


What is Money

FINANCIAL SECTOR & THE ECONOMY

Part One What is Money?

CHAPTER 12

The Financial Sector and the Economy



“The peculiar essence of our banking system is an unprecedented trust between man and man; and when that trust is much weakened by hidden causes, a small accident may greatly hurt it, and a great accident for a moment may almost destroy it.”

— Walter Bagehot

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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 a:
 - 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 \$50 an hour would be swamped with application

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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

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