ANSWER OUTLINE

ECONOMICS 353 **L. Tesfatsion/Fall 06**

EXERCISE 4: Six Questions (8 Points Total) DUE: Tuesday, September 26, 2:10pm

****IMPORTANT REMINDER: LATE ASSIGNMENTS WILL NOT BE ACCEPTED – NO EXCEPTIONS****

EXERCISE INSTRUCTIONS:

- (1) Please **fill in your name and student ID number** on Side 1 of your bubble sheet and write **Econ 353-Ex4** in the top margin of Side 1.
- (2) Use a number 2 pencil to **mark your answers** on Side 1 of the bubble sheet to the first five questions Q1 through Q5, below, which are in multiple choice format.
- (3) The sixth question Q6 is a Web Browse Exercise that asks you to comment on remarks by Alan Greenspan on the so-called "Free Banking Era" (1837-1863) in the United States. Please put your **name and student ID number** at the top of your answer sheet for Q6 along with **Econ 353-Ex4:Q6** and **separately** hand in the answer sheet for Q6 in addition to your bubble sheet answers for questions Q1 through Q5.
- (4) Each question Q1 through Q5 is worth 1 point, and Q6 is worth 3 points.

Q1 (1 point). MONEY is defined as

A. anything with intrinsic use value.

B. anything that permits the storage of value over time.

C C. anything generally accepted as payment for goods and services and for the repayment of debts.

D. any claim on real assets.

E. anything that serves as a unit of account.

Q2 (1 Point). In economies with at least four types of goods, ADVANTAGES of a monetary payment system (MPS) relative to a barter payment system (BPS) include

A. an MPS discourages production specialization and division of labor.

B B. an MPS requires fewer prices to conduct trades.

C. an MPS ensures that all traded quantities have intrinsic use value.

D. all of the above.

E. Only A and B.

Q3 (1 Point). One important monetary development leading up to the outbreak of the American Revolution in 1775 was that Britain

A. forbade the colonies from establishing a central bank.

B B. forbade the colonies from issuing paper money as legal tender.

C. forbade the colonies from issuing backed paper monies.

D. forbade the colonies from using British coins.

Q4 (1 Point). The monetary aggregate M1 exemplifies the ____ approach to measuring money in that ________

A. empirical; M1 consists of a selection of financial assets judged best for controlling GDP growth.

B. empirical; M1 consists of a weighted aggregate (average) of all of the most widely held financial assets.

C C. theoretical; M1 consists of a selection of financial assets judged to most closely satisfy the definition of money.

D. theoretical; M1 consists of a weighted aggregate (average) of all financial assets acting to some degree as a medium of exchange.

Q5 (1 Point). Monetary policymakers have learned from experience that

A A. M1 and M2 cannot be used interchangeably because they do not always move together.

B. M1 is preferable to M2 as a measure of money because it is less volatile over time.

C. M1 and M2 can be used interchangeably because they tend to move together over time.

D. short-run movements in M1 and M2 are more reliable than longer-run movements because of data revisions.

**SEE THE FOLLOWING PAGE FOR
Q6: WEB EXERCISE**

Q6: Web Exercise (3 Points Total): The U.S. Free Banking Era (1837-1863)

Key On-Line References:

[**1**] Alan Greenspan, "Our Banking History," Remarks Before the Annual Meeting and Conference of the State Bank Supervisors, Nashville, Tennessee
http://www.federalreserve.gov/Boarddocs/speeches/1998/19980502.htm

[**2**] "The Free Banking Era: More than 30,000 Different Notes in Circulation," Federal Reserve Board of San Francisco, April 5, 2006.
http://www.frbsf.org/currency/expansion/history/text2.html

[**3**] Gerald P. Dwyer, Jr., "Wildcat Banking, Banking Panics, and Free Banking in the United States," *Economic Review*, Federal Reserve Bank of Atlanta, December 1996.
http://www.frbatlanta.org/filelegacydocs/ACFCE.pdf#search=%22free%20banking%20era%22

NOTE: Please prepare your answer to Q6 on a separate answer sheet with "Econ 353-Ex4:Q6" at the top of the sheet. Turn in your answer sheet for Q6 together with your bubble sheet answers for Q1 through Q5 – but please do not staple or otherwise attach the bubble sheet to your Q6 answer sheet.

PART A (1/2 Point): Greenspan [1] argues that entry into the U.S. banking business between 1781 and the start of the Free Banking Era "was far from free." Explain more precisely what Greenspan meant by this statement.

Answer Outline to Q6:Part A: In ref.[1, pp. 1-2], Greenspan notes that — from 1781 through the start of the Free Banking Era — anyone seeking entry into the U.S. banking industry typically sought a corporate charter either from state or federal authorities. He goes on to say (page 2) that most charters were issued at the state level and — by the early 1800s — chartering decisions by state authorities had become heavily influenced by political considerations. In this sense, entry into the banking industry was not "free" but rather was heavily politicized.

PART B (1/2 Point): According to Greenspan [1], what does "free banking" refer to, and what was the purpose of introducing it?

Answer Outline to Q6:Part B: According to Greenspan [1, pp. 2-3], "free banking" meant that entities could enter the banking industry under the terms of a state's general law of incorporation rather than by means of discretionary approval through a specific legislative act. The purpose was to reduce the extent to which political favoritism and bribery were being used to determine the award of bank charters.

PART C (1 Point): Does Greenspan [1] view the Free Banking Era as a time of increasing bank instability (i.e., increasing risk of bank defaults) that established the need for tighter federal regulation over the U.S. banking industry? Explain.

Answer Outline to Q6:Part C: No. To the contrary, Greenspan (pages 2-3) appears to take the view that, apart from times of severe economic shocks, the banking sector exhibits a great deal of stability stemming mainly from state regulation and supervision together with the discipline of the marketplace. He argues (p. 3) that the Free Banking Era was not nearly as unstable as commonly perceived; indeed, he asserts there was a reduction in the risk of bank defaults over the course of the Free Banking Era, reflecting the increasing sophistication of depositors and an improvement in state regulation and supervision helped along by technological improvements facilitating the monitoring of banks. Interestingly, he suggests that the ABSENCE of depositor safety nets during the Free Banking Era reduced moral hazard problems because depositors had keen reasons to keep close watch over bank activities.

PART D (1 Point): Is Greenspan's conception of bank stability/instability during the Free Banking Era in accordance with the views expressed by the Federal Reserve Board of San Franciso in ref.[2]? In accordance with the views expressed by Dwyer in ref.[3]? Explain briefly.

Answer Outline to Q6:Part D:

In ref.[2] the Federal Reserve Board of San Francisco (FRB-SF) speaks of the "instability" of the Free Banking Era, referring specifically to the "especially obvious" instability in the state of Michigan as follows: "Almost all of the banks formed under Michigan's General Banking Law (in 1837) failed or went broke within two years. The terms "broken banks" and "wildcat banks" are used to describe these short-lived Michigan banks. Overall, the FRB-SF in ref.[2] paints a much darker picture of the Free Banking Era than Greenspan in ref.[1].

Dwyer [3, p. 6] agrees with the FRB-SF that Michigan was "a fantastic failure of free banking." However, Dwyer notes (p. 4) that 17 other states also eventually adopted free banking. Of these, Indiana, Illinois, and Wisconsin had severe difficulties (including bank panics), New York had a "notably successful" experience, and other states fell somewhere in between. Dwyer concludes (p. 16) that "free banking in the United States was not the disaster portrayed by some, but it also was not problem-free." He also asserts: "With the exception of episodic events that generated atypical losses, free banking's performance improved over time. This improvement is associated with, and possibly due to, adjustments in the laws in response to problems that arose." Consequently, Dwyer seems generally in accordance with Greenspan in his assessment of the Free Banking Era.