

The background of the entire page is a close-up photograph of several stacks of gold coins. The coins are stacked vertically, and the lighting is warm, highlighting the metallic texture and the ridges on the edges of the coins. The stacks are arranged in a way that creates a sense of depth and abundance.

Why Do We Use *MONEY?*

by Robert P. Murphy

ALTHOUGH IT'S A PRETTY BASIC QUESTION, it's worth asking: *Why do we use money?* Once we think through the answer, it becomes clear just how awful our current monetary system is.

For those wanting a comprehensive treatment, I refer you to our book (co-authored with Carlos), *How Privatized Banking Real-*



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ly Works. I also refer you to our new podcast, the Lara-Murphy Show, and in particular episodes 15 and 16 where we discuss how governments historically have used inflation to cover their budget shortfalls. (Everything is available at our new website, www.Lara-Murphy.com)

But for our purposes in this article, let me cover the essentials. Again I ask: Why do we use money? This is such a critical institution

in our lives, and yet most people really have no idea. As we'll see, even most *economists* can't give the kind of deep answer that Austrian thinkers such as Ludwig von Mises provided.

The Shortcoming of Direct Barter

The typical way economists motivate a discussion of the *why* of money goes like this: Direct exchanges (sometimes called barter) are certainly a great thing, which provide win-win improvements on the original distribution of goods. However, the "gains from trade" in this fashion are limited.

For example, there couldn't be much specialization and division of labor if everybody were restricted to direct exchanges of goods or services that they planned on using themselves. Imagine a dentist trying to survive in a world without money. If he wanted meat, he'd have to find a butcher with a toothache. And if the dentist wanted a house, he'd have to find a team of carpenters, roofers, and bricklayers who all needed their teeth cleaned right then.

As these silly scenarios illustrate, we obviously need some way of distributing the trading of goods and services among different people, and across time. In other words, we need a way to split up sales and purchases into separate transactions. Rather than the

dentist needing to find the exact butcher and bricklayer who need dental work, with the use of money the dentist can simply sell his services to the highest bidders, and then at a later date the dentist can take his pile of money and go buy whatever *he* needs from the community.

The Ivy League Leaves Us Hanging

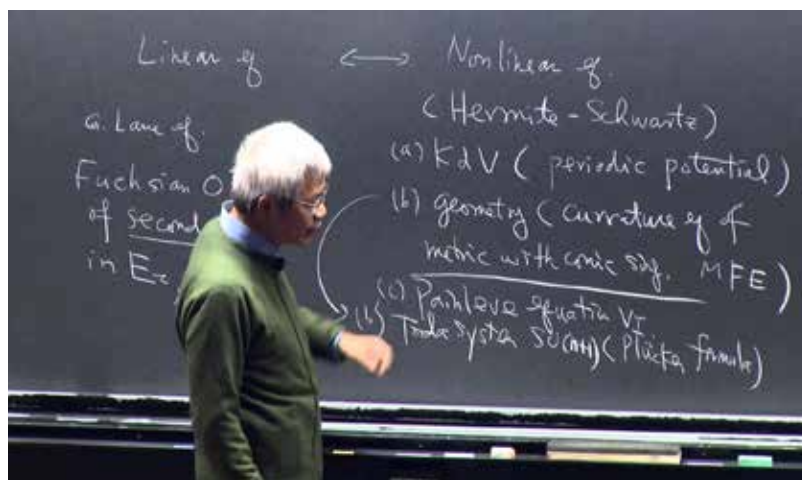
As I said earlier, the above analysis about the dentist is not unique to the Austrian School; *all* intro economics textbooks would give some story about the limitations of direct barter. Yet ironically, if you go on to advanced study at the doctoral level, even at elite universities, you end up using mathematical models of the economy in which *money serves no purpose*.

Let me make sure you understand just *how* artificial and unrealistic these typical mainstream models are. For example, I remember at NYU in my PhD program we had a test question in macro that asked us to imagine a lone individual on a tropical island, where the only wealth was a coconut tree that shot out coconuts in a predictable pattern over time. The coconuts could not be physically carried forward into the next period (they would rot), and there was nothing the man could do to plant more trees or otherwise in-

crease production in the future. The question also gave us the mathematical form of the man's "utility function," which specified how many "utils" he got from a specified stream of coconut consumption over time. In this setting, the exam question asked, what would be the equilibrium real rate of interest?

I hope the reader can appreciate my perplexity at this question, as I sat there in my exam. What in the heck did it even mean to talk about an interest rate, on an island with one guy, one tree, and no money?!

To end your suspense, the answer they were



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looking for was something like this: In each period, the interest rate had to be such that the man, when maximizing his utility, didn't want to "sell" his coconuts and then use the

proceeds to earn interest and “buy” more coconuts down the road. In other words, since we knew that (by construction) it was impossible for the guy to do anything other than to consume his endowment of coconuts each period, then in equilibrium it had to be the case that market prices were consistent with the guy voluntarily choosing precisely that course of action.

Once you learn the tricks of the trade and how to think like a mathematical economist,



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this type of approach is actually logical and has a certain elegance. However, I am sure most people can recognize that a model like this probably does not shed much light on “optimal Fed policy.” Similarly, other macro models featured one “representative agent” who was a single individual who lived for-

ever and consumed one good. In this type of world, there is no need for money, since there aren’t even other people with whom to trade—we can’t tell the story about the dentist and the butcher, since there aren’t dentists and butchers in a world consisting of one “representative agent.”

The Austrians Have the Insight

As in other arenas, here too Ludwig von Mises—and his followers in the Austrian tradition—is a giant among men. He recognized that the crucial role of money prices was that they allowed entrepreneurs to engage in *economic calculation*.

As Mises (and Hayek) pointed out during the famous Socialist Calculation Debate (which occurred in the first half of the 20th century), the central planners in a socialist government can’t come up with an efficient use of society’s scarce resources. Even if we stipulate, for the sake of argument, that the central planners are equipped with all of the state-of-the-art technical knowledge, and have the best of intentions, nonetheless they can’t use any procedure to determine whether their production plans entail a sensible use of resources.

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To see the difficulties involved, consider that there are thousands of different ways to produce and deliver specific goods to

specific consumers. For example, even if we take it as a given that *some* oranges should be produced and distributed to individuals in Alaska, there are many different ways to do so. For example, the oranges could be grown in Florida, or in California, or even in a greenhouse in Alaska for that matter.

And if the oranges *are* grown in Florida, there are different ways of transporting them to Alaska, involving trains, planes, or even mules.

The crucial point is that it's not a mere matter of engineering or agronomy to answer these questions. There are various ways it is physically *possible* to make oranges and put them into the hands of Alaskans. But in order to know *how* this should be done—including the question of how many oranges we produce and move—we must consider the *economic* consequences. Specifically, we need to consider the tradeoffs involved.

If, for example, we moved a single crate of oranges from Florida to Alaska on a supersonic jet, that would probably be wasteful or “inefficient.” But the reason is that there are more important things to do with a supersonic jet. Yet “importance” in this context is something we can only discover in light of both technological facts and subjective value judgments made by the consumers.

Economic Calculation and Money

What Mises demonstrated was that these almost philosophical conundrums are solved seemingly effortlessly, day in and day out, through the use of money prices. Accountants can tell an entrepreneur how much was



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spent on “inputs,” and how much revenue was collected from the sale of the product or service, during a given period. If revenues exceeded expenses, then that's the market's way of saying, “You have deployed scarce resources in an efficient manner.”

In contrast, if a business operation is losing money, it means that those resources are more urgently desired elsewhere in the economy. That's why *other* entrepreneurs are bidding up their prices to levels that make it unprofitable to use the resources in the losing

operation. To repeat, whether a given business venture is profitable or unprofitable is *not* a technical or scientific question—it can only be answered if we have genuine market prices to associate with both the inputs and the outputs.

purchasing power of money has drastically changed during the production period. This is why Mises and his followers agreed with the classical liberal respect for “sound money,” meaning money that was protected from government debasement.



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Sound Money

In this context, we see then that the social function of money is to facilitate economic calculation. Money *cannot* do this if its future purchasing power is subject to violent swings because of political intervention. It makes little sense to compare the input and output prices for a given operation, if the

full power of voluntary market solutions to the production of a sound money that has desirable properties such as a predictable purchasing power. We would shudder to hand over control of science or the press to a political institution, and thus we should not let a group of Federal Reserve officials control our monetary destiny.



Conclusion

If we don't understand the social function of money, then we can't appreciate just how badly our current monetary system serves us. Rather than trying (without success) to ensure “full employment” or to hit an arbitrary rate of annual dilution of purchasing power (also known as a price “inflation target”), the government should get out of the business of money altogether.

By returning money to the private sector, where it originated, we can bring