





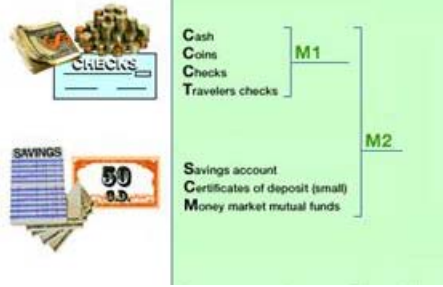


# The Money Supply

- Economists use the term money to describe anything that makes exchanges of goods and services easier.
- Money serves three basic functions: medium of exchange, unit of account, and store of value.
- The characteristics of money are that it is durable, portable, standardized, and divisible.
- The money supply is made up of **M1** and **M2**.

<p><b>Defining barter</b></p> <p>Suppose: You are a canoe maker and you want to buy a chicken.</p>  <p>Canoe to trade      Chicken to buy</p>	<p>In a barter economy, exchanging goods and services requires extensive search costs. Suppose, for example, that you are a canoe maker and want to buy a chicken. You must first find someone willing to accept a canoe for a chicken. Then determine how many canoes are worth one chicken. Then you must haul the canoes to trade them.</p>
<p><b>The functions of money</b></p> <p>A medium of exchange such as salt, will lower the search costs.</p>  <p>*Money*</p>	<p>A medium of exchange is a widely-accepted good that can be used as <b>money</b> in the economy to lower the search costs of matching trades and make trading easier to do.</p> <p>A unit of account allows people in the economy to assign economic value to particular goods and services. Instead of quoting the value of chickens in terms of canoes (a good that only few people may want), you can now determine the value of a chicken in terms of salt (the medium of exchange widely accepted in the economy).</p> <p>A store of value allows people to hold money now and use it for purchasing goods and services later.</p>
<p><b>The Characteristics of Money</b></p> <p>Money is durable, portable, standardized, &amp; divisible.</p> <p>Example</p>  <p>The gold can be cut up into standard sizes (coins) and circulated as money.</p>	<p>For a good to be accepted as a medium of exchange, it must be durable and portable. In addition, the good must be able to be divided and standardized before it can be circulated in the economy.</p>
<p>How the government gives money value:</p> <ol style="list-style-type: none"> <li>1. Money is used to pay taxes.</li> <li>2. Money (fiat money) is legal tender.</li> </ol> <p><b>Q.</b> Why should we care about money?</p> <p><b>A.</b> Money makes transactions easy to do.</p> <ol style="list-style-type: none"> <li>1. Enough money → Business is normal </li> <li>2. Not enough money → Recession </li> <li>3. Too much money → Inflation </li> </ol>	<p>The illustration on the left tells us why money in our economy is important. Recall the analogy explaining the difference between microeconomics and macroeconomics. If microeconomics is the study of the cell and macroeconomics is the study of the organism, then the money supply is the lifeblood of the organism and vital to its health.</p>

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Note that economists use the term money to describe only those things commonly accepted for exchange of goods and services.

The money supply is made up of the two components seen on the left. **M1** encompasses the narrowest and most basic forms of money, while **M2** includes the broadest forms.