

## LECTURE 25: 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. 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.<sup>1</sup>
  - b. *Representative money*—this money is worth more than what it physically is. It represents something more valuable than itself.

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<sup>1</sup> <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<sup>th</sup> 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 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.