Rupayan Gupta

Lecture 15, Parkin, Ch. 12

Till now we have looked at the role of Fiscal Policy in influencing the macroeconomic equilibrium. However, the government has another policy tool it can resort to: Monetary Policy. In order to study about monetary policy, we will first need to understand what money is.

**What is money?**

Money is what money does. That is, money is a commodity that acts as:

1. A medium of exchange.
2. A unit of account.
3. A store of value.
4. A means of payment.

1. **Medium of exchange:** It is a commodity that is accepted in exchange for all other goods & services.
   
   Note: In a barter economy there would always need to be a ‘double coincidence of wants’ (two agents want to sell exactly the good that the other wants to buy, and exactly the right amount respectively) for trade to occur.

2. **Unit of account:** It is a measure for accounting the value of different goods & services.
   
   Note: This gives us a way for comparing the value of multiple goods & services.
   
   Example. If an apple costs $1 and an orange $2, then the orange is twice as valuable as the apple.

3. **Store of value:** It is a commodity that can be stored today to purchase goods & services in the future.
   
   Note: So purchasing power might be transferred between two different time periods using money. However, how good a store of value money is depends on the inflation rate, which decreases the value of money itself over time.

4. **Means of payment:** It is a commodity that can be used for settling debts.

**What makes up the money supply of a country?**

1. Currency
2. Deposits at banks & other depository institutions
Currency: Bills & coins
Deposits: Money deposited at banks, savings & loan associations, etc.
Official measures of money adopted by the Federal Reserve:
M 1: Currency + Traveler’s checks + Checking deposits owned by individuals and businesses.
   (Highly liquid monetary assets, i.e. either currency, or easily convertible to currency)
M 2: M 1 + time deposits + savings deposits + money market mutual funds & other deposits
   (The latter items are not as liquid as the items in M 1)
Note:
1. Checks are not money they are instruments (documents) recording the transfer of money from one banking account to another.
2. Credit cards are not money. They are identity cards that let you instantaneously borrow money from financial institutions (credit card companies, in this case).

**Commercial Banking**
Commercial Banks take deposits from their customers and pay interest on those deposits. They lend these deposits out to borrowers and charge interest on those loans. In the banking business they act as profit-maximizing firms (like firms in other sectors of the economy).

What aspects of commercial banking does the government legally control?
1. Equity-capital requirements (the amount of an owner’s financial resources that must be put into a depository institution).
2. The reserve-ratio (the percentage of deposits that must be held in currency or safe liquid assets by banks).

Example: If a bank has $100 worth of deposits, and the RR is 0.2, then $20 must be held by the bank. It can lend out at most $80.
3. Deposit rules (different types of deposits that an institution may accept).
4. Lending rules (proportions of different types of loans that a depository institution may make).