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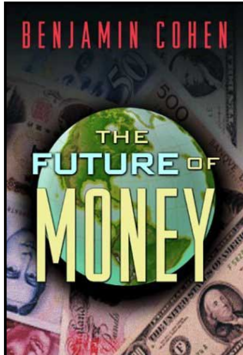

The Future of Money

by Benjamin J. Cohen
Princeton University Press © 2003
294 pages

Focus

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Take-Aways

- Three currencies top the global monetary order: the dollar, the euro and the yen.
- The dollar's pre-eminence is unquestionable and no other currency is likely to offer it a serious challenge.
- Significant advantages accrue to countries whose currencies achieve global or regional dominance.
- Notwithstanding the undeniable power of the currency markets, national governments still have a significant degree of monetary authority.
- Some economists predict that given transaction costs and network economies, the number of global currencies will shrink dramatically. This is the Contraction Theory.
- Governments benefit from issuing their own currency, getting unity and seignorage.
- The development of new forms of money — e-currency and various types of scrip — will not present a qualitatively new problem for central bankers.
- Currency issuers, especially the top three, will keep competing for market share.
- Other countries sacrifice some sovereignty to a lead currency issuer or to the market.
- Ultimately, the market determines which currency it will accept and therefore which currency will prevail.

Rating (10 is best)

Overall	Applicability	Innovation	Style
6	**3**	**9**	**7**

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Relevance

What You Will Learn

In this Abstract, you will learn: 1) How and why governments issue currencies; 2) The advantages and disadvantages of various monetary policies, particularly for less powerful countries; and 3) Why the dollar, euro and yen may end up as the world's only currencies.

Recommendation

This book is a thoughtful, amply documented reflection on the future of currency. The dollar, euro and yen dominate the global monetary order, with the dollar now unrivaled at the top and unlikely to be threatened in the future. The countries that issue lesser currencies face a trade-off between monetary sovereignty and international acceptability (with all its economic advantages). Some economists say these lesser currencies should simply dollarize, that is, sacrifice their monetary sovereignty on the altar of international economic efficiency by adopting a stronger currency as their own. Author Benjamin J. Cohen argues that these countries are likely to reject dollarization because the emotional and political advantages of issuing one's own currency are simply too strong. He suggests various alternate mechanisms that allow countries to maintain some monetary independence and authority while gaining the advantages of a fully liquid, widely used currency. Non-specialists may find his extensive discussions a bit dry or sometimes tedious, but *getAbstract.com* applauds the author's ability to explore monetary economics in admirably lucid detail.

Abstract

Issuing Money: Currency and Territory

Money matters. A currency gives political advantages to its issuer. Even in the past, when currency was gold or silver coins, the mint retained a piece of the ingot for the king. Nowadays, the issuer of a currency receives valuable, real benefits — including liquidity, low transaction costs and reliable value — in exchange for mere paper. A widely accepted currency becomes a badge of national status, because the respect users give the currency is largely a function of the awe inspired by the issuing country.

"The future of money is already upon us, but it is not unmanageable."

In the nineteenth century, national borders began to circumscribe the area of a currency's legitimacy and acceptance. This was an innovation. In antiquity, a few monies were widely accepted. Roman and Greek coins traded far from Rome and Athens. Spanish coins bought fur and whiskey on the North American frontier. Money was not a function of territory.

Nowadays, money is again deterritorializing, as instantaneous global communication, trade and frequent travel shrink the currency world. Although many national currencies still exist, the international monetary structure seems to resemble a "Currency Pyramid" with a narrow top and a broad base. The scant few currencies at the top compete among themselves for acceptance in and dominion over trade and finance. These currencies are:

"The population of the world's monies is more likely to expand, not contract, both in number and diversity."

- The U.S. dollar — Clearly pre-eminent, the dollar is on one side or the other of 90% of the world's currency trades.
- The Japanese yen — This currency's influence probably peaked with the Japanese economy and market during the 1980s, only to fall with them during the 1990s.

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- The European euro — This new currency could increase its share of the market at the dollar's expense, but its fate depends on the resolution of some troubling doubts.

"How can we best visualize money's emerging geography? The key characteristic of the new age, as in the more distant past, is the prevalence of cross-border competition, which naturally gives rise to a hierarchy among currencies."

Some economists predict that market forces will compel a further contraction of the number of currencies. The most extreme form of this hypothesis suggests that one currency will dominate the world so clearly that the others will become scarcely more than tokens. Yet this "Contraction Contention" hypothesis ignores some important facts of monetary life. First, countries derive distinct advantages from issuing currencies, and will not easily abandon minting. Second, the private sector has begun to create currencies, which thrive when they meet a real need. Examples include airline frequent flyer miles, scrip and e-money.

Nations can select among four distinct strategic options:

1. Leadership — A state seeking to lead the market will compete aggressively to expand the market share of its currency.
2. Preservation — A state seeking to preserve and defend the status of its currency may adopt measures to persuade others to use it. Japan may be engaged in such a strategy with respect to the yen.
3. Followership — A state facing the unpleasant fact that it lacks the attributes necessary to support a strong, widely accepted currency can adopt one of several strategies for subordinating itself to another, stronger issuer. Examples include dollarization and currency boards.
4. Alliance — States may opt to pool their sovereignty through a currency alliance, a strategy most successful in Europe that has adherents in Africa and elsewhere.

"No longer can governments hope to dominate the supply side of the market as they have done in the past."

For most states, leadership is not an option. Their size and influence prevent their currency from becoming a world leader no matter what economic or monetary measures they implement. They may have no choice but to surrender monetary sovereignty either vertically, by subordination to a currency such as the dollar or euro, or horizontally, through a regional currency arrangement with other states.

The Currency Pyramid and Monetary Geography

Money has been around a long time. Coins started to circulate in Greek city-states as early as 500 BCE. By then, China's Chou dynasty, dating from 1022 BCE, had been minting for half a millennium. At the time, rulers rarely demanded that their subjects use their currency exclusively. A country's coin might be accepted far from its borders. Gresham's Law, named for an advisor to Queen Elizabeth I, stated, "Bad money drives out good." This meant that people were apt to hoard good, undebased currency, and to circulate less reliable currency. Clearly, this law had some limitations, because dominance eventually devolved to sounder currencies, such as the Athenian drachma, the Byzantine solidus, the Mexican silver dollar and the Dutch guilder, each of which had a period of dominance.

"A new geography of money is beginning to emerge."

Monetary territoriality came only after the 1648 Peace of Westphalia established the sovereignty of each European state within its borders. Sovereignty came to include currency, so each state undertook to make its own money the exclusive legal tender in its dominions. For example, in North America, as early as 1793, legislation protected the status of the Mexican dollar and various British, French, Portuguese and Brazilian gold coins that had long circulated on the continent. In the mid-1800s, pressure grew to establish the dollar as the United States' exclusive legal tender, a status it gained by 1861.

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By the twentieth century, it was assumed that states would have their own currencies. When the Great Powers withdrew from their colonial empires after WWII, each post-colonial nation-state established a national currency among its first, fundamental measures of independence.

“Monetary geography will not be greatly simplified by the power of economies of scale.”

Yet currencies are not equal. The fittest ones achieve international acceptance and all the political and economic advantages of monetary dominance. Three factors determine fitness:

1. Confidence — Users have confidence in currencies whose value is reliable. In practice, this means an established record for low and unvarying inflation rates.
2. Liquidity — Users must be able to move in and out of the currency without paying high transaction costs, and must be able to predict its value with reasonable assurance.
3. Network economies — The more people use a currency, the more people are likely to use it. No currency has ever achieved dominance without the backing of a major trading economy. For example, the U.S. dollar is now involved in 90% of all currency trades and more than half of the world’s export transactions.

“At the (U.S.) domestic level, the diffusion of power in today’s monetary geography represents a fundamental transformation in the manner in which money is governed.”

Monetary sovereignty confers other real advantages on a state. Symbolically, a currency represents national identity and can have deep emotional connotations. Witness the discomfort many in Britain express at the prospect of abandoning the pound for the euro. Monetary sovereignty lets a state increase or decrease its money supply to guide its economic activity. Seignorage, the gap between a currency’s value and its cost of production, can be an important source of revenue and allows a state to mobilize real resources quite inexpensively.

Deterritorialization means that many countries which now enjoy the benefits of monetary sovereignty will have to live without those advantages. A few dominant currencies will inevitably erode local monetary monopolies. The Contraction Contention suggests that economic pressure will force almost all countries to abandon their own currencies. An analysis of factors determining the demand for currency makes the Contraction Contention seem reasonable. But it does not adequately address the supply side, the factors that cause countries to create currencies. Moreover, countries are not the only creators of currency. Consider a few privately created currencies:

“A challenge from Europe is certainly possible — but improbable.”

- Discount coupons — In Great Barrington, Massachusetts, when delicatessen owner Frank Tortoriello wanted to get financing to move to a new site but couldn’t get a bank loan, he created Deli-Dollars, discount coupons that allowed customers to save when they purchased various items if they paid in advance for the coupons. Other companies there and elsewhere have begun to offer similar coupons. These coupons are in fact a form of currency since you can buy things with them.
- Hours — In Ithaca, New York, an activist named Paul Glover created a new currency called “Ithaca Hours.” Each Ithaca Hour is worth an hour of labor — nominally $10 — and participants can trade them within a radius of 20 miles of Ithaca. Similar “hours” currencies have developed in Vermont, California, Japan and Italy.
- E-money — Smart Cards, which store value in a chip on the card, and network money, which stores value in hard drives, are two examples of e-money. Aside from PayPal, which still requires transactions to proceed through the banking system, other fully independent electronic currencies sprung up in the 1990s. Even though Flooz and Beenz, two of the best known, failed, the stage is set for the emergence of a new, popular electronic form of money.

“Mundell himself, the pioneer of OCA theory, today quips that the optimum number of currencies is like the optimum number of gods — ‘an odd number, preferably less than three’.”

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What Is to Be Done

Countries can no longer enjoy the monetary autonomy and monopoly that seemed rightfully and inevitably theirs in the early decades of the twentieth century. To secure trustworthy values, liquidity and contained transaction costs, most nations can be reasonably expected to adopt some mechanism to link their currencies with a dominant global currency, be it the dollar, the euro or the yen. But this approach, called vertical integration, has both political and economic disadvantages. The most extreme form of vertical integration is dollarization, whereby the subordinate country simply adopts the dominant currency and gets out of the money business or retains only a token national currency, like the Panamanian balboa. A somewhat less draconian approach is a currency board. A currency board commits a country to issue only as much currency as it can back with its holdings of the dominant currency. Currency boards offer somewhat more flexibility, because the definition of "backed by" may vary, but they require an enormous amount of discipline and commitment, and there have been some dramatic recent failures (most notably in Argentina).

"A currency-board relationship is inherently asymmetrical, plainly favoring the central bank of the dominant partner, but need not be entirely one-sided."

Vertical integration has unquestionable advantages only for countries with such poor records of managing their own currencies that anything would be better. The political disadvantages include a strange but real sense that a country loses something of its essential nationhood when it no longer has its own currency. The loss of monetary sovereignty means a loss of seignorage and policy flexibility, in that the domestic economic needs of subordinate currencies do not rank very high in the decisions of dominant-currency central bankers.

Horizontal integration, achieved by pooling sovereignty with other countries and creating a currency union, may be appealing. Though it involves sacrificing sovereignty, the sacrifice is not as absolute as with vertical integration. When the advantages are clear to all participants, as with the euro, such currency unions can be successful. But the success of the euro is somewhat deceptive, insofar as its introduction was preceded by many years of careful work and the committed implementation of a plan for economic convergence.

The situation is clear and obviously difficult. Although demand-side economic factors favor the contraction and convergence of currencies into one or at most the scant trio now at the top, supply side factors will keep the world on a multi-currency footing for the foreseeable future. Yet this means the world will continue to face the risk of currency crises and contagions, such as the East Asian crisis of 1997. Ensuring stability and effective governance of a fractious, centripetal currency world requires monetary cooperation and fiscal discipline among all participants, but especially among the major actors.

About The Author

Benjamin J. Cohen is the Louis G. Lancaster Professor of International Political Economy at the University of California, Santa Barbara. He is the author of nine previous books, including *Organizing the World's Money*, *In Whose Interest* and *The Geography of Money.*

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