Money as a medium of exchange

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Trade between people

People are social creatures

We cannot do everything ourselves

We trade with each other

Barter

Exchange of goods for other goods

Barter - problem

Double coincidence of wants

A has a goat for sale, wants a sheep

B has a sheep for sale, wants a goat

A and B meet - they trade

Barter - problem

Double coincidence of wants

A has a goat for sale, wants a sheep

B has a sheep for sale, wants a cow

A and B meet - no trade!

Bottom line

Barter: I want your goat. Will you take my sheep?

Money: I offer you \$ for your goat. I don't care if you do or do not want to buy my sheep.

Money way more efficient!

Intrinsic value not key

Kiyotaki & Wright (1986), "On Money as a Medium of Exchange", Journal of Political Economy

 $trust \rightarrow positive value$

KW model

Three types, meeting randomly

- Butcher: has meat, wants raisins
- Baker: has bread, wants meat
- Farmer: has raisins, wants bread

No "double coincidence of wants"

Frictions

Storage costs

$$\infty = C_{meat} > C_{bread} > C_{raisins} > 0$$

Exchange of goods incurs a small cost

Random meetings

$$\infty = C_{meat} > C_{bread} > C_{raisins} > 0$$

Butcher meets baker

- BA wants meat, BU raisins
- lacksquare $C_{bread} < C_{meat}$
- trade

Random meetings

$$\infty = C_{meat} > C_{bread} > C_{raisins} > 0$$

Baker meets farmer

- F wants bread, BA meat
- lacksquare $C_{raisins} < C_{bread}$
- trade

Random meetings

$$\infty = C_{meat} > C_{bread} > C_{raisins} > 0$$

Farmer meets butcher

- F wants bread, BU raisins
- lacksquare $C_{raisins} < C_{meat}$
- no trade (F doesn't want to!)

Money

$$C_{raisins} > C_{money} > 0$$

Half of each type has money

But money has no intrinsic value

Two outcomes

Autarky

2 Trade

Equilibrium with autarky

Same as with barter

Money is worthless

Nobody wants it

Never used in exchange

Equilibrium with trade

People believe that money has value

Equilibrium with trade

$$C_{raisins} > C_{money} > 0$$

F w/out money meets BU w/ money

- lacksquare $C_{money} < C_{raisins}$
- trade F takes money
- F trusts that BA will accept it

$\mathsf{Trust} o \mathsf{positive}$ value

I accept your token in exchange for my good, because I trust that my supplier will accept that token from me.

Fiat money

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"Fiat lux" = "let there be light"
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God

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"Fiat money" = "let there be money"
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Government

Intrinsic value of USD

Without U.S. gov't - none

U.S. gov't ensures demand for \$ > 0 TAXES

Features of good money

scarce Easy to store

difficult to forge Divisible

Easy to trade