services increases, prices will rise. This will happen because there will be more money than there will be goods and services to spend it on at prevailing prices. But if, on the other hand, growth in the supply of money does not keep pace with the economy's current production, then prices will fall, the nations's labor force, factories, and other production facilities will not be fully employed, or both.

Just how large the stock of money needs to be in order to handle the transactions of the economy without exerting undue influence on the price level depends on how intensively money is being used. Every transaction deposit balance and every dollar bill is part of somebody's spendable funds at any given time, ready to move to other owners as transactions take place. Some holders spend money quickly after they get it, making these funds available for other uses. Others, however, hold money for longer periods. Obviously, when some money remains idle, a larger total is needed to accomplish any given volume of transactions.

Who Creates Money?

Changes in the quantity of money may originate with actions of the Federal Reserve System (the central bank), depository institutions (principally commercial banks), or the public. The major control, however, rests with the central bank.

The actual process of money creation takes place primarily in banks.(1) As noted earlier, checkable liabilities of banks are money. These liabilities are customers' accounts. They increase when customers deposit currency and checks and when the proceeds of loans made by the banks are credited to borrowers' accounts.

In the absence of legal reserve requirements, banks can build up deposits by increasing loans and investments so long as they keep enough currency on hand to redeem whatever amounts the holders of deposits want to convert into currency. This unique attribute of the banking business was discovered many centuries ago.

It started with goldsmiths. As early bankers, they initially provided safekeeping services, making a profit from vault storage fees for gold and coins deposited with them. People would redeem their "deposit receipts" whenever they needed gold or coins to purchase something, and physically take the gold or coins to the seller who, in turn, would deposit them for safekeeping, often with the same banker. Everyone soon found that it was a lot easier simply to use the deposit receipts directly as a means of payment. These receipts, which became known as notes, were acceptable as money since whoever held them could go to the banker and exchange them for metallic money.

Then, bankers discovered that they could make loans merely by giving their promises to pay, or bank notes, to borrowers. In this way, banks began to create money. More notes could be issued than the gold and coin on hand because only a portion of the notes outstanding would be presented for payment at any one time. Enough metallic money had to be kept on hand, of course, to redeem whatever volume of notes was presented for payment.

Transaction deposits are the modern counterpart of bank notes. It was a small step from printing notes to making book entries crediting deposits of borrowers, which the borrowers in turn could "spend" by writing checks, thereby "printing" their own money.

What Limits the Amount of Money Banks Can Create?

If deposit money can be created so easily, what is to prevent banks from making too much - more than sufficient to keep the nation's productive resources fully employed without price inflation? Like its predecessor, the modern bank must keep available, to