantity of money available determines the inflation rate.



186. What is *direct finance*? *Semi-direct finance*? *Indirect finance*?

- Direct finance: Borrower and lender meet each other and directly exchange funds (loans of spending power for an agreed-upon period of time) in return for financial assets (primary securities in the form of stocks, bonds, notes, etc., evidencing direct claims against borrowers) without the help of a third party to bring them together.

- Semi-direct finance: Direct lending with the aid of market makers (such as security brokers, dealers and investment bankers) who assist in the sale of direct claims against borrowers by bringing SBUs and DBUs together for fees and commissions.

- Indirect finance: Financial intermediaries (banks, savings and loan associations, insurance companies, credit unions, mutual funds, finance companies, pension funds) issue securities of their own (secondary securities – indirect claims against the ultimate borrowers in the form of deposits, insurance policies, retirement savings accounts, etc.) to the ultimate lenders and at the same time accept IOUs from borrowers (primary securities – direct claims against the ultimate borrowers in the form of loan contracts, stocks, bonds, notes, etc.).

187. In the evolution of the financial system, which came first – direct, indirect or semi-direct finance? Why do you think this is so?

- Most financial systems in history started out using direct finance, since it is the simplest method of carrying out financial transactions that satisfy the needs of savers and borrowers.

188. What are the essential differences between *primary* and *secondary securities*? Why are these instruments important to the operation of the financial system?

- primary securities – direct claims against the ultimate borrowers in the form of loan contracts, stocks, bonds, notes, etc

- secondary securities – indirect claims against the ultimate borrowers issued by financial intermediaries in the form of deposits, insurance policies, retirement savings accounts, etc.

- Both primary and secondary securities are financial assets. In the financial system, they are the instruments that are created and exchanged between savers and borrowers so that real assets can be acquired.

- Being direct claims against the ultimate borrowers, primary securities are essential to all methods of finance.

- Secondary securities, on the other hand, permit a given amount of saving in the global economy to finance a greater amount of investment than would have occurred without the presence of intermediation. This is so because intermediation makes saving and borrowing easier and safer – secondary securities generally carry low risk of default, can be acquired in small denominations and are mostly liquid.

189. Which financial institutions are the *largest* within the financial system? Why do you think these are the largest financial institutions?

- In most countries, banks are the dominant financial institution.

- This is because most goods and services are paid for using money and banks, being the primary depository institution, have developed extensively to facilitate payments (checking accounts, direct deposits, preauthorized payments, letters of credit, banker's acceptances, etc.). So, most households, businesses and units of government have bank accounts holding most of their working capital. Moreover, bank deposits are relatively safe and liquid (although money is not always a good store of value and the return is usually relatively low), such that savings usually accumulate in bank accounts first before they are invested elsewhere. And due to risk aversion, lack of time, inertia or inadequate investment knowledge, the amount of such savings can be quite substantial.

190. What factors influence the particular financial assets each financial institution acquires?
- The *relative rate of return* and risk attached to different financial assets.
 - The *cost, volatility and maturity of incoming funds* provided by surplus-budget units. The *hedging principle* refers to the approximate matching of the maturity of financial assets held with liabilities taken on.
 - The *size* of the individual financial institution. Larger financial institutions tend to have greater diversification in their sources and uses of funds and economies of scale.
 - *Regulations and competition*.
191. What is *disintermediation* and why is it important? How has disintermediation changed in recent years?
- *Disintermediation* refers to the withdrawal of funds from a financial intermediary by the ultimate lenders (savers) and the lending of those funds directly to the ultimate borrowers.
 - Disintermediation involves the shifting of funds from indirect finance to direct and semidirect finance.
 - Disintermediation forces a financial institution to surrender funds and if severe, may lead to losses of its assets and ultimate failure.
 - The phenomenon of disintermediation influences the selection of financial assets by financial institutions for their portfolios.
 - New forms of disintermediation include:
Initiation by financial intermediaries: Some banks sell off their loans because of difficulties in raising capital.
Initiation by borrowing customers: Some borrowing customers learned how to raise funds directly from the open market.
192. Please explain the difference between a *bank-dominated financial system* and a *security-dominated financial system*. Why is this distinction between types of financial systems an important one?
- In *bank-dominated financial systems*, banks and similar financial institutions dominate in supplying credit and attracting savings.
 - In *security-dominated financial systems*, traditional intermediaries play somewhat lesser roles in the lending and saving process and growing numbers of borrowers sell securities (such as stocks and bonds) to the public to raise the funds they need.
 - Typically, the lesser-developed financial systems are bank-dominated financial systems, while the more mature financial systems are security-dominated financial systems.
 - In the long run, today's trend toward more security-dominated financial systems may result in greater competition within the financial marketplace and perhaps, higher returns for many savers.

193. Identify which economic units are completely self-financed. Which economic units are deficit-budget units? Surplus-budget units? Balanced-budget units?

None of the economic units are completely self-financed, since they all have outstanding debt (liabilities). The household sector has financial assets of cash and securities (\$80) in excess of liabilities in the form of notes and taxes payable (\$35). It is a surplus-budget unit.

The business sector has liabilities in the form of bonds and taxes payable (\$100) in excess of financial assets, consisting of cash and securities (\$55). It is a deficit-budget unit.

The government is a balanced-budget unit. Its financial assets of loans and tax receivables (\$75) are equal to its liabilities of securities and money (\$75).

For each economic unit,

Equation 1: Real assets + Financial assets = Total liabilities + Net worth

For the economy and financial system as a whole:

Equation 2: Total financial assets = Total liabilities

Equation 3: Total real assets = Net worth

These equations hold for the units depicted.

Equation 1: For each unit, Real assets + Financial Assets = Total assets = Total liabilities + Net worth as shown on the balance sheets.

Equation 2: For the economy, Total financial assets = \$80+\$55+\$75 = \$210 while Total liabilities = \$35+\$100+\$75 = \$210. So, Total financial assets = Total liabilities.

Equation 3: For the economy, Total real assets = \$90+\$135+\$140 = \$365 while Net worth = \$135+\$90+\$140 = \$365. So, Total real assets = Net worth.

Consider the following balance sheets for a household (individual or family), business firm and government – the only units present in a *closed* economy.

Household:	<u>Assets</u>	<u>Liabilities and Net Worth</u>
	Cash \$15	Notes payable \$20
	Securities 65	Taxes payable 15
	Automobile 5	Net worth 135
	Home 75	
	Other real assets 10	Total liabilities
	Total assets <u>\$170</u>	and net worth <u>\$170</u>
Business Firm:	<u>Assets</u>	<u>Liabilities and Net Worth</u>
	Cash \$10	Bonds \$60
	Securities 45	Taxes payable 40
	Truck 25	Net worth 90
	Plant 60	
	Equipment 20	Total liabilities
	Other real assets 30	and net worth <u>\$190</u>
	Total assets <u>\$190</u>	
Government:	<u>Assets</u>	<u>Liabilities and Net Worth</u>
	Loans \$20	Securities \$50
	Buildings 85	Money 25
	Equipment 30	Net worth 140
	Tax receivables 55	
	Other real assets 25	Total liabilities
	Total assets <u>\$215</u>	and net worth <u>\$215</u>

194.d. Writing a bank check to purchase stock from your broker.

Disintermediation and semi-direct finance

c. Selling shares of stock to a colleague at work. *Direct finance*

b. Selling shares of stock through a broker. *Semi-direct finance*

In this chapter a number of different types of financial transactions were discussed: direct finance, semi-direct finance, indirect finance (intermediation) and disintermediation. Examine each of the following financial transactions and indicate which type it is. (*Note: Some of the transactions described below involve more than one type of financial transaction. Be sure to identify all types of transactions involved.*)

a. Borrowing money from a bank. *Indirect finance*

195.c. Your corporation's contracting with an investment banker to help sell its bonds.

Semi-direct finance

B. Withdrawing money from a savings deposit account and lending it to a friend. *Disintermediation and direct finance*

In this chapter a number of different types of financial transactions were discussed: direct finance, semi-direct finance, indirect finance (intermediation) and disintermediation. Examine each of the following financial transactions and indicate which type it is. (*Note: Some of the transactions described below involve more than one type of financial transaction. Be sure to identify all types of transactions involved.*)

a. Purchasing a life insurance policy. *Indirect finance*

196. ITT Corporation in the most recent period reported current sales receipts of \$542 million, current operating expenditures of \$577 million and net new debt issued of \$5 million. What change in holdings of financial assets must have occurred over the period? Was ITT a deficit-, surplus- or balanced-budget unit in the most recent period? Explain why.

Current Operating Expenditures = \$577 million

Current Sales Receipts = \$542 million

Net New Debt issued = \$5 million

Because: $R - E = DFA - DD$

$\$542 - \$577 = DFA - \$5$

And: $DFA = \$5 - \$35 = -\$30 \text{ million}$

Because current operating expenditures exceed current receipts by \$35 million, ITT was a deficit-budget unit in the most recent period.

197. Demonstrate that for any given time period for any economic unit, current receipts plus additions (positive or negative) to debt and equities outstanding must equal current expenditures plus additions (positive or negative) to holdings of financial assets. Please explain exactly what this statement means.

The Gurley-Shaw identity says that: $R - E = DFA - DD$. A simple algebraic transformation of terms across the equals sign says that $E + DFA = R + DD$

This equation reminds us that spending funds to acquire financial assets and to carry out current transactions (such as paying bills and making purchases of food, clothing and shelter) must be financed, dollar for dollar, from either current income or by borrowing from other economic units.

198. Ajax Corporation rejects a loan offered by its London bank and decides instead to issue Euronotes through security dealer Credit Suisse into the global financial marketplace in order to raise capital for a new project. What type of financial transaction (funds transfer) has been rejected by Ajax and what type of financial transaction (funds transfer) is Ajax going to use to raise the loanable funds it requires? If financial transactions of this latter type continue to grow in relative importance within the global financial system, how will this trend ultimately change the international system of money and capital markets? What impact do you think this might have on savers and borrowers within the global financial marketplace?
- Ajax rejected an indirect funds transfer from its London bank and instead used a semidirect funds transfer through Credit Suisse.
- If semidirect funds transfers continue to grow in relative importance, banks offering just indirect funds transfer services will suffer while increasing numbers of borrowers like Ajax will enjoy the benefits produced by semidirect funds transfers. This also represents a shift away from a bank-dominated financial system and towards a securities-dominated financial system.
- A possible impact of this trend would be increased competition, increased choices and increased returns for savers and borrowers. Savers, especially, would also be confronted with more risk.

199. Suppose the GDP deflator index has a base period of 100 in 1990 and by the year 2001 the deflator had an index value of 139. What was the percentage increase in this nation's price level? Suppose the deflator, instead, had dropped to 89.6 by 2001. What change in the national price level occurred?
- If 2001 index value = 139, percentage increase = $(139-100)/100 = 39\%$. I.e. inflation.
- If 2001 index value = 89.6, percentage increase = $(89.6-100)/100 = -10.4\%$. I.e. deflation.

ch02 Key

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- 94. FALSE
- 95. FALSE
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- 97. C
- 98. A
- 99. C
- 100. C
- 101. B
- 102. C
- 103. D
- 104. E
- 105. B
- 106. A
- 107. D
- 108. B
- 109. A
- 110. D
- 111. A
- 112. D

- 113. E
- 114. C
- 115. A
- 116. C
- 117. A
- 118. A
- 119. E
- 120. B
- 121. C
- 122. A
- 123. D
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- 127. C
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- 168. D
- 169. E
- 170. A
- 171. A
- 172. E
- 173. C
- 174. E
- 175. D
- 176. E
- 177. D

178. Terms :: Definitions or Descriptive Phrases *and* Financial Assets :: Claims against the wealth or income of economic units. *and* Store of Value :: Reserve of future purchasing power. *and* Net Worth :: Accumulated savings. *and* Internal Financing :: Purchases of assets funded out of current income and accumulated savings. *and* External Financing :: Issuing securities to raise funds. *and* Liability :: Always matched in amount by a financial asset held by some other unit. *and* Total Real Assets :: Must equal net worth of all units in the economy *and* Net Savings :: Must equal volume of net investment in the economy. *and* Deficit-Budget Unit :: Current expenditures exceed current income receipts. *and* Surplus-Budget Unit :: Net lender of funds. *and* Balanced-Budget Unit :: Change in debt and equity securities issued equals change in holdings of financial assets during the current period. *and* Money :: Perfectly liquid assets. *and* Direct Finance :: Borrowing money from a friend. *and* Semi-Direct Finance :: Using brokers and dealers to aid in marketing securities. *and* Indirect Finance :: Results in creation of secondary securities *and* Secondary Securities :: Issued by financial intermediaries to ultimate lenders. *and* Primary Securities :: IOUs accepted by financial intermediaries from borrowers. *and* Hedging Principle :: Matching of maturities of assets and liabilities *and* Economies of Scale :: Advantage enjoyed by larger intermediaries. *and* Disinter mediation :: Withdrawal of funds by ultimate lenders. *and* Depository Intermediaries :: Attract funds by offering deposit accounts to the public. *and* Contractual Intermediaries :: Attract funds by offering legal contracts to protect the saver from risk. *and* Investment Institutions :: Include money market funds, real estate investment trusts and investment companies. *and* Equities :: Certificates evidencing ownership of a business corporation. *and* Households :: Principal surplus-budget sector in the economy. *and* Fungible :: Characteristics of a financial asset that permit it to be easily changed in form and substituted for other assets.

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ch02 Summary

<u>Category</u>	<u># of Questions</u>
Difficulty: Easy	49
Difficulty: Hard	41
Difficulty: Medium	88
Rose - Chapter 02	199