UNIT 9- Money - Functions and Types

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What is Money?

The word "money" is omnipresent in our daily lives, which is centred around it. We all need money to purchase things whether it be desirables or necessities. We work hard for earning money and need money to reach our working places.
We need money if we need visit and travel to new destinations. We even need money to receive medical care and to keep ourselves healthy, and to fulfil most of our wants, needs, desires and necessities that we can possibly think of.

With this huge importance and all the focus on money in our day to day lives, have we ever imagined or given a thought to what money really is?

Money is defined as any item or verifiable record or legal tender that is generally accepted as payment for goods and services and repayment of debts in a particular country or a particular socio-economic context, or can easily be converted to such a form.

The main functions of money are:

1) It must act as a medium of exchange;
2) It must act as a unit of account;
3) It must be a store of value;
4) It must be a standard of deferred payment.

Medium of exchange

Money act as a medium of exchange when it is used to intermediate the exchange of goods and services.

Measure of value

For determining the market value of a good, service or any other transaction a unit of account is a necessity which acts as a standard of numerical monetary unit of measurement. It is also known as a “measure” or “standard” of relative worth of goods and services and deferred payment. A unit of account is a necessary prerequisite to formulate commercial agreements involving debt.
For carrying out trade, money acts as a standard measure and common denomination, and is necessary for efficient accounting.

Standard of deferred payment

In simple terms a "standard of deferred payment" (i.e. payments which are withheld until a specific time) is an accepted way of settling a debt. Money is used for settling debts. So debts and their settlement can be denominated in terms of money.

Store of value

Money acts as a store of value since it can reliably be saved, stored and retrieved and is also predictably usable as a medium of exchange whenever retrieved.

To summarise money is any item or verifiable record that fulfils all the functions mentioned above.
Various kinds of money are there varying in their liquidity, liability and strength. Society has modified money at different times and in the process several types of money has come into existence. In earlier times there was ample availability of metals which were cheap then, and as a result metal money came into existence. As the value of metals increased

metal money slowly became infeasible and thus was substituted by the paper money. Several commodities have been used as the medium of exchange at different times. Therefore, it can be said that according to the needs and availability of means, the kinds of money has changed.

There are 4 major types of money:

1) Commodity Money
2) Fiat Money
3) Fiduciary Money
4) Commercial Bank Money

Commodity Money

Commodity money is the simplest kind of money used in barter system in which valuable resources fulfil the functions of money. The value of the resources and the purpose determines the value of this kind of money and is only limited by the scarcity of resources. The parties involved in the exchange process of goods and services determine the value of this kind of money.

As commodity is used for the purpose of exchange, the commodity becomes equivalent to the money and is thus called commodity money. Certain types of commodity are used as commodity money.

Among them are precious metals such as gold, silver, copper, etc. In many parts of the world seashells (also known as cowrie shells), tobacco and many other items were used as a type of money & medium of exchange.

Example: gold coins, bronze coins, beads, shells, pearls, stones, tea, sugar, metal, etc.

Fiat Money

The meaning of the word fiat is "command of the sovereign" (i.e. command of authority holding supreme power). Fiat currency does not have any intrinsic value and it cannot be converted into valuable resource. Government by order determines the value of Fiat Money thereby making it a legal tender/instrument for all transaction purposes in areas within the jurisdiction of that government.

Fiat money needs to be controlled, because it's misuse may adversely affect the economy of an entire country. All modern money systems today are based on Fiat Money. Market forces of demand and supply determine the real value of Fiat Money.

Example: Paper currency, Coins.

Fiduciary Money

The meaning of the word fiduciary is "involving trust", and today's monetary system is highly fiduciary i.e. based upon trust. If a bank assures the customers payment in different types of money and if the customer can also sell these promises (legal tenders) or transfer them to somebody else, it is known as fiduciary money.

Generally gold, silver or paper money is generally used for payments as fiduciary money. Bank notes and cheques also are the examples of fiduciary money as both of them are kind of tokens/legal tenders which are used as money and carry the same value.

Commercial Bank Money

Demand deposits or commercial bank money are claims against financial institutions that can be used for the purchase of goods and services. A demand deposit account allows the owner to withdraw funds at any time by the means of cheque or cash withdrawal without giving the bank or financial institution any prior notice. Banks are legally obligated to return the funds to the owner of a demand deposit account immediately upon demand (i.e. at call). One can perform demand deposit withdrawals in person, via cheques or bank drafts, using ATMs (Automatic Teller Machines), or by the means of online banking.

There are some other types of money too, like the Credit money, Electronic money, Coin and Paper money, Fractional money and Representative money which are discussed below:

Credit Money

Any future monetary claim against an individual that can be used to buy goods and services is known as Credit money. There are many forms of credit money, such as bonds, money market accounts, IOUs etc. Any form of financial instrument that matures after a certain period of time or cannot be repaid immediately is considered as credit money.

Electronic Money

The money which exists only in banking computer systems and is not held in any physical form or rather is present in electronic form is known as Electronic money. In USA and many other developed countries, only a small fraction of the currency or money in circulation actually exists in physical form. Most of the money in such countries are in electronic form. Need of physical currency is on the decline as more and more citizens use electronic alternatives to physical currency.

Example: Bitcoins, etc.

Plastic Money

The term Plastic money is used predominantly to refer to the hard plastic cards we use everyday in place of actual paper money/bank notes. There are many different forms of plastic money such as credit cards, debit cards, cash cards, pre-paid cash cards and store cards.

Coins

Coins are manufactured by stamping metals into particular weight and sizes. Throughout human history various precious metals like gold, silver, copper, bronze, etc. have been used to make coins. Governments authorize and control the minting of coins.

Paper Money

Paper money does not have any intrinsic value by itself and it is a fiat money which is approved by the order of the government to be treated as legal tender to act as a medium of exchange of value. Paper money is printed by the government according to requirements which is tightly controlled as it's usage and supply have effects upon the economy of the country.

Fractional Money

Fractional money is a kind of hybrid money. It has a dual character. It is partly backed by a commodity and it also has a fiat money transaction purpose. When the commodity loses its value, the Fractional money converts into Fiat money.

Representative Money

It is the representation of a claim on a certain commodity and it can be redeemed for that commodity at a bank, financial institution or commercial institution such as a shop, or department store etc. It is kind of token or currency that can be exchanged for a fixed quantity of commodity without the payment of money to the limit of the value of the Representative money. Its value is dependent upon the commodity it backs.

Example: gift cards, etc.