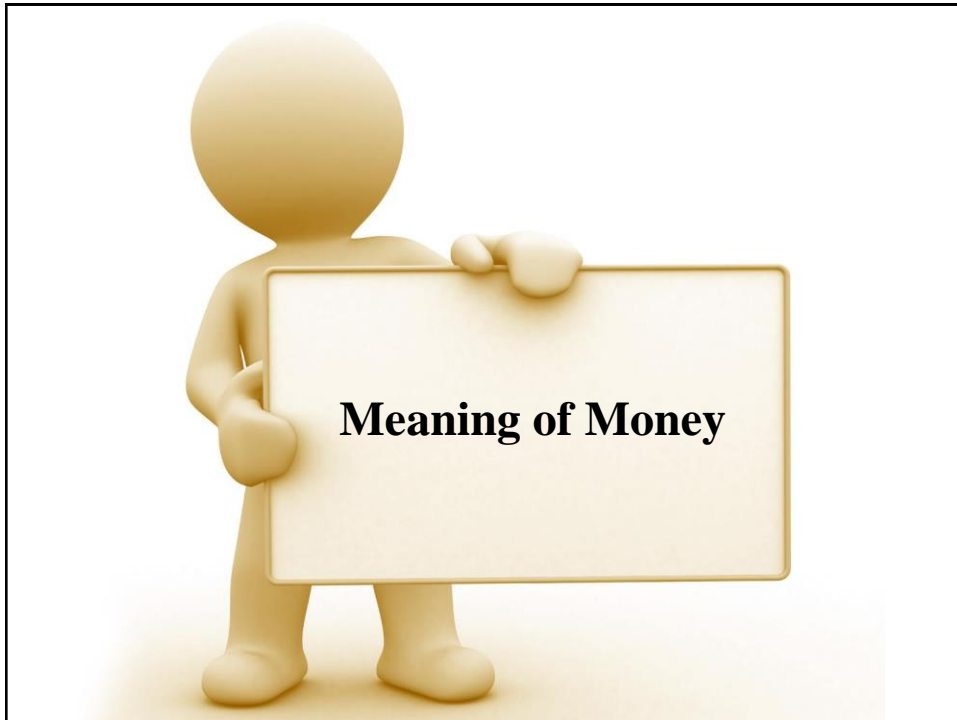


Chapter 3

What Is Money?

Learning Objectives

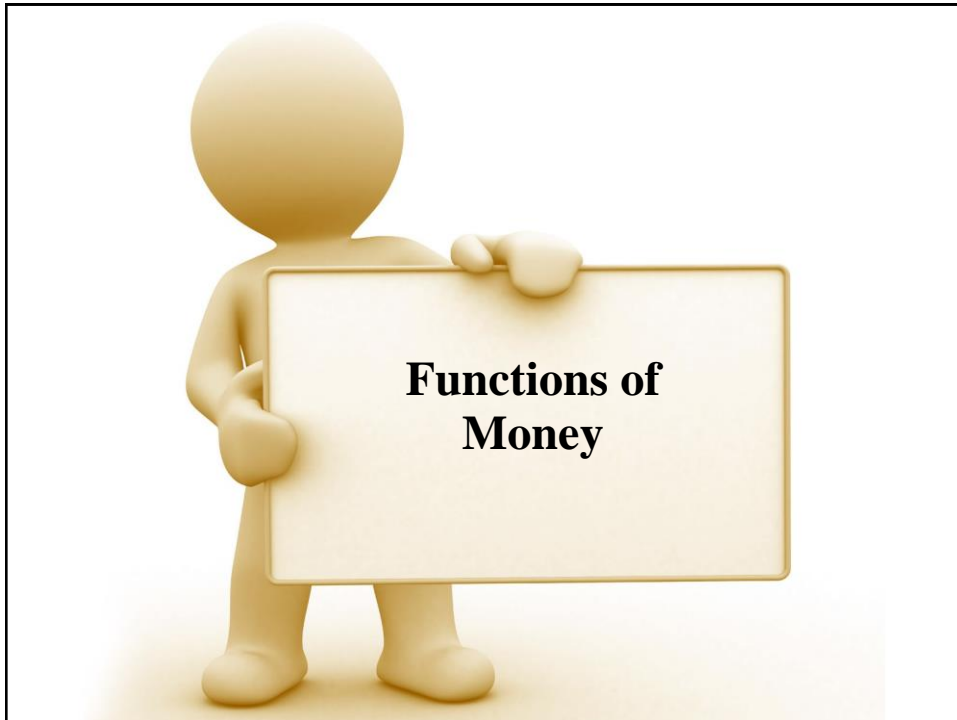
- Describe what money is
- List and summarize the functions of money
- Identify different types of payment systems
- Compare and contrast the M1 and M2 money supplies



Meaning of Money

- Money (or the “money supply”): **anything** that is **generally** accepted as **payment** for goods or services or in the **repayment** of debts.

- Money (a stock concept) is different from:
 - **Wealth**: the total collection of pieces of property that serve to store value
 - **Income**: flow of earnings per unit of time (a flow concept)



Functions of Money

1. Medium of Exchange:

- Eliminates the trouble of finding a **double coincidence of needs** (reduces transaction costs)
- Promotes **specialization**

2. A medium of exchange must:

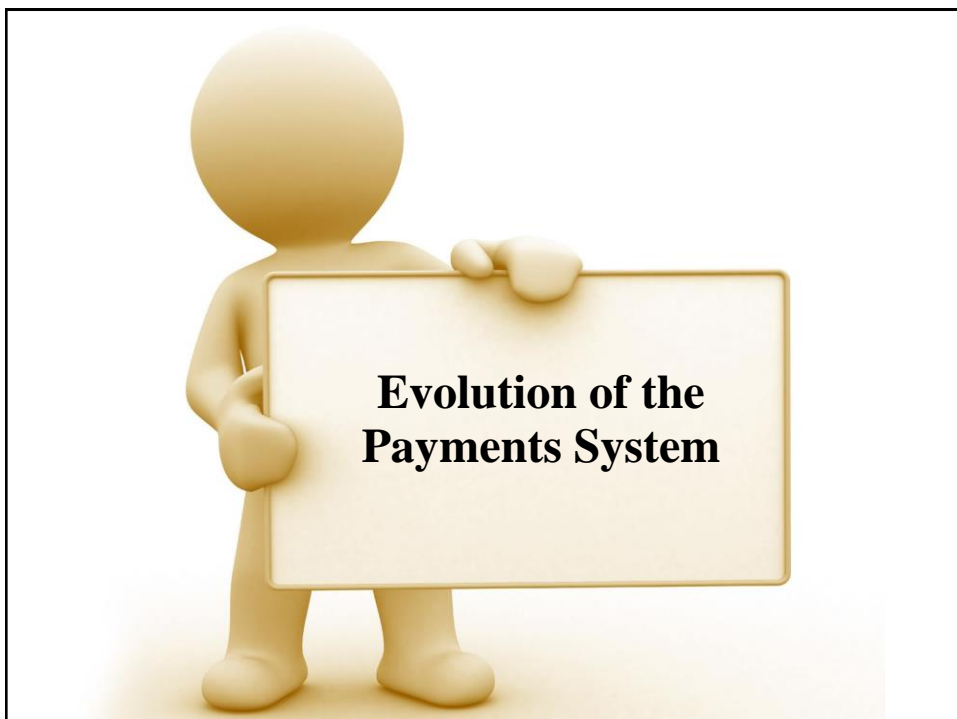
- be easily **standardized**
- be **widely** accepted
- be divisible
- be **easy to carry**
- **not deteriorate** quickly

3. Unit of Account:

- Used to measure **value** in the **economy**
- **Reduces transaction** costs

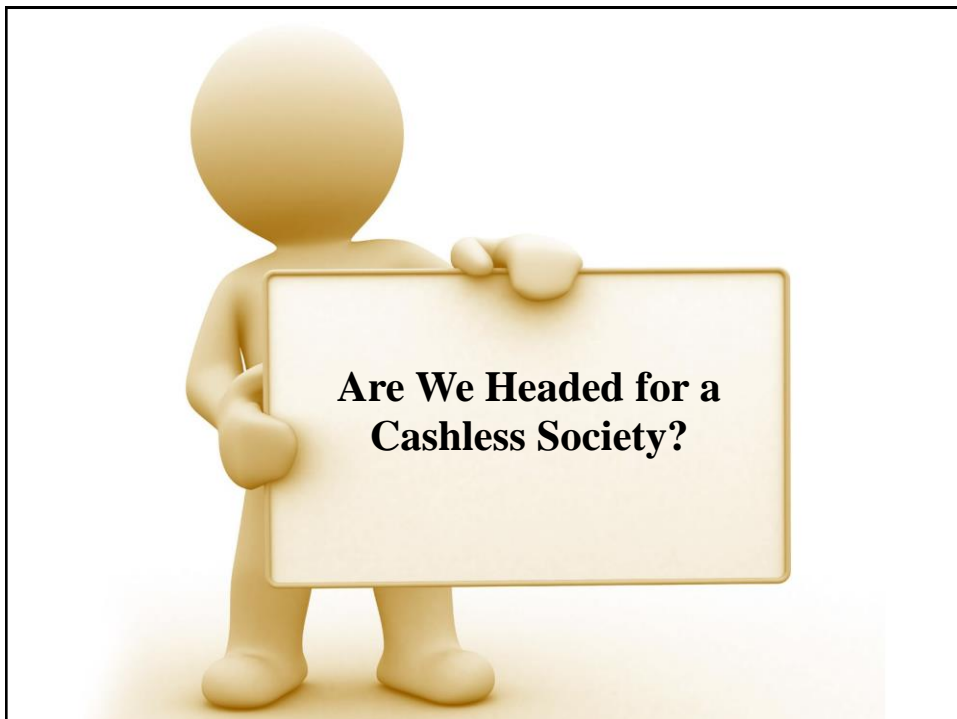
4. Store of Value:

- Used to save **purchasing power** over time
- Other assets **also** serve this function, but Money is the **most liquid** of all assets but loses value during inflation.



Evolution of the Payments System

- **Commodity Money:** valuable, easily standardized and divisible commodities (e.g. precious metals, cigarettes)
- **Fiat Money:** paper money decreed by governments as legal tender
- **Checks:** an instruction to your bank to transfer money from your account
- **Electronic Payment** (e.g. online bill pay).
- **E-Money** (electronic money):
 - Credit/Debit card
 - Stored-value card (**smart card**): a payments **card** with a monetary **value stored** on the **card** itself, not in an external account maintained by a financial institution.
 - **E-cash**



Are We Headed for a Cashless Society?

- **Predictions** of a **cashless society** have been around for decades, but they **have not** come to be **fully achieved**.
- Although **e-money** might be more convenient and efficient than a payments system based on paper, several factors **work against** the **disappearance** of the **paper system**.
- **However**, the use of **e-money** will likely still increase in the future.



Measuring Money (Different measures of money supply.)

- How do we measure money? Which particular assets can be called “money”?
- Construct **monetary aggregates** using the concept of liquidity:

M1 (most liquid assets) = **currency** + traveler’s checks + demand deposits + other checkable deposits.

M2 (adds to M1 other assets that are not so liquid) = M1 + time deposits + savings deposits and money market deposit accounts + money market mutual fund accounts

M1

Currency is a generally accepted form of money, including coins and **paper notes**, which is issued by a central bank/ government and circulated within an economy.

Demand Deposit is an account with a bank or other financial institution that allows the depositor to withdraw his or her funds from the account without warning/notice.

Traveler's Checks are paper documents that can be used like standard paper checks and cash. Traditionally, travelers carried these checks to get cash in local currency and pay merchants.

Checkable Deposits is a technical term for any demand deposit account against which checks or financial drafts of any kind may be written.

M2= M1+ the following other components:

A **time deposit** is an interest-bearing bank **deposit** account that has a specified date of maturity, such as a certificate of **deposit** (CD).

A **savings account** is an interest-bearing deposit account held at a bank or other financial institution that provides a modest interest rate.

A **money market account** is an interest-bearing account that typically **pays** a **higher** interest rate than a **savings account** and provides the **account holder** with **limited check-writing ability**. A money market account thus offers the account holder benefits typical of **both savings and checking accounts**.

It is a **mutual fund** that invests in **short-term** debt securities such as **Treasury bills** and **commercial paper**.

The Federal Reserve's Monetary Aggregates

TABLE 1 Measures of the Monetary Aggregates

	Value as of August 18, 2014, (\$ billions)
M1 = Currency	1,206.1
+ Traveler's checks	3.3
+ Demand deposits	1,089.9
+ Other checkable deposits	477.4
Total M1	2,776.7
M2 = M1	
+ Small-denomination time deposits	533.0
+ Savings deposits and money market deposit accounts	7,338.2
+ Money market mutual fund shares (retail)	642.5
Total M2	11,290.4

Source: <http://www.federalreserve.gov/releases/h6/hist>.

- M1 versus M2: Does it matter which measure of money is considered?
- M1 and M2 can move in different directions in the short run (see figure).
- **Conclusion:** the choice of **monetary aggregate** is important for **policymakers**.

The End