

The Story of Money: Banks Create Money

(A lesson plan based on *The Story of Money*,
a comic book published by the Federal Reserve Bank of New York)

Grade Levels: Elementary and Middle School

This activity involves a simple simulation to help students learn how the money supply increases when banks make loans. It can be used with upper elementary and middle school students.

Introduction



Changes in the money supply cause changes in the level of voluntary trade. The supply of money in the economy must grow neither too rapidly nor too slowly, but at a rate that keeps the value of our money stable and leads to steady growth in the economy. How do we make sure that the U.S. money supply grows at the right rate? That's the job of the Federal Reserve System. The "Fed" has three primary tools available to influence the growth of the money supply. One of these tools is the reserve requirement, which is the amount of money that banks hold on deposit. By adjusting the total amount of money in a bank, the Fed can influence the amount of money available for loans.

Concepts

Money – Anything that is freely accepted in exchange for goods and services.

Money Supply - The amount of money in the economy; U.S. money supply available for immediate spending includes currency and checking accounts at depository institutions.

Medium of Exchange – An item that is generally accepted as payment for other items.

Materials

- ⇒ A number of quarters, depending on the number of students in the class
- ⇒ 30 pieces of green paper money, marked "quarterbacks"
- ⇒ Deposit and loan record



Procedure

1. Discuss the importance of the supply of money in our economy. Explain that the Federal Reserve System has a number of tools to influence the growth of the money supply. (Pages 22,23) However, although banks and savings and loans do not print dollar bills or manufacture coins, they also create new money.
2. Explain that money is a medium of exchange. It enables people who specialize in producing one good or service to exchange their product for somebody else's product. People accept something as money if they have faith that they can exchange it for goods and services they want.
3. Give out the quarters randomly to the students. Tell them that you are going to start a bank to keep their quarters safe. Select one student as a teller. Have the teller record on the deposit record the name of each student and the number of quarters each deposited.

4. Take the quarters of several students, giving them green paper “Quarter Backs” in exchange. Put the quarters in a safe place – your desk or pocket. After several students make deposits, have the teller count up and record the total number of quarters deposited.
5. Tell the students that the “Quarter Backs” now held by several students will probably work as well (at least within this classroom) as the quarters as a medium of exchange. After all, anyone who holds such a bank note can take it to the bank at any time and get a quarter for it. The note is backed by the quarter on deposit at the bank. Therefore, it is probable that people in the area, if they trust the banker, will begin to accept bank notes in exchange for goods and services. When this happens, the bank notes become money.
6. Ask the students how much money is now in circulation. The answer is that the same amount of money is in circulation as there are quarters in the bank. The quarters in the bank are NOT money as long as they are at the bank instead of circulating in the economy.
7. Now make loans to several students who have no quarters so that they can buy lunch, buy school supplies, get tickets to the football game, and so on. Make the loans by using additional bank notes. Have the teller record each loan on the deposit record in the form of the number of quarters loaned.
8. Explain that the people students buy from will accept the bank notes because each note is backed by a quarter at the bank. Point out that anyone who acquires bank notes that were created by lending has the same right to trade them for quarters as the original depositors do. Ask students what the total money supply is now (all the bank notes) and show that the notes are no longer backed 100 percent by the quarters on deposit at the bank.
9. Ask students, “Is the bank in trouble?” They are likely to say that it is, but the bank probably isn’t in trouble as long as the ratio of paper money to quarters is not too large. The reason is that people don’t generally all come to the bank at the same time to redeem their quarters. Paper money is easier to carry than a big load of quarters or other coins. On any one day, several people may come to the bank to deposit coins.
10. Explain to the students that this willingness to leave cash on deposit at banks for long periods of time is the basis for fractional reserve banking – a banking system in which a relatively large amount of money can be created on the basis of a smaller amount of something of value like gold or silver in the 19th century, or deposits at the Federal Reserve Banks today.
11. Review some of the main ideas of the lesson simulation:
 - a. What is money? (Anything that is freely accepted in exchange for goods and services.)
 - b. How do banks expand the supply of money? (Banks do not keep a dollar of currency in their vaults for every dollar in deposits. They retain a fraction of their deposit and make loans with the rest.)
 - c. Why do banks make loans of deposits? (They charge interest on loans. The interest they earn constitutes their profit – their incentive to continue providing bank service.)

[Credit: The activity in this lesson plan is an adaptation of Lesson 2, Unit 7, pages 134-138, UNITED STATES HISTORY: EYES ON THE ECONOMY, Volume I, National Council on Economic Education, New York, NY, 1993. Adapted by Mary Oppedard, field representative for the Oklahoma Council on Economic Education, Fall 2004.]

DEPOSIT RECORD

Name	Number of Quarters Deposited
1. _____	_____
2. _____	_____
3. _____	_____
4. _____	_____
5. _____	_____
6. _____	_____

LOAN RECORD

Name	Amount of Loans
1. _____	_____
2. _____	_____
3. _____	_____
4. _____	_____
5. _____	_____
6. _____	_____