Fiat Money

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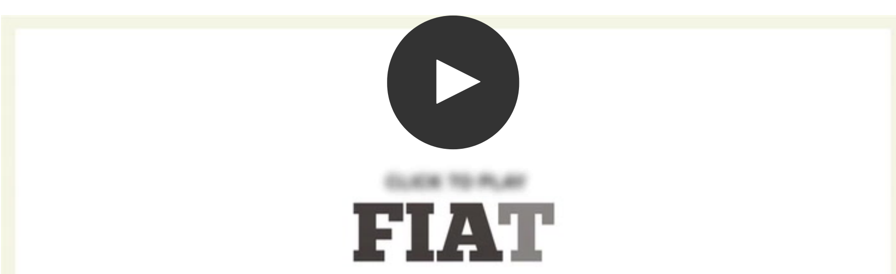
What Is Fiat Money?

Fiat money is government-issued currency that is not backed by a physical commodity, such as gold or silver, but rather by the government that issued it. The value of fiat money is derived from the relationship between supply and demand and the stability of the issuing government, rather than the worth of a commodity backing it as is the case for commodity money. Most modern paper currencies are fiat currencies, including the U.S. dollar, the euro, and other major global currencies. [1]

KEY TAKEAWAYS

- Fiat money is a government-issued currency that isn't backed by a commodity such as gold.
- Fiat money gives central banks greater control over the economy because they can control how much money is printed.
- Most modern paper currencies, such as the U.S. dollar, are fiat currencies.
- One danger of fiat money is that governments will print too much of it, resulting in hyperinflation.



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Fiat Money

How Fiat Money Works

Fiat money only has value because the government maintains that value, or because two parties in a transaction agree on its value. Historically, governments would mint coins out of a valuable physical commodity, such as gold or silver, or print paper money that could be redeemed for a set amount of a physical commodity. Fiat money is inconvertible and cannot be redeemed. The word "fiat" comes from the Latin and is often translated as the decree "it shall be" or "let it be done." [2]

Because fiat money is not linked to physical reserves, such as a national stockpile of gold or silver, it risks losing value due to inflation or even becoming worthless in the event of hyperinflation. [3] If people lose faith in a nation's currency, the money will no longer hold value. That differs from currency backed by gold, for example; it has intrinsic value because of the demand for gold in jewelry and decoration as well as the manufacture of electronic devices, computers, and aerospace vehicles.

Special Considerations

The U.S. dollar is considered to be both fiat money and legal tender, accepted for private and public debts. [4] Legal tender is basically any currency that a government declares to be legal. Many governments issue a fiat currency, then make it legal tender by setting it as the standard for debt repayment.

Earlier in U.S. history, the country's currency was backed by gold (and in some cases, silver). The federal government stopped allowing citizens to exchange currency for government gold with the passage of the Emergency Banking Act of 1933. [5] The gold standard, which backed U.S. currency with federal gold, ended completely in 1971, when the U.S. also stopped issuing gold to foreign governments in exchange for U.S. currency. [6]

Since that time, U.S. dollars are known to be backed by the "full faith and credit" of the U.S. government, "legal tender for all debts, public and private" but not "redeemable in lawful money at the United States Treasury or at any Federal Reserve Bank," as printing on U.S. dollar bills used to claim. In this sense, U.S. dollars are now "legal tender," rather than "lawful money," which can be exchanged for gold, silver, or any other commodity. [7]

Advantages and Disadvantages of Fiat Money

Advantages

account, and facilitating exchange. It also has excellent seigniorage.

Fiat currencies gained prominence in the 20th century in part because governments and central banks sought to insulate their economies from the worst effects of the natural booms and busts of the business cycle. [8] Since fiat money is not a scarce or fixed resource like gold, central banks have much greater control over its supply, which gives them the power to manage economic variables such as credit supply, liquidity, interest rates, and money velocity. For instance, the U.S. Federal Reserve has the dual mandate to keep unemployment and inflation low. [9]

Disadvantages

The mortgage crisis of 2007 and subsequent financial meltdown, however, tempered the belief that central banks could necessarily prevent depressions or serious recessions by regulating the money supply. [10] A currency tied to gold, for example, is generally more stable than fiat money because of the limited supply of gold. [11] There are more opportunities for the creation of bubbles with fiat money due to its unlimited supply.

Example of Fiat Money

The African nation of Zimbabwe provided an example of the worst-case scenario in the early 2000s. In response to serious economic problems, the country's central bank began to print money at a staggering pace. That resulted in hyperinflation, which ran between 230 and 500 billion percent in 2008. [12] Prices rose rapidly and consumers were forced to carry bags of money just to purchase basic staples. [11] At the height of the crisis, a 100-trillion Zimbabwean dollar was worth about 40 cents in U.S. currency. [13]

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Related Terms

Lawful Money

Lawful money is any form of currency issued by the United States Treasury and not the Federal Reserve System. It includes gold and silver coins. more

Bimetallic Standard

A bimetallic standard is a monetary system in which a government recognizes coins composed of gold or silver as legal tender. more

Silver Certificate

A silver certificate was a form of legal tender issued by the U.S. government beginning in 1878 and continuing through the 1960s. more

Legal Tender Definition

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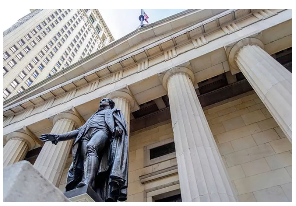

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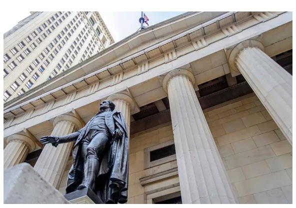

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