

Can "Good" Money Drive Out Bad?"

Remarks of George W. Mitchell

Member, Board of Governors of the Federal Reserve System

at the

American Management Association

New York

March 24, 1971

Can "Good" Money Drive Out "Bad?"

Not so long ago money was thought of as having four attributes described in textbooks as a medium of exchange, a measure of value, a store of value, and a standard of deferred payment. The concept of the value roles of money developed from the fact that at one time money was a commodity and most often a treasure, or a claim on treasure. In our part of the world the treasure was gold; in other countries and times it was silver, bronze and other metals. In primitive societies money was linked to commodities such as live stock or religious and ceremonial objects such as cowries, feathers, stones and hides.

The linking of money to objects of general acceptability, whether symbolic or utilitarian, sometimes resulted in certain monies being preferred to others. This could easily happen where metal coins were used and their treasure content could be altered. Debasement of the coinage was a popular method of government finance but it generally resulted in coins with the higher content of treasure disappearing from circulation. They were more prized simply because of their higher commodity value. This phenomena gave rise to the formulation of Gresham's law. Sir Thomas Gresham was a finance advisor to the government of Great Britain over 400 years ago, who noted that money which was inferior in its commodity value had the capacity to force out of circulation money that was superior in that respect. Eventually the phrase "bad money drives out good" became a monetary aphorism.

Times have changed greatly since then. Money no longer has worth as a commodity and its roles as a standard and store of value have been altered; on the other hand, money's medium of exchange role has greatly increased. Many factors have led to the unlinking of money and treasure, including the comparative political and economic stability most nations have achieved, and the fact that commodity money never gave any very great account of itself anyway, either in terms of stability or as a medium of exchange. To a considerable extent, the functions associated with money's role as a store-of-value have been gradually taken over by equities, credits based on earning assets or taxing power and a variety of institutional arrangements. Everyone has come to realize a fact which bankers have always known and on which much of their operation is based--that treasure is sterile and cannot rationally compete with earning assets as a wealth-holding form.

Thus money, while far from being entirely deposed in its value roles, serves those functions to a much more limited extent because they have been increasingly shared with other arrangements. On the other hand, money as a medium of exchange--and some would say as a determinant of economic activity--has now become a primary focus of public concern and attention.

In raising the question, can "good" money drive out "bad," my intent is to direct your attention to the comparative advantages of alternative forms of money from the standpoint of their relative efficiencies as media of exchange. So far as I can see, improving

money's efficiency (i.e., using less for a given volume of transactions) and lowering the processing, security and insurance costs per transaction would not alter in any significant way its value role capability or the problem of monetary management. Some sanctified rates of growth in the narrowly defined money supply might need to be revised but the actual increase in efficiency in money during the Sixties has long since made such revisions desirable.

For practical purposes there are only three vehicles for money transfer in the U.S.: (1) coin and currency; (2) checks or authorizations to draw on payors' demand deposit accounts at commercial banks (referred to hereafter as debit transfers); (3) authorizations by payors directing their bank to charge their account and credit payees' accounts in some designated bank--a system mainly used at present for transfers between banks and in the Government securities market--(referred to hereafter as credit transfers).

The money choices available to households and business at present are pretty well restricted to coin and currency or debit transfers. However, credit transfers are becoming possible and more common under preauthorization plans, payroll crediting, and so-called third party transfers.

The institutions in the money business are responsible for the money choices available to the public. Within general

statutory guidelines, these agencies are the Treasury, the Federal Reserve System and the commercial banks. Savings and loan associations and mutual savings banks may also receive Congressional approval to offer some kind of money services.

Within a fairly broad range, improving the transactions quality of our money depends on the readiness of the Federal Reserve and the commercial banks to recognize the need for more efficient money, and to move toward adapting the technological developments in data processing and transmission to the handling of money. Along with these positive attitudes a certain amount of resolution is needed to resist the retarding influence on decisions to innovate, which is inherent in established perquisites and the serendipitous features of obsolete money mechanics. Changes will, of necessity, erode these vested interests. But money users are entitled to the opportunity to realize advantages and conveniences of a modern money technology: they should not be victimized by inertia among the money institutions nor the fact that the quality of money, by the nature of things, cannot be enriched by a full range of competitive alternatives.

The potential of a skilled electronic processor of money transfers to become the community's accounts keeper is well recognized by some in the banking industry as is evident from the emphasis they are now giving to the latitude that should be accorded bank holding companies' activities in data processing. The promising

innovations proposed as serving the public interest in the form of cost reductions, expanded informational capability and instant access parallel in many ways the public advantages of an electronic transfer system. In fact, the two projects are not really separable.

The attributes of a "good" transactions money have to do with availability, convenience, safety and economy. In paying or getting paid almost everyone prefers money which can be handled conveniently, which does not involve exposure to loss, theft, or embezzlement when it is handled or stored, which provides a proof of payment, and which does not involve onerous fees or service charges when it is spent or received. But on the question of availability all of us as payees and payors become schizophrenic.

As payees we want to be paid in immediately available funds.

As payors we would just as soon settle our accounts on a deferred basis and, therefore, prefer a money form in which payment gets postponed. One way of realizing this latter objective is to use check money which requires a period of paper shuffling and shipping, and often reshuffling and reshipping, before our account is finally charged. The process also gives rise to float, check kiting, inflated deposit totals, superfluous availability accounting, and a variety of other effects adding to costs and frictions in the settlement system.

Getting paid with a money that cannot be immediately disbursed, or is only spendable, and sometimes contingently so, two or three days later is a disadvantage to the payee and a reason for him to regard the money with which such payments can be made as of inferior quality. If the sum is large, as in many financial transactions, the temporary loss of use may be costly; if the payee's cash position is precarious the delay may be embarrassing. Bankers in Europe settle their accounts in "good funds"--i.e., funds with immediate availability; in the United States their equivalent, Federal funds, is also used, but many banking transactions are also for next-day availability.

Changes in the payments mechanism now under way are having a profound influence on the relative efficiency and economy of these alternative transfer techniques.

Coin and currency still play an important role in money transfers of all households; between 10 and 15 per cent use no other means of payment. However, the credit card is undoubtedly reducing currency use and the role of coin has expanded due to meter vending.

In relationship to personal consumption expenditures, coins in circulation have increased nearly 40 per cent in the past decade but the ratio has been stable for the past three years. Small denomination currency use, on the other hand, has declined 25 per cent in the same period and that trend is continuing. Large denomination currency declined about 20 per cent in the late Fifties but has changed little since then.

Both coin and currency involve substantial handling, protection, shipping, insurance and processing costs but little technological effort has been made to develop substitutes. A multi-denominational pocket money tool would be a useful innovation.

Checks are the principal method of funds transfer today and they score high on flexibility and convenience. They are multi-denominational and provide an acceptable, though high priced, record of payment. Many check transfers, however, do not provide immediately available funds since they are, in fact, nothing more than an authorization to draw down the payor's account--if his balance covers the authorization--when the check finally reaches the payor's bank. In the interim, the payee can only spend the funds if his bank makes them available to him before the check is collected or before it receives the funds from the Federal Reserve.

The dimensions of the money job done by checks can be sketched in rough terms. According to the latest enumeration (June 30, 1970) there were 88 million demand deposit accounts in U.S. banks. Estimates of the total activity in these accounts are crude but one check per business day per account is reasonably consistent with available data. Weekly check volume thus is in the 400-450 million item range.

Our knowledge of payors and payees is sketchy, too. Deposits of individuals, partnerships and corporations make up 86 per cent of total demand deposits, excluding those of foreign and domestic banks. State and local government deposits account for 9 per cent of the total and the deposits of the Federal government make up the remainder. A recent survey by the FDIC showed 59 per cent of total IPC demand deposit balances to be those of businesses. From these facts it might be inferred that businesses write about 50 per cent of the checks, governments 12 to 15 per cent, and households the remainder. But it has yet to be established that deposit aggregates are a satisfactory basis for determining the relative dimensions of business, Government and household check writing activity. The probability is that businesses and governments write fewer checks than their balances imply and that households write more.

The most useful data on payees of which I am aware are regional findings developed in connection with a project sponsored by the Federal Reserve Bank of Atlanta, and directed by the late Professor Paul Han of Georgia Tech, which disaggregate check writing by households.

These data are especially relevant to the issue of improving the settlement system because, by reference to them, payments can be grouped according to repetitive payees and

repetitive amounts. About 13 per cent of household checks are repetitive as to payee and amount^{1/}; 35 to 40 per cent are repetitive as to payee only^{2/}.

These proportions suggest that an electronic pre-authorization technique along the line of SCOPE^{3/} would be applicable, given bill averaging by utilities (which makes up 10 per cent of the total); to about 25 per cent of household checks. Another 25-35 per cent could be incorporated into a crediting system in which the payor's role would be limited to dealing with his own bank: forwarding to it lists of payees, amounts and times for payment or approving similar lists submitted by the bank. A system along these lines would eliminate over half of household checks and displace it with an electronic system of greater convenience, certainty and economy.

Business and governments' check volume is closely associated with employment; fragmentary data suggests to the extent of more than half of the total. In addition to employees, other repetitive payees are stockholders, annuitants, and suppliers of goods and services. The Federal government, probably the country's largest check writer, generates nearly 3 per cent of the nation's volume. Approximately 25 per cent of Federal checks are for payroll,

1/ Mainly rent, house payments, insurance premiums, and installment loans.

2/ Mainly utilities, credit card companies, and retail stores (other than groceries, filling stations and drug stores). Checks payable to groceries, etc., constitute 15 per cent of the total written by households but seem to reflect in significant degree a currency service as withdrawals at banks account for only 5 per cent of checks written.

3/ Special Committee on "Paperless" Entries.

60 per cent for retirees, 10 per cent for tax refunds and the balance for all other payments.

As in the case of households, over 50 per cent of checks written by government and business are especially adapted to credit transfer. The Federal government, in fact, now employs this technique for payroll and allotment payments at the option of the recipient.

From what we know of the anatomy of money transfers it is evident that at least half of present-day check volume could be more efficiently processed by credit transfer. The basic advantage of the credit transfer is that the payor and his bank initiate the payment process and in doing so can establish a tight security on authorization of transfers and a full documentation of the transaction. Once the transfer is initiated it is electronically processed to the point of delivery without ever leaving the controls of the banking system and the Federal Reserve. No concomitant paper handling or movement is required.

The crediting process obviously adds to the responsibilities of banking institutions but there is no evidence that their software and equipment are unequal to the task. Moreover, the economic incentives to institutions and their customers appear to be substantial, particularly if all of the indirect costs are taken into account.

The Federal Reserve System's role in providing "good" money is to staff and equip its own offices with facilities equal

to any technological challenge it may confront. To that end, we have modernized and substantially expanded our wire transfer facilities, opened a new clearing facility covering the Washington-Baltimore area and have plans under way for another in Miami. We are projecting the extension of existing clearing areas in Reserve Cities and encouraging the organization of new clearing centers in certain other areas.

We have devoted substantial resources to numerous studies of various facets of the present settlement system. The latest is a contract with TRW for a model of check flows. We have cooperated to the fullest extent with industry studies, and such projects as SCOPE.

The product of this effort depends on the ability of the Federal Reserve System and the banking system to make it possible for "good" (better) money to drive out "bad"--something that has not happened up to now.