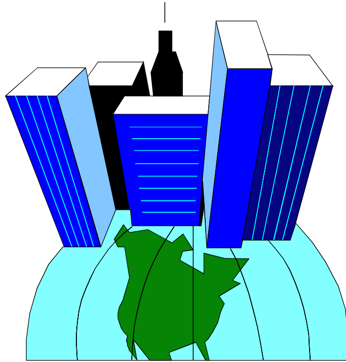
Introduction



Often when we speak of *institutions*, we're referring to buildings, as when we refer to our school as an *educational institution*. In the study of economics, some *economic institutions* are buildings. Banks, savings and loan associations, credit unions, and Federal Reserve Banks are all economic institutions—physical structures that we can visit and may do business with.

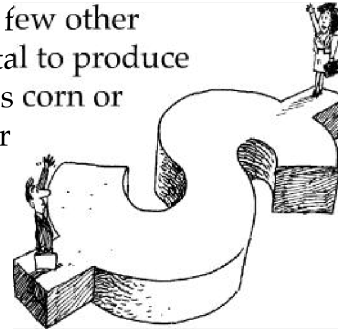
Economic institutions also include more than just physical structures. The word *institution* in its most complete definition includes the *organized way of doing something*. For example, a bank is a physical structure *and* provides an organized way of taking in money and returning it to its customers. So *economic institutions* refer to buildings, the way businesses are organized, and the way in which they compete in the marketplace.

The way in which businesses organize themselves and compete in the marketplace is closely watched and regulated by our government. There are laws that permit small businesses to operate in one way and large corporations to operate in another. For example, a business owned by a single person has great flexibility—the owner can make quick decisions. In exchange for this flexibility, the owner faces *unlimited liability*; she is personally responsible for all losses. Corporations are not very flexible, but their owners can only lose the money they've invested and no more. This is called *limited liability*.

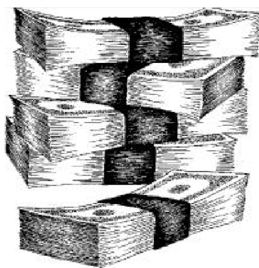
The way businesses compete in the marketplace is also watched and regulated by the government. In some markets, the government permits businesses to freely compete with few regulations. In other markets, the government may limit the competition for the benefit of consumers. Both the way businesses organize and the way they compete are covered by the phrase *economic institutions*.

Types of Business Competition: Pure Competition, Pure Monopoly, Oligopoly, and Monopolistic Competition

All businesses compete in a market. The kinds of products sold in a market will determine the type of competition producers engage in. For example, a company that chooses to produce automobiles realizes that it will compete in a market only against the few other manufacturers that also have the skills and capital to produce automobiles. However, a company that produces corn or wheat will compete in a market with many other producers. As you can see, all markets are not the same. Markets are defined by the way in which producers compete for customers of their products. Markets are structured in four different ways.



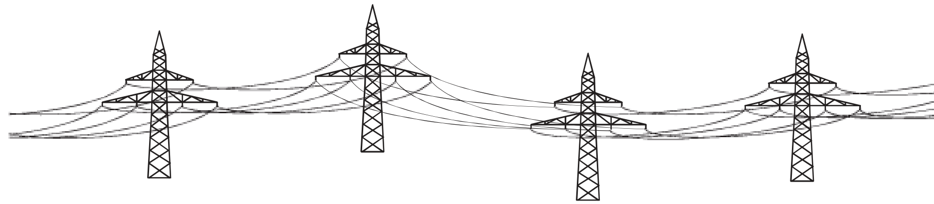
Pure Competition. *Pure Competition* exists when anyone can produce a product for sale to any consumer who wishes to buy it. Pure competition between many producers and many consumers creates a competitive *market price*, a price agreeable to both producers and consumers. This pure competition is based on the law of supply and demand: producers attempt to make the highest profit they can on their products, and consumers search the market for the lowest price on the products they want. This type of competition results in profits for producers and a variety of desirable products for consumers.



In the real marketplace of the United States economy, pure competition does not always exist. In fact only in the sales of a few products, such as farm products, do we see many manufacturers or producers competing with each other to sell their products to the millions of consumers in the United States. More often the type of business competition looks like one of the three markets described below.

Pure Monopoly. A *pure monopoly* is often called a *natural monopoly***.** This form of business competition exists when *only* one company provides a good or service that consumers demand. Governments permit the existence of pure monopolies to reduce the cost of a good or service for

consumers. So, for example, a city government grants a pure monopoly to a company to provide electric power to its residents. Many large companies may have the resources to supply electric power, but the price of electricity for homes and businesses would be much too expensive if each competing company had to install its own separate wires. Without pure monopolies, a city would soon have a large net of electrical wires running overhead.



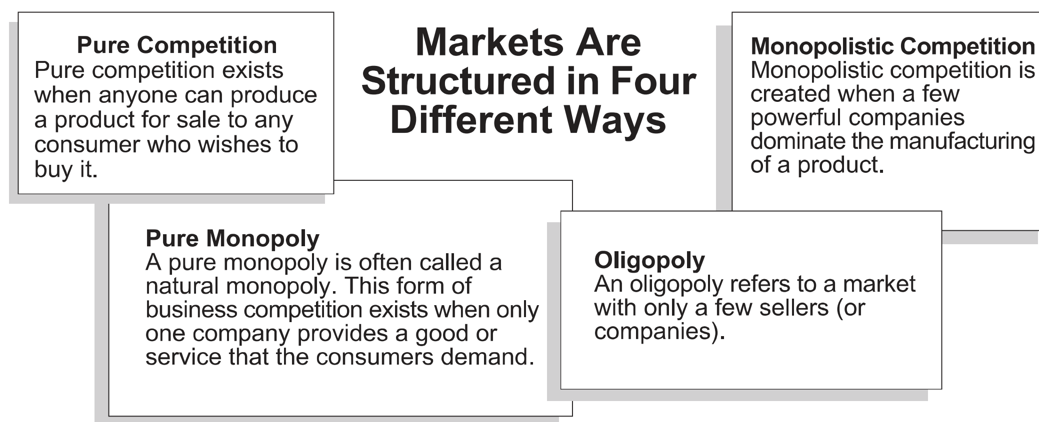
As you can see from the image of a dangerous net of wires overhead, it is the method of delivering the good or service to the public that makes a pure monopoly necessary. If the electrical company could deliver electricity to your home without wires, the city government would probably not grant a **monopoly**. A company that is granted a monopoly to provide a good or service such as electric power to the public is called a **public utility**. Water, sewage, and gas are other goods and services that must be delivered through pipes and wires. Without pure monopolies, providing these products would create a blight on our environment.

To insure that a company that has a pure monopoly does not overcharge the public, the government reserves the right to regulate the business. A public utility board usually helps set the maximum rates these pure monopolies can charge for goods or services. This is called a *price ceiling*.

Pure monopolies can also be created if a company has a patent for the production of a good. A government-issued patent gives the company the right to be the only manufacturer of a particular product. For example, a drug company may perfect a drug that cures or helps to treat a particular disease. That company will be granted a pure monopoly on the sale of this drug for a period of years, until its patent runs out and other companies can begin to compete. Without an assurance of a monopoly, few drug companies would invest the capital needed for such costly research and development.

Oligopoly. Another type of business competition is called an *oligopoly*. An *oligopoly* refers to a market with only a few sellers (or companies). Oligopolies develop when the production of a product requires a large amount of capital (money and equipment). Examples of this type of competition include manufacturers of automobiles and commercial aircraft. The large amounts of capital required and constant changes in technology have reduced the number of automobile manufacturers in the United States to only three big American companies and a few foreign-owned companies.

Monopolistic competition. *Monopolistic competition* is created when a few powerful companies dominate manufacture of a product. This is usually done by advertising that their product is somehow different or better than all of the other products of the same type. Wealthy companies can use advertising to drive out smaller companies and monopolize a market. For example, while it is true that all pain relievers made with acetaminophen are, by law, the same, people buy Tylenol because they think it is better than other pain relievers that contain exactly the same ingredient. Coca-Cola in the soft drink business, Kleenex in the tissue business, and M&M candies in the sugar-covered chocolate business are just a few examples of monopolistic competition.



Remember, all companies are competing in markets to obtain customers who are attempting to satisfy their unlimited wants and needs. We as consumers need companies and companies need us. Remember the circular flow of money, goods, services, and resources in Unit 3.

Practice

Match each definition with the correct term. Write the letter on the line provided.

______ 1. only one company produces a good or service that the consumers demand; examples include public utilities such as power, water, and gas

______ 2. few sellers or producers have the large amount of capital required to produce a particular product; examples include automobile or commercial aircraft manufacturers

______ 3. a few powerful companies that make such products as Coca-Cola and Kleenex dominate the market, largely through advertising

______ 4. many independent sellers such as food manufacturers compete

______ 5. the price agreeable to both producers and consumers; created by pure competition

______ 6. the conditions that determine the price

A. law of supply and demand

B. market price

C. monopolistic competition

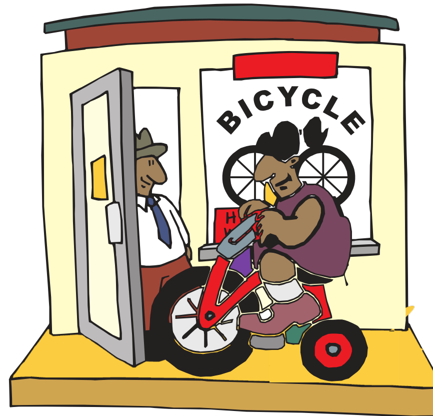
D. oligopoly

E. pure competition

F. pure monopoly

Business Organizations: Sole Proprietorship, Partnerships, and Corporations

Businesses can be organized, or owned and operated, in several different ways. Some businesses are owned by many investors, and some businesses are owned by one person or just a few persons. The product businesses produce will often determine the organization of the business. Equally, the way a business is organized will often determine the type of product it can produce and sell. A business owned by a single person would not have the resources to manufacture automobiles or even dishwashers. On the other hand, a bicycle store in a small town is an ideal kind of business for a single owner who can quickly and easily select the kinds of bicycles his unique customers desire.



Sole Proprietorship: Business Owned by One Individual

The vast majority of all businesses in the United States are owned by a single person. This type of business organization is called a **sole proprietorship**. Sometimes they are called *mom and pop businesses* because so many are family-owned and operated. American free enterprise was founded on the abilities of any citizen who has the energy, ability, and daring to strike out on her own and build a company, from tiny shoe repair stores to very large businesses. (The Ford Motor Company was for many years owned and operated by Henry Ford, who was followed by his children and grandchildren.)

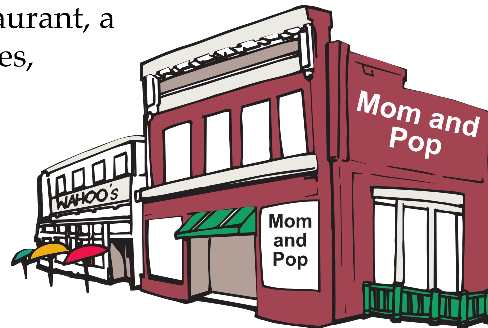
One advantage of a sole proprietorship is that the owner is his own boss. He can determine (within the law) what products he will sell, what hours his store will be open, how much profit he will keep, and how much he will invest to expand the business.

One disadvantage of a sole proprietorship is that the capital needed for establishment and expansion must come from the business owner, who might borrow some money from a bank or dig into her savings. The major point is that the resources of a single person or family are all the company can rely on for growth.

Another disadvantage of a sole proprietorship is that the business may cease to exist if the owner chooses to end the business or dies. This is why economists say that sole proprietorships have a *limited life*.

The biggest disadvantage is *unlimited liability*, meaning that the owner is responsible for all actions of business. Thus, as a sole proprietor, a person could lose everything he owns in a lawsuit.

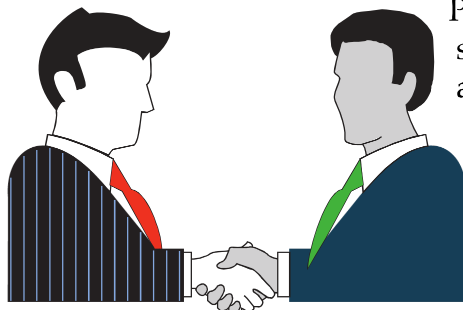
The most common type of sole proprietorship opening up in your city is often a restaurant, a company that repairs goods (cars, shoes, small appliances, bicycles, etc.), or a specialty store that sells a good or service to a select market. These sole proprietorships sell everything from dresses to computers to lawn mowers, or lawn-care services.



Of all the types of business organizations in the United States, sole proprietorships make up about 69 percent. However, because they are small and do not have the large sales of giant **corporations**, their worth amounts to about 10 percent of the value of all goods and services sold in the United States.

Partnerships: Business Owned by Two or More Individuals

Partnerships, or businesses owned by two or more persons, have the same disadvantage that sole proprietorships have—such companies often have a *limited life*. The death or retirement of one of the partners often leads to the end of the business. This problem can be overcome by having an attorney write a document that would allow the business to continue.



Partnerships do have advantages over sole proprietorships. Partners may be able to raise more money than a single individual. Their combined personal contributions and their power to borrow money may be greater than the capital one person could contribute or borrow.

Partnerships make up about 10 percent of all business organizations in the United States and make about four percent of the total income earned by all types of business organizations. Many partnerships are called *Professional Associates*. The letters *P.A.* often appear on the sign in front of their offices or on the office door. Most of these partnerships are formed by professional people such as doctors, lawyers, architects, and engineers. They form partnerships to help pay the cost of office space, share some of the work between the partners, share office help and equipment, and save costs on advertising.

The limitation of partnerships is similar to that of sole proprietorships in that capital for business growth is limited to the assets (wealth) of the partners plus the money they are able to borrow. A partnership cannot sell stock to raise money from the general public. The selling of stock to raise money for a business is limited to corporations. Again, the big disadvantage is *unlimited liability*. Each partner is liable for the company.

Corporations: Owned by Shareholders

Corporations make up 21 percent of all business organizations and earn 86 percent of all the revenue earned by all types of business organizations. Perhaps most importantly, corporations pay 68 percent of all wages earned by workers in this country.

Corporations are allowed to sell securities (stocks and bonds) to the general public in order to raise money for the business. Corporations are said to have *unlimited life* because they seldom have to reorganize when a stockholder dies or chooses to end her investment.

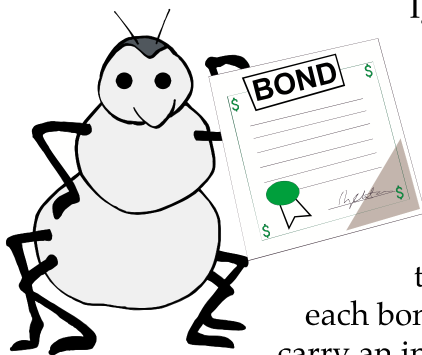
With their enormous ability to raise revenue through the sale of stocks and bonds, corporations are the largest type of business organizations in the United States. Corporations such as General Motors are worth billions of dollars. Corporations have *limited liabilities*. This means that the owners are liable only for what they have invested in the corporation.

The following case study explains how corporations grow by selling stocks and bonds.

Case Study: Understanding Stocks and Bonds

Ralph, Inc.

You remember Ralph from Unit 3. Well, Ralph approached his trusty bookkeeper Igor with a new problem: "Igor! The widget business is great, but we are not expanding our business as fast as we could. We are selling all the widgets we can make, and yet orders are coming in faster than we can manufacture widgets. If we do not expand soon, our competitors will step in and take business away from us. Igor, what is a poor ant to do?"



Igor returned to Ralph a few days later and gave Ralph a few ideas on how to expand the business. The first of these ideas was to sell bonds. A *bond* is a certificate issued by a company (or the government) in exchange for borrowed money. Igor suggested that if Ralph decided to issue bonds that each bond be issued at a value of $1,000 and carry an interest rate of nine percent.

Ralph understood that the people holding the bonds would not own part of his widget business but instead would be *creditors*—investors to whom Ralph owed money. The bonds would be issued for a term of 20 years at nine percent and then redeemed by Ralph when the bond *matured*. A bond is said to have *matured* when it has reached the date set for redemption that is printed on it. In Ralph's case, this meant that after 20 years of using the investor's money, Ralph would pay the investor not only nine percent interest each year for 20 years, but also pay back the original $1000 loan.

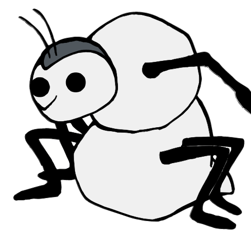
Ralph understood that he could sell bonds to investors. He then would pay investors the cost of the bond plus interest earned each year of the life of the bond. But Ralph had more questions.

Ralph asked, "What if I want to redeem the bonds early?"

"No, problem," answered Igor. "In fact this will make other issues of bonds easier to sell in the future."

Igor pointed out to Ralph that bondholders do have certain rights. They must be paid their dividends first from the company's profits before any other profits are distributed. Ralph decided that about 10 million dollars worth of bonds would be just about right to expand his business.

Igor suggested to Ralph that there are other ways to raise money to expand the widget business. For example, Ralph could sell preferred or common stock in his company. A share of stock entitles the investor to a certain part of the corporation's future profits and assets. Stockholders would become co-owners with Ralph of the widget company. By selling stock, Ralph would have to make his company into a corporation. He would have to issue a *prospectus*: a folder describing his company to prospective investors. Ralph would have to have annual stockholders' meetings to answer questions about how he was running the company. Ralph would also have to register his company with the Security and Exchange Commission (SEC). Registering with the SEC is required by the government when a private company becomes a publicly owned corporation and sells stock in itself. The government could not guarantee the public that Ralph was an honest ant, but registering would provide some important information to the public about Ralph's Widget Company, Inc. Registering with the SEC would allow the government to examine Ralph's books from time to time just to make sure the investors were not being taken advantage of. (Note: It is not necessary to incorporate to sell bonds, but it is necessary to register.)



Ralph instructed Igor, his bookkeeper, to get the prospectus ready. In the prospectus, Ralph listed the company's officers, cautioned investors about risks involved in investing in the widget business (especially one run by an ant), and described the operation of his business over the last few years. The prospectus was ready in just a few weeks to be sent off to the stock brokerage company that Ralph and Igor had selected to sell the initial offering of Ralph's Widgets, Inc. (Note: Only a broker or brokerage firm can sell stock.)

But Ralph had some more questions to ask Igor. For instance, "When the stock is sold, will I have to invite some of the stockholders to become directors of my company and allow them to

help run my business?" "Yes," answered Igor. "Humans may be bugging around the plant and telling us how to run the place." Ralph asked another question: "Will I be allowed to keep running the business just like I am doing now?"

"Sorry, Ralph," said Igor. "Humans will be around all the time from now on if we decide to sell stock."

"Igor, old bug," said Ralph, "what are the advantages then for us selling stock?" Igor then explained to Ralph that unlike bondholders, investors who bought stock in the Widget Company, Inc., would not be creditors. They would be part *owners*. They would take their risks of making a profit right along with Ralph. Their money, unlike that of the bondholders, never has to be returned. Their investment would be used to provide capital improvements to the company. (*Capital improvements* include new manufacturing plants, new machines, and other long-term improvements.)

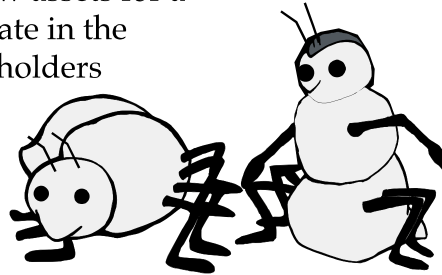
"In other words," Ralph said, "I will be sharing the profits I make with all of these investors, but because the business will be so much larger, I will end up making even more money."

"Plus," Igor added, "if for a few years profits are not that great, we can pay only a small dividend to the investors, or if the stockholders approve, no dividend at all." Igor continued: "If the stockholders agree, we could reinvest our profits into the company rather than distribute them to the stockholders."

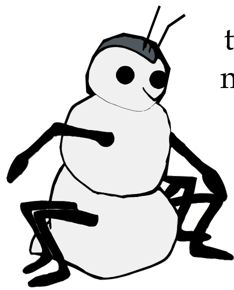
Questions to think about.

1. **What is a *prospectus*?**
2. **What rights do stockholders have in a company that they invest in?**
3. **Why would a company choose to issue stocks rather than bonds?**
4. **What must the owners of a company give up when they choose to incorporate?**

Fast Freddy of Stock Picking Dot-com arrived to help Ralph decide about this whole stock business. Freddy explained that, whereas bonds are used mainly for financing long-term debt, stock is used to buy new assets for a company. Bond owners do not participate in the operation of a company, whereas stockholders do. Bondholders, though, are guaranteed their dividends as long as the company makes a profit, whereas stockholders may not receive any dividends.



"Ralph," said Freddy, "there are two types of stocks: *preferred* and *common*. *Preferred* pays a set dividend (as long as the company earns enough to first pay the bondholders). Preferred stock, since it does not pay more dividends even if a company earns more money, does not often change in value. However, when interest rates go up, preferred stock tends to fall in value if its dividends fall below what investors could make in some other investments. If interest rates for other investments fall, preferred stock from a company earning a nice profit will tend to increase in value. Investors who own preferred stock do not get to vote at the company's annual meeting, but they are part owners in the company."

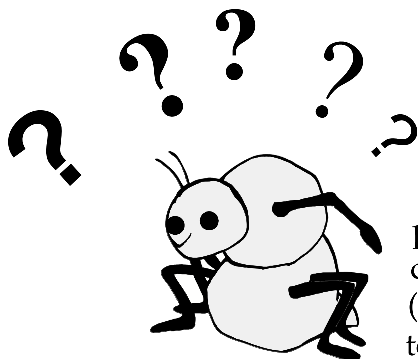


"*Common stock*," said Freddy, "is the most common type of stock issued by most companies. It is also the most popular type of stock for investors. Owners of common stock get a vote in the operation of a company and share in the profits of a company through dividends.

"As Igor has already explained to you," said Freddy, "you don't have to pay dividends, but if you do, your stock will go up in value. And if you decide to issue stock in the future, you could sell it for a higher price than we can for the initial offering."

Questions to think about.

1. **What is the difference between *preferred* and *common* stock?**
2. **What rights do *common* stockholders get over *bondholders* or *preferred* stockholders?**
3. **If the company only makes enough money to pay some dividends, which investors get their money first?**
4. **If the company makes a lot of money, which type of investment will most likely reflect the higher income?**



Then Ralph said, “Tell me something about how often I have to pay the investors.”

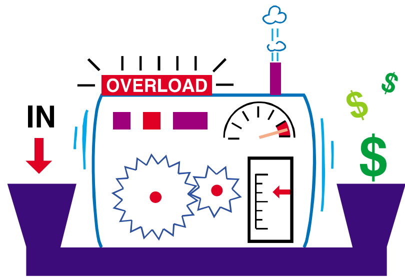
Freddy began explaining: “Bonds are paid once every six months, whereas dividends are paid four times a year (quarterly). Companies that have a tendency to use profits to buy new assets rather than to pay dividends are called *growth companies*. (Their stock is called a *growth* stock). Stocks in such companies, while they do not pay dividends, do increase in value. Stocks that pay most of their profits in dividends are called *income stocks*. Investors who need a steady income from their investments tend to prefer income stock over growth stocks.”

“Hey, Igor,” asked Ralph, “is it possible for a company to be a growth company for a few years and then become an income company?”

“Yes,” answered Igor. “As you know, ants and rats live close together. I was talking to my buddy Mickey about his place down in Orlando. Mickey said that while he was building his amusement park, his stock issued no dividends, but after the park was finished, the company resumed paying the dividends.”

At this point it was necessary for Ralph and Igor to find an expert in issuing initial stock offers. An *initial stock offer* is made up of the first shares a company issues after it decides to become a corporation. Jean, the Lean Mean Investment Machine (LMIM), used to run an exterminator business before he met Ralph and saw the error of his ways. He is now an investment broker and deals in initial stock offerings. Jean LMIM told Ralph that the more money the initial offering is sold for, the more income Ralph will have for capital growth. Too low a price will mean that his stock will increase rapidly in price, but the Widget Company will not get the money. Too high a price means that the stock may not sell, and Ralph will have no money for expansion. That was Jean's advice on how to determine what price the initial offering should be and how many shares to offer.

Money: A *Good* Whose Sole Use Is As a Medium of Exchange



It is difficult for any economy to advance very far without the use of money. One of the earliest references of societies using money can be found in the Bible. And the ancient civilizations of Greece and Rome minted coins of gold, silver, and copper. But even before money was first created, people traded goods. The exchange of goods without the use of money is called *barter*.

Barter is a system of exchange. You have something someone wants, and someone has something you want. You trade one good for another. This situation is called a *double coincidence of wants*. It is just an accident, a coincidence of fact, that you both have goods of equal value and that you are both willing to trade. Barter requires this type of double coincidence in order to work.

If you want a car and someone wants you to cut his grass, you do not have a double coincidence. You could barter cutting his grass for the next 20 years for a car, but this would require some bookkeeping to keep track of the work.

Barter has worked in the past and is still used as a way of trading for goods in our modern society. Barter, however, is not flexible enough to drive economies of large societies such as ours. Just think if you had to wait until you could locate someone who wanted to exchange her graphite tennis racket with a 4 ⅝ inch grip for your leather jacket with your high school's name embroidered on the back. Good luck!

Characteristics of Money

The first forms of money were very simple. In other countries, tobacco, wooden coins, and receipts from cotton warehouses were used for money. These early forms of money lacked the flexibility and widespread

acceptability of current money. In order for something to be used for money, it must meet the following characteristics:

- **Durability.** Money should be able to stand up under constant use.
- **Portability.** Money needs to be small enough so it can be conveniently carried in clothes, pockets, or purses.
- **Divisibility.** Money must be made in various units. You should be able to make change. By having various units of money, goods of various value can be paid for, and change for larger units of money can be made. Barter, on the other hand, requires goods that are traded to be of equal value.
- **Uniformity.** Every bill and coin of the same value needs to look the same.
- **Ease of Recognition.** Money needs to be easily recognizable. Everyone knows what a dollar bill, a ten dollar bill, or a quarter looks like. We should also be able to recognize genuine money from counterfeit.
- **Relative Scarcity.** Money needs to be hard to manufacture. If it were possible to manufacture money as easily as any other good, we would be flooded with counterfeit currency. Our money is a hard-to-manufacture special paper and metal coins that have proven to be very difficult to duplicate. Money also could not be common substances like sand or clam shells that anyone could pick up on a beach. Money must be made of scarce or difficult-to-make goods.

Types of Money: Species and Token

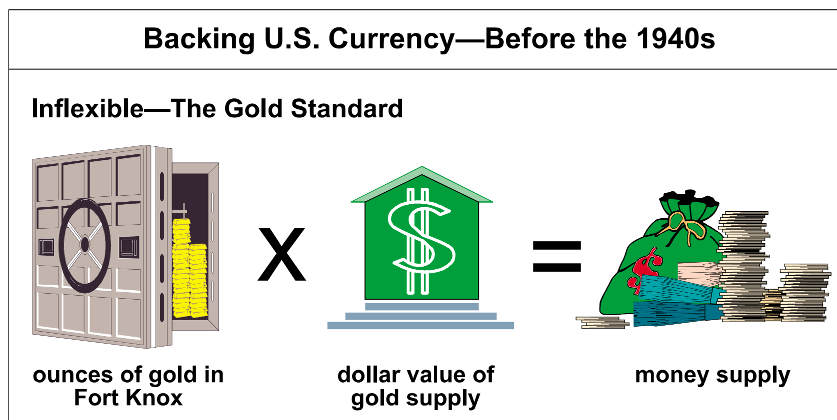
One of the earliest uses of precious (scarce) metals such as gold and silver was for money. Gold and silver coins meet all of the six characteristics above. Money made from gold or silver coins is called *species*. Some people call this *hard money*. In an economy as large as that of the United States, we do not have enough gold or silver to use as money. We use paper money (sometimes called *token money*) instead of species.

Gold and silver coins have value because people want these precious metals. We call their value *intrinsic* because these coins are valuable without the added purpose of serving as money. Paper money has no value except as money. The acceptance of paper money by people is based on the government's willingness to accept it to pay taxes and the willingness of business people to accept it as payment for goods.

Legal tender laws are government rules that require both the government and businesses to accept paper money for all debts both public and private. In the end, it is the acceptance of paper money by the people that makes paper money valuable. If the people lose faith in their government's ability to keep their paper money valuable, paper money will soon lose its value.

What Makes Money Valuable? The Ability to Exchange Money for the Goods and Services Desired

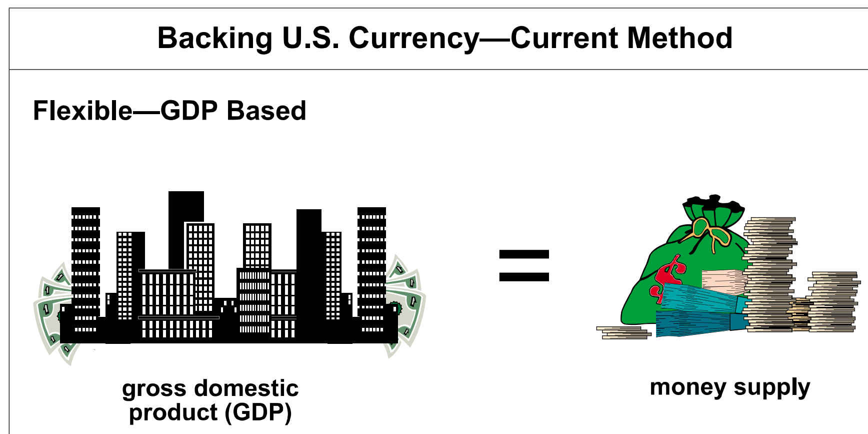
Keeping paper money valuable is called *backing the currency*. When the nation's currency was backed by gold, the equation for determining the nation's money supply looked like the one in the graphic shown below. The nation's money supply could not have been greater than the dollar value of its gold reserves.



Using this equation, our country could have found itself producing more goods and services than there was money to purchase them. Unless we had discovered vast new gold or silver mining areas, or the price of gold

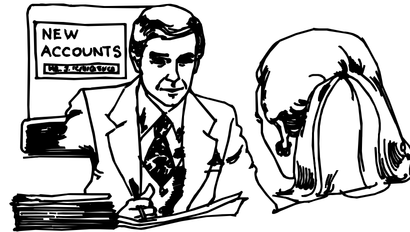
had suddenly gone up, we would not have had a very large supply of currency in the United States. We did not have enough gold in this country to issue only gold and silver coins. In the same way, we could not have issued paper money that could be redeemed in gold or silver coins. The United States gave up the gold standard, or backing its currency in gold, in the 1930s.

The government's solution was to back our currency with the dollar value of the nation's total production of goods and services each year. This figure is called the **gross domestic product** (**GDP**). The government began using the new equation, shown below, to determine the money supply. The government now issues currency equal to the GDP, or the amount of goods and services produced in the United States in one year. Using this equation, we would always have enough money in circulation to buy all of the goods and services produced. It is a sensible plan and has met with the approval of our citizens since we left the gold standard.

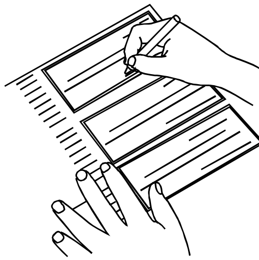


The Role of Banking Institutions: Providing Money to Businesses and Consumers

The Banking System



All financial institutions that provide banking services, whether they are commercial banks, savings and loan associations, or credit unions, serve their customers by offering some basic banking services. Each bank accepts money in the form of *deposits* from its customers.



Customers can deposit their money in either a checking or a savings account. Bankers refer to a checking account as a **demand deposit**: The bank must pay whomever the bank customer wrote the check to from the check writer's account, as long as the check writer has sufficient money in that account. Therefore, when you write a check, you are *demanding* that the bank cover your check with money from your account.

A savings account is called a **time deposit**. The longer the time you agree to keep your money in the bank, the higher the interest rate the bank will pay on your deposit. You can withdraw your money anytime from accounts called *passbook accounts*. Passbook accounts generally pay lower interest rates than those paid on time deposits. Accounts that require the depositor to leave money in the bank for months, or even years, are called *certificates of deposit* (or simply *CDs*).

The bank pays interest on deposits with the money it earns on loans made to customers. Loans are issued to pay for houses, cars, boats, or just regular purchases. A Visa or MasterCard purchase is, in fact, a form of a bank loan. You are charged interest on loans the bank makes to you. Credit cards are not money but loans of money.

Case Study: Loans to Customers

Credit Cards

Since we are talking about money, let's look at credit cards. First and foremost, credit cards are not money. Credit cards are loans from credit card issuers whom you pay back with interest.

When you pay for something using a credit card, you are in fact taking out a loan from the bank that issued the card. Many people use credit cards as a primary means of purchasing. However, some people do not use their credit cards in a responsible way. Often they end up buying more than they can pay in a reasonable period of time. The use of a credit card provides the convenience of not carrying around much cash. It also allows you to buy some things today that you would otherwise have had to wait and buy after you had saved the money. Keep in mind that a credit card does not make goods and services cheaper; it only delays your having to pay for the items you buy. Indeed, if you do not pay your credit bill in full each month, the items you buy on credit will cost you more than if you purchased them with cash due to the interest you will have to pay for using the credit card as a loan from the issuer. When deciding whether to purchase items with a credit card, it is good to keep these things in mind.

To keep from overextending your money supply and using your credit cards to buy more than you can afford, keep track of your expenditures just as you keep track of the checks you write. A bad credit history will have a negative impact that can affect your individual financial life now and in the future.

Banking Institutions

Commercial Banks

All commercial banks in the United States must be members of the **Federal Reserve System** (**Fed**). A commercial bank, sometimes called a *full service bank*, makes loans to both commercial and private customers. These banks are allowed by law to do all types of common banking functions,

including deposit banking such as checking and savings accounts; loans on commercial and private real estate (homes and businesses); car and boat loans; Visa and MasterCard loans; signature loans (loans for which there is no *collateral*—property offered to the bank in case you don't pay the loan). Commercial banks may also offer other banking services such as safety deposit boxes, financial advice, and trust departments, which handle the finances for people who *cannot*, *do not* want to, or by law *are not* allowed to handle their own banking. An example of a person with a trust account would be that of a 10-year-old movie star who earns millions of dollars per year. The bank would agree to oversee that person's money until he or she became 18 years of age and legally an adult.

Commercial banks are by far the largest financial institutions in the United States. The largest commercial banks in the United States finance huge projects such as shopping malls, office buildings, and even loans to the United States and foreign governments. Some commercial banks, called *private banks*, only take select commercial customers and do not even have lobbies or teller windows.

All of these commercial banks not only are required to be members of the *Federal Reserve System (Fed)* but are also required to be members of the Federal Deposit Insurance Corporation (FDIC), which was created in 1930. You've probably noticed those FDIC signs at the bank that say your deposits are insured up to $100,000. The FDIC insures the consumers' deposits and helps to prevent a run on the bank. A *run on the bank* occurs when people panic and withdraw their deposits because they think the bank is running out of money. This happened in 1929 during the Great Depression but has not happened since the creation of the FDIC.

Commercial banks are chartered by both the federal government and state governments. That's how we get banks with names like *The Florida State Bank* or *First Federal Bank of [Your City]*. Regardless of which government body *charters* the bank (gives them a license to operate as a bank), all banks must join the FDIC and the Fed and obey the sound banking rules of those two agencies.

Savings & Loan Associations and Credit Unions

Other banking institutions include savings and loan associations (S&Ls) and credit unions. Both of these institutions offer some of the same banking services offered by commercial banks. S&Ls were originally chartered to take in savings from consumers, pay a slightly higher rate of interest than commercial banks, and then use these deposits as loans to people wishing to buy houses. The government, through a series of recent changes in the law, no longer allows S&Ls to offer higher interest rates than commercial banks. Consequently, S&Ls have attracted fewer deposits, and the fewer deposits S&Ls have, the less money they can loan out for mortgages. S&Ls have also been hurt by a recent series of scandals in which S&Ls lost billions of dollars through poor financial practices.

A growing part of the banking business is in the hands of credit unions. Credit unions (CUs) are allowed to take in deposits and make most types of consumer loans. Credit unions, however, may not make most types of commercial loans. They may carry out transactions only with their members. Although their liberal rules allow many people to join credit unions, CUs are much more limited in whom their depositors may be and in the size and types of the loans they offer. Because CUs are not allowed to make a profit, they often provide their members with lower loan rates and higher rates for their deposits.

Electronic banking, which gives bank customers access to their accounts through automatic teller account cards, is offered by most financial institutions today. On a larger scale, banks transfer money between themselves and the Fed electronically. Less *actual* cash each year is moving through our banking system. Cash is becoming less and less a part of our banking system. Maybe someday we will become a cashless society that uses only plastic cards, paper checks, and electronic transfers of money.

Government Regulation of the Money Supply: The Federal Reserve System

The Federal Reserve System (Fed) is the national banking system of the United States. The Fed is responsible for increasing or decreasing the amount of money circulating in the United States. The regulation of the **money supply** is called *monetary policy*. The Fed establishes the monetary policy for our country.

Organization of the Federal Reserve System

The Federal Reserve System was first organized in 1913 under the Federal Reserve Act. The Federal Reserve System includes a Board of Governors, 12 Federal Reserve Banks, and hundreds of member banks. The Board of Governors runs the Fed. The board creates policy—a plan—for the nation's banking system.

The seven-member Board of Governors for the Fed are appointed by the president and then confirmed by the Senate of the United States. Members of the Board of Governors are protected from the year-to-year politics of the government by their 14-year appointments. The chairperson of the Board of Governors (chairperson of the Fed) is appointed for a four-year term from among the members of the Board of Governors.

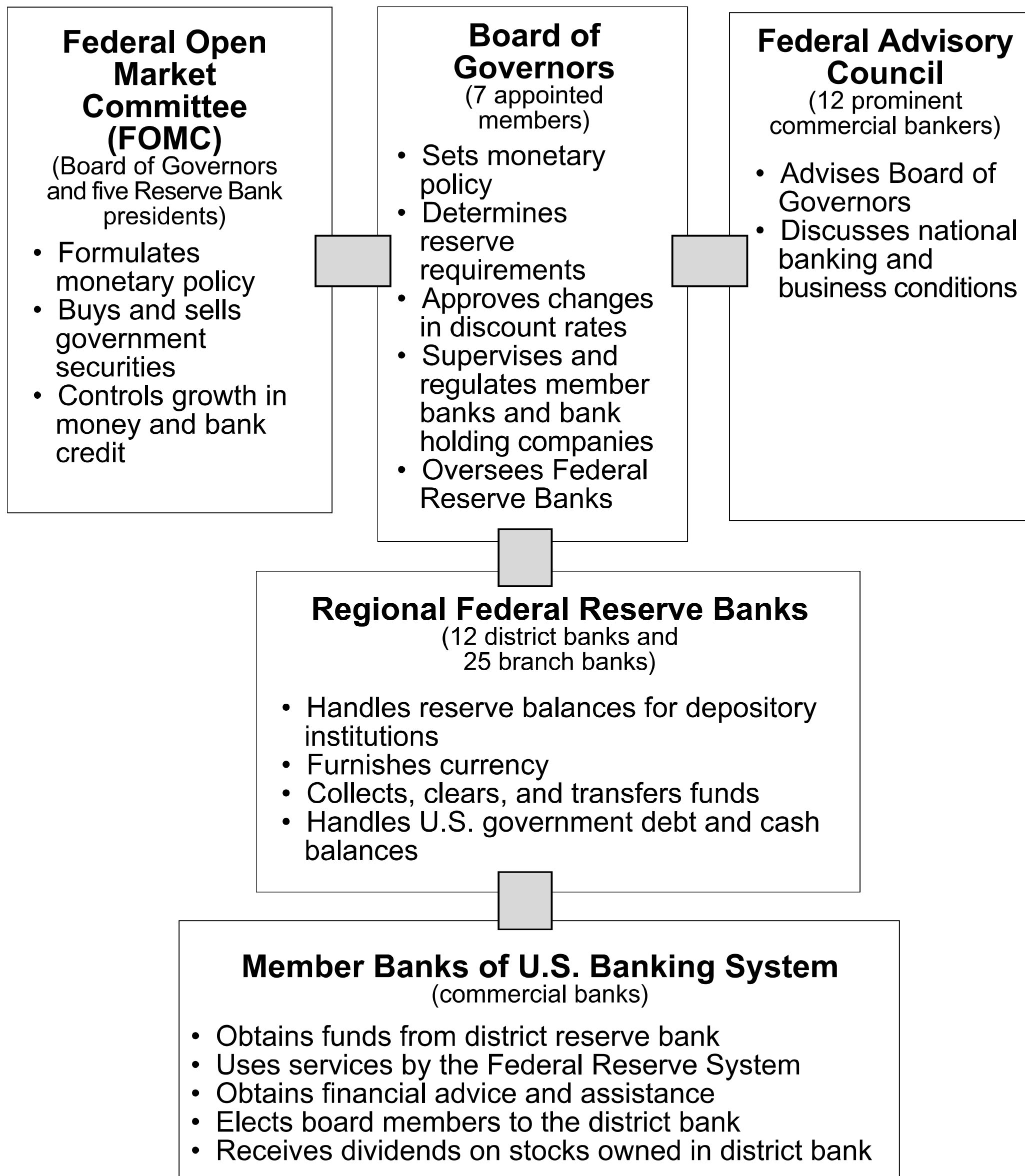
Twelve Federal Reserve Banks are spread out across the country. Each of these banks has its own district. These banks are owned by member banks located in each district. Member banks buy stock in the district Federal Reserve Bank, just as shareholders buy stock in a corporation.

Florida is served by the Sixth District Federal Reserve Bank located in Atlanta, Georgia. In addition, Florida has two branch Federal Reserve Banks, one in Jacksonville, one in Miami. Congress felt the country could be better met by Federal Reserve Banks within each area of the country rather than by one single Federal Bank.

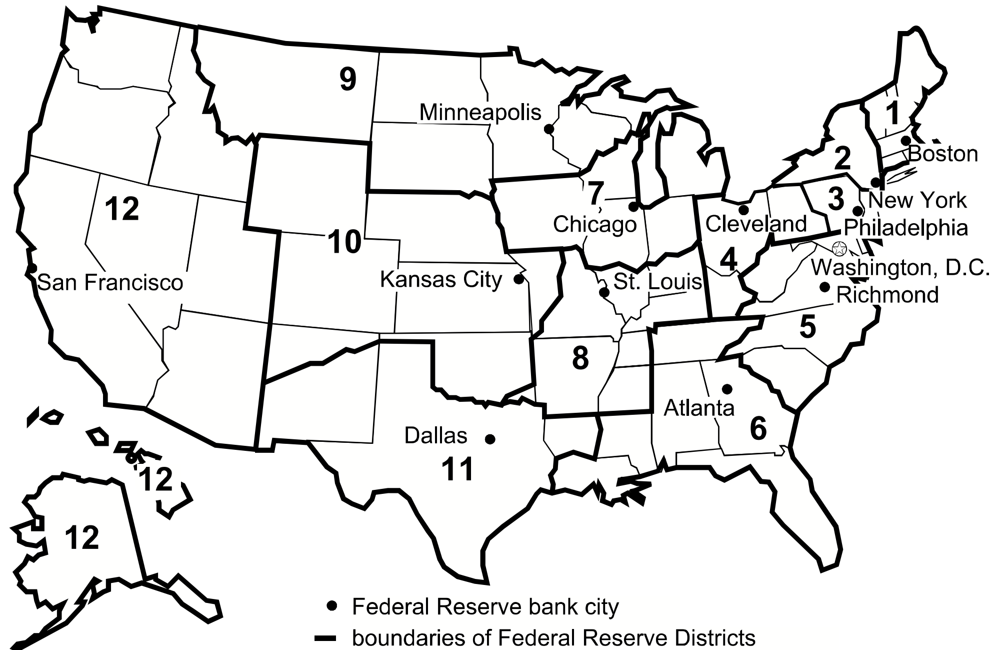
The Federal Reserve System also includes the Federal Open Market Committee and the Federal Advisory Council. The Federal Open Market Committee (FOMC) decides policy for buying and selling government securities. The Federal Advisory Council advises the Fed's Board of Governors on the nation's banking and business conditions.

The Fed regulates the money supply in three important ways.

- The Fed sets the reserve requirement for banks.
- The Fed sets the **discount rate** for banks.
- The Fed operates the federal open-market operations.



Federal Reserve Districts and Federal Reserve Bank Locations



Reserve Requirements: A Means of Insuring and Regulating the Currency

The Fed sets the reserve requirements for banks. The reserve requirement is the percentage of the money a bank takes in as deposits that it may not loan to customers. Money held in reserve by banks is our guarantee that money will be available for banks to cover both the checks we write on our checking accounts and the withdrawals we make from our savings accounts. By regulating reserve requirements, the Fed is insuring the acceptability of our currency.

If banks are permitted to maintain a smaller percentage of their deposits as reserves, then each of their reserve dollars can support more deposit dollars. Financial institutions can then make more loans and create more deposits.

On the other hand, raising the reserve requirement means that each reserve dollar can support fewer deposits. The bank will then have to reduce the amount of money available for loans.

The value of loans a bank can make is tied directly to the reserve requirement. The lower the reserve requirement, the more the bank can loan out of each dollar it receives as deposits.

The Discount Rate: Making Loans More and Less Attractive

The Fed also regulates the amount of money available by determining the discount (interest) rate. This rate is the interest financial institutions must pay on money borrowed from reserve banks. The Fed usually grants loans when financial institutions are faced with temporary or unusual operating needs.

If the discount rate is raised, the higher cost of borrowing from the Fed may cause financial institutions to be more selective and grant fewer loans. Thus, less money will be circulated. If the discount rate is lowered, financial institutions may be willing to grant more loans because of the lower cost of borrowing. More money will then be circulated. Adjusting the discount rate is one way the Fed responds to periods of **inflation** and **recession**. A rise in the price of goods and services is called *inflation*. *Recession* describes a decrease in the demand for goods and services and a decline in the economy.