# Banks, Credit & the Economy CLASS COPY! Do not write on this!

## It Makes the World Go Around!

Have you ever tried to imagine a world without money? Give it a try. Okay, done? How did it go? Easy? Probably not. No matter what your views are about money and how important it is, the fact remains: The world runs on money. We all use it to pay for the things we need and want. So what is money, and where does it come from? What role do banks play? And do you really need money? Can't you just use credit instead? It's time to find out.

Automatic teller machines (ATMs) make it easy to turn money stored in a bank account into cash. Bills and coins make up only 7% of the money in circulation in the U.S. Can you explain why?

## Money, Money, Money

You think you know what it is, right? It's that cold, hard cash in your pocket—that paper with presidents' faces on it, those coins that say "e pluribus unum." But money is more than just that. **Money** is a "medium of exchange," which means it's what is commonly accepted in exchange for goods and services. Money also sets a common standard of value among people in a country. (Everyone knows what a dollar is, right?)

Money includes coins and notes printed by the government, which are called **currency.** But it also includes things that can be easily changed into currency, such as a deposit in a bank account. Think of it this way: When people say "I don't have any money," they don't just mean they aren't carrying any cash. Usually they mean they also don't have a positive bank account balance that they could turn into cash.

## Bank Accounts

Most of the time, when you hear "bank" you think "account." Bank accounts are an important service that banks provide. When you have a bank account, you make **deposits** by putting your money in the bank, and you expect to be able to **withdraw** your money out of the bank whenever you want to.

Paper checks are used less often now that people have debit cards and pay bills online.

With a **checking account**, you deposit your money into the bank with the expectation that you will be depositing and withdrawing money from the account often. You get paper **checks** that let you transfer your money to other people. Normally you also get a plastic **debit card** that lets you pay for things with your account money by swiping the card in a store or entering the card number online. It's called a debit card because it debits, or withdraws, money from your account. Debit cards also let you use ATM machines to withdraw money from your account.

With a **savings account**, you deposit your money into the bank with the expectation that you will make limited withdrawals. (There's a reason why it's called a "savings" account.) In fact, federal regulations limit the type and number of withdrawals you're allowed to make each month from a savings account. But there's a benefit: The bank actually pays you to keep money in a savings account. The extra money you earn on a savings account is very low, though, so don't expect to get rich that way.

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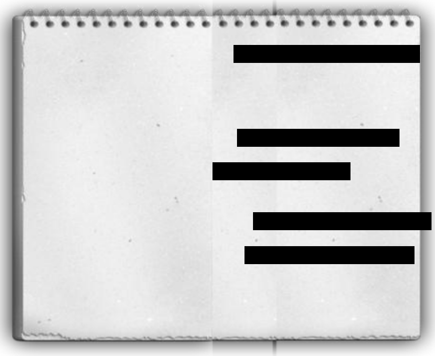


## Banks & Lending

So, what happens to the money you put in the bank? Do they carefully take it back to the vault and keep it there until you need it? If that's what you always imagined, you might want to close your eyes for this part: The reason banks accept deposits is so they can let other people use the money. Yes, you heard that right. Banks let other people spend your money when you're not using it! But don't worry, it will be there when you need it.


Here's the thing: Banks are businesses. Businesses want profits. Instead of selling shoes or pizzas to make a profit, banks sell the right to use money. Ever heard of a loan? When you get a **loan** from a bank, you pay the bank to let you borrow money. But the bank wouldn't have any money to lend if nobody put money into the bank. That's why saving and lending go hand in hand in the world of banking. A bank pays people to keep money in savings accounts. Then the bank turns around and charges other people a fee for borrowing that same money. The bank makes a profit by charging borrowers a higher fee than it pays to people who have savings accounts.


The fee charged for a loan is called **interest**. It is charged as a percent of the total loan amount. This percentage is the **interest rate**.

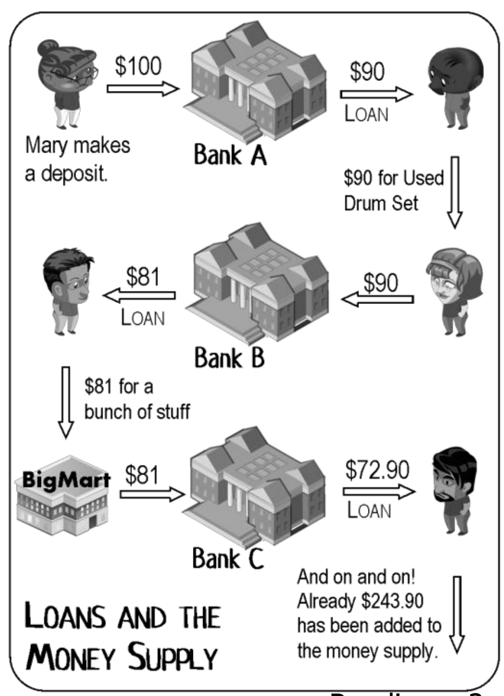
## Loans are Big Business

Lending is a huge, HUGE business. Why? Because lots of things are too expensive to pay for outright. (Think cars and houses.) Businesses borrow even more money than individual people do. Say you want to open an auto repair shop downtown. How are you going to pay for everything you'll need to start your business? Most people would need a loan to do that. Even established businesses need loans to construct new buildings or buy expensive new equipment. The money savers deposit into banks goes back out into the community in the form of loans that are used to build houses, expand businesses, get college degrees, and more.

## Loans: A Money Injection

Loans actually increase the amount of money available to spend. Magic? Sort of. When someone makes a deposit, the bank must keep part of the deposit in reserve. The bank is free to lend the rest to someone else. This starts a chain of depositing and lending that actually multiplies the amount of money available!

Here's what happens: Imagine that Mary deposits $100 into her account at Bank A. Bank A keeps 10% ($10) in reserve and loans $90 to Bob. Bob buys a used drum set from Jane for $90. He writes her a check. Jane deposits the check into Bank B. Bank B keeps 10% ($9) and loans out the rest ($81) to Keith. Keith goes to BigMart and buys a bunch of stuff that adds up to $81. He writes BigMart a check for $81. BigMart deposits the $81 into Bank C. Bank C keeps 10%... Get the idea? Follow the diagram to see how Mary's $100 deposit results in $1,000 of money being made available for people to use.



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The Federal Reserve headquarters in Washington, D.C. In addition to supervising our banking system, the Fed is the bank for the United States government.

### The Federal Reserve

Bees have a queen, aliens have a mother ship, and banks… well, banks have the Federal Reserve. The **Federal Reserve** (known as "the Fed") is the central bank of the United States. It is made up of 12 Federal Reserve Banks—one for each of 12 districts covering the United States. A Board of Governors oversees these banks. Federal Reserve Banks don't deal with the public. They are "bankers' banks."

Together with other agencies in the federal government, the Federal Reserve supervises the banking industry and makes rules that banks must follow. The Fed also oversees electronic payment systems and processes the checks people write. In addition, when banks need coins and paper money, they order currency from the Fed. (Paper money is actually made by the U.S. Bureau of Printing and Engraving; coins are made at the U.S. Mint.) But one of the biggest jobs of the Federal Reserve is to help keep the United States economy healthy.

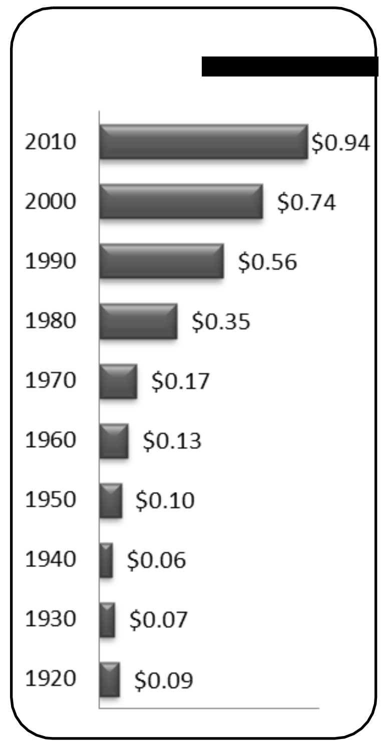
### The Fed & the Economy

The Federal Reserve works toward three goals for a healthy economy:

- Making sure the highest possible number of citizens have jobs
- Keeping the price of goods and services stable
- Making sure the cost of a loan is not too high or too low

Here's how these goals are related: When interest rates on loans are low, it is cheap to borrow money. This encourages businesses and people to borrow and spend money. With more spending, there is more demand for stuff. Producers want to make more stuff to meet this demand, so they employ more people. In order to attract workers, wages go up. With lots of money in people's pockets but the supply of "stuff" not necessarily meeting the demand, prices can go up. The rise of prices over time is called **inflation**.

Prices can skyrocket if the economy grows too fast, so the Fed works to keep things in balance. It does this by making changes that affect the interest rates that banks charge for loans. Expensive loans discourage people and businesses from making decisions that require borrowing. There is less spending and less hiring, so the economy slows. The Fed keeps an eye on the economy and adjusts loan interest rates up or down as necessary.




### Why Loans Work

Maybe you saw that chain of loans on the last page and wondered how all that money could be created out of thin air. Maybe you're thinking, "But there's nothing behind that money. Just Mary's $100!" So why doesn't the whole system just collapse? Because there is something behind all those loans: each borrower's ability to pay back the loan. Banks are pretty careful about lending money. They want to know about the borrower's past history of paying back loans, and they want to know that the borrower has a source of income. Income depends on a person's ability to produce goods or services. This is what you do at your job, whether you're farming or designing video games or giving haircuts. Ultimately, the ability to produce is what keeps our economy going.

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## Loans for the Future

A loan always costs more than paying for something outright. That's because banks won't lend money for free. You have to pay back the amount of the loan plus interest. Interest can add up to a lot of money over time. Sometimes people take out a loan because they know that in the long run they will make more money on what they are buying than they will pay in interest on the loan. In that case, the borrower sees the loan as an **investment**—money spent in order to make more money. Loans to buy a house are viewed as investments because the value of a house normally increases over time. College loans are seen as investments because getting more education usually means you'll qualify for higher-paying jobs. Business loans are also considered investments. When someone takes out a loan to start or expand a business, they are investing in their own ability to produce in the future.

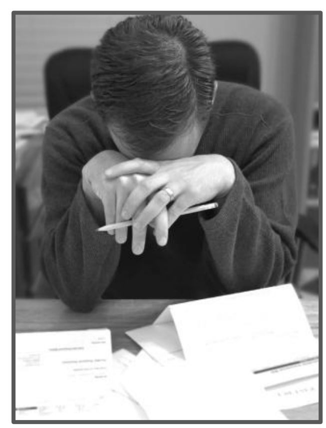
People who take risks to start a new business are called **entrepreneurs**. In a market economy, loans help finance businesses and development of new ideas.

## Loans for the Now

On the other hand, sometimes people take out a loan because they need or want something they can't afford to buy outright. These are loans for things that will only decrease in value—or even be used up completely! Cars are an example of something most people can't pay cash for and must buy with a loan. Vehicles decrease in value very quickly, so buying one with a loan almost always means you're paying more than the car is worth. But most people don't have any choice. Vacations are an example of the other extreme. Once a vacation is over, all that's left is a memory. There are lots of great reasons to take a vacation, but if you've paid for it with a loan, you could end up paying the bill—and the interest—for a long time.

## The Ugly Side of Lending & Borrowing

The ugly side of borrowing comes when people start to depend on credit. This can happen because of too much spending, expensive emergencies, or other financial problems. Very often, people in this situation already have a limited income. That makes it difficult to pay back their loans and credit cards. When you don't make a loan or credit card payment on time, there are severe penalties. First, the bank may raise your **interest rate**, which determines how much interest you pay on the loan. Starting with your next payment, you'll be paying more. A lot more. The bank also reports you to the three **credit reporting bureaus**—companies that keep track of your credit history. A bad credit history can make it hard to get any credit at all. Any credit you do get will be very expensive because the lender will be afraid you won't pay it back.




Sometimes people have a reasonable income, but they've let their spending get out of control. They're buying way more stuff then they can pay for, and they're buying it all with credit. Even if they're making all their payments on time, they're wasting tons of money on interest. This lifestyle can make it hard to save money for the future, which can mean disaster when there's an emergency. Taking out even more loans to meet the crisis may be difficult or make the problem worse. People in these situations often turn to a trustworthy **credit counseling** service to help them make a plan to pay off their loans and learn to live within their means instead of relying on credit.