Chapter 02

Money and the Payments System

Multiple Choice Questions

1. Which of the following would not be considered a characteristic of money?

   A. It is a store of value.
   B. It is a means of payment.
   C. It must have intrinsic value.
   D. It is a unit of account.

2. A society without any money:

   A. could never exchange goods and/or services.
   B. would find people doing everything for themselves.
   C. would have to rely on barter.
   D. would be more efficient since people would be more self-sufficient.

3. The use of money makes us more efficient because:

   A. we spend more time trading and more time producing.
   B. people can specialize in what they do well.
   C. with money we borrow less.
   D. money increases in value over time.

4. The unit of account characteristic of money:

   A. makes it difficult to compare the relative prices of goods and services.
   B. refers to how we use money to transfer purchasing power over time.
   C. means prices are expressed in terms of money.
   D. means that money finalizes payments.

5. Without the use of money, workers in an economy would:

   A. become more specialized
   B. have to spend a lot less time trading
   C. probably specialize less
   D. be far more productive

6. As an economy produces more different types of goods:

   A. it is more difficult to quote prices if the economy does not use money.
   B. the number of relative prices decreases.
   C. money becomes less useful as a unit of account.
   D. money becomes less useful as a standard of value.

7. The store of value characteristic of money refers to the fact that:

   A. people save most of their money.
   B. money allows people to shift purchasing power into the future.
   C. money is not valuable unless it is stored.
   D. money is the only way people have to store value.

8. Which best describes money as a means of payment?

   A. Money provides an immediate double coincidence of wants.
   B. Money makes sure a double coincidence of wants never occurs.
   C. Money requires at least two transactions to obtain the double coincidence of wants.
   D. To obtain a double coincidence of wants without money is impossible.

9. Compare two economies: a barter economy versus an economy that uses money. In order to exchange goods and services:

   A. a double coincidence of wants is necessary in the barter economy.
   B. a double coincidence of wants is more likely to occur in the barter economy.
   C. transactions are likely to be smoother in the barter economy because goods and services are exchanged directly.
   D. the money economy requires that sellers have more information about buyers' wants.

10. In a barter system people:

A. have to specialize in order to have goods to trade.
B. cannot specialize because they never know what goods will be desired.
C. are less likely to specialize as extensively as they would in a monetary economy.
D. must be self sufficient.

11. How many prices would a trader of a particular good need to know in a barter economy with 5 goods?

A. 5
B. 10
C. 20
D. 50

12. How many prices would a trader of a particular good need to know in a barter economy with 20 goods?

A. 190
B. 100
C. 20
D. 40

13. In a barter economy with "n" number of goods there will always be:

A. exactly "n" relative prices.
B. fewer than "n" relative prices.
C. more than "n" relative prices.
D. "n/2" relative prices.

14. The high transaction costs associated with a barter system refers to the:

A. fact that, often times, these exchanges are taxed by governments.
B. risk associated with having to carry an inventory of goods to trade.
C. high cost associated with finding someone with whom to exchange.
D. cost of drawing up complete contracts.

15. Suppose that in a barter economy Tom bakes bread and Hans produces chocolates. Tom wants chocolates but Hans doesn't like bread, so Hans is unwilling to trade with Tom. Tom's problem is an example of which problem associated with a barter system?

A. Too much specialization
B. Not enough prices
C. The law of diminishing returns
D. The double coincidence of wants problem

16. Specialization usually increases the output of a country; however effective specialization requires:

A. everyone in the country producing the same thing.
B. that workers have very similar skills.
C. an effective low-cost means to exchange goods and services.
D. a large stock of capital.

17. Which of the following is not an example of bartering?

A. Sue trading candles with Tom for his bread.
B. Mary paying for her new shoes with her credit card.
C. John cutting his neighbor's grass in return for his neighbor washing John's car.
D. Mrs. Smith treating the neighbor children to pizza after they helped clean up her yard.

18. Money eliminates the need for:

A. a search for a double coincidence of wants.
B. government regulation.
C. specialization of labor.
D. financial Intermediaries.

19. Money as a means of payment refers to:

A. only actual currency.
B. only coins and currency.
C. only coins, currency and credit cards.
D. anything that is generally accepted as payment for goods and services.

20. While money is an asset not all assets are money because:

A. only money stores value.
B. money works as a means of payment.
C. only money is a good asset to hold during times of inflation.
D. money must be legal tender.

21. An advantage that money has over other assets is that it:

A. increases in value over time.
B. has lower transaction costs to use as a means of payment than other assets.
C. provides a higher return to the owner.
D. is a safer asset to hold during times of inflation.

22. An individual who stores wealth in art rather than money will find that he/she:

A. suffers larger real losses during periods of high inflation.
B. has far more liquidity than most savers.
C. will incur higher transaction costs when he/she ultimately makes purchases.
D. will have to resort to barter exchanging the art for desired goods.

23. Which of the following statements is most correct?

A. Money is wealth but not all wealth is money.
B. Money is a means of payment but is not part of wealth.
C. In order to be considered part of a person's wealth, an asset must have a positive return.
D. Wealth is a store of value and a means of payment.

24. Which of the following is incorrect?

A. Money is wealth but not all wealth is money.
B. Money is a means of payment but is not part of wealth.
C. An asset doesn't have to be a means of payment to be a part of a person's wealth.
D. All items considered wealth can eventually be converted to a means of payment.

25. Which of the following statements is not true?

A. For most of history gold has been the most common commodity money.
B. The most common form of money in the U.S. is not a commodity money.
C. Gold is an example of a fiat money.
D. U.S. currency is legal tender.

26. Gold would be a superior commodity money compared to wheat because:

A. wheat has a high value relative to weight, which gold does not.
B. it is easier to divide wheat into small units.
C. wheat has more practical uses than gold.
D. wheat is perishable.

27. The fact that U.S. currency is legal tender means:

A. U.S. currency is good anywhere in the world.
B. the only money the government will accept for settlement of debts is U.S. currency.
C. private businesses in the U.S. and the U.S. government must accept currency for payment.
D. it cannot be backed by gold or other metals.

28. In comparing money to a U.S. Treasury bond held by an individual, we can say:

A. the treasury bond is an asset but money is not.
B. money is an asset but the U.S. bond is a liability of the individual.
C. both are stores of value.
D. money is a store of value but the bond is not.

29. In comparing money to a U.S. Treasury bond held by an individual, we can say:

A. both are legal tender.
B. both are units of account.
C. only the bond is legal tender since it is an obligation of the U.S. government.
D. both are stores of value.

30. In comparing money to a share of Microsoft stock held by an individual, we can say:

A. the share of stock is an asset, but money is a liability.
B. only the money is a means of payment, but both are stores of value.
C. only the money is a means of payment, but both are units of account.
D. both the Microsoft stock and the money are liabilities.

31. Comparing checks and currency, we can say:

A. both are money but only currency is legal tender.
B. only checks are both money and legal tender.
C. a check isn't money but currency is.
D. both are money and legal tender.

32. When the Continental Congress issued currency to finance the Revolutionary War, the Continental Congress:

A. issued too many "continentals," eventually making the currency worthless.
B. tied the value of the "continental" to gold.
C. tied the value of the "continental" to gold to French "assignats."
D. made "continentals" legal tender.

33. During the Civil War, the North issued currency, known as "greenbacks". Which of the following is true of "greenbacks"?

A. Greenbacks are still legal tender in the U.S.
B. Greenbacks were tied to the value of gold and silver.
C. The South used "greenbacks" to pay for salaries and supplies.
D. Greenbacks are a historical example of commodity money.

34. Most of the non-cash retail payments made each year in the United States are made by:

A. check.
B. credit card.
C. debit card.
D. electronic funds transfers.

35. All of the following are true about electronic funds transfers except:

A. sometimes involve the Federal Reserve sending electronic images of checks to banks.
B. occur when banks or individuals deposit/withdraw from one bank account to another electronically.
C. include automated clearinghouse transactions (ACH).
D. include credit card payments made online.

36. Carlos pays his cable bill using his bank's internet banking web site to withdraw funds from his checking account. This transaction is a(n):

A. automated clearinghouse transaction (ACH).
B. digitized-check transaction.
C. e-money transaction.
D. fedwire transaction.

37. As a result of "Check 21—The Check Clearing for the 21st Century Act":

A. banks no longer have to ship paper checks to complete the process of check clearing.
B. people can write checks and plan on having a couple of days to make a deposit to cover the check amount.
C. canceled checks can no longer be used as proof of payment.
D. the Federal Reserve is no longer involved in the check-clearing process.

38. The value of fiat money:

A. comes from its intrinsic value.
B. is worth more as a commodity than its value as money.
C. comes from government decree.
D. means that it is more desirable than currency.

39. Which of the following could not be commodity money?

A. Gold coins
B. Cigarettes
C. U.S. Currency
D. Silk

40. U.S. currency is:

A. A commodity money
B. Fiat money
C. Tied to the value of gold at a fixed rate
D. The only store of value

41. One major difference between a debit card and a credit card is:

A. only the debit card helps you to build a credit history.
B. the debit card has lower minimum monthly payments.
C. you do not need to actually have the funds in your account when you use a debit card.
D. debit cards have no late fees.

42. One major difference between a debit and credit card is:

A. you can build a credit history with the credit card but not with the debit card.
B. you have to pay interest on your purchases if you use a credit card.
C. credit cards are money and the debit card is not.
D. debit cards charge late fees.

43. To say an asset is liquid implies that:

A. we are focusing on a category of assets that are in a physically liquid form, like oil.
B. we are considering assets that may be readily converted into a means of payment.
C. we are considering any asset that can be sold.
D. we are only considering U.S. currency.

44. One advantage of using checks over a debit card is:

A. checks can be replaced if lost or stolen, a debit card cannot.
B. the bank is responsible if someone steals your checks and uses them; this isn't the case with debit cards.
C. a cancelled paper check is the only generally accepted proof of payment.
D. the person has "float," meaning time between writing the check and depositing funds to cover it.

45. Checks and currency function similarly, however:

A. currency is a more effective means of payment.
B. carrying currency entails greater risk, because it cannot be replaced if lost or stolen.
C. currency is a better store of value than checking deposits.
D. checks are not included in measures of money, whereas currency is.

46. Money aggregates can best be defined as a set of measures of the amount of:

A. money that exists at a particular point in time.
B. money the Federal Reserve has on deposit as reserves.
C. money available to the economy over a year.
D. U.S. currency the Bureau of Printing and Engraving has produced.

47. The money aggregate M1 includes each of the following, except:

A. currency in the hands of the public.
B. travelers checks that have been issued.
C. currency in the vaults of commercial banks.
D. demand deposits at commercial banks.

48. The amount of currency in the hands of the public is approximately what percentage of M1?

A. 45%
B. 25%
C. 30%
D. 90%

49. The money aggregate M2 includes:

A. large denomination time deposits.
B. stock and bond mutual fund shares.
C. savings deposits but not money market deposit accounts.
D. M1.

50. The most commonly quoted monetary aggregate is:

A. money-market mutual fund shares.
B. M1 since it is the most liquid.
C. public currency.
D. M2 since its movement is most closely related to interest rates and economic growth.

51. An automobile is an asset, but it is not liquid because:

A. the transactions costs for turning it into money are high.
B. the owner may still be making payments on the loan.
C. the automobile may not be in good repair.
D. the automobile cannot be sold without a loss in value.

52. Which of the following lists correctly orders assets from most liquid to least liquid?

A. Stocks, house, paper currency, savings deposits
B. Stocks, paper currency, house, savings deposits
C. Savings deposits, paper currency, house, stocks
D. Paper currency, savings deposits, stocks, house

53. Which of the following assets is the most liquid?

A. Art
B. Demand deposits
C. Houses
D. Stocks

54. Considering the roughly $1.2 trillion in U.S. currency held by the public:

A. over 90% of the amount is held in the form of $1 bills.
B. more than three-fourths is held in the form of $100 bills.
C. over half of the currency held in the form of $20 bills.
D. the Federal Reserve distributes the amount equally across all denominations of bills.

55. Ava buys a $2,000 computer using a paper check. At which step does $2,000 get recorded in M1?

A. When Ava hands the $2,000 check to the computer merchant.
B. Once the $2000 is credited to the merchant bank's reserve account and is debited from Ava's bank account.
C. Once the Federal Reserve sends the paper check (or an electronic image) to Ava's bank.
D. The check is never M1. The $2000 is M1 both in Ava's bank account and, later, in the merchant's account. It is the deposit balance that is counted.

56. Sophia receives a $400 gift card for her campus bookstore from her parents. Which of the following is true regarding the $400 gift card?

A. It is counted only in M1.
B. It is included in both M1 and M2.
C. It is counted in only M2.
D. Stored-value cards are not counted in either M1 or M2.

57. Gross Domestic Product in the U.S. is roughly:

A. equal to M1.
B. twice as large as M2.
C. equal to M2.
D. more than five times M1.

58. M1 is:

A. less than 25% of GDP.
B. equal to GDP.
C. about four times larger than GDP.
D. about one fourth the amount of GDP.

59. M1 is:

A. a more useful measure of the relationship between the money supply and inflation because it includes the most liquid assets.
B. the money supply the Federal Reserve pays the most attention to in conducting monetary policy.
C. less useful than M2 for understanding inflation.
D. the fastest growing of all of the money aggregates.

60. M1 has decreased in its usefulness in understanding inflation due to:

A. the increased use of checks in the economy.
B. the introduction of money market mutual fund shares and similar checking substitutes.
C. more reliance on the use of currency.
D. the increased use of electronic payments.

61. The introduction of money market substitutes for basic checking accounts was fueled partially by the:

A. relatively high rates of inflation that existed in the late 1970s and early 1980s.
B. reluctance of many retailers to accept checks.
C. high number of bank failures that were occurring in the 1970s.
D. higher interest rates banks had to pay on checking accounts.

62. A cross-country analysis of money growth supports the conclusion that:

A. there is no correlation between the growth rate of the quantity of money and the rate of inflation.
B. the correlation between the money growth rate and inflation in most countries was positive but very small.
C. the correlation between inflation and money growth in most industrialized countries was actually negative.
D. the correlation between inflation and the money growth rate was positive and relatively strong.

63. A cross-country analysis of money growth shows that the growth rate in the money supply was:

A. lower in countries with lower inflation rates.
B. higher in countries with lower inflation rates.
C. lower in countries with higher inflation rates.
D. the same whether the countries had high or low inflation rates.

64. The Consumer Price Index (CPI) is:

A. an example of an index that uses variable expenditure weights.
B. a fixed-expenditure-weight index used to measure changes in the GDP Deflator.
C. a fixed-expenditure-weight index used to measure changes in purchasing power for households.
D. the least commonly used measure of inflation.

65. The Consumer Price Index (CPI):

A. tends to understate the impact of price changes.
B. tends to overstate the impact of price changes due to substitution bias.
C. is more accurate than the GDP deflator.
D. assumes that consumers substitute away from cheaper goods.

66. The Consumer Price Index (CPI):

A. is calculated using a basket of goods and services adjusted annually by government statisticians.
B. answers the question, "How much more does it cost today to buy the same basket of goods and services that were purchased at some fixed time in the past?"
C. does not suffer from substitution bias because the basket used to measure prices changes every year.
D. understates the impact of price changes.

67. Economists study the link between money and inflation because:

A. they want to understand how to keep inflation low and stable.
B. economists believe that inflation in the 3-6% range is healthy for an economy.
C. as prices increase money becomes more valuable.
D. the Fed needs to increase the money supply as prices increase.

68. Inflation refers to growth in the economy's:

A. Gross Domestic Product (GDP).
B. interest rates.
C. money.
D. prices.

69. When the price level increases, the purchasing power of money:

A. increases by a similar amount.
B. stays the same since the purchasing power of money is not impacted by price levels.
C. decreases.
D. first increases and then decreases as people get used to higher prices.

70. The purchasing power of money:

A. rises when inflation rises.
B. decreases as the price level decreases.
C. decreases with inflation.
D. is not impacted by inflation, only by monetary policy.

71. Which of the following statements is incorrect?

A. If you can buy the same goods this year as you bought last year with less money there must have been deflation.
B. If you can buy the same goods this year as you purchased one year ago with the same amount of money, prices are stable.
C. If purchasing the same goods today that were purchased one year ago requires more money, there must have been inflation.
D. If you can buy the same goods this year as you bought last year with the same money there must have been deflation.

72. Which of the following statements is correct?

A. If you can buy the same goods this year as you bought last year with less money there must have been inflation.
B. If purchasing the same goods today that were purchased one year ago requires more money, there must have been deflation.
C. If purchasing the same goods today as one year ago requires less money, the money supply likely decreased.
D. If purchasing the same goods today as one year ago requires less money, the money supply likely increased.

73. The U.S. Treasury estimates that the fraction of U.S. currency held outside the United States is:

A. about one-fourth.
B. about half.
C. between two-thirds and three-quarters.
D. less than 10%.

74. In countries with low inflation:

A. M2 growth is a very strong forecaster of inflation.
B. there tends to be a greater reliance on checks than electronic payments.
C. M2 growth is a poor forecaster of inflation.
D. money stocks are a larger percentage of GDP.

75. Sue uses a credit card to purchase a new pair of jeans. Sue is:

A. using money to buy her jeans since credit cards is money.
B. creating a liability that she will ultimately have to pay with money.
C. using an electronic payment form of money.
D. using a form of money included in M2.

76. The value of money as a means of payment:

A. is independent of changes in the amount of money in the economy.
B. is fixed once relative prices are set.
C. depends on the amount of money in the economy, among other things.
D. depends on whether the majority of M1 is in currency or demand deposits.

77. The primary concern of current critics of fiat money is that:

A. fiat money is too costly to produce.
B. governments issue too much money threatening its value.
C. fiat money is too easy to counterfeit.
D. government will issue too little threatening economic growth.

78. Current critics of fiat money are urging governments to do what?

A. Return to a system of legal tender.
B. Move to a system of electronic transactions only.
C. Return to a gold standard.
D. Place limits on the creation.

79. A policy is time consistent when:

A. policymakers have incentives to adhere to a policy decision made today, in the future.
B. policymakers have incentives to make policy decisions in a time-sensitive fashion.
C. policymakers consider the future when making current policies.
D. the timing of a policy is irrelevant.

Short Answer Questions

80. Consider the following: there are two countries, A and B. Each country has the same resources, and produces the same goods. The residents of country A use money; the residents of country B rely on bartering of goods. Will each country produce the same quantity of output? Explain.

81. Consider an island where people use sand dollars (shells) as currency. For simplicity, assume that people consume only one good: fish. Currently, there are 400 sand dollars in circulation and there are 200 fish purchased each year. Based on this information, what is the price of fish? Now, suppose that a change in climate leads to new sand dollars washing ashore, leaving a total of 500 sand dollars. If there are still 200 fish purchased each year, what is the new price of fish? In order to prevent inflation, what would have to happen to the amount of fish purchased each year?

82. What does it mean to say that an asset is "liquid"?

83. There are three goods produced in an economy by three individuals:

Good	Producer
Oranges	Orchard owner
Bread	Baker
Chocolate	Candy Maker

If the orchard owner likes only bread, the baker likes only chocolate, and the candy maker likes only oranges, will any trade between these three persons take place in a barter economy? Explain.

84. Many college campuses use student ID cards as a way for students to pay for on-campus expenses, such as books, photocopies, and food. For convenience, some students will maintain a balance on their ID cards. Are these balances a means of payment? Are they a store of value? Explain why or why not.

85. Explain why the following statement is true, "money is an asset but not all assets are money."

86. Explain how money solves the problem of the "double coincidence of wants."

87. Suppose there is an economy that has 100 people each of whom makes a different good, and that they use a barter system for exchange. How many relative prices will there be?

88. Is the characteristic that distinguishes money from other assets its ability to be a store of value?

89. What distinguishes commodity money from fiat money?

90. During the U.S. Civil War the Confederate government had to resort to printing currency to obtain the goods they needed. Comment on what you think happened to both prices and the value of this currency at the end of the war.

91. You purchase a good by writing a check for $1,000. Considering the financial payments system this check follows, when is the check money? Explain.

92. Explain why credit cards are not considered money even though people seem to use them like money.

93. Explain the difference(s) between a debit card and a credit card.

94. Rank the following assets from most liquid to least liquid.

a) Common stock
b) Houses
c) Currency
d) Art
e) Savings accounts
f) Checking account deposits.

95. During what period was money a better store of value: 1960-1980 or 1990-2009? Explain.

96. The income velocity of money is defined as nominal GDP divided by the money supply. In the first quarter of 2013 the U.S. nominal GDP was estimated to be around $16 trillion annually and M2 was $10460.3 billion. Would the income velocity of M2 be equal to 1; < 1; or > 1? Explain.

97. What is included in M2 that is not included in M1?

98. Have the growth rates of the two measures of money moved together over time? Explain.

99. How useful is M2 in tracking inflation? Explain.

100. Has M2 always been a useful tool for forecasting inflation? Explain.

101. Why do economists claim the Consumer Price Index (CPI) tends to overstate the actual rate of inflation?

102. How has the Bureau of Labor Statistics (BLS) changed the calculation of the CPI in order to take substitution bias into account?

103. What was the double liquidity shock that occurred in the U.S. financial system in the summer of 2007?

104. Why are electronic transactions increasingly taking the place of paper transactions?

Essay Questions

105. Consider two barter economies: Duos and Varietas. Duos produces two different goods, whereas Varietas produces 80 different goods. Both countries have the same number of people. In which barter economy is it more likely that the means of payment and the units of account would be efficient? How many relative prices are there in Duos compared with Varietas? Which economy would benefit more from adopting money?

106. After the Revolutionary War, the U.S. monetary system was based on gold. Historically, why did the U.S. adopt the use of gold as a currency? How does this compare with the currency used today?

107. Historically, some governments have relied on the revenue generated from printing currency to finance government spending. Give two examples of government's relying on paper currency to finance wartime expenditures. What do you expect happened to inflation rates during these historical episodes?

108. In the chapter you read that it costs the U.S. Treasury's Bureau of Engraving and Printing around nine cents to print a note (currency), whether that bill is a one-dollar or one-hundred dollar bill. It seems the Treasury could generate a nice profit for the government by simply printing currency and using this currency to purchase the goods and services the government needs. In fact, this seems to be a way to eliminate the problem of budget deficits for the U.S. government. Comment on this idea.

109. A famous American has been visiting the same tropical island for 15 years for vacations. When she goes she pays for everything by writing checks drawn on her U.S. bank. The currency the natives use are not U.S. dollars; they use a currency called a fungo. The natives never cash her checks. She is so well known on the island that the natives simply trade her checks among themselves. The question you need to answer, complete with an explanation, is: who is paying for her vacation? (You can assume her bank would honor the checks if presented for payment even after a considerable period of time has passed.)

Chapter 02 Money and the Payments System Answer Key

Multiple Choice Questions

1. Which of the following would not be considered a characteristic of money?

A. It is a store of value.
B. It is a means of payment.
C. It must have intrinsic value.
D. It is a unit of account.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 1 Easy
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

2. A society without any money:

A. could never exchange goods and/or services.
B. would find people doing everything for themselves.
C. would have to rely on barter.
D. would be more efficient since people would be more self-sufficient.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

3. The use of money makes us more efficient because:

A. we spend more time trading and more time producing.
B. people can specialize in what they do well.
C. with money we borrow less.
D. money increases in value over time.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation

Blooms: Understand
Difficulty: 2 Medium
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4. The unit of account characteristic of money:

A. makes it difficult to compare the relative prices of goods and services.
B. refers to how we use money to transfer purchasing power over time.
C. means prices are expressed in terms of money.
D. means that money finalizes payments.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

5. Without the use of money, workers in an economy would:

A. become more specialized
B. have to spend a lot less time trading
C. probably specialize less
D. be far more productive

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Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

6. As an economy produces more different types of goods:

A. it is more difficult to quote prices if the economy does not use money.
B. the number of relative prices decreases.
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D. money becomes less useful as a standard of value.

AACSB: Analytic
Accessibility: Keyboard Navigation
Blooms: Evaluate
Difficulty: 3 Hard
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

7. The store of value characteristic of money refers to the fact that:

A. people save most of their money.
B. money allows people to shift purchasing power into the future.
C. money is not valuable unless it is stored.
D. money is the only way people have to store value.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 1 Easy
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

8. Which best describes money as a means of payment?

A. Money provides an immediate double coincidence of wants.
B. Money makes sure a double coincidence of wants never occurs.
C. Money requires at least two transactions to obtain the double coincidence of wants.
D. To obtain a double coincidence of wants without money is impossible.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 1 Easy
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

9. Compare two economies: a barter economy versus an economy that uses money. In order to exchange goods and services:

A. a double coincidence of wants is necessary in the barter economy.
B. a double coincidence of wants is more likely to occur in the barter economy.
C. transactions are likely to be smoother in the barter economy because goods and services are exchanged directly.
D. the money economy requires that sellers have more information about buyers' wants.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

10. In a barter system people:

A. have to specialize in order to have goods to trade.
B. cannot specialize because they never know what goods will be desired.
C. are less likely to specialize as extensively as they would in a monetary economy.
D. must be self sufficient.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

11. How many prices would a trader of a particular good need to know in a barter economy with 5 goods?

A. 5
B. 10
C. 20
D. 50

AACSB: Analytic
Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: 3 Hard
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

12. How many prices would a trader of a particular good need to know in a barter economy with 20 goods?

A. 190
B. 100
C. 20
D. 40

AACSB: Analytic
Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: 3 Hard
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

13. In a barter economy with "n" number of goods there will always be:

A. exactly "n" relative prices.
B. fewer than "n" relative prices.
C. more than "n" relative prices.
D. "n/2" relative prices.

AACSB: Analytic
Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: 3 Hard
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

14. The high transaction costs associated with a barter system refers to the:

A. fact that, often times, these exchanges are taxed by governments.
B. risk associated with having to carry an inventory of goods to trade.
C. high cost associated with finding someone with whom to exchange.
D. cost of drawing up complete contracts.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

15. Suppose that in a barter economy Tom bakes bread and Hans produces chocolates. Tom wants chocolates but Hans doesn't like bread, so Hans is unwilling to trade with Tom. Tom's problem is an example of which problem associated with a barter system?

A. Too much specialization
B. Not enough prices
C. The law of diminishing returns
D. The double coincidence of wants problem

AACSB: Analytic
Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: 2 Medium
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

16. Specialization usually increases the output of a country; however effective specialization requires:

A. everyone in the country producing the same thing.
B. that workers have very similar skills.
C. an effective low-cost means to exchange goods and services.
D. a large stock of capital.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

17. Which of the following is not an example of bartering?

A. Sue trading candles with Tom for his bread.
B. Mary paying for her new shoes with her credit card.
C. John cutting his neighbor's grass in return for his neighbor washing John's car.
D. Mrs. Smith treating the neighbor children to pizza after they helped clean up her yard.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 1 Easy
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

18. Money eliminates the need for:

A. a search for a double coincidence of wants.
B. government regulation.
C. specialization of labor.
D. financial Intermediaries.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 1 Easy
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

19. Money as a means of payment refers to:

A. only actual currency.
B. only coins and currency.
C. only coins, currency and credit cards.
D. anything that is generally accepted as payment for goods and services.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 1 Easy
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

20. While money is an asset not all assets are money because:

A. only money stores value.
B. money works as a means of payment.
C. only money is a good asset to hold during times of inflation.
D. money must be legal tender.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 1 Easy
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

21. An advantage that money has over other assets is that it:

A. increases in value over time.
B. has lower transaction costs to use as a means of payment than other assets.
C. provides a higher return to the owner.
D. is a safer asset to hold during times of inflation.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 2 Medium
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

22. An individual who stores wealth in art rather than money will find that he/she:

A. suffers larger real losses during periods of high inflation.
B. has far more liquidity than most savers.
C. will incur higher transaction costs when he/she ultimately makes purchases.
D. will have to resort to barter exchanging the art for desired goods.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

23. Which of the following statements is most correct?

A. Money is wealth but not all wealth is money.
B. Money is a means of payment but is not part of wealth.
C. In order to be considered part of a person's wealth, an asset must have a positive return.
D. Wealth is a store of value and a means of payment.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

24. Which of the following is incorrect?

A. Money is wealth but not all wealth is money.
B. Money is a means of payment but is not part of wealth.
C. An asset doesn't have to be a means of payment to be a part of a person's wealth.
D. All items considered wealth can eventually be converted to a means of payment.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

25. Which of the following statements is not true?

A. For most of history gold has been the most common commodity money.
B. The most common form of money in the U.S. is not a commodity money.
C. Gold is an example of a fiat money.
D. U.S. currency is legal tender.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

26. Gold would be a superior commodity money compared to wheat because:

A. wheat has a high value relative to weight, which gold does not.
B. it is easier to divide wheat into small units.
C. wheat has more practical uses than gold.
D. wheat is perishable.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 3 Hard
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

27. The fact that U.S. currency is legal tender means:

A. U.S. currency is good anywhere in the world.
B. the only money the government will accept for settlement of debts is U.S. currency.
C. private businesses in the U.S. and the U.S. government must accept currency for payment.
D. it cannot be backed by gold or other metals.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 1 Easy
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

28. In comparing money to a U.S. Treasury bond held by an individual, we can say:

A. the treasury bond is an asset but money is not.
B. money is an asset but the U.S. bond is a liability of the individual.
C. both are stores of value.
D. money is a store of value but the bond is not.

AACSB: Analytic
Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

29. In comparing money to a U.S. Treasury bond held by an individual, we can say:

A. both are legal tender.
B. both are units of account.
C. only the bond is legal tender since it is an obligation of the U.S. government.
D. both are stores of value.

AACSB: Analytic
Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

30. In comparing money to a share of Microsoft stock held by an individual, we can say:

A. the share of stock is an asset, but money is a liability.
B. only the money is a means of payment, but both are stores of value.
C. only the money is a means of payment, but both are units of account.
D. both the Microsoft stock and the money are liabilities.

AACSB: Analytic
Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

31. Comparing checks and currency, we can say:

A. both are money but only currency is legal tender.
B. only checks are both money and legal tender.
C. a check isn't money but currency is.
D. both are money and legal tender.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

32. When the Continental Congress issued currency to finance the Revolutionary War, the Continental Congress:

A. issued too many "continentals," eventually making the currency worthless.
B. tied the value of the "continental" to gold.
C. tied the value of the "continental" to gold to French "assignats."
D. made "continentals" legal tender.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

33. During the Civil War, the North issued currency, known as "greenbacks". Which of the following is true of "greenbacks"?

A. Greenbacks are still legal tender in the U.S.
B. Greenbacks were tied to the value of gold and silver.
C. The South used "greenbacks" to pay for salaries and supplies.
D. Greenbacks are a historical example of commodity money.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 3 Hard
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

34. Most of the non-cash retail payments made each year in the United States are made by:

A. check.
B. credit card.
C. debit card.
D. electronic funds transfers.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 1 Easy
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

35. All of the following are true about electronic funds transfers except:

A. sometimes involve the Federal Reserve sending electronic images of checks to banks.
B. occur when banks or individuals deposit/withdraw from one bank account to another electronically.
C. include automated clearinghouse transactions (ACH).
D. include credit card payments made online.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

36. Carlos pays his cable bill using his bank's internet banking web site to withdraw funds from his checking account. This transaction is a(n):

A. automated clearinghouse transaction (ACH).
B. digitized-check transaction.
C. e-money transaction.
D. fedwire transaction.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

37. As a result of "Check 21—The Check Clearing for the 21st Century Act":

A. banks no longer have to ship paper checks to complete the process of check clearing.
B. people can write checks and plan on having a couple of days to make a deposit to cover the check amount.
C. canceled checks can no longer be used as proof of payment.
D. the Federal Reserve is no longer involved in the check-clearing process.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 1 Easy
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

38. The value of fiat money:

A. comes from its intrinsic value.
B. is worth more as a commodity than its value as money.
C. comes from government decree.
D. means that it is more desirable than currency.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 1 Easy
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

39. Which of the following could not be commodity money?

A. Gold coins
B. Cigarettes
C. U.S. Currency
D. Silk

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

40. U.S. currency is:

A. A commodity money
B. Fiat money
C. Tied to the value of gold at a fixed rate
D. The only store of value

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

41. One major difference between a debit card and a credit card is:

A. only the debit card helps you to build a credit history.
B. the debit card has lower minimum monthly payments.
C. you do not need to actually have the funds in your account when you use a debit card.
D. debit cards have no late fees.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

42. One major difference between a debit and credit card is:

A. you can build a credit history with the credit card but not with the debit card.
B. you have to pay interest on your purchases if you use a credit card.
C. credit cards are money and the debit card is not.
D. debit cards charge late fees.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

43. To say an asset is liquid implies that:

A. we are focusing on a category of assets that are in a physically liquid form, like oil.
B. we are considering assets that may be readily converted into a means of payment.
C. we are considering any asset that can be sold.
D. we are only considering U.S. currency.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 1 Easy
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

44. One advantage of using checks over a debit card is:

A. checks can be replaced if lost or stolen, a debit card cannot.
B. the bank is responsible if someone steals your checks and uses them; this isn't the case with debit cards.
C. a cancelled paper check is the only generally accepted proof of payment.
D. the person has "float," meaning time between writing the check and depositing funds to cover it.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

45. Checks and currency function similarly, however:

A. currency is a more effective means of payment.
B. carrying currency entails greater risk, because it cannot be replaced if lost or stolen.
C. currency is a better store of value than checking deposits.
D. checks are not included in measures of money, whereas currency is.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

46. Money aggregates can best be defined as a set of measures of the amount of:

A. money that exists at a particular point in time.
B. money the Federal Reserve has on deposit as reserves.
C. money available to the economy over a year.
D. U.S. currency the Bureau of Printing and Engraving has produced.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 1 Easy
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

47. The money aggregate M1 includes each of the following, except:

A. currency in the hands of the public.
B. travelers checks that have been issued.
C. currency in the vaults of commercial banks.
D. demand deposits at commercial banks.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 1 Easy
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

48. The amount of currency in the hands of the public is approximately what percentage of M1?

A. 45%
B. 25%
C. 30%
D. 90%

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 1 Easy
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

49. The money aggregate M2 includes:

A. large denomination time deposits.
B. stock and bond mutual fund shares.
C. savings deposits but not money market deposit accounts.
D. M1.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 1 Easy
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

50. The most commonly quoted monetary aggregate is:

A. money-market mutual fund shares.
B. M1 since it is the most liquid.
C. public currency.
D. M2 since its movement is most closely related to interest rates and economic growth.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 1 Easy
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

51. An automobile is an asset, but it is not liquid because:

A. the transactions costs for turning it into money are high.
B. the owner may still be making payments on the loan.
C. the automobile may not be in good repair.
D. the automobile cannot be sold without a loss in value.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

52. Which of the following lists correctly orders assets from most liquid to least liquid?

A. Stocks, house, paper currency, savings deposits
B. Stocks, paper currency, house, savings deposits
C. Savings deposits, paper currency, house, stocks
D. Paper currency, savings deposits, stocks, house

AACSB: Analytic
Accessibility: Keyboard Navigation
Blooms: Create
Difficulty: 2 Medium
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

53. Which of the following assets is the most liquid?

A. Art
B. Demand deposits
C. Houses
D. Stocks

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 1 Easy
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

54. Considering the roughly $1.2 trillion in U.S. currency held by the public:

A. over 90% of the amount is held in the form of $1 bills.
B. more than three-fourths is held in the form of $100 bills.
C. over half of the currency held in the form of $20 bills.
D. the Federal Reserve distributes the amount equally across all denominations of bills.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 2 Medium
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

55. Ava buys a $2,000 computer using a paper check. At which step does $2,000 get recorded in M1?

A. When Ava hands the $2,000 check to the computer merchant.
B. Once the $2000 is credited to the merchant bank's reserve account and is debited from Ava's bank account.
C. Once the Federal Reserve sends the paper check (or an electronic image) to Ava's bank.
D. The check is never M1. The $2000 is M1 both in Ava's bank account and, later, in the merchant's account. It is the deposit balance that is counted.

AACSB: Analytic
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 3 Hard
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

56. Sophia receives a $400 gift card for her campus bookstore from her parents. Which of the following is true regarding the $400 gift card?

A. It is counted only in M1.
B. It is included in both M1 and M2.
C. It is counted in only M2.
D. Stored-value cards are not counted in either M1 or M2.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

57. Gross Domestic Product in the U.S. is roughly:

A. equal to M1.
B. twice as large as M2.
C. equal to M2.
D. more than five times M1.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 2 Medium
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

58. M1 is:

A. less than 25% of GDP.
B. equal to GDP.
C. about four times larger than GDP.
D. about one fourth the amount of GDP.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 1 Easy
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

59. M1 is:

A. a more useful measure of the relationship between the money supply and inflation because it includes the most liquid assets.
B. the money supply the Federal Reserve pays the most attention to in conducting monetary policy.
C. less useful than M2 for understanding inflation.
D. the fastest growing of all of the money aggregates.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 2 Medium
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

60. M1 has decreased in its usefulness in understanding inflation due to:

A. the increased use of checks in the economy.
B. the introduction of money market mutual fund shares and similar checking substitutes.
C. more reliance on the use of currency.
D. the increased use of electronic payments.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 2 Medium
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

61. The introduction of money market substitutes for basic checking accounts was fueled partially by the:

A. relatively high rates of inflation that existed in the late 1970s and early 1980s.
B. reluctance of many retailers to accept checks.
C. high number of bank failures that were occurring in the 1970s.
D. higher interest rates banks had to pay on checking accounts.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 2 Medium
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Money and How We Use It

62. A cross-country analysis of money growth supports the conclusion that:

A. there is no correlation between the growth rate of the quantity of money and the rate of inflation.
B. the correlation between the money growth rate and inflation in most countries was positive but very small.
C. the correlation between inflation and money growth in most industrialized countries was actually negative.
D. the correlation between inflation and the money growth rate was positive and relatively strong.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

63. A cross-country analysis of money growth shows that the growth rate in the money supply was:

A. lower in countries with lower inflation rates.
B. higher in countries with lower inflation rates.
C. lower in countries with higher inflation rates.
D. the same whether the countries had high or low inflation rates.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

64. The Consumer Price Index (CPI) is:

A. an example of an index that uses variable expenditure weights.
B. a fixed-expenditure-weight index used to measure changes in the GDP Deflator.
C. a fixed-expenditure-weight index used to measure changes in purchasing power for households.
D. the least commonly used measure of inflation.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 1 Easy
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

65. The Consumer Price Index (CPI):

A. tends to understate the impact of price changes.
B. tends to overstate the impact of price changes due to substitution bias.
C. is more accurate than the GDP deflator.
D. assumes that consumers substitute away from cheaper goods.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

66. The Consumer Price Index (CPI):

A. is calculated using a basket of goods and services adjusted annually by government statisticians.
B. answers the question, "How much more does it cost today to buy the same basket of goods and services that were purchased at some fixed time in the past?"
C. does not suffer from substitution bias because the basket used to measure prices changes every year.
D. understates the impact of price changes.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 2 Medium
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

67. Economists study the link between money and inflation because:

A. they want to understand how to keep inflation low and stable.
B. economists believe that inflation in the 3-6% range is healthy for an economy.
C. as prices increase money becomes more valuable.
D. the Fed needs to increase the money supply as prices increase.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

68. Inflation refers to growth in the economy's:

A. Gross Domestic Product (GDP).
B. interest rates.
C. money.
D. prices.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 1 Easy
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

69. When the price level increases, the purchasing power of money:

A. increases by a similar amount.
B. stays the same since the purchasing power of money is not impacted by price levels.
C. decreases.
D. first increases and then decreases as people get used to higher prices.

AACSB: Analytic
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 2 Medium
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

70. The purchasing power of money:

A. rises when inflation rises.
B. decreases as the price level decreases.
C. decreases with inflation.
D. is not impacted by inflation, only by monetary policy.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 1 Easy
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

71. Which of the following statements is incorrect?

A. If you can buy the same goods this year as you bought last year with less money there must have been deflation.
B. If you can buy the same goods this year as you purchased one year ago with the same amount of money, prices are stable.
C. If purchasing the same goods today that were purchased one year ago requires more money, there must have been inflation.
D. If you can buy the same goods this year as you bought last year with the same money there must have been deflation.

AACSB: Analytic
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 2 Medium
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

72. Which of the following statements is correct?

A. If you can buy the same goods this year as you bought last year with less money there must have been inflation.
B. If purchasing the same goods today that were purchased one year ago requires more money, there must have been deflation.
C. If purchasing the same goods today as one year ago requires less money, the money supply likely decreased.
D. If purchasing the same goods today as one year ago requires less money, the money supply likely increased.

AACSB: Analytic
Accessibility: Keyboard Navigation
Blooms: Analyze
Difficulty: 2 Medium

Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

73. The U.S. Treasury estimates that the fraction of U.S. currency held outside the United States is:

A. about one-fourth.
B. about half.
C. between two-thirds and three-quarters.
D. less than 10%.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Remember
Difficulty: 2 Medium
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

74. In countries with low inflation:

A. M2 growth is a very strong forecaster of inflation.
B. there tends to be a greater reliance on checks than electronic payments.
C. M2 growth is a poor forecaster of inflation.
D. money stocks are a larger percentage of GDP.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

75. Sue uses a credit card to purchase a new pair of jeans. Sue is:

A. using money to buy her jeans since credit cards is money.
B. creating a liability that she will ultimately have to pay with money.
C. using an electronic payment form of money.
D. using a form of money included in M2.

AACSB: Analytic
Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: 2 Medium
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Money and How We Use It

76. The value of money as a means of payment:

A. is independent of changes in the amount of money in the economy.
B. is fixed once relative prices are set.
C. depends on the amount of money in the economy, among other things.
D. depends on whether the majority of M1 is in currency or demand deposits.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

77. The primary concern of current critics of fiat money is that:

A. fiat money is too costly to produce.
B. governments issue too much money threatening its value.
C. fiat money is too easy to counterfeit.
D. government will issue too little threatening economic growth.

AACSB: Reflective Thinking
Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

78. Current critics of fiat money are urging governments to do what?

A. Return to a system of legal tender.
B. Move to a system of electronic transactions only.
C. Return to a gold standard.
D. Place limits on the creation.

AACSB: Analytic
Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

79. A policy is time consistent when:

A. policymakers have incentives to adhere to a policy decision made today, in the future.
B. policymakers have incentives to make policy decisions in a time-sensitive fashion.
C. policymakers consider the future when making current policies.
D. the timing of a policy is irrelevant.

AACSB: Analytic
Accessibility: Keyboard Navigation
Blooms: Apply
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

Short Answer Questions

80. Consider the following: there are two countries, A and B. Each country has the same resources, and produces the same goods. The residents of country A use money; the residents of country B rely on bartering of goods. Will each country produce the same quantity of output? Explain.

No, the residents of Country B will definitely spend more of their time transacting, trying to create a double coincidence of wants, and may have to rely on multiple trades to do so. They will also likely specialize less, reducing the gains to the country from specialization. In country A the residents will be able to transact immediately using money, and will also be able to specialize in what they do well creating a more efficient economy.

AACSB: Analytic
Blooms: Analyze
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

81. Consider an island where people use sand dollars (shells) as currency. For simplicity, assume that people consume only one good: fish. Currently, there are 400 sand dollars in circulation and there are 200 fish purchased each year. Based on this information, what is the price of fish?
Now, suppose that a change in climate leads to new sand dollars washing ashore, leaving a total of 500 sand dollars. If there are still 200 fish purchased each year, what is the new price of fish? In order to prevent inflation, what would have to happen to the amount of fish purchased each year?

When there are 400 sand dollars and 200 fish purchased in a year, this implies that each fish costs 2 sand dollars (= 400/200). When the number of sand dollars increases to 500, the price of fish will increase to 2.5 sand dollars per fish (= 500/200). In order to prevent this inflation in fish prices, the number of fish would have to be increased to 250. That is, if there are 500 sand dollars and 250 fish, the price of fish would go back to 2 sand dollars per fish (= 500/250).

AACSB: Analytic
Blooms: Apply
Difficulty: 2 Medium
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

82. What does it mean to say that an asset is "liquid"?

An asset is liquid when it can be converted into a means of payment, quickly without suffering a loss in value.

AACSB: Reflective Thinking
Blooms: Remember
Difficulty: 1 Easy
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

83. There are three goods produced in an economy by three individuals:

Good	Producer
Oranges	Orchard owner
Bread	Baker
Chocolate	Candy Maker

If the orchard owner likes only bread, the baker likes only chocolate, and the candy maker likes only oranges, will any trade between these three persons take place in a barter economy? Explain.

Yes, but this is a good example of the high transaction costs that can occur in a barter economy due to the double coincidence of wants problem. Any one of the individuals will have to make two trades to get what he/she wants; for example, the baker will have to trade bread with the orchard owner to get oranges, to then be able to trade with the candy maker to obtain the chocolate that he/she really wants.

AACSB: Analytic
Blooms: Analyze
Difficulty: 3 Hard
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

84. Many college campuses use student ID cards as a way for students to pay for on-campus expenses, such as books, photocopies, and food. For convenience, some students will maintain a balance on their ID cards. Are these balances a means of payment? Are they a store of value? Explain why or why not.

The balances on the cards serve as both a means of payment and a store of value. Using the student ID card in this way is an example of a stored-value card, similar to a gift card for a store, or a card used to pay for public transportation. While these stored value cards are not included in the money supply, they are used as a means of payment and a store of value.

AACSB: Analytic
Blooms: Analyze
Difficulty: 2 Medium
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

85. Explain why the following statement is true, "money is an asset but not all assets are money."

Money is an asset because it represents something of value to the owner. But not all assets can be used as an immediate means of payment.

AACSB: Reflective Thinking
Blooms: Understand
Difficulty: 1 Easy
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

86. Explain how money solves the problem of the "double coincidence of wants."

In an economy that does not rely on the use of money, if people are going to specialize at all they have to resort to barter, which is the exchange of one good or service for another. In the situation of barter, it may be likely that the individual who has what the other person wants will not want what the other person has. In this case multiple trades may be necessary to ultimately obtain what is desired. With the use of money, since everyone generally accepts it, one exchange will suffice. In reality you can say that money creates an immediate double coincidence of wants.

AACSB: Reflective Thinking
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

87. Suppose there is an economy that has 100 people each of whom makes a different good, and that they use a barter system for exchange. How many relative prices will there be?

The general formula for the number of prices is $n(n - 1)/2$; where n = the number of goods. Since we have 100 people each producing one good, we have 100 goods, so $n = 100$. Plugging this into our formula, we obtain: $100(99)/2 = 4950$; so there will be 4,950 relative prices.

AACSB: Analytic
Blooms: Apply
Difficulty: 3 Hard
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

88. Is the characteristic that distinguishes money from other assets its ability to be a store of value?

No; there are many assets that fall into the category of financial assets that are good stores of value, these include bonds and stocks. What distinguishes money is that it is liquid, meaning it can immediately serve as a means of payment. This is not true of other assets, which must be converted to spendable form. Moreover, it can be costly to turn a bond or stock into a means of payment, especially if it must be done on short notice.

AACSB: Reflective Thinking
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

89. What distinguishes commodity money from fiat money?

Commodity money, such as gold or silver, has value even if it is not used as money. For example, gold coins could be melted down and converted to jewelry. Fiat money, such as U.S. paper currency really has no value other than its use as money. Its value derives from the fact that it is deemed to be legal tender by the U.S. government and along with people's willingness to accept it.

AACSB: Reflective Thinking
Blooms: Understand
Difficulty: 1 Easy
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

90. During the U.S. Civil War the Confederate government had to resort to printing currency to obtain the goods they needed. Comment on what you think happened to both prices and the value of this currency at the end of the war.

While the Confederate government was printing this currency in increasing amounts the prices in the South undoubtedly were rising. Any time currency is made increasingly available the eventual result will be higher prices. In addition, when the war ended and the Confederate states lost, the currency was basically worthless since there was no government that could guarantee its value. It was probably the case that as it was becoming clearer to people living in Confederate states that the outcome of the war was not going to be in their favor, it would not have been surprising if the people relied less on the currency and more on barter.

AACSB: Analytic
Blooms: Analyze
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

91. You purchase a good by writing a check for $1,000. Considering the financial payments system this check follows, when is the check money? Explain.

The check itself is never money; rather it is the balances on deposit that represent money. Therefore the $1,000 was money when it was in your checking account and that $1,000 will be money again when the Federal Reserve credits the reserve account of the bank receiving the check (and debits your bank's reserve account).

AACSB: Analytic
Blooms: Analyze
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

92. Explain why credit cards are not considered money even though people seem to use them like money.

A credit card isn't money for a few reasons. One, it is not an asset. The use of a credit card actually creates a liability for the user. A credit card is a promise by a bank to lend the cardholder money with which to make purchases. The store supplying the goods being purchased receives money, but the money that is used does not belong to the buyer. The credit card provides the cardholder with access to someone else's money.

AACSB: Reflective Thinking
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

93. Explain the difference(s) between a debit card and a credit card.

A debit card works the same way as a check, in that it provides the bank with instructions to transfer funds from the cardholder's account to the merchant's account. The debit card-holder must have adequate funds in his/her checking account to cover the purchase. A credit card is a promise by a bank to lend the cardholder money with which to make purchases. The store supplying the goods being purchased receives money, but the money that is used does not belong to the buyer, the credit card provides the cardholder with access to someone else's money.

AACSB: Reflective Thinking
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

94. Rank the following assets from most liquid to least liquid.

a) Common stock
b) Houses
c) Currency
d) Art
e) Savings accounts
f) Checking account deposits.

Ranked from most liquid to least liquid: #1) Currency; #2) Checking account deposits; #3) Savings accounts; #4) Common Stock; #5) Houses; #6) Art.

AACSB: Reflective Thinking
Blooms: Understand
Difficulty: 1 Easy
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

95. During what period was money a better store of value: 1960-1980 or 1990-2009? Explain.

The period 1990-2009. During the period 1960-1980, inflation often rose to more than 5 percent; during the period 1990-2000, it rarely did.

AACSB: Analytic
Blooms: Evaluate
Difficulty: 2 Medium
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

96. The income velocity of money is defined as nominal GDP divided by the money supply. In the first quarter of 2013 the U.S. nominal GDP was estimated to be around $16 trillion annually and M2 was $10460.3 billion. Would the income velocity of M2 be equal to 1; < 1; or > 1? Explain.

Greater than one. If you divide nominal GDP of $16 trillion (or $14,500 billion) by $10460.3 billion the result is 1.53.

AACSB: Analytic
Blooms: Apply
Difficulty: 3 Hard
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

97. What is included in M2 that is not included in M1?

Small denomination time deposits, plus Savings Deposits and Money Market Deposit Accounts and Retail Money Market Mutual Fund Shares.

AACSB: Reflective Thinking
Blooms: Remember
Difficulty: 1 Easy
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

98. Have the growth rates of the two measures of money moved together over time? Explain.

From 1960 to 1980 the growth rates of the two money measures did move together. After 1980 M1 behaved very differently than M2. The main reason for this seems to be the high rates of inflation that began in the late 1970s and fostered innovation into other types of accounts that people could hold to earn a higher return and yet were relatively liquid, such as money market accounts.

AACSB: Analytic
Blooms: Analyze
Difficulty: 2 Medium
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

99. How useful is M2 in tracking inflation? Explain.

Empirical research mentioned in the chapter shows that across many countries, high rates of growth in M2 were associated with high rates of inflation and relatively low growth rates in M2 in many countries also were associated with low rates of inflation. For this reason many economists believe that, at least for moderate inflation rates, controlling inflation means controlling the money growth.

AACSB: Analytic
Blooms: Create
Difficulty: 2 Medium
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

100. Has M2 always been a useful tool for forecasting inflation? Explain.

From 1960 to 1980 it seemed that growth of M2 was a good tool to forecast inflation, with a two-year lag; in fact the correlation was over 0.5. For the years 1990 to 2013 this does not seem to be the case, in fact the correlation was 0. There is no clear explanation for why the growth of M2 has ceased being a good forecast tool for inflation, but there are some ideas economists are researching.

AACSB: Analytic
Blooms: Analyze
Difficulty: 2 Medium
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

101. Why do economists claim the Consumer Price Index (CPI) tends to overstate the actual rate of inflation?

The CPI is measured using a fixed-expenditure-weight index. As a result, when the price of a good included in the index increases the assumption is people continue to purchase the same quantity of this item when in reality many consumers (to whatever degree possible) may stop purchasing this item and select a lower priced substitute. This substitution toward a lower-priced good is not reflected in the reported CPI.

AACSB: Analytic
Blooms: Analyze
Difficulty: 3 Hard
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

102. How has the Bureau of Labor Statistics (BLS) changed the calculation of the CPI in order to take substitution bias into account?

Substitution bias is an overstatement of inflation by the CPI that comes from the fact that the calculation of the index is based on the assumption of an unchanging market basket of goods and services. Since prices do not all rise at the same rate (and some may not rise or may even fall), people can avoid some inflation by changing their spending pattern, that is, substituting lower-priced goods in place of those whose prices have risen. In order to take this into account, the BLS now changes the weights used in the CPI every two years, and today's CPI is a much more accurate measure of inflation than the one published a decade ago.

AACSB: Analytic

Blooms: Analyze
Difficulty: 3 Hard
Learning Objective: 02-03 Understand money links: inflation and economic growth.
Topic: Measuring Money

103. What was the double liquidity shock that occurred in the U.S. financial system in the summer of 2007?

Investors began to doubt the value of a wide class of securities so market liquidity for those instruments disappeared and financial institutions that held them faced large losses. In turn, funding liquidity for these institutions dried up as the potential losses caused their lenders to be worried about their safety.

AACSB: Reflective Thinking
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

104. Why are electronic transactions increasingly taking the place of paper transactions?

Because efficient payments systems continue to evolve and seek easier and cheaper ways to pay for things.

AACSB: Reflective Thinking
Blooms: Understand
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

Essay Questions

105. Consider two barter economies: Duos and Varietas. Duos produces two different goods, whereas Varietas produces 80 different goods. Both countries have the same number of people. In which barter economy is it more likely that the means of payment and the units of account would be efficient? How many relative prices are there in Duos compared with Varietas? Which economy would benefit more from adopting money?

Payments would be far easier and efficient in Duos. With fewer goods to be traded, the likelihood of reaching a double coincidence of wants would be greater. Also, with fewer goods being produced, the need for specialization is not as great as it would be in Varietas. With 80 different goods, people in Varietas are likely to be specialized. Also, with many different goods, the need for information is much greater in Varietas. Duos would have one relative price, 1 = 2(2 - 1)/2. Varietas would have thousands of relative prices: 3160 = 80(80 - 1)/2. This suggests that quoting prices and recording debts would be easier in Duos. Varietas would benefit more from adopting money, for the reasons cited above.

AACSB: Analytic
Blooms: Analyze
Difficulty: 2 Medium
Learning Objective: 02-01 Understand money and its functions.
Topic: Money and How We Use It

106. After the Revolutionary War, the U.S. monetary system was based on gold. Historically, why did the U.S. adopt the use of gold as a currency? How does this compare with the currency used today?

Historically, the U.S. adopted the use of gold as a currency (or as a way to back paper notes) because people had grown suspicious of the use of fiat money. During the Revolutionary War, the Continental Congress issued continentals that became worthless with rising inflation. Using gold to back currency gave the public trust in the government's ability and desire to protect its value (e.g., to prevent rising inflation). Today, the currency printed by the U.S. Treasury Bureau of Engraving and Printing is fiat money. That is, it has little or no intrinsic value. The general public is willing to use this fiat money because it trusts the government's promise to protect its value. People have an expectation that they will be able to use the existing currency to pay for goods and services.

AACSB: Analytic
Blooms: Analyze
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

107. Historically, some governments have relied on the revenue generated from printing currency to finance government spending. Give two examples of government's relying on paper currency to finance wartime expenditures. What do you expect happened to inflation rates during these historical episodes?

The Continental Congress issued continentals in 1775 to finance the Revolutionary War. The French Revolutionary Government issued assignats in 1793. The inflation rates during both historical episodes increased. The money supply is linked to the economy's inflation rate. As the money supply grows at a faster rate, the inflation rate rises.

AACSB: Reflective Thinking
Blooms: Remember
Difficulty: 2 Medium
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

108. In the chapter you read that it costs the U.S. Treasury's Bureau of Engraving and Printing around nine cents to print a note (currency), whether that bill is a one-dollar or one-hundred dollar bill. It seems the Treasury could generate a nice profit for the government by simply printing currency and using this currency to purchase the goods and services the government needs. In fact, this seems to be a way to eliminate the problem of budget deficits for the U.S. government. Comment on this idea.

At first it seems the Treasury could buy one hundred dollars worth of goods for an actual cost of less than six cents, the cost of printing the note. Plus the Treasury can avoid having to borrow to finance the difference between tax receipts and expenditures. But what may be profitable for the Treasury can be very harmful to the economy. The printing of this additional currency can have many serious consequences. The additional currency will increase the money supply, which can fuel higher prices, lowering the real purchasing power of money. If the problem becomes large enough it can actually make people reluctant to accept the currency as a means of payment and they would revert to increased use of barter which can make the economy less efficient.

AACSB: Analytic
Blooms: Analyze
Difficulty: 3 Hard
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System

109. A famous American has been visiting the same tropical island for 15 years for vacations. When she goes she pays for everything by writing checks drawn on her U.S. bank. The currency the natives use are not U.S. dollars; they use a currency called a fungo. The natives never cash her checks. She is so well known on the island that the natives simply trade her checks among themselves. The question you need to answer, complete with an explanation, is: who is paying for her vacation? (You can assume her bank would honor the checks if presented for payment even after a considerable period of time has passed.)

Obviously neither the famous American nor her bank is paying for the vacation since the checks are never presented for payment. On the other hand, the famous American is providing the people on the island with additional money, which they seem very comfortable using. As a result, the money supply on the island has increased by the amount of these checks. One result of the added money will be inflation, so islanders will see the real purchasing power of their money decrease, thus their loss in real purchasing power has been used to pay for the famous American's vacations.

AACSB: Analytic
Blooms: Analyze
Difficulty: 3 Hard
Learning Objective: 02-02 Understand the payments system today and tomorrow.
Topic: The Payments System