CHAPTER 29

The Monetary System

PRINCIPLES OF
Economics
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Premium PowerPoint Slides
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In this chapter, look for the answers to these questions:

- What assets are considered "money"? What are the functions of money? The types of money?
- What is the Federal Reserve?
- What role do banks play in the monetary system? How do banks "create money"?
- How does the Federal Reserve control the money supply?

What Money Is and Why It's Important

- Without money, trade would require **barter**, the exchange of one good or service for another.
- Every transaction would require a **double coincidence of wants**
- Most people would have to spend time searching for others to trade with – a huge waste of resources.
- This searching is unnecessary with **money**,

The 3 Functions of Money

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

The 2 Kinds of Money

Commodity money:

Fiat money:

The Money Supply

- The **money supply** (or **money stock**):
- What assets should be considered part of the money supply? Two candidates:
  - **Currency**: the paper bills and coins in the hands of the (non-bank) public
  - **Demand deposits**:

Measures of the U.S. Money Supply

- **M1**:

  M1 = $1.4 trillion (June 2008)

- **M2**: everything in M1 plus

  M2 = $7.7 trillion (June 2008)

> ***The distinction between M1 and M2 will usually not matter when we talk about "the money supply" in this course.***

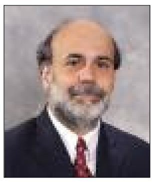
Central Banks & Monetary Policy

- **Central bank**:
- **Monetary policy**:
- **Federal Reserve (Fed)**:

The Structure of the Fed

The Federal Reserve System consists of:

- **Board of Governors** (7 members), located in Washington, DC
- **12 regional Fed banks**, located around the U.S.
- **Federal Open Market Committee (FOMC)**, includes the Bd of Govs and presidents of some of the regional Fed banks
  The FOMC decides monetary policy.



Ben S. Bernanke
Chair of FOMC, Feb 2006 – present

Bank Reserves

- In a **fractional reserve banking system**,
- The Fed establishes **reserve requirements**,
- Banks may hold more than this minimum amount if they choose.
- The **reserve ratio**, ***R***

Bank T-account

- **T-account**: a simplified accounting statement that shows a bank's assets & liabilities.
- Example:

FIRST NATIONAL BANK	
Assets	**Liabilities**

- Banks' liabilities include assets include
- In this example, notice

Banks and the Money Supply: An Example

Suppose $100 of currency is in circulation.

To determine banks' impact on money supply, we calculate the money supply in 3 different cases:

1. No banking system
2. 100% reserve banking system: banks hold 100% of deposits as reserves, make no loans
3. Fractional reserve banking system

Banks and the Money Supply: An Example

CASE 1: No banking system

Public holds the $100 as currency.

Money supply =

Banks and the Money Supply: An Example

CASE 2: 100% reserve banking system

Public deposits the $100 at First National Bank (FNB).

FNB holds 100% of deposit as reserves:

FIRST NATIONAL BANK	
Assets	**Liabilities**
Reserves	Deposits
Loans	

Money supply
= currency + deposits =

In a 100% reserve banking system,

Banks and the Money Supply: An Example

CASE 3: Fractional reserve banking system

Suppose ***R*** = 10%. FNB loans all but 10% of the deposit:

FIRST NATIONAL BANK	
Assets	**Liabilities**
Reserves	Deposits
Loans	

Money supply =
Depositors have
Borrowers have

Banks and the Money Supply: An Example

CASE 3: Fractional reserve banking system

How did the money supply suddenly grow?

When banks make loans,

The borrower gets

- $90 in currency (an asset counted in the money supply)
- $90 in new debt (a liability)

A fractional reserve banking system

Banks and the Money Supply: An Example

CASE 3: Fractional reserve banking system

Suppose borrower deposits the $90 at Second National Bank (SNB).

Initially, SNB's T-account looks like this:

SECOND NATIONAL BANK			
Assets		**Liabilities**	
Reserves	$ 90	Deposits	$ 90
Loans	$ 0		

If ***R*** = 10% for SNB, it will loan all but 10% of the deposit.

Banks and the Money Supply: An Example

CASE 3: Fractional reserve banking system

The borrower deposits the $81 at Third National Bank (TNB).

Initially, TNB's T-account looks like this:

THIRD NATIONAL BANK			
Assets		**Liabilities**	
Reserves	$ 81	Deposits	$ 81
Loans	$ 0		

If ***R*** = 10% for TNB, it will loan all but 10% of the deposit.

Banks and the Money Supply: An Example

CASE 3: Fractional reserve banking system

The process continues, and money is created with each new loan.

Original deposit	=	$ 100.00
FNB lending	=	$ 90.00
SNB lending	=	$ 81.00
TNB lending	=	$ 72.90
⋮		⋮
Total money supply =		

In this example,

The Money Multiplier

- **Money multiplier**:
- The money multiplier equals
- In our example,

  R = 10%

  money multiplier =

  $100 of reserves creates

ACTIVE LEARNING ***1***

Banks and the money supply

While cleaning your apartment, you look under the sofa cushion find a $50 bill (and a half-eaten taco). You deposit the bill in your checking account.

The Fed's reserve requirement is 20% of deposits.

A. What is the maximum amount that the money supply could increase?

B. What is the minimum amount that the money supply could increase?

ACTIVE LEARNING **1**

Answers

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The Fed's 3 Tools of Monetary Control

1. **Open-Market Operations (OMOs)**:

- To increase money supply,

- To reduce money supply,

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The Fed's 3 Tools of Monetary Control

- OMOs are easy to conduct,

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The Fed's 3 Tools of Monetary Control

2. Reserve Requirements (RR):

- <u>To increase money supply</u>,
- <u>To reduce money supply</u>,

The Fed's 3 Tools of Monetary Control

3. **The Discount Rate**:

- When banks are running low on reserves, they may borrow reserves from the Fed.
- <u>To increase money supply</u>,
- <u>To reduce money supply</u>,

The Fed's 3 Tools of Monetary Control

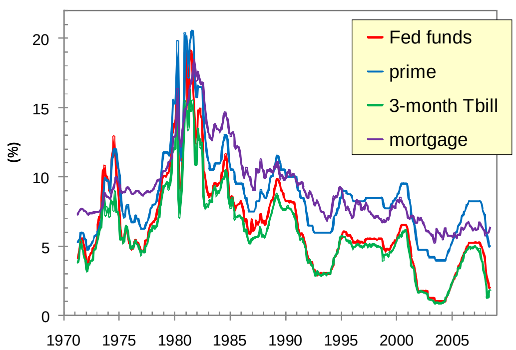
- The Fed uses discount lending to provide extra liquidity when financial institutions are in trouble, *e.g.* after the Oct. 1987 stock market crash.
- If no crisis,

The Federal Funds Rate

- On any given day, banks with insufficient reserves can borrow from banks with excess reserves.
- the **federal funds rate**

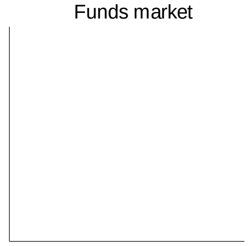
- Many interest rates are highly correlated, so changes in the fed funds rate cause changes in other rates and have a big impact in the economy.

The Fed Funds Rate and Other Rates, 1970-2008



Monetary Policy and the Fed Funds Rate

The Federal Funds market



Problems Controlling the Money Supply

- If households
- If banks
- Yet, Fed can compensate for household and bank behavior to retain fairly precise control over the money supply.

Bank Runs and the Money Supply

- A **run on banks**:
- Under fractional-reserve banking, banks don't have enough reserves to pay off ALL depositors, hence banks may have to close.
- Also, banks may make fewer loans and hold more reserves to satisfy depositors.

Bank Runs and the Money Supply

- During 1929-1933, a wave of bank runs and bank closings caused money supply to fall 28%.
- Many economists believe this contributed to the severity of the Great Depression.
- Since then,
- In the U.K., though, Northern Rock bank experienced a classic bank run in 2007 and was eventually taken over by the British government.