CAPACITARTE

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Curso de inglés económico, de finanzas y tributos

Module 4. Personal Finance

1. Money

What do the following things have in common: cattle, corn, rice, salt, copper, gold, silver, seashells, stones, and whale teeth?

At different times and in different places, they have all been used as money. In fact, **money** is anything that people will accept as payment for goods and services.

2. Functions of Money

Whatever it is that people choose to use as money, it should perform three important functions:

- **Medium of Exchange**

  Money must serve as a **medium of exchange**, or the means through which goods and services can be exchanged.

  Without money, economic transactions must be made through **barter**—exchanging goods and services for other goods and services. Barter is cumbersome and inefficient because two people who want to barter must at the same time want what the other has to offer. For example, suppose you want to trade two T- shirts for a pair of jeans. One classmate might have the jeans but not want your shirts; another might want your shirts but not have jeans to trade. It is much easier for you to buy a pair of jeans by giving money to the seller who, in turn, can use it to buy something else.

  Money allows for the precise and flexible pricing of goods and services, making any economic transaction convenient.

- **Standard of Value**

Money also serves as a **standard of value**, the yardstick of economic worth in the exchange process. It allows people to measure the relative costs of goods and services. A $20 T-shirt is worth two $10 phone cards, four $5 burritos, or twenty $1 bus rides.

The basic monetary unit in Argentina is the Argentinian Peso, which serves as the standard by which the economic worth of all goods and services can be expressed and measured.

- **Store of Value**

Finally, money acts as a **store of value**, that is, something that holds its value over time. People, therefore, do not need to spend all their money at once or in one place; they can put it aside for later use. They know that it will be accepted wherever and whenever it is presented to purchase goods and services.

One situation where money does not function well as a store of value is when the economy experiences significant inflation—a sustained rise in the general level of prices. For example, in Argentina in the first half of 2002, prices rose by about 70 percent. Basic goods that cost 150 pesos in January cost 255 pesos in June. In other words, in that time period, Argentina's money lost over two-thirds of its purchasing power.

3. Types of Money

Money draws its value from three possible sources. **Commodity money** derives its value from the type of material from which it is composed. **Representative money** is paper money backed by something tangible—such as silver or gold—that gives it value. **Fiat money** has no tangible backing, but it is declared by the government that issues it, and accepted by citizens who use it, to have worth.

- **Commodity Money**

Commodity money is something that has value for what it is. Items used as commodity money have value in and of themselves, apart from their value as money.

Over the course of history, for example, gold, silver, precious stones, salt, olive oil, and rice have all been valued enough for their scarcity or for their usefulness to be used as money. However, the most common form of commodity money throughout history has been coins made from precious metals. Such coins contain enough of the precious metal that if each was melted down it would be worth at least its face value.

One problem with commodity money is that if the item becomes too valuable, people will hoard it rather than circulate it, hoping it will become more valuable in the future. Commodity money is rarely used today.

- **Representative Money**

Representative money is paper money that can be exchanged for something else of value. The earliest forms of representative money were seen in the Middle Ages, when merchants, goldsmiths, and moneylenders began issuing receipts that promised to pay a certain amount of gold or silver. This came about because it was not always convenient or safe to transport large quantities of those precious metals from place to place for the purpose of trading. These practices signal the beginning of the widespread modern use of paper money.

Eventually, governments got involved with representative money by regulating how much metal needed to be stored to back up the paper money. One problem with representative money is that its value fluctuates with the supply and price of gold or silver, which can cause problems of inflation or deflation—a sustained rise or fall, respectively, in the general level of prices.

- **Fiat Money**

Unlike representative money, fiat money has value only because the government has issued a fiat, or order, saying that this is the case. The value of the U.S. dollar was linked to the value of gold until 1971. Since then, a $10 bill can no longer be exchanged for gold; it can only be converted into other combinations of U.S. currency that also equal $10.

In fiat money, coins contain only a token amount of precious metal that is worth far less than the face value of those coins. Paper money has no intrinsic value, and people cannot exchange it for a certain amount of gold or silver. Fiat money has value because the government says it can be used as money and because people accept that it will fulfill all the functions of money.

Dollar bills in the United States carry the statement "This note is legal tender for all debts, public and private." This statement assures people that sellers will accept such money from buyers as payment for goods or services and lenders will accept it as payment for debts. A crucial role of the government in maintaining the value of fiat money is controlling its supply—in other words, maintaining its scarcity.

4. Money and income

The money a person receives or earns is his or her income. This can include: a salary (money paid monthly by an employer) or wages, which is paid by the day or the hour, usually received weekly.

Sometimes workers do overtime and they earn money for these extra hours worked. People working in sales earn a commission, which is money paid to sales peoples and agents, a certain percentage of the income the employee generates.

An employee can also receive extra money when meeting a target or for good financial results.

Professionals charge their clients' fees, money paid for the professional services provided.

When employees become unemployed or sick, they receive social security, which is money paid by the government to cover the period they are out of work or without it.

Finally, pension is money paid by the Company or the government an employee retires.

Salaries and wages are often paid after deductions such as social security charges and pension contributions.
Social security is the British equivalent to welfare in the U.S.A. This is an amount of money that people has to spend regularly are outgoings and it often includes:

- living expenses (money spent on everyday needs such as food, clothes and transportation)
- bills (electricity, gas and telephone expenses)
- rent (money paid for the use of a house)
- mortagage
- health insurance
- taxes

A financial plan showing how much money a person or organization expects to earn and spend is called a Budget.

5. What services do banks provide?

Banks offer a number of services that allow them to act like "money stores." In other words, just as stores are places where goods are bought and sold, banks are places where money can be bought (borrowed) and sold (lent).
By using these services, customers are able to do three things—store money, earn money, and borrow money.

Banks are businesses that earn money by charging interest or fees on these services.

SERVICE 1 Customers Can Store Money

Banks began as safe places to store money and other valuables.

They still serve the same purpose today. Customers deposit money in the bank, and the bank stores currency in vaults and is also insured against theft and other loss. Customers' bank accounts are also insured in case the bank fails. Banks are also a safe place to store important papers and valuables—through the use of safe deposit boxes.

SERVICE 2 Customers Can Earn Money

When customers deposit their money in bank accounts, they can earn money on their deposits. Savings accounts and some checking accounts pay some level of interest. Banks offer other accounts, such as money market accounts and certificates of deposits (CDs), that pay a higher rate of interest.

SERVICE 3 Customers Can Borrow Money

Banks also allow customers to borrow money through the practice of fractional reserve banking. The percent of deposits that banks must keep in reserve is set by the Fed.

Banks provide customers, each of whom must be approved by the bank, with different loans for different circumstances. One common loan is a mortgage. A mortgage loan allows a buyer to purchase a real estate property, such as a house, without paying the entire value of the property up front. The lender and the borrower agree on a time period for the loan (often up to 30 years) and an interest rate to be paid to the lender. From this, a monthly mortgage payment amount is settled. In this arrangement, the real estate property acts as collateral. So if the borrower defaults on the loan (stops making the payments), the lender takes control of the property. It can then be sold by the bank to cover the balance of the mortgage.

It may not seem so, but a purchase made on a credit card is a loan too. Credit cards are issued by banks to users who are, in effect, borrowers. When you use a credit card to buy a new skateboard or a tank of gasoline, the issuing bank pays the seller and lends you the money. When you pay the bank back, you're repaying a loan. And if you don't pay it back within a month, you'll owe the bank extra in interest.

Bank Statements

Banks usually send monthly statements listing recent sums of money going out, called debits, and sums of money coming in, called credits.

They are records usually sent to the account holder once per month. They list sums of money going out, called debits, and sums of money coming in, called credits, in an account during the time from the previous statement to the current statement. The opening balance from the prior month combined with the net of all transactions during the period should result in the closing balance for the current statement.

6. Types of Banks

The term *bank* is used to refer to almost any kind of financial institution that takes in deposits and makes loans, helping individuals, businesses, and governments to manage their money. In the end, though, the goal of a bank is to earn a profit.

All financial institutions receive a charter from the government, either state or federal. Government regulations set the amount of money the owners of a bank must invest in it, the size of the reserves a bank must hold, and the ways that loans may be made. The term may refer to commercial banks, savings and loan associations, or credit unions.

In the past, these institutions provided very different and distinct services. Today, however, because of the deregulation of banking, these distinctions are much less apparent.

TYPE 1 Commercial Banks

Privately owned commercial banks are the oldest form of banking and are the financial institutions most commonly thought of as banks. As their name implies, commercial banks were initially established to provide loans to businesses. Now they provide a wide range of services, including checking and savings accounts, loans, investment assistance, and credit cards to both businesses and individual consumers.

TYPE 2 Savings Institutions

Savings and loan associations (S&Ls) began in the United States in the 1830s. They were originally chartered by individual states as mutual societies for two purposes— to take savings deposits and provide home mortgage loans. In other words, groups of people pooled their savings in a safe place to earn interest and have a source of financing for families who wanted to buy homes.

The S&Ls continue to fulfill these purposes, but they now also offer many of the services provided by commercial banks. Since 1933, the federal government may also charter S&Ls, and since 1982, many federally chartered S&Ls have chosen to call themselves savings banks. Many savings institutions are now financed through the sale of stock, just as commercial banks are.

TYPE 3 Credit Unions

Credit unions are cooperative savings and lending institutions, rather like the early S&Ls. They offer services similar to commercial banks and S&Ls, including savings and checking accounts, but specialize in mortgages and auto loans.

The major difference between credit unions and other financial institutions is that credit unions have membership requirements. To become a member, a person must work for a particular company, belong to a particular organization, or be part of a particular community affiliated with the credit union. Credit unions are cooperatives—nonprofit organizations owned by and operated for members.

7. Bank Accounts

A bank account is a financial account maintained by a financial institution for a customer.

A bank account represents the funds that a customer has entrusted to the financial institution and from which the customer can make withdrawals.

The financial transactions which have occurred within a given period of time on a bank account are reported to the customer on a bank statement and the balance of the accounts at any point in time is the financial position of the customer with the institution.

The laws of each country specify the manner in which accounts may be opened and operated. They may specify, for example, who may open an account, how the signatories can identify themselves, deposit and withdrawal limits and many other matters.

There are two main bank accounts:

- **Current or Checking Account**

This type of account enables customers to take out/withdraw money with no restrictions. Money in the account does not usually earn a high rate of interest.

- **Savings or Deposit Account**

This type of account pays more interest but has restrictions on when you can withdraw money.

8. **A Cheque (BrE) or Check (AmE)**

A check is a written, dated and signed instrument that contains an unconditional order from the drawer (the person who writes the check).

A check directs a bank to pay a definite sum of money to a payee (the person who receives the payment). The money is drawn from a banking account.

All checks share the same basic parts:

- The name and contact information of the drawer, or the person writing the check in the top corner
- The name of the bank that holds the drawer's account
- A line to specify the payee, or the recipient of the money
- A line to specify the amount to pay.

The check must be signed by the drawer to be considered valid. The check also includes a bank routing number, the bank account number and, lastly, the check number.

When someone writes a check for an amount larger than the amount held in his or her checking account, the check might **bounce**, meaning the check cannot be processed and often incurs a penalty fee to the drawer.

Cheque Clearing

Cheque clearing or clearance is the process of moving a cheque from the bank in which it was deposited to the bank on which it was drawn, and the movement of the money in

the opposite direction. This process is called the clearing cycle and normally results in a credit to the account at the bank of deposit, and an equivalent debit to the account at the bank on which it was drawn.

The process would take a number of days as cheques would have to be physically taken back to the issuing bank until the development of cheque truncation in the 1990s, which allowed physical cheques to be converted to electronic images and MICR data, for electronic clearance.

In many countries this would be via a central clearing house operated by the banks to make the process more efficient. If there were not enough funds in the account when the cheque arrived at the issuing bank, the cheque would be returned as a **dishonoured cheque** marked as non-sufficient funds.

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Example of a clearing process

9. Type of cards

There are two main kinds of bank cards: Debit cards and Credit Cards.

Debit cards can be used to withdraw cash and make other transactions at ATM (Automatic Teller) machines. Debit cards are sometimes called check cards because they are linked to bank accounts and can be used like checks to make purchases at many retail outlets.

Retailers often prefer debit cards because they avoid the problem of people writing checks with insufficient funds in their accounts.

Debit cards often look like credit cards, and they are similar in that they can be used to make purchases at stores.

An important difference is that credit card purchases involve getting a loan. Your money stays in your account until you pay your credit card bill. With a debit card you make an immediate payment, since the price of your purchase is deducted from the account that is linked to your card. Therefore, it is important to keep track of debit card purchases along with checks so that you know how much money is available in your account at any given time.

Because of the way debit cards work, they are often seen as safer ways to manage your money than with credit cards. With credit cards, if you do not pay your balance in full each month, you pay interest on the outstanding balance and can build up considerable debt. With debit cards, you can only spend money that you actually have in a bank account.

In some countries, people pay bills with cheques; in other countries, banks do not issue cheque books and people pay bills by bank transfer. These include **standing orders**, used to pay regular fixed sums of money, and **direct debits** used when the amount and payment date varies.

10. Bank Capital. Reserve Requirement.

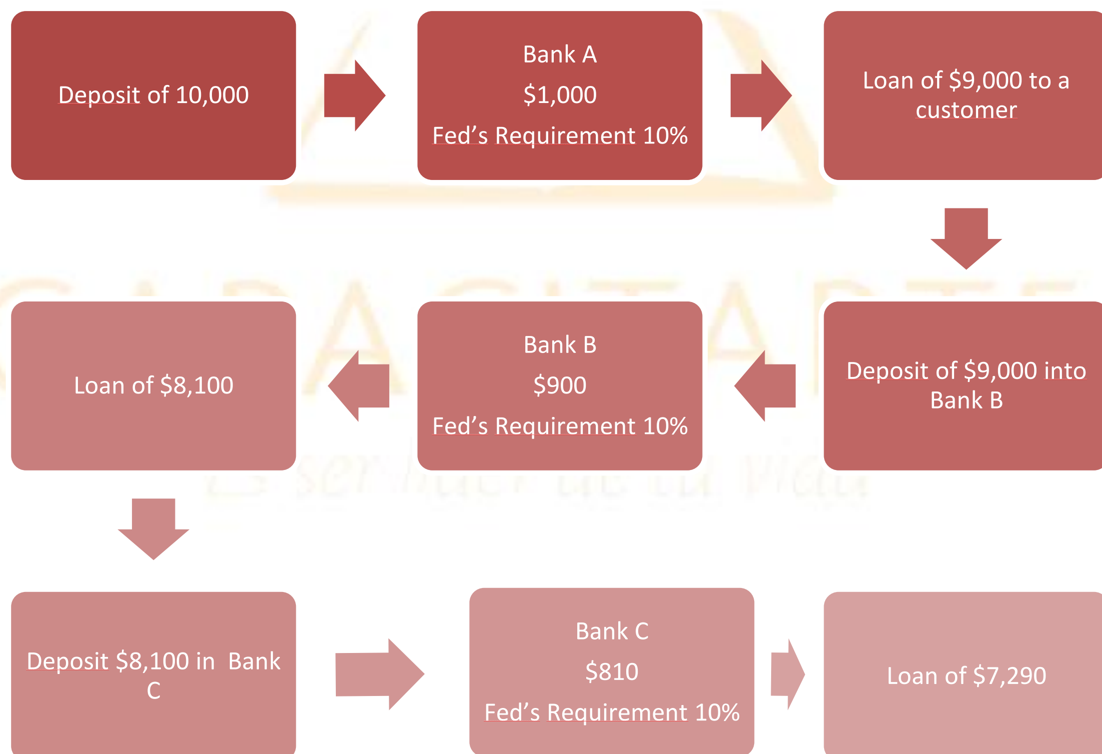
Banks create credit, which means that they make money available for someone to borrow, because the money they lend is usually spent and so transferred to another bank account.

The capital a bank has and the loans it has made are its assets. The customers' deposits are liabilities because the money is owned to someone else.

Banks have to keep a certain percentage of their assets as reserves for borrowers who want to withdraw their money. This is known as the reserve requirement.

The reserve requirement varies from country to country.

Let's take the example below. Borrowers spend money lent by the Banks and the banks receive deposits and keep on lending money, minus the reserve requirement.



11. Loans and Risks

Before lending money, a bank has to assess or calculate this risk involved.

Generally, the greater the risk of the bank of being repaid, the higher the interest rate they charge. Most commercial banks have standardized products for personal customers (personal loans). These standardized products means that the loans granted have all the same terms and conditions.

Banks have more complicated risk assessment methods for corporate customers, but large companies prefer to raise their own finance rather than borrow from banks.

12. Financial Institutions and other specialized banks

For most of the 20th century, most Banks operated in one country only.

Before the deregulation, rules and regulations in the US, Britain and Japan prevented commercial Banks doing investment banking business. Some other countries (such as Germany and Switzerland) already had universal Banks doing all kinds of financial business.

Today, different kinds of Banks offer a complete range of financial business. Individuals and companies can use a single financial institution for all their financial needs.

Retail Banks worked with individuals and small companies (received deposits and made loans). Investments Banks worked with big companies by giving advice, raising companies capital (issuance of stock or shares and bonds), organizing mergers and acquisitions (one Company acquires another Company or two companies together). Insurance companies provide life insurance and pensions.

Finally, building societies specialized in mortgages. Many have now become normal commercial Banks.

There are different ways of naming the types of Banks:

BrE: Merchant bank; AmE Investment bank
BrE: Retail bank, Commercial bank, High Street bank;
AmE: Retail bank. Commercial bank
BrE: Building Societies; AmE: Savings and Loans Associations

There are other types of banks which have specialized functions.

- **Central Banks** issue currency and carry out the government's financial policy.
- **Private Banks** manage the assets of rich people or high net worth individuals.
- **Clearing Banks** pass cheques and other payments through the banking system.
- **Non-Bank Financial Intermediaries**, such as car manufacturers, now offer products like personal loans, credit cards and insurance.

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