8 The monetary system

8.1 What is money?

People can ask “How much money do you have?” referring to “How much wealth do you have?”. However, in economics, money refers to a country’s asset with which people buy and sell goods and services between them. So, in the United States, the dollar currency is a form of money. In India, the rupee is the Indian currency or money. But, the function of money is not only to buy and sell goods and services. Let’s see.

8.2 The functions of money

There are three functions of money in an economic system:

- A medium of exchange: Money is the asset which allows us to buy and sell goods and services in a specific place. It’s assumed everybody in that place, country or region will use that money to make transactions.
- A unit of account: It serves to give price value to goods and services in terms of mathematical units. For example, a computer in the US can cost “2000” dollars. 1 kg of apple can cost 5 dollars. So, money serves to measure in “unit dollars” how much a good or service costs.
- A store of value: People save this money in their bank accounts in order to save this money for future consumption. Whenever a seller receives money from the buyer, he will feel secure that he can save this money for future expenses or investments.

Gold can be considered as having intrinsic value since it is used in many world industries and for jewellery. It has been used previously as money. Money that doesn’t have intrinsic value is fiat money.

Fiat money is usually provided by the country’s government, specifically, the central bank.

8.3 The central bank

It’s the authority which takes care of the money supply and regulates its circulation in the economy. In the US, the central bank is called the Federal Reserve Bank, a.k.a. FED. In India, it’s called the Reserve Bank of India In Singapore it is MAS and in the UK it is the Bank of England.

Central banks have different responsibilities depending on the country’s preferences. In the United States, they care about inflation and the unemployment rate. In other countries, they only care about inflation.

8.4 Fed tool to impact its economy

The Fed has some tools to regulate its economy. The main tool is the interest rate or FED funds rate. This rate is offered to the market as an indicator for all the interest rates of the United States banks, financial institutions and firms. This funds rate, in turn, controls the money supply in the economy, which is important to maintain good levels of the inflation rate.

The central bank also serves the purpose of “lender of last resort”, as it happened to be in the following crisis

8.5 The Financial Crisis of 2008

In the US subprime crisis, the FED started the policy known as “Quantitative Easing” (QE). This policy consists of buying the government treasury assets. When the FED buy these assets, treasury bond prices tend to increase, which in turn, makes the yield rates stay low (there’s an inverse relationship between prices and yields in the bond market).

One way the FED intervened in the market was with the recent Silicon Valley Bank (SVB) rescue. Once the SVB found itself unable to meet its liabilities money withdrawal due to the decrease of its assets’ value, SVB entered into an enormous bank run. The FED said it will help as a “lender of last resort”, i.e., it will assure the SVB depositors will receive the integrity of their lost money at the bank. This way, the FED intervened in the market increasing the money supply in the market.

QE is not allowed in all countries. Whenever you trade, you should be careful that a country is applying this QE. QE has been applied in Japan, Europe and the US. There were other countries that applied this policy but ended in hyperinflation. QE risk is hyperinflation whenever it is not well managed. Before you start trading or investing in any country, please be sure you are making a good analysis of the country in order to manage risks properly.