



W04: Money

1. Define money and describe its functions
2. Define a depository institution
3. Explain the economic functions of banks

Reading: Ch 8, pages 182-188



What is Money?

Money is any commodity or token that is generally acceptable as a means of payment

Money has three other functions:

- Medium of exchange
- Unit of account
- Store of value



Functions of Money

Medium of Exchange

A medium of exchange is an object that is generally accepted in exchange for goods and services

In the absence of money, people would need to exchange goods and services directly, which is called **barter**

Barter requires a double coincidence of wants, which is rare, so barter is costly



Functions of Money

Unit of Account

A *unit of account* is an agreed measure for stating the prices of goods and services

Store of Value

As a *store of value*, money can be held for a time and later exchanged for goods and services





Money in The U.S. Today

Consists of:

- **Currency** – the notes and coins held by individuals and businesses
- **Deposits** at banks and other depository institutions



Measures of Money

The two main official measures of money in the United States are M1 and M2

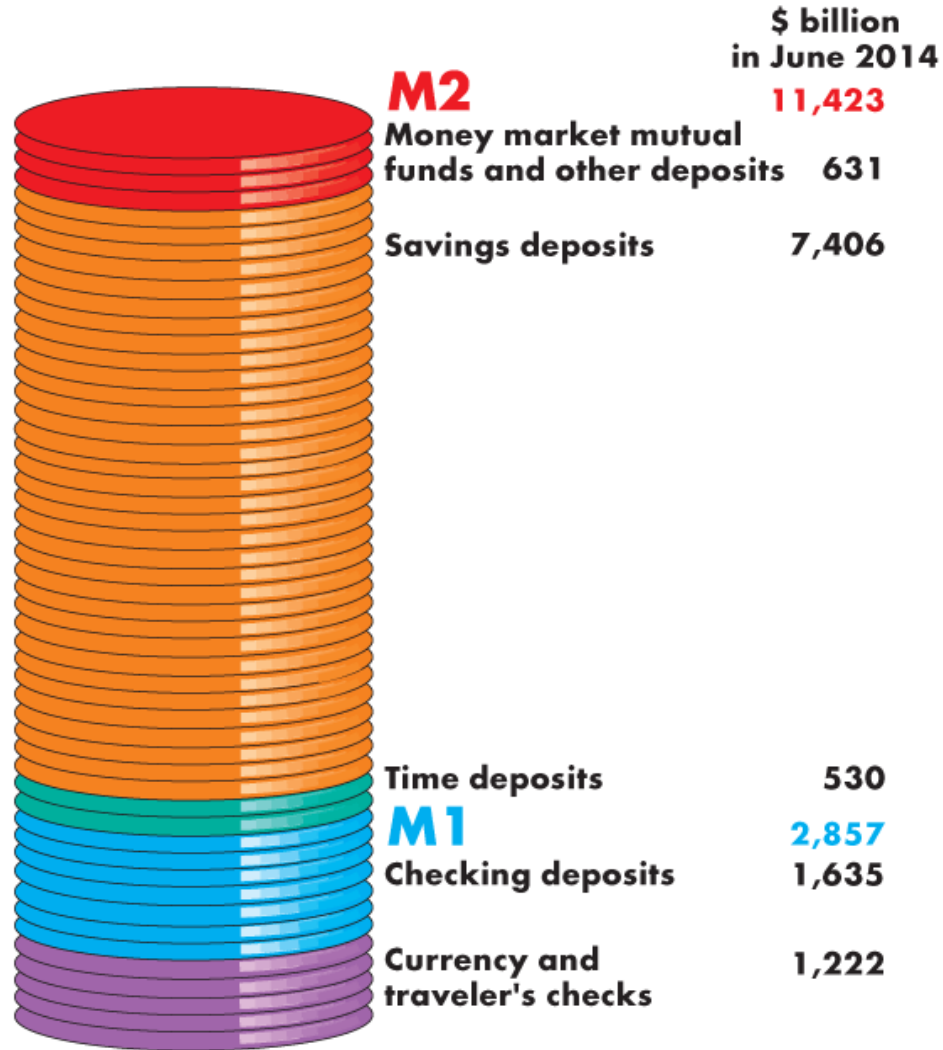
M1:

1. currency
2. traveler's checks
3. checking deposits owned by individuals and businesses

M2:

1. M1
2. time deposits
3. saving deposits
4. money market mutual funds
5. and other deposits

What is Money?



Two Measures of Money





Are M1 and M2 Really Money?

All the items in M1 are means of payment, so they are *money*

Some saving deposits in M2 are not means of payments — they are called liquid assets

Liquidity is the property of being instantly convertible into a means of payment with little loss of value



What is Money

Are checks money?

- A **check** is an instruction to a bank to transfer money
- The deposit on which a check is written is money

Are credit cards money?

- A credit card enables the holder to obtain a loan
- It must be repaid with money



Depository Institutions

A **depository institution** is a firm that takes deposits from households and firms and makes loans to other households and firms

Types of Depository Institutions

- Commercial banks
- Thrift institutions
- Money market mutual funds



Types of Depository Institutions

Commercial Banks

Private firms that are licensed by the Comptroller of the Currency or by a state agency to receive deposits and make loans

Thrift Institutions

Savings and loan associations, savings banks, and credit unions

Money Market Mutual Funds

A money market mutual fund is a fund operated by a financial institution that sells shares in the fund and holds assets such as U.S. Treasury bills



What Do Depository Institutions Do?

The goal of any bank is to maximize the wealth of its owners

To achieve this objective, the interest rate at which it lends exceeds the interest rate it pays on deposits

But the banks must balance profit and prudence:

- Loans generate profit
- Depositors must be able to obtain their funds when they want them



What Do Depository Institutions Do?

A commercial bank puts the depositors' funds into:

- **Cash assets** – notes and coins in its vault or its deposit at the Federal Reserve
- **Securities** – U.S. government Treasury bills and commercial bills and longer-term U.S. government bonds and other bonds such as mortgage-backed securities
- **Loans** – commitments of fixed amounts of money for agreed-upon periods of time



What Do Depository Institutions Do?

TABLE 8.2 Commercial Banks: Sources and Uses of Funds

	Funds (billions of dollars)	Percentage of deposits
Total funds	14,662	144.3
Sources		
Deposits	10,161	100.0
Borrowing	1,698	16.7
Own capital and other sources (net)	2,803	27.6
Uses		
Cash Assets	2,850	28.0
Securities	2,809	27.6
Loans	7,666	75.4
Other assets	1,337	13.2





Economic Benefits Provided by Depository Institutions

- Create liquidity
- Pool risk
- Lower the cost of borrowing
- Lower the cost of monitoring borrowers



Regulation of Depository Institutions

- Depository institutions are required to hold levels of reserves and owners' capital equal to or that surpass the ratios laid down by regulation
- If a depository institution fails, deposits are guaranteed up to \$250,000 per depositor per bank by the **FDIC** – Federal Deposit Insurance Corporation