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Currencies Today Are "I O U Nothings" *

by

John Exter

"Now that the international monetary system we have so long known has broken down, and the world is groping through monetary reform for a new one, it is time to consider some fundamentals. What is money anyway?

"First, it is a means of payment or medium of exchange. I prefer that first phrase. It is simpler. We all use money to pay our bills, to buy goods and services. We also accept money when we sell. Second, it is a standard of value. We quote values of goods and services in terms of it. The resulting ratios are prices. Third, it is a store of value. We hope to avoid loss by holding it. Money holds its value if it is scarce and remains scarce. Scarcity is the keystone of store-of-value money.

"Today no money in the world fully performs all three services. National currencies are being used as means-of-payment and standard-of-value money, but none in this inflationary age is an assured store-of-value money. In fact, a foremost concern to voters and politicians everywhere is that so many currencies are so rapidly losing their value in terms of commodities and services. Commodities like gold and silver, which are being used as store-of-value money, are not being used as either means-of-payment or standard-of-value money.

"Thus the world we have so long known, in which most currencies were redeemable at a fixed price in a store-of-value money like gold, is in disarray. People are confused and wondering what money they can trust. Sensing the instability of the system as a whole, they turn day by day from one means-of-payment money to another in the foreign exchange markets, and much more gradually to store-of-value money like gold in the London and Zurich gold markets.

*This article, by Mr. John Exter, was first published in the May 22, 1972 issue of *Barron's*. It is reprinted here by courtesy of *Barron's National Business and Financial Weekly.*

Scarce Commodity

"If we carefully look into the meaning of this market churning, it becomes clear that store-of-value money, if it is to endure, must be a commodity, and a scarce commodity, too. Silver has long been a less satisfactory store-of-value money than gold, principally because it has been, and promises to continue to be, more abundant. Many of the currencies used as means-of-payment and standard-of-value money have not proved good store-of-value money chiefly because they, too, have grown too abundant. Since they are simply either paper (currency notes) or bookkeeping (deposits) promises to pay, i.e., debt obligations or IOUs, the confidence of people in them as store-of-value money depends heavily upon the ability of the central banks responsible for their issuance to honor those promises to pay in a commodity that is indeed store-of-value money. This is the issue of convertibility, which the Europeans, especially the French, are emphasizing today.

"Until March 1968, when the two-tier gold system was established, the central banks issuing all major currencies were promising all holders: 'IOU gold at $35 an ounce." Under the two-tier system, however, the IOU-gold promise was abrogated for private people, and, except for the South African Reserve Bank, central banks refused to sell any gold at any price to private people. The IOU-gold-at-$35-an-ounce promise was honored only among central banks and governments, and even among them it became gradually more tenuous. On August 15, 1971, the IOU-gold promise was abrogated even among central banks.

Same Relative Rates

"So today all currencies in the world are saying, 'I do not owe anybody anything.' Each one says, in effect, 'IOU nothing' in the way of any commodity that is a store-of-value money. In that situation an attempt was made at the Smithsonian to re-establish fixed exchange rates, which meant making one central bank's IOU nothing equal to a certain number of another central bank's IOU-nothings, with a 2¼% spread on either side of parity. It is obvious that such an arrangement could last only if the exchange rates agreed on at the time were equilibrium rates, and if in future all central banks agreed to control the issue of their new IOU-nothings at the same relative rates. The second condition was certainly not met and no one can be sure the first one was.

"Although it was agreed to raise the price of store-of-value money, gold, to $38 an ounce, no arrangement was made for a central bank that went into deficit because it issued too many IOU-nothings to pay a surplus central bank in gold at that fixed price. Meanwhile, the gold owned by central banks remains for the most part buried inactive in their vaults. Gresham's Law has worked. Bad money has driven good out of circulation, even among central banks. All currencies are inconvertible into gold. We are in a world of irredeemable paper money.

"Further conclusions follow from this analysis. Good store-of-value money is clearly the strongest kind of money. IOU-nothing money, which people may continue to hold as a store of value for a long time, but only with the enticement of ever higher rates of interest, may continue, also for a long time, to serve as a means of payment and standard of value. But as it becomes more abundant, it will serve these functions less and less satisfactorily—if too abundant, not at all. It would then also cease being held as a store of value, 'not worth a Continental.' History is full of examples of IOU-nothing currencies that have disappeared. Some currencies will, of course, become over-abundant faster than others. Over time it is scarce store-of-value money like gold that endures.

"If enduring store-of-value money must be a commodity, it follows that governments and central banks cannot create it, unless they were to go, let us say, into the gold mining business. It follows also that if they persist in creating IOU-nothing money, they will slowly but surely run themselves out of the money-making business altogether and have to start over again.

"So it is also apparent, and at the same time reassuring, that it is private people in the marketplace, not governments, who decide what money is, and what different kinds of money they are going to use and hold, especially the enduring store-of-value money, the most important of all.

Gresham's Law

Governments will always try to shore up IOU-nothing money with laws making it legal tender, or even laws prohibiting the holding of store-of-value money like gold, but such laws cannot for very long add value to something that is losing value in the marketplace. Gresham's Law, which is really a special form of the law of supply and demand, will override man-made laws. In fact, there would be no Gresham's Law if governments did not persistently try by man-made laws to over-value their IOU-nothing money in terms of store-of-value money. Thus laws prohibiting people from holding store-of-value money like gold cannot succeed, for gold as a commodity can be held in countless forms and readily converted from one form to another. People will hold jewelry, or old coins, or what have you. And people whose governments permit them to hold gold will do so in any form.

'It should also be apparent that monetary theorists cannot arbitrarily decide what money is. Theories that are based on an arbitrary definition of the stock of money, particularly IOU-nothing money, will slowly lose their relevance. Such theories try to over-value IOU-nothing money just as governments do, and in the marketplace Gresham's Law will override man-made theories just as it overrides man-made laws.

"So it also follows that governments cannot reduce the importance of a store-of-value money like gold in the monetary system, much less demonetize it. A monetary authority monetizes anything by buying it and taking it into its balance sheet as an asset and paying for it by creating or issuing monetary liabilities (now IOU-nothings) which are accepted by the seller. It demonetizes anything by selling it from its assets and extinguishing an equivalent amount of its liabilities tendered to it by the buyer.

Obviously Inflationary

"To demonetize gold, the central banks of the world would have to sell all of their holdings in the open market. If they were to try, the exercise would be very deflationary, for they would be extinguishing their monetary liabilities with every sale. To avoid the risk of deflation in today's monetary world, they would simultaneously have to monetize IOU-nothings like government securities by creating new IOU-nothings of their own more rapidly then they extinguished the old by demonetizing gold.

"Such an exercise would obviously be inflationary and central bank IOU-nothings would steadily lose value in the marketplace. Under Gresham's Law the bad IOU-nothing money would drive the good gold store-of-value money out of circulation. But if the central banks persisted, and there would be precious few restraints to stop them, their IOU-nothings would slowly lose value and, under runaway conditions, all value in the marketplace. Thus over time the marketplace would frustrate central banks if they tried all together to demonetize gold. It would demonetize their IOU-nothing money instead. So they are not likely to try.

"It is not even likely that one central bank would try. Others would welcome the opportunity to monetize the gold that it sold, and at the same time to demonetize some of their IOU-nothings.

"In recent years there has been an attempt to substitute so-called paper gold, or special drawing rights (SDRs), in the International Monetary Fund for real gold. One high IMF official is even reported to have called gold 'metallic SDRs.' If used seriously, such an appellation flies in the face of marketplace assessment of store-of-value money.

The SDR has no obligor, no promise to pay any store-of-value money at a fixed price, and no fixed maturity date (other than a complicated reconstitution provision). It cannot be sold at will, only by central banks in deficit and only to central banks strong enough to be designated by the IMF to receive them.

"So it is a 'Who owes you nothing?', and 'When?', and it does not even pay a market rate of interest, only 1½%. If central banks ever monetize them in significant amounts, they will have moved from days when they issued their IOUs principally to buy enduring store-of-value money like gold, to these days when they issue their IOU-nothings principally to buy government IOU-nothings, to days when they would issue their IOU-nothings to buy who-owes-you-nothings.

"In days to come, international monetary reformers will have to consider whether these new kinds of money will produce a stable monetary world. In the world's marketplaces will they hold their value against goods and services in general? More particularly, will those issued by different central banks hold their value against one another? Most particularly, will any of them hold their value against store-of-value money like gold?"

To: All Friends of American Institute for Economic Research

We are pleased to inform all friends and supporters of the Institute that Mr. John Exter, author of the preceding article, has been awarded and has accepted a 3-year appointment as a Senior Research Fellow at the Institute.

Mr. Exter retired this past spring from his position as senior vice-president of First National City Bank, New York. Prior to joining First National City Bank in 1959 he had served as governor of the Central Bank of Ceylon and as vice-president of the Federal Reserve Bank of New York as well as economist for the Board of Governors of the Federal Reserve System and chief of the Middle East division of the International Bank for Reconstruction and Development (World Bank).

Throughout his long and distinguished career as a banker and economist he has been widely known as a leading student of developments in the international monetary field. In the major capitals of the world, especially in the leading central banks, his views are sought and respected. Unlike many economists, he also has a marked ability to present his views in language readily understandable by laymen. The preceding article is an excellent example of this unusual ability.

At the Institute, Mr. Exter will study the latest developments in modern procedures of scientific inquiry and continue his research on domestic and international monetary problems. His findings, as published from time to time, will be of unusual interest during the difficult and uncertain times that lie ahead.

Sincerely,

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C. Russell Doane

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