Chapter 10: Money and Banking
Section 3

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Objectives

1. **Explain** how the money supply in the United States is measured.
2. **Describe** the functions of financial institutions.
3. **Identify** different types of financial institutions.
4. **Describe** the changes brought about by electronic banking.

Key Terms

- **money supply:** all the money available in the United States economy
- **liquidity:** the ability to be used, or directly converted into, cash
- **demand deposit:** money in a checking account that can be paid out “on demand” or at any time
- **money market mutual fund:** a fund that pools money from small savers to purchase short-term government and corporate securities

Key Terms, cont.

- **fractional reserve banking**: a banking system that keeps only a fraction of its funds on hand and lends out the remainder
- **default**: failing to pay back a loan
- **mortgage**: a specific type of loan that is used to buy real estate
- **credit card**: a card entitling its owner to buy goods and services based on the owner's promise to pay for those goods and services

Key Terms, cont.

- **interest**: the price paid for the use of borrowed money
- **principal**: the amount of money borrowed
- **debit card**: a card used to withdraw money from a bank account
- **creditor**: a person or institution to whom money is owed

Introduction

- What banking services do financial institutions provide?

  – Financial institutions:
    - Provide electronic services
    - Issue credit cards
    - Make loans to businesses
    - Provide mortgages to prospective home buyers
    - Manage ATM machines

Measuring the Money Supply

- To keep track of the different kinds of money, economists divide the money supply into categories.

- M1 represents money that people can gain access to easily. This includes:
  - Currency held by the public
  - Deposits in checking accounts
  - Traveler's checks

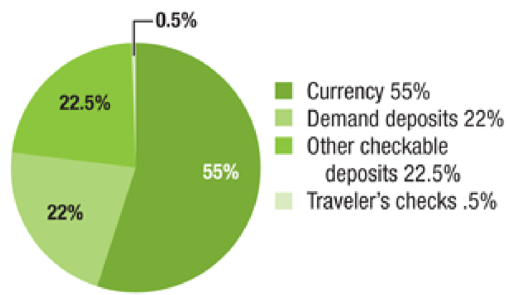
M2

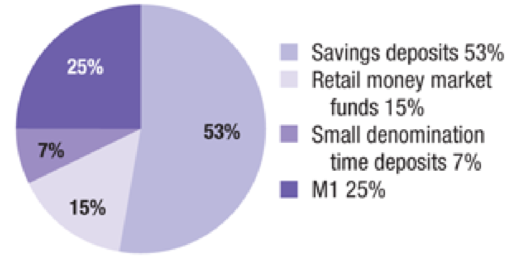
- M2 consists of all the assets in M1 plus several additional assets. These funds cannot be used as cash directly, but can be converted to cash fairly easily.
  - What is the difference between M1 and M2?

Action Graph online

M1 Components	Billions
Currency	$749.6
Demand deposits	$305.9
Other checkable deposits	$304.0
Traveler's checks	$6.7
Total M1	$1,366.2

M2 Components	Billions
Savings deposits	$2,902.1
Retail money market funds	$805.0
Small denomination time deposits	$398.7
Total M1	$1,366.2
Total M2	$5,472.0





Individual categories may be affected by rounding.
SOURCE: Statistical Supplement to the *Federal Reserve Bulletin*, July 2007

Functions of Financial Institutions

- Banks and other financial institutions provide a wide range of services to customers.
- Storing money
  - They provide a safe place to store money
- Saving money
  - They offer people ways to save money through:
    - Savings accounts
    - Checking accounts
    - Money market accounts, which allow people to save and write a limited number of checks
    - CDs, which offer a guaranteed rate of interest but cannot be removed until after a specified period of time.

Loans

- Financial institutions lend money to consumers and charge interest on those loans.
- Loans help consumers:
  - Buy homes
  - Pay for college
  - Start and grow businesses

- Many banks loan money to other financial institutions and individuals. A banking system that only keeps a fraction of its funds on hand and lends out the rest is called fractional reserve banking.

Mortgages and Credit Cards

- A mortgage is a specific type of loan that is used to buy real estate.

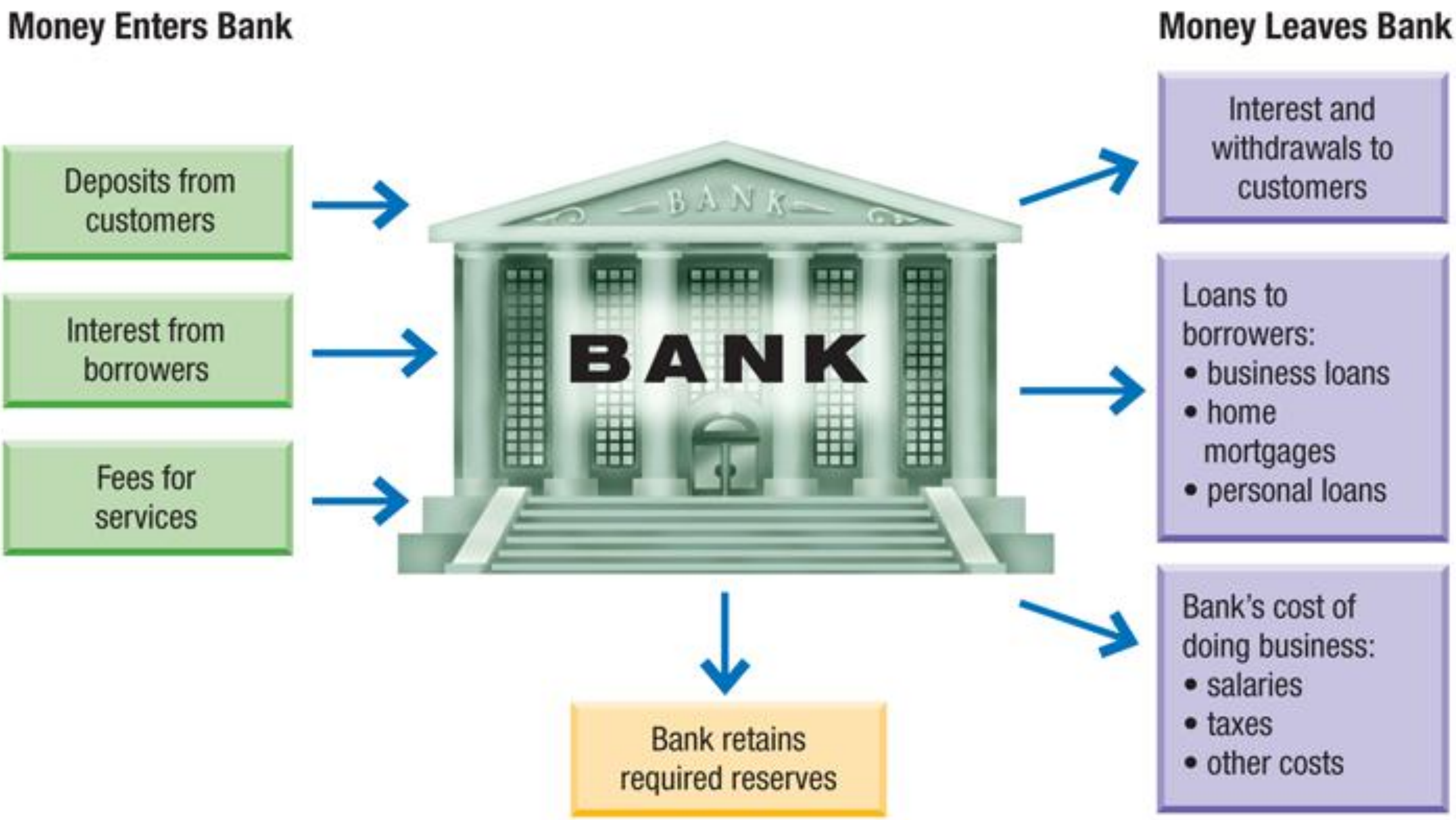
- Banks issue credit cards, which entitle their owners to buy goods and services based on the owners promise to pay.
  - Banks usually charge high interest rates on credit cards.

Simple and Compound Interest

- Banks pay simple interest only on the principle of a deposit.
- Compound interest is interest paid on both principal and accumulated interest.
  - According to the table, after five years, what is the total interest that the deposit-holder will have earned?

End of Year	Principal Amount	Interest Earned at 5%	Principal at End of Year
—	$100.00	$5.00	$105.00
1	$105.00	$5.25	$110.25
2	$110.25	$5.51	$115.76
5	$127.63	$6.38	$134.01
10	$162.90	$8.14	$171.04
15	$207.90	$10.39	$218.29

How Banks Make a Profit



Types of Financial Institutions

- **Commercial Banks**
  - Offer checking accounts, accept deposits, and make loans
- **Savings and Loan Associations**
  - Allow people to save up and borrow enough for their own homes
- **Savings Banks**
  - Owned by depositors who make smaller deposits than a commercial bank would handle
- **Credit Unions**
  - Cooperative lending associations established for particular groups
- **Finance Companies**
  - Make installment loans to consumers

Electronic Banking

- With the increased importance of computers in today's world, electronic banking has seen an upsurge.
  - ATMs allow customers to deposit money, withdraw cash, and obtain information.
  - Debit cards can be used at an ATM or in a store to purchase goods. These cards require a PIN for security reasons.
  - Home banking—More and more people use the Internet to check balances, transfer money, automatically deposit paychecks, and pay bills.
  - Checkpoint: How does a debit card work?

ACHs and Stored-Value Cards

- Automated Clearing Houses (ACHs) allow consumers to pay bills without writing checks.
- Stored-value cards carry money on them and can be used by college kids on campus or by people using a phone card with stored minutes.

Review

- Now that you have learned about the banking services that financial institutions provide, go back and answer the Chapter Essential Question.
  - How well do financial institutions serve our needs?