Chapter 1
Why Study Financial Markets and Institutions?

■ Multiple Choice Questions

1. Financial markets and institutions
   (a) involve the movement of huge quantities of money.
   (b) affect the profits of businesses.
   (c) affect the types of goods and services produced in an economy.
   (d) do all of the above.
   (e) do only (a) and (b) of the above.
   Answer: D

2. Financial market activities affect
   (a) personal wealth.
   (b) spending decisions by individuals and business firms.
   (c) the economy's location in the business cycle.
   (d) all of the above.
   Answer: D

3. 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) funds markets.
   (c) derivative exchange markets.
   (d) financial markets.
   Answer: D

4. The price paid for the rental of borrowed funds (usually expressed as a percentage of the rental of $100 per year) is commonly referred to as the
   (a) inflation rate.
   (b) exchange rate.
   (c) interest rate.
   (d) aggregate price level.
   Answer: C

5. The bond markets are important because
   (a) they are easily the most widely followed financial markets in the United States.
   (b) they are the markets where interest rates are determined.
   (c) they are the markets where foreign exchange rates are determined.
   (d) all of the above.

   Answer: B

6. Interest rates are important to financial institutions since an interest rate increase _________ the cost of acquiring funds and _________ the income from assets.
   (a) decreases; decreases
   (b) increases; increases
   (c) decreases; increases
   (d) increases; decreases

   Answer: B

7. Typically, increasing interest rates
   (a) discourage individuals from saving.
   (b) discourage corporate investments.
   (c) encourage corporate expansion.
   (d) encourage corporate borrowing.
   (e) none of the above.

   Answer: B

8. Compared to interest rates on long-term U.S. government bonds, interest rates on _________ fluctuate more and are lower on average.
   (a) medium-quality corporate bonds
   (b) low-quality corporate bonds
   (c) high-quality corporate bonds
   (d) three-month Treasury bills
   (e) none of the above

   Answer: D

9. Compared to interest rates on long-term U.S. government bonds, interest rates on three-month Treasury bills fluctuate _________ and are _________ on average.
   (a) more; lower
   (b) less; lower
   (c) more; higher
   (d) less; higher

   Answer: A

10. The stock market is important because
   (a) it is where interest rates are determined.
   (b) it is the most widely followed financial market in the United States.
   (c) it is where foreign exchange rates are determined.
   (d) all of the above.

   Answer: B

11. Stock prices since the 1950s have been
    (a) relatively stable, trending upward at a steady pace.
    (b) relatively stable, trending downward at a moderate rate.
    (c) extremely volatile.
    (d) unstable, trending downward at a moderate rate.

    Answer: C

12. The largest one-day drop in the history of the American stock markets occurred in
    (a) 1929.
    (b) 1987.
    (c) 2000.
    (d) 2001

    Answer: B

13. A rising stock market index due to higher share prices
    (a) increases people's wealth and as a result may increase their willingness to spend.
    (b) increases the amount of funds that business firms can raise by selling newly issued stock.
    (c) decreases the amount of funds that business firms can raise by selling newly issued stock.
    (d) both (a) and (b) of the above.

    Answer: D

14. A declining stock market index due to lower share prices
    (a) reduces people's wealth and as a result may reduce their willingness to spend.
    (b) increases people's wealth and as a result may increase their willingness to spend.
    (c) decreases the amount of funds that business firms can raise by selling newly issued stock.
    (d) both (a) and (c) of the above.
    (e) both (b) and (c) of the above.

    Answer: D

15. Changes in stock prices
    (a) affect people's wealth and their willingness to spend.
    (b) affect firms' decisions to sell stock to finance investment spending.
    (c) are characterized by considerable fluctuations.
    (d) all of the above.
    (e) only (a) and (b) of the above.

    Answer: D

16. (I) Debt markets are often referred to generically as the bond market. (II) A bond is a security that is a claim on the earnings and assets of a corporation.
    (a) (I) is true, (II) false.
    (b) (I) is false, (II) true.
    (c) Both are true.
    (d) Both are false.

    Answer: A

17. (I) A bond is a debt security that promises to make payments periodically for a specified period of time. (II) A stock is a security that is a claim on the earnings and assets of a corporation.
    (a) (I) is true, (II) false.
    (b) (I) is false, (II) true.
    (c) Both are true.
    (d) Both are false.
    Answer: C

18. The price of one country's currency in terms of another's is called
    (a) the exchange rate.
    (b) the interest rate.
    (c) the Dow Jones industrial average.
    (d) none of the above.
    Answer: A

19. A stronger dollar benefits _________ and hurts _________
    (a) American businesses; American consumers.
    (b) American businesses; foreign businesses.
    (c) American consumers; American businesses.
    (d) foreign businesses; American consumers.
    Answer: C

20. A weaker dollar benefits _________ and hurts _________
    (a) American businesses; American consumers.
    (b) American businesses; foreign consumers.
    (c) American consumers; American businesses.
    (d) foreign businesses; American consumers.
    Answer: A

21. From 1980 to early 1985 the dollar _________ in value, thereby benefiting American _________
    (a) appreciated; businesses.
    (b) appreciated; consumers.
    (c) depreciated; businesses.
    (d) depreciated; consumers.
    Answer: B

22. Money is defined as
    (a) anything that is generally accepted in payment for goods and services or in the repayment of debt.
    (b) bills of exchange.
    (c) a riskless repository of spending power.
    (d) all of the above.
    (e) only (a) and (b) of the above.
    Answer: A

23. 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.
    (d) Bureau of Monetary Affairs.

    Answer: C

24. The central bank of the United States is
    (a) Citicorp.
    (b) The Fed.
    (c) Bank of America.
    (d) The Treasury.
    (e) none of the above.

    Answer: B

25. Monetary policy is chiefly concerned with
    (a) how much money businesses earn.
    (b) the level of interest rates and the nation's money supply.
    (c) how much money people pay in taxes.
    (d) whether people have saved enough money for retirement.

    Answer: B

26. Economists group commercial banks, savings and loan associations, credit unions, mutual funds, mutual savings banks, insurance companies, pension funds, and finance companies together under the heading financial intermediaries. Financial intermediaries
    (a) act as middlemen, borrowing funds from those who have saved and lending these funds to others.
    (b) produce nothing of value and are therefore a drain on society's resources.
    (c) help promote a more efficient and dynamic economy.
    (d) do all of the above.
    (e) do only (a) and (c) of the above.

    Answer: E

27. Economists group commercial banks, savings and loan associations, credit unions, mutual funds, mutual savings banks, insurance companies, pension funds, and finance companies together under the heading financial intermediaries. Financial intermediaries
    (a) act as middlemen, borrowing funds from those who have saved and lending these funds to others.
    (b) play an important role in determining the quantity of money in the economy.
    (c) help promote a more efficient and dynamic economy.
    (d) do all of the above.
    (e) do only (a) and (c) of the above.

    Answer: D

28. Banks are important to the study of money and the economy because they
    (a) provide a channel for linking those who want to save with those who want to invest.
    (b) have been a source of rapid financial innovation that is expanding the alternatives available to those wanting to invest their money.
    (c) are the only financial institution to play a role in determining the quantity of money in the economy.
    (d) do all of the above.
    (e) do only (a) and (b) of the above.

    Answer: E

29. Banks, savings and loan associations, mutual savings banks, and credit unions
    (a) are no longer important players in financial intermediation.
    (b) have been providing services only to small depositors since deregulation.
    (c) have been adept at innovating in response to changes in the regulatory environment.
    (d) all of the above.
    (e) only (a) and (c) of the above.

    Answer: C

30. (I) Banks are financial intermediaries that accept deposits and make loans. (II) The term "banks" includes firms such as commercial banks, savings and loan associations, mutual savings banks, credit unions, insurance companies, and pension funds.
    (a) (I) is true, (II) false.
    (b) (I) is false, (II) true.
    (c) Both are true.
    (d) Both are false.

    Answer: A

■ True/False

1. Money is anything accepted by anyone as payment for services or goods.
   Answer: FALSE

2. Interest rates are determined in the bond markets.
   Answer: TRUE

3. A stock is a debt security that promises to make periodic payments for a specific period of time.
   Answer: FALSE

4. Monetary policy affects interest rates but has little effect on inflation or business cycles.
   Answer: FALSE

5. The government organization responsible for the conduct of monetary policy in the United States is the U.S. Treasury.
   Answer: FALSE

6. Interest rates can be accurately described as the rental price of money.
   Answer: TRUE

7. Holding everything else constant, as the dollar weakens vacations abroad become less attractive.
   Answer: TRUE

8. In recent years, financial markets have become more stable and less risky.
   Answer: FALSE

9. Financial innovation has provided more options to both investors and borrowers.
   Answer: TRUE

10. A financial intermediary borrows funds from people who have saved.
    Answer: TRUE

11. Holding everything else constant, as the dollar strengthens foreigners will buy more U.S. exports.
    Answer: FALSE

12. In a bull market stock prices are rising, on average.
    Answer: TRUE

■ Essay

1. Have interest rates been more or less volatile in recent years? Why?
2. Why should consumers be concerned with movements in foreign exchange rates?
3. How does the value of the dollar affect affect the competitiveness of American businesses?
4. What is monetary policy and who is responsible for its implementation?
5. What are financial intermediaries and what do they do?
6. What is money?
7. How does a bond differ from a stock?
8. Why is the stock market so important to individuals, firms, and the economy?