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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 – Principles of Note Issue:

Principles of Note Issue:

At present, all the countries of the world have adopted paper standard.

In fact this standard has proved a boon to the modern monetary system. The central bank of a country, which plays an important role in the paper standard, is assigned the job of note issue.

A good note issue system should possess the following qualities:

(a) It should inspire public confidence, and, for this, it must be based on sufficient reserves of gold and silver.

(b) It should be elastic in the sense that money supply can be increased or decreased in accordance with the needs of the country.

(c) It should be automatic and secure.

To ensure a good note issue system, two principles of note issue have been advocated:

(1) Currency principle and

(2) Banking principle.

1. Currency Principle:

The currency principle is advocated by the ‘currency school’ comprising Robert Torrens, Lord Overstone, G. W. Norman and William Ward. Currency principle is based on the assumption that a sound system of note issue should command the greatest public confidence. This requires that the note issue should be backed by 100 per cent gold or silver reserves. Or in other words, paper currency should be fully convertible into gold or silver.

Thus, according to the currency principle, the supply of paper currency is subjected to the availability of metallic reserves and varies directly with the variations in the metallic reserves.

Merits:

The currency principle has the following advantages:

(i) Since, according to this principle, the paper currency is fully convertible into gold and silver, it inspires maximum confidence of the public.

(ii) There is no danger of note issue of the paper currency leading to the inflationary pressures,

(iii) It makes the paper currency system automatic and leaves nothing to the will of the monetary authority.

Demerits:

The currency principle has the following drawbacks:

(i) The currency principle makes the monetary system inelastic because it does not allow the monetary authority to expand the money supply according to the needs of the country.

(ii) It requires full backing of gold reserves for note issue. Thus, it makes the monetary system expensive and uneconomical.

(iii) This principle is not practical for all countries because gold and silver are unevenly distributed among countries.

2. Banking Principle:

The banking principle is advocated by the ‘banking school’, the important members of which are Thomas Tooke, John Fullarton James, Wilson and J.W. Gilbart. The banking principle is based on the assumption that the common man is not much interested in getting his currency notes converted into gold or silver.

Therefore 100 per cent metallic reserves may not be necessary against note issue. It is sufficient to keep only a certain percentage of total paper currency in the form of gold or silver reserves. The banking principle of note issue is derived from the practice of the commercial banks to keep only a certain proportion of cash reserves against their total deposits.

Merits:

The following are the merits of banking principle:

(i) The banking principle renders note issue system elastic. The monetary authority can change the supply of currency according to the needs of the economy.

(ii) Since the banking principle does not require 100 percent metallic backing against the note issue, it is the most economic principle and thus can be followed by both rich and poor countries.

Demerits:

The banking principle has the following demerits:

(i) The banking principle is inflationary in nature, because it involves the danger of over-issue of paper currency.

(ii) The monetary system based on the banking principle does not command public confidence because the system is not fully backed by metallic reserves.

Conclusion:

The main conclusion regarding the two principle of note issue is:

(i) Both the currency principle and the banking principle fail to satisfy all the, requirements of a good note issue system. The currency principle ensures security and public confidence, but it lacks elasticity, economy and practicability. On the contrary, the banking principle provides elasticity and economy to the note issue system, but it suffers from the drawbacks of over-issue and loss of public confidence.

(ii) Despite the incompleteness of both the principles, the banking principle, rather than the currency principle, has been preferred and widely accepted in the modern times mainly because of its emphasis on the qualities of elasticity, economy and practicability of the note issue system. The quality of convertibility, which is basic to the currency principle, is no longer considered as necessary requirement for a good note issue system.