
money
And
Banking

money (mun´e) *n.*

Money, the banking system and monetary policy must work together

ally accepted as a

people to exchange goods and services without having to rely on a system

and a measure and

to borrowers and earn interest in the process, and it gives borrowers a

banking (bank´eng)

is sufficient money in the economy to keep it growing, but not so much

bank, in which savers

is inflation. Inflation—too much money chasing too few goods—creates

brought together for

productivity and lowers the economy's long-term rate of growth. This something gener-

smoothly for the economy to run well. Money makes it possible for

medium of exchange,

of bartering. Banking provides a means for savers to lend their money

store of value.

place to go for loans. The aim of monetary policy is to ensure that there

n. the business of a

that the economy overheats. When the economy overheats, the result

and borrowers are

an inefficient price system. It also distorts decisionmaking, reduces

mutual benefit.

results in lower living standards for everyone.

Anything people will accept in exchange for goods or services can be considered money. Just imagine being an American soldier during World War II. Because paper currency was scarce, servicemen and women overseas often used chocolate, cigarettes and even silk stockings as mediums of exchange. It was all part of a very basic barter system. Still, it wasn't nearly as simplistic as the one used by the people of the South Pacific island of Yap, who, at the same time, used rocks of various sizes as money.

Over the course of history, beads, rocks, shells, hooks, fish, grain and cattle were used as money. However, using such goods in transactions was sometimes quite difficult, as people weren't always able to agree on their comparable values. Currency and coins with specified denominations enabled all parties to trade on a level playing field.

What Is Money?

We may not think we have enough of it, but in many ways, we tend to take money for granted. When you buy a pair of jeans or a CD, for example, you never wonder whether the merchant will accept the bills and coins in your wallet as payment. But suppose money as we know it didn't exist. How would you pay for the things you want to buy?

That was the situation in the early days of the American colonies. British money was scarce, so colonists substituted basic products of their local economies that were always in demand—things like tobacco, grain and fish. For small change, they often received nails and bullets.

But their system, called barter, had many shortcomings. How many fish would it take to buy a bag of flour or an oil lamp, for example? Suppose the merchant didn't want fish, or they spoiled before he could trade them to someone else? Later, as trade developed with other colonies and countries, colonists used various foreign coins, such as gold Spanish reales. That's when money as we know it finally gained a foothold in the U.S. economy.

Money is a medium of exchange accepted by the community, meaning it's what people buy things with and sell things for. Money provides a standard for measuring value, so that the worth of different goods and services can be compared. And lastly, money is a store of value that can be saved for later purchases.

The young United States experimented with a variety of monetary mechanisms for well over a century before settling on a system that was based on coins, paper currency and money in bank checking accounts. The early government tried unsuccessfully several times to make paper money work, but people relied mostly on gold, silver and copper coins because they were made of precious metals that had intrinsic value.

Today, though, our coins don't contain any gold or silver. You can see this for yourself by looking at the edge of a dime or quarter; you'll see a copper core, sandwiched between silvery nickel. The metal value of modern American coins is much less than its worth as money. American currency no longer is backed by gold or silver either, but it no longer really matters.

The first issue of paper currency in North America was in 1685. A paymaster in the French army decided to issue playing cards with assigned values and an official seal to restless troops in Canada

That's because what gives money real value is its purchasing power, not what it's made of. In fact, any economy's health can be measured not by how much money people *earn*, but by how much their money *buys*. The overall assortment and quantity of goods and services your money lets you buy reflect your standard of living.

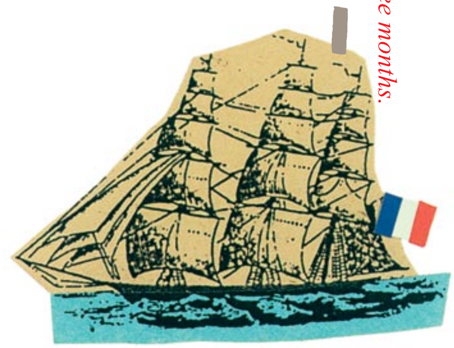
Like diamonds, money is relatively scarce—on purpose—and that's just what makes it valuable. You as an individual want to earn as much as you can, of course. But the national economy can actually have too much money. When the amount of money circulating grows faster than the rate at which goods and services are produced, the result is inflation. Say you want a new pair of jeans, for example. Last year, they cost $40, but this year an identical pair costs $45. If prices of most other goods have also risen, then you are probably dealing with inflation—too much money chasing too few goods. Prices have inflated, and your $40 buys less than it did. You must earn more just to stay even.

The Fed's Role

Keeping prices stable is part of the job of the Federal Reserve, which was created by Congress in 1913. There had been two attempts at establishing a central bank in the United States in the 19th century, but politics killed them even though they were successful. Back then, state-chartered banks issued their own paper money backed only by their individual gold and silver reserves. As a result, there were once more than 10,000 different kinds of bank notes in circulation.

who were growing tired of waiting for a ship from France carrying their pay. The cards were even circulated as currency for a short time, but were redeemed for French coins within three months.

Suppose you owned a store in those days. How would you know which banks had enough gold reserves to make their currency worth its face value? Should you decrease the value of bills from a weaker bank? And how would you keep track of all those bank notes? You can imagine the shopkeeper's dilemma. If a bank went broke, its currency was instantly worthless, and those who held its notes could lose everything.



DEPOSIT
$100
1ST
national bank
20%
reserve
requirement
$20
2nd
national bank
$80
LOAN
cars
$80
deposit

The Money Machine

It may not seem to make much sense, but banks actually "create" money when they lend it. How do they do it? They take a portion of the money that has been deposited in the bank and make a loan to an individual or business. When that individual or business uses the loan to make a purchase, the seller deposits the money in a bank, which then lends a portion to another individual or business. The process goes on and on, providing a continuing source of funds to keep the economy moving forward.

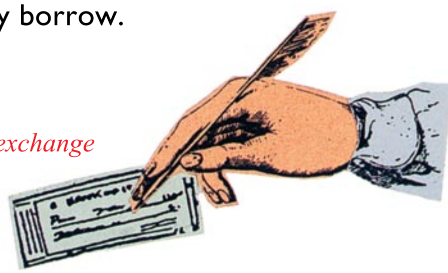
Naturally, people hurried to withdraw their money at the first hint of trouble in the economy. The result was periodic financial panics that could devastate the national economy for years. Finally, after a particularly bad panic in 1907, Congress decided to solve the problem. In 1913, it established the Federal Reserve System to provide for a safer and more flexible banking and monetary system.

With the Fed as safeguard, banks can perform their proper role of bringing savers and borrowers together for the benefit of both. For any economy to be successful, a country first needs political stability so its citizens feel safe; then it needs a stable financial system that includes both trustworthy money and reliable financial institutions. Healthy, profitable banks, therefore, are a vital part of the nation's economic welfare.

Banks provide many services, but for most people, banking consists of depositing their income into a checking account and writing checks or using a debit card on that account to buy things that cost more money than they want to carry in their wallets. People also have savings accounts in which they deposit money they don't need right away or they are saving for a particular purpose. The bank pays interest, or a price paid for use of the money, on savings accounts and often on checking accounts, too.

During inflationary periods in the economy, one of the factors that can contribute to the continuation of inflation is simply that people expect it to continue. When people believe a high inflation rate is the norm, businesses and workers will attempt to upwardly

Very little of this money is kept in the bank's vault, however. While the Federal Reserve requires banks to keep a specified percentage of customer deposits on hand (reserves) to meet routine withdrawals, they lend the excess. Banks, like any other business, must make a profit to stay in business. Their profit comes from interest people pay on the money they borrow.



In the United States, checks didn't come into widespread use as a medium of exchange until deposit banking became established in the late 1700s.

How Banks Create Money

Banks actually create money when they lend it. Here's how it works: Most of a bank's loans are made to its own customers and are deposited in their checking accounts. Because the loan becomes a new deposit, just like a paycheck does, the bank once again holds a small percentage of that new amount in reserve and again lends the remainder to someone else, repeating the money-creation process many times.

The tricky part of monetary policy is making sure there is enough money in the economy, but not too much. When people have the money to demand more products than the economy can supply, prices go up and the resulting inflation hurts everyone. While in the United States we get concerned when inflation climbs above 3 percent a year, we've been more fortunate than some other countries. Just imagine trying to survive in post-World War II Hungary, for instance, where for awhile inflation averaged nearly 20,000 percent per month!

adjust prices and wages to compensate for the higher prices they believe are on the way.

Balancing the Money Supply

One of the most important functions of the Federal Reserve System is protecting the value of money. Like a doctor monitoring a patient, the Fed checks the economic health of the nation constantly, making sure there isn't too much or too little money in the economy. Too much money could cause inflation. Too little could cause a recession. The goal of the Fed is to find a happy medium—to make sure prices remain stable and the nation's economy stays healthy.


F
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D
FOR ALL DEBTS, PUBLIC AND PRIVATE
B81127646H
WASHINGTON, D.C.
TWENTY DOLLARS
TEN DOLLARS
FIVE DOLLARS
FIVE DOLLARS
TEN DOLLARS
INF LATION

Monetary Policy and the Economy

Controlling the money supply to help the economy grow steadily without inflation is the Federal Reserve's job. Called setting monetary policy, the Fed does this primarily by buying and selling Treasury securities on the open market. Buying securities on the open market can make it easier for banks to loan money and can give the economy a boost, while selling securities can restrict lending and can help cool down an overheated economy. When the Fed buys securities, the Fed pays for them by crediting the reserve accounts of the sellers' banks. With more money in their reserves, banks can lend more. By contrast, when the Fed sells securities, the Fed collects for the sale by debiting the reserve accounts of the buyers' banks. With less money in their reserves, banks can't lend as much.

Soon after Congress created the Fed, its monetary policy role was substantially strengthened by the outbreak of World War I. As countries began refusing to ship gold to one another for payment of international debt, the need

Conducting monetary policy is a tremendous responsibility, for the nation's economic health is at stake. You can see why politicians might want to control the money supply for short-term interests. For that reason, the Fed, by law, is not government controlled or funded by Congress. While it is a centralized banking system comprising 12 regional banks, it is independent in operation.

Besides conducting monetary policy, the Fed also acts as the bankers' bank. As people withdraw more currency to buy things when the economy is booming, the banks in turn pull additional currency from their own reserve accounts with the Fed. When the economy slows down and people increase their savings, banks *arose for new monetary criteria and standards to replace gold's automatic operation. Fortunately, the groundwork for these new criteria and standards had already been laid with passage of the Federal Reserve Act just a year earlier.*

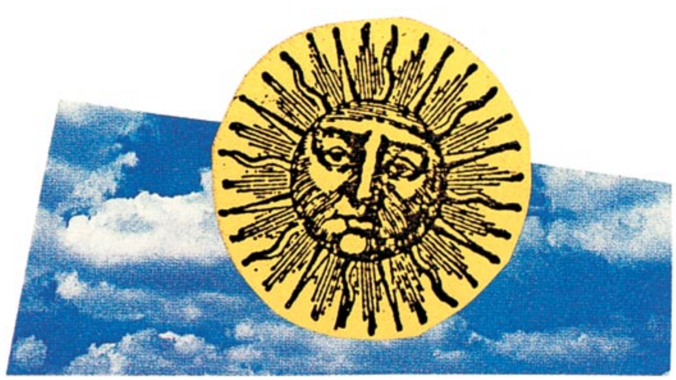
return the surplus to their reserve accounts. The Fed handles check processing for banks as well, to make sure the billions and billions of dollars in checks written each year move smoothly from one bank to another.

The Fed has other functions also. It helps regulate and supervise banks to keep them financially sound, and it serves as the government's banker by maintaining the U.S. Treasury's "checking account."

The Fight Against Inflation

It's a complex system, but the goal is simple: to keep the economy stable and growing at a pace that can be sustained without inflation. Economic security underlies nearly every hope and dream people have. It enables businesses to know they can afford to hire more workers, and it lets people plan for the future. If you are saving for college now, for instance, you want to know how much you need altogether and how much you must set aside each month. An inflationary economy can wreck your plans—what you've saved isn't nearly enough anymore, and you don't know how much more will be needed.

A healthy monetary policy, sensitive to changing economic conditions, helps prevent such worries, so you can get on with the business of working to turn your dreams into reality.



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