

OPINION

A Penny's Worth

BY RAYMOND E. OWENS

The penny is under attack. Soaring prices of metals have pushed the cost of producing a penny above 1 cent. The U.S. Mint recently estimated that it could soon cost as much as 1.23 cents to produce a penny. (Today's pennies are mostly made up of zinc; it hasn't been since 1837 that they were pure copper.) Right now, the Mint says that it makes a profit on the coins, which the Federal Reserve pays face value for to distribute. But with escalating metal prices, by some estimates the government could lose \$20 million a year on the production of pennies alone.

The inference in the popular media has been that pennies are now a losing proposition for our nation. That may be, but not necessarily for the reasons most often discussed in the articles.

The "cost exceeds value" argument seems plausible at first glance. After all, if it costs more to produce a good than the good can be sold for, no private individual or firm in their right mind would engage in that business. But the penny situation is different.

The penny is produced by the government, not the private market. The United States mints pennies (and other coin and currency) because it knows that money makes the exchanging of goods and services easier. This means that we don't have to go to the considerable trouble of trading between ourselves or bartering, for example, freeing up a lot of time for work and leisure. The more precisely that coins and currency allow us to determine prices, the more effective is money in freeing up our time.

Consider if we had just \$100 bills. Something worth far less than \$100 — a haircut, for example — would still require some bartering to make up the difference. Or you may decide to do without or overpay. In either case, the outcome is more time-consuming, less satisfying, or more costly than if \$1 bills were available.

The value of currency is not determined by its nominal value alone. It also depends crucially on the transaction costs that are saved by having a particular denomination. Thus, the value of a penny is its role in allowing you to determine prices to the penny rather than, say, to the nearest nickel. If you were at a street corner with one gas station charging \$2.52 a gallon and the other \$2.55, where would you fill up your tank? Now, if a single penny can be used in thousands of transactions, the added value per transaction can be quite small, but the value of the penny

relatively large. Taking this perspective, whether it costs a little more than a penny to produce a penny may not be so terribly important (though if there is a penny alternative that is less costly, that would be a little better).

This does not suggest that pennies play as important a role in daily transactions as they always have, however. I see pennies lying on the ground nearly every day. People simply don't place much value in picking them up. If they are like me, they probably have more than enough lying around their house anyway. In addition, pennies cause inefficiencies in the form of lost time when people fumble for them at cash registers.

On the other hand, it may be worth noting that the penny remains the most widely used denomination in circulation. In fact, the government mints more pennies than any other coin — 7.7 billion last year, compared with about 3 billion quarters. Apparently, the demand endures.

The casual attitude toward pennies probably reflects price inflation over time. The prices of most goods and services are well above the 1 cent level and few people probably care whether most prices are calculated to the nearest nickel. (Though they certainly might notice if pennies were suddenly pulled from circulation.) That is, when prices rise, a penny represents a smaller fraction of the price of a typical good, so the gains from calculating prices to the penny erode.

Thus, the popularity of the penny likely wanes not because of its high cost of production but because of its declining ability to make us much better off. Inflation has a long history of making some coins (and even some larger denominations) meaningless. After all, when was the last time you saw a halfpenny? (Hint: The Mint stopped making them in 1857.) Another factor behind the penny's declining popularity is the increased use of electronic payment technology, which has made our life easier while reducing demand for physical currency.

The bottom line is that the future of the penny may continue to be debated. But within limits, the cost of producing a penny (or a nickel or a quarter) shouldn't be the decisive factor in deciding the penny's future. The real key is how much time and effort it can save us relative to the actual cost of production.

RF

The value of currency depends crucially on the transaction costs that are saved by having a particular denomination.

Raymond E. Owens is a research economist at the Federal Reserve Bank of Richmond.