

Functions of Money



The Four Jobs of Money

- **Medium of exchange**
- **Standard of value**
- **Store of value**
- **Standard of deferred payment**

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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**

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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

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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 well it maintains its value.

Standard of Deferred Payment

- **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

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Standard of Deferred Payment

- **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

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Standard of Deferred Payment

- **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

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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

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