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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 is more than one individual but these individuals do not take part in market transactions, example: family living on an isolated island, money has no function for them. However, as soon as there is 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.

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 $10 \div 2 = 5$ 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 $1 \div 2 = 0.5$ pencil or $1 \div 10 = 0.1$ pen. Thus if prices of all commodities increase in terms of money i.e., there is 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.

Some countries have made an attempt to move towards an economy which use less of cash and more of digital transactions. A cashless society describes an economic state whereby financial transactions are not connected with money in the form of physical bank notes or coins but rather through the transfer of digital information (usually an electronic representation of money) between the transacting parties. In India government has been consistently investing in various reforms for greater financial inclusion. During the last few years' initiatives such as Jan Dhan accounts, Aadhar enabled payment systems, e –Wallets, National financial Switch (NFS) and others have strengthened the government resolve to go cashless. Today, financial inclusion is seen as a realistic dream because of mobile and smart phone penetration across the country.