ECON UN3265 ▪ MONEY AND BANKING ▪ SUMMER 2026 ▪ SESSION 2

CHAPTER 3

What Is Money?

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Outline

The Meaning of Money

Functions of Money

Evolution of the Payments System

Measuring Money

Wrap-up

Reading and objectives

- Mishkin, *The Economics of Money, Banking, and Financial Markets*, 13th ed.
- This deck: **Chapter 3** — What Is Money?
- Chapter 4 (The Meaning of Interest Rates) follows in a separate deck for this session.

Learning objectives

3.1 Describe what money is.

3.2 List and summarize the functions of money.

3.3 Identify different types of payment systems.

3.4 Compare and contrast the M1 and M2 money supplies.

PART 1

The Meaning of Money

What is money?

Money (the money supply)

Anything that is generally accepted as payment for goods or services or in the repayment of debts.

- This is a *broad* definition — it is not limited to currency.
- The economists' use of "money" is narrower than everyday speech: "she's got a lot of money" usually means *wealth*, and "a good job earns more money" means *income*.

Money, wealth, and income

Three distinct ideas — keep them separate:

- **Money** — anything generally accepted in payment. A *stock*: measured at a point in time.
- **Wealth** — the total collection of pieces of property that serve to store value. Also a stock; money is one component of it.
- **Income** — a flow of earnings per unit of time. A *flow*: it only makes sense with a time period attached (e.g. \$60,000 *per year*).

PART 2

Functions of Money

The three functions of money

Money serves three functions in any economy:

1. **Medium of exchange** — used to pay for goods and services.
2. **Unit of account** — used to measure value in the economy.
3. **Store of value** — used to save purchasing power over time.

The first — medium of exchange — is what *distinguishes* money from other assets.

Medium of exchange

- Without money, trade requires *barter* — and barter needs a **double coincidence of wants**: two people who each have what the other wants.
- Money eliminates that requirement, sharply *reducing transaction costs* — the time and resources spent making trades.
- Lower transaction costs let people *specialize* in what they do best, raising economic efficiency.

A good medium of exchange must be

easily standardized · widely accepted · divisible · easy to carry · slow to deteriorate.

Unit of account and store of value

Unit of account

- Money measures value, so prices are quoted in one common unit.
- This reduces transaction costs: with N goods, a barter economy needs $N(N-1)/2$ prices; with money, only N.

Store of value

- Money lets you save purchasing power from the time income is received to the time it is spent.
- Other assets (stocks, bonds, real estate) also store value — often *better*. But money is the most **liquid** asset.
- *Liquidity*: the ease and speed of converting an asset into a medium of exchange. Money's weakness as a store of value is **inflation** — it loses real value as prices rise.

PART 3

Evolution of the Payments System

Commodity money and fiat money

The *payments system* — the method of conducting transactions — has evolved over time.

- **Commodity money**: money made of a valuable commodity — precious metals, or (in POW camps) cigarettes. Valuable, easily standardized, divisible.
- **Fiat money**: paper currency decreed by governments as *legal tender* but not convertible into coins or a precious metal. It is money by "fiat" — because the government says so and people accept it.

Paper is far lighter than precious metal — but it can be stolen and is costly to transport in large amounts.

Checks, electronic payment, and e-money

- **Checks** — an instruction to your bank to transfer money from your account to someone else's. They avoid moving currency, but take time to clear.
- **Electronic payment** — e.g. paying bills online; cheap and fast.
- **E-money** (electronic money) — money that exists only in electronic form:
  - debit cards;
  - stored-value cards (*smart cards*);
  - e-cash.

A cashless society? And Bitcoin

Are we headed for a cashless society?

Predicted for decades — but it has not arrived. Paper persists (it needs no equipment, no power, and is private). Still, the use of e-money will keep rising.

Will Bitcoin become the money of the future?

Bitcoin is electronic money created in 2009; new units are "mined" by decentralized users who verify transactions. It *can* function as a medium of exchange — but it performs poorly as a *unit of account* and *store of value* (its price is extremely volatile), so it is unlikely to become the money of the future.

PART 4

Measuring Money

Monetary aggregates

Which assets, exactly, should we call "money"? There is no single answer — "moneyness" is a matter of degree.

- The Federal Reserve constructs **monetary aggregates** — measures of the money supply — ranked by *liquidity*.
- **M1** (the most liquid assets):

$$\text{M1} = \text{currency} + \text{traveler's checks} + \text{demand deposits} + \text{other checkable deposits}.$$

M2 — a broader measure

M2 adds to M1 a set of less liquid assets:

$$\begin{aligned} \text{M2} = \text{M1} + \ & \text{small-denomination time deposits} \\ & + \text{ savings deposits and money market deposit accounts} \\ & + \text{ money market mutual fund shares (retail).} \end{aligned}$$

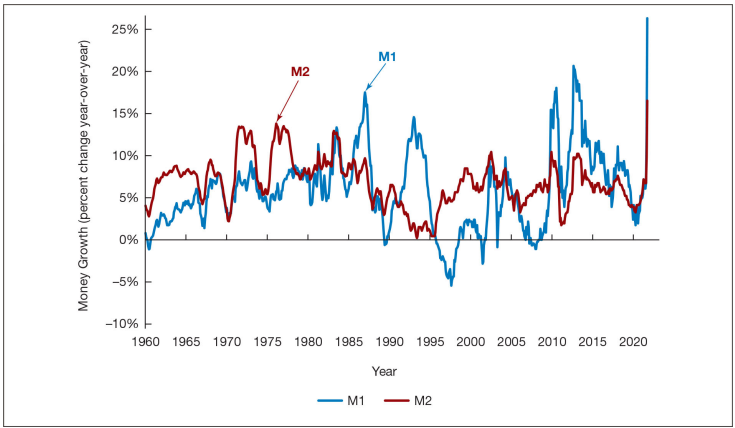
These additional assets are still fairly liquid, but you cannot spend them as directly as the components of M1.

Table 1 Measures of the Monetary Aggregates

	Value, Aug 31 2020 ($ billions)
M1 = Currency	1,920.4
+ Demand deposits	2,317.0
+ Other checkable deposits	1,176.4
Total M1	**5,413.8**
M2 = M1	5,413.8
+ Small-denomination time deposits	351.9
+ Savings deposits and money market deposit accounts	11,593.4
+ Money market mutual fund shares (retail)	1,105.2
Total M2	**18,464.3**

Mishkin Ch. 3, Table 1. Source: Federal Reserve Statistical Release H.6.

Figure 1 Growth Rates of the M1 and M2 Aggregates, 1960–2020



Mishkin Ch. 3, Figure 1. Source: Federal Reserve Bank of St. Louis (FRED).

Does the choice of measure matter?

- M1 and M2 usually move together — but **in the short run they can move in different directions**, even diverge.
- So a statement like "money growth is high" depends on *which* aggregate you mean.
- **Conclusion:** the choice of monetary aggregate matters for policymakers, and we will be careful to specify which measure we mean.

PART 5

Wrap-up

Key terms from Chapter 3

- money (money supply)
- wealth, income
- stock vs. flow
- medium of exchange
- double coincidence of wants
- transaction costs, specialization
- unit of account, store of value
- liquidity
- commodity money, fiat money
- e-money, payments system
- monetary aggregates
- M1, M2

Looking ahead

- Next deck this session: **Chapter 4** — The Meaning of Interest Rates.
- *Quiz 1* (Session 3, next Tuesday) covers Week 1 — Chapters 1–4, including this material.