Activity 3.3

Myths About Money

Money is something we use every day. Perhaps because money is so familiar, many widespread beliefs have developed about it. Unfortunately, many of our common beliefs are only partially true. Perhaps you have encountered some of the money myths which follow.

Myth 1—Most money is currency.

The Grain of Truth

A common belief is that most of the money we use is currency. Currency consists of coins and paper currency (mostly Federal Reserve notes) produced by the U.S. Treasury and issued by the Federal Reserve Banks. Currency is used in many of the transactions we make every day. This is probably why we tend to think of currency as comprising most of our money.

The Rest of the Story

Money, however, is much more than currency. Money can be defined as currency and deposits that can be transferred to make immediate payment. Transaction accounts, which include all types of checking accounts, are money. In fact, there is much more money in such accounts than there is in the form of currency. These accounts include deposits at banks, savings and loans, and credit unions, which can be drawn upon (or transferred) by checks, negotiable orders of withdrawal (NOWs), share drafts, and electronic transfers. These are examples of methods people use to make money payments.

An increase in the amount of currency in circulation does not mean that there is an increase in the total amount of money in the economy. Rather, it means that we prefer to have more of our money in the form of cash. When our demand for cash increases, such as during the Christmas season, commercial banks order more currency from the Federal Reserve Banks. The currency isn't "free." The Fed Banks deduct the amount of currency from accounts the banks have at the Federal Reserve. In turn, the banks distribute the cash to us when we make withdrawals from our checking accounts. In short, we have just exchanged one form of our money for another.

What about credit cards? Are they considered money? While they are considered by many to be nearly money, they really are not. Credit cards do not pass the three tests for being classified as money. They are close to being a medium of exchange but actually they are a method of deferring, not making, payment. Credit cards are not a store of value or a measure of value.

Myths About Money (continued)

Myth 2—Money is backed by gold.

The Grain of Truth

In most myths, there is a grain of truth, and that is the case here. Until 1933, individuals could redeem U.S. currency for gold. Historically, people often viewed gold as a means of restraining government from supplying too much money and overinflating the economy. This attitude was evident when the Federal Reserve System was established in 1913. Congress required initially that the 12 Federal Reserve Banks "back" their currency, known as Federal Reserve notes, with gold and securities.

The Rest of the Story

In today's economy, gold is no longer required to "back" currency and our currency need not be exchanged for a set amount of gold.

Why didn't our monetary system collapse when gold was no longer used to "back" it? There are two key reasons. First, gold never actually gave money its value. Gold may have provided people with confidence in their currency. However, the value of the dollar has always been determined by its purchasing power. Money has value because people are willing to accept it when making exchanges. It is a medium of exchange when people are confident that it can be used to obtain the goods and services they want.

The second reason has to do with the fact that the amount of money in circulation needs to be limited. As long as the Federal Reserve keeps the availability of money in line with the overall growth of the economy, then its value is preserved as if it were "backed" by a fixed supply of precious metal. People who call for a return to a gold-backed currency are expressing a lack of confidence in the Fed's ability to limit the amount of money in circulation.

Many people today who are interested in returning to gold as a "backing" for our currency do not really want to exchange their money for a precious metal. Instead, they are expressing distrust in the ability of government institutions to limit the quantity of money. Governments, at times, are tempted to create too much money during times of crisis such as during a war or a debt crisis. It is distrust of government, not confidence in gold itself, that sometimes stimulates modern talk of restoring gold as a "backing" for currency.

Questions for Discussion

Why do we tend to think that money is backed by gold?

What actually gives money its value?

Why do we think that most money is currency?

In addition to currency, what other things serve as money?