THE USES AND ABUSES OF MONEY

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Money was not invented, it evolved. It only has value because of its acceptability, which follows from the trust granted by people when they use it in millions of everyday transactions. Politicians have often laboured under the delusion that money is something created and manipulable by themselves, when in fact it is the spontaneous institution of a free society and will continue to evolve in ways outside their grasp.

Money evolved as a solution to a problem that economlsts call "non-coincidence of wants". Simply, if I take a goat to market looking to exchange it for a sack of grain, then I may find someone who wants to buy my goat but has no grain, or I may find someone with grain to sell but who wants to exchange it for chickens rather than for my goat. To avoid this inconvenience, people began to use an intermediate good that could be held and then spent later without the need for any exact coincidence of wants. This intermediate good became known as money.

Without money, trade becomes much more difficult. For a start, the people involved in any transaction would have to hold goods that the other desired.

Then there is a problem of measurement. It is far more complex to work out the exchange value of goats in terms of grain, of grain in terms of chickens, of chickens in terms of cotton, and so on, than it is to use a common monetary standard.

Money is accepted as a medium of exchange also because it is expected to hold its value more reliably than other goods. In its cash form, money also has the advantages of being durable and portable in comparison to other goods.

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The only other form of exchange compatible with a free society is barter, which has all the inconveniences and inefficiencies outlined above. Money evolved as a way of improving the barter economy.

THE ROOT OF ALL EVIL?

Yet stripped of these functions which derive from other goods, money would be next to worthless. Unlike other goods money's value is an exchange-value based on the use-values of other goods, which in turn are based upon the subjective valuations of individuals. In its metal form money would have some straight use-value for other purposes. Currency notes are next to worthless as anythlng other than money while bank balances are conceptual entities which would not exist if they were not money.

Spelled out this may sound obvious, but it is still popularly believed that money is valuable of itself and this is one part of its demonisation. Although it would make more sense, nobody says that shoes or microwave ovens are the root of all evil. As von Mises says:

> Money is regarded as the cause of theft and murder, of deception and betrayal. Money is blamed when the prostitute sells her body and when the bribed judge perverts the law. It is money against which the moralist declaims when he wishes to oppose excesslve materialism.[1]

Perhaps this is also an illustration of the demotion of personal responsibility in modern society, where people seek external influences to excuse their actions.

It is also quite clear that money has grown up with our civilisation because of our own wish for more material goods, rather than being some alien imposition from without. Even so, the latter notion is probably more widely held than the former.

A part of the popular misunderstanding about money is the belief that money is the tangible form which it sometimes takes - notes and coins. Money is in fact wholly conceptual and definable only as a widely accepted medium of exchange. It is a good example of a wholly subjective feature of human soclety, as described by Hayek.[2] At different times people have chosen to use different items as money, such as seashells and cigarettes, while metal coins have sometimes ceased to be money. What remains the same, whatever the form it takes, is that money is a medium of exchange.

GOVERNMENT INTERFERES

Most people think of money as something administered by the government. It is true that government has assumed control over the issuance of currency, and has usually forbade the use of other currencies, through the use of legal tender laws.[3]

Ultimately, however, government does not control money. It is people in their transactions accepting a certain good as a medium of exchange that allows money to exist. If that acceptance is withdrawn then money ceases to be, whatever exhortation the government may use.

There are cases of people rejecting the government's decreed currency. In Israel, for example, when inflation raged in the 1970s, people chose to recognise dollars as money and used them instead of the official tender. In the former Soviet Union the legal tender ruble has at times plunged in value and been shunned by many, while dollars, sterling, deutsche marks and Marlboro cigarettes are more acceptable as exchange media.

Historically, government attempts to control money have often been disastrous. The biggest problems have arisen when governments have used money for political ends rather than to ensure the smooth functioning of the economy. Sometimes this has been purely cynical but at other times it has been the result of the misconception described above, that money has some intrinsic value, and hence that the more of it there is the richer a country becomes. The mercantilists - economists who preceded Adam Smith - held that a country's wealth was measured by the amount of gold and silver it owned.

The more modern version, usually labelled Keynesianlsm, says that while a larger quantity of money does not of itself represent greater wealth it will bring forth more production.

The consequence of these doctrines has been inflatlon, an expansion of the supply of money that leaves each unit of a currency worth less. A symptom of inflation has been the suspension of convertibility of fiduciary money into its (once) underlying commodity.

Paper monies originally arose as receipts for deposits of precious metals, which were considered the real money. These receipts became acceptable as exchange media, but each note was still backed by an amount of gold or silver. Later the deposit holders would issue more receipts than were backed by metal, in the knowledge that only a minorlty of holders at any one time would ask for the notes to be redeemed. Until 1889 the Bank of England redeemed notes with full gold coins.

Now we have a currency which is backed by nothing. Its supply is determined by whichever rules of issuing policy are being pursued. This obviously allows far more scope for abuse by governments than a metal-backed currency. If the government's central bank flooded the economy with notes of a metal-backed currency it would very soon face the exhaustion of its metal deposits by noteholders seeking redemption.

Inflation is a way for governments to achieve a short-term boost to economic activlty, but an illusory one. A surge in the supply of money will be felt by different individuals at different times and with different intensity. The businessman is likely to discern the first results in new orders, to which he responds by raising production and employing more staff and by upping the prices of his goods. Later he realises that the prices of his inputs have also risen and that the increase in demand was purely monetary. His production increase is reversed, and the extra staff are laid off.

Inflation also has a drastic impact on the capital goods sector through the effect it has on interest rates. Interest rates essentially express the ratio of preferences between present and future goods. An increase in the supply of money will depress short-term interest rates (or this may be engineered directly by the central bank lowering its lending rates, or by prices of other goods rising while nominal interest rates remain unchanged). This implies a heightened preference for future goods relative to present goods and will lead to greater investment to produce those future goods. It will lead to a lengthening of the process of production, that is, it will make more ambitious processes feasible when before they weren't.

However, input costs for the capital goods sector then rise. At the same time, the increased money supply begins to be manifested in higher consumer demand, and consumers hold the same preferences between present and future goods which are not reflected in the prevailing exchange rate. It becomes evident that more future goods are not being demanded. At the same time, credit markets begin to factor in the higher inflation, so that interest rates rise.

The result of this monetary expansion is therefore to cause 'malinvestment' - greater capital investment than is merited by the current state of demand. This is why capital goods industries suffer particularly during recessions.[4]

The boost to production caused by inflation can only be sustained with larger and larger increases in money supply. Ultimately this will lead to so-called hyper-inflation and possibly to demonetization when individuals revert to barter.[5]

BAD POLICY EXPORTED

Commercial banks have often been complicitous in abusing the monetary system. With the encouragement of Western Governments, for example, banks in the 1970s and 80s made huge loans to corrupt and incompetent governments in the developing world.

Predictably, the recipient governments proved poor credit risks. With their economies smothered by regulation and bureaucracy, they were unable to generate the returns even to meet interest payments, let alone to repay the capital sums lent.

The problem was compounded where recipient governments debased the value of their domestic currencies. Since most of the loans had to be repaid in dollars, a debased money supply meant a falling exchange rate, so that more and more revenue had to be generated to repay the same amount of dollars. The Mexican peso, for example, in the 1980s lost 75% of its value against the dollar, so that in effect, four times as many pesos had to be repaid than when dollar loans were taken out.[6]

In both the country of the lending bank and the recipient country, the little guy lost out. The man with a current account at his local high street bank now pays more in charges to cover the losses incurred by the bank, and the Mexican taxpayer pays more in income tax to cover the costs of previous economic mismanagement.

CHANGE

Money is evolving all the time. At one time most was notes and coins, but now we have many more types of money and it becomes difficult to measure just how much there is. This means that government attempts to control and direct money are more likely to be thwarted in the long run.

The monetary system will certainly become more sophisticated, but more stable and resilient at the same time. The financial sector is one of the least regulated and one of the most innovative parts of the economy, and is continually becoming more efficient. The development of futures contracts and other derivatives has enabled investors to protect themselves from and to benefit from unexpected fluctuations in prices, interest rates and exchange rates. While this can be seen as one cost of inflation, it also neutralises inflationist policies and reduces the incentive for pursuing them.

Most financial markets will grow in size and will become more integrated into international markets. Size adds stability because it means that one shock can be absorbed by many more participants. This also means that government economic policies have less effect because markets are better able to anticipate the effects and to avoid them where necessary. Controls on credit, for example, would now prove almost useless in any developed economy because funds can simply be moved across borders or packaged in different ways.

We will never arrive at a cashless economy, as some have predicted. Despite the widespread use now of "plastic money", there will always be a demand for notes and coins. Many people prefer to make transactions with anonymity and cash is the form of money that allows this. And as long as we have taxes, there will be people who want to evade them through using cash in the underground economy.[7]

Money evolved because it is useful but the purposes for which it is used are not part of the system. Like the wider exchange economy of which it is a part, money is a means for people to achieve what they want, but does not tell them what to want or guarantee that everyone can obtain what they want.

Money does not by itself make people happy, but it helps. Money does not make a society, because it is simply a medium. What it does, and what the development of an efficient monetary system does, is to provide people wlth more opportunities for pursuing whatever ends they choose.

NOTES

1. Ludwig von Mises, *The Theory Of Money And Credit*, Liberty Press, Indianapolis, Indiana, 1981, p. 111.
2. See F.A. Hayek, *The Counter-Revolution of Science*, Liberty Press, Indianapolis, Indiana, 1979.
3. Although there are examples of non-state monetary systems. See for example, Kevin Dowd, *Private Money*, Institute of Economic Affairs, London, 1988; Michael Fry, *Banking Deregulation: The Scottish Example*, David Hume Institute, Edinburgh, 1985.
4. See Mark Skousen, *The Structure of Production*, New York University Press, 1990; and von Mises, *op. cit*., pp. 399-402.
5. See F. A. Hayek, *A Tiger By The Tail: The Keynesian Legacy of Inflation*, Institute of Economic Affairs, London, 1972.
6. Hans F. Senholz, *Money and Freedom*, Libertarian Press Inc., South Holland, Illinois, 1985.
7. Hans F. Senholz, *The Underground Economy*, Ludwig Von Mises Institute, Burlingame, California, 1984.

And see also: Antoine Clarke, *The Micropolitics of Free Market Money: A Proposal*, Economic Notes No. 39, Libertarian Alliance, London, 1992, which contains a useful Free Market Money bibliography.