

Money

Chapter 11

Today's lecture will:

- Discuss why the financial sector is central to almost all macroeconomic debates.
- Explain what money is.
- Enumerate the three functions of money.
- State the alternative measures of money and their components.

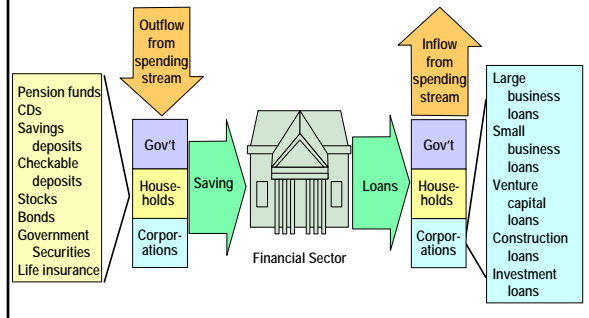
Today's lecture will:

- Explain how banks create money.
- Calculate both the simple and the approximate real world multiplier.
- Explain how a financial panic can occur and the potential problem with government guarantees to prevent such panics.

Why is the Financial Sector Important to Macro?

- The financial sector channels savings back into the circular flow.
- For every financial asset, there is a corresponding financial liability.
 - **Financial assets** – assets such as stocks or bonds, whose benefit to the owner depend on the issuer of the asset meeting certain obligations.
 - **Financial liabilities** - obligations by the issuer of the financial asset.

The Financial Sector as a Conduit for Savings



The Role of Interest Rates in the Financial Sector

- **Bonds** are promises to pay a certain amount plus interest in the future.
- The price of a bond is determined by the market interest rate.
- The price of bonds varies inversely with the interest rate.



Interest Rates and Inflation

Real interest rate = nominal interest rate – expected inflation

- **Nominal interest rate** – the interest rate you actually see and pay when borrowing or receive when lending.
- **Real interest rate** – the nominal interest rate adjusted for inflation.
- If inflation occurs, the value of money decreases, so lenders charge a higher interest rate to compensate for the loss of purchasing power.

Functions of Money

- Money is a medium of exchange.
- Money is a unit of account.
- Money is a store of wealth.

Money As a Medium of Exchange

- Money facilitates exchange by reducing the cost of trading.
- Without money, we would have to barter.
- **Barter** – a direct exchange of goods and services.

Money As a Medium of Exchange

- Money does not have to have any inherent value to function as a medium of exchange.
- All that is necessary is that everyone believes that other people will exchange it for their goods.

Money As a Unit of Account

- Money prices are actually relative prices.
- A single unit of account saves our limited memories and helps us make reasonable decisions based on relative costs.

Money As a Unit of Account

- Money is a useful unit of account only as long as its value relative to other prices does not change too quickly.

Money as a Store of Value

- Money is a financial asset.
- As long as money is serving as a medium of exchange, it automatically also serves as a store of wealth.

Money as a Store of Value

- Money's usefulness as a store of wealth also depends upon how well it maintains its value.
- Hyperinflations destroy money's usefulness as a store of value.

Alternative Measures of Money

- A number of different financial assets serve some functions of money and thus have a claim to being called money.
- They are called M1, M2, and L.

Alternative Measures of Money: M1

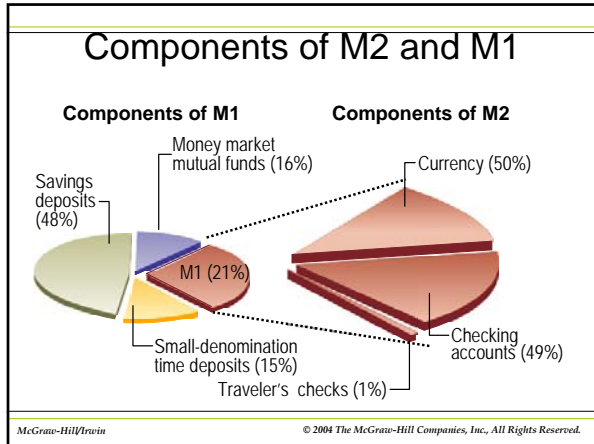
- **M1** consists of currency in the hands of the public, checking account balances, and travelers' checks.
- Checking account deposits are included in all definitions of money.

Alternative Measures of Money

- **M1** – currency in the hands of the public, checking account balances, and travelers' checks.
- **M2** – M1 plus other relatively liquid assets, such as savings deposits, small-denomination time deposits (CDs), and money market mutual fund shares.
- **L** – almost all short-term liquid financial assets.

Beyond M2:

- It has become difficult to define money in an ever-changing world.
- Broader concepts of asset liquidity have taken the place of measures of money.



Distinguishing Between Money and Credit

- Credit card balances cannot be money since they are assets of a bank.
- In a sense, they are the opposite of money.

Distinguishing Between Money and Credit

- Credit cards are prearranged loans.
- Credit cards affect the amount of money people hold.
- Generally, credit card holders carry less cash.

The Definition and Functions of Money

- **Money** is a highly liquid financial asset.
 - **Liquid** – easily changeable into another good or asset.
- Money serves as:
 - A medium of exchange.
 - A unit of account.
 - A store of wealth.

Money as a Medium of Exchange

- Money facilitates exchange by reducing the cost of trading.
- Without money, we would have to barter.
- Money has no inherent value to function as a medium of exchange.
- It acts as a medium of exchange because people are willing to accept as payment for goods and services.

Money as a Unit of Account

- Money is used as a common denominator to measure the relative values of goods and services.
- Without money, we would have to measure the value of goods and services in terms of other goods and services.
- Money is a useful unit of account only if its value relative to the average of all other prices doesn't change too quickly.

Money as a Store of Value

- Money is a financial asset that can be used to store wealth (income that you have saved and not consumed).
- As a store of wealth, money pays no interest, but is perfectly liquid.
- Money's usefulness as a store of wealth depends on how well it maintains its value.
