ALL ABOUT THE MONEY

Paper Money from Various Countries

Unit Overview

Because we cannot get the things we need and want without it, money is an essential part of our daily lives. If asked, most of us would define it as the bills in our wallets or as what we receive when we cash our paychecks. It should come as no surprise that economists have their own language when it comes to defining money. In this unit, you will view money from an economist's perspective. What gives money value? What are its characteristics and functions? How does it circulate throughout the economy? Let's see how it all works.

How an Economist Defines Money

Almost all societies have established a form of money to simplify financial transactions. An economist defines money as anything that provides a medium of exchange, a unit of account and a store of value. If something is going to work as money, it must be accepted by all parties as payment for goods and services. In other words, an object has to function as a **medium of exchange** to be considered money. Workers must agree to accept it in exchange for their labor, and merchants must agree to accept it as payment for goods. Throughout history, a wide variety of materials, such as gold dust, rice, salt and cattle, have been used as a medium of exchange.

For an article to be regarded as money, it must serve as a **unit of account**. This is also referred to as measure of value. This function assists consumers in comparing the values of goods and services. For example, let's say you see a pair of running shoes on sale in a shop for $45.00. Because the price is expressed the same way in every store in the United States, you can easily compare the cost of the shoes if you see the same item offered elsewhere. Units of account provide a convenient and easily understood method of identifying and communicating value. In the United States, dollars and cents operate as units of account, but other countries use their own money for this purpose. For the Russians, the ruble is a unit of account, while Mexicans use the peso in a similar way.

Price in Dollars and Cents Helps Buyers to Compare Value

To be considered money, an item must serve as a **store of value**. This means that money maintains its value whether you spend it today or tomorrow. If you keep your money in your purse or in the bank, it will still be a unit of account and recognized as a medium of exchange for the same amount months or years from now. Money works well in this capacity with one important exception. Sometimes economies experience a quick rise in prices, or **inflation**. In this case, purchasing power declines. The running shoes that were once $45.00 are now $55.00, and consumers are able to purchase less with their stored funds. When an economy experiences inflation, money does not function well as a store of value.

Go to Questions 1 through 4.

Characteristics of Money

Along with having specific functions, objects used as money need to have certain characteristics if they are going to serve society successfully. They must be durable, divisible, uniform, portable, limited in supply and acceptable. Because it is used over and over again, money must withstand physical wear and tear. After all, it cannot be trusted as a store of value if it is not **durable**. Coins are some of the longest-lasting examples. In fact, Greek and Roman coins, made over two thousand years ago, are highly prized by collectors today. Because American paper money has a high degree of cloth, or rag, content, it withstands the rigors of circulation and can be easily replaced if it does not.

To serve a practical purpose, buyers and sellers should be able to divide money into smaller units simply. In the 1700s, Spanish coins, called **doubloons**, had lines etched on them so that they could be broken apart easily. Because these coins were designed to be **divisible**, Spaniards referred to them as pieces of eight. Today, instead of tearing dollars into smaller pieces, Americans address this issue by relying on coins and paper bills that come in a variety of denominations. In other words, we do not need to cut up twenty-dollar bills because we have ones, fives and tens. At the same time, money should also be **uniform**. Everyone must be able to count and to measure it accurately. Each dollar is obliged to buy the same amount of a good or a service. What would happen if the U.S. economy adopted oak leaves as money? Because not all oak leaves are the same size, consumers might spend one on one day and three on another day to purchase the same product. This would probably result in frequent arguments between buyers and sellers.

An Example of the Portability of Paper Money and Coins

Portability is one of the most necessary and practical characteristics of money. People first exchanged goods and services through **barter**. This refers to the direct transfer of one product for another. Although it is still currently used in some parts of the world, specialized economies find the practice difficult and time-consuming. To conduct business efficiently, buyers and sellers need to take their money with them. In other words, money is more useful when it is **portable**. Since coins and paper bills are small and easily carried, they have a distinct advantage over bartered goods. Everyone in the economy needs to be able to trade the objects serving as money for goods and services. This means that money must be **acceptable** across the country. In the United States, store owners accept American money because they can spend it anywhere to buy things that they want our need. At the same time, Americans expect that businesses will continue to honor paper money when they make purchases.

Barter vs Trade

Like almost everything else, money loses its value when there is too much or too little of it. In colonial Virginia, for example, tobacco functioned as money. This worked reasonably well until more farmers started to grow it. As the supply of tobacco increased, the price dropped from thirty-six cents per pound to one cent per pound. This made “tobacco money” worthless. To avoid situations like this, the U.S. government controls the amount of money in circulation through the Federal Reserve. This gives money value because the supply is **limited**. The Federal Reserve keeps enough money in circulation to encourage economic growth. It can also decrease the amount money in circulation to avoid inflation.

Go to Questions 5 through 9.

What Makes Money Valuable?

Although paper bills are practical objects, they have little value of their own. In reality, they are only pieces of paper. What makes the objects used as money special, and why do we regard them as valuable? There are several possible answers because there are different kinds of money. Economists divide money into three types: commodity money, representative money and fiat money.

- **Commodity money:** Commodity money consists of objects that are not only useful as money but also have value in their own right. You read earlier that tobacco was used as money in colonial Virginia. However, it could also be traded as a product. Salt is another example. Although it, too, served as money, it also had value as a seasoning and as a preservative. Commodity money has the advantage of being functional in other ways when it is not being used as money. However, it also has drawbacks. Commodity money is often not durable, divisible or portable. As societies grow and become more sophisticated, they usually require a more convenient system for the exchange of goods and services.

Examples of Items Used as Commodity Money: Arrow heads, Rice and Gold Dust

- **Representative money:** Unlike commodity money, representative money has no value itself, but it stands for something that does. In the 1800s, the United States government began to issue gold and silver certificates. These pieces of paper were backed by actual gold and silver, and holders could redeem them for an equal amount of these precious metals at a local bank. In 1900, Congress passed the Gold Standard Act. This law fixed the price of gold at $20.67 and obligated the federal government to exchange dollars for gold at that rate. Americans felt more secure knowing that their money represented gold in the National Treasury. The 1930s, however, ushered in uncertainty, unemployment and a record number of bank failures. Americans no longer trusted banks to keep their money safe and redeemed cash for gold. The federal government feared that it did not have enough reserves to meet the public’s demands. In 1933, President Franklin Roosevelt declared a national emergency, and America went off the gold standard. U.S. money was no longer representative.

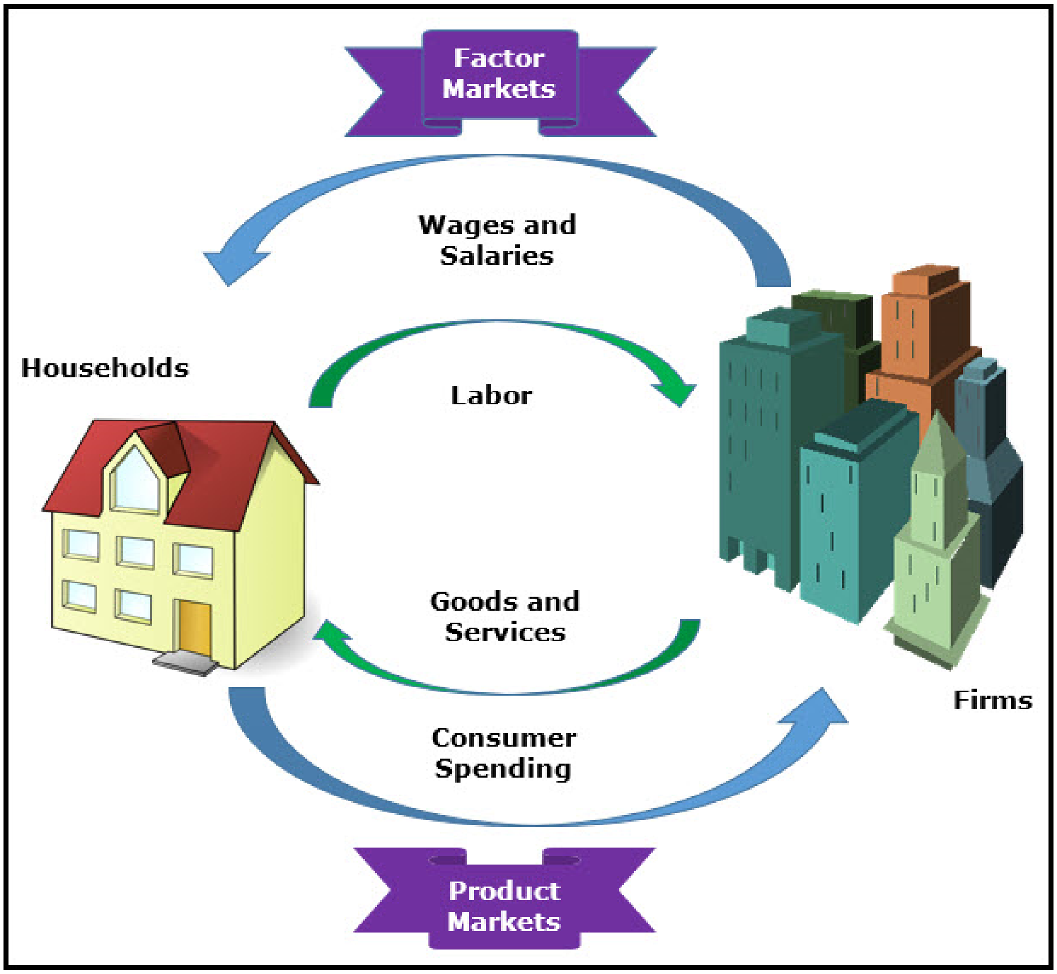
U.S. Gold Certificate

- **Fiat money:** American dollars and coins today are classified as fiat money. A **fiat** is an order or a decree. Also referred to as **legal tender**, fiat money has value because the federal government says that it does. The Federal Reserve monitors the supply of fiat money carefully so that it remains limited and, therefore, valuable.

Go to Questions 10 through 13.

Money and the Circular Flow

In a market economy, **households**, which are made up of individuals living in the same residences, and **firms**, or businesses, exchange resources, products and money in the marketplace. Economists use diagrams like the one below to illustrate this process. Follow the circle created by the blue arrows. Households spend money to purchase goods and services from firms. Firms, in turn, use this money to pay households for the resources that they need to manufacture their products. For example, companies hire workers to whom they pay salaries, wages and benefits. This outer circle is known as the **monetary flow**. On the other hand, the green arrows of the inner circle form the **physical flow**, or the flow of resources. Households supply firms with labor and capital, while firms supply households with goods and services.



Let's look at the diagram another way. Focus on the upper part of the graphic. It represents the markets where resources are bought and sold. These are called **factor markets** because businesses buy the factors of production in them. The lower portion of the diagram shows households and firms interacting in **product markets**. Here, households buy goods and services produced by firms. Once individuals receive their income in the factor market, they spend it in the product market. Firms then use this money to produce more goods and services. This creates a continuous flow, or cycle.

The Circular Flow

Go to Questions 14 through 17.

The Future of Money

In this unit, you have read about the functions and characteristics of money. Although paper bills and coins have their advantages, some analysts argue that they will soon be obsolete. Will cash as we know it cease to exist in the near future? Would it be better to replace it with electronic money or smart cards? Is cyber money a serious threat to our privacy? Read the opposing points of view quoted in the graphic below.

The Pros and Cons of Eliminating Paper Bills and Coins	
Bring on the Cashless Future	**The Hubris of Eliminating Cash**
Cash had a pretty good run for 4,000 years or so. These days, though, notes and coins increasingly seem outdated. They're dirty and dangerous, unwieldy and expensive, antiquated and so very analog. Sensing this dissatisfaction, entrepreneurs have introduced hundreds of digital currencies. This is a welcome trend. In theory, digital legal tender could combine the inventiveness of private virtual currencies with the stability of a government mint. Most obviously, such a system would make moving money easier. Properly designed, a digital fiat currency could move seamlessly across otherwise incompatible payment networks, making transactions faster and cheaper. It would be of particular use to the poor, who could pay bills or accept payments online without need of	An end to cash would mean that every financial transaction is exposed to a third party. Protecting one's privacy from the prying eyes of the government isn't the only concern either. Cashlessness has implications for people who want to hide their medical conditions. It has implications for people who don't want their credit score dinged when, say, they make a purchase at Walmart. Beyond a certain threshold I'd alert my wife to a purchase, but do I want her knowing exactly what I spend on my insatiable avocado habit? Thank goodness for cash. Cash should remain, always and everywhere, because it allows, private, peer-to-peer transactions. In doing so, it decentralizes power in society (as well as adding a layer of resilience to

a bank account, or make remittances without getting gouged. For governments and their taxpayers, potential advantages abound. Issuing digital currency would be cheaper than printing bills and minting coins. It could improve statistical indicators, such as inflation and gross domestic product. Traceable transactions could help inhibit terrorist financing, money laundering, fraud, tax evasion and corruption. Editorial Board, *Bloomberg View* January, 2016	the financial system—a diversification between the physical and virtual). Having stuff in society that elites can't completely control is a good thing. Keeping a large swath of the economy away from Big Finance and Big Data is a good thing. Finally, people like cash; we shouldn't let the elites take it away. Conor Friedersdoft, *The Atlantic* June, 2014

Go to Questions 18 through 23.

What's next?

The circular flow model shows that households sell their talents and skills in return for salaries and wages. They sometimes also provide financial capital for businesses in the form of investments. Investments often earn profits and grow the nation's wealth, but they always come with varying amounts of risk. Before moving on to explore this topic in the next unit, review the terms found in Unit 9; then, complete Questions 24 through 33.

Go to Questions 24 through 33.