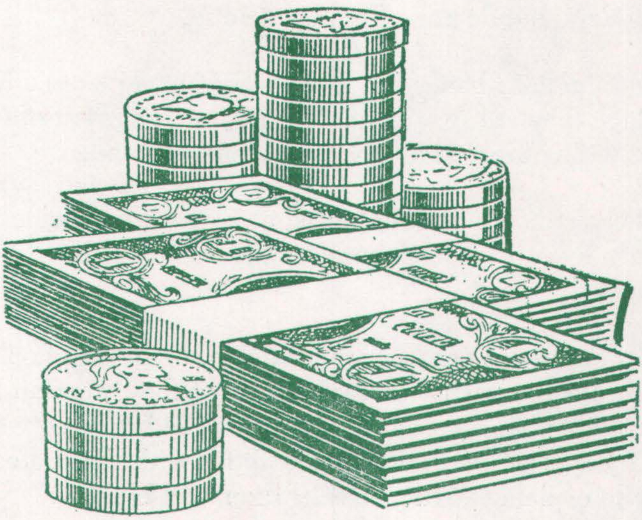
D Curtis Mumford

What We Use For MONEY



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WHAT do we use for money? Where does it come from? Where does it go?

This bulletin attempts to answer these apparently simple but fundamental questions; to show how the money supply of the United States is increased and how it is decreased; and to explain briefly how our monetary system works.

Our monetary laws are a crazy quilt, put together a piece at a time throughout our history. Like the crazy quilt, the system serves its purpose satisfactorily, even though we do not know where each piece came from or how it happened to be there. We have, therefore, omitted or ignored minor details and exceptions that may concern the bank operator or the technical student, but do not affect anyone else.

Certain state banks are given very incomplete consideration, since they are swept along in the broad current of federal policies without regard for their nominal independence.

The vast hoard of gold buried at Fort Knox does not affect our daily lives or the economy of the country, so we leave it undisturbed.

Most of us are not very interested in the inside of our automobiles, but are vastly interested in how they steer and what happens when we step on the gas or on the brake; so with our monetary system, we leave technicalities with the professional but try to explain steering, acceleration, and braking.

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What We Use For Money

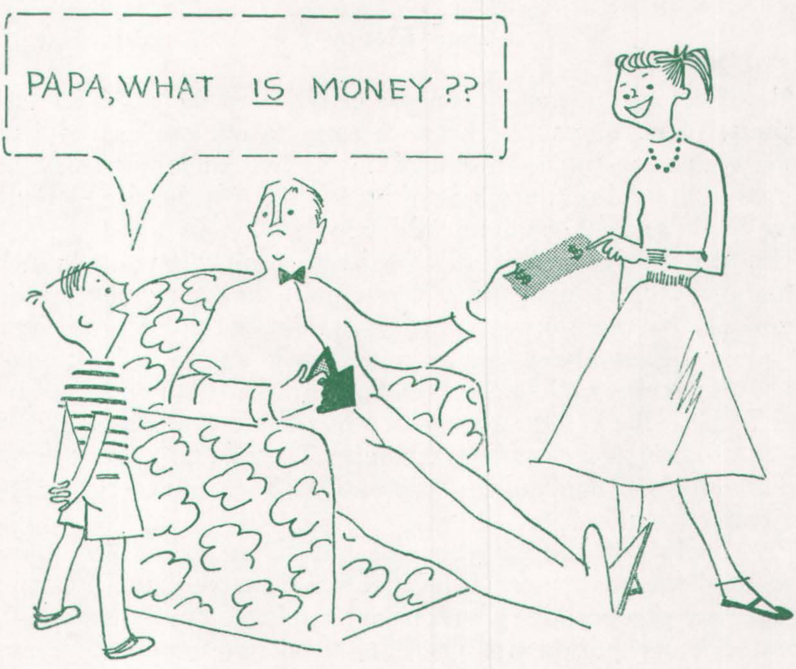
E. L. Potter

The money of the United States is all "IOU's" and has been for the past 30 years. The same is true all over the world. There is no longer any metallic money that circulates on the basis of the market value of the metal.

"IOU" is slang but unfortunately we have no other word that covers all of the various kinds of credit money that are in legal circulation in this country.

By "money" we mean the generally accepted medium of exchange with which we pay our debts, that is, our bank deposits plus our paper money and coin.

The money of the United States is good money, exceptionally good, but it is not easily understood. Also not easily understood are the responsibilities and powers of our government as they relate to the quantity and quality of our money.



What is Good Money?

If an IOU is to serve as money, and particularly as good money, it must meet four rigid requirements. First, it must be an IOU in which everyone has confidence, such as an IOU of our banks or our government. Second, it must be payable on demand and not at some future date. Third, it must be of convenient denominations so it may be used to make payments of any desired size. Fourth, it must be legally approved for the payment of all debts including taxes.

To illustrate: a personal note may be perfectly good, but the general public does not know it is good. A twenty-year government bond for $10,000 is good, but the size is inconvenient and 20 years in the future does not buy groceries today. Things that are saleable quickly, such as government bonds, wheat, or fat pigs, are often said to be "the same as money." They are not money since they must be exchanged for money before we can pay our bills.

Fortunately, the American citizen rarely has need to question the quality of his money. Our government not only determines what may circulate as money but prohibits anything that the careless individual might possibly mistake for money.

Bank Money

About 90% of our money consists of IOU's of banks. These are of two kinds: paper money, such as we carry in our pockets, and bank deposits which are subject to check. These two kinds of money come from two entirely different kinds of banks. We call these, (1) Federal Reserve banks and (2) commercial banks.

There are twelve Federal Reserve banks, each with many branches, but they operate as a unit and are essentially an agency of the federal government. We therefore speak of the group as the Federal Reserve.

Federal Reserve banks are permitted by law to issue simple promissory notes payable to the bearer on demand. We call these notes "paper money." These banks also accept deposits subject to check but only from other banks or government agencies. They do not accept deposits from individuals or nonbanking corporations. They are therefore essentially "banker's banks."

The banks with which you and I deal are called "commercial banks" to distinguish them from Federal Reserve banks. Commercial banks are corporations which have been legally authorized and incorporated to accept deposits subject to check and to perform the various other functions normally associated with commercial banking. Such corporations are prohibited from transacting nonbanking business, but the line of demarcation is not always clear.

Banks operate under the continuous supervision of state or federal agencies legally authorized to supervise banking operations. Some of these banks are incorporated under state laws and some under federal laws. The difference is technical and may be ignored by the general public.

It is important to note that commercial banks may accept deposits from any individual or corporation, while the Federal Reserve banks may accept deposits only from banks or government agencies.

On the other hand, Federal Reserve banks may issue demand notes which we call paper money but commercial banks may not. Of course, commercial banks may pay checks with paper or coin, but they will have purchased such paper or coin from the Federal Reserve. Both kinds of banks are subject to many legal and other regulations.

The word "bank" sometimes appears in the name of corporations which are not authorized to perform the functions which we normally associate with banking.

The Use of Coins

The coins used in this country are minted by the United States government. The metal in such coins is worth less than the face value of the coin, but since the government will pay the holder the face value in any kind of money requested, these coins become, in effect, promissory notes of the government.

Since many people do not like to carry silver, the government issued silver certificates in lieu of silver dollars. Silver certificates performed the same function as Federal Reserve notes and looked the same.

Coins and silver certificates were sold by the government to the Federal Reserve banks, by them to commercial banks, and by them to customers as needed.

As this is written, the rising price of silver is making our silver coins worth more as bullion than as coin and thus forcing them out of circulation. The government is substituting cheaper metal now for part of the silver and is no longer issuing silver certificates.

Worn or defaced coins and paper money are sold back to the Federal Reserve banks and then sold back to the government.

The Nature of Bank Deposits

When a deposit is made, the customer receives a receipt known as a "deposit slip." This deposit slip is merely a memorandum showing what has been deposited, but the law says that the bank issuing such a deposit slip is legally obligated to honor the depositor's checks in any kind of legal money the holder of the check may demand. This obligation is ironclad regardless of what the depositor put into the bank. Depositors sometimes say that the bank should pay back exactly what was put in. Actually, they would be very much shocked if the bank should offer to return the identical items deposited.

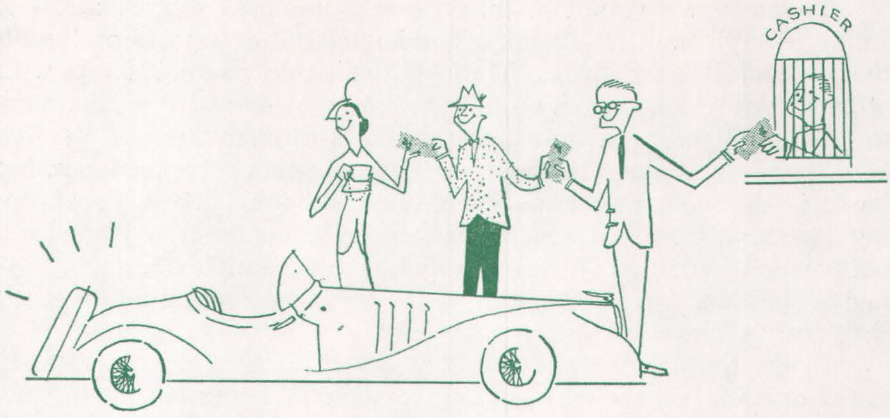
When we make a deposit in a bank, the item deposited is usually some form of money, such as checks, paper, or coin, but this is not always the case and the exceptions are very important. When a customer "borrows" money from a bank, he actually deposits his note and receives a deposit slip which shows plainly that the item deposited was a note and was not checks or currency. Likewise, if a customer "sells" a government bond to his bank, he receives a deposit slip showing that he deposited a bond. We therefore deposit a note or bond just as truly as we deposit money, in spite of the fact that we call the act "borrowing" or "selling" rather than "depositing." Furthermore, the obligation of the bank to honor the customer's checks is just as binding as if the deposit had been made in money.

Banks are free to refuse any deposits, whether checks, notes, or bonds. However, they are legally prohibited from accepting common stocks, real estate, or chattels as deposits.

When we deposit money in the bank we merely exchange one kind of money for another, so the total amount of money in the country is not affected. On the other hand, when we deposit notes or bonds, which are not money, and receive in return the bank's obligation to honor checks, which are money, the total supply of money is increased by just that much.

In reverse, when we pay our notes with checks against our deposit accounts, the obligation of the bank to honor our checks and our obligation to pay our notes are cancelled. Thus, the total money supply of the country is decreased.

Since the total money supply increases every time a customer deposits a note or bond in his bank, and decreases every time a customer pays a note or bond with a check, the total changes every minute of the business day. Increases and decreases tend to offset each other, unless some definite economic pressure or political policy tends to increase or decrease deposits of notes or bonds in our banks.



The central fact of our whole monetary system is, therefore, that new money is created by depositing notes or bonds in the banks, and the total money supply is decreased by paying off such notes and bonds with our checks. The only exceptions are silver certificates and metal coins, which comprise less than 2% of our total money supply.

When money is created by depositing government bonds in our banks, the process is technically known as "monetizing the public debt." This is rarely a deliberate governmental policy, but in the normal course of business, a substantial part of our debt reaches our banks and thus creates money, regardless of the wishes of the administration. As this is written, approximately one third of our government debt has been so monetized.

How Checks are Paid

The holder of a check may demand payment in any one of three ways: first, he may deposit the check in the bank against which it was drawn; second, he may deposit the check in any one of the thousands of other banks of the country; and third, he may demand payment in paper or coin.

In the first instance, the bank pays by merely subtracting the amount of the check from the account of the drawer and adding that amount to the account of the payee. Nothing changes except the figures on the books for these two accounts.

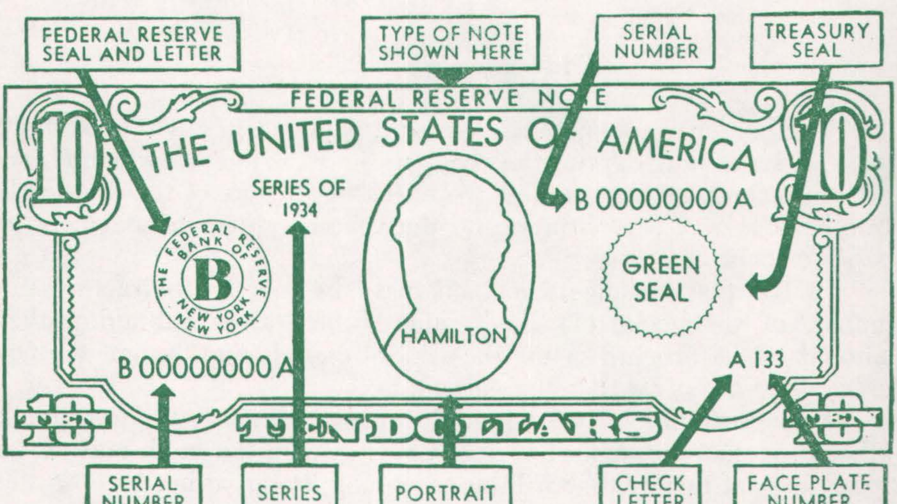
In the second instance, where the check is deposited in some bank other than the one against which it was drawn, the bank must have some form of money that will be acceptable to any other bank in the United States.

To meet this situation, the "Federal Reserve" was established. Almost every commercial bank in the United States has a deposit with the Federal Reserve banks. Those that do not, have accounts with other banks which do have such accounts. Payments from one bank to another therefore always may be made through Federal Reserve banks. Federal Reserve banks settle these accounts between depositing banks in the same manner as do commercial banks; that is, bookkeeping. Payments from one bank to another can be made through any bank with which both debtor and creditor have accounts. Interbank payments are not therefore always made through the Federal Reserve, but they always may be so made.

In the third instance, the holder of a check demands payment in paper or coin. It is the custom of all commercial banks to keep a ready supply of paper and coin in their vaults. If more is needed, the bank buys it from the Federal Reserve.

Legal Tender

We have noted that good credit money must be legally approved for the payment of all debts including taxes. Money which has been so approved by Congress is known as "legal tender." All our paper money and coin are legal tender. Bank deposits are not technically "legal tender," but since the banks are required to pay checks in legal tender when so requested, the difference is of little practical significance.



Bank Supervision and Control

The powers of our commercial banks seem extreme until we examine the legal control and supervision under which banks must operate. These factors will be considered under various headings.

Bank Capital

It is obvious that a sound bank must have adequate capital. Our governments, both state and national, recognize this clearly. Therefore, banks are not permitted to begin or to continue operations until and unless the stockholders have invested an amount of money which the legally authorized banking authorities consider adequate for the protection of the depositors.

The total of this stockholders' investment is technically known as the "capital account." Subdividing this under such headings as: capital, surplus, undivided profits, reserves, and so forth is mere bookkeeping convenience and of little significance to the public. The total, however, is important.

The income of banks is from interest on their loans and bonds plus charges for various services. In a successful bank, these earnings will cover expenses and losses on bad accounts plus a margin for the stockholders. This margin to the stockholders may be used as the management determines, including improvement of the physical and financial status of the bank and the payment of dividends to the stockholders.

If the income of the bank is not sufficient to cover expenses and losses, the capital account will be reduced. If this reduction is significant, the bank examiners step in.

Bank Examinations

Adequate legal supervision of bank operations requires frequent and thorough examination of the operations of each and every bank.

Banks may be examined by the state, the federal government, or the Federal Deposit Insurance Corporation, or all of these. The difference is not significant.

The most important phase of bank examination is the appraisal of the assets of the bank, particularly the loans made, bonds purchased, and the general financial policies of the bank.

If the examiners find any notes or bonds which, in their judgment, are of doubtful value, they will order such items to be "charged off." That is, they will be removed from the list of assets of the bank, and the capital account will be reduced to balance the account. If the capital account, so reduced, is, in the judgment of the examiners, less than the amount needed for a bank of that size, the stockholders may be required to add to the capital account out of their own pockets. All else failing, the bank will be closed and its affairs turned over to the Federal Deposit Insurance Corporation.

Many banks charge off assets of doubtful value on their own initiative and without waiting for the judgment of the examiners. Such charged off items remain the property of the bank, but they do not appear in any published statement of assets.

The examiners also check accounting methods and all other matters that may affect the soundness of the bank.

In banking accounting, a complete statement of assets and liabilities is prepared at the close of each business day.

Banks may publish their financial statements whenever they wish but are required to publish them when ordered to do so by the examiners. Such orders apply to all banks and are usually given without advance notice.

Deposit Insurance

Since 1934, nearly all bank deposits in the United States have been insured through the Federal Deposit Insurance Corporation. This is essentially a cooperative insurance corporation financed by the commercial banks but under very strict federal supervision. No single account may be insured for more than $15,000.

Commercial banks are not required to participate in this insurance but they find it wise to do so.

Federal Control of Money

The United States Government controls our monetary system both as to quantity and quality. The instrument of control is the Federal Reserve. The point of contact is the "reserves" of our commercial banks.

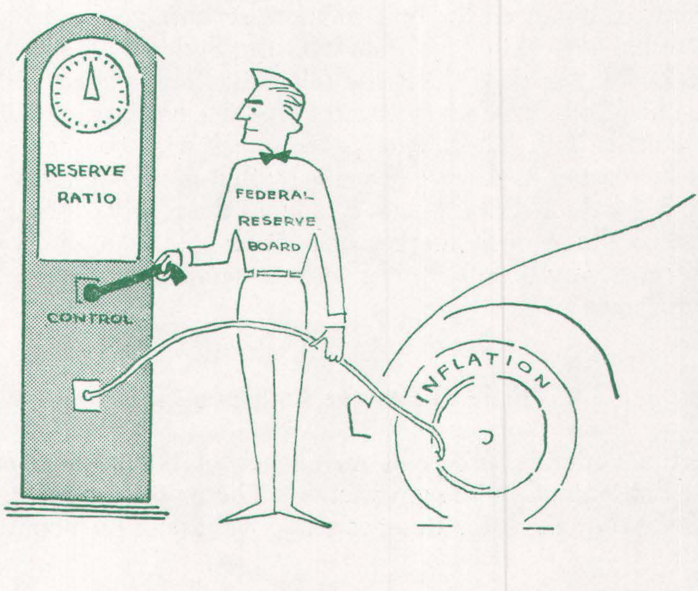
The word "reserves" in banking language means the deposits which commercial banks have with the Federal Reserve. Since these deposits are the key to the ability of commercial banks to pay depositors with any kind of money, control of these deposits (reserves) controls everything.

There are three ways in which the Federal Reserve may control the reserves of our commercial banks. These are (1) fixing the minimum reserves which each bank must maintain, (2) changing the interest rate at which the Federal Reserve makes loans or buys bonds, and (3) open market operations.

These controls deal with our entire banking system and do not discriminate between banks.

Minimum Reserves

Each commercial bank is required to maintain its reserve at not less than a specified percent of its deposits. Congress has given the Federal Reserve power to fix these percentages within rather wide limits. Congress can, of course, change these percentages. These required limits are enforced with heavy penalties.



While changing these requirements has some influence on bank activities, the real purpose and effect is to insure that our commercial banks always have on deposit with the Federal Reserve, amounts that are more than adequate for safe and efficient banking business.

Discount Rates

The term, "discount rate" is now used to indicate the rate of interest which the Federal Reserve expects to receive on loans to commercial banks. It also fixes, rather closely, the price which it will pay for bonds which it may buy from banks or others. Since bank reserve deposits draw no interest, the discount affects the cost of maintaining reserves.

Changing these rates tends to encourage or discourage bank operations. It also tends to affect all interest rates and sometimes to have psychological and unpredictable effects on our whole economy. Such changes are therefore made with great caution.

Open Market Operations

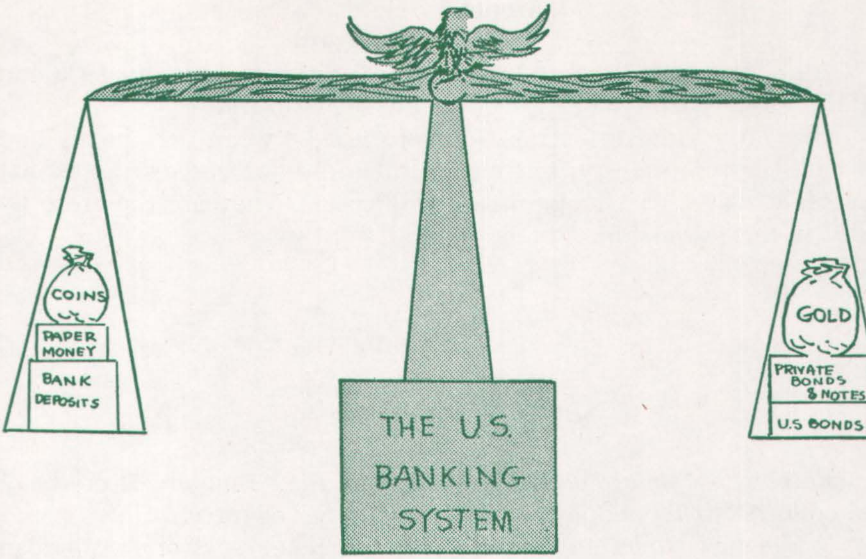
The most powerful instrument of the Federal Reserve is its "open market operations." With this instrument it can raise or lower commercial bank reserves without consulting the commercial banks in any way.

This power is made possible by two facts: first, the Federal Reserve in recent years has had enough money and bonds to buy or sell large amounts of bonds on the open market; second, you and I are not permitted to have checking accounts with the Federal Reserve.

This is how it works: If the Federal Reserve buys a bond, the seller receives a check on the Federal Reserve which he deposits with his commercial bank. This bank deposits the check with the Federal Reserve, thus increasing its reserve account by that much. Conversely, the sale of bonds by the Federal Reserve reduces the reserves of our commercial banks. These open market operations are not only powerful but they receive very little publicity and cause a minimum of psychological disturbance.

Federal Reserve Policies

Since the Federal Reserve is an agency of the government, its policies are determined by the government. These policies are based on two considerations: the estimated economic welfare of the country and



the political and financial problems of the administration. These considerations are tempered by the extreme sensitivity of our economy to monetary change. The tendency is therefore toward caution.

The powers of the Federal Reserve, as presented here, have been developed under authority of the Act of 1934 and have not been significantly modified since that date.

The National Balance Sheet

In light of what has been already said, we would expect that in the combined statements of all the banks in the United States, the assets of the banks should exceed the money supply by the capital account of the banks. Such is the case.

The combined statements for the banks of the United States are prepared and published each month by the Federal Reserve and published in the monthly *Federal Reserve Bulletin*. For example, the statement for May 28, 1965, showed assets of \$391 billions; deposits and currency, \$354.7 billions; and capital, \$36.3 billions.

Monetary Gold

All of our monetary gold was taken out of circulation in 1933 and has therefore ceased to be legal money in this country.

Our laws indicate certain relationships between our money and the gold in our treasury, but our gold supply has been so large that these laws have been inoperative for 30 years. They are therefore ignored in this discussion.

Foreign Exchange

Foreign exchange means the exchange of the money or credit of one country for the money or credit of another country.

While our banks are required to cash checks in any American money requested, they are under no legal obligation to furnish foreign money. Most of our larger banks do, however, make a business of foreign exchange. These transactions are purely on a merchandising basis and upon terms of mutual agreement.

Much of this foreign exchange business involves bills of exchange and sundry other credit instruments that we do not consider as money. Our banks also loan large sums to exporters and importers, particularly to finance the time and expense involved between the premises of the seller and the premises of the buyer.

Since the moneys of the world are all credit money controlled by the various governments, their value depends upon their buying power. The buying power of one money may vary without relation to the buying power of other moneys, but fluctuations in the rate of exchange disturb business. To avoid this, most European countries try to fix the rate at which their money may be exchanged for other moneys, especially for dollars. This fixed rate, however, can not get far from the relative buying power of the currencies involved without impeding trade. In recent years, most European countries have been able to keep their economy quite stable and thereby to minimize changes in the rate of exchange.

The United States does not try to fix exchange rates but it does have a unique gold policy. Our Treasury buys or sells gold to foreign governments at any time and in any amount requested at $35 an ounce. Other countries do not reciprocate; they sell gold to us only under special circumstances and under special permit.

Summary

• The money of the United States is all IOU's and has been since 1934.

• The quantity and quality of this money is controlled by the United States Government, acting through the Federal Reserve.

• This money is good money in that it will pay any debts or taxes or buy goods anywhere in the United States.

• Money throughout the civilized world is similar to ours in that it is all IOU's, the quantity and quality of which are controlled by the government of the country concerned.

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