NATURE, DEVELOPMENT, FORMS AND FUNCTIONS OF MONEY

The Nature of Money

Though the concept of money is not amenable to a single definition, there is consensus among economists about the essential characteristics or qualities of money and these include general acceptability, portability, durability, cognisability, homogeneity, divisibility, stability and scarcity. Most commodity moneys did not possess all the characteristics or qualities of money and contributed to their loss of marketability as civilisation progressed over the years and hence to their loss of being money. Modern money in terms of representative tokens, however, possesses all the characteristics or qualities listed above.

The functions of money have been extensively investigated in the literature. McCulloch argues that "money ordinarily serves as the economy's customary unit of account, as a standard of deferred payment, and as a store of value in addition to its function as a medium of exchange". He further argues that only the medium of exchange function is however essential because once the economy settles on the common medium of exchange, goods would automatically have their values computed in terms of the monetary good. To McCulloch, money serves as a store of value from the instant it is received to the time it is spent. Again, he further argues that, provided the future purchasing power of money is relatively predictable, contracts in loans could be written in terms of monetary units and to serve as the standards for deferred payment. McCulloch thus concludes, "The unit of account, standard of deferred payment and store of value functions of money are only secondary functions. The only really indispensable role of money in the economy is its role as medium of indirect exchange".

Theoretical and Empirical Definitions of Money:

There being no unanimity over the definition of money. Prof. Johnson distinguishes four main schools of thought in this regard which are discussed below along-with the views of Pesek and Saving.

1. The Traditional Definition of Money:

According to the traditional view, also known as the view of the Currency School, money is defined as currency and demand deposits, and it's most important function is to act as a medium of exchange. Keynes in his General Theory followed the traditional view and defined money as currency and demand deposits. Hicks in his Critical Essays in Monetary Theory points towards a threefold traditional classification of the nature of money: "to act as a unit of account (or measure of value as Wick-sell put it), as a means of payment, and as a store of value." The Banking School criticised the traditional definition of money as arbitrary. This view about the meaning of money is very narrow because there are other assets which are equally acceptable as media of exchange.

These include time deposits of commercial banks, commercial bills of exchange, etc. By ignoring these assets the traditional view is not in a position to analyse their influence in increasing their velocity. Further, by excluding them from the definition of money, the Keynesians place greater emphasis on the interest elasticity of the demand function for money. Empirically, they forged a link between the stock of money and output via the rate of interest.

2. Friedman's Definition of money:

The monetarist (or Chicago) view is associated with Prof. Friedman and his followers at the University of Chicago. By money Friedman means "literally the number of dollars people are carrying around in their pockets, the number of dollars they have to their credit at banks in the form of demand deposits and commercial bank time deposits". Thus he defines money as "the sum of currency plus all adjusted deposits in commercial banks".

This is the "working definition" of money which Friedman and Schwartz use for the empirical study of the monetary trends of the US for selected year 1929, 1935, 1950, 1955 and 1960. This was a narrower definition of money and the adjustment in both demand and time deposits of commercial banks was devised to take into account the increasing financial sophistication of the commercial banks and the community. But he could not establish a single index of this sophistication. Even with this adjustment, cash and deposit monies were not strictly comparable over long periods.

However, the correlation evidence for 1950, 1955 and 1960 suggested a broader definition of money as "any asset capable of serving as a temporary abode of purchasing power". So Friedman gives two types of definitions of money. One on theoretical basis and the other on empirical basis. This led to a lot of controversy which Friedman tried to solve on the basis of methodological issues. According to Friedman, "The definition of money is to be sought for not on grounds of principle but on grounds of usefulness in organising our knowledge of economic relationships."

Thus the definition used for empirical purposes is unimportant because different definitions will give different results. The empirical results will ultimately depend upon the nature of assets included in the definition of money as a temporary abode of purchasing power.

Thus concludes Friedman, "The selection of a specific empirical counterpart to the term money seems to us a matter of convenience for a particular purpose, not a matter of principle." He is, therefore, not rigid in his definition of money and takes a broader view which includes bank deposits, non-bank deposits and any other type of assets through which the monetary authority influences the future level of income, prices, employment or any other important macro variable.

3. The Radcliffe Definition:

The Radcliffe Committee defined money as "note plus bank deposits". It includes as money only those assets which are commonly used as media of exchange. Assets refer to liquid assets by which it means the monetary quantity influencing total effective demand for goods and services. This is interpreted widely to include credit.

Thus the whole liquidity position is relevant to spending decisions. Spending is not limited to cash or money in the bank but to the amount of money people think they can get hold of either by selling an asset or by borrowing or by receipts of income from, say, sales. The Committee did not make use of the concept of velocity of circulation because as a numerical constant, it is devoid of any behavioural content.

On the basis of crude empirical tests, the Committee did not find either direct or indirect link between money and economic activity via the interest rate. But it gave a new transmission mechanism based on liquidity. It explained that a movement of interest rates implies significant changes in the capital value of many assets held by financial institutions.

other hand, strengthens balance sheets and encourages lenders to seek new business.

4. The Gurley-Shaw Definition:

Gurley and Shaw regard a substantial volume of liquid assets held by financial intermediaries and the liabilities of non-bank intermediaries as close substitutes for money. Intermediaries provide substitutes for money as a store of value. Money proper which is defined as equal to currency plus demand deposits is only one liquid asset.

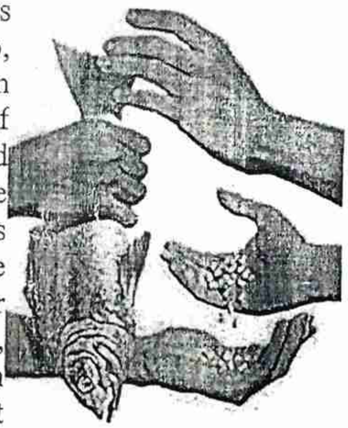
They have thus formulated a wider definition of money based upon liquidity which includes bonds, insurance reserves, pension funds, savings and loan shares. They believe in the velocity of the money stock which is influenced by non-bank intermediaries. Their views on the definition of money are based on their own and Goldsmith's empirical findings.

ORIGIN AND EVOLUTION OF MONEY

Barter

Money, as we know it today, is the result of a long process. At the beginning, there was no money. People engaged in barter, the exchange of merchandise for merchandise, without value equivalence.

Then, a person catching more fish than the necessary for himself and his group, exchanged his excess fish for the surplus of another person who, for instance, had planted and harvested more corn that what he would need. This elementary form of trade prevailed at the beginning of civilization, and may be found today among people of primitive economies, in regions where difficult access makes money scarce and, even in special situations, where people barter items without regard for their equivalence in value. This is the case, for instance, of a child who exchanges with his friend an expensive toy for another of lesser value, which it treasures.



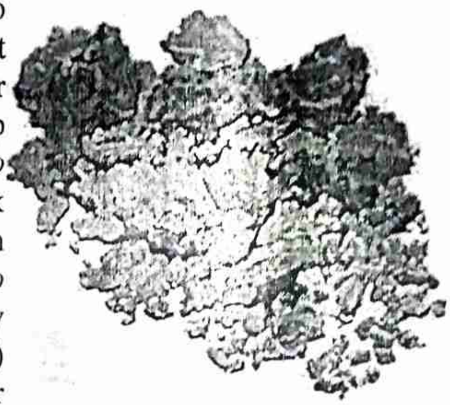
Goods used in barter are generally in their natural state, in line with the environment conditions and activities developed by the group, corresponding to elementary needs of the group's members. This exchange, however, is not free from difficulties, since there is not a common measure of value among the items bartered.

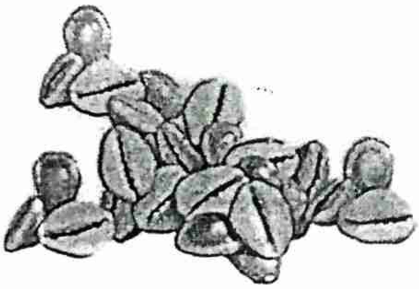
Commodity Money

Some commodities, for their utility, came to be more sought than others are.Accepted by all, they assumed the role of currency, circulating as an element of exchange for other products and used to assess their value. This was the commodity money.

Cattle, mainly bovine, was one of the mostly used, and had the advantages of moving for itself, reproducing and rendering services, although there was the risk of diseases and death.

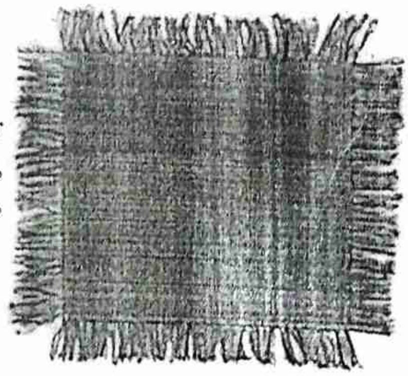
Salt was another commodity money, difficult to obtain, mainly in the interior part of continents, also used as a preservative for food. Both cattle and salt left the marks in the Portuguese language of their function as an exchange instrument, as we keep using words such as *pecunia* (money) and *pecúlio* (accumulated money) derived from the Latin work *pecus* (cattle). The word *capital* (asset) comes from the Latin *capita* (head). Similarly, the work *salário* (salary, compensation, normally in money, due by the employer for the services of an employee) originates from the use of *sal* [salt], in Rome, for payment of services rendered.





Brazil used, among other commodity moneys, cowry – brought by Africans –, Brazil wood, sugar, cocoa, tobacco and cloth, exchanged in Maranhão in the 17th Century due to the almost complete lack of money, traded in the form of yarn balls, skeins and fabrics.

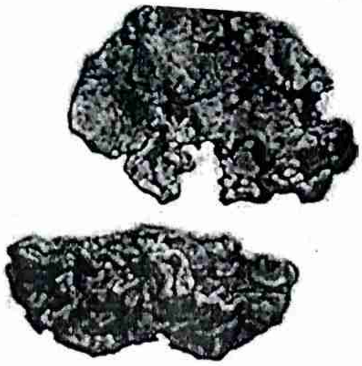
Later, commodities became inconvenient for commercial trades, due to changes in their values, the fact of being indivisible and easily perishable, therefore checking the accumulation of wealth.



Metal

As soon as man discovered metal, it was used to made utensils and weapons previously made of stone.

For its advantages, as the possibility of treasuring, divisibility, easy of transportation and beauty, metal became the main standard of value. It was exchanged under different forms. At the beginning, metal was used in its natural state, and later under the form of ingots and, still, transformed into objects, from rings to bracelets.



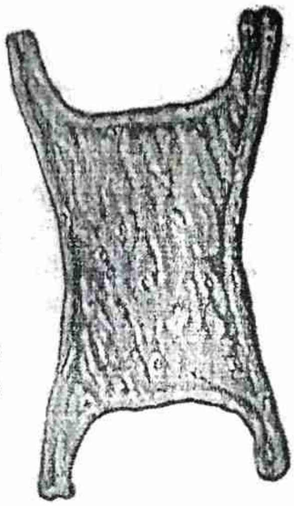
The metal so traded required weight assessment and assaying of its purity at each transaction. Later, metal money gained definite form and weight, receiving a mark indicating its value, indicating also the person responsible for its issue. This measure made transactions faster, as it saved the trouble of weighing it and enabled prompt identification of the quantity of metal offered for trade.

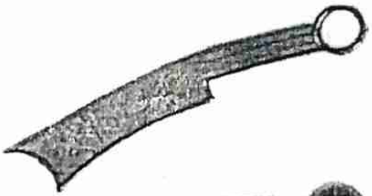
Money in the Form of Objects

Metal items came to be very valued commodities.

As its production required, in addition to knowledge of melting, knowing where the metal could be found in nature, the task was not at the reach of everyone.

The increased value of these objects led to its use as money and the circulation as money of small-scale replicas of metal objects.





This is the case of the knife and key coins found in the East and the talent, a copper or bronze coin with the form of an animal skin that circulated in Greece and Cyprus.

Ancient Coins

In the 7th century B.C. the first coins resembling current ones appeared: they were small metal pieces, with fixed weight and value, and bearing an official seal, that is the mark of who has minted them and also a guaranty of their value.

Gold and silver coins are minted in Greece, and small oval ingots are used in Lydia, made of a gold and silver alloy called electrum.

Coins reflect the mentality of a people and their time. One may find political, economic, technological and cultural aspects in coins. Through the impressions found in coins, we are able to know the effigy of personalities who lived centuries ago. Probably, the first historic character to have his effigy registered in a coin was Alexander the Great, of Macedonia, around the year 330 B.C.

At the beginning, coin pieces were made by hand in a very coarse way, had irregular edges, and were not absolutely equal to one another as today's ones.

Gold, Silver and Copper

The first metals used in coinage were gold and silver. Employment of these metals happened for their rarity, beauty, immunity to corrosion, economic value, and for old religious habits. In primeval civilizations, Babylonian priests, knowledgeable about astronomy, taught to people the close relationship between gold and the sun, silver and the moon. This led to a belief in the magic power of such metals and of objects made with them.

Minting of gold and silver coins was common for many centuries, and pieces were guaranteed by their intrinsic value, that is to say, by the trade value of the metal used in their production. Then, a coin made with twenty grams of gold was exchanged for goods of even value.

For many centuries, countries minted their most highly valued coins in gold, using silver and copper for lesser value coins. This system was kept up to the end of the last century, when cupronickel, and later other metallic alloys, became used, and coins came to circulate for their extrinsic value, that is to say, for their face value, which is independent from their metal content.

With the appearance of paper money, minting of metal coins was restricted to lower values, necessary as change. In this new role, durability became the most requested quality for coins. Large quantities of modern alloys appeared, produced to support the high circulation of change money.

Paper Money

In the Middle Ages, the keeping of values with goldsmiths, persons trading with gold and silver items, was common. The goldsmith, as a guaranty, delivered a receipt. With time, these receipts came to be used to make payments, circulating from hand to hand, giving origin to paper money.

In Brazil, the first bank notes, precursors of the current notes, were issued by Banco do Brasil in 1810. They had its value written by hand, as we today do with our checks.

With time, in the same form it happened with coins, the government came to conduct the issue of notes, controlling counterfeits and securing the power to pay.

Currently, all countries have their central bank in charge of issuing coins and notes.

Paper money experienced an evolution regarding the technique used in their printing. Today, the printing of notes uses especially prepared paper and several printing processes, which are complementary to each other, assuring to the final product a great margin of security and durability conditions.

FORMS OF MONEY

According to the nature and uses there are different forms of money. Some of them are very briefly explained below.

a) Money of Account:

Money of account refers to the unit in which the transactions of an economy are settled. It may vary from economy to economy. For example, in U.S economy transactions are accounted in Dollar, in Indian economy it is in Rupees, in European economy it is in Euro and so on. The entire transactions of such economies are delivering by money of account.

b) Legal Tender Money

Legal tender money is one which is sanctioned legally, since it ensures the acceptability of money. That is any amount of debt can be paid by the money. Generally legal tender money includes both notes (with high face value) and coins (with less face value). In India paper currency or notes have the quality of unlimited legal tender while coins lack. That is coins cannot used to pay huge amounts, it creates difficulties. In such a case the money receiver can reject the payment. So, it shows limited legal tender of the money.

c) Standard Money

If the entire value of an economy's transactions is measured in a particular label, then we can say it as standard money. For example; Dollar, Euro, Rupee, Yen etc are standard money forms, and the goods and services are measured based on these standard money. It includes all the coins and notes. So, it performs the quality of legal tender money.

d) Full Bodied Money

Full bodied money is a form of money which is based on the intrinsic value. That is the face value of the money will equal to the metallic value contained in the money. Actually this form of money was widely used in olden times.

e) Token Money

This is the advanced form of full bodied money. Token money is a form of money in which the face value is greater than the metallic value. Today almost all the money is coming under this form. We use paper notes of high values, but the metal value of the paper is very less.

f) Bank Money / Deposit Money

Bank money refers to the deposits in the bank. Generally there are two types of deposits like time deposits and demand deposits. Time deposits are deposited by the people based on a specific maturity date. At the same time demand deposits are widely assisting the business people and allow to deposit and withdrew at any time.

g) Inside Money and Outside Money

Today, people are borrowing loans and advances from financial institutions. That is the private debt of inside the economy. This is actually meant by inside money. In other words inside money is the quantity of money which created from endogenous private sector, and it is the debt of private units.

On the other side, outside money is the amount of money in the economy which created by exogenous unit, that is government. So, government issued money is called outside money.

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. 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.

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.

(ii) Money as Unit of Value:

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.

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.

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 subtracted."

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."

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."

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."

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 in Abuja and purchase fresh assets in Lagos. Thus money facilitates transfer of value between persons and places.