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From then to now

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The *love* of money is the root of all evil. – *King James Bible*

Lack of money is the root of all evil. – *George Bernard Shaw*

”



Venezuela, led by Hugo Chavez, is allowing Caribbean countries to pay for oil using bananas and sugar cane – a modern example of the barter system.

Barter – a thing of the past?

On 22 December 2007, the President of Venezuela, Hugo Chavez, indicated that his country was prepared to let Caribbean nations pay partly in kind, using food items and services, rather than in cash for the oil they get from his country. Currently, 17 countries, including Antigua and Barbuda, Granada, Guyana, Jamaica and Saint Lucia, are members of the PetroCaribe oil alliance with Venezuela. Under this arrangement, Venezuela supplies oil to the members of the alliance, which can be paid for over a period of up to 25 years, at an interest rate of 1 per cent. It is this debt that Chavez has suggested may be paid with items such as bananas and sugar cane. In effect, Caribbean countries are allowed to swap bananas and sugar cane for oil – essentially a cashless transaction. This is just one of many examples that bring into focus one of the issues to be discussed in this chapter – the barter system, a system for trading without money.

In this chapter you will:

- discuss early trading and systems of exchange
- explain why money is necessary
- discuss different types of economic systems
- classify and describe business organisations.

SECTION A The barter system and money

Life before trading

Can you imagine a society in which people did not **trade**? In such an economy, you and your family would have to produce everything that you wanted to consume. Your wants would be satisfied directly by your production and not through **exchange** or the purchasing of goods that others had produced. Earlier societies were structured in this way – there was no trading and wants were satisfied directly. This type of system came to be called **direct production** and was not without its faults. Could you imagine what would happen, for example, if a flood destroyed your rice crop? Without trading, you would not have any rice to eat. Alternatively, what if you had more rice than you could consume? What would you do with the surplus? Furthermore, it may not be possible to produce a little of everything that you wanted to consume. These problems quickly led members of early societies to trade with each other in what was called **indirect production**.

What was early trading like?

Trading requires that you produce more than you want to consume so that you can exchange the surplus. Early societies quickly realised that trading made it possible for them to produce one or two items in excess of their needs, rather than producing a small amount of everything. This came to be known as **specialisation**, since each member of these early societies was now concentrating on the production of one or two **goods** or **services**. Of course, having given up the production of some items, there needed to be a way to access these for consumption – in other words, the farmer with an entire field of corn and yams may want some chicken and rice. A system of exchange, therefore, became necessary so that this farmer could access what he did not produce himself. This system was the **barter** system.

Now it's your turn

- 1 Explain two differences between direct and indirect production.
- 2 Why did trade become necessary in early societies?

The barter system

It is quite likely that your only experience with trading is using money to buy what you want. From an early age, you may have realised that money can be used as a **medium of exchange**; that is, you can use it in exchange for what you want. Early societies, however, operated without the concept of money and all trading activities were done without a medium of exchange. In these societies, goods and services were exchanged directly for other goods and services in a system that came to be known as the barter system – the oldest system of trading known to man. As our opening account with Chavez's offer to the Caribbean has shown, however, barter is still practised in modern economies.

A transaction in a barter system is possible when a **double coincidence of wants** occurs. Each party must have an item to exchange with the other party before trading can take place. This means that bartering between individuals was possible only in a simple economy. As the **economy** developed and more products, **producers** and **consumers** entered the market, the direct exchange of goods without the use of money was no longer possible. With the advent of the internet, and as communication across long distances becomes easier, bartering between individuals and businesses has become more popular.

Making connections: history

Do you know about the triangular trade? If not, talk to a history teacher or read up on it. How was barter used in the triangular trade?

Problems with the barter system

As mentioned above, barter is not feasible in developed economies where there are many products, producers and consumers. Some of the reasons for this are discussed below.

A lack of double coincidence of wants

Each party in a barter transaction must have an interest in the other party's commodity. For example, if a butcher has meat and wants a hammer, he must find

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somebody who has a hammer and wants meat. When this fails to occur, we say that there is a lack of double coincidence of wants. This occurred very often in the barter system and, as a result, the time it took to make a transaction was very high.

Think about it

Imagine that you want to trade in a market that uses a barter system. Although there are people in the market who have what you want, they do not want what you have. Discuss what you could do to create a double coincidence of wants.

Indivisibility of commodities

Some commodities, by their very nature, cannot be divided without a significant drop in their value. For example, a carpenter, having built a house, cannot give up a piece of the house in exchange for a meal. Nor can a farmer give up a piece of meat for a shirt, without killing the cow. It therefore became difficult to trade items that had a high value. How could the carpenter trade his house for a meal? How many meals should he get for his house? How many meals does he want anyway?

Absence of a store of value

It is difficult to store wealth in the form of commodity, since many commodities perish or lose value rapidly over time.

Absence of standard value

It is difficult to agree on a standard exchange rate between two items. For example, how many goats should the farmer give the carpenter for building him a house? The absence of a standard value means that one party often loses out in a barter transaction.

The money economy – an improvement in the barter system

The problems experienced by those trading in the barter system required the development of a better system of exchange that could more efficiently facilitate specialisation and trade. This resulted in the introduction of money as a medium of exchange – but money has not always been paper and coins as we have in the modern world.

Previously, various items, which had their own intrinsic values, were used as trading instruments. For example, shells, gold and silver have been used as money in various societies, as well as cattle and agricultural produce. When objects that have other uses are used as money, they are called **commodity money**. For example, cattle can be used as money but they can also be slaughtered for food; similarly, gold can be used as money or it can be fashioned into jewellery.

Many problems are associated with the use of commodity money – primarily because commodities are not always easily divided and the same items can often vary in quality and therefore value. Also, they are not always portable, which makes carrying out large transactions with them difficult. It makes sense, therefore, to use paper as money, since it has none of these problems. Of course, it should be obvious to you that the paper on which money is printed has little or no value, which means that it is not commodity money, but rather **fiat money**. In other words, the government is prepared to redeem a banknote for the value stated on its face. If the money loses the backing of the government then the paper it is printed on is only useful for starting a fire!

Think about it

The problem with commodity money is related to the innate value of the objects being used as money. Consider, for example, what would happen if you had \$100 entirely in coins that you could melt down and create an item that is of a value greater than \$100. Would you spend these coins or would you melt them down? Does this problem arise with fiat money? Why or why not?

The uses of money – what can money do?

- **Money is a medium of exchange:** money can be used in exchange for other goods and services. As shown in Figure 1.1, individuals exchange what they have for money and use the money to buy what they want.
- **Money is a store of value:** can you imagine what would happen to your savings if there was no money, and you were forced to save

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your wealth in commodities, such as perishable tomatoes? Money is used to store wealth for a later date, because its value remains reasonably fixed over time.

- **Money is a measure of value:** in the same way as length is measured in metres and weight in grams, money is the unit of value. Prices

are quoted using money and this simplifies accounting.

- **Money is a standard for deferred payments:** because money does not lose value quickly, items can be bought on credit with an arrangement to pay for them with money at a later date.

 Business in your world

Store of value and inflation

Money is supposed to be a store of value, but if there is inflation this may not be the case. Inflation is what happens when prices rise and you are unable to buy the same amount with your money as you once could – in other words, money loses value. For example, if the annual inflation rate in a country is 10 per cent then it would take 10 per cent more money this year than it did last year to buy the same commodity. It also means that for wealth that is stored as money in the form of savings, the value of these savings decreases as time passes. This is not such a big problem in the Caribbean, where the inflation rate is between 7 and 12 per cent in most years. But imagine if you lived in Zimbabwe where, in 2008, the inflation rate reached

a whopping 400 000 per cent. Would you then want to store your wealth in the form of money? Things got so bad in Zimbabwe that it was reported that businesses allowed workers to go and spend their money immediately after they were paid as it would have no value by the following day.

- 1 What is the inflation rate in your country? Do you think it is too high?
- 2 How can you ensure that the money you save does not lose value over time?
- 3 Some people insist on saving money under their mattresses at home. This money is never banked and can be accessed when needed. Why might it be a bad idea to save in this manner?

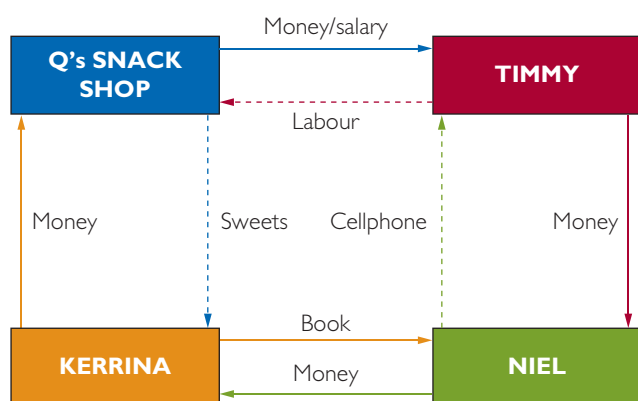


Figure 1.1 Money as a medium of exchange. Note that in all transactions, money is exchanged for a good or a service. No barter is necessary – people simply need to exchange what they have for money and use this money to buy what they want.

Modern forms of money

In addition to notes and coins, trading instruments may also take the following forms:

Credit cards

A bank may give a person a **credit card**, which they can use to buy things and then repay the money to the bank when they receive their monthly bill, or over a period of time. The credit card may be used to spend up to a set amount of money – when this amount has been reached, the card is said to have reached its limit. When this happens, no further spending can take place until the customer pays all or a part of the amount already spent. Usually, interest is charged only if the person does not pay the full amount owed at the end of the month.

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Credit and debit cards allow users to avoid walking around with cash.

Debit cards

Debit cards are used by holders of bank accounts to buy goods or services without the need for cash. When used, a debit card (which looks like a credit card) transfers funds directly from your account to the merchant's account. Unlike credit cards, a debit card only allows you to spend your own money, which you have previously deposited in your account. These cards can be used to carry out regular transactions such as buying groceries and paying bills, and they are often used as a substitute for cash.

Electronic transfer

Electronic transfers, also called wire transfers, allow account holders to transfer funds from their bank to

Now it's your turn

- 1 What is the fundamental difference between debit and credit cards?
- 2 Can you think of any advantages that credit or debit cards may have over money held in the form of cash? Talk to an adult who has a credit card, if this helps.

another bank and, therefore, avoid the use of cheques. Wire transfers are often used by businesses as opposed to individuals and often involve large amounts of money – often millions of dollars.

Tele-banking

Many banks allow customers to pay bills and arrange various payments over the telephone. With Tele-Scotia, for example, a service offered by the Bank of Nova Scotia (BNS), customers are able to pay utility bills, check account balances and transfer funds between accounts, all from the comfort of their home.

Bills of exchange

A bill of exchange is a written agreement in which one person (called the drawer) instructs another (called the drawee) to make a payment of a specified amount by a specified time to another party (called the payee). A cheque, therefore, is actually an example of a bill of exchange. Bills of exchange are popular when trading parties live in different countries or are separated by huge distances. A bill of exchange is a trading instrument since it can be endorsed by the payee to be paid over to a third party, who in turn may endorse it for a fourth party, and so on.

Summary – Section A

- In early societies, no trading took place and everyone provided for their own needs through their own production.
- With the advent of specialisation, barter was developed as a system of exchange in order to facilitate the swapping of excess goods.
- Money was developed in order to solve the problems associated with the barter system – including the lack of double coincidence of wants and indivisibility of commodities.
- Money has taken many forms over time including notes and coins and other commodities such as salt, cattle and shells.

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End of section activities

Quick questions

Copy the following statements into your exercise book and complete them using the words from the word bank, which appears at the end of the activity.

- 1 When someone _____, they concentrate their productive efforts and resources on producing one or two goods in excess of their needs.
- 2 When someone produces all the items that they consume without specialising in any single item, they are involved in _____.
- 3 Indirect production required _____ since people had to be able to acquire what they did not produce.
- 4 The first system of trading known to man was the _____.
- 5 Money is a _____ because it addresses the problem of a lack of double coincidence of wants experienced in the barter system.
- 6 _____ cards allow a user to spend money that they have already deposited in a bank account.
- 7 Because money is a _____, comparing the value of two similar items can be done by simply examining their prices.
- 8 Businesses usually use _____ to move funds between their accounts and the accounts of their customers.
- 9 _____ may lower the value of money, if it is stored for a long time.

- 10 Money whose value is determined by the backing given to it by the government is called _____ money.

electronic transfers	barter system
specialises	direct production
inflation	debit
medium of exchange	measure of value
commodity	trading
	credit

Applying what you have learnt

- 1 'Nobody wants money – rather individuals want the items that money can buy.'
 - a Using your understanding of the idea of money as a 'medium of exchange', explain why people are willing to work for money.
 - b Look up the meaning of the term 'derived demand'. Why is money considered to have a derived demand?
 - c Have you ever done any work or a task for someone who agreed to pay you in kind? Perhaps you helped a sibling with some chores who in turn gave you a CD. Would this be considered barter? Why or why not?
- 2 It is often said that a barter system could not be maintained in a modern economy. Give three reasons why this is so.
- 3 People sometimes wish that money was like the leaves on the trees – freely available in abundance. Why would this not be feasible in a modern economy?

Model exam questions

Question 1

- a** Give two reasons why transactions were difficult to make in the barter system. (4 marks)
- b** Money solved many problems that the barter system had. Explain how money solved the following problems:
 - i** indivisibility (2 marks)
 - ii** lack of double coincidence of wants. (2 marks)

Question 2

- a** Trading became necessary only after indirect production started.
 - i** What is the difference between indirect and direct production? (2 marks)

- ii** List two reasons why indirect production became necessary. (2 marks)

- b** Associated with indirect production is the phenomenon of specialisation. What does specialisation mean? (2 marks)

Question 3

- a** Describe the difference between indirect and direct production. (3 marks)
- b** Explain the role that specialisation played in developing the barter system. (3 marks)
- c** Discuss why the barter system could not work in the modern economy. (3 marks)