Econ-Hub
Money, Banking & Monetary Policy

[Unit **7**] [Theory]

Chapter [**1**], Part [1]

Intro to Money & Related Concepts

***2024 A/L** edition*

Part - I

[SPECIFICALLY DESIGNED FOR ADVANCED LEVEL **2024** & **ONWARDS**]

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Economics, **Unit – (7)**
Introduction to the Concept of Money
Chapter – (1)

Learning Outcomes
What you should know & learn

- ✓ Identifying the Functions of money
- ✓ Identifying the main Features of good money
- ✓ A basic understanding of the Evolution of modern money
- ✓ Different Types of money and it's Features.
- ✓ An understanding of the different methods of Defining a country's Monetary Aggregates (Money Supply)
- ✓ A basic understanding of the main factors deciding the quantity of a country's Money Supply (Factors affecting Monetary Aggregates)
- ✓ Identifying the factors affecting the Demand for Money (Motives for Liquidity Preference)

Mind-ventures Special Economics Program [MVSEP]

Learning Key [1]

[1.1] Money: [What is Money?]

The term money can be explained in many different ways; perhaps the most accurate manner is to define money as **any item or substance commonly accepted by the general public as a medium of exchange [1].**

The special or distinct feature of money is **perfect liquidity** [2] due to its **common acceptance**. Many definitions of money are based on the principal **functions of money** including the above definition

[1.2] Functions of Money:

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Brief Discussion:

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[1] Method of payment for goods and services [a direct method of payment]
[2] Money is perfectly liquid; when in the form of 'Currency' [valid coins and notes]

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Further Functions of Money

[3] Unit of Account

- **Money** is the 'Unit' in which the prices of goods are quoted (measured) and in which accounts are maintained (recorded).
- Makes it possible to compare the relative value of goods when making purchasing decisions (relative price)

[4] Standard of Deferred Payment

- Ability to delay payment for goods or settling of debt, even though goods are provided immediately.
- Credit transactions, contracts to pay for things at a later date is possible due to this function.

[1.3] Barter Vs. Monetary System [Drawbacks of the Barter System]

[1] Essential, 'Double Coincidence of Wants'

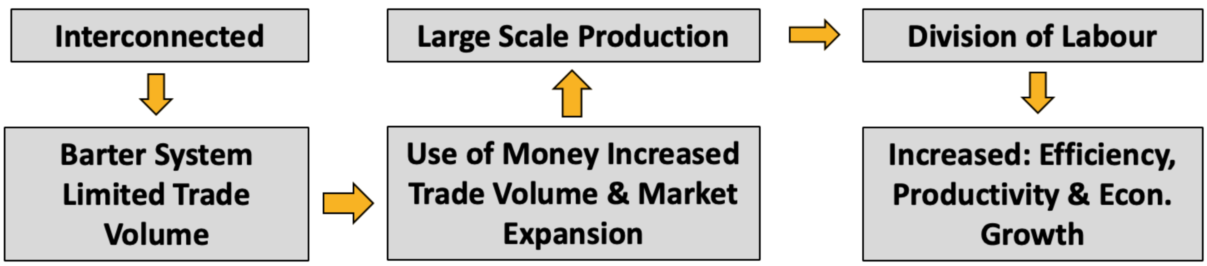
A double coincidence of wants refers to a pre-requirement (prerequisite) which essentially needs to be satisfied for a transaction to take place within a direct exchange based or barter exchange system.

This is where both parties engaged in the transaction process should be able to achieve a 'mutual' satisfaction of each other's requirements (wants) by exchanging the given products with each other.

[2] Lack of a commonly accepted Medium of Exchange
[3] The lack of a specific rate of exchange
[4] Limiting or Discouraging specialization and division of labour
[5] Limited Divisibility and limited Portability
[6] High perishability (or difficulty to store)
[7] Inhibiting the economic growth and development process

MONEY, TRADE, SPECIALIZATION & DIVISION OF LABOUR

- Specialization, Division of Labour & Trade, are Interconnected Processes
- Trade volume is limited ← drawbacks of the barter system (Double Coincidence of wants)
- Use of money makes trade easy, and increasing trade volumes and expands markets
- Encourages large scale production
- Suitable (Logical) to to use complicated production method of division of labour
- Rapidly increases efficiency, productivity and economic growth



[1.4] Attributes of 'Good Money' [What makes a good medium of exchange]

[1] Common Acceptance
[2] Durability
[3] Stability of Value
[4] Relative Scarcity
[5] Divisibility
[6] Portability
[7] Recognizability & Homogeneity
[8] Difficulty in Counterfeiting

[1.5] Types of Money [in use]

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(01) MONEY: CURRENCY

- **Concept [Items]:**
  Coins and Notes (Bank Notes) issued by a central bank
- **Features:**
  - Legal Tender or Fiat Money [Cannot be rejected as a medium of exchange]
  - Coins limited legal tender, notes unlimited legal tender
  - Perfectly Liquid [Direct means of payment], performs all functions of money
  - Nominal (Face) value given by the CB, real value affected by inflation
  - AKA: Cash, token money or simply 'money'

(02) BANK MONEY

- **Concept [Examples]:**
  Demand Deposits or **Current Account Balances** in Commercial Banks
- **Features:**
  - Current Account or Demand Deposits **Balance** is bank money and not cheques (a cheque is only an instrument to operate a current account)
  - Perfectly Liquid, same as money or currency
  - Demand deposits or bank money is **not money** [since other functions of money are not performed by demand deposits]

(03) NEAR (QUASI) MONEY

- **Concept:**
  Near money or quasi money refers to financial assets that effectively function as a **store of wealth**, which is highly liquid and **cannot be directly used as a medium of exchange.**

  Items [e.g.,]: TSDs [Time and Savings D**eposits]** in banks and finance companies

Alternatively:
The Central Bank of Sri Lanka identifies near money or quasi money some of the following financial assets as near money in estimating the broad money supply (M2b – M4).

- Time and savings deposits (TSDs) held by general public in LCB's
- Foreign currency banking units and non-resident foreign currency (NRFC) accounts
- Licensed Specialized Bank (LSB) deposits
- Licensed Finance Corporations (LFC) deposits

- **Features:**
  - Financial assets that **effectively function as a store of wealth**
  - **Cannot** be directly **used** as a **medium of exchange**
  - **Highly liquid**, not perfectly liquid
  - AKA: Quasi Money

(04) MONEY SUBSTITUTES

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Items [e.g.,] Credit Cards, Shopping (Debit) Cards, **Cheques**, **Bills of Exchange**

- **Features:**
  - Effective, temporary medium of exchange or means of payment
  - Not a store of wealth or value
  - Not money or currency, since other functions are not performed
  - Temporary, since only a gross settlement is done and a net settlement is pending (i.e. until the credit card bill is paid in full)

(05) E – MONEY [DIGITAL MONEY]

E money or cash refers to any tangible or a software device that can be used to store purchasing power in an electronic or digital form. The assigned value of the device or electronic card reduces when transactions are performed. Any such digital payment systems or facilities are identified as electronic money. E - Money is used with in the economy in two main forms

- Electronic money pouch (E – Purse)
- Digicash

SPECIAL NOTE
VIRTUAL OR 'CRYPTO CURRENCY'

A cryptocurrency is a digital or <u>virtual currency</u> that is secured by cryptography, which makes it nearly impossible to counterfeit or double-spend.

Many cryptocurrencies are decentralized networks based on <u>blockchain</u> technology—a distributed ledger enforced by a disparate network of computers.

A defining feature of cryptocurrencies is that they are generally not issued by any central authority, rendering them theoretically immune to government interference or manipulation.

Cryptocurrencies face criticism for a number of reasons, including their use for illegal activities, exchange rate volatility, and vulnerabilities of the infrastructure underlying them. However, they also have been praised for their portability, divisibility, inflation resistance, and transparency.

The first blockchain-based cryptocurrency was <u>Bitcoin</u>, introduced in 2009, which still remains the most popular and most valuable

Some of the competing cryptocurrencies spawned by Bitcoin's success, known as "altcoins," include <u>Litecoin</u>, Peercoin, and <u>Namecoin</u>, as well as <u>Ethereum</u>, Cardano, and <u>EOS</u>.

(06) BLACK MONEY (DIRTY MONEY)

Black money refers to any amount of money earned through means which cannot be disclosed or illegal means. In most situations this is money generated through illegal and unethical means.

The government regularly tries to attract the stock of black money in the economy, through financial institutions (Commercial Banks, Special Banks, and Finance Companies).

- Enacting legislative measures such as the 'Prevention of Money Laundering Act No. 5 of 2006' and 'Financial Transactions Reporting Act No. 6 of 2006'

- Offering a common amnesty/pardon period to attract black money from foreign financial institutions to legal circulation
- Inland revenue department creating certain provisions or exemptions for undisclosed funds to be disclosed.
- Measures to encourage voluntary disclosure of black money by offering certain benefits or incentives such as tax free vehicle permits, permitting the purchase of state assets and other benefits

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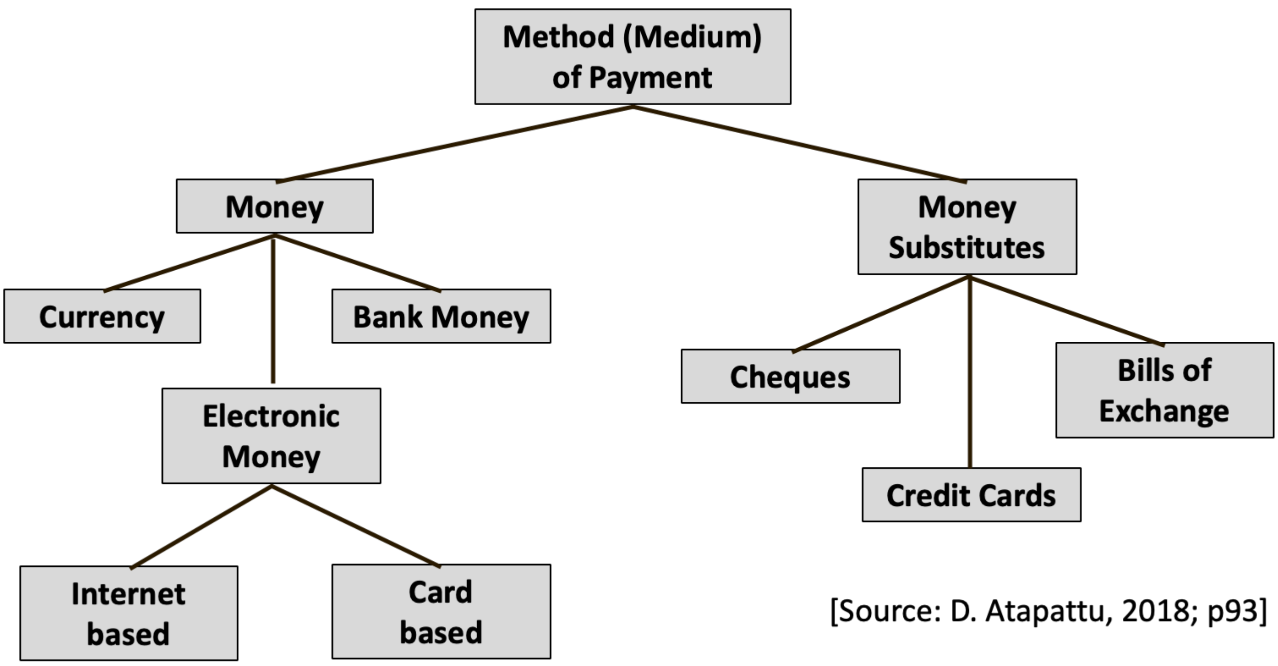
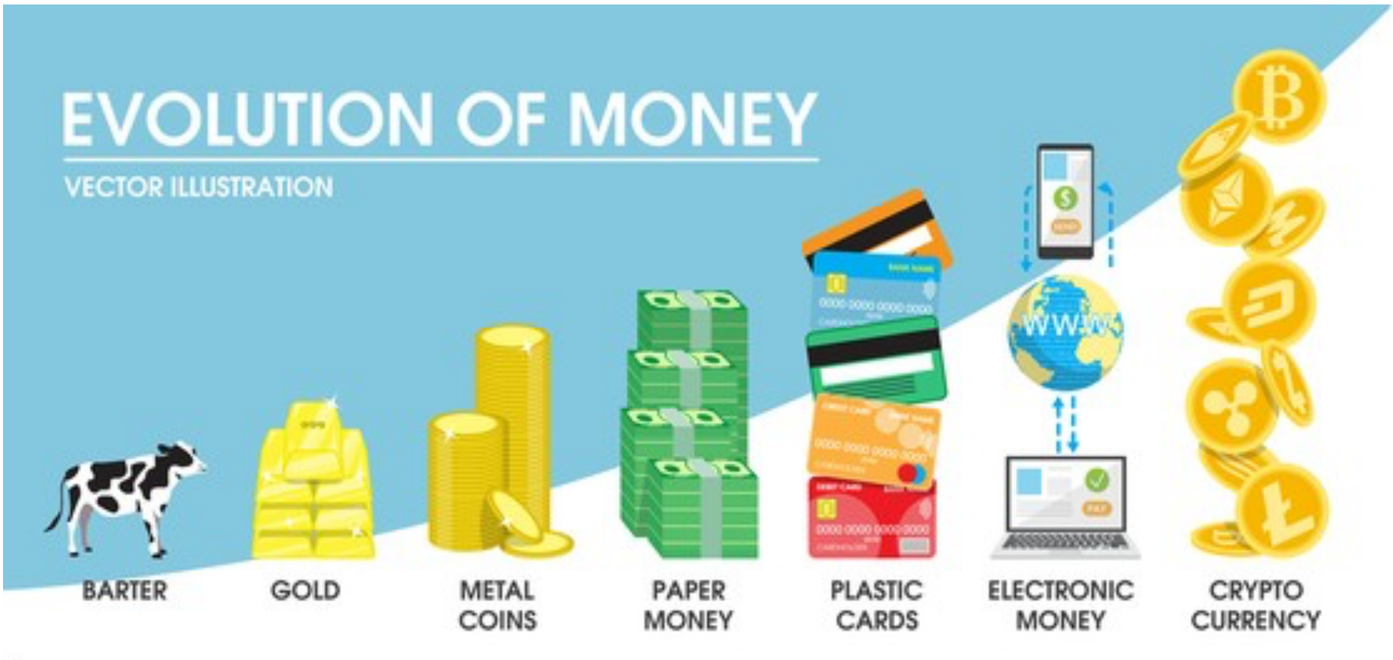
Classifying Money based on Medium of Exchange

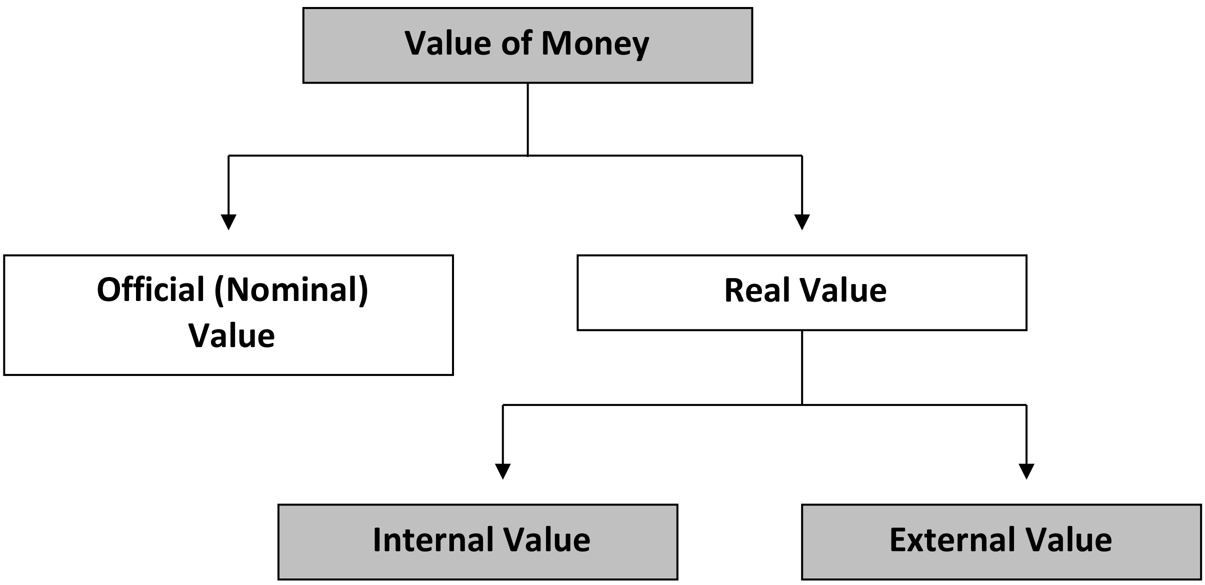


[Source: D. Atapattu, 2018; p93]



[1.6] Value of Money

Schematic **[1.1]**



OFFICIAL VALUE OF MONEY

- The face value of a given country's currency unit, which is printed or minted in different denominations.
- The face value of money in modern day currency tends to be a government enforced value. Accordingly modern currency is known as "Legal Tender or Fiat Money"

REAL VALUE OF MONEY

- The real value of money refers to the purchasing power of money, i.e. the amount of goods and services that can be purchased with a unit of currency of a given country.
- The principal factor affecting the real value of money within a given country (i.e. internal value of money), tends to be movement in general price levels within the country (or domestic inflation rate)

INTERNAL VALUE OF MONEY

Internal value of money refers to the amount of goods and services that can be purchased using a unit of currency within a given country. In simple terms this is the domestic purchasing power of money or the real value of money domestically, which depends on general price levels and its changes (Inflation rates).

This can be presented in terms of an index as well as a value:

METHODS OF PRESENTING (INTERNAL VALUE)

As a value

As an index

EXTERNAL VALUE OF MONEY

External value of money refers to the rate at which the domestic currency unit is exchanged with that of another country's currency or the foreign exchange rate.

The amount of goods and services that can be purchased in a foreign country using the domestic currency (rupee) is decided based on this rate.

In Sri Lanka the external value of money is decided by the market demand and supply for foreign currency (floating FOREX rate system).

RELATIONSHIP

The relationship between internal & external value

- A change in internal value of may cause a change in external value and changes in external value may affect the internal value. In simple terms these two value estimations of money tend to be interdependent.
- The relationship between internal and external values essentially tends to be direct or positive.
- If the external value of money decreases (e.g., the rupee value of a dollar increases from 80 to 100 rupees) the domestic price of imported goods tends to increase. This will decrease the amount of goods and services that can be purchased within the country using a unit of currency (cost push or imported inflation).
- Accordingly, a reduction in the external value of money decreases the internal value.
- If the internal value of money decreases (increase in domestic price of goods and services), the demand for comparatively low priced or cheap imports shall increase, which encourages imports.
- On the other hand, foreigners tend to decrease demand for domestic exports due to high prices, which discourages exports. When imports are motivated, and exports are discouraged, the external value of money shall decrease.
- Accordingly, a reduction in the internal value, decreases the external value.