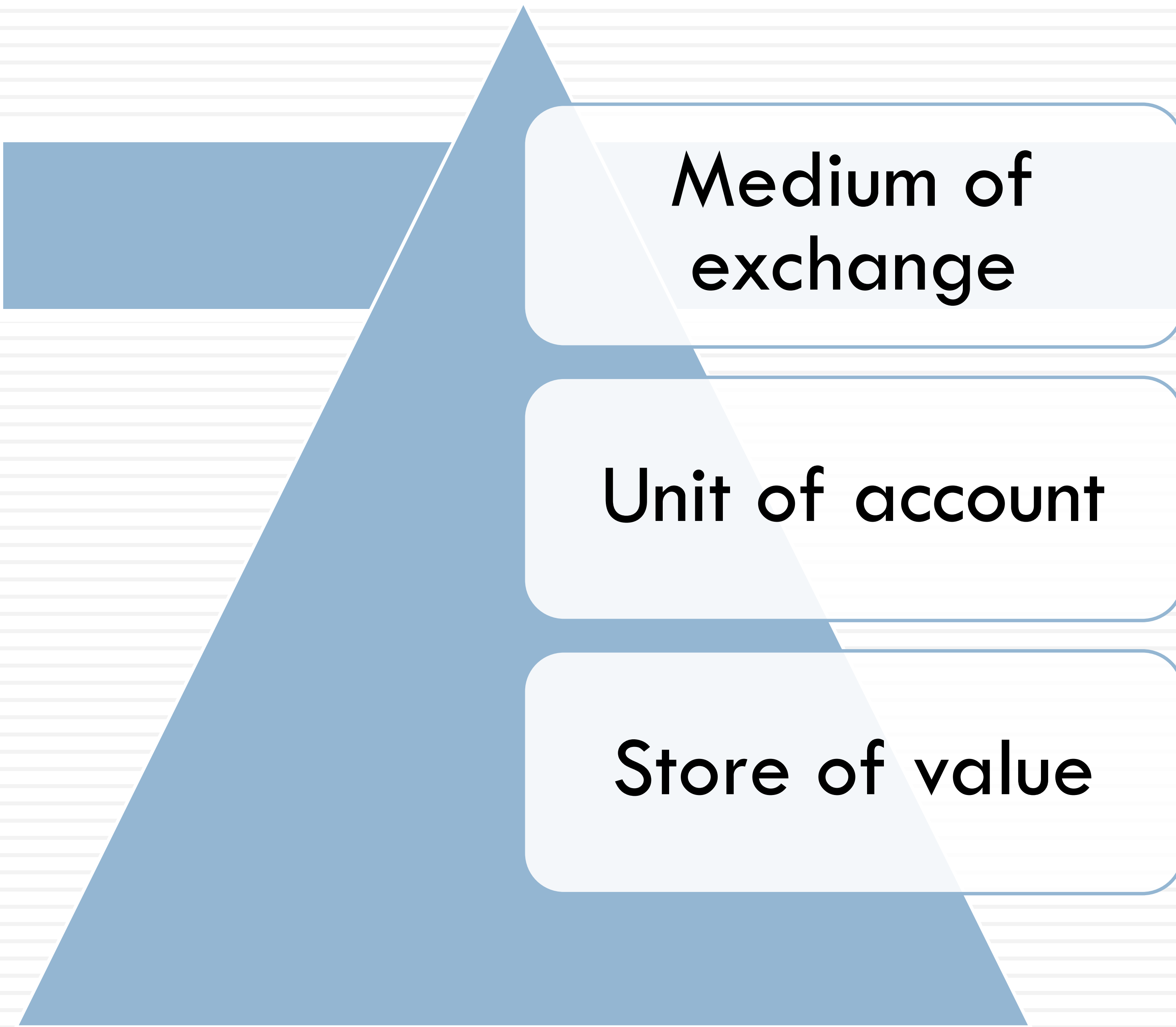
MONEY AND INFLATION

Meaning of Money

- Money (or the “money supply”): **anything** that is generally accepted as payment for goods or services or in the repayment of debts.
- The definition of money as anything that is generally accepted in payment for goods and services tells us **that money is defined by people’s behavior.**

Functions of money



Functions of Money

- **Medium of Exchange:**
- It is used to pay goods or services.
- The use of money as a medium of exchange promotes economic efficiency by minimizing the time spent in exchanging goods and services.
- It eliminates the trouble of finding a double coincidence of needs (reduces transaction costs) unlike the barter economy. The time spent in trying to exchange goods or services is called transaction cost.

A medium of exchange must:

- be easily standardized
- be widely accepted
- be divisible
- be easy to carry
- not deteriorate quickly

- Unit of account:
- It is used to measure the value in the economy.
- We measure the value of goods and services in terms of money just as we measure weight in terms of pounds or distance in terms of miles.

Store of value

Store of value:

- It is a repository of purchasing power over time.
- A store of value is used to save purchasing power from the time income is received until the time it is spent.
- This function of money is useful because we most of us do not want to spend our income immediately upon receiving it, but rather prefer to wait until we have the time or the desire to shop.

- Money is not unique as a store of value; any asset-whether money,stocks,bonds,land,jewelry can be used to store wealth.
- They often pay the owner a higher interest rate rather than money, experience price appreciation and deliver services such as providing a roof over one's head.If these assets are a more desirable store of value than money,why do people hold money at all?

- The answer to this question relates to the important economic concept of liquidity, the relative ease and speed with which an asset can be converted into a medium of exchange.
- Money is the most liquid asset of all because it is the medium of exchange ;it does not have to be converted into anything else to make purchases.
- Other assets have transactions cost when they are converted into omoney.
- How good a store of value money depends on the price level.A doubling of all prices means that the value of money has droppped by half.

Evolution of the payments system

Types of money:

Commodity money

Fiat Money

Checks

Electronic payment

Commodity money

- An object that clearly has value to everyone is a likely candidate to serve as money, and a natural choice is a precious metal such as gold or silver.
- Money made up of such precious metals or another valuable commodity is called commodity money.
- The problem with a payments system based exclusively on precious metals is that such a form of money is very heavy and is hard to transport from one place to another.

Fiat Money

- The next development in the payments system was paper currency(pieces of paper that function as a medium of exchange).
- Currency has evolved into fiat money, paper currency decreed by governments as legal tender but not convertible into coins or precious metal.
- Paper currency has the advantage of being much lighter than coins or precious metal but it can be accepted as a medium of exchange only if there is some trust in the authorities who issue it.
- Paper currency has evolved into a legal arrangement, countries can change the currency that they use at will.
- Major drawback of paper currency is that they are easily stolen .

Cheque

- A check is an instruction from you to your bank to transfer money from your account to someone else's account when she deposits the check.
- Checks allow transactions to take place without the need to carry around large amounts of currency.
- The introduction of checks was a major innovation that improved the efficiency of the payments system.
- Without checks, this would involve the movement of a lot of currency.
- The use of checks reduces the transaction cost .
- Another advantage is that they can be written for any amount up to the balance in the account, making transactions for large amounts much easier.
- And also theft is greatly reduced.

Electronic payment

- The development of computers and the spread of the internet now make it cheap to pay bills electronically.
- Bank now provide websites at which you just log on, make few clicks and thereby transmit your payment electronically.

Measuring money

M1 (most liquid assets) = currency + demand deposits + other checkable deposits

M2 (adds to M1 other assets that are not so liquid) = M1 + small denomination time deposits + savings deposits

What is Narrow Money?

Narrow money is a way of measuring and categorizing the money supply within an economy. It includes specific kinds of money that are highly liquid. Due to its liquidity, it is easily accessible and can be used for immediate spending.

Some examples include cash or checkable deposits.

Narrow money can also be known as M1. **Narrow money is a subset of broad money.**

What is Broad Money?

Broad money is the secondary component of measuring the money supply. Although it does include all forms of narrow money, it includes additional forms that are less liquid. Typically, broad money is known as M2, M3, or M4.

Quantity theory of money

- Quantity theory of money is a theory of how the nominal value of aggregate income is determined .Because it tells us how much money is held for a given amount of aggregate income,it is a theory of the demand for money.The most important feature of this theory is that it suggests that interest rates have no effect on the demand for money

- Fisher wanted to examine the link between the total quantity of money M and the total amount of spending on final goods and services produced in the economy P*Y, P is the price level and Y is aggregate output.The concept the provides the link between M and P*Y is called the velocity of money,the number of times per year that a dollar is spent in buying the total amount of goods and service produced in an economy.

- Velocity V is defined more precisely as total spending P * Y divided by the quantity of money M:
- $V=P*Y/M$
- If for example,nominal GDP(P*Y)in a year is 5 trillion and the quantity of money is 1 trillion,velocity is 5 ,meaning that the average dollar is spent in five times in purchasing goods and services in the economy.

- By multiplying both sides of this definition by M,we obtain the equation of exchange,which relates nominal income to the quantity of money and velocity:
- $M*V=P*Y$
- The equation of exchange thus states that the quantity of money multiplied by the number of times that this money is spent in a given year must equal nominal income .

- Fisher's view that velocity is fairly constant in the short run transforms the equation of exchange into the quantity theory of money,which states that nominal income is determined by movements in the quantity of money.When the quantity of money M doubles,M*V doubles and so must P*Y,the value of nominal income.

Keynes Theory

- Role in the theory of money demand was put forward by John Maynard Keynes, this theory is inversely proportional to the quantity theory of money. If the quantity of money is not the need for interest rates, another case with this theory, in the theory of interest rates affects the behavior of people to choose cash or hold securities.
- According to Keynes there are three motives which affect the level of demand for money, such as:

1. Transaction motive
2. Precautionary motive
3. Speculative motive

- This is due to the three motives that led to the emergence of three different kinds of demand for money demand. Among them are:

  a) Demand for Transactions

  b) Demand for Precautionary Purposes

  c) Demand for Purposes Speculation

- Transaction motive

  This motive arises because the money is used to make regular payments for the completed transaction. The magnitude of the demand for money for transaction purposes is determined by the level of income , in example the greater the level of income generated, the amount of money required for the transaction also increased and vice versa.

- Precautionary motive

In addition to finance the transaction, the money requested also by the public for the purposes of that nature in the future just in case. According to Keynes the amount of money held guard depending on income level. The higher one's income, the higher the money held as a precaution in the future.

- Speculative motive

In the modern economic system where financial institutions have experienced the rapid growth encourages communities to use the money for speculative activities, which are stored or used to purchase securities, such as government bonds, stocks, or other instruments. Factors affecting the magnitude of demand for money with this motive is the interest rate, securities dividends, or capital gains.

How the quantity of money is controlled?

- The quantity of money available in an economy is called money supply.
- In an economy that uses fiat money such as most economies today, the government controls the money supply: legal restrictions give the government a monopoly on the printing of money.Just as the level of taxation and the level of government purchases are policy instruments of the government, so it the supply of money. The control over the money supply is called monetary policy.

- Formulation of monetary is delegated to the central bank of a country.
- The primary way in which the central bank controls the supply of money is called open market operations.

Seigniorage: The revenue from printing money

- All government must spend money.Some of this spending is to buy goods and services and some is to provide transfer payments. A government can finance its spending in three ways.First, it can raise revenue through taxes.Second, it can borrow from the public by selling government bonds.Third, it can print money. The revenue raised by the printing of money is called seigniorage.

- When the government prints money to finance expenditures, it increases the money supply. The increases in money supply, in turn, causes inflation. Printing money to raise revenue is like imposing an inflation tax. Who then pays the inflation tax? The answer is holders of money.
- As prices rise, the real value of the money falls. Thus, inflation is like a tax on holding money.