**Chapter One**

**I. Review Questions**

1.

(1) Widely accepted. It is usable by most people.

(2) Easily standardized. It must be easily standardized in terms of quality, so that any two units are identical.

(3) Divisible. It must be divisible, so that it is easy to “make change” when prices of goods and services vary.

(4) Easy to carry. It is valuable relative to its weight, so that amounts large enough to be useful in trade can be easily transported.

(5) Durable. It must not quickly become too worn out or deteriorate to be usable.

2.

Virtual currencies can function well as a medium of exchange and be attractive for its lower transaction costs and anonymity. However, they do not satisfy other two functions of money – as a unit of account and a store of value. The price of Bitcoin has been extremely volatile. This high volatility of the value means that it is too risky to be a store of wealth. Meanwhile, Bitcoins cannot become a unit of account due to the volatility of the value. Almost no one quotes the prices of their products in terms of Bitcoins. Furthermore, governments are concerned about the use of virtual currencies to conduct drug transactions and money laundering. Virtual currencies leave room for a lot of risks for the monetary system due to the unlawful issuance of cryptocurrencies, which may also involve multi-level marketing and Ponzi schemes to scam less crypto-savvy citizens out of their hard-earned money. The security of virtual currencies is also a big issue. There have been serious thefts of Bitcoins. Despite Bitcoins’ use for buying goods and services, there are still no uniform international laws that regulate Bitcoins.

3.

Inflation means a continual increase in the price level. It is generally regarded as an important problem, affecting individuals, businesses, and the government.

The term inflation contains the following points:

(1) It reflects rising prices for goods and services. It looks at the prices of goods and services, not stocks, bonds or other financial assets.

(2) It emphasizes the ““price of money”“, that is, the price in monetary quantities per unit of goods or services. It focuses on the relationship between goods or services and money, rather than the relationship between goods or services and goods or services.

(3) It is an increase in the “general price level”. The general price level refers to the average price level of all goods and services in the whole society. Partial or individual price fluctuation in goods and services cannot be considered as inflation.

(4) It is a persistent rise in prices. Seasonal, temporary or accidental price fluctuation cannot be considered as inflation. It must be a continuous process in which prices tend to rise.

The classic explanation of inflation is that “too much money is chasing too few goods”. Inflation reduces the real purchasing power of the currency—people can buy fewer goods or services with the same nominal amount of money.

4.

When prices rise at a rate of no more than 2 to 3 percent a year, it is moderate inflation, or creeping inflation. Many economists, businessmen, and politicians maintain that moderate inflation levels are needed to drive consumption, assuming that higher levels of spending are crucial for economic growth. A slowly increasing price level keeps businesses profitable and prevents consumers from waiting for lower prices before making purchases. There are some, in fact, who believe that the primary function of inflation is to prevent deflation.

A big reason for keeping moderate inflation is wage rigidity—the observation that wages cannot be adjusted downwards, the general difficulty a company experiences in trying to reduce wages. Whether because of a labor agreement, fears for lost productivity or other reasons, companies often find it hard to reduce employee wages or salaries. Wage rigidity has important implications for labor markets and macroeconomic performance. Empirical evidence on the extent, causes and consequences of wage rigidity on the individual level is relatively scant, however.

5.

Hyperinflation will lead to sudden panic buying and runs on banks. The redistribution of income and the sharp decline in living standards caused by hyperinflation will lead to the aggravation of class conflicts. The result of all this is often political upheaval. The most serious hyperinflation would destroy the whole economy or monetary system. The paper currency circulation system would not be maintained, gold and silver precious metals would become the media of exchange or means of payment again, and the underdeveloped areas would rapidly revert to barter economy.

Some examples are Germany during the early 1920s, China during the late 1930s and the 1940s, Hungary during the late 1940s, Argentina during the 1990s, and Zimbabwe, Venezuela during recent years.

**II. Multiple Choice**

1-5 BCADB

6-10 DDCBD

11-15 BDDDC

16-20 DCABA

**III. True or False**

1-5 FFFTF

6-10 TFTFT

**IV. Problems and Applications**

Within these nations the Euro had to be universally accepted as a medium of exchange, meaning that henceforth all economic transactions would be conducted in this new money. It also had to be used as a standard of value, or unit of account, so that all prices, wages, salaries, and assets would be converted from their previous currency values such as French francs and German marks into euros at an agreed-upon exchange rate. Lastly, it had to be utilized as a store of value, being used in such financial instruments as bank savings accounts and CDs.

The cigarettes performed the three functions of money. They served as the medium of exchange because individuals did exchange items for cigarettes. They served as a unit of account because prices were quoted in terms of the number of cigarettes required for the exchange. They served as a store of value because an individual would be willing to save their cigarettes even if they did not smoke because they believed that they could exchange the cigarettes for something that they did want at some time in the future.

The answer depends on the purpose of the measurement. Economists are primarily interested in the relation between monetary aggregates and other economic variables, such as output, the price level, and interest rates. In this respect, a monetary aggregate is most useful when it is most closely related to these economic variables. Until the 1980s, M1 was the most widely accepted measure of the money supply. From the 1990s, M2 has been most widely accepted.

Demand deposits are part of both M1 and M2, while time deposits and money market mutual funds are only listed in M2. So, as people switch their money from demand deposits to time deposits and money market mutual funds, M1 is falling and M2 is increasing. This means that people have reduced and delayed their current consumption. Current purchasing power has been lowered. But potential purchasing power has been improved.

In terms of the issues discussed in this chapter, inflation reduces the usefulness of currency as a store of value and as a standard of deferred payment. In extreme cases, high rates of inflation have led to a shift to a barter system or to the use of foreign currency as a medium of exchange. These effects would tend to reduce the efficiency of the economy and the rate of economic growth.

**Chapter Two**

**I. Review Questions**

1.

The first mechanism is direct finance, also named financial disintermediation. Borrowers borrow funds directly from lenders in financial markets by selling the lenders securities (also called financial instruments), which are claims on the borrower’s future income or assets.

The second mechanism is indirect finance, which involves a financial intermediary that stands between the lender-savers and the borrower-spenders and helps transfer funds from one to the other.

2.

There are three reasons:

(1) To reduce transaction costs. Transaction costs mean the time and money spent in carrying out financial transactions. Financial intermediaries can substantially reduce transaction costs because they can take advantage of specialization and economies of scale, the reduction in average transaction costs as the size (scale) of transactions increases.

(2) To allow diversification. Diversification means the splitting of wealth among many different assets to reduce risks. Financial intermediaries allow savers to hold a portfolio of assets, with the result that overall risk is lower than for individual assets, improving the chances of a steady return.

(3) To produce information. Financial intermediation partially solves the adverse selection and moral hazard problems. Financial intermediaries are major contributors to information production. They specialize in gathering information in conjunction with tailor-made financial contracts designed to help them sort out the good from the bad before any money is lent—and to provide appropriate incentives for responsible borrower behavior afterward. Sometimes these contracts can be quite restrictive.

3.

Adverse selection in financial markets occurs when the potential borrowers who are the most likely to produce an undesirable (adverse) outcome—the bad credit risks—are the ones who most actively seek out a loan and are thus most likely to be selected. Because adverse selection makes it more likely that loans might be made to bad credit risks, lenders may decide not to make any loans, even though good credit risks exist in the marketplace.

Moral hazard in financial markets is the risk (hazard) that the borrower might engage in activities that are undesirable (immoral) from the lender’s point of view, because they make it less likely that the loan will be paid back. This situation is more likely to occur when the borrower has an incentive to conceal information or to act in a way that does not coincide with the lender’s interests.

Financial intermediaries can reduce adverse selection through intensive screening and can reduce moral hazard by monitoring the borrower.

4.

A primary market is a financial market in which stocks, bonds, and other securities are sold for the first time. It is a market for issuing, so sometimes it is called the new issues market. Investment banks specialize in helping borrowers in the primary market. They gather information about the demand for particular securities by potential buyers and for a fee, help borrowers structure and price those securities and then sell them to the public at the most favorable price.

A secondary market is a financial market in which investors buy and sell already existing securities. It is a market for exchanging. Once securities are issued, they can be bought and sold in stock exchanges or over-the-counter (OTC) markets.

5.

Both of them sell shares to acquire money, but they do not invest in the same areas.

A mutual fund uses the proceeds to purchase diversified portfolios of stocks and bonds. It belongs to the capital market. Buying shares in a mutual fund is riskier than buying a certificate of deposit or a money market instrument like a Treasury bill. But due to diversification, it is less risky than buying individual stocks or bonds on one’s own.

A money market mutual fund does not invest the money in the stock market or in bonds. Instead, it purchases highly liquid short-term money market instruments, such as large-size bank negotiable CDs, Treasury bills, and high-grade commercial paper (a short-term debt instrument). It belongs to the money market and has higher liquidity and safety than a mutual fund.

**II. Multiple Choice**

1-5 BDCAD

6-10 BBCBC

11-15 BABBA

16-20 CCDDC

**III. True or False**

1-5 TTFFT

6-10 FFTFF

**IV. Problems and Applications**

The advantages of direct financing, such as purchasing shares of stock, are that it offers the investor a higher potential return, it allows the investor to diversify as he or she prefers, which provides total control over investment funds, and it offers the possibility of capital gains. The disadvantages are that the investor assumes all market risks and it is illiquid until the instrument matures or can be sold, such as a stock share.

The advantages of indirect financing for the investor are capital value security and a high degree of liquidity when choosing maturity dates, such as in a checking account or short-term CD. The disadvantages include a lower overall return, no control over investment funds once deposited in a bank or a savings and loan, and no possibility of enjoying capital gains.

Institutionalization refers to the fact that increasing amounts of funds have been flowing into financial markets indirectly through financial intermediaries such as pension funds, mutual funds, and insurance companies rather than directly from individual savers. These intermediaries are able to access market information on the creditworthiness of a firm floating a stock or bond issue much easier and cheaper than an individual investor can. Thus, pension or mutual fund managers can better utilize market information, producing a more efficient allocation of investment funds over time.

This statement is false. Prices in secondary markets determine the prices that firms issuing securities received in primary markets. In addition, secondary markets make securities more liquid and thus easier to sell in the primary markets. Therefore, secondary markets are, if anything, more important than primary markets.

Putting our money in a bank increases the liquidity (we can withdraw money conveniently), decreases the risk (money is safe in the bank, and usually we won’t lose our principal), and decreases our information cost. Instead, it is difficult for a private investor to assess the true credit quality of an individual or a business. Since private individuals can more easily hide their true financial position than a publicly-owned company. Also, the condition of the business may be tied to other aspects of the owner’s financial condition. The collapses of some publicly-traded corporations suggest that asymmetric information is a serious problem even for large companies.

The portfolios of life insurance companies are much more concentrated in the capital market. The number of persons that die within a group tends to be highly predictable. Thus, funds obtained from premiums can be invested in longer-term capital market instruments. Property and casualty companies have a much greater need for liquidity, due to the greater uncertainty of their obligations such as claims due to fire damage or auto accidents. Thus, funds obtained from premiums will be invested in shorter-term (usually money market) instruments.

Moral hazard is the asymmetric information problem that exists after the transaction occurs. A moral hazard exists when a person or entity engages in risk-taking behavior based on a set of expected outcomes where another person or entity bears the costs in the event of an unfavorable outcome. For lenders, it is the difficulty in making sure the borrower uses the funds appropriately. Mortgage securitization can lead to moral hazard—and did, in the subprime meltdown and financial crisis of 2008.

Financial intermediaries can reduce moral hazard by monitoring the borrower. Originators of mortgages can pool the loans and then sell pieces of this mortgage pool to investors, thus passing the risk of default on to someone else. In such a situation, it benefits the buyer or buying agency to be diligent in monitoring the originators of the loans and in verifying loan quality.

**Chapter Three**

**I. Review Questions**

1.

The essence of the time value of money is that a dollar received in the future is not equivalent to a dollar received in the present, and time value brings them together. Time value of money is the principle that money received now can be invested to earn additional money in the future. Time value of money relates to the opportunity cost of giving up money or resources for a period of time—either forgone investments or consumption. Cash flows that occur at different points in time cannot simply be added together or subtracted.

2.

Future value is the amount which a present sum will accumulate to at a future date through the operation of interest. Present value is the amount that corresponds to today’s value of a promised future sum. Present values and future values do not simply trade dollar for dollar. The rate at which a present value should transform into a future value, or vice versa, depends on the time value of money (usually expressed as r or i). The present value is the current value of a future cash flow, or series of cash flows, discounted by the required rate of return. Alternatively, the present value of an amount of money is the necessary amount invested today to yield a particular value in the future. For example, how much will a payment of $1,000 after 20 years be worth today if the funds earn five percent annually? This is a question of present value. The process by which this question is answered is called discounting. Discounting determines the present value of funds that are to be received in the future.

3.

A coupon bond pays the owner of the bond a fixed interest payment (coupon payment) every year or every six months until the maturity date, when a specified final amount (face value or par value) is repaid. A coupon bond is identified by four pieces of information: First is the bond’s face value; second is the corporation or government agency that issues the bond; third is the maturity date of the bond; and fourth is the bond’s coupon rate, which is the amount of the yearly/semiyearly coupon payment expressed as a percentage of the face value of the bond.

One special case of a coupon bond is called a consol or a perpetual bond. A perpetual bond, also known as a “consol bond” or “perp”, is a fixed income security with no maturity date. The coupon payments on perpetual bonds will, theoretically, be paid forever. So, we don’t tend to pay any attention to the “par value” for a perpetual bond/consol. This type of bond is often considered a type of equity, rather than debt. Perpetual bond payments are similar to stock dividend payments, as they both offer some sort of return for an indefinite period of time.

Another type of bond is a zero-coupon bond (also called a discount bond), which does not pay interest during the time the bond is outstanding. Rather, zero-coupon bonds are sold at a discount to their value at maturity. Bond holders receive no coupon interest payments, only the face value of the bond when it matures. For example, a one-year discount bond with a face value of $1,000 might be bought for $920; in a year’s time, the owner would be repaid the face value of $1,000. U.S. Treasury bills are an example of a zero-coupon bond.

4.

Yield to maturity (YTM) is the interest rate (rate of discount) which makes sum of present values of all expected future payments (annual interest plus face value) equal to purchase price. The YTM is based on the belief or understanding that an investor purchases the security at the current market price and holds it until the security has matured (reached its full value), and that all interest and coupon payments are made in a timely fashion. Yield to maturity is a very important interest rate and is considered by economists to be the most accurate measure of interest rates.

The current yield is calculated by dividing the annual coupon by the current market price. This measure examines the current price of a bond, rather than looking at its face value. Current yield represents the return an investor would expect to earn, if the owner purchased the bond and held it for a year.

Return or rate of return measures the cash flows received during a period relative to the amount invested at the beginning. It is the gain or loss of an investment over a certain period of time. For any security, the rate of return is defined as the amount of each payment to the owner plus the change in the security’s value, expressed as a fraction of its purchase price.

5.

The Fisher Effect is an economic theory created by economist Irving Fisher that describes the relationship between inflation and both real and nominal interest rates. The Fisher Effect states that the real interest rate equals the nominal interest rate minus the expected inflation rate. Therefore, real interest rates fall as inflation increases, unless nominal rates increase at the same rate as inflation.

**II. Multiple Choice**

1-5 BACAC

6-10 BCDCA

11-15 DCDAD

16-20 DDCBA

**III. True or False**

1-5 FFFTT

6-10 FFFTF

**IV. Calculation**

S = P (1 + rt)

S = 2,300 P = 2,000 t = 3 r = ?

2,300 = 2,000 ( 1 + r \* 3)

r = 0.05 or 5% per annum

S = P ( 1 + i)n

P = 5 i = 0.10 p.a. n = 45 years

S = 5 ( 1 + 0.1) 45

S = $364.45

P=FV/(1+r)n

P=(1000+1000\*6%)/(1+10%)=963.64

P=FV/(1+r)n

1000=1210/(1+r)2

r = 10%

r = [(900-1000)+1000\*0.05]/1000= -5%

**Chapter Four**

**I. Review Questions**

1.

With a coupon bond, borrowers issuing coupon bonds make interest payments in the form of coupons at regular intervals, typically semiannually or annually, and repay the face value at maturity. The coupon is the semiannual or annual fixed money amount of interest paid by the issuer of the bond to the buyer. The coupon rate is the value of the coupon expressed as a percentage of the par value of the bond.

A zero-coupon bond does not pay interest but instead trades at a deep discount, rendering a profit at maturity, when the bond is redeemed for its full-face value. The borrower pays the lender the par value at maturity but receives less than the par value initially. The interest paid on the loan is the difference between the amount repaid and the amount borrowed.

2.

The first reason is that firms (borrowers) can reborrow more cheaply if interest rate falls. The second reason is that call provision makes it possible for issuers to buy back their bonds according to the terms of the sinking fund. A sinking fund is a requirement in the bond indenture that the firm pays off a portion of the bond issue each year. This provision is attractive to bondholders because it reduces the probability of default when the issue matures. Because a sinking fund provision makes the issue more attractive, the firm can reduce the bond’s interest rate. The third reason is that firms may have to retire a bond issue if the covenants of the issue restrict the firm from some activities that are good for shareholders. Suppose that a firm needed to borrow additional funds to expand its factories. If the firm’s bonds carried a restriction against adding debt, the firm would have to retire its existing bonds before issuing new bonds or taking out a loan to build the new factory. The last reason is that a maturing firm with excess cash flow may wish to reduce its debt load if few attractive investment opportunities are available. So, the firm may choose to call bonds if it wishes to alter its capital structure.

3.

Both common stock and preferred stock represent partial ownership of a corporation, but they have significant differences in either the distribution of dividends or voting rights.

Common stockholders elect the members of the board of directors, but preferred stockholders are not eligible to vote. Preferred stockholders receive a fixed dividend that is set when the corporation issues the stock. Because the dividend does not change, the price of preferred stock is relatively stable. Common stockholders receive a dividend that fluctuates as the profitability of the corporation varies over time, and hope that the price of their stock will rise. If the corporation declares bankruptcy, its debt holders—investors and financial institutions that have bought the corporation’s bonds or made loans to the corporation—are paid off first, and then the preferred stockholders are paid off. If any money remains, then the company pays the common stockholders.

4.

Whether or not the interest rate is fixed, homeowners have the right to repay their mortgages early, which they might very well do if they move to a new location or if interest rates fall and they can refinance their indebtedness (borrow again) on better terms. From the lender’s viewpoint, this prepayment uncertainty, known as prepayment risk, makes mortgages less desirable than other forms of debt.

Some of the uncertainty is reduced when individual mortgages are packaged together into a “pool” and sold as a unit. A new security backed by (secured by) a large number of mortgages assembled in the pool is created, named mortgage-backed security (MBS), or securitized mortgage. A trustee, such as a bank or a government agency, holds the mortgage pool, which serves as collateral for the new security. This process is called securitization. Securitization occurs when funds that used to flow through intermediated markets now flow through financial markets.

5.

With futures contracts, buyers and sellers have symmetric rights and obligations. That is, the seller must deliver the underlying asset, and the buyer must take delivery at the futures price on the delivery date. In contrast, with options contracts, the owner or buyer has rights, and the seller, called the option writer, has obligations. The buyer of an option is not obligated to take any action but rather has the right to exercise the contract if he or she so chooses, that means he or she can let the option expire without using it. The seller of an option, by contrast, has no choice in the matter. He or she must buy or sell the underlying asset if the buyer exercises the option.

**II. Multiple Choice**

1-5 CACCD

6-10 DCCBD

11-15 CDDCC

16-20 BCDAB

**III. True or False**

1-5 FTTFF

6-10 TFFTF

**IV. Problems and Applications**

Foreign ownership of a government debt means that foreigners have a claim on the future output of a country or region. It also means that if foreigners suddenly decide to reduce their savings or to buy other assets and thus are looking to cash out their Treasury issues, the government bond prices will fall and the interest rates will rise.

Though sovereign debt defaults are relatively infrequent, countries can and periodically do default on their sovereign debt. This happens when a country’s government is either unable or unwilling to repay creditors. Argentina, Lebanon, and Ukraine are among the countries that have defaulted on their debt in recent years. The causes of a default can range from high debt burden and economic stagnation to political instability or a banking crisis.

Junk bonds are bonds rated BB or lower by private rating companies. They can be an appropriate addition to a portfolio (depending on return correlations). The increased use of such bonds has served to reduce the cost of raising capital for many smaller firms.

Purchasing them, according to portfolio theory, should depend on how much risk they add to the investor’s portfolio and on whether their expected return is sufficient to compensate the investor for this risk. Given the low credit rating of junk bonds and thus the high credit risk of default, investors in these securities are risk lovers in the true sense of the term.

Both are securities, which are a source of funds for a corporation and a claim to future streams of payment. Stocks are ownership shares with infinite maturity, while bonds are debt with, in most cases, a finite maturity. Bonds make fixed-dollar commitments, where the value of stocks are contingent on the issuers’ performance.

Options are probably more attractive. The asymmetric payoff to puts and calls means that unlimited gains are possible, while losses are limited to the premium paid for the option. But any recommendation would also depends on the other assets the person had in his or her portfolio.

The contract would guarantee the amount of RMB that would be purchased with foreign currency when the payment is received from the foreign importer in the future. This precludes any foreign exchange risk from being absorbed by the exporter and guarantees a pre-determined RMB payment for the exported products or services.

**Chapter Five**

**I. Review Questions**

1.

Money market securities have three basic characteristics in common: First, they are usually sold in large denominations. Second, they have low default risk, high liquidity and low yields. Third, they mature in one year or less from their original issue date.

Money market transactions are often arranged by traders and completed by electronic ways. Because of this characteristic, money market securities usually have an active secondary market.

Another characteristic of money markets is that they are wholesale markets. This means that most transactions are very large. The size of these transactions prevents most individual investors from participating directly in money markets.

2.

No, I don’t agree. Treasury bills are very close to being risk-free since they are backed by the full faith and credit of the government, especially a strong government. Even so, they are not exactly risk-free.

T-bills pay a fixed rate of interest, which can provide a stable income. However, if interest rates are rising, existing T-bills fall out of favor since their rates are less attractive compared to the overall market. As a result, T-bills have interest rate risk meaning there is a risk that existing bondholders might lose out on higher rates in the future. T-bill prices fluctuate similarly to other debt securities. Many factors can influence T-bill prices, including macroeconomic conditions, monetary policy, and the overall supply and demand for Treasuries. If they are sold early, there could be a gain or loss depending on where bond prices are trading at the time of the sale.

Treasuries also have to compete with inflation, which measures the pace of rising prices in the economy. Even if T-bills are the most liquid and safest debt security in the market, fewer investors tend to buy them in times when the inflation rate is higher than the T-bill return. As a result, T-bill prices tend to fall during inflationary periods as investors sell them and opt for higher-yielding investments.

3.

Repurchase agreements are an alternative to borrowing in the interbank market. And they work much the same as interbank loans: First, both markets are sources of overnight funds. Second, both markets settle payments the same day the transaction is completed. For example, in the case of the repo, the same day the dealer sells the securities with an agreement to repurchase them at a fixed price, the funds are transferred into the dealer’s accounts by whoever did the other side of the transaction (the reverse RP).

The main difference between a repo and an interbank loan transaction is that the latter is an unsecured overnight loan between financial institutions, while the former is essentially a secured loan (pledge loan), with the securities that are subject to repurchase acting as the pledge. Thus, the repo rate and interbank loan rate over the same period tend to move closely together, and the former is always slightly lower than the latter to reflect the fact that repos are pledged.

4.

Usually they are large corporations and finance companies. The need for commercial paper often arises due to corporations facing a short-term need to cover their expenses such as payroll, accounts payable and inventories. Finance companies, who are often associated with well-known manufacturing firms, use commercial paper extensively to finance the loans that they extend to their customers.

Large corporations with established businesses and high credit ratings will be able to sell the instrument at a reasonable rate. Such corporations enjoy the option of issuing such debt instruments without collateral backing. If a smaller organization were to try to issue commercial paper, it is quite likely that there would not be enough trust on the part of investors to buy the securities. The credit risk, which can be defined as the likelihood that a borrower is unable to repay the loan, will be too high for smaller organizations, and there will be no market for this type of issue.

5.

A promissory note is often described as “one-name paper”. The sole liability to repay the face value of a promissory note at maturity is with the issuer. There is no party that acts as an acceptor (like a bill of exchange), nor is there a series of contingent liabilities established by endorsement. When a promissory note is sold in the market, unlike the bill, there is no requirement for the seller to endorse the note.

Compared with a promissory note, a bill of exchange is an order of payment, involving three parties: drawer, drawee and payee. While a promissory note is a promise of payment, only involving two parties: drawer/payer, and payee. In the event of a bill of exchange, there is an acceptor. The acceptor is the party to whom the bill is addressed and who undertakes to pay the face value of the bill to the person presenting the bill at the maturity date. That means the debtor, namely drawee, must accept the bill in order for it to be considered valid.

**II. Multiple Choice**

1-5 CDDAB

6-10 ABCCD

11-15 AADBC

16-20 CDDAB

**III. True or False**

1-5 FFTFF

6-10 FFFTT

**IV. Problems and Applications**

The money market is comprised of short-term financial instruments maturing within one year or less (e.g., T-bills, commercial paper and certificates of deposit), and the capital market is comprised of long-term financial instruments with a maturity in excess of one year (e.g., bonds, stocks and mortgages).

The investment rate is more accurate because it accounts for the fact than an investor does not pay full face value, and also it accurately reflects the number of days in the year.

If there is a decline in interest rates, we would rather be holding long-term bonds because their price would increase more than the price of the short-term bonds, giving them a higher return. However, long-term bonds have a greater interest-rate risk. And, this answer really depends on the duration of the bonds, not just their term to maturity. For example, a five-year coupon bond might be subject to less interest rate risk than a four-year zero-coupon bond.

When government central banks repurchase securities from private banks, they do so at a discounted rate, known as the repo rate. Repo rates are set by central banks. The repo rate system allows governments to control the money supply within economies by increasing or decreasing available funds.

A decrease in repo rates encourages banks to sell securities back to the government in return for cash. This increases the money supply available to the general economy. Conversely, by increasing repo rates, central banks can effectively decrease the money supply by discouraging banks from reselling these securities.

QUESTION a.

Option 1: 1.02\*100%=1.02

There is no risk involved and it has a return of 2%.

100,000 \*(1+2%) = ¥102,000

Option 2: 1.05\*90%=0.945

Invest $100,000 \* 1.05 = $105,000, $105,000\* 90% = ¥94,500 (probability)

90% (5%) +10% (-100%)

4.5% + (-10%)= -5.5%

-5.5% \* 100,000 = -5500

-5,500 + 100,000 = ¥94,500

Option 3: 1.08\*93%=1.0044

$100,000 \*(1 + 8%) = $108,00, 108,000 \*93% = ¥100,440

93% \* (8%) + 7% (-100%)

7.44% + (-7%) = 0.44%

Option 4: 1\*100%=1

¥10,000 return (v=0)

So, Option 1 has the highest expected return of the four options.

QUESTION b.

• Lily is scum: ¥99,000; 100,000 − 1,000 payout to find information = ¥99,000

• Lily is good: ¥107,000; 100,000 \* 1.08 = ¥108,000, 108,000 – 1,000 = ¥107,000

• Expected value: ¥99,000 \* 7% + 107,000 \* 93% = ¥106,440

• We are paying ¥1,000 in order to get ¥6,000 more.

Better information regarding risk addresses the problem of asymmetric information. In this case adverse selection reduces risk, increases our expected returns, and ultimately facilitates transactions.

**Chapter Six**

**I. Review Questions**

1.

Whenever we import foreign goods, buy foreign stocks or bonds, or travel abroad, we have to make payments to people in other countries. Naturally enough, these people want to get paid in their own money. So, we have to get hold of foreign exchange, which we can do by going to a bank or currency exchange and buying some. Our imports thus give rise to a demand for foreign currency. Notice that when we buy foreign money we do so by offering our own currency, so that a demand for foreign money also amounts to a supply of domestic currency on foreign exchange markets.

On the other hand, whenever we export our goods, sell our securities to others, or are host to foreigners traveling here, payments have to be made to us. Naturally, we also want to get paid in our own money. So, foreigners have to buy our currency, which they can do by going to a bank or currency exchange and offering their own money. Our exports thus give rise to a supply of foreign currency. Notice that when they offer foreign money, they are trying to buy our money, so that the supply of foreign money also amounts to a demand for domestic currency on foreign exchange markets.

The price of foreign money, the foreign exchange rate, like the price of anything that is bought and sold, is determined by supply and demand.

2.

Nominal exchange rates tell us how many pounds or euros or U.S. dollars we will receive in exchange for one Yuan, but they do not tell us how much of another country’s goods or services we can buy with one Yuan. When we are interested in the relative purchasing power of two countries’ currencies, we use the real exchange rate, which measures the rate at which goods or services in one country can be exchanged for goods or services in another country. The main purpose of calculating real exchange rates is to analyze the deviation of exchange rates and inflation rates of the two countries. It can further illustrate the international competitiveness of goods and services of the countries concerned. But the exchange rate we usually refer to is the nominal exchange rate, which is used by banks or dealers in foreign exchange transactions.

3.

One of the most prominent theories of how exchange rates are determined is the theory of purchasing power parity (PPP), which is based on the law of one price in the context of international trade. It states that exchange rates between any two currencies will adjust to reflect changes in the price levels of the two countries. In other words, in the long run, exchange rates should be at a level that makes it possible to buy the same amount of goods and services with the equivalent amount of any country’s currency.

Even though PPP theory provides some guidance to the long-run movement of exchange rates, it is not perfect and in the short run is a particularly poor predictor. Three real world complications keep purchasing power parity from being a complete explanation of exchange rates: (1) Not all products can be traded internationally. (2) Products are differentiated. (3) Governments impose barriers to trade.

4.

The current account shows international transactions that involve currently produced goods and services. The difference between merchandise exports and imports, the net receipts from trade, is called the trade balance. When merchandise imports are greater than exports, the result is a trade deficit; if exports are greater than imports, the result is a trade surplus. The vast majority of the current account is the trade balance. Except it, additional items included in the current account are the net receipts (cash flows received from abroad minus cash flows sent abroad) from three categories: investment income, service transactions, and unilateral transfers (gifts, pensions, and foreign aid). The sum of these three items plus the trade balance gives the current account balance. Among them, the trade balance is the vast majority. Therefore, the current account balance is considered the broadest gauge of trade.

Another important item is the capital account, the net receipts from capital transactions that involve assets like stocks, bonds, bank loans, etc. The capital account’s balance will inform us whether the country is a net importer or net exporter of capital. If more capital flows out of a country than in, the country experiences a capital account deficit. The reverse situation is a capital account surplus.

5.

Benefits: (1) Stability in the balance of payments (BOP). In theory, any imbalance in a balance of payments automatically changes the exchange rate. For example, if the imbalance is a deficit, it would cause the currency to depreciate. The country’s exports would become cheaper, resulting in an increase in demand and eventually attaining equilibrium in the BOP. (2) Foreign exchange is unrestricted. Floating exchange rate currencies can be traded without any restrictions, unlike currencies with fixed exchange rates. Hence, governments and banks do not need to resort to a continuous management process. (3) Market efficiency enhances. A country’s macroeconomic fundamentals affect the floating exchange rate in global markets, influencing the flow of portfolios between countries. Thus, floating exchange rates enhance the efficiency of the market. (4) Large foreign exchange reserves are not required. For a floating exchange rate, central banks are not required to keep large foreign currency reserve amounts for defending the exchange rate. Hence, the reserves can be utilized for promoting economic growth by importing capital goods. (5) Import inflation protected. Countries with fixed exchange rates face the problem of importing inflation through surpluses of the balance of payments or higher prices of imports. However, countries with floating exchange rates do not face such a problem.

Limitations: (1) Exposed to the volatility of the exchange rate. Floating exchange rates are prone to fluctuations and are highly volatile by nature. A currency value against another currency may deteriorate only in one trading day. Furthermore, the short-term volatility in a floating exchange rate cannot be explained through macroeconomic fundamentals. (2) Restricted economic growth or recovery. The lack of control over floating exchange rates can limit economic growth or recovery. The negative currency exchange rate movements may lead to serious issues. For example, if the dollar rises against the euro, it will be more difficult to export to the Eurozone from the U.S. (3) Existing issues may worsen. If a country is suffering from economic issues, such as unemployment or high inflation, floating exchange rates may intensify the existing problems. For example, depreciation of a country’s currency already suffering from high inflation will cause inflation to increase further due to an increase in demand for goods. Moreover, expensive imports may worsen the country’s current account.

**II. Multiple Choice**

1-5 AABCD

6-10 BBDBB

11-15 BCCBD

16-20 BDDAC

**III. True or False**

1-5 FFTTF

6-10 TFFFT

**IV. Problems and Applications**

In the long run, there are four major factors that influence supply and demand conditions: (1) Relative price levels. If one country has a higher inflation rate than another country, the currency of the high-inflation country will depreciate relative to the currency of the low-inflation country. (2) Preferences for domestic versus foreign goods. Increased demand for a country’s exports causes its currency to appreciate in the long run; conversely, increased demand for imports causes the domestic currency to depreciate. (3) Productivity. As a country becomes more productive relative to other countries, its currency appreciates. (4) Trade barriers. Increasing trade barriers causes a country’s currency to appreciate in the long run.

In the short run, some factors influence the relative expected return of foreign assets which determines the quantity of foreign assets demanded: (1) Foreign interest rate. An increase in the foreign interest rate shifts the demand curve for foreign assets to the right and causes the foreign currency to appreciate. (2) Domestic interest rate. An increase in the domestic interest rate shifts the demand curve for foreign assets to the left and causes the foreign currency to depreciate. (3) Changes in the expected future exchange rate. A rise in the expected future exchange rate shifts the demand curve to the right and causes an appreciation of the foreign currency. (4) The expectations from other long-run determinants: ① expectations of a fall in the foreign price level relative to the domestic price level, ② expectations of higher domestic import demand, ③expectations of lower foreign demand for domestic exports, ④ expectations of higher foreign productivity relative to domestic productivity, and ⑤ expectations of higher foreign trade barriers relative to domestic trade barriers. All of these changes increase the relative expected return on foreign assets, shift the demand curve of foreign assets to the right, and cause an appreciation of the foreign currency.

The demand for the Yuan curve shifts to the right. These shifts cause the Yuan to appreciate to a price somewhere above $0.15.

Solve for e\* in: 1.05 e\* = 1.03 × 0.93. e\* = €0.9123 per dollar.

The dollar will depreciate against the yen if investors sell large amounts of U.S. securities for dollars and convert these dollars into yen. Or we’re getting less yen per dollar.

Nations were committed to buy up any excess supplies of their currencies at the fixed exchange rates. But none of those nations had unlimited supplies of the international reserves needed to do this.

**Chapter Seven**

**I. Review Questions**

1.

The bank balance sheet is a list of a bank’s sources of funds (liabilities and owners’ equity) and uses of funds (assets). The balance sheet is based on the following accounting equation: Total assets = Total liabilities + Owners’ equity (Bank capital).

In the three parts of the balance sheet, an asset is something of value that the bank owns. A liability is something that the bank owes, or in other words, a claim on the bank. Owners’ equity in banking is usually called bank capital. Bank capital is the funds contributed by the shareholders through their purchases of the bank’s stock plus the bank’s accumulated, retained profits. Banks obtain funds by borrowing and by issuing other liabilities, such as deposits. They then use these funds to acquire assets such as securities and loans. Banks make profits by earning interest on their asset holdings of securities and loans that is higher than the interest and other expenses on their liabilities.

2.

Although asset and liability management has traditionally been the major concern of banks, in the more competitive environment of recent years banks have been aggressively seeking out profits by engaging in off-balance-sheet activities.

Traditional banking activity, such as taking in deposits and making loans, affects a bank’s balance sheet because deposits appear on the balance sheet as liabilities, and loans appear as assets. Off-balance-sheet activities generate income but do not affect the bank’s balance sheet, because they do not increase either the bank’s assets or its liabilities. For example, when a bank buys and sells foreign exchange for customers, the bank charges the customers a fee for the service, but the foreign exchange does not appear on the bank’s balance sheet. In fact, off-balance-activities have been growing in importance for banks.

Specialized services, loan sales, trading activities are some typical off-balance sheet businesses.

3.

A bank income statement is a type of financial tool that is used in assessing the performance of a bank under consideration during a stated period. Just like any other type of company income statement, the bank income statement usually lists the various earnings and expenses incurred by the bank over the period with the aim of coming up with a final assessment derived from the final result. After studying a bank income statement, the data contained in it should give investors and other interested parties an idea of whether the bank is a profitable enterprise. The items on the bank income statement are unique according to the circumstances of the banks, which include the ability to earn income from interest and also the expense in the form of the payment of interest, which is not common in other industries.

4.

Although there are some differences in the system of commercial banks in different countries, they usually follow the “triple principles” of safety, liquidity and profitability in business operation.

Safety is a problem that must be considered in the bank management. First, banks must consider extremely truly the parts of security of the loaned-out money. Second, the constraints of commercial banks’ assets and liabilities do not match. Third, commercial bank operation has high risk. One measure of the safety of a bank is the equity multiplier (EM).

Liquidity here refers to the ability of commercial banks to meet the needs of withdrawals or loans from customers at any time. In order to maintain liquidity, banks can do two things: first, the assets have enough liquidity. Second, there are more financing channels and strong financing ability.

The principle of profitability is the ultimate goal of commercial banks’ operation and the necessary condition for their survival and development. The return on assets (ROA) and return on equity (ROE) are the two basic indicators of bank profitability.

Banks must constantly seek the best balance between safety, liquidity and profitability, which is also the difficulty of bank management.

5.

Although a government safety net can help protect depositors and other creditors and prevent, or ameliorate, financial crises, it is a mixed blessing. The most serious drawback of the government safety net stems from moral hazard, the incentives of one party in a transaction to engage in activities detrimental to the other party. With a safety net, depositors and creditors know they will not suffer losses if a financial institution fails, so they do not impose the discipline of the marketplace on these institutions by withdrawing funds when they suspect that the financial institution is taking on too much risk. Consequently, financial institutions with a government safety net have an incentive to take on greater risks than they otherwise would, because taxpayers will foot the bill if the bank subsequently goes belly up. Financial institutions can place the following bet: “Heads I win, tails the taxpayer loses.”

Another problem with a government safety net like deposit insurance is adverse selection. The fact that the people who are most likely to produce the adverse outcome insured against (bank failure) are the same people who most want to take advantage of the insurance. Because depositors and creditors protected by a government safety net have little reason to impose discipline on financial institutions, risk-loving entrepreneurs might find the financial industry a particularly attractive one – they know they will be able to engage in highly risky activities. Even worse, because protected depositors and creditors have so little reason to monitor the financial institution’s activities, without government intervention, outright crooks might also find finance an attractive industry for their activities because it is easy for them to get away with fraud and embezzlement.

The moral hazard created by a government safety net and the desire to prevent financial institution failures have presented financial regulators with a particular quandary, the too-big-to-fail problem, in which regulators are reluctant to close down large financial institutions and impose losses on the institutions’ depositors and creditors because doing so might precipitate a financial crisis.

**II. Multiple Choice**

1-5 ADBAB

6-10 ABCDD

11-15 DBCBA

16-20 BCADC

**III. True or False**

1. TFFFF
2. FTFTT

**IV. Problems and Applications**

There has been a tremendous drop in the importance of transactions deposits, fluctuations in the importance of time deposits and CDs, an increase in foreign deposits in response to globalization, and a huge growth in a variety of “miscellaneous liabilities” such as repurchase agreements and interbank market funds.

Floating-rate loans reduce interest rate risk because the rate on the loan fluctuates with short-term market rates, which are more closely related to the bank’s interest rate costs on its liabilities, i.e., deposits. This becomes especially desirable during periods of volatile interest rates.

Banks have an unusually high “liquidity risk” relative to nonfinancial firms. Many of their liabilities can be claimed at unpredictable times and on the spot primarily by depositors. Because of this, banks like to hold assets that maintain market value and can be easily liquidated, although modern bank management techniques are moving away from this practice.

ROA=2/100=2%, ROE=2/10=20%.

(The answer is open-ended. Students can analyze the problem from the leverage risk, interest-rate risk and liquidity risk.)

SVB’s collapse came suddenly, following a frenetic 48 hours during which customers yanked deposits from the lender in a classic run on the bank.

But the root of its demise goes back several years. Like many other banks, SVB ploughed billions into U.S. government bonds during the era of near-zero interest rates.

What seemed like a safe bet quickly came unstuck, as the Federal Reserve hiked interest rates aggressively to tame inflation.

When interest rates rise, bond prices fall, so the jump in rates eroded the value of SVB’s bond portfolio. The portfolio was yielding an average 1.79% return last week, far below the 10-year Treasury yield of around 3.9%, Reuters reported.

At the same time, the Fed’s hiking spree sent borrowing costs higher, meaning tech startups had to channel more cash towards repaying debt. At the same time, they were struggling to raise new venture capital funding.

That forced companies to draw down on deposits held by SVB to fund their operations and growth.

(Why Silicon Valley Bank collapsed and what it could mean | CNN Business https://edition.cnn.com/2023/03/13/investing/silicon-valley-bank-collapse-explained/index.html)

**Chapter Eight**

**I. Review Questions**

1.

(1) A central bank has the uniqueness of operations.

Compared with commercial banks, a central bank’s business is unique in:

① the business purpose. Central banks do not operate for profit and are not competitive.

② the business customers. Central banks do not do business with firms and individuals. They only serve commercial banks, other financial institutions and governments.

③ the business scope. Central banks have certain privileges in their operations. For instance, a central bank has the power to issue money. It is also responsible for collecting required reserves, managing the nation’s gold and foreign exchange reserves, and maintaining the settlement and clearing system.

(2) A central bank has the uniqueness of status.

A central bank stands at the center of a country’s financial system. It is the highest authority of the country’s monetary system, credit system and financial system. Though they may be established by a governing body, central banks are independent authorities. They have a number of duties related to monetary policy, providing financial services, regulating lower banks, and conducting research. Central banks aim to keep a nation’s currency and economy stable.

2.

If divided into domestic and foreign assets, the assets of the central bank can be divided into net foreign assets (mainly international reserves) and domestic assets (credit provided by the central bank to domestic institutions).

Net foreign assets (NFA) are the difference between the foreign assets and foreign liabilities of the central bank of the country. It is the value of overseas assets owned by a nation, minus the value of its domestic assets that are owned by foreigners, adjusted for changes in valuation and exchange rates. If the central bank buys foreign assets from commercial banks in the foreign exchange market, the result is an increase in the “Foreign Assets” of the assets column and a corresponding increase in the “Deposits of Other Depository Corporations” (reserve deposits) of the liability column. The increase in reserves expands the monetary base, which can be loaned by commercial banks and derives large amounts of cash and demand deposits, thus increasing the money supply. This part of the increase in the money supply is called funds outstanding for foreign exchange, which refers to the corresponding release of domestic currency by a country’s central bank through the purchase of foreign exchange assets.

Domestic assets include funds provided by the central bank to various levels of government, financial institutions and other sectors. The claims on government include overdrafts, loans and purchase of government bonds. The claims on other depository corporations, other financial corporations, and non-financial sectors, are mainly the rediscount and relending provided by the central bank. The central bank’s purchase of securities (mainly Treasuries) in the inter-bank bond market, as well as its rediscount and relending to commercial banks or other institutions, can affect the changes of liabilities through asset items. These actions increase the money base, thereby expanding the money supply.

3.

High employment, or full employment, does not mean a zero percent rate of unemployment. Even under the best economic conditions, some workers move into or out of the job market or are between jobs. Workers sometimes leave one job to pursue another and might be unemployed in the meantime. Individuals also leave the labor force to obtain more education and training or to raise a family, and reentry may take time. This type of frictional unemployment enables workers to search for positions that maximize their well-being. Structural unemployment refers to unemployment that is caused by changes in the structure of the economy, such as shifts in manufacturing techniques, increased use of computers, and increases in the production of services instead of goods. The tools of monetary policy are aimed at affecting economic conditions throughout the economy, so they are ineffective in reducing the levels of frictional and structural unemployment. Instead, central banks attempt to reduce levels of cyclical unemployment, which is unemployment associated with business cycle recessions. Sometimes economists have difficulty distinguishing structural unemployment from cyclical unemployment.

When all workers who want jobs have them (apart from the frictionally and structurally unemployed) and the demand and supply of labor are in equilibrium, economists say that unemployment is at its natural rate (sometimes called the full-employment rate of unemployment). The exact value of the natural rate of unemployment varies over time in response to changes in the age and gender composition of the labor force and changes in government policies with respect to taxes, minimum wages, and unemployment insurance compensation. Currently, most economists estimate that the natural rate of unemployment is between 5% and 6%.

4.

Open market operations refer to central banks’ purchases and sales of securities, mainly government bonds, in financial markets. Central banks conduct most of open market operations in Treasury securities, especially Treasury bills, because the market for these securities is the most liquid and has the largest trading volume. It has the capacity to absorb central banks substantial volume of transactions without experiencing excessive price fluctuations that would disrupt the market. Open market operations are the most important conventional monetary policy tool because they are primary determinants of changes in interest rates and the monetary base, the main source of fluctuations in the money supply. When a central bank carries out an open market purchase of Treasury securities, the prices of these securities increase, thereby decreasing their yield. Open market purchases expand reserves and the monetary base, thereby increasing the money supply and lowering short-term interest rates. They are considered an expansionary policy. An open market sale decreases the price of Treasury securities, thereby increasing their yield. Open market sales shrink reserves and the monetary base, decreasing the money supply and raising short-term interest rates. They are considered a contractionary policy.

5.

Forward guidance is a tool used by a central bank to try and influence market expectations of future levels of interest rates. “Forward guidance” in monetary policy means providing some information about future policy settings. Central banks publicly provide their own thoughts on the state of the economy and on what their likely future course of monetary policy will be. For instance, in the current post-COVID19 world, forward guidance is nothing more than a central bank like the Fed or ECB saying it does not expect to raise interest rates for a period of time. According to the theory of term structure of interest rates, long-term interest rates are equal to the average of short-term interest rates plus a risk premium. The longer central banks keep interest rates low, the more the correlation between long-term and short-term rates becomes apparent. Moreover, by lowering the financing cost of enterprises and households, central banks can achieve the purpose of promoting consumption and stimulating the economy.

Forward guidance can take different forms. It can be open-ended. For example, a central bank might announce that “Interest rates are expected to remain low for an extended period”. It can entail more concrete conditionality in terms of timing (date-dependent). For example, “Interest rates are expected to remain at present levels at least through the fall of next year”. It can be in terms of economic development (state-dependent). For example, “Current policy is anticipated to be appropriate at least as long as the unemployment rate remains above 5.5%”. Forward guidance can be quantitative or qualitative, depending on whether it provides specific figures or not. Whatever its form, forward guidance can influence public perceptions about the monetary policy reaction function and policy commitment, and thereby influence market prices and economic outcomes.

**II. Multiple Choice**

1-5 CCBDD

6-10 CCBBB

11-15 CDDBB

16-20 CBADA

**III. True or False**

1-5 FTFFF

6-10 FFTFT

**IV. Problems and Applications**

There is strong evidence that countries with a more independent central bank tend to have lower inflation rates in the long run. Before the European Monetary Union was completed, the most independent central banks, in Germany and Switzerland, presided over very low inflation. The United States has a highly independent Fed and low inflation. Countries with less independent central banks tend to have higher inflation on average.

Expansion is weakened, for example, when banks increase their cushion of excess reserves because they expect a recession or tighter monetary policy. The multiplier becomes smaller because each bank holds onto more of a reserve increase and therefore makes smaller loans, which become smaller deposit increases at other banks.

A recession can be avoided or mitigated when additional spending is encouraged via an expansion of the money supply through bank lending. When the central bank buys securities, the excess reserves of the entire banking system increase by the amount of the purchase, and the money supply can then expand by a multiple of this amount; i.e., the excess reserves times the value of the deposit expansion multiplier.

A central bank’s purchases of government bonds in the primary market show up on the balance sheet as increased “claims on government” by the assets side and increased “deposits of government” by the liabilities side. That means the central bank is lending money to the government, which then uses the fund for administrative spending. The money supply in such a situation lacks a market base, and excessive money is issued, which could easily trigger inflation.

The central bank would raise the reserve requirement, thereby decreasing both excess reserves and the deposit expansion multiplier; it would increase the rediscount rate, with all other interest rates likely increasing also; and it would sell securities, lowering the excess reserves of banks. This trio of tools would therefore decrease the money supply, rein in spending, and lessen inflationary pressures.

**Chapter Nine**

**I. Review Questions**

1.

Corporate finance examines how a company can effectively use various sources of financing, obtain the lowest cost source of funds, and form an appropriate capital structure, as well as organize corporate financial activities and handle financial relationships in accordance with the principles of corporate finance.

The areas to be studied in corporate finance broadly include four components: corporate valuation, corporate investment, corporate finance, and corporate governance issues.

2.

A sole proprietorship is a business owned by one person. A sole proprietorship is owned and controlled by an individual, who bears the business risks and enjoys all the benefits, so the business owner has full decision-making and operating rights over the business.

Any two or more people can get together and form a partnership. A partnership is a formal arrangement by two or more parties to manage and operate a business and share its profits. Partnerships fall into two categories: (1) general partnerships and (2) limited partnerships.

A corporation is a legal entity created by individuals, stockholders, or shareholders, with the purpose of operating for profit. It is a distinct legal entity. Corporations are allowed to enter into contracts, sue and be sued, own assets, remit federal and state taxes, and borrow money from financial institutions. Of the forms of business enterprises, the corporation is by far the most important.

3.

Corporation is a common form of business, and almost all large businesses use it.

Compared to sole proprietorships and partnerships, the advantages of a corporation are as follows:

(1) In contrast to the limited lives of sole proprietorships and partnerships, a corporation can continue to exist after the initial owners and operators have withdrawn.

(2) The debts of the corporation are the debts of the legal entity and not the debts of the owners. The debts of the corporation are limited to the capital invested by the shareholders and have nothing to do with the personal property of the shareholders.

(3) The corporation’s ownership is highly liquid and easily transferable.

(4) The corporation has diversified sources of financing. A joint stock company can raise funds by issuing shares or issuing bonds in the capital market.

(5) Compared to sole proprietorships and partnerships, corporations are larger in size, have open access to equity and debt financing, and have higher levels of profitability, all of which make it easier for corporates to use debt financing instruments flexibly.

Compared to sole proprietorships and partnerships, corporations also have drawbacks:

(1) Double taxation. The corporation as a legal entity is subject to corporate income tax, and shareholders are also subject to personal income tax on income received from the corporation after tax.

(2) Agency problems. The corporation’s ownership and management are separated, and agents may harm shareholders’ interests for their own benefit, agents are subject to moral hazard and adverse selection behavior.

4.

In terms of the movement of capital, financial management can be divided into four areas: corporate investment, corporate finance, working capital management and earnings distribution management.

The company invests to maximize returns, and the company acquires funds that must be put to use to generate returns in order to continually increase the value of the company.

Financing is the act and process of raising capital for a company, as reflected on the right side of the balance sheet.

Working capital is the management of current assets as well as current liabilities, and is reflected around the top of the balance sheet, where a company must have the right amount of working capital to maintain normal operations.

Revenue refers to the company’s income and profit. Earnings distribution management solves the problem of rational allocation between dividend distribution to shareholders and retained earnings based on the specific operating conditions and future development requirements of the company.

5.

An agency problem is a conflict of interest between an agent and a principal, where an agent is a person or group of people who performs a task on behalf of someone else, the principal. A conflict of interest occurs when one party doesn’t fulfill contractual obligations in favor of their own personal or professional interests. It’s best practice for the agent to make decisions that will yield the best outcome for the principal, even if an alternative decision may positively benefit them instead.

When the agent acts in their own best interest, rather than the interest of the principal, this can create a problem between the two. For example, corporate finance managers may act as the agent for stockholders where their job is to use the money and invest it in stocks that will be in the best interest of the client. However, if the stockholder notices unapproved stock purchases, they may speak with the agent about the discrepancy and consider hiring a new finance manager.