

The Banking and Monetary System

After this silly activity, you should REALLY understand the banking system!

Activity: The Evolution of Money and Banking on the Isle of Florin

I am your Big Chief on the Isle of Florin. There are four other families on the Isle:

*Sunbeam the Baker

*Mr. (or Ms.) Brown the Wheat Farmer

*Ahab the Fisherman

*Thor the Hut Builder

Step 1: Bartering: trading goods directly for other goods, no “money”

Problems: *Hard to value things, “double coincidence of wants”, hard to save
Need a lot of “prices”

Step 2: Trees on a mountain produce Reese’s® Cups, everyone likes them, and they have value in themselves. The fisherman can’t save up enough non-rotten fish to buy a hut, etc. So, the people start trading things for Reese’s Cups instead of bartering. They store value, you can save them(better than fish or bread) to buy huts, and people begin to know what things are worth in terms of Reese’s cups.

Commodity money: Reese’s cups, like gold, silver, and jewels have become commodity money. This is money that has a value in and of itself, but is commonly used for transactions.

Question: Why do coins have ridges or a raised edge?

How much money is there in the economy? _____

Step 3: El Niño causes a big heat wave on the island. The Reese’s cups start melting, and also, everyone suspects Thor’s son is breaking into people’s huts and eating their savings of Reese’s. Being the Big Chief, I have to do something clever to keep people from panicking. I have a basement in my hut that is cool and stays locked. I offer to store everyone’s Reese’s Cups for them, and I give people receipts for their cups, and tell them that they can get them back whenever they want to, at least between noon and 3:00.

Everyone does this, but they carry a few cups around just in case they can’t get to the Chief’s house before they need some “money”.

Mr. Brown walks by Ahab’s fish stand and remembers that Mrs. Brown wanted him to pick up some fish. The Chief is sleeping, but he really doesn’t want to come back later. Brown says “Look Ahab, I don’t have any Reese’s on me, but I DO have some receipts. Will you take those? Ahab sees no problem with it, since when the Chief wakes up he can get the Reese’s if he wants, or, he could just keep the receipts!

Paper Currency: when paper is used to represent Commodity Money, like when the dollar was on the “Gold Standard”.

How much money is there in the economy now? _____

Step 3, part II: Run on the bank: When people flock to the bank wanting to convert one form of money into another form of money. What if everybody gets nervous about the receipts and all want their Reese’s back? _____

Step 3, part III: Ahab comes to the Chief and says “I need a hut NOW, but don’t have enough Reese’s to buy a hut from Thor. You have all of those Reese’s sitting in your basement, could I borrow some and pay you back later?”

Answer “OK, here take these 30 Reese’s, but pay me back by the Full Moon, or I’ll have you killed.”

OR: What could he do? _____

How much money is in the economy now? _____

Money Creation: When a bank makes a loan, it means there is MORE MONEY!

When loans are paid off, the money “disappears”!

Run on the bank now? _____

Step 3, part IV: The Chief wakes up at Noon and wants a snack. The Reese’s have been sitting in his basement for months, untouched. He eats them all.

Run on the bank now? _____

Fiat (fiduciary) Money: When money isn’t actually backed by a commodity.

Step 3, part V: This fiat money is cool! I’ll print up a bunch and spend it! I’ll create a lot of wealth! Problems? Equation of Exchange: $MV=PQ$

Step 4: **Checking accounts:** The receipts start to fall apart or get lost, so the Chief comes up with a new idea. How about you bring your receipts back to me, and I will keep a log of how much people have, and keep the receipts in my basement. If you want to buy something, just write down on a piece of paper:

Your Name pays to the order of Other Person the amount of (amount) Reese’s Cups.

Signed Your Name

This is a “**checkable deposit**” system! You deposit the money, but can write a check to transfer funds from yourself to someone else.

Questions: *Run on the bank now?

*What if the Chief burns most of the paper receipts (money)?

*How could the Chief make loans now?

*Where is the *money*?

*Suppose I want to increase the amount of money in the economy.

How could I do that?

*Decrease the amount of money?

*Suppose I have a credit card in one hand, and a debit card (ATM card) in the other. I walk up to an ATM machine. I put my ATM card in, and get \$20. I put my credit card in, and get \$20. What difference is there between these two?