The role of money in an economy Cheat Sheet

by nelaorav via cheatography.com/167833/cs/36054/

Why do we need money?

Why do we need money?	to exchange for those Gs & Ss we wach need and want but are unable to produce for ourselves
	we are **not self-suffiecient and we specialize** which makes us dependent for some Gs & Ss on others
Specialization	community that practised specialization was able to produce more than enough food, clothes, pots, etc.
	increased production achieved by specialization is the result of the division of labour, where each worker specializes on doing a particular task
Barter	was not a first form of money, because the value couldn't be measured fairly
	it was an exchange of Gs & Ss without using money
Problems with barter	**fixing a rate of exchange** - the value of each good had to be expressed in the value of another one
	finding someone to swap with - not having the same intrests
	trying to save for later usage - you can't store Gs for later usage as many of them can go bad

Functions and characteristics of money

Functions	**medium of exchange** - is generally accepted for all Gs & Ss and we don't have to search for someone who is willing to trade with us
	unit of account/measure of value - we can reliably price Gs & Ss to express their true value

Functions and characteristics of money (cont)

store of value - it can't go bad (only inflation can make it lose value)

means of deferred payment - borrowers, hire purchase, loans (therefore payments can be spread overtime)

What makes good money?

Money	is generally acceptable medium of exchange
Development	**commodity money** - shells, beads or bones were commonly accepted in exchange for Gs & Ss; later abandoned because it didn't possess the qualities of good money
	precious metals - gold or silver which were scarce enough but harder to divide
	coinage - precious metals in predetermined weights and easier to walk around with; they could be easily worn out
	paper money - people with money saved them at goldsmith's and in return they were given the paper receipt stating their value, later goldsmiths realized that they could issue papers with much more money than they have since nobody is depositing them
	token money - nowadays money is no longer convertible into gold

What makes good money? (cont)

Why is money important?	it encourages specialization by making trade easier which results in increased national output and income and standard of living

Creation of deposit money

Creation of deposit money	deposits in banks can be converted back into cash so the bankers must ensure they have enough cash to do so
credit creation	for this purpose bankers create reserves - banks receive deposits from which they deduct the deposit ratio to create reserves
	the remaining money can be used to lend to other clients and so does the list go on and on since when someone buys something the seller does the same with his profit
	this process is called credit creation - bankers create moeny by relending any cash that returns to the bank as a bank deposit
deposit ration	a certain percentage of money from deposits
the multiplier effect	if reserve requirement is 20% and the deposit is 100€ then 80€ can be loaned out to other bank customers, 16€ (20% from 80€) is then kept as reserve and 64€ is loaned againg until 100€ creates a total of 500€ deposits

Creation of deposit money (cont)

the higher the reserve requirement the tighter the money supply - which leads to lower multiplier effect

Money multiplier equation

$$Total\ money\ created\ =\ Initial\ deposit\ x\ \frac{1}{Reserve\ ratio}$$

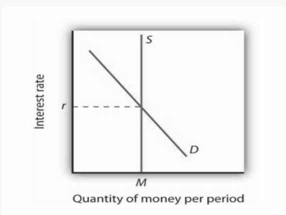
Forms of money

Types of money	**notes, coins and deposits with banks and other financial institutions create the money supply in an economy**
	financial assets can be a good store of value if they are **liquid assets** meaning how quickly we can turn them into money
	financial assets can be though of as **near money**
	near money - a form of money, these are non-cash assest which are highly liquid and can be quickly converted into cash (bills of exchange, treasury bills, bonds, shares, fixed and saving deposits, saving certificates, etc.)
	to sum up some assets are nearer money than other because **some assets fulfill the funcions of money better than other, som assets can be converted into cash quicker than other and some retain their value on conversion to cash better than other**

Forms of money (cont)

Velocity of circulation	NI of an economy is not equal to SoM because money can be used more than once - they circulate
	VoC is the number of times notes and coins are exchanged or circulate in an economy each year, the higher the VoC the lower the SoM needs to be
Equation of exchange	**M***V = PY*
	M = SoM, V = VoC, P = price lvl, Y = real GDP (P*Y = the nominal GDP)
Liquidity	the ability to exchange an asset for cash without losing its value
Money aggregates	are definitions of what money is, there are two groups of money aggregated in GB
	M0 (base money) contains money as a medium of exchange, cash held by general public
	M4 is a wider definition of what money is, it contains money as a medium of exchange as well as store of value - cash, savings in banks and savings in other financial institutions such as building societies

The equilibrium interest rate



Price of money

Interest	is the price of money
The equilibrium interest rate	is determined on the money marker when SoM equals demand for money, when ther is and exess demand for money IR rises and vice versa
Changing of IR	**missing out the opportunity to use the money**
	risk of not returning
	loss of value
Financial system	money needs to flow where it can be used the best and financial system allows this to happen
	is made up of different parts (banks, other financial institutions - insurance companies, etc.) and it provides crucial services which keep the economy moving (payments, borrowing, saving, risk management)
Financial stability	a way of describing the financial system when it's fulfillin its basic roles

Market for money

financial institutions	business organizations that specialize in providing financial services (borrowing money, making investments, exchanging the money, etc.)
Money market	is made up of all those people and organizations that want money, and all the people and organizations willing and able to supply money

Market for money (cont)

Commercial banks	a banks is a financial intermediary because they bring clients who want to save money and clients who want to borrow money
How banks earn revenue	**charge IR on loans**
	charge fees for the provision of other financial services (withdrawls from ATMs, exchanging and transferring foreign currency, etc.)
	they make invesments, etc.
Commercial banks provide these services	**accepting deposits of moeny and savings**
	helping customers make and receive payments
	making personal and commercial loans
	arranging insurance
	buying and selling shares for customers
	privision of other services - exchange services, operating pension funds, deposits in banks safes, leasing, etc.
The central bank	is the centre of the banking system in most economies
	its main funcion is to maintain the stability of the national curreny and the SoM

Market for money (cont)

The role of CB	**to issue notes and coins for the nation's currency**
	it manages payments to and from the government
	it manages the national debt
	it supervises the banking system, regulates the conduct of banks, hols their deposits and transfers funds between them
	it is the lender of the last resort to the banking system
	it manages the nation's gold and foreign currency reserves
	it operates the government's monetary policy
Open-market operations	refer to CB purchases or sales of government securities in order to expand or contract money in the banking system and influence IR

Market for money (cont)

	when people or organizations buy gov. securities they will take money from their bank account and so reduce deposits available to lend by the banks to private sector - so selling gov. sec. to private sector reduces the SoM, when the CB purchases the gov. sec. it increases the SoM
Special deposits	the CB can order commercial banks to deposit money with it for a certain period of time
	this reduces the amount of money banks have available to lend to its clients
Quantitative easing	a tool the CB can use to inject money directly into the economy
	this invloves using newly created money to buy up financial assets held by banks (gov. or corporate bonds)
	by buying these assets back from banks a CB can increase the quantity of money banks have available to lend to people and firms in order to stimulate the economy and increase liquidity