A Competitor for the Fed?

By: Lawrence H. White
"Ideas on Liberty", Foundation For Economic Education
July 1st, 2000

About a year ago I received a phone call from an entrepreneur named Bernard von NotHaus. He was eager to tell me about a new private currency, backed by silver, that he had designed and that his nonprofit organization is issuing. I was naturally skeptical, but being a student of private money, I agreed to get together with him at a local pub when he came through town. (It's often easier to argue monetary economics over a beer.) His outfit is called NORFED - short for the National Organization for the Repeal of the Federal Reserve Act and the Internal Revenue Code - and von NotHaus is an affable spokesman for the project.

Since October 1998, NORFED has been issuing American Liberty Currency (ALC) as a private alternative to Federal Reserve notes. The business magazine Forbes (April 3, 2000) has publicized the project, reporting that $230,000 in ALC is already in circulation. NORFED also sells one-ounce Silver Liberty pieces (for legal reasons, these are not called "coins," but for all practical purposes they are privately minted coins). Von NotHaus also calls his product line "the New American Dollar ' " which seems appropriate enough given that the original dollar was a silver coin. He likes to call today's government fiat dollar the "Federal Reserve Accounting Unit of Denomination." You can figure out the corresponding acronym.

NORFED's currency project offers an innovative approach to monetary reform. For most of us, the Federal Reserve's unlimited discretion over monetary policy is like bad weather: we complain about it, but few of us do anything about it. Why don't we do anything about it? Largely because we imagine that securing a better money means trying to rally massive political support for fastening a constitutional or legislated rule on monetary policy. Personal sacrifices in that direction seem unlikely to have a big personal payoff. Your expected personal payoff seems higher from taking the policy regime as it is, and simply trying to shelter your own assets from the vagaries of inflation and business cycles.

A silver-backed currency with widespread acceptance would provide a useful alternative to the Federal Reserve's product. Then, if you don't like the way the federal government manages (or mismanages) the value of the fiat dollar, you aren't limited to complaining. You can switch to the private alternative.

A Monetary FedEx

In a news story in Coin World (October 19, 1998), von NotHaus compared his organization's effort to the introduction of private alternatives to the U.S. Postal Service: "Federal Express brought competition to this heavily subsidized government agency that no one thought could change.... NORFED emulates this model by bringing a superior product to America's monetary system, its currency." A similar statement appears in NORFED's brochures and on its Web site (www.norfed.org). Apart from having a beer with von NotHaus, the Web site is the best place to get all the operational details of the project. There is also a lot of what I consider theoretical nonsense on the site about the supposed horrors of "debt-based" currency and "usury," but we can ignore all that for the sake of focusing on the prospects for the currency project.

Does the American Liberty Currency have any chance of gaining widespread acceptance? Good question. It's prudent to be skeptical, but it's not prudent to be too skeptical or skeptical for the wrong reasons.

One wrong reason for dismissing the ALC is the notion that something identical has been tried before and failed. In the 1980s a Kansas City firm called the Gold Standard Corporation, in addition to selling gold and silver pieces, issued notes denominated in units of gold, and even offered transferable deposit accounts denominated in gold. Its advertising slogan was "put yourself on the gold standard."

But the marketplace did not move to embrace the gold-denominated media of exchange, and it's easy to see why. As Carl Menger's well-known theory of the origin of money teaches us, any seller prefers to be paid in the medium of exchange that is the most popular with other sellers. When the monetary unit that everyone uses is the fiat dollar, sellers of goods want to receive dollars, not gold, because it is only dollars that they know they can turn around and re-spend. The first Gold Standard Corporation customers who tried to spend gold-denominated notes around town in 1988 would have discovered almost no stores willing to accept them in payment. Customers of a firm currently offering gold-denominated accounts transferable through the Internet, E-gold (www.e-gold.com), face the same problem.

The problem is one of achieving critical mass. Unless an alternative currency is regarded as a much more stable store of value, people will be reluctant to accept it knowing that it just isn't as spendable as the incumbent currency here and now. (When the incumbent currency approaches hyperinflation, however, as in Russia today, alternative currencies do gain acceptance.) Gold-denominated payments are incompatible with the prevailing dollar-denominated payments network. A critical mass does not exist until the network of traders who do accept payments denominated in gold is large enough to make paying in gold about as convenient as paying in dollars, and therefore to make the network self-sustaining. Doesn't a new silver-backed currency face the same problem? The American Liberty Currency cleverly avoids the obstacle of unit-of-account incompatibility by denominating its certificates in U.S. dollars. NORFED currently offers ALC certificates of $1, $5, and $10 denominations, and Von NotHaus has shown me a $20 proto-type.

But wait: How can a currency denominated in U.S. dollars have its value "backed and guaranteed" by silver? At first glance, this is the most perplexing feature of the American Liberty Currency program.

Ten dollars in an ordinary checking account has its dollar value (though not its purchasing power) "backed and guaranteed" by being redeemable for a $10 Federal Reserve note (or a $10 entry on the books of the Federal Reserve, which is how one bank pays another when a $10 check is written against the account and deposited into another bank). Any bank that issues a checking account balance is obliged and stands ready to redeem it dollar for dollar. ALC redemption centers, by contrast, are under no obligation to buy back ALC certificates in U.S. dollars; they only offer redemption in silver.

The face of the $10 American Liberty Currency certificate reads: "Silver Certificate. This is a receipt for Ten (US$10.00) Dollars given in exchange for Title to One (1) Troy ounce of .999 Fine Silver.... Redeemable by Bearer on Demand." The back declares that the certificate is a "warehouse receipt for one (1) troy ounce of .999 fine silver." Thus a $10 certificate is redeemable for one ounce of pure silver. It is redeemable for silver at any of NORFED's 300-plus redemption centers around the country. The text of the certificate does not specify in what form the ounce of silver will be provided, but let us suppose (in line with what the NORFED Web site suggests) that the redemption centers stand ready to give a one-ounce Silver Liberty piece in exchange for a $10 ALC certificate.

Of course, a one-ounce silver piece is not necessarily worth $10 in the market, in the sense of what coin dealers stand ready to pay for it. From March 1999 to March 2000, the spot price of silver on the metals exchange (the wholesale price for un-minted silver in bulk) largely stayed in the neighborhood of $5.00 to $5.50 per ounce. On the day this is being written the highest transacted price was $5.09 per ounce. Internet coin dealers on that day were offering to sell single one-ounce round silver pieces minted by private firms like Englehard and Sunshine for $5.49, or spot plus about 40 cents (they offered spot plus 29 cents in bulk), plus shipping and handling fees. They were bidding (were ready to buy them back for) an amount less than that. How much less? The dealer Web pages I looked at did not specify the bid prices for privately minted silver pieces (instead they said "call for price"). But clearly $5.49 is an upper bound for the current bid price of one-ounce private silver pieces.

Why Demand the Certificates?

Does NORFED then have any hope of maintaining a $10 value for a certificate redeemable for a one-ounce piece of silver? To answer the question fairly, we need to consider why such certificates might be demanded. There are basically three possibilities.

(1) If the certificates are demanded only as tickets to obtain pieces of silver, then they simply can't be maintained at a $10 value in the market when the silver pieces are selling for under $6. Recognizing this, NORFED forthrightly says to its potential clients: if your objective is to invest in silver, then buy silver, not our certificates.

It should be mentioned that the certificates promise one-ounce redemption at par for the next five years (fees may be imposed after that), so they do have some "option value." That is, they have an additional value over the current price of silver based on the possibility that a one-ounce piece of silver might go above $10 at some point in the near future, at which point it would clearly pay to redeem. But as a practical matter, the market currently considers this event so unlikely that the market value of the option is negligible.

(2) If only numismatic collectors demand the certificates, or people disgusted with the status quo who want to make a personal statement in favor of the hard money cause, NORFED faces a limited demand. The quantity of certificates demanded by collectors naturally declines with the size of the premium over the spot price of silver. It follows that the only way to keep the certificates at $10 is to keep them sufficiently scarce as collectibles.

The same logic applies to the possibility of keeping the Silver Liberty at $10 when other private one-ounce pure silver pieces are going for $5.49. By being the only seller of new Silver Libertys, NORFED can maintain the selling price at $10 easily enough, though it means selling very few Libertys when similar round pieces carrying the Englehard or Sun-shine imprint sell for far less. But maintaining the selling price at $10 is not sufficient to maintain the resale value or market bid price of the pieces at $10.

A very different organization is pursing the scarce-collectible-plus-good-cause strategy in marketing its own dollar-denominated notes. The Antarctica Overseas Exchange Office, Ltd. (www.bankofantarctica.com) promotes its "Antarctican Dollar" notes as colorful collectibles and promises to contribute its profits toward preserving the continent of Antarctica. Although the NORFED's brochures and Web site do mention the collector value of its certificates, and although the face of each certificate does declare "the Bearer's First Amendment right to petition the Government for a silver based currency," this is clearly not the primary strategy NORFED wants to pursue. It is primarily promoting the certificates as an alternative currency, an instrument potentially useful as a medium of exchange. (The Antarctican Overseas Exchange Office, by contrast, frankly warns that its notes may be difficult to spend even in Antarctica.)

(3) Consumers living in our current fiat-dollar-denominated economy will demand American Liberty Currency as a medium of exchange only if the malls and grocery stores where they shop will accept the $10 ALC certificate at face value. The larger the group of such accepting retailers, the more useful ALC certificates are as currency, and the more consumer demand the ALC will attract. But typical retailers will accept the $10 ALC certificate at face value only if they can be sure of getting $10 worth for it in turn. Because nobody is obliged to redeem the certificate for $10, and because banks won't accept it, this means finding ways to spend it where it will be accepted as $10. Although the "informal" cash economy is large, deriving value from the certificates by spending them poses a serious logistical problem for "formal" retailers, who seldom use currency to pay wages or purchase supplies. Retailers routinely deposit most of their currency receipts in a bank account at the end of the day, and pay their workers and suppliers by check. If banks won't take ALC, neither will most retailers.

Acceptance is problematic even with the sort of retailer most likely to accept a non-bankable currency, a small business proprietor who can pocket and spend the currency that ties in his cash register at the end of the day. His decision on whether to accept the certificates at face value depends on whether he can find ways to spend the certificates at face value, which depends on how many other businesses are willing to accept the certificates at face value, and so on in a self-feeding circle. We have returned, in a slightly different context, to the problem of establishing a critical mass.

The NORFED Web site provides a list of small businesses that accept ALC; many of them are also redemption centers. Even if the list represents only one-tenth of the businesses that currently accept ALC, there are fewer than one thousand acceptors. Of course, even a growing network has to start somewhere. The challenge facing NORFED is to get the network of acceptors to grow.

The problem of establishing critical mass in a new market network, where the value of the good to each user depends on the number of other users, is not always insurmountable. After all, the world is filled with fax machines, even though there was very little use for the first two fax machines (their owners could only fax each other). The world is filling with DVD players and DVD-format movie discs, even though the incentive to buy a DVD player depends on the number of DVD movie titles available, and the incentive to make a movie title available in the

DVD format depends on the number of DVD players bought. Because of the advantages their technologies offered, fax machine and DVD manufacturers were able to persuade early adopters that their networks would achieve critical mass. (For discussion of how entrepreneurs can jump-start new networks, see John Hagel III and Arthur G. Armstrong, Net Gain, Harvard Business School Press, 1997, or Kevin Kelly, New Rules for the New Economy, Viking, 1998.)

No Significant Advantage

NORFED's problem, to restate it, is to convince people to accept a $10 ALC certificate at face value on the supposition that other people will do the same, when most other people do not yet do the same. Does the ALC certificate offer any significant advantages over the established currency, the Federal Reserve note, the way the DVD format offers advantages over the videocassette? The fact that it is denominated in dollars (to provide unit-of-account compatibility) means that the ALC certificate offers no great advantage in prospective purchasing-power stability. For the foreseeable future, the purchasing power of ALC certificates is tied to that of Federal Reserve notes. The ALC certificate does have the one-ounce silver redemption option setting a lower limit to how far its purchasing power can fall - unlike a Federal Reserve note, which has no lower bound - but given current prices and expected inflation the silver redemption option seems financially irrelevant at present. (The futures market in silver is forecasting a spot price in the neighborhood of $5.40 per ounce in December 2000.) To become relevant, the price of silver would have to rise much closer to $10, or expected inflation rates rise sharply, so as to make "$10 silver in the near term" distinctly probable.

NORFED's literature emphasizes the superior anti-counterfeiting technology of its certificates. But the odds of being stuck with a counterfeit Federal Reserve note are small enough that few are likely to regard that as a large practical advantage.

I admire the courage of Bernard NotHaus in launching a private alternative to the federal government's currency. Economic theory and economic history indicate that currency is in fact best provided by private enterprise. But theory and history also indicate that, among private firms, banks are the most advantageous issuers of currency. Private bank-issued currency predominated around the world until government-sponsored central banks gained exclusive note-issuing privileges. Private banknotes still predominate today in Scotland and Northern Ireland.

Bank-issued currency provides full compatibility with the bank payment system. Unfortunately, the federal government has made bank-issued currency illegal in the United States. I have been told that the legal restriction has been lifted in the last few years, but (except for some very tentative trials of "prepaid cards" like Visa Cash) no bank has yet stepped forward to see whether the Federal Reserve will allow direct competition with its notes.

American Liberty Currency is fully legal, but unfortunately is not accepted by banks, and won't be so long as it is not interchangeable for Federal Reserve dollars in the ways that checking account balances are, and so long as the Federal Reserve runs the inter-bank payment system. ALC certificates are thus at a serious disadvantage as a medium of exchange under the payment institutions that presently prevail. Because they don't presently offer a purchasing-power-stability advantage over Federal Reserve notes large enough to offset this disadvantage, I see little prospect of the American Liberty Currency catching on in a big way any time soon. But the situation could change. High inflation is not currently in the forecast (to judge by long-term interest rates), but nothing guarantees that it won't return. If it does, we might then find a very practical advantage in a silver-backed alternative to the free-falling Federal Reserve note.