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All Money Is Fiat Money



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Business

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It's important to understand how money works, and it's counterintuitive. One aspect which is missed in the debate between commodity-backed currencies and fiat currency, that is to say currency which is not backed by a commodity or anything else, is the fact that all currencies are really fiat currencies*.



(Image credit: Getty Images via @daylife)

Nothing illustrates this better than [this story in New York Magazine](#) that reports that Tide detergent has become a black-market currency in the drug trade.

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It's become a meme in pop culture that cigarettes are often used as currency in prison (I have no idea whether this is still in fact true). We all instinctually understand how a cigarette-based currency system would work, right: people would mass cigarettes, use them as a medium of exchange and store of value, etc., but we don't think about the implication.

In both cases, what makes Tide detergent, or cigarettes, or the US dollar, or Bitcoin, or whatever, a currency, is simply common agreement that these an item of currency is valuable. What makes it possible to buy drugs with Tide is not because Tide is useful as a detergent. It's because drug dealers and users have agreed that it is currency.

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This is, of course, equally true of gold. Gold's uses in industry are marginal to its appeal. What makes gold valuable is that we've all agreed since time immemorial that it's valuable.

Switching to a gold-backed currency regime does not mean switching away from fiat currency, it means switching to a fiat currency system where the money supply is linked to a commodity.

This is one of those things where our instincts fight our good sense. We want to believe things have intrinsic value, whereas value in a marketplace is determined by supply and demand, not anything intrinsic. It's scary to think that the US dollar is backed by "nothing", until you realize that any currency system is backed by "nothing", or rather by the same thing, which is a common agreement to use the currency.

(* Actually, properly understood, no currencies are "fiat" currencies, since the word "fiat" refers to a government decree that makes money money, but in reality, while the government fiat matters, it is useless without the consent of the currency users. But insofar as we use the expression "fiat currency" to refer to currencies that have no "intrinsic value", then all currencies are fiat currencies.)



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