

MONEY

Introduction:

This chapter is a detailed version of barter system and its difficulties, how money has overcome its drawbacks, money supply and its measures.

Barter System And Its Difficulties, Money And Functions Of Money:

1. **Barter system** of exchange is a system in which goods are exchanged for goods.
2. **For example**, wheat may be exchanged for cloth; house for horses, etc., or a teacher may be paid wheat or rice as a payment for his/her services.
3. Such exchange exists in the C-C Economy (commodity to commodity exchange economy).

Note: In C-C Economy C stands for commodity. C-C economy is the one in which commodities are exchanged for commodities. C-C exchange refers to barter system of exchange. Hence, C-C Economy is an economy dominated by barter system of exchange.

Difficulties of barter system

(a) Lack of double coincidence of wants:

- (i) Barter is possible only if goods produced by two persons are needed by each other. It is double coincidence of wants.
- (ii) Double coincidence of wants means that goods in possession of two different persons must be useful and needed by each other. It is the main basis of barter system of exchange. But it is rare.
- (iii) It is difficult to find such a person every time. In barter system, exchange becomes quite limited.

(b) Lack of divisibility:

- (i) In commodity exchange, difficulty of dividing the commodity arises.
- (ii) For example, if a car is to be exchanged for a scooter, then car can not be divided. Similarly, animals can not be divided into smaller units.

(c) Difficulty in storing wealth:

- (i) It is very difficult to store wealth for future use.
- (ii) Most of the goods like wheat, rice, cattle etc. are likely to deteriorate with the passage of time or involve heavy cost of storage.
- (iii) Further, the transfer of goods from one place to another place involves huge transport cost.
- (iv) Transfer of immovable commodities (such as house, farm, land, etc.) becomes almost impossible.

(d) Absence of common measure of value:

- (i) Different commodities are of different values. The value of a good or service means the amount of other goods and services it can be exchanged for in the market. There is no common measure of value under barter system.
- (ii) In this situation, it is difficult to decide in what proportions are the two goods to be exchanged.

(e) Lack of standard of deferred payment: In a barter economy future payments would have to be stated in terms of specific goods or services. This leads to following problems:

- (i) There could be disagreement regarding the quality of the goods or services to be repaid.
- (ii) There would be disagreement regarding which specific commodities would be used for repayment.

5. Money: Money is something which is generally acceptable as a medium of exchange and can be converted into other assets without losing its time and value.

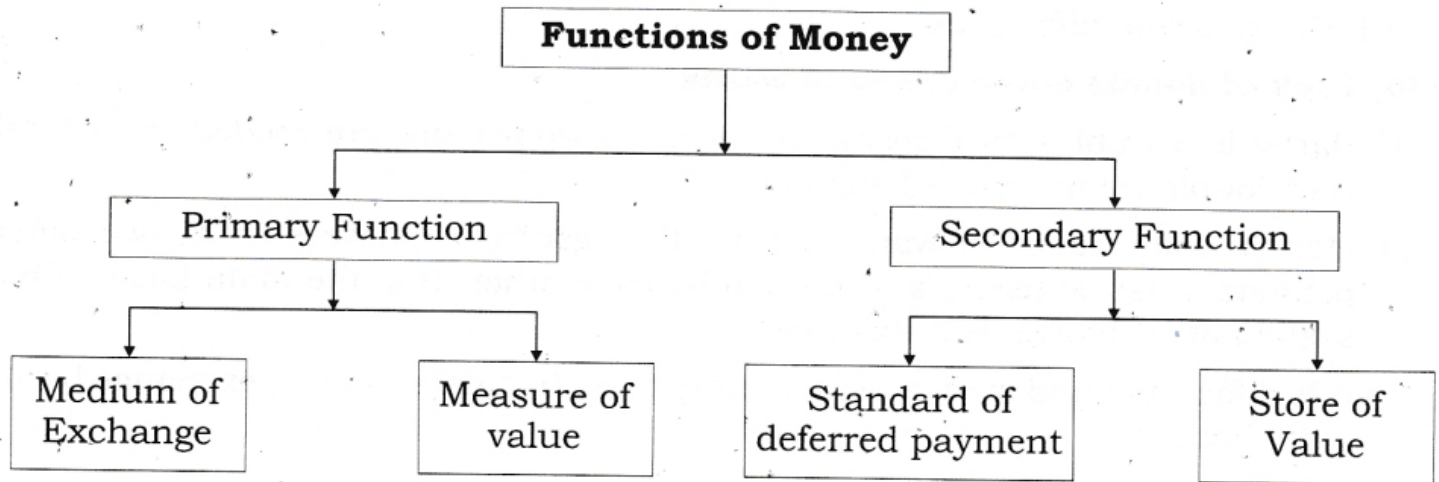
6. Functions of money: Functions of money can be summed up as follow:

“Money is a matter of the following four functions:
A medium, a measure, a standard, a store”

A medium, a measure, a standard, a store”

We can conclude these four functions under the following two functions:

- (a) Primary function
- (b) Secondary function



(a) Primary function or Main function: Primary function includes the most important functions of money, which it must perform in an economic system irrespective of time and place. The following two functions are included under this category.

(i) Medium of exchange

- Money when used as a medium of exchange helps to eliminate the basic limitation of barter trade, that is, the lack of double coincidence of wants.
- Individuals can exchange their goods and services for money and then can use this money to buy other goods and services according to their needs and convenience.
- Thus, the process of exchange shall have two parts: a sale and a purchase.
- The ease at which money is converted into other goods and services is called “liquidity of money”.

(ii) Measure of value /unit of account

- Another important function of money is that it serves as a common measure of value or a unit of account.
- Under barter economy there was no common measure of value in which the values of different goods could be measured and compared with each other. Money has also solved this difficulty.
- As Geoffrey Crowther puts it, “Money acts as a standard measure of value to which all other things can be compared.” Money measures the value of economic goods.
- Money works as a common denominator into which the values of all goods and services are expressed.
- When we express the values of a commodity in terms of money, it is called price and by knowing prices of the various commodities, it is easy to calculate exchange ratios between them.

(b) Secondary Functions**(i) Standard of deferred payments**

- Credit has become the life and blood of a modern capitalist economy.
- In millions of transactions, instant payments are not made.
- The debtors make a promise that they will make payments on some future date. In those situations money acts as a standard of deferred payments.
- It has become possible because money has general acceptability, its value is stable, it is durable and homogeneous.

(ii) Store of value

- Wealth can be conveniently stored in the form of money. Money can be stored without loss in value.
- Savings are secured and can be used whenever there is a need.
- In this way, money acts as a bridge between the present and the future.
- Money means goods and services. Thus, money serves as a store of value.
- It is also known as asset function of money.

Characteristics or features of money

(a) Durability: Money must be durable and not likely to deteriorate rapidly with frequent handling. Currency notes and coins are being used repeatedly and shall continue to do so for many years.

(b) Medium of exchange: Money is the thing that acts as a medium of exchange for the sale and purchase of goods and services.

(c) Weight: Money must be light in weight. Paper money is better than metal coins because it is light in weight.

(d) Measure of value: It not only serves as medium of exchange but also acts as a measure of value. The value of all the goods and services is expressed in terms of money.

The Drawbacks Of Barter System: Barter system makes the exchange process very difficult and highly inefficient. Money has overcome the drawbacks of barter system in the following manners:

(a) Medium of exchange

- Under barter system, there is lack of double coincidence of wants.
- With money as a medium exchange individuals can exchange their goods and services for money and then use this money to buy other goods and services according to their needs and conveniences.
- A buyer can buy goods through money and a seller can sell goods for money.

(b) Measure of value

- Under barter system, there was no common measure of value. Money has also solved this difficulty.
- As Geoffrey Crowther puts it, "Money acts as a standard measure of value to which all other things can be compared." Money measures the value of economic goods.
- Money works as a common denominator into which the values of all goods and services are expressed.
- When we express the values of a commodity in terms of money, it is called price and by knowing prices of the various commodities, it is easy to calculate exchange ratios between them.

(c) Store of value

- Under barter system it is very difficult to store wealth for future use.
- Most of the goods are perishable and their storage requires huge space and transportation cost.
- Wealth can be conveniently stored in the form of money.
- Money can be stored without loss in value.
- Money can easily be stored for future use.

(d) Standard of deferred payments

- Under barter system, transactions on deferred payments are not possible.
- With money, the debtors make a promise that they will make payments on some future dates. In these situations money acts as a standard of deferred payments.
- It has become possible because money has general acceptability, its value is stable, it is durable and homogeneous.

Legal definition of money:

- (a) Legally, money is anything proclaimed by law as a medium of exchange.
- (b) Paper notes and coins (together called currency) is money as a matter of law.
- (c) Nobody can refuse its acceptance as medium of exchange.
- (d) In other words, it is legal tender. It means people have to accept it legally for different payments. Currency is also called FIAT money because it commands 'FIAT' (order/ authority) of the government.

Functional definition of money: Functional definition of money refers to money as anything that performs four basic functions,

- (a) It serves as a medium of exchange.
- (b) It serves as a standard unit of value.
- (c) It serves as a means for future / contractual payments or standard of deferred payments.
- (d) It serves as a store of value.

According to this, definition of money includes both notes and coins as well as chequeable deposits with the banks.

Narrow definition of money: Functional definition of money is a narrow definition of money. It includes only notes, coins and demand deposits as money. In other words, in its narrow definition, money includes only those things that function as money in terms of:

- (a) Medium of exchange.
- (b) Measure of value.
- (c) Standard of future/Deferred payments.
- (d) Store of value.

Broad definition of money:

- (a) A broad definition of money also includes time deposits/term deposits with the banks or post offices as a component of money.
- (b) These deposits can be converted into demand deposits on a short notice, and are "Near money assets". Money assets and near money assets together make up a definition of money.

Money Supply And Measures Of Money Supply

1. Money supply: The volume of money held by the public at a point of time, in an economy, is referred to as the money supply. Money supply is a stock concept.

2. Measures of money supply: On the recommendation of the second working group on money supply, the RBI presented four measures of money supply in its 1977 issues of RBI Bulletin, namely M_1 , M_2 , M_3 and M_4 .

Measures of M_1 include:

- (a) Currency notes and coins with the public (excluding cash in hand of all commercial banks) [C]
- (b) Demand deposits of all commercial and co-operative banks excluding inter-bank deposits. (DD),

Where demand deposits are those deposits which can be withdrawn by the depositor at any time by means of cheque. No interest is paid on such deposits.

- (c) Other deposits with RBI [O.D]

$$M_1 = C + DD + OD$$

Where, Other deposits are the deposits held by the RBI of all economic units except the government and banks. OD includes demand deposits of semi-government public financial institutions (like IDBI, IFCI, etc.), foreign central banks and governments, the International Monetary Fund, the World Bank, etc.

Measures of M_2 :

- (i) M_1 [C + DD + OD]

(if) Post office saving deposits

Measures of M_3 :

(i) M_1

(ii) Time deposits of all commercial and co-operative banks.

Where, Time deposits are the deposits that cannot be withdrawn before the expiry of the stipulated time for which deposits are made. Fixed deposit is an example of time deposit.

Measures of M_4 :

(i) M_3

(ii) Total deposits with the post office saving organization (excluding national savings certificates).

WORDS THAT MATTER

- 1. Barter system:** Barter system of exchange is a system in which goods are exchanged for goods.
- 2. Double coincidence of wants:** It means that goods in possession of two different persons must be useful and needed by each other.
- 3. Money:** Money is something which is generally acceptable as a medium of exchange and can be converted into other assets without losing its time and value.
- 4. Legal definition of money:** Legally, money is anything proclaimed by law as a medium of exchange. Paper notes and coins (together called currency) is money as a matter of law.
- 5. FIAT Money:** It is defined as a money which is under the 'FIAT' (order/authority) of the government to act as a money.
- 6. Functional definition of money:** Functional definition of money refers to money as anything that performs four basic functions. (Medium of exchange, standard unit of value, standard of deferred payments, store of value)
- 7. Narrow definition of money:** Functional definition of money is a narrow definition of money. It includes only notes, coins and demand deposits as money.
- 8. Broad definition of money:** A broad definition of money also includes time deposits/ term deposits with the banks or post offices as a component of money.
- 9. Money Supply:** The stock of money held by the public at a point of time, in an economy, is referred to as the money supply. Money supply is a stock concept.
- 10. High-powered money:** It is money produced by the RBI and the government. It consists of two things: (i) currency held by the public and (ii) Cash reserves with the banks.
- 11. Demand deposits:** These are the deposits that can be withdrawn by the depositor at any time by means of cheque. No interest is paid on such deposits.
- 12. Time deposits:** These are the deposits that cannot be withdrawn before the expiry of the stipulated time for which deposits are made. Fixed deposit is an example of time deposit.
- 13. Other deposit measures of M_1 :** Other deposits are the deposits held by the RBI of all economic units except the government and banks. OD includes demand deposits of semi-government public financial institutions (like IDBI, IFCI, etc.), foreign central banks and governments, the International Monetary Fund, the World Bank, etc.