Module 1: How Money Actually Works

How Money Actually Works

The financial system, the rules, and who benefits.

Nobody hands you a rulebook when you open your first bank account. You are expected to figure it out — usually after making expensive mistakes. This lesson is that rulebook. It will explain how money is created, how the financial system is organized, and why some financial products help you build a better future while others quietly drain it away. By the end, you will be able to look at any financial product and ask the right questions before you sign anything.

What You Will Learn in This Lesson

- ✓ How banks actually create money — and why it matters to you as a borrower
- ✓ The four core financial terms that define your financial health: assets, liabilities, income, and net worth
- ✓ How inflation quietly erodes the value of money you are not growing
- ✓ Why financial institutions are structured the way they are — and whose interests they serve
- ✓ How predatory financial products specifically target low-income households, and how to spot them
- ✓ A practical pre-signing checklist to apply to any financial product

Section 1: How Banks Create Money Through Lending

Most people assume that banks work like piggy banks: customers deposit money, the bank stores it safely, and when someone needs a loan the bank hands over the saved cash. This is almost entirely wrong.

Here is what actually happens: When a bank approves your loan, it does not reach into a vault and pull out bills. It types a number into your account. That is it. The money did not exist before the bank typed it. This process is called credit creation, and it is how the majority of money in the modern economy comes into existence.

> 📖 **Credit Creation:** The process by which banks create new money simply by approving loans and recording the amount as a deposit in the borrower's account. Roughly 90% of the money in circulation today was created this way — not printed by a government.

So if banks can create money, why can they not just create unlimited amounts? Two reasons:

- Regulation: Central banks (like the U.S. Federal Reserve) set rules about how much banks can lend relative to the real money — called reserves — they actually hold.

- Repayment risk: Banks only profit if loans are repaid with interest. Lending too freely leads to losses that can collapse a bank.

Why This Matters to You

When you borrow money, you are not borrowing someone else's savings. You are accepting newly created money that you must repay — with real interest — out of your real earnings. The bank profits whether or not you do. Understanding this asymmetry is the foundation of financial awareness. Interest is the price of borrowing money. The higher the interest rate, the more of your future income you are committing to someone else.

Section 2: Assets, Liabilities, Income, and Net Worth

These four terms are the vocabulary of personal finance. Once you understand them, you can diagnose your financial situation the way a doctor reads a chart.

Asset: Anything you own that has value or can generate value. Examples: a home you own, a car (partially), a savings account, stocks, or a business.

Liability: Any debt or financial obligation you owe to someone else. Examples: a mortgage, a car loan, credit card balances, student loans, medical debt.

Income: Money that flows in — from wages, a salary, freelance work, rental income, or investment returns. Income is not wealth; it is a stream of money that can become wealth if managed well.

Net Worth: The simple math of your financial life: Net Worth = Total Assets minus Total Liabilities. If you own a $200,000 home but owe $180,000 on the mortgage, your net worth from that asset is just $20,000.

The goal of building wealth is simple in concept: grow your assets, reduce your liabilities. The gap between the two — your net worth — is what financial security actually looks like.

Wealth-Building Direction	Wealth-Draining Direction
Buying a home you can afford (asset)	Maxing out credit cards (liability)
Contributing to a retirement account	Taking out payday loans at high interest
Paying down debt faster than required	Leasing a car you cannot afford to buy
Building an emergency savings fund	Borrowing to cover everyday expenses

Section 3: How Inflation Erodes Purchasing Power

Imagine you stuff $1,000 under your mattress today and leave it there for ten years. When you pull it out, you still have $1,000 in bills. But here is the problem: that $1,000 will buy you less than it does today. This is inflation at work.

> 📖 **Inflation:** The gradual increase in the price of goods and services over time, which means each dollar you hold buys a little less each year. The U.S. Federal Reserve aims for about 2% inflation per year. At that rate, $100 today would only have the purchasing power of roughly $82 in ten years.

Inflation is not always dramatic. But its effects compound quietly over time — just like interest on debt.

> **The Real Cost of Doing Nothing**
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> At 3% annual inflation, money sitting in a zero-interest account loses about 26% of its purchasing power over 10 years. You did nothing wrong and spent nothing — you simply held cash while the world got more expensive around it. This is why financial advisors say 'your money needs to work.' Savings accounts, investments, and assets that grow faster than inflation preserve and build your real wealth. Cash under a mattress does the opposite.

This matters in two important ways:

- For savers: Money in a high-yield savings account or invested in the stock market can outpace inflation. Money in a checking account or stuffed away often cannot.
- For borrowers: Inflation can actually help people repaying long-term fixed-rate debt. If you locked in a mortgage at 4% and inflation runs at 4%, the real cost of your debt is shrinking every year.

Section 4: Why Financial Institutions Are Designed the Way They Are

Banks, insurance companies, investment firms, and credit card companies did not appear by accident. They were built — and are continuously regulated and redesigned — to serve specific purposes, often balancing public needs with private profit. Understanding why they are structured the way they are helps you navigate them.

Commercial Banks

These are the everyday banks where most people keep checking and savings accounts. Their core business model: borrow money cheaply (your deposits, which they pay low interest on) and lend it out expensively (mortgages, car loans, credit cards). The spread between those two rates is their profit. Banks are regulated because unregulated banks in history caused economic collapses — including the Great Depression of the 1930s.

Credit Unions

Credit unions are member-owned, nonprofit financial cooperatives. Because they do not answer to outside shareholders, they typically offer lower loan rates and higher savings rates than commercial banks. They are regulated separately and often serve specific communities — teachers, military families, employees of a company, or residents of a region. If you qualify for a credit union, it is often a better deal than a commercial bank.

The Federal Reserve

The Federal Reserve is the central bank of the United States. It does not serve individual customers. Instead, it sets the interest rates that banks use to borrow from each other overnight — a rate that ripples through every loan, mortgage, and credit card in the country. When the Fed raises rates, borrowing becomes more expensive for everyone. When it cuts rates, borrowing becomes cheaper. The Fed's main jobs are controlling inflation and keeping employment stable.

Investment Banks and Brokerages

These institutions help businesses raise money (by issuing stocks or bonds) and help individuals invest. They are not the same as commercial banks. Their products include retirement accounts (401k, IRA), brokerage accounts for buying stocks, and mutual funds. Some are accessible to everyday people with low minimums; others primarily serve the wealthy.

> 🏛 **The Key Insight**
> Every financial institution earns money from the products it sells you. A bank earns from interest on your loans. An investment firm earns from fees on your account. An insurance company earns from premiums you pay. This is not inherently wrong — these institutions provide real value. But it means their interests and yours are not always perfectly aligned. The product being promoted to you is often the one that is most profitable for them, not necessarily the best one for you.

Leap

Section 5: How Predatory Financial Products Target Low-Income Households

Not all financial products are created equal. Some are designed to help you build wealth. Others are specifically engineered to extract money from people who are financially vulnerable — often during moments of crisis. These are called predatory financial products, and they are legal, widely advertised, and extremely profitable for the companies that sell them.

Payday Loans

A payday loan is a short-term, small-dollar loan — typically $200 to $500 — due in full on your next payday, usually within two weeks. They are marketed as fast cash for emergencies, with no credit check required.

The catch: the fees translate into staggering annual percentage rates (APRs). A $15 fee on a $100 two-week loan equals an APR of nearly 400%. If you cannot repay on payday — and many borrowers cannot — you roll it over, paying another fee. The average payday borrower takes out eight loans per year, trapped in a cycle.

> 📖 **APR (Annual Percentage Rate):** The total annual cost of borrowing money, expressed as a percentage. APR includes both interest and fees, making it the best single number to compare the true cost of any loan. A credit card at 20% APR is expensive. A payday loan at 300–400% APR is catastrophic.

Rent-to-Own Stores

Rent-to-own businesses let you take home furniture, appliances, or electronics today with small weekly payments. What they do not advertise prominently: when you add up all the payments, you often pay two to four times the item's retail price. A $500 television could end up costing you $1,400. You would have been better off saving for a few weeks and buying it outright.

Subprime Credit Cards and High-Fee Prepaid Cards

Credit cards marketed to people with poor or no credit history often carry interest rates above 25% and a long list of fees: annual fees, monthly fees, activation fees, and overlimit fees. Some prepaid debit cards charge fees every time you use them, check your balance, or call customer service. These products may provide some access to the financial system, but they can cost hundreds of dollars a year for people who can least afford it.

Buy Now, Pay Later (BNPL) Traps

Buy Now, Pay Later services like Affirm, Klarna, and Afterpay allow you to split purchases into installments, often with 0% interest — if you pay on time. Miss a payment, and penalty fees and retroactive interest can kick in. More dangerously, BNPL makes it psychologically easy to spend more than you planned. Research shows BNPL users consistently overspend their budgets, especially on non-essential items.

> ⚠ **Red Flags of a Predatory Financial Product**
> The APR is not clearly stated or is buried in fine print • The pitch focuses on the small monthly payment, not the total cost • You are required to decide quickly or the offer expires • No credit check is advertised as a feature, not a flag • The product is heavily marketed in low-income neighborhoods • Fees are charged for basic account actions (checking your balance, transferring funds) • Rolling over or renewing the loan is presented as a normal, easy option

Section 6: Before You Sign Anything — Pre-Signing Checklist

You now understand the basics of how money is created, what your financial position actually looks like, what inflation does to savings, and how the system is built — including its most exploitative corners. Use this checklist for any financial product before committing to it.

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Before You Sign Anything

Use this checklist for any financial product — loan, credit card, rent-to-own agreement, Buy Now Pay Later, or prepaid card — before committing.

Part A — Cost Clarity

- ☐ I know the APR (Annual Percentage Rate) and have it in writing
- ☐ I have calculated the TOTAL cost — adding up every payment, not just the monthly amount
- ☐ I have compared this APR to at least one alternative (credit union, nonprofit lender)
- ☐ I understand all fees: annual fees, monthly fees, late fees, rollover fees

Part B — Asset or Liability Test

- ☐ This product adds to my assets (savings, investment, owned property) — OR —
- ☐ This product adds to my liabilities, AND the reason is truly unavoidable
- ☐ I am not being pressured to decide before I am ready
- ☐ I have taken at least 24 hours to consider this decision

Part C — Red Flag Scan

- ☐ The APR is clearly stated (not buried in fine print)
- ☐ The pitch is NOT focused only on the small monthly payment
- ☐ I am NOT required to decide immediately or the offer expires
- ☐ There is no 'no credit check required' language being used as a selling point
- ☐ This product is NOT heavily marketed in my neighborhood as a quick-cash solution
- ☐ Basic account actions (balance check, transfers) do NOT carry fees

Part D — My Decision

Product or loan I am considering: ____________ APR: %

Total cost if I pay minimums: $ ____________ Total cost if I pay more: $

Credit union or nonprofit alternative I checked first: ____________

My decision: ____________ Reason: ____________

Lesson Summary

- Banks create money through lending, not from stored deposits — and they profit whether you succeed or not.
- Your net worth = assets minus liabilities. Growing assets and reducing liabilities is the core of wealth-building.
- Inflation silently erodes idle cash. Money must be growing to maintain its real value.
- Every financial institution has its own profit motive. The best product for them is not always the best for you.
- Predatory products — payday loans, rent-to-own, BNPL — are specifically designed to extract money from people in financial stress.
- Always ask: What is the APR? What is the total cost? Does this add to my assets or liabilities?

Next Steps and Action Items

Apply what you learned before you take on any new financial product or obligation.

1. Write down your current net worth: list everything you own (assets) and everything you owe (liabilities). Subtract liabilities from assets. This number is your starting point.
2. Use the pre-signing checklist in this lesson the next time you are offered any loan, credit card, or payment plan.
3. Look up the APR on any debt you currently carry (credit cards, auto loans, personal loans). Write them down in order from highest to lowest.
4. Ask your bank or credit union what interest rate your savings account currently pays. If it is below 4%, research a high-yield savings account.
5. Proceed to Module 2: Understanding Credit to learn how your credit history affects the rates and terms you are offered.

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