Chapter 01

An Introduction to Money and the Financial System

Multiple-Choice Questions

1. Identify which item is not one of the six parts of the financial system. a. Financial markets

b. Central banks c. Credit cards

d. Financial institutions

Ans: C

Difficulty: 01 Easy

Learning Objective: 01-01

AACSB: Reflective Thinking

Blooms: Remember

Topic: The Six Parts of the Financial System

2. Identify which item is not one of the six parts of the financial system. a. Financial instruments

b. Central banks c. Credit cards

d. Financial institutions

Ans: C

Difficulty: 01 Easy

Learning Objective: 01-01

AACSB: Reflective Thinking

Blooms: Remember

Topic: The Six Parts of the Financial System

3. The central bank of the United States is:

a. the Bank of America

b. the Federal Reserve System

c. the U.S. Treasury

d. Citibank

Ans: B

Difficulty: 01 Easy

Learning Objective: 01-01

AACSB: Reflective Thinking

Blooms: Remember

Topic: The Six Parts of the Financial System

4. Identify which of the following is not one of the five core principles of money and banking. a. Risk requires compensation

b. Time has value

c. Information is the basis for decisions d. Stability creates risk

Ans: D

Difficulty: 01 Easy

Learning Objective: 01-02

AACSB: Reflective Thinking

Blooms: Remember

Topic: The Five Core Principles of Money and Banking

5. Investing in financial instruments in today's economy:

a. is an activity practiced only by the wealthy.

b. involves costly transactions.

c. requires a relatively large sum of money to invest (more than $100,000).

d. is made easier by the use of mutual funds.

Ans: D

Difficulty: 02 Medium

Learning Objective: 01-02

AACSB: Reflective Thinking

Blooms: Understand

Topic: The Five Core Principles of Money and Banking

6. Which of the following is an example of a financial market?

a. A local coffeehouse where people regularly buy and sell financial instruments.

b. A bank that only accepts deposits and issues loans.

c. An electronic network used for buying and selling textbooks.

d. A central bank used for raising taxes and borrowing on behalf of the government.

Ans: A

Difficulty: 02 Medium

Learning Objective: 01-01

AACSB: Reflective Thinking

Blooms: Understand

Topic: The Six Parts of the Financial System

7. The amount of information an individual would seek before making a decision:

a. is about the same across all individuals.

b. varies directly with the importance of the decision.

c. is the same across all decisions but varies across individuals.

d. depends on how much time it will take to get the information regardless of the decision.

Ans: B

Difficulty: 02 Medium

Learning Objective: 01-02

AACSB: Reflective Thinking

Blooms: Understand

Topic: The Five Core Principles of Money and Banking

8. The statement "risk requires compensation" implies that people:

a. do not take risk.

b. only accept risk when they absolutely have to.

c. will only accept risk when they are rewarded for doing so.

d. avoid risk at all cost.

Ans: C

Difficulty: 01 Easy

Learning Objective: 01-02

AACSB: Reflective Thinking

Blooms: Understand

Topic: The Five Core Principles of Money and Banking

9. Mutual funds have:

a. been created for very wealthy individuals with a lot of money to invest.

b. increased the risks associated with constructing a portfolio.

c. reduced the costs associated with gathering information on stocks and bonds.

d. increased the transactions costs associated with participating in financial markets.

Ans: C

Difficulty: 02 Medium

Learning Objective: 01-02

AACSB: Reflective Thinking

Blooms: Understand

Topic: The Five Core Principles of Money and Banking

10. Central banks can improve the welfare of a society by doing all of the following except:

a. serving the interests of government rather than the public at large.

b. helping to promote economic growth.

c. focusing on keeping the overall level of prices stable.

d. helping to reduce the volatility of business cycles.

Ans: A

Difficulty: 02 Medium

Learning Objective: 01-01

AACSB: Reflective Thinking

Blooms: Understand

Topic: The Six Parts of the Financial System

11. In the United States, control of the quantity of money is given to the:

a. President.

b. Federal Reserve System.

c. Bureau of Printing and Engraving.

d. Department of the Treasury.

Ans: B

Difficulty: 01 Easy

Learning Objective: 01-01

AACSB: Reflective Thinking

Blooms: Remember

Topic: The Six Parts of the Financial System

12. Which of the following statements best describes financial instruments?

a. All financial instruments are a means of payment.

b. Financial instruments can transfer resources between people but not risk.

c. Financial instruments can transfer resources and risk between people.

d. Financial instruments can transfer risk but not resources between people.

Ans: C

Difficulty: 01 Easy

Learning Objective: 01-01

AACSB: Reflective Thinking

Blooms: Understand

Topic: The Six Parts of the Financial System

13. Which of the following statements best describes financial markets?

a. Financial markets lower the cost and increase the speed of buying and selling financial instruments.

b. Financial markets increase the speed of buying and selling, but they also increase the cost since people are earning fees for these transactions.

c. Financial markets are a good example of unregulated markets.

d. Financial markets today offer fewer instruments than they did in the past.

Ans: A

Difficulty: 01 Easy

Learning Objective: 01-01

AACSB: Reflective Thinking

Blooms: Understand

Topic: The Six Parts of the Financial System

14. The New York Stock Exchange is an example of a:

a. financial instrument.

b. financial institution.

c. financial market.

d. bank.

Ans: C

Difficulty: 01 Easy

Learning Objective: 01-01

AACSB: Reflective Thinking

Blooms: Remember

Topic: The Six Parts of the Financial System

15. When an individual obtains a car loan and makes all of the regular monthly payments, the sum of the payments made will exceed the purchase price of the car. This is due primarily to the core principle:

a. risk requires compensation.

b. information is the basis for decisions.

c. markets determine prices and allocate resources.

d. time has value.

Ans: D

Difficulty: 02 Medium

Learning Objective: 01-02

AACSB: Reflective Thinking

Blooms: Understand

Topic: The Five Core Principles of Money and Banking

16. Most financial markets in the United States operate under a system:

a. without any formal rules or regulation.

b. with many rules and regulation to ensure a fair market.

c. where it depends on which state where the financial market is located since some states do not have any regulations.

d. that is totally controlled by the federal government.

Ans: B

Difficulty: 02 Medium

Learning Objective: 01-01

AACSB: Reflective Thinking

Blooms: Remember

Topic: The Six Parts of the Financial System

17. How do financial institutions evaluate the creditworthiness of potential borrowers?

a. They offer high interest rates because only the best borrowers will be able to afford them.

b. They gather information regarding the borrowers' finances.

c. They do not evaluate creditworthiness because everyone is treated the same.

d. They do not evaluate the creditworthiness because they know the borrower will honor his/her obligation to repay the loan.

Ans: B

Difficulty: 02 Medium

Learning Objective: 01-02

AACSB: Reflective Thinking

Blooms: Understand

Topic: The Five Core Principles of Money and Banking

18. Stock prices are:

a. set by the company issuing the stock.

b. set by the central bank.

c. determined by market transactions.

d. unrelated to the value of the company issuing the stock.

Ans: C

Difficulty: 02 Medium

Learning Objective: 01-01

AACSB: Reflective Thinking

Blooms: Understand

Topic: The Six Parts of the Financial System

19. The primary function of central banks is to:

a. increase risk and volatility to increase compensation.

b. control inflation, as well as help reduce the size and frequency of business cycle fluctuations.

c. increase the uncertainty that firms face in making investment decisions.

d. eliminate the need for banks to collect financial information.

Ans: B

Difficulty: 01 Easy

Learning Objective: 01-01

AACSB: Reflective Thinking

Blooms: Understand

Topic: The Six Parts of the Financial System

20. U.S. monetary policy is best described as:

a. aimed at keeping inflation low and stable and growth high and stable. b. determining the denominations of a country's currency.

c. one of the most important functions of congress.

d. attempting to keep inflation constant at zero percent.

Ans: A

Difficulty: 01 Easy

Learning Objective: 01-01

AACSB: Reflective Thinking

Blooms: Understand

Topic: The Six Parts of the Financial System

21. Studying money and banking through five core principles is helpful because:

a. studies have shown students have a difficult time remembering more than five topics. b. everything in economics can be reduced to five core principles.

c. money and banking can undergo drastic changes overtime, but the five principles do not. d. these five principles are understood by everyone.

Ans: C

Difficulty: 01 Easy

Learning Objective: 01-02

AACSB: Reflective Thinking

Blooms: Understand

Topic: The Five Core Principles of Money and Banking

22. The largest regulatory change in U.S. financial markets since 1930 is known as:

a. Basel III.

b. the Fred-Bob Act.

c. the Gramm-Leach-Bliley Act.

d. the Dodd-Frank Act.

Ans: D

Difficulty: 01 Easy

Learning Objective: 01-01

AACSB: Reflective Thinking

Blooms: Remember

Topic: The Six Parts of the Financial System

23. In 2010, regulators of many nations agreed on a major update of internationally active banks known as:

a. Basel III.

b. the Fred-Bob Act.

c. the Gramm-Leach-Bliley Act.

d. the Dodd-Frank Act.

Ans: A

Difficulty: 01 Easy

Learning Objective: 01-01

AACSB: Reflective Thinking

Blooms: Remember

Topic: The Six Parts of the Financial System

**Short Answer Questions**

24. Identify the five core principles of Money and Banking.

Ans: #1) Time has value; #2) Risk requires compensation; #3) Information is the basis for decisions; #4) Markets determine prices and allocate resources; #5) Stability improves welfare. Difficulty: 01 Easy

Learning Objective: 01-02

AACSB: Reflective Thinking

Blooms: Remember

Topic: The Five Core Principles of Money and Banking

25. Identify the six parts of the financial system.

Ans: They are: money, financial markets, financial instruments, financial institutions, government regulatory agencies, and central banks.

Difficulty: 01 Easy

Learning Objective: 01-01

AACSB: Reflective Thinking

Blooms: Remember

Topic: The Six Parts of the Financial System

26. What is the primary function of U.S. regulatory agencies in the U.S. financial system? Ans: To provide wide-ranging financial regulation—rules for the operation of financial institutions and markets—and supervision —oversight through examination and enforcement.

Difficulty: 01 Easy

Learning Objective: 01-01

AACSB: Reflective Thinking

Blooms: Remember

Topic: The Six Parts of the Financial System

27. If the U.S. Supreme Court ruled that states could no longer require people to have auto insurance, do you think most people would cancel their policies? Explain.

Ans: Probably not. Auto insurance falls under the principle that risk requires compensation. For most people the additional risk they would face of driving without insurance exceeds the cost of the insurance, so they are better off purchasing auto insurance to reduce their risk.

Difficulty: 02 Medium

Learning Objective: 01-02

AACSB: Analytical Thinking

Blooms: Analyze

Topic: The Five Core Principles of Money and Banking

**Essay Questions**

28. How do central banks, like the U.S. Federal Reserve, contribute to the welfare of a society? Ans: One of the core principles is that stability improves welfare (primarily by reducing risk). One of the functions of a central bank is to try to get rid of the risk that people cannot get rid of on their own, like the risk that comes from economic fluctuations, volatile price level changes or volatility in economic growth. To whatever degree the central bank can smooth these fluctuations, risk can be reduced and the overall welfare of a society can be improved.

Difficulty: 02 Medium

Learning Objective: 01-02

AACSB: Reflective Thinking

Blooms: Understand

Topic: The Five Core Principles of Money and Banking

29. Which core principle(s) could you use to explain why credit card issuers charge such high rates of interest?

Ans: You could explain the high rates of interest from three principles. First, risk requires compensation, and certainly the credit card issuers are taking a risk when they let people use the cards. There is a risk that some users may not repay the credit card company. Second, you can also justify it from the principle that time has value. The borrowers are using the issuer's funds, and the issuer needs to be compensated for letting the borrower use these funds. Some borrowers do not repay for considerable periods of time. Third, you could also invoke the principle that people use information in making their decisions. Credit card issuers need to acquire information on each applicant before a card is issued and this process is costly. Unfortunately, the applicants who are denied do not get the card, but those who are approved must help cover the information costs.

Difficulty: 02 Medium

Learning Objective: 01-02

AACSB: Analytical Thinking

Blooms: Analyze

Topic: The Five Core Principles of Money and Banking

30. Suppose that IBM considers expanding its operations. The expansion will require $400 million for two new factories which the corporation plans to raise by selling stock and bonds. Which of the core principles will come into play as investors decide whether or not to buy the stock and the bonds?

Ans: The five core principles are: 1) Time has value; #2) Risk requires compensation; #3) Information is the basis for decisions; #4) Markets determine prices and allocate resources; #5) Stability improves welfare. Investors considering buying IBM's stock and bonds would surely have principle #2 in mind; they would assess the risk involved in IBM's expansion and want to

be compensated for it. This would clearly involve information (principle #3). Principle #1 would come into play with the bonds; are they 1-year bonds? 5-year bonds? The longer the time period involved, everything else constant, the greater the return investors would require. Principles #4 and #5 are not totally irrelevant here, as investors will rely on markets to price the stocks and bonds and will judge IBM's expansion based on the outlook for the economy as a whole (stability).

Difficulty: 02 Medium

Learning Objective: 01-02

AACSB: Analytical Thinking

Blooms: Analyze

Topic: The Five Core Principles of Money and Banking

31. A borrower seeking a mortgage today is often presented with the choice between a mortgage whose interest rate and monthly payment stays fixed for the duration of the loan, or a mortgage whose interest rate and monthly payment can change as other interest rates change. Typically the interest rate on the fixed-rate mortgage is higher. Having learned the five core principles, does this make sense?

Ans: Yes. The lender is shifting risk to the borrower. The risk here is that the lender agrees to a mortgage at (for example) 6% but then over the life of the loan (which can be 10, 25, even 30 years) interest rates in the market go up, putting the lender in the position of being "stuck" with the 6%. If the rate on the mortgage would change with market rates the lender would not have the risk. But remember, risk requires compensation, so to entice the borrower to take on the added risk the lender provides an inducement in the lower rate. A smart borrower will make the decision about whether or not the lower but changeable rate is a good decision based on information about interest rates (information, stability), and the decision may also depend on how long the borrower plans to live in the house (time).

Difficulty: 03 Hard

Learning Objective: 01-02

AACSB: Analytical Thinking

Blooms: Analyze

Topic: The Five Core Principles of Money and Banking