

# Money and the Financial Sector

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## Money and the Financial Sector

Before money existed, people exchanged goods directly. That system broke down as economies grew. Money solved the problems of barter and made complex, specialised economies possible. This page covers what money is, how it works, and the institutions that manage it.

### The History of Money: From Barter to Fiat

**Barter** is the direct exchange of goods and services for other goods and services without using money. While simple in theory, barter has three serious problems:

- **1. Double coincidence of wants** — you must find someone who has what you want and wants what you have at the same time. The seamstress with a dress cannot simply trade it for a television unless she finds someone who both owns a television and wants a dress.
- **2. Unequal values** — dividing goods to make up an exactly equal exchange is often impossible. A cow and a pair of shoes are not easily compared.
- **3. Difficulty of saving** — many goods are perishable; storing value in fish or vegetables is impractical.

**Commodity money** solved some of these problems. Societies began using items that had value in themselves — gold, silver, cattle, tobacco, and even cigarettes in prisoner-of-war camps — as a medium of exchange. Gold became the dominant commodity money because of its durability, divisibility, and relative scarcity.

**Fiat money** (token money) is the modern form: notes and coins that have no intrinsic value but are accepted because the government declares them legal tender. Their value rests entirely on trust and general acceptability.

### Features of Money

For anything to function effectively as money, it must possess these seven characteristics:

Feature	Meaning
Acceptability	Everyone must willingly accept it in settlement of debts

Scarcity (limited supply)	Must be scarce enough to have value — pebbles would not work
Homogeneity	All units of the same denomination must be identical
Divisibility	Must exist in denominations small enough for everyday transactions
Portability	Must be easy to carry to enable transactions anywhere
Durability	Must not wear away or decay quickly
Legal tender	Creditors are legally obliged to accept it in settlement of a debt

## Functions of Money

Money serves four essential functions in a modern economy:

- 1. Medium of exchange** — Money eliminates the need for a double coincidence of wants. Sellers accept money for goods and then use it to buy what they need from others. This is money's most important function.
- 2. Store of value** — Unlike fish or bread, money retains its purchasing power over time and can be saved for future use. (Inflation erodes this function; during hyperinflation, people prefer to hold assets rather than cash.)
- 3. Unit of account (measure of value)** — Money provides a single standard unit in which prices are expressed. Instead of quoting the price of bread in terms of fish, shoes, and hours of labour, every price is stated in dollars (or the local currency). This makes accounting and comparison straightforward.
- 4. Standard of deferred payment** — Money allows debts and contracts to span time. A consumer can purchase furniture now and pay in instalments over two years because the value of each payment is fixed in monetary terms. Under barter, this would be nearly impossible.

## Money Supply

The **money supply** is the total stock of money in the economy at a given point in time. It is controlled by the central bank.

Measure	What it includes
M0 (narrow money / monetary base)	Notes and coins in circulation plus commercial bank reserves held at the central bank

M1 (narrow money)	M0 plus demand deposits — current accounts that can be withdrawn on demand
M2 (broad money)	M1 plus savings deposits, time deposits, and other near-money assets

M2 is the broader measure most commonly used for policy analysis because it includes assets that can be quickly converted to spending power.

## Demand for Money

People hold money (rather than investing it) for three reasons:

- **Transactions motive** — to carry out day-to-day purchases of goods and services.
- **Precautionary motive** — to have cash on hand for unexpected events or emergencies.
- **Speculative motive** — to take advantage of future investment opportunities; holding cash gives flexibility when interest rates or asset prices change.

## The Financial Sector

The **financial sector** is the network of markets, institutions, households, businesses, and laws that facilitate the flow of funds from those who save (surplus units) to those who borrow (deficit units) for consumption and investment. Its core function is **financial intermediation** — channelling savings into productive investment.

### Roles of the Financial Sector

- Mobilising savings from households and firms
- Making loanable funds available to borrowers at an interest rate
- Facilitating payments through the banking system
- Managing financial risk through insurance and diversification
- Providing price information through financial markets

## The Central Bank

Every country has a **central bank** — the apex of the financial system. In Jamaica it is the Bank of Jamaica; in Trinidad and Tobago, the Central Bank of Trinidad and Tobago.

## Roles of the Central Bank

**Monetary policy:** The central bank uses several tools to influence the money supply and interest rates:

Tool	How it works
Interest rate (discount rate)	Sets the rate at which it lends to commercial banks; higher rate 'more expensive borrowing' 'less lending' 'less money in circulation
Reserve requirement	Specifies the minimum percentage of deposits commercial banks must hold in reserve; raising it reduces the funds banks can lend out
Open market operations (OMO)	Buys or sells government securities. Buying securities injects money into the economy; selling securities withdraws money
Moral suasion	Uses advice, guidance, and persuasion to influence banks' behaviour without formal regulation

**Supervision:** Regulates and supervises commercial banks and other financial institutions to maintain stability.

**Banker to the government:** Manages government accounts, advises on borrowing, and handles national debt.

**Banker to commercial banks:** Holds commercial banks' reserves and acts as lender of last resort in a banking crisis.

**Manages foreign exchange reserves:** Holds reserves of foreign currencies and gold to stabilise the exchange rate.

**Issues currency:** Has the sole authority to issue notes and coins.

## Other Financial Institutions

Institution	Primary role
Commercial bank	Accepts deposits; makes loans to individuals and businesses; facilitates payments
Stock Exchange	Provides a market where company shares and government bonds are bought and sold
Credit Union	Member-owned cooperative that accepts savings and provides loans to members at favourable rates

Development Bank	Provides long-term finance for large development projects, especially in agriculture and industry
Insurance Company	Provides financial protection against risk (health, life, property) in exchange for premiums
Mutual Fund	Pools money from many investors and invests it across a diversified portfolio
Building Society	Accepts savings and specialises in providing mortgage loans for property purchase
Investment Trust Company	Manages and invests pooled funds on behalf of investors
Informal credit institutions	Community-based savings and loan arrangements: Sou Sou, Box, Partner (Jamaica), Sindicatos, Meeting Turns

### Remember

Informal credit institutions like the Sou Sou and Partner are part of the Caribbean financial system and frequently appear in Paper 02 questions on the financial sector. They provide credit outside the formal banking sector, often to individuals who lack access to commercial banks.


## Financial Instruments

A **financial instrument** is a document or contract representing a financial asset to one party and a liability to another.

Instrument	Description
Treasury bills	Short-term government debt instruments, usually maturing in 90 days; used to fund short-term government spending
Treasury notes and bonds	Medium and long-term government debt; pay regular interest (coupon payments) and return face value at maturity
Corporate bonds	Long-term debt issued by companies to raise capital; pay fixed interest; riskier than government bonds
Municipal bonds	Debt issued by local governments or public authorities
Equity securities (shares/stocks)	Represent ownership in a company; shareholders receive dividends and capital gains but bear the risk of the firm's performance
Share certificates	Documents confirming ownership of a specified number of shares in a company

Certificates of deposit

Time deposits issued by banks guaranteeing a fixed return if held for a specified period

 **Exam Tip**

The distinction between debt instruments (bonds, treasury bills, certificates of deposit) and equity instruments (shares) is commonly tested. Debt instruments promise a fixed return; the holder is a creditor. Equity instruments carry ownership rights and variable returns; the holder is a shareholder who bears risk.

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