



MONEY

Money and Finance

- https://www.youtube.com/watch?v=Dugn51K_6WA&index=10&list=PL8dPuudLjXtPNZwz5_o5uirJ8gQXnhEO

What is Money?

- Money: any commodity or token that is generally acceptable as a means of payment
- **Means of payment:** method of settling debt
- Money also serves as a:
 - Medium of exchange
 - Unit of account
 - Store of value

Medium of Exchange

- Any object that is generally accepted in exchange for goods and services
- Without this, goods/services must be exchanged for other goods and services, called bartering
- Credit cards are also mediums of exchange, but they're not money
 - It doesn't make final payment, and the debt it creates must eventually be settled by money

Unit of Account

- Agreed measure for stating the prices of goods and services
- Basically the expression of goods and services in dollars and cents

Store of Value

- Money is a store value: it can be held and exchanged later for goods and services
- House, car, and work of art are other examples of store value
- The more stable the value of a commodity or token, the better it can act as a store value and the more useful it is as money

Components of the Money Supply

Currency

- The notes and coins held by individuals and businesses
- Government declares notes to be money.
- Notes/coins inside banks **not** money as it is not held by a business or individual .
- Currency convenient for settling small debts/purchasing low priced items.

Deposits

- Deposits of individuals and businesses at banks and other depository institutions, like trust and mortgage companies, credit unions
- Owners of deposits can use them to make payments.
- Different types of deposits:
 - Demand
 - Notice
 - Term
 - Money Market Mutual Funds

- Demand deposits
 - Funds to which depositors have immediate access (ex: chequing, current and savings accounts).
- Notice deposits
 - Funds for which the depositor must give notice to the bank before withdrawal.
- Term deposits
 - Funds to which depositors have no access for a fixed period.

- Money Market Mutual Funds
 - Mutual funds specializing in short-term securities issued by the government and corporations.
 - Treasury bill and bonds.

Official Measures of Money

- The Bank of Canada has broken the money supply into several categories:

1. M1

- Narrowest definition of money supply.
- It is money that is used primarily as a medium of exchange to make payments.
- It includes all currency in circulation outside the banks as well as demand deposits held in chequing and current accounts.

2. M2

- Larger measure of the money supply.
- Includes all M1 plus personal savings accounts, including chequing-savings accounts, term deposits and non-personal notice deposits.
- Broader definition as it includes two types of deposits (term deposits and non-personal notice deposits) not generally used for making immediate payments.

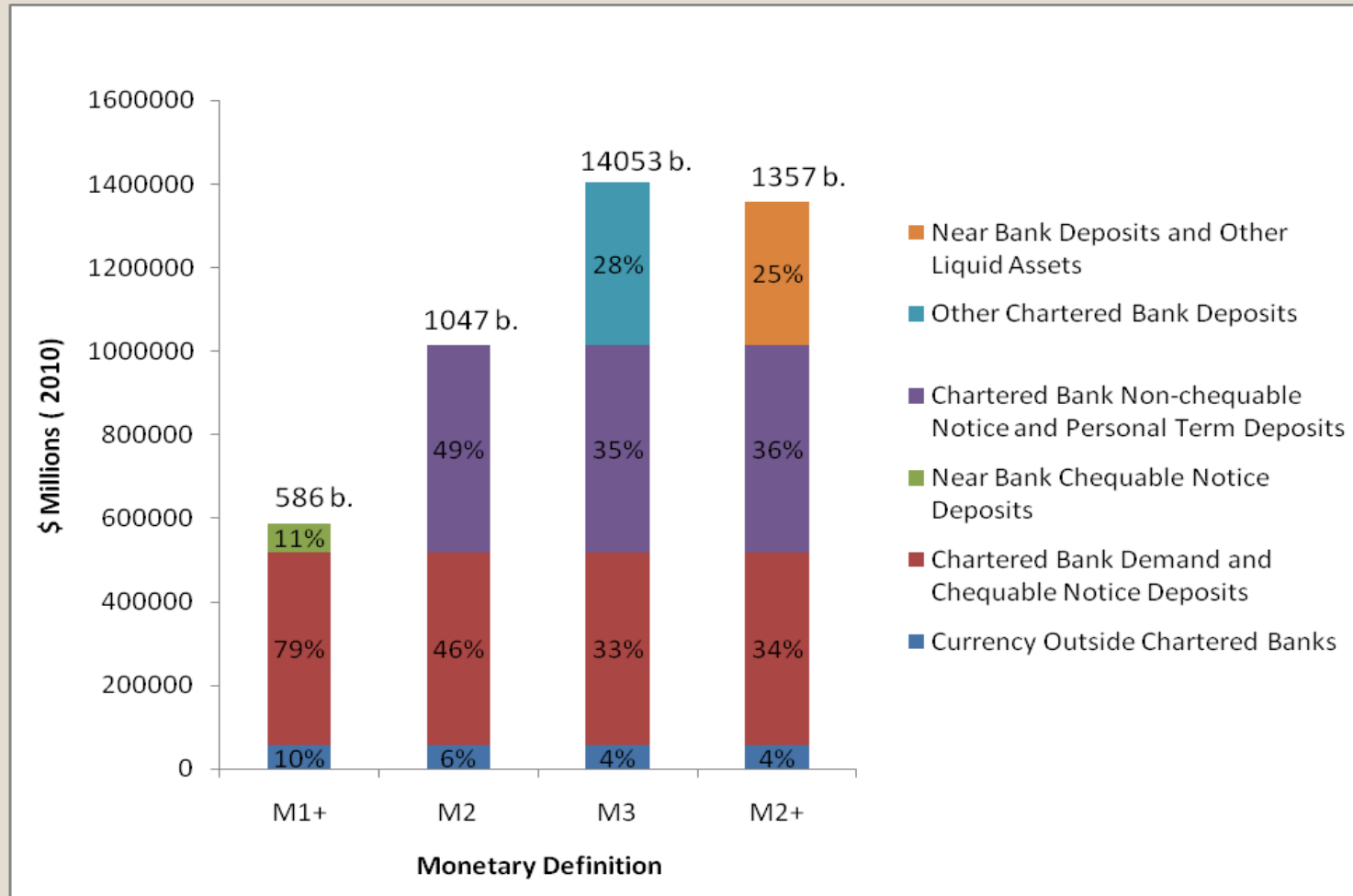
3. M2++

- Includes all M2 as well as deposits at non-bank deposit taking institutions (credit unions, trust companies), money market mutual funds, and individual annuities at life insurance companies.
- These assets are used primarily as a store of value but typically cannot be turned into cash in a couple of business days.

4. M3

- Comprises M2++ as well as large term deposits held by businesses and foreign currency held by Canadians.

The Canadian Money Supply



The Canadian Financial System

- The four traditional pillars of the Canadian financial system were:
 - Chartered banks
 - Trust companies
 - Insurance companies
 - Investment dealers
- Financial deregulation has allowed institutions in each pillar to perform a wider range of functions

Chartered Banks

- Chartered banks are deposit-takers allowed by charter to offer a wide range of financial services.
- Private firm chartered under Bank Act of 1991 to receive deposits and make loans
- Largest institutions in banking system and conduct all types of banking and financial business

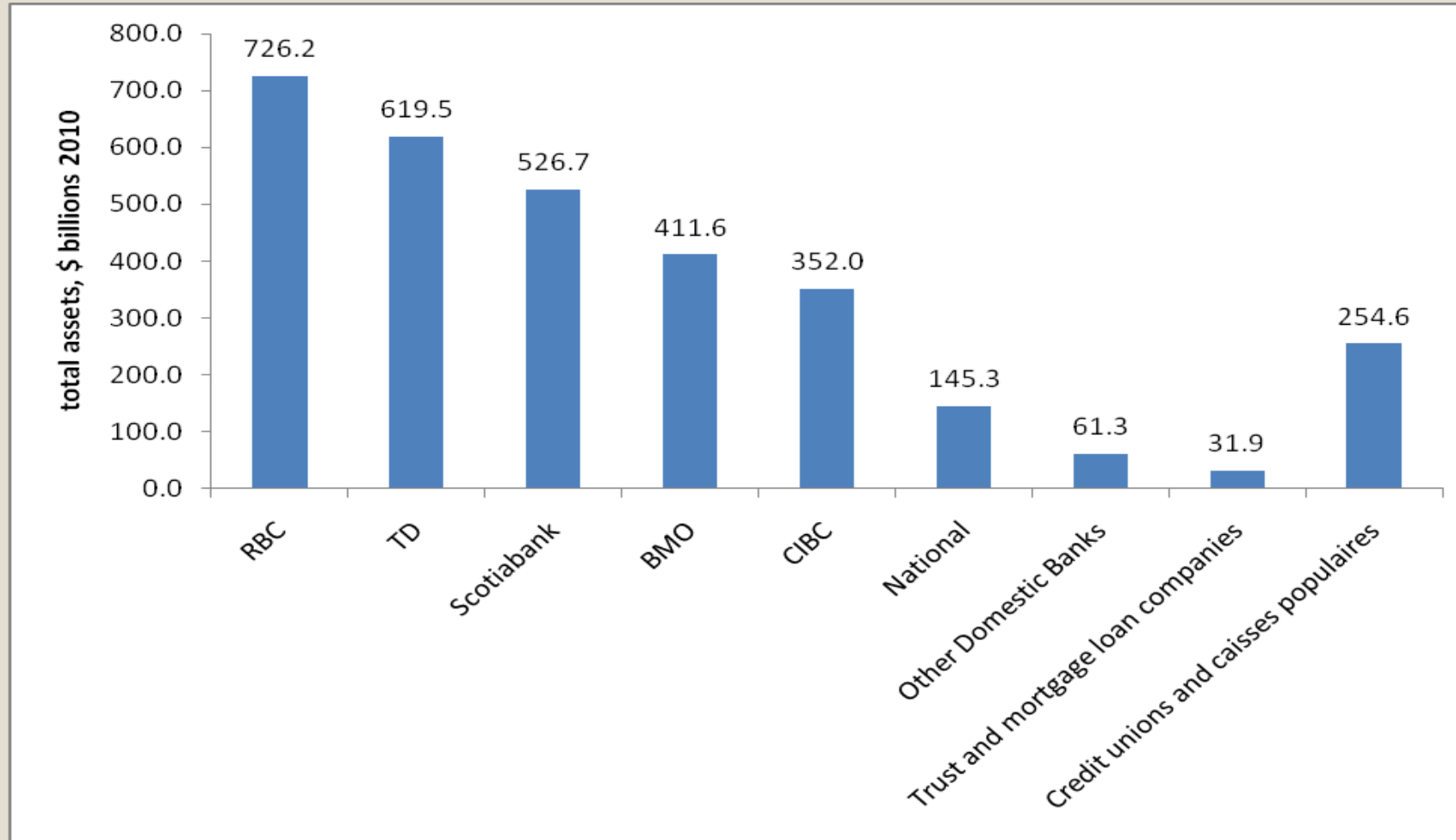
Credit Unions and Caisses Populaires

- Credit union: cooperative organization that operates under the Cooperative Credit Associations Act of 1991 and receives deposits from/makes loans to its members
- Caisse populaire is a similar type of institution that operates in Quebec

Trust and Mortgage Loan Companies

- Privately owned depository institution that operates under the Trust and Loan Companies Act of 1991
- Receive deposits, make loans, act as trustee for pension funds and for estates

Chartered Banks and Near Banks in Canada



What Depository Institutions Do

- Provide services such as cheque clearing, account management, credit cards, internet banking, all of which provide an income from service fees.
- Earn most of income by using funds they receive from depositors to make loans and buy securities that earn higher interest rates than that paid to depositors.
- Institution must perform balancing act of return vs. risk.
- Chartered banks puts funds it receives into 4 areas:

Reserves

- Notes and coins in its vaults or deposit account at Bank of Canada.
- Funds used to meet depositors' currency withdrawals and to make payments to other banks.
- Normal times, keeps half of 1% of deposits as reserves.

Liquid Assets

- Government of Canada treasury bills and commercial bills.
- First line of defense if they need reserves.
- Can be sold and instantly turned into reserves with virtually no risk of loss.
- Earn low interest rate.

Securities

- Government of Canada's bonds and other bonds such as mortgage backed securities.
- Assets can be converted to reserves but prices fluctuate.
- Riskier than liquid assets but have higher interest rate.

Loans

- Commitments of funds for an agreed upon period of time.
- Banks make loans to corporations to finance purchase of capital.
- Mortgage loans to finance the purchase of homes and personal loans to finance consumer durable goods like cars or boats.
- Outstanding balances on credit card accounts are also bank loans.
- Loans riskiest asset, cannot be converted until due to be repaid.
- Some borrowers default on loans.
- Earns highest interest rates.

Economic Benefits Provided by Depository Institutions

1. Create liquidity

- By borrowing short and lending long (taking deposits and standing ready to repay them on short notice or on demand, and making loan commitments that run for terms of many years.

2. Pool Risk

- Loan may not be repaid, but when making so many loans, one loss is negligible so banks pool risk.

3. Lower the Cost of Borrowing

- Firms are able to get money from a single institution, and the institution gets the money from various deposits, spreading cost over many people.

4. Lower Cost of Monitoring Borrowers

- Lenders can encourage good decisions that prevent defaults by monitoring borrowers.
- This is costly.
- Depository institutions can do this at a lower cost.

How Banks Create Money

Creating Deposits by Making Loans

- Bank deposits are money, so when you take a loan and pay another company, you increase the size of the bank deposit of the company's bank.
- Three factors limit quantity of loans and deposits that the banking system can create through transactions.

1. The monetary base

- Size of base limits total quantity of money that banking system can create.
- Banks have a desired level of reserves, households and firms have a desired holding of currency, and both these holdings of monetary base depend on quantity of deposits.

2. Desired Reserves

- Reserves that banks *plan* to hold.
- Contrast with required reserves, that a bank *must* hold.
- Quantity desired depends on level of deposits and is determined by desired reserve ratio.
 - Ratio of reserves to deposits that the bank plans to hold.
 - Desired reserve ratio exceeds required reserve ratio by an amount that bank determines to be prudent.

3. Desired Currency Holding

- Proportions of money held as currency and bank deposits depend on how households and firms choose to make the payments.
 - Currency, debit cards, cheques
- If bank deposits increase, desired currency holding also increases.
- When banks make loans that increase deposits, some currency leaves banks.
 - Currency drain
 - Ratio of currency to deposits is the currency drain ratio