Economics for Business Environment

Unit 9

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Lecture Outline

Money

- Most of the activities you need money.
- It is a social custom to exchange money with goods or services.
- Our society could not function without it today.
- Before money were invented we used the ***barter system***.

Introduction

- People exchanged goods or services.
- However this meant that we had to want the good or service that the other person had to exchange
- Money helped the society overcome this product
- *Money is the set of assets in an economy that people use to buy goods or services.*

Functions of Money

- *Medium of Exchange*: We use money to purchase goods and services.
- *Unit of Account*: We use money to measure and record prices, transactions and debts.
- *Store of Value*: We use money to transfer purchasing power from today to the future.

Money in the Economy

The amount of money circulating in the economy is called **money stock**.

- Currency, all the banknotes and coins
- Demand deposits, balances on bank accounts that you can immediately access.
- Deposits with longer maturity.
- Repos, capital and reserves and many others.

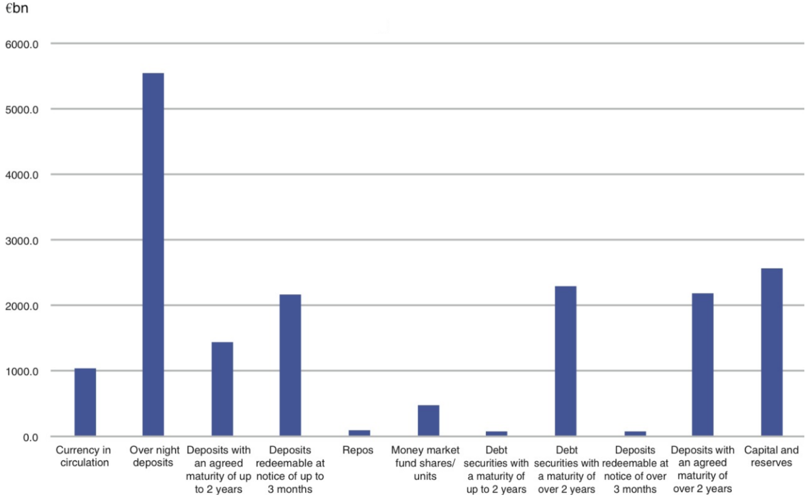
Money in the Economy

- It is very complicated to measure money in modern economies.
- It depends on how broad our definition is.
- Then we use M# to define how broad a measure is.

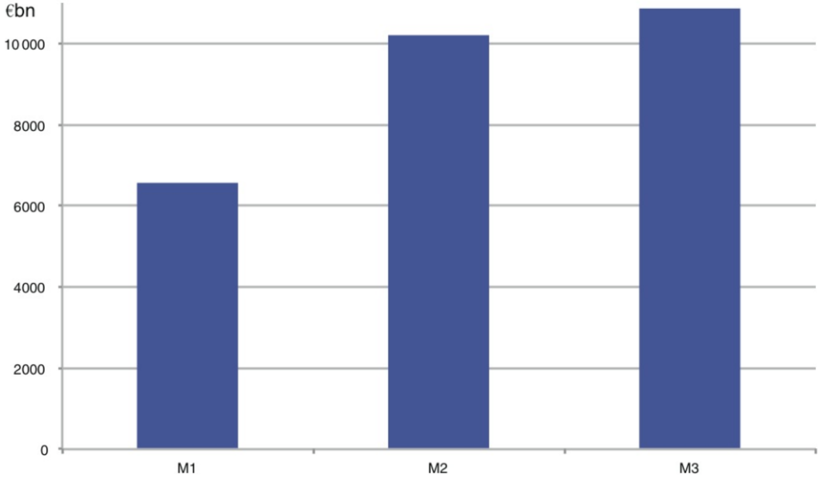
Money in the Economy

- $M0$: notes and coin in circulation.
- $M1$: $M0+$ UK private sector's (defined as non-bank private sector) sterling current accounts held with banks in the UK
- $M2$: $M1+$ deposits with agreed maturity up to two years $+$ deposits redeemable at notice up to three months
- $M3$: $M2+$ long-term deposits (discontinued)
- Out of all measures of money in the economy $M2$ is the one most commonly used by economists.

Money in the Euro Area



Money in the Euro Area



Central Banks

- The agency responsible for the money in the economy is the **central bank**.
- Central banks regulate the quantity of money in the economy, the **money supply**
- Some of the most important central banks are the European Central Bank (ECB), the Bank of England, the Federal Reserve (US Central Bank), People's Bank of China and others.
- The banks are responsible for the macro stability of the economy.
- Control prices (i.e. inflation) and maintain growth.

Tools of Monetary Policy

- To achieve their targets CBs can control the amount of money circulating in the economy.
- The actions taken by the CBs are called ***monetary policy***
- The CBs can increase or decrease the amount of money in the economy using ***open market operations***
- Purchase and sale of non-monetary assets from and to the banking sector.

Open Market Operations

- If the Bank of England wants to *increase* the amount of money in the economy, they will **purchase** bonds from bond holders. So they trade assets (bonds) with "cash" (or deposits). After the transactions the amount of currency in the economy is higher, i.e. M_s increases.

- If the Bank of England wants to *decrease* the amount of money in the economy, they will **sell** bonds to people (or banks). So they trade cash with bonds. After the transactions the amount of currency in the economy is lower, i.e. M_s decreases.

Tools of Monetary Policy

- The Central Banks also lend money to commercial banks. However the banks do not borrow money in the same way people do.
- The CB gives a loan to the bank in exchange for bonds ("collateral") and charges a rate for this loan (refinancing rate)
- This form of transaction is called a **repurchase agreement** or"*repo*"
- ***Repurchase agreement***: the sale of a non-monetary asset together with an agreement to repurchase it at a set price at a specified future date

Money Market

- Banks have their balance sheets to monitor the credit and liquidity risk they face.
- Because the bank transactions (deposits and withdrawals) are random, some banks may have an excess of reserves one day while others may be short.
- They lend money to each other in the short-term (overnight to 2 weeks) to cover imbalances.
- All these transactions take place in the ***money market***

Financial Risks

- ***Credit Risk***: The risk that a bank faces in defaults on loans
- ***Systemic Risk***: The risk of failure across the whole of the financial sector
- ***Liquidity Risk***: The risk that a bank may not be able to fund demand for withdrawals

Financial Risks

- During the financial crisis many criticised the banking system for not being able to deal with *systemic risk*. Financial institutions are interconnected (one depends on the rest) the risk was increased.
- For many, this is the primary reason of the severity of the financial crisis.
- For this reason, the authorities that regulate the financial sector set up a system to prevent or reduce such risks.
- ***Macroprudential Policy***: Policies designed to limit the risk across the financial sector

Financial Risks

Apart from CBs, governments can influence the economy as well. Remember from the previous lecture:

$$Y = C + I + G + NX$$

- Directly through G
- Increasing or decreasing government expenditure the AD will shift up or down.
- Indirectly, through ***taxes, (T)***

Taxation and the AD curve

- Taxes refer to a decrease to a person's (or a company's) income.
- A person decides how much to consume based on their *disposable income*.
- **Disposable income** is simply your income minus the taxes you have to pay ($Y - T$).

Taxation and the AD curve

- Increasing or decreasing taxes, will change your disposable income.
- Indirectly, through ***taxes, (T)***
- An increase in T means that your disposable income falls.
- When your disposable income falls, you have less for consumption
- As consumption decreases the AD curve shifts down.

Policies

- Governments and CBs choose their policies (independently) to stabilize the economy and promote economic growth.
- How fast and how hard they act will affect the way these policies act on the economy.
- The austerity measures that were the policy decision in many cases after the last crisis was not effective everywhere
- In some cases, it made the situation even worse (Greece see pages 777-781).
- *Austerity policies* refer to cuts in public spending (G) and increase in taxes (T) to stabilize the economy.