

MONEY

How it works and why

by Steven Horwitz



Money is one human institution that is so ubiquitous that we do not often step back and try to understand exactly how it works and why. After all, when one thinks about it, it is somewhat strange that a customer can walk into a store, hand over a piece of paper with ink on it, or just transfer some bytes of information over a computer, and walk out with merchandise worth much more than the ink and paper or the bytes. How has it come to be that we engage in this massive network of trust that we call monetary exchange? What exactly makes something money, and what role does money play in the economy and in generating economic growth and preserving economic freedom?

Money, like many other economic institutions, is not the product of human design. No one invented money. Rather, money is a classic example of a spontaneous, or unplanned, order.

Prior to the system of monetary exchange, people had to barter their goods and services for the goods and services of others. But the problem with a barter economy is that it can be very difficult to find someone who both has what you want and wants what you have. Frustrated in their ability to make

exchanges, people began to hold stocks of goods that they thought other people really wanted as a way

to make it easier to exchange with them. This so-called “indirect exchange” (e.g., exchanging eggs for corn and then corn for meat) involved two steps rather than one, but it was still easier than direct exchange. Eventually, people discovered that certain goods fulfilled that intermediary role particularly well, and these indirect exchanges converged upon one or two such goods, giving us money. Consequently, money is often defined as a generally accepted medium of exchange. Which goods worked best was often culturally specific—some societies adopted things like shells, stones, or even cattle—but precious metals became standard because they had a commodity value of their own and had physical properties that enabled them to be stored and divided easily.

The use of money means that we no longer have to worry about finding someone who both wants what we have and has what we want. We only need to find someone who has what we want because we know people will accept money for their goods or services. Thus, money makes it much easier for people to engage in exchange, and this, in turn, improves economic well-being by getting goods into the hands of the people who value them most.

The spontaneous order view of money also implies that governments cannot declare as money anything they wish. Money is what money does; it is whatever market traders converge on as a generally accepted medium of exchange. Even when governments create “fiat money”—money that they declare to be money using the law—they will have to somehow link the new money to the one the market has already decided upon. Money must always have a contemporary or historical relationship to an actual commodity that the public has chosen to use as a medium of exchange.

The most important consequence of the use of money is that it makes it possible for each good or service to have a unique price assigned to it in terms of that money. When

all prices in a country are stated in terms of the national currency it is very easy to compare the values of the goods and services in

that economy. The act of exchanging money for goods is a form of communication that enables the prices that emerge from those exchanges to be signals to producers and consumers about value. When prices are stated in terms of money, consumers can formulate budgets and determine the wisdom of their various expenditure choices. Perhaps more importantly, producers can determine which goods will be the most cost-efficient to produce, and they can know, based on profits and losses, whether the choices they have made in the past were good ones. They can also use current prices to inform any changes in behavior that they think may be necessary in the future. Money prices make it possible for producers and consumers to engage in the crucial task of



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economic calculation, without which economies would not progress. The more extensive an economy's use of money, the easier it is to improve the well-being of all who take part in it.

Initially, money was produced by private actors. Money first came in the form of gold coins, which were originally produced by private minters and stored by goldsmiths. But governments quickly realized that they could profit by monopolizing coin production, particularly if they spent them into circulation by purchasing goods and services for the king or queen to use. Paper money was also pioneered by the private sector, as banks discovered that they could give customers paper "receipts" for gold held in vaults and that those receipts could then be traded in the marketplace instead of the gold itself. As long as banks were required to keep their promise to redeem the paper notes in gold, this system worked quite well. However, here, too, governments realized that by intervening in this process, or by claiming a monopoly over the production of currency, they could use this money to acquire resources. The central banking systems that we have around the world today exist not because the private production of money failed, but because governments saw control over money production as a way to fund their activities, especially the military, without having to raise taxes.

In a modern economy, a variety of financial instruments are used as money or money substitutes. We still use paper bills and coins, but we also use checks and, more recently, debit cards to make payments. Both checks and debit cards are ways of conveniently accessing the funds that people keep in banks. Rather than withdrawing money every time we need it, checks and debit cards offer us a way to order our bank to transfer funds to the bank account of the person from whom we wish to purchase. Credit cards, by contrast, are not technically a form of money but are unsecured lines of credit. Credit cards eventually have to be paid off using money in one form or another.

Other financial instruments can work like money by enabling people to write checks from them. One good example is money market mutual funds, where small savers' funds are pooled by a bank to purchase interest-bearing financial instruments, with the bank paying a slightly lower interest rate to their customers than they earn on the instruments. Most of these funds allow their owners to write checks, usually with a high minimum amount, from their accounts, and those checks are, in essence, or-

ders to the bank to sell off some of their funds to pay the recipient's bank.

The challenge facing central banks today is knowing how much money to supply and then which actions of theirs will supply that exact amount at the correct time so as to avoid the artificial inflation of the prices of goods and services. If the central bank issues too much money, the public will spend those extra funds on more goods and services, causing their prices to rise ("inflate") above the levels justified by the real factors in the economy. Inflation not only reduces the value of money (and the value of people's financial assets, such as savings accounts, that are denominated in terms of that money), but it also undermines the ability of prices to provide reliable information for economic calculation. Persistent inflation reduces economic growth and can even trigger a depression by making it harder for producers and consumers to disentangle the influence of inflation on prices from that of changes in the real economy.

Severe or "hyper" inflation can ultimately destroy an entire economy by making its money worthless. Such a scenario demonstrates one of money's most important roles: it makes possible a society based on voluntary consent, contract, and exchange. When money is destroyed, our ability to interact on the basis of exchange is also destroyed, leaving force and coercion as the only option for human interaction. In this way, money is not just a symbol of economic freedom, but is also one of its most fundamental institutions. Not only does money allow us as individuals to turn our labor or assets into whatever purchases we desire, but it also enables us as a society to live by consent and exchange, rather than by brute force. Money makes us better off and it civilizes and humanizes us.

Suggestions for further reading

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Menger, Carl (1892). On the Origin of Money. *Economic Journal* 2: 239-55.

Selgin, George (2008). *Good Money*. University of Michigan Press.

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