

What is money?

Money in the modern economy

Money today is a type of IOU¹, but one that is special because everyone in the economy trusts that it will be accepted by other people in exchange for goods and services.

There are three main types of money. Each represents an IOU from one sector of the economy to another.

1 Currency

In Samoa this includes tala notes, as well as tala and sene coins.

2 Bank deposits

Created by the commercial banks.

3 Central bank reserves

Created by the country's central bank, in Samoa this is CBS.

¹ IOU - A document acknowledging a debt.

What counts as money?

The first role of money is to be a store of value – something that is expected to retain its value in a fairly predictable way over time.

Money's second role is to be a unit of account – the thing that goods and services are priced in terms of, for example on menus or price tags.

Thirdly, money must be a medium of exchange – something that people hold because they plan to swap it for something else, rather than because they want the good itself.

Currency

Samoa's currency², the tala (notes and coins) and sene (coins), is issued by the Central Bank of Samoa.

To make sure the tala does not lose its usefulness in exchange, one of

the Central Bank of Samoa's objectives is to safeguard the value of the currency.

The Central Bank does this in many ways, including:

- Deciding which currency represents legal tender, i.e. only official notes and coins produced by CBS.
- Producing banknotes that are difficult to counterfeit. Tala notes have many complicated security features.
- Ensuring the value of the tala remains stable over time, so currency will hold its stored value. This means CBS works to maintain a low and stable rate of inflation³.

CBS has an inflation target it aims to achieve over time. The aim of this is to ensure money is relatively stable in the amount of products and services it can buy.

For example if three tala can buy a loaf of bread today, we want to

² For more about Samoa's currency, see the CBS Factsheet "Currency".

³ Inflation - A sustained increase in the general level of prices for goods and services. As inflation rises, every tala you own buys a smaller percentage of a good or service. (For more on this topic see the CBS Factsheet "Inflation".)

ensure a loaf of bread costs around the same price next year.

This means people can be confident their money will be worth a stable amount of real products from one year to the next.

Bank deposits

Currency only accounts for a small amount of the money in the economic system. The rest consists of deposits with banks.

For security reasons, consumers generally do not want to store all of their assets as physical banknotes. Moreover currency does not pay interest⁴ making it less attractive to hold than other assets, such as bank deposits, that do.

For these reasons, consumers prefer to mostly hold an alternative medium of exchange – bank deposits.

When a consumer makes a deposit

of his or her banknotes with a bank, they are simply swapping a Central Bank of Samoa IOU for a commercial bank IOU. The commercial bank gets the extra banknotes, and in return it credits the consumer's account by the amount deposited.

Consumers only swap their currency for bank deposits because they are confident that they could always be repaid. Banks therefore need to ensure that they can always obtain sufficient amounts of currency to meet the expected demand from depositors for repayment of their IOUs.

In the modern economy, bank deposits are often the default type of money.

Most people now receive payment of their salary in bank deposits rather than currency. And rather than swap those deposits back into currency, many consumers use them as a store of value, and increasingly as a medium of exchange.

⁴ Interest - Money paid regularly at a particular rate for the use of money lent, or for delaying the repayment of a debt. (For more on this topic see the CBS Factsheet "Interest".)

For example, when a consumer pays a shop by debit card, the banking sector reduces the amount it owes to that consumer – the consumer’s deposits are reduced – while increasing the amount it owes the shop – the shop’s deposits are increased.

Unlike currency in Samoa, which is printed and minted by the Central Bank, bank deposits are mostly created by commercial banks themselves.

This money creation process, and its limits, are discussed in further detail in the CBS Factsheet “How is money made?”.

Central Bank reserves

Commercial banks need to hold some currency to meet frequent deposit withdrawals and other outflows, but to use physical banknotes

for this large volume of transactions would be cumbersome.

So banks are also allowed to hold a different kind of IOU from the Central Bank of Samoa, known as central bank reserves. These are just an electronic record of the amount owed by the central bank to each individual commercial bank.

Reserves are a useful medium of exchange for banks, just as deposits are for households and companies.

If one bank wants to make a payment to another – as they do every day on a large scale when customers want to make transactions – they will tell the Central Bank who will then adjust their reserves balances accordingly.

If lots of households wanted to convert their deposits into banknotes, commercial banks could swap their reserves for currency to repay those households.