Chapter 2
The Role of Money in the Macroeconomy

Introduction
- What is finance
- Dimension of finance
- Sectors of economy
- Importance of financial system
- Govt. interest in financial sector
  * What is money
  - Why hold financial assets

What is Finance?
Finance is "the science of managing money."
Finance has two significant dimensions:
  (1) return
  (2) risk

The higher the risk is perceived the greater the return will be required. The more variable the return on an investment, the greater the likelihood of loss.

An individual's or a complex of financial markets and institutions. A financial system includes the instruments, and institutions, markets, and rules governing the routing of funds from buyers to sellers and from savers to lenders. The monetary system is that part of the financial systems that encompasses only the institutions, including the central bank that is involved in the creation and the distribution of money.

In the monetary sector, we are interested in how institutions make available to the lender and borrower their services. How does a bank manage its loan portfolio in order to meet the needs of the borrower and provide a profit for the stockholder? What are the constraints involved in their ability to meet this need? These constraints include the Federal Reserve's regulatory influence, competitors within the monetary sector, innovations in the financial system such as money market accounts and general economic states.
Economy

Monetary/Fiscal Policy

Financial System

Financial Sector

Instruments, institutions, markets, rules

Financial markets & institutions

Institutions
Money & Prices

* Define:
  money
  income
  wealth

• Properties of money – Functions of Money
  Medium of exchange
  Standard of value
  Store of Value

History of money
  specie
    - monetary value
    - intrinsic value
  fiat money

Measures of Money
  Appear in WSJ every Friday
  M1---most liquid assets ---demand deposits, other checkable, and currency outside banks
  M2---M1+small denominations time deposits,money-market accounts, savings, and retail
    money market mutual funds
  M3---M2+ large denomination time deposits, institutional money market mutual funds,
    repos, and Eurodollars
  L---M3 plus liquid assets (savings bonds, ST T-Bills, Commercial Paper)

Who determines the money Supply?
  Central bank is responsible for national monetary policy
  Federal Reserve System
    Determine the total of currency and demand/other checkable deposits
    66% of money supply is in the form of checking accounts

Money permits the separation of the act of investment from the act of saving
  People can invest without first saving and people can save without investing
  I.e. Buy home by borrowing from savers

• Value of Money
  Determined by the price level of the goods money is used to buy
  Inflation reduces the value of money (CPI)

Banks create money (checking accounts) by making loans and buying securities
  Banks can only create money if it has excess reserves

How large should the money supply be?
  Large enough to generate a level of spending on new domestically produced
    goods and services —growing GDP that produces high employment at
    stable prices

  Economic stabilization
    Increasing the money supply in a recession
    Decreasing the money supply during a boom
Velocity
Relationship between the increase in GDP over a period of time and the initial change in the money supply.
Velocity of total amount of money in country by dividing total GDP by the total money supply.
Federal Reserve main job is to regulate the flow of spending. The flow of spending depends upon (1) supply of money and (2) the velocity.

Inflation
An increase in the money supply is a necessary condition for continuation of inflation but not a sufficient condition. Increase in money supply will not increase inflation if velocity falls. Even if velocity remains unchanged, if production expands, inflation does not necessarily occur.

As full employment and capacity output are reached, increases in money supply become more likely to cause inflation. Only when money supply increases under conditions of high employment and exceeds the requirements of economic growth can it be held responsible for inflation.