

WHAT IS MONEY?

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We all use money every day. Yet many people do not know what money actually is. There are many myths about money, including the idea that the government “prints” all of it and that it has some intrinsic value. But actually, money is less a matter of value, and more a matter of faith.

Money is sometimes called the universal commodity, because it can be traded for all other commodities. But for this to happen, everyone in society must believe that money will be accepted. If people stop believing that it will be accepted, the existing money ceases to be money. Recently in Poland, people stopped accepting the zloty, and used vodka as money instead.

In addition to facilitating exchanges, money allows us to “store” value from one point in time to another. If you sell your car today for \$4,000, you probably won’t buy that amount of other products today. Rather, you store the value as money, probably in a bank, until you want to use it.

The “things” that get used as money have changed over time, and “modern” people often chuckle when they hear about some of them. The Romans used salt (from which we get the word “salary”), South Sea Islanders used shark’s teeth, and several societies actually used cows. The Three Wise Men brought gold, frankincense, and myrrh, each of which was money in different regions at the time.

If money does not exist, or is in short supply, it will be created. In prisoner of war camps, where guards specifically outlaw its existence, prisoners use cigarettes instead. In the American colonies, the British attempted to limit the supply of British pounds, because they knew that by limiting the supply of money, they could hamper the development of independent markets in the colonies. Today, the United States uses a similar policy, through the International Monetary Fund, in dealing with Latin America.

To overcome this problem, the colonists began to use tobacco leaves as money. This helped the colonies to develop, but it also allowed the holders of large plots of land to grow their own money! When the colonies gained independence, the new government decreed gold to be money, rather than tobacco, much to the dismay of Southern plantation owners. Now, rather than growing money, farmers had to find or buy it.

To aid the use of gold as money, banks would test its purity, put it in storage, and give the depositor paper certificates of ownership. These certificates, “paper money,” could then be used in place of the gold itself. Since any bank could store gold and issue certificates, by the beginning of the Civil War, over 7,000 different types of “paper money” were in circulation in the United States, none of it printed by the government.

While paper money is easier to use than gold, it is still risky to carry around large amounts of cash. It is safer to store the paper in a bank and simply sign over its ownership to make a purchase. We sign over the ownership of our money by writ-

ing a check. Checking account money became popular when, in an unsuccessful attempt to control the amount of money created by banks, the government outlawed the printing of paper money by private banks in 1864.

How Banks Create Money

Banks are central to understanding money, because in addition to storing it, they help to create it. Bankers realize that not everyone will withdraw their money at the same time, so they loan out much of the money that has been deposited. It is from the interest on these loans that banks get their profits, and through these loans the banking system creates new money.

If you deposit \$100 cash in your checking account at Chase Manhattan Bank, you still have \$100 in money to use, because checks are also accepted as money. Chase must set aside some of this cash as "reserves," in case you or other depositors decide to withdraw money as cash. Current regulations issued by the Federal Reserve Bank (the Fed) require banks to set aside an average of three cents out of each dollar. So Chase can make a loan of \$97, based on your deposit. Chase does not make loans by handing out cash but instead by putting \$97 in the checking account of the person, say Emily, who is taking out the loan. So from your initial deposit of \$100 in cash, the economy now has \$197 in checking account money.

The borrower, Emily, pays \$97 for some product or service by check, and the seller, say Ace Computers, deposits the money in its checking account. The total amount of checking account money is still \$197, but its location and ownership have changed. If Ace Computer's account is at Citibank, \$97 in cash is transferred from Chase to Citibank. This leaves just \$3 in cash reserves at Chase to cover your original deposit. However, Citibank now has \$97 in "new" cash on hand, so it sets aside three cents on the dollar (\$2.91) and loans out the rest, \$94.09, as new checking account money. Through this process, every dollar of "reserves" yields many dollars in total money.

If you think this is just a shell game and there is only \$100 in "real" money, you still don't understand money. Anything that is accepted as payment for a transaction is "real" money. Cash is no more real than checking account money. In fact, most car rental companies will not accept cash as payment for a car, so for them, cash is not money!

As of June 2010, there was \$883 billion of U.S. currency, i.e., "paper money," in existence. However, somewhere between 50% to 70% of it is held outside of the United States by foreign banks and individuals. U.S. \$100 bills are the preferred currency of choice used to facilitate illegal international transactions, such as the drug trade. The vast majority of all money actually in use in the United States is not cash, but rather checking account money. This type of money, \$1,590 billion, was created by private banks, and was not "printed" by anyone. In fact, this money exists only as electronic "bits" in banks' computers. (The less "modern" South Sea Islanders could have quite a chuckle about that!)

The amount of money that banks can create is limited by the total amount of reserves, and by the fraction of each deposit that must be held as reserves. Prior to

1914, bankers themselves decided what fraction of deposits to hold as reserves. Since then, this fraction has been set by the main banking regulator, the Fed.

Until 1934, gold was held as reserves, but the supply of gold was unstable, growing rapidly during the California and Alaska "gold rushes," and very slowly at other times. As a result, at times more money was created than the economy needed, and at other times not enough money could be created. Starting in 1934, the U.S. government decided that gold would no longer be used as reserves. Cash, now printed by the Fed, could no longer be redeemed for gold, and cash itself became the reserve asset.

Banks, fearing robberies, do not hold all of their cash reserves in their own vaults. Rather, they store it in an account at a regional Fed bank. These accounts count as reserves. What banks do hold in their vaults is their other assets, such as Treasury bonds and corporate bonds.

The Fed and Bank Reserves

The only role of the government in creating money is indirectly through the Fed, which is controlled by neither the Congress nor the executive branch. If the Fed wants to expand the money supply, it must increase bank reserves. To do this, the Fed buys Treasury bonds from a bank, and pays with a check drawn on the Fed itself. By depositing the check in its reserve account at the Fed, the bank now has more reserves, so the bank can now make more loans and create new checking account money.

By controlling the amount of reserves, the Fed attempts to control the size of the money supply. But as recent history has shown, this control is limited. During the late 1970s, the Fed tried to limit the amount of money banks could create by reducing reserves, but banks simply created new forms of money, just like the POW camp prisoners and colonial farmers. In 1979, there was only one form of checking account money. Today, there are many, with odd names such as NOWs, ATs, repos, and money market deposit accounts. If there is a profit to be made creating money, banks will find a way.

In 2010, we have the opposite problem. The Fed is trying to expand the money supply, but banks are refusing to create new money. In good times, banks hold as few reserves as possible, so they can profit from making loans. In times of crisis, banks fear that we will lose faith in the commercial banking system and all try to take out our "money" as cash. Since there is far more electronic money than cash, this is impossible. But if the bank cannot give us our money in the form we want it, the bank fails and ceases to exist. Since the start of 2007, over 300 banks, with assets totalling more than \$637 billion, have failed.

Since all banks fear they will be next, they want as many reserves as possible. Excess reserves are any reserves above those required by the Fed. During the 1990s, these averaged about \$1 billion for the entire banking system. During the crisis of 2001, they spiked to the then unheard of level of \$19 billion. As of June 2010, excess reserves in the banking system were \$1,035 billion! This is the classic case of trying to push on a string. The Fed can create reserves, but only banks can create money and they are not yet willing to make any new loans.

These amorphous forms of money function only because we believe they will function, which is why the continued stability of the banking system is so critical. While it is true that the bailout of the banking system was not handled very well, and that many people who created the crisis are still profiting from it, the bailout was a necessary evil. In a modern market economy, banks create the money, and no market economy can function without its money. Money only exists if we believe in it, so we have to maintain the faith. To maintain the faith we need more democratic control over money creation, which can only come if regulation of the financial system is greatly expanded. □

Sources: Money supply: Federal Reserve Board, www.federalreserve.gov/releases/h6/current/;
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