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TOPIC 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 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

[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.