9.1 What is a Financial Crisis?

1) A major disruption in financial markets characterized by sharp declines in asset prices and firm failures is called a
A) financial crisis.
B) fiscal imbalance.
C) free-rider problem.
D) "lemons" problem.
Answer: A
Ques Status: Previous Edition

2) A financial crisis occurs when an increase in asymmetric information from a disruption in the financial system
A) causes severe adverse selection and moral hazard problems that make financial markets incapable of channeling funds efficiently.
B) allows for a more efficient use of funds.
C) increases economic activity.
D) reduces uncertainty in the economy and increases market efficiency.
Answer: A
Ques Status: Previous Edition
AACS0: Reflective thinking skills

3) A serious consequence of a financial crisis is
A) a contraction in economic activity.
B) an increase in asset prices.
C) financial engineering.
D) financial globalization.
Answer: A
Ques Status: Previous Edition
AACS0: Reflective thinking skills
9.2 Dynamics of Financial Crises in Advanced Economies

1) Financial crises in advanced economies might start from a
A) debt deflation.
B) currency crisis.
C) mismanagement of financial innovations.
D) currency mismatch.
Answer: C
Ques Status: New
AACSB: Reflective thinking skills

2) When financial institutions go on a lending spree and expand their lending at a rapid pace they are participating in a
A) credit boom.
B) credit bust.
C) deleveraging.
D) market race.
Answer: A
Ques Status: Previous Edition

3) When the value of loans begins to drop, the net worth of financial institutions falls causing them to cut back on lending in a process called
A) deleveraging.
B) releveraging.
C) capitulation.
D) deflation.
Answer: A
Ques Status: Previous Edition

4) When financial intermediaries deleverage, firms cannot fund investment opportunities resulting in
A) a contraction of economic activity.
B) an economic boom.
C) an increased opportunity for growth.
D) a call for government regulation.
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills

5) A credit boom can lead to a(n) ________ such as we saw in the tech stock market in the late 1990s.
A) asset-price bubble
B) liability war
C) decline in lending
D) decrease in moral hazard
Answer: A
Ques Status: Previous Edition
6) Most U.S. financial crises have started during periods of ________ either after the start of a recession or a stock market crash.
A) high uncertainty
B) low interest rates
C) low asset prices
D) high financial regulation
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills

7) If uncertainty about banks' health causes depositors to begin to withdraw their funds from banks, the country experiences a(n)
A) banking crisis.
B) financial recovery.
C) reduction of the adverse selection and moral hazard problems.
D) increase in information available to investors.
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills

8) In a bank panic, the source of contagion is the
A) free-rider problem.
B) too-big-to-fail problem.
C) transactions cost problem.
D) asymmetric information problem.
Answer: D
Ques Status: Previous Edition
AACSB: Reflective thinking skills

9) Debt deflation occurs when
A) an economic downturn causes the price level to fall and a deterioration in firms' net worth because of the increased burden of indebtedness.
B) rising interest rates worsen adverse selection and moral hazard problems.
C) lenders reduce their lending due to declining stock prices (equity deflation) that lowers the value of collateral.
D) corporations pay back their loans before the scheduled maturity date.
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills
10) A substantial decrease in the aggregate price level that reduces firms' net worth may stall a recovery from a recession. This process is called
A) debt deflation.
B) moral hazard.
C) insolvency.
D) illiquidity.
Answer: A
Ques Status: Previous Edition

11) A possible sequence for the three stages of a financial crisis in an advanced economy might be _______ leads to _______ leads to _______.
A) asset price declines; banking crises; unanticipated decline in price level
B) unanticipated decline in price level; banking crises; increase in interest rates
C) banking crises; increase in interest rates; unanticipated decline in price level
D) banking crises; increase in uncertainty; increase in interest rates
Answer: A
Ques Status: Revised
AACSB: Reflective thinking skills

12) The economy recovers quickly from most recessions, but the increase in adverse selection and moral hazard problems in the credit markets caused by _______ led to the severe economic contraction known as The Great Depression.
A) debt deflation
B) illiquidity
C) an improvement in banks' balance sheets
D) increases in bond prices
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills

13) _______ is a process of bundling together smaller loans (like mortgages) into standard debt securities.
A) Securitization
B) Origination
C) Debt deflation
D) Distribution
Answer: A
Ques Status: Previous Edition
14) A ________ pays out cash flows from subprime mortgage-backed securities in different tranches, with the highest-rated tranche paying out first, while lower ones paid out less if there were losses on the mortgage-backed securities.
A) Collateralized debt obligation (CDO)
B) Adjustable-rate mortgage
C) Negotiable CD
D) Discount bond
Answer: A
Ques Status: Previous Edition

15) The originate-to-distribute business model has a serious ________ problem since the mortgage broker has little incentive to make sure that the mortgagor is a good credit risk.
A) principal-agent
B) debt deflation
C) democratization of credit
D) collateralized debt
Answer: A
Ques Status: Previous Edition
AACSB: Ethical understanding and reasoning abilities

16) Mortgage brokers often did not make a strong effort to evaluate whether the borrower could pay off the loan. This created a
A) severe adverse selection problem.
B) decline in mortgage applications.
C) call to deregulate the industry.
D) decrease in the demand for houses.
Answer: A
Ques Status: Previous Edition
AACSB: Ethical understanding and reasoning abilities

17) Agency problems in the subprime mortgage market included all of the following except
A) homeowners could refinance their houses with larger loans when their homes appreciated in value.
B) mortgage originators had little incentives to make sure that the mortgage is a good credit risk.
C) underwriters of mortgage-backed securities had weak incentives to make sure that the holders of the securities would be paid back.
D) the evaluators of securities, the credit rating agencies, were subject to conflicts of interest.
Answer: A
Ques Status: Previous Edition
AACSB: Ethical understanding and reasoning abilities
18) The growth of the subprime mortgage market led to
A) increased demand for houses and helped fuel the boom in housing prices.
B) a decline in the housing industry because of higher default risk.
C) a decrease in home ownership as investors chose other assets over housing.
D) decreased demand for houses as the less credit-worthy borrowers could not obtain residential mortgages.
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills

19) When housing prices began to decline after their peak in 2006, many subprime borrowers found that their mortgages were "underwater." This meant that
A) the value of the house fell below the amount of the mortgage.
B) the basement flooded since they could not afford to fix the leaky plumbing.
C) the roof leaked during a rainstorm.
D) the amount that they owed on their mortgage was less than the value of their house.
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills

20) If a borrower takes out a $200 million loan in a repo agreement and is asked to post $220 million of mortgage-backed securities as collateral, the "haircut" is
A) 5%.
B) 10%.
C) 20%.
D) 50%.
Answer: B
Ques Status: New
AACSB: Analytic skills

21) As "haircuts" increased during 2007-2009, financial institutions found that to borrow the same loan amount now required ________ collateral.
A) less
B) no
C) more
D) default-free
Answer: C
Ques Status: New
AACSB: Reflective thinking skills
22) Although the subprime mortgage market problem began in the United States, the first indication of the seriousness of the crisis began in
A) Europe.
B) Australia.
C) China.
D) South America.
Answer: A

23) Which investment bank filed for bankruptcy on September 15, 2008 making it the largest bankruptcy filing in U.S. history?
A) Lehman Brothers
B) Merrill Lynch
C) Bear Stearns
D) Goldman Sachs
Answer: A

24) Typically, the economy recovers fairly quickly from a recession. Why did this not happen in the United States during the Great Depression?
Answer: The 25% decline in the price level from 1930-1933 triggered a debt deflation. The loss of net worth increased adverse selection and moral hazard problems in the credit markets and increased and prolonged the economic contraction.

9.3 Dynamics of Financial Crises in Emerging Market Economies

1) Financial crises generally develop along two basic paths:
A) mismanagement of financial liberalization/globalization and severe fiscal imbalances.
B) stock market declines and severe fiscal imbalances.
C) mismanagement of financial liberalization/globalization and stock market declines.
D) stock market declines and unanticipated declines in the value of the domestic currency.
Answer: A

2) In emerging market countries, the deterioration in bank's balance sheets has more ________ effects on lending and economic activity than in advanced countries.
A) negative
B) positive
C) affirming
D) advancing
Answer: A
3) All of the following might create problems from financial liberalization in emerging countries except
A) ineffective screening of borrowers.
B) limits on risk-taking.
C) lax government supervision of banks.
D) lenders failure to monitor borrowers.
Answer: B
Ques Status: New
AACSB: Reflective thinking skills

4) The mismanagement of financial liberalization in emerging market countries can be understood as a severe
A) principal/agent problem.
B) asymmetric information problem.
C) lemons problem.
D) free-rider problem.
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills

5) Factors likely to cause a financial crisis in emerging market countries include
A) severe fiscal imbalances.
B) decreases in foreign interest rates.
C) a foreign exchange crisis.
D) too strong oversight of the financial industry.
Answer: A
Ques Status: Revised
AACSB: Reflective thinking skills

6) The two key factors that trigger speculative attacks on emerging market currencies are
A) deterioration in bank balance sheets and severe fiscal imbalances.
B) deterioration in bank balance sheets and low interest rates abroad.
C) low interest rates abroad and severe fiscal imbalances.
D) low interest rates abroad and rising asset prices.
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills

7) Severe fiscal imbalances can directly trigger a currency crisis since
A) investors fear that the government may not be able to pay back the debt and so begin to sell domestic currency.
B) the government may stop printing money.
C) the government may have to cut back on spending.
D) the currency must surely increase in value.
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills
8) In emerging market countries, many firms have debt denominated in foreign currency like the dollar or yen. A depreciation of the domestic currency
A) results in increases in the firm's indebtedness in domestic currency terms, even though the value of their assets remains unchanged.
B) results in an increase in the value of the firm's assets.
C) means that the firm does not owe as much on their foreign debt.
D) strengthens their balance sheet in terms of the domestic currency.
Answer: A

Ques Status: Previous Edition
AACSB: Reflective thinking skills

9) A sharp depreciation of the domestic currency after a currency crisis leads to
A) higher inflation.
B) lower import prices.
C) lower interest rates.
D) decrease in the value of foreign currency-denominated liabilities.
Answer: A

Ques Status: Previous Edition
AACSB: Reflective thinking skills

10) The key factor leading to the financial crises in Mexico and the East Asian countries was
A) a deterioration in banks' balance sheets because of increasing loan losses.
B) severe fiscal imbalances.
C) a sharp increase in the stock market.
D) a sharp decline in interest rates.
Answer: A

Ques Status: Previous Edition
AACSB: Dynamics of the global economy

11) Factors that led to worsening conditions in Mexico's 1994-1995 financial markets include
A) failure of the Mexican oil monopoly.
B) the ratification of the North American Free Trade Agreement.
C) increased uncertainty from political shocks.
D) decline in interest rates.
Answer: C

Ques Status: Previous Edition
AACSB: Dynamics of the global economy

12) Factors that led to worsening financial market conditions in East Asia in 1997-1998 include
A) weak supervision by bank regulators.
B) a rise in interest rates abroad.
C) unanticipated increases in the price level.
D) increased uncertainty from political shocks.
Answer: A

Ques Status: Previous Edition
AACSB: Dynamics of the global economy
13) Factors that led to worsening conditions in Mexico's 1994-1995 financial markets, but did not lead to worsening financial market conditions in East Asia in 1997-1998 include
A) rise in interest rates abroad.
B) bankers' lack of expertise in screening and monitoring borrowers.
C) deterioration of banks' balance sheets because of increasing loan losses.
D) stock market decline.
Answer: A
Ques Status: Previous Edition
AACSB: Dynamics of the global economy

14) Argentina's financial crisis was due to
A) poor supervision of the banking system.
B) a lending boom prior to the crisis.
C) fiscal imbalances.
D) lack of expertise in screening and monitoring borrowers at banking institutions.
Answer: C
Ques Status: Previous Edition
AACSB: Dynamics of the global economy

15) A feature of debt markets in emerging-market countries is that debt contracts are typically
A) very short term.
B) long term.
C) intermediate term.
D) perpetual.
Answer: A
Ques Status: Previous Edition
AACSB: Analytic skills

16) The economic hardship resulting from a financial crisis is severe, however, there are also social consequences such as
A) increased crime.
B) difficulty getting a loan.
C) currency devaluations.
D) loss of output.
Answer: A
Ques Status: Previous Edition
AACSB: Reflective thinking skills

17) Before the South Korean financial crisis, sales by the top five chaebols (family-owned conglomerates) were
A) nearly 50% of GDP.
B) about 10% of GDP.
C) almost 90% of GDP.
D) nearly 25% of GDP.
Answer: A
Ques Status: Previous Edition
AACSB: Dynamics of the global economy
18) The chaebols encouraged the Korean government to open up Korean financial markets to foreign capital. The Korean government responded by
A) allowing unlimited short-term foreign borrowing but maintained quantity restrictions on long-term foreign borrowing by financial institutions.
B) allowing unlimited short-term and long-term foreign borrowing by financial institutions.
C) maintaining quantity restrictions on short-term foreign borrowing but allowing unlimited long-term foreign borrowing by financial institutions.
D) not allowing any foreign borrowing by financial institutions.
Answer: A
Ques Status: Previous Edition
AACSB: Dynamics of the global economy

19) At the time of the South Korean financial crisis, the government allowed many chaebol owned finance companies to convert to merchant banks. Finance companies ________ allowed to borrow abroad and merchant banks ________.
A) were not; could borrow abroad
B) were not; could not borrow abroad
C) were; could borrow abroad
D) were; could not borrow abroad
Answer: A
Ques Status: Previous Edition
AACSB: Dynamics of the global economy

20) At the time of the South Korean financial crisis, the merchant banks were
A) almost virtually unregulated.
B) subject to heavy government regulation.
C) engaged in long-term lending to the corporate sector.
D) restricted to long-term foreign borrowing.
Answer: A
Ques Status: Previous Edition
AACSB: Dynamics of the global economy

21) What two key factors trigger speculative attacks leading to currency cries in emerging market countries?
Answer: The deterioration in bank balance sheets and severe fiscal imbalances are the key factors. To counter a speculative attack, a country might try to raise interest rates. Raising interest rates, however, would worsen the problem of banks that are already in trouble. Speculators recognize this and seize the opportunity. When their are severe fiscal imbalances, there is concern that government debt will not be paid back. Funds are pulled out of the country and domestic currency is sold leading to a decline in the value of the domestic currency. Speculators will once again seize the opportunity.
Ques Status: Previous Edition
AACSB: Reflective thinking skills