



CHAPTER 2: DEMAND, SUPPLY AND MEASUREMENT OF MONEY

Understanding key concepts in
monetary economics

DEMAND FOR MONEY



CONCEPTS AND THEORIES OF MONEY DEMAND

Definition of Money Demand

Money demand is the desire to hold money for transactions, precaution, and speculative purposes.

Keynesian Motives

Keynes identified transaction, precautionary, and speculative motives for holding money.

Friedman's Quantity Theory

Friedman suggested money demand depends on permanent income and expected returns on assets.

MODELS AND DETERMINANTS OF MONEY DEMAND

Money Demand Models

The Cambridge Equation and Baumol-Tobin model explain money demand through income, price levels, interest, and transaction costs.

Key Determinants

Income, interest rates, inflation expectations, and financial innovation play essential roles in determining money demand.

Impact of Mobile Banking

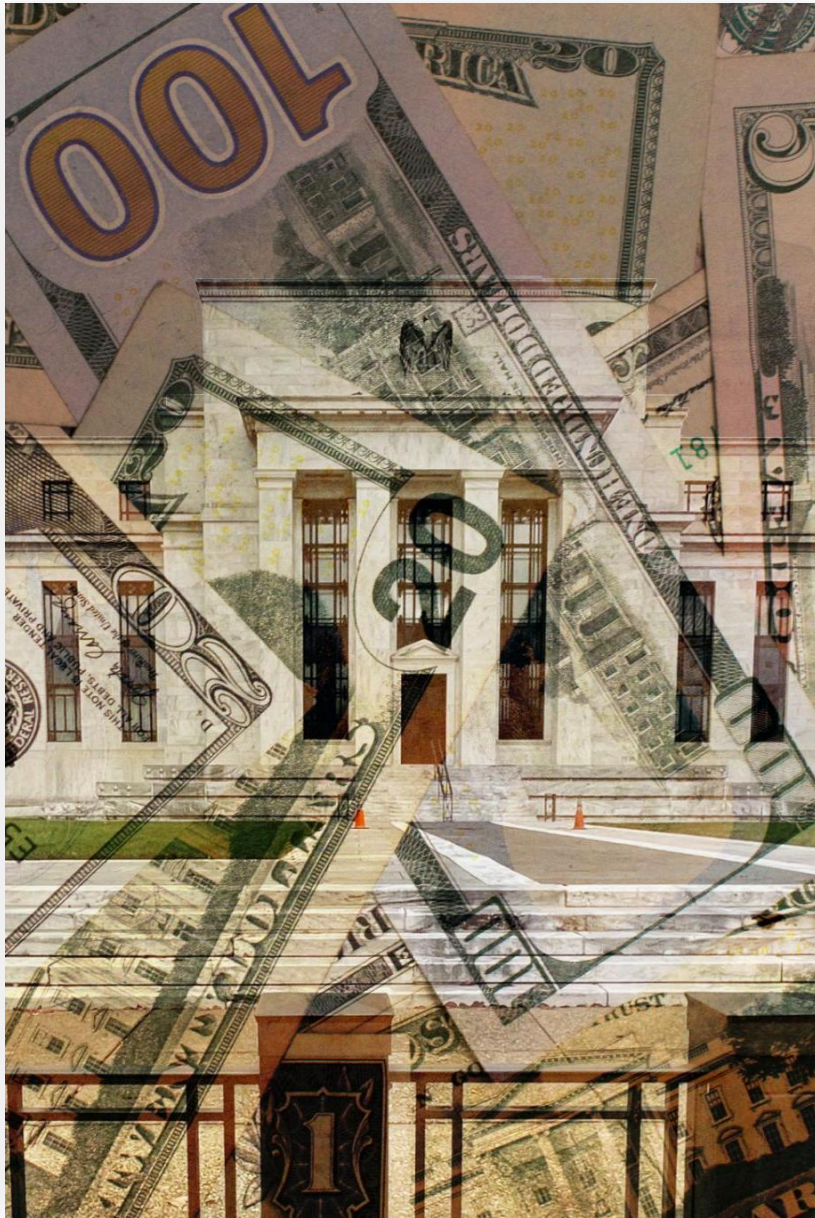
Mobile banking platforms like Telebirr reduce physical cash demand, reshaping money holding behaviors in Ethiopia.

Inflation and Transaction Motives

Inflation volatility affects speculative demand; rural and urban areas differ in transaction motives for holding money.



SUPPLY OF MONEY



DEFINITIONS AND SOURCES OF MONEY SUPPLY

Money Supply Definition

Money supply is the total money available in an economy, including currency and deposits.

Categories of Money Supply

Narrow money (M1) covers currency and demand deposits; broad money (M2, M3) includes savings and time deposits.

Sources of Money Supply

Central banks issue currency and regulate banks; commercial banks create money through credit expansion.

Ethiopia's Monetary Role

The National Bank of Ethiopia manages money supply via monetary policy and regulatory frameworks.

MONEY MULTIPLIER AND POLICY TOOLS

Money Multiplier Concept

The money multiplier shows how deposits increase the total money supply based on the reserve ratio.

Reserve Ratio Influence

The multiplier size depends on the reserve ratio set by central banks, influencing money creation.

Monetary Policy Tools

Central banks use tools like reserve requirements, open market operations, and discount rate adjustments.

Ethiopian Central Bank Practices

Ethiopia's National Bank uses treasury bills and reserves to manage liquidity and support stability.



VELOCITY OF CIRCULATION OF MONEY



CONCEPT AND FORMULA OF VELOCITY

Definition of Velocity

Velocity of money shows how often money changes hands within an economy over a period.

Velocity Formula

Velocity is calculated as $V = PY / M$, involving price level, real output, and money supply.

Economic Impact

Higher velocity indicates active transactions; lower velocity suggests slow economic activity.

Influencing Factors

Technological advances, consumer confidence, and payment efficiency affect velocity of money.



ETHIOPIAN CONTEXT OF VELOCITY

Cash-Based Transactions

Cash remains the dominant payment method in Ethiopia, impacting the speed of money circulation across the economy.

Digital Payment Adoption

Mobile money platforms and point-of-sale terminals are growing, especially in Addis Ababa, increasing transaction velocity.

Seasonal Agricultural Impact

Agricultural cycles cause fluctuations in transaction frequency, with peaks during harvest and market periods.

VALUE OF MONEY



CONCEPT AND HISTORICAL CONTEXT

Purchasing Power Dynamics

The value of money inversely relates to price levels, affecting its purchasing power over time.

Historical Commodity Standards

Money historically was backed by commodities like gold and silver, providing economic stability.

Modern Fiat Money

Today's economies use fiat money, valued by government support rather than intrinsic material worth.

Economic and Policy Implications

Understanding money's value influences inflation control, savings, investment, and policy decisions.



ETHIOPIAN CONTEXT OF MONEY VALUE

Inflation and Currency Depreciation

Inflation and depreciation reduce the Ethiopian Birr's purchasing power, especially for essential goods and services.

Transition to Fiat Currency

Ethiopia shifted from commodity-based systems to fiat currency, increasing the National Bank's role in monetary stability.

Impact on Living Costs

Currency fluctuations affect import prices and living costs, influencing economic conditions for citizens.

Monetary Policy Importance

Effective monetary policy is crucial to preserving money value and supporting Ethiopia's economic development.

MEASUREMENT OF CHANGES IN THE VALUE OF MONEY



PRICE INDICES AND INFLATION TYPES

Price Indices Overview

Price indices like CPI, WPI, and GDP deflator measure average price changes in goods and services over time.

Demand-Pull Inflation

Demand-pull inflation occurs when excess demand in the economy drives prices higher.

Cost-Push Inflation

Cost-push inflation is driven by rising costs of production, pushing prices up.

Importance of Inflation Measurement

Accurate inflation measurement supports economic planning, wage adjustments, and informed policy decisions.



ETHIOPIAN CONTEXT OF MEASUREMENT

Monthly CPI Publication

Ethiopia's Central Statistics Agency releases the Consumer Price Index monthly, tracking inflation trends accurately.

Major Inflation Contributors

Food and transportation heavily influence inflation, reflecting their importance in Ethiopian household spending.

Economic Impact of Inflation

Rising inflation affects savings, investments, and income distribution across Ethiopian households.

Policy Responses

Policymakers adjust interest rates and public spending to stabilize the economy and protect consumers.

MONETARY STANDARD



TYPES AND EVOLUTION OF MONETARY STANDARDS

Metallic Monetary Standards

Gold and silver standards provided intrinsic value and long-term currency stability historically.

Bretton Woods System

Introduced fixed exchange rates backed by gold, shaping international currency relations until 1971.

Fiat Money System

Currency backed by government authority, providing flexibility in monetary policy and economic responses.

Central Banks' Role

Central banks maintain currency stability and implement policies reflecting monetary standard evolution.



ETHIOPIAN CONTEXT OF MONETARY STANDARD

Fiat Monetary Standard

Ethiopia uses a fiat monetary system with the Ethiopian Birr regulated by the National Bank of Ethiopia.

Monetary Policy Goals

The central bank focuses on price stability, economic growth support, and currency stability through monetary policy.

Monetary Challenges

Challenges include inflation control, exchange rate management, and promoting financial inclusion across Ethiopia.

Policy Effectiveness

Effectiveness relies on sound implementation and responses to domestic and global economic pressures.