

Macroeconomic Definitions -- Dr. Tom McGahagan -- Spring 2005

VI. MONEY

1. **Money.** A generally acceptable medium of exchange, which also may function as a unit of account, as a standard of deferred payment, and as a store of value. Distinguish **money** from other **financial assets** (bonds, stocks, savings accounts)
2. **Medium of exchange.** Exchange by barter involves a "double coincidence of wants" -- the buyer must have precisely the good the seller wishes to acquire, and must be willing to part with it. Since this is improbable for most transactions, a generally acceptable medium of exchange will lower transactions costs to far below what they would be in a barter economy.
3. **Legal tender.** The legal obligation to accept money as payment for goods or in fulfillment of debts. Not included as part of the definition of money, since the government's assertion that a piece of paper is legal tender does not necessarily mean that people will in fact accept it (especially during hyperinflation), and pieces of paper which are not legal tender have in fact been widely and generally accepted (US banknotes issued by banks before the Civil War, claims on checking accounts today).
4. **Unit of account.** The measure of the value of goods is of course usually done in terms of the circulating unit of currency, but not necessarily. American colonists kept accounts in pounds sterling even when the circulating currency was Spanish dollars; the Dutch still abbreviate the guilder as fl., a survival from the day when their accounts were kept in florins issued by the Italian city-state of Florence; English shopkeepers often quote prices in guineas, a coin that has not circulated since the seventeenth century.
5. **Standard of deferred payment.** Contracts for later payment of wages and debts are denominated in monetary terms.
While this is an aspect of the "unit of account" function of money, it is of great importance in understanding the effects of inflation and therefore is listed separately.
6. **Store of value.** Money will store value in the sense that (as long as the issuer of money honors the money it has issued) it will preserve its nominal value. There is however no guarantee money will preserve its real value; its real value will diminish with inflation. Holding money also bears an **opportunity cost**, namely the opportunity to collect interest on other assets.
7. **Opportunity cost of holding money.** In making a decision to hold money, you are giving up the opportunity to convert the money into an interest-bearing asset such as a bond or savings account. The INTEREST RATE is therefore the opportunity cost of holding money.
8. **Real value of money.** What money will buy; the reciprocal of the price level.
9. **Asset.** Anything of value that is owned or on which one has a claim. Houses and computers are real assets; stocks, bonds and money are financial assets to their owners (and liabilities to their issuers).
10. **Liquidity.** The quality of an asset which measures its ability to be turned into money more or less rapidly. Money itself is perfectly "liquid", savings accounts only slightly less so (since they require a trip to the bank before they become a generally acceptable medium of exchange). Some financial assets such as US Treasury Bills are highly liquid; others such as stocks in little known companies may be very illiquid. Real assets such as houses or cars are very illiquid, since they may take a long time to convert into money.

11. **M1 measure of money.** The sum of currency and cash in circulation, of traveller's checks, and of checkable deposits. This is the measure which corresponds to the "medium of exchange" definition of money. Note that "vault cash" is excluded, since it is not in circulation.

12. **Checkable deposits.** Either "**demand deposits**" or standard checking accounts (which bear no interest and on which the bank issuing them has the legal obligation to make payment immediately on demand) or "other checkable deposits" such as **NOW** accounts ("negotiable order of withdrawal", but the withdrawal is technically in one's saving deposit).

13. **M2 measure of money.** M1 plus savings accounts and small certificates of deposit; since savings accounts are so highly liquid as to be "near money", this may be in practice a better measure of people's demand for a medium of exchange than the M1 definition.

14. **Bank.** A financial intermediary which accepts deposits, makes loans, and creates about half of the money supply by creating checking deposits.

15. **Reserves.** Money kept on hand at a bank ("**vault cash**") or on deposit at the Federal Reserve in order to meet its customers demand for payment or the Federal Reserve regulations.

16. **Required reserves.** The level of reserves the Federal Reserve requires banks to keep; currently about 3 percent of demand deposits.

17. **Reserve ratio.** The ratio of required reserves to deposits.

18. **Excess reserves.** Reserves in excess of requirements, kept for the purpose of safety or because safe loans do not appear to exist.

19. **Money multiplier.** The factor by which banks can increase the money supply given an increase in their reserves. This will be the reciprocal of the reserve ratio (if banks do not hold excess reserves and if all payments are redeposited).

20. **Central Bank.** The officially recognized central bank has the power to control the money supply of a country and often regulatory powers over the rest of the banking system. Examples include the Bank of the United States established by Alexander Hamilton, the Federal Reserve System established in 1913, the Bank of England (1694), the Bundesbank or German central bank, and the European Central Bank established in 1999.

21. **Federal Reserve System.** The central bank of the United States. Directors of the Board of Governors of the Fed are partly named by the government (but not removable), and partly by the member banks of the Fed. It has the power to set the reserve ratio which all banks must observe, make discount window loans, and conduct open market operations.

22. **Discount window.** Direct loans by the Federal Reserve to member banks. The "discount rate" or interest rate on discount loans can be set directly by the Fed and is the only interest rate which can be set directly by the Fed.

23. **Open market operations.** The buying or selling of Treasury securities on the open market by the Fed. The most important policy tool of the Fed. If the Fed buys Treasury securities, their price will tend to rise, their interest rate will tend to fall and the money supply will increase. The **Federal Open Market Committee** is the body which sets Fed monetary policy.