Topic 3

What is money?

Learning outcomes

After studying this topic, you will be able to:

- define money;
- explain the purposes of money; and
- outline the sources and features of money.

Introduction

When we talk about 'money', most people immediately picture cash: the coins and banknotes that we see every day. However, money is not only these physical objects, but also any records that are accepted as payment. With the rise of new technologies, cash is not always necessary to complete transactions between buyers and sellers. Money has a long and varied history, but it has always primarily been used as a medium of exchange. This means that someone can exchange it for something that they want of an equal value.

People used to pay for the goods and services that they wanted by means of barter (see section 3.1), but over time money became the primary way in which people paid for trade. This developed into the monetary system that we have today, in which people work to earn money (income) that they can then spend on the goods and services that they need and want.

The growing popularity of this kind of currency meant that money had to be made into a physical object. This led to the development of the 'mint', which is essentially a factory that manufactures coins. As people accumulate money, they also need somewhere to store it, and this is usually (although not always) in a bank.

As technology has advanced, the use of physical coins and notes has reduced. We now have plastic cards that can be used in the same way as physical money, as well as the ability to transfer funds directly between bank accounts or to pay people online or via mobile phone. If you transact in this way, you may never see the money that you earn as anything other than figures on a screen!

In this topic, you will learn about the history of money and how the use of money has changed, as well as considering the features of money and where it comes from. Understanding more about money will help you to understand better the workings of the economy and the movement of money around the monetary system.

3.1 A short history of money

There have been financial systems in place all over the world for centuries. Before cash, people used a system called 'bartering'. This meant that they exchanged goods and services that they needed for something that they had that someone else needed.

Example

A doctor might agree to see a farmer as a patient if the farmer gives the doctor some meat or eggs. A fisherman who needs to get his house fixed might exchange some of his catch with a builder.

However, there were problems with this system: bartering took a lot of effort – you had to find someone who had what you wanted and who was willing to exchange it with you. If you and I were bartering, it would work only if you were to want something that I have and I were to want something that you have. There is also the problem that both items have to be worth the same; otherwise, one of us will not want to make the trade. In order to overcome this problem, different systems were developed, most of which were based on the use of a highly valued material, such as jade (in Ancient China) or gold. Anything could be used as money, as long as people would accept it.

3.1.1 Where does the word 'money' come from?

The term 'money' comes from *Juno Moneta*, a Roman goddess. The Romans established a mint near her temple in Ancient Rome and the coins that they made showed the head of the goddess, whose name means 'Juno the wise' or 'Juno the adviser'. These coins became known as *monetas*. Over time, the word came to mean both 'mint' and 'money' (British Museum, undated).

Did you know?

The earliest coins on Earth

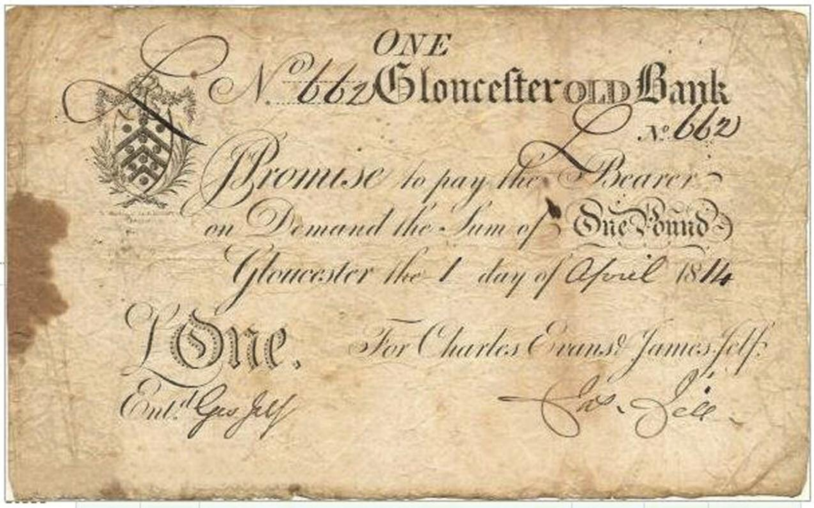
Although the mint near Juno Moneta's temple is the origin of the word 'money', other coins were in use about 200 years before those of the Romans. The earliest coins were made in kingdoms including ancient Lydia (modern Turkey), dating from about 650BC. The coins were produced in different weights and sizes, and were stamped with an image by the state.

Source: Classical Numismatic Group, Inc.

3.1.2 Pounds, shilling and pence

Britain has used different systems of currency over time. Historically, the most recognised of these has been pounds, shilling and pence, which started with the penny in about AD785. The shilling had been around in some form since the late 1400s. It was not until 1694 that the Bank of England introduced banknotes and the pound note was introduced in 1725 (Bank of England, undated).

Originally, the pound was paper money printed only on one side. As a unit of currency, the term 'pound' comes from the value of one pound by weight of sterling silver for which the banknote could be exchanged.



A pound note from 1814: one of the early English banknotes, printed on one side only.

In 1971, the British currency was decimalised, meaning that the basic unit of currency became pounds and pence, which we use today. It is based on units of ten, with £1 divided into 100 pence.

3.2 A short history of banking

Although there is a long history of storing tradable items that spans centuries, such as grain in Ancient Egypt, the modern banking system derives from the systems of the early Greeks and Romans. In the ancient world, the early days of banking were more about money exchange and lending than storage of personal funds.

A large variety of coins existed in Greece and Rome, so money changing was an important function in the marketplace. Money changers set up benches around the marketplace where they conducted their business, exchanging a huge number of foreign coins for locally accepted currency. In fact, the word 'bank' comes from the Old Norse term bakki, meaning 'bench'.

Before this time, money had generally been stored only by kings and queens, or priests, usually in temples. As personal wealth grew, there was more demand for lending to support business enterprises, such as exporting and mining. However, the fall of the Roman Empire meant that this type of 'banking' disappeared until the time of the Crusades, when the money needed for a large-scale war introduced the need for borrowing.

A form of the modern 'current account' was first introduced in the Dutch city of Amsterdam in the early sixteenth century, but many of the features that we have come to expect have been added gradually over the years. It is thought that the overdraft, for example, was invented in Scotland in 1778.

Until the turn of this century, however, some people still considered personal banking to be a luxury for the wealthy. Since 2000, however, the number of low-income families in the UK without an account has dropped from around 25% to just 4% – a result largely of the new types of basic account that banks have been required to offer.

Having a bank account has become almost obligatory in modern life, because it can be difficult to get by in society without one: salaries are paid into your account; payments made online need an account number; and state benefits are paid only into bank accounts. Electronic receiving and spending of money has also reduced the need for physical bank branches, which are becoming ever fewer; cashpoints and internet banking are taking their place.

3.3 The purposes of money

Coins and notes represent different values of money (known as 'denominations'). For example, British banknotes state on their face 'I promise to pay the bearer on demand the sum of £[amount]'. The amount might be £5, £10, £20, or £50.

The Chief Cashier of the Bank of England makes this promise, and he can do so because it is based on the gold reserves held by the Bank. The very first banknotes were really receipts given for gold coins, but these days there is more money in circulation than there is gold. If you were to exchange your money (coins and banknotes) for gold these days, you would not be able to do anything with the gold – other than sell it for more money!

Money has three main purposes, as follows.

- It is a form of payment or medium of exchange.
- It is a unit of account, allowing us to keep track of how much things are worth.
- It is a store of value: it can be held, and then reliably used to pay for goods and services when we need them.

We can see that the main purpose of money is to transfer value from one person to another. It solves the problems encountered in the bartering system of a mismatch between the item or service wanted and that offered, or of the trading of items of unequal value. Money allows people to buy goods and services, and it allows the providers of these goods and services to be paid. Therefore money forms the basis of our economic system.

We get money in different ways (see section 3.5), and we can then spend this income or save it. Businesses try to make profits so that they can expand and make more money, and many people invest their money or take on more work in order to make more money. As we discussed in Topic 1, having money means that you are able to contribute to society by buying goods and services, by repaying debts, by giving to charity and by saving. Saving money allows you to remain independent and to afford large purchases, such as a house, or to have enough money to live on when you retire.

3.4 The features of money

Coins and notes need to have certain features to function well as money. They must be:

- easily recognised by everyone;
- easy to carry around;
- not easily available;
- available in different amounts;
- consistent in what they are worth; and
- long-lasting/hard-wearing.

The fact that everyone can recognise money is important. If you were to walk into a shop and try to give the cashier some random bits of metal, the cashier would not want to accept them. This is because the bits of metal would not be recognised as having any value. Consistency is vital here: people in the UK all have an idea of what £1 will buy and what it is worth in relation to 1p; if they did not, then the £1 and the 1p would not function as money.

Having money that you can easily transport is also essential if you are going to be able to use it effectively. Imagine if you had to pay for your shopping with coins that were as big as footballs: how would you carry them all? Where would you keep them?

Money also has to be divisible into smaller parts, so that you can make up different values. If you had only £10 notes, the least that anything could cost would be £10. This is why coins and notes must be available in different amounts (or different ‘denominations’).

Another key feature of money is that it cannot be easily available. You might have wondered before why the government does not simply print more money if there is not enough of it or if it wants to pay its debts? The reason is that the more there is of something, the less it is worth, because it is easily and readily available to everyone. When something is more difficult to get, its value is higher.

> **Did you know?**
> In the 1920s, for example, Germany tried to get out of its economic depression by printing more money. This caused very high inflation, called 'hyperinflation' (see Topic 2 for a reminder about inflation). As a result, money was worth so little that people used it simply as paper – and banks had the notes recycled by the ton!

3.4.1 Counterfeiting

If we are to make sure that money is not easily available, it has to be difficult to counterfeit (ie to produce fakes). Notes and coins are designed with security features to ensure that this is the case. Coins are harder to counterfeit than notes, because they are made from specific materials that are difficult to reproduce without the right sort of industrial machinery. This means that forgeries of banknotes are attempted more often than forgeries of coins.

British banknotes have a range of anti-counterfeiting measures embedded into them, to make forgeries more difficult. These security features include:

- raised print;
- watermarks;
- holograms;
- fluorescent ink; and
- a combination of traditional and computer-based printing methods.

In 2016 the UK introduced a polymer £5 note with additional security features, including a see-through window and tiny letters and numbers that you can see under a microscope. Visit www.thenewfiver.co.uk to learn more.

As well as these features, the Bank of England uses other methods to fight against counterfeiting. In particular, it works with both the police and with retailers to train people to be able to identify counterfeit notes.

3.4.2 Making coins and banknotes

The Royal Mint (based in Llantrisant, Wales) makes coins for the UK, as well as for more than 60 other countries around the world. The Bank of England designs and issues banknotes, and De La Rue (a company that prints and designs currencies across the world) manufactures them.

In Scotland, the Bank of Scotland, Clydesdale Bank and the Royal Bank of Scotland issue their own banknotes; in Northern Ireland, the Bank of Ireland, First Trust Bank, Danske Bank (formerly Northern Bank) and Ulster Bank issue their own banknotes (Association of Commercial Banknote Issuers, 2016).

Coins in the UK are made from different materials depending on the type of coin:

- **1p** and **2p** pieces used to be made from bronze, but this was changed to copper-plated steel owing to the increase in the price of metals;
- since January 2012, **5p** and **10p** coins have been made from nickel-plated steel;
- **20p** and **50p** pieces are made from copper and nickel; and
- the **£1** coin is made from copper, nickel and zinc, and the **£2** coin is the same on the outside, with the copper / nickel material on the inside.

Banknotes are a type of paper made from cotton and linen fibres, which is much more hard-wearing than paper made from wood pulp. From September 2016, new £5 banknotes are printed on a type of plastic called polymer. This material is more durable than paper, will stay cleaner and will be more secure because the Bank of England can use better anti-counterfeiting features. Polymer banknotes are also more environmentally friendly and cheaper to produce than paper banknotes. Polymer will be used for making new £10 and £20 notes by 2020.

Did you know?

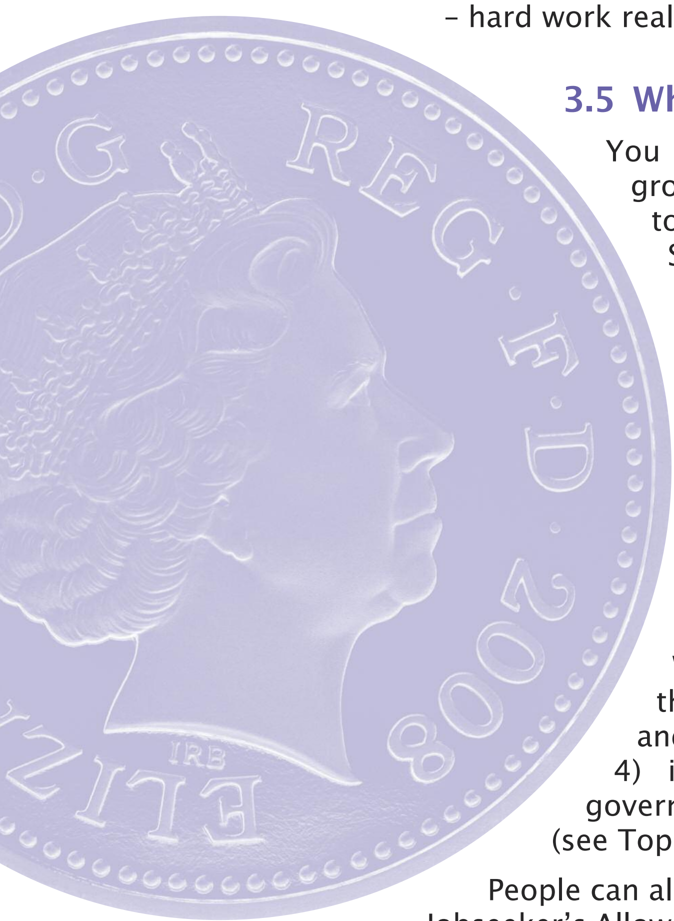
The lifespan of banknotes

Despite the greater durability of banknote paper in comparison to paper made of wood pulp, it is thought that the average paper £5 note lasted only between six months and two years. Polymer banknotes should last at least 2.5 times longer.

Money around the world

There are 180 official currencies in the world, made in a variety of materials including paper, cotton, linen, polymer and different combinations of metals. Most countries still use paper of some sort for banknotes and metal for coins. However, more than 20 countries in the world use plastic banknotes made from polymer, with Australia among the first to introduce them in 1988.

Remember, it is not what money is made from that makes it valuable: if banknote paper itself were valuable, we could just cut up a load of paper and use that instead! Money is valuable because of what it represents: our time and effort. Your labour is spent working hard to accumulate money, so when you spend money, you are really spending your hard work – hard work really does pay!



3.5 Where do we get money from?

You may have heard the phrase 'money doesn't grow on trees', meaning that it is not always easy to get money and that you have to work for it. So how do we get money?

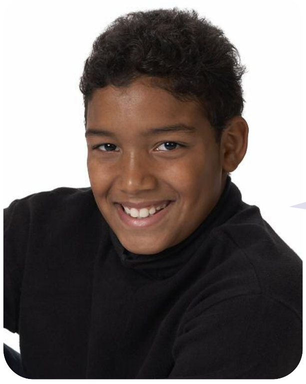
People may receive money (income) from a variety of different sources. Most people have a job that pays them a certain amount each week or month in the form of a salary or wage. Being in employment also entitles you to certain levels of sick pay, so that you can continue earning even when you are ill. Other money may come from investments (things that you buy that make you money in the future) or the interest from savings.

When people are not able to work anymore, they may retire and receive money from state and personal pensions. If your income (see Topic 4) is larger than an allowance set by the government, then you will have to pay income tax (see Topic 5).

People can also receive money from state benefits (such as Jobseeker's Allowance, Child Benefit and Personal Independence Payment), gifts, pocket money and inheritances.

People can also raise money by selling their belongings (for example on eBay or at a car boot sale).

Ben Baker's savings

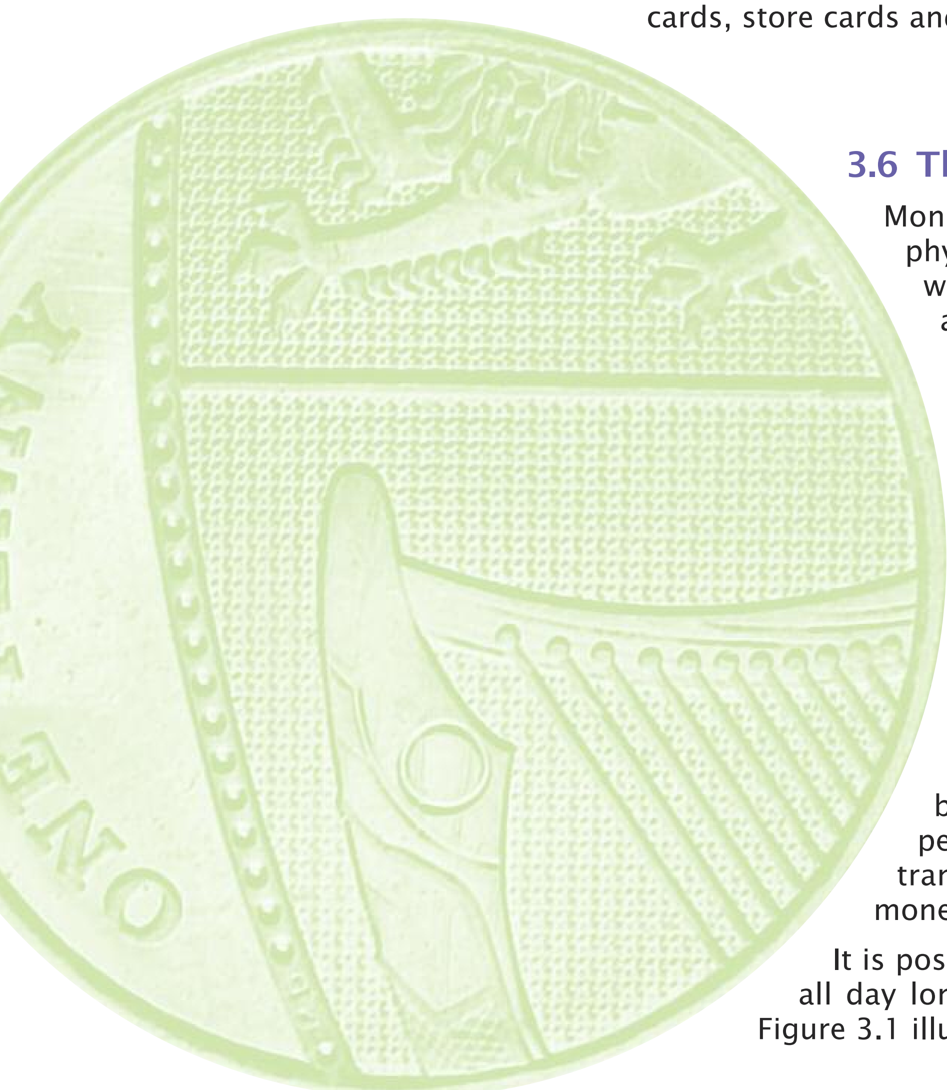


I get pocket money in cash from my parents once a week. I also earn cash mowing my neighbours' lawns. My goal is to save enough to buy a smartphone. Mum and Dad have promised to match the amount of money I've saved by the end of the year. So, at least once a month, I put the cash I've saved into a savings account at a building society to earn interest. Here, my money is held as an electronic balance that I can withdraw using a cash card if I want.

Some people will receive money as cash, such as gifts or small amounts of earnings known as ‘cash in hand’. However, the majority of money in the UK economy is held as electronic balances in bank accounts. Most people receive a salary directly into their bank account, after tax, National Insurance and pension contributions have been taken out. These people can then pay their bills and spend money through their accounts. For example, money can be transferred from one account to another to make payments to other people or to companies. This can be done by:

- direct debit, in which case the company takes whatever is owed at the time of invoicing;
- standing order, in which case you set up a regular payment of a fixed amount; or
- electronic transfer, in which case you pay money directly from your bank account as necessary.

Other methods of payment include debit and credit cards, store cards and loyalty cards.



3.6 The future of money

Money is not only these physical notes and coins that we have described; it can also be anything that is accepted to pay for goods and services. The rise in technology has meant that we use less and less physical cash, and spend more of our money electronically. This includes buying goods and paying bills online, or using debit cards, credit cards or different kinds of store card or payment card. It is becoming less common for people to use cash and some transactions see no physical money changing hands at all.

It is possible to make transactions all day long without using cash, as Figure 3.1 illustrates.

Figure 3.1 Who needs cash anyway?

Samantha leaves the house and tops up her Oyster card at a cash machine, using her debit card.

She takes the train to work and pays with her Oyster card.

At work, Samantha remembers that she needs to pay her electricity bill.

She goes online and transfers money electronically from her bank account.

A number of direct debits also come out of her account today, including her mortgage and council tax.

At lunchtime, Samantha pays at her workplace cafe by putting her fingerprint on a scanner.

At the end of the day she gets the train back home, again paying with her Oyster card.

She does her grocery shopping online and orders her civil partner a gift from Amazon

Before going to bed, she checks eBay and finds that someone has bought her old sofa for £150.

This money has gone straight into the same account into which Samantha's monthly wage is paid.

Developments in technology have transformed the way in which we spend money and will continue to do so. However, there are problems with moving towards a 'cashless society'. One of the biggest challenges linked to cashless spending is that it is much easier to spend money by clicking a button than by handing over cash. In fact, you are less likely to spend money if you have to pay cash for it than if you pay electronically.

It is also harder to keep track of your money when you are spending blindly. In other words, if you have £50 in your wallet, you can see this figure reducing as you spend, so you know just by looking how much you have left. When you use cashless systems, it is much harder to see how much you are spending and you do not have the same attachment to the money, because it is not physically 'there'.

There are other forms of money that you can use to buy goods and services. Some local currencies exist, which are useful only in a certain location.

Example

The Bristol Pound is a city-wide currency used in Bristol that can be spent in local independent stores, and for some local services and taxes. This ensures that the money stays in Bristol, making for a stronger local economy.

You can buy Bristol Pounds in the same way as you would buy any foreign currency (see Topic 10).

A financial institution manages electronic accounts, from which you can draw and deposit money of this currency, and which may even allow you to pay bills.

Another new form of money is 'Bitcoin'. Bitcoin is an open-source, electronic currency that is not controlled by a bank or government. It has been described as the financial equivalent of email or Skype, allowing relatively free transfer of money online to anyone, anywhere.

Did you know?

A new currency?

A 2007 viral advertising campaign for Travelex announced the QUID (standing for 'Quasi Universal Intergalactic Denomination'), which was a proposed currency designed to be used for space tourism. It was stated to be chemically inert and with round edges, so that if the money were to float in zero gravity, it would not cause any damage!

Summary

Finally, we can recap what we have learned in this topic.

- Financial systems have a long history. Money too dates back to at least 650BC, and different forms of payment and types of money have been used since that time.
- The main purpose of money is to provide a means of exchange, so that we can buy goods and services, and so that the people providing them can receive payment.
- In order for money to work properly, it has to have a number of distinctive features that make it possible and effective to use. These features mainly concern portability, durability and holding value. This used to be achieved in the form of cash, ie banknotes and coins.
- However, the rise of technology has meant that we now pay for many things without cash, and electronic payments are becoming much more common.
- The bulk of our money comes to us through our work, but people can get money in a variety of other ways, including state benefits, investments, interest on savings, gifts, pocket money, inheritances and selling personal items.
- In whatever form it comes, money is a central part of the economy and how we live our lives – in terms of earning, spending, saving and participating in society.

Thinking points

- What kinds of system do you think are best for making payments?
- Could you design your own monetary system?
- What do you think the future of money is likely to be?
- Why do people want to earn more money?
- Why do businesses want to increase their profits?
- What kinds of problems can you see with a cashless society?
- Could we give up cash completely?

Key terms

Barter – the exchange of goods and services for payment of other goods and services without using money.

Cashless society – a social system in which no cash is used to pay for goods and services.

Counterfeiting – producing an imitation (fake) of a 'real' product, with the intention of gaining (usually financially) from people not knowing the difference.

Credit – the ability to buy goods and services before you are able to pay for them, by using money borrowed from the bank; using more money than you currently have.

Credit card – a small plastic card that allows the owner to use credit.

Debit – withdrawing money from your own account, from money that you already have; not using more money than you have.

Debit card – a small plastic card that allows someone to withdraw money that they already have available in an account.

Denomination – the value of money, eg a coin or a banknote.

Direct debit – an arrangement made with the bank to allow a company to take money directly from your bank account, in payment for goods or services; often used to pay bills.

Income – all of the money that you receive, including through work, investments and state benefits.

Investment – something that you buy because it is likely to make you money in the future (eg if a property increases in value, you can sell it for more than the amount for which you bought it and so make a profit).

Mint – where coins are made (the Royal Mint produces coins for the UK and more than 60 other countries).

Money – a medium of exchange in a commonly recognised form, which will be accepted for payment of goods and services.

Pension – money received from the government or a pension provider after retirement.

Salary – a regular fixed payment for work carried out, usually paid monthly and expressed in terms of an annual amount.

Standing order – a regular sum of money that you instruct the bank to make out of your bank account to a company or person.

Transfer – move money from one account to another.

Wage – a sum of money paid for work carried out, usually paid weekly or monthly at an hourly or daily rate, or paid as a fixed, agreed amount per task completed.

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