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Money and finance

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This powerpoint serves as a study material for the students of the course Introduction to economics (MEB435/MEBn5035) at FSS MU in Fall 2019. Using this presentation for other purposes without consent of the author is prohibited.

VISA
MasterCard

£20 Bank of England
£10 Bank of England
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
E R

Money and society

- What is money?
- How is money produced?
- How does it get/lose value?
- What is the relationship between money and states?

The standard economic story (metallist)

- Carl Menger (1892)
- Problems of **rational actors** engaged in economic **exchange**
  - Double coincidence of wants
- Type of an **evolutionary** explanation – increasing effectiveness of economic exchanges
  - 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
- With this theory, money is first and foremost a **means of exchange**, its other functions (unit of account, store of value) are secondary
- Money is **neutral** (at least in the long run) and **exogenous** (to the economic system)
- **Inflation × deflation** (a sustained increase/fall in the general price level)
- Barter -> money -> credit

Problems with the standard approach

- Questionable role of the state
  - It is considered unnecessary for monetary system to operate
  - States have a tendency to destabilize their monetary systems
  - But in some cases it's recognized that states have some important role to play (prevents counterfeiting, guarantees quality
- Theoretical problems
  - Hoarding of a thing makes it more scarce and thus less likely to be used as money
  - Unstated presuppositions (economic exchange, property rights)
- **Empirical issues** – anthropological surveys are at odds with the barter story, money predate coins by millennia

State/credit theory of money

- Money is first and foremost a **unit of account** for recording debts, its primary purpose is to enable economic coordination for public purpose
- It is an **IOU** (I owe you) 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)
- Money is **endogenous** and **NOT neutral**
- credit -> money (-> barter)
- Problems (role of the private sector, legitimacy issues)

Essence of money

- What is money?
  - **measure of value**
  - 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)
  - It's vital to differentiate between money (unit of account), money as an expression of debts and money things (what represents debts)
- How is money produced?
  - By issuing an IOU (× destruction of money)
- How does it get/lose value?
  - Credibility × quantity theory of money × taxes (it's complicated)
- Some historical examples – Sumer, Lydia, early US banking

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
  - In a closed economy is true by definition that **expenditures = incomes**
- **Hierarchy of money** (government > banks > firms > households)
- Most money today is issued by **private commercial banks**
- Governments are for historical and political reasons **limited** in their power to exploit their monetary systems

Limits of domestic monetary power

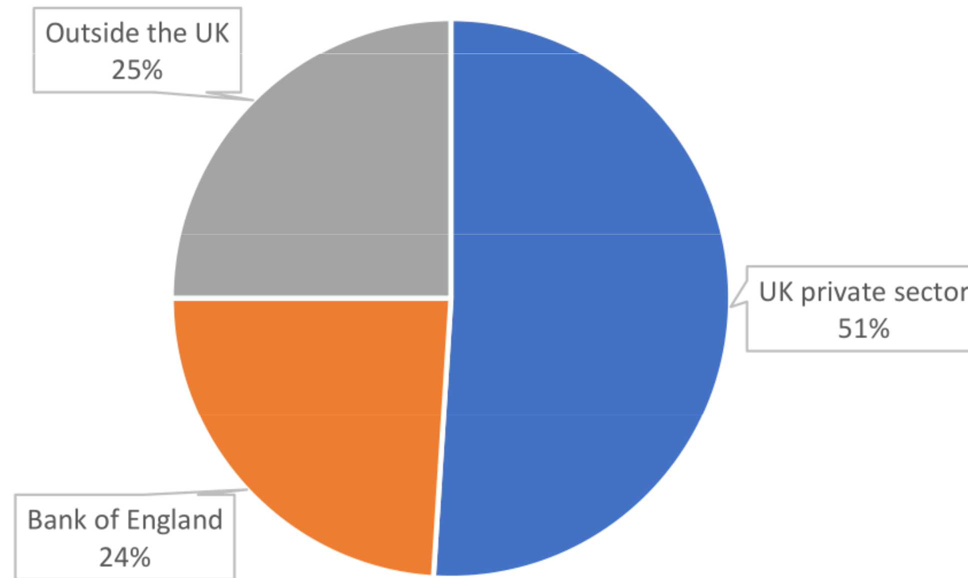
- Struggles over monetary systems
  - Ancient Greece, Rome, England 17th century, Great Financial Crisis
- Political and institutional constraints
  - Central bank independence
  - Deficit limit
  - Debt ceiling
  - Limited money supply (metal standard, currency peg)
- Inflation and real constraints (output level)
- International constraints
  - Balance of payments constraints
  - Debt in a foreign currency

Government debt (% of GDP in 2017)

Russia	13	UK	85
Switzerland	30	Spain	98
China	48	United States	105
Germany	64	Portugal	126
Ireland	68	Greece	179
Hungary	74	Japan	253

Source: IMF

Who owns UK goverments debt?



Source: jubileedebt.org.uk, UK Treasury

Capital

- **Capital (investment)**
  - For an individual
  - For the society as a whole
- Capital consists of assets that can enhance one's power to perform economically useful work
- **Capital goods**, are already-produced, durable goods or any non-financial asset that is used in production of goods or services
- **Financial** vs. **real** capital
- **Interest** is a payment for borrowing money
- **Interest rate** is a price of credit and plays the role of the cost of capital.

Financial system and banking

- Financial system - a system that allows the exchange of funds between lenders, investors, and borrowers
- **Orthodox account** of banking
  - Banks are intermediaries between lenders (savers) and borrowers
  - Money multiplication – additional credits created from deposits
- **Heterodox account** of banking
  - Banks finance capitalist production (financial investments precede savings)
  - Money created “out of thin air” loans created simultaneously with deposits
- Problems with **liquidity** a and **solvency**
- **Minimum reserves requirements and capital requirements**