Money by Decree

A summary of today's financial system by Paul Holtfrerich, Economist

The aim of this article is to equip people with simple principles and some history to aid in the interpretation of financial news happening today.

The Fundamentals

Scarcity, trade, and work

Everything in this universe has a limited quantity, which means that everything is scarce. As a result, we humans cannot have all that we desire. At any point in time, there is a fixed supply of every physical item in the universe, and each of us owns a subset of that supply. The way we get access to items we desire but don't own is either through trade or work. For example, if I have apples but want shoes, I can either trade my apples with someone else who has shoes or work to make my own shoes, thus increasing the total supply of shoes in the universe. This illustrates an important point: trade simply reallocates resources, but work actually reduces scarcity. The road to abundance for humanity is through increasing work/production, not trade by itself.

Money

Trading is difficult when you can't find a willing party. Imagine you have apples but want shoes, and no one you know with shoes wants any of your apples. This is formally called the **non-coincidence of wants** problem and plagued humanity until money was discovered. Money is simply defined as the most marketable good, or the good that everyone (the most people) wants. Because everyone wants money, you can now trade your apples for money, then trade your money for shoes. You would have no issues finding willing trading partners because money, by definition, is the good everyone wants. In the future, I will write an article going into more detail about what attributes make an item (money) desirable by everyone, but historically that item has been gold.

Debt

This is when things get more tricky. Earlier, I said that at any point in time, there is a fixed supply of every item in the universe; however, with debt, I can actually pull supply from the future and use it to trade today. I can trade 2 shoes for 5 apples, even if I don't have any shoes today, by promising to make the shoes and provide them at some point in the future. If the trade does not occur, then the supply looks like (0 shoes, 5 apples) today and (2 shoes, 0 apples) tomorrow (assuming I consume the apples). But if the trade does happen, then the supply becomes (2 shoes, 5 apples) today and (0 shoes, 0 apples) tomorrow. Notice how after the trade, we pulled the 2 shoes from tomorrow's supply and moved them to today's supply, leaving tomorrow with no

supply. Of course, if I am unable to produce the shoes by tomorrow, the debt is “paid for” by the person with the apples since he traded five apples but received nothing in return.

To quickly summarize, at any point in time, there is a fixed supply of every item in the universe. You can trade these items, or you can work to increase the supply of items. Money is the item that is wanted by the most people. Debt allows me to borrow from the future’s supply of items and add them to today’s supply.

Corruption of the Gold Standard

Since the dawn of mankind, humans have either traded for items, worked to produce more items, or, unfortunately, stolen items. Due to the fact that humans sometimes try to steal items, people decided to band together and form tribes or nation-states in an attempt to protect one another from having their items stolen. Generally, this works until the people in charge of the nation-state (government) decide that they themselves will participate in the stealing of items. When this happens to a large enough degree, the people revolt, and a new government is established with the aim of protecting people's items from being stolen again. However, if the government succeeds in protecting people's items from being stolen (property rights), people will freely trade and work hard to invent better ways to produce even more items (innovation).

The wealthiest individuals or nations are those who hold the largest number of items that people desire. Hence, whoever owns the most money (the item most people want) is the wealthiest and has the greatest freedom in whom they trade with and what they trade for. As mentioned earlier, historically, money was identified by humans to be gold, and whichever country, business, or person owned the most gold had the most power. One of the reasons gold was desired by everyone is because gold (money) is the most difficult item to increase its supply. One can relatively easily work to increase the supply of other items like apples, shoes, homes, clothes, etc., but gold is painfully difficult to find and acquire. Therefore, as people innovate and increase the world's supply of all items, gold's supply barely increases at all, giving people the ability to trade gold for more and more items, having a deflationary effect, or, in other words, people who owned gold saw their trading (purchasing) power increase over time.

Up until the late 1800s, the economy functioned very simply: people worked to earn gold so they could trade with whomever for whatever, and debt was seldom used because why risk the uncertainty of trading for a future item when you can simply save gold and watch your purchasing power grow over time. If history had stopped there, "the financial system" would not be very interesting, and the average individual would not need to know much about finance to make sound financial choices. Financial life would be intuitive: work hard, save money, and be part of a nation-state that best protects your items (property) from theft.

Toward the end of the 1800s, the system began to change in a big way. At that time, you could trade in your gold for pieces of paper (currency) that stated you had a claim on a certain amount of gold. This was very convenient in that you did not have to carry chunks of metal around, but rather pieces of paper that were as

good as gold. So convenient, in fact, that eventually, everyone began using paper backed by gold for trading purposes, and most of the real gold was held in the custody of banks. Unfortunately, what started out as a good idea was eventually corrupted. Under this system, which we refer to as "the gold standard," governments learned they could demand banks to loan them paper (which represented real gold) far beyond the amount of actual gold banks held in custody. As briefly discussed in the debt section above, this effectively allowed governments to borrow large quantities from the future's supply of gold to fund expenses today. Borrowing gold from the future far in excess of what you can produce to replenish it led to huge shortages in the supply of gold. Bank runs became the inevitable result where people rushed to be first in line to exchange their paper for gold, knowing the bank did not have enough gold to cover what they originally deposited *(see appendix below for an example). Those who were unable to pull their money out in time ended up being the ones who ultimately footed the bill for all of those government expenses.

As a result of persistent bank runs, the government finally decreed that the exchange of paper and gold was no longer a constant rate and that paper would become a new item of its own right, not tied to any other item. This essentially meant the government converted paper, which represented gold, into a brand-new item type or good called fiat currency. Interestingly, the name "fiat" in Latin literally means "by decree."

The Financial System Today

This brings us to the system we have today, called the fiat system or fiat standard, as opposed to the gold standard of previous decades. With gold being the underlying item of the old system, you were unable to trade in excess of the supply of gold (both current supply and future supply using debt) without causing bank runs. But in the new system, the supply of fiat paper or "dollars" has no physical limit. Like all items, the supply of gold is determined by how difficult it is to produce, but the supply of dollars is determined by a group of people called the "central bank," or, more specifically, in the US, the Federal Reserve. Now if the government wants to take out a loan, the central bank does not need any gold to do so. They can create the dollars at no cost and hand them over to the government. If the government is unable to produce or trade for enough dollars to pay back the central bank in the future, then they can simply ask for another loan to pay back their old one. They have currently done this repeatedly over the past century, continuing to take out loans to pay off old ones, borrowing from the central bank's seemingly *infinite* future supply.

Of course, this is not without consequences. Someone always has to pay for this debt. With a bank run, it is clear who foots the bill for unpaid debts: the poor soul who arrived last at the bank to withdraw their money. In the fiat system, however, the person footing the bill is not so easily recognized. The debt is instead paid by anyone holding dollars through a decrease in purchasing power, aka inflation. Remember, the reason people in the past gravitated towards gold as money was that as the supply of all other goods increased, gold's supply stayed nearly constant due to its difficulty to produce, meaning your ability to trade grew as you held it. But

when you use money like fiat that grows in supply quickly, the opposite effect happens: your trading power decreases.

In the US specifically, what used to cost $1 in 1913 now costs $26 dollars today because the supply of money has increased so dramatically. The unpaid debt of the past century has been so large that anyone holding dollars during that time has footed the bill, using 96% of their wealth! The US government is one of the largest debtors to the Federal Reserve as of March 2023, with $31 trillion dollars of debt that needs to be repaid; however, there are only 21 trillion dollars of current supply. Essentially, not even all the dollars in existence today would be enough to pay off the national debt. If the central bank decided not to issue any more loans and hold the supply of dollars constant forever, then it would take the US 8 years of only paying off debt and nothing else to bring the outstanding debt to 0 (US tax revenue is roughly $4 trillion per year).

Conclusion

Now you may ask, why would anyone save in fiat knowing this? The answer is simply that they mistake fiat money for real money. The average person still thinks of money as if it is like gold, but in reality, **fiat** is ***debt*** owed to the central bank. This is the primary point I want to get across in the article, and understanding this simple idea can change the entire way you view the global financial system and how you personally choose to invest. When you hold a dollar, you are trusting the central bank to the management of its supply. If you believe the central bank will hold the supply of money constant, then you would be fine saving in fiat. However, if you believe the central bank will increase the supply of money though issuing more debt, then you will want to save other items that are more resistant to supply changes, like stocks, gold, real estate, or Bitcoin. This is why in today's economy, you can see counterintuitive behavior. When employment statistics go down, the stock market goes up, or if employment goes up, the stock market goes down. Financially savvy people understand that the only signal worth paying attention to is what is going on with the central bank and its supply of money. True indicators of economic productivity, like employment, become less important.

In today's financial system, be wary of evaluating value in terms of fiat without first understanding what is happening with the supply of fiat. If you see the stock market double in value, don't assume it's because every business just got twice as valuable. It may be possible that the money supply simply doubled instead (the stock market gains in 2020 is an example of this), making it seem as if every company became more productive. Evaluate each business based upon its productive output. Remember, the only way to increase abundance for humanity is through more efficient work, producing more items per unit of effort. Economic value is created through increased productivity, not debt.

Appendix:

To help illustrate the issuance of debt, imagine if you had one bar of gold in the year 1900, you could take that gold to a bank and exchange it for $20.67 USD paper. As a result, today's supply of items would be the following:

Supply: Gold bars = 1, USD = $20.67

However, unknown to you, the bank also decided to issue debt and lend another $20.67 to someone else in exchange for one bar of gold in the future. After the debt is issued, today's supply of items becomes:

New Supply: Gold bars = 1, USD = $41.34

Due to the bank's actions, the quantity of USD doubled, but nothing was physically traded, and no work was done (see Scarcity, trade, and work above). The only way this is possible is if the second person manages to produce one bar of gold in the future. However, if they are unable to produce a gold bar, then USD was created for free, and someone must do the work to produce it. Once you realize the bank will not be paid back the gold they are owed, you quickly rush to the bank and attempt to trade $20.67 USD for your gold bar. However, once you get there, you realize someone else beat you to it and traded in their USD before you, and you are left losing one gold bar. You were the one who ended up paying for that new USD created by the bank.