

History of Money

by Sophia Tutorial



WHAT'S COVERED

This tutorial will cover the history of money, including the three functions of money, the problems with a barter system, and the use of commodities as money.

Our discussion breaks down as follows:

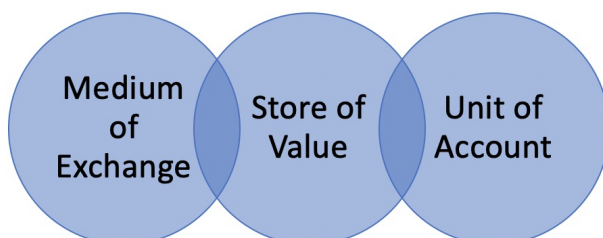
1. Functions of Money
 - a. Medium of Exchange
 - b. Store of Value
 - c. Unit of Account
2. Barter
3. Commodity Money

1. Functions of Money

So, what is money? You might tend to think of money as bills, coins, checks, or something along those lines.

However, is this what money has *always* involved? Broadly defined, money is anything that lets us get what we want.

Now, money serves three functions:



Let's look at each of these separately.

1a. Medium of Exchange

A **medium of exchange** is the first function that money has to serve. It is an item used as an intermediary in

non-barter based trade, and it facilitates trade.

What do we mean by that? We mean that this is what helps us to get what we want.

➦ **EXAMPLE** If you go to the grocery store, you are not bartering. You are not exchanging something that you have for your groceries. Rather, you are going to use your debit card to pay for those groceries. That debit card is acting as a medium of exchange because it is an acceptable form of payment to trade for what you want--in this case, your groceries. Your debit card is linked to your checking account that contains your money, and that money is acting as a medium of exchange.



TERM TO KNOW

Medium of Exchange

An item used as an intermediary in non-barter based trade; facilitates trade

1b. Store of Value

A **store of value** is a slightly different function of money. It is an item having a recognized value that can be stored and retrieved.

Now, you are not always using your money right now to purchase something that you need--because when you do, it is acting as a medium of exchange.

However, when you are not using your money to purchase what you need, perhaps you store some of it in a savings account. You know that it will retain its value, and you can access it later, whenever you need to. This is a store of value.



TERM TO KNOW

Store of Value

An item having a recognized value that can be stored and retrieved

1c. Unit of Account

A **unit of account** is the third function of any money. This is an item used in financial transactions and record keeping.

So, once a money becomes an acceptable form of payment--like the dollar is in the U.S., as the current form of currency--things are then quoted in terms of dollars. Dollars are used in financial transactions and to help keep records.

This provides a way for us to compare the value of things.

➦ **EXAMPLE** For example, if you know that one item is a certain price in dollars, and a different item is another price in dollars, you can compare the two items to determine which is the better deal.



TERM TO KNOW

Unit of Account

An item used in financial transactions and record keeping

2. Barter

Now, we did not always have money as the form of currency. Before money, people engaged in barter for what they needed. Barter is simply exchanging one item for another.

The image below shows white traders bartering with the Indians. You have likely learned about their exchanges of items in history classes.



White traders bartering with the Indians.

Here is another historical example, dating back to 1874. This man is trying to buy a newspaper subscription with chickens--because that is the item he had available to exchange for what he wanted.



THE COUNTRY EDITOR—PAYING THE YEARLY SUBSCRIPTION.—[Drawn by F. S. Church.]

Barter has worked in many economies throughout history, but it can also be quite inconvenient. One of the biggest problems with barter is called the double coincidence of wants.

IN CONTEXT

Suppose you do not have any money, but you desperately need a haircut. What can you give? Well, suppose you have the ability to tutor others in economics. You may not have money, but if you can find someone who needs tutoring services in economics, then perhaps you can convince them to give you a haircut.

The problem is, though, that you will need to find a hairdresser who is willing to accept your economics tutoring as a form of payment.

In most cases, then, your tutoring services are likely not a great medium of exchange, because it is going to be difficult for you to find someone who needs such a specific thing.

3. Commodity Money

Because of the time wasted trying to find someone who has what you want and also wants what you have, people started trading commodities.

A commodity is something that has value in and of itself, because it is useful in an economic system or society, and therefore easily traded.

Here are some examples of commodity monies that have been used over time:

- Salt (extremely valuable before refrigeration as a way to preserve things)
- Shells
- Large stones
- Cigarettes and alcohol (cigarettes are still used today in prison as a form of payment for items)
- Barley
- Cocoa beans
- Cotton (in the South)
- Gold, silver, and copper



THINK ABOUT IT

If you think about this list of commodities, which are a good medium of exchange? Which would be easy to use to purchase the things that you want? Well, you probably would not want to lug around large stones with you to use as a medium of exchange. It would also be difficult to trade them for something small because they are not exactly divisible. In addition, some of these items would not really last a long time, like barley or shells.

What about a store of value? Will these items retain value over time? As mentioned, barley might not last very long, so which of these are a good medium of exchange and a good store of value?

Well, the better commodities were:

- Portable, or easy to carry around
- Durable, so they retained their value and did not spoil
- Divisible

People might value large stones, but they are not necessarily easy to carry around, nor easy to divide. An item like milk is going to spoil quickly, so that would not serve as a good store of value.

However, gold, silver, copper, and jewels are easy to transport and do not spoil. Therefore, they turned out to be the most efficient of the commodities.

Many people, then, began using gold as a medium of exchange. As that happened, it began to serve that third purpose as a unit of account.

People could cite prices of items in terms of gold (e.g., this item is worth a certain number of ounces of gold), and perform and record financial transactions using gold as a unit of account.



SUMMARY

Today we learned about the three **functions of money** as a **medium of exchange**, **store of value**, and **unit of account**. We learned about the double coincidence of wants and the problems encountered with a **barter** system. Lastly, we learned about some **commodities used as money** and discussed which commodities meet those three functions of money most efficiently.

Source: Adapted from Sophia instructor Kate Eskra.



TERMS TO KNOW

Medium of Exchange

An item used as an intermediary in non-barter based trade; facilitates trade.

Store of Value

An item having a recognized value that can be stored and retrieved.

Unit of Account

An item used in financial transactions and record keeping.