

CHAPTER 18

The Functions of Money

- **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

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?

- **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

- **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

- **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

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