

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

