How Money Has Developed over Time

by Sophia

WHAT'S COVERED

What, exactly, is money? Is it the bills that fold in your wallet? Or the quarters and pennies that jingle in your pocket? Or is it something different, something much more? The answer might surprise you. This tutorial will cover has money has developed over time, discussing the history and functions of money. Our discussion breaks down as follows:

1. How Money Has Developed

Let's begin with how money has developed over time. Now, traditionally, when people want something that someone else has, they can go about it through an exchange. A **medium of exchange** is simply an item that allows a simplified sale or purchase process.

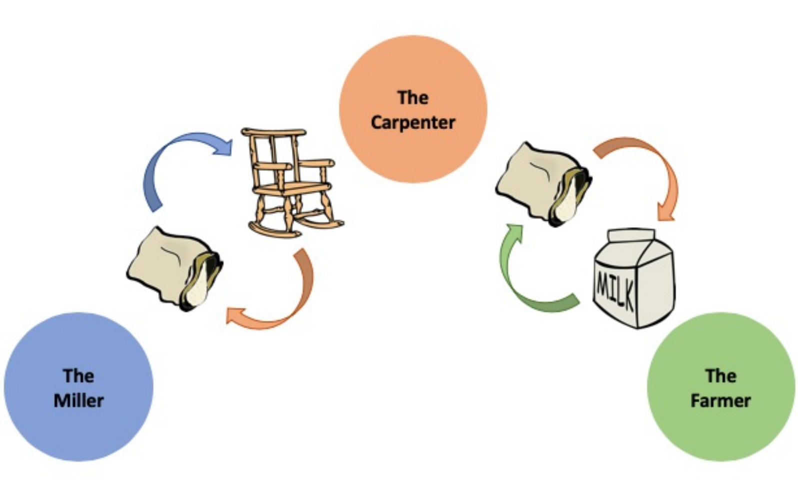
Traditionally, before people had easy mediums of exchange, they followed a practice called bartering. Bartering involves a direct exchange of goods between two people.

IN CONTEXT

Suppose this carpenter is rather thirsty, and he'd like some milk. So, he finds a dairy farmer and they work out a deal where the carpenter will build the dairy farmer a chair and the dairy farmer gives the carpenter some milk.

You can see how this is beneficial for both parties. However, there is a potential problem. Now the dairy farmer already has a chair, so when the carpenter wants some more milk, what can the carpenter provide to trade?

This dilemma resulted in individuals accepting things that were considered universal--a universal exchange. For instance, suppose the carpenter, in this case, builds a chair or other item for a miller, and in exchange, he receives a big sack of flour. Then, when he wants something from somebody else,--like milk, for instance--he can simply trade cups of flour for that milk, and that serves as the medium of exchange.



The flour becomes that thing by which he can exchange "product for product" and get the goods that he wants or needs. The flour is portable, divisible, and it can be stored for a long period of time without spoiling, so it's also durable.

This is essentially how the whole idea of money as we know it today started.

TERM TO KNOW

Medium of Exchange
An item that allows a simplified sale or purchase process.

2. Four Functions of Money

For something to be considered money, it must be the following four functions.

Functions of Money	Description
Be portable	It must be easy to carry. It wouldn't be any good—or much fun—if you had to carry gallons of fresh milk everywhere you go, for instance, as your medium of exchange. Governments eventually began to create their own money with stamped metals, and later on with printed paper to help with this portability issue.
Be divisible	It has to be divisible to serve and function well as money. If you only wanted a loaf of bread, a hundred dollar gold coin is not going to be very helpful. Or, how many cups of milk equal a loaf of bread? Whatever the currency, you need to be able to divide it. You can't simply have one big rock or stone that you trade for one thing. Going back to the carpenter example, half a chair doesn't work!
Be durable	It must be able to withstand the wear and tear of many people using it and needs to last. Imagine using fresh milk as your money source. It's only good for a day or so, so it wouldn't be very durable, and it wouldn't last for very long as a type of money.
Be stable	It needs to retain its value. Again, consider the milk example. If you're losing value every moment that you're holding it because it's steadily going bad, it doesn't stay stable very long.

3. Money's Worth

For money to serve its purpose, people have to agree on what it's worth; there must be an agreed-upon value between the two parties. This is determined in part by the supply of money that exists. The more money that is in circulation, generally, the less value it has.

When money supply goes up, the value goes lower, and when the supply goes down,—because there's less of it out there and people want more of it—the value of that money tends to go up.

It can be a challenge to measure money in this way, especially when factoring across national boundaries, because, again, there must be a consensus as to what this money is worth. Typically, businesses monitor money supply as a reflection of the economic health of a country.

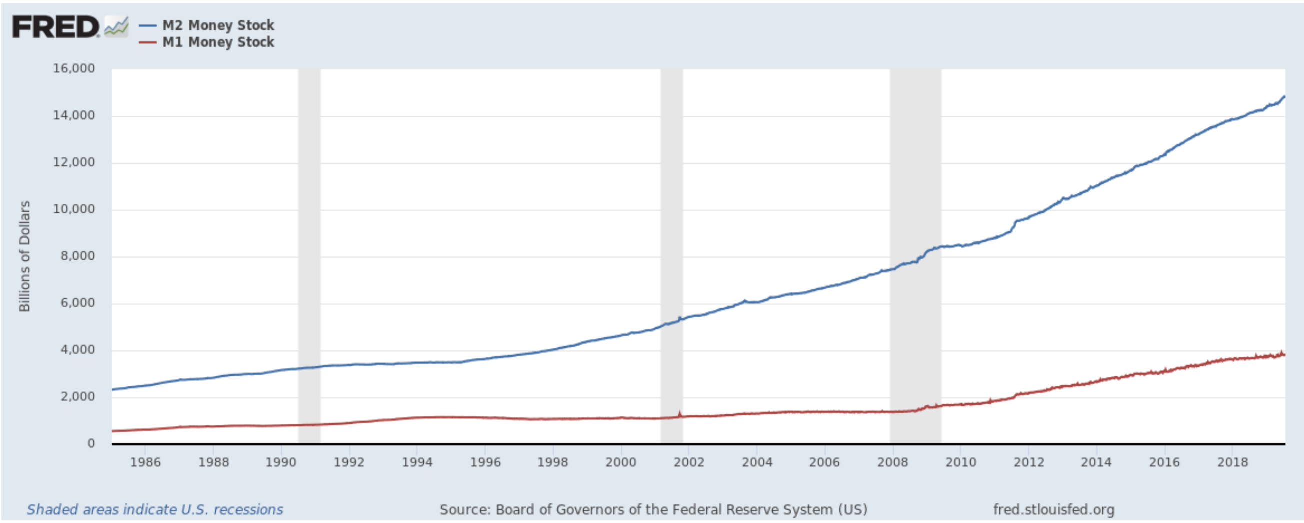
As money supply increases, so the economy is considered to be more healthy. This means that the economy is growing and money is being created within the economy. Therefore, up to a point, increasing money in the economy is considered a good thing.

4. Types of Money Supply

Generally speaking, there are two different types of money supply in the economy that are evaluated to assess a country's economic health.

- **M1 money supply**: This is money that is either physical money or immediately accessible through an account, such as a checking account. This can also include cash, checks, or any demand deposit. It is considered to be the money that is the most spendable *right now*--the funds that you can get your hands on the fastest.
- **M2 money supply**: This is all the money that is in the M1, plus funds or investments that are easily converted into cash, such as a saving account or money market fund. This includes monies that are convertible into CDs, or certificates of deposit, money market accounts, and savings accounts.

Here is an example of a money supply growth chart for M1 and M2. Note, this particular one also has M3, but we're going to focus on the M1 and M2 money supply. This graph reflects units in billions of U.S. dollars.



You can see that through the '80s until the mid-'90s, there was a steady growth of the money supply. In the mid-'90s, the M1 money supply started to shrink a bit.

In the M2 supply, however, you can see that right at the mid-'90s, there was a little pause, then it continued to go up. So, as far as immediately convertible cash is concerned, the M1 was holding steady or retreating a bit in the early 2000s, before starting to come back again.

Money sources that are less liquid, like CDs and investments, kept climbing higher and higher, and as a percentage of the total, you can see the M1 supply steadily shrinking as a percentage, meaning there is less immediately convertible cash here and more in the M2 supply.

TERMS TO KNOW

M1 Money Supply
Money that is either physical money or immediately accessible through an account such as a checking account.

M2 Money Supply
All of the money that is in the M1, plus funds or investments that are easily converted into cash such as a saving account or money market fund.

SUMMARY

Today we learned **how money has developed** over time. We also learned about the **four functions of money**; it must be portable, divisible, durable and stable. We learned about **money's worth**, and how an expanding economy will generally have a higher amount of money in supply. Lastly, we discussed the two **types of money supply**: M1 and M2.

Good luck!

Source: Adapted from Sophia instructor James Howard. Board of Governors of the Federal Reserve System (US), M1 Money Stock [M1], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/M1, July 26, 2019.

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