What is money?

This might seem a strange place to start—certainly a strange question--but paradoxically it is necessary to grasp the most pressing danger we face: the subversion of our currency. This is abstract, yes, but that very abstraction is how this danger has developed silently over the years without objection from voters. Most of us don't get how our system actually works, which I will correct here. If your biggest concern is our national debt—which is a great many of us—the solution starts here. This treatment will be quick, but if you spend a bit of time thinking it over, you should get it.

If you were purely self sufficient—if you provided your own shelter, clothing and food--you would have no need of money. Trade would never be necessary. However, you can get more stuff through the specialization of labor, where one person or group of persons focuses on making one thing, you focus on another, and you exchange them.

In barter, you might bring a beaver skin to market and exchange it for a new paddle for your canoe. If beaver skins were rare, and paddles common, you might get 3 or more paddles. If paddles were rare, you might need three beaver skins. This is the law of Supply and Demand, which states that as demand increases prices go up, with a fixed supply. Conversely, if supply increases, and demand stays the same, then prices go down. This is pretty basic.

Let us suppose, though, that I walk into a market wanting to buy some new moccasins. I find someone with moccasins, but he doesn't want my beaver skins. He does want paddles, though, so I swap for the paddles, then swap those for the moccasins. This is a cumbersome process—called indirect exchange--and obviously it might break down entirely if the guy with the moccasins is 40 miles from the guy with the paddles. There is no means by which to efficiently exchange goods.

There is a further problem of indivisibility, which means that one beaver skin may be worth vastly more than 1 pair of moccasins, but there is no way to parcel it up, since the beaver skin is usually used as a whole (this may not literally be true, but let's assume it for this purpose.)

This is where money comes in. Money is really ANY thing that people will agree has exchange value. It could be skins, or goose eggs, or cigarettes or beads. As long as everyone agrees on it, you're good to go. In our example above, the beaver skin is sold for money, and that money is then used to buy moccasins.

Historically, gold has by far been the most common unit of currency. It is attractive, it doesn't rust, it is somewhat rare (so it can't be easily added to the economy), and it can be melted reasonably easily, such that you can make units of any size or weight that you want, as well as jewelry. Let us compare, say, a classical Chinese coin and a Roman coin. What is the exchange rate? Absent governmental coercion (a big caveat), it is whatever the ratio of gold is. Say the Roman coin has twice as much gold: it is worth twice as much. You can just melt it, such that the picture of the Roman Emperor disappears, and then mint two new coins with the Chinese Emperor on it. It is the gold that matters, not the imprint.

Who actually made the money has varied throughout history. Sometimes it was traders, sometimes banks, and of course quite often governments. One almost universal pattern of behavior in the last case is that governments almost always spend more than they can bring in in taxes—typically for war or to fund a lavish lifestyle for the power elite--and sooner or later realize they can in effect "print" their own money, since they make the laws, own the police, and run the jails if anyone disagrees. Such policies are economically dangerous, and if pursued far enough ruinous, but by definition not illegal for those who make the laws.

With respect to gold money what they do is add another cheaper metal, such that the coins are only perhaps 90% pure gold. Say they had 100 pounds of gold bullion, they can make 111 pounds worth of coins, which of course is 11 pounds more than there ought to be. This allows them to spend money that they in effect created from nothing. This also means more total coins are in circulation, which creates inflation. The Romans did this, late in their imperial history.

Here is how inflation works. Let us assume that a merchant sells bread in a neighborhood where a lot of government officials live. These officials gave themselves "raises" by minting more money, and they are eager to spend that money. Normally he sells 20 loaves a day, but notices a gradual pattern that he is selling 30 loaves. He decides he isn't charging enough, so he raises the price, such that he is back to selling 20 loaves, and apparently making more money. However, because he has been selling more bread his flour costs also go up—since his wholesaler is using the same logic, and raising his prices--as do his other costs, so that even though he is making more money, he is paying more money, so it evens out. <u>The only people who win with inflation are those who create and spend the money that causes it. This point is critical.</u>

In ancient times, and even relatively modern times, money was usually "specie", which is to say a precious metal you could melt down. At some point, people got the bright idea that they could warehouse their gold, and simply trade receipts for the gold. That way they didn't have to truck the stuff around. You deposit, say, 10 pounds of gold into a vault, and you get ten pounds worth of gold receipts. Anyone who has one of these receipts can go to the bank the note was drawn on at any time, and get the actual gold. In theory, there are only as many paper notes in circulation as there is actual gold in the vaults, so they are effectively equal. They are claim tickets, just like you get when you check your coat.

One day, someone whose name we will never know was sitting in his front office, thinking. Nobody had redeemed any gold in a year. They just traded the notes, because they were simpler and lighter. He had printed the notes/receipts himself, with the press in the back office. He had friends in the shipping business: why not print up some notes for them, and loan them at interest? So he did. It worked. Nobody came to get their gold, and he made a tidy profit off of the gold he had stored. So he did it again. And again. He made money off money that was not his to loan. For all intents and purposes, he was counterfeiting receipts for real money, such that each piece of gold had 3 or more claim tickets issued against it . He was making money off of nothing.

Somewhere down the road, one of the more astute consumers of these notes realized he was seeing them everywhere, and started to wonder if there was really that much gold down in the vault. So he decided to redeem the notes. He goes into the vault, and see maybe 10% as much gold as should

actually have been there. Quietly, he tells his friends, who go redeem their tickets too. Eventually, word gets out, and there is a rush on the depository. Our “entrepreneur” runs out of gold, and has to close his door, and slip out of town before he is brought up on charges of being a thief, and jailed or worse.

As we will see, this is how our system, more or less, works today. This is called a Fractional Reserve System. By law, most banks in the United States only have to keep 10% of the deposits they hold actually in hand. They lend out as much of the rest as they think they can get away with. It is not a wonder when we have financial crashes. It’s a wonder we have as few as we do.

Discussion Questions:

1. How would you define counterfeit money? What makes money “real”?

2. Did our early banker actually commit a crime?

3. Was what he did ethical?

4. How does inflation transfer wealth? This will be discussed shortly, but can you see where this is going?