

# The evolution of currency

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Until the formation of the Bank of England in 1694, money and currency were one and the same. Money was a tangible asset and this asset itself circulated as currency.

Money most often took the form of gold or silver coins, though history shows that many assets have from time to time served as money. But regardless of what 'thing' served as money, each shared one characteristic; they were all a tangible asset. Consequently, money had value in transactions because the asset being used to represent it was perceived to possess some inherent usefulness and was therefore valuable. What is more is that it was this tangible asset that circulated as currency. In other words, though money often took different forms, with coins of precious metals being the most common, the asset serving as money passed current from hand-to-hand.

Assets serving as money, however, were inconvenient. Coins were heavy and bulky, and the large number required to complete high value transactions was unwieldy. Even worse, coins could easily be nicked or scratched in use and were worn down from constant handling, dissipating the precious metal content that gave them their value. As a consequence, gold and silver were considered too valuable to circulate as currency, a reality that acted as an incentive to develop alternatives. And in fact these limitations were overcome by an important technological innovation from the Bank of England.

It created paper currency, called banknotes, which were a promissory note obligating the bank to pay the weight of metal printed on the note. This new currency enabled the gold and silver to remain in the bank's vault, with these paper notes circulating as currency in place of the inconvenient and valuable metals.

This new currency was therefore a money substitute, and not money itself. The currency allowed the appropriate weight of precious metal to be paid on demand when the bank note, on which a given stated weight of the metal was represented, was handed to the bank for redemption. This feature provided

holders of the notes some certainty that their money would be returned to them, but it also introduced a risk, namely that the bank would default on its obligation.

This risk of default was generally perceived to be acceptable given the advantages offered by this new currency. Because bank notes were very convenient and lowered the cost of transactions, they offered significant advantages over coins. Therefore, increasing amounts of bank notes were put into circulation. It was a successful innovation. However, the essential nature of currency was radically altered.

In contrast to the tangible asset commodities that circulated as currency, bank notes do not have any intrinsic value. Their value is derived from the assets backing them, thus making it clear that currency had become an item that requires balance sheet accounting and double-entry bookkeeping. Currency was no longer a tangible asset, the value of which arose from the asset itself. Currency was now a money substitute, and in particular, a liability of the Bank of England, which promised to pay money on demand.

There is an important difference between money and money substitutes, which has its basis in common law, that for an exchange in the marketplace to be extinguished assets have to be exchanged for assets. So if one uses gold to buy a horse, for example, an asset (gold) is being exchanged for an asset (the horse), and the instant the assets change hands the exchange is extinguished. There are no lingering obligations. But consider this transaction if one uses a national currency, i.e., a money substitute.

The national currency is not a tangible asset. It is a deposit liability of a bank, and it derives its value from the assets backing it. Therefore, the buyer in this exchange walks off with a horse (an asset) and the seller walks off with a money substitute (a bank's liability), so the exchange is not extinguished. There is a lingering obligation, and the exchange is not extinguished until the seller manages to exchange the national-currency money-substitute for a good or service.

Thus, the concept of a money substitute introduces a new risk into the transaction, normally called payment risk. It is the risk that the recipient may not be able to exchange the money substitute received in a transaction for a good or service. The payment risk means that the money substitute may lose all or some of its value before it can be exchanged for items of value.

For more than 300 years we have been using money substitutes. Their problems are readily apparent. Paper currencies often become worthless if banks fail, or when central banks pursue reckless policies that erode, and in some cases destroy, the value of the currency.

Furthermore, money substitutes are expensive. They are based upon credit, and it is costly to monitor credit-worthiness. In addition, substitutes do not circulate efficiently in online commerce. There are costs when converting one currency to another, and more importantly, with national currencies it is not possible to make instantaneous and nonrepudiable 24/7 payments, which have clearly become important requirements for global online commerce. In short, while money substitutes have more or less met the needs of the marketplace up to now, they have become inadequate.

Importantly, modern computer and communications technologies make possible new forms of currency, even private free-market currency, such as GoldMoney. The digital gold currency is driven by bottom-line objectives to earn a profit, in contrast to the often capricious and harmful political aims under which central bankers operate.

Therefore, it is my expectation that currency is about to evolve yet again. Global online commerce requires it, and so does the high cost of operating our present currency system of money substitutes.

Banks in the U.S. earn approximately U.S.\$70 billion annually, and it is estimated that some 40% of their profit is derived from their payment systems that enable the money substi-

tutes they create to circulate as currency. That is a high cost indeed to consumers and businesses, particularly when considering that the technology exists today to significantly lower these costs.

I expect, therefore, that currency will evolve into new forms. And, it will not be the first time that technology has caused profound changes. Take the history of PCs as an example. In 1977 corporate IT departments 'ruled the roost' and PCs were a hobby for a handful of enthusiasts. Yet in ten years, the PC had turned corporate IT departments on their head. Because of developing hardware and software technology, the PC had become an important new tool, forever changing the face of corporate computing. This same potential exists today for the Internet to fundamentally and forever change bank payment systems. As a consequence, look for new companies to exploit these new technologies, and in the process create a currency that once again is money, and not a money substitute.