

Audio Review Transcript

Chapter 19 Understanding Money, Banking, and Credit

Businesses transform resources into money. If a firm has a good idea for a product or a service, a bank or other lender may lend it money to develop, produce, and market the good or service. The loan, with interest, will be repaid using future sales revenue. Both the firm and the lender earn a reasonable profit. And money helps make it happen.

In the past, people exchanged goods and services without using money. Instead they used a barter system, in which goods and services are traded directly for other goods and services. The problem with the barter system is that the two parties must need each other's products at the same time and the two products must be of similar value. To eliminate these inconveniences, the concept of money was developed. Money is anything a society uses to purchase products, services, or resources. The most commonly used objects today are metal coins and paper bills, called currency.

Money has three primary functions. First and foremost, it is a medium of exchange. A medium of exchange is anything accepted as payment for products, services, and resources. If a business needs a certain raw material, it exchanges money for the product and transforms it into a product it can sell, in exchange for more money. Second, money is a measure of value. A measure of value is a single standard, or "yardstick" used to assign values to, and compare the values of, products, services, and resources. Money serves as a measure of value because the prices of all goods, services, and resources are stated in terms of money. The third function of money is as a store of value. A store of value is a means of retaining and accumulating wealth. Money received by an individual or a business may be held for now and spent later. It is important to remember, though, that the value of stored money is affected by inflation, the general rise in the level of prices. To determine the effect of inflation on buying power, economists refer to the consumer price index, which shows the price changes of typical consumer goods over a period of time.

To be acceptable as a medium of exchange, money must be easy to use, trusted, and capable of performing its three functions. It must possess five characteristics: divisibility, so it can be divided into smaller units to accommodate large and small purchases; portability, so that it is light enough and small enough to be carried easily; stability, so that it retains its value over time; durability, so that it is strong enough to last through reasonable repeated usage; and difficulty of counterfeiting, so that people feel confident about accepting it as payment.

So how much money is there in the United States? Let's start by defining a few money concepts. A demand deposit is an amount on deposit in a checking account. It is called a demand deposit because the owner can demand it immediately, by presenting a properly made out check, withdrawing from an ATM, or transferring money between accounts. A time deposit is an amount on deposit in an interest-bearing savings account. The time sometimes required between the notice and the withdrawal is why it is called a time deposit. But because they can be converted to cash easily, they are called near-monies.

Now let's talk about how much money there is in the United States. There are three main measures of the supply of money: M1, M2, and M3. The M1 supply of money

consists of only currency and demand deposits. The M2 supply of money consists of M1 (currency and demand deposits), plus certain money-market securities and small denomination time deposits, or certificates of deposit, of less than \$100,000. The M3 supply of money consists of M1 and M2 plus time deposits, or certificates of deposit, of \$100,000 or more. Generally, economists, politicians, and bankers tend to focus on M1, or a variation of M1.

A discussion of the money supply generally includes talk about the Federal Reserve System. The Federal Reserve System, also simply called “the Fed,” is the central bank of the United States. It's responsible for regulating the banking industry. Its mission is to maintain an economically healthy and financially sound business environment in which banks can operate. The Fed has tremendous power to regulate the money supply, control inflation, and regulate financial institutions. To regulate the money supply, it controls bank reserve requirements, regulates the discount rate and runs open market operations.

When money is deposited in a bank, the bank must retain a portion of it to satisfy customers who may want to withdraw money from their accounts or to fund loans. The reserve requirement is the percentage of its deposits that a bank must retain, either in its own vault or in a Federal Reserve District Bank. Banks can use the remaining funds to create more money and make more loans by deposit expansion, a process that allows banks to continually reloan money that has been deposited in the bank. The Fed sets the reserve requirement. When it increases the requirement, banks have less money available for lending. When it decreases the requirement, the Fed can make additional money available to stimulate a slow economy.

The Fed also controls the money supply by regulating the discount rate. The discount rate is the interest rate the Federal Reserve System charges for loans to member banks. When the Fed lowers the discount rate, it is easier and cheaper for banks to obtain money, increasing the amount of money available to consumers and businesses and stimulating the economy. When the Fed raises the discount rate, banks begin to restrict loans, raise their lending rates, and tighten loan requirements, which slows the economy and checks inflation by making money more difficult and expensive to obtain.

The third way that the Fed controls the money supply is in open-market operations. The federal government finances its activities partly by selling US government securities. These securities pay interest, and are available to an individual or organization, including the Fed. Open-market operations is the buying and selling of US government securities by the Federal Reserve System for the purpose of controlling the money supply. To reduce the nation's money supply, the Fed sells government securities on the open market. The money it receives from purchasers is taken out of circulation, making less money available for investment, purchases, or lending. To increase the money supply, the Fed buys government securities, which puts money back into circulation and makes it available to individuals and firms.

One of the major players in banking is the commercial bank, a profit-making organization that accepts deposits, makes loans, and provides related services to its customers. Its mission is to meet the needs of its customers while earning a profit. They earn a profit by accepting money from depositors, for which they pay interest, and then by lending it to qualified individuals and businesses that pay interest on the borrowed money. A national bank is a commercial bank chartered by the US Controller of the

currency, and a state bank is a commercial bank chartered by the banking authorities in the state in which it operates. Both national and state banks are carefully regulated and subject to unannounced inspections by federal and/or state auditors.

In addition to commercial banks, there are at least 8 other types of financial institutions that perform either full or limited banking services. Let's look briefly at each. (1) Savings and loan associations offer checking and savings accounts and certificates of deposit. They also offer NOW accounts, which are interest-bearing checking accounts. NOW stands for negotiable order of withdrawal. (2) Mutual savings banks are owned by their depositors and offer many of the same services offered by savings and loan associations. Mutual savings banks generally have state charters, and their profits are returned to the depositors, usually in the form of higher interest rates on savings. (3) Credit unions accept deposits from and lend money to only those people who are their members. (4) Insurance companies provide long-term financing for commercial real estate projects. (5) Pension funds are set up by firms to guarantee their employees a regular monthly income on retirement, and may earn additional income from conservative investments. (6) Brokerage firms offer combination checking and savings accounts at higher-than-usual interest rates, called money-market rates. (7) Finance companies provide financing to individuals and firms that may be unable to get financing from other lenders. And (8) investment banking firms assist corporations in raising funds by selling new issues of stocks, bonds, or other securities.

Financial institutions provide customers with a wide range of services. One of the most common is a checking account. A check is a written order for a bank or other financial institution to pay a stated dollar amount to the business or person indicated on the face of the check. Today most financial institutions offer interest-paying checking accounts, often called NOW accounts. In addition to checking accounts, savings accounts provide a safe place to store money until it is needed. A depositor who is willing to leave money on deposit with a bank for a set period of time can earn a higher rate of interest by buying a certificate of deposit, or CD, which is a document stating that the bank will pay the depositor a guaranteed interest rate for money left on deposit for a specified period of time. These rates change weekly.

Financial institutions also offer short-term and long-term loans. Short-term business loans must be repaid in one year or less. They are typically used to purchase inventory, finance promotional needs, and solve cash flow problems. To ensure that short-term money will be available when needed, many firms establish either a line of credit, a loan that is approved before the money is actually needed, or a revolving credit agreement, which is a guaranteed line of credit. Long-term business loans are repaid over a longer period, usually 3 to 7 years. They are most often used to finance expansion of facilities, replace equipment, or develop the firm's product mix. Most lenders require collateral, real estate or property pledged as security for a loan, for long-term loans. If the borrower fails to repay the loan, the lender can repossess the collateral.

Finally, financial institutions offer credit card and debit card transactions. Credit is welcomed by businesses because credit transactions are easily convertible to cash. In return for this, the bank charges the merchant a fee. Individuals like credit cards because they allow purchasers to buy immediately and have almost a month to repay without any penalty. A debit card, on the other hand, electronically subtracts the amount of your purchase from your bank account at the moment the purchase is made.

Banking is undergoing enormous changes, particularly as a result of technology. More and more Americans visit ATMs for cash and do some or all of their banking electronically. Many of these changes began some 30 years ago, when Congress enacted a number of laws designed to deregulate the banking industry, including allowing savings and loans to offer NOW accounts, phasing out interest ceilings on deposits, eliminating ceilings on home mortgages, and raising the deposit insurance ceiling to \$100,000. In the next decades, increased technology and the need to help American businesses compete in the global marketplace will mean that financial institutions will offer an even wider array of services. Online banking includes such activities as electronic funds transfer (EFT), which is a means of performing financial transactions through a computer terminal or telephone hookup. EFT activities are expected to grow substantially, and include the use of ATMs, automated clearinghouses or ACHs (used by large companies to transfer wages and salaries directly to employees' bank accounts), and point-of-sale (or POS) terminals, which are computerized cash registers located in retail stores and connected to a bank's computer.

International banking services are extremely important. A bank can help a firm in two ways, by providing (1) a letter of credit, which is a legal document issued by a financial institution guaranteeing to pay a seller a stated amount for a specified period of time, if certain conditions are met, or (2) a banker's acceptance, which is a written order for the bank to pay a third party a stated amount of money on a specified date.

Long before Congress enacted laws that began the deregulation process, it passed the Banking Act of 1933 to protect depositors from the risk of bank failure. It also organized the Federal Deposit Insurance Corporation, or FDIC, which insures deposits against bank failures. The FDIC insures all deposits in all member financial institutions up to \$100,000. All banks that are part of the Federal Reserve system, must belong to the FDIC and pay insurance premiums, and many others choose to join.

How do banks and other lenders decide to whom they are going to lend money or extend credit? They evaluate all applicants by looking at several factors. Credit is immediate purchasing power that is exchanged for a promise to repay borrowed money, with or without interest, at a later date. Lenders generally look at the five Cs of credit management. The first is character, which is the borrower's attitude toward credit obligations. The second is capacity, the borrower's financial ability to meet the credit obligations. The third is capital, which refers to the borrower's assets or net worth. The fourth is collateral, which you may recall is real estate or property pledged as security; and the fifth is conditions, which refers to the general economic conditions.

The lender then verifies the accuracy of the borrower's claim by consulting global or local credit-reporting agencies, or checking industry associations.