What is Money
FINANCIAL SECTOR & THE ECONOMY

Part One: What is Money?

CHAPTER 12

The Financial Sector and the Economy

Chapter Goals

➤ Discuss the functions and measures of money
➤ Define banks and explain how they create money
➤ Explain why the financial sector is so important to macroeconomic debates
➤ Explain the role of interest rates in an economy
The Financial Sector and the Economy

- The financial sector is central to almost all macroeconomic debates.
- The real sector is the market for the production and exchange of goods and services.
- The financial sector is the market for the creation and exchange of financial assets.
  - Financial assets include money, stocks, and bonds.
  - Plays a central role in organizing and coordinating our economy.

The Definition and Functions of Money

- Money is a highly liquid financial asset that serves as:
  - Medium of exchange
  - Unit of account
  - Store of wealth
- Liquid means to be easily changeable into another asset or good.
- Money is a financial asset that makes the real economy function smoothly.

Medium of Exchange

- The most important job of money is to serve as a medium of exchange.
- When any good or service is purchased, people use money.
- Money makes it easier to buy and sell because money is universally accepted.
- Money, then, provides us with a shortcut in doing business.
- By acting as a medium of exchange, money performs its most important function.
Money as a Medium of Exchange

- Money facilitates exchange by reducing the cost of trading.
- Without money, we would have to barter.

Money As a Medium of Exchange

- Money does not have to have any inherent value to function as a medium of exchange.

- All that is necessary is that everyone believes that other people will exchange it for their goods.

Standard of Value (from another textbook)

- Money is a common denominator in which the relative value of goods and services can be expressed.

  - A job that pays $2 an hour would be nearly impossible to fill, while one paying $30 an hour would be swamped with application
Money as a Unit of Account

- Money is used as a common denominator to measure the relative values of goods and services.
- Without money, we would have to measure the value of goods and services in terms of other goods and services.
- Money is a useful unit of account only if its value relative to the average of all other prices doesn’t change too quickly.

Money as a Store of Wealth

- Money is a financial asset that can be used to store wealth (income that you have saved and not consumed).
- As a store of wealth, money pays no interest, but is perfectly liquid.
- Money’s usefulness as a store of wealth depends on how well it maintains its value.

Money versus Barter

- Without money, the only way to do business is by bartering
- For barter to work, I must want what you have and you must want what I have
- This makes it pretty difficult to do business
- “Everything, then, must be assessed in money: for this enables men always to exchange their services, and so makes society possible”
- Aristotle, Nicomachean Ethics