UNIT - I

Money: Definition - Functions of Money - Role of Money - Defects of Money - Kinds of Money - Qualities of Good Money - Supply of Money: Changes in Money Supply - Velocity of Circulations.

MONEY

DEFINITION:

Money is an economic unit that functions as a generally recognized medium of exchange for transactional purposes in an economy. **Money** originates in the form of a commodity, having a physical property to be adopted by market participants as a medium of exchange

The word "money" is believed to originate from a temple of Juno, on Capitoline, one of Rome's seven hills. In the ancient world, Juno was often associated with money. The temple of Juno Moneta at Rome was the place where the mint of Ancient Rome was located. The name "Juno" may derive from the Etruscan goddess Uni (which means "the one", "unique", "unit", "union", "united") and "Moneta" either from the Latin word "monere" (remind, warn, or instruct) or the Greek word "moneres" (alone, unique).

There are three basic conditions should be operated to define money:

1. Medium of exchange

When money is used to intermediate the exchange of goods and services, it is performing a function as a *medium of exchange*. It thereby avoids the inefficiencies of a barter system, such as the "coincidence of wants" problem. Money's most important usage is as a method for comparing the values of dissimilar objects.

2. Measure of value

A *unit of account* (in economics) is a standard numerical monetary unit of measurement of the market value of goods, services, and other transactions. Also known as a "measure" or "standard" of relative worth and deferred payment, a unit of account is a necessary prerequisite for the formulation of commercial agreements that involve debt.

Money acts as a standard measure and a common denomination of trade. It is thus a basis for quoting and bargaining of prices. It is necessary for developing efficient accounting systems.

3.Store of value

To act as a *store of value*, money must be able to be reliably saved, stored, and retrieved – and be predictably usable as a medium of exchange when it is retrieved. The value of the money must also remain stable over time. Some have argued that inflation, by reducing the value of money, diminishes the ability of the money to function as a store of value.

<u>FUNCTIONS OF MONEY</u>

The following points highlight the top six functions of money.

1. A Medium of Exchange:

The only alternative to using money is to go back to the barter system. However, as a system of exchange the barter system would be highly impracticable today.

For example, if the baker who supplied the green-grocer with bread had to take payment in onions and carrots, he may either not like these foodstuff or he may have sufficient stocks of them.

The baker would, therefore, have to re-sell the product which would take time and be very inconvenient. By replacing these complicated sales by the use of money it is possible to save a lot of trouble. If the baker accepts payment in money this can be spent in whatever way the baker wishes. The use of money as a medium of exchange overcomes the drawbacks of barter.

Thus, money provides the most efficient means of satisfying wants. Each consumer has a different set of wants. Money enables him (her) to decide which wants to satisfy, rank the wants in order of urgency and capacity (income) and act accordingly.

2. A Measure of Value:

Under the barter system, it is very difficult to measure the value of goods. For example, a horse may be valued as worth five cows or 100 quintals of wheat, or a Maruti car may be equivalent to 10 two- wheelers. Thus one of the disadvantages of the barter system is that any commodity or service has a series of exchange values.

Money is the measuring rod of everything. By acting as a common denominator it permits everything to be priced, that is, valued in terms of money. Thus, people are enabled to compare different prices and thus see the relative values of different goods and services.

3. A Store of Value (Purchasing Power):

A major disadvantage of using commodities — such as wheat or salt or even animals like horses or cows — as money is that after a time they deteriorate and lose economic value. They are, thus, not at all satisfactory as a means of storing wealth. To realise the problems of saving in a barter economy let us consider a farmer. He wanted to save some wheat each week for future consumption. But this would be of no use to him in his old age because the 'savings' would have gone off.

Again, if a coal miner wanted to set aside a certain amount of coal each week for the same purpose, he would have problems of finding enough storage space for all his coal. By using money, such problems can be overcome and people are able to save for the future. Modern form of money (such as coins, notes and bank deposits) permit people to save their surplus income.

Thus money is used as a store of purchasing power. It can be held over a period of time and used to finance future payments. Moreover, when people save money, they get the assurance that the money saved will have value when they wish to spend it in the future. However, this statement holds only if there is no severe inflation (or deflation) in the country.

4. The Basis of Credit:

Money facilitates loans. Borrowers can use money to obtain goods and services when they are needed most. A newly married couple, for example, would need a lot of money to completely furnish a house at once. They are not required to wait for, say ten years, so as to be able to save enough money to buy costly items like cars, refrigerators, T.V. sets, etc.

5. A Unit of Account:

An attribute of money is that it is used as a unit of account. The implication is that money is used to measure and record financial transactions as also the value of goods or services produced in a country over time. The money value of goods and services produced in an economy in an accounting year is called gross national product. According to J. R. Hicks, gross national product is a collection of goods and services reduced to a common basis by being measured in terms of money.

6. A Standard of Postponed Payment:

This is an extension of the first function. Here again money is used as a medium of exchange, but this time the payment is spread over a period of time. Thus, when goods are bought on hire-purchase, they are given to the buyer upon payment of a deposit, and he then pays the remaining amount in a number of installments.

Under the barter system this type of transaction could involve problems. Imagine a farmer buying a video-recorder and agreeing to pay for it in terms of a fixed amount of wheat each week for a certain number of weeks. After a few weeks the seller of the video recorder might have more than enough wheat.

In a modern economy, most transactions (buying and selling) are made on the basis of credit. For example, it is possible to purchase consumer durables such as T.V. sets or washing machines on hire-purchase; houses may be purchased by means of L.I.C. or H.D.F.C. loan; most business dealings permit payment in the future for goods delivered now; and employees wait for a month or a week to receive their wages and salaries. Thus, the use of money permits the members of society to defer their spending from the present to some future date.

ROLE OF MONEY

Money Promotes Productivity and Economic Growth:

Barter system was full of difficulties of exchanging goods and services between individuals. In the absence of easy exchange of goods and services the barter system worked as an obstacle to the division of labour and specialisation among individuals which is an important factor for increasing productivity and economic growth. Further, the process of economic growth leads to the expansion of production of goods and services and consequential rise in incomes of the people.

Money Promotes Investment:

From the viewpoint of development another important role of money lies in making the magnitude of investment independent of the current level of savings. In a barter system, the goods not consumed constitute the savings as well as investment. That is, investment is not different from current savings. The greater the current savings, the greater the investment. However, in a modern economy, this is not so. Whereas it is households which save in the form of money, it is the firms which invest money in capital goods.

Money and Investment in Quick-Yielding Projects:

It is widely believed that any increase in the supply of money in developing countries would lead to the rise in prices or to the emergence of inflationary pressures. However, this is not always true. A reasonable amount of newly created money helps the development of the economy by raising the level of investment. In the developing economies a lot of natural and human resources lie un-utilised and underutilized which can be employed for productive purposes.

If the newly created money is used for investment in those projects such as small irrigation works, land reclamation schemes, flood control and anti-soil erosion measures, cottage industries which yield quick returns, then the danger of inflation will not be there. These quick- yielding projects will increase the production of essential consumer goods in the short run and will therefore prevent the rise in prices.

Monetization and Economic Growth:

Further, as is well known, most underdeveloped countries have a large non-monetised (i.e. barter) sector where production is for the purpose of subsistence only. To break the subsistence nature of economic activity and thus generate new forces for economic growth, its monetisation is required. The introduction of money helps in bringing it in contact with the modern sector. This contact of the subsistence sector with the modern sector will lead to the expansion of its output.

In order to obtain the products of the modern industrial sector, the people engaged in the subsistence sector will make efforts to raise their output. Thus, a surplus of output over their self-consumption will be generated in this way which will ultimately break their subsistence nature.

Further, the monetisation of the subsistence sector will also help in raising the volume of savings. Monetisation will bring this sector in contact with the financial institutions such as commercial and cooperative banks and insurance companies.

The opportunities of earning more income through interest on saving will raise the propensity to save of the people in the present-day subsistence sector. If proper monetary policies are pursued, then instead of consuming or hoarding all their therefore incomes, these people can deposit a part of them in the financial intermediaries.

DEFECTS OF MONEY

(1) Instability in the Value of Money:

The first drawback about money is that its value does not remain stable over time. When the value of money falls, it means rise in the price level or inflation. On the contrary, rise in the value of money means fall in the price levels or deflation. These changes are brought about by increase or decrease in the supply for money. Large changes in the value of money are disastrous and even moderate changes have certain disadvantages.

(2) Unequal Distribution of Wealth and Income:

The second defect of money is that changes in the value of money lead to unequal distribution of wealth and income. Inflation or deflation which brings benefits to some and damages to others leads to redistribution of wealth and income not only between social and industrial classes, but between different persons in the same class. Such changes in the structure of the society. Widen the differences between the rich and the poor and lead to class conflict.

(3) Growth of Monopolies:

Too much of money leas to the concentration of capital in the hands of a few capitalists. This leads to growth of monopolies which exploit both consumers and workers.

(4) Wastage of Resources:

Money is the basis of credit. When banks create too much of credit, it may be used for productive and unproductive purposes. If much credit is used for production, it leads to over capitalisation and overproduction, and consequently to wastage of resources. Similarly, if liberal credit facilities are given for unproductive uses, they also lead to wastage of resources.

(5) Black Money:

Money being the store of value lures people to hoard it. The tendency to hoard money and become rich is the root cause of the evil of black money. When people evade taxes and conceal their income and hoard it, it is black money. This leads to a "parallel" economy within the country which encourages conspicuous consumption, black marketing, speculation, etc.

(6) Cyclical Fluctuations:

Another defect of the institution of money is that it leads to cyclical fluctuations in the economy. When the supply of money increases it leads to a boom and when it contracts there is a slump. In a boom, output, employment and income increase which lead to overproduction. On the contrary, they decline during a depression, thereby leading to under consumption. Such cyclical fluctuations bring untold miseries to the people.

Non-economic Defects:

Money has the following non-economic defects:

(1) Besides the above noted economic drawbacks of money the institution of money has brought down the moral, social and political fibre of the society. It leads to corruption, turpitude, political bankruptcy and artificiality in religion based on materialism. In fact, money is "the cause of theft and murder, of deception and betrayal. Money is blamed when the prostitute sells her body and when the bribed judge perverts the law. Significantly enough avarice is called the love of money; all evil is attributed to it."

(2) Political Instability:

Over-issue of money leading to hyper-inflation leads to political instability and downfall of government. This has happened in many Latin American countries.

(3) Tendency to Exploit:

People, who want to amass money and wealth, adopt underhand methods and have tendency to exploit others. Even nations are not far behind in this. As pointed out by Davenport, "Money has enabled strong nations to destroy backward communities to win them on their side with the help of financial aid."

Conclusion:

All these defect are not due to money but are the result of the attribute of man towards the use of money. It is of immense importance to every type of society whether it is capitalist or socialist. It is impossible to imagine this world without money. Money is an indispensable lubricant, a tool of convenience, for a continuous and smooth functioning of the economic machine.

<u>KINDS OF MONEY</u>

Market-Determined Money

Money originates as a feature of the spontaneous order of markets through the practice of barter (or direct exchange), where people trade one good or service directly for another good or service. In order for a trade to occur in barter, the parties to the exchange must want the good or service that their counter-parties have to offer. This is known as the double coincidence of wants, and it sharply limits the scope of transactions that can occur in a barter economy.

Legal Tender and Fiat Money

Sometimes a market-determined money is officially recognized as legal money by a government. Under some circumstances, goods that do not necessarily meet the five properties of optimal market-determined money outlined above, can be used to fulfill the functions of money in an economy. Typically this involves a legal mandate to use a specific good as money (known as a legal tender law) or some kind of prohibition on the use of money (such as the use of cigarettes as a medium of exchange among prison inmates). Legal tender laws specify a certain good as legal money, which courts will recognize as a final means of payment in contracts and the legal means of settling tax bills. By default, the legal tender will typically be used as a medium of exchange by market participants within the political jurisdiction of the authority that declares it to be money.

Commodity Money

Commodity money is the simplest and, most likely, the oldest type of money. It builds on scarce natural resources that act as a medium of exchange, store of value, and unit of account. Commodity money is closely related to (and originates from) a barter system, where goods and services are directly exchanged for other goods and services. Commodity money facilitates this process because it acts as a generally accepted medium of exchange. The critical thing to note about commodity money is that its value is defined by the intrinsic value of the commodity itself. In other words, the commodity itself becomes money. Examples of commodity money include gold coins, beads, shells, spices, etc.

Fiat Money

Fiat money gets its value from a government order (i.e., fiat). That means, the government declares fiat money to be legal tender, which requires all people and firms within the country to accept it as a means of payment. If they fail to do so, they may be fined or even put in prison. Unlike commodity money, fiat money is not backed by any physical commodity. By definition, its intrinsic value is significantly lower than its face value. Hence, the value of fiat money is derived from the relationship between supply and demand. Most modern economies are based on a fiat money system. Examples of fiat money include coins and bills.

Fiduciary Money

Fiduciary money depends for its value on the confidence that it will be generally accepted as a medium of exchange. Unlike fiat money, it is not declared legal tender by the government, which means people are not required by law to accept it as a means of payment. Instead, the issuer of fiduciary money promises to exchange it back for a commodity or fiat money if requested by the bearer. As long as people are confident that this promise will not be broken, they can use fiduciary money just like regular fiat or commodity money. Examples of fiduciary money include cheques, banknotes, or drafts.

Commercial Bank Money

Commercial bank money can be described as claims against financial institutions that can be used to purchase goods or services. It represents the portion of a currency that is made of debt generated by commercial banks. More specifically, commercial bank money is created through what we call fractional reserve banking. Fractional reserve banking describes a process where commercial banks give out loans worth more than the value of the actual currency they hold. At this point just note that in essence, commercial bank money is debt generated by commercial banks that can be exchanged for “real” money or to buy goods and services.

<u>QUALITIES OF GOOD MONEY</u>

1. General Acceptability:

It is the very essence of money. Unless a person knows that the money which he accepts in exchange for his goods or services will be taken without any objection by others as well, he will not accept it.

It will cease to be current. In order to possess general acceptability, a commodity should have some intrinsic utility independent of its value for monetary purpose. Gold and silver are generally acceptable to all without any hesitation because they are used for ornamental and other purposes and can be easily sold as bullion, besides being used for monetary purposes.

2. Portability:

A commodity fit to be used as money must be such that it can be easily and economically transported from one place to the other. In other words, it must possess high value in small bulk. Precious metals possess this quality. In the case of oxen and grain, a small value occupies a large bulk and weight; hence, they are unsuited as money commodity.

3. Indestructibility or Durability:

As money is passed from hand to hand and is kept in reserve, it must not easily deteriorate, either in itself or as a result of wear and tear. "It must not evaporate like alcohol, nor purely like animal substance, nor decay like wood, nor rust like iron.

Destructible articles, such as eggs, dried cod fish, cattle or oil has certainly been used as currency; but what is treated as money one day must not soon afterwards be eaten up." Gold coins are very lasting; they take about 8,000 years to wear out completely. Silver coins are not equally lasting but wear out fairly slowly. As such gold and silver are considered to be excellent money commodities.

4. Homogeneity:

All portions or specimens of the substance used as money should be homogeneous, that is, of the same quality, so that equal weights have exactly the same value. In order that a commodity may be used as a measure of value, it is essential that its units are similar in all respects. Gold and silver are of the same quality throughout; their various parts are similar in chemical and physical composition and their consistency is the same throughout the mass.

5. Divisibility:

The money material should be capable of division; and the aggregate value of the mass after division should be almost exactly the same as before. If we use diamond as money and by chance it drops from our hand and breaks, we will suffer an enormous loss. This is not the case with precious metals. Their portions can be melted and remelted together any number of times without much loss.

6. Malleability:

The money material should be capable of being melted, beaten and given convenient shapes. It should be neither too hard nor too soft. If the former, it cannot be easily coined; If the latter, it would not last long. It should also possess the attribute of impressionability so that it may easily receive the impressions.

7. Cognizability:

By it, we mean the capability of a substance for being easily recognised and distinguished from all other substances. As a medium of exchange, money has to be continually handed about; and it will cause great inconvenience if every person receiving it has to scrutinise, weigh and test it.

It should have certain distinct marks which nobody can mistake. Gold and silver are at once recognised by their distinctive colour, metallic and heavy weight for small bulk, and, as such, satisfy this condition admirably

8. Stability of Value:

Money should not be subject to fluctuations in value. Fluctuating standard of value is just like a changing yard or kilogram. The value of a material, which is used to measure the value of all the other materials, must be stable.

The ideal money commodity should, as such, possess utility, portability, durability, homogeneity, divisibility, malleability, Cognoscibility and stability of value.

SUPPLY OF MONEY

In macroeconomics, the **money supply** (or **money stock**) is the total value of money available in an economy at a point of time. There are several ways to define "money", but standard measures usually include currency in circulation and demand deposits (depositors' easily accessed assets on the books of financial institutions). The central bank of each country may use a definition of what constitutes money for its purposes.

Money supply data is recorded and published, usually by the government or the central bank of the country. Public and private sector analysts monitor changes in the money supply because of the belief that such changes affect the price levels of securities, inflation, the exchange rates, and the business cycle.

The relationship between money and prices has historically been associated with the quantity theory of money. There is strong empirical evidence of a direct relationship between the growth of the money supply and long-term price inflation, at least for rapid increases in the amount of money in the economy. For example, a country such as Zimbabwe which saw extremely rapid increases in its money supply also saw extremely rapid increases in prices (hyperinflation). This is one reason for the reliance on monetary policy as a means of controlling inflation.

The nature of this causal chain is the subject of some debate. Some heterodox economists argue that the money supply is endogenous (determined by the workings of the economy, not by the central bank) and that the sources of inflation must be found in the distributional structure of the economy.

In addition, those economists seeing the central bank's control over the money supply as feeble say that there are two weak links between the growth of the money supply and the inflation rate. First, in the aftermath of a recession, when many resources are underutilized, an increase in the money supply can cause a sustained increase in real production instead of inflation. Second, if the velocity of money (i.e., the ratio between nominal GDP and money supply) changes, an increase in the money supply could have either no effect, an exaggerated effect, or an unpredictable effect on the growth of nominal GDP.

<u>CHANGES IN MONEY SUPPLY</u>

Effect of Money Supply on the Economy

An increase in the supply of money typically lowers interest rates, which in turn, generates more investment and puts more money in the hands of consumers, thereby stimulating spending. Businesses respond by ordering more raw materials and increasing production. The increased business activity raises the demand for labor. The opposite can occur if the money supply falls or when its growth rate declines.

Change in the money supply has long been considered to be a key factor in driving macroeconomic performance and business cycles. Macroeconomic schools of thought that focus heavily on the role of money supply include Irving Fisher's Quantity Theory of Money, Monetarism, and Austrian Business Cycle Theory.

Historically, measuring the money supply has shown that relationships exist between it and inflation and price levels. However, since 2000, these relationships have become unstable, reducing their reliability as a guide for monetary policy. Although money supply measures are still widely used, they are one of a wide array of economic data that economists and the Federal Reserve collects and reviews.

How Money Supply is Measured

The various types of money in the money supply are generally classified as Ms, such as M0, M1, M2 and M3, according to the type and size of the account in which the instrument is kept. Not all of the classifications are widely used, and each country may use different classifications. The money supply reflects the different types of liquidity each type of money has in the economy. It is broken up into different categories of liquidity or spendability.

M0 and M1, for example, are also called narrow money and include coins and notes that are in circulation and other money equivalents that can be converted easily to cash. M2 includes M1 and, in addition, short-term time deposits in banks and certain money market funds. M3 includes M2 in addition to long-term deposits. However, M3 is no longer included in the reporting by the Federal Reserve. MZM, or money zero maturity, is a measure that includes financial assets with zero maturity and that are immediately redeemable at par. The Federal Reserve relies heavily on MZM data because its velocity is a proven indicator of inflation.

Money supply data is collected, recorded, and published periodically, typically by the country's government or central bank. The Federal Reserve in the United States measures and publishes the total amount of M1 and M2 money supplies on a weekly and monthly basis. They can be found online and are also published in newspapers. According to data from the Federal Reserve, as of June 2020 a little over $5.2 trillion in M1 money was in circulation, and more than $18.1 trillion in M2 money was circulating in the United States.

VELOCITY OF CIRCULATION OF MONEY

Velocity of Circulation refers to the average number of times a single unit of money changes hands in an economy during a given period of time. It can also be referred to as the velocity of money or velocity of circulation of money. It is the frequency with which the total money supply in the economy turns over in a given period of time.

If the velocity of money is increasing, then the velocity of circulation is an indicator that transactions between individuals are occurring more frequently. A higher velocity is a sign that the same amount of money is being used for a number of transactions. A high velocity indicates a high degree of inflation.

Example

Consider the following example. Let us assume that an economy consists of two individuals, a carpenter and a grocery shop owner. Over the course of a year, they exchange $100 to buy goods/services from each other in just four transactions, which are as follows:

- The carpenter buys vegetables from the grocer for $50.
- The carpenter also buys milk worth $50 from the grocer.
- The grocer gets some repair work done from the carpenter and pays him $30.
- The grocer also gets wooden shelves constructed in his shop by the carpenter for $70.

We can observe that $200 changed hands during the year, even though initially there was only $100 in the economy. This is because each dollar was spent on new goods and services twice a year. We can say that the velocity of circulation is 2/year.

However, only monetary transactions are considered in this situation. For example, if the carpenter gifts something to the grocer, it will not be considered a transaction to be added to the calculation.

Velocity of Circulation and Money Demand

Whenever the interest rate on financial assets is high, the desire to hold money falls as people try to exchange it for other goods or financial assets. As a result, the velocity of circulation rises. Hence, when the money demand is low, the velocity will be high. Conversely, when the opportunity cost/alternate cost is low, money demand is high and the velocity of circulation is low.

Factors Affecting the Velocity of Circulation

- Money Supply – Money supply and the velocity of money are inversely proportional. If the money supply in an economy falls short, then the velocity of money will rise, and vice versa.
- Frequency of Transactions – As the number of transactions increases, so does the velocity of circulation.
- Regularity of Income – Regularity of income enables people to spend their money more freely, leading to a rise in the velocity of circulation.
- Payment System – It is also affected by the frequency with which labor is paid (weekly, monthly, bi-monthly) and how fast the bills for various goods and services are settled.
- There are several other factors involved, including the value of money, the volume of trade, credit facilities available in the economy, business conditions, etc.

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