

How it all started: a brief history of money

Why do we need money at all? The barter system had plenty of attractions – it can't be taxed, for one thing. But it's inefficient. Say I sell spades, and you sell dressing gowns. For any deal to happen you must want a spade at just the moment I happen to want a dressing gown. So even the most primitive societies developed some kind of payment system, or money, that was accepted by everyone in exchange for goods and services.

Money has to have two qualities. It must be portable and it must have a purchasing power that lasts, so it can be used at a later stage. Shells, cocoa beans, even feathers have been used over the years as money. At one stage Roman soldiers were paid in salt, from where we derive the word 'salary'. These early forms of money were 'commodity money'.

Gold and silver were widely used. Their rarity gave them value – a great deal of worth could be stored in a single gold coin – as did their immutability. Gold doesn't tarnish. You could dig up a gold coin buried in the ground a thousand years ago and it would be more or less intact. And just as gold preserves over time, so does its purchasing power. An ounce of gold would have bought a Roman Senator a jolly decent toga and perhaps a pair of sandals; today the sterling equivalent (£500 or so) would buy your local MP a respectable suit and shoes.

To facilitate trade, gold was turned into coins of a certified weight and purity by goldsmiths. The goldsmiths, who had built vaults to store their gold safely, also began to store the gold of their fellow townsmen, issuing a certificate as receipt for the gold deposited. Over time these certificates were used in the marketplace as if they were the gold itself. World trade had slowly moved from a 'commodity money' to a 'representative money'.

Seeing that very few depositors ever removed their actual gold, instead using their certificates for trade, goldsmiths realised they could make money by lending out certificates against depositors' gold. Despite the inherent duplicity in the scheme – lending what is not yours to lend - it worked. The depositors did not lose anything. As long as there was no bank run, their gold was all still safe in the goldsmith's vault.

Depositors, however, soon wanted their share. Rather than taking back their gold, the depositors simply demanded that the goldsmith, now in effect their banker, pay them a share of the interest. The goldsmith paid one rate on deposits and then lent at a higher rate.

But in times of panic some borrowers would demand their real gold back, instead of the paper certificates. Before long, you had the dreaded run on the bank, with the banker not having enough gold and silver to redeem all the paper he had put out. It would have been straightforward to outlaw this new lending practice, but the large volumes of credit the bankers had created had become vital to the success of European commercial expansion, so, instead, the practice was legalized and regulated. The monetary system had moved on from representative to debt.

Bankers agreed limits on the amount of loan money that could be lent out, limits still much larger than the amount of gold and silver on deposit. Usually, the ratio was nine loaned units to one actual unit in gold and these regulations were enforced by

surprise inspections. It was also arranged that, in the event of a run, central banks would support local banks with emergency gold. Only if there were runs on a lot of banks simultaneously would the bankers' credit bubble burst and the system come crashing down.

The root of our current financial crisis

Over the twentieth century, this fractional reserve system, where you need only hold a fraction of the money you lend out, became the dominant money system of the world. But, at the same time, the fraction of gold backing the paper money steadily shrunk. With the Bretton Woods agreement of 1944, which established monetary order between the major industrial nations after World War Two, the USA was the only nation left with a currency backed by gold, and the dollar became the global reserve currency. But in 1971, under pressure from the French, who were demanding gold instead of dollars, and faced with the rising cost of the Vietnam War, President Nixon removed this backing. Now, for the first time in history, no currency on the planet, nor any small fraction of any currency, was backed by anything tangible. The basic nature of money had changed again.

We were now in an era where money is money by government edict - by the law. In the past, people had the choice to refuse privately created bank credit notes, but now legal tender laws declare that citizens must accept this government edict money - or fiat currency - as payment. Their value is determined by how they trade against other fiat currencies on international currency markets. Belief in the integrity and competence of the central banks and government that issue a currency is essential to its success.

And that's where the problem lies. As Winston Churchill put it: "All previous attempts to base money solely on intangibles such as credit or government edict or fiat have ended in inflationary panic and disaster."

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