Unit 6: Introduction to Money

Introduction

This unit provides an in-depth exploration of the concept of money, its nature, functions, and its significant role in the economy. Understanding money is crucial for grasping how economic systems function, as money plays a vital role in resource allocation and economic transactions.

6.1 Definition of Money

Economists define money as anything that is generally accepted in payment for goods and services or in the repayment of debts. In everyday life, when we talk about money, we often refer to currency—like cash in hand. However, money, in an economic sense, is much broader.

Characteristics of Money: For a commodity to function effectively as money, it must meet several criteria:

1. **Standardization**: Easily standardized so its value can be easily determined.
2. **Acceptability**: Widely accepted as a medium of exchange.
3. **Divisibility**: Divisible into smaller units to facilitate transactions.
4. **Portability**: Easy to carry and transfer.
5. **Durability**: Long-lasting and not prone to quick degradation.

Money, therefore, is a medium of economic exchange, a unit for expressing value, and a measure of wealth that circulates widely to facilitate trade.

6.2 Evolution of Money

Early Human Society: In ancient times, humans were self-sufficient, producing everything they needed. However, as society grew more complex, self-sufficiency gave way to **bartering**—the direct exchange of goods for goods.

Limitations of the Barter System:

1. **Lack of Double Coincidence of Wants**: Both parties needed to have what the other wanted.
2. **Lack of a Common Measure of Value**: No standardized way to measure the value of different goods.
3. **Indivisibility of Commodities**: Some goods couldn't be divided for exchange.

4. **Difficulty in Storing and Transferring Wealth**: Goods could spoil or be expensive to store and transport.
5. **Difficulty in Deferred Payments**: Problems arose in making payments over time due to fluctuating values.

History of Money:

- **Commodity Money**: Items like cattle, grain, or salt were initially used as money.
- **Metallic Money**: Coins made from precious metals began to be used.
- **Paper Currency**: Represented a promise to pay in metal coins, later evolving into fiat money, which has value because a government decrees it.
- **Checks and Electronic Payments**: Checks allowed for large transactions without carrying physical money, while electronic payments made transactions faster and more secure.

Ethiopia's Monetary History: In Ethiopia, various forms of money were used, including the **Maria Theresa Thaler**, salt bars, and eventually modern coins and paper money. Ethiopia began using its own coins during the Axumite Kingdom, with significant developments occurring under Menelik II and later with the introduction of the Ethiopian Birr in 1945.

6.3 Functions of Money

Money performs four basic functions in society, each crucial to economic operations.

1. **Medium of Exchange**:
   - Money is primarily used to pay for goods and services, making trade easier by eliminating the need for a direct exchange of goods.
2. **Unit of Account**:
   - Money provides a standard measure of value, simplifying the comparison of prices for different goods and services.
3. **Store of Value**:
   - Money allows individuals to save purchasing power for future use. Unlike other assets, money is highly liquid, meaning it can be easily converted into other forms of value.
4. **Standard of Deferred Payment**:
   - Money facilitates borrowing and lending by providing a means to settle debts over time, allowing resources to be reallocated efficiently within the economy.

6.4 Demand and Supply of Money

Demand for Money: Historically, the demand for money was linked to business transactions. Modern economics, influenced by John Maynard Keynes, views money demand as a preference for liquidity, driven by three motives:

1. **Transactional Motive**: The need for money to conduct everyday transactions.
2. **Precautionary Motive**: Holding money for unexpected needs.
3. **Speculative Motive**: Holding money to take advantage of future investment opportunities.

Supply of Money: The supply of money in an economy is typically controlled by central banks through various monetary policies that influence interest rates and inflation.

This summary provides an overview of the nature of money, its evolution, its functions, and the dynamics of money demand and supply in the economy. These concepts are fundamental to understanding how modern economies operate and how money facilitates economic activity.