FINC 402
Monetary Theory

Session 1 – Why Study Money and Monetary Policy?

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Session Overview

In this session, we will explore;

- the functions of money,
- why and how it promotes economic efficiency,
- how its form have evolved over time

Session Outline

The key topics to be covered in the session are as follows:

- Why should accountants and financial analysts be interested in monetary theory?
- Describe what money is and was
- List and summarize the key functions of money

Reading List

- Frederic S. Mishkin, The Economics of Money, Banking, and Financial Markets, 7th or 9th edition (Addison Wesley: New York).
- Walsh, Carl E. Monetary theory and policy. MIT press, 2010.

Topic one

WHY SHOULD ACCOUNTANTS AND FINANCIAL ANALYSTS BE INTERESTED IN MONETARY THEORY?

Why should accountants and financial analysts be interested in monetary theory?

- Majority of us are going to be working with financial institutions (Financial intermediaries, banks, insurance companies, pension funds, mutual funds etc.).

Financial intermediaries: institutions that borrow funds from people and give loans to others.

- Banks: institutions that accept deposits and make loans.

- And therefore it is important to understand how financial institutions work.

- Also, importantly, to understand the role of money in the economy.

Why should accountants and financial analysts be interested in monetary theory?

- Money, also referred to *as the money supply*, is defined as anything that is generally accepted in payment for goods or services or in the repayment of debts.

- Money plays a key role in generating business Cycles (recessions and booms).

- Business Cycles are upward and downward movement of aggregate output produced in the economy. (follow on screen description how many impacts economic growth)

- Business cycles affect all of us in immediate and important ways. When output is rising, for example, it is easier to find a good job; when output is falling, finding a good job might be difficult.

Why should accountants and financial analysts be interested in monetary theory?

- Recession (unemployment) and economic booms affect all of us.

- Changes in the money supply impacts changes in *aggregate economic activity and inflation*.

Topic Two

ROLE AND NATURE OF MONEY

Role and nature of money

What Is Money?

- Money has been different things at different times; however, it has always been important to people and to the economy.
- To understand the effects of money on the economy, we must understand exactly what money is.
- We will explore the key functions of money, looking at why and how it promotes economic efficiency.

Role and nature of money

Meaning of Money?

- As the word money is used in everyday conversation, it can mean many things, but to economists, it has a very specific meaning.

- Economists define money *(also referred to as the money supply)* as anything that is generally accepted in payment for goods or services or in the repayment of debts.

- Currency, consisting of cedi bills, euro bills, dollar bills and coins, clearly fits this definition and is one type of money.

- When most people talk about money, they're talking about currency (paper money and coins).

Role and nature of money

Meaning of Money?

- To define money merely as currency is much too narrow for economists.
- Because cheques are also accepted as payment for purchases, checking/current account deposits are considered money as well.
- An even broader definition of money is often needed, because other items such as savings deposits can in effect function as money if they can be quickly and easily converted into currency or checking/current account deposits.

Role and nature of money

Meaning of Money?

- To complicate matters further, the word money is frequently used synonymously with wealth. When people say, “Mike is rich—he has an awful lot of money,” they probably mean that Mike has not only a lot of currency and a high balance in his checking account but has also stocks, bonds, four cars, three houses, and a yacht.

- Thus while “currency” is too narrow a definition of money, this other popular usage is much too broad.

Topic Three

FUNCTIONS OF MONEY

Functions of Money

- Whether money is kola or shells or rocks or gold or paper, it has three primary functions in any economy:

- Medium of Exchange
- Unit of account
- Store of value

Functions of Money

Medium of Exchange

- In almost all market transactions in our economy, money in the form of currency or cheque is a medium of exchange; it is used to pay for goods and services.

- The use of money as a medium of exchange promotes economic efficiency by minimizing the time spent in exchanging goods and services.

- HOW??
- Use the scenario of a Finance/Economics Professor, who can do just one thing well: give brilliant monetary theory lectures.

Functions of Money

Medium of Exchange

- In a barter economy, if the Professor wants to eat, she must find a farmer who not only produces the food he likes but also wants to learn economics. As you might expect, this search will be difficult and time-consuming, and Ellen might spend more time looking for such an economics-hungry farmer than she will be teaching.

- It is even possible that she will have to quit lecturing and go into farming herself. Even so, she may still starve to death.

Functions of Money

Medium of Exchange

- The time spent trying to exchange goods or services is called a transaction cost.

- In a barter economy, transaction costs are high because people have to satisfy a “double coincidence of wants”—they have to find someone who has a good or service they want and who also wants the good or service they have to offer.

- The use of money as a medium of exchange there promotes economic efficiency by minimizing the time spent in exchanging goods and services.

Functions of Money

Medium of Exchange

For a commodity to function effectively as money, it has to meet several criteria:

- It must be easily standardized, making it simple to ascertain its value;
- It must be widely accepted;
- It must be divisible, so that it is easy to "make change";
- It must be easy to carry; and
- It must not deteriorate quickly.

Examples of money (in history): Tobacco, whiskey, cigarettes used in prisoner-of-war camps, beads etc

Functions of Money

Unit of Account

- The second role of money is to provide a unit of account; that is, it is used to measure value in the economy. We measure the value of goods and services in terms of money.
- Just as we measure weight in terms of kilograms or distance in terms of kilometers.
- To see why this function is important, let’s look again at a barter economy where money does not perform this function.

Functions of Money

Unit of Account

- If the economy has only three goods—say, Plantain, books, and pens—then we need to know the price (value) of a kilo of plantain in terms of books or pens. In other words, how many kilos of plantain you have to pay for a book or pen or how many books (exercise book, textbook etc.) you have to pay for a pen.

- This will indeed become more complicated with more than three goods.

- The solution to the problem is to introduce money into the economy and have all prices quoted in terms of units of that money

Functions of Money

Unit of Account

- We can see that using money as a unit of account reduces transaction cost
- The benefits of this function of money grow as the economy becomes more complex.

Functions of Money

Store of Value

- Money also functions as a store of value; it is a repository of purchasing power over time.
- A store of value is used to save purchasing power from the time income is received until the time it is spent.
- This function of money is useful, because most of us do not want to spend our income immediately upon receiving it, but rather prefer to wait until we have the time or the desire to shop.

Functions of Money

Store of Value

- Money is not unique as a store of value; any asset—whether money, stocks, bonds, land, houses, art, or jewelry—can be used to store wealth.

- Many such assets have advantages over money as a store of value: They often pay the owner a higher interest rate than money, experience price appreciation, and deliver services such as providing a roof over one's head.

Question: If these assets are a more desirable store of value than money, why do people hold money at all?

Functions of Money

Store of Value

- The answer to this question relates to the important economic concept of liquidity, the relative ease and speed with which an asset can be converted into a medium of exchange.

- Liquidity is highly desirable. Money is the most liquid asset of all because it is the medium of exchange; it does not have to be converted into anything else in order to make purchases. Other assets involve transaction costs when they are converted into money.

Examples?

Functions of Money

Thank You