ECON UN3265: Money and Banking

Summer 2026 — Practice Quiz

Chapters 12 — Practice Quiz

How to use this quiz. These multiple-choice questions are based on Chapter 12 practice questions on financial crises in advanced economies. The answer key is on the last page.

Questions

1. How does asymmetric information help define a financial crisis?

- **A)** A financial crisis occurs when asymmetric information problems worsen so much that financial markets cannot efficiently channel funds to productive borrowers.
- **B)** A financial crisis occurs when all firms have identical information and therefore refuse to borrow.
- **C)** Asymmetric information matters only for stock prices, not for lending or crises.
- **D)** A financial crisis is defined as any temporary decline in interest rates.

2. How can the bursting of an asset-price bubble in the stock market help trigger a financial crisis?

- **A)** It raises borrowers' net worth and makes lending safer.
- **B)** It reduces firms' net worth and collateral values, worsening adverse selection and moral hazard and reducing lending.
- **C)** It eliminates uncertainty because prices become perfectly predictable.
- **D)** It increases bank capital automatically and expands credit.

3. How does an unanticipated decline in the price level cause a drop in lending?

- **A)** It lowers the real value of debt, so lenders become unwilling to lend.
- **B)** It raises borrowers' real debt burdens, weakens balance sheets, and makes lending riskier.
- **C)** It makes all nominal contracts disappear.
- **D)** It reduces the need for collateral because borrowers become safer.

4. Define financial frictions and explain why an increase in financial frictions is a key element in financial crises.

- **A)** Financial frictions are taxes on bank profits; they matter only because they raise government revenue.
- **B)** Financial frictions are barriers such as asymmetric information, transaction costs, and agency problems that make financial intermediation less efficient; when they rise, credit falls and crises deepen.
- **C)** Financial frictions are increases in the money supply that always lower credit risk.
- **D)** Financial frictions are rules that force lenders to ignore borrower risk.

5. How does a deterioration in balance sheets of financial institutions and the simultaneous failures of these institutions cause a decline in economic activity?

- **A)** Weaker balance sheets reduce capital and lending capacity, and failures disrupt intermediation, causing credit to contract and spending to fall.
- **B)** Institution failures raise household wealth, which increases consumption.
- **C)** Failures improve information in credit markets and therefore expand lending.
- **D)** A deterioration in bank balance sheets affects only shareholders and has no macroeconomic effect.

6. What is a credit spread, and why do credit spreads rise significantly during a financial crisis?

- **A)** A credit spread is the gap between risky and safe interest rates; it rises in crises because default risk, liquidity risk, and risk aversion increase.
- **B)** A credit spread is the difference between inflation and unemployment; it rises because wages become sticky.
- **C)** A credit spread is the central bank policy rate; it rises only when the central bank raises rates.
- **D)** Credit spreads rise because risky assets become safer than government bonds.

7. Describe securitization. Was this process solely responsible for the Great Recession financial crisis of 2007-2009?

- **A)** Securitization means keeping loans permanently on a bank's balance sheet; it was the only cause of the crisis.
- **B)** Securitization is pooling loans and selling claims backed by their cash flows; it contributed to the crisis by weakening incentives and spreading risk, but it was not the sole cause.
- **C)** Securitization means issuing central bank reserves; it prevented the crisis entirely.
- **D)** Securitization is the same as deposit insurance and had no connection to the crisis.

8. Provide one argument in favor of and one against the idea that the Fed was responsible for the housing price bubble of the mid-2000s.

- **A)** In favor: low interest rates may have encouraged mortgage borrowing and risk-taking; against: global savings, lax regulation, securitization, and private-sector incentives also helped drive the bubble.
- **B)** In favor: the Fed directly ordered banks to make every subprime loan; against: housing prices never rose.
- **C)** In favor: the Fed controlled all mortgage underwriting; against: interest rates have no effect on housing demand.
- **D)** In favor: the Fed banned securitization; against: banks had no role in mortgage markets.

9. What do you think prevented the financial crisis of 2007-2009 from becoming a depression?

- **A)** The complete absence of government intervention.
- **B)** Aggressive monetary and fiscal policy, lender-of-last-resort actions, bank rescues, guarantees, and deposit insurance helped prevent a full-scale depression.
- **C)** A ban on all lending immediately after the crisis began.
- **D)** The disappearance of unemployment insurance and bank supervision.

10. True, false, or uncertain: Deposit insurance always and everywhere prevents financial crises.

- **A)** True, because deposit insurance eliminates all bank risk and all moral hazard.
- **B)** False, because deposit insurance can reduce bank runs but may create moral hazard and does not eliminate all sources of financial crises.
- **C)** True only if deposit insurance is kept secret from all depositors.
- **D)** Uncertain because deposit insurance affects only stock markets.

11. How did a decline in housing prices help trigger the subprime financial crisis that began in 2007?

- **A)** Falling house prices increased equity and reduced defaults, which expanded mortgage lending.
- **B)** Falling prices reduced homeowner equity, increased defaults, lowered mortgage-backed security values, weakened financial institutions, and tightened credit.
- **C)** Falling prices made all mortgage-backed securities risk-free.
- **D)** Falling prices had no effect because mortgages are unrelated to collateral values.

12. Why would haircuts on collateral increase sharply during a financial crisis? How would this lead to fire sales on assets?

- **A)** Haircuts rise when lenders distrust collateral values and counterparties; borrowers must post more collateral or sell assets quickly, pushing prices down in fire sales.

B) Haircuts rise because collateral becomes more valuable, allowing borrowers to buy more assets.
C) Higher haircuts make leverage easier and prevent forced sales.
D) Haircuts apply only to wages and cannot affect asset markets.

13. How did the global financial crisis promote a sovereign debt crisis in Europe?

A) The crisis increased bank rescue costs, fiscal deficits, and recession-related debt burdens, making investors worry about sovereign solvency in vulnerable euro-area countries.
B) The crisis eliminated all government debt in Europe.
C) The crisis raised tax revenues so much that sovereign risk disappeared.
D) The crisis affected only the United States and had no European consequences.

14. Why is it a good idea for macroprudential policies to require countercyclical capital requirements?

A) They force banks to hold more capital in booms, creating buffers that can be used in downturns and reducing procyclical credit cycles.
B) They require banks to hold less capital when risk is rising during booms.
C) They eliminate all need for supervision.
D) They apply only to households, not financial institutions.

15. Why is international regulatory cooperation important, and what forms did it take after the 2007-2009 financial crisis?

A) Because finance is global and risks cross borders; cooperation took forms such as Basel III, Financial Stability Board coordination, stress testing, and cross-border resolution efforts.
B) Because countries have no domestic regulators and must outsource all supervision.
C) Because international cooperation prevents all future crises automatically.
D) Because financial institutions operate only in one country at a time.

Answer Key

1. A 2. B 3. B 4. B 5. A 6. A 7. B 8. A 9. B 10. B 11. B 12. A 13. A 14. A 15. A