Exercise walk-through

Money and banking ▪ 9.4

eXercise

You must be able to

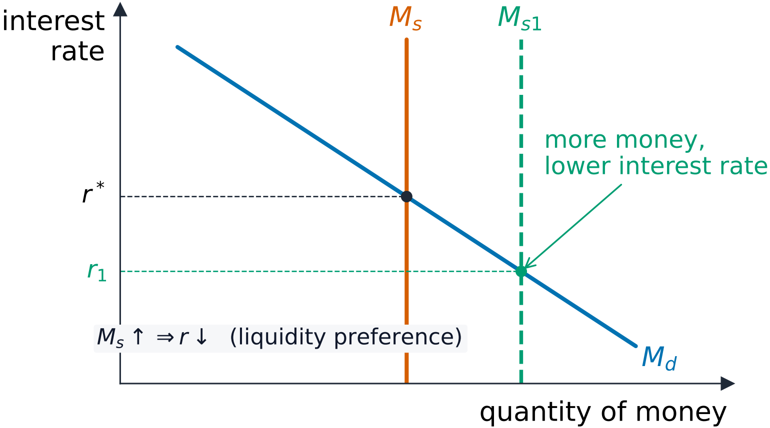
- state the four functions of money
- explain the roles of central and commercial banks
- analyse how the interest rate is set and the risk of moral hazard

Method — Money and the money market

- **Four functions of money: medium of exchange 交换媒介, store of value 价值储藏, unit of account 记账单位, standard of deferred payment 延期支付标准.**
- **Central bank 中央银行**: issues notes, runs monetary policy, **lender of last resort 最后贷款人**. **Commercial banks** create money by lending.
- **Liquidity preference 流动性偏好**: the demand to hold money → with money supply, sets the **interest rate 利率**.
- **Moral hazard 道德风险**: banks take bigger risks if they expect a bailout.

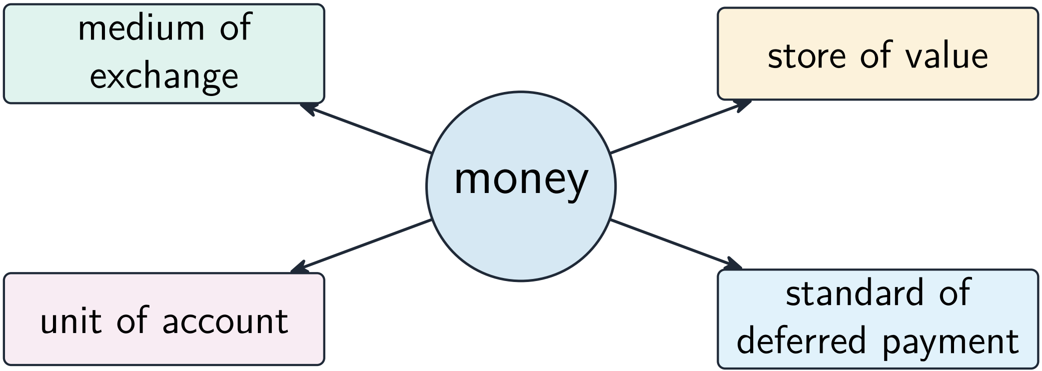
Answer shapes: AO1 + AO2 + AO3 (analysis) + AO4 (a supported judgement *in context*).

Method — Money and the money market



The interest rate is set where money demand meets money supply

Method — Money and the money market



Practice 2.1 ▪ 2 marks

State the four functions of money.

Solution 2.1

Method: Money and the money market

Worked steps

medium of exchange; store of value; unit of account; standard of deferred payment (2 for all four; 1 for two or three).

Practice 2.2 ▪ 2 marks

Define the term *liquidity preference*.

Solution 2.2

Method: Money and the money market

Worked steps

the demand to hold money rather than other assets, because of its liquidity (the ability to spend it at once) (2 for a clear definition; 1 for a partial idea).

Practice 2.3 ▪ 2 marks

Define the term *moral hazard*.

Solution 2.3

Method: Money and the money market

Worked steps

the risk that a party takes bigger risks because it expects to be protected from the consequences (e.g. a bank expecting a bailout) (2 for a clear definition; 1 for a partial idea).

Exam-style 3.1 ▪ 1 mark

Which is **not** a function of money?

A a medium of exchange

B a store of value

C a factor of production

D a unit of account

Solution 3.1

- **A** a medium of exchange
- **B** a store of value
- **C** a factor of production ✓
- **D** a unit of account

Worked steps

C. A factor of production is not a function of money.

Exam-style 3.2 ▪ 6 marks

Explain how an increase in the money supply affects the interest rate.

Solution 3.2

Method: Money and the money market

Worked steps

[6] AO1 1 + AO3 up to 5 — with money demand (liquidity preference) downward-sloping, a larger money supply means there is more money than people wish to hold at the current rate → they lend the surplus, bidding the interest rate down → the rate falls until demand for money equals the new, larger supply.

Exam-style 3.3 ▪ 12 marks

Discuss whether moral hazard means governments should never rescue failing banks.

Solution 3.3

Method: Money and the money market

Worked steps

[12] AO1/AO2/AO3 up to 8 + AO4 up to 4. **For not rescuing:** bailouts create moral hazard — banks lend recklessly expecting rescue, raising future risk. **Against:** letting a major bank fail can trigger a wider financial crisis, freezing lending and harming the whole economy. Judgement: a blanket “never rescue” rule is risky; the better answer is to rescue only where failure threatens the system, while adding regulation to limit moral hazard — it depends on the bank’s systemic importance.