

Topic 1

Purposes of money

Learning outcomes

After studying this topic, students will be able to:

- ◆ define the purposes of money; and
- ◆ outline its key features.

Introduction

This topic explores the question, 'What is money?' To answer this question we will discuss why money was invented, what purposes money serves today and some of the many ways that people use it.

If you were to ask people what money is, many would think first of coins and notes. These are used every day to pay for items in a wide variety of places including shops, cafes and bus or train stations. Collectively, coins and notes are termed 'cash'. If people were asked where they store their money, they might mention their purses or wallets and their bank accounts. The contents of bank accounts are held as electronic records that the banks keep. Banks notify people about how much is in their bank account by giving them statements of the current balance – that is, the total in their account on the date of the statement.

Coins and notes are described as 'money' but most money is in the form of electronic balances in bank accounts. People can take coins and notes out of their bank account, for example by using their cash card at a branch. The reason to have cash is to make a payment. Payments can take several forms, for example people may spend it, pay it into a savings account, give it to another person as a gift or repay money they have borrowed. People can also instruct their bank to pay some of the contents of their bank account to someone else, for example by writing a cheque. Payment is the common feature of what money is and its main purpose.



We can define money as 'anything that is widely accepted as a means of making payments' and specify that 'money' means coins, notes and the electronic balances held in bank accounts. Being 'widely accepted' is an important feature of money and we will explore it further during this topic. For example, people in the UK can pay using pound coins in shops because the retailers will accept these coins.

Many people think of 'money' as coins and notes but it also includes electronic balances held in bank accounts.

Because the main purpose of money is to make payments, it is able to fulfil other purposes as well. Sellers use money to set the price of goods – that is, how much someone must pay for them. People can store their money and so save it for making payments in the future. Money also makes it possible for people to buy items now, even if they do not have enough money themselves to make the purchase. They can borrow the money they need from someone else and repay the lender in the future.

As money fulfils all these purposes, people use it in different ways. For example:

- ◆ Jack buys snacks and magazines from a corner shop using cash on his way home from school;
- ◆ Beth has given her bank instructions to pay her electricity bill by transferring money from her bank account to the electricity company every month;
- ◆ Raj and Tamsin are saving for a holiday they want to take in six months' time, by depositing money in a savings account;
- ◆ Mark has borrowed money from a bank to buy a moped and is repaying it over several years in monthly instalments;
- ◆ Cindy goes online to compare prices for the handbag she wants to buy.

1.1 The development of money

1.1.1 Using barter to trade goods and services

Before money was created, people used a system of barter to trade goods or services. The case study explains how bartering worked.

Bartering in early history

Consider an example from California in 1841. A farmer needs nails to be able to mend the wooden roof of his home. This need is important to him because winter is approaching and without the nails the roof will let the rain in and the heat out. The farmer specialises in growing wheat and producing flour. He can spare some flour to offer in exchange for nails. He therefore travels to the local blacksmith.

The blacksmith makes nails. He does not grow wheat himself and therefore does not produce his own flour. He needs flour to be able to make bread. When the farmer arrives at the forge, the blacksmith is willing to give him nails in exchange for flour.

Now they must decide how much flour each nail is worth. The farmer has brought a wooden jug with him to measure out the flour. He starts by offering the blacksmith enough flour to fill the jug once for each nail. The blacksmith does not agree. Each nail took him an hour to make using skills he has built up over 15 years. He asks for four jugs of flour for each nail. After discussing the relative value of flour and nails for nearly an hour, the farmer and the blacksmith agree on two jugs of flour per nail and exchange their goods.

The barter system of exchanging goods or services has many limitations. It relies on a 'double coincidence of wants', that is, the farmer must want nails and have flour to offer and the blacksmith must want flour and have nails to offer. It relies on the two parties agreeing a rate of exchange, that is, how much flour each nail is worth. This could be a time-consuming process. And it relies on the farmer having surplus flour when he needs to acquire extra nails.

1.1.2 Using items with intrinsic value as payment

The limitations of barter led people to create systems where the local community used an item they all valued as a means of payment. People in Japan, for example, used rice as 'money'. Buyers and sellers would agree how much rice an item was worth: the buyer would then give the seller the agreed quantity of rice and receive the goods they wanted in exchange.

The use of valuable items such as cattle or grain as 'money' can be traced back to around 9000 to 6000 BCE. Other items that communities have used in the past include:

- ◆ cowrie shells;
- ◆ feathers;
- ◆ leather;
- ◆ oxen;
- ◆ pigs;
- ◆ stones;
- ◆ salt; and
- ◆ vodka.

Metals, including gold, were valued because they could be used to make weapons, tools and jewellery. Pieces of metal began to be used as 'money', too.

The use of an intermediate item (such as cattle, shells or gold) that all local people value as a form of 'money' allows people to sell any surplus or specialist goods they produce for this intermediate item. Sellers can then use the item they have been paid to buy other goods.

Using gold as payment

Fast forward to California in 1850 and another farmer is in need of nails. The Gold Rush has arrived and prospectors are digging gold out of the ground and finding it in rivers. Gold is valuable in its own right (it has an intrinsic value) so local people are willing to exchange goods and services for gold. When the farmer sells his flour to the town store he is paid in small gold nuggets. As gold has become a measure of value that is common throughout the area, he can use this gold to pay for a range of goods from different specialists. He is no longer restricted to trading only with people who want flour.

The farmer goes to the blacksmith and asks what weight of gold the blacksmith wants for the nails. After some discussion, they agree on the price. Then the farmer and blacksmith use scales to weigh the gold and the farmer breaks a nugget into smaller pieces to get the exact amount of gold agreed. The blacksmith can then use this gold to pay for items he needs or wants.

Looking at the list above, we can see practical drawbacks with early forms of money. Some items are not durable – for example, cattle and pigs die, and grain can perish if not stored correctly. Some items cannot be divided into small amounts to enable people to make low-value purchases or to give change. For example, if a seller wanted payment of one live pig but the purchaser did not agree the goods were worth a whole pig there were few options available. If the purchaser did not have a smaller pig to offer, the trade could not be made, causing problems for both parties. Many early forms of money were not easily portable. The *fei* stones used as money on the Pacific island of Yap, for instance, varied in size, but included some that were more than 6 metres across.



Fei stones like these were used as money until about 1965 on the island of Yap in the Pacific Ocean. (© Bartek Cieslak at pl.wikipedia)

Another problem with using an item that has value in its own right is that the value of that item itself can vary. For example, gold was an intermediate item used as ‘money’ before the introduction of coins. It has an intrinsic value of its own because it is rare and in demand to make items such as jewellery. However, suppose a particular source of gold runs out or a war prevents buyers and sellers from meeting to trade. Gold becomes scarcer and its value rises. One week, a trader might offer an ounce of gold for two cows; a month later, they might want four cows in exchange for their single ounce of gold. The chart on page 5 shows how the price of gold changed over a 40-year period in the twentieth century.

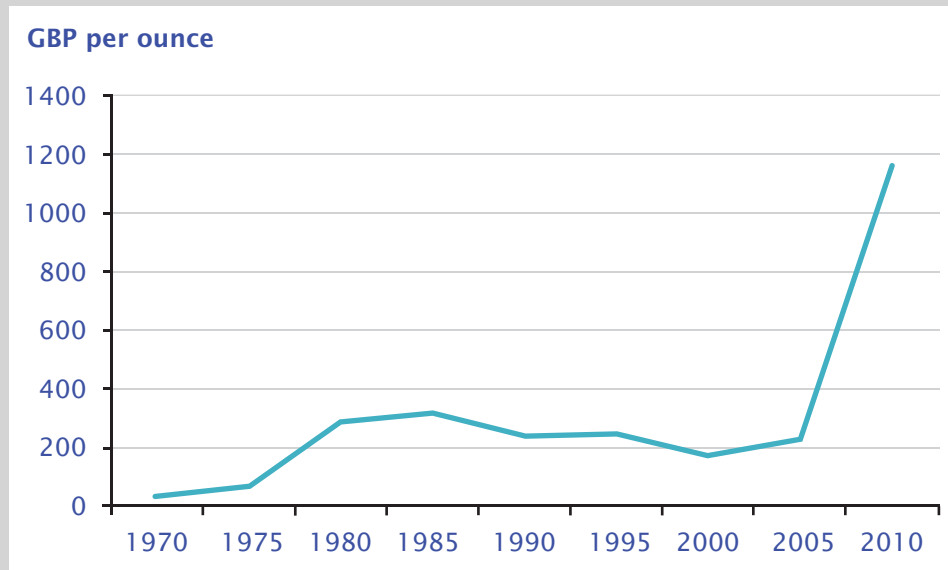
1.1.3 Using items that represent value as money

An important stage in the development of money, then, was changing from an intermediate item that had value in its own right (an intrinsic value) to an item that *represented* value but had no value of its own. In China, for example, spades and knives, which had an intrinsic value of their own, were used in barter systems. Later, coins in the shapes of small spades and knives were used to represent a standard value where each coin was worth roughly the same as the real spade or knife.

The changing price of gold

Figure 1.1 illustrates how the price of one ounce of gold (approximately 28 grams) varied between 1970 and 2010. The values shown are for the highest price that year and are in GBP which stands for Great British Pounds. The latest figures show that the price of gold has fallen since 2013 and in early 2015 was around £755.21 per ounce.

Figure 1.1 The changing price of gold, 1970–2010



Source: World Gold Council (2015), www.gold.org

These coins were made of metal, often bronze or copper, but the value of the metal was low. The coins themselves had no intrinsic value as pieces of metal. They had representational value because local people agreed that a coin symbolising a spade or knife had the same value as a real spade or knife. They also had the advantage of being smaller than the real item (and therefore more portable) and durable.

Over time, the coins were made into standard shapes that look much like round, modern coins. Different coins came to represent different values, and the value was written on them, just as modern coins come in different denominations such as 5p, 20p and 50p.

The word 'money' itself is thought to have its roots in Ancient Rome, where a mint was located next to a temple to the goddess Juno Moneta (meaning Juno the Protector). The coins produced at this mint from about 300 BCE onwards bore an image of the goddess and became known as *moneta*, later 'money'.



The development of coin shapes in China

The Chinese bronze spade money shown here dates from the period 1050 BCE to 221 BCE. In this early stage of development each coin looks very similar to a spade, with a hollow handle, sloping shoulders and an arched base. The coins weigh 27.7g and are 66mm in length.

The shape of the coins was gradually refined; the ones shown here are from 9–23 CE. They are still made of bronze but are flatter, shorter and lighter than the earlier version. Each coin weighs 14.53g and is 55mm in length. The hole at the top of the coin makes it easy to carry them on string or cords.



From around 621 CE the coins shown here were issued. They are round, 25mm in diameter, made of bronze and weigh just 4.1g each, making them easy to carry. The Chinese words read Kai yuan tong bao which means ‘new beginning circulating treasure’ (or ‘coin’). The first emperor of the Tang dynasty, Gaozu, created a new system of coins in 621 CE which lasted over 1,200 years.

(All images © Trustees of the British Museum)

1.1.4 Using paper notes as money

China developed the idea of paper banknotes around the seventh century CE. Merchants who traded high-value goods found it impractical to carry large quantities of copper coin. Instead they deposited the coins with a trusted person, who gave them written receipts stating how much was stored in their name. Rather than paying for goods with the actual coins, merchants paid by passing the receipt for the coins to the person selling the goods, who could claim the coins in storage.

Over time, people no longer claimed the coins from storage because buyers and sellers agreed that the banknote represented the value of the coins and would accept the banknote as payment, knowing they could use it to make payments of their own.

1.1.5 Modern payments

Most purchases are now made using coins and banknotes or by transferring electronic balances between bank accounts. However, barter systems still exist in some communities, especially those where the people have little or no cash. Some barter systems are informal, with friends and neighbours trading skills such as gardening and cake-baking or baby-sitting. There are also bartering websites that help put people with a 'coincidence of wants' in contact. More formal systems exist, too, such as local exchange trading systems or schemes (LETS), which operate on a system of credits without the need for cash. Another variation on the local theme is alternative currencies. These are explored in more detail in the next section.

LETS

A LETS is a local network that enables people to exchange goods and services with each other without using money. Suppose Abas is a member of his local LETS. He advertises on the LETS website that he can give other members basic computer training. When Abas gives Jake a three-hour computer lesson, Jake pays him in credits via the LETS credit administration system. Sometime later, Abas buys a flat-pack wardrobe and needs help putting it together. So he searches the LETS website for a member who has DIY skills and finds Neville. When Neville helps Abas with putting together the wardrobe, Abas pays him for one hour of his time with some of the credits he earned from Jake.

LETSLINK UK (www.letslinkuk.net) describes about 300 LETS across the country including:

- ◆ Brum LETS which uses a unit of credits called Hearts;
- ◆ Dorchester and South Dorset LETS which uses Marts;
- ◆ West Lothian LETS which uses a credit unit called Shales and offers members a LETS chequebook.

The Brum LETS website suggests that members charge a standard rate of 6 Hearts per hour and equal value is placed on the services on offer – so an hour's cleaning is worth the same number of Hearts as an hour checking someone's household budget.

1.2 Features of money

In order to fulfil its purposes, money needs to have certain features; we saw some of these when we looked at how money developed. Money must be:

- ◆ acceptable;
- ◆ durable;
- ◆ recognisable;
- ◆ portable;
- ◆ stable;
- ◆ scarce but sufficient;
- ◆ divisible;
- ◆ homogeneous.

We will explore what each of these terms means in the following sections.

1.2.1 Acceptable

People are only willing to accept money as payment for goods and services if they are confident that others will, in turn, accept money from them as payment in later transactions. We have seen that coins, banknotes and balances in bank accounts all *represent* value rather than having an intrinsic value of their own. This means that people have to trust that they will be accepted.

Part of the reason why people are prepared to accept money is because they have faith that coins and banknotes are worth their face value, that is, the denomination written on them. British banknotes have the following written on the front: 'I promise to pay the bearer on demand the sum of' followed by the amount of money the banknote represents.



This promise is signed by the Chief Cashier of the Bank of England. It is an example of the role the Bank of England plays in maintaining people's trust in the money they use. Money is said to have a 'fiduciary value' (from the Latin *fides* meaning faith), which is based on trust in the banking system.

Another aspect of faith in the monetary system is that sellers will receive the funds transferred between bank accounts electronically. This money is transferred using a variety of payment mechanisms such as payment cards and cheques. We will look at the different methods of transferring these funds in detail in **Topic 3**.

1.2.2 Recognisable

Cash must be recognisable so that people are confident they are receiving genuine coins and banknotes – in the UK, for example, a 20p coin has seven sides, so if someone was given a round 20p coin they would know it was not genuine. Cash must also have security features to ensure that it is difficult to make forgeries. For example, the Bank of England has introduced features such as raised print, metallic thread, micro lettering, watermarks, holograms, ultraviolet features and complicated designs to the notes it issues (see www.bankofengland.co.uk for details). Some of these features, such as watermarks and metallic thread, are easy for merchants to verify; others, such as ultraviolet features, require specialist equipment.

1.2.3 Stable

Money needs to hold its value so people can be confident that the money they accept now will be worth the same or a similar amount in the future. Inflation, which is when the general level of prices in an economy rise, means that the same amount of money will buy less in the future and so its value falls in real terms. Inflation and its impact on savings is explored in more detail in **Topic 3**.

1.2.4 Divisible

Coins and banknotes must be provided in a variety of denominations so that people can use them in different combinations to make transactions of different sizes. Having smaller denominations allows people to pay with larger amounts of cash and to receive change. The Royal Mint website (www.royalmint.com) has details of the coins it issues and the Bank of England website (www.bankofengland.co.uk) shows the banknotes it currently issues. Banknotes for Scotland and Northern Ireland are issued by a number of banks. Details can be found on the website for The Association of Commercial Banknote Issuers (ACBI) at www.acbi.org.uk.

Payments from bank accounts are for specific amounts and do not need to be divisible.

1.2.5 Durable

Coins and banknotes need to be strong enough to be used many times before they need to be replaced by the Royal Mint or the Bank of England. Although UK coins are coloured gold, silver or bronze they are made of metal alloys to ensure they are durable. Coins made of pure gold, for example, are quite soft and damage easily.

Coins are produced in a range of denominations to allow people to make transactions of different values and be given change.



1.2.6 Portable

People must be able to carry the coins and banknotes they need for everyday use. This is another reason why they are produced in different denominations and that larger amounts are paper-based.

The payment mechanisms used to transfer bank balances are very portable, for example cheque books and payment cards such as debit cards. Details about how these mechanisms work will be discussed in **Topic 3**.

1.2.7 Scarce but sufficient

The Bank of England manages the supply of cash in the economy so that there is enough for people's transaction needs. It is important to make sure that there is not too much cash in circulation, though, because this leads to inflation and the value of money falls. Inflation and the impact it has on people's savings will be covered in more detail in **Topic 5**.

1.2.8 Homogeneous

All coins and banknotes of a certain denomination need to be homogeneous, that is, to look and feel the same. This helps them to be recognisable and therefore acceptable. The designs on coins and banknotes vary but the shapes and main features remain the same. Occasionally the Bank of England or Royal Mint changes the size of a note or coin but they provide plenty of information about the change, to ensure the new note or coin is recognisable. They also withdraw the earlier version over a limited period to achieve homogeneity as quickly as possible. For example, a new, smaller 5p coin was introduced in June 1990 and the older, larger coin was taken out of use the following January.

1.3 Functions money must perform

We have seen that people use money to:

- ◆ measure value;
- ◆ make payments;
- ◆ save;
- ◆ borrow.

These four uses give us the following four functions that money must perform.

1.3.1 A unit of account

Money offers a standard measure of financial value, for example, for the value of goods and services and the financial assets that a person owns. This enables people to compare prices between goods and to see how prices or values change over time or between countries.

It is the measure used in accounting and on bank statements to record transactions and provide balances.

1.3.2 A means of exchange

Money enables people to make payments. We saw in section 1.2.1 that money functioning as a means of exchange is made possible because people trust the banking system. There is also a legal element. Certain banknotes and coins are 'legal tender'. This means that they must be accepted in settlement of a debt. There are other notes and coins in circulation that are widely accepted but are not defined as legal tender; in theory, people can refuse to accept these to pay off a debt, but it is rare for anyone to do so.

Coins worth £1 and more are legal tender throughout the UK but the situation is more complicated in relation to coins of smaller denominations and banknotes.

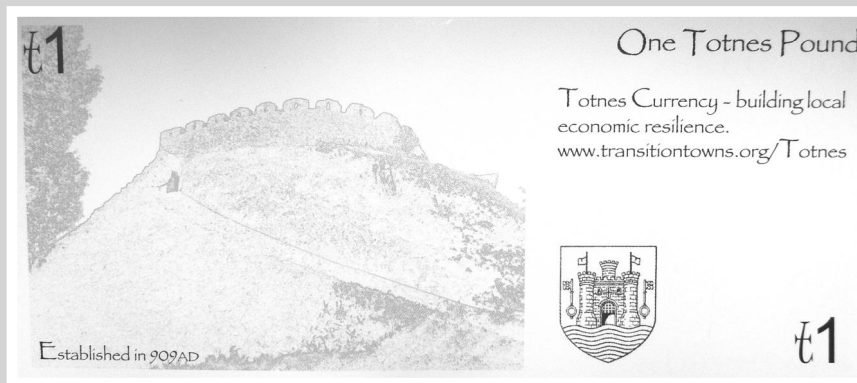
- ◆ Coins for amounts smaller than £1 are only legal tender for debts up to a certain amount. For example, 20p coins are legal tender for up to £10 in a single transaction. This is mainly because it is not practical to pay a large amount in small coins.
- ◆ Bank of England banknotes are legal tender in England and Wales, but not in Scotland or Northern Ireland.
- ◆ There are banks in Scotland and Northern Ireland that issue their own banknotes. These Scottish and Northern Irish banknotes are not legal tender anywhere, including in the countries that issue them, but they are widely accepted. The value of the banknotes is backed by these banks holding account balances at the Bank of England.

The money held in bank accounts is not legal tender but people accept transfers of this money into their bank accounts because they trust in the banking system.

Local currencies

Some communities have created their own currency to encourage people to spend in local shops and so keep the money in the local economy. Examples include the Lewes Pound, Brixton Pound, Stroud Pound and Cardiff Taffs.

The Totnes Pound was introduced in 2007. People buy the currency at an issuing point in the town and spend it in local shops or on locally based services.



The Totnes pound note (© Totnespound.org)

Each Totnes Pound note meets the criteria listed in section 1.2. It is:

- ◆ accepted as payment by local merchants;
- ◆ recognisable because it has a picture of a local landmark on it;
- ◆ stable because its value is the same as the Great British pound;
- ◆ divisible because it is issued in a small denomination and change can be given in English coins;
- ◆ durable because it is made of strong paper;
- ◆ portable because it is a similar size to other banknotes;
- ◆ scarce because it is only issued in Totnes;
- ◆ homogeneous because all Totnes Pounds look and feel the same.

See www.totnespound.org for more details.

1.3.3 A store of value

Money is used to store financial value for future use. For example, people save money in bank and building society accounts and they keep small stores of cash to spend in the future.

1.3.4 A means of borrowing and then repaying the debt

People can borrow money to buy goods now that they cannot afford out of current income. In effect they are delaying payment. Instead of paying the full price of the item, the borrower pays in small amounts over a period of months or years. These small payments are the repayments they make to the lender. During the borrowing term, the lender cannot use the loan money for any other purpose. Borrowers therefore compensate lenders by paying interest. The technical name for this function is that money is acting as a standard measurement of deferred (that is, delayed) payments.

1.4 Considerations when using money

When people plan how to use their money, a key consideration is its current and future purchasing power. The purchasing power of money is the quantity of goods and services it can buy.

1.4.1 Purchasing power and time

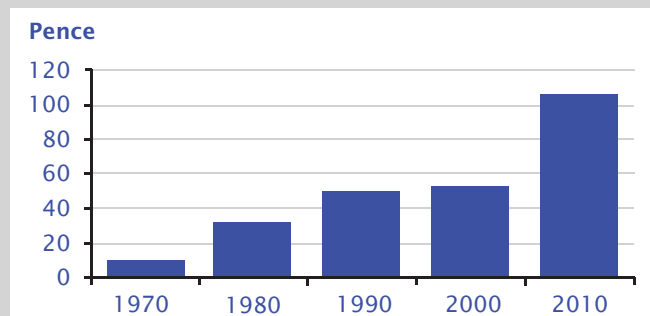
A key consideration for savers is that inflation can reduce the purchasing power of the money saved over time. For example, £100 in three years' time will buy fewer goods than £100 today.

Changing prices over time in the UK

Inflation has caused the price of a 800g white, unwrapped loaf of bread to rise from 9p in 1970 to 108p in 2010, an increase of 1,100% in 40 years:

1970	9p
1980	33p
1990	50p
2000	52p
2010	108p

Increase in price of bread, 1970–2010



Source: ONS (2010)

£499 per week in 2010. This means that the loaf of bread represented 0.28% of an average week's wage in 1970 and 0.22% of an average weekly wage in 2010 (ONS, 2010).

By July 2014 the average cost of the loaf was 139p and the average wage was £479 per week. This means that the loaf was relatively more expensive at 0.29% of the average weekly wage (ONS, 2014).

The aim is therefore to find a savings interest rate that is higher than the rate of inflation. This will enable savers to maintain or grow their purchasing power.

The Bank of England website publishes the current rate of inflation (<http://www.bankofengland.co.uk/Pages/home.aspx>). Further information can be found about inflation at the Office for National Statistics (ONS) website (<http://ons.gov.uk/ons/index.html>) and the GOV.UK website's Statistics section (<https://www.gov.uk/government/statistics>).

1.4.2 Purchasing power and other countries

The same goods can cost different prices in different countries because of factors such as the cost of living, wage rates and taxation. These differences can have an impact upon people when they travel or live abroad. A key consideration when budgeting for a stay abroad is therefore to find out the relative costs of accommodation, transport, food, drink and so on. Guide books and travel websites provide information, and exchange rates for currencies are available in newspapers and online.

Exchanging currency for holiday spending

Scott and Rachel are travelling to Paris, France for a holiday. Before they leave the UK they decide to buy some foreign currency so that they have cash to buy meals and metro (underground train) tickets as soon as they arrive in Paris. France's currency is the euro (€). Scott and Rachel do some research online and discover that they can get a set menu three-course meal without wine in a café for about €20 each, €40 in total.

They look up the exchange rate online and discover that 1 euro equals 0.85 British pounds, that is, 85p on that day. The online currency converter uses the abbreviations 'EUR' for euro and 'GBP' for pounds. A meal for the two of them that costs €40 is the equivalent of £33.97 at that exchange rate (40 multiplied by 0.85 = 33.97). Scott and Rachel think this cost is slightly cheaper than they are used to paying for a similar meal out in Manchester city centre.

Scott and Rachel know that exchange rates vary from day to day and so they decide to exchange £100 for euros to cover two meals and some transport costs when they first arrive in Paris. As they know that every £0.85 equals €1, they expect to get euros to the value of 100 divided by 0.85, that is 117.64. They go to the Post Office and convert £100 into €117.64. This is the same exchange rate of 1 EUR equals 0.85 GBP expressed as 1 GBP equals 1.1764 EUR.

We will look at exchange rates and the cost of living in different countries in more detail in **Unit 2**.

1.5 Bank account balances

The majority of money is held as bank account balances rather than as coins and banknotes. There are many different types of bank account designed to fulfil the different purposes of money. For example, there are accounts targeted at savers that offer returns on the money stored there in the form of interest. When people borrow money via a personal loan, they have a separate loan account. For now, however, we will focus on current accounts as people can use these to fulfil all the purposes of money.

Current accounts are offered by a range of providers including banks, building societies and the Post Office. People can use them to deposit money and to make payments by withdrawing cash or issuing instructions to the provider. These instructions can take many forms such as cheques, standing orders and payment card transactions. We study these different payment methods in detail in **Topic 3**.

People monitor the value of their current account holdings using statements. Statements list the incoming and outgoing transactions on the account and the balance at the end of the accounting period. They can be paper-based, provided electronically on a computer or mobile phone screen, or provided over the telephone.

People can use current accounts to store money for future use. If account holders plan to spend the money more than one or two months in the future, however, they would probably benefit from transferring the money into a savings account that offers a higher rate of interest.

Borrowing is also a feature of many current accounts. Overdrafts enable people to borrow from the provider by paying out more money than they have stored in the account. Overdrafts are designed for short-term use – for example, a person might need to pay a bill the week before they receive their monthly salary payment. They overdraw their account to pay the bill and the following week the borrowing is repaid when their salary is paid in. We will compare different methods of borrowing in **Topic 6**.

1.6 Using money to meet changing needs

We have seen that people use money to make payments, save, borrow and record value. At any one time an individual might be using money for one or more of these purposes. Certain combinations are more likely at certain times in a person's life.

- ◆ Young children receiving an allowance are likely to spend most of their money. They may save the financial gifts they receive for higher-value items that they want and for unspecified items in the future.
- ◆ Young adults who have just left home and are earning a low wage are likely to spend most of their money on living expenses.
- ◆ Adults with more job experience and better wages may spend money on living expenses and 'fun items', borrow money through a mortgage to buy a home and save for the future.

- ◆ Parents might borrow money to pay for items such as a family-sized car. They may spend most of their income on living expenses and gifts for their children and find it difficult to save.
- ◆ Middle-aged people are more likely to have paid off their debts and to be saving for their old age.
- ◆ Retired people are more likely to be spending all of their income which will have fallen since their years in employment.

When people plan their finances they need to consider how much they can afford to spend, save and borrow from their income to be able to pay for the items they want now and in the future. The proportions of spending, saving and borrowing are likely to vary at different stages in a person's life. We will explore these ideas in more detail in **Topic 2**.

Key ideas in this topic

- ◆ Definition of money.
- ◆ The purposes of money.
- ◆ Bartering and its limitations.
- ◆ The development of money over time.
- ◆ The features money needs to fulfil its purposes.
- ◆ The functions of money.
- ◆ Legal tender.
- ◆ The purchasing power of money.
- ◆ How people's need to spend, save and borrow changes over the course of their life.

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