Topic 1
Purposes of money

Learning outcomes

After studying this topic, students will be able to:

- define the purposes of money; and
- outline its key features.

Introduction

This topic explores the question, 'What is money?' To answer this question we will discuss why money was invented, what purposes money serves today and some of the many ways that people use it.

If you were to ask people what money is, many would think first of coins and notes. These are used every day to pay for items in a wide variety of places including shops, cafes and bus or train stations. Collectively, coins and notes are termed 'cash'. If people were asked where they store their money, they might mention their purses or wallets and their bank accounts. The contents of bank accounts are held as electronic records that the banks keep. Banks notify people about how much is in their bank account by giving them statements of the current balance – that is, the total in their account on the date of the statement.

Coins and notes are described as 'money' but most money is in the form of electronic balances in bank accounts. People can take coins and notes out of their bank account, for example by using their cash card at a branch. The reason to have cash is to make a payment. Payments can take several forms, for example people may spend it, pay it into a savings account, give it to another person as a gift or repay money they have borrowed. People can also instruct their bank to pay some of the contents of their bank account to someone else, for example by writing a cheque. Payment is the common feature of what money is and its main purpose.

We can define money as 'anything that is widely accepted as a means of making payments' and specify that 'money' means coins, notes and the electronic balances held in bank accounts. Being 'widely accepted' is an important feature of money and we will explore it further during this topic. For example, people in the UK can pay using pound coins in shops because the retailers will accept these coins.

Many people think of 'money' as coins and notes but it also includes electronic balances held in bank accounts.

Because the main purpose of money is to make payments, it is able to fulfil other purposes as well. Sellers use money to set the price of goods – that is, how much someone must pay for them. People can store their money and so save it for making payments in the future. Money also makes it possible for people to buy items now, even if they do not have enough money themselves to make the purchase. They can borrow the money they need from someone else and repay the lender in the future.

As money fulfils all these purposes, people use it in different ways. For example:

Jack buys snacks and magazines from a corner shop using cash on his way home from school;

Beth has given her bank instructions to pay her electricity bill by transferring money from her bank account to the electricity company every month;

Raj and Tamsin are saving for a holiday they want to take in six months' time, by depositing money in a savings account;

Mark has borrowed money from a bank to buy a moped and is repaying it over several years in monthly instalments;

Cindy goes online to compare prices for the handbag she wants to buy.

1.1 The development of money

1.1.1 Using barter to trade goods and services

Before money was created, people used a system of barter to trade goods or services. The case study explains how bartering worked.

Bartering in early history

Consider an example from California in 1841. A farmer needs nails to be able to mend the wooden roof of his home. This need is important to him because winter is approaching and without the nails the roof will let the rain in and the heat out. The farmer specialises in growing wheat and producing flour. He can spare some flour to offer in exchange for nails. He therefore travels to the local blacksmith.

The blacksmith makes nails. He does not grow wheat himself and therefore does not produce his own flour. He needs flour to be able to make bread. When the farmer arrives at the forge, the blacksmith is willing to give him nails in exchange for flour.

Now they must decide how much flour each nail is worth. The farmer has brought a wooden jug with him to measure out the flour. He starts by offering the blacksmith enough flour to fill the jug once for each nail. The blacksmith does not agree. Each nail took him an hour to make using skills he has built up over 15 years. He asks for four jugs of flour for each nail. After discussing the relative value of flour and nails for nearly an hour, the farmer and the blacksmith agree on two jugs of flour per nail and exchange their goods.

The barter system of exchanging goods or services has many limitations. It relies on a ‘double coincidence of wants’, that is, the farmer must want nails and have flour to offer and the blacksmith must want flour and have nails to offer. It relies on the two parties agreeing a rate of exchange, that is, how much flour each nail is worth. This could be a time-consuming process. And it relies on the farmer having surplus flour when he needs to acquire extra nails.

1.1.2 Using items with intrinsic value as payment

The limitations of barter led people to create systems where the local community used an item they all valued as a means of payment. People in Japan, for example, used rice as ‘money’. Buyers and sellers would agree how much rice an item was worth: the buyer would then give the seller the agreed quantity of rice and receive the goods they wanted in exchange.

The use of valuable items such as cattle or grain as ‘money’ can be traced back to around 9000 to 6000 BCE. Other items that communities have used in the past include:

- cowrie shells;
- feathers;
- leather;
- oxen;
- pigs;
- stones;
- salt; and
- vodka.

Metals, including gold, were valued because they could be used to make weapons, tools and jewellery. Pieces of metal began to be used as ‘money’, too.

The use of an intermediate item (such as cattle, shells or gold) that all local people value as a form of ‘money’ allows people to sell any surplus or specialist goods they produce for this intermediate item. Sellers can then use the item they have been paid to buy other goods.

Using gold as payment

Fast forward to California in 1850 and another farmer is in need of nails. The Gold Rush has arrived and prospectors are digging gold out of the ground and finding it in rivers. Gold is valuable in its own right (it has an intrinsic value) so local people are willing to exchange goods and services for gold. When the farmer sells his flour to the town store he is paid in small gold nuggets. As gold has become a measure of value that is common throughout the area, he can use this gold to pay for a range of goods from different specialists. He is no longer restricted to trading only with people who want flour.

The farmer goes to the blacksmith and asks what weight of gold the blacksmith wants for the nails. After some discussion, they agree on the price. Then the farmer and blacksmith use scales to weigh the gold and the farmer breaks a nugget into smaller pieces to get the exact amount of gold agreed. The blacksmith can then use this gold to pay for items he needs or wants.

Looking at the list above, we can see practical drawbacks with early forms of money. Some items are not durable – for example, cattle and pigs die, and grain can perish if not stored correctly. Some items cannot be divided into small amounts to enable people to make low-value purchases or to give change. For example, if a seller wanted payment of one live pig but the purchaser did not agree the goods were worth a whole pig there were few options available. If the purchaser did not have a smaller pig to offer, the trade could not be made, causing problems for both parties. Many early forms of money were not easily portable. The *fei* stones used as money on the Pacific island of Yap, for instance, varied in size, but included some that were more than 6 metres across.

Fei stones like these were used as money until about 1965 on the island of Yap in the Pacific Ocean. (© Bartek Cieslak at pl.wikipedia)

Another problem with using an item that has value in its own right is that the value of that item itself can vary. For example, gold was an intermediate item used as 'money' before the introduction of coins. It has an intrinsic value of its own because it is rare and in demand to make items such as jewellery. However, suppose a particular source of gold runs out or a war prevents buyers and sellers from meeting to trade. Gold becomes scarcer and its value rises. One week, a trader might offer an ounce of gold for two cows; a month later, they might want four cows in exchange for their single ounce of gold. The chart on page 5 shows how the price of gold changed over a 40-year period in the twentieth century.

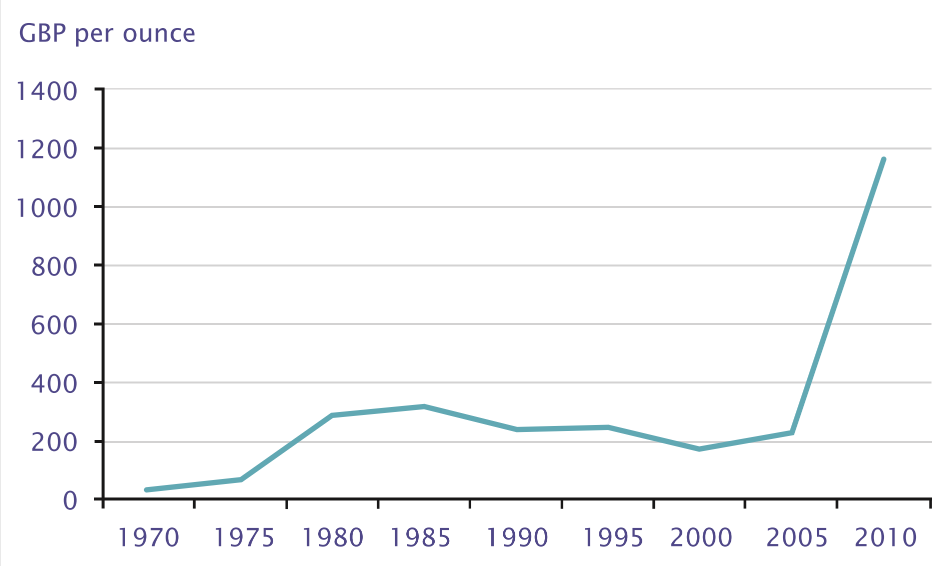
1.1.3 Using items that represent value as money

An important stage in the development of money, then, was changing from an intermediate item that had value in its own right (an intrinsic value) to an item that *represented* value but had no value of its own. In China, for example, spades and knives, which had an intrinsic value of their own, were used in barter systems. Later, coins in the shapes of small spades and knives were used to represent a standard value where each coin was worth roughly the same as the real spade or knife.

The changing price of gold

Figure 1.1 illustrates how the price of one ounce of gold (approximately 28 grams) varied between 1970 and 2010. The values shown are for the highest price that year and are in GBP which stands for Great British Pounds. The latest figures show that the price of gold has gone up and down in recent years.

Figure 1.1 The changing price of gold, 1970–2010



Source: World Gold Council (2020), www.gold.org

These coins were made of metal, often bronze or copper, but the value of the metal was low. The coins themselves had no intrinsic value as pieces of metal. They had representational value because local people agreed that a coin symbolising a spade or knife had the same value as a real spade or knife. They also had the advantage of being smaller than the real item (and therefore more portable) and durable.

Over time, the coins were made into standard shapes that look much like round, modern coins. Different coins came to represent different values, and the value was written on them, just as modern coins come in different denominations such as 5p, 20p and 50p.

The word ‘money’ itself is thought to have its roots in Ancient Rome, where a mint was located next to a temple to the goddess Juno Moneta (meaning Juno the Protector). The coins produced at this mint from about 300 BCE onwards bore an image of the goddess and became known as *moneta*, later ‘money’.

The development of coin shapes in China

The Chinese bronze spade money shown here dates from the period 1050 BCE to 221 BCE. In this early stage of development each coin looks very similar to a spade, with a hollow handle, sloping shoulders and an arched base. The coins weigh 27.7g and are 66mm in length.

The shape of the coins was gradually refined; the ones shown here are from 9–23 CE. They are still made of bronze but are flatter, shorter and lighter than the earlier version. Each coin weighs 14.53g and is 55mm in length. The hole at the top of the coin makes it easy to carry them on string or cords.

From around 621 CE the coins shown here were issued. They are round, 25mm in diameter, made of bronze and weigh just 4.1g each, making them easy to carry. The Chinese words read Kai yuan tong bao which means ‘new beginning circulating treasure’ (or ‘coin’). The first emperor of the Tang dynasty, Gaozu, created a new system of coins in 621 CE which lasted over 1,200 years.

1.1.4 Using paper notes as money

China developed the idea of paper banknotes around the seventh century CE. Merchants who traded high-value goods found it impractical to carry large quantities of copper coin. Instead they deposited the coins with a trusted person, who gave them written receipts stating how much was stored in their name. Rather than paying for goods with the actual coins, merchants paid by passing the receipt for the coins to the person selling the goods, who could claim the coins in storage.

Over time, people no longer claimed the coins from storage because buyers and sellers agreed that the banknote represented the value of the coins and would accept the banknote as payment, knowing they could use it to make payments of their own.

1.1.5 Modern payments

Most purchases are now made using coins and banknotes or by transferring electronic balances between bank accounts. However, barter systems still exist in some communities, especially those where the people have little or no cash. Some barter systems are informal, with friends and neighbours trading skills such as gardening and cake-baking or baby-sitting. There are also bartering websites that help put people with a ‘coincidence of wants’ in contact. More formal systems exist, too, such as local exchange trading systems or schemes (LETS), which operate on a system of credits without the need for cash. Another variation on the local theme is alternative currencies. These are explored in more detail in section 1.3.

LETS

A LETS is a local network that enables people to exchange goods and services with each other without using money. Suppose Abas is a member of his local LETS. He advertises on the LETS website that he can give other members basic computer training. When Abas gives Jake a three-hour computer lesson, Jake pays him in credits via the LETS credit administration system. Sometime later, Abas buys a flat-pack wardrobe and needs help putting it together. So he searches the LETS website for a member who has DIY skills and finds Neville. When Neville helps Abas with putting together the wardrobe, Abas pays him for one hour of his time with some of the credits he earned from Jake.

LETSLINK UK (www.letslinkuk.net) describes about 300 LETS across the country including:

- Brum LETS which uses a unit of credits called Hearts;
- Dorchester and South Dorset LETS which uses Marts; Edinburgh
- LETS uses a credit unit called a Reekie.

The Brum LETS website suggests that members charge a standard rate of 6 Hearts per hour and equal value is placed on the services on offer – so an hour’s cleaning is worth the same number of Hearts as an hour checking someone’s household budget.