Money and the Economy

THOMAS LADENBURG

ZP662 v2.01

PO Box 802
Culver City, CA 90232-0802
United States of America

(310) 839-2436
(800) 421-4246

Fax: (800) 944-5432
Fax: (310) 839-2249

http://www.socialstudies.com/
access@socialstudies.com

Printed in the United States of America.

ISBN: 978-1-56004-720-9

Product Code: ZP662

Table of Contents

CHAPTER 1
Money—An Overview 1
Student Pages 3
Student Activities 8

CHAPTER 2
Expanding and Contracting the Money Supply 11
Student Pages 13
Student Activities 15

CHAPTER 3
The Classroom Banking Game 17
Student Pages 19
Student Handouts 21

CHAPTER 4
The Federal Reserve System 25
Student Pages 27
Student Activities 30

CHAPTER 5
Growth or Stability? 33
Student Pages 35
Student Activities 38

CHAPTER 6
Gross Domestic Product 41
Student Pages 43
Student Activities 45

CHAPTER 7
The Circular Flow of Goods and Services 47
Student Pages 49
Student Activities 52

CHAPTER 8
Unit Review 55
Student Pages 57
Student Questions 60

Answer Key 63

CHAPTER 1

MONEY—AN OVERVIEW

Overview

The purpose of this chapter is to help students learn the definition of money as a means of exchange. They learn that while various objects (e.g., seashells, cigarettes, precious metals, paper, and checks) have at different times been used as money, most of these do not meet the needs of today's complex economy. Finally, they learn that a scheme devised by London goldsmiths became the model for expanding the money supply through our banking system.

Objectives

Students will:

- realize that, for an object to serve as money, it must be universally acceptable, portable, divisible into smaller units, difficult to duplicate, durable, remain fairly stable in value, and expandable when necessary
- be able to explain the difference between three kinds of money: money with intrinsic value, paper money, and fiat money
- understand how the practice by London goldsmiths of issuing certificates indicating that customers had entrusted them with gold, became the forerunner for the means of expanding the money supply through the banking system.

Strategies

Assuming you have assigned students to read the first chapter of this book, check to see whether they have and have completed the Student Activities. Hold up a dollar bill and ask students why it is literally worth more than the paper it is printed on. Make sure they understand the reason is not "because the government will give you gold or silver in exchange for the bill," or something similar. Have them note that, in essence, the dollar is "fiat money" (i.e., money whose worth is based on government decree) and that the decree is itself inscribed on the bill: "This note is legal tender for all debts, public and private." Review the characteristics that money must have to serve its purpose in a modern economy. Ask students why a daffodil, an ice cube, a boulder, or any item on the list in the Student Activities isn't suitable today for use as money. Then ask students how American currency serves all of the requirements of a useful currency. Ask a volunteer to explain how certificates that an individual entrusted gold worth £100 at a goldsmith's could serve as a way of expanding the money supply in 17th-century London.[1]

Assign the reading and exercises in Chapter 2.

1. Part of the answer is that the owner of the pawnshop could print more such certificates than he had gold in his shop. He could get away with this as long as not all of the holders of these certificates want to redeem them for gold.

CHAPTER 1

MONEY—AN OVERVIEW

Introduction

It has been said that it does not bring happiness and has been called the root of all evil. In 2007–08, golfer Tiger Woods earned a cool $111 million. When Shaquille O’Neal signed a ten-year contract to play basketball with the Los Angeles Lakers for $120 million, he said it was not for the money. But some people will kill for it, or die without it. Others admit they could not be happy without it.

A $100 bill is sometimes referred to as a “Benjamin.”
It is the largest American bill in circulation.

This chapter explains what money really is and what can serve as money in a modern society. You will also become familiar with the history of money. Later chapters describe how banks actually create money without printing it and how the nation’s central bank can affect the money supply and why it would want to.

What Money Really Is

It's hard to get and easy to spend. But what is money really? Economists call it **"a means of exchange."** That means, you can:

1. use it to buy things
2. hold on to it, and it will generally keep its value
3. use it as a means of deferred payment (to pay later)
4. use it as a measure of the value of other things

To be useful in a modern society, money must have several characteristics. Among these are:

1. **It must be universally acceptable:** People must be willing to accept it in exchange for goods and services.
2. **It must be portable:** People must be able to take money with them.
3. **It must be divisible into smaller denominations:** $50, $20, $0.50, $0.10, and so on.
4. **It must be difficult to duplicate**—that is, it can't be easily counterfeited.
5. **It must be durable:** The money itself must resist physically breaking down.
6. **It must remain fairly stable in value,** worth about as much today as it was worth last month or even last year.
7. **It must be expandable as needed,** enough to keep up with the increased number of available goods and services.

A Very Brief History of Money

Historians can't pinpoint the day when money first came into use, but one thing is certain: The exchange or trade of goods took place long before people developed money to make this process easier. Even in very primitive societies, Ug the caveman could not always have a disposable stone ax at his side every time he wanted to trade for a mammoth hide. Ug might have exchanged shiny stones or rare seashells (or something else) for the goods he wanted. Gradually, the shells became valuable because members of Ug's traditional society could more easily exchange them for the goods they desired, and thus money was invented. However, no one person patented this invention, and many different societies developed their own forms of money in their own ways. In one of the South Sea islands, huge stones—too heavy for a person to move—were considered the coin of the realm. Some societies consider cattle the basic form of exchange and buy and sell brides

The "Lydian Lion" (c. 600 BCE), considered by many experts to be the first known government-issued coin with cows. During the 1790s in western Pennsylvania, whiskey served as money. In some World War II prison camps, a rare commodity served as the means of exchange: cigarettes.

As societies became more complex, the creation of money became a deliberate process. The first coins were probably minted in what is today Turkey, some 2600 years ago. Paper money came into use in China in the ninth century CE and was used sporadically for some 600 years before it was abandoned.

The process by which paper currency emerged in the Western Hemisphere may be interesting to some and instructive to others. During the 17th century, some Londoners with gold deposited it with goldsmiths for safekeeping. In exchange for the gold, the goldsmith would give the depositor a receipt. Soon the receipts themselves began to circulate and serve the same purpose as the gold deposits they represented. Goldsmiths eventually realized that people often wouldn't redeem the receipts (turn them in for gold) for years at a time. Cautiously at first, they began to write receipts that didn't have gold backing them up. As long as relatively few people came to reclaim the gold they had deposited, these receipts could expand the money supply and make the goldsmith richer. This practice led to the development of the modern banking system.

Three Kinds of Money

At this point, we should distinguish between three kinds of money: **commodity** money, **representative** money, and **fiat** money. Commodity money has worth because what it's physically made of has a value on the open market. For example, melting down a silver dollar should yield a dollar's worth of silver.[1]

Representative money, often in the form of paper money, carries with it the promise that it can be redeemed for precious metals such as gold or silver. This money is as good as a government's promise to back it up, along with other people's willingness to accept it.

The worth of **fiat money** is established by decree (or fiat). The king, emperor, dictator, or the U.S. government simply declares that something is money and must be accepted. Fiat money is also usually paper money. Take out a dollar or a five-dollar bill from your pocket and you can read the words printed on it, "This note is legal tender for all debts, public or private." It does not say, for example, "This note is redeemable in gold or silver" (and the U.S. government no longer exchanges gold or silver coin for the dollars it prints). Nevertheless, nearly all people or businesses are very happy to be paid for their goods or services with U.S. dollars.

A Short History of Money in the U.S.

In reality, the U.S. operates with a mixture of the three types of money just described. At one time, the U.S. minted gold and silver coins worth intrinsically about the same as what the government printed on the their face. Banks also issued paper, sometimes more than they could back up. As long as only a relatively small number of people at one time came to redeem this paper for gold coins, this system worked.

1. Actually, in 2009, the silver in a silver dollar was worth a little more than five cents.

During the Revolution and the Civil War, the U.S. government issued paper money not backed by gold or any precious metal. In both cases, this money lost its value. The U.S. government retired (redeemed for gold-backed dollars) the paper money from the Revolution at the rate of one dollar in gold for every 40 dollars of paper. The government-issued paper during the Civil War was itself retired several years after the war.

The Great Depression of the 1930s led the U.S. to leave the gold standard, discontinuing the policy of guaranteeing that representative money (i.e., paper money) could be redeemed in gold. However, the government still issued silver certificates. But these were also recalled, and today, the government does not provide gold, silver, or any precious metal in exchange for paper money.

That Americans cannot exchange U.S. dollars for gold or silver does not stop them from accepting them in return for goods and services. Why is that? The answer is that the American dollar has all of the characteristics of money: It has universal value (it's very widely accepted), it's portable (you can carry it around with you), divisible (into denominations from 1¢ to 5¢, 10¢, 25¢, and 50¢, and from $1 to $5, $10, $20, $50, and $100), difficult though not impossible to counterfeit, durable (doesn't wear out quickly), remains stable over time (low inflation), and is expandable when needed (the government can create more).

American dollars, British pounds, European Union euros, and scores of other currencies serve the purpose of money. They all provide a means of exchange and of deferred payment, and serve as a measure of value. So do you really care whether you can exchange dollar bills for gold or silver?

Items That Serve as Money

Forms of money exist other than those just mentioned. Fewer than 30% of monetary transactions in the U.S. are conducted with the paper money in circulation today. Most people pay their bills with a check or credit card, and not money. In fact, the money (actually, the credit) that is in your bank account is considered part of the money supply.

It's easy to see why economists count so-called checkbook money as part of the basic money supply. Most businesses pay their employees by check. Employees deposit most of that money into banks, and pay most of their bills by check. But if checking deposits are counted as money, why aren't credit cards as well? Because credit cards represent loans, not actual money. They should in theory be paid off at the end of the month—and how are they paid? By check.

Economists call other kinds of deposits, money, such as savings accounts—bank accounts that the depositor cannot write checks against. In addition, CDs (certificates of deposit), government bonds, and mutual funds are all considered money.

However, a distinction is made between money's various forms when accounting for a country's money supply. Currency, checking accounts, and traveler's checks, because they can all be readily used as money and are universally accepted, are classified as one type of money (M1). But depositors can't turn savings deposits into money as easily, nor can holders of most CDs, who incur a penalty for cashing in early (i.e., before the date of maturity). These are therefore considered a second, broader category of money, M2 (which also includes M1). Bonds, mutual funds, and larger CDs are even less likely to be exchanged for currency at a moment's notice; economists put these in the broadest category, M3 (which also includes M2). While M3 allows for the widest assessment of the money supply, the U.S. central bank, the Federal Reserve, stopped tracking M3 in 2006, saying that M2 alone provided sufficient data. To summarize:

- M1: currency, checking deposits, and traveler's checks
- M2: M1 plus savings accounts, CDs worth less than $100,000
- M3: M2 plus CDs worth over $100,000, government bonds, stocks, and mutual funds
- Credit cards: not money
- Houses, cars, cell phones, etc.: not money

Name: ______________________________ Date: ____________

Student Activities

Money—An Overview

A. Money or Not

Which of the criteria for being used as money in a modern society does each of the following not meet? Use each answer only once. The first question is answered for you.

Items that could not be used for money	**Why not?**
1. Ice cubes	*Not durable*
2. Bowling balls	
3. Rare gems	
4. Whiskey	
5. Sand	
6. Cigarettes	

The criteria are (a) not rare, (b) indivisible into smaller units, (c) not durable, (d) doesn't maintain its value over time, (e) not portable, (f) not expandable, (g) too easy to counterfeit.

B. M1, M2, and M3

Which of the following are M1, M2, M3, or not money at all?

	M1, M2, M3, or not money
1. A credit card's unused balance	
2. A checking account	
3. Stocks and bonds	
4. A savings account	
5. A $100 bill	
6. Antique furniture	

