UNIT 1 MONEY: NATURE, FUNCTIONS AND SIGNIFICANCE

Structure

1.0 OBJECTIVES

After reading this unit, you should be able to:

- define money
- identify problems of barter which led to invention and evolution of money
- distinguish between money and near-money
- appreciate the role and importance of money in a capitalist economy
- identify functions of money and its defects.

1.1 INTRODUCTION

We are all familiar with money as we live in a monetary economy where money is used freely and widely in settlement of various economic transactions. We are so much accustomed to money now that it is difficult for us to imagine a modern society without money. It will be interesting to know why and how this money came into being. In this introductory unit, you will study how money came into being, its definition, role, importance, actions and defects.

1.2 PROBLEMS OF BARTER SYSTEM

Before the 'advent of money, the activity of exchange was carried out through barter system. In barter system people exchanged goods and services in their possession with goods and services available with others. For example, a farmer exchanged his surplus foodgrain (over and above his own needs) with the weaver for his surplus cloth. This activity helped both the farmer and weaver to satisfy their wants. The barter system of exchange worked well so long as human wants were simple and limited in number. However, in course of time human wants multiplied, which led to specialisation of occupations. This resulted in a lot of difficulties for exchange through the barter system. Consequently, need for a single and commonly acceptable medium of exchange was fell, This ultimately led to invention and evolution of money.

In the barter system people faced the following major problems:

1) **Lack of double coincidence of wants:** Barter requires double coincidence of wants. For instance, if 'A' has a goat rind wants to exchange it for cloth. Then he

must find some person who has surplus cloth to offer while, at the same time, needs the goat which is offered by 'A'. Such coincidences were easy when human wants were simple and number of goods produced were limited. But, as number of goods multiplied, such coincidences of wants became both difficult and time-consuming. With the advent of money, this difficulty disappeared, as one can now sell product for money and then with the help of that money he/she can buy goods and services of his/her choice.

2) **Problem of a common measurement of value:** In the absence of money, value of every commodity was to be ascertained in terms of all other goods. For example, how much wheat or milk or salt or rice needs to be offered in exchange for one meter of cloth ? If there were, say, 10 goods in a society, people were required to determine and remember 45 values, while if there were 100 goods there would be 4950, such values. The number of exchange values required for transactions may be found by the expression,

$$\frac{n(n-1)}{2}$$ where 'n' is number of goods.

However, with money in circulation, vaiue of each commodity has to be expressed only in terms of money. Hence, in case of 100 goods, in a monetary economy people will have to know only 100 values.

3) **Loss due to sub-division of goods:** Many goods, if sub-divided, will lose their value partially or sometimes wholly. For example, a table or a refrigerator or a TV set cannot be sub-divided into parts as in doing so they will lose their value. In this situation, a person who wants to exchange his TV for five or six commodities, will find it difficult to get all these five or six desired goods from one person. Hence, he would need to sub-divide the TV into five or six parts, but by doing so TV will lose its value. On the other hand, if money is used as a medium of exchange, there would not be any such problem as money is perfectly divisible.

4) **Difficulty in storage of** wealth: It is veiy difficult to save and create wealth in the absence of money as many of the goods lack durability, and all kinds of services are perishable and hence cannot be stored for future use. People could not think of storing something to provide against future contingencies as wealth stored in the form of goods like wheat, animal skin, etc., would not last long. However, money being durable has become a convenient form to save and store wealth.

1.3 EVOLUTION AND KINDS OF MONEY

As you know, at present money consists of coins, currency notes and deposit money. However, it has taken hundreds of years to acquire its present form. During the early

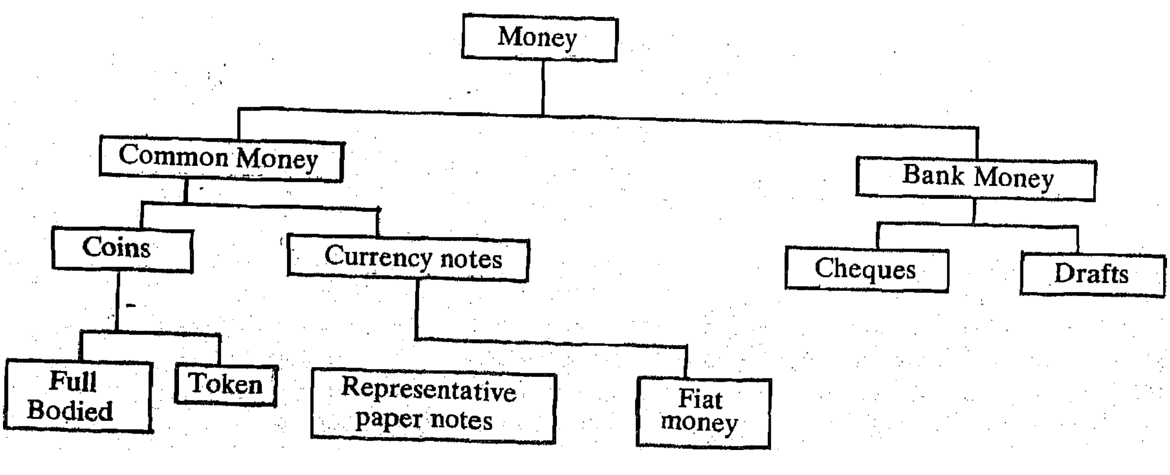

Figure 1.1 Kinds of Money

part of civilisation, money was in the form of commodity money like the cow. sheep, wheat, rice, tobacco, tiger teeth, elephant tusks, etc. The particular commodity chosen as money depended upon various factors like the climate, the level of cultural and economic development of the community, etc. In cold countries like Alaska and Siberia, animal skins and furs were used as money. In tropical countries elephant tusks and tiger jaws were used as money. In agricultural communities domestic animals and goods of daily use took the form of money. However, with the passage of time their use as money was given up due to lack of their durability, absence of a standard form, etc. The present day nroney has also passed through three stages : (i) metallic money, (ii) representative paper money, and (iii) credit money. The present inconvertible paper currency and other credit instruments acting as substitutes for legal money are only a recent development. Figure 1.1 shows the different kinds of money which exist in modern economies.

With progress of civilisation and economic advancement of societies, metallic coins made of gold, silver, copper etc., were used as money. These coins were of two types :

i) Standard coins or full-bodied coins, as they were called, because their face value and intrinsic value were the same ; and ii) token coins, those coins whose face value was much higher than their intrinsic value.

Later on, currency notes were introduced to replace metallic coins primarily for two reasons: *firstly,* to economise the use of precious metals and avoid their wastage ; and *secondly,* for the sake of convenience of storage and transportation of paper vis-a-vis the coins. In order to build up the confidence of the public in paper currency, initially the currency notes took the form of representative notes. These rapresentative notes were simply substitutes for metallic money, i.e., convertible into gold or silver coins on demand by the bearer. With increased use of paper money for transactions (due to expansion in production, population and monetized section of the economy) it became almost impossible to allow such convertibility. The present day currency notes are, therefore, no longer convertible into gold or silver coins and as such may be termed as flat money. Nowadays a sizeable portion of common money comprises this non-convertible paper currency.

Credit money is of more recent origin. People keep a part of their cash with banks which they can withdraw at any time they like or can transfer to some other person through a bank cheque. The cheques and drafts, being most convenient form of transferring value, have come to be accepted as bank money, though they are not money proper as their acceptance is optional. However, they perform the most important function of money, viz. as a medium of payment.

1.4 WHAT IS MONEY 3

Different economists have given different definitions of money. Some of the definitions are too narrow while others are too extensive. A few of the important definitions are given below :

A. C. Pigou — "In order for anything to be classed as money, it must be accepted fairly widely as an instrument of exchange."

G. D. H. Cole — "Money is anything that is habitually and widely used as means of payment and is generally acceptable in the settlement of deb."

Walker — "Money is what money does."

J. M. Keynes — By money is to be understood "that by delivery of which debt-contracts and price-contracts are discharged, and in the shape of which a store of General Purchasing Power is held."

Alfred Marshal — "Money constitutes all those things which are at any time and place, generally current without doubt or special enquiry as a means of purchasing commodities and services, and of defraying expenses."

D. H. Robertson — "Money is anything which is widely accepted in payment for goods or in discharge of other kinds of business obligations."

Crowther — "Money can be anything that is generally acceptable as a means of exchange and that at the same time acts as a measure and a store of value."

Analysis of the above mentioned definitions will reveal that it is not easy to include all the essentials of money in one sentence. None of the above definitions is, therefore, comprehensive and satisfactory. However, these definitions help us to identify the basic features of money which may be summed up as under:

1) Money may be anything (even a piece of paper) which is chosen by common consent as a medium of exchange or means of transferring purchasing power.

2) It is widely accepted in payment for goods and services and in settlement of all transactions, including future payments.

3) It should be acceptable without reference to the standing of the person who offers it in payment. This is because money contains liquidity, i.e. generalised purchasing power, which can be passed on to others in exchange of goods and services.

4) Money is received customarily by all without any special tests of quality or quantity.

Near-Money

There are certain assets which are highly liquid, though not perfectly liquid like money. These assets can easily be converted into money without much loss of time or value and have, therefore, come to be known as 'Near-Money.'

Examples of near-motley are bills of exchange, bonds, saving certificates, treasury bills, debentures, etc. Such near-money assets are **claims on money** i.e., these assets have to be first converted into actual money before using them for the purchase of any commodity. The importance of near-money asset, therefore, lies in the ease with which it can be sold in the market without much loss of time or value. However, both money and near-money are similar in one respect: that both of them are claims. Money is a claim over the government or central bank of the country, who has issued it while bank money is a claim over banks with whom money is held as public deposits. Like wise near-money is also a claim over it's issuing authority. For instance, a bill of exchange is a claim over the party which has agreed to pay the amount specified in the bill at the expiry of the specified period, say 91 days. Similarly, a bond represents a claim on the government which has issued it.

Check Your Progress A

1) List the essential features of money.

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2) Distinguish between money and near-money.

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3) **A** barter system of exchange faces the following problems:

i) ....

ii) ....

iii) ....

iv) ....

4) Which of the following statements are *True* and which are ***False*** ?

i) In a barter system of exchange people exchange goods for goods.

ii) Fiat money is convertible into gold or silver coins on demand by its bearer.

iii) Bank money performs the function of a medium of exchange.

iv) Those assets which are perfectly liquid like money are called near-money.

) Money is something which is widely accepted in payment for goods and services.

1.5 NATURE OF MONEY

Money is only a means and not an end in itself. It is demanded not for its own sake but because it helps us in buying goods and services to salisfy our wants. Money cannot directly satisfy human wants, but assists in production and exchange of goods and service's. Its significance lies in its ability to command goods and services and liquidate business obligations. Money gives mobility to capital and aids division of labour and specialisation, thereby making large scale production possible. It has been rightly remarked that 'we cannot eat **money** but we cannot eat without money either.'

1.6 FUNCTIONS OF MONEY

Money is what money does.' According to this statement, the importance of money lies in the functions it performs. Primarily money performs four basic functions which are summed up in the following couplet : ***"Money is a matter of functions four: A , medium, a measure, a standard & a store."*** However, it has become customary to classify the functions of money under three heads :

1) Primary Functions — Money performs two basic functions. It acts as a :
   i) Medium of exchange
   ii) Measure of value.
2) Secondary Functions — The other important functions of money (derived from the primary functions) are :
   i) Standard of deferred payments
   ii) Store of value
   iii) Transfer of value
3) **Contingent** Functions — In the modern economy money has certain incidental uses like :
   i) It is the basis of a credit system
   ii) It helps in the distribution of national income
   iii) It helps in maximisation of utility as well as of profits
   iv) It imparts liquidity to wealth

Let us describe each of these functions briefly.

Primary Functions

1) Money as a **medium of** exchange : It is the most important and unique function of money which separates it from near-money assets. The use of money as a common medium of exchange has greatly facilitated the activity of **buying** and selling goods and services. Without money, exchange could be possible only through barter system whose basic weaknesses have been discussed earlier in **this** Unit On the other hand, the use of money as a medium of exchange avoids **most** of the problems of a barter exchange.

   Though use of money splits exchange into two parts, **viz.,** sale and purchase, but it does not result in loss of time and energy.

2) Money as a measure of **value** : Money serves as a yardstick to measure values of all other goods and services in terms of their money price. In the absence of money, value of one commodity could be expressed only in terms of the other goods and services. As shown earlier, if there are, say, one hundred goods in **the** market, then under the barter system value of each product will have to be expressed in terms of the remaining 99 goods, i.e. in all there would be 4950 values. On the other hand, if money is used as a measure of value, then we need to measure value of each good in terms of money only, i.e. just 100 values for 100 goods. Further, there are goods which are expressed in different physical units, e.g. a metre of cloth, a kilogramme of wheat, a litre of milk, etc. Comparison of values of such goods is also possible if we know the money value

of these goods. For example, one metre of cloth is equal to 6 kg. of wheat or 3 litres of milk because they cost the same amount of money etc. The use of money prices also help us in estimating national income by adding up values of a wide variety of goods and services which are measured in different physical units and hence, cannot be lumped together to estimate national Income. Also, the use of money makes it possible to compare value of goods over time and between different regions.

However, money as a measure of value can serve satisfactory only when its own value (i.e., purchasing power) remains stable over time. Continuous rise in general level of prices all over the world has made money a poor measure of value.

Secondary Functions

1) **Money as a standard of deferred payments**: Money facilitates not only the current transactions of gods and services but also their credit transactions. It facilitates credit transactions when present goods are exchanged against future payments. In the modern world, the bulk of deferred payments are stipulated in money terms only. Examples in this regard are repayment of loan alongwith interest, pensions, rents, salaries, insurance premio, etc. Money could be an effective standard of deferred payments only if value of money itself does not change. If prices increase or decrease sharply, resulting in large fluctuations in the value of money, it would make money a poor standard of deferred payments.

2) **Money as a store of value**: People can hold a part of their present earnings in the form of money to be spent in future. Money represents generalised purchasing power and is a perfectly liquid asset as well. Besides, it is durable and more stable in its value. It is easy to store as it is relatively light in weight and occupies less space. Hence, it is convenient to accumulate wealth in the form of money which can be converted into any asset at any time. In this way money serves as a bridge from the present to the future, as money saved today implies shifting of purchasing power from the present to the future.

3) Money as a means of **transferring** purchasing power: Money is the most convenient form in which value can be transferred from one person to another and also from one place to another. It is because money is readily accepted by all and its cost of transfer from one place to another is very low due to its high value and less weight compared to other goods. For example, a person can transfer crores of rupees to another person at a distant place with the help of a bank draft or a cheque almost at a nominal cost. But transferring this value in terms of, say, .rice is obviously very difficult, costly and involves wastages.

Contingent Functions

1) **Distribution** of national income: Money helps in the distribution of national output among the people who have contributed in its production. In a modern society people co-operate together as workers, owners of capital, landlords, etc., to produce goods. The resultant output is, therefore, to be distributed among all of them in the form of wages and salaries, interest, rent, etc. In the absence of money it would not always be possible to distribute such an output, particularly in case of indivisible goods, e.g. a machine. With the help of money we can overcome such a problem. .

2) Basis of credit system: The modern economy is based on credit i.e., promise to pay. The present day money itself (coins, currency notes, cheques, bank drafts, etc.) is nothing but only promise to pay. However, this money also helps banks to create more money by the process of credit creation, when the banks expand secondary deposits with the help of cash deposits (you will study this in Unit 5). In this way money serves as a basis of credit creation by banks.

3) Maximisation of utility and profits: Money helps consumers in maximising their satisfaction. When money is allocated between different goods and services, the consumer maximises his utility. Likewise, producers can calculate money cost of production and then decide the price that can result in maximum profits,

4) Money imparts **liquidity** and uniformity to assets: It is convenient to hold wealth in the farm of money as it'is the most liquid of all assets. Money can buy any asset and all asset$ can be converted into money as well. Thus, money

imparts liquidity to all assets. Besides, total wealth of a person or a country can be assessed by adding up money values of all assets. Thus money also brings an element of uniformity to the wealth of the nation.

1.7 SIGNIFICANCE OF MONEY

Money is the life blood of a modern capitalist economy. Without money this economy cannot function smoothly. Just as the strength and vitality of a human body is judged by the amount of blood and its proper circulation, in the same way the strength and extent of development of the economy can be judged by the requisite supply and proper circulation of money in the economy. The significance of money, to a great extent, depends upon and is derived from the various functions it performs. These are given below :

1) Significance of money in **consumption :** Nowadays people receive their incomes in terms of money. This facilitates in exercising Free choice of consumption. Though, given their limited money income the consumers cannot buy each and everything that they desire yet money income gives them freedom to buy such goods and in such quantities which can yield them maximum satisfaction within that income-limit Besides, money gives the consumers liberty to choose between the present and the future consumption, i.e. how much to be spent on present consumption and how much to be saved from the given present income for Future consumption.

2) Significance of money in production: Money is not a factor of production, yet it facilitates production Use of money has led to expansion of market of goods and services. This has resulted in large scale production and technological improvements, thus minimising the cost of productipn. I- ow ever, large scale production requires division of labour and specialisation which is impossible under a barter-system. Besides, money (through price mechanism) indicates to producers the type and quantity of goods they should produce.

3) Significance of money in trade: Being a medium of exchange, money facilitates trade as well. Money constitutes basis of price-mechanism and, thus, helps in determining prices of goods and services through the forces of demand and supply. Besides by equalising marginal cost with marginal revenue of each product (measured in terms of money), the sellers can arrive at profit-maximising level of sales of their products.

4) Significance of money and economic progress : Introduction of money has led to the emergence of large scale production resulting in constant urge to accumulate capital and develop new techniques of production. Thus, the role of money in encouraging material progress is significant

5) Significance **of** money in public finance : Governments require resources to run the administration smoothly for which they levy taxes and also charge fees, fines, etc. Without money, taxes received will be in the form of goods which may or may not be useful from government's point of view, e.g., shoemaker paying tax in the form of shoes and green-grocer in the form of vegetables. But taxes received in money give freedom to government regarding choice of things which government needs for the developmental purposes.

6) **Money** and foreign trade : Money has helped in the expansion of foreign trade and thereby raise the levels of consumption the worldover. It is because with the help of money we can transact not only those goods which are produced domestically but also those which are produced by other countries. The possibilities of **exports** and imports with the help of money has resulted in expansion of international trade and co-operation.

The significance of money in **all** walks of life is so immense that modem life without money cannot even be imagined. It has rightly been remarked that 'money is a pivdt around which **all** economic activities cluster'.

1.8 EVILS OF MONEY

Invention of money has not proved to be an unmixed blessing as its use has become a source of so many evils too. If money is not used properly, it can create havoc and may prove to be disastrous for the mankind. Some of the evil effects of money arc listed here.

Economic Defects

1) Use of money has given rise to greed and exploitation of poor which has resulted in greater inequalities of incomes and wealth. History shows that it is the economic exploitation that triggers any social upheaval.

2) Money helps in extending the scale of production, which after certain limits may result in a situation where production far exceeds the demand. This leads to fall in level of prices, unemployment, decline in incomes and thereby misery for the masses.

3) By facilitating borrowing and lending, money may encourage overcapitalisation (i.e., using too much capital in place of labour) in production, thereby creating large scale unemployment in the economy.

4) When a government/central bank increases the supply of money by simply printing new notes, it leads to sharp rise in prices. This adversely affects the purchasing power of fixed income groups in the society, resulting in class-conflicts and social disorder.

Social Defects

1) Money has encouraged many kinds of anti-social activities like gambling, fraud, robbery, etc.

2) It makes people greedy and acquisitive.

3) It encourages tendencies of exploiting others.

However, it cannot be denied that most of the evils listed above arise because of improper use of money; these are not evils of money itself. Hence, there is a greater need to use money as a faithful servant than to become slaves of money and invite troubles. It has been rightly remarked that money which has been source of so many blessings to mankind becomes a source of peril and confusion unless we control it.

Check Your Progress B

1) List some of the important functions of money.

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2) What are the main evils of money ?

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3) Which of the following statements are True and which are False ?
   i) Money is a perfect measure of value.
   ii) By making capital mobile, money helps in large scale production.
   iii) Money facilitates in exercising free choice of consumption.
   iv) It is only money that causes exploitation of the poor.
   v) Money helps in the expansion of both domestic and foreign trade.

4) Match the function (as given in Column B) that money performs when the following things (as shown in Column A) happen.

Column A	Column B
a) You are told that price of Sugar is Rs. 10 per kg.	i) Medium of exchange

b) You pay Rs. 10 and buy a kg of sugar. ii) Store of value

c) You buy a national saving certificate from post-office for Rs. 100 which promises to repay after 6 years. iii) Measure of value

d) A person keeps apart Rs. 100 from his salary as his saving. iv) Standard of deferred payments.

1.9 LET US SUM UP

Modem economy is a monetary economy where money is used freely and widely in all spheres of life. Before the advent of money there was barter-system of exchange. Barter created many problems which not only made the process of exchange difficult but also forced the producers to produce on very small scale due to small sizè of the market. These limitations of barter ultimately led to the invention of a common medium of exchange, called money.

Money can be anything which is chosen by common consent and is generally acceptable as means of payment. Money had to pass through many stages, i.e., commodity money, metallic money, paper currency, bank money, etc. At present paper currency and bank money form the bulk of total money supply.

In the modem times money is only a claim with nearly zero intrinsic value. It is widely accepted due to the fiat (i.e., legal backing of the issuing authority) or else it is only a piece of paper. The demand for money also stems from the fact that it is the perfectly liquid asset and hence the most convenient form in which wealth can be stored Another form to store wealth is near-money assets which are highly but not perfectly liquid, as they have to be first converted into money before any transaction of goods and services can be undertaken.

The importance of money lies in the functions that it performs. The most important functions which money performs are : i) medium of exchange, ii) measure of value, iii) standard of deferred payments, and iv) stork of value. However, apart from these four functions money also helps in many other ways, like distribution of national income, transfer of value, basis of credit creation, maximisation of utility and profits and imparting liquidity and uniformity to assets.

Money has influenced all branches of economic activities such as consumption, production, exchange, international trade, public finance, etc. The net impact of the use of money has been a sharp rise in the production of goods and services, and thereby achieving higher levels of consumption for the people. Besides, it has helped raise efficiency through greater division of labour, specialisation and technological change, resulting in higher level of national income. Money has helped tremendously in the expansion of foreign trade.

However, money has also created such conditions whereby there is a greater scope for exploitation of labour, leading to class-conflicts and industrial unrest. Use of money has also given rise to all kinds of social evils, like theft, dacoity, frauds, etc. by encouraging greed and acquisitiveness. Above all, sharp fluctuations in value of money prove harmful for the progress of trade and industry.

1.10 'KEYWORDS

Barter System : The system of direct and mutual exchange of goods and services.

Chequable Deposits : Deposits with banks which can be withdrawn at anytime by issuing a cheque.

Fiat Money: Money that people have to accept as it has legal backing.

Intrinsic Value: The value of metal that the coin contains.

Liquidity: Quality of the asset by which it can be readily converted into any other asset

Specialisation of Labour: A system of production when a worker looks after a specific part of the production process, rest of the process being looked after by others.

1.11 'ANSWERS TO CHECK YOUR PROGRESS

A 3 i) Lack of double coincidence of wants
ii) Problem of common measurement of value
iii) Loss due to sub-division of goods
iv) Difficulty in store of wealth
4 i) True ii) False iii) True iv) False v) True
B 3 i) False ii) True iii) True iv) False v) True
4 a) iii b) i c) iv d) ii

1.12 TERMINAL QUESTIONS

1) What is money ? Distinguish between money and near-money.
2) Explain briefly the inconveniences of barter-system and trsce the evolution of money.
3) Discuss the nature and functions of money.
4) Bring out the importance of money in a modern capitalist economy. Can money be abolished ?
5) 'Money is a good servant but a bad master'. In the light of this statement highlight the evils of money.

Note: These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University for assessment. These are for your practice only.