Money & The Federal Reserve System

Read Topic 6: all; Topic 9: Lessons 4 & 5

What is Money?

- anything that is generally accepted and used as a method of payment
    - replaces barter
        - double coincidence of wants
    - characteristics of money
        - durable
        - accepted
        - portable
        - divisible
        - stable in value
- Types
    - coins
        - arise from precious metals
        - now based on fiat
            - government decree
    - paper money
        - arises from receipt for goods
        - no longer backed by gold (gold standard)
            - backed by federal government
    - checkbook money
        - over 98% of all money
        - used against demand deposits
        - includes checks and electronic transfers
    - other deposit accounts
        - savings and time deposits
            - compound interest

Banks

- originally existed to protect precious metals
- issued paper receipts
    - developed into paper currency
- began to loan out money at interest to maximize profits
    - don't need all funds at all times
- commercial banks
    - chartered by federal or state government
        - can offer full checking, securities, cashier's checks
        - member of Federal Deposit Insurance Corporations (FDIC)
            - insures up to $250,000/per account title
    - Functions
        - safekeep funds
        - make loans
        - create money
            - required reserves
                - approx. 10%

- excess reserves
  - can be loaned to create more funds
    - money multiplier effect
- Objectives
  - Liquidity
    - keeping assets in near cash form
  - Profitability
    - investments that make the bank money
      - loans
      - government securities
      - investments in businesses
  - Safety
    - protecting money with good investments

Non-Bank Institutions
- Savings and Loan
  - started with neighborhood associations
    - couldn't get bank accounts
    - pooled money for investment and loans
    - can now offer almost full banking
- mutual savings banks
  - pooled savings for higher returns
- credit unions
  - nonprofit associations
    - can then offer higher savings rates, lower loan rates

Federal Reserve System
- established in 1913
  - needed to organize national banking
- Board of Governors
  - seven members
    - chairman – Jerome Powell
  - organized Fed and monetary policy
  - 14 year terms
  - not overseen by any authority
- Federal Open Market Committee
  - 12 members
    - Governors plus five Fed Bank presidents
  - controls buying and selling of government securities
- Federal Advisory Council
  - 12 members
    - one appointed by each federal reserve bank
  - strictly advisory capacity to federal reserve
- The Federal Reserve Banks
  - 12 banks
    - each one covers one area of country
      - banker's banks

        - do not deal directly with the public
        - thousands of member banks
        - all government transactions run through the Fed
    - Functions
        - check clearing
        - supervises compliance with banking laws
            - holds required reserves
        - supplies paper currency
            - Federal Bureau of Engraving and Printing
        - money creation
            - changes in required reserves affect money supply
        - lender of last resort
            - can loan money to banks and institutions in a crisis
                - discount rate

- Monetary Policy
    - actions taken by Fed to control money supply and interest rates
    - tight-money policy
        - restricts availability of money
        - fights inflation
    - easy-money policy
        - makes more money available
        - fights recession and high interest rates
    - instruments of monetary policy
        - changing required reserves
        - changing the discount rate
            - the rate at which banks borrow money
                - prime rate
                    - ties to most interest rates
        - open market operations
            - buying and selling government securities
            - buying increases money in system
                - quantitative easing
                    - Fed buys gov and corporate securities
            - selling decreases money in system
- Monetarism
    - Monetarists believe that money supply is key to controlling economy
        - oppose use of fiscal policy
            - Milton Friedman
    - Monetary Policy
        - Affects
            - investment in factories and equipment (capital goods)
                - lower interest rates for loans
            - housing markets
                - many second order conditions
            - consumer spending
                - many purchases made on credit