Functions of money

- Medium of exchange
  - eliminates the logistical problems of barter
- Unit of account
  - A proxy for "utility" it allows us to measure and state the relative value of apples and oranges
  - Whats worth more a diamond or a book of poetry?
- Store of value
  - KEY: Cash vs. Balances
    - Cash a defective store of value
    - Balances: Savings => a special kind of money

Types of money represent a laddering of "money's" by<u>liquidity</u>.

An asset's liquidity is the easy with which it can be used in a transaction.

The most liquid assets are easy to use because:

- They are accepted by everyone
- They can be used by everyone
- Involve no time delay
- They are accepted at a clear, commonly acknowledged value (face value)

The economist wants to track liquid wealth,
because liquid wealth has value as a scarce commodity with its own market.

- Its availability controls how many actual transactions you can do a year.

  An economy does not happen without transactions.

- A market for money is important because the price of liquidity ends up have real economic effects.

  Economies need money to do business. Money is, therefore, a necessary tool to doing business. How available and costly this tool is affects how much business the economy can do.

M1 =

The real thing (cash and coin)*****

+

Checkable deposits (DDAs):

The bank agrees to turn it over as close to NOW as possible.

***** in the public's hands, not in vaults

the vault money is already counted as a checking deposit.

Lots of this -> transactions are easy

M2 =

M1

+

savings and MMDA (interest bearing but as close to DDA as possible, easily moved to DDA)

+

small CDs (100,000 or less, generally called time deposits)

+

money market mutual funds- a non-bank version of savings accounts *

* an interest story in themselves

Commercial banks

Thrifts - limited purpose banks:

- Savings and loans: personal savings to mortgages
- Credit unions: people with some tie form a savings and loan group

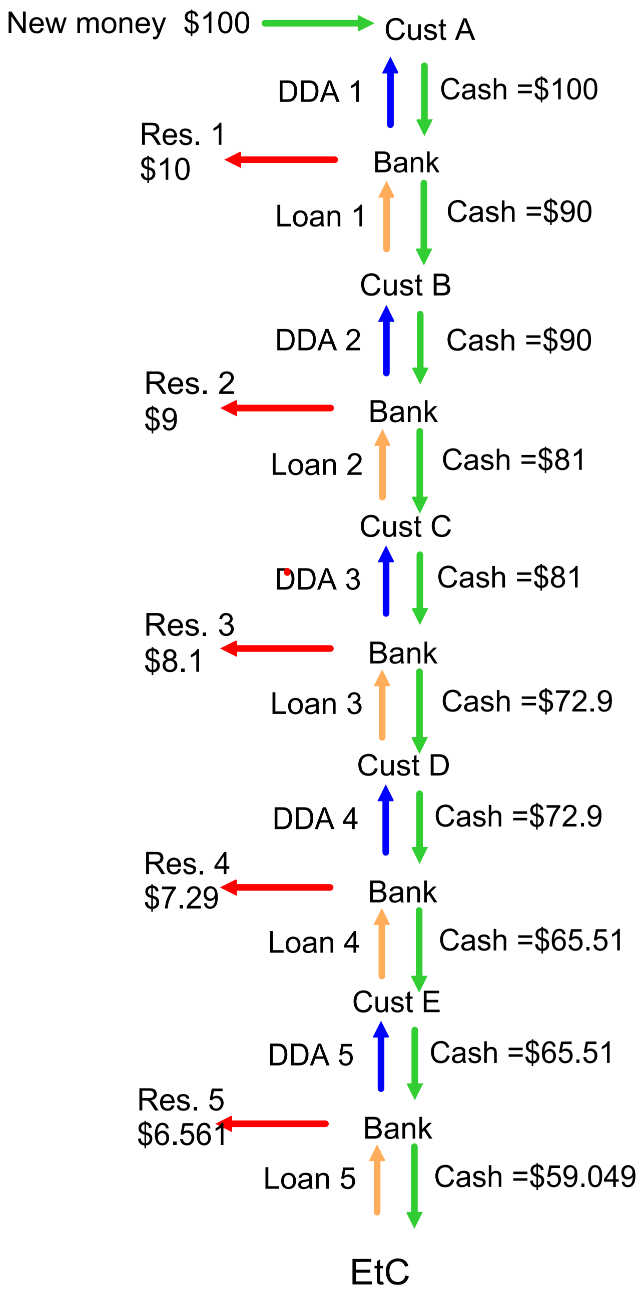
Did types of money (M1 etc.) and function of money.
What to use T accounts throughout, so introduce now

We are building to understanding monetary policy, the alternate to fiscal policy.

Because fiscal policy has 5 or 6 substantial problems.

Monetary policy is the art of controlling output and inflation through controlling the money supply

So, we must know what money is and how it can control the transactions in the economy, how it moves through the economy, and how to keep track of it.



The cash gets passed on fast, not stopping except leaking out to reserves.

Accounting magic: Customer owns DDA instead, money they can use when they want, like cash.

The law says the bank has to keep some cash in case someone wants there money bank.

The rest they lend to make a profit. (You get paid more interest on a loan then you pay interest on DDA {usually 0}).

Banks

Asset reserves: $100
Asset Loans: $900
Liability DDA: $1,000

M1 !!!

Customers

Asset DDA: $1,000
Liability Loans: $1,000

Where's the cash?
Back at the fed!

How much money did
$100 turn into?
$1,000 = 100*1/ (res req)

There is a money multiplier, an injection of new funds creates more M1 than the original injection.

Different from GDP multiplier, which is the increase in GDP resulting from a new injection.

That was $\dfrac{1}{\text{the amount leaked every pass}}$ is this $\dfrac{1}{\text{the amount leaked every pass}}$?

Yes, but watch it.

With a reserve requirement of .10, \$100 injected results in a supply increase of \$1,000

But that is \$100 of original cash and \$900 of money created by the banks (DDA/loans)

Reserve rate = 10%. The Fed adds $5 billion of liquidity.
What is the resulting impact on M1?

The reserve rate is 10%. The Fed has expanded the money supply. The result was that the banking system created $800 billion of money. What was the initial injection?

How can the fed control the money supply with the reserve ratio?