Name _____ Date _____

Money and Banks: What Money Does and How Lending Creates Deposits

Directions: Answer each question about the economic functions of money and the role that commercial banks play in the financial system. The individuals, banks and countries described are invented, and every reserve ratio applies only to its particular example.

1. Match each situation to the function of money that it demonstrates most directly.
Write the letter of the matching answer on each line.

1. _____ A diner lists every menu item's price in dollars, allowing customers to compare the value of a sandwich with a salad
2. _____ Theo pays a mechanic in dollars instead of attempting to exchange his guitar for the repair
3. _____ A farmer holds on to money from last autumn's harvest so she can purchase seed the following spring

Choices for question 1

A. Unit of account
B. Medium of exchange
C. Store of value
D. Standard of deferred payment

2. Lena, a plumber, wants bread from a local baker, but the baker needs a haircut rather than plumbing work, so the two cannot arrange a direct exchange. Which problem with barter does this situation illustrate?

A. Barter succeeds only when each trader wants what the other trader offers.
B. Barter fails whenever the goods being exchanged have different market values.
C. Barter is permitted only when a government agency approves each exchange.
D. Barter causes prices to rise faster than they would rise in a monetary economy.

3. The paper bills circulating in the invented country of Lorvia are not backed by gold or any other commodity, and people accept them because Lorvia's government declares them legal tender. Which statement correctly describes these bills?

A. They are commodity money, because paper is itself a commodity that people can use.
B. They are commodity-backed money, because a government stands behind their value.
C. They are not money at all, because nothing physical guarantees their value.
D. They are fiat money, because their value rests on a government declaration and public trust.

4. Suppose the general price level for goods and services rises 10 percent over one year, while a shop owner keeps $1,000 in cash in a safe for that entire year. Which statement about that cash is accurate?

A. It purchases more than before, because prices increased during the year.
B. It still functions as money, but its purchasing power declined over the year.
C. It purchases exactly what it did before, because the amount printed on the bills is unchanged.
D. It no longer qualifies as money, because money must preserve its full value.

5. A commercial bank accepts deposits from savers and uses those funds to make loans to individuals and businesses. What economic role is the bank performing?

A. A government printer that manufactures the paper bills it lends to borrowers

B. A storage vault that holds every deposit until the depositor returns

C. A central bank that determines the quantity of money in the entire country

D. A financial intermediary that channels funds from savers to borrowers

6. Customers' deposits appear as liabilities on a commercial bank's balance sheet. Why do accountants classify deposits as liabilities rather than assets?

A. The bank owes the deposits to its customers, who can withdraw them.

B. The bank owns the deposits and may spend them however it prefers.

C. Deposits are loans the bank has extended to its customers.

D. Deposits generate interest payments for the bank from its borrowers.

One Deposit, Many Loans

Teodor deposits $5,000 in cash at Harbor Bank. In this example, every bank keeps 20 percent of each new deposit as reserves and lends out the remainder, and every loan is spent and then deposited in full at some bank. The 20 percent ratio applies only to this example; it is not a legal requirement.

7. In this example, how many dollars can Harbor Bank lend from Teodor's deposit after setting aside its reserves?

_____ dollars

8. Harbor Bank lends money from Teodor's deposit to Wren, who spends it at a hardware store, and the store deposits the full amount at Ridge Bank, while Teodor's $5,000 remains in his account. What has happened to the total of all deposits in the banking system?

A. It is unchanged, because the loan merely transferred Teodor's money elsewhere.

B. It has decreased by the amount that Harbor Bank retained as reserves.

C. It has grown, because the store's new deposit adds to Teodor's deposit.

D. It has decreased, because Harbor Bank surrendered part of Teodor's deposit.

9. Using the money multiplier, what is the largest total amount of deposits that Teodor's $5,000 can support across the banking system in this example, counting his original deposit?

_____ dollars

10. Suppose that every bank in this example kept 25 percent of each new deposit as reserves instead of 20 percent, with nothing else changed. How would the largest total of deposits that Teodor's $5,000 can support change?

A. It would increase, because banks would be holding additional reserves.

B. It would increase, because the money multiplier would rise to 25.

C. It would decrease, because banks would lend a smaller fraction of each deposit.

D. It would remain unchanged, because Teodor's deposit would still equal $5,000.