Chapter 7: Money and Banking

Preamble

• Economists view money as one form of holding wealth.
• It is possible to be wealthy yet hold no money.
• The problem with holding money is that money, itself, does not accumulate; that is, you cannot earn a return from money alone (to do so requires converting the money into a bond, stock, etc.).
• Adam Smith relates money to a river: it brings the goods to the market, but does not affect the actual volume of goods (thus it is a veil that conceals the phenomenon of real product lying behind it).
• Historically, the influx of gold into sixteenth- and seventeenth-century colonies in Europe resulted in demand-pull inflation, since the amount of money in the economy increased rapidly while the volume of production changed slowly.

7.1 The Functions and Characteristics of Money

• There are three key functions of money: a medium of exchange, a store of wealth, and a unit of account.
• Money acts as a medium of exchange, meaning that it is accepted as payment for goods and services.
  o It is far easier to work with than bartering, which requires the double coincidence of wants.
  o For example, Zach wants to buy wool from Kelly but only has goats to sell; if Kelly has a need for goats, the exchange will occur, but if this double coincidence of wants is non-existent, then Zach cannot complete the exchange without getting other people (intermediaries) involved.
  o The barter system thus requires great effort to execute and has high transaction costs; money reduces this wasted effort.
• Money acts as store of wealth in that it allows people to hold and accumulate wealth.
  o Money can be stored in stocks, bonds, and other venues, but these are not as convenient and can carry high risk.
• Money acts as a unit of account, meaning that it acts a uniform measure of value, allowing us to determine easily the relative values of goods.
  o We thus can compare prices, incomes, levels of savings and debts, etc.
• Still, the value of money is relative—its worth it determined by what it can purchase.
  o Thus, the value of money is related inversely to the price level; as the price level rises, the value of a monetary unit declines because it can purchase less and less.
• Money should be acceptable (agreed upon as a medium of exchange), durable (so the economy does not waste money on replacing money), portable (so that it can be carried around easily for exchange), divisible (into different unit sizes), easily recognized (to facilitate easy exchange), and relatively scarce (to keep demand for goods and service, and the overall perception of wealth, in check).

7.2 Different Kinds of Money

• Commodity money refers to items that have intrinsic values in and of themselves; this type of money can also function, and is useful, as a commodity.
• Gold (or other precious metals) has been used as money over the ages because it is portable, durable, and scarce; however, it does not come in standardized units.
• Civilizations created coins in specific sizes and weights to address this issue, although abuse of gold was common (i.e. taking the soft gold coins and using them to produce money out of money).
• Because gold was heavy, people in Europe in the Middle Ages began depositing their money in a goldsmith’s vault, for which they received a certificate from the goldsmith acknowledging the deposit.
These certificates could be transferred from person to person, thus leading to the introduction of paper money.

- In the eighteenth century, commercial banks were formed and took over the functions of the goldsmiths, including the issuance of paper money.
- Since 1935, the Bank of Canada is the only bank with the power to issue currency (sometimes called fiat money as it is legal tender) in Canada.
- Wariness of carrying large sums of money around led to the advent of chequebook money, that is, the use of a standardized form (a cheque) which tells the bank to transfer a sum of money from the customer’s account to the account of the person specified on the cheque.
- Banks only keep a small fraction of the amounts that have been deposited; the remainder is lent out.
  - The consequence of this action is that if there is a run on the bank, meaning all account holders want to withdraw their funds, the bank will not have enough funds to satisfy its consumers.

### 7.3 Fractional Reserve Banking

- Goldsmiths learned that the gold deposited into their vaults often sat there uninterrupted for periods on end, so they started to lend out some of it; when they lent it, the borrowers often preferred not to have the physical gold but rather a certificate that verified the borrowers had a certain amount of funds available to them—in other words, goldsmiths could grant loans simply by giving customers a slip of paper, signalling the dawn of fractional reserve banking.
- The **fractional reserve system** is a banking system in which banks keep only a small fraction of their total deposits on reserve in the form of cash.
- Cash that one bank issues to its customers generally finds its way back to another bank, that is, back into the banking system, allowing the fractional reserve system to function relatively (though not entirely) safely.