MONEY AND BANKING

I. THE FUNCTIONS OF MONEY

a. MEDIUM OF EXCHANGE – Is usable to buy goods and services.

b. UNIT OF ACCOUNT – Society (U.S.) uses monetary units- dollar- as a yardstick for measuring the relative worth of a wide variety of goods and services. Prices stated in terms of monetary unit.

c. STORE OF VALUE- allows people to transfer purchasing power from the present to the future. In order to buy things later, they store some of their wealth as money.

d. People can choose many other assets other than money to store wealth; real estate, stocks, bonds, commodities, precious metals, etc.

   i. Key to money is that it is LIQUID- ease of convertibility into cash. By definition, cash is perfectly liquid.

II. THE COMPONENTS OF THE MONEY SUPPLY

a. MONEY DEFINITION: M1

   i. Consists of:

      1. Currency (coins and paper money) in the hands of the nonbank public.
      2. All checkable deposits (all deposits in commercial banks and "thrift" of savings institutions where checks of any size can be drawn).

   ii. CURRENCY: COINS AND PAPER MONEY

      1. Coins are issued by the U.S. Treasury while paper money consists of FEDERAL RESERVE

NOTES issued by the Federal Reserve System (the U.S. central bank). Coins are minted by the U.S. Mint while the paper money is printed by the Bureau of Engraving and Printing: both are part of the U.S. Treasury.

2. Money is TOKEN MONEY – where the currency has greater value than the materials used to produce it.
3. Figure 16.1 on page 389 shows the components of M1

iii. CHECKABLE DEPOSITS- The safety and convenience of checks has made checkable deposits a large component of M1
   1. About 44% of M1

iv. MONEY, M1 = CURRENCY + CHECKABLE DEPOSITS.

v. INSTITUTIONS THAT OFFER CHECKABLE DEPOSITS
   1. Commercial banks are the primary depository institutions.
   2. S&L's, mutual savings banks, and credit unions or collectively THRIFT INSTITUTIONS are the other component.

vi. TWO QUALIFICATIONS
   1. Currency held by the U.S. Treasury, the Federal Reserve Banks, commercial banks, or thrift institutions is EXCLUDED from M1 and other measures of the Money Supply.

2. Any checkable deposits by the government (U.S. Treasury) or the Federal Reserve that are held by commercial banks or thrifts.

b. MONEY DEFINITION: M2

i. These are NEAR-MONIES - highly liquid financial assets

ii. SAVINGS DEPOSITS, INCLUDING MONEY MARKET DEPOSIT ACCOUNTS

1. A person can withdraw funds from a MONEY MARKET DEPOSIT ACCOUNT (MMDA) which is an interest bearing account containing interest-earning short term securities

iii. SMALL (LESS THAN $100K) TIME DEPOSITS

1. CD'S

iv. MONEY MARKET MUTUAL FUNDS (MMMF)

1. Combine the funds of individual shareholders to buy interest-bearing short-term credit instruments such as CDs and U.S. government securities.

v. ALL THREE CATEGORIES OF NEAR-MONIES IMPLY SUBSTANTIAL LIQUIDITY.

vi. MONEY, M2 = M1+SAVINGS DEPOSITS, INCLUDING MMDAs + SMALL (LESS THAN $100K) TIME DEPOSITS = MMMFs

III. WHAT "BACKS" THE MONEY SUPPLY?

a. Backed by the government’s ability to keep the value of money relatively stable.
b. If the government backed money with something tangible, such as gold, the value of the money would be totally dependent on the supply and demand of gold
    i. By not backing money with something tangible, the government has chosen to give itself the ability to freely manage the nation’s money supply.
c. VALUE OF MONEY – What give money its value?
    i. ACCEPTABILITY – People accept money as value: acceptable as a medium of exchange.
    ii. LEGAL TENDER – government has designated money as legal tender; the general acceptance of paper currency as money is more important than legal tender.
    iii. RELATIVE SCARCITY- Scarcity relative to its utility.
d. ARE CREDIT CARDS MONEY? No…it is a short-term loan from the issuing financial institution. They allow individuals and businesses to economize in the use of money…don’t have to carry around large amounts of cash.
e. MONEY AND PRICES- The purchasing power of money is the amount of goods and services a unit of money will buy
    i. THE PURCHASING POWER OF THE DOLLAR – When the CPI goes up, the purchasing power of money decreases:

example – a loaf of bread 30 years ago versus now.

ii. INFLATION AND ACCEPTABILITY
   1. Runaway inflation or HYPERINFLATION can significantly depreciate the purchasing power of money between the time it is received and the time it is spent.
   2. People will use money as a store of value only as long as there is no significant deterioration in the value of that money due to inflation.

IV. THE FEDERAL RESERVE AND THE BANKING SYSTEM.
   a. A key element of the U.S. Banking system is the FEDERAL RESERVE SYSTEM (the FED).
      i. Review figure 16.2 on page 395
   b. BOARD OF GOVERNORS
      i. The central authority of the FED.
      ii. U.S. President, with confirmation of Senate, appoint board members,
         1. Terms are 14 years and staggered.
         2. President selects the chairperson (Ben Bernancke) and vice-chairperson; 4 year terms which can be reappointed.
   c. THE 12 FEDERAL RESERVE BANKS
      i. Review figure 16.3 on page 396
      ii. CENTRAL BANKS- the 12 banks
      iii. QUASI-PUBLIC BANKS – blends private ownership and public control. The Federal Reserve Bank is owned by the

private commercial banks in its district, but act like public institutions.

iv. BANKERS' BANKS – they perform essentially the same functions for banks and thrifts as those institutions perform for the public; lender of last resort; they issue currency which regular commercial banks do not.

d. FOMC – FEDERAL OPEN MARKET COMMITTEE
   i. Seven members of the Board of Governors
   ii. President of NY Federal Reserve Bank
   iii. Four of the remaining presidents of Federal Reserve Banks on a 1-year rotating basis.
   iv. Directs the purchase and sale of government securities (bills, notes and bonds) in the open market on a daily basis.
   v. Named open market operations.

e. COMMERCIAL BANKS AND THRIFTS
   i. About 7300 commercial banks; ¾ are state chartered banks; the other ¼ are national banks, chartered by the federal government.
   ii. The 11,000 thrifts, mostly credit unions, are regulated by agencies separate from the Federal Reserve.

f. FED FUNCTIONS AND RESPONSIBILITIES
   i. ISSUING CURRENCY – Issues Federal Reserve Notes, the paper currency of the U.S. monetary system.

ii. SETTING RESERVE REQUIREMENTS AND HOLDING RESERVES – the FED sets legal reserve ratios, which the banks must maintain.
iii. LENDING MONEY TO BANKS AND THRIFTS; charges them an interest rate called the DISCOUNT RATE.
iv. PROVIDING FOR CHECK COLLECTION- a banking system with a means for collecting checks.
v. ACTING AS A FISCAL AGENT- provider of financial services for the Federal government; carries out activities in tax collection and selling and redeeming bonds.
vi. SUPERVISING BANKS- periodic examinations to assess bank profitability and performance, along with uncovering questionable practices and fraud.
vii. CONTROLLING THE MONEY SUPPLY- major task of the FED. Indirectly sets interest rates according to the needs of the economy.

g. FEDERAL RESERVE INDEPENDENCE
   i. Congress purposely established the FED as an independent agency of government so there is no political pressure to act in certain ways.

V. THE FRACTIONAL RESERVE SYSTEM
   a. Only a portion of the total money supply is held in reserve as currency.
   b. Banks can create money through lending; depends on the amount of reserves they need to hold

i. Smaller amount of reserves held, larger amount of money created.
ii. CURRENCY RESERVES- amount that the banks feel obligated or by law required to keep.
iii. Could be vulnerable to panics or runs on the bank.

VI. A SINGLE COMMERCIAL BANK
a. BALANCE SHEET is an statement of assets and claims against those assets; summarizes the financial status of a bank at a given point in time.
i. ASSETS = LIABILITIES + NET WORTH
b. TRANSACTION 1: CREATING A BANK – review balance sheet on page 401
c. TRANSACTION 2: ACQUIRING PROPERTY AND EQUIPMENT – review balance sheet on page 402
d. TRANSACTION 3: ACCEPTING DEPOSITS – review on page 402
e. TRANSACTION 4: DEPOSITING RESERVES IN A FEDERAL RESERVE BANK – must keep required reserves in own bank; specified percentage is the RESERVE RATIO.
i. RESERVE RATIO = COMMERCIAL BANK'S REQUIRED RESERVES / COMMERCIAL BANK'S CHECKABLE-DEPOSIT LIABILITIES.
f. EXCESS RESERVES = ACTUAL RESERVES – REQUIRED RESERVES
i. CONTROL – because reserves are fractional, checkable deposits are usually much greater than a bank's required

reserves; help the FED control the lending ability of commercial banks.

g. TRANSACTION 5: CLEARING A CHECK DRAWN AGAINST THE BANK: whenever a check is drawn against one bank and deposited in another bank, collection of that check will reduce BOTH the reserves and the checkable deposits of the bank on which the check is drawn. What one bank loses, another gains.
h. TRANSACTION 6: GRANTING A LOAN (CREATING MONEY) – when a bank grants a loan, it creates money. Much of the money we use in our economy is created through the extension of credit by commercial banks.
    i. A single commercial bank in a multibank system can lend only an amount equal to its initial preloan excess reserves.

VII. THE BANKING SYSTEM: MULTI-DEPOSIT EXPANSION
a. Review assumptions on page 408 to follow creation path.
b. THE BANKING SYSTEM'S LENDING POTENTIAL
    i. Review table 16.1 on page 409 to see how money is created down through the system.
    ii. With a 20% reserve requirement, the money multiplier is 5 and with $80 in excess reserves, $400 is created in the system
c. THE MONEY MULTIPLIER = 1 / RRR
    i. M = 1/RRR
    ii. MAXIMUM CHECKABLE-DEPOSIT CREATION = EXCESS RESERVES x MONETARY MULTIPLIER

d. REVERSIBILITY: THE MULTIPLE DESTRUCTION OF MONEY
   i. Money is destroyed when loans are paid off.
   ii. Direction of the money supply in a given period will depend on the net effect of money creation and money destruction.

e. REVIEW THE BANK PANICS OF 1930 TO 1933 on page 411.