Chapter 24 - Money, The Price Level, and Inflation

**What is Money?**

**Money** is any commodity or token that is generally accepted as a means of payment.

Means of payment is a way of settling debt.

Money has three functions:

1. Medium of exchange: It is like a barter system where we instead of trading goods trade money. Furthermore, barter system requires double coincidence of wants.
2. Unit of Account: It is an agreed measure for stating the prices of goods and services.
3. Store of Value: Money can be held longer than some commodities for exchanges

*Money in Canada Today*

Currency: It is the notes and coins held by individuals and businesses.

Deposits at banks and other depository institutions

*Official Measures of Money*

M1 consists of currency held by individual and businesses plus chequable deposits owned by indivisuals and businesses.

M2 consists of M1 plus all other deposits – non-chequable deposits and fixed term deposits. (M1 + all other deposits)

All the items in M1 are means of payment. They are money.

Some savings deposits in M2 are not means of payments – they are called liquid assets.

**Depository Institutions**

A **depository institution** is a firm that takes deposits from households and forms and makes loans to other households and firms.

Type of depository institutions

1. Chartered Banks: A private firm chartered under the Bank Act of 1991
2. Credit Unions and Caisses Populaires: A cooperative under Cooperative Credit Association Act of 1991
3. Trust and Mortgage Loan Companies

Depository Institutions provide four benefits:

Create liquidity

Pool risk

Lower the cost of borrowing

Lower the cost of monitoring borrowers

**The Bank of Canada**

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**How Banks Create Money**

Banks create money when they lend out excess reserves.

The quantity of deposits that banks can create is limited by three factors:

1. The monetary base: It is the sum of the BoC notes coins and banks’ deposits at the BoC. Size limits the total quantity of money that banking system can create because,
   1. Banks have desired reserves
   2. Households and firms have desired currency holdings
2. Desired Reserves: Banks actual reserves of notes and coins in its vault in BoC
3. Desired Currency Holding: Money held as currency. It can lead to currency drains

*The money multiplier*

The ratio of the change in he quantity of money to the change in the monetary base.

**The Money Market**

Influences of Money Holding

Four main factors:

1. The price level:
2. The nominal interest rate
3. Real GDP
4. Financial innovation