

## Chapter 3

### What Is Money?

## Meaning of “Money”

- Common uses of the word “money”
  - currency (banknotes and coins)
  - wealth (all property that serves to store value)
  - income (the flow of earnings per unit of time)
- Economists' meaning of “money” is *stock*
  - anything that is generally accepted in payment for goods and services
  - not the same as wealth or income

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## Functions of Money

1. *Medium of exchange* = used to pay for goods and services
  - it reduces transaction costs (vs. a barter economy)
  - a commodity can be used as money if:
    - is easily standardized
    - is widely accepted
    - is divisible
    - is easy to carry
    - does not deteriorate quickly

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## Functions of Money (cont.)

2. *Unit of account* = prices are expressed in terms of the same unit,
  - allows the comparison of goods in terms of cost (price)
  - reduces transaction costs – no need for pairwise prices
3. *Store of value* = allows the intertemporal transfer of purchasing power
  - not that much in case of (hyper)inflation

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## Evolution of Payment Systems

- precious metals like gold and silver – heavy, so hard to transport
- paper currency (fiat money) – easy to steal
- checks – not that fast to travel to different locations (so funds are not immediately available), costly to process
- electronic means of payment – online bill-pay
- electronic money: debit cards, stored-value cards (e.g., prepaid phone cards), smart cards, e-cash

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## Federal Reserve's Monetary Aggregates

- Monetary Aggregates, most liquid first:
  - *M1* = assets that can be clearly used as medium of exchange (like-cash assets, checking accounts)
  - *M2* = adds onto *M1* assets on which checks can be written or other assets that can be turned into cash fast and at very little cost (e.g., savings accounts)
  - *M3* = adds onto *M2* less liquid assets

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## Federal Reserve's Monetary Aggregates – Example

Table 1 Measures of the Monetary Aggregates

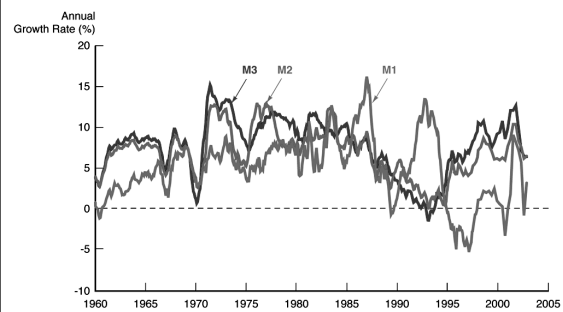
|  | Value as of December 2002<br>(\$billions) |
|--|---|
| M1 = Currency  | 626.5                                     |
| + Traveler's checks  | 7.7                                       |
| + Demand deposits  | 290.7                                     |
| + Other checkable deposits                                   | 281.2                                     |
| Total M1   | 1,206.1                                   |
| M2 = M1  |   |
| + Small-denomination time deposits and repurchase agreements | 1,332.3                                   |
| + Savings deposits and money market deposit accounts         | 2,340.4                                   |
| + Money market mutual fund shares (noninstitutional)         | 923.7                                     |
| Total M2   | 5,802.5                                   |
| M3 = M2  |   |
| + Large-denomination time deposits and repurchase agreements | 1,105.2                                   |
| + Money market mutual fund shares (institutional)            | 767.7                                     |
| + Repurchase agreements                                      | 511.7                                     |
| + Eurodollars  | 341.1                                     |
| Total M3   | 8,528.2                                   |

Source: www.federalreserve.gov/releases/h08hist.

Note: The *Traveler's checks* item includes only traveler's checks issued by non-banks, while traveler's checks issued by banks are included in the *Demand deposits* item, which also includes checkable deposits to businesses and which also do not pay interest.

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## Growth Rates of Fed's Monetary Aggregates



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## How Reliable Are M2 Money Data: Data Revisions

**Table 2 Growth Rate of M2: Initial and Revised Series, 2002**  
(percent, compounded annual rate)

| Period    | Initial<br>Rate | Revised<br>Rate | Difference<br>(Revised Rate - Initial Rate) |
|-----------|-----------------|-----------------|---|
| January   | 2.2             | 5.4             | -3.2  |
| February  | 6.8             | 8.7             | 1.9   |
| March     | -1.4            | 0.2             | 1.6   |
| April     | -4.0            | -2.6            | 1.4   |
| May       | 14.8            | 15.4            | 0.6   |
| June      | 7.6             | 7.1             | -0.5  |
| July      | 13.6            | 11.0            | -2.6  |
| August    | 9.9             | 8.6             | -1.3  |
| September | 5.1             | 5.7             | 0.6   |
| October   | 10.9            | 8.3             | -2.6  |
| November  | 10.2            | 8.0             | -2.2  |
| December  | <u>-2.8</u>     | <u>-2.8</u>     | <u>0.0</u>                                  |
| Average   | 6.5             | 6.5             | 0.0   |

Source: Federal Reserve Statistical Release H.6. [www.federalreserve.gov/releases/h6](http://www.federalreserve.gov/releases/h6).