Money and monetary policy

Money

- **What is money?**

- **Barter economy**
  - double coincidence of wants

- **Functions of money**
  - medium of exchange (means of payment)
  - unit of account
  - store of value
• **What money is not**
  – income
  – wealth
  – factor of production

• **What does money consist of?**
  - notes and coins
  - deposits

• **How is the total amount (stock) of money measured?**
  – M1 (notes and coins and demand deposits)
  – M2 (broader, more deposits)
  – M3 (broadest measure, includes long-term deposits)

• Note small share of notes and coins

• **By what is money backed up?**
  – gold?
  – confidence
  – role of the SARB
South African Reserve Bank

- South Africa’s central bank and main monetary authority

**Functions**
- formulation and implementation of monetary policy
- service to government
- provision of economic and statistical services
- maintenance of financial stability

**Monetary policy**
- discussed later

**Service to government**
- acts as banker and advisor
- custodian of gold and foreign exchange reserves
- exchange control

**Economic and statistical services**

**Maintenance of financial stability**
- supervises banks
- National Payment System
- acts as banker to other banks (lender of last resort)
- banknotes and coins (sole issuer)
Demand for money

• Why do households, firms and government hold money?

• **Cost of holding money**
  – opportunity cost
  – interest forgone
  – impact of inflation

• Why do people hold part of their income or wealth in the form of money, which earns little or no interest and loses some of its value during inflation?

• **Motives for holding money**
  – transactions motive (money as means of payment/medium of exchange)
  – speculative motive (money as an asset; store of value)

• **Demand for money as a medium of exchange (L1)**
  = transactions demand (demand for active balances)
    (positively related to income $Y$)

• **Demand for money as an asset (L2)**
  = speculative demand (demand for passive balances)
    (inversely related to interest rate $i$)
**Graphical presentation:**

- Thus: total demand for money (or liquidity preference) determined by income $Y$ and interest rate $i$

$$L = L_1(Y) + L_2(i)$$

**Summarised in table below**

<table>
<thead>
<tr>
<th>Function</th>
<th>Motive</th>
<th>Active/passive</th>
<th>Main determinant</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medium of exchange</td>
<td>Transactions</td>
<td>Active balances</td>
<td>Income</td>
</tr>
<tr>
<td>Store of value</td>
<td>Speculative</td>
<td>Passive balances</td>
<td>Interest rate</td>
</tr>
</tbody>
</table>

*The demand for money (or liquidity preference): a summary*
Money creation

- Many misconceptions
- Money created by banks, not by mint or printing press
- Banks create deposits (money) by granting loans
- Banks limited only by:
  - demand for loans
  - actions of central bank (SARB), by varying repo rate

Stock of money determined by interaction between demand for money and the interest rate

The money market

- Stock (quantity) of money thus essentially dependent on the demand for money
Monetary policy

- Definition (interest rates, quantity of money)
- Responsibility of SARB
- Monetary Policy Committee (MPC)

Monetary policy framework:
- ultimate objective (balanced and sustained economic growth)
- intermediate objective (pre-announced inflation target)
- operational variable (repo rate)
- monetary control system (classical reserve system)

Instruments
- accommodation policy/repo system/repo rate
- open market policy
- other instruments