International Journal of
Community Currency Research

Commodity Currencies for Fair and Stable International Exchange Rates

J. Walter Plinge

5 Les Fauchers
33580 MonsZgur
France

International Journal of Community Currency Research
2001: Volume 5
ISSN 1325-9547

> "Since a currency's value represents the current and anticipated purchasing power, the trade value of a currency should be tied to the productivity of an economy rather than to its dollar reserves."
>
> Reform of the Global Financial System
> by Henry C. K. Liu, University of Colorado
> http://wfhummel.cnchost.com/globalfinancereform.html

Early debate between Monetarism & Commodities

For the greater part of the history of money, most nations and cultures have used commodities as the basis of currency systems, whether it was cattle, salt, gold, tobacco, seashells, or something else. Nonetheless economists such as Henry C. Simons and Lloyd Mints appeared in the early 1900s calling themselves "monetarists." Monetarism is probably more easily explained by what it is opposed to rather than what it is for. It is opposed to the gold standard; commodity reserve currencies. Monetarists advocated fiat currencies. "Monetarism was at the height of its influence on economy policy-making in the late 1970s and early 1980s," says the Center For Economic Policy Analysis, without noting that this happens to be the decade following the world's shift to the floating U.S. dollar and hence worldwide fiat money.

http://cepa.newschool.edu/het/essays/monetarism/mpolicy.htm

Proposals for commodity reserve currencies date back to the early 1870s by economists such as Walter Bagehot, whose article suggesting a currency based on a "market basket of commodities" appeared in the *Economist* in 1872.

Both gold-backed currencies and fiat currencies have now been tested and have been found to have fatal flaws. That the Gold standard was a failure is the subject of few debates today, but the evidence that fiat currencies have failed, while clear to many, is less obvious to others: people with money think it is successful; the poor think it has failed. But more tellingly, there are fewer and fewer in the middle.

Gold failed because it cannot be warehoused and retain its market value. Also there is simply not enough gold to represent the amount of money in the world today. More importantly, the gold standard ignores that there are other commodities that can be of use in money creation.

Fiat money failed because, as even the staunch monetarist Milton Friedman observed, keeping self-interested parties out of the central bank's operations is imperative in theory but is impossible in reality.

The Bretton Woods conference of 1944 was convened to address the problem of foreign exchange rates. Their solution was to adopt a commodity backed currency which was the gold standard with a fixed price on the gold. The gold standard was subsequently abandoned by President Nixon in 1971 in favor of a fiat currency trial.

Because the focus of this paper is to find a correct system of foreign currency exchanges, I propose another look at commodity backed currencies, the first choice of Bretton Woods. The object is to find a currency which, because it has a commodity backing, will have a meaningful value an thus a valid exchange rate can be established.

This is of major concern because it is the fiat system we use today that caused the collapse of currencies in Thailand, Indonesia, Singapore, Russia, Brazil, Philippines, South Korea, and Malaysia in 1997-9, and Mexico 1994. If nothing changes, the cycle will simply repeat itself as it has been doing for the past 30 years (i.e. since the commencement of fiat money) as Meir Kohn notes below:

"After a rash of bank failures in the early 1930s, Federal deposit insurance was enacted by Congress, but over strong opposition. The opponents argued that it would encourage bad banking and eventually become a burden to the taxpayer. But for the first time in the history of American banking, there was a lengthy period without bank runs or banking panics, and very few banks failed. That all began to change in the 1970s. It reached a crisis in the 1980s when bank failures, though less numerous, far exceeded the total assets (in constant dollars) of failed banks in the 1930s."

"Deposit Insurance" chapter
Financial Institutions and Markets by Meir Kohn, 1994
http://wfhummel.cnchost.com/depositinsurance.html

Commodity Reserve Currencies

The idea of commodity backed currencies, or commodity currencies, for short, is not a new one. The implementation of a durable commodity currency has been the problem.

When F.A. Hayek, wrote his paper *Commodity Reserve Currency*, in 1943, he proposed a shift from the gold standard to a commodity based currency based on what he called a "basket of goods." That is, Hayek saw that if currencies were to be traded internationally they had to be based on commodities, and that commodities are not just gold alone. It was a sound theory to that extent, but he too, assumed that currencies should be issued by the government. Also, his theory was criticized because of the "difficulty in warehousing perishable goods." The critics were thinking about the existing gold system which involved the need for a Fort Knox to store gold reserves more or less forever. So Hayek suffered from the same two problems that Bretton Woods did even though he saw the need for currencies to be based on commodities in order that the currencies could be traded internationally at their market value.

Bernard Lietaer has even put a term in his glossary, Global Reference Currency, to describe his vision of a commodity reserve currency.

"A proposed currency which would use a fixed basket of a dozen commodities as a reference and backing of a currency designed for international trade. The cost of storage of the commodities backing would be passed along to the bearer, and functions therefore as a built-in demurrage charge. This features reverses the tendency to discount the future, and therefore realigns corporate financial interests with long-term sustainability."

Lietaer addresses the same topic in "A 'Green' Convertible Currency." As he describes it, "a currency backed by a predetermined basket of commodities, is more familiar. An original aspect of my proposed plan is that a country's central bank would guarantee delivery of the value of the basket but would remain free to deliver it in the form of any mix of the commodities included in it.

"With a commodity-based currency, a central bank could issue a New Currency backed by a basket of from three to a dozen different commodities for which there are existing international commodity markets. For instance, 100 New Currency could be worth 0.05 ounces of gold, plus 3 ounces of silver, plus 15 pounds of copper, plus 1 barrel of oil, plus 5 pounds of wool.

"The bank could keep and trade its commodity inventories wherever the international market was most convenient for its own purposes — Zurich for gold, London for copper, New York for silver, and so on."

http://www.transaction.net/money/gc/gc01.html#commbase

The problem with centrally issued backed currencies remains: any "basket of goods" will not be big enough. According to the Federal Reserve, if we must have some figures, the total amount of M3 money in the U.S. on Dec 31, 1999, was, in billions, $6,484, or $6,484, 000,000,000,000, or $6.48 quadrillion, in cash and in banks in the form of checking, savings deposits and long term deposits.

In order to have a backing for such a currency it would be necessary to warehouse commodities worth at least $6.5 quadrillion. Undoubtedly the value of real goods in the U.S. is substantially more than $6.5 quadrillion, but unfortunately that data is not at hand presently. Perhaps it is 10 times greater; perhaps it's 100 times greater; or maybe it is even 1,000 times greater than the money supply. Whatever it is, the job of warehousing one tenth, one hundredth or even one thousandth of those goods would be a formidable job.

To put it on a more realistic level, as a microcosm of the economy, a person who ordinarily has say, $5,000 in cash and savings, might look around the house to see what of their possessions is worth $5,000 and is also available to be warehoused as a backing for their money. Probably those of us with a particularly ugly Picasso in the bathroom would not have a big problem here, but most people would surely find it difficult to part with a substantial amount of their real capital on an ongoing basis.

And one still must address the question of what happens to the price of copper plumbing fittings when all available copper, or even a substantial part of it, is warehoused permanently in London.

Problems plagued both the gold backed system and the fiat system and continue to confound the suggestions for commodity reserve currencies:

> 1) All three systems automatically assume that it was within the jurisdiction of government, or a central body, to issue and control a nation's currency rather than to simply administer the currency, as a nation's economic infrastructure, and facilitate its use.
>
> 2) Bretton Woods and commodity reserve proposals maintain the notion that a commodity can be used as a backing for a currency, based on its "market value" when all of that commodity is permanently warehoused in places like Fort Knox, thus destroying any possibility of establishing what the real market value should be.

The gold standard may have been a failure but the floating currency system is a worse failure. It's time to rethink the whole system, so, starting with the fundamentals let's first look at money:

> 1) Money is about trade; without trade money would never have come into existence.
>
> 2) The fundamental and natural way of trade is barter.
>
> 3) Money is a human invention to "simplify" barter.
>
> 4) No form of money will ever duplicate barter entirely, but the form which most closely represents barter will work most accurately and fairly.

But there are all kinds of money. There are commodities like gold that substitute for money, there are fiat monies, there are currencies that issue from the State and currencies that issue from individuals.

The U.S. fiat system takes only a passing interest in commodities and has determined to regulate money supply synthetically with non-market driven central bank manipulations such as interest rates, and government spending through bond sales, treasury notes, etc. I use the term ‘synthetically' because this is the same way one cuts the lawn and, having removed the clippings which provide natural fertilizer, must resort to artificial solutions. So we could add:

> 6) Those forms of money which ignore the fundamentals of barter, which ignore commodities and the source of money, are the least likely to act fairly and naturally and are most apt to be dependent on artificial solutions.

And for reasons addressed below we will add:

> 7) The Mutual Credit banking systems reflects barter far better than the fiat monies we now use and they are far superior to backed currencies of the past.

8) Money is a nation's economic infrastructure. A nation that permits the privatization of its currency and its banks will inevitably encounter difficulties as if it had privatized its roads.

The Fundamental Commodity Currency

Commodity currencies can be redeemed from the issuer for something of value, unlike the fiat money of today which can only be redeemed for more fiat money. To be clear about our terms, let's start at the beginning.

When Smith gives Jones a bushel of wheat for a bushel of corn we claim to have a barter transaction. What we actually have is two sales and two purchases, in one concise efficient transaction. But where is the money?

The money is the corn and the wheat.

Recall that various cultures throughout history have used different things for money, such as cattle, salt, gold, tobacco, seashells, or... corn and wheat.

Money, *REAL Money* to be clear, is commodities (goods and services, or labor). Smith is using wheat as money; Jones is using corn as money and both are acceptable to the other. Since the term "money" has come to mean a "coin" or "bill" or "gold" and has even become synonymous with "currency" the point has to be made clear that the original money; the first money; the very basic of all monies, is the commodities themselves. The problem is that when one says "commodities" most people have been conditioned to think of something *other* than money, and when one says "money" we have been conditioned to think of something *other* than commodities. But the two are actually the same thing: Real Money is commodities. ALL commodities.

To emphasize: money is any or all commodities, because if that is incorrect then it remains to be shown which commodities are not acceptable, and why.

Money is whatever is mutually agreed to use to purchase or acquire something else. Because the term "mutually agreed" is inherently vague, some interpret that to mean that the notion of money is in some way fanciful. Nothing could be further from the truth with Real Money. When Smith offers a *half* bushel of wheat for a full bushel of Jones' corn, Jones will want to know the reason why. Such terms may not be mutually agreed. This may seem silly to mention but barter is the most fundamental form of commodity money. One needs to have a foundation when the topic turns to foreign currency trades and the value of the dollar as compared to the value of the peso.

Gold, as a commodity, is Real Money but since one rarely consumes it, it is just one of many commodities popularly used for indirect barter. Smith wants to trade his wheat for corn. But corn is not in season, so he accepts gold (or any other convenient commodity), an indirect commodity, and postpones his purchase of corn. Indirect barter adds an additional step to the barter process and so is not as efficient as barter, even though it may sometimes be unavoidable.

Our dictionary, to date:

"Real Money" = Commodities,
"Currency" = Notes, coins, IOUs, etc.
"Money" = General term for either currency or Real Money

Our Primary Currency: the IOU

The IOU is a substitute indirect barter. Smith sells his wheat to Jones but Jones has no commodity Smith wants, and he has no indirect commodity that Smith wants, so Smith accepts the IOU as a substitute. Notice that the IOU is the basis of commodity based currency, since the IOU is actually a worthless piece of paper, but it is backed by the understanding that Jones will deliver the agreed upon commodity, or indirect commodity.

But the IOU has an important and much ignored feature which was observed by Thomas Greco in chapter 2 of his book *New Money for Healthy Communities* at: http://www.ic.org/market/money/chp2.html.

"...one must first recognize this essential fact, that [paper] money has a beginning and an ending; it is created and it is extinguished. ... The money issued may be thought of as an IOU which the buyer uses to pay for the goods and services he bought. That IOU might be passed along from hand-to-hand as each recipient in turn uses it to pay for his/her own purchase. Eventually, it must come back to the originator of the IOU who redeems it by selling something of value.

"As an example, ... The originator, Mr. Able, buys something of value from Mr. Baker. He gives Mr. Baker his IOU Baker then uses the IOU to buy something from Mr. Cook, who, in turn uses it to buy something from Ms. Drew. The IOU may continue to change hands any number of times as others use it to buy and sell, but eventually, it must return to Mr. Able. At that point, Able has fulfilled his commitment to redeem the money he issued (the IOU)."

So, keeping to the fundamentals, we can deduce that any legitimate paper money which can be called "commodity backed" is issued as an IOU to the producer of real goods or commodities and that money must return to the issuer for payment of something of equivalent value. For lack of any explanation of how a central authority might come to issue and redeem money, that brings us to the logical conclusion...

A citation by Greco, of E. C. Riegel, 1944: "That the Government can issue money for the people, is an utter fallacy."

That, in a few easy steps, answers problem #1: Who shall properly issue a nation's currency. It is the producers of commodities (not the government nor the central bank) who produce wealth and who then may generate paper currencies which are IOUs backed by something of value. It also is the way that many, but not all, community currency banking systems function.

Furthermore, it explains the difficulties of the fiat system. If the producers of goods and services are prevented from issuing currencies as they are today, then the fiat system must create money artificially. The U.S. uses such synthetic means as, government spending and bank lending to create money, and such methods have serious drawbacks, not the least of which is a nearly $6 trillion debt, and a central banking system that, when it has instigated financial collapses around the globe, is motivated solely by self-interest to tend only to the needs of its own investors.

The Rules for A Commodity Currency

The principles for a commodity backed currency are:

> It is issued as an IOU for something of value.
>
> It is redeemed by the issuer with something of equal value.

Those community currency banking systems which use The Rules above, have the proper means to create commodity backed currencies. The real question then becomes: Can community currencies form the basis for a national, commodity-backed currency and thus form a national currency which can be traded legitimately in international currency trades? And, can it be done while avoiding the warehousing trap? One question at a time:

How do you create a centrally issued currency with a commodity backing, without warehousing?

For centuries the world has been looking for the answer to that question. The answer is: it is not possible. The fountain of youth does not exist and there is no way to have a properly functioning centrally issued commodity money. Centrally issued currencies do not work, and warehousing commodities will not work. But what is more important is, there is no need to bother with that. There are community currencies that do the same thing. Nearly.

So community currencies are the solution?

Not all community currencies are the same. There are LETS, Ithica Hours, InterLETS, ROCS, Time Dollars, e-gold, Barter Clubs, WIRs, and various scrips like Berkshire Farm Preserve Notes, Deli Dollars, etc. And these fit into several categories such as, community service banks, fiat monies, mutual credit systems, scripts, and even hybrids. To which we must add "open" systems and "closed."

Of the community currencies available, only the mutual credit (MC) systems, which includes LETS, WIRs and ROCS, follow the rules of commodity monies listed above. And even when we narrow it down to three systems, there are further considerations.

In the end, the mutual credit systems which follow The Rules, create and extinguish commodity backed money throughout the system in the normal course of business. It matters not, whether we are discussing the Commodity Market, a chain store, a college, or a rabbit farm; under The Rules above, all money created is commodity backed. The whole Fort Knox concept is the un-necessary and redundant relic of people overly focused on centralization and authority.

So, there is a problem with some mutual credit systems?

Yes, possibly. Any MC system that links its currency to its national currency risks losing its connection with value of commodities in favor of the value of the national currency. The WIR links its MC unit of value directly to the Swiss Franc, so that if the Franc value fluctuates, the value of the WIR currency may fluctuate also. A true commodity currency will remain independent. ••see R Davies•• [I am still checking on this - JWP]

Would it not be total chaos to tell every business in the world to change their accounting procedure to the MC system?

Yes indeed. But there are innumerable examples around the world where a chain store allows its customers to pay a certain percentage of their bill in community currencies. A grocery store may accept 10% payment in community currencies because they have a few employees and local suppliers who will accept them as payment. But they have limited use for community currencies because they cannot pay their stockholders, truckers, or out-of-town suppliers with local money. Next year it may rise to 15%, then 20%.

Changes should be gradual, but the process is already underway. As more community banks open, more community currencies will circulate and be accepted in larger percentages by interstate businesses.

But aren't community currencies awfully complex and cumbersome for a national currency?

The issue of complexity is bound to arise. My experience is that it is a non-issue. One need only do a cursory survey of the present system of money creation with their M0, M1, M2, M3, and L monies, and the interminable discussions of trying to control something so unnatural to begin with, to arrive at the conclusion that money creation under the MC system is actually a way to *simplify* money creation. When a system can be made simpler *and* increase benefits at the same time — an unusual combination indeed — it seems a worthwhile consideration.

At the personal level many community currencies are like a checkbook but without the bank charges (bounced check fee, instant teller fee, etc.). We talk about issuing and redemption and that sounds complex but, as in most of the mutual credit systems like LETS, this redemption process happens in the clearing process at the bank and is no more or less obtrusive than the checking accounts we use today. And for those who are addicted to their credit cards Michael Linton who started the LETS banking system in 1983 has already been experimenting with electronic card readers. The technology is there waiting for users.

Getting today's economists to understand that simplicity is better may be difficult but there is still hope. The Center for Economic Policy Analysis had this to say about Milton Friedman, a monetarist, "He has since warmed to the idea of commodity-reserve currencies (c.f. Friedman, 1985) as that would implement the money growth rule [Friedman's money creation theory] almost automatically."

http://cepa.newschool.edu/het/essays/monetarism/mpolicy.htm

Sometimes it is encouraging to hear that the fine-tuners have approved of a natural system because it's almost as good as their artificial one.

Aren't community currencies too small to be considering international currencies?

It is always preferable to predict the future in hindsight. The term community currency gives the impression that they can only be used in small communities. But John Turmell has already shown how he can travel from Canada to and throughout Europe using his UNILets system, using hours as the common exchange rate. As the systems grow I suspect that people are going to realize that such currencies are useful for trading merchandise as well as tourism. Exporters for instance might be encouraged to take a look. When traders see that their Brazilian currency has dropped by 50% but their community currency has kept its value, then perhaps community currencies will be taken more seriously.

As one correspondent recently wrote, "If our systems here in Indonesia take off, we could offer some really great goods, from arts and textiles to hardwood products from a sustainable forestry project. This could extend to coffee, herbal medicines (an excellent herbal anti-AIDS drug is being produced here), spices, etc. However the other systems would have to have something useful to offer in return."

Should a nation strive for a single nationwide currency?

Both Thomas Greco and Michael Linton recommend a mixture of competing community currency systems, and, to the extent that the field is level and the customer is clear about the purpose of the system, this is probably sensible. The problem is that (a) our present fiat system is essentially a popularity contest, and currency values are unrelated to the underlying economy, and such a contest can spread to community currencies, and (b) there are so many community currency systems around that customers are already confused.

Some centralization of information would be helpful. For example, there is a problem with the lack of an educated public as regards money, but it has to be noted that it is unrealistic to expect people to read a book — or several books — before selecting a currency system. If information for the non-economist could be presented in a single page (or a few pages) in a chart fashion with a rating system it would surely help. The best analysis is probably that by Bernard Lietaer at: http://www.transaction.net/money/index.html.

And even that site is aimed more a the economically savvy student. This runs the risk of being lost under a plethora of Barter Clubs, some of the more useless systems, in terms of commodity currencies.

If you leave the creation of money up to individuals, will that not invite abuse and fraud?

With community currencies, local pressure is put on individuals to keep their accounts in order. If an individual broaches an acceptable standard, most systems offer assistance and the chronic abusers are refused access to the system. There is room for deception but it is not organized deception. With centralization one gets organized deception on a grand scale; there is no such thing as community pressure. There are are many questions that arise and the answers have to be found by trial and error. Mutual credit systems are relatively new and that is to be expected.

For instance, in the LETSystem there is the question of whether the use of Hours is as good as a local commodity as a unit of value. In a centralized system it is possible that a small elite group could insist that one is better than the other and make a grave error. In a decentralized system every IOU note that is spent into existence is spent by an individual and accepted by another individual and if there is a better way the individuals themselves will likely find it as quickly as anyone. While central bodies make firm decisions, there is little to indicate they make informed decisions.

How do you link community currencies from one community to the next?

Nobody can answer that question right now. There is no consensus at any rate. There are mono-lets and multi-lets and inter-lets and there are proponents of each. It is not the purpose of this paper to make policy for mutual credit systems; the purpose is to show that mutual credit money systems answer the problem of commodity currency creation and they can pave the way for fair and equitable international exchange rates. It is up to the people who are creating the systems to tailor them to their own purposes, and, as ever, co-operation and decentralization work best.

J. Walter Plinge *Commodity Currencies for Fair and Stable International Exchange Rates*

International Journal of Community Currency Research
2001: Volume 5
ISSN 1325-9547