 Money and Banking

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Why is a course on money important?

Why is a course on banking important?

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Banking Versus Automobiles

Since the product and income generated in the automobile industry is much larger than that in the banking industry, why doesn't the economics department offer a course on the automobile industry?

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Properties of Money

Medium of exchange Money is used to buy things.

Store of Value Money has value.

Standard of value Prices are expressed in terms of money.
Debts are repaid in money.

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Money and Inflation

Money affects prices throughout the economy. In the long run, money determines the price level and the rate of inflation.

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Neutrality of Money

Many economists argue that money is *neutral* in the long run. This point-of-view is standard in microeconomic thinking.

Neutrality of money is a fundamental concept. Money has no effect on real economic variables—real quantities and relative prices. In particular, money affects neither the level or the growth rate of real national income and product. Money affects neither the real wage nor the real interest rate.

Instead money affects only the overall price level.

Microeconomics

That money is neutral is standard in microeconomic thinking. There is no role for money, so money is absent from microeconomic models. One analyzes how relative prices affect real quantities.

Curiously, microeconomists do not prove or explain why money is neutral. The neutrality of money is a fundamental assumption underlying the modelling.

Macroeconomics

In contrast, macroeconomics studies money and its role and does not assume neutrality.

Many macroeconomists argue that money is neutral in the long run. From this point-of-view, perhaps money is not important.

However money is not neutral in the short run. In the short run, money affects the real interest rate.

The real interest rate is important throughout the economy. In particular, the real interest rate affects investment, a driving force in the economy.

Banking Crisis

Throughout the world, the banking system is unstable and seems prone to crisis. Credit dries up, investment collapses, and the economy contracts.

Many economists blame money for the Great Depression, 1929-1940.

The 2008 financial crisis was a banking crisis.

What causes a banking crisis? Might the banking system be organized differently, to avoid crisis?

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Medium of Exchange

The economy needs a smoothly functioning medium of exchange. Trust in the medium of exchange is essential. Any disruption to the ability to buy and sell would undermine economic activity.

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Central Bank

The Federal Reserve is the central bank of the United States. Overall, economists see it as a valuable institution striving to fight recession, to prevent inflation, and to achieve economic growth. It works for the social good, in a neutral, objective, technocratic manner.

A Political Central Bank?

Not all economists see the Federal Reserve in this way (for example, Rothbard [1], *The Case Against the Fed*). Some contend that it is a political institution supporting banks and bank profits, at the expense of others. The federal government needs strong banks to finance its huge borrowing. Because the after-tax real return on government debt is negative, borrowing enables the federal government to expand its spending and power.

References

[1] Murray N. Rothbard. *The Case Against the Fed*. Ludwig von Mises Institute, Auburn, AL, 1994. 11