

### 3. About the quality of our money

According to central banks (e.g. ECB<sup>1</sup>) money is an economic good, with three basic functions:

- Medium of exchange
- Store of value
- Unit of account

In this article I evaluate the quality of our money based on the ECB's main objective: maintaining price stability. This is defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2% (to be maintained over the medium term). The ECB realises this goal by keeping interest rates as low as possible and by increasing the money supply at an appropriate speed.

We will now evaluate the 3 functions of money and discuss how a price stability policy results in a lower quality of money.

#### 1. Medium of Exchange

The ECB explains that commodity money goods avoid inconveniences associated with a barter economy. Money should be easy to carry, durable, divisible and the quality should be easy to verify. As written extensively by for instance Menger and Mises, this is how money initially developed in a free market, where market participants decided that gold and to a similar extent silver were the best mediums of exchange.

Money is an economic good. The laws of supply and demand and the laws of marginal utility hence also apply to money. In a more economic sense, money should be a rare good to function well as medium of exchange. This would imply that creating more money does not contribute well to this function. The ECB will always aim for money growth to achieve 2% price inflation, which makes money less of a rare good. Despite this, our current money functions well as medium of exchange.

#### 2. Store of Value

If the good used as money maintains its value over time, it can be held for longer periods, the ECB maintains. For this reason commodities that also serve as a store of value are preferable to commodities that only serve as a medium of exchange. In my view price stability, meaning prices rising on average by 2%, is not beneficial. If prices are rising, the stored money will lose purchasing power, if no interest is paid. Obviously in general interest will be paid, by banks for instance, but for the past decades the interest compensation was hardly ever sufficient to compensate for the loss of purchasing power. In any case, a policy aiming for price deflation would contribute better to this function than the current policy of 2% annual price inflation.

#### 3. Unit of Account

The ECB believes that if the value of all goods can be expressed in terms of a "numeraire" this helps economic agents in agreeing upon transactions, as *'all economic agents would calculate things such as costs, prices, wages, income etc. in the same units of money. The less stable and reliable the value of money is, the more difficult it is for money to fulfill this important function.'*

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<sup>1</sup> See ECB website [https://www.ecb.europa.eu/ecb/educational/explainers/tell-me-more/html/what\\_is\\_money.en.html](https://www.ecb.europa.eu/ecb/educational/explainers/tell-me-more/html/what_is_money.en.html)

First of all, the ECB confuses the value of money and the concept of the 'numeraire'. Value cannot be measured. Value is subjective, meaning it is different for each individual. Value can only be ranked by individuals, based on their preferences. Maintaining stability in the value of money is therefore in itself a mission impossible, because there is no norm to compare this objective against.

As a side comment, I wonder why prices have to rise to benefit the unit of account. Prices going down by 2% a year are statistically speaking equally stable as prices going up by 2% a year.

Secondly, why is it more difficult for economic agents to calculate with less stable numbers? If preferences or technologies are changing suddenly and prices adjust accordingly, why would it matter if prices fluctuate more? Agents just need to include other numbers in their spreadsheets in order to evaluate if (new) products can be offered and produced profitably. It is true that agents as entrepreneurs and companies will have to act more swiftly, in response to strongly fluctuating prices, indicating strongly fluctuating preferences. This can be difficult for such agents, but it is important as only this way consumers will best be served when faced with quickly changing circumstances. Why should entrepreneurs benefit at the expense of consumers?

Thirdly, monetary policies compromise the function of unit of account, as the ECB cannot keep all prices stable. The ECB does not know beforehand the impact of their monetary policy on individual prices. Some prices may go up more than others. To the ECB this is not important, they are only concerned about the average price level. However, economic agents do care. On top of the uncertainty around changing consumer preferences, economic agents are now also faced with the impact of monetary policies on prices. Are certain prices rising because there is more demand, or due to the impact of monetary policies? By definition, economic agents are now dealing with more uncertainty. Consequently, money that is being influenced by monetary policy is less reliable as a unit of account.

## **Conclusion**

The ECB aims for price stability, which it defines as an annual increase in the HICP for the euro area of below (but near) 2%. It achieves this by increasing the money supply at the right speed. Based on the 3 functions of money, adopting such a mandate is not too beneficial.

Our money (the Euro) functions quite well as a medium of exchange. It functions less well as a store of value, where the quality of our money would be better off if the ECB would accept prices that are going down on average. The ECB policies make money as a unit of account less reliable, as agents are faced with more uncertainty (rather than less) and money does not reflect consumer preferences as well anymore.

This is an important reason why the quality of our money can be improved. This conclusion may well contribute to the explanation why the price of gold has been going up for quite some time now and why the price of bitcoins has been going up in more recent periods.

The ECB believes though that there are additional advantages to price stability, such as that these policies contribute to improving our welfare. In the next articles I will come back to this point, explaining that based on the Austrian School, also this is not the case.