Money and Banking

Section 2

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During this section we will discuss the following main points:

- ✓ **PRINCIPLES AND METHODS OF NOTE ISSUE**
- ✓ SIGNIFICANCE OF MONEY IN CAPITALIST ECONOMY
- ✓ INFLATION
- ✓ DEMAND SHOCK
- ✓ SUPPLY SHOCK
- ✓ FISCHER EQUATION

PRINCIPLES AND METHODS OF NOTE ISSUE

Principles

(1)**Currency Principle:** - According to the currency principle, the central bank of the country should keep 100% gold for every note issued. The currency principle assures maximum safety for the notes, but it lacks elasticity.

2)**Banking Principle: -** According to this principle, there is no need to keep 100% gold or silver against notes issued.

The notes issued in the country should be according to the needs of trade and Industry. this Principle of note issue provides the country with an elastic currency.

<u>The disadvantages of Banking principle</u>

is the danger of over issue of notes, possibility of inconvertibility of excess notes, loss of public confidence in the currency and monetary instability.

Methods of Note Issue

1- Fixed Fiduciary System

2- Proportional Reserve System

3- Minimum Reserve System

(1) Fixed Fiduciary System

- Under this system, a fixed amount is laid down by law which needs to be covered by government securities.

- Notes issued in excess of this amount must be fully backed by gold.
- England adopted this system in 1844.

- The system lacked elasticity and was not capable of satisfying the needs of trade and industry.
- This system was abandoned in 1913 in favour of proportional reserve system.

(2) Proportional Reserve System

- Under this system, the central bank is to keep a certain percentage of the total notes issued in gold. There is to be covered by sound government securities, trade bills,…etc.

- This system was abandoned in 1965 as it was rigid and lacked elasticity.

(3)Minimum Reserve System

According to this system, the central bank is required to keep only a minimum amount of reserve in the form of gold and foreign exchange securities.

The central bank can expand note issue in accordance with the volume of business activities without backing of gold.

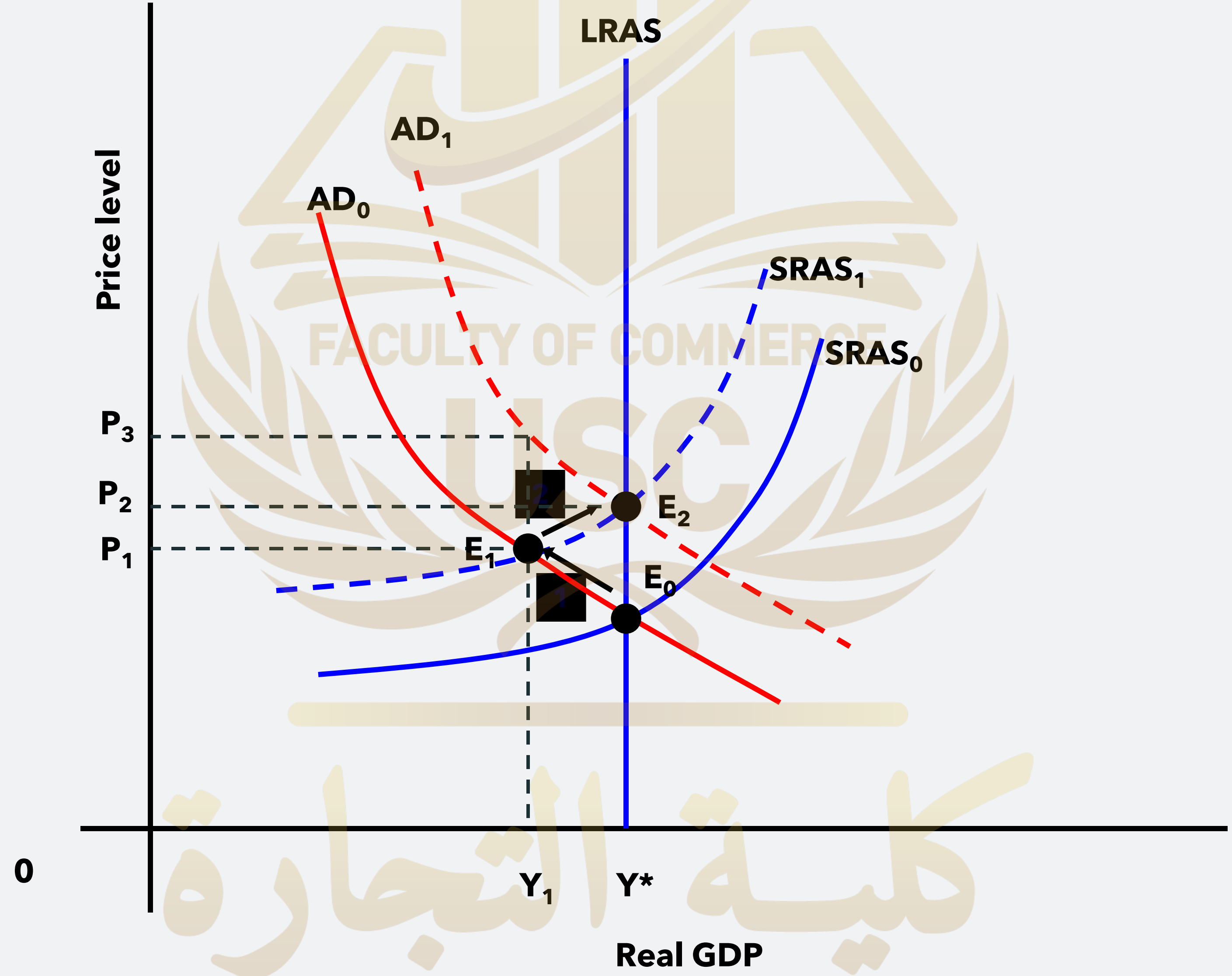
The advantages of this system is that it ensures an adequate supply of currency to meet the business demands of the country. In other words, the method of note issue is sufficiently elastic.

The disadvantages is that paper currency issued is practically inconvertible in this system.

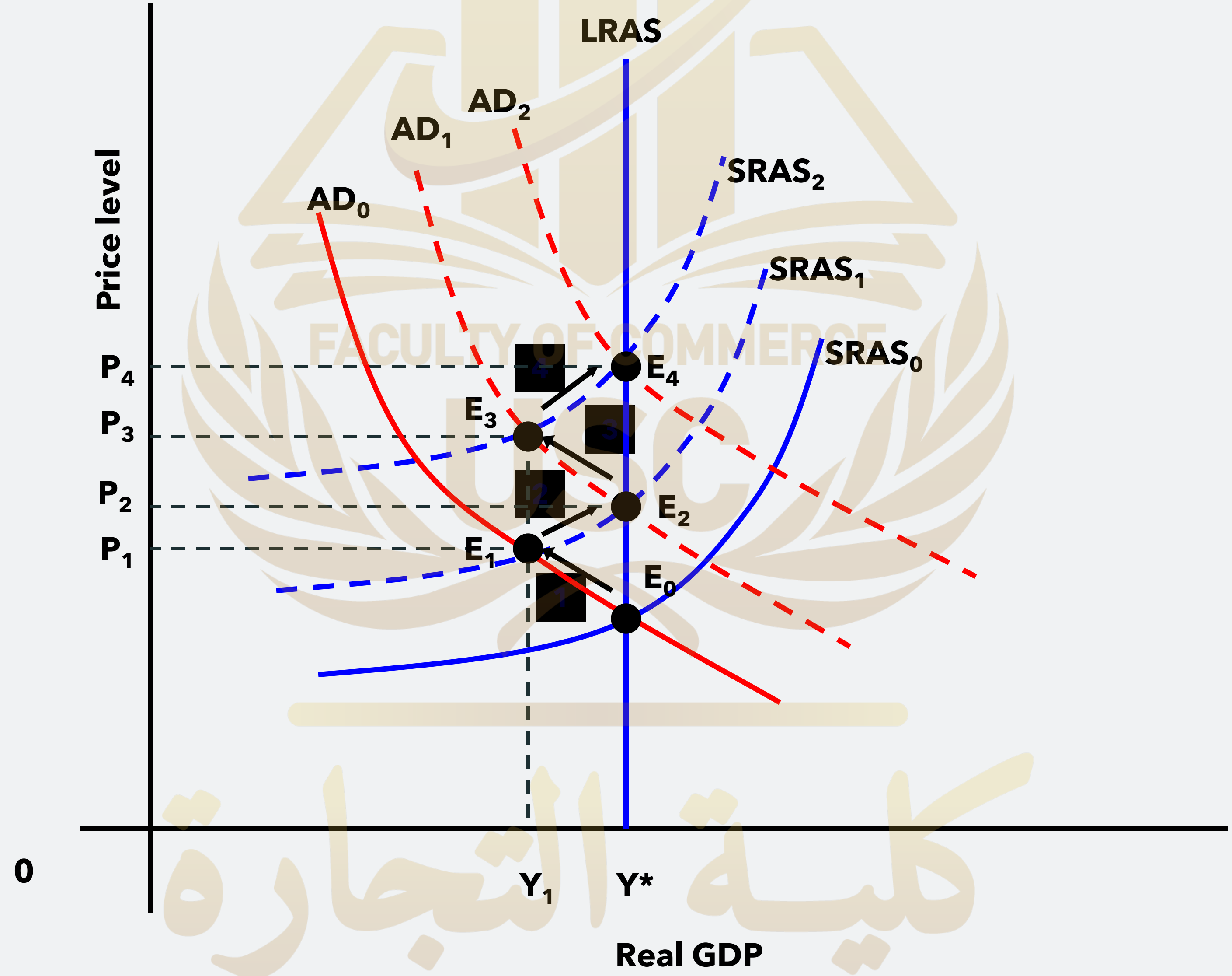
SIGNIFICANCE OF MONEY IN CAPITALIST ECONOMY

- **In a capitalist economy, where allocation of resources, production and distribution of national dividend are all decided by market mechanism i.e. by the forces of demand and supply.**
- **Money plays an important role in this system.**
- **It has substantial effects on output, income, employment, consumption and economic welfare of the community.**

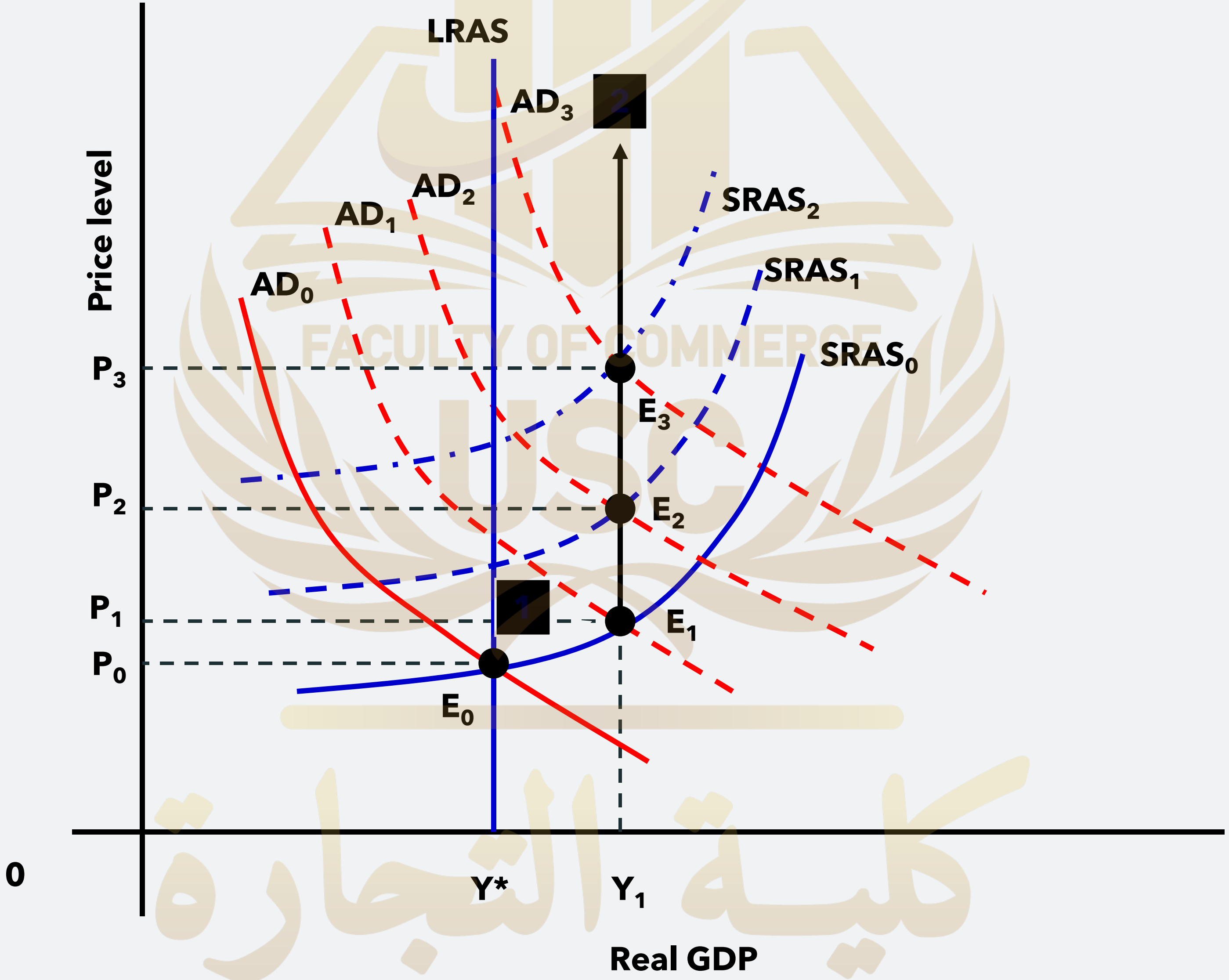
A Single Supply Shock



Monetary Accommodation of a Repeated Supply Shock



A Validated Demand-shock Inflation



The effect of inflationary shocks

Initial shock	Initial effects	Alternative possibilities	Final effects
Demand shock (*AD* curve shifts rightward)	*P* rises *Y* rises above *Y** (inflationary gap) *SRAS* curve starts to shift upwards	Isolated shock Not validated →	Case 1 *P* rises further *Y* falls back to *Y**
		Sustained shock Validated →	Case 2 *P* rises continuously *Y* remains above *Y**
Supply shock (*SRAS* curve shifts leftward)	*P* rises *Y* falls below *Y** (recessionary gap)	Isolated shock → Not accommodated →	Case 3 *P* falls *Y* returns to *Y**
		Isolated shock → Accommodated →	Case 4 *P* rises further *Y* returns to *Y**
		Repeated shock Accommodated →	Case 5 *P* continues to rise *Y* remains at, or below *Y**

Types of value of money:

Value of money is of two types:

1. Internal value of money:

It refers to the purchasing power of money within a country. It is value of national currency over domestic goods and services. It is based on the internal price level.

2. External Value of money:

It refers to the value of money over foreign goods and services. It is the purchasing power of the national currency outside the currency. It is based on the ‘exchange rate’ between two currencies.

Fisher's Quantity Theory of Money or Cash Transaction Approach.

The Cash transaction approach of the quantity theory of money was provided by the American economist Irving Fisher in his book- The Purchasing Power of Money (1911). According to Fisher, "Other things remaining unchanged, as the quantity of money in circulation increases, the price level also increases in direct proportion and the value of money decreases and vice versa".

Fisher's quantity theory is explained with the help of his famous equation of exchange:

$MV = PT$ or $P = MV/T$

Where, M – the total quantity of money of all types.

V – is the velocity of circulation of money. The product MV is the total supply of money in a year.

T – is the total amount of goods and services exchanged for money.

p – is the price per unit, Hence the product PT is the total value of all the transactions for which money is used.

Like other commodities, the value of money or the price level is also determined by the demand and supply of money.

1. Supply of Money:

The supply of money consists of the quantity of money in existence (M) multiplied by the velocity of money (V). In Fisher's equation, V is the velocity of money which means the average number of times a unit of money turns over or changes hands.

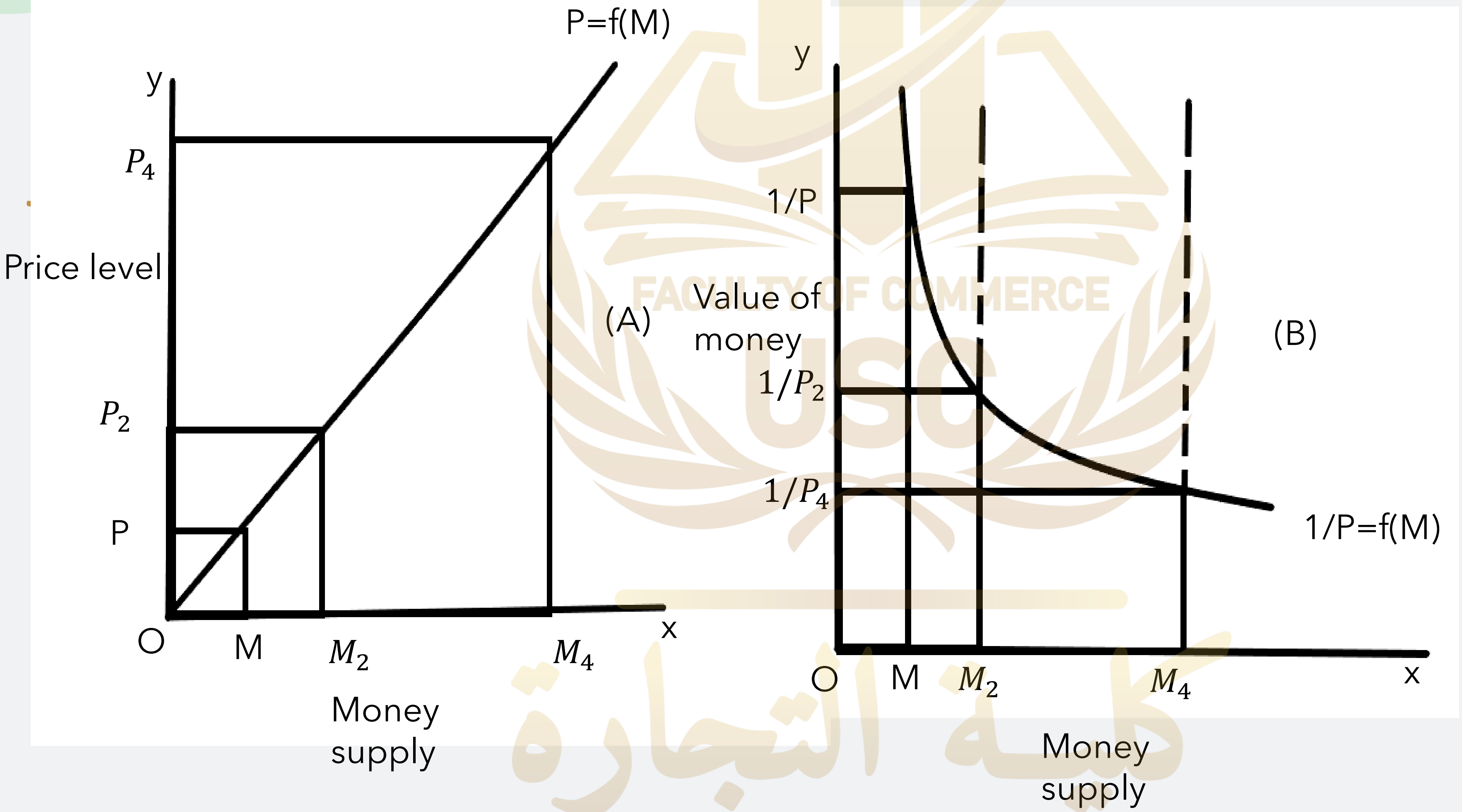
Thus, MV refers to the total volume of money in circulation during a period of time.

ii. Demand for Money:

Money is demanded for transaction purposes. The demand for money is equal to the total market value of all goods and services transacted. It is obtained by multiplying total amount of things (T) by average price level (P).

MV=PT suggest that in an economy, the total value of all goods sold during any period PT, is equal to the total quantity of money MV spent during that period. The equation further denotes that the price level is directly related to MV and inversely related T.

Fisher quantity theory of money is explained with the help of diagram.



Q1: High inflation levels in the economy leads to ________ in the supply of money

A Increase

B Decrease

C No change

D None of the above

Answer: A

Q2: Which of the following is the feature of money?

A General acceptability

B Homogeneous unit

C Liquid asset

D All of these

Answer: D

Q3: Which of the following concepts is the opposite of inflation?

A stagflation

B Deflation

C Recession

D None of the above

Answer: B

Q4: A government resorts to ___________ to reduce inflation.

A Cuts in government spending

B Increase in government expenditure

C Reduction in repo rate

D None of the above

Answer: A

Q5: When the price levels of goods and services are falling continuously, this phenomenon is called __________.

A stagflation

B Deflation

C Inflation

D None of the above

Answer: B

Q6: Inflation is measured by ________

A smith's index

B sale price index

C Consumer price index

D None of the above

Answer: C

Q7: The combination of stagnation and inflation is known as ______.

A Demand-pull inflation

B Cost-push inflation

C Stagflation

D None of the above

Answer: C

Q8: Purchasing power of money falls when:

A Price level rises.

B Income falls.

C Price level falls.

D Money supply falls.

Answer: A

Q9: ……. Represents a measure of inflation.

A Consumer Price Indexes (CPIs)

B Product Price Indexes (PPIs)

C Wholesale Price Indexes

D All the above

Answer: D

Q10: Represents The Causes Of Inflations

A Increase in Public Expenditure

B Deficit Financing

C Less Production

D All the above

Answer: D

Q11: A situation where prices of essential goods and servic decline over time.

A Inflation

B Deflation

C Stagflation

D None of the above

Answer: B

Q12: Represents The Causes Of Deflations

A Growth Deflation

B Bank Credit Deflation

C Cash-Building Deflation

D All the above

Answer: D

Q13: Refers to economic condition where economic growth is very slow, and prices are rising.

A Inflation

B Deflation

C Stagflation

D None of the above

Answer: C

Q14: is a financial institution and a financial intermediary that accepts deposits and channels those deposits into lending activities.

A Financial markets.

B Banks.

C Companies.

D Intermediators.

Answer: B

Q15: ……………. is a public institution that manages a state's currency, money supply, and interest rates.

A Saving bank.

B Commercial bank.

C Central bank.

D Consumer bank.

Answer: C

Q16 Which of the following is the feature of money?

A General acceptability

B Homogeneous unit

C Liquid asset

D All of these

Answer: D

Q17 Which of the following is an effect of inflation?

A Erosion in purchasing power.

B Homogeneous unit

C Liquid asset

D All of these

Answer: D

THANK YOU FOR YOUR ATTENTION