Test Bank for Money Banking and the Financial System 5th Edition by Hubbard, O'Brien

ISBN: 9780135429280

***Money, Banking, and the Financial System, 5e* (Hubbard/O'Brien)**
Chapter 1 Introducing Money and the Financial System

1.1 Key Components of the Financial System

1) The financial system is primarily a means by which
A) funds are transferred from savers to borrowers.
B) money is put into circulation.
C) the government puts into operation its plans for the economy.
D) business firms distribute their goods.
Answer: A
Diff: 1
Topic: financial system
Objective: Identify the key components of the financial system

2) Which of the following is NOT a financial asset?
A) a bond issued by Google
B) Wells Fargo Bank
C) a home mortgage loan
D) a certificate of deposit
Answer: B
Diff: 1
Topic: financial assets
Objective: Identify the key components of the financial system

3) If you buy a bond issued by Intel, the bond is a(n)
A) liability to Intel and an asset to you.
B) liability to you and an asset to Intel.
C) liability to both you and Intel.
D) asset to both you and Intel.
Answer: A
Diff: 2
Topic: financial assets
Objective: Identify the key components of the financial system

4) Which of the following forms the largest share of household holdings of financial assets?
A) corporate stocks
B) bonds
C) pension entitlements
D) equity in unincorporated businesses
Answer: C
Diff: 1
Topic: financial assets
Special Feature: Apply the Concept: What Do People Do with Their Savings?
Objective: Identify the key components of the financial system

5) From 1978 to 2024, the percentage of wealth held by households decreased for all of the following categories of assets EXCEPT
A) corporate stocks.
B) bonds.
C) deposits.
D) equity in unincorporated businesses.
Answer: A
Diff: 1
Topic: financial assets
Special Feature: Apply the Concept: What Do People Do with Their Savings?
Objective: Identify the key components of the financial system

6) Which of the following is NOT a key financial service provided by the financial system?
A) risk sharing
B) profitability
C) liquidity
D) information
Answer: B
Diff: 1
Topic: financial system
Objective: Identify the key components of the financial system

7) Economists define risk as
A) the difference between the interest rate borrowers pay and the interest rate lenders receive.
B) the chance that the value of financial assets will change from what you expect.
C) the ease with which an asset can be exchanged for other assets or for goods and services.
D) the difference between the return on common stock and the return on corporate bonds.
Answer: B
Diff: 1
Topic: financial system
Objective: Identify the key components of the financial system

8) Economists define liquidity as
A) the difference between the return on the asset and the return on a long-term U.S. Treasury bond.
B) the fraction the asset makes up of an investor's portfolio.
C) the ease with which an asset can be exchanged for money.
D) the difference between the total demand for an asset and the total supply of the asset.
Answer: C
Diff: 1
Topic: financial system
Objective: Identify the key components of the financial system

9) Which of the following assets is the most liquid?
A) money market mutual fund
B) computer
C) washing machine
D) U.S. Treasury bond
Answer: A
Diff: 2
Topic: financial system
Objective: Identify the key components of the financial system

10) By providing and communicating information, the financial system
A) reduces the difference between the return on three-month U.S. Treasury bills and the return on thirty-year U.S. Treasury bonds.
B) relieves individual savers from the necessity of searching out individual borrowers.
C) eliminates the risk in investing in the stock market.
D) guarantees investors a reasonable return on their money.
Answer: B
Diff: 2
Topic: financial system
Objective: Identify the key components of the financial system

11) Financial securities that represent partial ownership of a corporation are known as
A) bonds.
B) stocks.
C) coupons.
D) dividends.
Answer: B
Diff: 1
Topic: financial assets
Objective: Identify the key components of the financial system

12) Securitization is the process of
A) issuing stocks to finance capital spending.
B) issuing bonds to finance purchases of equipment and structures.
C) reducing risk by decreasing corporate debt loads.
D) converting loans into securities.
Answer: D
Diff: 1
Topic: financial assets
Objective: Identify the key components of the financial system

13) If a bank grants you a mortgage, the mortgage is
A) an asset to you as well as an asset to the bank.
B) an asset to you, but a liability to the bank.
C) a liability to you, but an asset to the bank.
D) a liability to you as well as a liability to the bank.
Answer: C
Diff: 2
Topic: financial assets
Objective: Identify the key components of the financial system

14) Financial markets
A) channel funds indirectly between borrowers and lenders.
B) channel funds directly from lenders to borrowers.
C) act as go-betweens by holding a portfolio of assets and issuing claims based on that portfolio to savers.
D) generally provide lenders with lower returns than do financial intermediaries.
Answer: B
Diff: 2
Topic: financial institutions
Objective: Identify the key components of the financial system

15) If you purchase a Treasury bond, the Treasury bond is
A) an asset to you as well as an asset to the U.S. government.
B) an asset to you, but a liability to the U.S. government.
C) a liability to you, but an asset to the U.S. government.
D) a liability to you as well as a liability to the U.S. government.
Answer: B
Diff: 2
Topic: financial assets
Objective: Identify the key components of the financial system

16) Funds flow from lenders to borrowers
A) indirectly through financial markets.
B) directly through financial intermediaries.
C) indirectly through financial intermediaries.
D) primarily through government agencies.
Answer: C
Diff: 1
Topic: financial institutions
Objective: Identify the key components of the financial system

17) Which of the following is NOT a financial intermediary?
A) NASDAQ
B) Allstate Insurance Company
C) Bank of America
D) Vanguard Total Stock Market Index Fund
Answer: A
Diff: 1
Topic: financial institutions
Objective: Identify the key components of the financial system

18) Which of the following is NOT a financial intermediary?
A) mutual fund
B) bank
C) stock exchange
D) insurance company
Answer: C
Diff: 1
Topic: financial institutions
Objective: Identify the key components of the financial system

19) The main role of financial intermediaries is to
A) provide funds to the federal government to cover the budget deficit.
B) borrow funds from savers and lend them to borrowers.
C) provide advice to consumers on how they should handle their finances.
D) help ensure that there is enough money in circulation.
Answer: B
Diff: 1
Topic: financial institutions
Objective: Identify the key components of the financial system

20) Financial intermediaries
A) include banks and other depository institutions.
B) include the New York and American Stock exchanges.
C) directly issue claims on individual borrowers to savers.
D) are owned and operated by the federal government.
Answer: A
Diff: 1
Topic: financial institutions
Objective: Identify the key components of the financial system

21) A "primary market" is a market
A) for government securities.
B) in which newly issued claims are sold to buyers by borrowers.
C) in which newly issued claims are sold by savers to borrowers.
D) for debt by large or "primary" corporations.
Answer: B
Diff: 1
Topic: financial institutions
Objective: Identify the key components of the financial system

22) A bank lending depositors' money to a local business and a pension fund investing contributions in shares of a company are similar financial activities in that
A) both involve the use of financial markets.
B) both involve funds being channeled from savers to borrowers through financial intermediaries.
C) both involve a reduction in the overall level of liquidity in the financial system.
D) both involve in an increase in the overall level of risk in the financial system.
Answer: B
Diff: 2
Topic: financial system
Objective: Identify the key components of the financial system

23) The leading federal regulatory body for financial markets in the United States is the
A) Federal Bureau of Investigation.
B) Securities and Exchange Commission.
C) Federal Financial Market Bureau.
D) Investors Protection Agency.
Answer: B
Diff: 1
Topic: financial institutions
Objective: Identify the key components of the financial system

24) Economists define money as
A) cash in circulation.
B) deposits in commercial banks.
C) anything that people are willing to accept in payment for goods and services or to pay off debts.
D) bonds issued by large corporations.
Answer: C
Diff: 1
Topic: financial system
Objective: Identify the key components of the financial system

25) The Federal Reserve System
A) is in charge of managing the New York Stock Exchange.
B) is headed by the Secretary of the Treasury.
C) is the central bank of the United States.
D) is responsible for conducting fiscal policy for the United States.
Answer: C
Diff: 1
Topic: Federal Reserve
Objective: Identify the key components of the financial system

26) Monetary policy refers to the government's
A) decisions on how much money to spend.
B) decisions on how much money to collect in taxes.
C) plans for retiring the national debt.
D) management of the money supply and interest rates to achieve macroeconomic objectives.
Answer: D
Diff: 1
Topic: Federal Reserve
Objective: Identify the key components of the financial system

27) Diversification refers to the
A) splitting of wealth into many assets.
B) difference between the liquidity of an asset and its risk.
C) difficulty of converting investments in common stocks into investments in bonds.
D) difficulty of selling common stocks in a weak market.
Answer: A
Diff: 1
Topic: financial system
Objective: Identify the key components of the financial system

28) The purpose of diversification is to
A) increase the liquidity of a financial portfolio.
B) reduce the brokerage fees involved in managing a financial portfolio.
C) reduce risk.
D) reduce tax liability.
Answer: C
Diff: 1
Topic: financial system
Objective: Identify the key components of the financial system

29) The financial system provides risk sharing by allowing
A) borrowers to obtain funds either directly or indirectly.
B) savers to earn interest tax-free.
C) borrowers to convert liabilities into assets.
D) savers to hold many assets.
Answer: D
Diff: 2
Topic: financial system
Objective: Identify the key components of the financial system

30) Liquidity
A) is the best available measure of the riskiness of an asset.
B) is a characteristic of money, and of no other asset.
C) is the ease with which an asset can be exchanged for money.
D) was declining for many financial assets during the 1990s.
Answer: C
Diff: 1
Topic: financial system
Objective: Identify the key components of the financial system

31) Which of the following assets is the least liquid?
A) money market mutual fund
B) stock
C) treasury bond
D) house
Answer: D
Diff: 1
Topic: financial system
Objective: Identify the key components of the financial system

32) Increased liquidity in recent decades has reduced interest rates on which of the following assets (holding constant all other things that affect interest rates)?
A) U.S. government bonds
B) bonds issued by large corporations
C) business loans
D) bonds issued by state governments
Answer: C
Diff: 2
Topic: financial system
Objective: Identify the key components of the financial system

33) The financial system performs the role of communicating information by
A) constantly increasing the liquidity of most assets.
B) constantly reducing the riskiness of most assets.
C) incorporating all available information into the prices of financial assets.
D) providing to investors for a nominal charge all government reports available about a particular company.
Answer: C
Diff: 2
Topic: financial system
Objective: Identify the key components of the financial system

34) The distinguishing feature of a well-functioning financial market is the
A) continual increase in the liquidity of most assets.
B) continual reduction in the riskiness of most assets.
C) increased ease of converting common stocks into bonds.
D) incorporation of available information into asset prices.
Answer: D
Diff: 2
Topic: financial system
Objective: Identify the key components of the financial system

35) In the United States, monetary policy is carried out by
A) the Federal Reserve System.
B) Congress.
C) the President.
D) Congress and the President acting together.
Answer: A
Diff: 1
Topic: Federal Reserve
Objective: Identify the key components of the financial system

36) In the United States, the lender of last resort is
A) Fannie Mae.
B) the Federal Reserve.
C) the Federal Deposit Insurance Corporation.
D) the Securities and Exchange Commission.
Answer: B
Diff: 1
Topic: Federal Reserve
Objective: Identify the key components of the financial system

37) A decline in bank lending has the most significant effect on
A) small businesses.
B) large businesses.
C) state governments.
D) the federal government.
Answer: A
Diff: 2
Topic: financial institutions
Special Feature: Apply the Concept: The Rise of Peer-to-Peer Lending and Fintech
Objective: Identify the key components of the financial system

38) As it became clear that the COVID pandemic would cause a significant recession in the United States, all of the following took place EXCEPT
A) the Federal Reserve took steps to stabilize the financial system.
B) employment started to decline.
C) many investors stopped buying financial assets.
D) cities and school districts found it easier to use financial markets to borrow money.
Answer: D
Diff: 2
Topic: financial crises of 2007-2009 and 2020
Special Feature: Chapter Opener: The Covid Pandemic, Financial Markets, and the Flow of Funds
Objective: Provide an overview of the financial crises of 2007-2009 and 2020

39) The Consumer Financial Protection Bureau estimates that about ________ people in the United States lack credit scores.
A) 800,000
B) 17 million
C) 45 million
D) 160 million
Answer: C
Diff: 1
Topic: financial system
Special Feature: Apply the Concept: The Rise of Peer-to-Peer Lending and Fintech
Objective: Provide an overview of the financial crises of 2007-2009 and 2020

40) The funds for loans from peer-to-peer lenders come from three key sources. Which of the following is NOT one of those key sources?
A) individuals
B) government
C) financial firms
D) other businesses
Answer: B
Diff: 1
Topic: financial institutions
Special Feature: Apply the Concept: The Rise of Peer-to-Peer Lending and Fintech
Objective: Identify the key components of the financial system

41) The interest rate on loans made by peer-to-peer lenders tends to be
A) lower than the interest rate on bonds and lower than the interest rate on credit cards.
B) higher than the interest rate on bonds and higher than the interest rate on credit cards.
C) lower than the interest rate on bonds and higher than the interest rate on credit cards.
D) higher than the interest rate on bonds and lower than the interest rate on credit cards.
Answer: D
Diff: 1
Topic: financial institutions
Special Feature: Apply the Concept: The Rise of Peer-to-Peer Lending and Fintech
Objective: Identify the key components of the financial system

42) Peer-to-peer lenders make a profit by
A) paying a lower interest rate to depositors than they charge to borrowers.
B) charging borrowers a one-time fee and charging those who provide funds a fee for collecting payments from borrowers.
C) charging borrowers quarterly interest rates, but paying the providers of funds on an annual basis.
D) securitizing their loans and selling them to large financial institutions.
Answer: B
Diff: 1
Topic: financial institutions
Special Feature: Apply the Concept: The Rise of Peer-to-Peer Lending and Fintech
Objective: Identify the key components of the financial system

43) The process by which investment banks guarantee a certain price to a firm issuing stocks or bonds is known as
A) underwriting.
B) securitization.
C) proprietary trading.
D) peer-to-peer lending.
Answer: A
Diff: 2
Topic: financial institutions
Objective: Identify the key components of the financial system

44) Until very recently, investment banks rarely engaged in which of the following?
A) proprietary trading
B) securitization
C) lending to households
D) underwriting
Answer: C
Diff: 2
Topic: financial institutions
Objective: Identify the key components of the financial system

45) All of the following represent returns to savers EXCEPT
A) dividends on stocks.
B) fees on loans.
C) interest payments on loans.
D) coupon payments on bonds.
Answer: B
Diff: 1
Topic: financial system
Objective: Identify the key components of the financial system

46) The role of the financial system is to
A) channel funds from households and other savers to businesses.
B) protect commercial banks from government regulation.
C) ensure that investment banks remain profitable.
D) provide loans from the Federal Reserve to households and businesses.
Answer: A
Diff: 1
Topic: financial system
Special Feature: Chapter Opener: The Covid Pandemic, Financial Markets, and the Flow of Funds
Objective: Identify the key components of the financial system

47) Ordinary (non-securitized) loans cannot be resold after they have been granted by a bank or another lender. Therefore, these loans are
A) financial assets but not financial securities.
B) financial securities but not financial assets.
C) both financial assets and financial securities.
D) neither financial assets nor financial securities.
Answer: A
Diff: 2
Topic: financial system
Special Feature: Solved Problem: The Services That Securitized Loans Provide
Objective: Identify the key components of the financial system

48) Because securitized loans are loans that have been bundled with other loans and sold to investors, they are
A) financial assets but not financial securities.
B) financial securities but not financial assets.
C) both financial assets and financial securities.
D) neither financial assets nor financial securities.
Answer: C
Diff: 2
Topic: financial system
Special Feature: Solved Problem: The Services That Securitized Loans Provide
Objective: Identify the key components of the financial system

49) All of the following are true regarding securitized loans EXCEPT
A) they provide risk sharing.
B) they provide information.
C) they provide liquidity.
D) they cannot be resold.
Answer: D
Diff: 2
Topic: financial system
Special Feature: Solved Problem: The Services That Securitized Loans Provide
Objective: Identify the key components of the financial system

50) Briefly discuss three reasons why firms may borrow funds from a bank.
Answer: Many firms rely on bank loans to meet their short-term needs for credit, such as funds to pay for inventories or to meet their payrolls. Many firms rely on bank loans to bridge the gap between the time they must pay for inventories or meet their payrolls and when they receive revenues from the sales of goods and services. Some firms also rely on bank loans to meet their long-term credit needs, such as funds they require to physically expand the firm.
Diff: 2
Topic: financial system
Objective: Identify the key components of the financial system

51) Briefly explain the process of securitizing mortgages.
Answer: The mortgage lender sells the loan to a government-sponsored enterprise or financial firm that bundles the mortgage with mortgages from other lenders, providing the basis for a mortgage-backed security.
Diff: 2
Topic: financial assets
Objective: Identify the key components of the financial system

52) How are interest payments on mortgages distributed to investors who own mortgage-backed securities?
Answer: The banks that grants, or *originates*, the original mortgages will still collect the interest paid by the borrowers and send those interest payments on to the government agency or financial firm to distribute to the investors who have bought the mortgage-backed security.
Diff: 2
Topic: financial assets
Objective: Identify the key components of the financial system

53) Briefly explain the difference in how banks and peer-to-peer lenders make profits on loans.
Answer: Banks have traditionally earned profits on loans by paying a lower interest rate to depositors than they charge to borrowers. Peer-to-peer lenders make profits by charging borrowers a one-time fee and charging the people providing funds a fee for collecting the payments from borrowers.
Diff: 2
Topic: financial institutions
Special Feature: Apply the Concept: The Rise of Peer-to-Peer Lending and Fintech
Objective: Identify the key components of the financial system

1.2 The Crises of 2007-2009 and 2020

1) Which president said, "We have now passed the worst ... and we shall rapidly recover"?
A) Herbert Hoover near the start of the Great Depression
B) Franklin Delano Roosevelt near the start of the Great Depression
C) George W. Bush near the start of the Great Recession
D) Donald Trump during the COVID-19 pandemic
Answer: A
Diff: 1
Topic: financial crises of 2007-2009 and 2020
Objective: Provide an overview of the financial crises of 2007-2009 and 2020

2) What made the recession of 2007-2009 different than any other recession since the Great Depression?
A) The government did not implement a fiscal stimulus.
B) The Fed failed to reduce interest rates.
C) It was accompanied by a financial crisis.
D) The impact was primarily limited to the financial sector.
Answer: C
Diff: 2
Topic: financial crises of 2007-2009 and 2020
Objective: Provide an overview of the financial crises of 2007-2009 and 2020

3) Fannie Mae and Freddie Mac both
A) sell bonds to investors and use the funds to purchase mortgages.
B) help regulate the banking system.
C) directly lend funds to people seeking mortgages.
D) reduce access to funds for mortgages by purchasing existing mortgages.
Answer: A
Diff: 2
Topic: financial crisis
Objective: Provide an overview of the financial crises of 2007-2009 and 2020

4) The Coronavirus Aid, Relief and Economic Security (CARES) Act provided all of the following EXCEPT
A) direct payments to households.
B) loans and grants to businesses under the Paycheck Protection Plan (PPP).
C) direct payments to educational institutions to compensate for lower tax revenues.
D) supplemental unemployment insurance payments.
Answer: C
Diff: 1
Topic: financial crisis
Objective: Provide an overview of the financial crises of 2007-2009 and 2020

5) Which of the following best describes a "bubble"?
A) when the price of an asset reaches a new high
B) an unsustainable increase in the price of a class of assets
C) rapid increases in inflation
D) when bond prices rise more quickly than stock prices
Answer: B
Diff: 1
Topic: financial crisis
Objective: Provide an overview of the financial crises of 2007-2009 and 2020

6) All of the following were significant changes in the mortgage market in the 2000s EXCEPT
A) investment banks became significant participants in the secondary mortgage market.
B) lenders loosened lending standards.
C) mortgage-backed securities became more popular with investors.
D) borrowers tended to increase the amount of their down payments.
Answer: D
Diff: 2
Topic: financial crisis
Objective: Provide an overview of the financial crises of 2007-2009 and 2020

7) In March 2021, Congress and President Biden enacted the American Rescue Plan. This spending bill included funding for the same categories as the CARES act, and also increased tax credits for
A) single-person households.
B) parents of children and for low-income workers.
C) individuals with annual income between $100,000 and $500,000.
D) charities and non-profit organizations.
Answer: B
Diff: 1
Topic: financial crisis
Objective: Provide an overview of the financial crises of 2007-2009 and 2020

8) The Troubled Asset Relief Program (TARP) allowed
A) the Treasury to inject funds into commercial banks in return for stock in the banks.
B) the Fed to provide funds to commercial banks in return for stock.
C) the Treasury to insure bank deposits at major U.S. banks.
D) the Fed to make loans to banks as the lender of last resort.
Answer: A
Diff: 1
Topic: financial crisis
Objective: Provide an overview of the financial crises of 2007-2009 and 2020

9) Which firm did the Treasury allow to fail during the financial crisis?
A) J.P. Morgan
B) Bear Stearns
C) Lehman Brothers
D) American International Group (AIG)
Answer: C
Diff: 1
Topic: financial crisis
Objective: Provide an overview of the financial crises of 2007-2009 and 2020

10) Alt-A borrowers were those who
A) used mortgages to purchase apartments.
B) chose adjustable-rate mortgages instead of fixed-rate mortgages.
C) borrowed using "interest-only" mortgages.
D) did not provide documentation of their income when applying for a mortgage.
Answer: D
Diff: 1
Topic: financial crisis
Objective: Provide an overview of the financial crises of 2007-2009 and 2020

11) The financial crisis of 2007-2009 worsened after the failure of which firm?
A) General Motors
B) Lehman Brothers
C) Bear Stearns
D) American International Group (AIG)
Answer: B
Diff: 1
Topic: financial crisis
Objective: Provide an overview of the financial crises of 2007-2009 and 2020

12) All of the following occurred at the beginning of the financial crisis of 2007-2009 EXCEPT
A) the value of mortgage-backed securities declined sharply.
B) many borrowers defaulted on their mortgages.
C) banks began to ease lending requirements to all borrowers.
D) commercial and investment banks suffered heavy losses due to their holdings of mortgage-backed securities.
Answer: C
Diff: 2
Topic: financial crisis
Objective: Provide an overview of the financial crises of 2007-2009 and 2020

13) Borrowers with flawed credit histories are referred to as ________ borrowers.
A) subprime
B) alt-A
C) adjustable-rate
D) securitized
Answer: A
Diff: 1
Topic: financial crises of 2007-2009 and 2020
Objective: Provide an overview of the financial crises of 2007-2009 and 2020

14) Which of the following was the largest fiscal policy action in U.S. history?
A) the Coronavirus Aid, Relief and Economic Security (CARES) Act
B) the Paycheck Protection Plan (PPP)
C) the Troubled Asset Relief Program (TARP)
D) the Affordable Care Act (ACA)
Answer: A
Diff: 1
Topic: financial crisis
Objective: Provide an overview of the financial crises of 2007-2009 and 2020

15) Why did some economists and policymakers criticize the Fed and Treasury for arranging the sale of Bear Stearns to JP Morgan Chase in 2008?
Answer: The main concern was with the *moral hazard problem*, which is the possibility that managers of financial firms such as Bear Stearns might make riskier investments if they believe that the federal government will save them from bankruptcy.
Diff: 2
Topic: financial crisis
Objective: Provide an overview of the financial crises of 2007-2009 and 2020

16) What are the four main provisions of the Coronavirus Aid, Relief and Economic Security (CARES) act?
Answer:
1. Direct payments to households
2. Supplemental unemployment insurance payments
3. Funds to state governments to offset some of their costs from fighting the epidemic
4. Loans and grants to businesses under the Paycheck Protection Plan (PPP)
Diff: 2
Topic: financial crisis
Objective: Provide an overview of the financial crises of 2007-2009 and 2020

17) How did securitization and the bursting of the housing bubble contribute to the Financial Crisis of 2007-2009?
Answer: Many investment banks and other investors purchased mortgage-backed securities because they paid higher interest rates than securities of comparable default risk. When the housing bubble burst, the value of the mortgage-backed securities declined significantly, resulting in massive losses for those who owned them, including many investment banks.
Diff: 2
Topic: financial crisis
Objective: Provide an overview of the financial crises of 2007-2009 and 2020

Chapter 1
Introducing Money and the Financial System

▪ Brief Chapter Summary and Learning Objectives

1.1 Key Components of the Financial System
Identify the key components of the financial system.

- Financial assets, financial institutions, the Federal Reserve, and financial regulators are the key components of the financial system.
- There are many different types of financial assets with distinctive characteristics.
- Financial institutions are distinguished by how they transfer funds from savers or lenders to borrowers.
- There are various regulators that provide oversight to different sectors of the financial system.

1.2 The Crises of 2007–2009 and 2020
Provide an overview of the financial crises of 2007–2009 and 2020.

- The financial crises of 2007–2009 and 2020 give us an opportunity to explore the importance of the financial system and the role of the Fed in the economy.

1.3 Key Issues and Questions About Money, Banking, and the Financial System
Explain the key issues and questions concerning the financial system.

- Beginning with Chapter 2, the start of each chapter highlights one key issue and a related question. Answers to the questions appear at the end of the chapters, using analysis from the chapters.

■ Key Terms

Asset: Anything of value owned by a person or a firm.

Bond: A financial security issued by a corporation or a government that represents a promise to repay a fixed amount of money.

Bubble: An unsustainable increase in the price of a class of assets.

Commercial bank: A financial firm that serves as a financial intermediary by taking in deposits and using them to make loans.

Diversification: Distributing wealth among many different assets to reduce risk.

Interest rate: The cost of borrowing funds (or the payment for lending funds), usually expressed as a percentage of the amount borrowed.

Liquidity: The ease with which an asset can be exchanged for money.

Monetary policy: The actions the Federal Reserve takes to manage the money supply and interest rates to pursue macroeconomic policy objectives.

Money: Anything that is generally accepted in payment for goods and services or to pay off debts.

Dividend: A payment that a corporation makes to its shareholders.

Federal funds rate, The interest rate that banks charge each other on short-term loans.

Federal Reserve: The central bank of the United States; usually referred to as "the Fed."

Financial asset: An asset that represents a claim on someone else for a payment.

Financial crisis: A significant disruption in the flow of funds from lender to borrowers.

Financial intermediary: Financial institutions, including financial firms such as banks, insurance companies, and financial companies, that accept funds from savers and lend them to borrowers.

Financial liability: A financial claim owed by a person or a firm.

Financial market: A place or channel for buying or selling stocks, bonds, and other securities.

Foreign exchange: Units of foreign currency.

Information: Facts about borrowers and expectations of returns on financial assets.

Money supply: The total quantity of money in the economy.

Portfolio: A collection of assets, such as stocks and bonds.

Primary market: A financial market in which stocks, bonds, and other securities are sold for the first time.

Risk sharing: A service the financial system provides that allows savers to spread and transfer risk.

Secondary market: A financial market in which investors buy and sell existing securities.

Securitization: The process of converting loans and other financial assets that are not tradable into securities.

Security: A financial asset that can be bought and sold in a financial market.

Stock: A financial security that represents partial ownership of a firm; also called an equity.

Chapter Outline

The Covid Pandemic, Financial Markets, and the Flow of Funds

Individuals and firms buy and sell stocks, bonds, and other securities in financial markets. By early 2020, the Covid pandemic had spread worldwide. Governments responded by issuing travel restrictions, lockdowns of nonessential businesses, and stay-at-home orders. March 16, 2020 was "one of the worst days the financial markets have seen," according to an article in the *Wall Street Journal*. As it became clear that the pandemic would cause a significant recession, many investors stopped buying financial assets. Corporations, cities, and school districts all found it difficult to use financial markets to borrow money and so had difficulty paying their bills, including the salaries and wages of their employees.

The Federal Reserve (the Fed)—the central bank of the United States—took steps to stabilize the financial system and restore the flow of credit to borrowers. A country must have a well-functioning financial system to achieve economic prosperity. Without an efficient financial system, there will be a little borrowing or lending, and so people will be stuck earning low incomes and the country will make very little economic progress.

To see the importance of borrowing and lending to an economy, suppose that you come up with an idea for a company: you design a smartphone app that will deliver a textbook chapter to a student's phone for a limited time for a low price. You have a lot of work to do to get your company off the ground, including—perfecting the software, designing the page in the app store where you will sell it, negotiating with textbook publishers to gain access to their books, and marketing your idea to students. You will have to spend a lot of money before you receive any revenue from sales. Where will you get this money?

We can demonstrate the importance of borrowing and lending to an economy by considering the process a company uses to develop a new product. The company will have to spend a lot of money before it receives any revenue from sales of the new product. Nearly every entrepreneur faces the same challenge. The role of the financial system is to channel funds from savers to businesses. During the Great Depression of the 1930s and the more recent recessions of 2007-2009 and 2020 were all accompanied by financial crises. Officials of the U.S. Treasury Department and the Fed took strong actions during the crises of 2007–2009 and 2020 to restore the flow of money through banks and financial markets to firms and households.. As we'll see in later chapters, some of those interventions were partially responsible for inflation rising rapidly beginning in the spring of 2021.

Teaching Tips

This chapter contains two innovations worth noting: (1) An overview of the Federal Reserve System and (2) an overview of the financial crises of 2007–2009 and 2020. Federal Reserve policy plays an important role in most money and banking courses. Because of the variety of new policies the Fed implemented during the financial crisis, many instructors have begun discussing the Fed earlier in their courses. In their own teaching, the authors found that they couldn't always rely on students recalling the basics of how the Fed operates from their principles courses. So the authors included an overview in this first chapter.

Many students have become more interested in the financial system due to the financial crises of 2007–2009 and 2020. The Covid pandemic will be fresh in the minds of undergraduates and many of their families still bear financial scars from the deep recession of 2007–2009. Some students have formed their opinions of what happened during these episodes based on incomplete or erroneous information. Discussion of the two financial crises at the beginning of the semester can help to motivate the study of money, banking, and financial markets while also highlighting why students need to grasp the fundamental concepts underlying the financial system, including how financial assets are traded in financial markets, how financial institutions operate, and the role of regulatory agencies (including the Fed).

Instructors who prefer to leave discussion of the Federal Reserve and the financial crises for later in the course should feel free to do so by omitting these sections of the chapter. None of the discussion in later chapters directly requires knowledge of these topics.

1.1 Key Components of the Financial System

Learning Objective: Identify the key components of the financial system.

There are three major components of the financial system: Financial assets, financial institutions, and the Federal Reserve and other financial regulators.

A. Financial Assets

Financial assets can be divided among five categories: money, stocks, bonds, foreign exchange, and securitized loans. Money is anything that people are willing to accept in payment for goods and services or to pay off debts. Stocks, also called *equities*, are financial securities that represent partial ownership of a firm. A *dividend* is a payment that a corporation makes to its shareholders. When you buy a bond issued by a corporation or a government, you are lending the corporation or the government a fixed amount of money. Foreign exchange refers to units of foreign currency. Loans that banks could sell on financial markets become securities, so the process of converting loans into securities is known as securitization.

B. Financial Institutions

The financial system is made up of two types of financial institutions: (1) banks and other financial intermediaries and (2) financial markets. Funds flow from lenders to borrowers indirectly through financial intermediaries, such as banks, or directly through financial markets. Commercial banks are the most important financial intermediaries. Some financial intermediaries, such as savings-and-loans, savings banks, and credit unions, are legally distinct from banks, although these "nonbanks" operate in a very similar way by taking in deposits and making loans. Other financial intermediaries include investment banks, insurance companies, pension funds, mutual funds and exchange-traded funds (ETFs), and hedge funds. Financial markets are places or channels for buying and selling stocks, bonds, and other securities.

C. The Federal Reserve and Other Financial Regulators

The federal government of the United States has several agencies that are devoted to regulating the financial system, including:

- The Securities and Exchange Commission (SEC), which regulates financial markets
- The Federal Deposit Insurance Corporation (FDIC), which insures deposits in banks
- The Office of the Comptroller of the Currency, which regulates federally chartered banks
- The Federal Reserve System, which is the central bank of the United States
- The Consumer Finance Protection Bureau (CFPB), which Congress created to protect consumers from fraud and deceptive practices in financial markets.

Two of the major roles of the Fed are serving as the lender of last resort and conducting monetary policy. Monetary policy is the actions the Federal Reserve takes to manage the money supply and interest rates to pursue macroeconomic policy objectives such as high levels of employment, low rates of inflation, high rates of growth, and stability of the financial system. Figure 1.2 shows the location of the 12 districts of the Federal Reserve System.

D. What Does the Financial System Do?

The financial system provides three key financial services: risk sharing, liquidity, and information. Risk sharing gives savers and borrowers ways to reduce the uncertainty to which they are exposed. Liquidity is a measure of how easily an asset can be converted to cash. The financial system gathers and communicates information about borrowers' circumstances.

Teaching Tips

Solved Problem 1.1, "The Services That Securitized Loans Provide," shows students how to solve an economic problem by breaking it down step by step. Encourage students to read the *Solved Problems* in each chapter because this feature can help them solve homework problems on their own and develop the skills they'll need to perform well on exams.

1.2 The Crises of 2007–2009 and 2020

Learning Objective: Provide an overview of the financial crises of 2007–2009 and 2020.

The only episode comparable to the financial crises and recessions of 2007–2009 and 2020 during the past 100 years was the Great Depression of the 1930s.

A. Origins of the 2007-2009 Financial Crisis

The origins of the financial crisis lie in large part in the housing bubble of 2000–2005. Many economists believe that changes in the market for mortgages played a key role in the housing bubble. By the 2000s, significant changes had taken place in the mortgage market. First, investment banks became significant participants in the secondary market for mortgages. Second, by the height of the housing bubble in 2005 and early 2006, lenders had greatly loosened the standards for obtaining a mortgage loan. The decline in housing prices that began in 2006 led to rising defaults among subprime and Alt-A borrowers, borrowers with adjustable-rate mortgages, and borrowers who had made only small down payments. By mid-2007, the decline in the value of mortgage-backed securities and the large losses suffered by commercial and investment banks began to cause turmoil in the financial system. Many investors refused to buy mortgage-backed securities, and some investors would only buy bonds issued by the U.S. Treasury. Banks began to restrict credit to all but the safest borrowers. The flow of funds from savers to borrowers, on which the economy depends, began to be greatly reduced.

B. The Deepening Crisis and the Response of the Fed and Treasury

Some economists and policymakers criticized the Fed and the Treasury for arranging the sale of the failing investment bank Bear Stearns to JP Morgan Chase in March 2008. The main concern was with moral hazard, which is the possibility that managers of other financial firms would make risky investments if they believed that the government would also save them from bankruptcy. In September 2008, the Fed and Treasury allowed another investment bank, Lehman Brothers, to go bankrupt. The fallout from the Lehman Brothers bankruptcy had widespread repercussions, including a sharp decline in most types of lending. In October 2008, Congress passed the *Troubled Asset Relief Program (TARP)*, under which the Treasury provided funds to commercial banks in exchange for stock in those banks. These actions by the Fed and the Treasury were meant to restore the flow of funds from savers to borrowers.

C. The Financial Crisis Caused by the Covid Pandemic

The financial system suffered an immediate shock from the effects of the Covid pandemic. By mid-March 2020, many nonessential businesses were closed, reducing revenues and leading firms to lay off workers. Savers and investors became reluctant to lend because they worried that both household and business borrowers might have difficulty repaying loans. The Fed revived some of the lending programs used during the 2007–2009 financial crisis and set up new facilities with the goal of maintaining the flow of funds. The federal government also passed several aid packages. The main aid package was the Coronavirus Aid, Relief, and Economic Security (CARES) Act, a more than $2 trillion spending bill—the largest fiscal policy action in U.S. history. Many economists and policymakers believed the severity of the financial crisis resulting from the Covid pandemic justified the Fed's use of innovative policies, but some worried that the Fed's actions in working closely with the U.S. Treasury during the crisis might reduce the Fed's independence. In March 2021, Congress and President Joe Biden enacted the American Rescue Plan, a $1.9 trillion spending bill that included funding for the same categories as the CARES Act and also increased tax credits for parents of children and for low-income workers. Some economists criticized the American Rescue Plan on the grounds that the economy was already rapidly recovering from the pandemic, making it likely that the additional spending would increase the inflation rate.

1.3 Key Issues and Questions About Money, Banking, and the Financial System

Learning Objective: Explain the key issues and questions concerning the financial system.
This section lists the issues and questions that are addressed in the main text, beginning with Chapter 2.

Teaching Tip

The "Issues and Questions" in Section 1.3 serve as a roadmap for the topics the book will explore in the remaining chapters.