Unit 7: Money, Banking and International Trade

[6 Hrs.]

Contents

- Concept and functions of money- value of money-money supply —components of money supply (M_1 and M_2)
- Inflation : Types, causes and effects of inflation
- Banking: role and functions of commercial banks , role and functions of central bank with reference to Nepal Rastra Bank.
- International Trade: Distinction between internal and international trade, balance of trade and balance of payment.

Concept of Barter System

- Direct exchange of goods against other goods. There are difficulties with this system:
  - Lack of Double Coincidence of Wants
  - Lack of Common Measure of Values
  - Problem in Sub-Division of Wants
  - Lack of Standard of Deferred Payments
  - Lack of Efficient Store of Value

Concepts of Money

- "Anything that is generally acceptable as a means of exchange and that at the same time acts as measure and a store of value."- Crowther
- "Money means all types of currency notes, postal orders, postal notes, money orders, cheques, drafts, traveler's cheques, Letter of Credit, Bills of Exchange, Promissory Notes and Credit Cards and the word also includes similar types of monetary instruments as the Bank (Nepal Rastra Bank) may prescribe, as per the requirement, through the publication and transmission of public notices."- Nepal Rastra Bank

Functions of Money

Primary Functions

- Money as a unit of account
- Money as a medium of exchange

Secondary Functions

- Money as a standard of Deferred Payments
- Money as a Store of Value
- Money as a means of Transferring Value

Contingent Functions

- Basis of Credit System
- Maximization of Satisfaction
- Distribution of National Income

Value of Money

- It means purchasing power of money.
- Refers to quantity of goods and services which a unit of money can buy.
- The greater amount of goods and services it can buy the more powerful or more valuable will be the money.
- "The purchasing power of money is the reciprocal of the level of prices so that the day of the purchased power of money is identical with the study of price level."- Irving Fisher

Standards of Value of Money

- Wholesale Standard
  - Value of money measured in terms of all goods that are transacted in wholesale markets.
- Retails Standard
  - Value of money measured in terms of retail prices at the end consumer level.
- Labour Standard
  - Value of money measured in terms of rates of wages payable to labour for a day's work.

Money Supply

- Currency and demand deposits held by the non-bank public.
- Does not include amount with banks and the government.
- **Classical economists-** money as exchange only. Currency with public for transaction.
- **Modern economists-** Money as a store of exchange and store of value. Includes, currency with public, demand deposits and time deposits.

Components of Money Supply

Narrow Money (M_1):

- It is the sum total of currency held by public (C) and demand deposit (DD) and other deposits at the bank.
  - $M_1 = C + DD + OD$

Broad Money (M_2):

- Sum total of narrow money (M1) and the time deposits (TD) held at commercial banks.
  - $M_2 = M_1 + TD$

Inflation

- **Classical View:** Inflation as a monetary phenomenon i.e. rising prices due to excess money supply. "Too much money chasing too few goods" - Coulborn.
- **Keynesian View:** When aggregate demand exceeds aggregate supply, inflation occurs.
  - Investment, employment, output and income increase with increase in price level. At full employment level, there is no further production, there is only increase in price.
  - As per Keynes, inflation occurs as a phenomenon of full employment.
- **Modern View:** Practical purpose, excess demand for investment as well as consumer goods over supply. When expansion in production is held back by some obstacles, inflation occurs.

Types of Inflation

On the Basis of Rate

- **Creeping:**
  - When price of goods and services **rises by 3%** or less in a year.
  - Consumers expect prices will keep rising so it boosts demand.
  - The increased demand boosts up production and economic growth.
- **Walking:**
  - When price of goods and services **rises by 3% to 10%** or in a year.
  - Can be harmful as producers cannot keep up to increased demand.
- **Galloping:**
  - When price of goods and services **rises by 10% or more** in a year.
  - Harmful to the economy.
- **Hyperinflation:**
  - When price of goods and services **rises by 50% or more in a month**.
  - Price changes even in few hours.It mainly occurs when government prints too much money.

Types of Inflation

On the Basis of Government Control:

- **Open Inflation:**
  - Free Market mechanism functions without government intervention.
  - If the price rises when there is no government control, it is open inflation.
  - The government and monetary authorities do no take any measure to spending of the people which may lead to hyperinflation. Germany 1920-23.
- **Suppressed Inflation:**
  - Government and monetary authorities do not allow the prices to rise to a high level.
  - If government imposes fiscal and monetary controls to check open inflation, it is suppress inflation.
  - Government checks on spending of people like price control and rationing of essential goods, control of investment, etc.
  - Viable when efforts are made to increase domestic production and reduce import demand by tariffs, import restrictions, limits on foreign loans, etc.
  - Price rises as production is low, higher unemployment, black marketing, corruption.

Causes of Inflation

- **Demand Raising Factors**
  - Increase in Money Supply
  - Increase in Government Expenditure
  - Increase in Private Investment
  - Increase in Population
  - Decrease in Tax Rate

- **Cost Raising or Supply Reducing Factors**
  - Increase in Wage Rate
  - Increase in Profit Margin
  - Scarcity of Inputs
  - Supply Shock
  - Higher Indirect Taxes (Tariffs, Excise Duty etc.)

Consequences or Effects of Inflation

1. Disrupts Price System
2. Reduces Saving
3. Reduces Production
4. Encourages Hoarding
5. Reduces Foreign Investment
6. Increase Inequality
7. Socio-Political Effects

Functions of Commercial Banks

- **Acceptance of Deposits from Public**
  - Demand Deposits
  - Fixed Deposits or Time Deposits
  - Saving Deposits
- **Advancing of Loans**
  - Overdrafts
  - Discounting Bill of Exchange
  - Direct Loans
  - Money at Call
- **Credit Creation**
  - Creates equal deposits when deposits loans
- **Agency Function**
  - Collects various credit instruments
  - Transfer funds
  - Standing instructions
  - Wills of customers
  - Customer Representative
- **General Utility Functions**
  - Locker facility
  - Traveller cheque
  - Letter of Credit
  - Underwrite Securities
  - Foreign Exchanges
  - Statistics and Data of Businesses
  - Ebanking

Functions of Central Bank/Nepal Rastra Bank.

Bank of Issue

- Legally can issue currency
- Considers: Uniformity, elastic and Security
- Inspire Public Confidence

Banker, Agent and Advisor to Government

- Maintains banking account of Government
- Loans and Treasury bill are issued after advice from Central Bank.
- Advises Government on important policy matters
- Representative of Government in Int'l financial matters.

Banker's Bank

- Custodian of Cash Reserves of Commercial Banks.
- Lender of the Last Resort
- Clearing Agent

Foreign Exchange Reserves

- Holds all foreign key currency like US dollar, British Pound, Gold stock etc.
- Maintains and stabilizes external value of home currency

Controller of Credit

- Controls overflow of credit which may lead to misuse
- Controls purchasing power of money

Development Functions

- Developing banking systems.
- Launch special financial programs
- Provides training to banking employees
- Maintains relations with int'l organizations like World Bank, IMF, ADB, etc.

Trade and its Types

- Trade means exchange of goods among people.
- Two types: Internal and International Trade
- **Internal trade** means to trade between regions within a country
- **International trade** means to trade between two nations or countries. Also called foreign trade.

Difference Betn Internal and International Trade

1. Factor Mobility
2. Different Currencies
3. Balance of Payment Problems
4. Different National Policies
5. Separate Markets
6. Different Political Units
7. Geographical Distance
8. Gains from Trade
9. Competition

Balance of Trade and Balance of Payment

- **Balance of Trade :** balance between exports and imports of visible items.
  - Visible items: recorded in customs.
- **Balance of Payment (BOP):** is systematic record of all visible and non-visible transactions.
  - It is systematic record of all economic transactions between one country and rest of the world.
  - Follows double entry book keeping system (Debit Credit)
  - Receipts on credit and payments on debit side.