23. Money and Banking

'What is money?' Money is anything that is used to buy/sell goods and services. Money (including credit) is the fuel to the economy.

Before money, there was **bartering…**

Swapping of good(s) for another

Very inefficient/costly. Why?

- **Relies on double coincidence of wants** What you want to buy must be accompanied with what someone wants to sell and vice versa
- **Relative value of goods** How do you quantify and worth?
- **Stops specialisation and division of labour**

So What Defines Money?

Functions of Money

Medium of Exchange
Aid the process exchanging goods/services between people

Measure of Value
Provides a common value where relative values can be compared

Store of Wealth
Allows people to save wealth for the future by depositing it and gaining interest

Means of Payment
Allows for efficient buying/selling (no back and forth as with bartering)

Different Types of Money

Commodity Money
Good whose value serves as value of money i.e. gold coins

Fiat Money
Good whose physical value is less than the value It represents i.e. paper money

Bank Money
Credit created by banks extended to customers via loans, cheques and credit cards

How do Banks Create Credit?

Commercial Banks

- Accept cash from depositors
- Depositors only ever demand a small proportion back to use (around 10%)
- Bank can use the 90% to loan out on credit (keeping enough cash (10%) to meet customers demands)

Reserve Ratio (RR)

This 10% is the bank 'reserve ratio' i.e. what % it keeps in reserve

What Determines RR?

- Availability of **creditworthy** customers
- Central bank **monetary policy**
- The state of the **economy**
- The **liquidity** requirements of the bank
- The **solvency** of the bank

Credit Creation

Banks can create credit in the economy this way

↑ **Money Supply** =

$$\uparrow \text{Cash Deposits} \times \frac{1}{\text{Reserve Ratio}}$$

> Money Supply

- **↑Consumer spending** + Boost **aggregate demand** (and **employment**)
- But could **↑Inflation** and **imports** (worsen balance of trade)

Commercial Banks can borrow money from the

Central Bank

Functions of the Central Bank

Government Banker
Holds public monies (tax revenue)

Loans
Make loans to commercial (high-street) banks

Reserves
Hold gold and foreign exchange reserves

Research
Carry out economic research and make projections

Interest/Currency Rate
Adjusting interest rates and currency exchange rates (Monetary policy *or* MP)

Supply Money
Issues notes/coin and 'prints money' by issuing credit

Note: Remember!

- For the eurozone-17, these functions are carried out by the European Central Bank (ECB) under European Monetary Union (EMU)
- Each member country within EMU maintains a Central Bank with **limited functions**
- Within EMU – a country lacks the ability to do **'Interest/Currency Rate'** and **'Supply Money'**

Commercial Bank Assets

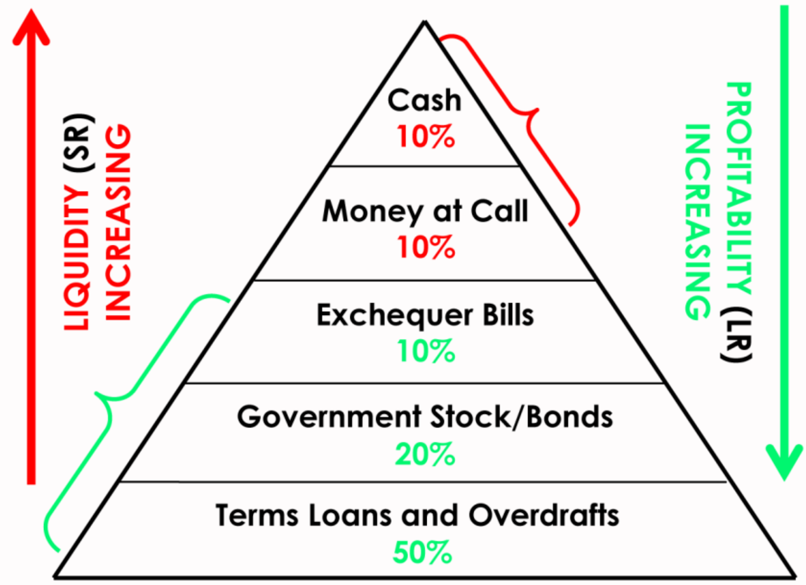
Bank assets are in two broad categories: **profitable** (normally over the long term) and **liquid** (short term assets readily converted into cash at short notice)

Liquid (SR)

1. **Cash**
2. **Money at call** Money loaned on the interbank market (loaned between banks)
3. **Exchequer Bills (aka Bills of Exchange)** Gov 'loans' out bonds to be repaid with interest after a given time

Profitable (LR)

1. **Government bonds (aka Gilt edged securities)** 'Sold' to debtors at a given rate of interest to be repaid over 3, 5 or 10 years
2. **Term loans (+ Overdrafts)**



Banks Borrow From Each Other

(Interbank Market)

- Major source of **short term financing** for banks
- Banks lends funds to each other and an interbank Interest rate is paid
- If more money is available on the interbank market than is demanded, there is a **surplus.** The interbank interest rate will fall (because demand is insufficient) making lending cheaper