

Money and Banking



Money is the commonly accepted medium of exchange. In an economy which consists of only one individual there cannot be any exchange of commodities and hence there is no role for money. Even if there are more than one individual but they do not take part in market transactions, such as a family living on an isolated island, money has no function for them. However, as soon as there are more than one economic agent who engage themselves in transactions through the market, money becomes an important instrument for facilitating these exchanges. Economic exchanges without the mediation of money are referred to as *barter exchanges*. However, they presume the rather improbable *double coincidence of wants*. Consider, for example, an individual who has a surplus of rice which she wishes to exchange for clothing. If she is not lucky enough she may not be able to find another person who has the diametrically opposite demand for rice with a surplus of clothing to offer in exchange. The search costs may become prohibitive as the number of individuals increases. Thus, to smoothen the transaction, an intermediate good is necessary which is acceptable to both parties. Such a good is called money. The individuals can then sell their produces for money and use this money to purchase the commodities they need. Though facilitation of exchanges is considered to be the principal role of money, it serves other purposes as well. Following are the main functions of money in a modern economy.

3.1 FUNCTIONS OF MONEY

As explained above, the first and foremost role of money is that it acts as a *medium of exchange*. Barter exchanges become extremely difficult in a large economy because of the high costs people would have to incur looking for suitable persons to exchange their surpluses.

Money also acts as a convenient *unit of account*. The value of all goods and services can be expressed in monetary units. When we say that the value of a certain wristwatch is Rs 500 we mean that the wristwatch can be exchanged for 500 units of money, where a unit of money is rupee in this case. If the price of a pencil is Rs 2 and that of a pen is Rs 10 we can calculate the relative price of a pen with respect to a pencil, viz. a pen is worth

$10 \text{ ₹} = 5 \text{ pencils}$. The same notion can be used to calculate the value of money itself with respect to other commodities. In the above example, a rupee is worth $1 \text{ ₹} = 0.5 \text{ pencil}$ or $1 \text{ ₹} = 0.1 \text{ pen}$. Thus if prices of all commodities increase in terms of money which, in other words, can be regarded as a general increase in the price level, the value of money in terms of any commodity must have decreased – in the sense that a unit of money can now purchase less of any commodity. We call it a deterioration in the purchasing power of money.

A barter system has other deficiencies. It is difficult to carry forward one's wealth under the barter system. Suppose you have an endowment of rice which you do not wish to consume today entirely. You may regard this stock of surplus rice as an asset which you may wish to consume, or even sell off, for acquiring other commodities at some future date. But rice is a perishable item and cannot be stored beyond a certain period. Also, holding the stock of rice requires a lot of space. You may have to spend considerable time and resources looking for people with a demand for rice when you wish to exchange your stock for buying other commodities. This problem can be solved if you sell your rice for money. Money is not perishable and its storage costs are also considerably lower. It is also acceptable to anyone at any point of time. Thus money can act as a *store of value* for individuals. Wealth can be stored in the form of money for future use. However, to perform this function well, the value of money must be sufficiently stable. A rising price level may erode the purchasing power of money. It may be noted that any asset other than money can also act as a store of value, e.g. gold, landed property, houses or even bonds (to be introduced shortly). However, they may not be easily convertible to other commodities and do not have universal acceptability.

3.2 DEMAND FOR MONEY

Money is the most liquid of all assets in the sense that it is universally acceptable and hence can be exchanged for other commodities very easily. On the other hand, it has an opportunity cost. If, instead of holding on to a certain cash balance, you put the money in a fixed deposits in some bank you can earn interest on that money. While deciding on how much money to hold at a certain point of time one has to consider the trade off between the advantage of liquidity and the disadvantage of the foregone interest. Demand for money balance is thus often referred to as liquidity preference. People desire to hold money balance broadly from two motives.

3.2.1 The Transaction Motive

The principal motive for holding money is to carry out transactions. If you receive your income weekly and pay your bills on the first day of every week, you need not hold any cash balance throughout the rest of the week; you may as well ask your employer to deduct your expenses directly from your weekly salary and deposit the balance in your bank account. But our expenditure patterns do not normally match our receipts. People earn incomes at discrete points in time and spend it continuously throughout the interval. Suppose you earn Rs 100 on the first day of every month and run down this balance evenly over the rest of the month. Thus your cash balance at the beginning and end of the month are Rs 100 and 0, respectively. Your average cash holding can then be calculated as $(\text{Rs } 100 + \text{Rs } 0) / 2 = \text{Rs } 50$, with which you are making transactions worth Rs 100 per month. Hence your average transaction demand for money is equal to half your monthly income, or, in other words, half the value of your monthly transactions.

