A Shred of Evidence on Public Acceptance of Privately Issued Currency

Martin S. Eichenbaum
Assistant Professor of Economics
Carnegie-Mellon University

Neil Wallace
Adviser
Research Department
Federal Reserve Bank of Minneapolis

and *Professor of Economics*
University of Minnesota

According to what is becoming known as the *legal restrictions theory,* both the potential level of nominal interest rates and the potential effectiveness of open market operations are closely linked to government rules that prevent private currency-issue—that is, that prevent private financial intermediaries from issuing liabilities that, like currency, are in small and standard denominations and are payable to the bearer. Without such legal restrictions, the theory says, an upper bound on nominal interest rates would be implied by the standard equilibrium condition that arbitrage between government currency and interest-bearing securities not be profitable. One form that such arbitrage could take, if it were allowed, is the buying of interest-bearing, nominally default-free securities and the selling of small-denomination notes which promised to pay the bearer government currency when the purchased securities matured. If the public would accept such backed, dated privately issued notes as perfect substitutes for government currency (so that the former would not bear interest if the latter did not), then the no-profit condition implies that the costs of engaging in such intermediation would set an upper bound on nominal interest rates.[1] If, moreover, those costs were the same for the central bank as for private firms, then open market operations would not affect the total amount of currency, government and private, or anything else.[2]

Most would agree that the most questionable of the assumptions behind these conclusions is that the public would accept backed, dated currency-like notes offered by private firms as perfect substitutes for government currency. That the public would do this is perhaps not obvious, considering what are often described as past unhappy experiences with private forms of currency. We will not review that historical evidence here. Instead, we will describe some fairly recent evidence on which we have stumbled: reports of two experiences with a form of private currency in Canada. The form of currency is a bit unorthodox: coupons issued by retail businesses. The form of evidence is unorthodox, too: primarily anecdotes, reported in newspapers. However, these anecdotes can be instructive. They seem to suggest that it would be unwise to reject the legal restrictions theory because of a belief that the public would reject privately issued currency.

Coupon-Issuing as Intermediation

The merchant coupons we will describe are somewhat different from most coupons. They are denominated in Canadian dollars, in small and standard sizes, and can be used at any time at their face value to buy any goods offered for sale by the issuing merchants. The coupons are given to customers as a discount on their purchases.

These merchant coupons are also somewhat different from the private currency described above. Instead of being claims to government currency at some time in the

[1]Casual evidence concerning the costs of operating other kinds of financial intermediaries and the costs of issuing and maintaining government currency suggests that the upper bound would be about 1 percent per year or less.

[2]For a more complete description of this theory and its implications, see Wallace 1983.

future, the coupons are claims to a dollar value of a limited set of goods (the merchant's) at any time. The at-any-time, or on-demand, feature of the coupons would seem to work in their favor as potential substitutes for government currency. But their explicit restriction to only particular goods would seem to work against them. Thus, experiences with these coupons are not ideal experiments for judging public acceptance of dated private notes backed by default-free securities. The experiences should, nevertheless, provide some hints.

Moreover, the experiences with merchant coupons are worth attention because these coupons are like dated, backed private notes in a crucial way: their issue is a form of intermediation between government currency and interest-bearing assets. This similarity may not be immediately apparent, but it can be seen by considering what the no-profit condition implies for a merchant coupon scheme. If a merchant's customers expected that the coupons would circulate at face value, then sales of goods would depend on net prices—gross prices minus the discount in coupons. In such circumstances, the profit per period from operating a coupon scheme would equal the interest the merchant could earn on the amount of the discount not yet claimed (the nominal interest rate times the average volume of coupons outstanding) minus the costs of operating the scheme. Thus, the equilibrium condition that it not be profitable to expand such coupon schemes implies that the costs of operating them would determine an upper bound on nominal interest rates, a familiar conclusion. Also familiar is the most controversial assumption behind it: that the public would accept the privately issued substitute for government currency—here, merchant coupons—at face value.

A Short-Lived Coupon Scheme . . .

One of our two Canadian coupon experiences lasted only three months, but not because the public wouldn't accept the coupons. On March 2, 1983, Steinberg, Inc., the third-largest supermarket chain in Quebec, introduced an across-the-board 5 percent rebate payable to all customers in coupons. The immediate result was a price war among supermarkets. On March 4, 1983, Provigo, Inc., Quebec's largest food chain, reacted by simply reducing all prices 6 percent. Metro-Richelieu, Inc., the second-largest chain, matched Steinberg's 5 percent discount by stamping cash register receipts and offering 5 percent of the total as a discount on future purchases. Because of large losses, Steinberg's announced on June 1, 1983, that it was ending the 5 percent discount and the issue of coupons. It would, however, honor all existing coupons.

For our purposes, we would like to know whether Steinberg coupons were used at face value for any transactions beyond Steinberg's—to pay a taxi driver or buy a newspaper, for example. As one might imagine, determining this is not easy, and unfortunately, we can offer no hard evidence. The best we can do is quote at length from a newspaper story (Bryan 1983b) which suggests that at least in their first month these coupons had begun to be traded at face value in a significant number of Canadian stores; in other words, they had begun to be treated somewhat like a privately issued currency.

> The coupon "money" that the Steinberg supermarket chain introduced this month is being spent in record stores, drugstores and at least one competing food chain, as other retailers try to piggyback on the widely-advertised promotional scheme.
>
> "A Steinberg coupon is cash. I have absolutely no qualms about it," said Irving Heisler, president of the Discus chain of 50 record stores.
>
> Heisler began accepting the coupon money a few days after Steinberg Inc. brought it out March 2, and now has "a couple thousand dollars" worth stuffed into filing-cabinet drawers at his company's St. Laurent headquarters.
>
> The A & P food chain, with 15 Quebec supermarkets, and Kane's Super Drug marts, with two Montreal stores, have followed.
>
> All three calculate that by accepting Steinberg money, they will attract at least a few customers who wouldn't otherwise have come in. . . .
>
> Discus, which is the only one of the three to have more than a week's experience with the coupon money, believes the move was a success. "It looks like we'll take them forever," said Heisler.
>
> A & P hopes not only to bring in new shoppers, but also to reduce the number of its own customers who might make purchases at Steinberg and then feel they should keep going back so as not to waste the coupon money.

. . . And Quite a Long One

Our other Canadian coupon experience lasted much longer than Steinberg's. In fact, the Canadian Tire Corporation Limited is still operating a coupon system which it began in 1958. The Toronto-based firm has 354 retail outlets sprinkled all over Canada. These outlets sell primarily gasoline, but also hardware and sporting goods. Although the precise details of the system differ from province to province, in Quebec customers receive a 4

percent rebate payable in small-denomination coupons.[3] According to Canadian Tire, the face value of the average stock of the coupons outstanding in 1982 was approximately 20 million Canadian dollars.

The age of this coupon scheme and its volume of coupons may alone suggest that the public is accepting Canadian Tire coupons as currency in at least a limited way. However, systematic evidence about how generally the coupons trade at face value is no easier to find for them than for Steinberg's short-lived coupons.

One little bit of evidence on the general acceptance of Canadian Tire coupons comes from Andre Dion, executive vice president and director general of Le Groupe Ro-Na Inc., a large Quebec chain of hardware, renovation, sports, and garment stores which competes with Canadian Tire. He reportedly told a newspaper (Canadian Tire . . . , 1983) that a company survey indicated that "80% to 82% of the people have Canadian Tire money." According to Dion, that survey prompted Ro-Na to start its own coupon scheme and to accept Canadian Tire coupons at face value "for at least two months and perhaps longer."

One final newspaper story (Tory MP . . . , 1983) suggests that Canadian Tire coupons are being used generally:

> It seems that Sinclair Stevens is often kidded by colleagues for being tight with a buck. But they say that frugality paid off for the one-time Treasury Board chairman when he hopped into a cab for a trip to the airport and found he had no cash when he reached his destination.
>
> Embarrassing for a millionaire? No problem for Sinc.
>
> "You take Canadian Tire coupons?" he asked the driver.
>
> "Why not?" replied the cabbie.
>
> Whereupon Stevens reached into a hoard of merchandise coupons he'd saved in his briefcase, and cheerfully paid off in funny money.

Concluding Remarks

These Canadian experiences with coupons issued by merchants demonstrate how privately issued currency can be created and come to be widely used. They lend some support to the view that, given the chance, the public would accept backed, privately issued currency as a perfect substitute for government currency. Although the available evidence is entirely anecdotal, that these Canadian experiences provide even a shred of evidence is remarkable because a Canadian law explicitly prohibits privately issued currency.[4] This law is likely responsible for limiting the medium-of-exchange role of coupons in Canada. The law not only prevents coupon-issuers from touting their product as an alternative currency; it also encourages issuers to act to inhibit the general use of their coupons. Canadian Tire recently acted in this way, for example, when it sought an injunction to prevent a rival company from accepting Canadian Tire coupons.[5] In the face of such actions, our anecdotal evidence is more impressive than it may otherwise appear.

References

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[3] Remarkably, the coupons, except for those in denominations smaller than 10 cents, are produced by the firms which print Canadian legal tender, using paper with the same rag content and spot marks as Canadian legal tender.

[4] "Every bank or other person who issues or reissues, makes, draws or endorses any bill, bond, note, cheque or other instrument, intended to circulate as money, or to be used as a substitute for money, is guilty of an offence against this Act." (Banks and Banking Law Revision Act, 1980, 29 Eliz. 2, c. 40, s. 311.1)

[5] For the details of this action, see Moule 1983. An alternative explanation for seeking the injunction is related to a marketing consultant's view of the profitability of coupon-issuing (described in Bryan 1983a): "the introduction of the coupons . . . appears to be a good marketing technique. 'It's much better than just cutting your prices,' since customers must return . . . to get the discount."

The views expressed herein are those of the authors and not necessarily those of the Federal Reserve Bank of Minneapolis or the Federal Reserve System.