Lesson 1 The Evolution, Functions, and Characteristics of Money

ESSENTIAL QUESTION

How has money evolved to meet the needs of people everywhere?

Reading HELPDESK

Academic Vocabulary

revolution an overthrow of government
converted changed into a different form

Content Vocabulary

Federal Reserve System (Fed) privately owned, publicly controlled, central bank of the United States
Federal Reserve notes paper currency issued by the Fed that eventually replaced all other types of federal currency
barter economy moneyless economy that relies on trade or barter
commodity money money that has an alternative use as an economic good; gunpowder, flour, corn etc.
fiat money money by government decree; has no alternative value or use as a commodity
specie money in the form of gold or silver coins
monetary unit standard unit of currency in a country’s money supply; American dollar, British pound etc.
medium of exchange money or other substance generally accepted as payment for goods and services; one of the three functions of money
measure of value one of the three functions of money that allows it to serve as a common denominator to measure value
store of value one of the three functions of money allowing people to preserve value for future use
demand deposit accounts (DDAs) account whose funds can be removed by writing a check or using a debit card, and without having to gain prior approval from the depository institution
M1 money supply components conforming to money’s role as medium of exchange; coins, currency, checks, other demand deposits, traveler’s checks
M2 money supply components conforming to money’s role as a store of value; M1, savings deposits, time deposits
The Evolution of Money

Guiding Question Why did money replace the barter system?

Take a moment to think what life would be like in a barter economy. A barter economy is a moneyless economy that relies on trade. Without money, the exchange of goods and services would be more difficult because the products some people have to offer are not always able to be used by others, or what they have to offer may not be comparable to what they want in return. For example, how could a milkman with a pail of milk get a pair of shoes if the cobbler wanted a basket of fish? There has to be a situation where two people want exactly what the other has and are willing to trade what they have for it. Otherwise it is difficult for trade to take place.

Life is simpler in an economy with money. The milkman sells the milk for cash and then uses that cash to buy a pair of shoes. The cobbler takes the cash and looks for someone selling fish. Money, as it turns out, makes life easier for everybody in ways we may have never considered.

Money in Colonial America

The money used by early settlers in the American colonies was similar to the money in early societies. Some of it was commodity money—money that has an alternative use as a commodity, or an economic good or service. Many products served as commodity money. These included corn, hemp, gunpowder, and musket balls. These items could be used to pay debts and make purchases. At the same time, colonists could use these products to eat, drink, or use in other ways, if necessary.

Tobacco was a commonly accepted type of commodity money. In 1618 the governor of colonial Virginia set a value of three English shillings per pound on tobacco. Two years later, the colonists used some of this money to bring their wives to the colonies.
Other colonies established **fiat money**. Fiat money is money by government decree. For example, in 1637, Massachusetts established a monetary value for wampum. Wampum was a form of currency the Wampanoag Native Americans made out of white and purple mussel shells. The Wampanoag and the settlers used these shells in trade. There were more white shells than purple ones, so one English penny was made equal to six white or three purple shells. The colonial settlers could even pay their taxes with wampum.

**Early Paper Currency**

Paper currency was another popular form of fiat money in the colonies. Some state laws let people print their own paper currency if they promised to redeem the currency for gold or silver. States even printed money in the form of tax anticipation notes. People used them to pay salaries, buy supplies, and meet other expenses until they received taxes and could redeem the notes.

The United States Continental Congress issued paper money to pay for the Revolutionary War. In 1775, it printed Continental dollars, a form of fiat paper currency with no gold or silver backing. By the end of the war, it had printed nearly one-quarter billion Continental dollars. This was so much that it was practically worthless by the end of the revolution.

**Specie in the Colonies**

Colonists also used small amounts of **specie**—or money in the form of silver or gold coins. These included English shillings, Austrian talers, and different European coins that immigrants brought to the colonies. Coins were the most desirable form of money, not only because of their mineral content, but because they were in limited supply. By 1776, only $12 million in specie was disbursed and used in the colonies, compared to nearly $500 million in paper currency.

The most popular coin in the colonies was the Spanish peso that came to America through trade and piracy. Long before the American Revolution had begun, the Spanish were mining silver in Mexico. They melted silver into bullion, which were ingots or bars of precious metals, or they made it into coins to ship to Spain. When the Spanish treasure ships stopped in the West Indies to buy fresh supplies, they often became victims of Caribbean pirates. The pirates spent their stolen treasure in America’s southern colonies.

The “triangular trade” between the colonies, Africa, and the Caribbean brought more pesos to America. Traders took molasses and pesos from the Caribbean to the colonies. There they sold the molasses to be made into rum and spent their pesos on other goods. Traders shipped the rum to Africa to trade it for enslaved Africans. They took the enslaved Africans to the Caribbean to sell them for pesos and more molasses. The trade cycle started again when they took the molasses and pesos to the colonies.

**From “Talers” to “Dollars”**

Pesos were known as “pieces of eight” because they were divided into eight parts known as “bits.” Because the pesos resembled the Austrian talers, they were nicknamed “talers.” Talers sounded like the word dollars. This term became so popular that the dollar became the basic **monetary unit**, or standard unit of currency, in the U.S. money system.

Rather than dividing the dollar into eightths as the Spanish had done with the peso, it was decided to divide it into tenths, which was easier to understand. Still, some of the terminology used with the Spanish peso remains. For example, people sometimes call a 25-cent coin—one quarter of a dollar—“two bits.”
Lesson 1  The Evolution, Functions, and Characteristics of Money, Continued

Characteristics and Functions of Money

Guiding Question  What are the qualifications for something to be used as money?

The study of early forms of money is useful because it helps us understand the characteristics, or features, that give money its value. In fact, any substance can serve as money if it has four main characteristics.

Characteristics of Money

First, money must be portable, or easily moved from one person to another, to make the exchange of money for products easier. Most money in early societies was very portable—including shells, wampum, tobacco, and compressed blocks of tea.

Second, money must also be reasonably durable, or long-lasting, so it does not deteriorate when people handle it. Most colonial money was quite durable, especially types like musket balls and wampum. Even the fiat paper money of the colonial period was durable in the sense that people could easily replace it with new bills when old ones became worn.

Third, money should be easily divisible into smaller units so that people can use only as much as they need to purchase, or buy, an item. Most early money was highly divisible. People cut the blocks of tea or cheese with a knife. They could easily break apart the bundles of tobacco leaves. People even cut Spanish pesos into eights to make “bits” for payment.

Finally, money must be available, but only in limited supply. People on the Yap Islands, for example, used stones as money that they carried in open canoes from other islands 400 miles away. Because navigation was uncertain and the weather was hard to predict, only one canoe in 20 completed the round-trip, making the supply of stones limited.

Money, like almost everything else, loses its value whenever there is too much of it. This was a major problem for most types of commodity money. In Virginia, the price of tobacco went from 36 pennies a pound to 1 penny a pound after everyone started growing their own tobacco. Wampum even lost its value when settlers used industrial dyes to turn white shells into purple—thereby doubling their value.

Three Functions of Money

Any substance that is portable, durable, divisible, and limited in supply can serve as money. If it does, it will serve three roles in the economy.

- **Medium of exchange**—A medium of exchange is accepted by all parties as payment for goods and services. Throughout history, people have used various materials as a medium of exchange, including colored shells, tobacco, gold, silver, and even salt.
Lesson 1 The Evolution, Functions, and Characteristics of Money, Continued

- **Measure of value**—Money serves as a measuring stick. Whenever we see a price tag, we can compare the cost of one item to another, expressed in dollars and cents in the United States.

- **Store of value**—This feature of money allows time to pass between earning and spending an income, saving purchasing power. For example, when you earn a paycheck, you can spend it when and where you need to. You do not have to exchange the value of your labor immediately to buy products from your employer.

The modern money we use today serves all of these functions.

**Characteristics of Modern Money**

*While our modern money may seem to be quite different from earlier forms of money, it shares the same fundamental characteristics and functions of money. For example,*

- **Portability**—Modern money is portable. Our currency is lightweight, convenient, and can be easily transferred from one person to another. The same applies to the use of checks.

- **Durability**—Modern money is reasonably durable. Metallic coins last about 20 years under normal use. Paper currency is also reasonably durable, with a $1 bill lasting about 18 months in circulation. The introduction of the Sacagawea dollar coin was part of an attempt to make the money supply even more durable by replacing the $1 bill with longer lasting coins.

- **Divisibility**—Modern money is divisible. The penny, the smallest denomination (value) of coin, is small enough for almost any purchase. In addition, people can write checks for the exact amount of a purchase.

- **Scarcity**—Modern money is in limited supply. This is because the Fed monitors the size of the money supply and takes steps to keep it from growing too fast.

**Exploring the Essential Question**

*In what way is our modern money an improvement over money used during the Colonial period? Is there any way in which Colonial money was superior to our money today?*

The fact that our money supply works so well contributes to the success of the American economy. Our money supply continues to evolve under the supervision of the Fed.

**Components of Modern Money**

*Today the money supply has several different components. Some is in the form of Federal Reserve Notes and some is in the form of metallic coins made by the U.S. Bureau of the Mint. Other components include demand deposit accounts (DDAs), or funds deposited in a bank that can be accessed by writing a check, without having to get bank approval.*

The Fed defines our money supply in two ways. **M1** includes coins and currency, traveler’s checks, DDAs, and checking accounts held at depository institutions. Depository institutions are places where money is deposited or stored, such as banks, savings and loans, and credit unions. These forms of money are all a medium of exchange. **M2** is a broader group. It includes M1 along with savings deposits, time deposits, and money market funds, forms of money that store value.
Chapter 10: Money and Banking

Lesson 1  The Evolution, Functions, and Characteristics of Money

Think of how these different components made our money supply more useful to us! For example, paper currency was an improvement over coins because paper currency could be produced in higher denominations and was much more portable. Checking accounts were an improvement over coins and paper currency because people can easily mail checks, making it easier to transfer money. In addition, a cancelled check serves as a receipt for the transaction. Also, a bank can cancel a lost check, unlike missing coins or bills that might never be seen again.

Funds transferred electronically are faster, simpler, less expensive, and usually more convenient than checks. An example of this is when a company pays its employees by transferring funds directly into their bank accounts. These changes are likely to continue in unpredictable ways, making money safer and more useful.

✅ Reading Progress Check

Explaining  How does modern money reflect the functions and characteristics of money?

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