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## INTRODUCTION TO BUSINESS

### CONTENTS

# Chapter 7: Money and Banking



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## Learning Objectives

After reading this chapter, you should be able to answer these questions:

1. What is money, what are its characteristics and functions, and what are the three parts of the Canadian money supply?
2. How does the Bank of Canada manage the money supply?
3. What are the key financial institutions, and what role do they play in the process of financial intermediation?
4. How does the Canada Deposit Insurance Corporation (CDIC) protect depositors' funds?
5. What trends are reshaping financial institutions?

## 7.1 Show Me the Money

**What is money, what are its characteristics and functions, and what are the three parts of the Canadian money supply?**

**Money** is anything that is acceptable as payment for goods and services. It affects our lives in many ways. We earn it, spend it, save it, invest it—and often wish we had more of it. Businesses and governments use money in similar ways. Both require money to finance their operations. By controlling the amount of money in circulation, the federal government can promote economic growth and stability. For this reason, money has been called the lubricant of the machinery that drives our economic system. Our banking system was developed to ease the handling of money.

## Characteristics of Money

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characteristics:

- **Scarcity:** Money should be scarce enough to have some value but not so scarce as to be unavailable. Pebbles, which meet some of the other criteria, would not work well as money because they are widely available. Too much money in circulation increases prices and inflation. Governments control the scarcity of money by limiting the quantity of money in circulation.
- **Durability:** Any item used as money must be durable. A perishable item such as a banana becomes useless as money when it spoils. Even early societies used durable forms of money, such as metal coins and paper money, which lasted for a long time.
- **Portability:** Money must be easily moved around. Large or bulky items, such as boulders or heavy gold bars, cannot be transported easily from place to place.
- **Divisibility:** Money must be capable of being divided into smaller parts. Divisible forms of money help make transactions of all sizes and amounts possible.

## Functions of Money

Using a variety of items as money would be confusing. Thus, societies develop a uniform money system to measure the value of goods and services. For money to be acceptable, it must function as a medium of exchange, as a standard of value, and as a store of value.

As a **medium of exchange**, money makes transactions easier. Having a common form of payment is much less complicated than having a barter system, wherein goods and services are exchanged for other goods and services. Money allows the exchange of products to be a simple process.

Money also serves as a **standard of value**. With a form of money whose value is accepted by all, goods and services can be priced in standard units. This makes it easy to measure the value of products and allows transactions to be recorded in consistent terms.

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choose to keep their money for future use rather than exchange it today for other types of products or assets.

## The Canadian Money Supply

The Canadian money supply is composed of currency, demand deposits, and time deposits. **Currency** is cash held in the form of coins and paper money. Other forms of currency include travelers' checks, cashier's checks, and money orders. The amount of currency in circulation depends on public demand. Domestic demand is influenced primarily by prices for goods and services, income levels, and the availability of alternative payment methods such as credit cards.

**Demand deposits** consist of money kept in checking accounts that can be withdrawn by depositors on demand. Demand deposits include regular checking accounts as well as interest-bearing and other special types of checking accounts. **Time deposits** are deposits at a bank or other financial institution that pay interest but cannot be withdrawn on demand. Examples are certain savings accounts, money market deposit accounts, and certificates of deposit. Credit cards, sometimes referred to as "plastic money," are routinely used as a substitute for cash and checks. Credit cards are not money; they are a form of borrowing. When a bank issues a credit card to a consumer, it gives a short-term loan to the consumer by directly paying the seller for the consumer's purchases. The consumer pays the credit card company after receiving the monthly statement. Credit cards do not replace money; they simply defer payment.

## 7.2 The Bank of Canada

### How does the Bank of Canada manage the money supply?

The Bank of Canada is Canada's central bank. It was created in 1935 during the depression. The Bank plays a crucial role in managing the Canadian economy and is very important to Canada's financial system as it regulates certain areas of

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one else in the government) does not make decisions for the Bank nor can it instruct the Bank of Canada on how to operate. The Bank is managed by a board of governors which consists of a governor, a deputy governor, and 12 directors appointed from different regions of the country. The Bank has four main responsibilities: regulating the financial system, designing and issuing bank notes, managing monetary policy and funds for the federal government.

The Bank of Canada's primary mission is to oversee the nation's monetary and credit system and to support the ongoing operation of Canada's private-banking system. The Bank's actions affect the interest rates banks charge businesses and consumers, help keep inflation under control, and ultimately stabilize the Canadian financial system.

**Bank of Canada video:** <https://youtu.be/ULqvuY2penk>

## Carrying Out Monetary Policy

The most important function of the Bank of Canada is carrying out monetary policy. It uses its power to change the money supply in order to control inflation and interest rates, increase employment, and influence economic activity. Two tools used by the Bank of Canada in managing the money supply are open market operations and the discount rate. Table 7.1 summarizes the short-term effects of these tools on the economy.

**Open market operations**—the tool most frequently used by the Bank of Canada to control the money supply growth rate—involves the buying and selling of government securities (Canadian government bonds). If the Bank wants to increase the money supply in the Canadian economy, it can buy government securities. When the Bank of Canada buys government securities, it puts money into the economy. Banks have more money to lend, so they reduce interest rates, which generally stimulates economic activity. The opposite occurs when the Bank of Canada sells government securities.

The Bank of Canada is called “the banker’s bank” because it lends money to banks that need it. The interest rate that the bank of Canada charges its member banks

The Bank of Canada's Monetary Tools and Their Effects				
Tool	Action	Effect on Money Supply	Effect on Interest Rates	Effect on Economic Activity
Open market operations	Buy government bonds	Increases	Lowers	Stimulates
	Sell government bonds	Decreases	Raises	Slows Down

Table 7.1

The Federal Reserve System's Monetary Tools and Their Effects				
Tool	Action	Effect on Money Supply	Effect on Interest Rates	Effect on Economic Activity
Discount rate	Raise discount rate	Decreases	Raises	Slows Down
	Lower discount rate	Increases	Lowers	Stimulates

Table 7.2

tomers. The banks profit from the *spread*, or difference, between the rate they charge their customers and the rate paid to the Bank of Canada. Changes in the discount rate usually produce changes in the interest rate that banks charge their customers. The Bank of Canada raises the discount rate to slow the growth rate in the money supply, this makes it more expensive for the commercial banks to borrow. Commercial banks then raise the interest rates they charge to businesses and consumers at their branches. This slows down economic activity. When the Bank of Canada lowers the discount rate it has the opposite effect and stimulates growth.

## 7.3 Canadian Financial Institutions

**What are the key financial institutions, and what role do they play in the pro-**

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ing. The system allows those who wish to borrow money to do so with relative ease. It also gives savers a variety of ways to earn interest on their savings. For example, a computer company that wants to build a new headquarters in Toronto might be financed partly with the savings of families in Calgary. The Calgarians deposit their money in a local financial institution. That institution looks for a profitable and safe way to use the money and decides to make a real estate loan to the computer company. The transfer of funds from savers to investors enables businesses to expand and the economy and grow.

Households are important participants in the Canadian financial system. Although many households borrow money to finance purchases, they supply funds to the financial system through their purchases and savings. Overall, businesses and governments are users of funds. They borrow more money than they save.

Sometimes those who have funds deal directly with those who want them. A wealthy realtor, for example, may lend money to a client to buy a house. Most often, financial institutions act as intermediaries—or go-betweens—between the suppliers and demanders of funds. The institutions accept savers' deposits and invest them in financial products (such as loans) that are expected to produce a return. This process, called **financial intermediation**, is shown in [Exhibit 7.1](#). Households are shown as suppliers of funds, and businesses and governments are shown as demanders. However, a single household, business, or government can be either a supplier or a demander, depending on the circumstances.

Financial institutions are the heart of the financial system. They are convenient vehicles for financial intermediation. They can be divided into two broad groups: depository institutions (those that accept deposits) and nondepository institutions (those that do not accept deposits).

## Depository Financial Institutions

Not all depository financial institutions are alike. Most people call the place where they save their money a “bank.” Some of those places are indeed banks, but other depository institutions include credit unions.

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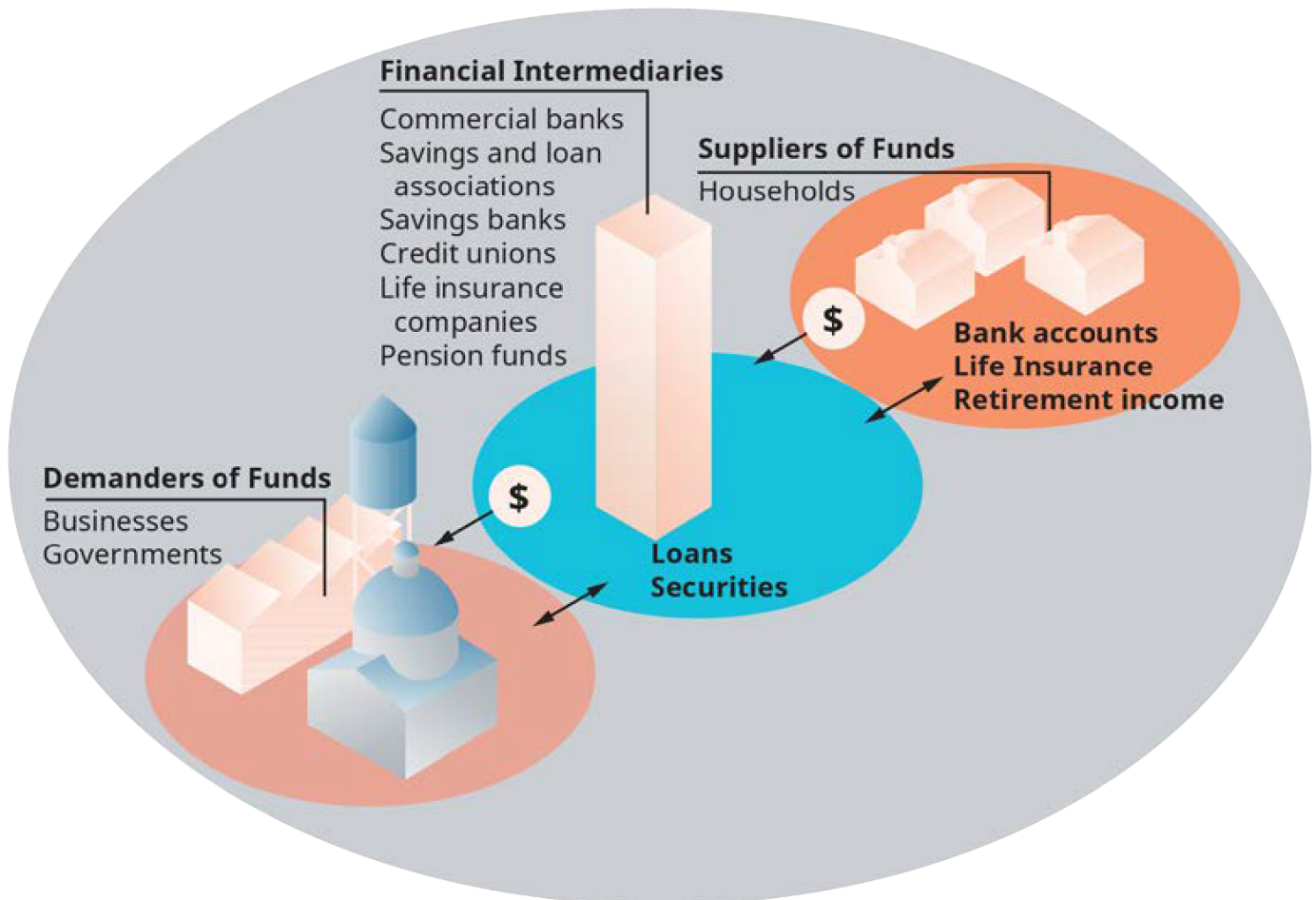


Exhibit 7.1 The Financial Intermediation Process\* Only the dominant suppliers and demanders are shown here. Clearly, a single household, business, or government can be either a supplier or demander, depending on circumstances. (Attribution: Copyright Rice University, OpenStax, under CC BY 4.0 license.)

## Commercial Banks

A **commercial bank** is a profit-oriented financial institution that accepts deposits, makes business and consumer loans, invests in government and corporate securities, and provides other financial services. Commercial banks are corporations owned and operated by individuals or other corporations. A large share of the nation's banking business is held by a relatively small number of big banks.

Customers' deposits are a commercial bank's major source of funds, the main use for which is loans. The difference between the interest the bank earns on loans and the interest it pays on deposits, plus fees it earns from other financial services, pays the bank's costs and provides a profit.

## Credit Unions

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union members typically have something in common: they may, for example, work for the same employer, belong to the same union or professional group, or attend the same church or school. The credit union pools their assets, or savings, in order to make loans and offer other services to members. The not-for-profit status of credit unions makes them tax-exempt, so they can pay good interest rates on deposits and offer loans at favorable interest rates.

**Credit unions video:** <https://youtu.be/0LIpQ5Er02E>

## Nondepository Financial Institutions

Some financial institutions provide certain banking services but do not accept deposits. These nondepository financial institutions include insurance companies, pension funds, brokerage firms, and finance companies. They serve both individuals and businesses.

### Insurance Companies

Insurance companies are major suppliers of funds. Policyholders make payments (called *premiums*) to buy financial protection from the insurance company. Insurance companies invest the premiums in stocks, bonds, real estate, business loans, and real estate loans for large projects.

### Pension Funds

Corporations, unions, and governments set aside large pools of money for later use in paying retirement benefits to their employees or members. These **pension funds** are managed by the employers or unions themselves or by outside managers, such as life insurance firms, commercial banks, and private investment firms. Pension plan members receive a specified monthly payment when they reach a given age. After setting aside enough money to pay near-term benefits, pension funds invest the rest in business loans, stocks, bonds, or real estate. They

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*Exhibit 7.2 Insurance companies, hurt by billions of dollars in unforeseen payouts during natural disasters such as Hurricane Irma in 2017, are rethinking their reliance on catastrophe-risk modelers, whose risk estimates failed to anticipate cataclysmic storms such as Hurricanes Katrina, Irma, and Harvey. Cat-risk businesses forecast potential weather-related expenses for insurers through sophisticated computer modeling that analyzes historical meteorological data. How do frequent natural disasters affect insurance companies and their policyholders? (Credit: Cayobo/ Flickr/ Attribution 2.0 Generic (CC BY 2.0))*

## Brokerage Firms

A **brokerage firm** buys and sells securities (stocks and bonds) for its clients and gives them related advice. Many brokerage firms offer some banking services. They may offer clients a combined checking and savings account with a high interest rate and also make loans, backed by securities, to them.

## Finance Companies

A **finance company** makes short-term loans for which the borrower puts up tangible assets (such as an automobile, inventory, machinery, or property) as security. Finance companies often make loans to individuals or businesses that cannot

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Services Offered by Depository Financial Institutions	
Service	Description
Savings accounts	Pay interest on deposits
Checking accounts	Allow depositors to withdraw any amount of funds at any time up to the amount on deposit
Money market deposit accounts	Savings accounts on which the interest rate is set at market rates
Certificates of deposit (CD)	Pay a higher interest rate than regular savings accounts, provided that the deposit remains for a specified period
Consumer loans	Loans to individuals to finance the purchase of a home, car, or other expensive items
Business loans	Loans to businesses and other organizations to finance their operations
Electronic funds transfer	Use of computers and mobile devices to conduct financial transactions
Automated teller machine (ATM)	Allows bank customers to make deposits, withdrawals, and transfers from their accounts 24 hours a day
Debit cards	Allow customers to transfer money from their bank account directly to a merchant's account to pay for purchases
Online banking	Allows customers to conduct financial transactions via the internet or through a dial-in line that operates with a bank's software
Mobile apps	Technology that allows consumers to download programs to mobile devices that enable them to take care of banking, financial, and other transactions
Direct deposit of paychecks	Enabled through employers and payroll service vendors; allows financial institutions to accept direct deposits of payroll checks to consumers' checking and/or savings accounts on a regular basis

Table 7.3

**companies.** **Consumer finance companies** make loans to individuals, often to cover the lease or purchase of large consumer goods such as automobiles or major household appliances. To compensate for the extra risk, finance companies usually charge higher interest rates than banks.

## 7.4 Insuring Bank Deposits

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## **funds?**

The Canada Deposit Insurance Corporation (CDIC) is a federal agency that insures most bank deposits in Canada. It was created in 1967 to instill public confidence in the Canadian banking system. Before the CDIC was established, if a bank was in trouble or even if there was a rumour that a bank was in financial jeopardy, depositors would rush to the bank to withdraw their money, this was known as a run on the bank. Only the people that got their first would get their money as the banks would run out of money and then go bankrupt leaving many depositors without receiving any of their money. Now, if a CDIC-insured bank goes bankrupt depositors are reimbursed up to \$100 000.

## **7.5 International Banking**

### **What roles do Canadian banks play in the international marketplace?**

The financial marketplace spans the globe, with money routinely flowing across international borders. Canadian banks play an important role in global business by providing loans to foreign governments and businesses. Multinational corporations need many special banking services, such as foreign-currency exchange and funding for overseas investments. Canadian banks also offer trade-related services, such as global cash management, that help firms manage their cash flows, improve their payment efficiency, and reduce their exposure to operational risks. Sometimes consumers in other nations have a need for banking services that banks in their own countries don't provide. Therefore, large banks often look beyond their national borders for profitable banking opportunities.

Many Canadian banks have expanded into the United States. The arena that the Boston Bruins and Celtics play out of is now called the TD Garden. They have also expanded into overseas markets by opening offices in Europe, Latin America, the Caribbean, and Asia. They often provide better customer service than local banks and have access to more sources of funding.

For Canadian banks, expanding internationally can be difficult. Banks in other nations are often subject to foreign regulations that Canadian banks making it easier

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the Chinese government imposes high fees and limits the amount of deposits that foreign banks can accept from customers. It also controls foreign-bank deposit and loan interest rates, limiting the ability of foreign banks to compete with government-owned Chinese banks.

The World's Biggest Banks, 2017
Industrial and Commercial Bank of China
China Construction Bank
JPMorgan Chase & Co. (USA)
Wells Fargo & Co. (USA)
Agricultural Bank of China
Bank of America Corp. (USA)
Bank of China Ltd.
Citigroup (USA)
BNP Paribas (France)
Mitsubishi UFJ Financial Group (Japan)

Table 7.4 Source: "The World's Biggest Banks in 2017: The American Bull Market Strengthens," *Forbes*, <http://www.forbes.com>, May 24, 2017.

Political and economic uncertainty in other countries can make international banking a high-risk venture. European and Asian banks were not immune to the financial crisis of 2007–2009. In fact, several countries, including Greece, Portugal, Spain, and Ireland, continue to rebound slowly from the near-collapse of their economic and financial systems they experienced a decade ago. Financial bailouts spearheaded by the European Union and the International Monetary Fund have helped stabilize the European and global economy. It is unclear at this time, however, whether the impending "Brexit" move by the United Kingdom (leaving the European Union) will impact international banking, as many of the

world's top financial institutions seek to move their global operations out of London and shift them to other financial capitals within the eurozone.<sup>1</sup>

## The World Bank and International Monetary Fund

Two international financial organizations are instrumental in fostering global trade. The **World Bank** offers low-interest loans to developing nations. Originally, the purpose of the loans was to help these nations build infrastructure such as roads, power plants, schools, drainage projects, and hospitals. Now the World Bank offers loans to help developing nations relieve their debt burdens. To receive the loans, countries must pledge to lower trade barriers and aid private en-

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The **International Monetary Fund (IMF)** was founded in 1945, one year after the creation of the World Bank, to promote trade through financial cooperation and eliminate trade barriers in the process. The IMF makes short-term loans to member nations that are unable to meet their budgetary expenses. It operates as a lender of last resort for troubled nations. In exchange for these emergency loans, IMF lenders frequently extract significant commitments from the borrowing nations to address the problems that led to the crises. These steps may include curtailing imports or even devaluing the currency.

Some global financial problems do not have a simple solution. One option would be to pump a lot more funds into the IMF, giving it enough resources to bail out troubled countries and put them back on their feet. In effect, the IMF would be turned into a real lender of last resort for the world economy.

The danger of counting on the IMF, though, is the “moral hazard” problem. Investors would assume that the IMF would bail them out and would therefore be encouraged to take bigger and bigger risks in emerging markets, leading to the possibility of even deeper financial crises in the future.

**World Bank and IMF video:** <https://youtu.be/IN3qrFA4jXc>

## 7.6 Trends in Financial Institutions

### What trends are reshaping financial institutions?

What factors will influence financial institutions in the coming years? The latest reports suggest there will be a continued focus on regulatory and compliance issues (especially after the recent financial crisis), as well as on operational efficiency and technological advances.

Banks will continue to tackle customer engagement and technology initiatives over the next few years. According to a report by Aite Group, a Boston-based firm that forecasts banking trends, technology continues to empower consumers to control their banking and commerce experiences. Financial institutions have become better at using data and data analytics to improve their understanding of

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Financial technology (or “fintech” services) will continue to disrupt the banking industry and provide opportunities for banks and other institutions to work closely with fintech companies that can help them innovate and streamline their business practices. According to recent research by Goldman Sachs, fintech startups have the potential to take away billions of dollars in business from traditional investment and lending institutions. Some of the services offered by fintech firms include payment transaction processing, mobile and web payment services for e-commerce firms, peer-to-peer lending, and integrated financial software programs.<sup>3</sup>

Mobile financial apps will continue to be a strategic advantage that separates traditional banking approaches from innovative companies that can offer their clients a connected, digital experience when it comes to their money and investments. Consumers will expect personalization of bank products and services as part of their routine interaction with financial institutions. Otherwise, they will look elsewhere for a competitive platform to meet all of their financial and banking needs.<sup>4</sup>

Although most banks continue to offer local branch offices, the next few years will see branch banking become less prevalent as online and mobile services become more popular. Most banking institutions already offer apps that allow customers to move money between accounts or deposit a check via their smart-

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In addition, online payment platforms such as PayPal, Apple Pay, Google Wallet, Shopify, Stripe, and others continue to make personal and business transactions seamless. In this 24/7 world, consumers expect their banking and financial transactions to happen quickly and efficiently.<sup>5</sup>



Exhibit 7.3 Online payment platforms such as Google Wallet, Apple Pay, and others continue to make personal and business transactions seamless and efficient. How can companies continue to leverage technology to make financial transactions as easy as a swipe or tap on a mobile device? (Credit: Sergio Uceda/ flickr/ Attribution 2.0 Generic (CC BY 2.0))

## Key Terms

## Summary of Learning Outcomes



## Key Terms

<b>commercial banks</b>	Profit-oriented financial institutions that accept deposits, make business and consumer loans, invest in government and corporate securities, and provide other financial services.
<b>credit unions</b>	Not-for-profit, member-owned financial cooperatives.
<b>currency</b>	Cash held in the form of coins and paper money.
<b>demand deposits</b>	Money kept in checking accounts that can be withdrawn by depositors on demand.
<b>discount rate</b>	The interest rate that the Federal Reserve charges its member banks.
<b>Canada Deposit Insurance Corporation (CDIC)</b>	An independent, quasi-public corporation backed by the full faith and credit of the Canadian government that insures deposits in commercial banks and thrift institutions for up to a ceiling of \$100,000 per account.
<b>financial intermediation</b>	The process in which financial institutions act as intermediaries between the suppliers and demanders of funds.
<b>money</b>	Anything that is acceptable as payment for goods and services.
<b>open market operations</b>	The purchase or sale of Canadian government bonds by the Bank of Canada to stimulate or slow down the economy.
<b>pension funds</b>	Large pools of money set aside by corporations, unions, and governments for later use in paying retirement benefits to their employees or members.
<b>time deposits</b>	Deposits at a bank or other financial institution that pay interest but cannot be withdrawn on demand.

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