2. THE EVOLUTION OF MONEY

The word "money" is derived from the Latin word "Moneta" which was the surname of the Roman Goddess of Juno in whose temple at Rome, money was coined. The origin of money is lost in antiquity. Even the primitive man had some sort of money. The type of money in every age depended on the nature of its livelihood. In a hunting society, the skins of wild animals were used as money. The pastoral society used livestock, whereas the agricultural society used grains and foodstuffs as money. The Greeks used coins as money.

Stages in the Evolution of Money

The evolution of money has passed through the following five stages depending upon the progress of human civilisation at different times and places.

1. *Commodity Money.* Various types of commodities have been used as money from the beginning of human civilisation. Stones, spears, skins, bows and arrows, and axes were used as money in the hunting society. The pastoral

[3] L.V. Chandler and S.M. Goldfield, *The Economics of Money and Banking*, 7/e, 1977.

society used cattle as money. The agricultural society used grains as money. The Romans used cattle and salt as money at different times. The Mongolians used squirrel skins as money. Precious stones, tobacco, tea, shells, fishhooks, and many other commodities served as money depending upon time, place and economic standard of the society.

The use of commodities as money had the following defects: (1) All commodities were not uniform in quality, such as cattle, grains, etc. Thus lack of standardisation made pricing difficult. (2) Difficult to store and prevent loss of value in the case of perishable commodities. (3) Supplies of such commodities were uncertain. (4) They lacked in portability and hence were difficult to transfer from one place to another. (5) There was the problem of indivisibility in the case of such commodities as cattle.

2. *Metallic Money*. With the spread of civilisation and trade relations by land and sea, metallic money took the place of commodity money. Many nations started using silver, gold, copper, tin, etc. as money.

But metal was an inconvenient thing to accept, weigh, divide and assess in quality. Accordingly, metal was made into coins of predetermined weight. This innovation is attributed to King Midas of Lydia in the eighth century B.C. But gold coins were in use in India many centuries earlier than in Lydia. Thus coins came to be accepted as convenient method of exchange.

But some ingenious persons started debasing the coins by clipping a thin slice off the edge of coins. This led to the hoarding of full-bodied coins with the result that debased coins were found in circulation. This led to the minting of coins with a rough edge.

As the price of gold began to rise, gold coins were melted in order to earn more by selling them as metal. This led governments to mix copper or silver in gold coins so that their intrinsic value might be more than their face value. As gold became dearer and scarce, silver coins were used, first in their pure form and later on mixed with alloy or some other metal.

But metallic money had the following *defects:* (1) It was not possible to change its supply according to the requirements of the nation both for internal and external use. (2) Being heavy, it was not possible to carry large sums of money in the form of coins from one place to another by merchants. (3) It was unsafe and inconvenient to carry precious metals for trade purposes over long distances. (4) Metallic money was very expensive because the use of coins led to their debasement and their minting and exchange at the mint cost a lot to the government.

3. *Paper Money*. The development of paper money started with goldsmiths who kept strong safes to store their gold. As goldsmiths were thought to be honest merchants, people started keeping their gold with them for safe custody. In return, the goldsmiths gave the depositors a receipt promising to return the gold on demand. These receipts of the goldsmiths were given to the sellers of

commodities by the buyers. Thus receipts of the goldsmiths were a substitute for money. Such paper money was backed by gold and was convertible on demand into gold. This ultimately led to the development of bank notes.

The bank notes are issued by the central bank of the country. As the demand for gold and silver increased with the rise in their prices, the convertibility of bank notes into gold and silver was gradually given up during the beginning and after the First World War in all the countries of the world. Since then the bank money has ceased to be representative money and is simply fiat money which is inconvertible and is accepted as money because it is backed by law.

4. *Credit Money*. Another stage in the evolution of money in the modern world is the use of the cheque as money. The cheque is like a bank note in that it performs the same function. It is a means of transferring money or obligations from one person to another. But a cheque is different from a bank note. A cheque is made for a specific sum, and it expires with a single transaction. But a cheque is not money. It is simply a written order to transfer money. However, large transactions are made through cheques these days and bank notes are used only for small transactions.

5. *Near Money*. The final stage in the evolution of money has been the use of bills of exchange, treasury bills, bonds, debentures, savings certificates, etc. They are known as "near money". They are close substitutes for money and are liquid assets. Thus in the final stage of its evolution money has become intangible. Its ownership is now transferable simply by book entry.

Thus the origin of money has been through various stages: from commodity money to metallic money, and to paper money, and from credit money to near money.

3. CLASSIFICATION OF MONEY

Money can be classified on the following different bases: (1) the physical characteristics of the materials of which money is made; or the monetary system criterion, and (2) the nature of the issuer such as a government, central bank, commercial bank, or other, or the acceptability criterion, and (3) the relationship between the value of money as money and the value of money as commodity or what Keynes called Money of Account and Money Proper. We shall follow this classification while explaining the various *kinds of money*.

1. MONETARY SYSTEM CRITERION

The monetary system criterion classifies money into (1) metallic money, (2) paper money, and (3) credit money which we discuss below:

(1) Metallic Money

Money made of any metal such as gold, silver, nickel, copper, etc. is called

metallic money. Metallic money is further classified into standard money, token money and subsidiary money.

(i) Standard Money. Standard money "is money whose value as a commodity for non-monetary purposes is as great as its value as money." Such money is made of coins whose face value equals their intrinsic or metallic value. The holder of such coins may use them as metal by melting them or as money, because the value of the metal in the coins is the same as their monetary value. Standard money is, therefore, known as *full-bodied money*. Between 1835-93 the Indian Rupee-coin made of silver was a full-bodied coin. Further, standard money is unlimited legal tender in which any amount of payments can be made.

(ii) Token Money. Token money is representative money whose intrinsic value of the metal is less than its face value. The rupee coin in circulation in India is a token coin. If it is melted, its metal will not be sold worth one rupee.

(iii) Subsidiary Money. Subsidiary money is to assist the token money. All coins of the denominations from 5 paise to 25 paise in India are subsidiary money. Such coins are limited legal tender in which payments can be made only up to Rs. 25 in India.

(2) Paper Money

Paper money refers to notes of different denominations made of paper and issued by the central bank and/or the government of the country. Paper money can be classified into representative paper money, convertible paper money, inconvertible paper money and fiat money.

(i) Representative Paper Money. Representative paper money is "in effect a circulating warehouse receipt for full-bodied coins or their equivalent in bullion." It is also known as representative full-bodied money because it is fully backed by gold coins or gold bullion held by the treasury. They are fully convertible into gold coins or bullion. The gold certificates which circulated in the United States prior to 1933 were representative paper money.

(ii) Convertible Paper Money. Convertible paper money is that which does not have 100 per cent backing in the form of standard coins or bullion. But the holder of paper money can get it converted into bullion or coins on demand. The only difference between representative and convertible paper money is that the former is fully backed by standard coins or bullion while the latter is not fully backed by them. But both types of paper money are convertible.

(iii) Inconvertible Paper Money. The paper money which does not have any backing of standard coins or bullion and is also not convertible into them is known as inconvertible paper money. Notes issued by central banks of all countries represent inconvertible paper money. They are also known as fiduciary money.

(iv) Fiat Money. Paper money which circulates on the authority (i.e. fiat) of the government is fiat money. Fiat money is created and issued by the State. But

it is not convertible by law and is legal tender. Fiat money is thus representative or token money. One rupee note issued by the Ministry of Finance and token coins issued by the Government of India are fiat money. Practically, there is no difference between fiat money and inconvertible paper money these days.

(3) Credit Money

Credit money or bank money is transferred by a commercial bank in the form of a cheque or draft. But a cheque or draft is not money. Demand deposits in a bank is money which is withdrawable by a holder of the deposit through a cheque or draft. Thus it is demand deposit which is credit or bank money that is transferable from one person to another through a cheque or draft. But a cheque or draft is not legal tender and may not be accepted as a means of payment or medium of exchange. However, in advanced countries bank money is as important as the paper notes issued by the government or the central bank of the country.

2. ACCEPTABILITY CRITERION

On the basis of acceptability criterion, money is classified into legal tender money and non-legal tender money.

(1) *Legal Tender Money*. Legal tender money is that which the state and the people accept as the means of payment and in discharge of debts. Since it has the authority of the government, such money is accepted compulsorily by the people. All notes and coins issued by the government and the central bank of a country are compulsory legal tender in that country. Legal tender money is further divided into limited and unlimited legal tender money.

(i) Limited Legal Tender Money. Limited legal tender money is that in which payments can be made legally upto a certain limit. All coins of the denominations of 5 paise to 25 paise are limited legal tender in India. Payments in them can be made up to a limit of Rs. 25.

(ii) Unlimited Legal Tender Money. A money is unlimited legal tender when payments can be made in it legally in unlimited quantities. All paper notes and coins of 50 paise and 1 Rupee are unlimited legal tender in India. People have to accept payments in unlimited quantities in notes and these coins.

(2) *Non-Legal Tender or Optional Money*. Money which does not possess any legal authority of the state or the central bank is non-legal tender money. Robertson called it "optional money". Bank money in the form of cheques, drafts, etc. are the forms of non-legal tender money. People are not bound to accept such money because there is no legal sanction behind their issue.

Besides cheques and drafts, there are many other forms of optional money such as time deposits, bonds, securities, debentures, bills of exchange, treasury bills, postal certificates, insurance policies, etc. They are known as "near money" or "money substitutes". They are almost perfect substitutes for money as a store

of value. They possess moneyness or liquidity. They also yield income. They economise in the use of currency. But they do not have any legal status.

3. MONEY OF ACCOUNT AND MONEY PROPER

Keynes distinguished between money of account and money proper. According to him, "Money of account is that in which Debts and Prices and General Purchasing Power are expressed." On the other hand, money proper is the actual money in which contracts or debts are settled, such as the Indian rupee, the British pound, the American dollar, the French franc, the German mark, the Japanese yen, the Italian lira, etc. Usually, there is no difference between money of account and money proper when the accounts in a country are maintained in money proper. But if accounts are kept in some other currency money of account differs from money proper, as happened in Germany after World War I when the money of account was the American dollar and the money proper was the German mark. However, the two may differ when the value of money as money and the value of money as commodity are different. For example, value of Indian rupee as money of account has remained the same but the value of Indian rupee as commodity or money proper has been changing over time, that is, it is an unlimited legal tender. It is a token coin or money whose present intrinsic value is negligible in relation to its face value as compared to 1939.

4. MONEY AND NEAR MONEY

Money consists of currency and bank deposit. Coins and currency notes issued by the central bank of a country and cheques of commercial banks of a country are liquid assets. In fact, cheques and bank drafts are almost perfect substitutes for money. This is because they perform the medium of exchange function of money. But cheques and drafts can be issued at a short notice only in the case of *demand deposits*. This is not the case with time deposits which can be withdrawn either at the end of the fixed period or by giving a prior notice to the bank and incurring a penalty. Thus time deposits are not 'real' money and for them to become money they must be converted into cash or demand deposits. However, they are near money for they can be converted into real money in a short period without any loss. For example, a time deposit of Rs. 10,000 for three years can always be converted into demand deposit or Rs. 10,000 in cash at any time before the completion of three years. They also fetch a fixed rate of interest which may be reduced if the deposit is converted into cash or demand deposit before the expiry of the fixed period. Thus near money assets serve the store of value function of money temporarily and are convertible into a medium of exchange in a short time without loss in their face value.

Besides time deposits, other near money assets are bonds, securities, debentures, bills of exchange, treasury bills, insurance policies, etc. All these types of

assets have a market and are negotiable so that they can be converted into real money within a short time. We discuss how these negotiable instruments are near moneys.

Bonds, securities and debentures fall in the same category. Bonds and securities are issued by the government, while debentures are issued by companies. They are the means to borrow funds for short, medium or long periods and carry a fixed rate of interest. They are near money assets because they are convertible into cash at a short notice in the money market.

A bill of exchange is another form of money. It is an IOU (I owe you). It is drawn by an individual or firm to pay a stated sum of money on a specified date which is never more than 90 days. A bill of exchange is not money by itself but is certainly money on the due date. It is, however, near money if its owner wishes to turn it into cash. It can be easily converted into money at a discount or by receiving less money than its face value.

Treasury bills issued by the government also fall in the category of near money. A treasury bill is a promise by the government to pay a stated sum in the near future usually 30, 60 or 90 days. A treasury bill is also like a bill of exchange which is convertible into money at a discount within a short period.

Life insurance policy is another example of near money. The holder of a life insurance policy can obtain cash in the form of loan on his policy at a short notice. Thus a life insurance policy is a form of liquid asset which can be regarded as near money.

Besides these recognised instruments of near money, some intermediaries have come into existence to provide a market for certain assets. Such intermediaries are financial companies which provide funds on the security of some assets, and brokers who buy and sell property, bonds, debentures, shares, etc. They help in increasing the liquidity of such assets thereby converting them into near money.

Money and near money can now be distinguished. Money is a legal-tender and gives the possessor liquidity in hand. It performs the medium of exchange function. On the other hand, near money assets do not have any legal status. They possess moneyness or liquidity but not ready liquidity like money. They are almost perfect substitutes for money as a store of value. They are superior to money because they yield income. They also economise in the use of money proper and tend to reduce the quantity of money used by the people as a medium of exchange, as a medium of deferred payments and as a store of value.

Despite the fact that near money assets do not possess ready liquidity, they are preferred by individuals. According to Professor A.G. Hart, near money is preferred to cash by individuals because it serves as a margin of safety motive. Prof. Dean points out that 80 per cent of near money in the USA is held by individuals. The tremendous growth of near money assets in the United States is due to the fact that the yield from them is higher than that from demand deposits

and that they are safer than cash. Moreover, savings in the near money assets have been encouraged by such special techniques as pay roll saving plan, and commercial bank plans covering automatic regular transfer of specified sums from the demand to time deposits of the customers.

5. NATURE AND DEFINITION OF MONEY

There has been lot of controversy and confusion over the meaning and nature of money. As pointed out by Scitovsky, "Money is a difficult concept to define, partly because it fulfils not one but three functions, each of them providing a criterion of moneyness ... those of a unit of account, a medium of exchange, and a store of value."[4] Though Scitovsky points toward the difficulty of defining money due to moneyness[5], yet he gives a wide definition of money. Professor Coulborn defines money as "the means of valuation and of payment: as both the unit of account and the generally acceptable medium of exchange." Coulborn's definition is very wide. He includes in it the 'concrete' money such as gold, cheques, coins, currency notes, bank draft, etc. and also abstract money which "is the vehicle of our thoughts of value, price and worth." Such wide definitions have led Sir John Hicks to say that "money is defined by its functions: anything is money which is used as money: 'money is what money does.'[6] These are the functional definitions of money because they define money in terms of the functions it performs.

Some economists define money in legal terms saying that "anything which the state declares as money is money." Such money possesses general acceptability and has the legal power to discharge debts. But people may not accept legal money by refusing to sell goods and services against the payment of legal tender money. On the other hand, they may accept some other things as money which are not legally defined as money, in discharge of debts which may circulate freely. Such things are cheques and notes issued by commercial banks. Thus besides legality, there are other determinants which go to make a thing to serve as money.

7. FUNCTIONS OF MONEY

Money performs a number of primary, secondary, contingent and other functions which not only remove the difficulties of barter but also oils the wheels of

trade and industry in the present day world.[13] We discuss these functions one by one.

1. Primary Functions

The two primary functions of money are to act as a medium of exchange and as a unit of value.

(i) Money as a Medium of Exchange. This is the primary function of money because it is out of this function that its other functions developed. By serving as a medium of exchange, money removes the need for double coincidence of wants and the inconveniences and difficulties associated with barter. The introduction of money as a medium of exchange decomposes the single transaction of barter into separate transactions of sale and purchase thereby eliminating the double coincidence of wants.[14] This function of money also separates the transactions in time and place because the sellers and buyers of a commodity are not required to perform the transactions at the same time and place. This is because the seller of a commodity buys some money and money, in turn, buys the commodity over time and place.

When money acts as a medium of exchange, it means that it is generally acceptable. It, therefore, affords the freedom of choice. With money, we can buy an assorted bundle of goods and services. At the same time, we can purchase the best and also bargain in the market. Thus money gives us a good deal of economic independence and also perfects the market mechanism by increasing competition and widening the market.

As a medium of exchange, money acts as an intermediary. It facilitates exchange. It helps production indirectly through specialisation and division of labour which, in turn, increase efficiency and output. According to Prof. Walters, money, therefore, serves as a 'factor of production,' enabling output to increase and diversify.

In the last analysis money facilitates trade. When acting as the intermediary, it helps one good or service to be traded indirectly for others.

(ii) Money as Unit of Value.[15] The second primary function of money is to act as a unit of value. Under barter one would have to resort to some standard of measurement, such as a length of string or a piece of wood. Since one would have to use a standard to measure the length or height of any object, it is only sensible that one particular standard should be accepted as *the* standard. Money is the standard for measuring value just as the yard or metre is the standard for measuring length.[16] The monetary unit measures and expresses the values of all

goods and services. In fact, the monetary unit expresses the value of each good or service in terms of price. Money is the common denominator which determines the rate of exchange between goods and services which are priced in terms of the monetary unit. There can be no pricing process without a measure of value.

The use of money as a standard of value eliminates the necessity of quoting the price of apples in terms of oranges, the price of oranges in terms of nuts, and so on. Unlike barter, the prices of such commodities are expressed in terms of so many units of dollars, rupees, francs, pounds, etc., depending on the nature of the monetary unit in a country. As a matter of fact, measuring the values of goods and services in the monetary unit facilitates the problem of measuring the exchange values of goods in the market. When values are expressed in terms of money, the number of prices are reduced from $n(n-1)$ in barter economy to $(n-1)$ in monetary economy.

Money as a unit of value also facilitates accounting. "Assets of all kinds, liabilities of all kinds, income of all kinds, and expenses of all kinds can be stated in terms of common monetary units to be added or substracted."[17]

Further, money as a unit of account helps in calculations of economic importance such as the estimation of the costs, and revenues of business firms, the relative costs and profitability of various public enterprises and projects under a planned economy, and the gross national product. As pointed out by Culbertson, "Prices quoted in terms of money become the focus of people's behaviour. Their calculations, plans, expectations, and contracts focus on money prices."[18]

2. Secondary Functions

Money performs three secondary functions: as a standard of deferred payments, as a store of value, and as a transfer of value. They are discussed below.

(i) Money as a Standard of Deferred Payments. The third function of money is that it acts as a standard of deferred or postponed payments. All debts are taken in money. It was easy under barter to take loans in goats or grains but difficult to make repayments in such perishable articles in the future. Money has simplified both the taking and repayment of loans because the unit of account is durable. Money links the present values with those of the future. It simplifies credit transactions. It makes possible contracts for the supply of goods in the future for an agreed payment of money. It simplifies borrowing by consumers on hire-purchase and from house-building and cooperative societies. Money facilitates borrowing by firms and businessmen from banks and other non-bank financial institutions. The buying and selling of shares, debentures and securities

is made possible by money. By acting as a standard of deferred payments, money helps in capital formation both by the government and business enterprises. In fine, this function of money develops financial and capital markets and helps in the growth of the economy.

But there is the danger of changes in the value of money over time which harms or benefits the creditors and debtors. If the value of money increases over time, the creditors gain and debtors lose. On the other hand, a fall in the value of money over time brings losses to creditors and windfalls to debtors. To overcome this difficulty, some of the countries have fixed debt contracts in terms of a price index which measures changes in the value of money. Such a contract over time guarantees the future payment of debt by compensating the loser by the same amount of purchasing power when the contract was entered into.

(ii) Money as a Store of Value. Another important function of money is that it acts as a store of value. "The good chosen as money is always something which can be kept for long periods without deterioration or wastage. It is a form in which wealth can be kept intact from one year to the next. Money is a bridge from the present to the future. It is therefore essential that the money commodity should always be one which can be easily and safely stored."[19] Money as a store of value is meant to meet unforeseen emergencies and to pay debts. Newlyn calls this the asset function of money. "Money is not, of course, the only store of value. This function can be served by any valuable asset. One can store value for the future by holding short-term promissory notes, bonds, mortgages, preferred stocks, household furniture, houses, land, or any other kind of valuable goods. The principal advantages of these other assets as a store of value are that they, unlike money, ordinarily yield an income in the form of interest, profits, rent or usefulness . . . , and they sometimes rise in value in terms of money. On the other hand, they have certain disadvantages as a store of value, among which are the following: (1) They sometimes involve storage costs; (2) they may depreciate in terms of money; and (3) they are "illiquid" in varying degrees, for they are not generally acceptable as money and it may be possible to convert them into money quickly only by suffering a loss of value."[20]

Keynes placed much emphasis on this function of money. According to him, to hold money is to keep it as a reserve of liquid assets which can be converted into real goods. It is a matter of comparative indifference whether wealth is in money, money claims, or goods. In fact, money and money claims have certain advantages of security, convenience and adaptability over real goods. But the store of value function of money also suffers from changes in the value of money. This introduces considerable hazard in using money or assets as a store

of value.

(iii) Money as a Transfer of Value. Since money is a generally acceptable means of payment and acts as a store of value, it keeps on transferring values from person to person and place to place. A person who holds money in cash or assets can transfer that to any other person. Moreover, he can sell his assets at Delhi and purchase fresh assets at Bangalore. Thus money facilitates transfer of value between persons and places.

3. Contingent Functions

Money also performs certain contingent or incidental functions, according to Prof. David Kinley. They are:

(i) Money as the Most Liquid of all Liquid Assets. Money is the most liquid of all liquid assets in which wealth is held. Individuals and firms may hold wealth in infinitely varied forms. "They may, for example, choose between holding wealth in currency, demand deposits, time deposits, savings, bonds, Treasury Bills, short-term government securities, long-term government securities, debentures, preference shares, ordinary shares, stocks of consumer goods, and productive equipment."[21] All these are liquid forms of wealth which can be converted into money, and vice-versa.

(ii) Basis of the Credit System. Money is the basis of the credit system. Business transactions are either in cash or on credit. Credit economises the use of money. But money is at the back of all credit. A commercial bank cannot create credit without having sufficient money in reserve. The credit instruments drawn by businessmen have always a cash guarantee supported by their bankers.

(iii) Equaliser of Marginal Utilities and Productivities. Money acts as an equaliser of marginal utilities for the consumer. The main aim of a consumer is to maximise his satisfaction by spending a given sum of money on various goods which he wants to purchase. Since prices of goods indicate their marginal utilities and are expressed in money, money helps in equalising the marginal utilities of various goods. This happens when the ratios of the marginal utilities and prices of the various goods are equal. Similarly, money helps in equalising the marginal productivities of the various factors. The main aim of the producer is to maximise his profits. For this, he equalises the marginal productivity of each factor with its price. The price of each factor is nothing but the money he receives for his work.

(iv) Measurement of National Income. It was not possible to measure the national income under the barter system. Money helps in measuring national income. This is done when the various goods and services produced in a country are assessed in money terms.

(v) Distribution of National Income. Money also helps in the distribution of

[21] *Ibid.*

national income. Rewards of factors of production in the form of wages, rent, interest and profit are determined and paid in terms of money.

4. Other Functions

Money also performs such functions which affect the decisions of consumers and governments.

(i) *Helpful in making decisions.* Money is a means of store of value and the consumer meets his daily requirements on the basis of money held by him. If the consumer has a scooter and in the near future he needs a car, he can buy a car by selling his scooter and money accumulated by him. In this way, money helps in taking decisions.

(ii) *Money as a Basis of Adjustment.* To carry on trade in a proper manner, the adjustment between money market and capital market is done through money. Similarly, adjustments in foreign exchange are also made through money. Further, international payments of various types are also adjusted and made through money.

It is on the basis of these functions that money guarantees the solvency of the payer and provides options to the holder of money to use it any way, he likes.