

Study Questions for Lovett Chapters 21 and 22

A refresher from Intro to Macro

1. _____ Which of the following best describes a “clearing house”?
 - a. Yikes! I left out the options.
 - b. I hate it when that happens.
 - c. The point is that, when studying, one should not just get in the habit of looking for answers that are recognizable.
 - d. One should, instead, stop and ponder the question. Perhaps there are more than one possible answer.

2. _____ Which of the following best describes how a clearing house can result in a more stable and uniform monetary system?
 - a. Poop! I left out the answers again.
 - b. I’m not sure which is more obnoxious; leaving out the answers or using the word; “poop” as an expletive.
 - c. Think of a situation in which there are 1,000s of different banks with each bank issuing their own checks (or notes in the 1800’s, or debit cards today).
 - d. Why should I trust and accept a check from a person banking at a different bank than I do? How do clearing houses help this process?

3. _____ Which of the following also describes how a clearing house can result in a more stable and uniform monetary system? In particular, what can a clearing house do (more easily) during a financial panic that other banks cannot?
 - a. Well shucks! I left out the answers again.
 - b. The answer has something to do with a lender of last resort.
 - c. What does a lender of last resort need a lot of (at a times other banks are trying to hold on to as much of this as possible)?
 - d. I thought “shucks” went out in the 1950’s.

4. _____ In the early 1600s, Indians on the American East Coast used “wampum” (i.e., polished beads made of shells) in trade. These beads were also worn as jewelry. Which best describes these beads?

<ol style="list-style-type: none">a. Ponzi moneyb. Fiat money	<ol style="list-style-type: none">c. Commodity moneyd. Quasi-liquid money	<ol style="list-style-type: none">e. an accounting place-holderf. Vini money
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5. ____ Cool! You discover a chest owned by Mr. Petes, a store owner in 17th-century Maryland. In it you find some tobacco “script.” This script is a piece of paper that says, “The holder of this certificate owns 100 lbs. of tobacco in Mr. Johnson’s tobacco barn. Said tobacco is redeemable on demand.” On the back you see many signatures as ownership of the piece of paper was transferred from one person to another in exchange for goods and services. What is this tobacco “script” an example of:
- | | | |
|-------------------|-----------------------|-------------------------------|
| a. a gateway drug | c. Commodity money | e. an accounting place-holder |
| b. Fiat money | d. Quasi-liquid money | f. Vini money |
6. ____ It’s 1785 and you are on a trading post on what was then the Southwestern American frontier (i.e. what is today Alabama). In this store, trade almost always involves the exchange of deerskin. For example, you can buy a rifle for 8 deerskins. You can sell your corn and get 2 deerskin. In fact, the trading post lists all of its prices in terms of deerskin. At this trading post, deerskin is serving as:
- | | | |
|-------------------------|-----------------------|-------------------------------|
| a. A backup food source | c. Commodity money | e. an accounting place-holder |
| b. Fiat money | d. Quasi-liquid money | f. Vini money |
7. ____ It’s 1835 and you are holding a Bank of England 10 £ note. This piece of paper can be exchanged for a 10 £ coin, that, by law, contains 2.35 troy ounces of gold. This note is:
- | | | |
|--------------------|-----------------------|-------------------------------|
| a. Inorganic money | c. Commodity money | e. an accounting place-holder |
| b. Fiat money | d. Quasi-liquid money | f. Vini money |
8. ____ It’s 1985 and you are holding a U.S. \$10 bill (a Federal Reserve Note). By law, this piece of paper can be used to pay off a \$10 debt. The person to whom you owe the \$10 cannot refuse this piece of paper as payment of the debt. This note is:
- | | | |
|----------------|-----------------------|-------------------------------|
| a. Ponzi money | c. Commodity money | e. an accounting place-holder |
| b. Fiat money | d. Quasi-liquid money | f. Vini money |
9. ____ A barter economy tends to promote:
- | | |
|---|--|
| a. self-sufficiency instead of specialization. | b. high levels of specialization. |
| c. a “universally” accepted medium of exchange. | d. money that is, by nature, nondurable. |
| e. Both c & d | |
10. ____ A barter economy tends to:
- | |
|--------------------------------------|
| a. reduce living standards. |
| b. leave living standards unchanged. |
| c. increase living standards. |
11. ____ A professor, whose first book unexpectedly produces a \$20,000 advance, uses the money to buy his college-age daughter a car. This transaction illustrates money functioning as:
- | | |
|--------------------------|------------------------------------|
| a. a unit of account. | b. a standard of deferred payment. |
| c. a medium of exchange. | d. a store of value. |

12. ____ Brandon, an 18-year-old, just inherited \$20,000 from his uncle. Brandon puts the money into a certificate of deposit (CD) at a bank to save for his college education. This transaction illustrates money functioning as:
- a. a unit of account.
 - b. a standard of deferred payment.
 - c. a medium of exchange.
 - d. a store of value.
13. ____ Amanda just received a \$1 bill from the tooth fairy. What makes her \$1 bill valuable?
- a. \$1 bills are very liquid, and people have faith that the government will not print too many of them.
 - b. U.S. currency can be exchanged for U.S. government bonds at a guaranteed rate.
 - c. That tooth fairy will put some nasty voodoo on you if you mess with Amanda's \$1 bill.
 - d. The federal government guarantees it can be traded for .005 troy ounces of gold any time.
 - e. While the federal government does not guarantee to give .005 troy oz of gold for each \$1, it is bound by law to pursue policies aimed achieving a "long-run parity with gold" at .005 oz per \$1.
 - f. Foreign currency reserves are held by the U.S. government, and it has a legal requirement to exchange small amounts of \$s for foreign currency at a specified rate
14. ____ What of the following is the most liquid?
- a. \$1,000 of cash
 - b. \$1,000 in a (bank) Certificate of Deposit (CD)
 - c. a 10-year government bonds with a current market value of \$1,000
 - d. a road bike with an average U.S. re-sale value of \$1,000
15. ____ What of the following is the least liquid?
- a. \$1,000 of cash
 - b. a 1992 fender guitar with an average re-sale value of \$1,000
 - c. a 10-year government bonds with a current market value of \$1,000
 - d. \$1,000 in your checking account
- #s 16 – 19:** It's 2013 and you just received a \$1,000 in U.S. \$20 bills from your Aunt. What makes these \$20 bills valuable? Check (✓) each blank that applies (i.e. is both true & makes the \$20 bill valuable).
16. ____ Gold. Each \$1 of currency printed by the U.S. government can be traded for \$0.02 troy ounces of gold at the U.S. mint by anyone holding \$'s.
17. ____ Gold. Each \$1 of currency printed by the U.S. government can be traded for \$0.02 troy ounces of gold at the U.S. mint, but only by foreign governments, the IMF, and World Bank.
18. ____ \$ bills are very useful and, thus far, the U.S. government has not printed so many of them that people have lost faith in their continued value.
19. ____ The government says it is valuable. The U.S. government has declared the \$ to be legal tender, i.e. the official currency, in the U.S.

20. Look up “Liquidity”. Rank the following assets from *most liquid* to *least liquid*. **1** indicates the most liquid asset, **2** the 2nd most, etc.

_____ \$10,000 in your checking account

_____ a \$10,000 boat you own

_____ \$10,000 of Peruvian government bonds

_____ \$10,000 in a money market account

21. _____ Johanne is living in the town of Hamburg in the year 1450. He is a merchant. Johanne takes 40 ounces of gold and gives it to Gerhardt the Goldsmith for safe-keeping. Gerhardt gives Johanne a receipt for the 40 oz of gold. What, according to the text, will Gerhardt do with the 40 oz of gold?

- Keep all of it in his safe, but charge Johanne interest to cover his (Gerhardt’s) costs.
- Loan all of it out. Gerhardt will, however, agree to get 40 ounces of gold for Johanne if Johanne gives him prior notice (usually 2 weeks).
- Loan all of it out. Gerhardt still, agrees to give Johanne 40 ounces of gold at a moment’s notice. Gerhardt is just hoping Johanne will not ask for his gold back soon.
- Keep some of it, but lend the rest out.

22. _____ What is the name for what Gerhardt the Goldsmith is doing?

- | | |
|------------------------------------|---------------------------------|
| a. setting the reserve requirement | c. money laundering |
| b. fractional reserve banking | d. financial dis-intermediation |

23. _____ How are Gerhardt’s actions affecting society?

- Gerhardt is benefitting society by keeping the money supply in check and fighting inflation.
- Gerhardt is benefitting society by providing funds for investment projects.
- Gerhardt is harming society by taking money out of circulation. GDP will be smaller.
- Gerhardt is harming society by charging someone interest for borrowing money, a non-productive asset.

24. _____ Two weeks after depositing the gold at Gerhardt’s, Johanne is in Wedel, a town about 5 miles from Hamburg. There, Johanne really wants to buy a boat from Bertram for 40 ounces of gold. Bertram is familiar with Hamburg and know that Gerhardt’s family has been in the goldsmith business for 4 generations. Their reputation is very good. What, according to lecture, is Johanne likely to do regarding the boat?

- Go back to Hamburg & withdraw his gold from Gerhardt. Then make the trip back to Wedel.
- Hire a runner to take the Goldsmith receipt, go Hamburg, and withdraw his gold from Gerhardt, then run back to Wedel with Johanne’s money. Johanne will hold the runner’s house as Blutfaide (i.e. collateral) until the runner returns.
- Sign the receipt for 40 ounces of gold at Gerhardt’s over to Bertram.
- Use barter. Prior to modern banking, Johanne would likely have to come up with something worth 40 ounces of gold that Bertram wants.

25. _____ What is the name for what the bank in # 24 is doing?

- | | |
|------------------------------------|---------------------------------|
| a. setting the reserve requirement | c. money laundering |
| b. fractional reserve banking | d. financial dis-intermediation |

26. _____ Do the banks actions in # 24 generate any benefit for society (other than John and bank)?
- Yes. The bank is benefitting society by keeping the money supply in check and fighting inflation.
 - Yes. The bank is benefitting society by providing funds for investment projects.
 - No. The bank is harming society by taking money out of circulation. GDP will be smaller.
 - No. The bank is harming society by charging someone interest for borrowing money, a non-productive asset.
27. _____ Do the banks actions in # 24 cause any problems for society?
- Yes. The bank cannot come up with lots of cash quickly. If a great many people demand their money, the bank could fail spreading panic to the rest of the financial system and economy.
 - Yes. The bank is changing the nature of money from “hard” cash to “soft” checking accounts. This makes it harder to spend money. As a result production will be lower than otherwise.
 - No. While there is a possibility that some borrowers won’t repay the loan, the bank has already factored this risk in.
 - No. Control of the money supply is best left in the hands of the private sector. At least that is what most economists and financial experts believe.
28. _____ Today, John deposits \$4,000 of cash in a local bank. What (typically) does the bank do with the money?
- Keep all of it in his safe, but charge John interest to cover the bank’s costs.
 - Loan all of it out. The bank will, however, agree to get \$4,000 cash for John if John gives him prior notice (usually 2 weeks).
 - Loan all of it out. The bank still agrees to give John \$4,000 cash at a moment’s notice. The bank is just hoping John will not ask for his money back soon.
 - Loan all of it out. The bank still agrees to give John \$4,000 at a moment’s notice, but does not have to pay John in cash. The bank can give him a post-dated check instead.
 - Keep some of it, but lend the rest out.
29. _____ What is the name for what the bank in # 28 is doing?
- | | |
|------------------------------------|---------------------------------|
| a. setting the reserve requirement | c. money laundering |
| b. fractional reserve banking | d. financial dis-intermediation |
30. _____ Do the banks actions in # 28 generate any benefit for society (other than John and bank)?
- Yes. The bank is benefitting society by keeping the money supply in check and fighting inflation.
 - Yes. The bank is benefitting society by providing funds for investment projects.
 - No. The bank is harming society by taking money out of circulation. GDP will be smaller.
 - No. The bank is harming society by charging someone interest for borrowing money, a non-productive asset.

31. _____ Do the banks actions in # 28 cause any problems for society?
- Yes. The bank cannot come up with lots of cash quickly. If a great many people demand their money, the bank could fail spreading panic to the rest of the financial system and economy.
 - Yes. The bank is changing the nature of money from “hard” cash to “soft” checking accounts. This makes it harder to spend money. As a result production will be lower than otherwise.
 - No. While there is a possibility that some borrowers won’t repay the loan, the bank has already factored this risk in.
 - No. Control of the money supply is best left in the hands of the private sector. At least that is what most economists and financial experts believe.
32. _____ **Today**, what, if anything, keeps banks from lending out “too much” of their cash?
- The Bank fairy will bring some bad voodoo magic on the bank if the banks lends too much.
 - Private money clearing services such as VISA and Mastercard will not service a bank’s customers if that bank lends out too much cash.
 - The bank will not get its charter renewed if it loans out too much money. By law, cash has to make up 25% of a bank’s financial assets.
 - The Federal Reserve sets the required reserve ratio.
33. _____ What is one way the banking system can get into really bad trouble?
- Customers deposit more cash in banks in exchange for checking accounts.
 - The Federal Reserve lowers the MPC.
 - The Federal Reserve raises the MPC.
 - The value of loans held by banks rises greatly.
 - The value of loans held by the banks falls greatly.
34. _____ The use of barter means:
- it is easier for people to avoid paying high prices. As a result, buyers have incentive to buy more but producers have incentive to produce less. The net result is that production is probably about the same as with money.
 - It is easier for people to avoid paying high prices. Production is generally thought to be higher than it is when money is used.
 - there is a single, well-accepted form of money, but it is commodity money.
 - it’s harder for a person to specialize in the production of one good than with money. Production is probably less than it would be if there was money.
35. _____ An economy that relies solely on barter when trading will:
- have a less equal income distribution than modern economies.
 - have difficulty achieving high levels of specialization and production.
 - have lower interest rates than a modern economy.
 - be more stable (fewer recession) than a modern economy.
36. _____ Which of the following best illustrates a “double coincidence of wants”, as defined in lecture?
- Both Henry and Richard want the same thing, to be King.
 - Lady MacBeth is torn. She wants to both: 1) keep her crimes a secret and, 2) confess her crimes.
 - Romeo want to date Juliet. Juliet wants to date Romeo.

37. ____ Look up “Liquidity”. Which of the following best define a “highly liquid” asset ?
- an asset that can rapidly and easily be spent for its normal value
 - an asset with a very high long-run rate of return
 - a financial asset that can also be used as a commodity
 - a class of assets, cars for example, that is sold all over the world

38 - 40. What was the basis or backing for the U.S. dollar during each time period? Use 1 check per row.

Time period	Gold	Silver	Silver & Gold	Fiat Money	British Currency	Spanish Currency	Stay-Puff Marshmallows
38. 1792 - 1860							
39. 1900 - 1932							
40. 1972 - Today							

41. ____ Which of the following is true of fractional reserve banking?
- Fractional reserve banking was legal for most of the 1800’s but is not legal today.
 - Fractional reserve banking was illegal for most of the 1800’s but is legal today.
 - Fractional reserve banking helps banks make profits. It also leads to more physical investment for the economy.
 - Fractional reserve banking helps banks make profits. It, however, leads to less physical investment for the economy.
42. ____ Bank Banque has just opened. New customers (i.e. depositors) put \$25 billion of their cash into Bank Banque . Bank Banque gives these depositors checking accounts? What does Bank Banque do with the \$25 billion it received? Bank Banque:
- Keeps almost all of the \$25 as cash, but issues about \$25 billion in new savings accounts to borrowers using the \$25 billion as collateral.
 - keeps some (about \$3 billion) of the \$25 billion in cash, but lends most of it (\cong \$22 billion) out.
 - deposits almost all of the \$25 billion at the Federal Reserve. In return Bank Banque gets private commercial paper it can lend to customers.
 - deposits almost all of the \$25 billion at the Federal Reserve. In return Bank Banque gets Federal Reserve Special Drawing rights it can lend to customers.
43. ____ In the long-run, how do the bank’s actions in # 41 affect society?
- Savings is channeled into new physical capital. The economy grows faster as a result.
 - High savings is rewarded. This means less consumption & an economy that grows more slowly.
 - The money supply decreases. While this can push an economy into recession in the short-run, in the long-run, the economy grows at a normal pace but has lower inflation.
 - The money supply decreases. While this can stimulate an economy in the short-run, in the long-run, the economy grows more slowly in the long-run.

44. ____ When a bank loans cash, the bank:
- gives away a liquid asset (the cash) in exchange for a less liquid asset (the IOU or loan).
 - gives away a illiquid asset (the cash) in exchange for a highly liquid asset (the IOU or loan).
 - prints its own money as allowed by the U.S. Federal Reserve
 - draws from its allotted reserve of money the Federal Reserve printed for that bank
45. ____ When a bank loans cash, the bank:
- creates new wealth for itself but destroys wealth for the borrower
 - decreases its wealth for itself but creates new wealth for the borrower
 - gives away an asset that doesn't earn the bank any money (the cash) in exchange for an asset that does earn the bank money (the IOU or loan).
 - decreases the wealth of the government (the source of the newly printed cash) but creates new wealth for the borrower
46. ____ The more of its cash that a bank loans:
- the more newly printed money that bank is legally entitled to.
 - the lower its taxable assets are, resulting in lower taxes for the bank.
 - the less money it can earn (assuming the loans are good loans).
 - the more money it can earn (assuming the loans are good loans).
47. ____ As a bank lends out more and more its cash, it becomes:
- less able to meet a "run on the bank".
 - more able to meet a "run on the bank".
- # 48 – 50:** Yikes! It's 2020 and a wave of panic has gripped the United States. Millions of customers are lining up at banks to withdraw their cash.
48. ____ Yikes! There is panic, great panic, in the street & especially in the U.S. financial system. People are lining up to get their cash out their banks. What problem will banks likely run into?
- Banks need to borrow cash to pay their depositors. However, since all (or at least most) banks also want to borrow cash, banks have nowhere in the private sector from which to borrow.
 - Depositors will want to buy gold (and silver) backed securities. Cash will pour into banks, but banks will run short of gold (and silver) backed securities.
 - Debtors will want to get rid of cash to reduce their debt load. Instead of paying off their bank loans early, debtors will dump massive amounts of cash into mutual funds. Banks will have to borrow from mutual funds at high interest rates to get their cash.

49. _____ What can banks **today** do to alleviate this crises?
- Print “Certificates of Deposit” instead of giving their depositors cash. The bank promises to accept each “\$1.00” of CD’s as payment, &, at a specified time in the future, give \$1 cash for each \$1 of CD’s.
 - Borrow from the U.S. Federal Reserve (assuming it acts as a lender of last resort).
 - Offer their depositors an increase in their checking account if the depositor agrees to not withdraw any cash for a certain period of time.
 - All of the above are legal and common methods to deal with banking panics.
50. _____ What does the U.S. government, **today**, do to help ensure that such a bank panic does not occur in the first place?
- Regularly collect money from banks and use it as insurance to guarantee depositors will get their money even if a bank fails.
 - Regularly declare “banking holidays”, short periods of time in which customers can still write check (and use their debit cards), but cannot withdraw cash from banks.
 - Allow banks to issue different “classes” of checking accounts. Some offer high interest but the depositor cannot withdraw cash on short notice. Others pay low (or no) interest but allow depositors to withdraw cash from the bank at any time.
51. _____ What is one way the U.S. Federal Reserve, **today**, attempts to regulate the U.S. banking system?
- The Federal Reserve directly sets the interest rate at which banks lend for each category of loans. For example, the Federal Reserve sets the rate for all classes (based on risk, etc) of home loans.
 - While the exchange rate (ex. \$’s per Euro) for private transactions is set by markets, the exchange rate for all government transactions is set by the Fed.
 - The Federal Reserve sets the required reserve ratio.
 - All of the above are correct.