Functions of Money

The Four Jobs of Money
- Medium of exchange
- Standard of value
- Store of value
- Standard of deferred payment

Medium of Exchange
- The most important job of money is to serve as a medium of exchange
  - When any good or service is purchased, people use money
  - Money makes it easier to buy and sell because money is universally accepted
  - Money, then, provides us with a shortcut in doing business
- By acting as a medium of exchange, money performs its most important function
Money as a Medium of Exchange

- Money facilitates exchange by reducing the cost of trading.
- Without money, we would have to barter.

Money As a Medium of Exchange

- Money does not have to have any inherent value to function as a medium of exchange.
- All that is necessary is that everyone believes that other people will exchange it for their goods.

Standard of Value

- Money is a common denominator in which the relative value of goods and services can be expressed
  - A job that pays $2 an hour would be nearly impossible to fill, while one paying $50 an hour would be swamped with application
Money as a Unit of Account

• Money is used as a common denominator to measure the relative values of goods and services.
• Without money, we would have to measure the value of goods and services in terms of other goods and services.
• Money is a useful unit of account only if its value relative to the average of all other prices doesn’t change too quickly.

Store of Value

• If you could buy 100 units of goods and services with $100 in 1982, how many units could you buy with $100 in 2000?
  – Answer: you could have bought just 51 units
  – During this period, inflation robbed the dollar of almost half of its purchasing power
• Over the long run, particularly since World War II, money has been a very poor store of value
  – However, over relatively short periods of time, say, a few weeks or months, money does not lose much of its value

Money as a Store of Value

• Money is a financial asset that can be used to store wealth (income that you have saved and not consumed).
• As a store of wealth, money pays no interest, but is perfectly liquid.
• Money’s usefulness as a store of wealth depends on how will it maintains its value.
Many contracts promise to pay fixed sums of money well into the future.

- A couple of examples are 30-year corporate bonds and a 20-year mortgage.

When Dave Winfield signed a 10-year, $23 million contract with the New York Yankees in 1980, he really got stuck.

- Because over the next 10 years the consumer price index went up by almost 59%.
- Today when a professional ballplayer, entertainer, or virtually anyone else signs a long-term contract, she or he is generally protected by an escalator clause, which calls for increased payments to compensate for any future inflation.

How well does money do its job as a standard of deferred payment?

- About as well as it does as a store of value.
- Usually quite well in the short run, but not well at all over the long run of, say, three years or more.
Money versus Barter

- Without money, the only way to do business is by bartering
- For barter to work, I must want what you have and you must want what I have
  – This makes it pretty difficult to do business
- “Everything, then, must be assessed in money: for this enables men always to exchange their services, and so makes society possible”
  – Aristotle, Nicomachean Ethics