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The Functions of Money and Other Issues

Introduction

Money was initially a medium of exchange and a measure of value. However, over time it has acquired other functions:

1. Money is a medium of exchange
2. Money is an a unit of account, i.e., a measure of value:
3. Money is a store of value
4. Money is a means of deferred payments

The functions above are dealt in the same order in sections 1, 2, 3 and 4 below.

There are multiple types of "money" utilised around the world, i.e. national currencies. This implies the application of exchange rates among all these currencies. These fluctuations may hamper the third function of money and needs intervention from the Central Bank of the country concerned. This point is dealt in section 5.

Money, as any other good has a price. However, a particular price for its use which is the rate of interest. There are several types of rates of interest depending on the use given to money; nevertheless, there is a special rate which is a monetary policy tool that the Central Bank manages. This is dealt in section 6.

1. First Function: Money as a Medium of Exchange

Money is a medium of exchange between any two goods. The importance of this function of money is that it has solved the "barter system problem". In the barter system for an exchange to take place, there must be "double coincidence of wants", e.g., for the barter exchange to take place between any two traders, one trader must be willing to accept the good that the other trader is offering, and reciprocally, fact which obviously restrains the possibilities of trade. For instance, if a trader is willing to barter cloth against meet, he would be constraint to find a butcher that needs specifically cloth.

The "double coincidence wants" is solved by the means of money, as the trader selling cloth can sell it against money, and use the money to buy meet. However, in order for money to solve this problem, money would need certain unique merits:

1. Money bears general acceptability
2. Money is easy portable
3. Money is divisible
4. Money is difficult to counterfeit
5. Money value is guaranteed (or simply confidence on) by the government
6. Money is legally enforceable as means of compensation

2. Second Function: Money as a Unit of Account

Money is a measure of account in the sense that is a measure of value of goods and services. All values are measured in terms of money. Therefore, money works as a common denominator, and hence as a unit of account.

This function means that the value of all goods are expressed in terms of money. Not only each good and service has a price, but relative prices can be compared in terms of money as well.

Money being a common denominator, the values of different goods can be added in order to find the total value of the assets of a corporation, possessions of an individual, or the national income or gross domestic product of a country.

3. Third Function: Money as a Store of Value

Money stores value for a future use. This means that money can be "saved" for future use. This function has arisen for such reasons as:

1. Needs for storing surpluses in trade or production for future use
2. Needs for storing value for future uncertainties
3. Savings of individuals for future purposes

The invention of money has provided means to store value. Even perishable goods can be converted into money through the market, and value stored in terms of money.

Nevertheless, the function of money as storing value may be hamper by increase in prices (actually loose of purchasing power of money). In this case, i.e., in an inflationary environment, money stored will lose its value proportionally to the rise in general prices.

4. Fourth Function: Money as a Standard of Deferred Payments

This function arises from the common practice of borrowing today for repaying in the future, or by the commercial practice of buying today and repaying in the future. The necessity for this was, originally, that the value of the today's operation should be the same in the future. However, money, as any good, may not have the same value, as it has today, in the future. Therefore, there is a rate of interest applied to money in time that is accepted as the price on the monetary value of the borrowing or buying today applied to it in order to calculate the value of the future payment.

The system of deferred payments has extended as a common practice in futures derivatives, which are different from borrowing or buying today in order to repay in the future. However, these instruments are also possible thanks to the acceptance of money as a standard of deferred payments.

The fourth function of money is possible because:

1. Deferred payments involving money are generally accepted
2. Deferred payments agreements are legally enforceable
3. A deferred payment in money has a relatively more stable value than any other good

5. Volatility of Value of Money

However, there are many kinds of "money" in a global economy, i.e. there are different currencies around the world, and they have relative values that are called "exchange rates". An exchange rate will express how much one monetary unit of one currency buys in value of other currency. For instance, on 12 May 2014 at 17hrs New York time, one Euro buys 1.3758 US dollars, which is expressed using the three digits ISO code for currencies following the convention:

EUR/USD = 1.3758

Or the other way around, which is only the reciprocal of the above value:

USD/EUR = 0.7268

As mentioned when dealing with the third function, money has a role to “store of value”. Therefore, high fluctuations of one currency in respect to another may seriously affect the function “store of value” of the currency of another country.

This phenomenon causes serious disruptions in the economic life of a country, like outflows of capital. Therefore, the Central Bank of every country has a paramount role stabilising the exchange rate of the country against the currencies of its main countries trading partners.

The Central Bank does this by selling or buying the foreign currency, using its international reserves, for stabilising the national currency exchange rate against that foreign currency. And by doing so, stabilising the function of money to store of value.

6. Price of Money: the Rate of Interest

Another particularity that money has is that, as any other commodity, it has a price. This very particular price is the rate of interest. Rates of interest may vary in function of the use to which the money will be devoted. However, there is the rate applied by the Central Bank to pay deposits from commercial banks (in the US the Fed rate), that will give an indication of the rate to be charged by banks and other financial or quasi-financial institutions to borrowers.

The role of the Central Bank of a country to stabilise and use this rate of interest as a means to manage the national economy is very important.