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The Five Pillars of Money

A successful monetary system must fulfill certain basic social requirements.

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I would like to share with you five ideas about money that may change your economic world. We economists don't usually share things such as these with people outside the club—they are from the first lecture I used to give at the university to PhD students being admitted to the inner circle. These notions are drawn from my own training at the hands of professors who learned their craft in the famous Money and Banking Workshop at the University of Chicago under the guidance of Nobel Laureate Milton Friedman.

The five pillars are: Money is a social institution. It is based on trust. It is a store of value. It separates sales from purchases. It is a contract.

Most economists would embrace most of these elements as part of their conceptual framework, even if they do not share Professor Friedman's views.

Not to worry, there will be no discussions of overlapping generations or money-in-the-utility function (MIUF) models, or other specialized terms of an economist's craft. Instead, these ideas operate at the most basic level. They go to the essential conception of what money is and does in our society, and clearly they are not independent of each other. If a monetary system is to function properly, it must address these five pillars of economic thinking in some way.

Pillar One: Money is a social institution. In the sense it is used here, the word "institution" refers to a structural arrangement at the center of some range of social relationships. That is to say, money is a product of social interaction, not intrinsic value.

Money only has meaning in a world in which at least two people want to exchange things of value.

While government can foster and support social institutions, it cannot sustain them if they do not serve the public or are inconsistent with public sensibilities. No amount of government posturing can save a currency that has been over-issued, widely counterfeited, or otherwise debased. The currencies of the Continental Congress and the Confederate States of America, victims of all of these ills, were both used eventually as wallpaper and kindling.

Money is a nexus of social activity that arises naturally as human beings relate to one another through economic exchange. In a world with only one person, there would be no money. Money only has meaning in a world in which at least two people want to exchange things of value. No society, no exchange, no need for money. In a society, money emerges as a link between individuals.

Key leaders at the Federal Reserve understand and espouse this idea. Narayana Kocherlakota, president of the Federal Reserve Bank of Minneapolis, has argued that money is simply memory—societal memory. Money is a system of chits or markers, which people hold when society owes them future goods and services in exchange for goods and services that they have already surrendered to someone else. Money is a social construct that formalizes the economic relationship of each person to society.

A direct implication is that monetary policy directly affects the fabric of society. It changes the way that people relate to one another. It changes relative wealth through distributional effects. And it affects every contract in the economy.

Pillar Two: Money is based on trust. If Kocherlakota is correct, then the usefulness and acceptance of money in an economy relies on a trust between buyers and sellers that the value of money will remain constant through time: "I am willing to accept your $5 for this thing or my labor that I'm selling now *only if*

everybody else in society promises to accept my $5 later for something of similar value." Without such a trust, why would anyone accept money?

Fiat money is money that is not backed by any commodity. It is backed only by the good faith and credit of the issuing government. That is, it is based solely on trust. With only a few notable exceptions, people tend to have less trust in other governments than in their own. If the currency is going to be traded in international markets, facilitating foreign trade, then fiat money is complicated. People are more likely to trust a commodity they (think they) understand, than a foreign government that may embrace policies that are not in their interests.

Domestic or foreign, it is easier to maintain trust in a commodity currency than a fiat currency. This is especially true if the commodity tends to maintain a fairly constant value relative to other goods and services in the economy. The commodity should be widely traded and valued. Historically, this has often led to successful currencies being backed by gold, silver, or some other widely valued and traded commodity.

One of the first forms of money to be used in the New World was the Spanish dollar, issued as eight-real coins (pronounced "ray-all"), also known as "pieces of eight." Two reales amount to a quarter of a dollar, hence "two bits" as a colloquial expression for a quarter. This coin was not minted in the U.S., but yet was still used, circulated, and trusted in the U.S. from colonial times forward. Ultimately, the U.S. Congress passed a resolution supporting the use of the Spanish dollar on August 8, 1786, and dollar references in the U.S. Constitution are to this Spanish coin. The Coinage Act of 1792 made the dollar the basic unit of account for the U.S., defined in terms of the Spanish coin. The first distinctly U.S. coin did not appear until 1793.

No one had to trust the Spanish government to trust in the Spanish dollar. It was a silver coin.

The chart on page 3 shows that the dollar maintained its long-term purchasing power until the Great Depression, despite wars, failed central bank systems, a bimetallic standard, and even a period of 25 years with no central bank at all. Whenever the gold standard was intact, deviations in purchasing power were relatively small, and the long-term purchasing power of the dollar was maintained. Purchasing power went into free fall after the U.S. abandoned the gold standard briefly in the 1930s, despite the attempt at a *gold exchange standard* with Bretton Woods after WWII.

Changes in the value of money by central banks such as the Federal Reserve undermine the public trust in the currency, and therefore undermine the monetary system.

Recognizing this, central banks around the world have been studying and adopting policy rules that they hope will assert the same kind of discipline on fiat money as found intrinsically in commodity money.

Many U.S. economists, for example, have argued for a constitutional amendment requiring the Fed to focus entirely on stabilizing prices by targeting a specific inflation rate. Countries around the world with fiat moneys have adopted inflation targeting. These include Australia, Brazil, Canada, Chile, Colombia, the Czech Republic, the Eurozone, New Zealand, Norway, Iceland, Philippines, Poland, Sweden, South Africa, Turkey, and the United Kingdom.

Other economists have argued for a constant growth rate rule requiring the slow, steady growth of a

Management, Trust, and Fiat Money

Fiat money has worked at times. Its success depends precariously on achieving, in other ways, the same kind of trust that is intrinsic to commodity money.

Following World War II, for example, the productive capacity of the U.S. remained essentially intact, while the rest of the developed world lay in ruins. More than half of total global production took place in the U.S. The nation abounded in wealth, and its political system was one of the most stable in the world. The Treasury had nearly unlimited tax authority over a potential tax base that was orders of magnitude greater than any other in the world.

When finance ministers met in Bretton Woods, N. H., to form the new monetary system, they relied heavily on the sense of trust that people universally had in the U.S. When the Bretton Woods Agreement was dissolved in the early 1970s, that sense of trust allowed the U.S. dollar, even as a fiat currency, to survive as the standard of payment for all international settlements. A trust was earned and respected.

By the late 1970s, though, overprinting of money had caused inflation rates to spike in the U.S. To combat this, the Fed, under the leadership of Paul Volcker, reined in the growth rate of money, bringing inflation under control. This served to restore order to the monetary system and confidence in the U.S. dollar.

Commodity money exerts this discipline without policy makers. Fiat money requires constant management involving sometimes difficult or unpopular political choices. Volcker's deflation resulted in two back-to-back recessions in which unemployment rates exceeded 10 percent. Governments and central banks are often unwilling to take such difficult stands. That is what makes Volcker's Fed legendary.

monetary aggregate, consistent with stable prices. This approach is often associated with monetarist or new classical economists.

Under fiat money regimes, either form of targeting can only succeed if central bankers are disciplined, benevolent, and unmotivated by political interests.

The Fed's current marching orders involve trying to maintain low inflation, low unemployment, and moderate long-term interest rates compatible with a high growth rate of GDP. Unfortunately, these objectives are often inconsistent. At present, there is nearly unanimous agreement among economists that, at best, monetary policy can only change unemployment and real output in the short run, and then only at a cost of higher future inflation rates. So it appears that short-term political concerns have displaced long-term monetary concerns. This is often the case with managed fiat money systems.

To be clear, there are two components to money trust. The first is that everyone accepts the money, and the second is that the valuation of things in money terms always remains the same.

Pillar Three: Money must be a store of value. To be trusted, to serve as a social nexus, money has to preserve buying power through time. Although almost no one catches it, this is really a compound statement of sorts. First of all, it implies that to serve effectively as money, a thing must *have* value. It doesn't make sense to value other goods against something that has no value itself. As written by Georg Simmel in 1900:

> A measuring instrument, it is said, has to have the same quality as the object to be measured: a measure of length has to be long, a measure of weight has to be heavy, and a measure of space has to have dimensions; consequently, a measure of value has to be valuable. No matter how unrelated two things may be in all other respects, when I measure them against each other they must both have the quality that I am comparing.

Based on this, it may seem almost definitional to use a commodity as the basis for a currency. Certainly using a commodity as the basis for your money is probably the easiest, most straightforward way to address Simmel's issue. In particular, we would prefer a commodity that is widely valued and demanded, that can be delivered and measured in a uniform measure or purity, and that is easily divisible. The commodity should not rot, spoil, or lose value over time.

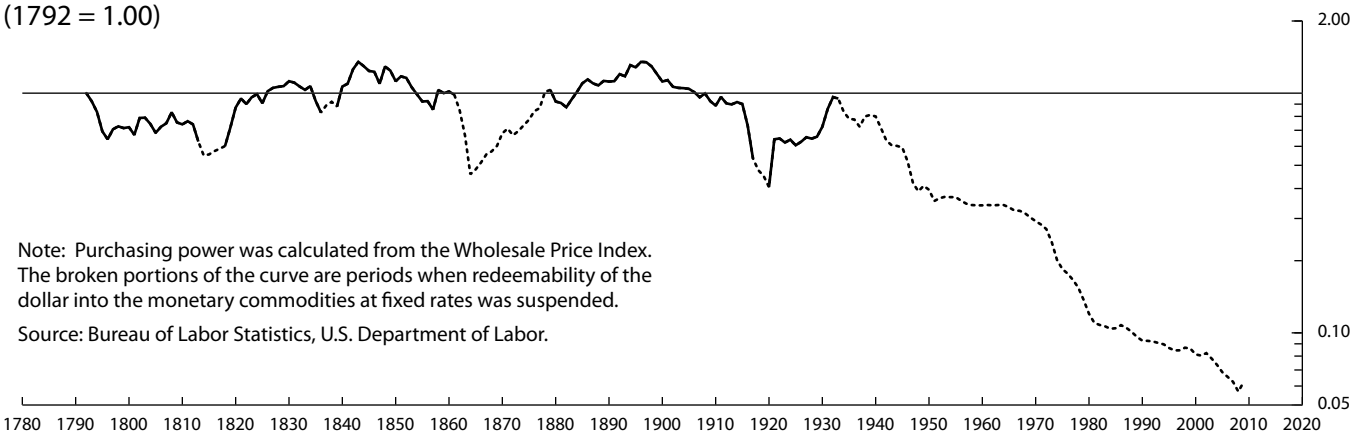
Fiat money only has value because it is demanded and is available in limited supply. At first glance, this valuation may appear to be a simple supply-and-demand analysis. Looking more closely, we realize that fiat money has no intrinsic value, so in some sense the demand is artificial. And central banks, which have a monopoly on money supply, may choose to oversupply, lowering its value.

Since the start of the recession in 2007, the Fed has increased the U.S. money supply at record-breaking rates, and has recently engaged in a second round of quantitative easing. Many economists have questioned the wisdom of this because of its potential effect of reducing the value of money. Fiat money can only serve as a store of value if it is overseen with an unwavering discipline.

Pillar Four: Money separates sales from purchases. This follows directly from money's ability to function as a store of value. When a person barters, when he or she engages in an exchange without money, that one person engages in a sale and a purchase at the same moment. That person gives up (sells) a good or their labor, and simultaneously receives (buys) another good.

With money it is possible to sell now, preserve your buying power, and later use it to buy something of similar value. That is what money does—it decouples purchases and sales by being a store of value. Money is said to allow *nonsynchronous transactions*. This is a remarkable thing. But people will only use money if they believe that later

Purchasing Power of the Dollar
(1792 = 1.00)



Note: Purchasing power was calculated from the Wholesale Price Index. The broken portions of the curve are periods when redeemability of the dollar into the monetary commodities at fixed rates was suspended.

Source: Bureau of Labor Statistics, U.S. Department of Labor.

they, in fact, will be able to purchase something of (nearly) equal value to whatever they gave up earlier.

No responsible person is going to continue to take money in exchange for their goods or services (labor, for example) once they find out that others are not willing to accept the same money for things of similar value. Once this happens, the monetary economy begins to self-destruct.

To see how this plays out in the real world of experience, we need only consider countries where the reckless issuance of money has created high inflation. In the 1990s, an array of former Soviet republics and satellites suffered hyperinflation as they restructured their economies. Workers often received their pay in currency, only to race to the nearest store to buy… anything. Anything *real*. Then the trading, the bartering, would begin. Economic activity was actually conducted by barter, with money involved in a short, inconvenient step at the beginning. These monetary economies had self-destructed.

Money has to carry buying power through some amount of time. A direct implication is that if something fails to be a store of value, it cannot be money. This means that the value of whatever society is using as money must not vary in relation to the things people want to buy. In a monetary economy, people do not exchange things (goods or services) for other things—that is, they do not barter. They exchange real things for money, and then money for things. Hence, for the intervening period, buying power must be preserved.

Pillar Five: Money is a contract. Anything that serves to damage this contract of trust also serves to destabilize monetary exchange, society, and the economy. Changes in the money supply by central banks, by design, directly change the value of money. Because money is a social institution, this affects the nature of the social interaction, redistributing wealth from one individual to another. Central bankers are aware of this and play on it to make policies that influence behavior. By changing the value of money and the trust relationship between you and everyone else in society, the Fed is changing your entire world.

Giving the Fed the right to issue fiat money and conduct active monetary policy grants these central bankers enormous power over your life. It is with good reason that the *Washington Times* has called the Fed the most powerful agency in the U.S. government. *Time Magazine* referred to Fed Chairman Ben Bernanke as the most powerful nerd in the world, while *Forbes* ranks him fourth behind only Barack Obama, Hu Jintao, and Vladimir Putin as the most powerful man in the world. And an array of political and financial writers have claimed that the Fed is now more powerful that Congress.

The greater the frequency and magnitude of changes in the value of money, the more its usefulness is reduced in its most basic function as a store of value. The non-synchrony of purchases and sales imposes risk in the face of such changes in the value of money. People become less willing to use money in exchange because they cannot reliably separate purchases from sales without risk (which conflicts with Pillar Four). Once this trust is lost (Pillar Two), people become reluctant to make transactions in money, economic activity slows, credit markets fail, and the society begins to decline.

Consider the Supreme Court, nine individuals nominated by the president and confirmed by the Senate. Imagine the reaction if they were to meet on a given Tuesday and decide to change the payments to be made and received on every contract in the country? Businesses and individuals would go bankrupt, business relationships would be destroyed, banks would default, mortgages foreclosed. Our entire economic world would be in disarray.

But this is exactly what the Federal Open Market Committee does when its 12 members, including the seven Federal Reserve System Governors appointed by the president and confirmed by the Senate, meet on a Tuesday and change the supply of money. By changing supply, they are changing the value of money. By doing so, they are changing the terms of every contract in the country. Before we accept active monetary policy by the Federal Reserve, we need to be aware of these broader implications.

Conclusion. Historically, the considerations outlined in this article have led to the use of commodity money—gold- or silver-backed money in particular. Buried deep in the human psyche, there is something that makes gold and silver attractive and credible to us. As a monetary economist would say, "gold serves well as a long-term anchor to the money supply."

The use of fiat money under the management of central banks is a fairly recent development. Because it requires constant management and political discipline, the value of U.S. fiat money has consistently lost value.

This is not to say that metallic standards are a panacea. Both gold and silver were used throughout the 1800s in the U.S. until miners found large silver deposits out West. This led to a rapid growth in the supply of silver, collapsing the market price of silver. Some argued for a switch to gold only to re-inflate the economy. Many argue that the subsequent debates are played out in stylized form in *The Wizard of Oz*. Remember the yellow brick road?

Short-term fluctuations can occur in the value of money based on a single commodity. There is no way to avoid short-term, random fluctuations in any currency. What is unique in our experience is that over the long term, commodity money is the only form of money that has maintained its value very well.

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