UPSC Civil Services Examination

UPSC Notes [GS-III]

Topic: Monetary System - UPSC Economy Notes

The monetary system refers to a set of institutions that provides a supportive framework for the creation of money in an economy by the government.

There are 3 types of the monetary system:

1. Commodity money
2. Commodity-based money
3. Fiat money

The most common system of a monetary system is Fiat money.

Types of Monetary system

The types of monetary system are discussed below:

Commodity Money

Commodity money is the type of money that is made of precious. It is not just a token or representative of monetary value like banknotes. Its worth remains intact even after it is melted. Gold and silver coins are the perfect example of commodity money.

Commodity-based money

This type of monetary system can also be addressed as representative money. This type of currencies are mostly like physical bank-notes with no financial value but can be exchanged with precious metals like gold and silver. This is closely related to the term gold standard.

Fiat Money

This type of money is also termed as legal tender as notified by the Central government and central bank. This is unlike the commodity money; it might not have an intrinsic value. Paper currencies and metal coins are examples of fiat money.

In modern economies or current phase, it mainly exists as data such as bank balances and records of credit or debit card purchases.

Important terms related to Money

Money – Anything which has general acceptance as a means of payment.

Functions of Money

Medium of Exchange

- Common measure of value
- Standard for deferred payments
- Store of wealth

Barter System – A commodity is exchanged for other commodities.

- Problems of barter System are:-
- Double coincidence of what is required
- Valuation of commodities exchanged is a problem
- There won't be a standard to serve as future monetary obligations

Gresham's Law – Bad money drives out good money

Legal Tender Money – This money cannot be denied in the settlement of the monetary obligation

1. Limited Legal Tender Money: It is compulsory to accept up to a certain limit

- Example – A sum of 10 can be paid in denominations of 50 paisa coins and the recipient has to legally accept it.

1. Unlimited Legal Tender Money: This money can be used to make any amount of payment

Non-Legal Tender Money – There is no legal compulsion to accept this money. It is also called optional money or Fiduciary Money (on the basis of trust).

- E.g. – Nepalese currency at India – Nepal border may be used as but the recipient is not legally bound to accept it.

Near Money – Highly liquid financial assets like shares and bonds