Inflation & Central Banks

Principles of Macroeconomics // Spring 2025

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Readings

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Required readings:

- *Macroeconomics in Context*, 4th ed.
  - → Chapter 11, sections 1—2.

Words of the day

- Money functions;
- Central Banks;
- Open Market Operations;
- Federal Funds Rate.

Inflation & money

Inflation & money

As we have seen previously, one of the main **problems** caused by inflation is that it deteriorates the **value of money**.

- In particular, money loses its *store of value* property.

Time to dig deeper into **money** and its role in the (macro)economy.

Roles of money

Roles of money

Money exists in many different *forms*.

- Cash, bank accounts, and electronic payment systems, for example.

In more general terms, **money** is *anything* that satisfies *three specific roles*:

1. *Medium of exchange*;
2. *Store of value*;
3. *Unit of account*.

Roles of money

[1] Medium of exchange:

- The accepted **token** for sales and purchases.
- Avoids the "*double coincidence of wants*" problem.

[2] Store of value:

- A way of **holding wealth**.
- The most *liquid* asset.

[3] Unit of account:

- Monetary units define the **value** of goods and services.

Roles of money

- What makes us *believe* that **money** is **money**?

How money is created

How money is created

When it comes to money **creation**, we may distinguish between:

- Money *production* and *printing*;
- Money creation through *deposits.*

The **banking system**:

- *Fractional* reserve system;
- *Required* reserves;
- *Excess* reserves.

Central Banks

Central Banks

> *"A central bank is responsible for issuing money, conducting monetary policy, maintaining currency stability and overseeing the nation's banking system, while acting as a lender of last resort."* (Reardon et al., 2018)

- 🔗 `The bank panic of 1907`
- 🔗 `The U.S. Federal Reserve Act of 1913`

Central Banks

Structure:

- Board of 7 governors;
- Non-renewable 14-year terms;
- 4-year term chair;
- Based in Washington, DC.

- Twelve ***Regional*** Federal Reserve Banks:
  - → Atlanta
  - → Boston
  - → Chicago
  - → Cleveland
  - → Dallas
  - → Kansas City
  - → Minneapolis
  - → New York
  - → Philadelphia
  - → Richmond
  - → St. Louis
  - → San Francisco

Central Banks

Dual mandate:

- Maximum ***employment***;
- Stable ***prices***.

These two objectives guide the Fed's ***monetary policy***.

Monetary policy

Monetary policy

Central Banks play an *active* role in the macroeconomy through **monetary policy**.

> **Monetary policy** involves influencing the economy through changes in the banking system's **reserves**, thus affecting the *supply of money* and the *availability of credit*.

The **main** monetary policy tool is **targeting interest rates**.

Monetary policy

Basically, **monetary policy** addresses *two* main problems:

- *How much money in the economy?*
- *How costly to obtain money?*

To these ends, the Central Bank has **three** main *tools*:

- `Open Market Operations`;
- `Discount rate`;
- `Reserve requirements`.

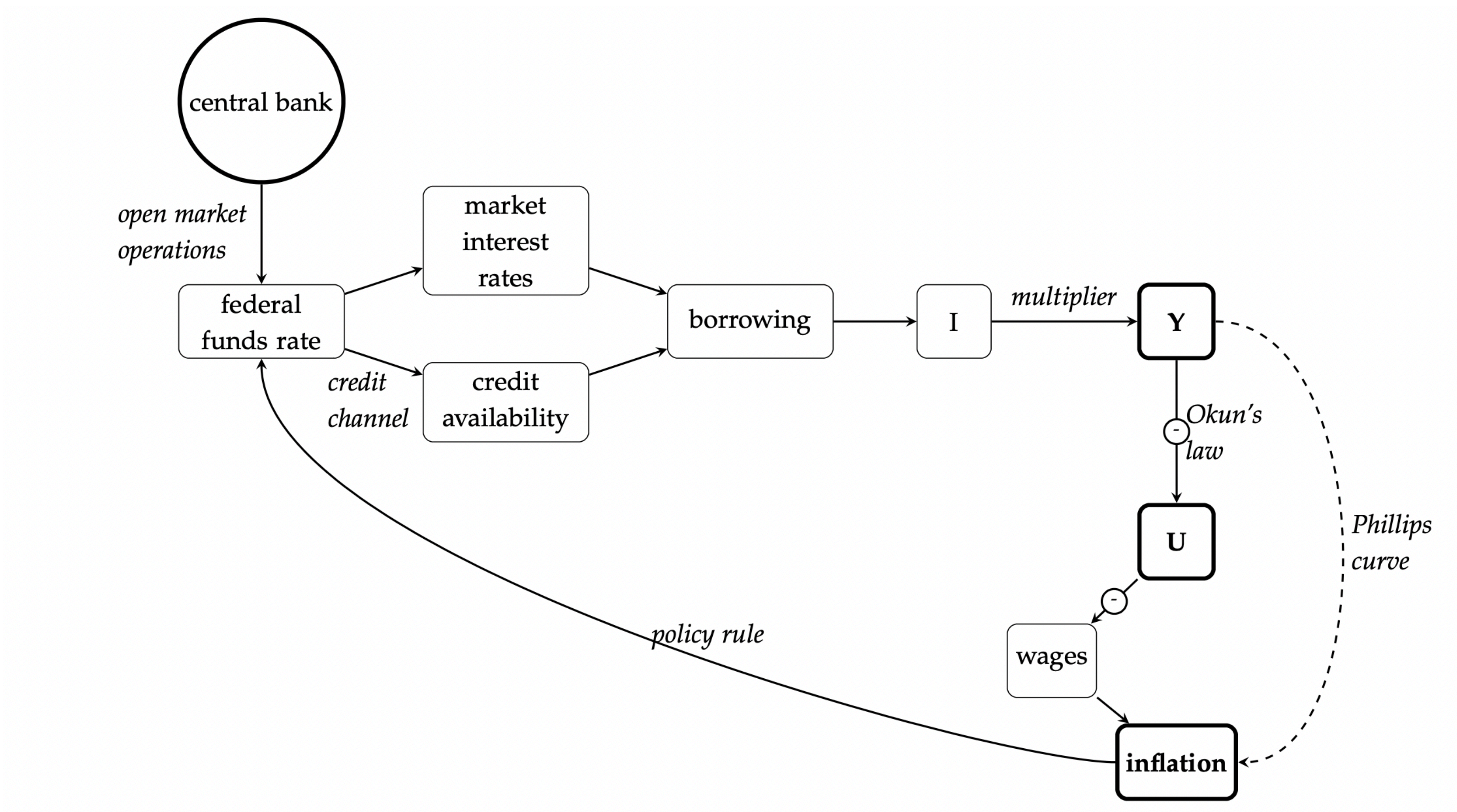
The *last two* are responsibility of the **Board of Governors**, while the *first* is determined by the **Federal Open Market Committee (FOMC)**.

Monetary policy

The **most important** of these three tools are *Open Market Operations*.

Let us use the ***board*** to better understand how these take place in the macroeconomy.

Monetary policy



By JW Mason

Next time: Inflation & reality