

# CHAPTER 18

## The Functions of Money

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- **Medium of exchange** - money is useable for buying goods and services
- **Unit of account** - dollars used in the USA to measure the relative worth of a variety of goods, services and resources
- **Store of value** - allows people to transfer purchasing power from the present to the future
- **Liquidity** - the ease with which an asset can be converted quickly into the most widely accepted form of money

# The Components of Money Supply

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## Money Definition M1

- The narrowest definition of the US money supply is M1. It consists of:
  1. **Currency** (coins and paper money)
  2. **All checkable deposits** (all deposits in commercial banks and “thrift” or savings institutions on which checks of any size can be drawn)

## Money Definition M2

- $M2 = M1 +$ 
  1. **Savings deposits, including money market deposit accounts (MMDA)**
  2. **Small time deposits (less than \$100,000)**
  3. **Money market mutual funds ( MMMF) held by individuals**

# What “Backs” the Money Supply?

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- **Money as Debt** - in the US, paper money is the circulating debt of the Federal Reserve Banks. Checkable deposits are the debts of commercial banks and thrift institutions.
- **Value of Money**
  - **Acceptability** - currency and checkable deposits are acceptable as a medium of exchange
  - **Legal tender** - “This note is legal tender for debts, public and private
  - **Relative scarcity** - Money derives its value from scarcity
- **Money and Prices**
  - **Purchasing power (PP) of the dollar** - Reciprocal relationship between the general price level and the purchasing power of the dollar:  $\$V = 1/P$
  - **Inflation and acceptability** - hyperinflation - value and PP goes down quickly
- **Stabilizing Money’s Purchasing Power** - stabilize the price level, monetary and fiscal policy to curb inflation

# The Federal Reserve and the Banking System

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- **Board of Governors** - central authority of the US money and banking system. The President with Senate confirmation appoints the 7 board members - terms: 14 years. The president selects the Chairperson and Vice Chairperson from the members - terms: 4 years.
- **12 Federal Reserve Banks** - serve as the nation's "central bank". These banks also serve as banker's banks. Federal Reserve Banks put into circulation the currency.
- **Federal Open Market Committee (FOMC)** - aids the Board of Governors in conducting monetary policy. Direct the purchase and sale of government securities (bills, notes, bonds) in the open market.

# The Federal Reserve and the Banking System

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- **Fed Functions and the Money Supply**
  - **Issuing currency** - Federal Reserve Banks issue paper currency in the US
  - **Setting reserve requirements and holding reserves** - balances that banks have to maintain as reserves. Excess reserves are held by the Fed.
  - **Lending money** - the Fed lends money to banks and charges them an interest rate called *discount rate*.
  - **Providing for check collection**
  - **Acting as fiscal agent** - The Fed is the provider of financial services for the Federal government
  - **Supervising banks** - the Fed supervises the operations of banks
  - **Controlling the money supply** - the Fed's ultimate responsibility is to regulate the money supply and thereby influences interest rates.
- **The Fed is an independent agency of the government** - To protect the Fed from political pressure

# Recent Developments in Money and Banking

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- **The Relative decline of Banks and Thrifts**
- **Consolidation Among Banks and Thrifts**
- **Globalization of Financial Markets**
- **Electronic Payments**