High School

Social Studies

Economics

Grade 12

2019 – 2020

Instructional Packet

Set II

Reading Essentials and Study Guide

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Chapter 10: Money and Banking

Lesson 1 The Evolution, Functions, and Characteristics of Money

ESSENTIAL QUESTION

How has money evolved to meet the needs of people everywhere?

Reading HELPDESK

Academic Vocabulary

revolution an overthrow of government

converted changed into a different form

Content Vocabulary

Federal Reserve System (Fed) privately owned, publicly controlled, central bank of the United States

Federal Reserve notes paper currency issued by the Fed that eventually replaced all other types of federal currency

barter economy moneyless economy that relies on trade or barter

commodity money money that has an alternative use as an economic good; gunpowder, flour, corn etc.

fiat money money by government decree; has no alternative value or use as a commodity

specie money in the form of gold or silver coins

monetary unit standard unit of currency in a country's money supply; American dollar, British pound etc.

medium of exchange money or other substance generally accepted as payment for goods and services; one of the three functions of money

measure of value one of the three functions of money that allows it to serve as a common denominator to measure value

store of value one of the three functions of money allowing people to preserve value for future use

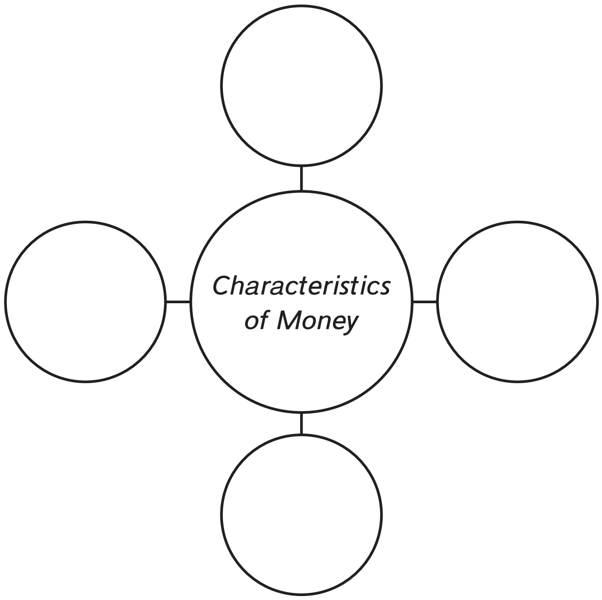
demand deposit accounts (DDAs) account whose funds can be removed from a bank or other financial institution by writing a check or using a debit card

M1 narrow definition of money supply conforming to money's role as medium of exchange; components include coins, currency, checks, other demand deposits, traveler's checks

M2 broad definition of money supply conforming to money's role as a medium exchange and a store of value; components include M1 plus savings deposits, time deposits, and money market funds

TAKING NOTES: *Key Ideas and Details*

Use a graphic organizer like the one below to identify the characteristics of money.



The Evolution of Money

Guiding Question *Why did money replace the barter system?*

Take a moment to think what life would be like in a ***barter economy****. A barter economy is a moneyless economy that relies on trade. Without money, the exchange of goods and services would be more difficult. The products some people have to offer as payment may not be what the other person wants or needs, or may be difficult to divide for payment. For example, how could a milkman with a pail of milk get a pair of shoes if the cobbler wanted a basket of fish? There has to be a situation where two people want exactly what the other has and are willing to trade what they have for it. Otherwise it is difficult for trade to take place.*

Life is simpler in an economy with money. The milkman sells the milk for cash and then uses that cash to buy a pair of shoes. The cobbler takes the cash and looks for someone selling fish. Money, as it turns out, makes life easier for everybody in ways we may have never considered.

Money in Colonial America

The money used by early settlers in the American colonies was similar to the money in early societies. Some of it was ***commodity money****—money that has an alternative use as a commodity, or an economic good or service. Many products served as commodity money. These included corn, hemp, gunpowder, and musket balls. These items could be used to pay debts and make purchases. At the same time, colonists could consume these products if necessary.*

Tobacco was a commonly accepted type of commodity money. In 1618 the Governor of colonial Virginia set a value of three English shillings per pound on tobacco. Two years later, the colonists used some of this money to bring their wives to the colonies.

Other colonies established **fiat money**. Fiat money is money by government decree. For example, in 1637, Massachusetts established a monetary value for wampum. Wampum was a form of currency the Wampanoag Native Americans made out of white and purple mussel shells. The Wampanoag and the settlers used these shells in trade. There were more white shells than purple ones, so one English penny was made equal to six white or three purple shells. The colonial settlers could even pay their taxes with wampum.

Early Paper Currency

Paper currency was another popular form of fiat money in the colonies. Some state laws let people print their own paper currency if they promised to redeem the currency for gold or silver. States even printed money in the form of tax anticipation notes. People used them to pay salaries, buy supplies, and meet other expenses until they received taxes and could redeem the notes.

The United States Continental Congress issued paper money to pay for the Revolutionary War. In 1775, it printed Continental dollars, a form of fiat paper currency with no gold or silver backing. By the end of the war, it had printed nearly one-quarter *billion* Continental dollars. This was so much that it was practically worthless by the end of the **revolution**.

Specie in the Colonies

Colonists also used small amounts of ***specie****—or money in the form of silver or gold coins. These included English shillings, Austrian talers, and different European coins that immigrants brought to the colonies. Coins were the most desirable form of money, not only because of their mineral content, but because they were in limited supply. By 1776, only $12 million in specie was disbursed and used in the colonies, compared to nearly $500 million in paper currency.*

The most popular coin in the colonies was the Spanish peso that came to America through trade and piracy. Long before the American Revolution had begun, the Spanish were mining silver in Mexico. They melted silver into bullion, which were ingots or bars of precious metals, or they made it into coins to ship to Spain. When the Spanish treasure ships stopped in the West Indies to buy fresh supplies, they often became victims of Caribbean pirates. The pirates spent their stolen treasure in America's southern colonies.

The "triangular trade" between the colonies, Africa, and the Caribbean brought more pesos to America. Traders took molasses and pesos from the Caribbean to the colonies. There they sold the molasses to be made into rum and spent their pesos on other goods. Traders shipped the rum to Africa to trade it for enslaved Africans. They took the enslaved Africans to the Caribbean to sell them for pesos and more molasses. The trade cycle started again when they took the molasses and pesos to the colonies.

From "Talers" to "Dollars"

Pesos were known as "pieces of eight" because they were divided into eight parts known as "bits." Because the pesos resembled the Austrian talers, they were nicknamed "talers." Talers *sounded like the word* dollars. *This term became so popular that the dollar became the basic* ***monetary unit****, or standard unit of currency, in the U.S. money system.*

Rather than dividing the dollar into eighths as the Spanish had done with the peso, it was decided to divide it into tenths, which was easier to understand. Still, some of the terminology used with the Spanish peso remains. For example, people sometimes call a 25-cent coin—one quarter of a dollar—"two bits."

Reading Progress Check

Comparing Compare the costs and benefits of commodity money and fiat money.

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Characteristics and Functions of Money

Guiding Question *What are the qualifications for something to be used as money?*

The study of early forms of money is useful because it helps us understand the characteristics, or features, that give money its value. In fact, any substance can serve as money if it has four main characteristics.

Characteristics of Money

First, money must be portable, *or easily moved from one person to another, to make the exchange of money for products easier. Most money in early societies was very portable—including shells, wampum, tobacco, and compressed blocks of tea.*

Second, money must also be reasonably *durable*, or long-lasting, so it does not deteriorate when people handle it. Most colonial money was quite durable, especially types like musket balls and wampum. Even the fiat paper money of the colonial period was durable in the sense that people could easily replace it with new bills when old ones became worn.

Third, money should be easily *divisible* into smaller units so that people can use only as much as they need to purchase, or buy, an item. Most early money was highly divisible. People cut the blocks of tea or cheese with a knife. They could easily break apart the bundles of tobacco leaves. People even cut Spanish pesos into eights to make “bits” for payment.

Finally, money must be available, but only in *limited supply*. People on the Yap Islands, for example, used stones as money that they carried in open canoes from other islands 400 miles away. Because navigation was uncertain and the weather was hard to predict, only one canoe in 20 completed the round-trip, making the supply of stones limited.

Money, like almost everything else, loses its value whenever there is too much of it. This was a major problem for most types of commodity money. In Virginia, the price of tobacco went from 36 pennies a pound to 1 penny a pound after everyone started growing their own tobacco. Wampum even lost its value when settlers used industrial dyes to turn white shells into purple—thereby doubling their value. Most paper currency in the colonial period also lost its value when too much was printed.

Three Functions of Money

Any substance that is portable, durable, divisible, and limited in supply can serve as money. If it does, it will serve three roles in the economy.

- **Medium of exchange**—A medium of exchange is accepted by all parties as payment for goods and services. Throughout history, people have used various materials as a medium of exchange, including colored shells, tobacco, gold, silver, and even salt.

- **Measure of value**—Money serves as a measuring stick. Whenever we see a price tag, we can compare the cost of one item to another, expressed in dollars and cents in the United States.
- **Store of value**—This feature of money allows purchasing power to be saved until needed. For example, when you earn a paycheck, you can spend it when and where you need to. You do not have to exchange the value of your labor immediately to buy products from your employer.

The modern money we use today serves all of these functions.

Characteristics of Modern Money

While our modern money may seem to be quite different from earlier forms of money, it shares the same fundamental characteristics and functions of money. For example,

- **Portability—**Modern money is *portable*. Our currency is lightweight, convenient, and can be easily transferred from one person to another. The same applies to the use of checks.
- **Durability—**Modern money is reasonably *durable*. Metallic coins last about 20 years under normal use. Paper currency is also reasonably durable, with a $1 bill lasting about 18 months in circulation. The introduction of the Sacagawea dollar coin was part of an attempt to make the money supply even more durable by replacing the $1 bill with longer lasting coins.
- **Divisibility**—Modern money is *divisible*. The penny, the smallest denomination (value) of coin, is small enough for almost any purchase. In addition, people can write checks for the exact amount of a purchase.
- **Scarcity—**Modern money is in *limited supply*. This is because the Fed monitors the size of the money supply and takes steps to keep it from growing too fast.

Exploring the Essential Question

In what way is our modern money an improvement over money used during the Colonial period? Is there any way in which Colonial money was superior to our money today?

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The fact that our money supply works so well contributes to the success of the American economy. Our money supply continues to evolve under the supervision of the Fed.

Components of Modern Money

Today the money supply has several different components. Some is in the form of Federal Reserve Notes and some is in the form of metallic coins made by the United States Mint. Other components include ***demand deposit accounts (DDAs)****, or funds deposited in a bank that can be accessed by writing a check or using a debit card.*

The Fed defines our money supply in two ways. **M1** is the narrow definition that includes coins and currency, traveler's checks, DDAs, and checking accounts held at depository institutions. Depository institutions are places where money is deposited or stored, such as banks, savings and loans, and credit unions. These forms of money are all a medium of exchange. **M2** is a broader measure that includes M1 along with forms of money that serve as a store of value. This includes savings deposits, time deposits, and money market funds.

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Chapter 10: Money and Banking

Lesson 1 The Evolution, Functions, and Characteristics of Money

Think of how these different components made our money supply more useful to us! For example, paper currency was an improvement over coins because paper currency could be produced in higher denominations and was much more portable. Checking accounts were an improvement over coins and paper currency because people can easily mail checks, making it easier to transfer money. In addition, a cancelled check serves as a receipt for the transaction. Also, a bank can cancel a lost check, unlike missing coins or bills that might never be seen again.

Funds transferred electronically are faster, simpler, less expensive, and usually more convenient than checks. An example of this is when a company pays its employees by transferring funds directly into their bank accounts. These changes are likely to continue in unpredictable ways, making money safer and more useful.

Reading Progress Check

Explaining How does modern money reflect the functions and characteristics of money?

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Chapter 10: Money and Banking

Lesson 2 The Development of Modern Banking

ESSENTIAL QUESTION

How did the creation of the Fed improve our banking system?

Reading HELPDESK

Academic Vocabulary

clauses a stipulation, usually in a legal document

initial originally; at the beginning

Content Vocabulary

state bank a bank that receives its charter from the state in which it operates

legal tender currency that must be accepted for payment by decree of government

national bank a commercial bank chartered by the National Banking System

national currency currency backed by government bonds and issued by commercial banks in the National Banking System

Gold Certificates paper currency backed by gold; issued in 1863 and popular until recalled in 1934

Silver Certificates paper currency backed by, and redeemable for, silver from 1878 to 1968

gold standard a system in which the basic unit of currency is equivalent to, and can be exchanged for, a specific amount of gold

central bank a bank that can lend to other banks in times of need, or a "bankers' bank"

bank run sudden rush by depositors to withdraw all deposited funds, generally in anticipation of bank failure or closure

bank holiday brief period during which all banks or depository institutions are closed to prevent bank runs

Federal Deposit Insurance Corporation (FDIC) the United States government institution that provides deposit insurance on the depositor's account

TAKING NOTES: *Key Ideas and Details*

Use a graphic organizer like the one below to identify the key developments that led to the modern banking system. Add and fill in boxes as needed.

Early Banking in America

Guiding Question *Why was the national banking system developed?*

Banking practices in the United States have changed over time. In the past, the government hardly regulated banking at all. This led to abuses, and even affected the type of money we use.

Privately Issued Bank Notes

During the Revolutionary War, the government printed nearly 250 million Continental dollars. But by the end of the Revolution, Continental currency had become worthless. People did not trust the government to issue anything except coins. As a result, Article 1, Section 8, of the United States Constitution states:

> *The Congress shall have the power*
>
> *To coin money, regulate the value thereof, and of foreign coin, and fix the standard of weights and measures;*
>
> *To provide for the punishment of counterfeiting the securities and current coin of the United States; . . .*
>
> *To make all laws which shall be necessary and proper for carrying into execution the foregoing powers, and all other powers vested by this Constitution in the government of the United States, or in any department or officer thereof.*

Article 1, Section 10, further states:

> *No State shall . . . coin money; emit bills of credit; make anything but gold and silver coin a tender in payment of debts. . . .*

Because of these **clauses**, the federal government did not print paper money until the Civil War. Instead, it left the printing, distribution, and regulation of the paper money supply to the choice of privately owned banks and other companies that wanted to build canals, railroads, and other projects.

Growth of State Banks

The new Constitution left the printing of paper currency to individual states. By 1811 the country had about 100 state banks. A ***state bank*** *receives its operating charter, or contract, from a state government.*

Banks issued their own currency by printing their notes at local printing shops. The banks then put these notes in circulation with the promise that people could exchange them for gold or silver if they ever lost faith in the bank or its currency.

At first, most banks printed only the amount of currency that was honestly backed with the gold and silver reserves they had. But others were not as honest. They printed large amounts of paper currency in distant, or far away, areas to make it difficult for people to redeem their currency.

Problems with Currency

Even when banks were honest, there were problems with their currency. First, each bank issued its own currency in different sizes, colors, and denominations. As a result, hundreds of different kinds of notes could be in circulation in a city.

Second, banks were tempted to issue too many notes because they could print more money whenever they wanted. Third, counterfeiting, became a major problem. With so many different types of notes in circulation, some counterfeiters did not even bother to copy monetary notes issued by existing banks. Instead, they just made up fictitious ones.

By the beginning of the Civil War, more than 1,600 banks were issuing more than 10,000 different kinds of paper currency. Each bank was supposed to have backing for its notes in the form of gold or silver. But this was rarely what happened. As a result, when people tried to use their notes, merchants would often check the latest listing of good and bad currencies before deciding whether to accept them.

Politically powerful local bankers resisted making changes to improve the system until an event that would forever change commercial banking in the United States—the Civil War.

Greenbacks

To fight the Civil War, both the Union and the Confederacy needed to raise enormous sums. Congress tried to borrow money by selling bonds, but failed to raise as much money as they needed for the Union war effort. So Congress decided to print paper currency for the first time.

In 1861 it authorized the printing of $60 million in new currency that had no gold or silver backing. Congress simply declared that the notes were **legal tender**—and must be accepted as payment. These new notes were soon called "greenbacks" because of the green ink on the reverse side. This made it easy to tell them apart from state notes, which were usually blank on the back.

The National Banking System

As the war dragged on, people feared that the greenbacks might become worthless. This is what happened with the Continental dollars used almost a century earlier to finance the Revolutionary War. When the greenbacks did lose some of their value, people avoided using them, which forced Congress to find another way to pay for the war.

In 1863, Congress enacted (passed) the National Currency Act, which created a National Banking System (NBS) made up of national banks. A **national bank** is a privately owned bank that receives its operating charter from the federal government. These banks issued their own notes, called **national currency**, or national bank notes. These notes were backed with bonds that the banks bought from the federal government. The government hoped that rigorous bank inspections and other high standards would give people confidence in the new banking system and its currency. The new system also would help the Union cause because banks that joined the NBS had to buy Union bonds.

Initially, only a few state-chartered banks joined the system. This was because it was easier for them to print their money at local printers. Finally, in 1865, the federal government forced state banks to become part of the National Banking System. They did this by placing a 10 percent tax on all privately issued bank notes. Because state-chartered banks could not afford the tax, they removed their notes from circulation, leaving only the greenbacks and currency issued by the NBS in circulation.

In this way, the need to finance the Civil War changed paper money from issues by state banks to issues backed by the federal government.

Other Federal Currencies

The 10 percent tax made the money supply much simpler. This was because state banks withdrewmore than 10,000 different sizes and denominations of currency. Before long, though, new types of federal currency appeared.

In the same year it created the NBS, the government issued **Gold Certificates**. Gold certificates were paper currency backed by gold placed on deposit with the United States Treasury. At first, the government printed these certificates in large denominations only for banks to use. But by 1882, they were also available to the general population in smaller denominations.

In 1878, the government introduced **Silver Certificates**. Silver certificates were paper currency backed by silver placed on reserve with the Treasury. This increased demand for silver, which pleased silver miners. The government was already circulating silver dollar coins, but they were too big to be convenient. The public was happy to have another option.

Reading Progress Check

Explaining Why did the government issue greenbacks in the year 1861?

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The Gold Standard

Guiding Question *What does it take for a country to be on a gold standard?*

Gold coins had been a small part of the country's money supply ever since the colonial period. The California gold rush in the late 1840s greatly increased the amount of gold coins in circulation. By the end of the Civil War, gold coins seemed to be everywhere.

But the country did not go on a **gold standard** until Congress passed the Gold Standard Act in 1900. The gold standard is a system in which the basic unit of currency is equal to, and can be exchanged for, an exact amount of gold.

Going on the Gold Standard

The Gold Standard Act of 1900 said that a dollar was equal to 1/20.67 of an ounce of gold. People continued to use greenbacks, Gold Certificates, Silver Certificates, National Bank Notes, and other federal currencies. But now they could exchange these notes for gold at the Treasury whenever they wanted.

The government could hold much less gold than the currency represented because people liked the convenience of paper currency and usually did not demand gold. This is generally true when countries go on a gold standard.

Advantages of a Gold Standard

A gold standard has two major advantages. First, people may feel more secure about their currency. Second, the standard is supposed to stop the government from creating too much money. This is because gold is a limited resource. And if paper currency is relatively scarce, it should keep its value.

Since it is rare that all of a country's paper notes will be redeemed at the same time, the United States never held a gold reserve equal to their value.

Disadvantages of a Gold Standard

A growing economy needs its money supply to grow as well. So, under a gold standard, it will also need increasing stocks of gold. If gold is in small supply, the growth of the money supply may slow down and perhaps stop, which limits economic growth. That is one major disadvantage of the gold standard.

Another risk is that a large number of people may decide to convert their currency at the same time. This would empty the gold reserves.

Abandoning the Gold Standard

During the Depression years, many banks failed, and almost one person in four did not have a job. In such uncertain times, people began asking for gold in exchange for the paper currency they had. Foreign governments with large dollar holdings did the same. As a result, the gold stock held by the U. S. government rapidly shrank.

In 1933, President Roosevelt issued a series of orders that effectively denied the gold standard to the American people. Executive orders required all citizens to surrender their gold coins to the Federal Reserve System at the rate of one ounce of gold for $20.67 of Federal Reserve Notes. The next step was to raise the price of gold from $20.67 to $35 an ounce. By 1935, U.S. citizens could no longer redeem dollars for gold. But foreign governments were allowed to do so at the higher $35/oz. price.

After World War II, some European countries wanted to build their gold stocks, so they started to redeem their dollar holdings for gold. This severely drained U.S. reserves again. The official price of $35/oz. lasted until August 15, 1971. On this date, President Nixon took the final step and declared that the U.S. would no longer redeem any dollars for gold. Ever since, the price of gold has fluctuated with changes in supply and demand.

Reading Progress Check

Describing What are the advantages and disadvantages of the gold standard?

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Creation of the Fed

Guiding Question *How did the Fed strengthen the National Banking System?*

The national banking system also needed to evolve during the gold-standard years. Despite a huge number of banks, the system was having a hard time creating enough circulation to keep up with the growing population. Checking accounts were becoming popular, but many banks had trouble adapting to the challenge. And even minor recessions were causing them major problems.

The Federal Reserve System

Reform came in 1913 when Congress created the Federal Reserve System, now often called the "Fed," as the nation's central bank. A ***central bank*** *is a banker's bank, which can lend to other banks in times of need.*

The government set up the Fed in some ways like a corporation. Any bank that joined had to purchase shares of stock in the system. The government required all national banks to do this. It also allowed state-chartered banks to buy shares as well. As share-holders, or part-owners, banks own the Federal Reserve System, not the federal government.

The Fed's own currency, called Federal Reserve Notes, eventually took the place of all other types of federal currency. The Fed became the nation's first true central bank because it had the resources to lend to other banks during times of difficulty.

Exploring the Essential Question

The establishment of the Fed aimed to solve several problems in the nation's banking system. Match the problems listed with the solutions offered by the Fed.

Problems:

a. There were many national banks and no centralized system for keeping them strong.
b. Banks were vulnerable to failure because of lack of reserves.
c. The nation was operating with several different forms of national currency.

Solutions:

1. The Fed had the ability to loan money to banks that were in trouble.
2. Federal Reserve notes replaced all other types of federal currency.
3. The Fed served as a central bank, which strengthened the nation's banking system.

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Banking in the Great Depression

Despite the creation of the Fed, many banks were only slightly sound during the 1920s. One reason was that the number of banks had soared between the Civil War and 1921, to more than 31,000 banks. Although some merging happened over the next decade, there were still too many small struggling banks at the start of the Great Depression in 1929.

As **Figure 10.1** shows, a shocking number of bank failures happened. By 1934, more than 10,000 banks had closed or merged with stronger banks. If account holders became worried about their bank, they would rush to withdraw money before it failed, which created a **bank run**. These runs caused many banks to fail.

On March 5, 1933, President Roosevelt announced a **bank holiday**. This was a brief period during which every bank in the country had to close. Several days later, after Congress passed legislation to strengthen the banking industry, most banks were allowed to reopen.

Federal Deposit Insurance

When banks failed during the Great Depression, depositors lost most or even all their savings because deposits were not insured. The Banking Act of 1933 corrected this by creating the ***Federal Deposit Insurance Corporation (FDIC)*** *to insure customer deposits in case of a bank failure. At first, the FDIC insured customer deposits to a maximum of $2,500. But today the limit is $250,000 per customer per bank. If an account holds more than this amount, the depositor may go to court and sue the bank owners to get back the rest of their money.*

Lesson 2 The Development of Modern Banking

After the government created the FDIC, people worried less about the safety of their deposits. This decreased the number of bank runs. If a bank was in a danger of failure, the FDIC could do one of the following:

1. Take the bank,
2. Sell it to a stronger one, or
3. Liquidate it and pay off the depositors.

If the government sold the bank, it made the sale in secret to prevent panic. It also kept the sale secret to keep shareholders from selling worthless stock to innocent investors.

Federal Reserve Notes

*The Federal Reserve Notes that the government first introduced in 1914 have become the most visible part of our money supply. All of the other federal currencies have slowly been taken out of circulation and were replaced by Federal Reserve Notes. These include National Bank Notes, **Silver Certificates, Gold Certificates**, and even the U.S. Notes, or "greenbacks."*

During the early gold standard years, every dollar of Federal Reserve Notes was backed by $0.25 gold reserves. But they issued more and more notes and had difficulty keeping enough gold to back the notes. So the government reduced and then eventually removed the 25 percent reserve.

A Better Monetary System

Today, in part thanks to the Fed, we have a uniform currency and a more well-organized payment system, as well as a sound central bank.

One concern is that some banks have become so large that the government cannot allow them to fail. This is a problem the Fed was not designed to manage.

Reading Progress Check

Describing What is the purpose of the FDIC?

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Chapter 10: Money and Banking

Lesson 3 Banking Today

ESSENTIAL QUESTION

How has technology affected the way we use money today?

Reading HELPDESK

Academic Vocabulary

products things that are sold

Content Vocabulary

credit union nonprofit service cooperative that accepts deposits, makes loans, and provides other financial services

corporation form of business organization recognized by law as a separate legal entity with all the rights and responsibilities of an individual, including the right to buy and sell property, enter into legal contracts, sue and be sued

stock certificate of ownership in a corporation; common or preferred stock

shareholder person who owns a share or shares of stock in a corporation; same as stockholders

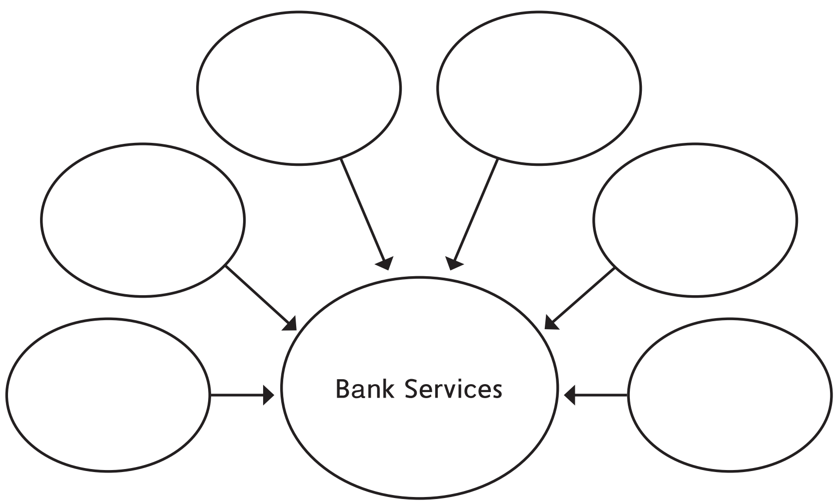
state-chartered bank bank that receives its charter from the state in which it operates

CD (certificate of deposit) receipt showing that an investor has made an interest-bearing loan to a financial institution

reserve requirement formula used to compute the amount of a depository institution's required reserves

TAKING NOTES: *Key Ideas and Details*

As you read the lesson, use a graphic organizer like the one below to identify the customer services most banks offer.



A commercial bank is like any other business—it is in business to make a profit. A bank or depository institution like a **credit union** is similar to many other businesses in that its "**products**," or the things it sells, are all services. A bank is also a bit different in that most of the money it loans has been borrowed from others.

How a Bank Gets Its Money

Guiding Question *How does a bank become established?*

Although banks perform several different activities, their main activity is lending money. They get the money they lend mainly as deposits from individual consumers and businesses. But a bank must be properly established to legally accept those deposits.

Issuing Stock

Most banks are set up as a ***corporation*** *for two reasons. First, a corporation can raise funds by selling* ***stock*** *to anyone who wants to be a part owner, or* ***shareholder****, in the bank. Second, a corporation is responsible for its debt, but none of its shareholders are. This is called "limited liability." If the corporation gets in trouble, its shareholders are protected.*

When people decide to start a bank, they hire attorneys to complete and file the legal papers to establish a corporation. Usually the founders reserve some of the initial shares of stock for themselves and sell the remaining shares to others. To set up a **state-chartered bank**, they must follow state laws that state the minimum amount of financial capital (or money) that a founder must contribute.

Consumer and Business Deposits

Once a bank is ready to begin performing the activities a bank performs, it accepts deposits and will pay interest on them. The rate of interest must be very close to rates paid by competing financial institutions, which might be savings and loans, credit unions, or other banks.

Most of its competitors will pay very little interest on checking deposits. Some even pay no interest on checking deposits. Financial institutions will pay a little more interest on longer-term savings deposits. The new bank might also offer **certificates of deposit**, or **CDs**, which actually are not deposits. Instead, they are seen as loans from a consumer to the bank.

Fractional Reserves Expand Bank Deposits

When a bank receives a new deposit or CD, it must keep some of it as part of the bank's reserves. ***Figure 10.2*** *shows how this process works for a $1000 deposit from a new customer called Kim. The deposit is subject to a 20 percent reserve requirement set by the Fed.*

As long as the bank keeps 20 percent of the deposit, it is allowed to lend the remaining $800. Let's say it lends the money to Bill, and Bill puts that money in a checking account for convenience. Bill could use an account at another bank or the lending bank. Either way, the $800 becomes a new deposit. This means it must meet the 20 percent **reserve requirement**, which would leave $640 that can be loaned to a new customer.

This process of depositing, lending, and then depositing again can continue until the total amount of new loans reaches $5000. The bank charges interest every time it makes a new loan. But it must also keep reserves. This means it can charge interest on $4000 of loans for every $1000 deposited. It can keep the reserves in the bank itself, or at the Fed.

The bank may continue getting deposits and making loans until it is "loaned out," or unable to make any more loans. If the Fed lowers the reserve requirement to 10 percent, every new loan can be as much as 90 percent of each deposit. On the other hand, if the Fed raises the requirement to 25 percent, the bank will need to find more reserves to back the existing loans.

Finally, the bank will have to report its reserves and its demand deposits to the Fed on a regular basis. The Fed, the Comptroller of the Currency, the FDIC, and possibly even some state banking officials all heavily regulate, or oversee, banks. Bankers are not very happy about this. But the regulation has prevented massive failures like those during the Great Depression.

Loans, Investments, and Fees

Loans to consumers and businesses are an important part of a bank's profits, or how much money it earns. For example, a bank might pay 2 percent on deposits, and lend the balance after reserves at 6 percent. It could lend at the 6 percent rate for home repair loans or mortgages. The difference between these two rates—2 percent and 6percent—is the "spread," 4 percent (6 percent – 2 percent = 4 percent). The spread creates profits that the bank may use to pay its employees and other bills.

A bank will also earn money on its investments, which could include a wide range of activities. For example, if a bank has extra funds that are not loaned out, it could buy U.S. bonds.

Finally, fees are also a major source of bank funds. For example, there may be fees for maintaining an account, fees for a loan application, withdrawal fees for using an automated teller machine (ATM) from another bank, fees for overdrawing your checking account, and fees for bouncing checks. A short list of typical fees is in **Figure 10.3**. Fees can be especially difficult for customers who keep minimal balances in their accounts or are late paying bills.

Reading Progress Check

Explaining What are the different ways banks can make money?

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Selecting a Bank

Guiding Question *Why have so many different methods evolved for accessing money?*

Almost everyone will need the services of a bank sometime, so it is never too early to shop around.

Evaluating Your Needs

You begin by thinking about which banking services you need. For example, does your employer only pay by check? Or does your employer also pay workers electronically by directly depositing funds in a bank? You might consider the second option, especially if a bank you like offers lower fees to customers who get their paychecks directly deposited into an account.

Next, think about the bills you normally pay. Do you actually go to different locations to pay monthly charges for car loans, food, rent, gas, and electric bills? Or can you pay these bills by mail or even electronically (using a computer or smartphone)?

If you can pay your bills by mail, then having a regular checking account makes sense. If you can pay them electronically, you might want a bank that will make this easy to do. Cash might work better for you if you pay your bills in person. But remember that cancelled checks and electronic records are excellent evidence hat you have made a payment and that the payment was accepted.

Banking Services

Banks offer a variety of services. You may not need to use all of them immediately, but it's good to know about what you might need later on.

- **Checking accounts or DDAs**—This is one of the most useful services. Checking accounts let you make purchases in any amount up to the limit of your deposit, and to make a payment by mail. The bank has to make the withdrawal on demand, or when presented with a check. This is why they are also known as DDAs for "Demand Deposit Accounts." Because they use a lot of paper, the banking industry is steadily moving toward electronic banking. Right now, for example, a cashier might process your check and hand it right back to you. The rest of the "paperwork" is done electronically. Many banks also prefer to present your monthly summary electronically, rather than mail you a paper copy.
- **Savings accounts and Time deposits**—Savings accounts and time or "term" deposits restrict how much money you can take out of your account. You may be able to make a certain number of withdrawals from a saving account, and fewer on time deposits. In return, a bank will usually pay slightly higher interest rates on money that you can't withdraw at will. If you close your account, you can have your money back, but you will forfeit most of the interest you expected to earn. Opening a savings account will help you get into the habit of saving. It will also help you build a credit rating if you want to apply for a credit card. Your best strategy might be to open a savings account and add to it with regular deposits, even if your deposits are small. You may be surprised how small amounts can build up over time and serve you in emergencies.
- **Debit cards—**A debit card looks just like a credit card, but it is electronically connected to your checking account. To make a purchase, you simply swipe the card. This is faster than writing a check. There is a lot less paperwork for you, the bank, and the merchant because the money goes immediately from your account to the merchant's account. Merchants like debit cards because the purchase will not go through if there is not enough money in your DDA. Then they don't have to deal with bounced checks. But, your risk of losses on a lost or stolen debit card is not limited as they are with a credit card. A stranger could have access to all of your money! The risk and the cost of fraud lie directly on consumers.
- **Credit cards—**A credit card allows you to borrow money directly from a bank up to a certain amount that has already been determined by the bank. You are usually allowed to pay the loan back in a 20- to 30-day grace period without having to pay any interest. If you fail to pay the loan off on time, the credit card company can charge you interest on the borrowed funds at rates often close to 20–25 percent. Credit cards are one of a bank's most profitable services. Most credit card holders do not or cannot repay the amount they put on their credit card before the end of the grace period. Because the monthly interest rate is so high, a careless consumer can

easily end up with the same thing as a perpetual, or never-ending, loan from the bank on a relatively small balance.

Exploring the Essential Question

It is your birthday and your uncle has given you a new, crisp one hundred dollar bill. You decide to open a checking account with the money. You go to the bank with your older brother. He is a recent college graduate who just started working as a reporter. At the bank, you get a debit card and the option of a credit card. Your older brother says he thinks you'd be better off without a credit card. In a few paragraphs, explain why your older brother might warn you against getting a credit card while you are still in high school. Be sure to include whether you agree or disagree with him.

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- **Smart card**—A smart card is similar to a credit card in size and appearance. But it has a built-in microprocessor instead of a magnetic security strip. The microprocessor has many more safety features. As a result, it is safer than a credit card. The information on the card includes much more data about you. You can also use it as an identification card as well as for electronic purchases from a merchant. Many people in Europe use smart cards, but they are just beginning to be accepted in the U.S. Switching from the magnetic stripe technology to embedded microchips will be slower than many people would like because the smart cards require a completely different type of card reader.
- **Electronic Funds Transfer (EFT)—**This term generally describes any system that uses computer and electronic technology instead of checks and other paper transactions. Some EFT services include services at ATMs that let you bank any time and direct deposits of payrolls by companies. They also include pay-by-phone systems, debit card purchases, electronic check conversions that change a paper check into an electronic payment at a store, or almost any other transaction, or financial activity, that involves the electronic movement of funds. The term applies to so many different situations that it no longer describes one type of activity.

Banks also offer several other services. These include providing safety-deposit boxes to store expensive items, and helping new corporations issue stock to investors. Whether you are a beginning entrepreneur or you have an established business, any one of your local bankers would be more than happy for a visit to help figure out your needs. Remember that competition in banking is like competition anywhere else. Talk to more than one banker to get the best services at the best price.

Reading Progress Check

Explaining What are some of the benefits of having a checking account?

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Rounding Out Your Financial Literacy

Guiding Question *How do smart banking practices contribute to your own financial literacy?*

There are many parts to financial literacy. A sound knowledge of banking fundamentals, or basics, is one of them. Developing your own creditworthiness is another important part. The relationship you have with your commercial bank or other financial institution will be very important to you in the future, especially if you want to buy a car, a house, or apply for a loan to go to college.

Why You Should Save

Get into the habit of saving. Do it as if your savings will be your only source of retirement income. If you have a Demand Deposit Account (DDA) with a bank, the bank will gladly make arrangements to have a small amount automatically deducted from your checking account and placed in savings. There, your money will earn a little more interest and will be a little harder to access. Or, if your employer can make automatic deposits in a credit union, also consider that option.

Saving on a regular basis will do more than provide a small amount of funds that will be able to be used in the future. It will also show that you have the discipline and patience to begin a career-long path to financial success. No one expects a young person to have a lot of savings. But a demonstrated track record of discipline and success will open up many other opportunities in life.

Pay Attention to the Details

You already know that banks offer a wide range of "products" or services to their customers. You also know that banks and depository institutions charge fees for almost all of them. This is understandable because banks are in business to make a profit. But what you should do is carefully consider which services you need, and which fees you really need to pay.

Banks in the same community often charge different rates for their services. So you should try to learn all you can about these alternatives. Then, decide which are most important to you. Finally, shop around for the best prices.

Only a few of the fees in Figure 10.3 are likely to apply to you right now. But over time many of them will apply to you. Also, banks charge some of them once a month, but charge others several times a month, such as overdraft charges, which occur when you use more money than you have in your account. The bank will front (loan) you the money so that you can complete the purchase, but will do so at a fee. Banks also offer some services, such as online bill payments, at no cost to attract new customers. The bottom line is: avoid unnecessary fees.

Making Yourself Creditworthy

Your "creditworthiness" is your financial standing today based on the credit history you have created. In other words, it is a measure of how much banks are willing to lend you based on your history of using credit wisely. While you may not have a credit history now, you can begin to build one at a store by purchasing an item on credit and making regular payments that are on time.

Eventually, your creditworthiness may allow you to have bigger and more expensive things, such as a car, a home, or a comfortable retirement. For now, keeping yourself out of debt will have its own rewards. When people find themselves in trouble with their credit card debt, they constantly have to earn enough income to pay for past purchases and often find they cannot put money aside for savings.

Reading Essentials and Study Guide

networks

Chapter 10: Money and Banking

Lesson 3 Banking Today

It is hard to put a price on peace of mind, but nothing in life is free. If you want creditworthiness, do not expect it to come without discipline on your part. But you should feel that the investment has been well worthwhile!

Reading Progress Check

Explaining Why should you make creditworthiness a goal for your future?

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