

Money: Banking, Spending, Saving, and Investing
The Creation of Money

Case Study: Cigarettes as Money

Page 1 of 2

The main problem in a barter economy is the need for double coincidence of wants. I have got cheese and I want chocolate. That means I have to find a trading partner who has chocolate and wants cheese and you can spend a lot of time looking. In order to reduce the search costs, people eventually begin to accept an exchange almost any good that is portable, durable, divisible, standardizable, and in broad enough demand that people know that they can rid of it anytime they want to trade for something else. That is, what I'll do is, I'll trade my cheese for salt because chances are I'll eventually find somebody who has chocolate and is willing to accept salt in exchange because he knows he can turn around and trade that salt for what he wants very shortly. This is how commodity money is brought into being. People begin to use some commodity as a medium of exchange in order to reduce search costs and eventually some commodity begins to circulate that is convenient to use and has all the good properties of money.

That brings up the question, "What can you do with you cigarettes after you quit smoking?" Well, if you are in a German prisoner of war camp during World War II, you might have used cigarettes for money. Cigarettes began to circulate as money, quite naturally, in order to solve the problem of double coincidence of wants. The Red Cross brought care packages in to the prisoner of war camps and gave prisoners little packages that contained chocolate, cheese, other goods, and cigarettes. If you did not want cigarettes, and you did not want chocolate, you could make a trade. If you had cheese and wanted chocolate, you could trade your cheese for cigarettes, knowing that eventually you would be able to trade the cigarettes for chocolate when you found the right trading partner. Cigarettes began to circulate as money, the medium of exchange. They also began to fulfill the other roles that money plays, a unit of account. That is, prices began to be quoted in cigarettes. It cost 80 cigarettes to buy a shirt or 2 cigarettes to get a shirt laundered. Also, cigarettes began to be used as a store of value. People would hoard cigarettes as a kind of savings and spend them whenever they needed to buy something. So cigarettes were a kind of commodity money, circulating, being saved, and being used as a unit of account.

What can we learn from the experience of German POW camps? First if all, they were not unique by any means. We have prisons now in the United States in which cigarettes circulate as money all the time because there are not dollar bills available there. To solve the double coincidence of wants, prisoners use cigarettes as money. Even people who do not smoke cigarettes will accept cigarettes in exchange because they know they can spend them whenever they want something. Also, cigarettes circulated in the countries of the former Soviet Union after the collapse of the ruble in the early 1990's because the government was printing so much money and sparking inflation. People were afraid to hold rubles and therefore an underground economy developed in which cigarettes were the commodity money and began to be used as a unit of account, a store of value, and a medium of exchange.

Anytime people find that commodities serve them better as money than the actual paper money of the government, they will shift and use commodities instead. This raises the prospect that even in the United States we could decide to use commodity money instead of the Federal Reserve notes. That could happen any time. The only reason we are so committed to Federal Reserve notes is, first of all, they are very convenient to use because everyone will accept them everywhere. The reason that is true is, first of all, they are legal tender. The government says that any contract you settle with dollars is settled and therefore, you cannot be sued for breach for non-payment. The second thing is, the Internal Revenue Service accepts payment of taxes only in dollars, so you have to have dollars to pay your taxes and that creates a demand for that paper money. However, if you and I are doing business among each other, we might settle our account in any way that is convenient for us to do so. So, why not commodity money beginning to arise in the United States today? Probably not cigarettes, because cigarettes are not as convenient as dollars. What about frequent flyer miles or cellular telephone minutes? Don't these have all the same properties as money? They are measured in numbers. They are very easy to carry around. They can be stored on a computer chip, on a magnetized strip, on a card. They work just like money except they have the added value that they are inherently valuable. They are good for their own sake. They are commodity money as opposed to the fiat money, which has value because the government says that it does. You can imagine a money system beginning to be organized around frequent flyer miles or cellular telephone minutes.

The Fed would probably find this to be an undesirable development because it is going to be harder to control the money supply when the money supply is effectively being controlled by airlines and telecommunications companies,

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Page 2 of 2

and being controlled by private operations. Because of this, the Fed then might demand that those different kinds of commodities be controlled in a particular way so as to prevent inflation and instability in the economy. That is, the Fed would get involved in the business of those particular commodities. So that is one thing, the loss of control of the money supply is one fear that comes with a shift to a commodity system.

The other thing is that once transactions begin to occur in terms of those commodities they are a little bit harder to tax. So the Internal Revenue Service would want to get involved in this development as well. You can imagine, it makes very little difference how your bank account is measured. Whether those numbers represent dollars or they represent frequent flyer miles, the system would work exactly the same either way. The commodity money is always going to be appealing because it represents something of real and final value.

The Fed has to watch out because a private money system can pop up any time just like the cigarettes began to create a money system after World War II, and just like the cigarettes began to be used as money when the Soviet Union fell apart. Anytime a commodity money system can arise if people find it easy and convenient to use.