Monetary Law and Monetary Policy

1. The concept of money, its functions and theories

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Defining money

- obvious yet difficult to describe: “I find it difficult to explain but every gentleman in England knows it” (a London accountant in 1819 quoted in „Mann and Proctor on the Law of Money”)
- A judicial definition in *Moss vs Hancock* (England, 1899): money is „that which passes freely from hand to hand throughout the community in final discharge of debts and full payment for commodities, being accepted equally without reference to the character or credit of the person who offers it and without the intention of the person who receives it to consume it or apply it to any other use than in turn to tender it to others in discharge of debts or payment for commodities”
- Usually defined via → **functions of money**

Functions of money

Old rhyme: „Money is a matter of functions four, a medium, a measure, a standard and a store"

- Medium of exchange
- Measure of value/unit of account
- Standard for obligations
- Store of value or wealth

Medium of exchange

- Intermediary used in transactions to avoid barter → allows to minimise time needed to exchange goods and services.
- Money lowers transaction costs, allows for specialisation and division of labour.
- Money is used and accepted universally by market participants (the general public).

Measure of value/ Unit of account

- Value of goods, services and assets can be expressed in money.
- Money allows for comparing respective value of different goods, services and assets.
- Money is expressed in a standard numerical unit of measurement, usually decimal (e.g. 1 złoty = 100 groszy, 1 euro = 100 cents)
- In some cases artificial units of account are used for accounting purposes, which are linked to existing currencies but do not represent money (ECU in 1979-1998, SDR).

Store of value

- Money preserves purchasing power over time → it can be **hoarded**.
- Money is the most liquid asset, as it serves as the medium of exchange → it allows to purchase goods or services anytime.
- Exception: case of high inflation

Gresham's (Copernicus/Oresme) law

- „Bad money drives out good" or „when one type of money is overvalued and another is undervalued, the undervalued („good") money will leave the country or disappear from circulation into hoards, while the overvalued („bad") money will flood into circulation" → „good" money is used as store of value or converted to other use.
- History: debasement of bullion coins.
- Rendered almost irrelevant by standardisation of cash money in circulation and the possibility of exchanging damaged or soiled banknotes and coins at face value.
- [Example from India – coins with face value below the value of scrap metal] http://news.bbc.co.uk/2/hi/south_asia/6766563.stm

Standard for obligations

- Money serves as unit in which debts/claims are denominated.
- Money is universally accepted to settle debts.

- The function of standard for obligations (or for deferred payment) can be also considered a combination of other functions: medium of exchange and store of value.

- See also the concept of „legal tender”.

Development of money

- <u>Barter exchange</u>
- <u>Commodity money</u> – from specific goods to <u>bullion money</u> (gold and silver coins)
- <u>Paper money</u> – initially certificates representing claims on commodity (gold or silver) → banknotes backed by gold → **<u>gold standard</u>**
- No need to maintain gold reserves for total banknotes issuance (→ fractional reserve banking), as banknotes holders were rarely exchanging them for gold → at any given time the total value of banknotes exceeded total value of gold reserves used to back them

[Development of money – examples]

- Case of camps for Allied POWs in Germany during WWII – use of cigarettes as money
- see R. A. Radford, The Economic Organisation of a P.O.W. Camp, *Economica*, Nov., 1945, pp. 189-201 https://courses.cit.cornell.edu/econ4260/out/radford_pow.pdf
- Use of mobile phone airtime as money in some African countries

https://www.economist.com/finance-and-economics/2013/01/19/airtime-is-money (may require creating an account)

[Development of money – examples]

- Some banknotes still include a clause indicating a claim against the issuer – formerly a claim for a specified amount in gold or silver currency
- Examples:
  - British pound (GBP) – „I promise to pay the bearer on demand the sum of [xx] pounds"
  - Indian rupee (INR) – „I promise to pay the bearer the sum of [xx] rupees"
  - Italian lire (ITL), until 2001 (before the introduction of the euro) – „Lire [xxx] pagabili a vista al portatore" („xx liras payable to the bearer on demand")

Development of money 2

- Problems with maintaining link between banknotes and bullion
  - occasional loss of confidence resulting from insufficient backing, insolvency of issuers or fraud
  - problems with financing wartime expenditure (suspension of gold standard during WWI)
  - world economic crisis from 1929 onwards and WWII

Substantial problem – total amount of gold in the world economy was not growing as fast as total output of all economies combined → maintaining an effective link to gold would cause persistent deflation

Development of money 3

- Re-establishment of a modified gold standard by the **Bretton Woods system** (1944 – 1971)
- the US dollar was linked to gold (1 oz. = $35), other Western currencies were pegged to US dollar.
- 1971: executive order by President R. Nixon cancelled the convertibility of the US dollar to gold
- Result: definite abolishment of the gold standard, introduction of **fiat currency**, based on sound monetary policy and confidence of the general public

Cashless (scriptural) money

- Cashless money:
  - technical aspect: balance on an account with a bank or other financial institution
  - legal aspect: claim against the financial institution for the sum of money corresponding to balance on the account

- Forms: debit cards, credit cards, electronic money transfers, mobile payments, e-money, cheques (outdated but still in use in some countries)

Cashless economy – discussion

- Will cash be eventually eliminated from our use?
- Factors facilitating development of cashless payments vs. obstacles.
- Who needs cash?

Legal aspect of money – theories

- State theory of money
- Societary theory of money
- Institutional theory of money

State theory of money

- Quality of money is acquired by chattels (objects) issued under the authority of the law in force within the state of issue. The law in force specifies that money:

– is denominated by reference to a unit of account,

– serves as universal means of exchange in the state of issue (see: **legal tender**)

- The existence of money results from the act of the state establishing a monetary system and authorizing the issue of banknotes and coins.

State theory of money – legal tender

- Legal tender is such money in the legal sense as the legislator has so defined in laws which organize the monetary system.
- Legal tender is the medium of payment valid for discharge of financial obligations.
- See clause on US dollar banknotes: „*This note is legal tender for all debts, public and private*".
- on Polish banknotes: „*Banknoty emitowane przez Narodowy Bank Polski są prawnym środkiem płatniczym w Polsce*".

Legal tender laws – example of Poland

- Constitution of Poland:
- Article 227(1): The central bank of the State shall be the National Bank of Poland. It shall have the exclusive right to issue money as well as to formulate and implement monetary policy. The National Bank of Poland shall be responsible for the value of Polish currency.
- Law of 29 August 1997 on the National Bank of Poland:
  - Article 31. The currency of the Republic of Poland shall be banknotes and coins denominated in złoty and grosz.
  - Article 32. Banknotes and coins issued by the NBP shall constitute legal tender on the territory of the Republic of Poland.

State theory of money – weak points

- No satisfactory explanation of the role of cashless money (created by commercial banks, representing claims against them), which constitutes most of the money in circulation.
- Legal basis for a monetary system does not prevent its erosion or breakdown in case of high inflation or hyperinflation – it is the willingness of the general public to accept and use money that allows it to function in the economy.

State theory of money – counterexamples

- Widespread use of foreign currencies in Poland and other Eastern Block countries before 1989.
- Hyperinflation resulting in the discontinuation of the Zimbabwean dollar in 2009.
- „Swiss dinars" in Iraqi Kurdistan, not controlled by Saddam Hussein's government prior to 2003 http://en.wikipedia.org/wiki/Iraqi_Swiss_dinar
- Somali shilling – a currency existing despite the breakdown of the state and demise of the issuing central bank in 1991

http://en.wikipedia.org/wiki/Somali_shilling

Societary theory of money

- Money is created by the **confidence of the society (the general public)** which results in universal willingness to use it in transactions and to accept it for settlement of debts.
- Purely functional approach – anything that functions as money should be considered money.
- Weak point: it does not reflect the monopoly of the State over the issue of currency existing in most modern states.
- Result: the societary theory is relevant to explain the concept of money from the economic perspective but it is not sufficient to cover its legal aspects.

Institutional theory of money

- Money as transferable credit within an overall institutional framework. Its acceptance by the public depends on a comprehensive legal framework that ensures its stable purchasing power, its availability even in time of banking stress and its functional capability to settle monetary obligations.
- Direct or indirect claim against a central bank.
- Claim which can be used by the public as medium of exchange and store of value.
- Originated and managed by the central bank in a manner preserving its availability, functionality and value.
- Author: A. Sáinz de Vicuña, head of legal services at the European Central Bank from 1998 until 2013

Institutional theory of money

- Adapted to fiat currencies and modern central banking → value of money results from monetary policy of the issuing central bank and from market forces.
- Credit balance of bank deposits payable on demand also included.
- Less linked to physical (cash) money → adapted to reduced role of cash in modern economies.
- Emphasis on central bank, its price stability mandate, independence and the conduct of its monetary policy (management of the money supply).

Institutional theory of money

- Weak point:
  - far from universal, greatly influenced by the construction of the Economic and Monetary Union and the principles of central banking in the EU
  - does not reflect alternative views on central banking and monetary policy (without assuming their correctness)
- Strong point:
  - much better than previous theories in explaining the role of money in a modern sophisticated economy
- Result: no definite endorsement of either of the above theories, as they all explain different aspects of money in the legal system.

Reading and reference materials

- F. Mishkin, The Economics of Money, Banking, and Financial Markets, Pearson, 13th ed. 2022 – Chapter 3 „What Is Money?", p. 97-103 (mandatory), p. 104-108 (additional reading and questions)
- Ch. Proctor, Mann and Proctor on the Law of Money, Oxford University Press, 8th ed., 2022 – Chapter 1 „The Concept of Money", p. 3-29
- English translation of the Constitution of Poland http://www.sejm.gov.pl/prawo/konst/angielski/kon1.htm
- English translation of the Law of 29 August 1997 on the National Bank of Poland

https://nbp.pl/wp-content/uploads/2022/10/the_act_on_the_nbp.pdf