



# What is Money and How Does Money Work in the Economy

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# Definition & Functions of Money



The term **Money** is defined by economists as anything that can be readily used as a means of payment in market transactions for goods and services and the settlement of debt. In a broad sense, money has four main functions in any economy.

- **Medium of exchange** – something that is generally accepted as a means of payment.
- **Store of value** - allows purchasing power to be carried from one period to the next.
- **Unit of account** – a standard unit in which relative prices of goods and services can be quoted and compared.
- **Standard of deferred payment** - allows payment for goods and services consumed today in a future time period.



# Features of Money



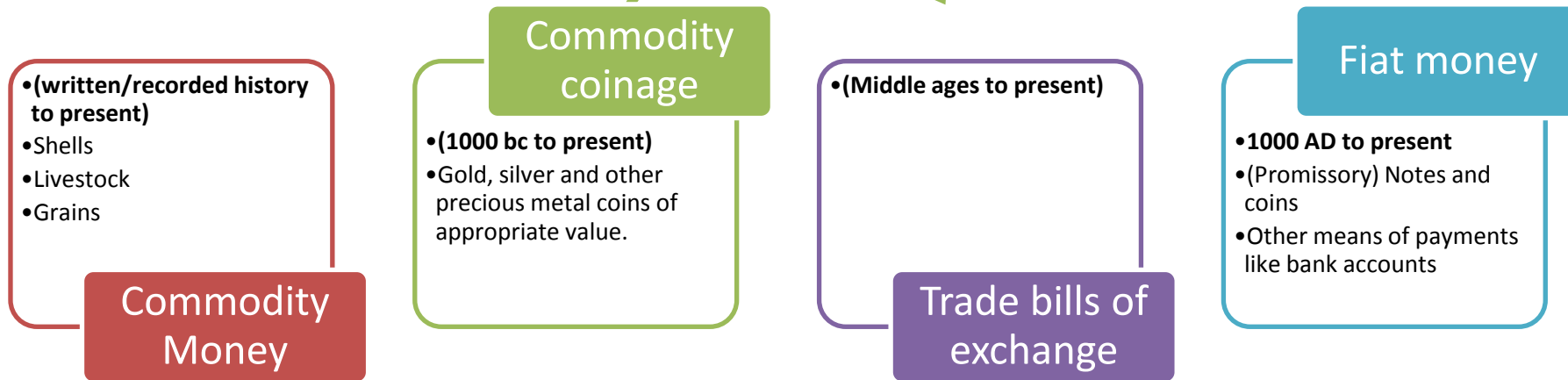
For an object to serve efficiently as money, it should possess the following features:

- It must be widely accepted as a means of payment.
- It must be divisible, i.e. it must exist in different denominations, for example, \$20, \$50, \$100.
- It must be easily identified.
- It must not be easily duplicated or counterfeited.
- It must be easily transported.
- It must be durable, allowing it to last for very long periods.



# History and Evolution of Money

Some form of money has existed since recorded history. As what is called money has evolved, each new type of money has remained in existence.



# Fiat Money and the Money Supply



- ***Fiat money*** is any money issued and declared by a government as legal tender. It typically has no intrinsic value outside of the ***promise*** by the government to pay the holder the value of this money.
- Fiat money allowed banks to increase the amount of money in the economy beyond the total supply of notes and coins issued by the government.





## Money Supply

- The money supply is usually looked at in two forms, the Monetary Base and Broad Money.
- **Monetary Base** – notes and coins available to the public *plus* moneys held by commercial banks in their current accounts at the central bank
- **Broad Money** – Monetary Base *plus* Deposits

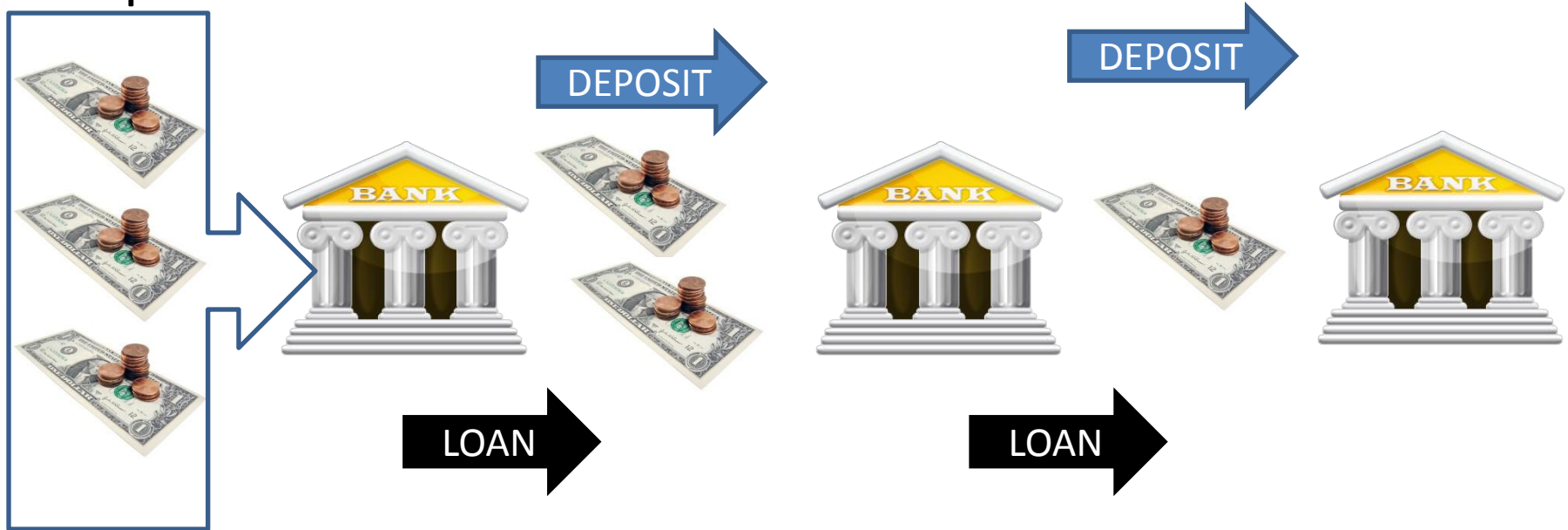




# Money Creation



- Banks create money by taking deposits and lending a portion to creditors



- As long as people deposit their savings in banks and banks make loans, the supply of money will be greater than the amount of notes and coins in the economy.



# Monetary Policy



The central bank (Bank of Jamaica) controls the money supply in the economy by controlling the monetary base, then regulating the banks ability to create money by:

1. Limiting the amount of deposits commercial banks can lend.
2. Using monetary policy to affect interest rates to change peoples demand for credit.







# Why is Monetary Policy Important?

*“Inflation is always and everywhere a monetary phenomenon”.* Milton Friedman, 1963. This leads to two important realizations:

1. If changes in the money supply are exactly the same as changes in output, then inflation will be zero.
2. However, changes in the money supply alters interest rate that impact credit which in turn impacts output.

Therefore monetary policy has to balance the trade-off between output and inflation to maximize welfare



# How Does Money Work in Our Economy?

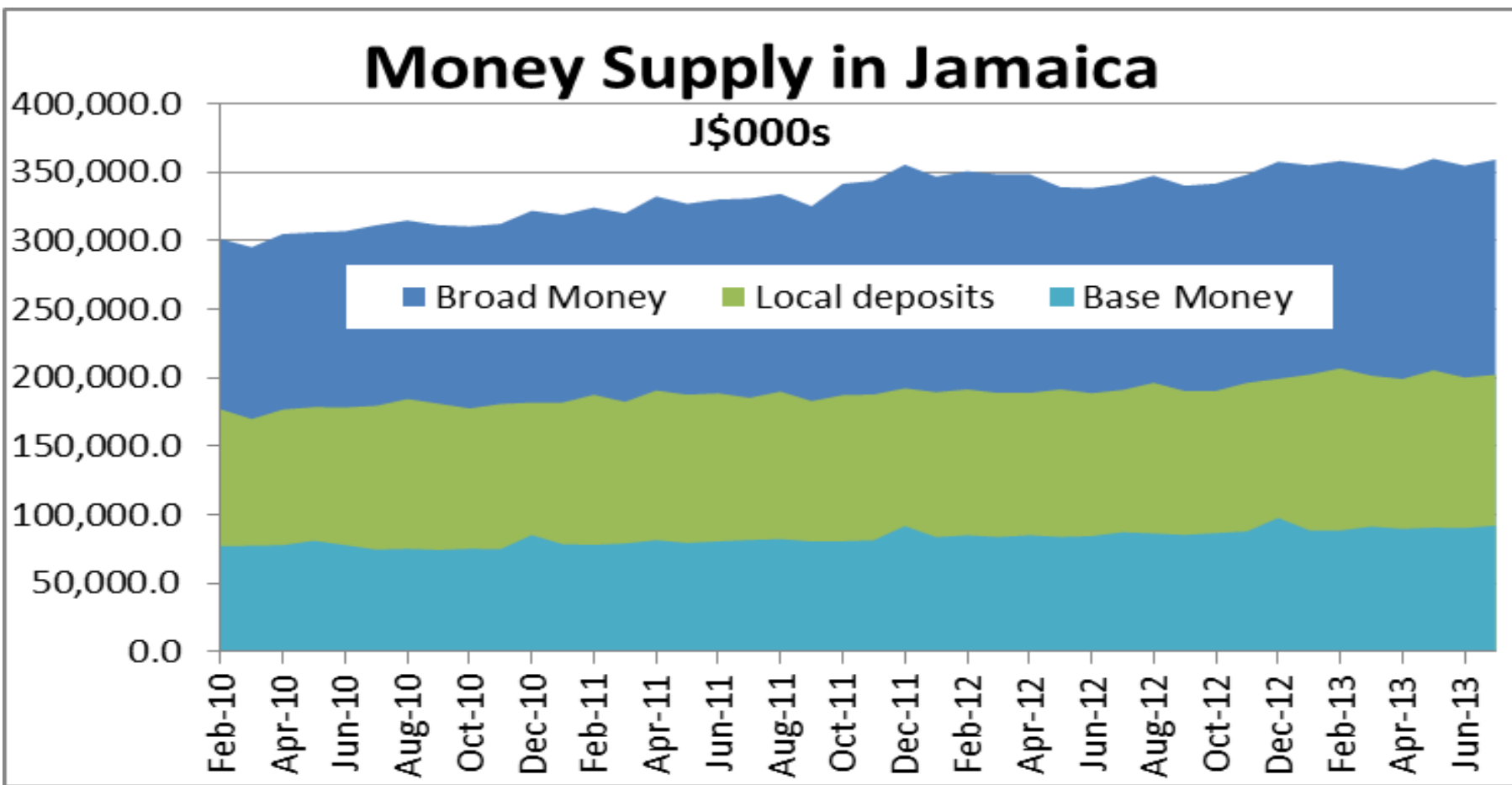


- Money
  - Legal tender – **Jamaica Dollar**
  - Other currencies used as money (US dollar, Canadian dollar, Pound Sterling etc.) ***These are not legal tender!***
  - Evidence of commodity money and trade bills being used in some communities and markets
- Monetary Policy
  - The BOJ uses reserve requirements to limit the quantity of credit banks can provide from local and foreign currency deposits. Open market operations (i.e. buying and selling securities) control interest rates.
  - Foreign currency operations impact the price of the Jamaica Dollar vis-à-vis the US dollar



# Money and You

- Monetary base is pretty stable and seasonal.
- Local deposits and monetary base account for more than 50 per cent of the money supply!





## Money and You

Every Jamaican seems to know how to “*make money*” but knowledge of how to “*make money work for you*” seems limited.

- Money in its most liquid form (cash and demand deposits) loses value over time because the interest it pays is always lower than inflation. *Keep this form of money limited to only what is needed for transactions.*
- Other forms of money (other deposits like time deposits) can yield interest rates equal to or higher than the inflation rate. This kind of money is like a good employee. *Shop around and keep as much of your money in this form.*
- *Use other peoples money where possible.* The smart and judicious use of credit is essential to wealth creation. This is like your best ever employee.





# Thank you!

