History Of Money

We use and talk about them everyday, but money's long and illustrous history is something very few of us know.

By Rohit Gupta

Money, along with the wheel, is one of greatest of all human inventions. It provides three basic functions, namely as a medium of exchange, unit of account and store of value. Money works best when everyone agrees on its value, and that they can swap it for goods and services.

Earliest forms of money were basic commodities - wide and liquid market, but bulky and perishable (so, not a good store of value). The solution? Expressing a fixed weight of barley (11 grams) in terms of pieces of metal that had equivalent value (both portable and durable). For most of history, it was silver that was the metal of choice (gold was too rare to be used in a liquid market).

The key challenge of "commodity money" was, did it contain the amount of commodity it was supposed to, so as to pass from person to person without being reweighed and checked for quality?

This saw the evolution of pieces of metals to coins - with rulers stamping the metals to certify weight and purity. Greed and war however saw debasement and "clipping", where the real value of the coins was less than the face value.

England (1616 – 1717): The Accidental Move To Gold!

In 1661 King Charles II of England, ordered all coins to have a "milled edge" (similar to using holograms and other security measures today). However, it failed due to "good" money driving out "bad" (Greshams Law).

The public hoarded the new coins money with higher silver content and used the older coins, to make new money (melted down to make conterfeit versions of old money with less silver content). Similar problems rose with gold coins in 1663, when England used a windfall of gold from West Africa to mint a series of gold coins known as guineas (while silver shilling was official money, gold guinea was an asset, with a suggested value of 20 shillings).

The solution was to standardise all money in circulation, such that there was no "good" and "bad" money. The Great Recoinage in 1696, saw all old degraded coins wthdrawn and melted down to produce new machine milled 100% silver coins. The new problem ofcourse was to fix the exchange rate between these and the gold coins. The task was assigned to Sir Isaac Newton, and in 1717 via a royal proclamation – the exchange rate for gold guineas was set at 21 shillings.

Money Titbits:

- Historically, debt came in the form of livestock.
- Sumerian word for interest, *mas*, means calves. The Roman word for a herd of animals, *pecua* – was the basis for pecunia for money (and pecuniary interest).
- French word for money and silver – *argent* – are the same.
- Dollar comes from *Thaler,* a coin minted in Bohemia
- These were cut in 8 pieces – origin of *Peso* (pieces of eight).
- Paper money was first introduced by Chinese in 800 AD, to overcome a copper shortage.
- The West followed suit with advent of printing machines (and chinese reverted back to silver after the Mongol empire).

While prices of assets such as land, diamonds or copper were freely set by demand and supply, gold guineas were guaranteed to be worth 21 shillings. Gold was now legally as good as silver. It too was money. Further given the arbitrage in lower gold prices in Europe - bad gold money drove out good silver money – to become the principal money in circulation. Britain had moved to the gold standard, by accident.

At the same time - the convenience of larger denominations led to increase in circulation of paper based notes. These were issued by Bank of England and

legally bound to exchange for a fixed weight of gold.

Birth Of Banking:

• Metals became difficult to store. Goldsmiths initially handed out receipts for the value of gold – the earliest forms of bank notes.
• Also, of the gold they held, only a small percentage was demanded back on a daily basis, meaning they could lend some of it and earn a profit.

Continental Europe (1717 – 1720): Paper Money

Across the channel, France was experimenting - replacing precious metals with paper money. Since metal was hard to come by, John Law proposed for the government to issue paper money backed by land.

The French coinage had been thoroughly debased to finance the wars of Loius XIV and his idea found ground in 1717. While it initially provided stimulus to the cash starved economy, large amounts of paper money were printed to pay off the massive debts acrued by the royal family. This lead to high inflation, and by 1720 France had abondoned fiat money and returned to metal money.

Across the Pond (1792 – 1862): Siver, Gold & Paper!

Initially the US dollar was backed by both Silver and Gold reserves (the new nation did not have enough of either metal to meet demands for its currency). This led to the same question England faced in 1717 - the fixed ratio between gold and silver – and the same challenge of bad money driving out good money.

The Coinage Act of 1792, undervalued Gold and America found itself defacto on a silver standard. Changes by congress in 1834, succeeded only in tipping the scale the other way and the US dollar joined the pound as a defacto gold backed currency.

The civil wars of 1861 - 1865 lead to the federal government printing money without the precious metals to back it (simiar to England and the wars with France).

With large reluctance on part of the public to accept the debased currency - Congress passed the Legal Tender Act of 1862, that required all Americans to accept these paper notes (the supreme court initially judged this unconstitutional, but reversed its decision – given the resultant chaos and Federal government insolvency).

With peace returning (again similar to England) - US returned to the Gold Standard.

The Wars & The Wall Street Crash: Abandonment Of Dollar Standard

WWI (1914) led to the European powers spending beyond their means and suspension of the gold standard (similar to England during Napoleonic wars and US during civil wars). However post-war, the Gold standard was restored in 1925. This however was not easy and meant austerity to earn back dollars paid out during the war.

The Wall Street crash of 1929 and resultant American recession and decline in world trade made this more difficult, and Britain finally quit the gold standard in 1931. While US remained on the Gold standard, it meant loss of export competitiveness and declining growth. Finally in Apr 1933, US abandoned the gold standard.

Germany & France:

• Germany had funded the war by printing money. In 1914, the dollar was worth 4.2 marks, but after the war - 65, by Aug 1923 – 620,000 and by Nov – 630 billion! By end of 1924 Germany did return to its post-war exchange rate of 4.2 marks – but the new currency, the *Retenmark*, was worth 1 trillion the old currency (the *Reichsmark*). In 1948 the *Reichsmark* was replaced by the new *Deutschmark* at a rate of 10:1.
• The French *Franc* which traded at 5 to a dollar in 1913, 25 to dollar in 1920, slumped to 119 after the war. By 1958 a further devaluation took it to 500, at which point the French knocked two zeros and the 5/$ rate was restored!

Bretton Woods (1944): The Dollar & Fiat Money

The war years saw large outflow of gold from Europe to US. By end of the war America controlled nearly 75% of the worlds gold reserves. A gold standard could not work if one country held all the gold. The alternative agreed in Bretton woods (1944) was rather than every currency being fixed to Gold, US dollar as the anchor currency was fixed to gold and all other countries were "pegged" to the dollar. This would allow both maintaining the value of money and greater flexibility to meet individual needs of countries.

In the Bretton Woods system - dollars were as good as gold. But how were countries to get dollars? Over time this required countries to build up a surplus against the US (and US trade position to deteriorate). By the 1960s, US debts to foreign countries exceeded the value of its dollar reserves.

US gold reserves steadilly declined. Germany, France and Japan had rebuilt their war-ravaged economies. The dollar had become overvalued, but a devaluation of anchor currency was fatal. Without a gold anchor, and without full capital controls, fixed exchange rates are not really feasible.

In 1968, the promise to exchange dollars for gold was restricted to central banks only. This led to two parallel market. for gold, and in 1971 the fixed rate in gold was removed. We had Fiat Money!

The value of the dollar and all other currencies was now based solely on the creditability of the government that printed it. SI

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