

MONEY AND BANKING

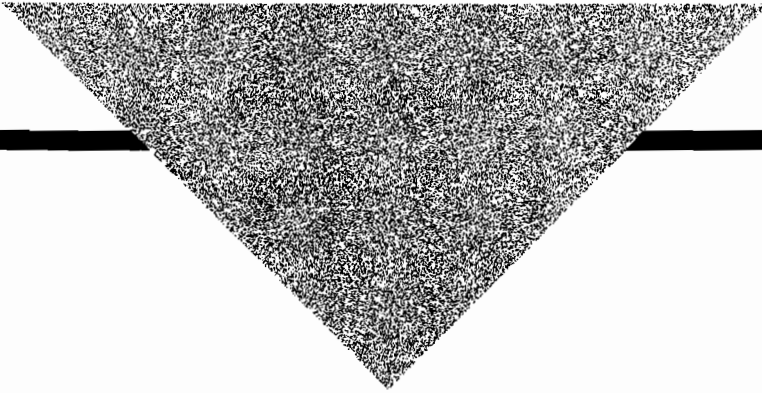
A MARKET-ORIENTED APPROACH

THIRD EDITION



IVAN C. JOHNSON ■ WILLIAM W. ROBERTS

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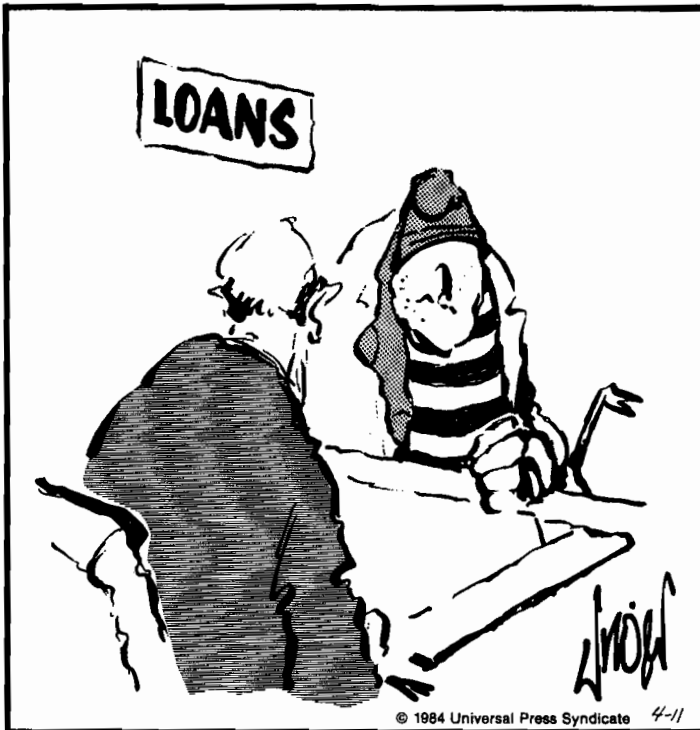
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to finance the production of goods and services or longer term to finance a business firm's capital outlays. Short-term loans are an important source for a business firm's working financial capital. In addition to receiving the interest income from the commercial loans, the commercial bank also may house the business firm's demand deposits. This gives the bank funds that can be used to extend additional loans.

Although banks generally extend short-term loans to match the short-term nature of their liabilities, commercial banks also hold longer-term **real estate** loans with terms to maturity upwards to 30 years. The growth in longer-term time and savings deposits has contributed to bank activity in longer-term markets. A commercial bank may issue more real estate loans than it intends to hold. These loans are then packaged and sold on the secondary market, perhaps to the Federal National Mortgage Association (FNMA). The bank earns a fee for processing the loan payments.

Consumer loans and other **loans to individuals** also are important in commercial bank portfolios. In addition to the traditional loans to finance automobiles, mobile homes, and home improvements, there has been an



"I could literally double my income with a 20-foot ladder."

increase in bank credit card loans. On the credit card loans, the commercial bank receives a processing fee in addition to any interest earnings. *Farm loans* generally are seasonal in nature and are issued to finance planting and harvesting. Loans on security purchases are restricted by Regulations G, T, and U of the Federal Reserve. These regulations impose margin requirements that allow the bank to finance only 50 percent of the security purchase. Commercial banks also hold a significant amount of loans with other **financial institutions**, both domestically and in foreign countries, in their highly diversified portfolios.

COMMERCIAL BANK LIABILITIES


The primary source of funds that enables a commercial bank to acquire assets is the bank's deposit liabilities. Deposit liabilities of commercial banks are assets of individuals, business firms, and governments, and are held by these parties because the commercial bank offers explicit interest payments and/or services. The profitability of a commercial bank relates as much to the costs of borrowed funds as it does to the earnings on the bank's asset portfolio. In addition to affecting the bank's profitability, the sources of liabilities affect the liquidity of the bank. Well-developed markets for short-term borrowing, such as the federal funds market, serve as a source for cash items.

A commercial bank creates deposit liabilities when it receives the deposit of an asset, usually in the form of cash or other reserves. Although most of the bank's liabilities are deposits of one kind or another, the holders of these deposits usually do not think of themselves as lending money to the bank. The bank, in fact, is borrowing the funds from the depositors for varying lengths of time. Commercial banks play an active role in attracting deposits, to the extent that a bank can be considered to be managing its liabilities almost to the same extent that it manages its assets. The basic composition of commercial bank liabilities is shown in Table 8.3, which represents the liabilities side of the portfolio whose assets are shown in Table 8.2.

Transactions Deposits

Transactions deposits are deposits that are transferrable to third parties by written order. These accounts include demand deposits and the other checkable deposits, NOW and ATS accounts. It is the potential for instant withdrawal from transactions accounts that causes banks to select such highly liquid portfolios. The primary holders of these accounts are individuals and business firms, though some are held by governments and their agencies.

Although explicit interest may be paid, the incentive to hold these accounts rests primarily with the services rendered. Banks have been prohibited from paying interest on demand deposits since the Bank Acts of 1933 and 1935. The 1970s innovations in deposit banking created transactions deposits that offer explicit interest payments.


 TABLE 8.3 Liabilities of All Commercial Banking Institutions, July 1986

Liabilities	Billions of Dollars	Percentage of Total Assets
Deposits	1817.5	71.6
Transactions	539.7	21.3
Savings	490.9	19.3
Time	786.9	31.0
Borrowings	380.4	15.0
Other Liabilities	170.1	6.7
Capital Account (residual assets minus liabilities)	169.6	6.7
Total Liabilities and Net Worth	2537.6	100.0

Source: Board of Governors of the Federal Reserve, *Federal Reserve Bulletin* (Washington D.C., October 1986), Table 1.25.

Transactions deposits are a significant part of the medium of exchange. These deposits provide their owners with the ability to transfer funds by means of checks, a system that has the added advantage of offering protection from theft and a record of the transactions made. Although this source of funds is not directly managed by banks, changes in the services provided, interest paid, or charges made for the use of checks do attract or reduce deposits.

Banks generally extend loans by creating a demand deposit for the borrower. Of course, the newly created deposit usually is withdrawn as the borrower uses the funds. Prior to the development of deposits, commercial banks created bank notes, as explained in "Bank Notes and Deposits," page 178.

Transactions deposits are held for their convenience in making payments. In addition, business firms often hold demand deposits as **compensating balances** for services they receive, such as payroll services, availability of lines of credit, and cash management. Compensating balances also are a technique used by banks to obtain security on a loan and also to adjust the effective interest rate charged for the loan. On a one-year loan of \$10,000 at 15 percent, the repayment due is the \$10,000 principal and \$1,500 interest. If the bank required a compensating balance of \$500, the firm would only have the use of \$9,500. The interest payment of \$1,500 would represent approximately 15.8 percent on the funds used ($\$1,500/\$9,500 = 0.158$).

HISTORICAL HIGHLIGHT

Bank Notes and Deposits

At the end of 1980, demand deposits accounted for approximately 65 percent of the circulating medium of exchange (M1), or the public held approximately \$2.30 in demand deposits in commercial banks for every \$1 they held in currency. This widespread use of deposits is, however, a relatively recent phenomenon. In 1853, for example, bank notes in circulation amounted to \$146 million, while bank deposits amounted to \$145.5 million.^a

Historically, commercial banks operated by extending loans in the form of bank notes. These bank notes were issued by the banks themselves. Upon presentation to the bank of issue, the notes could be exchanged for *specie* (gold or silver). While deposits were accepted by banks, loans were typically not issued as deposits, and the transfer of funds by check was not common. The use of checks gradually developed in the mid-1800s. The first full-fledged clearinghouse that provided for check clearing, as well as for the clearing of bank notes, was established in New York in 1853.

A significant incentive for the shift from circulating paper to the use of deposits occurred in the 1860s. The National Bank Act of 1863 as amended in 1864 provided for a national currency. The National Banks (those chartered by the Comptroller of the Currency) were permitted to issue national bank notes that had been printed for them by the Treasury, provided that they also purchased United States government securities. The circulation of bank notes issued by the other banks (the state banks) was halted by the imposition of a 10 percent tax on the amount of state bank notes paid out by any bank.

The intent of the National Bank Act and of the 10 percent tax was to cause banks to apply for federal charters as National Banks. Although the initial effect was to cause banks to shift over to being National Banks, this did not continue. State banks continued in operation and were able to flourish by adjusting to the use of demand deposits rather than note issue. In 1867, currency in circulation amounted to \$585 million, and the total amount of deposits amounted to \$729 million. By 1877 deposits had grown to \$1166 million, and the amount of currency had dropped to \$514 million.^b

^aRedlich, Fritz. *The Molding of American Banking. Part 2, 1840-1910*. (New York: Hafner Publishing Co. Inc., 1951): 7.

^bFriedman, Milton and Schwartz, Anna J. *A Monetary History of the United States, 1867-1960*. (Princeton University Press, 1963), Table A-1: 704.

Savings Deposits

Savings deposits are longer-term deposits of a commercial bank. These deposits include passbook savings accounts and money market deposit accounts. These deposits are less liquid than transactions deposits.

A **passbook savings account** has no stipulated date of maturity. Funds may be deposited into the account at any time, and (subject to the bank's

decision on whether or not prior notice for a withdrawal is required) funds may be withdrawn at any time. Small withdrawals from savings accounts are usually paid on demand. These accounts are primarily held by individuals and nonprofit concerns. Firms in business for profit are restricted to holding no more than \$150,000 in savings accounts in any one bank.

Commercial banks have actively competed for savings deposits by offering interest payments and services such as “free” safe-deposit boxes or “free” traveler’s checks when deposits exceed a certain minimum. The Depository Institutions Deregulation Act of 1980 has phased out interest rate ceilings. With higher interest-earning accounts available, passbook savings deposits have declined dramatically.

Money market deposit accounts were authorized by the Garn–St. Germain Depository Institutions Act of 1982 and are considered as savings accounts. These accounts were devised to allow banks and thrift institutions to compete with the money market mutual funds. Interest paid on these deposits is market determined. The rate of interest on these deposits may not be guaranteed for a period longer than one month. Although, as with savings accounts, withdrawals are usually paid on demand, the depository institution must reserve the right to require seven days’ notice before withdrawals.

Money market deposit accounts have limited transaction account features. The account permits the depositor six preauthorized, telephone, or automatic transfers per month, of which three may be by check. Personal withdrawals are unrestricted. The limitations on transactions features makes these accounts closer to savings deposits. Both types of savings deposits are not considered as part of the means of exchange (M1) but are counted in the broader definition of the money supply, M2.

Time Deposits

Time Deposits are interest-bearing accounts that have specific dates of maturity ranging upward from seven days. An **open account time deposit** allows the depositor to make additional deposits at any time before maturity, but the time of withdrawal is fixed. Most of these accounts are Holiday Funds, Christmas Clubs, and the like. In a **time certificate of deposit (CD)**, the funds are placed in the account at a specific time and are withdrawn at a specific time. These certificates are either negotiable or non-negotiable. By issuing these certificates, the banks have contracted for the use of the funds for a specific time period.

The 1970s saw the development of a wide range of non-negotiable time certificates of deposit, including six-month deposits with interest tied to the noncompetitive six-month Treasury Bill rate and 2½ year deposits with interest tied to the rate on Treasury notes. Like savings deposits, time deposits were subject to interest-rate ceilings. The development of this range of certificate accounts was the initial move to allow market adjustment of interest rates on deposits. The Monetary Control Act of 1980 provided for a phase-out of these interest-rate ceilings through 1986.