

Federal Reserve Bank of Cleveland

Private Money: Everything Old is New Again

by Barbara A. Good

It's hard to pick up a newsmagazine or financial paper these days without reading about one of the new forms of electronic money. Although the business case for stored-value cards and cyber-money has not been proven in this country, media coverage has been lavish. Nearly all the stories, however, neglect one important fact: High-tech payments systems are best defined as a form of private money, something that has existed for centuries.

Private money—currency that is not issued or backed by any government entity—can have all of the characteristics of money, being a medium of exchange, a store of value, and a unit of account. Since Colonial times, this country has seen many examples of private money systems. In fact, Americans today regularly use many types of privately issued stored-value systems—like traveler's checks—on a regular basis without even thinking about it.

Private money is not prohibited if it complies with certain government regulations. It must be smaller in size than U.S. currency and issued in denominations valued at a minimum of \$1; any income received in private money must be reported to the IRS.¹

This *Economic Commentary* discusses the operation and characteristics of two types of private money currently in use in the United States: local currencies and local electronic trading systems (LETS). Local currencies are low-tech, while LETS require a more sophisticated level of technology, but both have dealt with the very questions that emerging high-tech payments systems now must face:

What induces people to accept the money in exchange for goods and services? What or who determines how much money is issued? How is counterfeiting prevented? And what stabilizes the purchasing power of money? The answers provide important lessons for the developers of the new electronic forms of money.

Local Currency Systems

Today, local currency systems are used in more than 30 U.S. communities, including Tacoma Park, Maryland, Madison, Wisconsin, Waldo County, Maine, and Montpelier, Vermont. The most publicized one—"Ithaca Hours"—is in Ithaca, New York (see figure 1 for a sample).

Ithaca Hours were established in 1991 by town resident Paul Glover, an outspoken proponent of local currency. Each Hour is equivalent to \$10, the average hourly wage of workers in Tompkins County, where Ithaca (population 30,000) is located. Glover, a writer who describes himself as a "community economist," notes that the motive for establishing a local currency was social as well as economic: "We printed our own money to level the playing field and to keep Ithaca money from leaking out of the local economy."²

Since 1991, \$63,000 worth of Ithaca Hours (6,300 Hours valued at \$10 each) have been issued in five denominations, from one-eighth to two Hours. An estimated 1,600 participants, including 300 businesses, have both earned and spent Hours. Glover notes that the value of trade in Hours has now reached about \$2 million,³ a good indication of the

Private money systems have existed in this country for 200 years or more. Wherever they are used, they must solve problems similar to those confronting innovative electronic money systems. This *Economic Commentary* suggests that the high-tech newcomers could benefit from the experience of the low-tech veterans.

currency's popularity within the community, although the amount is small compared with other payments methods.

In keeping with the social agenda, commemorative Hours are issued to honor local people and the environment. One of these commemoratives is the first paper money in the United States to honor an African-American. Furthermore, 10 percent of all Hours issued are awarded as grants to community organizations.

■ How Ithaca Hours Work

Hours are printed locally, then stored under lock and key at a nearby credit union until they are stamped with serial numbers. The bills incorporate several (apparently successful) anticounterfeiting measures, including unique paper and specially developed inks. Multicolored Hours, some printed on locally made, watermarked cattail (marsh reed) paper and some with thermal ink, are probably harder to counterfeit than U.S. dollars. Printing services are paid for with Hours, and many other services are provided by volunteers, including promotions and recruiting merchant participants.

There are two methods of getting Hours into circulation. Businesses and individuals who have agreed to accept them are paid two Hours for signing up, and their names are printed in a free bimonthly newsletter, *Ithaca Money*, which currently lists 1,300 participants. Although some will accept only partial payment in Hours, the system is well known and used regularly. (Stores also receive a display decal announcing that they accept the alternative currency.) The second method is to let people purchase Hours with U.S. currency at an exchange rate of \$10 for one Hour.⁴ Those who want to support the system without providing goods and services themselves can buy Hours at the credit union or at any participating business.

Each participant is paid two Hours every eight months as a reward for continued participation. In this way, the supply of Hours circulating within the community is increased on a controlled basis. Ithaca's equivalent of the Federal Open Market Committee (the policymaking arm of the Federal Reserve System) is the Barter Potluck, a community-wide governing body that meets once a month and votes on whether to continue this

Hours supply policy or to award any grants. Since Hours were introduced in 1991, there has been no increase in the exchange rate. However, this may in fact represent a form of inflation.

The reason is that merchants can accept a combination of Hours and other payment methods in exchange for goods and services. If they believe they have accumulated too many Hours, they can change their terms for accepting them.⁵ This could serve to lower the exchange rate (in effect raising prices) until their supply returns to the level they think is appropriate.

■ Are Local Currencies Sustainable?

In the end, a local currency is only as good as its "spendability." Ithaca Hours' adoption by many types of local merchants and businesses has helped keep the system robust. Indeed, wide acceptance is a key indicator of the sustainability of any local currency system. Holders of a local currency must be able to use it for obtaining the goods and services they want. Communities that are smaller than Ithaca or that have a less progressive social philosophy may find it more difficult to develop and maintain a local currency system.

■ LETS

The local electronic trading system (LETS)⁶ is a network supported by its own internal currency. It is usually a computer-based membership organization in which transactions generate credits to be spent within the group. The first modern LETS was developed in 1983 on Vancouver Island, British Columbia. Although there are only about 10 LETS each in the United States and Canada, Australia has 200, New Zealand has 90, and Great Britain has 170.⁷

■ How LETS Work

Typically, new members pay an initiation fee and provide a list of the goods and services they are offering, which is printed and distributed to all members. Thus, a LETS functions as a clearinghouse and information system as well as an account network.

A member starts off with a computer-based account and a zero balance, to be credited or debited when a good or service is traded. The buyer and seller negotiate prices individually, but there is no exchange of paper currency. When the deal is made, the information is reported by mail or phone to the local LETS' central office, where the accounts are debited and credited. A member need not have the appropriate amount of computer credits on hand when the exchange is made, but his account is debited to reflect this negative condition. There is no interest on a debit balance and no repayment schedule, but members are expected to bring their account balances back to zero. Excluding any service fees assessed by the LETS to cover the costs of running the computers and paying data-entry clerks, debits and credits (which sum to the total value of currency in the system) always equal zero. LETS' biggest advantage to members is that no limit is placed on the size of a transaction, but this is also their largest potential drawback, threatening their very existence. LETS are based on mutual trust and the expectation that each member will repay any debt incurred. If one member fails to repay, the others must absorb the obligation.⁸

A LETS extends the barter system and addresses some of its limitations. Its philosophy involves both freedoms and responsibilities. Members must consent to join the system and offer their services and products, which guarantees the acceptability of the currency. They know that interest will not be charged or paid on account balances, or earned by lending balances to other participants. Common ownership results in a cost-of-service provision for support functions, keeping transaction costs affordable. Because information disclosure is complete, the provider of a product or service can determine the account position of the purchaser. This transparency of operations provides a form of self-regulation which helps ensure that no one can increase or decrease his balance in an unauthorized manner.

FIGURE 1



There are two ways to value LETS units, one based on the rate for a standard hour of work (similar to Ithaca Hours), the other pegged to the national currency. Pegging makes the system more practical, yet still maintains its basic philosophy—that LETS are independent of a country's standard monetary system. LETS units can be spent only in the system in which they have been issued. They are merely information about an individual's position within the trading community and represent promises made by those who issue them. As such, they cannot be “called in” as if they were a debt, nor can they be redeemed for national currency. Although the prices negotiated between members can change relative to one another, these shifts have no inflationary impact.

■ LETS Registries

Each LETS has a registry, where new members sign up. It coordinates the recording of transactions and sends out statements, and can also be linked with other registries, allowing several systems to trade together. Each LETS has a steward who is responsible for its integrity and answerable to account holders (although his/her powers are strictly limited). A steward's duties include instructing registries not to record transactions that are considered inappropriate; acting as liaison to other registries; and advising the trading community about actions that could endanger the integrity of the LETS.

A LETS is a network of people who agree to trade in a particular way. Problems arise if members do not receive the services or products they have purchased or do not adhere to a set of binding agreements, some of which are subject to contract law. LETS earnings must be reported as income for tax purposes, but as for all business earnings, expenses of doing business can also be considered. Registries themselves generally choose a not-for-profit status, although some small systems are set up as partnerships.

■ Are LETS Sustainable?

Trust is an essential ingredient for any monetary system. Unlike local currencies, a LETS allows its members to maintain a negative balance and thus is subject to credit risk. Confidence in a LETS depends mainly on two factors: the balance of offers and requests and the efficiency and accuracy of the account-recording process. If a LETS were to cease operations, those holding positive balances could lose (a situation analogous to hyperinflation, where savings become worthless). Under the structure and agreements currently governing LETS, there could be no legal redress against those holding negative balances, except through individual civil suits. This makes a LETS a somewhat risky proposition for members, especially as the system expands. The simplest way to address its default risk is to limit the debit balance that any member can incur.

■ Implications for Other Private Money Systems

The similarities—and differences—between private money and more high-tech systems (card-based and network-based) are good indicators of what will be involved in achieving widespread use of the new stored-value systems. The three characteristics required to sustain a local currencies or a LETS—trust that the currency will be acceptable today and in the future, monetary value that remains constant, and security against counterfeiting—are the primary requirements for widespread acceptance and use of any form of payment, including the emerging high-tech systems.⁹

People must have faith in a currency's monetary value and in their ability to exchange that value at a fair, acceptable rate, now and in years to come. If the value is not “spendable” on the goods and services people want, or if the currency is not a reliable store of value, it is not very usable and thus will not be widely accepted. Security against counterfeiting is also essential. No form of money, however convenient, will be acceptable if users must worry about counterfeit bills when receiving payment or change from a purchase.

The lower-tech forms of private money discussed here have been dealing with these issues for years. This means that local currency systems and LETS, although limited in geographic scope, offer interesting parallels to the high-tech payment technologies that are in the news today and may be in our pockets tomorrow.

■ Footnotes

1. See Ellen Graham, "Community Groups Print Local (and Legal) Currencies," *The Wall Street Journal*, June 27, 1996.
2. Interview with the author, August 7, 1996.
3. Ibid.
4. Although the exchange rate for purchasing Ithaca Hours is fixed at \$10/Hour, there is no similar exchange rate or market for exchanging Hours for dollars. A discount for trades could conceivably exist if a user had more Hours than could easily be spent and wanted to exchange them for dollars. Only a few Hours are purchased with U.S. currency, so little seigniorage results.
5. *Ithaca Money* tells participants not only where, but also under what conditions, Hours are accepted.
6. The acronym can also stand for "local employment and trading systems."
7. For a closer look at these systems, see Lewis D. Solomon, *Rethinking Our Centralized Monetary System: The Case for a System of Local Currencies*, Westport, Conn.: Praeger, 1996, p. 41.
8. Ibid, pp. 38–9.
9. The acceptability of U.S. dollars abroad provides a good example of this concept. See John B. Carlson and Benjamin D. Keen, "Where Is All the U.S. Currency Hiding?" Federal Reserve Bank of Cleveland, *Economic Commentary*, April 15, 1996.

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