

CAYMAN FINANCIAL REVIEW

FIRST QUARTER 2012

ISSUE NO. 26

THE FUTURE OF MONEY

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January 11, 2012

Will the euro last? The global debt crisis is leading to increased money chaos. Europe is in the worst shape, but the debt and money problems are to be found almost everywhere on the globe. As an economist who has often written about money, I feel a bit of embarrassment about how little progress we have made with “money”.

One marvels at all the human genius embodied in a Blackberry and an iPad and other electronic communication devices. Yet, when it comes to money, increasing numbers of people around the world are buying gold coins, viewing them as the ultimate money when government monetary systems collapse.

We know that gold coins have been used as money for at least 3,000 years. If the communications industry had made no more progress than the “money” industry, people might be hoarding tom-toms or other primitive drums to use to communicate when the end comes.

As bizarre as it may seem, now there is a real danger that the world’s monetary system may break down, and that most of the fiat currencies, including the euro, US dollar and Japanese Yen, will have little value. In this issue of the Cayman Financial Review, we look at the future of money from a variety of perspectives.

Even primitive peoples understood that using “money” was much more efficient than barter. Shells and other items were used as money before the advent of minted coins. Money is generally recognised to have three characteristics.

The first being a medium of exchange, the second being a unit of account, and the third being a store of value. A gold or silver coin can fulfil these three functions quite well. Because of the high value of gold, it is not possible to make a coin small enough to serve as practical money for purchasing very small quantities of inexpensive items, which is why coins of lesser intrinsic value are normally used for such purposes.

For large and expensive purchases, coins are heavy and somewhat impractical. The solution was to develop paper currencies often, but not always, backed by real assets such as gold or silver.

The Chinese were the first to use paper money as far back as the 7th century.

Governments quickly learned that they did not have to have full gold or other real asset backing for their currencies in order for them to retain full value; hence, the development of the modern fiat currencies issued by almost all governments.

The reason that a government issued fiat currency has value is the belief by the users of the currency that the state using its police powers can extract real assets from the population from taxation or other means to pay the debt represented by the banknote.

The breakdown in the system occurs where the government prints or issues more debt than realistically the tax system can produce to cover the interest and principle, and other government expenditures.

This is precisely what we are seeing in Greece today. The uncomfortable fact is that it is not only Greece which has maxed out on its taxing power, but much of the rest of Europe is at or close to the same point. A country is maxed out on its taxing power when further tax rate increases are likely to be offset by further decreases in economic activity, and people finding legal or illegal ways around the tax rate increase.

As the debt burden rises, government bond buyers demand higher and higher interest rates to offset the additional risk, until finally it results an un-financeable spiral. The explicit government liabilities of most major governments have reached or are close to reaching this point, and when implicit medical and pension promises are included, all are technically bankrupt.

The late great Austrian economist, FA Hayek, and others argued the only solution is for governments to get out of the money producing business because ultimately governments always debase the money. So where do we go from here? That is the subject of several of the articles in this issue of Cayman Financial Review.

More than a dozen years ago, I wrote a book, “The End of Money, and the Struggle for Financial Privacy”, where I argued that virtually all future monetary transactions would be by electronic means, and this would be a great boon to mankind. Unfortunately, incompetent governments have managed to thwart this progress by instituting destructive anti-money laundering laws, regulations and tax measures, none of which can meet a real cost-benefit test.

The result is large numbers of people are being driven back to not only paper money but now gold and silver coins. Real improvements in money will only occur when people find ways to free themselves from the monetary yokes of government.