Money

- What is money?
- What are the three uses of money?
- What are the six characteristics of money?
- What are the sources of money’s value?

What Is Money?

Money is anything that serves as a medium of exchange, a unit of account, and a store of value.

The Three Uses of Money

- **Money as Medium of Exchange**
  - A medium of exchange is anything that is used to determine value during the exchange of goods and services.
- **Money as a Unit of Account**
  - A unit of account is a means for comparing the values of goods and services.
- **Money as a Store of Value**
  - A store of value is something that keeps its value if it is stored rather than used.

The Six Characteristics of Money

The coins and paper bills used as money in a society are called currency. A currency must meet the following characteristics:

Durability
Objects used as money must withstand physical wear and tear.

Portability
People need to be able to take money with them as they go about their business.

Divisibility
To be useful, money must be easily divided into smaller denominations, or units of value.

Uniformity
Any two units of money must be uniform, that is, the same, in terms of what they will buy.

Limited Supply
Money must be available only in limited quantities.

Acceptability
Everyone must be able to exchange the money for goods and services.

The Sources of Money's Value

Commodity Money

- Commodity money consists of objects that have value in themselves.

Representative Money

- Representative money has value because the holder can exchange it for something else of value.

Fiat Money

- Fiat money, also called "legal tender," has value because the government decreed that is an acceptable means to pay debts.

Section 1 Assessment

1. Two units of the same type of money must be the same in terms of what they will buy, that is, they must be
   - (a) divisible.
   - (b) portable.
   - (c) acceptable.
   - (d) uniform.

2. What is the source of fiat money's value?
   - (a) it represents the value of another item
   - (b) government decree
   - (c) presidential pardon
   - (d) it is equal to the value of the stock market

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The History of American Banking

- **How did American banking change in the 1700s and 1800s?**
- **How was the banking system stabilized in the late 1800s?**
- **What developments occurred in banking during the twentieth century?**

American Banking Before the Civil War

Two Views of Banking

- Federalists believed the country needed a strong central government to establish economic and social order.
- Alexander Hamilton was in favor of a national bank which could issue a single currency, handle federal funds, and monitor other banks.
- Antifederalists were against a strong central government and favored leaving powers in the hands of the states.
- Thomas Jefferson opposed the creation of a national bank, and instead favored banks created and monitored by individual states.

Shifts in the Banking System

- **The First Bank of the United States**
  - **The first Bank of the United States was created in 1791. The Bank held tax revenues, helped collect taxes, issued representative money, and monitored state-chartered banks.**
- **Chaos in American Banking**
  - **The first Bank lost support and its charter expired in 1811. Different, state-chartered banks began issuing different currencies.**
- **The Second Bank of the United States**
  - **The Second Bank was created in 1816 and was responsible for restoring stability in banking.**
- **The Free Banking Era**
  - **The Second Bank's charter was not renewed in 1832, and another period dominated by state-chartered banks took hold.**

Banking Stabilization in the Late 1800s

The National Banking Acts of 1863 and 1864 gave the federal government the power to:

1. **Charter banks**
2. **Require banks to hold adequate reserves of silver and gold**
3. **Issue a single national currency**

In 1900, the nation shifted to the gold standard, a monetary system in which paper money and coins are equal to the value of a certain amount of gold. The gold standard had two advantages:

1. **It set a definite value on the dollar.**
2. **The government could only issue currency if it had gold in its treasury to back its notes.**

Banking in the Twentieth Century

- The Federal Reserve Act of 1913 created the Federal Reserve System. The Federal Reserve System served as the nation's first true central bank.

- The Banking Act of 1933 created the Federal Deposit Insurance Corporation (FDIC). Today, the FDIC insures customers' deposits up to $100,000. The nation was also taken off of the gold standard.

Figure 10.4 Developments in American Banking

Date	Development	Example
1780s	The nation has no reliable medium of exchange. Federalists and Antifederalists disagree about a banking system.	
1791	First Bank of the United States is established.	
1811–1816	Period of instability follows expiration of First Bank's charter.	
1816	Second Bank of the United States reestablishes stability.	
1830s–1860s	President Jackson vetoes recharter of Second Bank in 1832, giving rise to Free Banking Era.	
1861–1863	Civil War makes clear the need for a better monetary and banking system.	
1863–1864	National Banking Acts of 1863 and 1864 establish national banking system and uniform national currency.	
1907	Panic of 1907 leads to creation of the Federal Reserve System.	
1913	President Wilson signs the Federal Reserve Act.	
1929	The Great Depression begins.	
1933	President Roosevelt helps restore confidence in the nation's banks by establishing the FDIC.	
1940s–1960s	Period of government regulation and long-term stability	
Late 1960s–1970s	New laws make clear the rights and responsibilities of banks and consumers.	
1980s	Period of deregulation; S&Ls face bankruptcies	
2000s	After two decades of mergers, the banking system emerges stable and healthy.	

▶ 1780s
Continental

◀ 1861–1863
Greenback

▶ 1933
FDIC

Section 2 Assessment

1. During the Free Banking Era between 1837 and 1863, banking in the United States was dominated by which of the following?
   - (a) small, independent banks with no charters
   - (b) The Bank of the United States
   - (c) state-chartered banks
   - (d) savings and loans banks

2. After the Civil War, the National Banking Acts gave the federal government the power to do all of the following EXCEPT:
   - (a) insure banks against failure
   - (b) charter banks
   - (c) require banks to hold adequate gold and silver reserves
   - (d) issue a single national currency

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Banking Today

- How do economists measure the U.S. money supply?
- What services do banks provide?
- How do banks make a profit?
- What are the different types of financial institutions?
- How has electronic banking affected the banking world?

Measuring the Money Supply

M1

- M1 consists of assets that have liquidity, or the ability to be used as, or easily converted into, cash.
- Components of M1 include all currency, traveler's checks, and demand deposits.
- Demand deposits are the money in checking accounts.

M2

- M2 consists of all of the assets in M1, plus deposits in savings accounts and money market mutual funds.
- A money market mutual fund is a fund that pools money from small investors to purchase government or corporate bonds.

The money supply is all the money available in the United States economy.

Banking Services

- **Banks perform many functions and offer a wide range of services to consumers.**

Storing Money
Banks provide a safe, convenient place for people to store their money.

Credit Cards
Banks issue credit cards — cards entitling their holder to buy goods and services based on each holder's promise to pay.

Saving Money
Four of the most common options banks offer for saving money are:

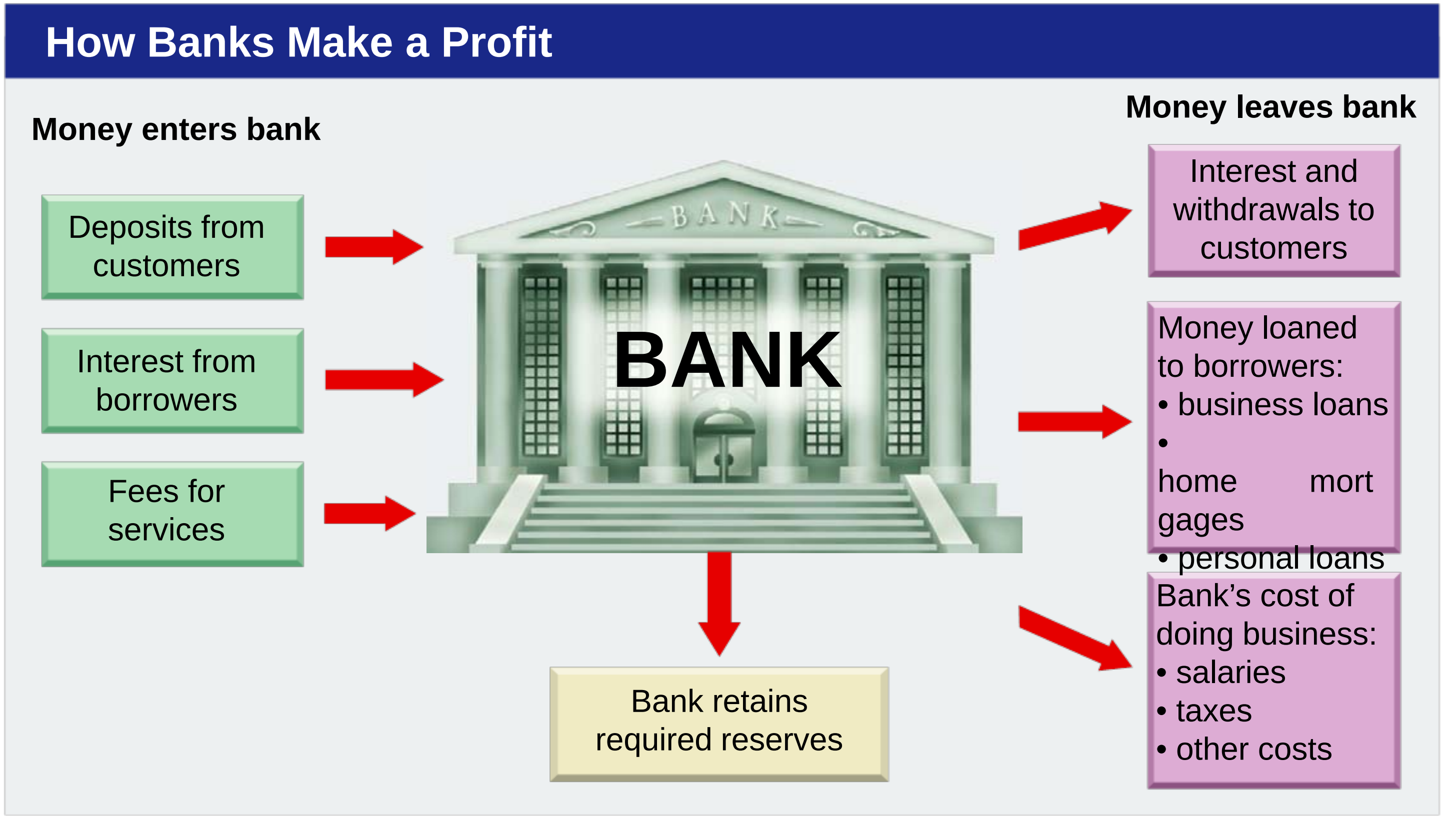
1. **Savings Accounts**
2. **Checking Accounts**
3. **Money Market Accounts**
4. **Certificates of Deposit (CDs)**

Loans
By making loans, banks help new businesses get started, and they help established businesses grow.

Mortgages
A mortgage is a specific type of loan that is used to purchase real estate.

How Banks Make a Profit

- **The largest source of income for banks is the interest they receive from customers who have taken loans.**
- **Interest is the price paid for the use of borrowed money.**



Types of Financial Institutions

- Commercial Banks
  - Commercial banks offer checking services, accept deposits, and make loans.
- Savings and Loan Associations
  - Savings and Loan Associations were originally chartered to lend money for home-building in the mid-1800s.
- Savings Banks
  - Savings banks traditionally served people who made smaller deposits and transactions than commercial banks wished to handle.
- Credit Unions
  - Credit unions are cooperative lending associations for particular groups, usually employees of a specific firm or government agency.
- Finance Companies
  - Finance companies make installment loans to consumers.

Electronic Banking

The role of computers in banking has increased dramatically.

Automated Teller Machines (ATMs)

Customers can use ATMs to deposit money, withdraw cash, and obtain account information.

Debit Cards

Debit cards are used to withdraw money directly from a checking account.

Automatic Clearing Houses (ACH)

An ACH transfers funds automatically from customers' accounts to creditors' accounts.

Home Banking

Many banks allow customers to check account balances and make transfers and payments via computer.

Stored Value Cards

Stored value cards are embedded with magnetic strips or computer chips with account balance information.

Figure 10.5 Major Components of the Money Supply

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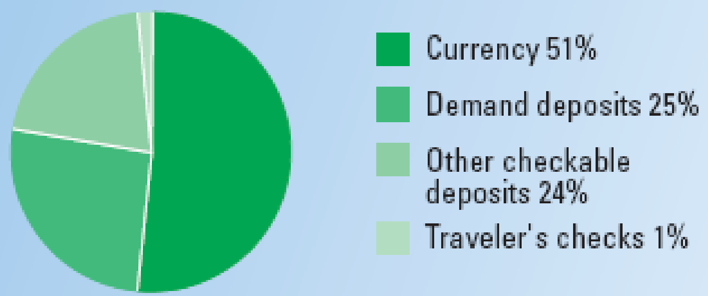
M1 Components	Billions	M2 Components	Billions
Currency	$704.1	Savings deposits	$3,550.0
Demand deposits	$337.7	Retail money market funds	$701.8
Other checkable deposits	$322.6	Small denomination time deposits	$851.1
Traveler's checks	$7.5	Total M1	$1,371.9
Total M1	**$1,371.9**	**Total M2**	**$6,474.9**



Individual categories may be affected by rounding.
Source: Federal Reserve Board Statistical Release H.6, April 28, 2005

Figure 10.6 The Fractional Reserve System

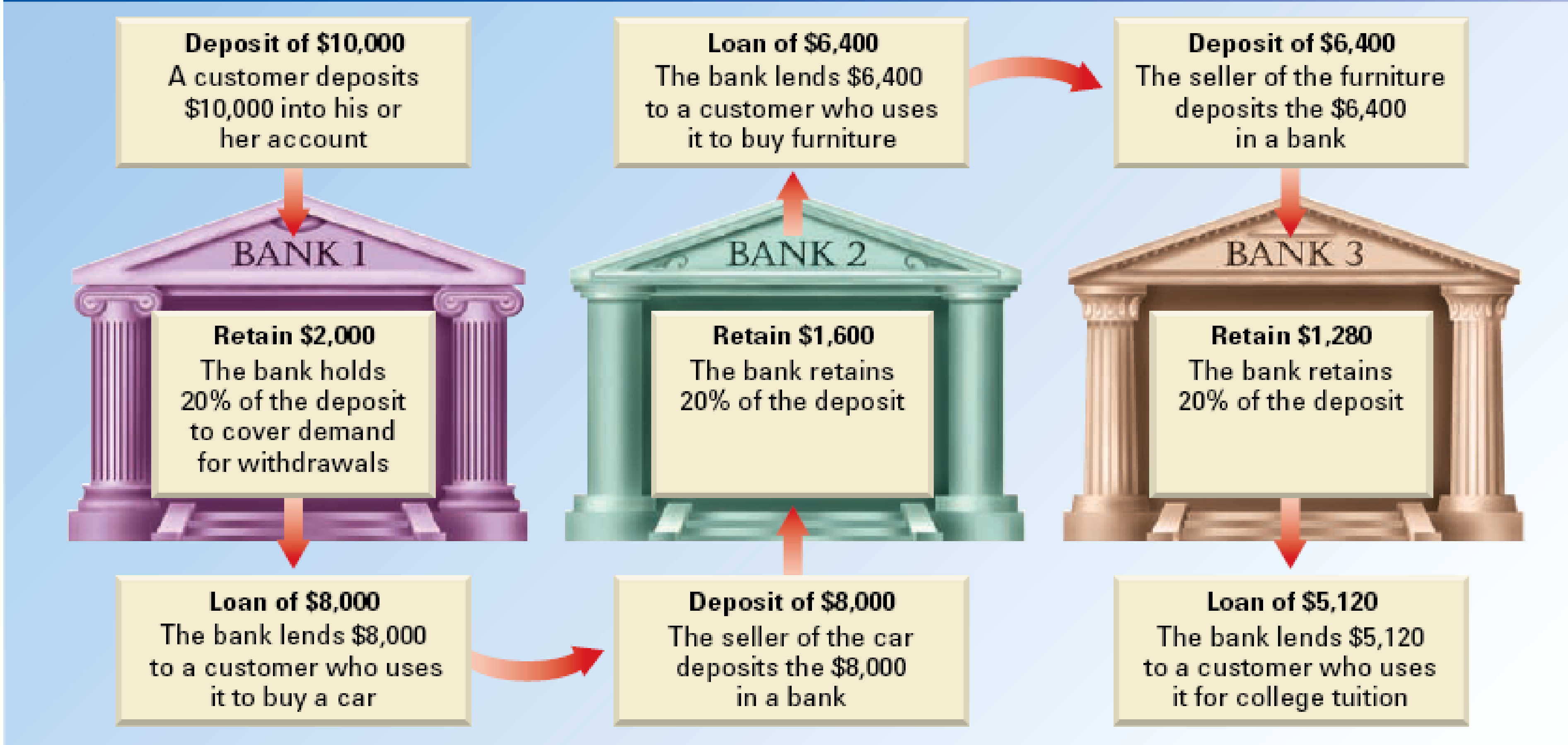


Figure 10.7 Compound Interest

Start of year	Principal amount	Interest earned at 5%	Principal at end of year
–	$100.00	$5.00	$105.00
1	$105.00	$5.25	$110.25
2	$110.25	$5.51	$115.76
3	$115.76	$5.79	$121.55
4	$121.55	$6.08	$127.63
5	$127.63	$6.38	$134.01
6	$134.01	$6.70	$140.71
7	$140.71	$7.04	$147.75
8	$147.75	$7.39	$155.14
9	$155.14	$7.76	$162.90
10	$162.90	$8.14	$171.04
11	$171.04	$8.55	$179.59
12	$179.59	$8.98	$188.57
13	$188.57	$9.43	$198.00
14	$198.00	$9.90	$207.90
15	$207.90	$10.39	$218.29

Section 3 Assessment

1. The money supply of the United States is made up of which of the following?

   (a) M1

   (b) M1 and parts of M2

   (c) all the money available in the economy

   (d) all the money available in the economy plus money that the country could borrow

2. Why are funds in checking accounts called demand deposits?

   (a) they are available whenever the depositor demands them by writing a check

   (b) they are not liquid

   (c) they are usually in great demand

   (d) they are held without interest by the bank

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