

LECTURE 16: NATURE OF MONEY

- I. Is money the root of all evil?
 - a. Consider the POW camp.
 - b. What if they had to rely on barter?
 - c. The problem with barter is that it relies on a *double coincidence of wants*. Not only do you need to find someone who has what you want, that person must want what you have.
 - d. This system is so inefficient barter is incredibly rare in practice. Even at the dawn of humanity reciprocal gifts—favors—was a sort of currency of the realm.
- II. Money has three basic functions
 - a. *Medium of exchange*—a common denominator that is always included in trades.
 - i. For a currency to fulfill this function, it must be both granular and portable.
 - b. *Unit of account*—a way to easily assess how much an item is worth.
 - i. For a currency to fulfill this function, it must be uniform.
 - c. *Store of value*—when earned, money can be held over time and used when needed.
 - i. For a currency to fulfill this function, it must be something which will not rot, decay, or unavoidably lose value over time.
- III. Transaction costs
 - a. All of the functions of money have one thing in common: they are ways to reduce *transaction costs*, or the costs of making a trade.
 - i. As a medium of exchange, money makes it easier to find people to trade with, avoiding the double coincidence of wants.
 - ii. As a unit of account, money makes it easier to compare prices and negotiate.
 - iii. As a store of value, money makes it easier to plan spending and to save for emergencies.
 - b. Transaction costs are a big idea in economics and not limited to money. Credit cards, courts, and internet user ratings all reduce transaction costs.
 - c. Douglass North—1993 Nobel Laureate in Economics—argued that good institutions have a fundamental role in reducing transaction costs and, thereby, create conditions necessary for economic growth.

IV. Types of money

- a. *Commodity money*—a currency that is physically made up of something with intrinsic value. It is derived from what is physically is. Gold is a popular example.
 - i. On one hand, a commodity currency makes hyperinflation hard because it's difficult to create more currency (depending on the commodity).
 - ii. But there's a danger of this type of currency: the government has little control over its value. For example, the California and Australian gold rushes coincided with an inflation rate of 30% between 1850 and 1855.¹
- b. *Fiat money*—a currency with value derived from the legitimacy of the issuing organization, often manifested as paper or low-grade coins.
 - i. In other words, a currency is worth because people think it's worth something. Because they think it's worth something, they'll accept it in exchange for goods and services. It's a self-fulfilling prophecy.
 - ii. Virtually all currencies, including cryptocurrencies, are fiat currencies.
- c. *Representative money*—a currency with a value derived from its representation of something with intrinsic value.
 - i. Representative money is like fiat money, because what's traded has no intrinsic value.
 - ii. But it's also like commodity money, because its value derives from something with intrinsic value.
 - iii. When the U.S. was on the gold standard, people didn't exchange pieces of gold. They paid with paper dollars that could be exchanged for gold.

V. Gresham's Law

- a. There is another problem with commodity currency, articulated by 16th century financier Sir Thomas Gresham.
- b. Like most commodity currencies, all coins are legally declared to be equally valuable. Now consider a merchant who discovers he scraps off a bit of the coin, it's still worth just as much *and* he can sell the sliver of gold.
- c. We now have two currencies circulating: “good” money (that with more gold) and “bad” money (that with less gold, a debased

¹ <http://eh.net/encyclopedia/california-gold-rush/>

currency). *Gresham's Law* states the bad money will drive out the good money.

- i. In other words, we will see people refuse to spend the “good” money, favoring to transform it into the debased currency.