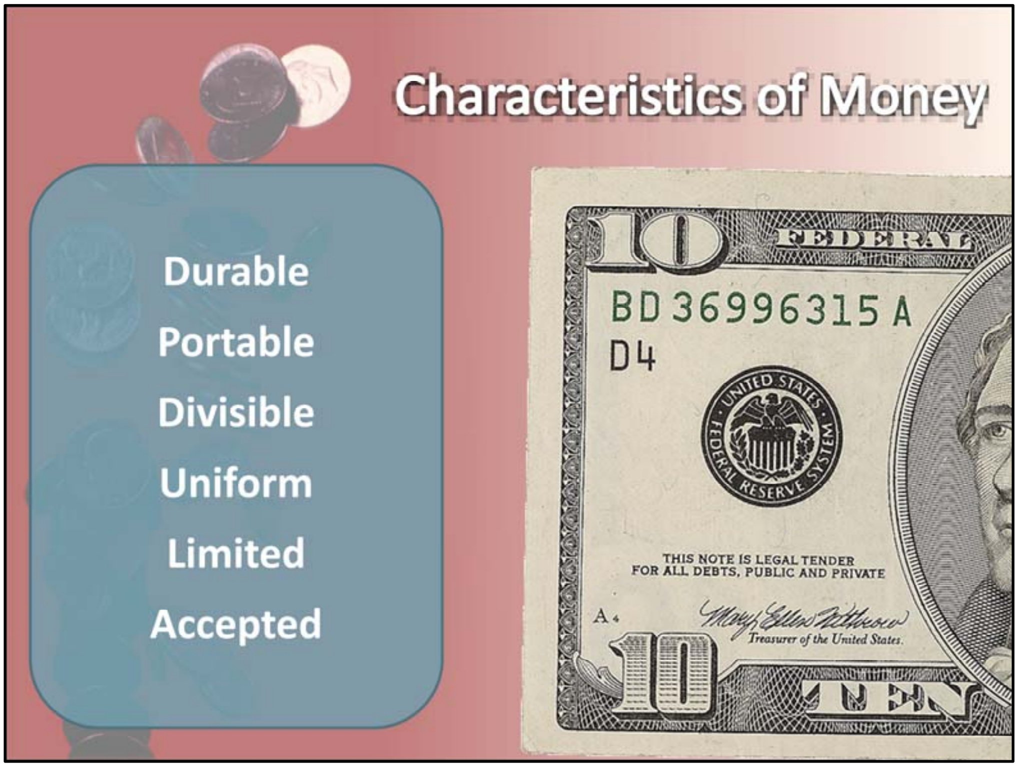
What is money? We just asked whether you could take your eggs to the store and exchange them for the new iPhone and the answer was “definitely not!” That might work on Craigslist, but the Apple® Store wants cold, hard cash, or at least your check!

So what is money? Let’s take a look at what it is, and how it’s changed over time.

Money is anything widely accepted as final payment for goods and services. While cash probably comes to mind first, it's not the only form of money. Before money was developed, barter was the only way for people to exchange goods. As you can imagine, that can be very time consuming. It might take some time before you can find someone who has a brand new iPhone that they're willing to trade for your chickens' eggs.

In many places in the past, people used precious metals like gold and silver as currency. Because they were in limited supply, durable and easy to exchange, these metals were used to make coins of standard weight and therefore, a standard value. People could then exchange them for goods and services that they wanted. This type of money was known as commodity money, because it has a value in itself in the metals that make it. Of course, this isn't that different than our modern coins that used to contain more precious metals than they do nowadays.

In the past, as individuals left their coins with the goldsmiths, they got a paper receipt. And, just as you might expect, people started trading that piece of paper for other goods and services. Once this idea of paper became acceptable as currency, governments began to issue paper money in different amounts that was accepted almost everywhere. This made it easier to carry larger amounts of currency. Imagine how big a one hundred dollar coin would have to be in order to have one hundred dollars worth of silver one hundred years ago when it was close to sixty cents an ounce: that's about three-and-three quarter pounds!



Modern money has six characteristics. It is durable, portable, divisible, uniform, limited, and acceptable.

By durable, we mean you can’t easily destroy it. Have you ever left money in your pants and put them through the washing machine? Good thing money is tough.

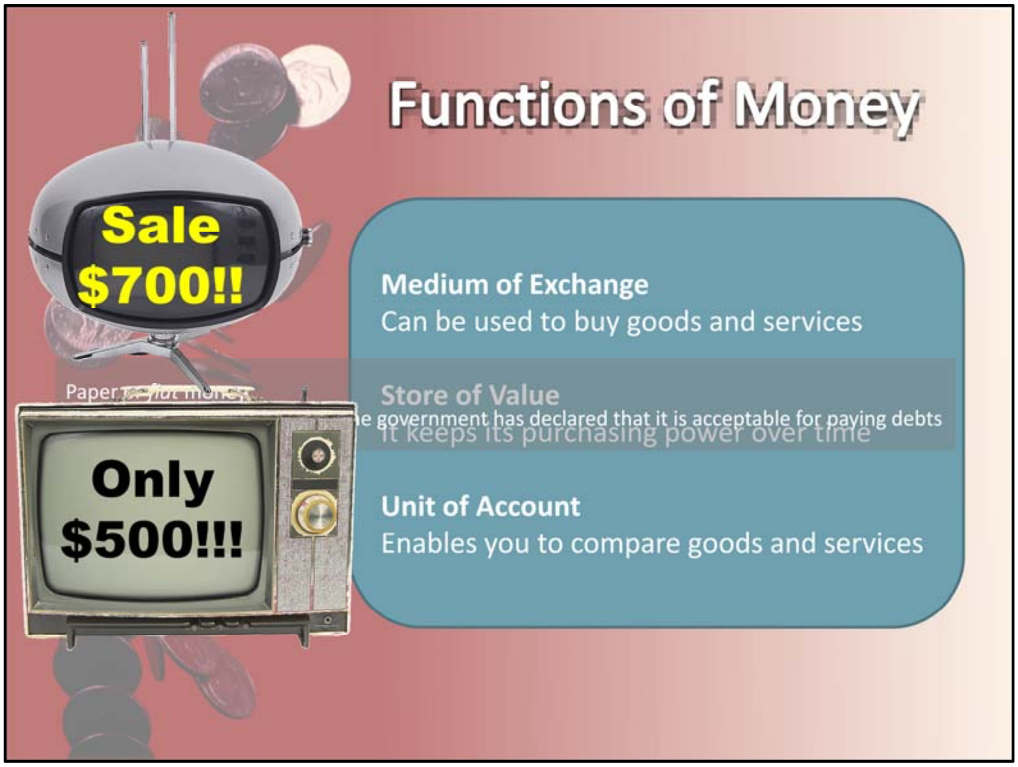
It’s also very portable, unlike that three-pound silver coin we were just talking about.

You can easily divide money into smaller amounts, up to point. For example, there are literally thousands of ways that can you change a twenty-dollar bill into smaller bills or coins.

Money is uniform. Every American twenty-dollar bill is worth the same, regardless of whether it’s a new or old bill.

The supply of money is limited. Only the government can print or coin money, and it has strict controls over how much is in circulation. If anyone else prints money, they are considered counterfeiters.

Finally, money is universally accepted as a medium of exchange. While one country’s currency may be worth more than another’s, consumers and businesses within each country will accept the local currency as payment for goods and services.



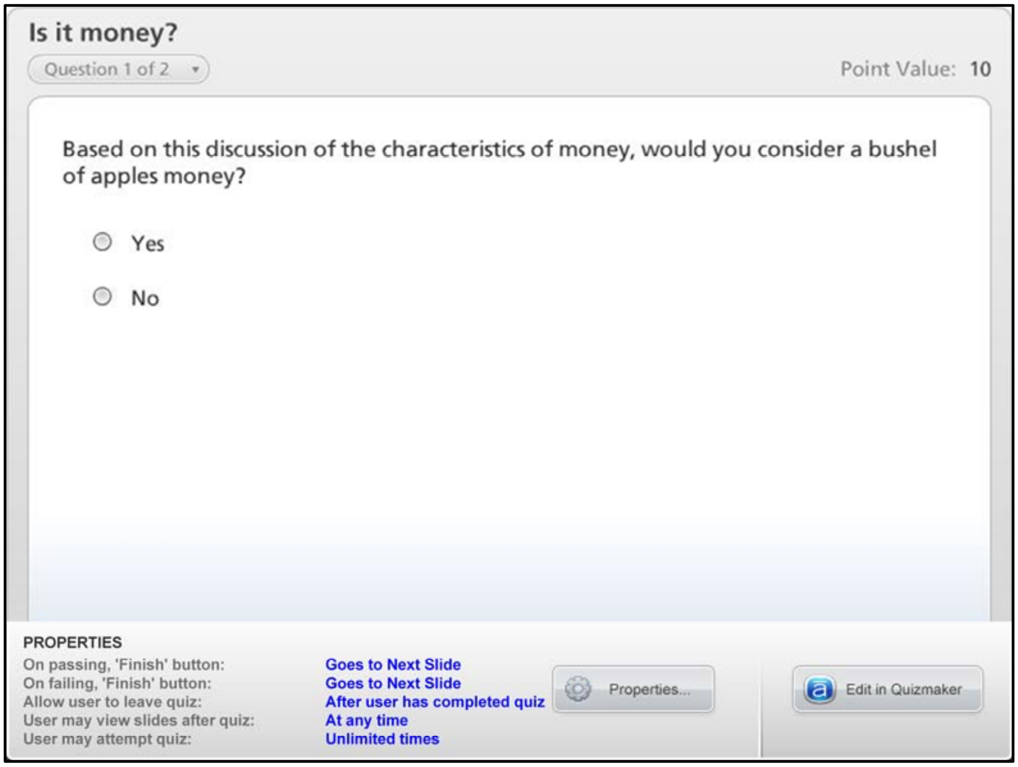
Money also has the following functions.

As a medium of exchange, you can use it to buy goods or services. As noted, barter is a time-consuming process because you have to find someone who has what you want and wants what you have before you can conduct a transaction. Money saves time because it has a clear value that everyone recognizes and can be traded for any good or service. Today we commonly use paper or *fiat* money. Fiat money has value because the government has declared that it is acceptable for paying debts.

Money acts as a store of value, making it easier to save and invest. We know that if we have one hundred dollars today, it will buy about the same amount of goods a month from now. As long as inflation isn't extremely high, the value of money changes relatively slowly.

Finally, money is a unit of account which enables you to compare the relative prices of different goods. If you go to the store to buy a TV, every TV has a price. Since you are paid in dollars at your job, you know how much work each set will cost you. It's up to you to decide what each feature is worth to you. This works because you could spend your dollars on any item at any store, so you can compare TVs to one another, as well as to other things you might buy at another store such as food or a couch.

Because money makes it easier to exchange goods, the development of money has encouraged specialization in commerce. If you were that egg farmer trying to buy an iPhone, you wouldn't have to find a willing trading partner: simply sell your eggs for the best price, and buy your phone with the money you receive.


Is it money?
Question 1 of 2
Point Value: 10
Based on this discussion of the characteristics of money, would you consider a bushel of apples money?
Yes
No
PROPERTIES
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On failing, 'Finish' button: Goes to Next Slide
Allow user to leave quiz: After user has completed quiz
User may view slides after quiz: At any time
User may attempt quiz: Unlimited times
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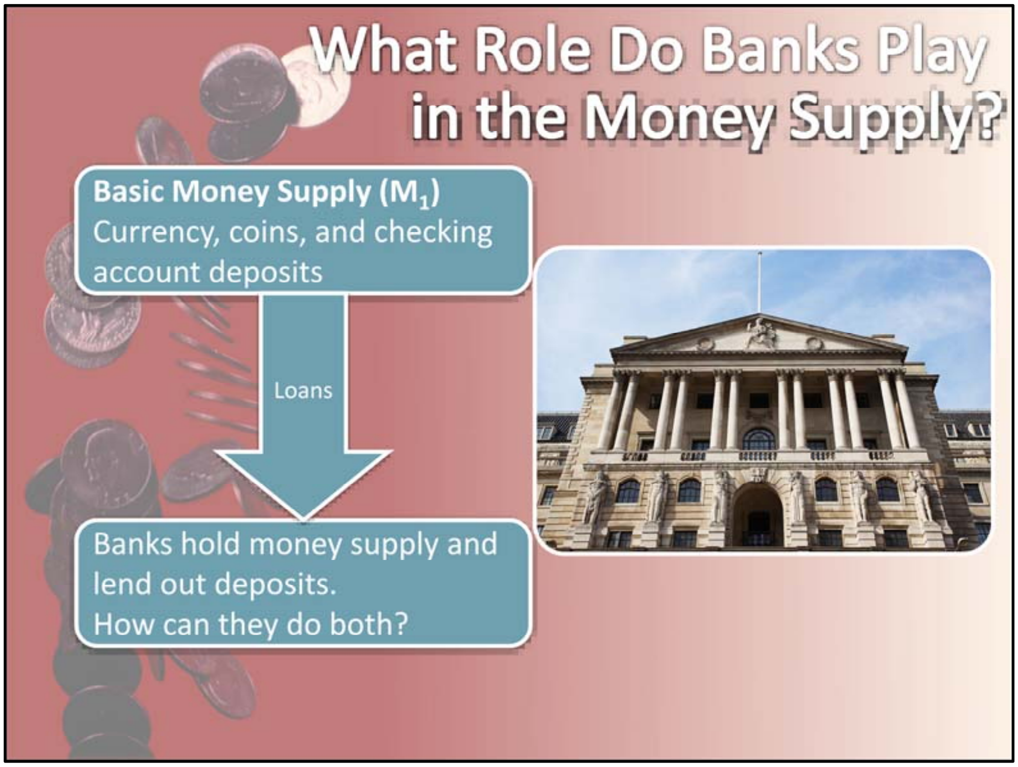
So, now that we have modern money, what else do we have that's part of our modern financial system that helps you with the money that you have, and to get more for the things you want?

Think for a moment about this scenario.

You have graduated from college and have been working for a year. You would like to start investing in your future by owning your own home. You have some money saved, but not enough to pay for the whole house. Which of the three options here would you do?

If you selected the last option, go to the bank to get a loan, you are correct. While your friends and family might be able to help you with a down payment for a house, most people don't have that much money to lend out. Banks, on the other hand, are in business to lend money.

So where do banks get the money to lend?



Before we answer that question, let's look at the important role that banks play in the money supply, which is the total amount of money available in an economy. The basic money supply is made up of currency, coins, and checking account deposits. Most of these are held in banks. This is the other function that banks play in addition to lending out funds: they hold the majority of the nation's money supply in accounts, although they don't store this money in the vaults at the branch.

So banks hold most of the money in the country, and they lend this money out to people to buy things they can't afford on their own.

How do the banks have enough money to do both of these activities? Can they only lend out as much as they have in deposits? Let's take a look at how this works.

In the U.S., banks use a fractional reserve system. What does this mean?
Banks are required to keep only a fraction of the money that people have deposited on hand to satisfy withdrawals. Then, the bank lends out the remaining money. The deposits kept by the bank are known as reserves. Banks are required by law to set aside a certain percent of deposits as required reserves, known as the required reserve ratio. Then, banks can lend out the remaining, or excess reserves. Currently, banks are required by the Federal Reserve to maintain ten percent of their deposits as reserves, although this number may change over time.

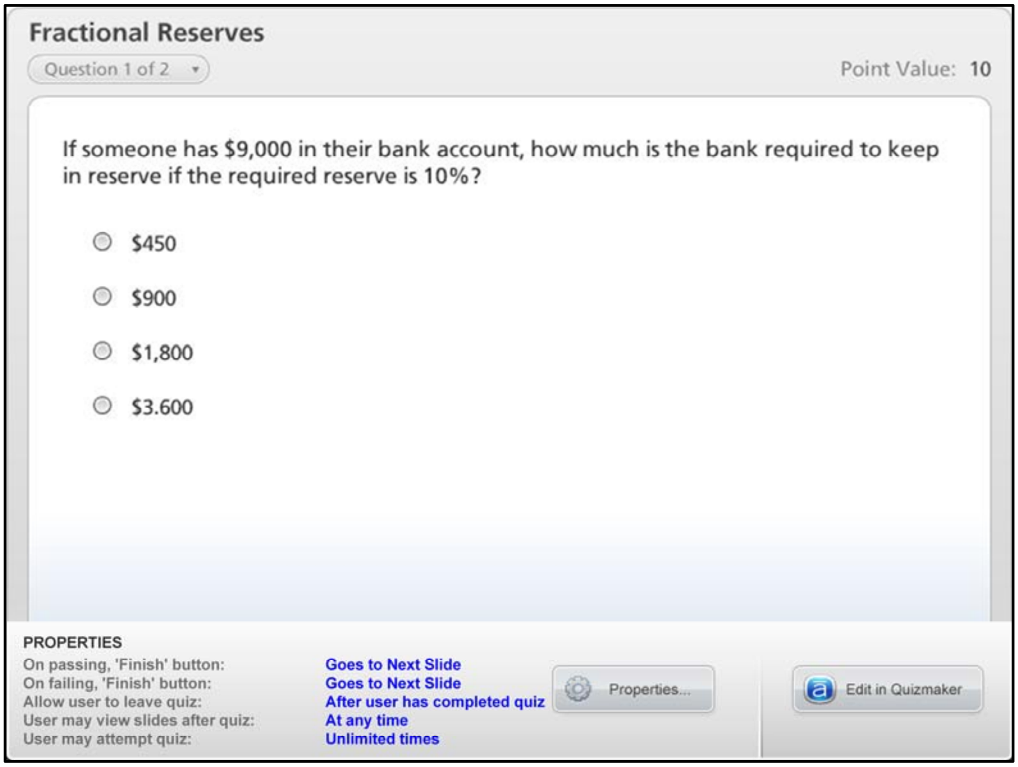
Many economists say that through the fractional reserve system, banks essentially create money. How is this possible?

Let's look at how the bank would use your hypothetical one thousand dollar deposit as an example of how this works.

The bank now has one thousand dollars which it owes to you, it's their liability. They are only required to maintain one hundred dollars as required reserves and can lend out the excess reserves of nine hundred dollars.

Another customer comes in and borrows the nine hundred dollars to use as operating capital in his business. He takes the money and puts it in his business account to use for expenses. You still have your one thousand dollars in your account. This is how the bank uses money to "create" money – it takes your money and lends it out, and then charges interest for the loans. This whole process is possible because of the fractional reserve system.

As long as all of the people who have deposited money with the bank don't withdraw it at the same time, which is known as a bank run, the arrangement works fine. As we'll learn about in the next presentation on the Federal Reserve Bank, if a bank run does happen, central banks can step in and provide money to these banks to cover the deposits, which is why you don't need to be worried about depositing your money in a bank – it's safe!


Fractional Reserves
Question 1 of 2
Point Value: 10
If someone has $9,000 in their bank account, how much is the bank required to keep in reserve if the required reserve is 10%?
$450
$900
$1,800
$3.600
PROPERTIES
On passing, 'Finish' button: Goes to Next Slide
On failing, 'Finish' button: Goes to Next Slide
Allow user to leave quiz: After user has completed quiz
User may view slides after quiz: At any time
User may attempt quiz: Unlimited times
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