Notes

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MONEY AND BANKING

Money is one of the most important discoveries of the human civilization. It is difficult to think about the world without money. Everybody needs money for various purposes; starting from day – to – day transactions to saving for future. But if you go back to history, you will find that before money came into existence there was barter system to facilitate transactions among individuals in the society. With development of civilization over time, barter system lost its ground and was replaced by money.
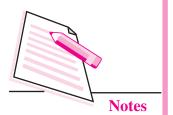
OBJECTIVES

After completing this lesson, you will be able to:

- know the meaning and limitations of barter system;
- understand the need for money;
- define money;
- explain the functions of money;
- tell the different measures of money supply in India;
- know the concept of High Powered Money;
- explain the meaning and functions of commercial banks;
- understand the process of credit creation;
- explain the meaning and functions of central bank; and
- know the methods of credit control.

28.1 FAILURE OF BARTER SYSTEM AND THE NEED FOR MONEY

In ancient days when there was no money, people used to exchange goods for goods to satisfy their wants without the use of money. Such a system was called barter system. However with passage of time the barter system had to be abandoned because of its inherent problems. Some of the demerits of barter system are as follows:

1. Search Cost

A common problem of barter system was that, one had to spend a lot of time in searching for the person who is willing to exchange the good at the given terms and conditions. In the early period of human civilization, this was a very difficult task as there was no proper facility with regard to transport and communication.

2. Lack of double coincidence of wants

A common problem with the barter system is the lack of double coincidence of wants which means that if one wants to exchange some good with another person then the latter must also be willing to exchange his/her good with the former. For example, let a person wants cloth and he has stock of wheat with him to exchange for it. In such a case the person can exchange wheat for cloth with another person who has cloth and who also wants wheat. In practical life, such situation may or may not arise. If the person who has cloth does not want wheat, then exchange of wheat for cloth will never take place and both the individuals cannot satisfy their wants. This is an example of lack of double coincidence of wants. So barter system will work when there is double coincident of wants, otherwise it will not work.

3. Lack of division of goods

Certain goods are not physically divisible into small pieces. Suppose, a person possesses a buffalo and he wants items, such as food grains. Then how much of buffalo can be traded for food grains? It was very difficult to determine because, a buffalo cannot be divided into several pieces.

4. Lack of common unit of measurement

Under barter system, it was difficult to equate the values of different goods which were traded because of lack of common unit of measurement. Taking the example in the previous paragraph, it will be very difficult to determine the amount of buffalo required to trade for some specific amount of food grains. Also it sounds absurd. This happens because a buffalo can never become a common measure of value. This problem is same for all other goods.

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5. Problem of Storage

Another problem of barter system is that a person must store a large volume of his own good in order to exchange for his/her desired goods with others on day to day basis. Take the example of a farmer who has produced wheat. Obviously, he will use some amount of wheat for his own consumption and keep some amount to get other necessary items by trading with others. If he wants furniture, then he will go to a carpenter who is willing to trade furniture in return of his wheat. Similarly, if he wants cloth, then he has to trade with a weaver who is ready to give cloth by receiving wheat and so on. So the farmer must construct a warehouse first to keep a stock of his wheat in order to carry out the transactions at the time of need for his desired good. But constructing and maintaining a warehouse was itself a very difficult task in early days of civilization.

6. Loss of Value

Finally, a major problem of barter system is that, a good looses its original quality and value if it is stored for a long period. Many goods, such as salt, vegetables etc., are perishable. Hence, goods were never accepted for trading in future because they could not be used as store of value. This also implies that no good could be used for the purpose of lending and borrowing.

Due to above problems, the barter system could not continue for long. As human civilization progressed, people realized that there has to be some common medium of exchange which can be easily carried, stored, and used to express the value of a good. So money came into being. Hence the need for money arose due to the failure of barter system.

INTEXT QUESTIONS 28.1

1. Under barter system a good was exchanged for coins.   (True or False)

2. Simran wants to have 6 pencils in exchange of a note book from Kavita. But Kavita is not agreeing to this condition. The problem may be related to lack of double coincidence of wants.   (True or False)

3. Ahmed took 10 kg of rice from Asghar last year as loan. Now he is willing to return the same. But Asghar is not accepting it. Give one possible reason for it.

28.2 MEANING OF MONEY

Money has been defined differently by different economists. But the most acceptable definition of money can be stated in terms of all the functions of money.

Money is anything which is generally accepted as a means of exchange, a measure and store of value and which also acts as standard of deferred payments.