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LECTURE 17: 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 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 be something which will not rot, decay, or unavoidably lose value over time.

III. Types of money
   a. *Commodity money*—a currency whose value is derived from a valuable commodity, whether physically made up of that commodity or can be redeemed for it (usually by the government). 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. *Representative money*—this money is worth more than what it physically is. It represents something more valuable than itself.

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[1] http://eh.net/encyclopedia/california-gold-rush/

i. Sometimes this means it's kind of like a commodity currency, except it's not a commodity itself; it represents or is backed by a commodity. For example, when the U.S. was on the gold standard, people didn't exchange pieces of gold. They paid with dollars that could be exchanged for gold.
ii. Sometimes it means it's what's called a *fiat money*—a currency whose value is derived from the legitimacy of the issuing government, often manifested as paper or low grade coins.
   1. 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.
   2. Virtually all currencies are fiat currencies.

IV. Gresham's Law
   a. There is another problem with commodity currency, articulated by 16^{th} 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 is 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 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.