ACCOUNTING FOR SOVEREIGN MONEY

Why State-Issued Money is Not 'Debt'

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PositiveMoney

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CONTENTS

INTRODUCTION

Positive Money advocates a shift away from the current 'debt-based' monetary system, in which almost all money is created by commercial banks as they issue loans, to a **'sovereign money'** system in which only the central bank is able to issue money[1]. Sovereign money would consist of physical cash (notes and coins) and electronic money which is issued exclusively by, and held at, the central bank.

There is some disagreement amongst economists about how sovereign money should be treated in the accounts of the central bank. Currently, notes issued by the central bank are recorded as liabilities of the central bank. This has led some writers to argue that all sovereign money is a liability, or debt, of the central bank, and therefore of the state.

In this briefing note we show that according to the International Accounting Standards and International Financial Reporting Standards, the guidelines used by accountants globally, sovereign money should be recorded as equity of the state, rather than debt. This initially counterintuitive result makes sense when we consider the way that sovereign money, or indeed any national currency, gets its value.

We start our analysis by looking at the official guidelines followed by accountants around the world, before asking whether sovereign money best conforms to the guidelines as a liability or as equity. We then look at the convention of recording central bank notes as a liability of the central bank, showing that this is a throwback to the gold era of the 17th-19th centuries. We consider the flaws in the argument that, since the state agrees to accept its own money in payment for taxes, then state money must be a debt of the state. Finally we ask, if sovereign money is equity, what it is equity *in*?

1. THE INTERNATIONAL ACCOUNTING STANDARDS

A useful guide to the appropriate way to account for sovereign money comes from the standards used by accountants. The International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) specify how different types of financial assets, liabilities and equity should be recorded. (Box 1 on page 3 gives a primer for those unfamiliar with the accounting concepts of balance sheets, assets, liabilities and equity). We can compare the nature of sovereign money to these definitions to see which is most appropriate.

Financial assets and financial liabilities are defined by IFRS as follows:

> **"Financial asset:** any asset that is:
>
> - cash
> - an equity instrument of another entity
> - a contractual right

1 See Jackson & Dyson (2013) or Dyson, Hodgson and Jackson (2014).

- to receive cash or another financial asset from another entity; or
- to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or

- [subject to defined exceptions] a contractual right that will or may be settled in the entity's own equity instruments."

"Financial liability:

- a contractual obligation
  - to deliver cash or another financial asset to another entity; or
  - to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
- [subject to defined exceptions], a contractual obligation to deliver the entity's own equity instruments to another entity."

Equity is defined as what it is not, i.e. not an asset and not a liability. Financial instruments which comply with the defined exceptions from classification as financial assets or liabilities are therefore defined as equity instruments. The definitions above introduce the term "equity instrument" which is defined as

"Equity instrument:

- any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities."

Equity is thus anything which represents a claim or a contractual entitlement but which does not qualify as an asset or a liability according to the definitions above.

We need to clarify whether sovereign money should be recorded as a liability or equity, according to the definitions above. Helpfully, the standard IAS 32[2] gives more instruction on the classification of liabilities or equity. We have highlighted key parts in bold, and will explain why they are relevant below.

"Classification as liability or equity

The fundamental principle of IAS 32 is that a financial instrument should be classified as either a financial liability or an equity instrument according to the substance of the contract, not its legal form, and the definitions of financial liability and equity instrument. Two exceptions from this principle are certain puttable instruments meeting specific criteria and certain obligations arising on liquidation. The entity must make the decision at the time the instrument is initially recognised. The classification is not subsequently changed based on changed circumstances. [IAS 32.15]

"A financial instrument is an equity instrument only if (a) the instrument includes no contractual obligation to deliver cash or another financial asset to another entity and (b) if the instrument will or may be settled in the issuer's own equity instruments, it is either:

"a non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or a derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. [IAS 32.16]

2 http://www.iasplus.com/en-gb/standards/ias/ias32 - "Classification as liability or equity"

BOX 1: A Quick Introduction to Assets, Liabilities and Equity

The financial position of any 'entity', such as a firm, household, bank or government, is shown by its 'balance sheet'. The balance sheet is an accounting statement that is defined by the accounting identity:

Assets – Liabilities = Equity

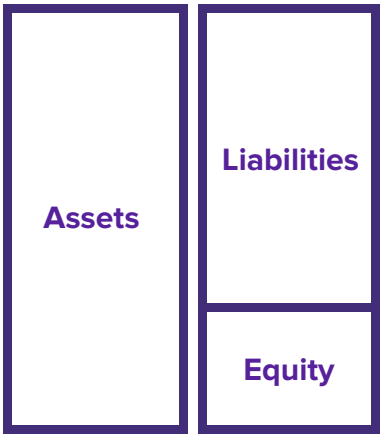
Assets represent the entity's ownership of tangible assets (such as buildings or equipment) and financial assets (such as cash, bank deposits, loan contracts, bonds, derivatives etc.).

Liabilities are determined by the transactions that the entity has entered into, for example, by borrowing funds, or accepting goods on a 'buy-now-pay-later' agreement or, alternatively, by accepting cash in advance of delivering the goods on a "pay now deliver later" agreement.

Equity is simply the residual difference between assets and liabilities. It is a measure of the net worth of the entity. In a corporate context, equity represents what would be left over for the owners (shareholders) of a company if all the assets were sold and the proceeds used to pay off all liabilities in full.

If the value of assets is reduced with no corresponding change in liabilities (for example, if a bank finds that some of its loans will never be repaid), then it is the equity which is automatically reduced. Likewise, if some of its liabilities are reduced without a corresponding change in assets (for example, when the bank collects interest from borrowers by reducing the balance of their deposit accounts), then equity is automatically increased.

Shown diagrammatically, assets are on one side of the balance sheet, whilst liabilities and equity are on the other side, 'balancing' out the assets.



2. IS SOVEREIGN MONEY A LIABILITY OF THE STATE?

Debt contracts and other liabilities oblige the debtor to deliver something of value (money, goods or services) to the creditor. For liabilities, there is typically a contract or enforceable order that defines:

- when the liability must be 'settled' (e.g. by 31st December; in equal monthly payments over the next 12 months; upon receipt of 7 days notice)
- what must be delivered to settle the debt (money or goods or services)
- whether any interest is charged whilst the liability is still outstanding.[3]

Sovereign money would not have any of these characteristics:

- The state would not obliged to deliver anything to holders of sovereign money other than identical sovereign money. There would therefore be no way to settle this 'debt'. (We address the argument that the state is obliged to accept sovereign money as payment for taxes later.)
- Sovereign money would have no maturity date (or expiry date). (In contrast, whilst bank deposits appear to have no maturity date, holders of bank deposits can request payments in either cash or electronic transfers to other accounts at any time and so the maturity date is effectively "right now", or zero, upon the customer's request.)
- No interest would be paid by the government or Bank of England to holders of sovereign money.

Referring back to the IFRS definition of financial liabilities, it is clear that sovereign money is not a 'contractual obligation to deliver cash or another financial asset to another entity', because sovereign money already is cash (in physical or electronic form) and has already been 'delivered' to the holder by virtue of the fact that it is in their possession. Nor is sovereign money a "contractual obligation to exchange financial assets or financial liabilities", since holders of sovereign money are not entitled to demand anything else from the state in exchange for that money.

The fact that sovereign money does not conform to the definition of a financial liability becomes clearer when it is compared to sovereign debt i.e. government bonds.

Government bonds have both interest rates payable (or are sold at issue at a discount to the face value, which has the same effect), and a maturity date at which money equivalent to the principal (face value) must be repaid to the holder of the bond[4]. Government bonds are clearly a form of debt (and therefore a liability), in which the bondholder expects to receive something else - specifically, money - in the future. Consequently, the issuance of government bonds creates two obligations for the government: (1) the obligation to pay a

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3 The absence of interest is not the distinguishing feature that makes something "not a debt". It is quite possible to have debts that do not bear interest. A typical example of this is loans between friends and family: such loans rarely carry interest, but they are debts that are expected to be repaid (to avoid awkwardness at dinner). A more commercial example of this is loans issued by the JAK Bank in Sweden, which do not bear interest (although they do come with administration fees).

4 The exception to this rule is a small residual amount of Consols, short for 'consolidated annuities', which were interest-bearing bonds, issued by the UK government from 1750 onwards, which have no maturity date.

stream of interest payments over the lifetime of the bond, and (2) the obligation to make a final lump sum payment when the bond matures. In contrast, the issuance of sovereign money requires no such obligation from the state[5].

3. IS SOVEREIGN MONEY EQUITY?

Sovereign money therefore does not meet the definition for a financial liability, but has far more in common with equity. With equity instruments:

- A firm is not obliged to make payments to holders of its equity
- Equity holders have no right to 'demand' anything of value from the equity issuer (except in liquidation)

Sovereign money has both of these characteristics:

- The state would not be obliged to make any payment at any time to holders of sovereign money.
- Holders of sovereign money would have no entitlement to 'demand' any asset from the state.

The IAS standards shown above seem to confirm that sovereign money is a form of equity:

> **"A financial instrument is an equity instrument only if (a) the instrument includes no contractual obligation to deliver cash or another financial asset."**

Since sovereign money already is a form of cash, it cannot be a contractual obligation to deliver that cash in the future; the central bank cannot be obliged to give holders of sovereign money something that they already hold.

The standard IAS32 gives a useful example in which two similar financial instruments are classified differently as a liability and equity according to their characteristics. The characteristics correspond to those of government bonds, and sovereign money respectively.

> **"Illustration – preference shares**
>
> "If an entity issues preference (preferred) shares that pay a fixed rate of dividend and that have a mandatory redemption feature at a future date, the substance is that they are a contractual obligation to deliver cash and, therefore, should be recognised as a liability. [IAS 32.18(a)] **In contrast, preference shares that do not have a fixed maturity, and where the issuer does not have a contractual obligation to make any payment are equity.** In this example even though both instruments are legally termed preference shares they have different contractual terms and one is a financial liability while the other is equity.

Government bonds (government debt) clearly have a 'fixed rate of dividend' in the form of the coupon (interest payment), and a 'mandatory redemption feature at a future date',

5 Although the non-interest bearing nature of sovereign money is not the distinguishing feature that makes it "not a debt", it does distinguish sovereign money from sovereign debt. Whereas the £1,485 billion of outstanding UK government debt currently generates an interest bill of £45 billion for the government (2.5% of GDP), the £1,000 billion or more of sovereign money that would exist under these proposals would have no interest cost.

in the form of their maturity. Consequently, government bonds, which are an obligation to deliver cash (or sovereign money), are correctly recorded as liabilities and debt of the state.

However, sovereign money has no fixed maturity (or put differently, infinite maturity), and the issuer has no obligation to 'pay' anything to the holders of sovereign money. **Therefore, it is clear that sovereign money should be recorded as equity, rather than debt, of the state.**

4. WHY ARE BANKNOTES CURRENTLY RECORDED AS LIABILITIES?

In the current monetary framework, paper money issued by central banks is recorded on the central bank's balance sheet as a liability. This is a throwback to the days when central bank notes were gold receipts. At the time, a holder of one of these notes could return the note to the Bank of England and it would be exchanged ('redeemed') for a specific quantity of gold. In this situation, it is clear that central bank notes were a form of debt of the central bank: in 1857, the £19.2 million of Bank of England notes in circulation obliged the Bank to deliver coins containing a total of 36.6 grams of gold for each £5 note, if note holders returned the notes to the Bank of England. Therefore, when banknotes were 'backed' by and redeemable for gold, the Bank of England owed gold to the holders of notes.

But central bank notes no longer represent promises to pay gold on demand. In the UK, banknotes have not been 'backed by' or redeemable for gold since 1931. The Bank of England's own website is quite clear about this:

> "The words 'I promise to pay the bearer on demand the sum of five [ten/twenty/fifty] pounds' date from long ago when our notes represented deposits of gold. At that time, a member of the public could exchange one of our banknotes for gold to the same value. For example, a £5 note could be exchanged for five gold coins, called sovereigns. But the value of the pound has not been linked to gold for many years, so the meaning of the promise to pay has changed. Exchange into gold is no longer possible and Bank of England notes can only be exchanged for other Bank of England notes of the same face value." (Bank of England website – FAQs)

Despite this, the Bank of England (and other central banks) still retains the accounting convention it used when bank notes were redeemable for gold. The stock of banknotes

circulating in the economy are recorded as a liability, called 'Notes in Circulation', on the balance sheet of the Bank of England's Issue Department[6], and this liability is balanced by financial assets in the form of government bonds[7].

Does the recording of banknotes as a liability of the central bank imply that they are also a debt of the central bank? No. The only obligation a central bank bears to the holders of its banknotes is to replace worn, damaged or obsolete banknotes with similar banknotes to the same value. The policy is adopted for reputational reasons, to ensure that bank-notes in circulation will be accepted at face value regardless of physical condition. Clearly a liability that imposes no obligation on the issuer to provide anything other than identical liabilities cannot be considered a debt. As Buiter (2003) writes:

> "Base money [banknotes, reserves and coin] does not have to be redeemed by the government – ever. It is the final means of settlement of government obligations vis-à-vis the private sector. It does not represent a claim on the issuer for anything other than the same amount of itself'." [Our additions in square brackets.]

Consequently, although notes are still recorded as a liability of the central bank, it is 85 years since the Bank of England last owed anything to holders of notes and coins. Notes are no longer a debt of the central bank or state, and the International Accounting Stand-ards suggest that, if they were initially recognised today, Bank of England banknotes would not be recorded as liabilities.

5. THE STATE ACCEPTS SOVEREIGN MONEY AS PAYMENT FOR TAXES. DOES THIS MAKE IT A FORM OF DEBT?

Writers from the Modern Monetary Theory school of thought (e.g. Wray, 2012, 2014), in particular, argue that state-issued money is an IOU that can be redeemed in payment for taxes. It is true that sovereign money is a financial asset which the holder can use to settle tax obligations, but it does not follow that we should view sovereign money as a debt of the state.

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6 Ever since the 1844 Bank Charter Act, the Bank of England has been required by law to maintain two separate balance sheets. One of the balance sheets, the Issue Department, covers the business of issuing banknotes (coins are dealt with by the Treasury), while the other – the Banking Department – covers all the rest of the Bank's activities. The Issue Department does not correspond to any actual department or office in the Bank of England; it is simply a set of accounts that measures a certain part of the Bank of England's assets and liabilities.

7 Strictly, the largest part of the assets matching the Issue Department's "Notes in Circulation" liability is made up of "Deposits at the Banking Department" i.e. central bank reserves. This is an internal liability of the Bank of England's Banking Department to its Issue Department. When the two balance sheets are consolidated, then it becomes clear that the Banking Department's liability "Deposits held by the Issue Department" is also matched by holdings of governments bonds.

The difference between sovereign money which can be used to pay taxes, and a debt in the conventional sense, becomes clear when we contrast the obligation that debt places upon a private sector business, with the obligation that the issuance of sovereign money places upon the government.

In the case of a private sector firm, the amount of money, goods or services a debtor must deliver to the creditor is defined by the firm's liability to that creditor. By this measure, 10 times more value must be delivered to the creditor who is owed £10,000 than to the creditor who is owed £1,000.

Does this principle apply equally to the state? If sovereign money were a debt of the state, then logically the state must 'owe' more to those who hold the most of this debt, (i.e. those who hold the most money). If this were the case, the state's debt to you, and therefore its obligation to deliver services to you, would be determined by how much of its liabilities (i.e. sovereign money) you held. Those holding the most sovereign money would be entitled to receive the greatest amount of government services, whilst those who held the least amount of sovereign money would receive the least services.

This is clearly not how government spending and taxation works. The state's obligation to you is determined by the state's policies, not by the level of its liabilities that you currently hold. The state decides how much service it will provide to each person based on criteria other than their holdings of money. A holder of sovereign money cannot hand over more currency and demand more services from the government. In practice, those who hold the most sovereign money are likely to receive a lower value of services (for the simple reason that the wealthy have less need to rely on direct support from the state[8]), whilst those who hold the least amount of sovereign money are likely to receive the greatest amount of services (because the poor are considered more needy of the state's support and services).

In this sense, sovereign money is clearly different from the debts of all other private sector firms and households. Wray and other writers argue that the holder of sovereign money is the creditor and the state is the debtor. But if state money is debt, then it is unlike no other form of debt, since no other form of debt allows the 'debtor' to unilaterally decide upon its obligation to its creditors, with no reference of the amount of its liabilities the creditor holds.

6. WHAT IS SOVEREIGN MONEY EQUITY *IN*?

If sovereign money is not a debt of the state as the institution of government, is sovereign money equity *in* the state? There are good arguments to say that it is.

Consider the case of equity in a business. A successfully run business will see the value of its equity rise, whilst a badly run business will see its equity fall. A truly badly run or corrupt business (e.g. Enron) will eventually see its equity drop to zero.

8 This is a general principle, although in practice it could be argued that the state and the tax system in its current form can have the effect of giving more to the rich than to the poor.

In a similar way, a well-run state, and well-run economy, will see the value of its production and output rise, and with it, the value of its currency. A badly-run or corrupt state (e.g. Zimbabwe) will see the value of its production collapse, and with it the value of its currency. So to a significant degree, the value of the currency depends on the effectiveness of the state, just as the value of an equity instrument (share certificate) in a firm depends on the effectiveness of the issuer of that instrument.

It could be argued that sovereign money represents equity in the wider economy of a nation. Writers from the Modern Monetary Theory school of thought are correct that some of the demand for the money the state issues, and therefore some of its value, derives from the fact that the state promises to accept its money in payment for taxes. However, this is not the only source of money's value. A large part - probably the more important part - of the acceptability of any currency comes from whether it can be exchanged for goods and services in the wider economy. In Zimbabwe, the Zimbabwean dollar was accepted in payment for taxes, but its value collapsed to zero in 2009 as a collapse in production meant that fewer goods and services were available to exchange the currency for. So the value of sovereign money (when viewed as equity) depends on the value and productive capacity of the economy as a whole. The economy as a whole operates to offer benefits to individuals in direct proportion to the amount of money that they hold and choose to spend. Their holdings of state money entitle them to share pound for pound in the value produced by the economy. In this sense, sovereign money could be seen as equity in the economy as a whole.

CONCLUSION

We have seen that, both logically and according to the International Accounting Standards, sovereign money cannot be considered to be a debt of the state. Instead, sovereign money conforms to the classification of equity.

This is important for two reasons. Firstly, issuing sovereign money does not simply mean that, as Wray (2014) claims, we are replacing one form of 'debt money' with another form of debt-based money. There is a significant difference between money issued as debt by commercial banks, and sovereign money issued by the state.

Secondly, there is a significant difference between issuing sovereign money and sovereign debt. Sovereign debt obliges the state to deliver a stream of interest payments over the lifetime of a bond, plus the obligation to deliver cash (sovereign money) when the bond matures. In contrast, sovereign money imposes no such obligations upon the state.

In some of our earlier papers we have proposed that sovereign money should be recorded as a liability on the central bank's balance sheet. As we have seen, this convention is a throwback to the gold era and is no longer consistent with International Accounting Standards. As the International Accounting Standards describe, "a financial instrument should be classified as either a financial liability or an equity instrument according to the substance of the contract, not its legal form…". **The substance of sovereign money means it should be classified not as a debt of the state, but as equity in the state and the wider economy that the state supports.**

However, the Standard goes on to say *"The entity must make the decision at the time the instrument is initially recognised. The classification is not subsequently changed based on changed circumstances. [IAS 32.15]"*. When initially recognised, base metal coins and

banknotes were redeemable promises to pay gold. According to the Standards the fact that circumstances have changed do not justify a change in the accounting treatment, and there is no pressing need to change these conventions. But we must not allow accounting conventions to become straitjackets to our understanding of money.

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