

Re: Interesting Economics Questions

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- *From:* parkinsonandy@xxxxxxxxxx
 - *Date:* 7 May 2005 13:26:57 -0700
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555666hahaha wrote:

- > Forgive me for not knowing as much as you think I should about
- > economics, but I have a few ideas I'd like the higher forms of life
- > here to comment on.
- >
- > The price of everything is going up all the time, which prompts 2
- > questions:
- >
- > 1 – If minimum wage keeps going up with the cost of living increase,
- > does that mean that there will come a day when this wage will be
- > \$100.00 per hour? And then even more ridiculously high wages in the
- > farther future? Are personal cars and trucks one day going to cost
- > millions of dollars each?
- >

This has been fairly well covered in other answers – in essence, if inflation continues, then yes. But the key concept here is the 'real' (inflation-adjusted) value of things. Real = nominal – inflation. If inflation is 2% this year, and my wage goes up 2% as well, my real wage is unchanged because I can buy the same amount of goods and services as I did last year. Real wages do in fact increase over time because peoples' productivity rises, as an input of one man-hour into production produces more goods (in real terms).

- > 2 – Why do prices go up anyway? The way I figure, everything most
- > people buy everyday, can ultimately be traced to large factories,
- owned
- > by fat cats or corporations that are never satisfied with their
- current
- > profit margin. Aside from rich fat cats that are never satisfied
- with
- > their profit increases, what else am I missing from this picture?
- > =====
- >

In the long term, prices go up because the quantity of real money balances rises.

In theory, the Fed (or other monetary authority such as the Bank of England) could target zero inflation, and the price level wouldn't rise

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if they achieved that. They don't for a number of reasons:

- nominal interest rates can't fall below zero, so if you need to cut real interest rates to stimulate the economy, you would hit that lower bound fairly quickly. The Fed cut interest rates aggressively after the dotcom crash, and achieved negative real interest rates (where the nominal interest rate is less than the rate of inflation). The Bank of Japan would have liked to cut real interest rates during the 1990s, but couldn't because the nominal interest rate was already at zero, but the real interest rate was positive because they were experiencing deflation (falling prices).
- related, if you get into deflation, you're a bit screwed for the reason above (see Japan), and so it's less likely you're going to accidentally get into deflation if you target 2% than if you target 0%.
- there's a lot of nominal wage stickiness downwards (people will resist cuts in their nominal wage), but people are less resistant to getting below–inflation wage increases even where the real wage cut would be the same in each situation. Having some inflation therefore better allows for some adjustment of real wages.
- the government gets some revenue (seignorage) from printing money, so essentially inflation is a tax on money balances. But that's a very minor component of government revenue nowadays and no responsible government increases inflation for the revenue, otherwise you get into hyperinflation.

- > I was intrigued by a discussion I happened upon a year ago, which said
- > that the idea behind money's "worth", originally, was because it was
- > backed up by gold at the treasury. The discussion went on to point
- > out, correctly I believe, that gold's relationship to the dollar
- notes
- > in your wallet is extremely superficial, and it's functionality has
- > more to do with the seller BELIEVING this money has actual worth (as
- he
- > takes the money from you), than in the money actually POSSESSING
- worth.
- > In other words, today's money is not worth the paper it is printed
- on.
- > This of course is obvious, but i cannot help but think of how
- deceitful
- > this scheme really is. To me, it boils down to this: that the value
- of
- > money is completely determined by the seller of goods you wish to
- > purchase from, and has absolutely NOTHING to do with possessing
- actual
- > worth. Further, the seller's appraisal of the money's worth, will be
- > determined by what HE thinks he can do with it. In other words,
- money
- > has no ACTUAL value, as it originally did, and thus has only illusory
- > value. Comments?
- >

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Money that isn't backed by any commodity is called fiat money, and we have seen it evolving in many societies. In a much simplified form, before money people had to barter to exchange goods, so I would swap my two goats for your cow. Obviously this is inconvenient because there has to be a double coincidence of wants – in order to buy a cow off someone, I have to find someone with a cow to sell who also wants my two goats. Some form of commodity money generally naturally arises out of this. Gold is the classic commodity money; it has only small intrinsic value, but became accepted as a medium of exchange, so I could sell my two goats to someone for gold, and then buy a cow of another person with gold. In prisoner of war camps, cigarettes were often used as currency even among those who did not smoke; on the Pacific Island of Yap, they used stone wheels up to 12 feet in diameter. Obviously this becomes inconvenient and the next natural progression is to exchanging title deeds to gold – these title deeds were the earliest banknotes. (Indeed on Yap, it became common for the new "owner" of the stone wheel not to take possession physically and instead simply accept a claim to the wheel which could then be traded on.)

Fiat money becomes a natural progression from that. Government may get involved initially to produce coins of a set weight and purity to facilitate exchange. Gold certificates are the next step. If people believe the government will not renege on its promise to swap gold for the paper bills, the bills are 'good as gold'. These bills become the monetary standard. Eventually the gold backing becomes irrelevant – no-one ever exchanges their bills for gold, and they have value precisely because everyone believes they have value. And if everyone believes they have value, they do have value (because you can go out with your banknote or dollar bill and exchange it for 'real goods' – you could even buy gold if you wanted).

So, even when money is not backed by gold or some other commodity, it is valuable because it is valued by others. (In economics jargon, it serves as a medium of exchange, a store of value and a unit of account.) It's just a social convention (self-reinforcing equilibrium) that aids trade. Fiat money has worth precisely because you can buy goods and services with it. The value isn't illusory, as long as other people also believe it has value. One example of a situation when this breaks down is during hyperinflation (more on that later).

- > Forgive me if you've heard this question before, but...
- >
- > What would be the economic consequences if the Treasury, only one time,
- > sent a stack of \$100 bills, say, \$500,000 worth, to every family
- > currently on welfare? How would this negatively impact the economy if
- > familie currently on welfare were suddenly able to pay off all debts,
- > buy cars and houses for themselves, and send their kids to private
- > schools? I see lots of businesses making profits and thus growing, and

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- > I cannot foresee any disasters.
- >
- > As you answer, ask yourself what you thought President Bush was up to,
- > when he sent that \$300 tax-refund check to so many blue collar workers
- > back in 2000 (2001?). The check was drawn on the "U.S. Treasury."
- >
- > If that didn't hurt the economy, why couldn't they have written the
- > check for \$300,000 for each person, instead of \$300?
- >

First, because Bush's tax rebate was actually of money they'd already taken in taxes. In order to send \$500,000 to each household, you'd have to print an awful lot of money. But that doesn't change the amount of goods and services produced in the economy (economists say that in the long run, money is neutral – i.e. it doesn't change any real quantities). Thus, there's a lot more money out there chasing the same number of 'real' items, and we simply get inflation. When the government prints money like this, we get hyperinflation – see <http://en.wikipedia.org/wiki/Hyperinflation> – Germany experienced hyperinflation in 1923 due to the government printing money to meet its obligations. With massive amounts of money chasing the same number of goods, prices rise by orders of magnitude. Money gets so worthless that it is debauched – it no longer acts as a store of value, and its function as a medium of exchange is severely threatened.

- > And finally, if it is true that fake money hurts the person who
- > discovers it and hands it over to authorities (or throws it away,
- etc),
- > let us suppose one that is so good that it never is detected? Would
- > this good fake still be hurting the economy as it is passed back and
- > forth between businesses, banks and customers?
- >

Well, it hurts the economy to the extent that (a) the government does not gain seignorage from that money, so has to make up the revenue from taxes, and (b) increases the monetary base (if never detected) so causes a decrease in the real value of money. Obviously these effects are very minor when compared to the size of the economy, but if fake money was prevalent these effects would be large. Plus, if fake money was prevalent, people may lose their confidence that money has value.

- > If it isn't hurting anybody in the chain of people who pass it back
- and
- > forth in the sincere belief that it is real, then this seems to
- cement
- > my earlier contention that modern American currency has no actual
- worth
- > itself, nor is it's being backed up by gold reserves sufficient to
- > impart actual worth, but that the money is believed falsely by

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sellers

- > of goods to have innate worth. They accept the money in your pocket
- > solely because they know other businesses will sell them products in
- > exchange, and for NO other reason. Is not then such worthless money
- a
- > very deceitful thing?

I don't see how it's deceitful. People generally know that you can't go to the bank and demand gold for your banknote, but it is a feature of all modern economies. Although it doesn't have intrinsic value, it does have value; you cannot say money is worthless, otherwise you would willingly go and throw it from the rooftops. It's a self-coordinating equilibrium; as long as the monetary authorities don't do anything irresponsible (such as printing vast quantities of money and causing hyperinflation), money does have value and that's why it's of use.

Hope that's useful, and I hope my economics is clear for those of you without economics knowledge.

Andy

- ***Follow-Ups:***

- ◆ ***Re: Interesting Economics Questions***

- ◆ *From:* The Trucker

- ***References:***

- ◆ ***Interesting Economics Questions***

- ◆ *From:* 555666hahaha

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