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Inflation Supplement

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Inflation & Wealth

The inaugural issue of The Sentinel described inflation as “*an increase in the supply of certificates relative to the supply of wealth (gold/silver) held in deposit*”. The increase in certificate supply (credit in modern terms), produces feeling of confidence. If confidence can inspire credit then credit can inspire confidence. This becomes a continuous feedback loop. Since items increase in “value”, there is the perception of greater wealth. The public feels wealthier since “on paper” prices are higher. Elected leaders also benefit from the perception of greater wealth. Frequently they credit legislation, policies and spending with increased wealth.

The feeling is illusory since frequently, it is not “owned” wealth. The wealth appears on paper or in the form of greater credit. From the inaugural issue we defined wealth as “*a material item produced by human effort having exchange value*”. Paper increases in value do not represent increases in wealth.

Consider a primary residence whose value appreciates. The additional “wealth” the owner feels cannot be liberated unless the home is sold. When selling the home, the former occupant requires a place to live. If the former occupant “downsizes” and converts the “capital gain” into a true form of wealth, there was an increase in wealth. The capital gain remains on paper until directed into a variety of other investments.

Homes are illiquid possessions. This publication stressed the importance of considering your primary residence as a consumption item.

To provide a semblance of liquidity to your primary residence, the banking community created a vehicle for paper wealth extraction.

Extracting “wealth” from a home via a loan against the home’s market value (home equity loan), is not wealth but rather, more credit. While this credit may inspire more confidence, there is an associated debt.

Since most, if not all, of this type of credit is non self-liquidating, no real wealth is acquired. Non-self-liquidating credit is associated with consumption. This type of credit produces no financial return with which to pay back the loan. It is simply consumption. Savings or future credit pays off loans.

Most people do not use the home equity loans for business improvement (something that can help pay back the loan), but rather for something they can consume.

Mini-Economy Example (Barter)

Since inflation is largely a creation of the money system used, is it possible to have a system without inflation? Let us consider a mini-economy where there is no money, as we know it. Transactions occur via a barter system. The only method of conducting economic transactions is by trading one's production for another's. Our mini-economy consists of the following persons:

- i. Person "A" produces apples
- ii. Person "B" produces bananas
- iii. Person "C" produces corn
- iv. Person "S" provides labor to produce any crop

Wealth Exchange System

	Apples (qty)	Bananas (qty)	Corn (bushel)	Labor (hrs)
Apples	N/A	3	1/3	1/3
Bananas	1/3	N/A	1/9	1/9
Corn	3	9	N/A	1
Labor	3	9	1	N/A

**Single units in first column are exchangeable for quantities in other columns*

Persons A, B, and C have established relationships between what they produce. For example, and referring to the Wealth Exchange System table:

- One (1) apple is exchanged for three (3) bananas.
- One (1) apple is exchanged for 1/3 bushel of corn or 3 apples are exchanged for one bushel of corn
- One (1) banana is exchanged for 1/3 of an apple or 3 bananas are exchanged for 1 apple.
- One (1) banana is exchanged for 1/9 of bushel of corn or 9 bananas are exchanged for 1 bushel of corn.
- One unit of labor is exchangeable for 3 apples, 9 bananas, and 1 bushel of corn.

The relationships could change in this economy. For example, a shortage of bananas could arise due to acts of nature. The result might be a 1:1 exchange of apples to bananas for a period while the shortage existed.

What happens when one person desires to consume more than they are capable of exchanging? Person B (producer of bananas) wishes to consume more corn in a given period but does not have sufficient bananas with which to pay Person C (producer of corn). Person B requests a corn loan from Person C. Person C gives Person B an additional bushel of corn as a loan payable in one month. For this transaction, C wants more than the 9 bananas (see Wealth Exchange Table) that is the typical exchange. Person C wants 12 bananas.

How does B pay back C for the extra bushel of corn? The payment is via additional bananas that B produces (the surplus) in the future. Person B has rented the surplus corn from C and the rental fee is the surplus banana production in the future. Person B has exchanged present consumption (corn) for future consumption (bananas). C has deferred consuming corn NOW in exchange for a greater number of bananas in the FUTURE. C actually has 3 more bananas than they would have at the regular exchange rate (9 bananas for 1 bushel of corn) by demanding 12 bananas in the future. The table below summarizes this transaction.

Person	Consumed Now	Given Now	Paid in Future	Received in Future
B	1 bushel corn	N/A	12 bananas	
C	N/A	1 bushel of corn	N/A	12 bananas

In this mini-economy, anyone wishing to consume more NOW must save their production in the future in order to pay back what they consumed. This point is vital to understand. **Future savings pay for current consumption.**

Person B could not have consumed the extra corn without saving bananas in the future with which to pay back Person C.

The items in the Wealth Exchange System table are wealth since human effort produces them, or in the case of labor, it is human effort. The items also have exchange value. There is no inherent inflation in this mini-economy. The only way to increase your wealth in this mini-economy is to produce more, consume less, or some combination thereof. Wealth increases with surplus production.

For this mini-economy, increasing wealth involves storing perishable items so it is not inherently practical. Additionally, hauling bushels of corn to trade for bananas can be cumbersome.

Mini-Economy Example (Wealth Money)

A new Person enters the economy, Person “G”, and produces gold coins of different sizes, exchangeable for other items in the economy. All Persons in the mini-economy agree to relationships between their product and the gold coin. Upon gold coins circulating, a store of wealth is available that is a medium of exchange, and a store of value (The Sentinel’s definition of money). Instead of accumulating perishable items, a person accumulates coins. The relationship between the perishable products and labor retain the same values to one another, only now the gold coin is the money representing the value. A new Wealth table follows:

Wealth Exchange System

	Apples (qty)	Bananas (qty)	Corn (bushel)	Labor (hrs)
Gold Coin (oz)	30	90	10	10

The Wealth Exchange table retains the same relationships between the crops and the labor. For example, (1) apple formerly was exchanged for (3) bananas. This is the same as saying (30) apples equals (90) bananas (multiply the quantities by 30).

The new Wealth Exchange System table clearly indicates that 1 oz of the gold coin equals either 30 apples or 90 bananas - meaning 30 apples = 90 bananas.

Now, there is a more convenient means of exchange (gold coin). In addition, the medium of exchange (gold coin) provides a reference to every item in this mini-economy. Inflation is not present in this economy even after the introduction of the gold coins. As before, a shortage of bananas will result in fewer bananas exchangeable for an ounce of gold. The “price” increase is temporary and is a result of acts of nature - not money inflation.

Consider the last sentence carefully. The new medium of exchange does not cause inflation by itself. Acts of nature are capable of creating upward “price” changes but this, is a temporary phenomenon. A new method of producing bananas could introduce more efficiencies making banana production more abundant. Such efficiencies should drive the “price” of bananas down, which is a good thing.

What if the supply of gold coins increased and everything else held constant? In this case, each ounce of gold coin purchases fewer apples, bananas and corn since the supply of coins increased relative to the other items. While one may consider this gold coin inflation, there had to be additional effort expended in order to increase the supply of coins or perhaps coin production became more efficient. The coins still represent wealth even if produced in greater quantities.

Mini-Economy Example (Devalued Money)

What happens if Person “P” appears and convinces the people that a barter system is not practical and that the supply of gold coins is not sufficient to grow their mini-economy? A law is passed requiring Paper Notes be used in the transactions. Person P creates Paper Notes that say “*Good as One Ounce of Gold*”.

The rest of the people in the mini-economy accept Paper Notes and treat it just like a one-ounce gold coin. It requires little effort to produce this paper, unlike other items in the economy. Upon introduction of this paper into the mini-economy, it becomes easy for Person P to acquire gold, apples, bananas, corn and labor. Soon the producers of the crops and the providers of the labor find that there are fewer items available since Person P is acquiring them. This causes them to demand more paper for their own items of production since they need more paper to buy the other things in the economy.

The people in the economy begin to request loans from Person P. Person P loans Paper Notes and requests the same value of Paper Notes plus interest in return for the loans. The Paper Notes only come into existence by Person P printing them. The interest payments on the loans require more Paper Notes themselves to be printed. The amount of Paper Notes in circulation begins to increase even more.

While this is occurring, the gold coins fall out of circulation since the participants in the economy begin to recognize their wealth value is superior relative to the Paper Notes. Even though the Paper Notes and the (1) ounce gold coin both say the same thing, instinctively people know they are not worth the same. Rather than exchanging a Paper Note for a gold coin, the people demand 100 Paper Notes now for the gold coin. People begin to say that the “price” of the gold coin has gone up since originally, it was exchanged 1:1 with the Paper Note and now it is 100:1 Paper to Gold.

The effect of Paper Note introduction is inflation. Prior to Paper Note introduction, “prices” were more stable. Only acts of nature or increases in efficiency disrupted pricing. Now, “prices” increased merely with the introduction of Paper Notes.

Summary

The mini-economy example highlights several effects.

Initially, the economy functioned using only barter for economic transactions. Relationships of one product to another were established. No inflation, as we know it, existed since no credit money existed. The barter economy was cumbersome and at times impractical since many of the goods produced were perishable.

Gold coins introduced a new level of economic functionality. The gold coins satisfied The Sentinel's definition of money and people conducted their economic transactions quite well. Changes in "price" resulted from acts of nature or by increases in efficiency. The former increased "prices" and the latter reduced them.

The introduction of Paper Notes, declared equivalent to gold coins, had an immediate inflationary effect on the economy. Suddenly all "prices" went up. People accepted the Notes since they assumed they were as good as gold. Initial confidence in the paper was not an issue. Over time, gold coins vanished from circulation (Gresham's Law). The "price" of the gold coin itself went from a 1:1 relationship with Paper Notes to 100:1 (Paper Notes to Gold Coin). Paper Note loans, requiring payment in Paper Notes for the principal and interest emerged. The interest to pay the loans originated with Person P who was the only source of Paper Notes.

Current Economic Parallels

How does the Mini-Economy compare to our present-day economy?

Persons A,B,C,S - represent people in our economy

Person G - represents another participant in economy. Person G also represents a wealth-based money system

Person P - represents any entity capable of expanding credit by making loans or creating money with little effort.

Gresham's Law - the removal of the good money (gold & silver coin) from circulation. The law says that an American Silver Eagle (1 oz of silver) whose face value says \$1 would NEVER be used to purchase a soda costing \$1. We use the Federal Reserve Note bearing George Washington's picture to purchase the soda. Even though the Silver Eagle says \$1, we intrinsically know it is worth much more.



**Does Not
Equal**



The ability to create money or in modern terms credit, is what creates inflation. Credit creation not matched by an equal amount of wealth creation, creates more “money” chasing goods and services. This causes their “price” to go up. The reality is, the “price” is not going up but rather the value of the money is going down. The concept sounds counterintuitive and is different than most people understand.

An understanding of this concept is essential to understand how our economy works - it works with credit. Unchecked credit creation breeds tremendous confidence. The usage of this credit spearheads excessive consumption and greatly diminished savings. The misallocation of credit facilitates choices that are not worthy if there were not so much credit. The unmitigated creation of credit has led our economy to a precipice from which a deflationary condition follows (Economic Law #3) where deflation follows inflation.