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Money, Banking, and Financial Institutions

McGraw-Hill/Irwin

Money is anything
that is generally
acceptable
in exchange
for goods, services,
economic resources,
or for the settlement
of debts

Advantages of monetary exchange

- Eliminates the coincidence of wants problem.
- (Meaning it is better than barter – you don't have to find someone who wants what you have and has what you want.
- Facilitates economic specialization.
- (Which we learned was a way to increase production overall.)

Functions of money

1. Medium of exchange
2. Unit of account
3. Store of value (or wealth)

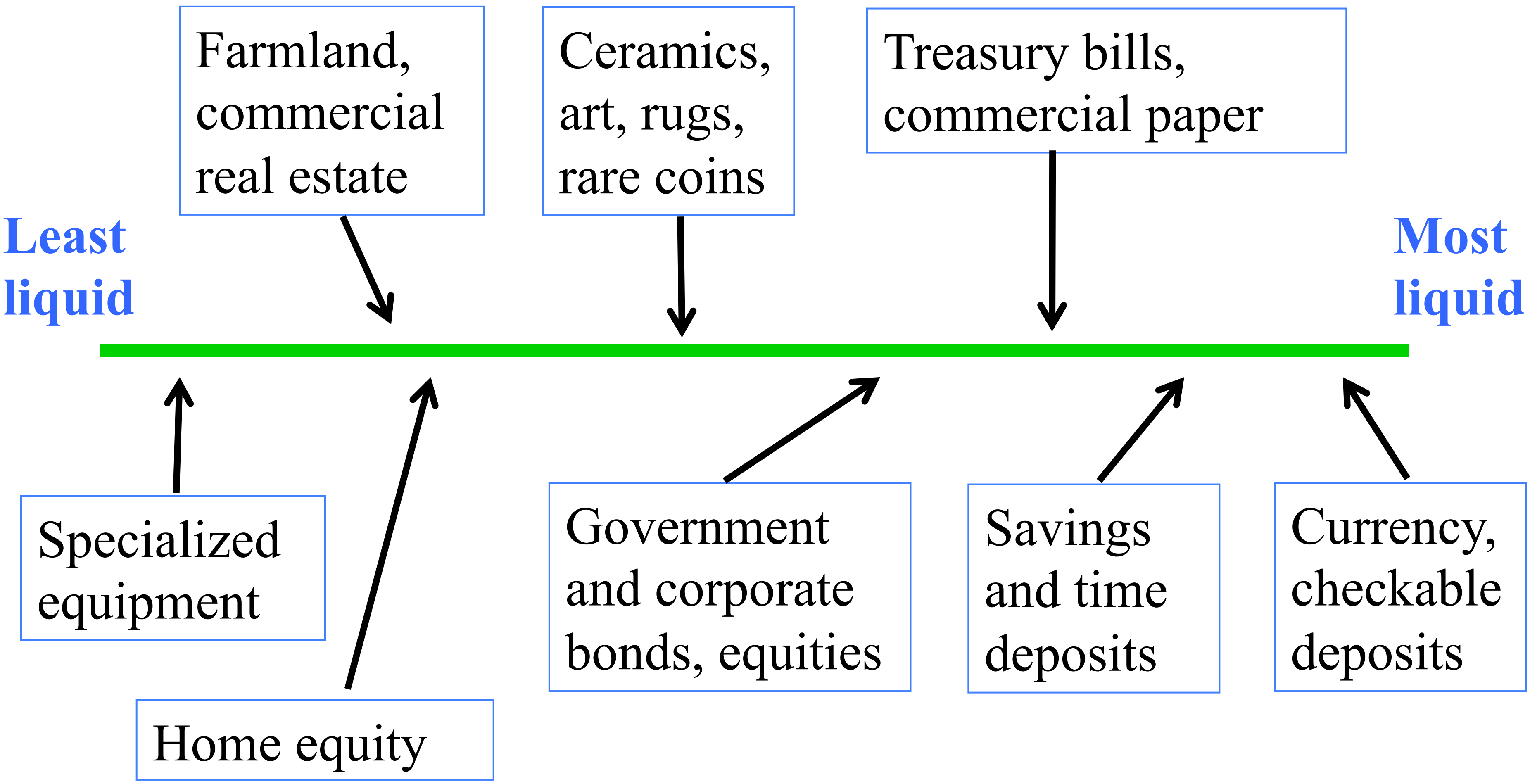
What is liquidity?

Liquidity refers
to two properties of assets
or stores of value, namely:

- The ready convertibility of the asset to generalized purchasing power (or money)
- The comparative safety of the asset.

Money is the most liquid asset available under normal circumstances

The liquidity scale



Commodity money

Anything that serves both as money and as a commodity; money that has intrinsic worth.

Domesticated cattle were one of the first examples of money.

Representative money

Bank notes that exchange
for a specific commodity, such as gold

Examples

1. Tobacco warehouse receipts

2. The Goldsmith bankers

Fiat Money: Anything which serves as a means of payment by government declaration

This Note Is Legal Tender For All Debts, Public and Private

You are willing to accept money not because it is "backed" by precious metals; but rather because you know it is generally acceptable in exchange

MONETARY AGGREGATES

These are measures of the money supply. We add together all assets that are liquid enough to be classified as money

M1

The narrow measure of the money supply; includes only the most liquid assets

M1 equals

Currency and coin in circulation

Plus: Checkable deposits

Plus: Travelers' checks

M2

A broader measure of the money supply favored by many economists.

M2 equals

M1

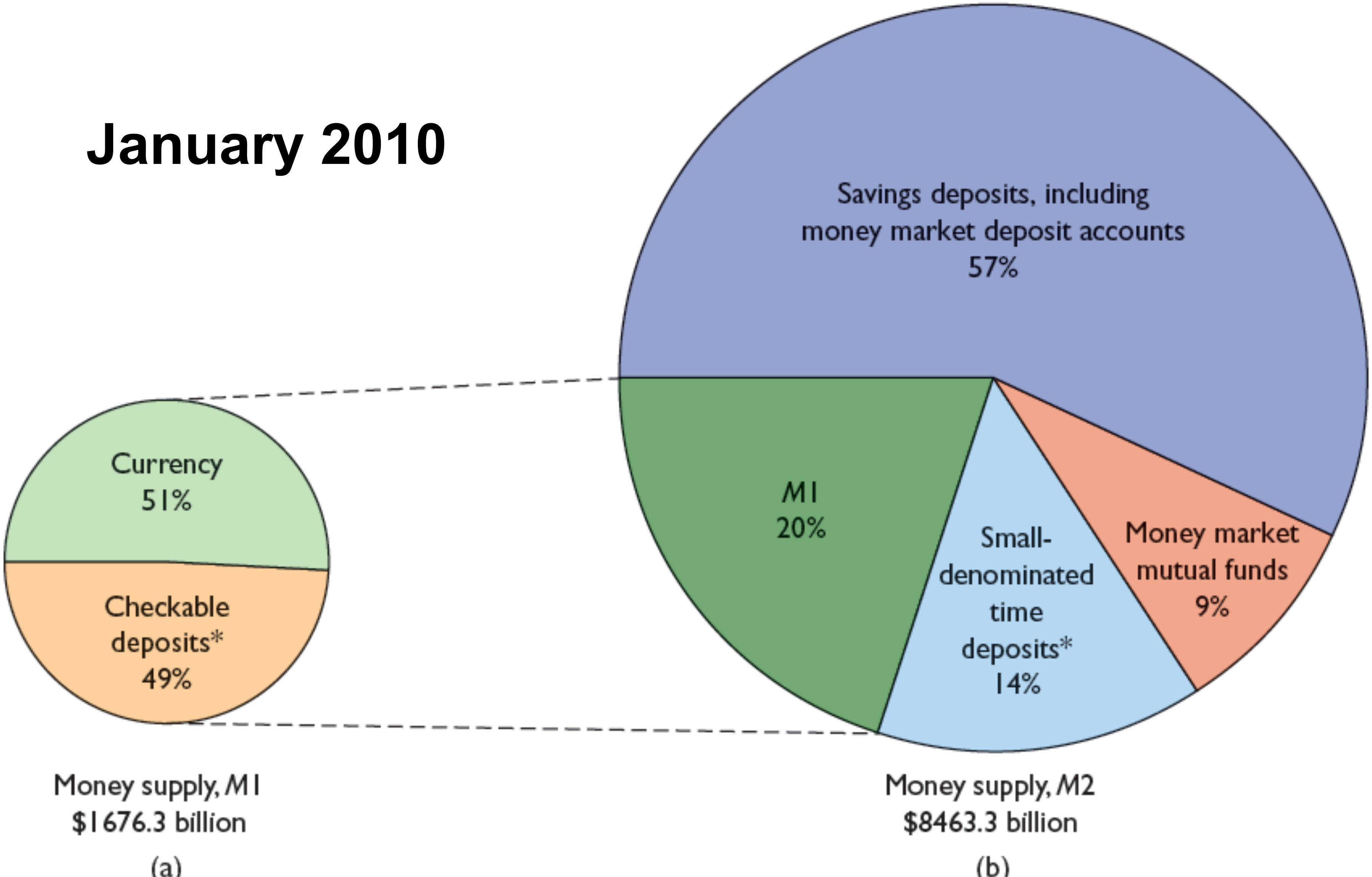
Plus: Miscellaneous near monies

Plus: Small denomination time deposits

Plus: Savings deposits

Plus: Money market deposit accounts

Money Definitions



Source: Federal Reserve System

What “Backs” the Money Supply?

- Guaranteed by government’s ability to keep value stable
- Money as debt
- Why is money valuable?
  - Acceptability
  - Legal tender
  - Relative scarcity

What "Backs" the Money Supply?

- Prices affect purchasing power of money
- Hyperinflation renders money unacceptable
- Stabilizing money's purchasing power
  - Intelligent management of the money supply – monetary policy
  - Appropriate fiscal policy

The Monetary System

The monetary system consists of the Federal Reserve and the banks and other institutions that accept deposits and provide the services that enable people and businesses to make and receive payments.

Financial Intermediaries

These units connect depositors and borrowers

1. Commercial banks
2. Thrift institutions
3. Money market fund:
   A financial institution that
   obtains funds by selling shares
   and using these funds to purchase assets
   such as U.S. Treasury bills.

HOW BANKS WORK

By bringing together
both sides of the money market,
banks serve as *intermediaries*
or go-betweens. Banks reduce
the *transactions costs*
of channeling saving
to creditworthy borrowers.

- Coping with asymmetric information.
- Reducing risk through diversification.

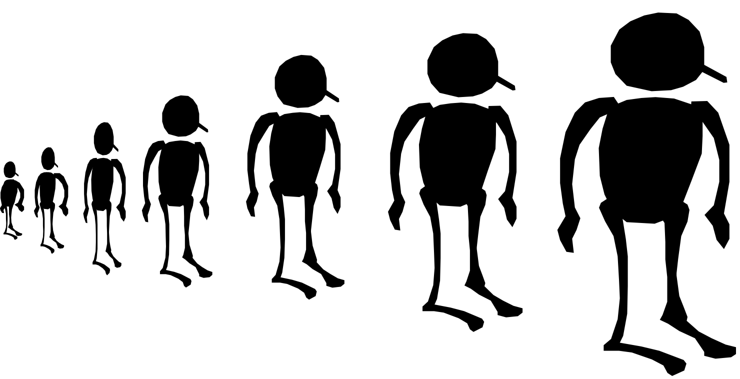
LIQUIDITY VERSUS PROFITABILITY

Banks must be ready for customers' withdrawals, so *liquid* bank assets are desirable. At the same time, less liquid assets such as commercial and real estate loans are more profitable.

The Federal Deposit Insurance Corporation (FDIC)

- **Created in 1933**
- **A government agency that insures deposits in commercial banks (up to $100,000 per account).**
- **Banks pay premiums to the FDIC**

Bank failures were often a "self-fulfilling prophesy."

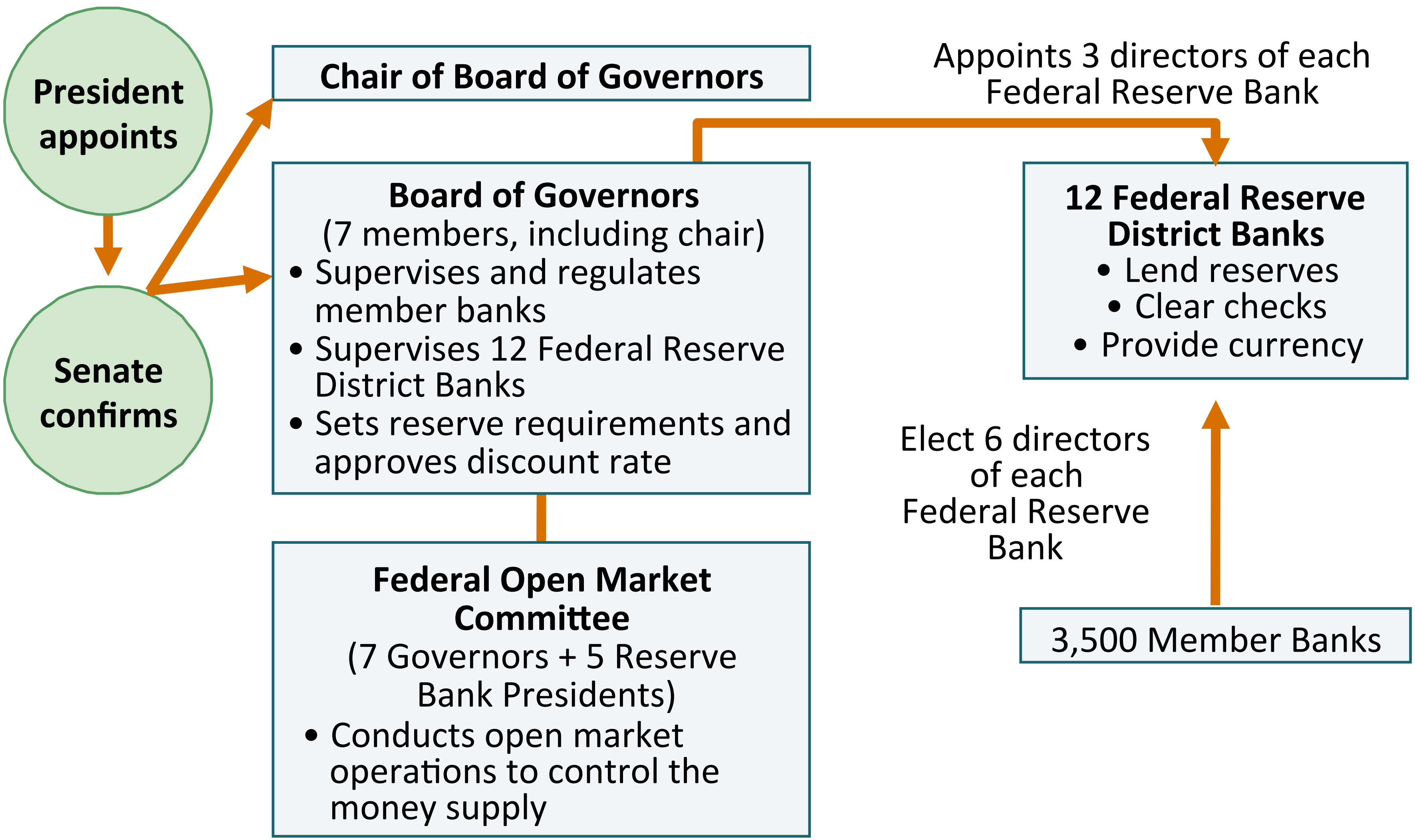


Federal Reserve Act of 1913

•The history of banking in the U.S. prior to 1913 is messy — featuring widespread panic and runs on banks — for example, in 1893 and 1907.

•The Federal Reserve System was created in 1913.

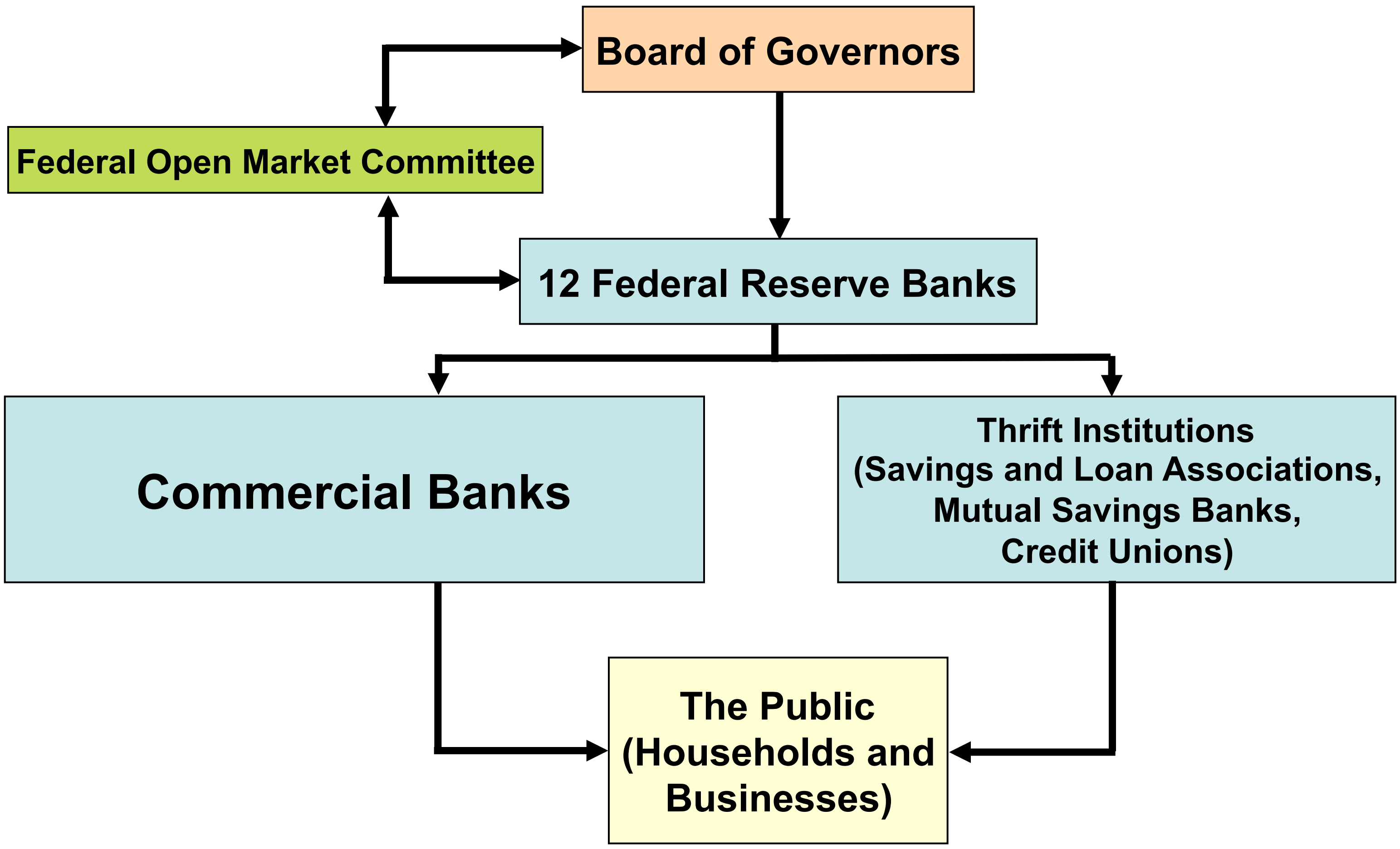
The Structure of the Federal Reserve



Federal Reserve - Banking System

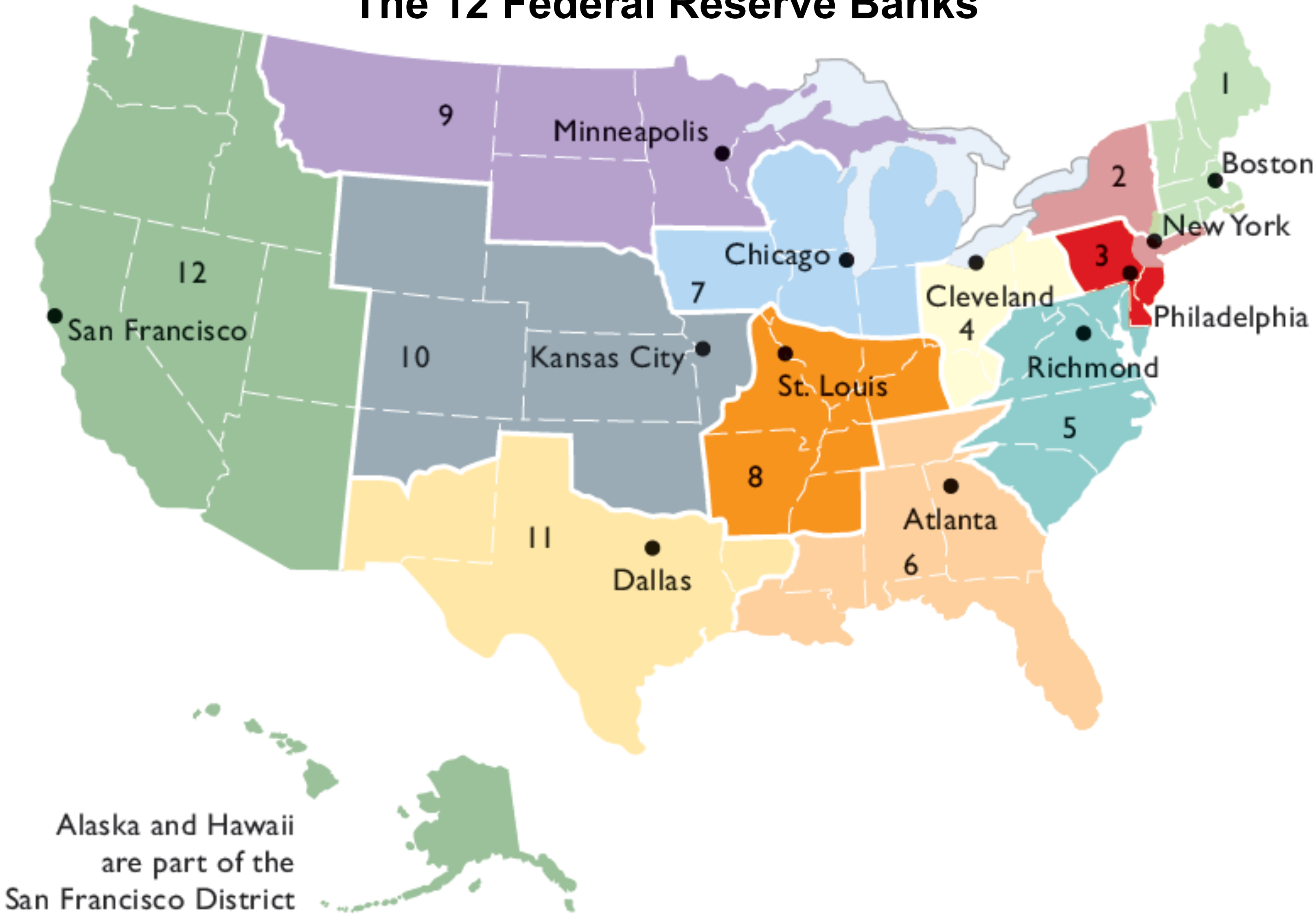
- 12 Federal Reserve Banks
  - Serve as the central bank
  - Quasi-public banks
  - Banker's bank

Federal Reserve – Banking System



Federal Reserve – Banking System

The 12 Federal Reserve Banks



Federal Reserve – Banking System

- Federal Open Market Committee
  - Aids Board of Governors in setting monetary policy
  - Conducts open market operations
- Commercial banks and thrifts
  - 6,800 commercial banks
  - 8,700 thrifts

Federal Reserve Functions

- Issue currency
- Set reserve requirements
- Lend money to banks
- Collect checks
- Act as a fiscal agent for U.S. government
- Supervise banks
- Control the money supply

Federal Reserve Independence

- Established by Congress as an independent agency
- Protects the Fed from political pressures
- Enables the Fed to take actions to increase interest rates in order to stem inflation as needed

The Financial Crisis of 2007 and 2008

- Mortgage Default Crisis
- Many causes
  - Government programs that encouraged home ownership
  - Declining real estate values
  - Bad incentives provided by mortgage-backed bonds

The Financial Crisis of 2007 and 2008

- Securitization – the process of slicing up and bundling groups of loans into new securities
- As loans defaulted, the system collapsed
- “Underwater” homeowners abandoned homes and mortgages

The Financial Crisis of 2007 and 2008

- Failures and near-failures of financial firms
  - Countrywide: second largest lender
  - Washington Mutual: largest lender
  - Wachovia
- Other firms came close

The Financial Crisis of 2007 and 2008

- Troubled Asset Relief Program (TARP)
  - Allocated $700 billion
    to make emergency loans
  - Saved several institutions from failure

Post-Crisis U.S. Financial Services

- Major Categories of Financial Institutions
  - Commercial Banks
  - Thrifts
  - Insurance Companies
  - Mutual Fund Companies
  - Pension Funds
  - Securities Firms
  - Investment Banks

Major Categories of Financial Institutions

Institution	Description	Examples
Commercial Banks	State and national banks that provide checking and savings accounts and make loans	JP Morgan Chase, Bank of America, Citibank, Wells Fargo
Thrifts	Savings and loan associations, mutual savings banks, credit unions that offer checking and savings accounts and make loans	Charter One, New York Community Bank
Insurance Companies	Firms that offer policies through which individuals pay premiums to insure against lose	Prudential, New York Life, Northwestern Mutual, Hartford
Mutual Fund Companies	Firms that pool customer deposits to purchase stocks or bonds	Fidelity, Vanguard, Putnam, Janus, T Rowe Price
Pension Funds	Institutions that collect savings from workers throughout their working years and then invest the funds to pay retirement benefits	TIAA-CREF, Teamsters' Union, CalPERs
Securities Firms	Firms that offer security advice and buy and sell stocks and bonds for clients	Merrill Lynch, Smith Barney, Charles Schwab
Investment Banks	Firms that help corporations and governments raise money by selling stocks and bonds	Goldman Sachs, Morgan Stanley, Deutsche Bank, Nomura Securities

Post-Crisis U.S. Financial Services

- Wall Street Reform and Consumer Protection Act
  - Passed to help prevent many of the practices that led to the crisis
  - Critics say it adds heavy regulatory costs

Electronic Banking

- Electronic-based payment systems have pushed aside currency and checks
  - Credit/debit cards
  - Fedwire transfers
  - Electronic money
  - Stored-value cards