Representative paper currency is fully backed by gold and silver reserves. Convertible paper money is a type of paper currency which can be converted to standard coins. Inconvertible paper money is not convertible to standard coins or other valuable metals. Today almost all countries have the system of inconvertible paper money. The promise made by the governor in Indian rupee simply means that the currency cannot be converted into any metal but notes and coins of equal value. To issue this type of currency, the issuing authority does not keep metallic reserves for backing the amount of currency issued. Fiat money is a variant of inconvertible money. It is issued at the time of crisis or emergencies. It is fiat because government has declared it as legal tender. It is a relatively modern invention. A central authority creates a new money object that has minimal intrinsic value. In this case, the public's faith in the money exists only because the central authority mandates the money's acceptance. In cases where the public loses faith in the fiat money, there is little a central authority can do to prevent the adoption of other money objects by society. The money itself is given value by government fiat in Latin means "let it be done" or decree, enforcing legal tender laws, previously known as "forced tender", whereby debtors are legally relieved of the debt if they (offer to) pay it off in the government's money. Intrinsic value in general, is the argument that the value of a product is intrinsic within the product rather than dependent on the buyers perception. An example of fiat money is the new, international currency, the Euro. Its introduction changed the face of money, superseding many of the world's oldest currencies.

Near Money: On the basis of liquidity money is classified into—actual money and near money. Actual money is perfectly liquid (quickly and without loss of value converted into cash) but near money is not perfectly liquid asset. Examples of near money are treasury bills, bonds, debentures etc.

Legal Tender Money: It is money accepted as medium of exchange. It is legally sanctioned money. No person can refuse it to as a means of transactions. Legal tender money can be grouped into two categories—limited legal tender and unlimited legal tender. Limited legal tender is that money which people cannot be forced to accept beyond a certain limit. For instance, in India, coins of face value one, two, five, ten, twenty and twenty five paise are legal tender up to a maximum of Rs. 25. It means a person cannot refuse to accept coins totaling Rs. 25 in India, but beyond this limit, one can refuse to accept. Unlimited legal tender is money which one has to accept up to any limit. Thus, one-rupee coin, 50-paise coin, and currency notes of all denominations are unlimited legal tender. Everybody has to accept this money.

Optional Money: It is the money which has no legal sanction behind it but generally accepted by people. No person can be forced to accept such money. It is an option to accept or not. For example, credit instruments like cheques, hundies, and bills of exchange are optional money.

Money Proper: Money proper or actual money is the money which circulates in a country as a medium of exchange. It is also the basis of deferred payments. Goods and services are purchased and sold in the market with the help of this money. Benham calls it units of currency. Keynes categorized actual money into—commodity money and representative money. Commodity money is made of certain commodity or metal and treated as money. It is also known as full-bodied money or standard money. It not only the medium of exchange but also acts as store of

value. Representative money circulates in the form of cheap metallic coins or convertible paper notes. In this case, purchasing power cannot be stored as it has little intrinsic value. A person can convert representative money into commodity money whenever is desired.

Money of Accounts: It is that form of money in which accounts are maintained and value is measured. According to Keynes, money of account is "that in which debts and prices and general purchasing power are expressed". For example, rupee in India and dollar in America is being used as money of accounts. It is static in nature and does not change with the passage of time.

A NOTE ON GRESHAM'S LAW

Gresham's law is stated as: "Bad money drives good money out of circulation". Money is a marketable good or token that acts as a store of value, a medium of exchange and a unit of account. Gresham's law applies specifically when there are two forms of commodity money in circulation which are forced, by the application of legal tender laws, to be respected as having the same face value in the marketplace. It is named after Sir Thomas Gresham, an English financier.

The terms "good" and "bad" money are used in a technical sense, and with regard to exchange values imposed by legal tender legislation. Good money is money that has little difference between its exchange value and its commodity value. In the original discussions of Gresham's law, money was conceived of entirely as metallic coins, so the commodity value is the market value of the bullion of which the coins are made. An example is the US dollar, which, prior to the 1900s was equal to 1/20.67 ounce (1.5048 g) of gold, and carried an exchange value roughly equal to its gold bullion market value.

Bad money is money that has a substantial difference between its commodity value and its market value, where market value is lower than exchange value. In Gresham's day, bad money included any coin that had been "debased," Debasement was often done by members of the public, cutting or scraping off some of the metal. Coinage could also be debased by the issuing body, whereby less than the officially mandated amount of precious metal is contained in an issue of coinage, usually by alloying it with base metal. Other examples of "bad" money include counterfeit coins made from base metal. In all of these examples, the market value was the supposed value of the coin in the market. In the case of clipped, scraped or counterfeit coins, the market value has been reduced by fraud, while the exchange value remains at the higher value. On the other hand, with coinage debased by a government issuer the market value of the coinage was often reduced quite openly, but the exchange value of the debased coins was held at the higher level by legal tender laws.

All modern money is "bad money" in this sense, since fiat money has entirely replaced the commodity money to which Gresham's law applies. The universality of fiat money could indeed be taken as evidence for the truth of Gresham's law.

Gresham's law says that any circulating currency consisting of both "good" and "bad" money, where both forms are required to be accepted at equal value under legal tender law, quickly becomes dominated by the "bad" money. This is because people spending money will hand over the "bad" coins rather than the "good" ones, keeping the "good" ones for themselves.

If "good" coins have a face value below that of their metallic content, individuals may melt them down and sell the metal for its higher bullion value. In addition to being melted down for its bullion value, money that is considered to be "good" tends to leave an economy through international trade. International traders are not bound by legal tender laws the way citizens of the country are, so they will offer higher value for good coins than bad ones, and thus higher

value than can be obtained within the country. The good coins may leave their country of origin to become part of international trade. Thus, the good money is driven out of the country of issue, escaping that country's legal tender laws and leaving the "bad" money behind. This occurred in Britain during the period of the Gold Exchange Standard.

As for Gresham himself, he observed "that good and bad coin cannot circulate together" in a letter written to Queen Elizabeth on the occasion of her accession in 1558. The statement was part of Gresham's explanation for the "unexampted state of badness" England's coinage had been left in following the "Great Debasements" of Henry VIII and Edward VI, which reduced the metallic value of English silver coins to a small fraction of what that value had been at the time of Henry VII. It was owing to these debasements; Gresham observed to the Queen, that "all your fine gold was conveyed ought of this your realm."

Gresham made his observations of good and bad money while in the service of Queen Elizabeth, with respect only to the observed poor quality of the British coinage. The previous monarchs, Henry VIII and Edward VI, forced the people to accept debased coinage by means of their legal tender laws. Gresham also made his comparison of good and bad money where the precious metal in the money was the same. He did not compare silver to gold, or gold to paper.

Questions for Review

1. What is money? What are the different forms of modern money?
2. What are the functions of money?
3. Distinguish between:
   (i) Currency and deposit money.
   (ii) Limited and unlimited legal tender.
   (iii) Convertible and inconvertible money.
4. Explain Gresham's law.
5. What is barter?
6. Explain double coincidence of wants.
7. What is metallic money?
8. Point out four characteristics of good money.
9. What are the drawbacks of barter?
10. What is money supply?
11. What are the various money stock measures?

BANKING

The word 'banking' is said to have derived from the Greek word 'banque', meaning bench. The German word 'banc' means a joint stock firm. In modern days, commercial banking occupies an important place in every economy. It is an important constituent of a country's financial system. Origins of modern banking dates back to ancient times. The New Testament mentions about the activities of money changers in Jerusalem. In ancient Greece, famous temples of Ephesus, Delphi and Olympia were used as depositories, where people who have surplus funds deposited their money. These temples were the sits of money-lending transactions. In India, the ancient Hindu scriptures refer to money lending transactions in the Vedic period. Banking became a full fledged activity during the periods of Ramayana and Mahabharata. Vaish community during Smriti period (period after Vedic and Epic age) carried on business of banking extensively. The bankers of Smriti period performed most of those functions which are performed by modern banks such as accepting of deposits, granting secured and unsecured loans, acting as treasurer and banker to the state and issuing and managing the currency of the country. It was only in the nineteenth century that the modern commercial banking system developed in the leading countries of the world.

COMMERCIAL BANKS

A bank is a financial institution which lend and accepts money. It is an institution which deals mainly in money. Thus, a bank is a financial institution that accepts deposits of money from the public, which can be withdrawn by cheques. Banks utilize money collected for lending to the households, the firms and the government. People deposit their surplus money in banks for two reasons—safety of money and earning some interest amount. According to Banking Regulation Act, 1949, *"accepting for the purpose of lending or investing of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheques, draft, order or otherwise"*, comes under the purview of a bank.

On analysis of the above definitions, it is clear that a bank is a financial institution that deals in money. It accepts people's surplus money and advance loans to the borrowers.

FUNCTIONS OF COMMERCIAL BANKS

Commercial banks, today, perform a variety of functions and provide a number of services to their customers. The important functions of commercial banks can be discussed under the following heads:

1. **Accepting of Deposits:** The most important function of commercial banks is to accept deposits from the public. Banks withdraw surplus funds from people or depositors. Banks accept deposits mainly by opening accounts in the name of their customers. They accept deposits in two forms—demand deposits and term or fixed deposits. Demand deposits can be withdrawn any time but term deposits are withdrawable only after the expiry of time period for which deposits are made. The three important forms of accounts, in which people like to deposit their money are—current account, savings bank account and fixed deposit account. Current accounts are particularly meant for business people who wish to deposit or withdraw their money many times in a single day. These deposits are therefore payable on demand. Banks do not pay any interest on these accounts but charge a maintenance or service fee known as incidental charge from the customers for providing various services. Savings bank accounts are also payable on demand. Banks impose a limit on the amount and number of withdrawals during a particular period of time. These accounts are opened by general public. A reasonable interest is paid on such deposits. Under fixed deposit accounts, money is kept for certain fixed period of time, say, a year, five years or six months. These deposits carry a higher rate of interest but are not withdrawable on demand. In other words, amount of such deposits can be withdrawn only at the time of maturity. One should note that such deposits can be withdrawn by presenting fixed deposit receipt (FDR) issued at the time of commencement of the account. Cheques cannot be used in place of FDR. These deposits are also known as time deposits. A variant of fixed deposit accounts is recurring deposit account under which a person has to make payment for a regular period at equal time intervals. For example, a person can choose five year term as maturity period and make a certain sum of money every month for five years. Such deposits also carry a high rate of interest.
2. **Advancing of Loans:** Another important function of commercial banks is to extend loans and advances to their customers. Banks charge interest from the borrowers, which is relatively higher than the interest they pay on deposits to their customers. Banks make profits out of such transactions. Banks provide advances in various ways. They provide term loans for a fixed period by crediting the entire amount sanctioned as loan to borrower's current account. The borrower pays interest on the entire amount borrowed. Cash credit is another way to provide loans particularly to businessmen. Under this system, the sanctioned amount is not given at a time but an account is opened and the borrower is allowed to withdraw amount as and when he requires. The bank charges interest only on the amount which is actually withdrawn from the account. Through overdraft facility also, banks provide loans to their customers. A customer, getting this facility, is allowed to withdraw amount in excess of the balance standing to his credit to the extent of overdraft limit permitted. Overdraft can be made only in respect of current accounts. The banks charge interest only on the amount overdrawn. Another important form of lending is through discounting of bills of exchange. A bill is drawn by the creditor on the debtor mentioning the amount of debt and also the date when it becomes payable. Such bills are generally issued for

a period of 90 days. This means that creditor cannot get money from debtor before 90 days. However, if the creditor needs money before this period, he can sell (called discounted by bank) to a bank. The bank makes payment specified on the bill after deducting commission or discount. The matured bill amount is obtained by the bank from the debtor.

3. **Transfer of Funds:** Banks help in the remittance or transfer of funds from one place to another through the use of various credit instruments such as cheques, drafts, mail transfers, online communications, etc.
4. **Agency Functions:** Banks provide various agency functions to their customers. The banks charge a very nominal fee for these services. The important agency services are the following:
   (i) Collection of cheques, drafts, bills of exchange, hundies etc;
   (ii) Payments and collection of insurance premia, pensions, scholarships, dividends, interest etc. on behalf of customers;
   (iii) Sale and purchase of securities. They provide investment services to the companies by acting as underwriters and bankers for new issues of securities to the public;
   (iv) Obtaining and selling of foreign currency on behalf of customers;
   (v) Acting as trusties and executors. For example, they keep safe the wills of their customers and execute the same after their death.
5. **Miscellaneous Services:** Banks provide services like locker facilities for safe custody of jewellery and other valuables, issue of travelers cheques, gift cheques, credit cards, ATM (Automated Teller Machine), internet banking services, tax assistance and investment advice.
6. **Credit Creation:** A very important function of modern banks is to create credit in the economy. Banks have the capacity of credit creation. They are able to create credit by accepting deposits from and providing loans and advances to their customers. In simple words, banks are able to multiply the initial deposits to a great extent which is called credit creation.

Credit creation is the process of multiplying initial deposits of banks into a huge amount. Banks create credit by advancing loans to its customers out of what they have received in the form of deposits from the public. They also grant loans, discount bills, provide overdraft facilities to create credit. All commercial banks are required to keep a certain percentage of their cash reserves with the central bank. To explain how banks create credit in the economy, let us assume that the cash reserve ratio (CRR) is 20% of total deposits a bank has to maintain with the central bank. Further, let us suppose that the SBI receives Rs. 1000 as deposits. This is called primary deposit of the bank. SBI keeps Rs. 200 (20% of Rs. 1000) as cash reserves and advances the balance amount of Rs. 800 as loans to a businessman, say Mr. X. The person deposits this amount (in cheque) in the Indian bank. It means the Indian bank receives Rs. 800 as primary deposits and keeps Rs. 160 (20% of Rs. 800) as cash reserves and grants the balance amount of Rs. 640 as loans. In the same way, the loan of Rs. 640 is deposited in Allahabad bank, which keeps Rs. 128 (as CRR) and the excess cash of Rs. 512 is lent.