Chapter 31: Money, Banking, and Financial Institutions

As Liza Minelli famously sang in the musical *Cabaret*, "Money makes the world go around." Chapter 31 introduces the role of money in the economy, as well as the structure and functions of the Federal Reserve System.

Money serves three functions in the economy. It is a medium of exchange, meaning it can be used to buy products. It is also a unit of account which can be used to measure the relative values of products in the economy. Money also serves as a store of value, allowing people to save purchasing power to buy more products in the future.

$M1$ is the primary measure of the money supply, which includes currency (coins and paper money) and demand deposits (checking accounts). These funds are perfectly liquid, meaning they can be spent immediately to buy products. $M2$, another measure of the money supply, also includes "near money" such as savings accounts, small certificates of deposit, and money market mutual funds, which can be easily converted into currency and demand deposits.

Money is no longer "backed" by gold; its value is determined by the government's ability to limit the size of the money supply. Inflation can result from a significant increase in the money supply. The purchasing power of a dollar represents the amount of products a consumer can buy with that dollar, so when prices rise, the purchasing power of the dollar falls.

The Federal Reserve System is the central banking system of the United States, specifically designed to shield its policymakers from political pressure. The Federal Reserve Board of Governors consists of seven members who are appointed by the president and confirmed by the Senate to serve 14-year terms. The 12 regional banks are publicly-controlled, yet privately owned by the member banks. They can be thought of as "bankers' banks," providing local banks with some of the same services local banks provide customers: a safe place to store savings and a place to get loans. The Federal Open Market Committee (FOMC) buys and sells government securities to change the nation's money supply.

The Fed's primary responsibility is to control the money supply. It also determines the reserve requirement, which is the percentage of deposits banks must hold and cannot loan out. The Fed also loans money to member banks, charging the discount rate as interest on the loan. In addition, the Fed issues currency, clears checks, serves as the federal government's bank, and supervises the member banks.

Material from Chapter 31 usually appears in one or two multiple-choice questions on the AP Macroeconomics Exam. The functions and measures of money are important to know, as well as how inflation affects purchasing power. The powers of the Federal Reserve System are more likely to be tested than knowledge of the structure of the Fed. The Fed's use of the reserve requirement, the discount rate, and open market operations will become central to the understanding of monetary policy in coming chapters, and that material is critical to the AP Macroeconomics Exam.