<u>'Money'</u>

Money, a commodity accepted by general consent as a medium of economic exchange. It is the medium in which prices and values are expressed; as currency, it circulates anonymously from person to person and country to country, thus facilitating trade, and it is the principal measure of wealth.

Money is any good that is widely used and accepted in transactions involving the transfer of goods and services from one person to another.

A medium of exchange that is centralized, generally accepted, recognized, and facilitates transactions of goods and services, is known as **money**.

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Hicks words in his '*Critical Essays in Monetary Theory'* - "to act as a unit of account (or measure of value as Wicksell put it), as a means of payment, and as a store of value."

The Radcliffe Committee defined money as - "notes plus bank deposits". It includes as money only those assets which are commonly used as media of exchange.

Coulborn defines money as "the means of valuation and of payment; as both the unit of account and the generally acceptable medium of exchange."

Functions of Money

Money performs a number of primary, secondary, contingent and other functions which not only remove the difficulties of barter but also oils the wheels of trade and industry in the present day world. We discuss these functions one by one.

1. Primary Functions

The two primary functions of money are to act **as a medium of exchange and as a unit of value.**

(i) Money as a Medium of Exchange

This is the primary function of money because it is out of this function that its other functions developed. By serving as a medium of exchange, money removes the need for double coincidence of wants and the inconveniences and difficulties associated with barter. The introduction of money as a medium of exchange decomposes the single transaction of barter into separate transactions of sale and purchase, thereby eliminating the double coincidence of wants. This function of money also separates the transactions in time and place because the sellers and buyers of a commodity are not required to perform the transactions at the same time and place. This is because the seller of a commodity buys some money and money, in turn, buys the commodity over time and place. When money acts as a medium of exchange, it means that it is generally acceptable. It, therefore, affords the freedom of choice. With money, we can buy an assorted bundle of goods and services. At the same time, we can purchase the best and also bargain in the market. Thus money gives us a good deal of economic independence and also perfects the market mechanism by increasing competition and widening the market. As a medium of exchange, money acts as an intermediary. It facilitates exchange. It helps production indirectly through specialization and division of labor which, in turn, increase efficiency and output.

According to **Prof. Walters**, money serves as a 'factor of production,' enabling output to increase and diversify.

In the last analysis money facilitates trade. When acting as the intermediary, it helps one good or service to be traded indirectly for others.

(ii) Money as Unit of Value

The second primary function of money is to act as a unit of value. Under barter one would have to resort to some standard of measurement, such as a length of string or a piece of wood. Since one would have to use a standard to measure the length or height of any object, it is only sensible that one particular standard should be accepted as *the* standard. Money is the standard for measuring value Justas the yard or metre is the standard for measuring length. The monetary unit measures and expresses the values of all goods and services. In fact, it expresses the value of each good or service in terms of price. Money is the common denominator which determines the rate of exchange between goods and services which are priced in terms of the monetary unit. There can be no pricing process without a measure of value. The use of money as a standard of value eliminates the necessity of quoting the price of apples in terms of oranges, the price of oranges in terms of nuts and so on. Unlike barter, the prices of such commodities are expressed in terms of so many units of dollars, rupees, francs, pounds, etc., depending on the nature of the monetary unit in a country. As a matter of fact, measuring the values of goods and services in the monetary unit facilitates the problem of measuring the exchange values of goods in the market. When values are expressed in terms of money, the number of prices are reduced from n (n–1) in **barter economy** to (n–1) in **monetary economy.**

This function is known by various other names such as

- Unit of account
- standard of value
- Common measure of value or common denominator of value

- Money as a unit of value also facilitates accounting when assets of all kinds, liabilities of all kinds, incomes of all kinds, and expenses of all kinds can be stated in terms of common monetary units to be added or subtracted.
- Further, money as a unit of account helps in calculations of economic importance such as the estimation of the costs, and revenues of business firms, the relative costs and profitability of various public enterprises and projects under a planned economy, and the gross national product.

As pointed out by **Culbertson**, "Prices quoted in terms of money become the focus of people's behavior. Their calculations, plans, expectations, and contracts focus on money prices."

2. Secondary Functions

Money performs three secondary functions: as a standard of deferred payments, **as a store of value**, and **as a transfer of value**. They are discussed below.

(i) Money as a Standard of Deferred Payments

The third function of money is that it acts as a standard of deferred or postponed payments. All debts are taken in money. It was easy under barter to take loans in goats or grains but difficult to make repayments in such perishable articles in the future. Money has simplified both the taking and repayment of loans because the unit of account is durable. Money links the present values with those of the future.

It simplifies credit transactions. It makes possible contracts for the supply of goods in the future for an agreed payment of money. It simplifies borrowing by consumers on hire-purchase and from house-building and cooperative societies. Money facilitates borrowing by firms and businessmen from banks and non-bank financial institutions. The buying and selling of shares, debentures and securities is made possible by money. By acting as a standard of deferred payments, money helps in capital formation both by the government and business enterprises. In fine, this function of money develops financial and capital markets and helps in the growth of the economy. But there is the danger of changes in the value of money over time which harm or benefit the creditors and debtors. If the value of money increases over time, the creditors gain and debtors lose. On the other hand, a fall in the value of money over time brings losses to creditors and windfalls to debtors.

(ii) Money as a Store of Value

Another important function of money is that it acts as a store of value. "The good chosen as money is always something which can be kept for long periods without deterioration or wastage. It is a form in which wealth can be kept intact from one year to the next. Money is a bridge from the present to the future. It is therefore essential that the money commodity should always be one which can be easily and safely stored."

Money as a store of value is meant to meet unforeseen emergencies and to pay debts. **Newlyn** calls this the *asset function of money*. "Money is not, of course, the only store of value. This function can be served by any valuable asset. One can store value for the future by holding short-term promissory notes, bonds, mortgages, preferred stocks, household furniture, houses, land, or any other kind of valuable goods. The principal advantages of these other assets as a store of value are that they, unlike money, ordinarily yield an income in the form of interest, profits, rent or usefulness...,and they sometimes rise in value in terms of money. On the other hand, they have certain disadvantages as a store of value, among which are the following:

- They sometimes involve storage costs
- They may depreciate in terms of money;
- They are "illiquid" in varying degrees, for they are not generally acceptable as money and it may be possible to convert them into money quickly only by suffering a loss of value.

Keynes placed much emphasis on this function of money. According to him, to hold money is to keep it as a reserve of liquid assets which can be converted into real goods. It is a matter of comparative indifference whether wealth is in money, money claims, or goods. In fact, money and money claims have certain advantages of security, convenience and adaptability over real goods. But the store of value function of money also suffers from changes in the value of money. This introduces considerable hazard in using money or assets as a store of value.

(iii) Money as a Transfer of Value

Since money is a generally acceptable means of payment and acts as a store of value, it keeps on transferring values from person to person and place to place. A person who holds money in cash or assets can transfer that to any other person. Moreover, he can sell his assets at Delhi and purchase fresh assets at Bangalore. Thus money facilitates transfer of value between persons and places.

3. Contingent Functions

Money also performs certain contingent or incidental functions as below, According to **Prof. David Kinley**. They are:

- **Money as the Most Liquid of all Liquid Assets**
  Money is the most liquid of all liquid assets in which wealth is held. Individuals and firms may hold wealth in infinitely varied forms. They may, for example, choose between holding wealth in currency, demand deposits, time deposits, savings, bonds, treasury bills, short-term government securities, long-term government securities, debentures, preference shares, ordinary shares, stocks of consumer goods, and productive equipment. All these are liquid forms of wealth which can be converted into money, and vice versa.

- **Money is the basis of the credit system**

Business transactions are either in cash or on credit. Credit economies the use of money. But money is at the back of all credit. A commercial bank cannot create credit without having sufficient money in reserve. The credit instruments drawn by businessmen have always a cash guarantee supported by their bankers.

- **Equaliser of Marginal Utilities and Productivities**

Money acts as an equaliser of marginal utilities for the consumer. The main aim of a consumer is to maximise his satisfaction by spending a given sum of money on various goods which he wants to purchase. Since prices of goods indicate their marginal utilities and are expressed in money, money helps in equalising the marginal utilities of various goods. This happens when the ratios of the marginal utilities and prices of the various goods are equal.

- **Equalizer of Marginal Productivities**

Money also helps in equalizing the marginal productivities of the various factors. The main aim of the producer is to maximize his profits. For this, he equalizes the marginal productivity of each factor with its price. The price of each factor is nothing but the money he receives for his work.

- **Measurement of National Income**

It was not possible to measure national income under the barter system. Money helps in measuring national income. This is done when various goods and services produced in a country are assessed in money terms.

- **Distribution of National Income**

Money also helps in the distribution of national income. Rewards of factors of production in the form of wages, rent, interest and profit are determined and paid in terms of money.

4. Other Functions

Money also performs such functions which affect the decisions of consumers and governments.

- **Helpful in Making Decisions**

Money as a means of store of value helps the consumer meet his daily requirements on the basis of money held by him. If the consumer has a scooter and he needs a car in the near future, he can buy a car by selling his scooter and money accumulated by him. In this way, money helps in taking decisions.

- **Money as a Basis of Adjustment**

To carry on trade in a proper manner, the adjustment between money market and capital market is done through money. Similarly, adjustments in foreign exchange are also made through money. Further, international payments of various types are also adjusted and made through money. It is on the basis of these functions that money guarantees the solvency of the payer and provides options to the holder of money to use it any way, he likes.

Factors affecting the Influences on Money Holding

The quantity of money that people plan to hold depends on four main factors:

- **The price level**
- **The *nominal* interest rate**
- **Real GDP**
- **Financial innovation**

The Price Level

The quantity of money measured in dollars is *nominal money*. The quantity of nominal money demanded is proportional to the price level, other things remaining the same. If the price level rises by 10 percent, people hold 10 percent more nominal money than before, other things remaining the same. If you hold $20 to buy your weekly movies and soda, you will increase your money holding to $22 if the prices of movies and soda—and your wage rate—increase by 10 percent. The quantity of money measured in constant dollars (for example, in 2005 dollars) is real money.

- ***Real money*** is equal to nominal money divided by the price level and is the quantity of money measured in terms of what it will buy.

In the above example, when the price level rises by 10 percent and you increase your money holding by 10 percent, your *real* money holding is constant. Your $22 at the new price level buys the same quantity of goods and is the same quantity of *real money* as your $20 at the original price level. The quantity of real money demanded is independent of the price level.

The Nominal Interest Rate

A fundamental principle of economics is that as the opportunity cost of something increases, people try to find substitutes for it. Money is no exception. The higher the opportunity cost of holding money, other things remaining the same, the smaller is the quantity of real money demanded. The nominal interest rate on other assets minus the nominal interest rate on money is the opportunity cost of holding money. The interest rate that you earn on currency and checking deposits is zero. So the opportunity cost of holding these items is the nominal interest rate on other assets such as a savings bond or Treasury bill. By holding money instead, you forgo the interest that you otherwise would have received.

Money loses value because of inflation, so why isn't the inflation rate part of the cost of holding money? It is. Other things remaining the same, the higher the expected inflation rate, the higher is the nominal interest rate.

Real GDP

The quantity of money that households and firms plan to hold depends on the amount they are spending. The quantity of money demanded in the economy as whole depends on aggregate expenditure—real GDP. Again, suppose that you hold an average of $20 to finance your weekly purchases of movies and soda. Now imagine that the prices of these goods and of all other goods remain constant but that your income increases. As a consequence, you now buy more goods and services and you also keep a larger amount of money on hand to finance your higher volume of expenditure.

Financial Innovation

Technological change and the arrival of new financial products influence the quantity of money held. Financial innovations include:

- Daily interest checking deposits
- Automatic transfers between checking and saving deposits
- Automatic teller machines
- Credit cards and debit cards
- Internet banking and bill paying

These innovations have occurred because of the development of computing power that has lowered the cost of calculations and record keeping.
We summarize the effects of the influences on money holding by using a demand for money curve.

Money market

Money market, a set of **institutions, conventions,** and **practices**, the aim of which is to facilitate the lending and borrowing of money on a short-term basis. The money market is, therefore, different from the capital market, which is concerned with medium- and long-term credit.

The definition of money for money market purposes is not confined to bank notes but includes a range of assets that can be turned into cash at short notice, such as **short-term government securities, bills of exchange, and bankers' acceptances**.

Money market basically refers to a section of the financial market where financial instruments with high liquidity and short-term maturities are traded.
It has become a component of the financial market for buying and selling of securities of short-term maturities, of one year or less, such as treasury bills and commercial papers.
Over-the-counter trading is done in the money market and it is a wholesale process. It is used by the participants as a way of borrowing and lending for the short term.

Money market consists of negotiable instruments such as

- **Treasury Bills**
- **Commercial Papers**
- **Certificates of Deposit**

It is used by many participants, including companies, to raise funds by selling commercial papers in the market. Money market is considered a safe place to invest due to the high liquidity of securities. It has certain risks which investors should be aware of, one of them being default on securities such as commercial papers.
Money market consists of various financial institutions and dealers, who seek to borrow or loan securities. It is the best source to invest in liquid assets.
The money market is an unregulated and informal market and not structured like the capital markets, where things are organized in a formal way.
Money market gives lesser return to investors who invest in it but provides a variety of products.

Withdrawing money from the money market is easier. Money markets are different from capital markets as they are for a shorter period of time while capital markets are used for longer time periods.

Meanwhile, a mortgage lender can create protection against a fallout risk by entering an agreement with an agency or private conduit for operational, rather than mandatory, delivery of the mortgage. In such an agreement, the mortgage originator effectively buys an option, which gives the lender the right, but not the obligation, to deliver the mortgage. Against that, the private conduit charges a fee for allowing optional delivery.

<u>‘Business or Economic cycle’</u>

Business cycle or trade cycle is a part of the capitalist system. It refers to the phenomenon of cyclical booms and depressions. In a business cycle, there are wave-like fluctuations in aggregate employment, income, output and price level. The term business cycle has been defined in various ways by different economists.

Prof. Haberler’s defined as- “The business cycle in the general sense may be defined as an alternation of periods of prosperity and depression of good and bad trade.”

Keynes’ definition in his ***Treatise of Money*** is more explicit:
"A trade cycle is composed of periods of good trade characterized by rising prices and low unemployment percentage, altering with periods of bad trade characterized by falling prices and high unemployment percentages.”

Gordon’s definition is precise: “Business cycles consist of recurring alternation of expansion and contraction in aggregate economic activity, the alternating movements in each direction being self-reinforcing and pervading virtually, all parts of the economy.”

The most acceptable definition is by **Estey**, “Cyclical fluctuations are characterized by alternating waves of expansion and contraction. They do not have a fixed rhythm, but they are cycles in that the phases of contraction and expansion recur frequently and in fairly similar patterns.

Phases of Business or Economic Cycle

A typical cycle is generally divided into four phases:

1. Expansion or Prosperity or The Upswing
2. Recession or Upper-Turning Point
3. Contraction or Depression or Downswing, and
4. Revival or Recovery or Lower-Turning Point.

We refer to it by different names: boom and bust; expansion and contraction; growth and recession; and the proverbial bull and bear. What we're talking about is the economic cycle, aka "business cycle."
These phases are recurrent and uniform in the case of different cycles. But no phase has definite periodicity or time interval. As pointed out by **Pigou**, cycles may not be twins but they are of the same family. Like families they have *common* characteristics that are capable of description.

- Starting at the trough or low point, a cycle passes through a recovery and prosperity phase, rises to a peak,
- Declines through a recession and depression phase and reaches a trough.

This is shown in Figure where ***E*** is the **equilibrium** position. We describe below these characteristics of a business cycle.

Recovery

We start from a situation when depression has lasted for some time and the revival phase or the lower-turning point starts. The "originating forces" or "starters" may be exogenous or endogenous forces. Suppose the semi durable goods wear out which necessitate their replacement in the economy. It leads to increased demand. To meet this increased demand, investment and employment increase. Industry begins to revive. Revival also starts in related capital goods industries. Once begun, the process of revival becomes cumulative. As a result, the levels of employment, income and output rise steadily in the economy. In the early stages of the revival phase, there is considerable *excess* or *idle* capacity in the economy so

> The recovery phase is when the economy hits its trough, bottoms out, and begins the cycle anew. Policies enacted during the contraction phase begin to bear fruit. Businesses that retrenched during the contraction begin to ramp up again. Stock values tend to rise as investors see greater potential returns in stocks than bonds. Production ramps up to meet rising consumer demand and with it, business expansion, employment, income, and GDP.

that output increases without a proportionate increase in total costs. But as time goes on, output becomes less elastic; bottlenecks appear with rising costs, deliveries are more difficult and plants may have to be expanded. Under these conditions, prices rise. Profits increase. Business expectations improve. Optimism prevails. Investment is encouraged which tends to raise the demand for bank loans. It leads to credit expansion. Thus the cumulative process of increase in investment, employment, output, income and prices feeds upon itself and becomes self-reinforcing. Ultimately, revival enters the prosperity phase.

Prosperity

In the prosperity phase, demand, output, employment and income are at a high level. They tend to raise prices. But wages, salaries, interest rates, rentals and taxes do not rise in proportion to the rise in prices. The gap between prices and costs increases the margin of profit. The increase of profit and the prospect of its continuance commonly cause a rapid rise in stock market values. The economy is engulfed in waves of optimism. Larger profit expectations further increase investment which is helped by liberal bank credit. Such investments are mostly in fixed capital, plant, equipment and machinery. They lead to considerable expansion in economic activity by increasing the demand for consumer goods and further raising the price level. This encourages retailers, wholesalers and manufacturers to add to inventories. In this way, the expansionary process becomes cumulative and self-reinforcing until the economy reaches a very high level of production, known as the *peak* or *boom*. The peak or prosperity may lead the economy to over full employment and to inflationary rise in prices. It is a symptom of the end of the prosperity phase and the beginning of the recession. The seeds of recession are contained in the boom in the form of strains in the economic structure which act as brakes to the expansionary path.

> During the expansion phase, interest rates are often on the low side, making it easier for consumers and businesses to borrow money. The demand for consumer goods is growing, and businesses begin ramping up production to meet consumer demand. To increase production, businesses hire more workers or invest capital to expand their physical infrastructure and operations. Generally, corporate profits begin to rise along with stock prices. Gross domestic product (GDP) also begins rising as the economy gets its "boom" cycle underway.

They are:

(i) Scarcities of labour, raw materials, etc. leading to rise in costs relative to prices;

(ii) Rise in the rate of interest due to scarcity of capital; and

(iii) Failure of consumption to rise due to rising prices and stable propensity to consume when incomes increase.

- ✓ The first factor brings a decline in profit margins.
- ✓ The second makes investments costly and along with the first, lowers business expectations.
- ✓ The third factor leads to the piling up of inventories indicating that sales (or consumption) lag behind production.

These forces become cumulative and self-reinforcing. Entrepreneurs, businessmen and traders become over cautious and over optimism gives way to pessimism. This is the beginning of the upper turning point.

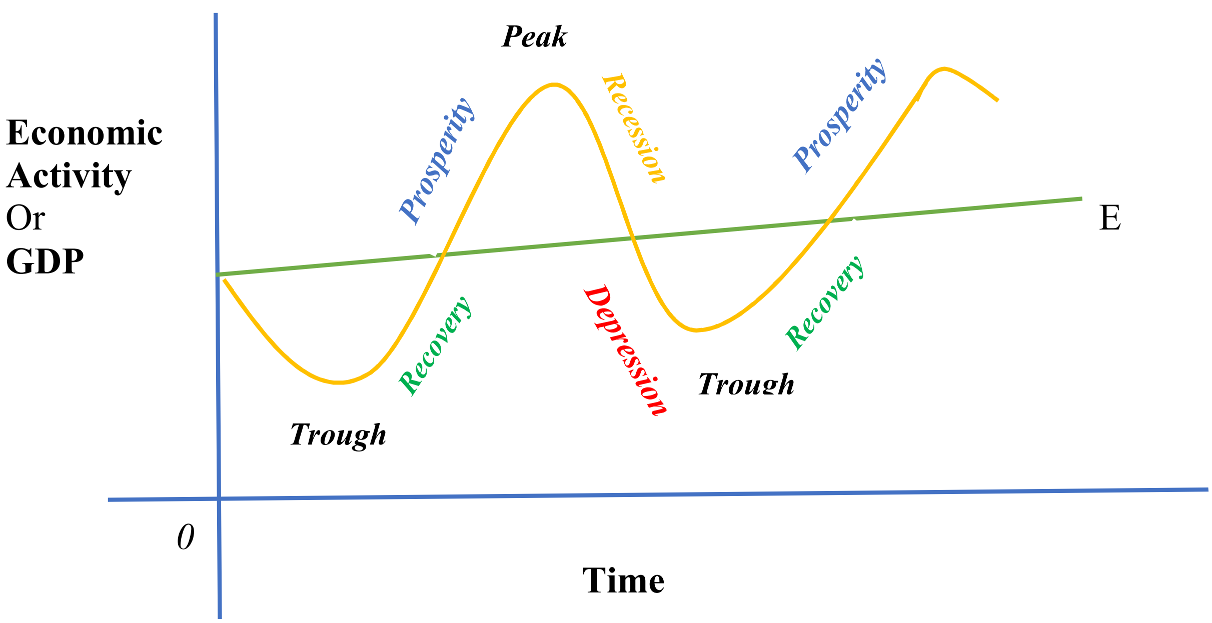

Figure: Economic or Business Cycle

Recession

Recession starts when there is a downward descend from the 'peak' which his of a short duration. It marks the turning period during which the forces that make for contraction finally win over the forces of expansion. Its outward signs are liquidation in the stock market, strain in the banking system and some liquidation of bank loans, and the beginning of the decline of prices. As a result, profit margins decline further because costs start overtaking prices. Some firms close down. Others reduce production and try to sell out accumulated stocks. Investment, employment, income and demand decline. This process becomes cumulative.

Recession may be mild or severe. The latter might lead to a sudden explosive situation emanating from the banking system or the stock exchange, and a *panic* or *crisis* occurs. "When a crisis, and more particularly a panic, does occur, it seems to be associated with a collapse of confidence and sudden demands for liquidity. This crisis of nerves may itself be occasioned by some spectacular and unexpected failure. A firm or a bank, or a corporation announces its inability to meet its debts. This announcement weakens other firms and banks at a time when ominous signs of distress are appearing in the economic structure; moreover, it sets off a wave of fright that culminates in a general run on financial institutions"...Such was the experience of the United States in 1873, in 1893, in 1907 and recently in 2008. In the words of M.W. Lee, "A recession, once started, tends to build upon itself much as forest fire, once under way, tends to create its own draft and give internal impetus to its destructive ability."

At this stage, the economy reaches a maximum rate of growth. As consumer demand rises, there's a point at which businesses may no longer be able to ramp up production and supply to match the increasing demand. Some companies may find it necessary to expand production capabilities, which entails more spending or investment. Businesses may also begin experiencing a rise in production costs (including wages), prompting some to transfer these costs over to the consumer via higher prices. Consequently, businesses may begin to see a "topping-off" in profits despite charging higher prices. Other businesses will see decreasing profits due to higher manufacturing (input) costs or higher wage demands. Overall, inflationary pressures start to build up, or "bubble," and the economy begins to overheat. Typically, the Federal Reserve will hike interest rates to combat rising prices—making it more expensive to borrow money—in an attempt to cool the economy.

Depression

Recession merges into depression when there is a general decline in economic activity. There is considerable reduction in the production of goods and services, employment, income, demand and prices. The general decline in economic activity leads to a fall in bank deposits.

Credit expansion stops because the business community is not willing to borrow. Bank rate falls considerably. According to Professor Estey, "This fall in active purchasing power is the fundamental background of the fall in prices, that despite the general reduction of output, characterises the depression." Thus a depression is characterised by mass unemployment; general fall in prices, profits, wages, interest rate, consumption, expenditure, investment, bank deposits and loans; factories close down; and construction of all types of capital goods, buildings, etc. comes to a standstill. These forces are cumulative and self-reinforcing and the economy is at the *trough*. The trough or depression may be short-lived or it may continue at the bottom for considerable time. But sooner or later limiting forces are set in motion which ultimately tend to bring the contraction phase to end and pave the way for the revival. A cycle is thus complete.

> Then the economic contraction begins. In this stage, corporate profits and consumer spending, particularly on discretionary (e.g., luxury) items, begins to fall. Stock values also decline as investors move their investments to "safer" assets such as Treasury bonds and other fixed-income assets, plus good ole cash. GDP contracts due to the decrease in spending. Production slows to match falling demand. Employment and income can also decline as businesses temporarily freeze hiring or resort to laying off workers. Overall, economic activity slows, stocks enter a bear market, and a recession typically follows. Sometimes a recession is mild, but other contractions—such as the Great Depression—are particularly severe and long-lasting. In a depression, many businesses close up shop for good.