Money and finance

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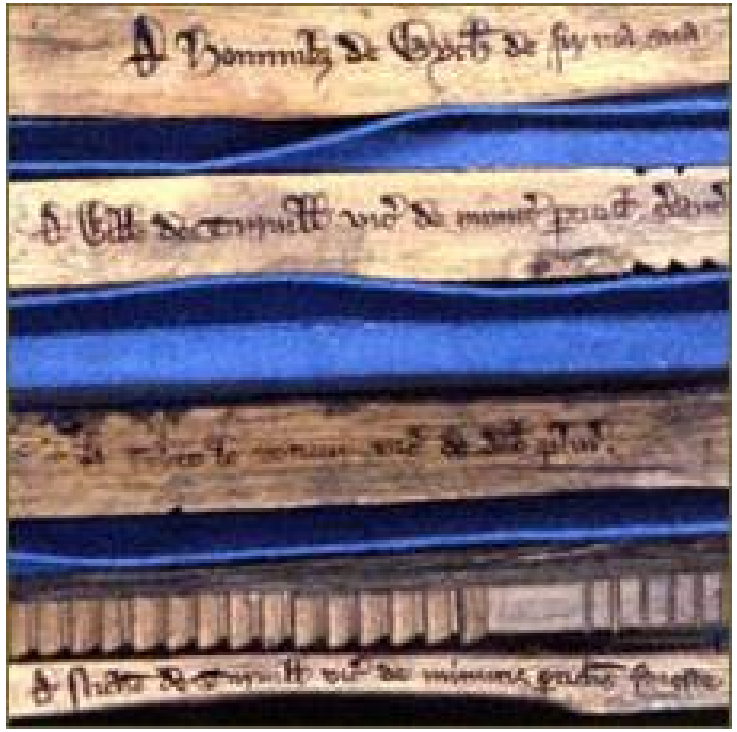



VISA
MasterCard


£20
Bank of England
I PROMISE TO PAY THE BEARER ON DEMAND THE SUM OF
£10
Bank of England
I PROMISE TO PAY THE BEARER ON DEMAND THE SUM OF
TEN
£5
Bank of England
I PROMISE TO PAY THE BEARER ON DEMAND THE SUM OF
FIVE
Pounds
JK37 747141
BANK of ENGLAND
TEN
£10

Essential questions about money

- What is money?
- How is money produced?
- How does it get/lose value?

The standard economic story (metallist)

- With this theory, money is first and foremost a **means of exchange**, its other functions (unit of account and store of value) are secondary
- A. Smith, **C. Menger**
- Problems of **rational actors** engaged in economic **exchange**
  - Double coincidence of wants
- Type of an evolutionary explanation – increasing effectiveness of the economic exchange
  - Precious metals (gold, silver) were selected due to their properties, particularly their high exchangeability
  - Paper and later electronic money were introduced as a transaction cost saving device, originally they were to represent the „real money“ deposited in vaults
- Barter -> money -> credit
- Problems with the standard approach (internal inconsistency, role of the state, historical facts)

State/credit theory of money

- Money is firstly a **unit of account** for recording debts
- It is an **IOU** and is created when an IOU is issued
- Its value depends on the **credibility** of the promise
- Money is an institution – a generalized and formalized type of an obligation (debt)
- Anyone can issue money (obligations) and almost anything can represent it (cattle, salt, wood, paper)
- The crucial problem is: **How to make people accept it?** How to make it generally recognized? (only then a generalized means of exchange is possible)
- **Hierarchy of money** (government > banks > firms > households)
- Problems (role of the private sector, legitimacy issues)

Essence of money

- What is money?
  - **measure of value (unit of account)**
  - It’s vital to differentiate between money of account and money things (what represents money)
  - A tool for economic coordiantion (technology)
  - People coordinate their economic behavior in various ways, the most common in-group coordination mechanism is some form of credit -> money usually measures debts (credits)
  - credit -> money (-> barter)
- How is money produced?
  - By issuing an IOU (× destruction of money)
- How does it get/lose value?
  - Money vs wealth
  - Credibility × quantity theory of money (but it’s complicated)
  - $M \times V = P \times Q$

Money and states

- A state is able to **determine its money** (unit of account) once it enforces **taxes/fees** in it
- Governments use money to **mobilize resources** for public purpose
- Money is **accepted** for several reasons: trust, habit, authority, but the ultimate reason is power
- The fact that a state issues its money and declares that it will accept it back in the form of taxes is an expression of **power** (+legal tender)
- Governments can buy anything that is for sale in its currency and is in theory able to **overbid** anyone
- Money has **distributional consequences** and is therefore prone to be abused for **political gains**
- Debtor × creditor interests

Modern money

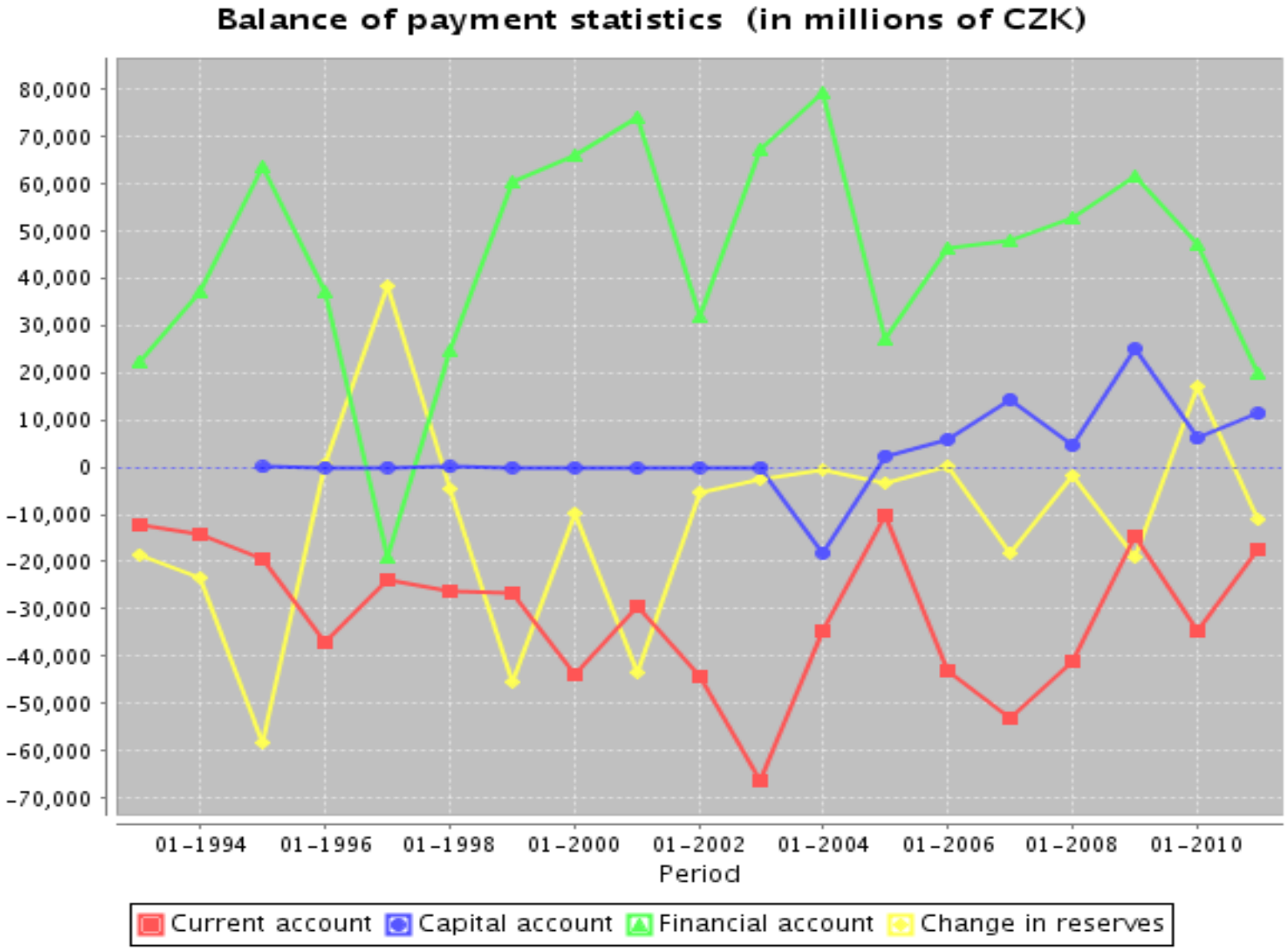
- Usually one state – one currency rule
- Governments owing in their **own currency can't be forced to go bankrupt** but they can decide to do so
- **Fallacy of composition –** what is true for a part (an individual) doesn't have to be true for the whole
  - Individuals × states
  - Expenditure = income
- Governments are for historical and political reasons **limited** in their power to exploit their monetary systems
- Most money today is issued by **private commercial banks**
  - Exogenous money – money multiplier
  - Endogenous money – credit creation ex-nihilo

Limits of domestic monetary power

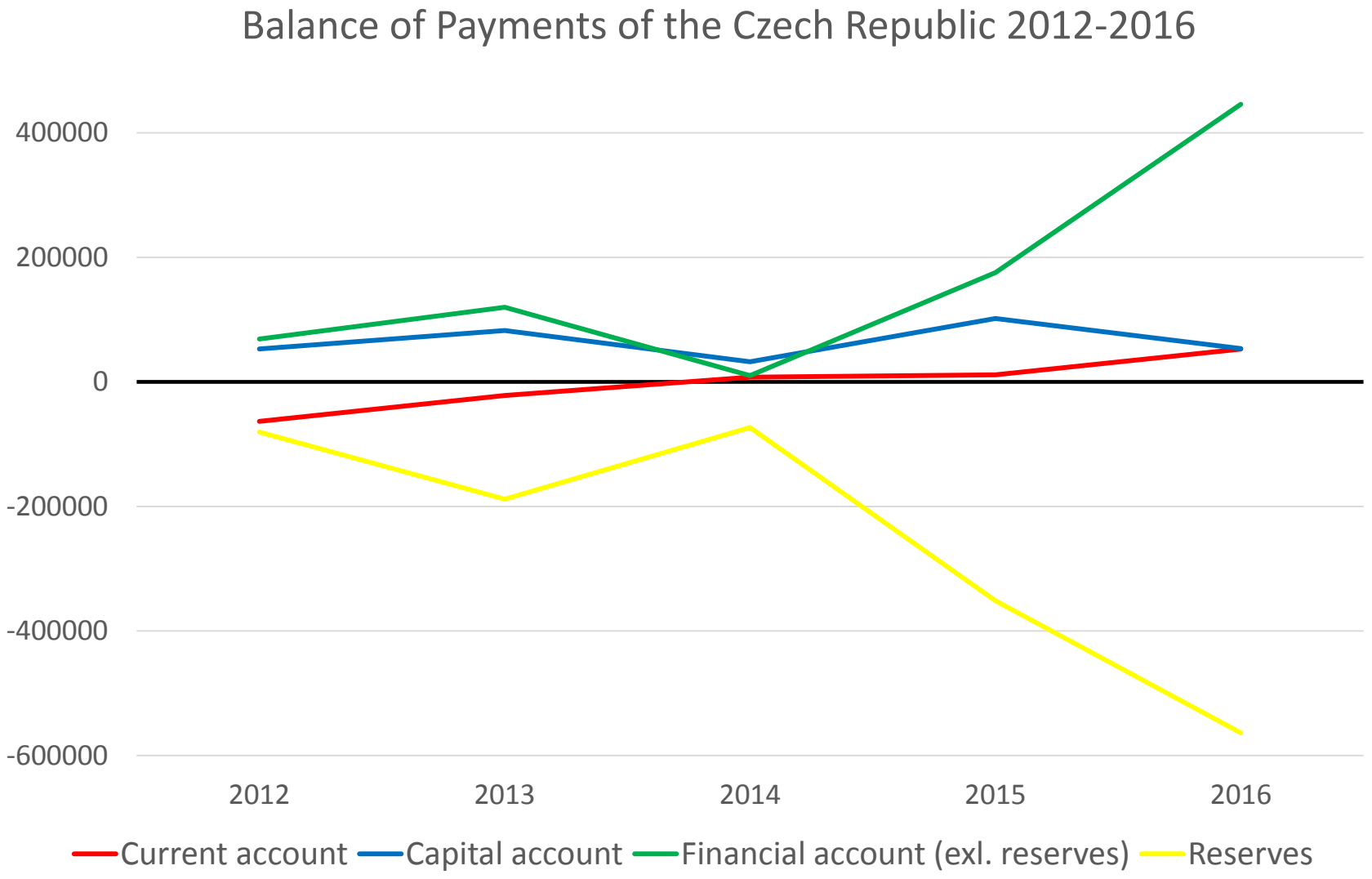
- Political and institutional constraints
  - Central bank independence
  - Deficit limit
  - Debt ceiling
  - Limited money supply (metal standard, currency peg)
- Inflation and real constraints (output level)
- International constraints
  - Balance of payments constraints
  - Debt in a foreign currency

International constraints

- **Balance of payments (flow)**
  - Accounting accord of all monetary transactions between a country and the rest of the world
  - The sum of all accounts has to be equal 0 by definition
- Composition (IMF × USA!)
  - Current account – trade + factor income
  - Financial (capital) account (including the reserve account) – net change of ownership of international assets
  - Balancing item (statistical errors)
- Relations between individual accounts
- **Net international investment position (stock)**
  - Accumulated CA, asset price changes, currency moves



Source: The Czech National Bank



Source: The Czech National Bank

Net international investment position (% of GDP in 2014)

Switzerland	119,6	United States	-39,7
Japan	74,8	Slovakia	-70
Germany	36,4	Spain	-94,5
China	17,1	Ireland	-106,7
Russia	16,7	Portugal	-111,6
CZ	-35,6	Greece	-121,9

Source: IMF

Balance of payments adjustment

- Most countries can’t run CA deficits for prolonged periods of time
- Relationship to government deficits and debts
- Balancing mechanisms
  - Exchange rate adjustment
  - Internal prices adjustment
  - Various others (debt forgiving, war, emigration)
- Adjustment cost
  - Transitional cost
  - Continuing cost

Monetary power

- Autonomy × influence
- Power to delay
  - Liquidity
  - Borrowing capacity
  - Special cases
- Power to deflect
  - Sensitivity (openness)
  - Vulnerability (adaptability)
- Who adjusts?
  - Deficit × surplus countries
- **Distributional consequences**