



Understanding Money and the Role of Banking

chapter # 16

Introduction

- **In this chapter we**
 - describe where money comes from and how national economies depend on it, and the public's trust in its value.
 - will give you a solid understanding of the different forms of money and how its supply is created and controlled by different kinds of financial institutions and government regulations.

learning objectives

- 1. **Define** money and identify the different forms that it takes in the nation's money supply.*
- 2. **Describe** the different kinds of financial institutions that compose the U.S. financial system and explain the services they offer.*
- 3. **Explain** how financial institutions create money and describe the means by which they are regulated.*

learning objectives

4. **Discuss** the functions of the Federal Reserve System and describe the tools that it uses to control the money supply.
5. **Identify** three important ways in which the money and banking system is changing.
6. **Discuss** some of the institutions and activities in international banking and finance.

What Is Money?

- **Money**

- object that is portable, divisible, durable, and stable, and that serves as a medium of exchange, a store of value, and a measure of worth

The Functions of Money

It is a medium of exchange

It is a store of value

It is a measure of worth

M-1: The Spendable Money Supply

- **M-1**

- measure of the money supply that includes only the most liquid (spendable) forms of money

- **Currency (Cash)**

- government-issued paper money and metal coins

M-1: The Spendable Money Supply

(cont.)

- **Check**
 - demand deposit order instructing a bank to pay a given sum to a specified payee
- **Checking Account (Demand Deposit)**
 - bank account funds, owned by the depositor, that may be withdrawn at any time by check or cash

M-2: M-1 Plus the Convertible Money Supply

- **M-2**

- measure of the money supply that includes all the components of M-1 plus the forms of money that can be easily converted into spendable forms

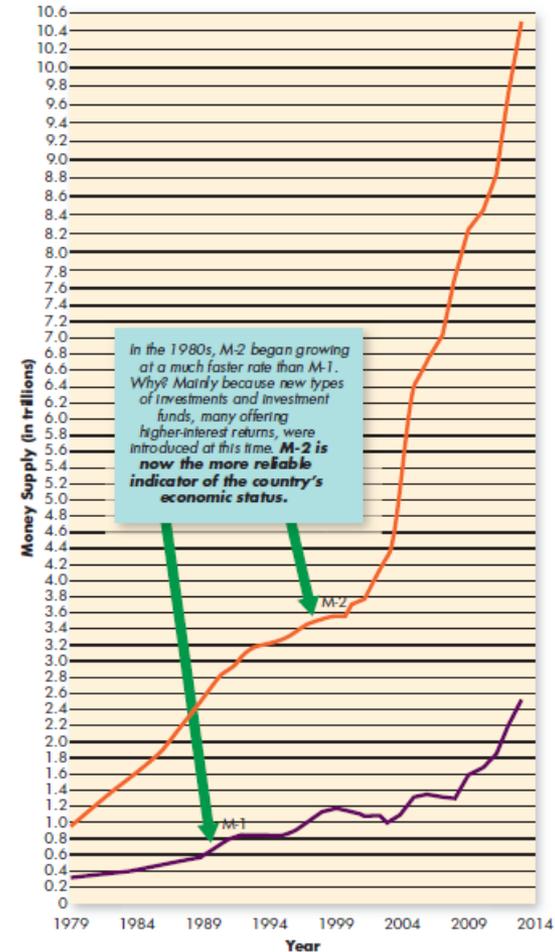


FIGURE 16.1 Money Supply Growth

M-2: M-1 Plus the Convertible Money Supply (cont.)

- **Time Deposit**

- bank funds that have a fixed term of time to maturity and cannot be withdrawn earlier or transferred by check

- **Money Market Mutual Fund**

- fund of short-term, low-risk financial securities purchased with the pooled assets of investor-owners

Financial Institutions

- **Commercial Bank**

- company that accepts deposits that it uses to make loans, earn profits, pay interest to depositors, and pay dividends to owners

- **Savings and Loan Association (S&L)**

- financial institution accepting deposits and making loans primarily for home mortgages

Financial Institutions (cont.)

- **Mutual Savings Bank**

- financial institution whose depositors are owners sharing in its profits

- **Credit Union**

- nonprofit, cooperative financial institution owned and run by its members, usually employees of a particular organization

Nondeposit Institutions

- **Pension Fund**

- nondeposit pool of funds managed to provide retirement income for its members

- **Insurance Company**

- nondeposit institution that invests funds collected as premiums charged for insurance coverage

Nondeposit Institutions (cont.)

- **Finance Company**
 - nondeposit institution that specializes in making loans to businesses and consumers
- **Securities Investment Dealer (Broker)**
 - financial institution that buys and sells stocks and bonds both for investors and for its own accounts

The Prime Rate

- **Prime Rate**

- interest rate available to a bank's most creditworthy customers

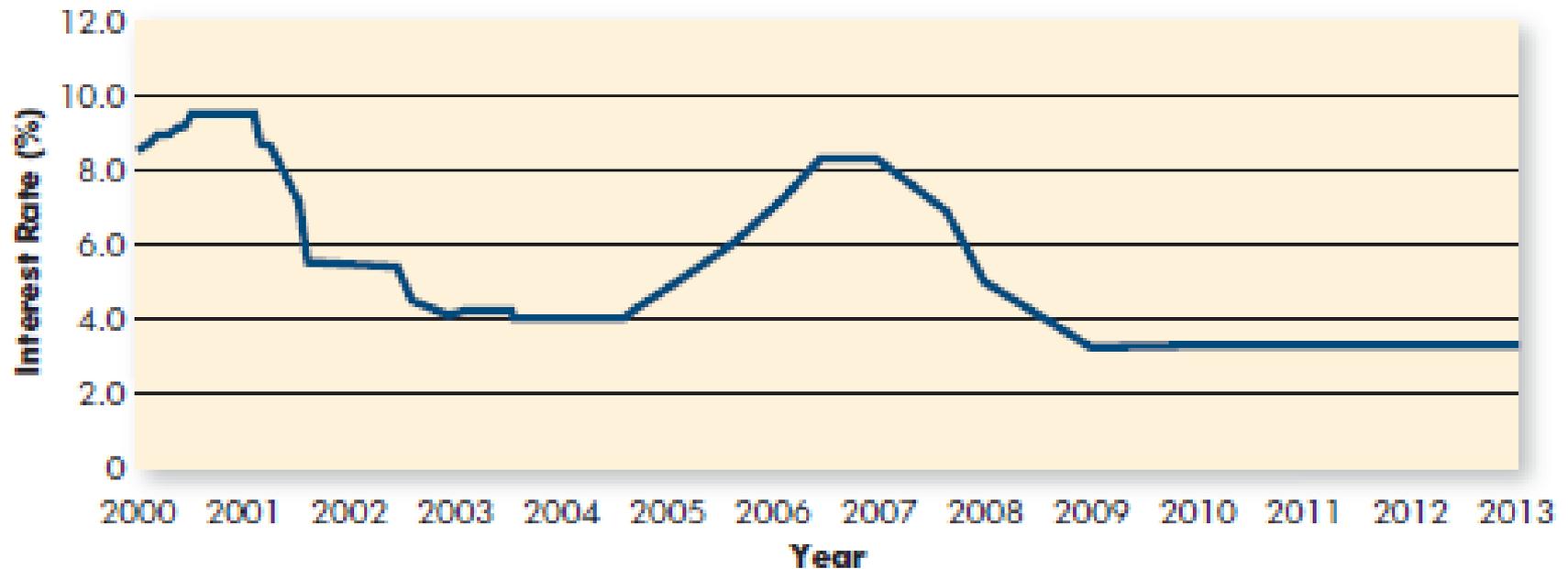


FIGURE 16.2 The Prime Rate

The Growth of Financial Services

- **Individual Retirement Account (IRA)**
 - tax-deferred pension fund that wage earners set up to supplement retirement funds
- **Trust Services**
 - management by a bank of an estate, investments, or other assets on behalf of an individual

International Services

- **Letter of Credit**

- bank promise, issued for a buyer, to pay a designated firm a certain amount of money if specified conditions are met

- **Banker's Acceptance**

- bank promise, issued for a buyer, to pay a designated firm a specified amount at a future date

Electronic Funds Transfer

- **Electronic Funds Transfer (EFT)**
 - communication of fund-transfer information over wire, cable, or microwave
- **Automated Teller Machine (ATM)**
 - electronic machine that allows bank customers to conduct account-related activities 24 hours a day, 7 days a week

Global Dispersion of ATMs

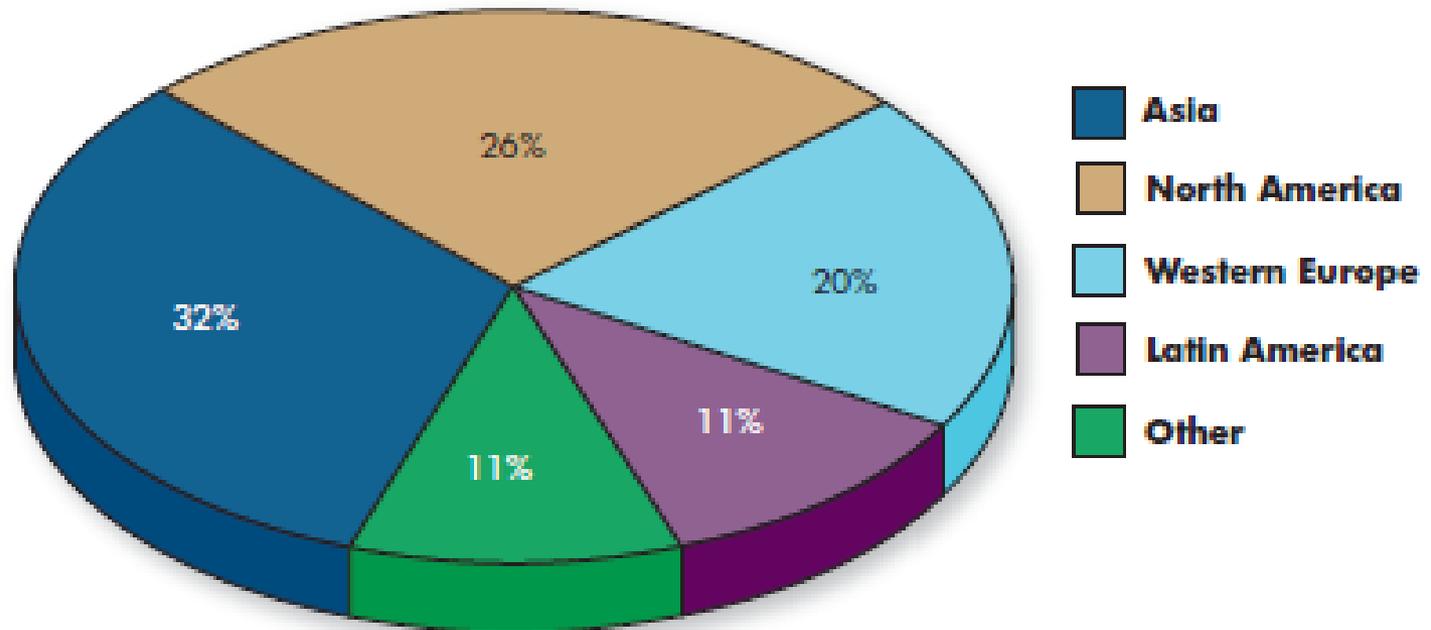


FIGURE 16.3 Global Dispersion of ATMs

How Banks Create Money

Deposit	Money Held in Reserve by Bank	Money to Lend	Total Supply
\$100.00	\$10.00	\$90.00	\$190.00
90.00	9.00	81.00	271.00
81.00	8.10	72.90	343.90
72.90	7.29	65.61	409.51
65.61	6.56	59.05	468.56

FIGURE 16.4 How Banks Create Money

Regulation of the Banking System

- **Federal Deposit Insurance Corporation (FDIC)**
 - federal agency that guarantees the safety of deposits up to \$250,000 in the financial institutions that it insures

Federal Deposit Insurance Corporation

- Preserves confidence by supervising banks and insuring deposits in banks and thrift institutions
- Commercial banks pay fees for membership in the FDIC
- Guarantees the safety of all deposits of every account owner up to the current maximum of \$250,000
- Maintains the right to examine the activities and accounts of all member banks

The Federal Reserve System

- **Federal Reserve System (The Fed)**
 - central bank of the United States, which acts as the government's bank, serves member commercial banks, and controls the nation's money supply

The Twelve Federal Reserve Districts

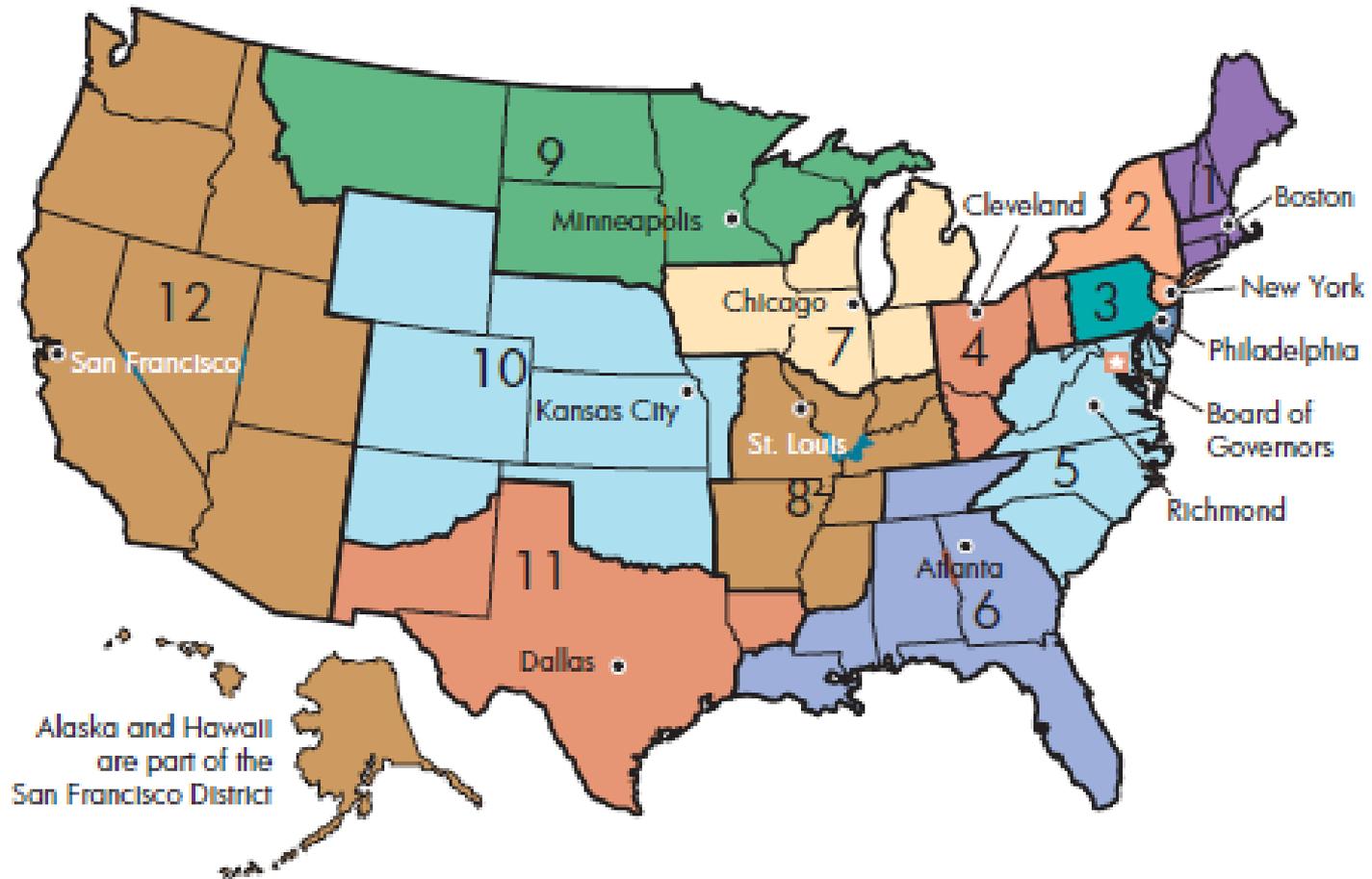


FIGURE 16.5 The Twelve Federal Reserve Districts

The Structure of the Fed

**The Board
of
Governors**

**Reserve
Banks**

**Open
Market
Committee**

**Member
Banks**

**Other
Depository
Institutions**

The Functions of the Fed

- The Government's Bank
- The Bankers' Bank
- Check Clearing
- Controlling the Money Supply

Controlling the Money Supply

- **Monetary Policy**

- management of the nation's economic growth by managing the money supply and interest rates
- By controlling these two factors, the Fed influences the ability and willingness of banks throughout the country to loan money.

The Tools of the Fed

- **Reserve Requirement**

- percentage of its deposits that a bank must hold in cash or on deposit with the Fed

- **Discount Rate**

- interest rate at which member banks can borrow money from the Fed

The Tools of the Fed (cont.)

- **Federal Funds Rate (Key Rate)**
 - interest rate at which commercial banks lend reserves to each other, usually overnight
- **Open-Market Operations**
 - the Fed's sale and purchase of securities in the open market

The Changing Money and Banking System

- **Government Intervention**
 - Government Emergency Investment
 - Assurances of Repayment
- **Anti-Crime and Anti-Terrorism Regulations**
 - Bank Secrecy Act (BSA)
 - U.S. Patriot Act

Automated Clearing House (ACH) Network

- **Automated Clearing House**
 - electronic funds transfer system that provides interbank clearing of electronic payments for the nation's financial institutions
 - network allows businesses, government, and consumers to choose an electronic-over-paper alternative for payments

Automated Clearing House (ACH) Network (cont.)

- **ACH payments** include:
 - Internet-initiated debit and credit payments by businesses and consumers
 - direct deposit of payroll, Social Security benefits, and tax refunds
 - federal, state, and local tax payments
 - e-checks
 - direct payment of consumer bills: mortgages, loans, utility bills, and insurance premiums

Check 21: Making the Paper Check Go Away

- **Check Clearing for the 21st Century Act (Check 21)**
 - allows a receiving bank to make an electronic image of a paper check and electronically send the image to the paying bank for instant payment instead of waiting days for the paper check to wind its way back to the sender.

The Impact of Electronic Technologies

- **Blink Credit Card**

- uses a computer chip that sends radio-frequency signals in place of the magnetic strips that are embedded in credit cards

- **Debit Card**

- plastic card that allows an individual to transfer money between accounts

The Impact of Electronic Technologies

(cont.)

- **Point-of-Sale (POS) Terminal**
 - electronic device programmed with electronic money that transfers funds from the customer's bank account to pay for retail purchases
- **Smart Card**
 - credit-card-sized plastic card with an embedded computer chip that can be programmed with electronic money

Currency Values and Exchange Rates

- **Exchange Rate**

- the value of one currency compared to the value of another

International Bank Structure

- **World Bank**

- UN agency that provides a limited scope of financial services, such as funding improvements in underdeveloped countries

- **International Monetary Fund (IMF)**

- UN agency consisting of about 150 nations that have combined resources to promote stable exchange rates, provide temporary short-term loans, and serve other purposes

Applying What You've Learned

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Applying What You've Learned (cont.)

- 4. Discuss** the functions of the Federal Reserve System and describe the tools that it uses to control the money supply.
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