

The Value of Money

Most economists are in agreement that the inflation in the United States during the past three years has been the worst since the early 1940's, taking account of both severity and duration. But they cannot agree on the nature of the inflation that is engulfing the American economy. To some, inflation denotes a spectacular rise in consumer prices; to others, an excessive aggregate demand; and to at least one economist, it is the creation of new money by our monetary authorities.

This disagreement among economists is more than an academic difference on the meaning of a popular term. It reflects professional confusion as to the cause of the inflation problem and the policies that might help to correct it. A review of some basic principles of economics that are applicable to money may shed light on the problem.

Two basic questions need to be answered: (1) What are the factors that originally afforded value to money, and (2) What are the factors that effect changes in the "objective exchange value of money" or its purchasing power?

Money is a medium of exchange that facilitates trade in goods and services. Wherever people progressed beyond simple barter, they began to use their most marketable goods as media of exchange. In primitive societies they used cattle, or measures of grain, salt, or fish. In early civilizations where the division of labor extended to larger areas, gold or silver emerged as the most marketable good and finally as the only medium of exchange, called money. It is obvious that the chieftains, kings, and heads of state did not invent the use of money. But they frequently usurped control over it whenever they suffered budget deficits and could gain revenue from currency debasement.

When an economic good is sought and wanted, not only for its use in consumption or production but also for purposes of exchange, to be held in reserve for later exchanges, the demand for it

obviously increases. We may then speak of two partial demands which combine to raise its value in exchange—its purchasing power.

The Origin of Money Value

People seek money because it has purchasing power; and part of this purchasing power is generated by the people's demand for money. But is this not reasoning in a vicious circle?

It is not! According to Ludwig von Mises' "regression theory," we must be mindful of the time factor. Our quest for cash holdings is conditioned by money purchasing power in the immediate past, which in turn was affected by earlier purchasing power, and so on until we arrive at the very inception of the monetary demand. At that particular moment, the purchasing power of a certain quantity of gold or silver was determined by its nonmonetary uses only.

This leads to the interesting conclusion that the universal use of paper monies today would be inconceivable without their prior use as "substitutes" for real money, such as gold and silver, for which there was a nonmonetary demand. Only when man grew accustomed to these substitutes, and governments deprived him of his freedom to employ gold and silver as media of exchange, did government tender paper emerge as the legal or "fiat money." It has value and purchasing power, although it lacks any nonmonetary demand, because the people now direct their monetary demand toward government tender paper. If for any reason this public demand should cease or be redirected toward real goods as media of exchange, the fiat money would lose its entire value. The Continental Dollar and various foreign currencies over the years illustrate the point.

On Demand and Supply

The purchasing power of money is determined by the demand for and supply of money, like the prices of all other economic goods and services. The particular relation between this demand and supply determines its particular purchasing power. So, let us first look at those factors that exert an influence on individual demand for money.

As money is a medium of exchange, our demand for it may be influenced by considerations of facts and circumstances either on the goods side of the exchange or on the money side. Therefore, we may speak of goods-induced factors and money-induced factors.

Variation on the Side of Goods

A simple example may illustrate the former. Let us assume we live in a medieval town that is cut off from all fresh supplies by an enemy army. There is great want and starvation. Although the quantity of money did not change—no gold or silver has left our beleaguered town—its purchasing power must decline. For everyone seeks to reduce his cash holdings in exchange for some scarce food in order to assure survival.

The situation is similar in all cases where the supply of available goods is decreased although the quantity of money in the people's cash holdings remains unchanged. In a war, when the channels of supply are cut off by the enemy or economic output is reduced for lack of labor power, the value of money tends to decline and goods prices rise even though the quantity of money may remain unchanged. A bad harvest in an agricultural economy may visibly weaken the currency. Similarly, a general strike that paralyzes an economy and greatly reduces the supply of goods and services raises goods prices and simultaneously lowers the purchasing power of money. In fact, every strike or sabotage of economic production tends to affect prices and money value even though this may not be visible to many observers.

Some economists also cite the level of taxation as an important factor in the determination of the exchange value of money. According to Colin Clark, whenever governments consume more than 25 per cent of national product, the reduction in productive capacity as a result of such an oppressive tax burden causes goods prices to rise and the purchasing power of money to fall. According to that view, with which one may disagree, high rates of taxation are the main cause of "inflation." At any rate, there can be no doubt that the American dollar has suffered severely from the burdens of Federal, state, and local government spending and taxing that exceed 35 per cent of American national product.

Yet, this purchasing power loss of the dollar would have been greater by far if a remarkable rise in industrial productivity had not worked in the opposite direction. In spite of the ever-growing burden of government and despite the phenomenal increase in the supply of money (to be further discussed below), both of which would reduce the value of the dollar, American commerce and industry managed to increase the supply of marketable goods, thus bolstering the dollar's purchasing power. Under most difficult circumstances, businessmen managed to form more capital and improve production technology, and thus made available more and better economic goods which in turn helped to stabilize the dollar. Without this remarkable achievement by American entrepreneurs and capitalists, the U.S. dollar surely would have followed the way of many other national currencies to radical depreciation and devaluation.

Factors on the Side of Money

There also are a number of factors that affect the demand for money on the money side of an exchange. A growing population, for instance, with millions of maturing individuals eager to establish cash holdings, generates new demand, which in turn tends to raise the purchasing power of money and to reduce goods prices.

On the other hand, a declining population would generate the opposite effect.

Changes in the division of labor bring about changes in the exchange value of money. Increased specialization and trade raises the demand and exchange value of money. The nineteenth century frontier farmer who tamed the West with plow and gun was largely self-sufficient. His demand for money was small when compared with that of his great grandson who raises only corn and buys all his foodstuff in the supermarket. Under a modern and a highly advanced division of labor, one needs money for the satisfaction of all his wants through exchange. It is obvious that such demand tends to raise the exchange value of money. On the other hand, deterioration of this division of labor and return to self-sufficient production, which we can observe in many parts of Asia, Africa, and South America, generates the opposite effect.

Development and improvement of a monetary clearing system also exert an influence toward lower money value. Clearing means offsetting payments by banks or brokers. It reduces the demand for money, as only net balances are settled by cash payments.

The American clearing system which gradually developed over more than 130 years from local to regional and national clearing, slowly reduced the need and demand for cash and thus its purchasing power. Of course, this reduction of the dollar's exchange value was negligible when compared with that caused by other factors, especially the huge increase in money supply.

Business practices, too, may influence the demand for money and therefore its value. It is customary for business to settle its obligations on the first of the month. Tax payments are due on certain dates. The growing popularity of credit cards reduces the need for money holdings throughout the month, but concentrates it at the beginning of the month when payments fall due. All such variations in demand affect the objective exchange value of money.

Quantity Theory of Money

What is the Quantity Theory of Money?

The quantity theory of money is a theory that variations in price relate to variations in the money supply. The most common version, sometimes called the "neo-quantity theory" or Fisherian theory, suggests there is a mechanical and fixed proportional relationship between changes in the money supply and the general price level. This popular, albeit controversial, formulation of the quantity theory of money is based upon an equation by American economist Irving Fisher.

Understanding the Quantity Theory of Money

The Fisher equation is calculated as:

$$M \times V = P \times T$$

where:

M=money supply

V=velocity of money

P=average price level

T=volume of transactions in the economy

Generally speaking, the quantity theory of money assumes that increases in the quantity of money tend to create inflation, and vice versa. For example, if the Federal Reserve or [European Central Bank \(ECB\)](#) doubled the supply of money in the economy, the long-run prices in the economy would tend to increase dramatically. This is because more money circulating in an economy would equal more demand and spending by consumers, driving prices north.

Economists disagree about how quickly and how proportionately prices adjust after a change in the quantity of money. The classical treatment in most economic textbooks is based on the Fisher Equation, but competing theories exist.