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Money matters: How money works (Part 1)

by William Cowie

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[This is Part 1 of a two-part series on banking -- what it does, and can do, for you.]

What is money? Seriously, answer the question: What do **you** say is money? Everyone thinks they have a basic idea what money is, but no two people will come up with the same definition. And chances are none of them are correct.

In order to understand what money really is, we need to first look at its uses and then at the history of banking, because money and banking are so intertwined as to be inseparable.

The attributes of money

1. Transfer: Our main use of money is as a means of exchange. Way back in the day, all Farmer Fred had to give Carl Cobbler for a new set of shoes was a bag of wheat. But what if Carl was gluten-intolerant? Then Fred had to schlep the bag of wheat over to Barry Butcher, who had to be desperate enough to unload that side of beef before it went bad so that he would take a bag of wheat. And so on. What a drag, literally. Toting around stuff to barter was very inconvenient.

Money is much easier; we can take it anywhere with us and buy anything with it. (Come to think of it, perhaps that is where our spending problem originated: It has become way too easy to carry around money. If we had to lug around 30-pound bags of stuff to barter, we might be a lot less tempted to spend it, wouldn't we?)

2. Storage: Money is also a convenient way to store wealth. Carl Cobbler doesn't need to build a shed to store all those shoes he so diligently makes to tide him over on a rainy day. With money, he can simply sell all the shoes he makes, and then store the money — much more compact than shoes.

3. Valuation: The third use for money is to assign a value to the things we trade. For example, it works much better to express the value of a pair of shoes at $50 than, say, 2.5 bushels of corn or 1/118th of a tractor.

You may have noticed, but, convenient as money is, we rarely use it in its pure form. In fact, if you wanted to pay for a new home or car with cash, the authorities will pay you a visit, and it will not be for a friendly cup of tea. Most money we spend (and earn) is of a different kind.

Moving from gold to paper

In earlier days, people used pieces of gold for money (which was infinitely better than bags of wheat or manure). Over time, though, even gold coins became a drag … literally (again) because gold is heavy and easy to steal.

But humans are smart, and invented banks. In his classic book "*The History of Banks*," Richard Hildreth tells how it all started with a bunch of rich merchants organizing themselves into what became the Bank of Venice to **lend** money to the government at an interest rate of 4 percent.

Clearly, the money they lent to the government was money they could spare; so when the loans were repaid (those being the days when governments actually repaid loans), the money just stayed in the new bank.

That led the merchant members to discover the convenience of simply **depositing** the money they received as part of their trading with this bank.

So, when Maria Merchant had to pay Vinnie Vendor, they would meet in the bank lobby, where Maria would withdraw the money from her vault and hand it to Vinnie, who would take it right back to the teller and deposit it into his account with the bank.

After a while, they realized this was time-consuming, so it didn't take long for merchants to simply write down instructions to the bank to simply transfer the money from Maria's account to Vinnie's account.

Vinnie would present the instruction at the bank, who would make an entry in their books that the 2.5 pounds of gold in the vault no longer belonged to Maria Merchant but to Vinnie Vendor.

Thus, the third function of a bank was born, **circulation**.

We still use those instructions today. And for all intents and purposes, they have remained pretty much unchanged for the past 700 years. We call them checks. If you carefully read what is written on one of your checks, you will see it is still (after all these centuries) literally an instruction to your bank to take money from your account and transfer it to the account of the fortunate person receiving your check.

Why the elaborate history lesson? It's to clarify that money is not what we carry in our wallet.

Rather, ***money is simply an entry in the books of a bank somewhere.***

To be sure, we do carry a few notes and coins around with us; but by far, the majority of our money exists in the form of an entry in the books of a bank.

But that's not all. Someone once said money is like a bunny — built to reproduce. It does so in two steps, lending and multiplication.

The rise of lending

Banking, as we noted above, started with lending: the state of Venice pretty much forced the rich merchants to lend it money to protect them and go open new markets for them.

When the conquests were over, the loans got repaid, the merchants got even richer, and banking developed the deposit and circulation functions mentioned above. Merchants came and drew their money every now and then, like when they financed an expedition of a few ships to find new treasures to bring back and trade at big profits.

But gradually, it became evident that the vast majority of deposits just sat there, never touched.

It didn't take long for men to figure out that all this idle money could be put to use. Here's what would happen: Dina Developer thought she could buy one of those Venetian islands in the lagoon, put some bridges over the canals, have a parking lot for the gondolas, and build and sell a few mini-palaces, all with a nice view. However, she needed a hundred thousand or so to get started. She happened to know Bennie Banker very well, and one night over dinner she mentioned her dream to him. A penny dropped in Bennie. He thought of all those bags of gold just sitting there in his bank, idle. They weren't his, but who would miss a hundred thousand for a few weeks?

So Bennie lent Dina the money, she developed her property, and repaid the loan. For that, Bennie received interest — without using any of his own money. He used depositors' money, and made sure to put the money back where it came from when it was repaid. **But *he* kept the interest.** Money for nothing. Bennie rubbed his hands, realizing that this could be the start of something good!

It wasn't long before others began to do the same thing. Bennie had discovered something nobody had in mind when the merchants left their money with the bank for safekeeping: You can make money for yourself using other people's money. (Well, we don't know his name, but if Antonio Benedetto can change his name to Tony Bennett and become a famous singer, we can work with Bennie Banker!)

But if you think that was a good thing, wait… there's more (again, literally).

The supply of money — multiplication

How much money is in America? You would think that would be easy to calculate: Simply add up the balances in everyone's accounts. Unfortunately, it's not that simple.

Let's say back in the day Bennie Banker, the guy running the Bank of Venice, sent his assistant to add up all the balances on their bank's books and the total came to a million dollars. How much money did Venice have? A million dollars. That was easy.

But the next day Dina showed up to get the loan Bennie promised over dinner a few nights earlier. Bennie, of course, handed her a check. What did she do with the check? She deposited the money in the new account Bennie opened for her. So, the following night, when Bennie sent his assistant to count all the balances again, the total came to $1.1 million.

Bennie had just expanded the money supply by 10 percent. He created money out of thin air. How did he do this?

By making a loan.

Amazing, isn't it? Bennie was not stupid. He had **$1 million** to work with, so he started making loans like crazy.

He couldn't lend out all the money on deposit, because he had to leave some to cover any withdrawals. So, let's say he decides he can lend out 80 percent of what he has in the bank. At the end of the first week, his deposits would have swollen to **$1.8 million**, an increase of $800,000.

Bennie now had an extra $800,000 he could lend to even more people. When he lent the money to those people, they would deposit their loan checks into their accounts, generating new deposits of $640,000 (80 percent of $800,000). At this point, the total money supply totaled **$2,440,000.**

After lending out 80 percent of the next round of increase, the total money in Venice would have climbed to about **$3 million.**

So, just with three rounds of loans, Bennie tripled the total money in Venice from $1 million to $3 million.

We call that the multiplier. By making loans, bankers increase the amount of money in circulation. You probably understand now why bankers try so hard to be careful when they lend money to others: It's not their own money they are lending out; and if anything happened to that loan, they have to make it good to the depositor from their own funds.

You also understand why, in the crisis of 2008, everyone was so concerned about making loans to keep the money supply from shriveling back to nothing.

From this first part you have an understanding of what money is, where it comes from, and how important banks are to the money supply in any country. In the second part, we will draw the discussion closer to home.