

# Financial Studies – Text for Assignment 2 – 16.7.21

## 1.2 Features of money

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In order to fulfil its purposes, money needs to have certain features; we saw some of these when we looked at how money developed. Money must be:

- |               |                        |
|---------------|------------------------|
| acceptable;   | durable;               |
| recognisable; | portable;              |
| stable;       | scarce but sufficient; |
| divisible;    | homogeneous.           |

We will explore what each of these terms means in the following sections.

### 1.2.1 Acceptable

People are only willing to accept money as payment for goods and services if they are confident that others will, in turn, accept money from them as payment in later transactions. We have seen that coins, banknotes and balances in bank accounts all *represent* value rather than having an intrinsic value of their own. This means that people have to trust that they will be accepted.

Part of the reason why people are prepared to accept money is because they have faith that coins and banknotes are worth their face value, that is, the denomination written on them. British banknotes have the following written on the front: ‘I promise to pay the bearer on demand the sum of’ followed by the amount of money the banknote represents.



This promise is signed by the Chief Cashier of the Bank of England. It is an example of the role the Bank of England plays in maintaining people’s trust in the money they use. Money is said to have a ‘fiduciary value’ (from the Latin *fides* meaning faith), which is based on trust in the banking system.

Another aspect of faith in the monetary system is that sellers will receive the funds transferred between bank accounts electronically. This money is transferred using a variety of payment mechanisms such as payment cards and cheques. We will look at the different methods of transferring these funds in detail in Topic 3.

## 1.2.2 Recognisable

Cash must be recognisable so that people are confident they are receiving genuine coins and banknotes – in the UK, for example, a 20p coin has seven sides, so if someone was given a round 20p coin they would know it was not genuine. Cash must also have security features to ensure that it is difficult to make forgeries. For example, the Bank of England has introduced features such as raised print, metallic thread, micro lettering, watermarks, holograms, ultraviolet features, see-through windows and complicated designs to the notes it issues (see [www.bankofengland.co.uk](http://www.bankofengland.co.uk) for details). Some of these features, such as watermarks and metallic thread, are easy for merchants to verify; others, such as ultraviolet features, require specialist equipment.

## 1.2.3 Stable

Money needs to hold its value so people can be confident that the money they accept now will be worth the same or a similar amount in the future. Inflation, which is when the general level of prices in an economy rise, means that the same amount of money will buy less in the future and so its value falls in real terms. Inflation and its impact on savings is explored in more detail in Topic 5.

## 1.2.4 Divisible

Coins and banknotes must be provided in a variety of denominations so that people can use them in different combinations to make transactions of different sizes. Having smaller denominations allows people to pay with larger amounts of cash and to receive change. The Royal Mint website ([www.royalmint.com](http://www.royalmint.com)) has details of the coins it issues and the Bank of England website ([www.bankofengland.co.uk](http://www.bankofengland.co.uk)) shows the banknotes it currently issues. Banknotes for Scotland and Northern Ireland are issued by a number of banks. Details can be found on the website for The Association of Commercial Banknote Issuers (ACBI) at [www.acbi.org.uk](http://www.acbi.org.uk).

Payments from bank accounts are for specific amounts and do not need to be divisible.

## 1.2.5 Durable

Coins and banknotes need to be strong enough to be used many times before they need to be replaced by the Royal Mint or the Bank of England. Although UK coins are coloured gold, silver or bronze they are made of metal alloys to ensure they are durable. Coins made of pure gold, for example, are quite soft and damage easily.



Introduced in England and Wales in September 2016, the durable polymer £5 note is hoped to last for five years. Polymer £10 and £20 notes followed in 2017 and 2020.

### 1.2.6 Portable

People must be able to carry the coins and banknotes they need for everyday use. This is another reason why they are produced in different denominations and that larger amounts are paper-based.

The payment mechanisms used to transfer bank balances are very portable, for example cheque books and payment cards such as debit cards. Details about how these mechanisms work will be discussed in Topic 3.

### 1.2.7 Scarce but sufficient

The Bank of England manages the supply of cash in the economy so that there is enough for people's transaction needs. It is important to make sure that there is not too much cash in circulation, though, because this leads to inflation and the value of money falls. Inflation and the impact it has on people's savings will be covered in more detail in Topic 5.

### 1.2.8 Homogeneous

All coins and banknotes of a certain denomination need to be homogeneous, that is, to look and feel the same. This helps them to be recognisable and therefore acceptable. The designs on coins and banknotes vary but the shapes and main features remain the same. Occasionally the Bank of England or Royal Mint changes the size of a note or coin but they provide plenty of information about the change, to ensure the new note or coin is recognisable. They also withdraw the earlier version over a limited period to achieve homogeneity as quickly as possible. For example, a new, smaller 5p coin was introduced in June 1990 and the older, larger coin was taken out of use the following January.

## 1.3 Functions money must perform

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We have seen that people use money to:

- measure value;
- make payments;
- save; borrow.

These four uses give us the following four functions that money must perform.

### 1.3.1 A unit of account

Money offers a standard measure of financial value, for example, for the value of goods and services and the financial assets that a person owns. This enables people to compare prices between goods and to see how prices or values change over time or between countries.

It is the measure used in accounting and on bank statements to record transactions and provide balances.

### 1.3.2 A means of exchange

Money enables people to make payments. We saw in section 1.2.1 that money functioning as a means of exchange is made possible because people trust the banking system. There is also a legal element. Certain banknotes and coins are 'legal tender'. This means that they must be accepted in settlement of a debt. There are other notes and coins in circulation that are widely accepted but are not defined as legal tender; in theory, people can refuse to accept these to pay off a debt, but it is rare for anyone to do so.

Coins worth £1 and more are legal tender throughout the UK but the situation is more complicated in relation to coins of smaller denominations and banknotes.

Coins for amounts smaller than £1 are only legal tender for debts up to a certain amount. For example, 20p coins are legal tender for up to £10 in a single transaction. This is mainly because it is not practical to pay a large amount in small coins.

Bank of England banknotes are legal tender in England and Wales, but not in Scotland or Northern Ireland.

There are banks in Scotland and Northern Ireland that issue their own banknotes. These Scottish and Northern Irish banknotes are not legal tender anywhere, including in the countries that issue them, but they are widely accepted. The value of the banknotes is backed by these banks holding account balances at the Bank of England.

The money held in bank accounts is not legal tender but people accept transfers of this money into their bank accounts because they trust in the banking system.

#### Local currencies

Some communities have created their own currency to encourage people to spend in local shops and so keep the money in the local economy. Examples include the Lewes Pound, Brixton Pound, Stroud Pound and Cardiff Taffs.

The Totnes Pound was introduced in 2007. People bought the currency at an issuing point in the town to spend in local shops or on locally based services.

The Totnes pound note (© Totnespound.org)

Each Totnes Pound note met the criteria listed in section 1.2. It was: accepted

- ◆ as payment by local merchants; recognisable because it had a picture of a
- ◆ local landmark on it; stable because its value was the same as the Great
- ◆ British pound; divisible because it was issued in a small denomination and
- ◆ change could be given in English coins; durable because it was made of strong paper; portable because it was a similar size to other banknotes;
- ◆ scarce because it was only issued in Totnes; homogeneous because all
- ◆ Totnes Pounds looked and felt the same.

◆ After inspiring many other local currencies, the Totnes Pound was withdrawn because fewer people were using cash (BBC News, 2019).

Bitcoin is an electronic form of currency that is decentralised, meaning it is not backed by a promise from a central bank such as the Bank of England. People use bitcoin to exchange money over the internet, but because bitcoin is not regulated the transactions are hard to trace and can be made anonymously.