CHAHAT AZAM
FACULTY OF COMMERCE
DSPMU

SUBJECT = ME & IB

UNIT I – MONEY (PART – III)

Functions of Money

1. Primary Functions

a. Medium of exchange - Money acts as a medium of exchange of all goods and services. The use of money has greatly facilitated process of exchange by dividing it into two parts i.e. sale and purchase. It has removed the difficulty of double coincidence of wants found under the barter system. Therefore, in modern world we hardly find any evidence of exchange of goods and services without the use of money. Example: You pay ₹ 10 to buy a pen. The seller receives ₹ 10 from you by selling the pen. So, a pen is exchanged for ₹ 10.

b. Common measure of value or unit of value - Money helps to measure value of goods and services in terms of price. The use of money has completely removed the confusion regarding value of one good/service vis-a-vis the other. This function has greatly facilitated the process of exchange of different goods and services. The value of a good is determined by multiplying its price with the quantity purchased. Since the price is expressed in monetary units, the value of a good is also expressed in monetary terms. Example: Let price of rice be ₹ 20 per Kilogram. One bag full of rice weighs 25 Kilograms. Then the value of the bag of rice is ₹ 20X25= ₹ 500.

2. Secondary Functions

a. Standard of deferred payment - Deferred payments are those payments which are promised to be made in future. Money acts as a means of deferred payments mainly because it has general acceptability. Its value remains relatively constant over time and it is more durable as compared to other goods. In case of borrowing and lending activities only money is normally acceptable to be paid at a future date. Goods lose their value over time and due to possibility of lack of double coincidence of wants they are not acceptable to settle debts in future.

b. Store of value - Money is the most convenient and economical means to store wealth which does not lose its value so quickly over time. Thus, it is the most accepted means to store wealth or value. As medium of exchange you can pay money to buy goods. This means if you have money, you have the power to purchase a good or a service. So, money has purchasing power. The value of the good is contained in that purchasing power. Hence value of good is indirectly stored in money, you hold. Similarly, as a seller of good, you receive the money which means value of good you sold, comes back to you through money. Example: Harpreet sells furniture to a buyer for ₹ 2500.This means a value of ₹ 2500 was exchanged. The buyer, who purchased the furniture, has the purchasing power to give ₹ 2500 as value. Hence a value of ₹ 2500 was stored in the money received by Harpreet as a seller. Harpreet could not have stored furniture, but she can store money which in turn has stored the value of ₹ 2500.

c. Transfer of value - This function of money is derived from the store of value function of money. Money is used to transfer value from one place to another or from one person to another. As a traveller when you move from one place to another, you can easily carry money to make necessary transactions on the way and in your destination place. You can also transfer the money through bank. Now people carry ATM card and withdraw cash wherever the facility is available.

3. Contingent Functions

a. Basis of credit - Credit creation by commercial banks was not possible until money was introduced. Money as a store of value has encouraged savings by people in the form of demand deposits in banks. Such demand deposits are used by the commercial banks to create credit.

b. Liquidity - Money can be easily carried and is easily divisible into smaller units as per convenience. The liquidity feature of money is manifested at the time when it can be withdrawn from the bank account repeatedly in certain amount in each transaction. For example, A's father has ₹ 10,000 deposited in his bank account. A wants to purchase a shoe worth ₹ 600. A's father can withdraw the amount from the bank to give to A. The balance of ₹ 9,400 will remain in A's father account. Money brings uniformity in value of different goods and services which are not comparable physically due to their differences in the units of measurement. For example, a Kg. of rice and a litre of cooking oil cannot be added together as these are given in different units. But they can be added together if expressed in monetary units. If a Kg. of rice is worth ₹ 25 and a litre of cooking oil is worth ₹ 75, the combined value of rice and oil comes out to be ₹ 100.

c. Maximum profit to the producers - All the factors of production are valued in monetary terms. Consequently, it becomes possible for a producer to maximise production by equalising marginal productivities of the different factors of production.

d. Maximum satisfaction to the consumers - Money helps the consumers and producers in maximizing their satisfaction. A consumer derives maximum satisfaction by equating the price (expressed in terms of money) of each commodity with its marginal utility (satisfaction). Similarly, a producer maximises his satisfaction (profit) by equating the marginal productivity of a factor with price of such factor.

e. Basis of distribution of income - Income is generated by the factors of production engaged in the production process. The factors are land, labour, capital and entrepreneurship. For the supply of these factor services to the production units, the supplier of labour gets wage, the supplier of land gets rent, the supplier of capital gets interest and the supplier of entrepreneurship gets profit. It should be noted that wage, rent, interest and profit are paid by the firms in money terms and received by the respective suppliers as factor incomes. Thus, national income is measured by using income method.