Part 3

SPENDING MONEY AND TAKING CONTROL

Module 8

MONEY BASICS

Let's Discuss...

- $ What money is
- $ What we use as money
- $ Characteristics of money
- $ Roles of money
- $ Impact of inflation on the purchasing power of money
- $ Role of the Bank of Canada
- $ How financial institutions work

Using money wisely is a skill – and a skill that will usually pay off. Any skill, like being a plumber, an auto mechanic, a doctor, or a dentist requires learning – what's important to know, how things work, how to do the work, what can go wrong, and what to do in certain circumstances.

That's the case with money too. There are things to learn about money that can help you to take better control, make better decisions, and have a better chance of achieving your goals. To help you take better control of money in your life, let's cover a few of the "basics." These can help build your basic understanding as you get more and more involved with money and money decisions.

How About You?

How would you rate your general money knowledge and skills?

1	2	3	4	5

NOT VERY GOOD ———— EXCELLENT

First question – What is money anyway?

In the old days, what people used as money often had value in and of itself. For example, some money was made from metals like gold and silver. The coins were actually valuable because of the metal they contained. A gold coin had a value based on the worth of the gold used to make it. Money made of material like gold and silver is said to have "intrinsic" value. There was actual value in the money itself.

That is not the case today. A $100 bill doesn't contain $100 worth of metal or any other material worth anything close to that. The $100 bill doesn't "contain" $100 in value – it "represents" $100 in value. You can use a $100 bill to buy $100 worth of stuff. Stores, for example, will provide you with products worth $100 in return for that colourful (and now plasticized) little piece of paper. You don't have to give them gold, or a goat, or bushels full of grapes. One little piece of paper and you can walk out with $100 worth of product – with nobody chasing you.

But why are they willing to accept it? They accept it because they know others will accept it from them. They will be able to get something else, from someone else, worth $100. The $100 bill has become "legal tender" – along with the quarter, the loonie, the ten dollar bill and all our other coins and currency. Legal tender is what we officially use as money.

Learn About

Go online if you can and do some quick research on things that have been used as money in the past.

Think About It

If you had to describe to someone what money is, what would you say?

Money that doesn't have "intrinsic value" but, instead, "represents value" is called "fiat money." That is what we use today. A dime isn't made of anything worth 10 cents. The same is true for the loonie, the toonie, the $5 bill and so on. They don't have "intrinsic value" – but they do have "purchasing power." You can use them to buy things.

In the course of history, a variety of things have served as money – gold, cows, shells, playing cards, and other things in countries around the world. But, in today's world, what is used as money has become pretty standard from country to country. That doesn't mean we all use the same money. Canada's money is different from money used in the U.S., Japan, Europe, Russia, and so on. What is common is that all countries, for the most part, use fiat money. There aren't countries using cows as currency anymore. However, in some countries you can probably still trade a cow for some things.

Trading one item in exchange for another without using money is called "bartering." Bartering is basically another word for trading – trading one thing for something else. The problem with bartering for a modern economy is that with so many goods and services produced, setting prices would be a nightmare. What is one computer worth – 500 towels? Or 3 bicycles? Or a six-person tent? Or ½ of a good lawnmower?

How About You?

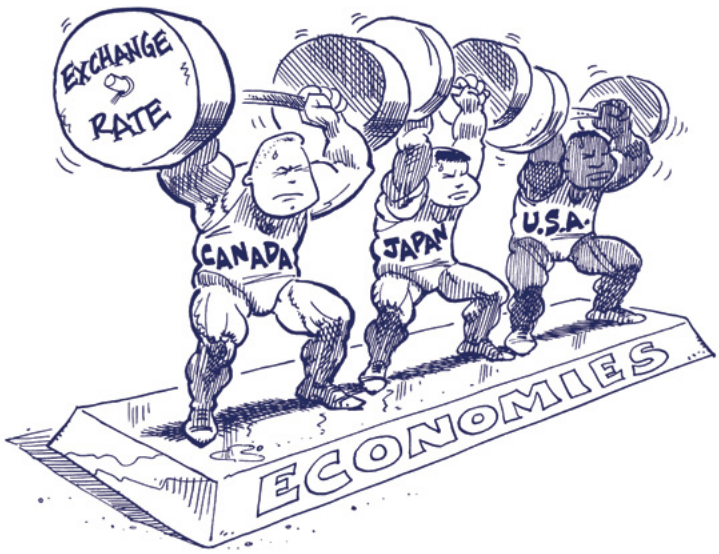
Have you ever bartered or made a trade – and exchanged one thing for another without using money? If so, how did that come about? Was it easy?

You get the picture. Money makes buying and selling (exchanging) things much easier. However, because all countries don't use the same money, there is also a need for "foreign exchange markets." You may have participated in a foreign exchange market if you have ever had to use Canadian dollars to buy U.S. dollars, or Euros, or Japanese yen. Foreign exchange markets enable the currency of one country to be exchanged for the currency of another country.

You have probably heard talk about the exchange rate of Canadian dollars in terms of the money used in another country – for example, the U.S.. You will often hear news reports talk about the value of the Canadian dollar in terms of the U.S. dollar because the U.S. is our neighbour, many Canadians travel there, and the U.S. is our largest trading partner.

Think About It

Have you ever had to exchange Canadian dollars for the currency of another country? If so, how did you do that? What was the cost to make the exchange? Why was there a cost? Did you use the money when you visited another country? If so, how did the costs for things compare with the costs in Canada? If costs were different than in Canada, why do you think that was the case?



The value of the Canadian dollar in terms of the U.S. dollar will be affected by many things. It would almost be a book on its own to discuss all the factors that can affect the international value of our money. For our purposes here, just be aware that the exchange rates between the Canadian dollar and other currencies will change over time and will be influenced by a variety of factors. (If you want to learn more about exchange rates, go to the Canadian Foundation for Economic Education's website, "Money and Monetary Policy in Canada.")

So different countries use different kinds of currencies as money. But, for something to serve as money, it has to have some specific characteristics.

- It has to be durable. If we used apples, they would rot. That wouldn't work.
- It must not be easily reproduced. We could use chestnuts. They're pretty durable. But soon everyone would be planting chestnut trees. There would soon be so many chestnuts, and prices would rise so high, you'd need a wheelbarrow full of chestnuts to buy a loaf of bread.
- While it must be relatively scarce and not easy to reproduce, it can't be too scarce. If it was, we wouldn't have enough for all the exchanges that have to take place. So we could use whooping cranes – but we'd never have enough for the money we need.
- It also has to be easy to transport and carry around. We could use elephants but just try putting a couple of them in your pocket or purse.
- And finally, it has to be divisible into fractions. We use a dollar as our basic unit of currency but we also have 5/100 of a dollar (nickel), 10/100 of a dollar (dime) and so on.

Examples of early Canadian coins.
National Currency Collection, Bank of Canada;
Photography James Zagon, Ottawa.

So money needs to be durable, not easily reproduced, available in sufficient quantity for transactions in the economy, easily carried, and divisible. But more than anything, it has to be widely accepted as money.

So what we use as money has changed over time. How we use money has also changed. Today, we have a pretty sophisticated financial system – one in which you often don't actually need to hold or handle much money. Why? Because we have things like debit cards and online banking. We can transfer money through our computers from the comfort of our homes – or in our car – or on the bus. We can send money to someone overseas in a flash. Things have changed dramatically over the last thirty years or so in terms of money and how we use it.

How About You?

How do you like to pay for things you buy? Do you carry much money on you? Why or why not?

But what roles do money serve for us?

There are three basic roles.

First, money serves as a "medium of exchange." As we have noted, it helps us buy things from one another. It is a lot easier to use money than to barter and try to exchange one item for another. We all use money to buy things – as a medium of exchange. But this brings us to another role of money – it makes it easy to set prices.

Rather than having to set prices in terms of all sorts of things, prices are set in terms of money. How much money does it cost? What is the price? Everything has a price – in terms of money. Money is said, then, to serve as a "unit of account." That makes things easier too.

Finally, money serves as a "store of value." That means we can save it and use it in the future. We can store money for the future in different ways – and in different places. We can even try and do things with the money we set aside to try to increase its value – by saving or investing it.

Think About It

Why might the price of a product decrease? What are possible reasons why a product might go on sale? Why might the price of a product rise?

How About You?

Do you have savings or investments?
If so, how have you saved or invested?
Has the value increased?
Or decreased?

So let's review a list of some key things to note about money:

- Our money isn't valuable in and of itself. Its value is in what we can get with our money – it's "purchasing power."
- Prices will affect the purchasing power of our money. If prices, on average, rise, that will lower what we can buy with the same amount of money. Rising prices therefore reduce the purchasing power of money.
- If prices, on average, rise in an economy, that is called "inflation." The job of trying to control inflation in Canada lies primarily with the Bank of Canada. You can't do your banking at the Bank of Canada. It is an agency of the federal government. The banks deal with the Bank of Canada – individual Canadians and businesses do not. An important job of the Bank of Canada is to try and influence the levels of spending, the money supply, and interest rates so that prices are kept pretty stable. There is probably no more important role for the Bank of Canada than to keep the rate of inflation under control to help protect the purchasing power of Canada's money. (The Bank of Canada usually sets its sights on about 2% inflation rate for Canada's economy.)

- Most of us keep much of our money in financial institutions. We have a variety of ways to get and use our money – cash, cheques, debit cards, online transfers – if, for example, we want to make a purchase – like buying a book, a meal, a car, a computer, etc.
- Credit cards are not a form of money and they don't help us get and use our money. They help us get and use someone else's money – such as money that a bank has made available to you on a credit card if you need it.
- Most of us "store" our money in financial institutions by putting it in different kinds of accounts – savings account, chequing account, savings-chequing account, tax-free savings account, and so on. We may invest some of those savings to try and increase the value of our savings in the future. For example, we might invest some savings in stocks, bonds, mutual funds, treasury bills, and so on. Therefore, by putting our money in a financial institution, we can store our money to protect it, be able to get it when we need it, and hopefully find ways to increase its value over time.
- Inflation makes it harder to increase the value of our savings. If you are able to earn 3% interest on your savings in a year, but inflation is 3%, your savings will have trouble increasing their "purchasing power." Inflation can eat away at the value of our money and make saving for the future more difficult.
- At the same time, if inflation is 3%, gaining 3% on your money is better than earning nothing at all. If you don't earn 3%, the purchasing power of your savings may actually fall. So it is a good idea to put your savings to work to try and earn some more money for you – and to protect its value and purchasing power from inflation.

Discuss

What do you and others think of Canada's "plasticized" money?

Before we wrap up this brief primer on money, there is another key point to make. In addition to the other key role we mentioned about the Bank of Canada – that is, influencing interest rates, the money supply, and level of spending to keep inflation under control – the Bank of Canada also produces our currency – our paper money. (Note: the Canadian Mint produces our coins.)

Since the Bank of Canada can print money, the question may come to mind – why not just print more money and give it to people and make everyone better off. Sounds like a good idea. Unfortunately, here's why it won't work.

Think of the game "Monopoly." If you have never played Monopoly, get someone to briefly explain the game. In essence, though, here's how it works. Players role dice and move their player pieces around the board, buy "properties" that are available for sale, trade to form "monopolies," (get all the properties that are of the same colour or type) and build houses and hotels to try and make more money than the other players – and win the game.

At the beginning of the game, players are given a certain amount of money. They use this money to buy properties, to buy and sell properties to form their monopolies, and to buy houses and hotels. Now what if we doubled the amount of money in the game? Would the players, overall, be better off?

No. Why not? Because there is no added "value" in the game that the money can buy. There are the same number of properties, houses, and hotels. The added money can't be used to buy anything new. The players may have more money but they will need more money, due to higher prices, just to buy the same things as they would in a game with half the amount of money. In terms of "real value," players are no better off having twice as much money.

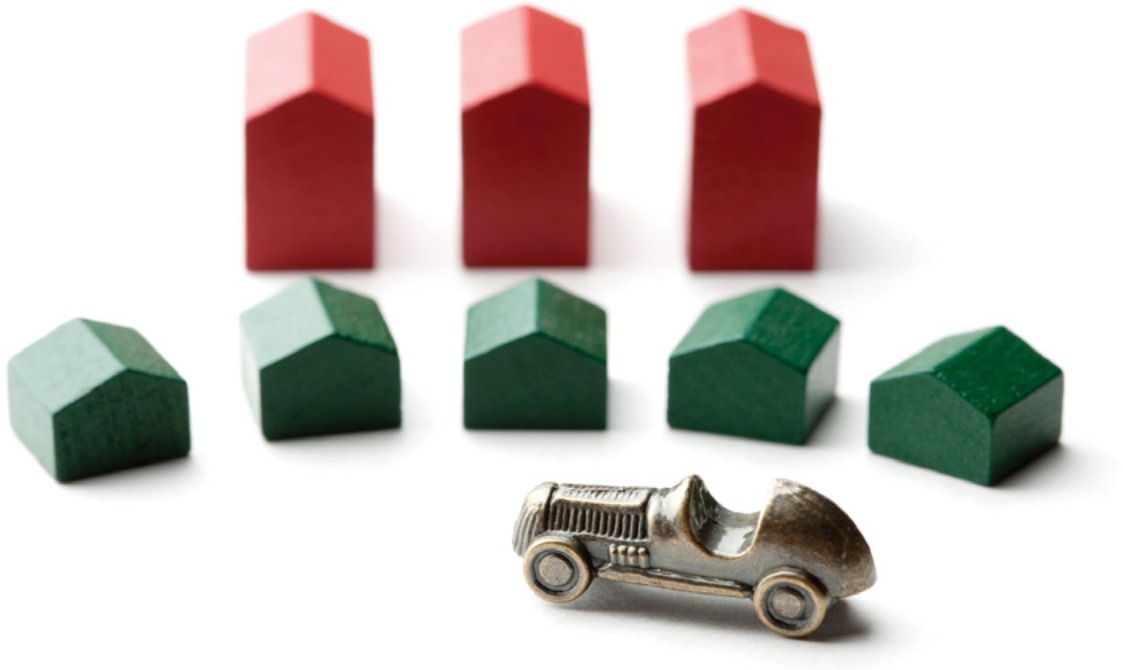
What will be the result? Prices in the game will increase. In fact, on average, they would likely double. The added money would be "chasing after" the same quantity of goods. With more money in the game, prices will be bid up as players look to build their monopolies and make exchanges with one another.

The same is true in our economy. If we add more money to the economy, but don't produce any more, the added money will just push up prices. This brings us to a key point. Money is of little value in and of itself. We can't eat it, wear it, or build houses with it. Its value is in what it can buy – its purchasing power. So if we have twice as much money – but prices double and we have nothing more to buy – we are no better off.

Things are different when the economy produces more. More money will be needed by the economy when there are more goods and services produced. More money will be needed so that the new items can be bought. But if it's just the same quantity of stuff in the economy this year as last year, any added money will just lead to things costing more. And inflation will just eat away at the purchasing power of our money.

So keeping inflation under control is a key job for the Bank of Canada. If you want to learn more about interest rates and monetary policy, visit CFEE's website, "Money and Monetary Policy in Canada." You can access the site via CFEE's main website www.cfee.org.

That's not an easy job. Luckily the Bank of Canada has very capable people managing our "monetary conditions." Canada has a very good international reputation for managing our money well – as a country.



50 livres, French Regime playing card money – Reproduction, 1714, Canada.

To review – money is a "medium of exchange" (we use it for spending), a "store of value," (we use it for saving and investing), and a "unit of account," (it enables us to set all prices in terms of money.)

When it comes to what we do with money, everyone faces a variety of money challenges and decisions. These decisions include:

- Getting money
- Spending money
- Overall budgeting, planning and managing money
- Borrowing money
- Saving and investing money
- Protecting money
- And donating money – giving some of our money away to others

We have looked at ways of "getting money" in earlier modules. We have also looked at how to make good decisions when it comes to spending money. We'll soon look more closely at some of the "major expenses" – the bigger things that many people spend money on. As we continue, we will look at each of these other money challenges and decisions as well. We will try and help you develop your money skills – take more control over your money – and have a better chance of reaching your financial goals.

Let's turn our attention to the overall challenge of budgeting, planning, and managing your money.

How Financial Institutions Work

The Business of Banking

Banks Aim to Earn a Profit for Shareholders

Banks operate as businesses and, as such, aim to make a profit. The profit earned by the banks can be reinvested, saved for reinvestment in the future, or distributed to shareholders – the owners of the bank. Most Canadian banks are privately owned by many shareholders and the shares are available for purchase on the public stock exchange. The shareholders receive a share of the profits, which are distributed as dividends.

How About You?

Do you have money deposited in a bank? If so, how did you decide which bank to use?

Think About It

Can you think of times when banks may need to have more cash on hand to respond to depositors wanting to withdraw cash?

What Do Banks Do With Their Deposits?

In managing their deposits, banks will allocate their deposits in three general areas:

- Cash reserves: These are held to cover day-to-day needs for cash, and some are held for precautionary reasons to cover potential, unforeseen needs.
- Highly liquid assets: These include treasury bills, which earn interest but are quickly convertible to cash if the bank should find that it has additional cash needs. Liquidity refers to how quickly an asset can be converted to cash at a predictable value.
- Less liquid assets: These include commercial, consumer, and mortgage loans, which return a higher rate of interest to the bank but are less easily converted to cash and represent greater risk.

How About You?

Do you actually use much cash these days to handle your purchases? How do you prefer to handle your purchases? Do you know of any costs you incur when you use other forms of payment?

Banks will hold on to sufficient funds as cash or highly liquid assets for those clients with deposits to feel confident that they can always access their funds when needed.

The decisions made by banks about the quantity of liquid assets, such as cash, to hold in reserve are determined by a variety of factors. For example, during the Christmas season, people tend to withdraw more funds and spend more. The banks will need to have a higher quantity of liquid assets available at such times.

But not all of the banks' deposits need to be held as cash or in highly liquid form. Why? Since the vast majority of payments made today are not in cash, but via cheque, debit card, or online transfers, the banks only need to hold a relatively small portion of all their deposits to service the needs of their depositors on a day-to-day basis. The rest of the deposited funds are then put to work by financial institutions as loans or investments to earn interest – with profit being the goal.

We noted that banks will aim to earn a profit for their shareholders. Profit is defined as Total Revenues minus Total Expenses. Let's look closer at the expense side of the banking business.

The Expense Side

What costs does a bank incur in operating its business affairs? We know that a bank incurs a cost for the funds held as interest-bearing deposits. That is, a bank has to pay interest on its deposits. In addition, a bank faces costs such as salaries for employees, property expenses for its branches and offices, advertising, branch operations, and taxes. In other words, a bank faces most of the normal operating costs that other businesses face.

Another potential expense for a bank is not as obvious – and that is the allowance for possible losses on loans. As you can imagine, banks make loans on the assumption that they will be repaid. Extensive checks are done on a borrower before the bank provides a loan in order to try to ensure the loan will, in fact, be repaid. But sometimes things don't go as planned or forecasted and some borrowers may find that they can't meet their payments. They may even encounter such hardship that they may not be able to repay the loan – or a portion of the loan. The banks have to plan for the possibility of such situations and the possible cost of loan losses.

That's the cost side of the banking business. What about the income side?

Discuss

What are the various kinds of costs a business may face in producing and providing a good or service?

The Income Side

Banks earn income on the spread (or the difference) between the interest rate they pay to depositors and the interest rate that they charge to borrowers. But that's not the only way in which the banks can earn income. Banks invest in assets such as bonds and treasury bills that pay interest to the banks. Banks also earn income from foreign exchange commissions as people and businesses pay a fee to convert money from the currency of one country to the currency of another. They also earn significant income from a variety of possible fees that may be charged, such as those charged on/for:

- certain bank accounts as maintenance fees
- providing hard copies of bank statements
- requesting a deposit slip
- returned deposit fees (if someone writes you a NSF cheque)
- overdraft charges
- ATM fees
- notarizing documents
- lost card fees
- and others

As with any business, if a bank's total revenue exceeds its total expenses, it earns a profit. Generally, the better a bank is managed, the higher its profit and its stock price will be. However, if a bank is not managed well, and if its performance doesn't meet expectations, disgruntled shareholders may exert pressure for changes in the bank's management.

Think About It

What fees might you be paying to a bank for services the bank provides?

Module Summary

Say What? Possible New Terms!

1. **Financial independence:** having access to enough income to enjoy life without having to work if you do not wish to do so. You are not reliant on others for the money you need to live.
2. **Intrinsic value:** when money has value in and of itself. For example, money made from gold or silver.
3. **Fiat money:** when money has no value in and of itself but only in terms of the value it represents and what it is able to buy – its purchasing power.
4. **Legal tender:** the official money in a country that is widely accepted.
5. **Exchange rate:** the value of one country's currency in terms of the currency of another country.
6. **Foreign exchange market:** locations where the currency of one country can be exchanged for the currency of another country.
7. **Bartering:** when one item is exchanged directly for another without using money.
8. **Medium of exchange:** one of the roles of money where money makes it easier to acquire goods and services we need and want.
9. **Unit of account:** one of the roles of money where we are able to set prices in terms of money to reflect the value of a good or service.
10. **Store of value:** one of the roles of money whereby it is possible to save money rather than spend it and try and increase its value in the future.
11. **Purchasing power:** the ability of money to acquire goods and services. As prices rise, the purchasing power of money falls.
12. **Inflation:** a rise in the average price level of good and services in the economy.
13. **Bank of Canada:** Canada's central bank that holds the responsibility, among other things, of influencing interest rates to keep prices relatively stable and protect the purchasing power of Canada's money.

Did It Stick? Can you recall ...?

1. What is money and what are the roles of money?
2. What are the characteristics of something that can serve as money?
3. Why does bartering pose challenges for a modern economy?
4. What are the different ways people can access and use their money today?
5. Why does the Bank of Canada try to keep prices stable in the economy?
6. Why can't the Bank of Canada just print more money, distribute it, and make everyone better off?

Thinkabout ... or Discuss:

- How and why could playing cards ever have been used as money?
- What are the disadvantages and harmful effects of inflation in the economy?
- Who tends to get hurt most by inflation? Who might benefit from inflation?
- How does the Bank of Canada try to keep inflation under control?
- What factors do you think might affect the exchange rate of the Canadian dollar with the U.S. dollar? Who benefits if the value of the dollar rises? Who benefits if the value falls?

Tips & Suggestions

- Keep an eye on the rate of inflation and whether it looks like inflation may be rising. This can affect prices and interest rates.
- Be careful when doing online banking. Do your banking from secure sites – and never share "PINS" or "passwords" with others. Don't have them on your cell phone, etc. so that, if your phone is lost or stolen, no one can find your passwords.
- Be careful in using random "ATMs" in locations where you think they might not be secure and well monitored. ATMs can be compromised by thieves to steal your PIN and then try and access your accounts. Try and use ATMs you feel you can trust and that are well protected.

Tech Talk

On the Internet you may want to search for, or visit the web sites of:

- Things used as money
- Money in early Canada
- Bank of Canada – and Role of the Bank of Canada
- Why we worry about inflation
- Canada's paper currency
- Factors affecting the value of Canada's money
- Canadian Mint