

Lecture 21 Money and Banking

Three functions of Money

1. Medium of Exchange

Examples: gold, silver, tobacco, wampum, stones

The alternative is barter

Double coincidence of wants: someone want to sell, and want your stuff

2. Unit of account
3. Store of value
4. One way we store our wealth

Three types of Money

1. Commodity money
2. Commodity-backed money
3. Fiat Money: no inherent value

New problem: Discretion

The government has discretion to change the quantity of money: if gov owes money, they just print money and pay bills

discretion is worse than inherent price risk

US Money Supply

M1: Money supply checking account: currency+checking account+Traveler's checks

M2: Broader measure of money supply: M1+Saving deposits (essentially)

15 trillion: GDP

Key:

$M = \text{Currency} + \text{Deposits}$

Commercial banks (banks)

banks is just like a firm: inputs \rightarrow firm output

Deposits Loans

Two macroeconomic Roles

1. Middlemen in loan market
2. Channel of monetary policy

Balance Sheet

| Assets (uses of funds) | Liabilities+Owner's Equity (sources of funds) |
|------------------------|---|
| Reserves | Deposits (key source) |
| Loans | Borrowings |
| US Treasury securities | Owner's equity |
| Other Assets | |

Reserves: the part that bank does not loan out

Bank Reserves: Fractional Reserve banking system

why don't bank keep everything reserve? because bank want make money, there is an opportunity cost of making reserves

loans make higher interest rate than reserves

why don't the banks loan out everything?

1. reduces their risk (everybody show up and want their money back)
2. it's the law, they have to, a reserve requirement

Bank Reserves

Required reserve ratio (rr)=10%

bankrupt: great depression: people want their money in the bank back

solution (new deposit): the federal deposit insurance (FDIC)

New problem: moral hazard (no moral consequences to your action)

banks are playing with other people's money, and people don't care

nobody care about the stability of the institution