

# MISHKIN

The Economics of Money, Banking,  
and Financial Markets



TENTH EDITION

## Chapter 3

# What Is Money?



# Meaning of Money

- What is it?
- Money (or the “money supply”): anything that is generally accepted in payment for goods or services or in the repayment of debts.
- A rather broad definition



# Meaning of Money (cont'd)

- Money (a stock concept) is different from:
- **Wealth**: the total collection of pieces of property that serve to store value
- **Income**: flow of earnings per unit of time (a flow concept)



# Functions of Money

- Medium of Exchange:
  - Eliminates the trouble of finding a double coincidence of needs (reduces transaction costs)
  - Promotes specialization
- A medium of exchange must
  - be easily standardized
  - be widely accepted
  - be divisible
  - be easy to carry
  - not deteriorate quickly



# Functions of Money (cont'd)

- Unit of Account:
  - used to measure value in the economy
  - reduces transaction costs
- Store of Value:
  - used to save purchasing power over time.
  - other assets also serve this function
  - Money is the most liquid of all assets but loses value during inflation



# Evolution of the Payments System

- Commodity Money: valuable, easily standardized and divisible commodities (e.g. precious metals, cigarettes).
- Fiat Money: paper money decreed by governments as legal tender.



# Evolution of the Payments System (cont'd)

- **Checks:** an instruction to your bank to transfer money from your account
- **Electronic Payment** (e.g. online bill pay).
- **E-Money** (electronic money):
  - Debit card
  - Stored-value card (smart card)
  - E-cash



# FYI Are We Headed for a Cashless Society?

- Predictions of a cashless society have been around for decades, but they have not come to fruition
- Although e-money might be more convenient and efficient than a payments system based on paper, several factors work against the disappearance of the paper system
- Still, the use of e-money will likely still increase in the future





# Measuring Money

- How do we measure money? Which particular assets can be called “money”?
- Construct monetary aggregates using the concept of liquidity:
- M1 (most liquid assets) = currency + traveler’s checks + demand deposits + other checkable deposits.



# Measuring Money (cont'd)

- M2 (adds to M1 other assets that are not so liquid) = M1 + small denomination time deposits + savings deposits and money market deposit accounts + money market mutual fund shares.



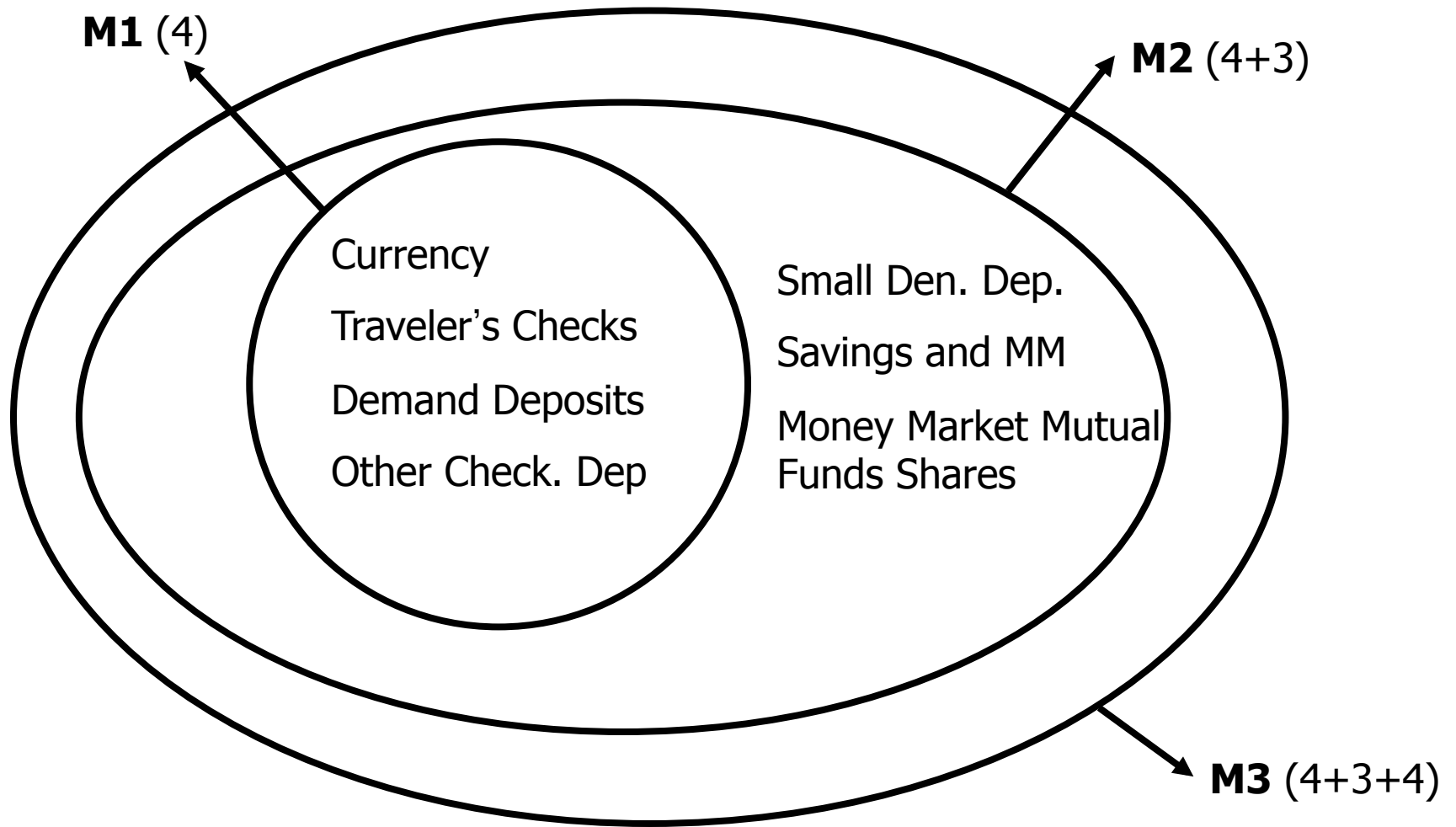
# Table 1 Measures of the Monetary Aggregates

Measures of the Monetary Aggregates	
	<u>Value as of May 16, 2011 (\$ billions)</u>
M1 = Currency	958.8
+ Traveler's checks	4.6
+ Demand deposits	573.1
+ Other checkable deposits	<u>399.0</u>
Total M1	1,935.5
M2 = M1	
+ Small-denomination time deposits	848.3
+ Savings deposits and money market deposit accounts	5,530.4
+ Money market mutual fund shares (retail)	<u>688.4</u>
Total M2	9,002.6

Source: [www.federalreserve.gov/releases/h6/hist](http://www.federalreserve.gov/releases/h6/hist).



# Monetary Aggregates





# M1 vs. M2

- Does it matter which measure of money is considered?
- M1 and M2 can move in different directions in the short run (see figure).
- Conclusion: the choice of monetary aggregate is important for policymakers.

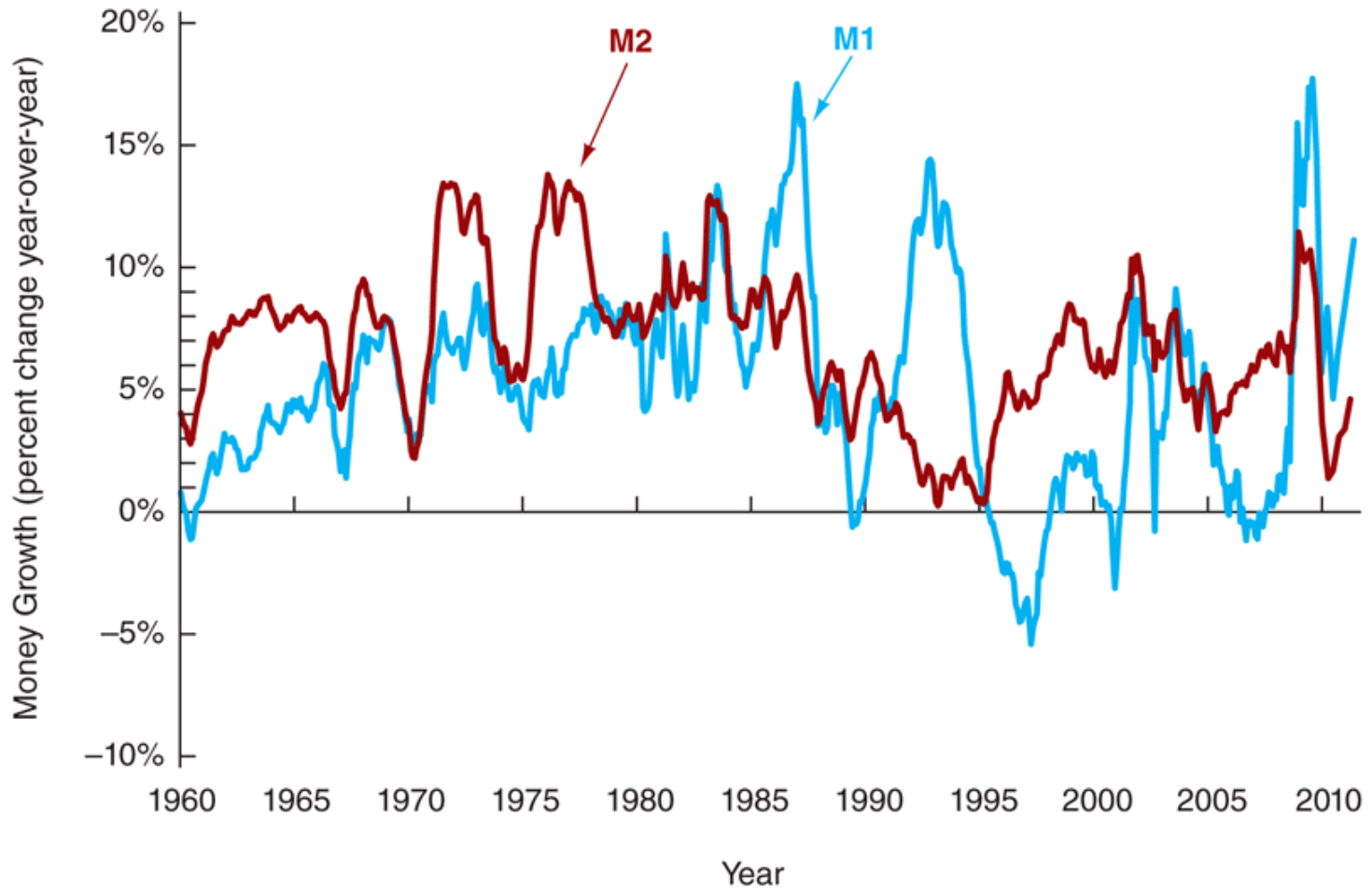


# FYI Where Are All the U.S. Dollars?

- The more than \$2,000 of U.S. currency held per person in the United States is a surprisingly large number
- Where are all these dollars and who is holding them?
  - Criminals
  - Foreigners



# Figure 1 Growth Rates of the M1 and M2 Aggregates, 1960–2011



Sources: **Federal Reserve Economic Database (FRED); Federal Reserve Bank of Saint Louis;**  
<http://research.stlouisfed.org/fred2/categories/25>