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# Chapter 1

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## Money, Banking, and Your World

### CHAPTER OBJECTIVES

By the end of this chapter, students should be able to:

1. Describe how ignorance of the principles of money and banking has injured the lives of everyday people.
2. Describe how understanding the principles of money and banking has enhanced the lives of everyday people.
3. Explain how bankers can simultaneously *be* entrepreneurs and *lend* to entrepreneurs.

## 1.1 Dreams Dashed

### LEARNING OBJECTIVE

1. How can ignorance of the principles of money and banking destroy your dreams?

At 28, Ben is in his prime. Although tall, dark, and handsome enough to be a movie star, Ben's real passion is culinary, not thespian. Nothing pleases him more than applying what he learned earning his degrees in hospitality and nutrition to prepare delicious yet healthy appetizers, entrées, and desserts for restaurant-goers. He chafes, therefore, when the owner of the restaurant for which he works forces him to use cheaper, but less nutritional, ingredients in his recipes. Ben wants to be his own boss and thinks he sees a demand for his style of tasty, healthy cuisine. Trouble is, Ben, like most people, came from humble roots. He doesn't have enough money to start his own restaurant, and he's having difficulty borrowing what he needs because of some youthful indiscretions concerning money. If Ben is right, and he can obtain financing, his restaurant could become a chain that might revolutionize America's eating habits, rendering Eric Schlosser's exposé of the U.S. retail food industry, *Fast Food Nation* (2001), [www.amazon.com/Fast-Food-Nation-Eric-Schlosser/dp/0060838582/sr=8-1/qid=1168386508/ref=pd\\_bbs\\_sr\\_1/104-9795105-9365527?ie=UTF8&s=books](http://www.amazon.com/Fast-Food-Nation-Eric-Schlosser/dp/0060838582/sr=8-1/qid=1168386508/ref=pd_bbs_sr_1/104-9795105-9365527?ie=UTF8&s=books) as obsolete as *The Jungle* (1901), [sinclair.thefreelibrary.com/Jungle;sunsite.berkeley.edu/Literature/Sinclair/TheJungle](http://sinclair.thefreelibrary.com/Jungle;sunsite.berkeley.edu/Literature/Sinclair/TheJungle) Upton Sinclair's infamous description of the disgusting side of the early meatpacking industry. If Ben can get some financial help but is wrong about Americans preferring natural ingredients to hydrogenized this and polysaturated that, he will have wasted his time and his financial backers may lose some money. *If he cannot obtain financing, however, the world will never know whether his idea was a good one or not.* Ben's a good guy, so he probably won't turn to drugs and crime but his life will be less fulfilling, and Americans less healthy, if he never has a chance to pursue his dream.

1. A mortgage with periodic payments lower than what would be required to pay the interest on the loan. Instead of declining over time, the principal owed increases as unpaid interest is added to it.
2. A principal payment due in a large lump sum, usually at the end of the loan period.

Married for a decade, Rose and Joe also had a dream, the American Dream, a huge house with a big, beautiful yard in a great neighborhood. The couple could not really afford such a home, but they found a lender that offered them low monthly payments. *It seemed too good to be true because it was.* Rose and Joe unwittingly agreed to a **negative amortization mortgage**<sup>1</sup> with a **balloon payment**<sup>2</sup>. Their monthly payments were so low because they paid just part of the interest due each year and none of the (growing) principal. When housing prices in their area began to slide downward, the lender foreclosed, although they had never missed a

payment. Traditionally, one has to miss several payments before a lender can foreclose, but several new types of mortgages developed during the housing boom of the mid-2000s have “call” features that allow lenders to ask for immediate repayment of the principal if the value of the home sinks, leaving the lender undersecured. They lost their home and, worse, their credit. The couple now rents a small apartment and harbors a deep mistrust of the financial system.

Rob and Barb had a more modest dream of a nice house in a good location with many conveniences, a low crime rate, and a decent public school system. They found a suitable home, had their offer accepted, and obtained a conventional thirty-year mortgage. But they too discovered that their ignorance of the financial system came with a price when they had difficulty selling their old house. They put it up for sale just as the Federal Reserve, [www.federalreserve.gov](http://www.federalreserve.gov) America’s central bank (monetary authority), decided to raise the **interest rate**<sup>3</sup> because the economy, including the housing market, was too hot (growing too quickly), portending a higher price level across the economy (inflation). Higher interest meant it was more expensive to borrow money to buy a house (or anything else for that matter). To compensate, buyers decreased the amount they were willing to offer and in some cases stopped looking for a new home entirely. Unable to pay the mortgage on both houses, Rob and Barb eventually sold their old house for much less than they had hoped. The plasma TV, new carpeting, playground set in the yard, sit-down mower, and other goods they planned to buy evaporated. *That may have been good for the economy by keeping inflation in check, but Rob and Barb, like Rose, Joe, and Ben, wished they knew more about the economics of money, banking, and interest rates.*

Samantha too wished that she knew more about the financial system, particularly **foreign exchange**<sup>4</sup>. Sam, as her friends called her, had grown up in Indiana, where she developed a vague sense that people in other countries use money that is somehow different from the U.S. dollar. But she never gave the matter much thought, until she spent a year in France as an exchange student. With only \$15,000 in her budget, she knew that things would be tight. As the dollar depreciated (lost value) vis-à-vis France’s currency, the euro, she found that she had to pay more and more dollars to buy each euro. Poor Sam ran through her budget in six months. Unable to obtain employment in France, *she returned home embittered, her conversational French still vibrating with her Indiana twang.*

*Jorge would have been a rich man today if his father had not invested his inheritance in U.S. government bonds in the late 1960s. The Treasury promptly paid the interest contractually due on those bonds, but high rates of inflation and interest in the 1970s and early 1980s reduced their prices and wiped out most of their purchasing power. Instead of inheriting a fortune, Jorge received barely enough to buy a midsized automobile. That his father had worked so long and so hard for so little saddened Jorge. If only his father had understood a few simple facts: when the*

3. The price of borrowed money.

4. Buying and selling of foreign currencies, for example, the British pound, the Japanese yen, and the European Union’s euro.

supply of money increases faster than the demand for it, prices rise and inflation ensues. When inflation increases, so too do nominal interest rates. And when interest rates rise, the prices of bonds (and many other types of assets that pay fixed sums) fall. Jorge's father didn't lack intelligence, and he wasn't even atypical. Many people, even some otherwise well-educated ones, do not understand the basics of money, banking, and finance. And they and their loved ones pay for it, sometimes dearly.

Madison knows that all too well. Her grandparents didn't understand the importance of portfolio diversification (the tried-and-true rule that you shouldn't put all of your eggs in one basket), so they invested their entire life savings in a single company, Enron.[www.riskglossary.com/link/enron.htm](http://www.riskglossary.com/link/enron.htm) They lost everything (except their Social Security checks)[www.ssa.gov](http://www.ssa.gov) after that bloated behemoth went bankrupt in December 2001. Instead of lavishing her with gifts, Madison's grandparents drained resources away from their granddaughter by constantly seeking handouts from Madison's parents. When the grandparents died—without **life insurance**<sup>5</sup>, yet another misstep—Madison's parents had to pay big bucks for their “final expenses.”[www.fincalc.com](http://www.fincalc.com)

### Stop and Think Box

History textbooks often portray the American Revolution as a rebellion against unjust taxation, but the colonists of British North America had other, more important grievances. For example, British imperial policies set in London made it difficult for the colonists to control the supply of money or interest rates. When money became scarce, as it often did, interest rates increased dramatically, which in turn caused the value of colonists' homes, farms, and other real estate to decrease quickly and steeply. As a consequence, many lost their property in court proceedings and some even ended up in special debtors' prisons. Why do history books fail to discuss this important monetary cause of the American Revolution?

Most historians, like many people, generally do not fully understand the principles of money and banking.

5. A contract that promises to pay a sum of money to beneficiaries upon the death of an insured person.

### KEY TAKEAWAY

- People who understand the principles of money and banking are more likely to lead happy, successful, fulfilling lives than those who remain ignorant about them.

## 1.2 Hope Springs

### LEARNING OBJECTIVE

1. How can knowledge of the principles of money and banking help you to achieve your dreams?

Of course, sometimes things go right, especially when one knows what one is doing. Henry Kaufman, [www.theglobalist.com/AuthorBiography.aspx?AuthorId=126](http://www.theglobalist.com/AuthorBiography.aspx?AuthorId=126) who as a young Jewish boy fled Nazi persecution in the 1930s, is now a billionaire because he understood what made interest rates (and as we'll see, by extension, the prices of all sorts of financial instruments) rise and fall. A little later, another immigrant from Central Europe, George Soros, made a large fortune correctly predicting changes in **exchange rate**<sup>6</sup>. [www.georgesoros.com](http://www.georgesoros.com) David did not become uberwealthy trading **financial derivatives**<sup>7</sup> for a Wall Street firm, but he did earn enough money to retire at the age of forty. Instead of missing the early years of his two children's lives in a maze of meetings and dying early from a heart attack, David spends his days raising his kids and living healthily.

*Millions of other individuals have improved their lot in life by making astute life decisions informed by knowledge of the economics of money and banking.* Over several decades, Henri leveraged his knowledge of the financial system by regularly buying low and selling high. A confirmed bachelor, he died of cancer at a relatively young age but felt blessed that he was able to share his substantial nest egg with online **microlender**<sup>8</sup> Kiva [www.kiva.org](http://www.kiva.org) and several other worthy charities. Songho doesn't earn much tutoring Korean, but he is single and frugal so he can save a little each month in conservative (low risk) investments that he will one day use to aid his aging parents or to bring his brother and neice to America. Aesha, a single mom and nurse, can't afford to invest, let alone retire, but she uses her knowledge of the financial system to minimize her borrowing costs, thus freeing up resources that she uses to send Kelton to a private school that provides him with a far better educational experience than his public school did. Your instructor and I cannot guarantee you riches and fame, but we can assure you that, if you read this book carefully, attend class dutifully, and study hard, your life will be the better for it.

6. The price of one currency in terms of another.
7. Financial contracts, like forwards, futures, options, and swaps, the value of which derives from the price of some underlying asset such as a commodity, an interest rate, or a foreign currency.
8. A company or nonprofit entity that makes very small loans to impoverished, self-employed individuals.

The study of money and banking can be a daunting one for students. *Seemingly familiar terms here take on new meanings.* **Derivatives** refer not to calculus (though calculus helps to calculate their value) but to financial instruments for trading risks. Interest is not necessarily interesting; stocks are not alive nor are they

holding places for criminals; zeroes can be quite valuable; CDs don't contain music; yield curves are sometimes straight lines; and the principal is a sum of money or an owner, not the administrative head of a high school. In finance, unlike in retail or publishing, returns are a good thing. *Military-style acronyms and jargon also abound: 4X, A/I, Basel II, B.I.G., CAMELS, CRA, DIDMCA, FIRREA, GDP, IMF, LIBOR, m, NASDAQ, NCD, NOW, OTS, r, SOX, TIPS, TRAPS, and on and on.* [www.acronym-guide.com/financial-acronyms.html](http://www.acronym-guide.com/financial-acronyms.html); [www.garlic.com/~lynn/fingloss.htm](http://www.garlic.com/~lynn/fingloss.htm)

People who learn this strange new language and who learn to think like a banker (or other type of financier) will be rewarded many times over in their personal lives, business careers, and civic life. *They will make better personal decisions, run their businesses or departments more efficiently, and be better-informed citizens.* Whether they seek to climb the corporate ladder or start their own companies, they will discover that interest, inflation, and foreign exchange rates are as important to success as are cell phones, computers, and soft people skills. And a few will find a career in banking to be lucrative and fulfilling. Some, eager for a challenging and rewarding career, *will try to start their own banks from scratch.* And they will be able to do so, provided they are good enough to pass muster with investors and with government regulators charged with keeping the financial system, one of the most important sectors of the economy, safe and sound.

One last thing. This book is about Western financial systems, not Islamic ones. Islamic finance performs the same functions as Western finance but tries to do so in a way that is sharia-compliant, or, in other words, in a way that accords with the teachings of the Quran and its modern interpreters, who frown upon interest. To learn more about Islamic finance, which is currently growing and developing very rapidly, you can refer to one of the books listed in Suggested Readings.

### Stop and Think Box

Gaining regulatory approval for a new bank has become so treacherous that consulting firms specializing in helping potential incorporators to navigate regulator-infested waters have arisen and some, like Nubank, [www.nubank.com](http://www.nubank.com) have thrived. Why are regulations so stringent, especially for new banks? Why do people bother to form new banks if it is so difficult?

Banking is such a complex and important part of the economy that the government cannot allow just anyone to do it. For similar reasons, it cannot allow just anyone to perform surgery or fly a commercial airliner. People run the regulatory gauntlet because establishing a new bank can be extremely profitable and exciting.

### KEY TAKEAWAY

- Not everyone will, or can, grow as wealthy as Henry Kaufman, George Soros, and other storied financiers, but everyone can improve their lives by understanding the financial system and their roles in it.

## 1.3 Suggested Browsing

**Financial Literacy Foundation: <http://www.finliteracy.org/>**

The FLF “is a nonprofit organization created to address the growing problem of financial illiteracy among young consumers.” Similar organizations include the Community Foundation for Financial Literacy (<http://www.thecommunityfoundation-ffl.org>) and the Institute for Financial Literacy (<http://www.financiallit.org/>).

**Museum of American Finance: <http://www.moaf.org/index>**

In addition to its Web site and its stunning new physical space at the corner of William and Wall in Manhattan’s financial district, the Museum of American Finance publishes a financial history magazine.

## 1.4 Suggested Reading

Ayub, Muhammed. *Understanding Islamic Finance*. Hoboken, NJ: John Wiley and Sons, 2008.

El-Gamal, Mahmoud. *Islamic Finance: Law, Economics, and Practice*. New York: Cambridge University Press, 2008.

Kaufman, Henry. *On Money and Markets: A Wall Street Memoir*. New York: McGraw Hill, 2001.

Soros, George. *Soros on Soros: Staying Ahead of the Curve*. Hoboken, NJ: John Wiley and Sons, 1995.