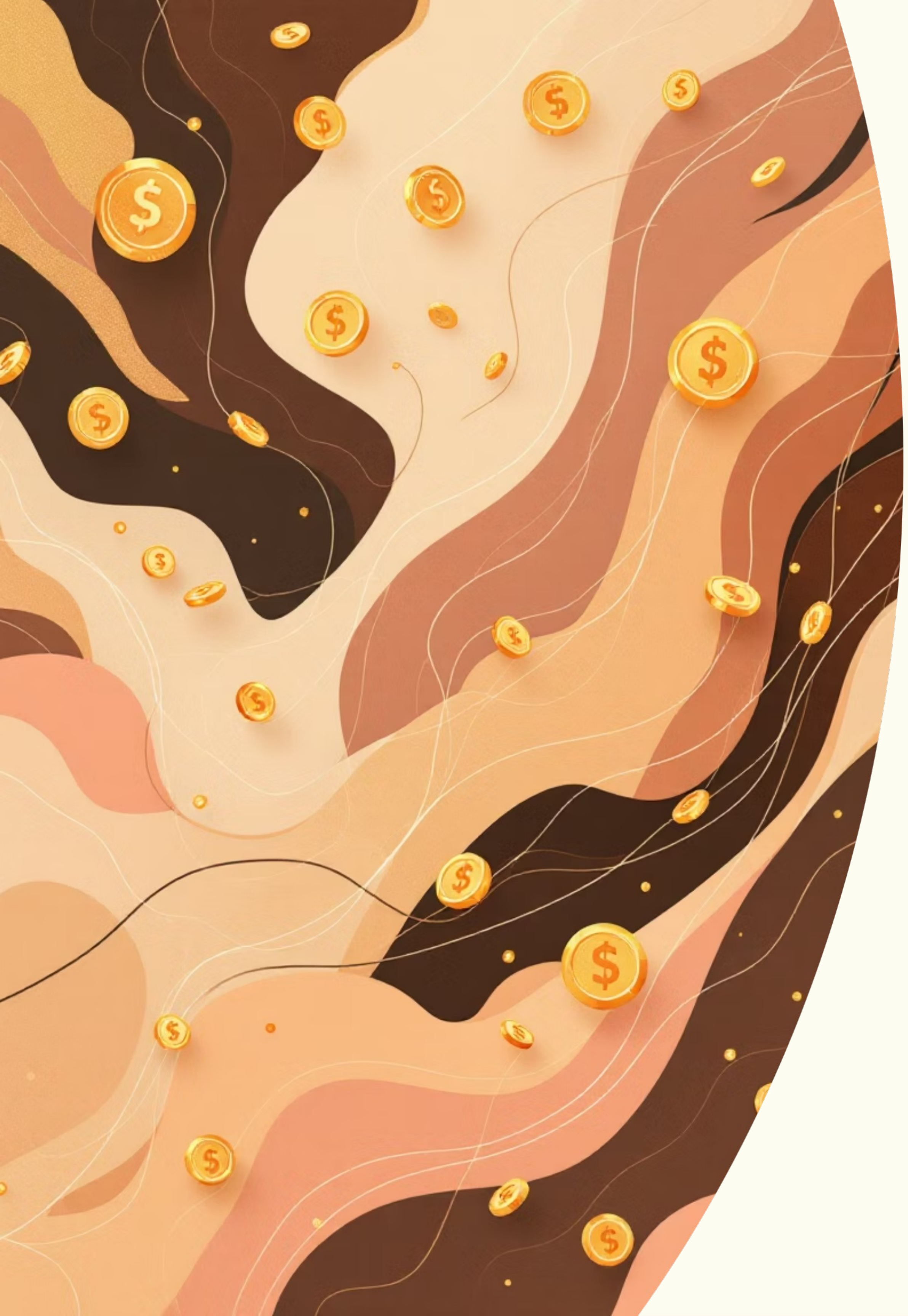


The Nature and Economic Role of Money

Exploring money's fundamental functions and its critical role in modern economies.

Three Core Functions of Money

Unit of Account

A measure of value for all goods, services, and assets in the economy.

Medium of Exchange

A means of payment that facilitates transactions between parties.

Store of Value

An asset that maintains purchasing power over time.

These interconnected functions form the foundation of monetary economics and enable modern market economies to function efficiently.

Unit of Account: Simplifying Economic Measurement

Without Money

For *n* goods, you need (1/2)n(n-1) exchange ratios.

With 700 goods (CPI categories), that's **245,000 different ratios** to track.

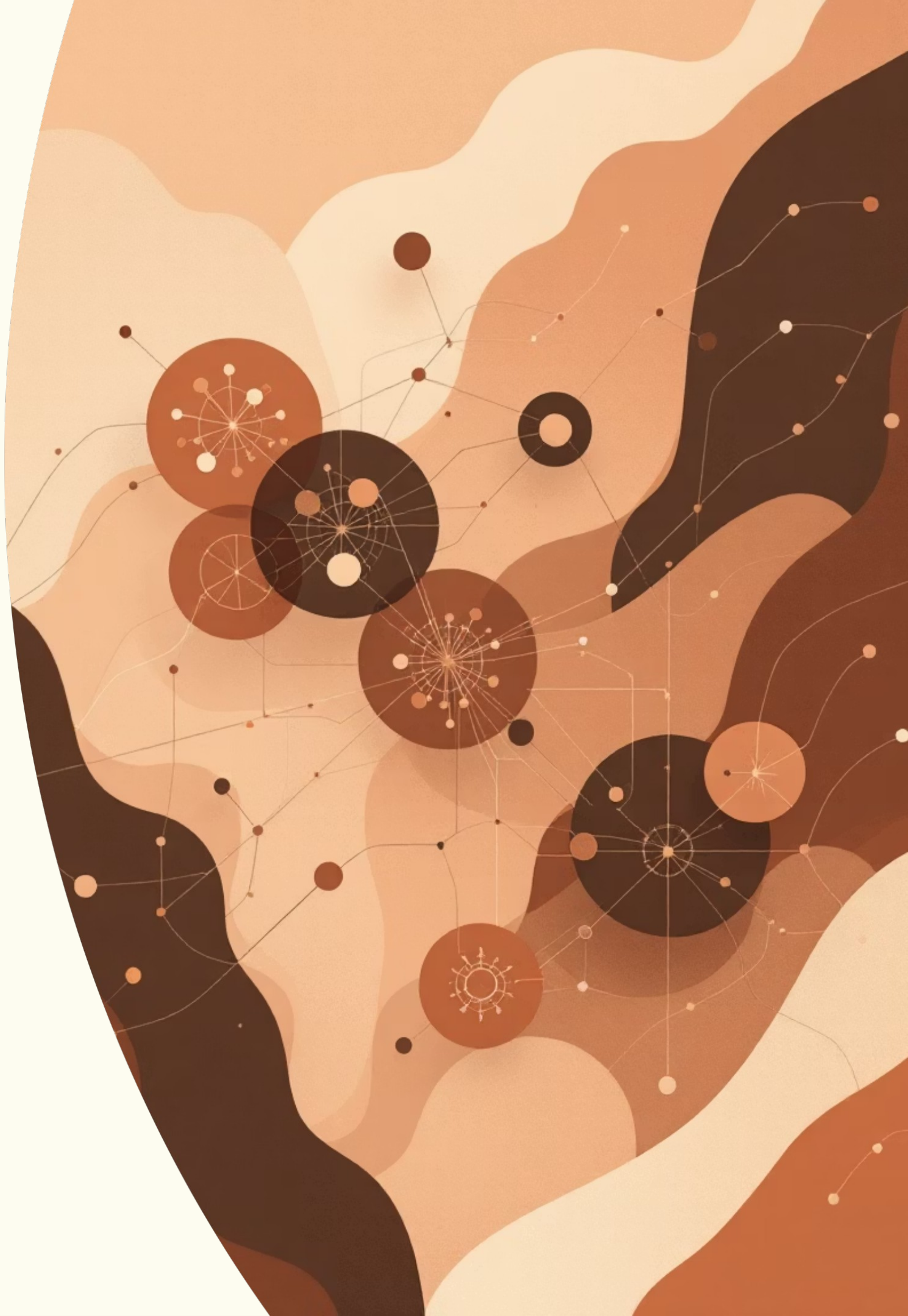
Imagine calculating every possible exchange between apples, bananas, cabbages, and hundreds of other items!

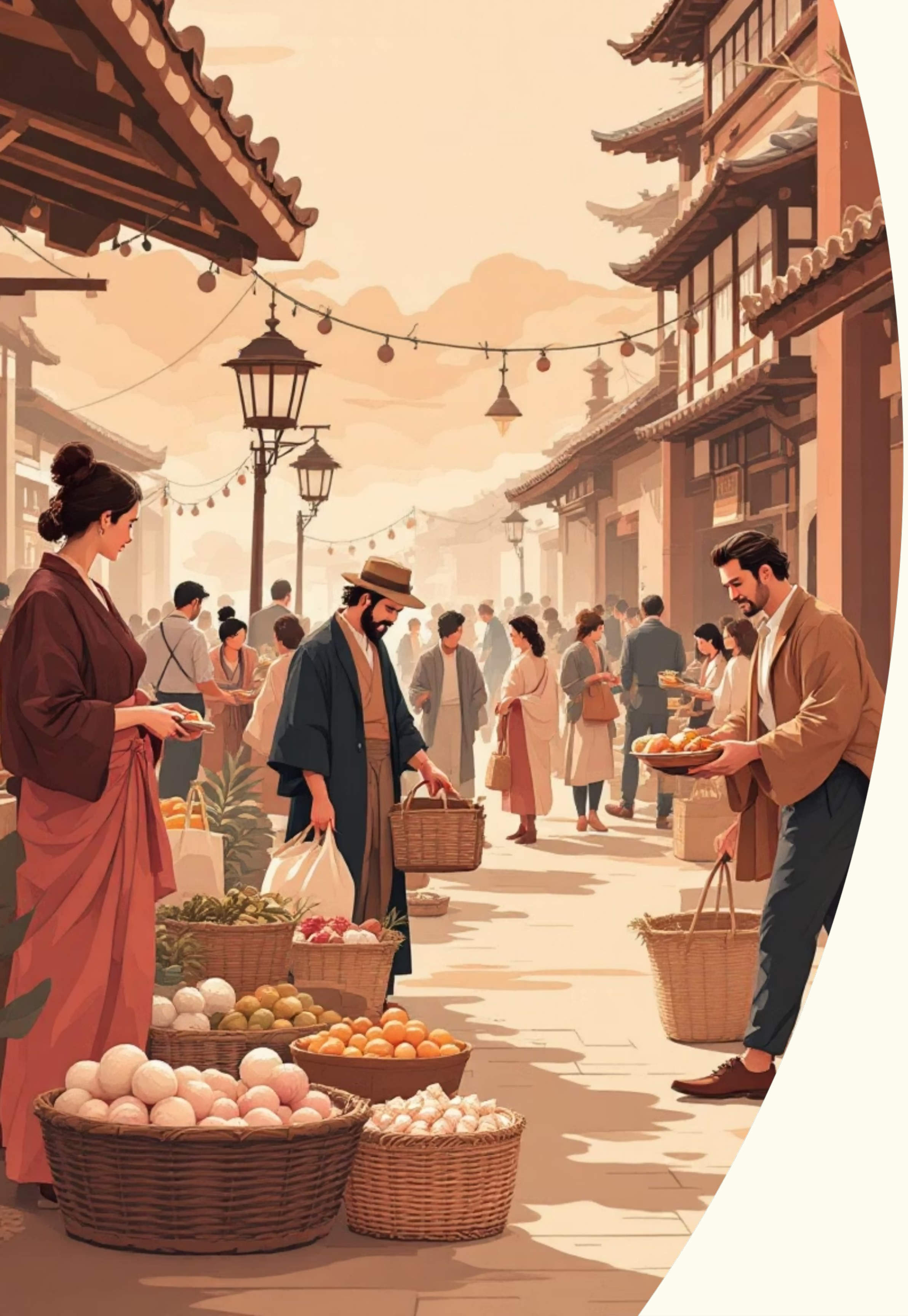
With Money

Only *n* money prices needed.

For 700 goods, just **700 prices** to track.

Relative prices can be calculated from monetary prices: PA/PB gives the exchange ratio.





Medium of Exchange: Solving the Double Coincidence Problem

Barter requires a **double coincidence of wants** – finding someone who has what you want *and* wants what you have.

1

Costly Search

Finding the right trading partner takes time and resources.

2

Trading Posts

Without money: (1/2)n(n-1) specialized posts needed for n goods.

3

Money Solution

With money: only one shop per commodity required.

The Misaligned Preferences Problem

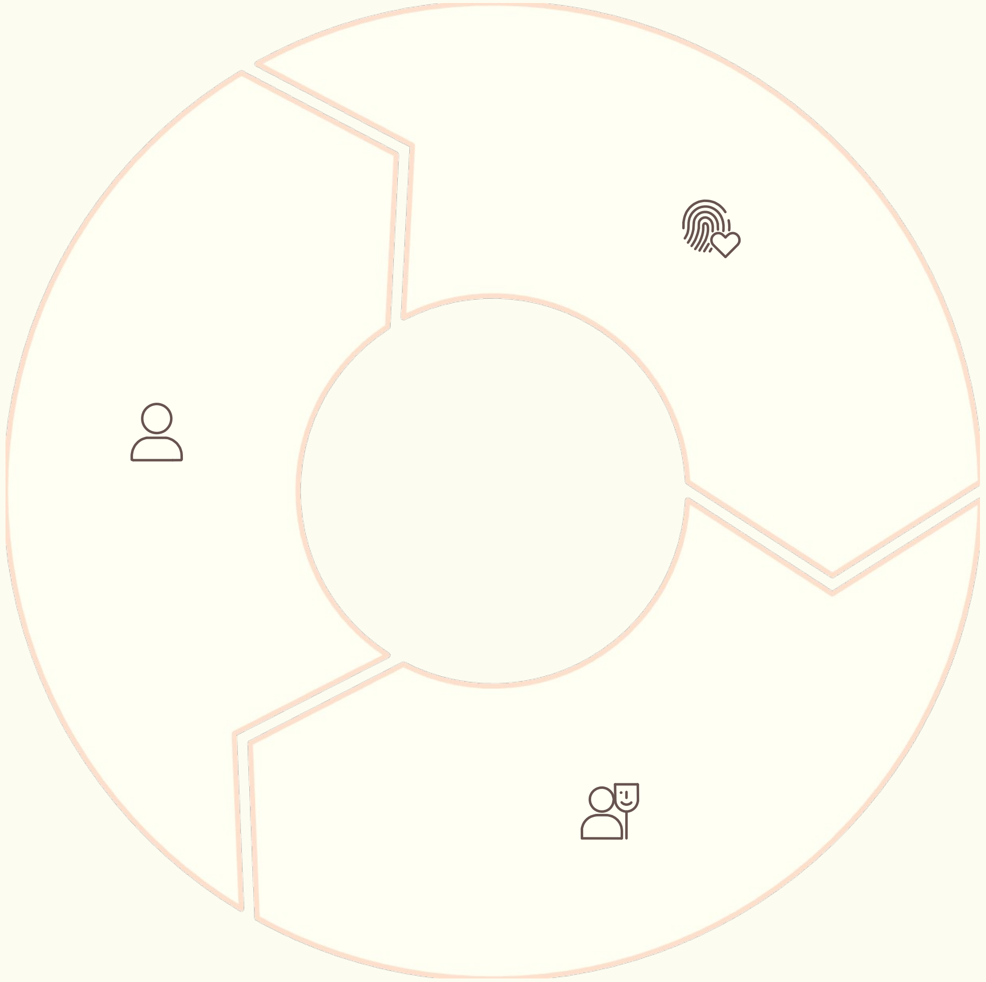
Three traders with different endowments and preferences illustrate why barter fails even when trades would benefit everyone.

Ina

Has: 6 Bananas
Wants: 1 Cabbage

Harriet

Has: 3 Apples
Wants: 6 Bananas



Jamal

Has: 1 Cabbage
Wants: 3 Apples

No bilateral trade works! But with money as an intermediary, all three can achieve their desired outcomes through sequential exchanges.

Store of Value and Liquidity

Money serves as a store of value during the gap between sales and purchases.

While other assets offer rewards (interest, dividends, appreciation), money provides **liquidity** – the ease of exchange.

01

Marketability

Ease of sale, high demand

02

Predictability

Stable exchange value

03

Reversibility

No gap between buy/sell value

04

Divisibility

Exchangeable in small units

What Makes an Object Suitable as Money?

Transportability

Easy to move and carry for transactions.

Durability

Maintains physical integrity over time.

Divisibility

Can be broken into smaller units without losing value.

Universal Appeal

Acceptable to all parties in transactions.

Modern money is intrinsically worthless but meets all objective criteria. Central banks create it specifically to fulfill money's three roles.

Monetary Aggregates

M0: Base Money

Coins and paper currency – most liquid, most "money-like"

M1: Narrow Money

M0 plus demand deposits – conventional definition of money

M2: Broad Money

M1 plus savings deposits – less liquid, offers more rewards

As we move to higher aggregates, liquidity decreases while pecuniary rewards increase. The line between "money" and "non-money" remains debated among economists.

Keynes Versus the Classical School

Keynesian View

Money's macroeconomic importance stems from its role as a **store of value**.

Liquidity demand creates spillover effects into markets for other assets and goods.

Greater desire for liquidity can reduce demand for assets and goods, affecting real economic activity.

Classical View

Focused on money as **medium of exchange** and unit of account.

Downplayed spillover effects to other markets.

Viewed money as a "veil" – important on surface but not affecting real activity.

The Quantity of Money Debate

In money's first two roles (unit of account and medium of exchange), the exact quantity seems unimportant. But in macroeconomic debates, **money supply levels** play a central role.

Classical Irrelevance

The amount of money doesn't affect real economic outcomes – only nominal values change.

Keynesian Significance

Money quantity matters because liquidity preferences affect real economic activity through spillover effects.

Ongoing Debate

These divergent views continue to shape modern monetary policy discussions and macroeconomic theory.