JAYOTI VIDYAPEETH WOMEN'S UNIVERSITY, JAIPUR

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Faculty of Education and Methodology

Faculty Name- JV'n Dr. Md Meraj Alam

Program- BA B.Ed 4th Semester

Course – Money Banking and Public Finance

Digital session name – Gresham's Law

Gresham's Law:

Gresham's law in its simple form states that when good and bad money are together in circulation as legal tender, bad money tends to drive good money out of circulation. This implies that less valuable money tends to replace more valuable money in circulation.

This law was enunciated by Sir Thomas Gresham who was the financial adviser to Queen Elizabeth I in the 16th century in England. Gresham was, however, not the first to develop this law, but it became associated with his name after he explained a problem faced by the Queen. With a view to reform the currency system, the Queen tried to replace bad coins of the previous regime by issuing new full-weighted coins.

But to her surprise, as soon as new coins were circulated, they disappeared and the old debased coins continued to remain in circulation. She sought the advice of Sir Thomas Gresham, who provided his explanation in the form of the law which states- "Bad money tends to drive out of circulation good money."

The theoretical explanation of this law is in terms of the divergence of the market rate of exchange of the two currencies from mint rate. If the mint rate (i.e., the official rate of exchange between two types of money) differs from the market rate of exchange between the two types of money, then the over-valued money at the mint will tend to drive the under-valued money out of circulation.

Suppose under bimetallism, one gold coin exchanges for 10 silver coins, i.e., the official rate of exchange or the mint rate is 1:10. Now, if the market rate is 1:12, then gold is under-valued and silver is over-valued at the mint rate (i.e. the market rate of gold exceeds the mint rate and the market rate of silver is less, than its mint rate). In this case, gold will become good money and silver a bad money. The bad money (silver) will drive out good money (gold) from circulation.

Operation of the Law:

When both good and bad money together are in circulation as legal tender, good money disappears in three ways:

i. Good Money is Hoarded:

When both good and bad money circulate simultaneously, people have the tendency to hoard good money and use bad money for making payment.

ii. Good Money is Melted:

Since both good coins and bad coins are in circulation and have the same value, people prefer to melt good coins to convert them into ornaments or other items of art.

iii. Good Money is Exported:

In payments to the foreign countries, gold coins are accepted by weight and not by counting. Thus, it would be profitable to pay to the foreigners in terms of new full-weight coins rather than old and light-weight coins.

Gresham's Law in General Form:

Gresham's law, in its original form, applies only to debased coins of monometallic system (i.e., gold standard).

But, the law can, however, be extended to all forms of monetary standards:

1. Under Monometallism:

Under monometallism (for example gold standard), the old and worn out coins are regarded as bad coins and full-weight coins are considered as good coins. According to Gresham's law, the old and worn out coins drive new and full- weight coins out of circulations.

2. Under Bimetallism:

Under bimetallism (generally a system of gold and silver coins), coins of overvalued metals are considered bad money and coins of under-valued metal as good money. Thus, according to Gresham's law, the over-valued coins will drive under-valued coins out of circulation.

3. Under Paper Standard:

Under paper standard, if both standard coins of superior metal and inconvertible paper notes are in circulation, the metallic coins will be good money and paper notes will be bad money. Thus, paper notes will drive out standard coins from circulation.

Thus, Gresham's law is a general law which can be applicable in different forms of monetary standards. Marshall presented a generalized version of the law – "Gresham's law is that an inferior currency, if not limited in amount, will drive out the superior currency."

Limitations of the Law:

Gresham's law will operate if the following necessary conditions are satisfied.
In the absence of these conditions the law will fail to apply:

i. Usefulness of Good Money:

An important condition for Gresham's law is that the intrinsically more valuable money (i.e., good money) must also be more valuable in other uses than it is as money in circulation. The failure of this condition to apply explains why the coin currency today remains in circulation as fairly as paper currency despite its higher intrinsic value.

ii. Fixed Parity Ratio:

The applicability of the law requires that the intrinsically more valuable money must be relatively fixed by law in its parity with money. The law will not hold where one money becomes intrinsically more valuable than another money (at the old parity) if the parity changes.

iii. Sufficient Money Supply:

The law will operate only if both good money and bad money are in circulation and the total money supply is more than the actual monetary requirements of the economy.

iv. Sufficient Supply of Bad Money:

The applicability of the law requires that there should be sufficient bad money in circulation to meet the transactions requirement of the people. If there is scarcity of bad money, both good and bad money will remain in circulation and the law will not operate.

v. Contents of Pure Metal:

The law will not operate if the contents of pure metal in coins are less than that in the old ones.

vi. Acceptability of Bad Money:

The law will operate if people are prepared to accept bad money in transactions.

vii. Distinction between Good Money and Bad Money:

The law assumes that people can distinguish between bad money and good money.

viii. Development of Banking Habit:

The law applies in the absence of banking habits. Development of banking habits among the people tends to discourage hoarding and thus restricts the operation of Gresham's law.

ix. Convertibility:

The law also does not operate if the country is on inconvertible paper standard.