Money, Banking and Financial Institutions

By: Divya Chawla

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BBA, MBA, B.Com, BMS, M.Com, BCA, MCA

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MONEY, BANKING AND FINANCIAL INSTITUTIONS

MONETARY THEORY

Money: Nature, Functions and Significance

1

INTRODUCTION

This chapter provides us an understanding about the concept of money which is used freely and widely in settlement of various economic transactions in the monetary economy that we live in.

This chapter begins with the definition of money and also identifies the various problems of Barter System which invariably led to the invention and evolution of money. The difference between money and near money has also been provided in the chapter. In the end the chapter provides for the role and importance if money in the capitalist economy along with the functions and defects of money.

CHAPTER AT A GLANCE

PROBLEMS OF BARTER SYSTEM

Before the invention of money it was the Barter System of exchange which was in place. This system created various problems which made the process of exchange difficult as well as forced the producers to produce on very small scale due to small size of the market.

The problems faced by the people due to the Barter System included:

- Lack of double coincidence of wants in the sense that it is difficult to find people who have similar kinds of wants and desires.
- Problem of a common measurement of value, that is, it is difficult to ascertain the value of every commodity in terms of all other goods in the absence of money.
- Loss due to sub-division of goods, as goods such as TV would lose its value if it were to be bought or sale in five to six parts.
- Difficulty in storage of wealth, that is, wealth stored in the form of goods like wheat, animal skin would not last for long as they lack durability etc. and are perishable therefore cannot be stored for future use.

EVOLUTION AND KINDS OF MONEY

Anything which is chosen with the common consent of the people and is generally acceptable as the means of payment can be regarded as money. Money had to pass through many stages like the commodity money, metallic money, paper, currency, bank money, etc. Currently it's the paper currency and the bank money which form the bulk of total money supply.

WHAT IS MONEY?

Many economists have defined money in their own ways based on the analysis of their definitions, money is said to have the following basic features:

- Money can be anything, even a piece of paper, which is chosen by the common consent as a medium of exchange or means of transferring purchasing power.
- It is widely accepted in payment for goods and services and in settlement of all transactions including future payments.
- Money is received customarily by all without any special tests of quality or quantity.
- It is a perfectly liquid asset and the most convenient form in which wealth can be stored.

NATURE OF MONEY

It is a true fact that money cannot satisfy human wants however it does assist in the production and exchange of goods and services. That is, its significance lies in its ability to command goods and services and liquidate business obligations.

Money also provides mobility to capital and also aids division of labour and specialisation.

FUNCTIONS OF MONEY

- **Primary Functions:**
  - Money as a medium of exchange, as it facilitates the sale and purchase of goods and services and also helps in covering up for the drawback caused due to the Barter System.
  - Money as a measure of value, that is, it acts as a measuring stick for all the other goods and services in terms of money.
- **Secondary Functions:**
  - Money as a standard of deferred payments by facilitating credit transactions apart from current transactions of goods and services.
  - Money as a store of value for future use as money acts as a representative of generalised purchasing power of an individual.
  - Money as a means of transferring purchasing power which can be transferred from one person or place to another in a convenient and easy way with its feature of low cost of transfer.
- **Contingent Functions:**
  - Distribution of national income amongst the people who have contributed in its production that is the society at large.
  - Basis of credit system, by being a promise to pay. Money also helps the banking system to create more money with the help of credit creation.
  - Maximization of utility and profits by being allocated and spread across various goods and services, which increases the consumer's utility.
  - Money imports liquidity and uniformity to assets as money being the most liquid form of all assets helps in the purchase of any kind of asset and *vice-versa*.

SIGNIFICANCE OF MONEY

The various functions performed by money are inclusive of the following:

- **In Consumption:** Monetary income helps the individuals in fulfilling and prioritizing their needs and desires and fulfilling them accordingly.
- **In Production:** Usage of money helps in the expansion of goods and services thereby leading to large scale production and technological improvements.
- **In Trade:** By affecting the forces of demand and supply money facilitates trades by being the basis of price mechanism.
- **In Economic Progress:** There has increase in the desire for accumulation of capital and newer techniques of production due to the introduction of large scale production techniques led in by money.
- **In Public Finance:** Money received by the government in the way of taxes and other fees is used for the smooth running of its administrative functions.

- **In Foreign Trade:** Money has led to the increase in the levels of consumption as well as in the expansion of foreign trade world over.

EVILS OF MONEY

- **Economic Defects:**
  - Rise to greed and exploitation which has further led to an increase in the inequalities of income and wealth.
  - Extending the scale of production which after a period of time leads to a fall in the prices, unemployment and trouble for the masses.
  - Encourages overcapitalisation by facilitating borrowing and lending money in production.
  - Sharp rise in prices by printing new notes which may further adversely affect the purchasing power of the fixed income group individuals leading to class conflicts and social disorders.
- **Social Defects:**
  - Increase in anti-social activities.
  - Makes people greedy and acquisitive.
  - Encourages tendencies of exploiting others.

CHECK YOUR PROGRESS

Q. 1. List the essential features of money.

Ans. The essential features of money can be listed as follows:

- Money can be anything which is chosen by common consent as a medium of exchange or means of transferring purchasing power.
- It is accepted by all normally without any special tests of quality or quantity.
- It should be acceptable without reference to the standing of the person who offers it in payment, due to its liquidity factor.
- It is widely accepted in payment for goods and services and in settlement of all transactions inclusive of future payments.

Q. 2. Distinguish between money and near-money.

Ans.

Money	Near-Money
Money refers to the generally accepted material, that is, currency note which can be used as a means of exchange and as a measure of value.	Near-money refers to those assets which are highly liquid though not perfectly liquid and which can be easily converted into money without much loss of time or value.
Examples: Currency note and coins	Examples: Bill of exchange, Bonds, Savings Certificates, Treasury Bills, Debentures, etc.

Q. 3. Which problems faces by a Barter System of exchange?

Ans. A barter system of exchange faces the following problems:

(i) Lack of double coincidence of wants.
(ii) Problem of a common measurement of value.
(iii) Loss due to sub-division of goods.
(iv) Difficulty in storage of wealth.

Q. 4. List some of the important functions of money.

Ans. The functions can be classified as:

1. Primary Functions:
(a) Medium of exchange
(b) Measure of value

2. Secondary Functions:
(a) Standard of deferred payments
(b) Store of value
(c) Transfer of value

3. Contingent Functions:
(a) It is the basis of a credit system
(b) It helps in the distribution of national income.

(c) It helps in maximization of utility as well as profits.
(d) It imparts liquidity to wealth.

Q. 5. What are the main evils of money?

Ans. The evil effects of money can be listed as follows:

1. Economic Defects:

(a) Greater inequalities of incomes and wealth due to rise in greed and exploitation of poor.
(b) Scale of production extends due to money which after certain limits may result in a situation where production far exceeds the demand.
(c) Money has encouraged overcapitalisation in production by facilitating borrowing and lending.
(d) When government/central bank increases the supply of money by simply printing new notes, it leads to sharp rise in prices which further affects the purchasing power of the fixed income groups and causes social disorder.

2. Social Defects:

(a) Anti-social activities have emerged due to money like gambling, fraud, robbery, etc.
(b) It makes people greedy and materialistic.
(c) It encourages tendencies of exploiting others.

TERMINAL QUESTIONS

Q. 1. What is money? Distinguish between money and near-money.

Ans. Different definitions of money have been provided by different economists, some of them include:

According to **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."

On the other hand, **Walker** has defined it very briefly as "Money is what money does." Based on this definition it can be said that money can be used as the valuation of commodities and medium of exchange for goods and services.

According to **D.H. Robertson**, Money is defined as "Anything which is widely accepted in payment for goods or in discharge of other kinds of business obligations."

Some of the basic features of money based on the above definitions include the following:

(i) Money can be anything, that is, even a piece of paper which is chosen by common consent as a medium of exchange or means of transferring purchasing power.
(ii) Money is accepted in payment for goods and services and in settlement of all transaction even inclusive of future payments.
(iii) Money is accepted without any references to the standing of the person who offers it in payment due to its liquidity factor.
(iv) Money is received customarily by all without any special tests of quality or quantity.

Near-money on the other hand refers to those assets which are highly liquid though not perfectly liquid and which can be easily converted into money without mush loss of time or value.

Money	Near-Money
Money refers to the generally accepted material, that is, currency note which can be used as a means of exchange and as a measure of value.	Near-money refers to those assets which are highly liquid though not perfectly liquid and which can be easily converted into money without much loss of time or value.
Money is a claim over by Reserve Bank of India as it is issued by RBI.	Near-money is a claim over by its issuing authority.
It is accepted in payment for goods and services and in settlement of all transactions. Examples: Currency note and coins.	Near-money needs to be transferred into money for making payment for goods and services. Examples: Bill of exchange, Bonds, Savings Certificates, Treasury Bills, Debentures, etc.