

7.3: What Is Money?

Learning Objective

1. Learn why money exists and what purpose it serves.

The money supply in a country refers to a stock of assets that can be readily used to purchase goods and services. An asset is anything that has value. Anything that has value could potentially be used in exchange for other goods, services, or assets. However, some assets are more easily exchangeable than other assets.

Examples of assets include currency, checking account balances, stocks, bonds, whole life insurance policies, real estate, and automobiles. Currency—dollar bills in the United States, pounds sterling in Britain, and pesos in Mexico—is an asset that is readily exchangeable for goods and services within its respective countries. In contrast, real estate is an asset that is very difficult to use to buy goods. For example, no grocery store would accept ownership of a few square feet of your house in exchange for your weekly groceries. The idea of this transaction is unimaginable. Yet these two extreme cases can help us understand the distinction we make between assets classified as money and those not considered money. Most textbook definitions of *money* begin by defining several of money's key features.

Money as a Unit of Account

One of the most important features of money is its application as a unit of account. In other words, we choose to measure the value of goods, services, and assets in terms of currency or money. In ancient societies, shells, shovels, hoes, knives, cattle, and grain were used as money. In these cases, it would have been common to define the value of an item in terms of how many shells, or knives, or cows, and so on the item exchanges for. The standard unit of account in a country is its currency: dollars in the United States, yen in Japan, and euros in the European Union.

Money as a Medium of Exchange

The key distinguishing feature of money, as compared with other nonmoney assets, is its role as a medium of exchange. Coin, and later currency, came into existence primarily to serve as a vehicle for the exchange of goods and services. Rather than hauling around items that you might hope to barter exchange for other goods you need, it is easier and more efficient to carry coin and currency to purchase goods. However, in order for money to function in this role, it must have widespread acceptability. Anyone selling something you want must be willing to accept the coin or currency you have. Their willingness to accept will in turn depend on the expectation that they'll be able to use that coin later to buy the goods they want.

Other types of assets are often not acceptable as a medium of exchange. For example, if I own a \$1,000 U.S. savings bond, I am unlikely to be able to use the bond to purchase items in a store. Bonds can be traded at a bank or a bond market, where exchanges of this sort are common, but not anywhere else. Thus bonds do not function as a medium of exchange.

Liquidity is a term used to describe the distinction made here between bonds and currency. An asset is said to be liquid if it is readily exchangeable for goods and services. An asset is illiquid if it is not easily exchangeable. Thus coin and currency are very liquid assets, while bonds are more illiquid. Real estate is an example of a very illiquid asset since it could take a considerable amount of time to convert the ownership share of a home into a spendable form.

Money as a Store of Value

Perhaps the least important characteristic of money is an ability to serve as a store of value. This is less important because it does not distinguish money from other assets. All assets serve as a store of value. As an example, if I want to save some income from each paycheck so that I can go on a vacation next year, I need to hold that income in a form that will maintain its purchasing power. One simple way to hold it is by cashing my paycheck and putting currency into an envelope. That money accumulating in the envelope will be easily used to purchase plane tickets and a hotel room when I take my vacation next year. In this way, holding currency will allow me to store value over time. On the other hand, I could cash each paycheck and deposit some of the money I want to save into my online stock trading account. With these funds I can purchase stocks, another form of asset. Next year, I can sell the stocks and use the money to take my vacation. Thus stocks represent a store of value as well.

Key Takeaways

- Money is any asset that serves as a unit of account and can be used as a medium of exchange for economic transactions. It is all assets that have a high degree of liquidity. Money also serves as a store of value, but it is not unique in this role.

exercise

1. **Jeopardy Questions.** As in the popular television game show, you are given an answer to a question and you must respond with the question. For example, if the answer is “a tax on imports,” then the correct question is “What is a tariff?”
 - The three characteristics that are used to define money.
 - This characteristic of money is shared by real estate assets.
 - This characteristic of money allows us to compare the values of different products.
 - Without this characteristic of money, individuals would be forced to trade by barter.

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