

The Hierarchy of Money

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In the "Treatise on Money," Keynes defines *money of account* as the *description* or *title* and *money* as the *thing* that "answers" to the description. He goes on to say, "If the same thing always answered to the same description, the distinction would have no practical interest. But if the thing can change, whilst the description remains the same, then the distinction can be highly significant."

Why a Hierarchy

It is because different things "answer" to the description of money that there exists a hierarchy of moneys. The description or title referred to by Keynes is the unit in which all money in the hierarchy is denominated. In the US the unit of account (money of account) is the dollar. Thus all money in the hierarchy is denominated in the dollar.

Why the dollar? Answer: Because the government's currency is the only legal means of discharging tax liabilities. Since taxes are recurring liabilities, the private sector will continuously need dollars. Nearly every household in the US has dollar-denominated tax liabilities. That makes the dollar the standard unit of account for all money in the hierarchy. Since the private sector will always be indebted to the government in dollars, they will prefer to write all money contracts (make all promises) in terms of dollars.

IOUs as Money

The creation of money involves accepting another's debt, an IOU. The key to making an IOU into money is getting other individuals or institutions to accept it. Thus the hierarchy of money can be thought of as a multi-tiered pyramid where the tiers represent IOUs (promises) with differing degrees of acceptability. At the apex is the most acceptable, the Government's IOU, i.e. the dollar. Every plane ticket, prepaid phone card, movie ticket, subway token, etc. is a form of money. The list is endless so we will focus on the most important groups of promise makers - the government, banks, non-bank firms, and households.

The Hierarchy of Multi-Layered Promises

When a firm issues a promise, e.g. commercial paper, it promises to convert that promise on some specified date into a bank's promise, namely a demand deposit. Likewise when a household makes a promise, e.g. issues debt to a credit card company, it promises to convert its promise to a bank's promise. The

secret to getting household and business debts accepted is an assurance that they are convertible into the promise of someone higher in the pyramid.

Delivering the promise of the bank will discharge commercial paper, bonds, and credit card debt. However unlike households and firms, Government promises and certain bank promises would be accepted even if they were not convertible into anything else.

It is easy to see why the Government's liabilities have come to serve as the means of payment and as a medium of exchange in private transactions. It is not their status as legal tender per se, but their acceptance in payment of taxes and other debts to the Government that makes them the most acceptable and liquid money in the hierarchy.

Unique Status of Bank Promises

Even though banks make their promises (demand deposits) convertible on demand into the Government's promises (Government money) that is not the reason they are accepted. It is because bank money (inside money) is accepted at Government pay-offices that it, along with Government currency (outside money), is treated as the definitive money of the system. The Government does not pay its liabilities by converting to something else. It has in effect already paid for them as tax credits in the form of Government money.

Demand deposits at banks have attained a special status in our economy because of the unique role commercial banks have come to play. Since the central bank guarantees that demand deposits will trade at par with Government currency, and because they are accepted in payment of taxes, bank deposits are nearly as liquid as Government money and therefore occupy the second tier in the pyramid.

Lower-Tier Promises

Promises of firms and households occupy the third and fourth tiers, respectively. This is because there is at least some chance that they will not trade at par with Government money. Promises of firms stand ahead because they can usually be traded in secondary markets and are therefore more readily convertible.

The structure and hierarchy of money can only be understood in the context of money as promises of varying acceptability, with Government money at the apex.