

Chapter 11, Money and Banking

IN CLASS: Stocks, bonds and mutual fund notes (beginning of lecture) are in chapter 10+ notes.

A. Overview

1. Functions of money:
 - a. Medium of exchange (contrast w. barter)
 - b. Unit of account (a standard)
 - c. Store of value (wealth)
2. Types of money
 - a. Commodity money: gold, silver, copper, cattle, rocks, shells
 - 1) Requirements: divisibility, uniformity, size, durability
 - 2) Examples: Silver and gold; Cigarettes in POW camps
 - 3) Paper money (has exchange merits)
 - a) Historically, debt notes
 - i. Initially, payment for storing/safekeeping valuables
 - ii. Later, loans and the "fractional reserve" system
 - b) Later, "silver certificates", exchangeable
 - b. Fiat money (a fiduciary system: faith)
3. Measuring money: money is CURRENCY and DEPOSITS owned by individuals
 - a. 2000 M1 (\$1105B), the narrow definition of money: Checkable deposits (\$579B), coins and paper (\$518B), traveler's checks (\$8B)
 - b. 2000 M2 (\$4683B), the broad definition of money: ...plus savings deposits, time deposits, money market mutual funds and other deposits
 - c. "Near money": reasonably liquid assets... Credit cards? Plastic money...? No.

B. Money (actually, Deposit) Creation

1. T-accounts
 - a. Assets: If paper is converted to cash, bank cash will increase!
 - b. Liabilities plus net worth: Reverse the above.
2. Immigrant example: Japanese immigrant deposits 10 million yen (\$100,000)
 - a. Required reserves (with $rrr=.2$) = $0.2 * \$100,000$.
 - b. Excess reserves = $(1-.2) * \$100,000 = \$80,000$ (also = $\$100,000 - \$20,000$)
 - c. The bank loans its excess reserves.
 - 1) The loan amount is deposited into a checking account.
 - 2) Check is written for full \$80,000 and deposited by someone else into another bank. As the check goes through the Federal Reserve check clearing process, this bank will then have \$64,000 in excess reserves which it can loan out....
 - 3) Money creation is original \$100,000 plus \$80,000 plus \$64,000 plus....
3. Widow(er) example: \$100,000 in mattress deposited into bank.
 - 1) The initial shock is not money creation (cash held by the public has decreased, while the demand deposit balance has increased)
 - 2) Money creation is only the maximum loan (\$80,000) divided by rrr.
4. Summary: the \$80,000 loan from Bank A is deposited in Bank B, which can then loan \$64,000 which is deposited in Bank C,
5. Money creation has a "theoretical maximum": initial shock/rrr
 - a. Banks must loan out their entire excess reserves.
 - b. Each loan recipient must redeposit full amount (no leakage).