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WHAT IS MONEY?

5/99

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Q: What is money?
A: Anything that serves as a means of payment is money.

Q: Then why do we all tend to use the same ‘thing’ as money?
A: You mean notes and coins of the ‘realm’?

Q: Of course. What else?
A: In the UK, many different ‘things’ are accepted as money, including notes and coins issued by Scottish, Irish, and Manx banks, and cheques drawn upon commercial banks and building societies, ...

Q: OK, OK, don’t be clever.
A: Heaven forbid! My point is that there is no definition of money. Some of the ‘things’ which are accepted as money one year may be unacceptable the next. Moreover, the fact that the most common forms of money are printed paper and metallic discs is largely irrelevant.

Q: How did we arrive at notes and coins?
A: You want a brief history lesson?

Q: If you like.
A: Very well. Barter trade is aided by a ‘double coincidence of wants’. This means that someone with a cart to sell and wanting to buy chickens would seek someone with chickens to sell and wanting to buy a cart.

Q: A testing search.
A: Indeed. As an alternative, the cart and the chickens (less saleable goods) might have first been exchanged for more saleable goods (say, flour)

Q: Because the flour is a more frequently exchanged commodity?
A: Yes, although such chains of exchange could be of any length: ‘saleability’ increasing until items reached their final destination.

Q: Neat.

A: But neater still, when gold and silver achieved the status of most highly exchangeable commodities.

Q: Why gold and silver?
A: For their high value to weight ratio; their durability; and their low storage costs.

Q: What about coins?
A: As reliable methods of assay were devised, uniform dies were used to strike coins of known weight and quality. This was an advance in that it reduced uncertainty over valuations.

Q: This was initiated by the state?
A: No. The first mints belonged to the church and to other respected bodies.

Q: So when did the state become involved?
A: In England, Henry VIII saw coinage as an opportunity to raise revenue on a large scale.

Q: How?
A: The royal mints bought bullion and paid it for with their own coins. A small charge covered operating costs, but the temptation to raise a margin for profit was irresistible.

Q: How was this was achieved?
A: By adding ever higher proportions of base metal to the coins!

Q: Surely assay methods showed up this debasement?
A: Yes. It was common knowledge, but debased coins continued to circulate. The inconvenience of having to agree upon alternative valuations may have been responsible.

Q: How far was debasement taken?
A: Until the gold content of coins was virtually nil.

Q: Were there no consequences?
A: Yes. Royal mints were unable to attract bullion. Foreign traders refused to accept English coins; and foreign coins were much sought after. Inevitably, a completely new coinage had to be introduced.

Q: No mention of banks, so far. Where did they spring from?
A: From goldsmiths, who sold space in their secure premises as storage for gold bullion. Goldsmiths were also engaged in foreign exchange: trading in foreign coins. These two activities made them the most obvious source of finance for international trade.

Q: I still don't see the relevance for banking.
A: Exporters received bills of exchange - a promise to pay at some future date - from their foreign customers. These gave time for goods to be sold. If they needed more instant cash, exporters could sell bills at a discount to the goldsmiths, who had ample funds available.

Q: Sharp practice!

A: Maybe; but to protect themselves against the possible accusation of misuse of their clients' bullion, the legal status of clients' receipts was changed. Instead of warehouse dockets, promissory notes were introduced.

Q: What was the difference?

A: Promissory notes acknowledged an obligation to pay a given amount of gold on surrender of the note, but there was no entitlement to have returned the same bullion which had been brought for safe storage.

Q: Neat.

A: By their prudent judgements, goldsmiths won public trust to the extent that their promissory notes began to circulate in settlement of debts between third parties.

Q: The first paper currency?

A: Exactly. At first, notes were exchanged by legal assignment, but the introduction of 'running cash notes' gave *any* bearer of the note the right to repayment. These notes had all the characteristics of modern paper currency, plus the extra guarantee of full convertibility into gold.

Q: Many different goldsmiths' notes were in circulation?

A: Certainly but, as their business expanded, goldsmiths sought more secure depositories. The natural choice was the most prestigious of their own kind. So, the largest goldsmiths became the goldsmiths' bankers; and the notes of these larger institutions became more readily accepted. These institutions were the embryonic clearing banks.

Q: What is a 'clearing bank'?

A: Small country banks held deposits with larger London banks and this allowed debts to be settled between themselves by book transfers at those bank. In this manner, their debts were 'cleared'.

Q: And the central bank?

A: The Bank of England was established in 1694, with the specific task of raising funds to finance wars in Europe. Its unique importance derived from the government's guarantee that its notes would remain convertible. As its reputation grew, other London banks began to settle debts between themselves by book transfers of deposits held at the Bank of England.

Q: Bank of England notes are no longer convertible?

A: No. Even at the time of the Napoleonic Wars, interruptions to the international transfer of bullion made it difficult for the Bank to maintain convertibility and the government would approve the temporary suspension of gold payments. However, public confidence in the Bank as the government's bank remained strong.

Q: But convertibility was restored?

A: For a while. It was finally abandoned with the onset of financial crises in the 1930s.

Q: But look: it still says on this Bank of England note that the governor and company of the Bank of England promise to 'pay the bearer on demand the sum of' ...

A: ... that promise has no substance. Originally that note was a receipt - an acknowledgement of indebtedness - and an invitation to redeem its value in gold.

Q: And now?

A: It is an anachronism. Individuals must seek convertibility at whatever price is determined by the market in gold bullion.

Q: The market rules.

A: No less in money and banking than elsewhere. Banks compete for deposits from clients who then use cheques to transfer funds into the accounts of their creditors.

Q: And, like their goldsmith predecessors, modern commercial banks put their clients' deposits to active use?

A: Yes, bank deposits are used to advance loans to governments, to commerce and to individuals. In principle these are no different from the activities of the original goldsmith banks.

Q: Can we stop there?

A: Perhaps we should.