



Mitchell's Musings 9-2-13: Bits of Wisdom

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I'm going to refer to Bitcoins below, but let's start with an observation. *Monetary policy is important.* No one really doubts that proposition. As we noted in an earlier musing, much heat is being generated by the alleged competition for chair of the Federal Reserve (when Ben Bernanke's term ends) between Janet Yellen and Larry Summers. Monetary policy is particularly important in the U.S. at present because with Congress gridlocked and a debt ceiling deadline looming, there is no effective U.S. fiscal policy.

For reasons that seem embedded in American history, there have long been controversies over money that seem not to have counterparts in most other countries. For example, there was the free silver movement in the late 19th century – a battle essentially over whether the U.S. should have a gold-backed or silver-backed currency. When the U.S. temporarily departed from gold under Franklin Roosevelt and when it permanently departed from gold under Richard Nixon, there was more controversy. Money nowadays is backed by nothing, a fact that seems to irk many people in the U.S. and gives rise to conspiracy theories. In contrast, the euro is backed by nothing and no one in Europe seems upset. The pound is backed by nothing and no one in the U.K. seems to care. The yen is backed by nothing and no one in Japan sees anything wrong.

In other countries, the fact that the local currency is created out of nothing by a central bank and yet everyone goes along with the use of the currency for transactions, wealth, etc., isn't a problem that stirs emotional political frenzies. There may be disagreement about how well the central bank is carrying out its monetary policy, but that is another issue. The U.S. position is rather unique, therefore, which is curious because whether you are an atheist who believes in the Big Bang or a fundamentalist who believes in Biblical creation, you believe that the entire universe was created out of nothing. (You disagree only on the timing.) If the entire universe could be created out of nothing, why not the dollar?

So now let's bring in Bitcoins, a "virtual currency" created out of nothing. The news media have carried stories on the creation of Bitcoins by a non-government source and how they "work."¹ There have also been stories about their potential for illicit money laundering which has attracted official regulatory concern, an issue we don't take up here. But what lessons do we learn from Bitcoins?

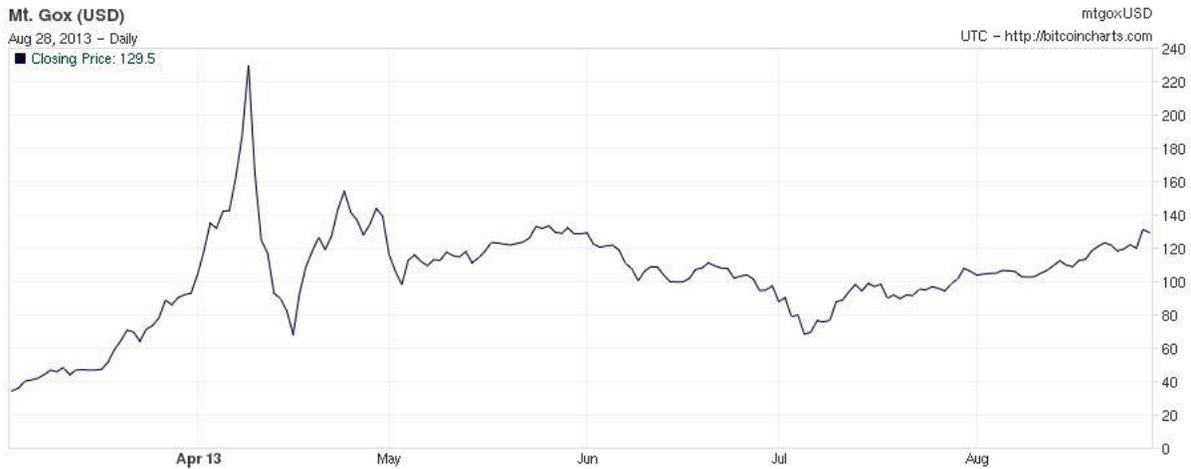
Lesson #1: If enough people accept the idea that something has value, it does. The something doesn't have to be "backed" in the conventional sense of that word, i.e., guaranteed to be interchangeable at a fixed price into something else (such as gold). If you are a libertarian of the variety that doesn't like the Fed because it creates something out of nothing (and who longs for the gold standard), but you are also a libertarian that likes Bitcoins because they have been created out of nothing by something other than

¹ For example: <http://www.dailynews.com/business/20130816/bitcoin-changing-money-to-change-the-world> and <http://www.politico.com/story/2013/08/decoding-bitcoin-95595.html>.

the Fed, you are carrying two contradictory thoughts in your head. Human beings have a remarkable capacity to hold contradictory thoughts at the same time, but still...

Lesson #2: The Bitcoin is not a very good currency because although some people “believe” in it, not enough do for it to have a relatively stable value. Take a look at the two charts I downloaded on August 28th from bitcoincharts.com, a website that seems to have some relation with bitcoin.com.

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The price of a Bitcoin is shown above on the right axis. The closing price at the latest date is 129.5 dollars per Bitcoin.

Buy bitcoins near Los Angeles, United States

Distance	Location	Price/BTC
7.4 miles	Santa Monica, CA, USA	167.57 USD
7.5 miles	Beverly Hills, CA 90210, USA	130.41 USD
10.2 miles	91356, Tarzana, United States	137.73 USD

Widely varying prices are shown above for locations at varying distances from downtown Los Angeles.

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Absent an official entity that puts a kind of stamp of approval on a currency, most people won't “think” in that currency. They won't set wages or make other long term contracts in the currency. And so the result is you get big short-term fluctuations in the currency's value over time or even agreement on what that value is at any moment in time.

All the modern dollar really promises is that you can buy a dollar's worth of products with it. But that amount is relatively stable within the U.S. (simply because the dollar is the official currency of the U.S.)

because people do set wages and prices in the dollar and make long term contracts (mortgages, bonds, etc.) in it. Why do people do that? The phrase used by economists is “network economies” which simply means they do it because everyone else (in the U.S.) does it. Note that the dollar is not stable in terms of what it will buy in *other* countries because folks there think in, and contract in, their local currency and not the dollar.

The euro experience is particularly useful here as an illustration. When people in diverse countries around Europe were told that their official currency was no longer going to be the franc, mark, lire, drachma, etc., they all began doing business in euros. Why? Because they knew everyone else would be doing so. And how did they know? Because it was announced by official institutions to which people normally pay attention. Creating the euro was a coordination success because there were official coordinators in the various countries (governments, central banks).

Lesson #3: Even unofficial virtual currencies such as the Bitcoin can't seem to escape conspiracy theories. Check out "*Bitcoin: The New World Order's Plot for a World Currency?*" if you don't believe me.²

Does all of this matter? You bet it does. Fuzzy understanding of what money is (and isn't) infects American politics and therefore impedes making appropriate monetary policy. We can have various views about what monetary policy is appropriate right now in the U.S. to foster the current recovery and lower the rate of unemployment. We can think the Fed is doing a good job or a bad job. But it is hard even to have that conversation when fantasies about money persist.

² <http://www.activistpost.com/2013/04/bitcoin-new-world-orders-plot-for-world.html>.