5 Meaning, Functions and Supply of Money

Contents

Money plays an important role in all economies. People want money not for itself but for things it will buy. Money is the basic necessity of every economy. The main function of money is to facilitate the exchange of goods and services. In this chapter, we will study the meaning and functions of money. Before money was invented all economic transactions were carried on the basis of barter system. So before we come to know the meaning and functions of money, we will briefly explain the barter system.

1. Barter System of Exchange

1.1 Meaning of Barter Exchange

In the initial phases of human civilization, human needs were simple and limited. People used to exchange goods with each other to satisfy their wants. *Barter means exchange of goods for goods.* An economy, where there is a direct barter of goods and services, is called a **'Barter Economy'** or **'C - C Economy'** (where C - C stands for commodity to commodity).

1.2 Difficulties of Barter System

Barter system of exchange suffers from the following drawbacks.

(1) **Lack of double coincidence of wants :** The barter system requires a double coincidence of wants on the part of those who want to exchange goods or services. For example, suppose a farmer possesses wheat and wants to exchange it for cloth. In the barter system, he has to find out a person who not only has cloth but also wants wheat in return. But, such a double coincidence is a rare possibility. Imagine how much effort (physical labour) it will require to find such a person. Moreover, it also involves waiting for the appropriate person. Waiting involves discomforts which implies disutility. **Efforts and disutility of discomforts taken together is called trading cost of barter exchange.**

(2) **Lack of common measure of value :** Another difficulty of barter is that at what rate any exchange is to be made. There is lack of common measure of value. For example, if there are 1000 goods in the market then the value of each would have to be expressed in terms of 999 goods. The price list then becomes extremely complicated. Not only this, no proper accounting is possible in the absence of common unit of value.

(3) **Problem of future payments :** Thirdly, the barter system lacks a standard of deferred payments. In the absence of money, future payments are not possible because of the following reasons:

(a) The borrower may not be able to arrange exactly the same good and of the same quality at the time of repayment.

(b) There could be disagreement regarding which specific commodity would be used for repayment.

(c) There exists a risk since the commodity may increase or decrease in its value at the time of repayment.

(4) **Problem of storing of value :** Lastly, the barter system does not provide a reliable method of storing value or wealth for future use. Storing of value means storing of the purchasing power i.e., storing of income for future use . Under barter system, it is difficult for people to store wealth for future use. Most of the goods like wheat, rice, vegetables etc. do not possess durability and their quality deteriorates with passage of time. Further, storage of goods require time, money and efforts. It makes their storage very difficult. As a result, goods cannot be used to store wealth for future use.

Due to these above mentioned drawbacks of the barter system, the process of exchange becomes highly inefficient. To overcome these difficulties, money was invented by the society.

2. Meaning of Money

Money has been defined by different economists differently. Some have defined it in terms of its general acceptability while others have defined it in terms of its functions. Basically, money was introduced as an instrument (or medium) of exchange. Accordingly, money meant anything that act as medium of exchange. With the passage of time, money came to be defined differently. The important definitions of money are explained under the following heads :

2.1 Legal definition of money

According to this definition, *money is what the law says is money.* In other words, anything which the government declares it as money is money. A thing will have general acceptability if the law declares it as money. Since it has the legal power to discharge debts, no creditor can refuse it or he may not demand anything else in payment of debt. Currency-notes and coins are **legal tender money.** It is also called **fiat money** because it serves as money on the fiat (order) of the government.

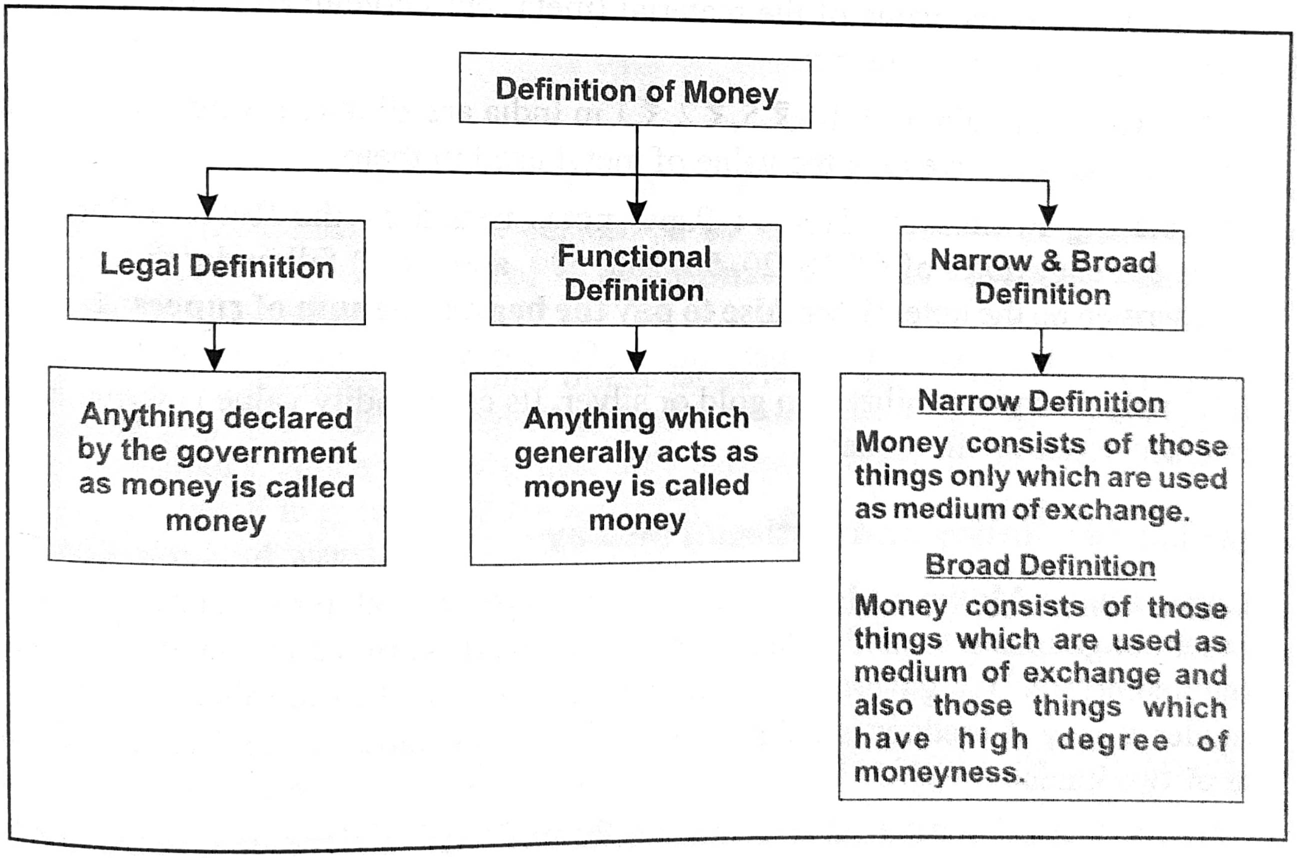
2.2 Functional definition of money

According to this definition, money is defined on the basis of functions it performs. This definition emphasizes the important functions of money. From this point of view **Crowther's definition** is considered as most suitable definition of money. He defines money as **'anything that is generally acceptable as a medium of exchange and at the same time acts as a measure and as store of value'.**

This is an ideal definition of money because of two reasons :

(i) This definition emphasizes all the important functions of money.

(ii) It stresses upon the basic characteristic of general acceptability.



2.3 Narrow and broad definitions of money

On the basis of scope, money has been defined in two ways : (i) narrow money and (ii) broad money. Narrow money includes only currency notes and coins. It includes only those things which function as medium of exchange. On the other hand, broad money, besides including currency-notes and coins, also includes some other things in the supply of money that have a high degree of moneyness e.g., time deposits at banks and post offices. These deposits can be converted into ready cash at short notice.

3. Classification of Money

Money can be classified as under :

3.1 Full Bodied Money

Full bodied money is that money whose value as a commodity is equal to its value as money. It is also called standard money. When the economies of the world were on gold standard or silver standard, gold coins or silver coins were full bodied money. A rupee coin during the British period in India was made of silver. Its commodity value (i.e., metallic value or intrinsic value) was equal to its money value (i.e., face value).

3.2 Credit Money

Credit money refers to that money whose value as money is greater than its commodity value (i.e., value of the material from which it is made). It means face value is greater than intrinsic value. Intrinsic value is the value of the material (metal etc.) contained in the unit of money. Credit money includes the following:

(a) **Token Coins :** (Coins of ₹ 10, ₹ 5, ₹ 2, ₹ 1 in India are all token coins) since their value as money is far above than the value of metal used in them.

(b) **Circulating Promissory Notes :** Paper notes issued by the Reserve Bank of India (e.g., currency notes of ₹ 5,10, 20, 50, 100, 500, and 1000) fall under this category. We find written on the note, **'I promise to pay the bearer the sum of rupees'** signed by the Governor of RBI. Any note is just a piece of paper with a promise on it. These words do not imply its convertibility into gold or silver. Its commodity value is virtually nothing and hence it is credit money.

3.3 Legal Tender Money and Optional Money

(a) **Legal Tender Money :** Money which can be legally used to make payment of debt or other obligations is termed as legal tender money. It is also called fiat money as runs by the authority of the government. Currency notes and coins are therefore, called legal tender money. A creditor is obliged by law to accept such money. Legal tender money is of two kinds :

(i) **Limited Legal Tender :** It refers to that form of legal tender money which can be paid in discharge of a debt upto a certain limit. Beyond this limit, a person may refuse to accept the payment and no legal action can be taken against him. In India, coins are limited legal tender.

(ii) **Unlimited Legal Tender :** It refers to that form of legal tender money which can be paid upto any extent. A person has to accept without any maximum limit. Legal action can be taken against a person who refuses to accept this money. In India, paper notes are unlimited legal tender.

(b) **Optional Money :** It refers to that form of money which is generally accepted as a medium of exchange, but legally, there is no compulsion to accept it. For example, cheques, bank drafts etc. do not have legal boundation. One may accept or refuse them. It is also called **fiduciary money** as it is accepted as money on the basis of trust between the payer and payee.

3.4 Bank Money

Bank money refers to the demand deposits of the people at banks. These deposits are payable on demand. Bank money facilitates the exact amount of payments through cheques, drafts etc. It is also called **deposit money**. Bank money is optional. A person may or may not accept the payment through cheque or draft etc.

4. Functions of Money

Money performs several important functions. These functions are classified into two categories :

(1) Primary functions and

(2) Secondary functions

4.1 Primary Functions

Primary functions refers to those functions which are the basic and essential functions of money. These functions must be performed by money in every economy and under all circumstances. These are also referred to as **original functions** of money. Following are the two primary functions of money :

1. **Medium of exchange :** Medium of exchange is the most important function of money. Money is generally and widely accepted as the medium of exchange. All purchases or sales are made through money. Since money is generally accepted, everyone accepts it in exchange for goods and services. It thus removed the difficulty of barter system by eliminating the need for double coincidence of wants.

Importance : While functioning as medium of exchange, money benefits the society in many ways:

(a) It overcomes the difficulties of barter exchange.

(b) It increases the ease of trade. Accordingly, it raises the level of production substantially.

(c) It allows freedom of choice as every person can buy goods of his choice from people who offer him best bargain

2. **Measure of value or unit of account :** The second primary function of money is that it acts as a common measure of value or unit of account. *Money as a measure of value means a standard unit for quoting prices.* Money acts as a standard measure of value into which the

values of all goods and services are expressed and compared. When we express the value of a commodity in terms of money, it is known as **price**.

Importance

(i) Measuring values in monetary units helps in measuring the exchange values of commodities. For example, if price of sugar is ₹ 30 per kg. and that of wheat is ₹ 10 per kg., then one kg. of sugar is worth 3 kg. of wheat.

(ii) Further, accounting is simplified, as all items are recorded in terms of monetary units that can be added and subtracted.

4.2 Secondary Functions

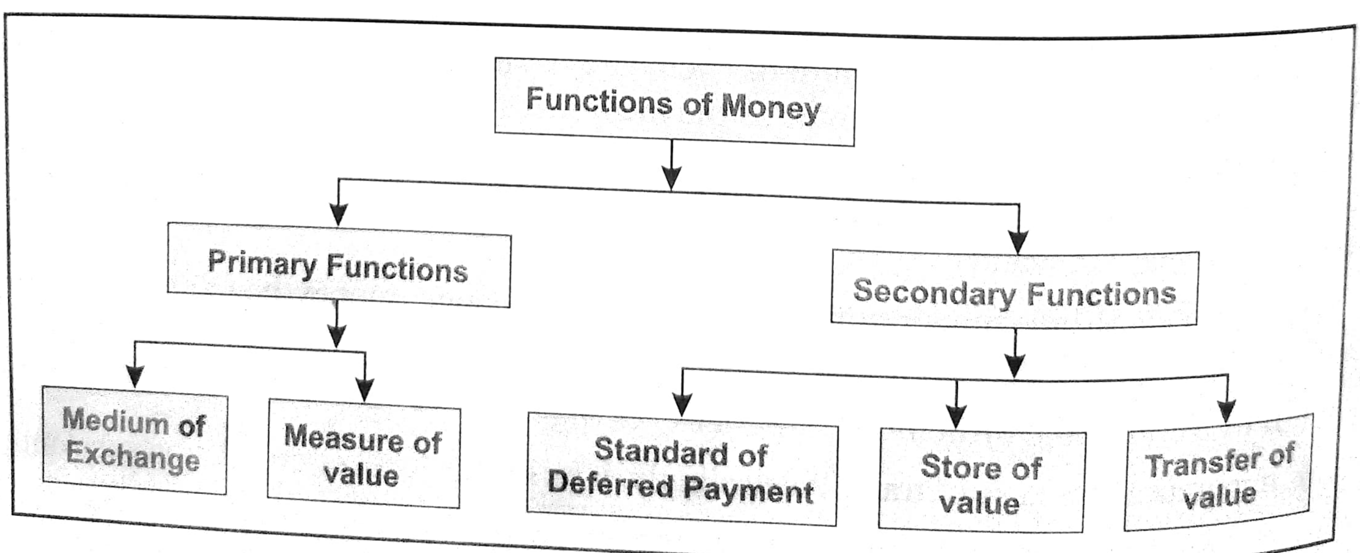
Secondary functions are complementary to the primary functions. The following are the secondary functions of money:

1. **Standard of deferred payments :** Money serves as a standard of deferred payment. *Deferred payments refer to those payments which are to be made in future.* In a modern economy, a large number of transactions involve future payments which can easily be stated in terms of money. Suppose you borrow a sum of ₹ 20,000 at 10 per cent interest per annum for one year. It means that you promise to pay ₹ 22,000 (₹ 20,000 as principal and ₹ 2000 as interest) after one year. Money serves as a standard of such future payments.

Importance : This function of money has two advantages :

(i) It facilitates the borrowing and lending activities.

(ii) Financial institutions are the backbone of modern business. Money has led to the creation of these financial institutions. There would have been no financial institutions, like banks, finance companies, etc. in the absence of money.



2. **Store of value :** *Store of value means store of wealth for use in future i.e., shifting of purchasing power from the present to future.* Money is not perishable and its storage costs are also considerably lower. It is acceptable to anyone at any point of time. It, thus, enables the

people to save a part of other current income and store it for future use. Thus the money provides the link between the present and the future. Store of value function of money is also called as **asset function of money**.

Importance : It was very difficult to store wealth under barter system. Now it has become most convenient to store wealth in terms of money. It is because

(i) money can be easily exchanged for goods at all times

(ii) money comes in convenient denominations. For example, in India, we have one rupee, two rupee, five rupee and ten rupee coins and currency notes ranging from one rupee to one thousand rupees, and

(iii) money is easily portable.

Drawback of Store of Value Function

However, store of value function of money has also its serious implication. Money which is not spent may cause aggregate demand for goods and services to fall. Fall in AD may reduce the level of output and employment in the economy. Therefore, savings need to be utilised for investment.

The four main functions of money can be summed up in the following couplet :

Money is a matter of functions four

A medium, a measure, a standard, a store

3. Transfer of value : Money also serves as **transfer of value.** It is because of this function of money, people can buy goods at far off places. They can also purchase immovable property at any specific place for money. Further, people can loan out their surplus funds and earn interest income. Money, thus, facilitates buying and selling of goods across all parts of the country and abroad.

Box 5.1 : Contingent Functions

Contingent functions refer to those functions of money which help various economic entities such as consumers, producers etc. in taking their economic decisions. These include the following :

(i) **Distribution of National Income :** Money helps in the distribution of national income among various factors of production in the form of rent, wages, interest and profit. Contribution of the factors of production namely land, labour, capital and enterprise is rewarded not in terms of goods and services they have produced but in terms of money.

(ii) **Maximisation of Utility :** With the help of money, a consumer maximises his satisfaction by equating the price of each commodity with the marginal utility. For equalising this, money plays an important role because prices of all goods are expressed in terms of money.

(iii) **Maximisation of Profit :** A producer can maximise his profit by equating the marginal productivity of a factor to its price.

(iv) **Basis of Credit :** It is money which provides the basis of the entire credit system. Without the existence of money, instruments like cheques, bills of exchange etc. cannot be used.

(v) **Productivity of Capital :** Money is the most liquid asset and can be put to any use. Due to this feature of money, capital can be transferred from less productive uses to more productive uses. It, thus, increases the productivity of capital.

Box 5.2 : Static and Dynamic Functions of Money

Paul Einzig has classified functions of money into *two broad* groups viz.,1. Static functions, and 2. Dynamic functions.

- **Static functions**

Static Functions are those which help the operation of the economy but these do not create movement in the economy. In this respect, the functions of money like medium of exchange, measure of value, store of value and measure of deferred payments are called the static functions of money. Static functions, in fact, are the **traditional functions of money.**

- **Dynamic functions**

The dynamic functions are those which actively influence the economy system through its impact on price level, interest rates, volume of production, etc. Important dynamic functions of money are stated below :

(i) Money influences the general price level which in turn affects (encourages or discourages) production and welfare of the society. Price level increases with the increase in money supply and decreases with the decrease in money supply.

(ii) Money directs idle resources into productive channels. People keep their savings in the form of bank deposits to earn interest income. Banks in turn lend this accumulated money to businessmen for investment. This makes capital mobile.

(iii) Money also has its great impact on economic activity by changing interest rates. As rate of interest falls, the level of investment rises. Interest rate falls with an increase in money supply.

5. Supply of Money

5.1 Meaning of Supply of Money

Supply of money is defined as the total stock of all the forms of money (paper money, coins and demand deposits at banks) which are held by the public on a specific day. The term public implies the people using money in carrying out their transactions. In it government and banking system are not included as they are creators (or producers) of money.

Two Features of Supply of Money

(i) **Stock variable :** Supply of money is a stock variable because it is related to a point of time.

(ii) **Money held by the public :** Supply of money always refers to the stock of money held by the public. The stock of money with government, Reserve Bank of India and banking system is not included in supply of money as it does not come into circulation in the country. Supply of money includes that money which belongs to the public for use to carry out transactions.

5.2 Components of Supply of Money

Money supply is composed of the following two elements:

(a) Currency with the public

(b) Demand deposits at banks

(a) **Currency with the public :** Currency with the public include following items :

(i) Currency notes in circulation issued by the Reserve Bank of India.

(ii) Small coins in circulation.

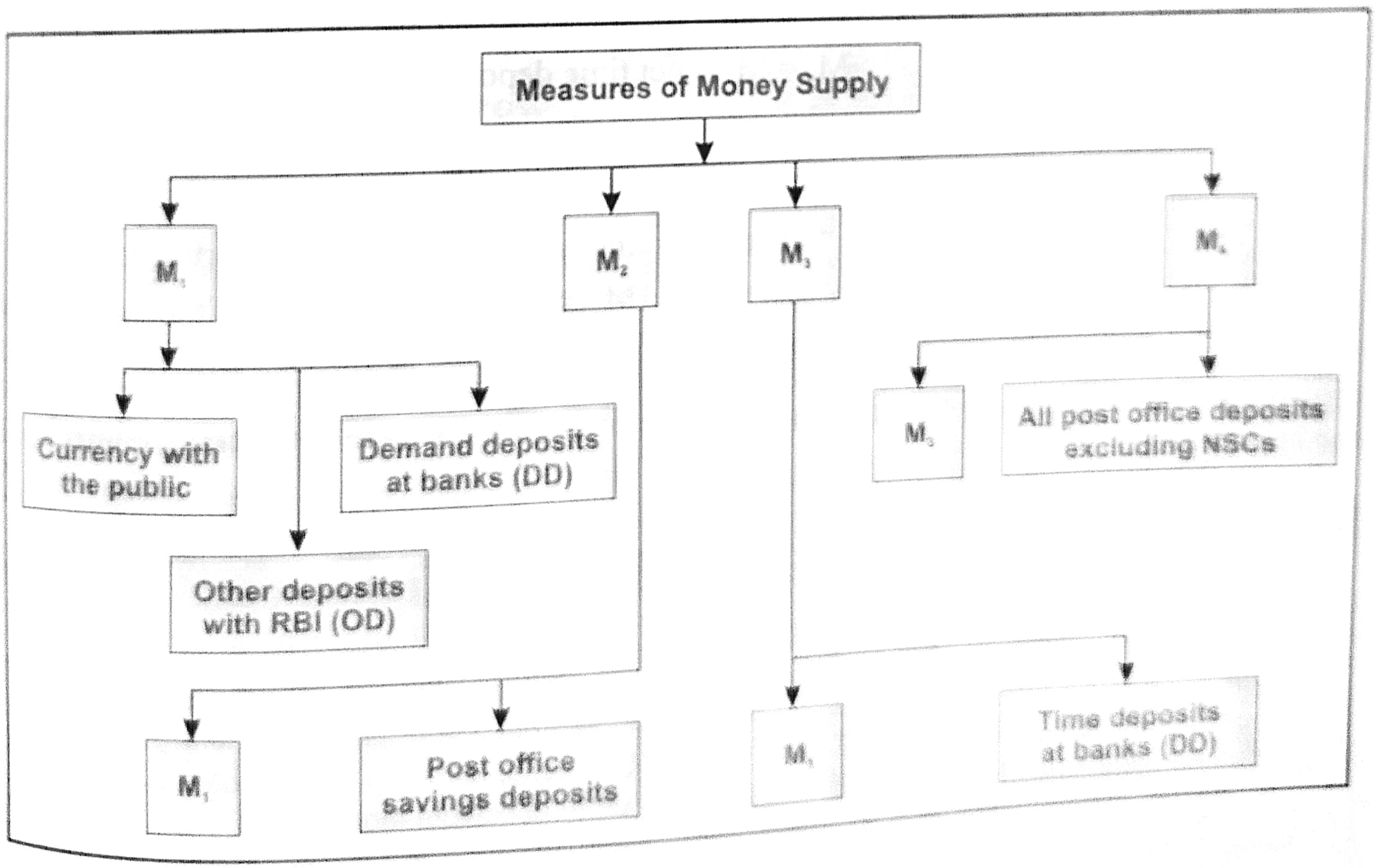
(b) **Demand deposits at banks:** Demand deposits are another important component of money supply. As mentioned earlier, demand deposits with banks are also called **bank money**. Demand deposits in the banks refer to those deposits which are payable on demand. These are the deposits on which cheques can be written. Through cheques these deposits can be transferred to others for making payments from whom goods and services have been purchased. Thus, cheques make these demand deposits as a medium of exchange and therefore, make them to serve as money.

Note that inter-bank deposits do not constitute part of money supply as they do not belong to the public. Only **net demand deposits of commercial banks** are included in money supply. **The word 'net' here implies only the deposits of public held by banks.**

Thus, money supply (M) is composed of currency held by the public (C) and demand deposits with banks (DD).

In short,

$$M = C + DD$$



5.3 Measures of money supply

The Reserve Bank of India has given four measures of money supply viz, M_1, M_2, M_3 and M_4. They are defined as follows:

M_1

$$M_1 = C + DD + OD$$

C is currency held by the public. DD is the demand deposits of people in banks. OD (other deposits) are the demand deposits held by the RBI of Public Financial Institutions (like IDBI), foreign central banks and foreign governments, international financial institutions like IMF. Deposits of government and banks are not included in these other deposits.

M_1 is the most liquid measure of money supply as all its components are easily used as medium of exchange.

M_2

It is a broader concept of money supply compared to M_1. Besides M_1, it also includes saving deposits with post offices.

$$M_2 = M_1 + \text{savings deposits with post offices}$$

M_3

It is a broader concept. Besides M_1, it also includes net time deposits at banks.

$$M_3 = M_1 + \text{net time deposits of commercial banks}$$

M_4

Besides M_3, it includes total deposits with post offices.

$M_4 = M_3$ + total deposits with post offices (excluding National Savings Certificates).

M_1 and M_2 are called **narrow money** while M_3 and M_4 are called **broad money**. This classification is based on the quality of liquidity. Among all the four measures, M_1 is the most liquid while M_4 is the least liquid. By liquidity we mean the conversion of an asset into cash easily and quickly without loss of value. **M_3 measure of money supply is known as aggregate monetary resources of the country.**