What is Money?
Econ 202
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The whole point of this section is to prepare everyone for a discussion of Monetary Policy by answering the question, what is money?

When it comes to the exchange of goods and services, we recognize that it's much more efficient to use money during those transactions than some alternative. E.g., money is certainly better than barter, where you trade one good for another. As we compare money to these alternatives, we discover that money has 3 important functions. That formed the beginning of our discussion within this section.

The 3 functions of money were as follows:

(a) **Medium of exchange** – money is something we can use in any transaction, because people will always accept money in exchange for the goods or services they sell.
(b) **Measure of value (unit of account)** – money is an accounting unit, with the value of goods and services being set in terms of how much money each is worth. E.g., when the value of something is measured in terms of money (e.g. dollars), we can very easily determine how valuable different goods are, relative to one another.
(c) **Store of value** – money can be used to buy things, but money also has value as an asset. I.e., money has a dual role, it can be used in transactions, but money is also something of value in and of itself. Money can also be an asset, something that makes us more wealthy as we hold more of it.

We noted as well that money, currency in particular, also serves one additional function. We can use currency or cash anonymously, which for people who participate in the underground economy is a very important function.

There are also different types of money.

In some economic systems, money may be created from a commodity (e.g. gold coins). Gold coins have value as money, but gold coins also have value as a commodity – i.e., you can melt down a gold coin and sell it as gold. This type of money is referred to as a commodity money. There are clearly issues with using a commodity money. E.g., if the value of the commodity increases relative to the value of the money as a currency, then people will be tempted to sell their money as a commodity – obviously affecting the overall money supply and the price of goods and services.

People might also be tempted to deface their currency. E.g., if it's a gold coin, then maybe shave some gold off the coin – but not so much that you can't use it as money. This creates "bad money", which would be the defaced currency and "good money" which would be the non-defaced currency. If you held both types of currency, then would use still use both types when making a purchase? Not likely, you would spend the bad money and hold onto (i.e. hoard) the good money. The only money in circulation would be bad money. This phenomena is called Gresham's Law, which states that *bad money chases out good money*.

There is also fiat money. Fiat money would be money that only has value as money, not as a commodity (e.g. US dollar bills). What gives fiat money any value? The value of fiat money as a currency is based on faith in the system which issues that money. If people lose faith in the system, then the value of that money decreases (e.g. this is what happened with Confederate money near the end of the Civil War).

When it comes to these two types of money, there is no "best" type, as both types have their advantages and disadvantages. E.g., with commodity money like gold coins, when the value of gold increases, people have an incentive to remove small amounts of gold from their money and ultimately sell their gold shavings as a commodity.