Chapter 7: Money and Banking

7.4 Definition of Money

- **Money** is anything that is widely accepted as a medium of exchange and therefore can be used to buy goods or to settle debts.
- Definitions of money can be broken down into M1, M2, and M3.
- **M1** includes currency in circulation (paper and coins) plus demand deposits in the chequing accounts of commercial banks (Ch. 7 focuses on this definition).
  - *Demand deposits* refer to those deposits which depositors can demand in cash at any time.
  - Money supply in Canada (August 2002): \[ M_1 = \text{currency} + \text{demand deposits} \]
    \[ \$135 \text{ billion} = \$40 \text{ billion} + \$95 \text{ billion} \]
    \[ 30\% + 70\% \]
- **M2** expands on the somewhat narrow definition of M1 to include all of M1 plus all notice deposits (savings accounts on deposit for an undefined length of time) and personal deposits (savings on deposit for a specific term).
  - *Notice deposits* are those deposits that require the depositor to give notice to the bank before making a withdrawal (although some banks do not enforce these notice requirements).
  - M2 in Canada (August 2002): \[ M_2 = M_1 + \text{notice deposits and personal term deposits} \]
    \[ \$551 \text{ billion} = \$135 \text{ billion} + \$416 \text{ billion} \]
    \[ 25\% + 75\% \]
- **M3** offers an even broader measurement of money by adding to M2 the term deposits of businesses (called certificate of deposits), which are easily convertible into chequable deposits.
  - M3 = M2 + certificate of deposits
  - Money supply in Canada (August 2002): \[ M_3 = M_2 + \text{certificate of deposits} \]
    \[ \$751 \text{ billion} = \$551 \text{ billion} + \$200 \text{ billion} \]
    \[ 73\% + 27\% \]
- Only the portion of currency in circulation is included as money, not currency in the vaults or tills of banks.
  - It would be double-counting to count both the increase in a depositor’s bank account and the increase in the bank’s tills.
- When people deposit currency in a bank, the amount of currency in circulation goes down, and the amount in deposit accounts goes up.
  - Therefore, a new bank deposit of currency changes the composition of the money supply but does not change its total.
- Gold, financial securities like stocks and bonds, available credit on credit cards, and cheques are excluded from the money supply.
  - Credit cards are means of accessing money (in this case, accessing a loan), but they do not represent money in and of themselves (just like cheques are not money but give you access to the money in a chequing account).
- Chequing accounts at near banks are also excluded from the definition of money since the Bank of Canada prefers to count as money only that which it can control directly.
  - Near banks are financial institutions, like credit unions or trust companies, which share many of the functions of commercial banks but are not defined as banks under the Bank Act (they are also known as non-bank financial intermediaries).
The Bank of Canada exercises a degree of control over the commercial banks but has a lesser degree of power over near-banks.

- **Chartered banks** include the six major commercial banks in Canada (all of which received a charter under the Bank Act) and seven much smaller banks.
  - The six major banks (as of October 200) are:

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<tr>
<th>Bank</th>
<th>Assets ($ billions)</th>
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<tr>
<td></td>
<td>291</td>
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<td>268</td>
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<td>76</td>
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- The seven smaller banks are the Laurentian Bank, Canadian Western Bank, Manulife Bank of Canada, CS Alterna Bank, President's Choice Bank, First Nations Bank of Canada, and Citizens Bank of Canada.

### 7.5 Modern Banks

- Modern banks make a profit by lending out excess deposits; their profit comes from the **spread**, which is the difference between the rate of interest a bank **charges** borrowers and the interest rate it **pays** savers.
- Total profits of a bank come more from the total volume of its transactions rather than from a difference in the spread.
- Banks endeavour to keep the amount of reserves (money kept as **inventory**) to a minimum, consistent with security regulation (which used to be specified in the Bank Act but have since been become regulated by the individual banks themselves).
- The **target ratio reserve** is the portion of demand deposits that a bank wants to hold in cash in its vaults of with the Bank of Canada, and they offer some security for the bank’s customers.
- All banks are required by law to take out insurance on customers’ deposits, which are insured with the Canada Deposit Insurance Corporation up to a maximum of $60,000 per depositor per bank.
- Canada’s use of a branch banking system allows for a secure and stable, yet conservative, banking system.
  - A few large banks, each with many branches operating across the country, dominate this system.
  - The size and geographical diversity of this structure minimizes the possibility of bank failure.
  - Cons of the system stem from its lack of competition, which yield poorer service, lack of face-time between customers and the banks’ decision-makers, a historically wider spread (compared to banks in the American system), and typically inflexible loan policies (which do not recognize the unique circumstances of small businesses or take risks on unproven companies and ideas).
- The U.S. uses a unit banking system, which is made up of thousands of relatively small banks that may have one or multiple branches confined to a single state, resulting in a less secure (because the banks rely on customers who are fairly homogenous—in that they live in the same area, largely work in the same industries, are susceptible to the same natural disasters, etc.) yet more competitive system.