Money, Banking and the Federal Reserve System

Chapter 10
Changes for the last few weeks...

- All work will be due during the class period it is assigned. I will NOT accept any late work!!
- Cell phone use has become increasingly blatant and disrespectful.
  - Providing a review for your final exam is conditional on me not seeing any cell phones/headphones out during class unless you have been given specific permission.
Your Final Exam

• ~ 110 multiple choice questions (5-7 per chapter + about 20 from Budget Challenge and What’s Next)
• ~ 5 free-response questions worth 4 points each.
• ~ 20 extra credit questions (these can add as much as 15% to your score but they will require some extended effort and knowledge)

• REMEMBER: Your final exam is in it’s own category and is worth 15% of your overall grade. Use the review sheets and study!!!
SECTION 1
Origins of Money

What’s It Like Living in a Barter Economy?

- A barter economy is an economy in which people trade goods and services instead of money.

- Living in a barter economy is difficult because many of the people you want to trade with don’t want to trade with you. This situation makes trade time consuming.

- Transaction costs are any costs associated with the time and effort needed to search out, negotiate, and complete an exchange. Reducing transaction costs would make trading easier.

- School House Rocks: Barter
How and Why Did Money Come to Exist?

- **Money** is a good that most people will accept in exchange for goods and services and in the repayment of debt. Historically, money has included gold, silver, copper, rocks, cattle, shells, and more.

- Cash, and any other good considered money, has value because of its general acceptability. You can use it to get what you want because other people will accept it in exchange for what they have.
Are You Better Off Living in a Money Economy?

- The transaction costs of exchange are lower in a money economy than in a barter economy. The use of money frees up more time for production, or leisure. Therefore, the residents of money economies are richer in goods, services, and leisure than the residents of barter economies.

- Residents of money economies are also more specialized. They do not need to conduct multiple transactions to obtain goods, so they tend to produce what they want to produce and purchase everything else. In a barter economy, trade is so difficult that people are likely to try to produce most of the things they need, which means that they tend to develop diverse skills.
What Are the Three Functions of Money?

Money has three major functions.

- Money functions as a medium of exchange. A medium of exchange is anything that is generally acceptable in exchange for goods and services.
• Money functions as a **unit of account**. A unit of account is a common measurement used to express values. In the United States, many goods and services are expressed in dollars.

• Money also serves as a **store of value**. A store of value is something that has the ability to hold value over time. A dollar will likely have the same value one week from now as it currently holds. Rising prices gradually diminish the stored value of money.
# The Major Functions of Money

<table>
<thead>
<tr>
<th>Function</th>
<th>Definition</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medium of exchange</td>
<td>Anything that is generally acceptable in exchange for goods and services</td>
<td>John uses money to buy haircuts, books, food, CDs, and computers. Money is the medium of exchange.</td>
</tr>
<tr>
<td>Unit of account</td>
<td>Common measurement in which values are expressed</td>
<td>The price of a candy bar is $1, and the price of a book is $14. The exchange value of both goods is measured by dollars (unit of account). Notice that exchange values can be compared easily when money is used. In this example, the book has 14 times the exchange value of the candy bar.</td>
</tr>
<tr>
<td>Store of value</td>
<td>An item that maintains value over time</td>
<td>Phil has a job and gets paid $100. He could use $100 to buy a ski jacket that he wants, but he decides not to. Instead, he saves the $100 and buys the ski jacket six months later. For Phil, money has acted as a store of value over the six-month period.</td>
</tr>
</tbody>
</table>
Who Were the Early Bankers?

- Gold was an early form of money. The weight of gold made it difficult, and unsafe, to transport. For this reason, goldsmiths became the first bankers. They took in other people’s gold and stored it for them.

- Goldsmiths issued warehouse receipts to their customers; these receipts stated the amount deposited. Soon, people began trading the warehouse receipts as a form of money. The warehouse receipts represented gold held with the goldsmith, and were considered fully backed by the gold.

- Some goldsmiths began lending out receipts and collecting interest on the loans. They could do this because depositors rarely turned in their warehouse receipts and asked for their gold back.
When a goldsmith gave a borrower a receipt for an amount of gold, the depositor still held a receipt for the same amount. This meant that two receipts for the same amount of gold were now circulating in the money supply. Thus, by issuing a loan, the goldsmith effectively raised the money supply.

This process was the beginning of fractional reserve banking. This is a banking arrangement in which banks hold only a fraction of their deposits and lend out the remainder.
SECTION 2
The Money Supply

What Are the Components of the Money Supply?

- A money supply is the total supply of money in circulation. It is composed of currency, checking accounts, and traveler’s checks. The most basic money supply is known as M1.

- **Currency** consists of coins issued by the U.S. Treasury and paper money issued by the Federal Reserve System. The paper money issued by the Federal Reserve system is called Federal Reserve notes. Our dollar bill is an example of a Federal Reserve note.
• The second component of the money supply is checking accounts. Checking accounts are also referred to as demand deposits. Funds are deposited into the accounts. Then the owners of the accounts can withdraw the funds in currency, or write a check to transfer the funds to a third party.

• The third component of the M1 money supply is traveler’s checks. Traveler’s checks are issued by a bank and sold to anyone who wishes to buy them.
Components of the Money Supply

The most basic money supply (M1) consists of three things:
1. Currency—coins and paper money
2. Checking accounts
3. Traveler’s checks

U.S. money supply $1,336 billion

- Currency: $710 billion
- Checking accounts: $619 billion
- Traveler’s checks: $7 billion
Is a Savings Account Money?

- A **savings account** is an interest-earning account. A savings account that allows for check-writing privileges is considered a checking account.

- A nonchecking savings account is not considered money because it is not widely accepted for purposes of exchange. **Near-money** is any asset, such as a nonchecking savings account, that can be easily and quickly turned into money.
Are Credit Cards Money?

- A credit card is not considered money. Money must be acceptable as a form of payment and repayment; a credit card cannot be used to repay debt. The use of a credit card places a person in debt, which he or she then has to repay with money.
Borrowing, Lending, and Interest Rates

- Why do interest rates rise and fall? Interest rates are determined in the loanable funds market, which is a market for loans. There is a demand for loans (stemming from borrowers) and a supply of loans (from lenders). Through the interaction of the demand for and supply of loans, the interest rate is determined.

- Sometimes a distinction is made between short-term interest rates and long-term interest rates. In general, a short-term rate applies to any loan that is to be repaid in less than one year. Any loan that is for one year or more, such as a 30-year home mortgage, has a long-term interest rate.