

What is money?

There is active discussion of what is money with the advent of crypto currencies. There are also those who see gold and silver as money, given the ability to convert these metals into coins and to trade them.

Money has three main characteristics. It is a means of exchange. It is a unit of account. It is a store of value. Most of our money today takes the form of an entry in an electronic ledger at a bank. We accept transfer of electronic money to our account as payment for our work or pension. We pay for many items by offering an electronic transfer from our bank account to the account of someone selling us the good or service.

Most of us rely on the monopoly fiat currency of the country where we live. We know that we can draw money out of our bank account in the form of bank notes, which are accepted as payment universally in our domestic economy. A bank note or a bank account credit possess the three characteristics of money. We can pay for anything with them. We can keep the notes or ledger entry as a store of value for future purchases. We use the value of the money we own to assess the prices and values of goods and assets we might buy or own. Assets, goods and services are all priced in the local money.

Money depends on trust. We trust UK banks to hold our money because they are large businesses with substantial reserves. We know that the Bank of England regulates them and stands behind them. The Bank of England has the power to create additional money if the system needs more liquidity. Our deposits in commercial banks are backed not just by the bank we use, but by the Bank of England standing behind that bank, and by the UK state and taxpayers who stand behind the financial system. There is a deposit insurance scheme for deposits up to the stated limit.

In some overseas countries trust has been badly damaged in their local money thanks to gross mismanagement. A country which manages its economy and banking system badly can end up with a run on its currency, lowering the external value of it too much. This in turn can lead people to want to be paid in foreign currencies, and even to trade in dollars instead of their local money to create some stability of values. A hyperinflation coupled with a collapse in the external value of money in a country is a destructive process.

Those who distrust all fiat currencies look for some other store of value. Gold has often been their choice. This precious metal has had a volatile past, with periods of large gains in value against paper currencies interspersed with periods of decline. Holding gold entails costs of storage and insurance. To use gold as a payment system normally requires selling the gold and using the proceeds in a paper currency to complete a purchase. Like paper currencies, the efficacy of gold rests on confidence and its popularity with users. It is not widely accepted as direct payment and is not normally used as a unit of account for valuing items.