Money And Banking Essay, Research Paper

1. Give a synopsis of the development of the concept of banking.

There are a number of innovations in the emergence of the concept of banking. These include the depository operations of metal smiths, written orders to pay bank notes. The recognition that depositors typically withdraw only a small fraction of the valuables, which they have on deposit, the possibility of lending gold while it is on deposit, and ultimately the possibility of lending a multiple amount of the deposited gold as long as borrowers make payments to parties, all of whom redeposit the borrowed gold back in the same bank. There are many events of discovery and innovation, which occurred in the emergence of money and banking. The process started with the recognition by metal smiths that they could earn income for depository services. Depository receipts issued for gold and silver on deposit consisted of liabilities of the depository, which the holder could use to redeem the specified amounts of gold or silver. The depository receipts could be transferred to second, third, and subsequent parties who could redeem them for gold or silver; depository receipts thus were fledgling examples of paper currency.

Deposit customers discovered that they could write orders to pay to second parties who could redeem them for gold or silver at the depository and these written orders to pay were the precursors of modern checks. Gold and silver placed on deposit tended to remain on deposit for extended lengths of time typically, only a small proportion of the gold and silver on deposit would be withdrawn on any day. Depository operators discovered that the bulk of the gold and silver on deposit could safely be loaned at interest as long as an adequate proportion of all of that on deposit was reserved to meet withdrawal demands. The adequate proportion became regarded as reserve ratio and metal smiths, now functioning both to receive deposits and issue loans, had become bankers. Gold and silver bars and coins are fungible.

Many loan customers came to prefer to receive the proceeds of their loans in the form of depository receipts for the loaned amount rather than gold or silver. Loan customers eventually became willing to receive loan proceeds in the form of pure promises to pay, which could be redeemed in gold or silver; these promises to pay in conventional denominations became bank notes which were dissociated with any particular deposits of gold or silver. Bank notes could be issued in total amount exceeding the actual quantity of gold and silver on deposit and experience indicated that the amount could safely become a multiple of the gold and silver on deposit. The safe multiple could be estimated as the reciprocal of the proportion of the total gold and silver deposit which could be expected to be withdrawn on any day. This proportion of the gold and silver deposit served as a reserve backing the note issue. Eventually loan customers became willing to accept loan proceeds in the form of additions to their checkable deposit balances and bankers no longer needed to issue loan proceeds in the form of bank notes. Monetary authorities eventually removed the privilege of bank note issuance from banks and reserved this process for their exclusive monopoly. Inter-bank deposits at other banks or at a central bank could serve as the reserves backing checkable deposit liabilities then gold and silver reserves became unnecessary. Gold and silver, no longer circulating as a medium of exchange and unnecessary to serve as reserves backing issues of either bank notes or checkable deposits, became irrelevant to money and banking.

2. Discuss they types of instruments which are operative in such environment, in regards to depository and non-depository financial institutions.

There are numerous financial instruments available to investors and financial managers. Each year new instruments arrive on the market and some leave. Many of the large investment houses have researchers developing new types of instruments. The major purpose of financial markets is to transfer funds from lenders to borrowers. Financial market participants commonly distinguish between the “capital market” and the “money market,” with the latter term generally referring to borrowing and lending for periods of a year or less. The capital market is the long-term sector of the financial system and serves as a source of funds for terms longer than three years. Both fixed and variable interest securities are traded

Money Market Instruments are short-term cash substitutes. They usually have short maturities (one year or less), little or no default risk, and are highly liquid. The second category is Capital Market Instruments. These instruments are characterized by longer term maturities (greater than a year), their default risk is sometimes higher and they are generally less liquid. Treasury Bills have maturities of up to one year. They are purchased at a discount from face value. Treasury bills are usually traded in $10,000 denominations. Municipal notes are debt securities issued by state and local governments. The notes are interest bearing with maturities that range from a month to more than a year. The interest from these notes is exempt from federal taxation and usually exempt from state income tax. Certificates of deposit are large deposits ($100,000 or more) placed in commercial banks at a stated rate of interest. There are also variable rate certificates of deposit. A third type of certificates of deposit is the Eurodollar. This is simply a certificate of deposit issued in U.S. dollars at a foreign bank (usually U.S. branches in London or the Caribbean). Commercial Paper is issued by large corporations as an alternative to securing short-term bank loans. Commercial paper is an unsecured promissory note and is usually issued on a discount basis. Eurodollars are simply U.S. dollar deposits in foreign banks. The deposits are often made for fixed time interval at a stated rate of interest. The eurodollar market is quite liquid and it offers the advantage of not being regulated the U.S. government.

Federal Funds are only available to banks that are members of the Federal Reserve System. Banks that are members of the system are required to keep required reserves with the Federal Reserve. Since interest is not paid on these required reserves, it is in the member bank’s interest to keep the reserves at the minimum level. Municipal Bonds are Issued by state and local governments. They are interest is exempt from Fed tax (no state/local in issuing state) and have a lower yield due to tax exempt status. However, capital gains are subject to tax. Corporate Bonds are private firms that borrow from public. They have semi annual coupons and higher default risk and are convertible into common stock. Mortgages and mortgage-backed securities are mortgage lenders originate loans, package and sell in secondary market The lender services and passes through the interest and principal. There has been large growth in the international financial instruments in recent years. Eirobonds are denominated in a currency other than that of the courty of orgin. A borrower no longer has to obtain funds from financial intermediaries in his or her own country, and a lender does not need to lend funds only to borrowers in its own country.

4. In your own view, what are the causes of inflation?

Inflation has been defined as “too much money chasing too few goods.” As prices rise, wages and salaries also have a tendency to rise. More money in people’s pockets causes prices to rise still higher so that consumers never quite catch up. Inflation can go on continuously year after year so long as the money supply continues to increase. Continued inflation affects people in diverse ways. Those who live on fixed incomes, or those whose incomes increase very slowly, suffer most from inflation because they are able to buy less and less. Those who lend money when prices are lower may be paid back in dollars of reduced purchasing power. Banks and savings and loan associations generally lose from inflation. People who borrow money, however, may profit by paying their debts in dollars that have shrunk in purchasing power. Inflation thus encourages borrowing and discourages saving. It also leads people to buy real estate and durable goods that will keep their value over time.

In the United States this tendency is reinforced by the tax system, which allows taxpayers to deduct property taxes and interest payments from their taxable incomes. If inflation continues for a long time, the country as a whole may begin to consume more and invest less as people find it more profitable to borrow than to save. In other words, inflation causes society to use more of its resources for today’s purposes and to set aside less for tomorrow’s needs. Inflation has many causes, but they all operate to raise the demand for goods and services beyond the capacity of the economy to satisfy that demand. Often inflation follows a war, when the government has spent vast sums on military equipment and has not raised taxes enough to pay for it. Heavy government spending in peacetime may also lead to inflation. The principal reason why governments create inflation is that they are able to print money. When a government pays its bills by printing money rather than by raising taxes, the effect is to increase the demand for goods and services. If demand is already high, increasing it will only push up the prices of those goods and services. But the government may not be the only player in the inflation scenario. Citizens, through their voting power, encourage the government to follow inflationary policies. In the United States special interest groups often exert pressure on Congress for programs that will benefit them at the expense of the treasury. Few taxpayers actually ask their congressional representatives to raise taxes.

Government deficits in themselves do not necessarily lead to inflation, but they make it more difficult to prevent inflation or to slow it down. Another part in the scenario is played by people’s efforts to protect themselves from the effects of inflation. Consumers want their incomes to increase so as to keep up with rising prices. Those who belong to unions may put pressure on employers to raise wages, a factor that tends to force up prices still further. Those who lend money expect to be paid back in inflation-adjusted dollars. Retired people want their social security and other pension payments to increase with the cost of living. As inflation continues, people expect it to become even worse and try to compensate for it in advance. The simple expectation of inflation thus helps to keep it going.