

PART V Money, Banking, and Monetary Policy



Chapter 14: Money and its Functions

Learning Objectives

After studying this chapter, you should be able to

- 14.1** Explain what money is and describe its characteristics and functions
- 14.2** Distinguish between money and money substitutes
- 14.3** Understand how the money supply is defined and measured in Canada
- 14.4** Describe the Canadian payments system
- 14.5** Understand the meaning of the value of money
- 14.6** Discuss the relationship between the money supply, inflation, and unemployment

Assess Your Knowledge

- 1.** Are debit (Interac) cards money?
- 2.** What is barter?

3. What is currency?
4. Is the Canadian dollar backed by gold? Is it backed by anything?
5. Are credit cards, such as Visa and MasterCard, money?
6. What happens to the value of money if the price level rises?

The Meaning of Money

LO 14.1 Explain what money is and describe its characteristics and functions

What Is Money?

Money is defined by what it does, not what it looks like. Canadians may picture coins and bills—quarters, loonies, ten-dollar notes—but the form of money has changed across time and cultures. What qualifies as money in one place may be useless in another, and past forms may no longer serve today's economy.

Economists define money as anything generally accepted as final payment for goods and services or to settle debts. This definition highlights function over form—what money does, not what it is.

***money** anything that is generally accepted as final payment for goods and services*

What Has Served as Money?

Throughout history, many different items have served as money, beads, salt, stones, gold, silver, paper, cattle, trinkets, and animal skins. What matters is not the object itself, but its general acceptance in exchange.

Today, most people think of money as coins and bills or bank accounts used to buy goods and services. In daily life, money refers to anything people routinely use to make payments.

The Characteristics and Functions of Money

Modern money must meet certain requirements to function effectively. While many items—shells, beads, gold, and furs—have served as money in the past, today’s monetary economy relies on standardized currency issued by central authorities.

Canada’s current currency system began in 1817 and took formal shape after Confederation. From then until 1935, government-issued Dominion notes served as money. In 1935, the Bank of Canada became the sole issuer of currency.

Since then, the Bank of Canada has produced durable, secure, and recognizable notes. These notes are continuously redesigned to preserve features that support their acceptance, security, and usability. Table 14.1 outlines how Canadian currency has evolved since Confederation.

Table 14.1 The history of Canadian currency from confederation to now

Year	Event
1867	The Dominion of Canada was formed. The federal government assumed control over money and banking, issuing coins in 5-, 10-, 25-, and 50-cent denominations. U.S. coins were gradually removed from circulation.
1887	Ottawa began issuing \$1, \$2, \$50, \$500, and \$1,000 notes, phasing out private bank-issued paper money.
1908	Canada opened its first domestic coin production facility—the Royal Mint in Ottawa—issuing a 50-cent coin featuring King Edward VII.
1922	Nickel replaced silver in the 5-cent coin, capitalizing on Canada’s large nickel reserves.
1931	The Ottawa branch of the Royal Mint became the Royal Canadian Mint, a fully Canadian institution. The first silver dollar was coined in 1935.
1937	New coin designs appeared with King George VI and symbols like the beaver, Bluenose schooner, maple leaf, Coat of Arms, and caribou.
1943	During wartime nickel shortages, the 5-cent coin was made from tombac (a brass alloy), shaped with 12 sides and marked with a “V” for victory and a Morse code message reading “We win when we work willingly.”

1953	The first image of Queen Elizabeth II appeared on Canadian coins, depicting her with a floral wreath.
1959	A simplified Coat of Arms appeared on the 50-cent piece.
1965	The Queen's effigy was updated to reflect her maturing age, featuring a jewelled tiara.
1967	Six special coin designs were minted to mark Canada's Centennial, each depicting native wildlife.
1969	The Royal Canadian Mint became a Crown Corporation with a mandate to operate as a self-sustaining business.
1976	A high-tech minting facility opened in Winnipeg. The Mint produced coins for Canada and foreign governments. Commemorative \$5, \$10, and \$100 coins were issued for the Montreal Olympics.
1980	A \$100 gold coin marked Canada's official adoption of "O Canada" as the national anthem.
1987	The \$1 note was withdrawn and replaced by the Loonie—a gold-coloured, 11-sided coin featuring a loon.
1996	The \$2 note was replaced by the bi-metallic Toonie, featuring a nickel outer ring and aluminum-bronze core.
1997	The composition of the penny changed from copper to copper-plated zinc to reduce costs.
2000	Canada issued its first coloured coin—a 25-cent piece bearing the red and white national flag.
2001	Steel cores replaced nickel and zinc in 5-, 10-, 25-, and 50-cent coins, further cutting production costs.
2006	New coins featured a mint mark and commemorative issues, including the "lucky loonie," a breast cancer awareness quarter, and a 10th anniversary Toonie.
2012	The penny was officially withdrawn from circulation because of low purchasing power and high production costs. Final distribution ended in early 2014.
2017	To celebrate Canada's 150th anniversary, the Mint released special edition coins featuring designs selected through national competition.

2023

The Royal Canadian Mint introduced coins bearing the effigy of King Charles III, beginning with the Loonie. The new portrait by Steven Rosati entered circulation in December.

Source: Royal Canadian Mint, *History of Circulation Coins*; Government of Canada, *Currency Timeline*. Available at: <https://www.mint.ca> and <https://www.bankofcanada.ca>

What Makes a Currency Viable?

A currency must meet specific conditions to function efficiently over time. Six characteristics determine whether a currency can support long-term use in a modern economy: it must be accepted, secure, portable, divisible, durable, and controlled.

Accepted and Secure

A viable currency must be widely accepted and difficult to counterfeit. People must trust it as a reliable medium of exchange, and it must be easily recognized and hard to replicate. In Canada, counterfeit activity peaked in 2004, prompting the Bank of Canada to introduce new banknotes with enhanced security features—fluorescent markers, transparent icons, ghost images, holographic stripes, and embedded security threads. In 2000, the \$1,000 bill was withdrawn from circulation at the request of the RCMP and the Solicitor General, due to concerns about its use in organized crime and money laundering. Although rarely seen, it remains legal tender.

Portable and Divisible

Money must be easy to carry and divide. When gold was used in bar form, it was both heavy and indivisible, making it impractical for everyday use. Livestock, used in barter economies, posed obvious problems of divisibility. Modern Canadian currency solves both issues. The five banknote denominations—\$5, \$10, \$20, \$50, and \$100—all measure 6 × 2.75 inches and weigh less than a gram. In addition, Canada issues six coins—1-cent, 5-cent, 10-cent, 25-cent, \$1, and \$2—allowing for flexible and precise transactions.

Durable

Money must withstand repeated handling without losing its function. People will not trust or use a currency that breaks down, rots, or erodes. The Royal Canadian Mint designs coins to last over 20 years in circulation, despite passing through billions of hands. At a cost of about 12 cents each, these coins offer a durable and efficient monetary tool.

Controlled

An effective currency must be scarce and managed by a central authority. If currency could be freely produced—such as using oak leaves—its supply would explode, causing inflation as too much money chased too few goods. A viable monetary system requires that the supply of money be limited and

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controlled by a public institution, such as the Bank of Canada, to maintain its value and purchasing power.

Summary: Characteristics of a Viable Currency

To function effectively in a modern economy, money must possess six essential characteristics:

1. **Acceptability** – It must be widely recognized and trusted as a medium of exchange.
2. **Security** – It must be difficult to counterfeit and easy to authenticate.
3. **Portability** – It must be easy to carry and transfer.
4. **Divisibility** – It must be divisible into smaller units for precise transactions.
5. **Durability** – It must withstand repeated use without deteriorating.
6. **Controllability** – Its supply must be limited and managed by a central authority to maintain value.

What Are the Economic Functions of Money?

Money performs three basic economic functions in a modern economy:

1. Medium of Exchange
2. Unit of Account
3. Store of Value

Medium of Exchange

Money facilitates buying and selling by eliminating the need for direct barter. In a barter economy, a transaction requires a *double coincidence of wants*—each party must want what the other has. For example, someone with wheat must find someone who both has shoes and wants wheat. This condition is difficult to meet in complex economies with many goods and services.

Money removes that barrier. A person can sell wheat to anyone who wants it and then uses the proceeds to buy shoes from a different seller. **This function makes transactions more efficient and supports economic specialization.** Money is used daily for countless transactions—buying groceries, paying bills, or purchasing an economics textbook.

medium of exchange – any item used to complete a purchase or sale

barter – the direct exchange of goods and services without using money

double coincidence of wants – a situation where each party in a transaction desires exactly what the other offers

Unit of Account

Money provides a common standard for expressing the value of goods and services. Just as distance is measured in kilometres and weight in kilograms, economic value is measured in dollars and cents. This function allows people to compare prices, evaluate economic output, and track financial performance.

For example, Canada's GDP is expressed as a single monetary figure—over \$1,600 billion—even though it consists of a wide range of goods and services. Likewise, a \$149.99 price tag on a pair of shoes signals its relative value.

unit of account (or measure of value) – the common unit used to express the value of goods and services

Store of Value

Money allows people to save purchasing power for future use. Individuals do not always spend all their income immediately; instead, they save some for later. Money stored in a savings account, for example, retains value over time and can be used in the future.

Other assets—such as real estate, artwork, precious metals, stocks, bonds, or even collectibles, can also serve this function. More recently, some people have treated digital assets like cryptocurrencies as stores of value, though their prices can fluctuate sharply. Despite the variety of alternatives, money remains the most convenient because it is highly liquid and can be used directly for transactions.

store of value (or store of wealth) – money or other assets held for future spending

liquidity – the ease with which an asset can be converted into cash with minimal loss

Kinds of Money, Near Money, and Money Substitutes

LO 14.2 Distinguish between money and money substitutes

Forms of Money in Canada

In the Canadian economy, three primary forms of money are used for transactions:

1. Coins

2. Notes

Reading Comprehension

1. Discuss the characteristics of an effective form of money.
2. Explain what characteristics ivory beads would lack in forming an effective medium of exchange.
3. Briefly describe the main functions of money. Which do you think is most important?

3. Chequing Accounts

Coins and Notes

The physical currency used in everyday transactions—coins and paper bills—is called currency or hand-to-hand money. This includes metallic coins like nickels, dimes, quarters, loonies, and toonies, and paper notes such as the \$5, \$10, \$20, and \$50 bills.

currency or hand-to-hand money – the notes and coins that serve as a country's medium of exchange

The value of coins and notes lies in their use, not their material. A toonie in your pocket has little worth unless it is exchanged for goods or services—for example, a coffee at Tim Hortons. The utility of money emerges only through exchange.

Most Canadian coins have a face value that significantly exceeds their metallic content. For example, a \$2 coin costs approximately 16 cents to produce and remains in circulation for up to 20 years. Because their exchange value surpasses their intrinsic metal value, such coins are classified as *token money*, a form of currency accepted by convention rather than by commodity worth.

token money – money whose face value exceeds its commodity value

If a toonie were made of gold, its value would far exceed its face denomination. At approximately 7.5 grams in weight and with the current market price of gold at around US \$107.35 per gram, the intrinsic value of the coin would amount to more than US \$800—or over CA \$1,000 at prevailing exchange rates. This makes it economically unviable for circulation. The example highlights why modern coins are made from inexpensive materials and why their value depends not on their metal content but on public trust and legal designation.

The Acceptance of Money Without Intrinsic Value

The Canadian dollar is fiat money: money that circulates by government decree. It is not backed by gold or any other precious metal and cannot be exchanged for gold as a matter of right.

fiat money – legal tender money that is not backed by gold or any other precious metal

Before 1940, Canadian currency was backed by gold. A \$20 bill could be exchanged for \$20 worth of gold. The government ended this convertibility in 1940, though the phrase “will pay to the bearer on demand” remained on banknotes for 14 more years.

People accept fiat money because others do. This broad acceptance is reinforced by its legal tender status—money that must be accepted in payment of debt.

legal tender – money that must legally be accepted if offered as payment to settle a debt

Legal tender status promotes trust but does not guarantee universal acceptance. Some businesses refuse large bills due to counterfeiting concerns.

From Good Money to Token Money

In the past, money often had intrinsic value. Metallic coins were once made from precious metals, and their face value matched the value of the metal itself. This type of money is called good money. When the face value exceeded the commodity value, it was called bad money.

good money – money whose face value equals its commodity value

bad money – money whose face value exceeds its commodity value

When both good and bad money circulate together, people tend to keep the good money and spend the bad. For example, if toonies were made of gold, they would likely be hoarded for their metal content. Over time, only the less valuable, or “bad,” money would remain in use. This tendency is explained by Gresham’s law, named after Sir Thomas Gresham, a financial adviser to Queen Elizabeth I.

Gresham’s law – the hypothesis that bad money will drive good money out of circulation

Chequing Accounts, Near Money, and Digital Currency

Chequing accounts are deposits held at banks or financial institutions that allow payments to be made by cheque or electronic transfer. These are also known as demand deposits, since funds can be withdrawn at any time without prior notice.

chequing accounts – bank deposits that are transferable by cheques

demand deposits – bank deposits that can be withdrawn without prior notice

The deposits themselves—not the cheques—are considered money. A cheque or electronic transfer simply instructs the bank to move funds or convert the balance into cash.

Near Money

In addition to currency and chequing accounts, some financial assets are highly liquid and can be readily converted into money. These are referred to as near money. While they do not directly serve as a medium of exchange, they function as temporary stores of value.

Examples of near money include notice deposits (such as savings accounts), deposits in credit unions, caisses populaires, and trust companies, as well as Canada Savings Bonds. These assets are not typically used for daily transactions but are easily accessible when needed.

notice deposits – interest-earning deposits subject to notice before withdrawal

near money – highly liquid assets that can be easily converted into currency or demand deposits without any appreciable loss of value

Digital Currency

Modern economies are also seeing the rise of digital forms of money. These include balances held in mobile payment platforms, prepaid cards, and central bank digital currencies (CBDCs). In Canada, while the Bank of Canada has not yet issued a digital dollar, it is actively studying the possibility.

Cryptocurrencies—such as Bitcoin and Ethereum—represent another form of digital asset. Though not officially recognized as legal tender, they are accepted in some transactions and function as speculative stores of value.

digital currency – money stored and exchanged electronically through digital systems

cryptocurrency – decentralized digital assets based on blockchain technology, used for payments or investment

The Trade-off Between Convenience and Interest

Although near money earns interest, people still hold some of their assets as currency or in chequing accounts. The reason is convenience. Currency and demand deposits allow immediate access to funds for daily transactions. If all assets were held in non-chequable, interest-earning accounts—like Canada Savings Bonds or notice deposits—individuals would need to visit their financial institution every time they made a purchase.

The ability to pay by debit card or write a cheque outweighs the modest interest gains on near money. People are willing to forgo some income for the flexibility and speed that liquid money provides.

Are Credit Cards Money?

Despite being commonly used for transactions, credit cards are not money. They are payment instruments that allow the user to delay settlement. Money, by contrast, immediately discharges debt at the point of purchase.

Consider two customers buying sporting equipment. Gabriella pays for her skis using a cheque drawn on her chequing account—her payment is final. Lucas pays for his goggles with a credit card. Several days later, he receives a bill from the credit card company. His debt remains unpaid until he settles it using actual money—currency or demand deposits.

Credit cards function as temporary substitutes for money. They grant immediate access to goods and services, but the transaction is completed only when money is used to repay the credit provider.

The Distinction Between Money and Credit

- **Money** discharges debt immediately (e.g., currency or chequing accounts).
- **Credit** postpones payment and creates a debt that must be settled later using money.

When money is used in a transaction, the debt is settled at once. In contrast, the use of a credit card creates a new debt. That debt must eventually be paid using money—whether in the form of cash, a debit card, or a transfer from a chequing account. A credit card does not eliminate the obligation; it simply delays the settlement.

Debit Cards and How They Differ from Credit Cards

- **A debit card allows direct access to the user's chequing account.** When a purchase is made using a debit card, the amount is immediately deducted from the account. The transaction is settled on the spot using money the account holder already possesses—currency in digital form.
- **A credit card, by contrast, allows the user to borrow money from the credit card issuer.** The purchase is not settled immediately; instead, it creates a short-term loan. The user receives a monthly bill and must later repay the borrowed amount using money—either currency or demand deposits.

- **In short, a debit card transfers your money; a credit card delays payment by creating debt.** One draws from existing funds, the other from borrowed funds.

BUSINESS SITUATION

14.1

Credit card companies charge merchants a fee, over and above the cost of the transaction, for accepting credit cards at their places of business. The merchant is usually charged a commission of 1%–3% of the value of each transaction paid for by credit card.

Given the existence of this charge, why might the owner of a small business, such as a snowboarding equipment and apparel store like Skiis & Biikes, accept credit cards?

The answer to this Business Situation can be found in Appendix A.

Reading Comprehension

1. What are the main types of money in common use in Canada?
2. State Gresham's law and briefly explain why it might be expected to hold.
3. What is the difference between the following sets of terms: (a) good money and bad money (b) demand deposits and notice deposits.
4. Explain why credit cards are not considered money.

The Money Supply in Canada

LO 14.3 Understand how the money supply is defined and measured in Canada

The Money Supply

The money supply refers to the total amount of money available in the economy at a given time. Economists measure it in different ways, depending on which forms of money are included. These measures are called **monetary aggregates**.

monetary aggregates – different measures of the money supply

The **Bank of Canada** currently reports three main monetary aggregates: **M2**, **M2+**, and **M2++**. These reflect varying degrees of liquidity, from highly liquid currency and chequing deposits to broader financial assets that can be converted into money with little loss of value.

M2: Broad Money at Chartered Banks

M2 includes the most common forms of money used by individuals and businesses. It consists of currency in circulation and both chequable and non-chequable deposits at chartered banks.

M2 = currency in circulation + personal chequing accounts + savings accounts and term deposits at chartered banks

This measure reflects money that is either used for transactions or can be quickly accessed.

M2+: Deposits at Non-Bank Institutions

M2+ expands the definition by including deposits at non-bank financial institutions. These include credit unions, caisses populaires, trust companies, and mortgage loan companies—sometimes called "near banks."

Table 14.2 shows various measures of the money supply in Canada.

Monetary Aggregates, April 2025
(millions)

Monetary Aggregate	Value
M2	2,702,153)
M2+	3,329,555
M2++	4,953,862

M2+ = M2 + deposits at non-bank deposit-taking institutions

This aggregate captures a broader range of deposit-based money held by individuals and organizations.

M2++: Near Money Instruments

M2++ includes highly liquid financial assets that are not classified as deposits but can be quickly converted into money. These instruments include

mutual funds invested in short-term fixed-income securities and **life insurance annuities** that permit cash withdrawal. Although **Canada Savings Bonds** were once part of M2++, they were discontinued in

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2017 and are no longer included. **M2++** = M2+ + Canada Savings Bonds + money market mutual funds + non-money market mutual funds (fixed income) + annuities redeemable at book value

These instruments serve as temporary stores of value and are commonly used in household savings.

Discontinued Measures

The Bank of Canada **no longer publishes M1 or M3**. M1, which included only currency and chequing deposits, was discontinued in 2007. M3, which once added foreign currency deposits and large non-personal term deposits, was discontinued in 2003.

In summary, the Bank of Canada now focuses on M2, M2+, and M2++ to track the supply of money in the economy. These measures reflect the liquidity and accessibility of financial assets used by households and businesses in the modern financial system.

- **M2** (currency + chequable and term deposits) stood at \$ 2.70 trillion in April 2025
- **M2+** (M2 + deposits at non-bank institutions + money-market funds) reached about \$ 3.33 trillion.
- **M2++** (M2+ + retail instruments and mutual funds) rose to nearly \$.95 trillion).
- **M3** (M2 + non-personal term and foreign currency deposits) was approximately \$ 3.85 trillion at Q3 2023.

The Bank of Canada **discontinued M1, M1+, M1++ after 2021**, focusing instead on broader aggregates like **M2, M2+, M2++, and M3** ([Bank of Canada](#)).

Reading Comprehension

1. Why does the Bank of Canada no longer compute M1 statistics?
2. What is the most liquid measure of the money supply?
3. What is the difference between M2, M2+, and M2++?
4. Do you think that Canada Savings Bonds should be included in the money supply?

Table 14.2 presents the main monetary aggregates in Canada as of April 2025, based on official data from the Bank of Canada. These aggregates reflect progressively broader definitions of money, from highly liquid assets like currency and chequable deposits (M2) to broader measures that include savings held at non-bank institutions and long-term investment instruments (M2++, M3).

M2, which includes currency in circulation, chequable deposits, and

term deposits at chartered banks, stood at **\$2.7 trillion**. **M2+**, which adds deposits at credit unions, caisses populaires, and other near-money instruments, reached **\$3.3 trillion**. **M2++**, the broadest official aggregate currently published, incorporates M2+ plus Canada Investment Funds and life insurance

annuities, totaling more than **\$5.0 trillion**. **M3**, which includes large non-personal term deposits and foreign currency holdings, was recorded at **\$3.85 trillion**.

The progression from **M2 to M2++** demonstrates the rising share of broader, less liquid financial assets in the economy. The gap between M2 and M2++—over **\$2.2 trillion**—illustrates the volume of assets held in savings accounts, mutual funds, and institutional instruments rather than in forms immediately available for spending.

These distinctions matter for monetary policy. Narrow aggregates like M2 are more responsive to interest rate changes and better reflect short-term liquidity and spending behavior. In contrast, broader aggregates like M2++ capture longer-term saving patterns and financial system depth. By tracking these aggregates, the Bank of Canada assesses inflation risks, the effects of rate changes, and the potential transmission of monetary policy through credit and financial markets.

(Source: Bank of Canada, Selected Monetary Aggregates, April 2025)

The Canadian Payments System

LO 14.4 Describe the Canadian payments system

Payment System

The payment system refers to the set of institutional arrangements that facilitate the exchange of goods and services by transferring purchasing power. In Canada, this system has evolved over time—from wampum in pre-colonial societies and furs during the fur trade to card money in New France, gold and silver coins under British rule, and eventually to today's use of fiat currency and deposit money.

At present, Canadians use coins and Bank of Canada notes for everyday transactions, especially small purchases. In contrast, most transactions by value are conducted through chequing accounts. Large purchases—vehicles, furniture, travel—are typically settled through deposit money. Credit card payments are widespread but require final settlement through currency or deposits.

A major development occurred in 1980 with the creation of the Canadian Payments Association, now known as Payments Canada. It supervises the clearing and settlement of transactions and plays a central role in maintaining a stable and efficient financial system.

Payments Canada

Payments Canada, formerly known as the Canadian Payments Association (CPA), is the organization responsible for clearing and settling payments among financial institutions in Canada. It operates the national clearing and settlement infrastructure, enabling secure and efficient transfers of funds between

banks, credit unions, and other financial institutions. All chartered banks are required to be members, while credit unions, caisses populaires, and trust or mortgage loan companies may choose to join.

Member institutions hold settlement accounts at the Bank of Canada, which facilitates the final transfer of funds between institutions. Payments Canada manages two core systems: the Lynx system, which handles large-value transactions in real time, and the Automated Clearing Settlement System (ACSS), which processes the bulk of retail payments—cheques, direct deposits, pre-authorized debits, and bill payments.

To illustrate how this works: imagine Mr. Alexander, who banks at Bank A, writes a \$500 cheque to Mr. Barnes, a client of Bank B. At the same time, Ms. Browne at Bank B writes an \$800 cheque to Mr. Aoki at Bank A. After offsetting these transactions, Bank B owes Bank A \$300. This net amount is settled through the Bank of Canada, which increases Bank A's reserve account by \$300 and decreases Bank B's by the same amount.

Since **1984, the clearing process has been automated**, and it continues to evolve. In 2021, **Payments Canada launched Lynx**, replacing the Large Value Transfer System (LVTS) to support real-time gross settlement, aligning Canada's system with international standards for payment risk and resiliency.

Recent Developments in the Payment System

Canada's payment system has advanced rapidly as electronic technology has become central to financial transactions. Corporations now transmit payment instructions electronically, allowing banks and credit unions to make real-time account entries. Direct deposit is now standard, replacing the paper cheque for most wage payments.

One of the most prominent developments has been Interac Direct Payment, introduced in 1994. At its inception, only about half of Canadian retailers accepted Interac. Today, over 99 percent of merchants support debit card transactions, making Interac the dominant point-of-sale network in Canada. Interac e-Transfer, launched later, has also become widely used for peer-to-peer transfers, particularly through mobile banking apps.

Reading Comprehension

1. What is the electronic funds transfer system (EFTS)?
2. What are debit cards? How do they differ from credit cards?
3. What is Interac? Who uses it?

Automated teller machines first appeared in Canada in the early 1980s and gained widespread use by the mid-1990s. As of 2024, there are approximately **60,921 ATMs operating in Canada**, according to IMF data (fred.stlouisfed.org).

Lynx, Canada's new high-value payment system, replaced the LVTS on

August 30, 2021, offering real-time gross settlement for large-value transactions. This upgrade enhances systemic stability and aligns Canada with global payment standards.

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Electronic Funds Transfer System (EFTS) continues to support fast transfers for direct deposits, bill payments, and interbank functions. **Debit cards**, which require sufficient existing funds, encourage more disciplined consumer spending.

Looking ahead, the payments system is expected to become even more digital. While predictions of a cashless society remain speculative, the trend toward mobile wallets, contactless payments, and real-time digital settlement suggests a future shaped more by smartphones than by coins or paper bills.

The Value of Money

LO 14.5 Understand the meaning of the value of money

What Makes Money Valuable

In Canada, money includes **coins, Bank of Canada notes, and deposits in financial institutions**. All of these forms are **fiat money**, meaning they are not backed by gold or other commodities and have little to no intrinsic value. A dollar in a bank account is simply a number recorded electronically. Yet, it holds value because it is widely accepted in exchange for goods and services.

The value of money depends on **collective trust**. You accept cash or a deposit because you are confident others will do the same. For example, if you sell an old phone, you will only accept payment in money because you know that the same money can be used to buy a new phone. **Money has value because it serves as a universally accepted medium of exchange.**

The Value of Money and the Price Level

The **value of money** refers to its **purchasing power**—what it can buy. This concept is different from the **exchange rate**, which measures the value of the Canadian dollar relative to foreign currencies. Instead, we focus here on **domestic purchasing power**.

The value of money is **inversely related to the price level**. If prices rise, the purchasing power of each dollar falls. For instance, if \$1 bought a coffee last year but only buys half a coffee today, the **value of money has declined**. On the other hand, if prices fall and a dollar buys more, then the **value of money increases**.

Periods of **high inflation** erode the value of money, as each unit buys fewer goods and services over time. Conversely, **stable or falling prices** increase money's value. Therefore, a key function of monetary policy is to **maintain price stability**, which in turn **preserves the value of money** for consumers and businesses alike.

An increase in the Canadian dollar's exchange rate—say, against the U.S. dollar—**does not necessarily change its domestic value**. Even if the Canadian dollar appreciates internationally, its purchasing power within Canada still depends on domestic prices.

Stability of the Canadian Dollar's Value

Over recent decades, the **purchasing power of the Canadian dollar has experienced fluctuations**, primarily influenced by inflation trends. While Canada has avoided extreme inflation, price increases have gradually eroded the dollar's value.

Since the early 1990s, the **Bank of Canada's inflation-targeting policy**, introduced in 1991, has aimed to keep inflation close to 2 percent, contributing to macroeconomic stability. However, in 2022, the **Consumer Price Index (CPI) rose by 6.8 percent**, the highest annual increase in four decades, driven by global supply chain disruptions and rising energy costs. In 2023, inflation slowed but remained above target, with the CPI increasing by **3.9 percent** (Statistics Canada, <https://www150.statcan.gc.ca/n1/daily-quotidien/240116/dq240116b-eng.htm>).

To illustrate the cumulative effect of inflation, **\$100 in 2023 is projected to have the same purchasing power as about \$104.01 in 2025**, assuming current trends continue (Inflation Tool, <https://www.inflationtool.com/canadian-dollar/2023-to-present-value>).

These developments show that while inflation surged briefly in the early 2020s, **monetary policy has gradually restored price stability**, helping to preserve the dollar's domestic value in recent years.

The Money Supply, Inflation, and Unemployment

LO 14.6 Discuss the relationship between the money supply, inflation, and unemployment

Reading Comprehension

1. What are we talking about when we refer to the "value" of money?
2. How is the value of money related to the price level?
3. Discuss the stability in the value of the Canadian dollar over the past few decades.

The Money Supply, Inflation, and Unemployment

A strong relationship exists between the **growth of the money supply and the rate of inflation**. Although Canada has not experienced hyperinflation,

certain periods—particularly the 1970s and early 1980s—exhibited **rapid price increases** that created pressure on consumers and policymakers. These episodes were largely driven by **excessive monetary expansion**. When the quantity of money in the economy increases beyond the growth of output, **households and firms increase their spending**, leading to upward pressure on prices. Once the economy approaches full employment, further increases in the money supply do not raise output but instead **accelerate inflation**.

In such conditions, the **value of money deteriorates quickly**, prompting people to spend their cash before it loses more purchasing power. In extreme cases, trust in currency erodes, and **barter systems may re-emerge**, undermining the core function of money as a **medium of exchange**.

The relationship also operates in reverse. **Sharp reductions in the money supply** can trigger recessions and **increase unemployment**. As discussed in Chapter 12, insufficient growth in the money supply constrains **aggregate expenditure**, leading to a fall in **income and output**. When spending slows, businesses cut production, and in many cases, **lay off workers**. This adjustment process produces a contraction in employment and economic activity.

For example, if the **Bank of Canada tightens monetary policy** to contain inflation—by slowing the growth of the money supply or raising interest rates—**aggregate demand will decline**. This contraction affects output levels and employment, particularly in interest-sensitive sectors like construction, housing, and durable goods.

In short, inflation is frequently driven by excessive growth in the money supply, while unemployment can result from restrictive monetary policy. This trade-off remains central to the Bank of Canada's monetary strategy, which aims to maintain low and stable inflation without triggering economic downturns.

BUSINESS SITUATION

14.2

Suppose that the Bank of Canada has just announced that it is loosening monetary policy in response to recessionary pressures.

As a business owner, can you anticipate how this policy action may affect your decisions regarding production and employment levels?

The answer to this Business Situation can be found in Appendix A.

The connection between money supply growth and inflation is evident in Canada's recent history. One clear case occurred during the COVID-19 pandemic in 2020. To stabilize the economy, the **Bank of Canada lowered interest rates and began quantitative easing**, which led to rapid growth in the money supply. For instance, **M2++ reached approximately \$4.917 trillion in January 2025**, compared to \$4.767 trillion in September 2024—a sharp rise over a short period (Bank of Canada, <https://www.bankofcanada.ca/rates/banking-and-financial-statistics/selected-monetary-aggregates-and-their-components-formerly-e1>).

This monetary expansion preceded a sharp increase in inflation. **Canada's inflation rate peaked at 8.1 percent in June 2022**, the highest level in nearly four decades, before declining to 2.5 percent by late 2024 (Statista, <https://www.statista.com/statistics/1312251/canada-inflation-rate-bank-rate-monthly>).

Another important example comes from 2023, when the **M2++ money supply grew at just 2.5 percent annually**, the slowest rate in decades. This deceleration coincided with a marked drop in inflation, reinforcing the role of monetary restraint in curbing price pressures (Better Dwelling, <https://betterdwelling.com/canadas-money-supply-is-growing-at-the-slowest-pace-in-decades>).

Analysts have linked these patterns to the Bank of Canada's policy shifts, especially its tightening cycle beginning in 2022. These moves were designed to restore price stability after pandemic-driven stimulus pushed inflation well above the 2 percent target (C.D. Howe Institute, https://www.cdhowe.org/wp-content/uploads/2024/06/Commentary_623.pdf).

These cases demonstrate that rapid increases in the money supply can trigger inflation, while tightening the supply can moderate price growth—a dynamic central to the conduct of monetary policy.

Reading Comprehension

1. Describe the relationship between the money supply and inflation.
2. Explain how a reduction in the money supply might cause unemployment.

Review

1. Review the learning objectives listed at the beginning of the chapter.
2. Have you accomplished all the objectives? One way to determine this is to answer the Reading Comprehension questions at the end of each section. These will help you assess your understanding of the learning objectives.
3. If you have not accomplished an objective, review the relevant material before proceeding.

Key Points to Remember

1. **LO 14.1** **Money** is anything generally accepted by society as final payment for goods and services or as settlement of debt. Its primary function is to act as a medium of exchange. It also serves as a unit of account and a store of value. An effective form of money is widely accepted, secure, portable, durable, divisible, and subject to centralized control.
2. **LO 14.2** **Near money** refers to liquid assets—such as notice deposits, term deposits, and highly liquid government securities—that can easily be converted into cash with minimal loss of value. Credit cards are not money, but rather temporary substitutes that delay payment until final settlement occurs using money.
3. **LO 14.3** **The narrow definition of money**, M1, includes currency in circulation and demand deposits. Broader measures, such as M2, include personal savings and notice deposits. The broadest aggregates—M2+, M2++, and M3—include deposits at non-bank financial institutions. Demand deposits continue to be the most widely used form of money for transactions in Canada.
4. **LO 14.4** **Canada's payments system** has evolved from barter and commodity-based exchange to one dominated by electronic fund transfers. Coins and notes remain in use for small transactions, but chequing accounts, debit cards, Interac e-Transfers, and mobile payments now dominate payment by value. Canada's shift toward a cashless society is well underway, driven by digital innovation and consumer adoption.
5. **LO 14.5** **The value of money** is defined by its purchasing power—what it can buy in goods and services. It is inversely related to the price level. Over time, the Canadian dollar has lost value as prices have risen. While inflation remained low from the 1990s through the 2010s, it spiked to 8.1 percent in 2022, reducing purchasing power before easing in 2023.
6. **LO 14.6** **Rapid growth** in the money supply can trigger inflation, as seen during the pandemic stimulus of 2020–2021. Conversely, tight monetary conditions can slow aggregate spending and raise unemployment, as occurred during the Bank of Canada's rate hikes in 2022–2023 to contain inflation. Monetary stability requires a balanced approach to managing money growth.