Fourth Edition

Money & Banking

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American Bankers Association

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and government entities. From the 1950s to the 1990s, the number of checks written more than quadrupled, representing a growth rate of about 5 percent annually.

The demand deposit (checking account), the traditional checkable deposit in the U.S. banking system, pays no interest but allows the holder to withdraw funds on demand and to transfer funds by check. Because demand deposits are the core component of the nation's money supply and because they are created in the commercial lending process, mainly by the nation's 9,500 commercial banks, the Federal Reserve's attempts to control the money supply focus on regulating the ability of banks to create demand deposits.

Only since the late 1970s have commercial banks and thrift institutions—savings banks, savings and loan associations, and credit unions—been allowed to offer checkable deposits that pay interest. In late 1997, Americans held about $250 billion in interest-earning checkable deposits—primarily negotiable order of withdrawal (NOW) accounts and credit union share drafts—compared with about $400 billion held in traditional demand deposits at commercial banks and thrifts. Americans held an additional $950 billion in money market deposit accounts which, although they pay interest and allow limited check-writing privileges, are legally classified as savings deposits rather than as checkable deposits. (Extended Study 1 discusses various definitions of the nation's money supply, in which checkable deposits, but not time and savings deposits, are included in the narrowest definition of money supply—known as M1.)

Legal Tender and Checkbook Money

Although checks are the preferred means of payment in the United States today, they carry no status as legal tender. The term *legal tender* refers to money items designated by the government and the courts as acceptable payment for goods and services or settlement of debt. In effect, the designation of certain items as legal tender leaves sellers of goods and services and creditors with no legal recourse to demand any other form of payment.

In the United States, only U.S.-minted coin and Federal Reserve-issued paper currency are designated as legal tender. Coin always has been so designated, whereas government-issued paper currency was first elevated to this status during the Civil War (in an attempt to win public confidence in paper money). In 1933, Congress made all U.S. coin and currency legal tender for all public and private debts.

Americans prefer using checkbook money, despite its lack of legal tender status, because it serves as a more efficient medium of exchange than coin or currency for many transactions. This preference is not new; bank deposits have been the dominant component of America's circulating money since the 1860s.

The Advantages of Checkbook Money

A check offers consumers numerous advantages:

- the ability to spend small or large amounts with the same instrument
- deterrence to theft or counterfeiting because of the signature requirement
- the ability to stop payment after a transaction has been made
- written proof of payment in the form of a canceled check
- a clear audit trail through the check collection process, which allows for identification of errors or improper transactions
- extended use of account funds (consumer float) due to the time required for check collection by recipients and their banks

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Exhibit 2.7 Assets of Selected Financial Intermediaries, 1970-1996 *(billions of dollars)*

	Commercial Banks	*Savings* Institutions*	*Credit Unions*	*Life Insurance Companies*	*Mutual Funds ***
1970	576	255	18	207	48
1980	1,537	803	72	479	135
1985	2,329	1,291	137	880	495
1996	3,669	910	277	1,630	2,300

* Includes savings banks and saving and loan associations. ** Includes both open-end and closed-end mutual funds and money market mutual funds. *Sources'.* Federal Reserve *Bulletin,* U.S. League of Savings Associations.

In the 1980s, the nation's large corporations also began to increase their use of direct financing to obtain funds. Instead of borrowing from banks, these companies borrowed funds by selling their own commercial paper (short-term, uncollateralized promissory notes) directly to the public. Exhibit 2.8 shows the sharp growth of commercial paper from the late 1980s to the late 1990s. During this period, the amount of commercial paper outstanding increased by 250 percent. The growth of the commercial paper market also enabled finance companies, which issue commercial paper to fund their lending, to expand their activities at the expense of commercial banks. In 1980, finance company loans to business firms amounted to about 30 percent of banks' business loans; in 1997, these loans amounted to more than 60 percent. (Finance companies held more than $650 billion in assets in 1997.)

The effect on commercial banks of regulatory restraints, competition from major non-bank lenders, and corporations' increased use of commercial paper sales to obtain borrowed funds has been profound. In 1975, commercial banks provided 35 percent of all borrowed funds; by 1997, commercial banks' share had fallen to about 20 percent.

Commercial Banks and Money Creation

Traditionally, commercial banks differed from other financial intermediaries in that only they could create money (in the form of new demand deposit balances) by making loans. Because demand deposits (checking accounts) represent the core medium of exchange in the U.S. economy and because commercial banks still create most of the demand deposit dollars that circulate in the U.S. economy, the Federal Reserve primarily uses the nation's 9,500 commercial banks to implement its monetary policy. This relationship also is illustrated in exhibit 2.1.

A bank that makes a loan monetizes a private debt by accepting as an asset the debt obligation of the borrower—that is, the borrower's promise to repay. The bank simultaneously creates a liability on its books in the form of a demand deposit balance in the amount of the loan.

To create money, a bank must have reserves—either funds on deposit at a Federal Reserve bank or vault cash—at least equal to the amount of money to be created. The more reserves a bank has, the greater its potential for expanding earnings because it can continue to make new loans and investments. The fewer reserves a bank has (or, more precisely, the closer its reserves are to its own liquidity margin or to the reserve requirements of the Federal Reserve), the smaller its potential for expanding earnings.

Commercial bank lending creates an increasing amount of demand deposits throughout the economy. The creation of these deposits by the banking system is constantly being modified by the flow of money between banks and other financial intermediaries, the movement of funds from checking to savings accounts, and the cashing of checks; however,

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