SECTION 11.2 MEASURING MONEY

- **Currency** consists of coins and paper notes that some institution or government has created to be used in the trading of goods and services and the payment of debts. Currency in the form of metal coins is still used as money throughout the world today. But metal currency has a disadvantage: It is bulky. Also, certain types of metals traditionally used in coins, like gold and silver, are not available in sufficient quantities to meet our demands for a monetary instrument. For these reasons, metal coins have for centuries been supplemented by paper currency, often in the form of bank notes.
- In Canada, the Bank of Canada issues currency in various denominations, and this paper currency, along with coins, provides the basis for most transactions of relatively modest size in Canada today.
- In Canada and most other nations of the world, metallic coins and paper currency are the only forms of **legal tender**. In other words, coins and paper money have been officially declared to be money—to be acceptable for the settlement of debts incurred in financial transactions. In effect, the government says, “We declare these instruments to be money, and citizens are expected to accept them as a medium of exchange.” Legal tender is **fiat money**—a means of exchange that has been established not by custom and tradition, or because of the value of the metal in a coin, but by government fiat, or declaration.
- Most of the money that we use for day-to-day transactions is not official legal tender. Rather, it is a monetary instrument that has become “generally accepted” in exchange over the years and has now, by custom and tradition, become money. It is assets in chequing accounts in banks, more formally called demand deposits.
- **Demand deposits** are deposits in banks that can be withdrawn on demand, by simply writing a cheque.
- Demand deposits have replaced paper and metallic currency as the major source of money used for transactions in Canada and in most other relatively well-developed nations. There are several reasons, including **safety of transactions**, lower transaction costs, and transaction records.
- Paying for goods and services with a cheque is easier (meaning cheaper) and less risky than paying with paper money. Paper money is readily transferable: If someone takes a $20 bill from you, it is gone, and the thief can use it to buy goods with no difficulty. If, however, someone steals a cheque that you have written, that person probably will have great difficulty using it to buy goods and services. If your chequebook is stolen, a person can use your cheque as money only if he or she can successfully forge your signature and provide some identification. Hence, transacting business by cheque is much less risky than using legal tender; there is, then, an element of insurance or safety in the use of transaction deposits instead of currency.

- Demand deposits are a popular monetary instrument precisely because they **lower transaction costs** compared with the use of metal or paper currency. In very small transactions, the gains in safety and convenience of cheques are outweighed by the time and cost required to write and process them; in these cases, transaction costs are lower with paper and metallic currency. It is unlikely that the use of paper or metallic currency will entirely disappear for that reason.
- Another useful feature of demand deposits is that they provide a **record of financial transactions**. In an age where detailed records are often necessary for tax purposes, this is a useful feature. Of course, paper currency transactions are also popular, in part, probably because a substantial amount of business activity is going on with cash payments so that no record will be available for the tax auditors to review.
- **Credit cards** are generally acceptable in exchange for goods and services. A credit card payment is a guaranteed loan available on demand to the cardholder. A credit card is not money but a convenient toll for carrying out transactions.
- **Savings deposits** are bank accounts against which the depositor cannot directly write cheques. People hold these accounts because they generally pay higher rates of interest.
- **Stocks and bonds** are not money because it takes a few days to sell them and receive money. Also, since the prices of these assets fluctuate, there is no guarantee you will receive the full amount of the transaction.
- **Liquidity** refers to the ease in which an asset may be converted into another asset or goods and services.
- The most common definition of the **money supply** is **M2**, which consists of currency held outside chartered banks plus savings deposits at chartered banks. A broader definition of the money supply is **M2+**, which includes M2 plus savings deposits and term deposits at the chartered banks as well as all deposits at trust and mortgage loan companies, credit unions and caisse populaires.

Exhibit 1: *Two Definitions of the Money Supply: M2 and M2+*

- Today, there is no meaningful precious metal "backing" to give our money value. The true backing behind money in Canada is faith that people will take it in exchange for goods and services—because we believe that they will be exchangeable for goods and services with an intrinsic value.
- As long as people have confidence in something's convertibility into goods and services, "money" will exist and no further backing is necessary.
- Governments are the institutional force that traditionally defines money in the legal sense. People are willing to accept pieces of paper as money only because of their faith in the government. When people lose faith in the exchangeability of pieces of paper that the Canadian government decrees as money, even legal tender loses its status as meaningful money.

- Something is money only if people will generally accept it. While governments play a vital role in defining money, much of it is actually created by private businesses in the pursuit of profit. A majority of Canadian money is in the form of deposits at privately owned financial institutions. People who hold money, then, must not only have faith in their government, but also in banks and other financial institutions as well.
- The primary function of money is to serve as a **medium of exchange**, to facilitate transactions, and to lower transactions costs. However, money is not the only medium of exchange; rather, it is the only medium that is generally accepted for most transactions.