

Chapter 3 Money and Prices

A. Money Defined

Money => is a financial asset, just like bonds, stocks and real estate.

M1 is: Currency, Demand deposits- checking account deposits- traveler's checks

How much money does Bill Gates have?

1. What Money Is Not

- a) **Wealth** is not money!
--> total collection of all the store of value.
i.e.: any and all assets
- b) **Income** is not money!
--> compensation for services
--> flow per time period,

Money is a **stock** at a given point in time. An amount of money.

2. What Money Is ...

Def: ANYTHING THAT IS GENERALLY ACCEPTED IN PAYMENT FOR G & S OR IN THE REPAYMENT OF DEBTS.

Ex: Cigarettes in Prison

Also note the need for a price to denominate everything with. We use the price of money. This is called the **numeraire** good. Remember that in economics only relative prices are important.

**Def: Opportunity Cost: Next best alternative
forgone**

- 1) prices need to be easily denominated by a readily understood measure - in the US \$
- 2) specialization is much easier due to the liquidity of money

KNOW THE DEFINITION OF MONEY! WE WILL USE THIS DEFINITION OFTEN AND KEEP IT SEPARATE FROM WEALTH AND INCOME.

3. The Three Functions of Money

1. MEDIUM OF EXCHANGE:

It is used as payment for shirts, shoes, ice cream, religious services –

i.e.: Goods and Services.

Promotes Economic Efficiency

It eliminates or **Decreases Transactions Costs**

i.e.: it lubricates the economy.

2. UNIT OF ACCOUNT:

This function gives us the value of my time teaching you, of the seats you sit on, your breakfast i.e.: The Measure of the Value of the Goods and Services.

3. STORE OF VALUE:

Accumulating dollars means you have more purchasing power; so it serves as a store of purchasing power.

Why hold money?--> **liquidity** -- EASE AND SPEED OF USE

However, the question of **how long** money retains its purchasing power is very important and will cover much of the discussion of this course!

FOR EXAMPLE:

Hyperinflations --> inflation > 50% month

Money loses value rapidly.

Russia: in 1992 the Rubble was at 100/\$, over 1000 in 1993, now it is?

Germany: work 2 hours - spend - then work for 2 more hours etc.

B. The History of Money

This section is mostly just a reading assignment but I do want you to know the basic definitions:

Commodity money- full valued money or metallic money, it has an

- 1) exchange value, and
- 2) intrinsic value.

Fiat money - has no intrinsic value

The penny was the last - but now it's made of a zinc alloy.

C. Measures of Money - M1, M2, M3, and L

Federal Reserve System's Numbers (aggregates)

TRANSPARENCIES:

1) Latest Federal Reserve Data

Assignment: Get the latest data, p. 30.

2) M^S and Targets

What are we really trying to measure here?

THE CHANGE IN THE **PURCHASING POWER** OF THE DOLLAR. THIS THEN TELLS US IF WE REALLY ARE PRODUCING A LARGER QUANTITY.

Let's look at the real money supply; Same Deal as before....

$$\text{Real } M^S = \frac{\text{Nominal } M^S}{P_L \text{ (CPI)}}$$

or

$$\text{Nominal } M^S = \text{Real } M^S \cdot P_L$$

$$\text{Nominal } M1 \cdot 2 X \Rightarrow \text{Real } M1 _ 24\%$$

(Fell and Rose)

When we look to what is the money supply when we look at its function as a store of wealth.

We need to take into account liquidity.

M1: - Cash

M²: - Almost or as good as cash.

How reliable are the Money Data?

The Fed's numbers are revised after first being posted, why?

1. Estimates are used for the first numbers, actual numbers are used in revisions.
2. Seasonal variation adjustments are much better as more data becomes available.

Moral: Don't pay too much attention to short-run changes in the M^S but rather concentrate on longer term movements.