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MONEY, INFLATION, BANKING AND INTERNATIONAL TRADE

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CONCEPT OF BARTER EXCHANGE SYSTEM

- In the beginning days of mankind, people's wants were limited, they just had to focus their attention for their food and shelter. They had to fulfill their demand themselves, they weren't dependent to other persons.
- As time passed, their wants increased and their self-sufficiency disappeared. They started to produce one goods and started to exchange with their neighbors for other goods directly. This type of direct transaction of goods versus goods without using money is called barter system.
- Still in rural areas, we can find some examples of barter system. But, in the urban areas, we can't think the life without money i.e. barter system is almost wiped by monetized system.

DIFFICULTIES OF BARTER EXCHANGE SYSTEM

- Double coincidence of wants is required for transactions.
- Difficulty of sub division.
- No standard common measure of value.
- Lack of store of value.
- Difficulty of transfer of value.
- Difficulty of future payments.
- Limited market.

MEANING OF MONEY

- 'A money is that what money does' - **Prof. Walker**
- Conceptually, any commodity that functions as a medium of exchange and measures the value is money.
- In other words, money is any object that is generally accepted as payment for goods and services and repayment of debts in a given country or socio-economic context.
- It circulates from person to person and country to country, facilitating trade, and it also measures of wealth.
- Due to the problems of uniformity, homogeneity, standard size and weight, durability and storability, portability, stability in value and divisibility in barter system, the money is produced.

FORMS/ KINDS OF MONEY

1. **Commodity money** (animal leather, bones during the hunting age, cattle during the pastoral age, grains during the agricultural age)
2. Metallic money (money made up of metals)

a. Standard or full bodied coin (Gold or Silver coin with definite weight and purity)
b. Token money (made with inferior metals like copper, aluminum. Higher face value with than the intrinsic value)

3. Paper money (Money made up with the paper)

a. Representative paper money (fully backed up by the gold and silver)
b. Convertible paper money (Assurance of convertibility with reserved gold and silver, represents gold and silver but less than the value of note issued)
c. Inconvertible paper money (Not convertibility with reserved gold and silver, backed by some reserve of gold, silver, government securities, bond, treasury bills etc.)
d. Fiat money (crisis money, no reserve behind the fiat paper money)

4. Bank or credit money (Cheque, bank draft, traveler's cheque, bill of exchange, promissory notes, credit card etc.)

FUNCTIONS OF MONEY

The functions of money can be classified as follows:

1. **Primary function.**

a. Medium of exchange.

b. Measurement of value.

2. **Secondary function.**

a. Store of value.

b. Transfer of value.

c. Standard of deferred(future) payment.

3. **Contingent function.**

a. Basis of credit.

b. Distribution of national income.

c. Liquidity and uniformity of wealth.

VALUE OF MONEY

- The value of money is the amount of goods that can be purchased for one unit of money. Therefore the value of money is its purchasing power.
- The quantity theory of money is the first theory that explains the value of money, was propounded by Davanzatti and further developed and explained by American economist as well Prof. Irving Fisher in 1911 AD.
- According to Fisher, "Other things being equal, as quantity of money in circulation increases, the price level also increases in direct proportion and the value of money decreases and vice versa.
- It means when quantity of money supply in economy is doubled, the price level also be doubled and the value of money is halved.

- **The Fisher's equation of quantity theory of money is;**

$$MV = PT$$

Where, M= total money in circulation

P = Price level

V = Velocity of money

T = Total volume of trade

The above equation can be expressed as

$$P = \frac{MV}{T}$$

This equation measures the price level and value of money.

Where, value of money $(VM = \frac{1}{P})$

Later Fisher modified his equation by adding bank money in supply side and equation becomes, $MV + m'v' = PT$

Or $P = \frac{MV + m'v'}{T}$

Where m' is volume of bank money and v' is velocity of bank money.

Numerical example

Quantity of money (M) = 1000

Velocity of money (V) = 20

Total volume of trade (T) = 10000

Hence, $P = \frac{MV}{T} = \frac{1000 \times 20}{1000} = Rs. 2$

Value of money VM $= \frac{1}{P}$ or =1/2 = 0.5

Let us suppose, the quantity of money has increased by 2 times & becomes Rs 2000 and there is no change in velocity of money and total volume of trade, then

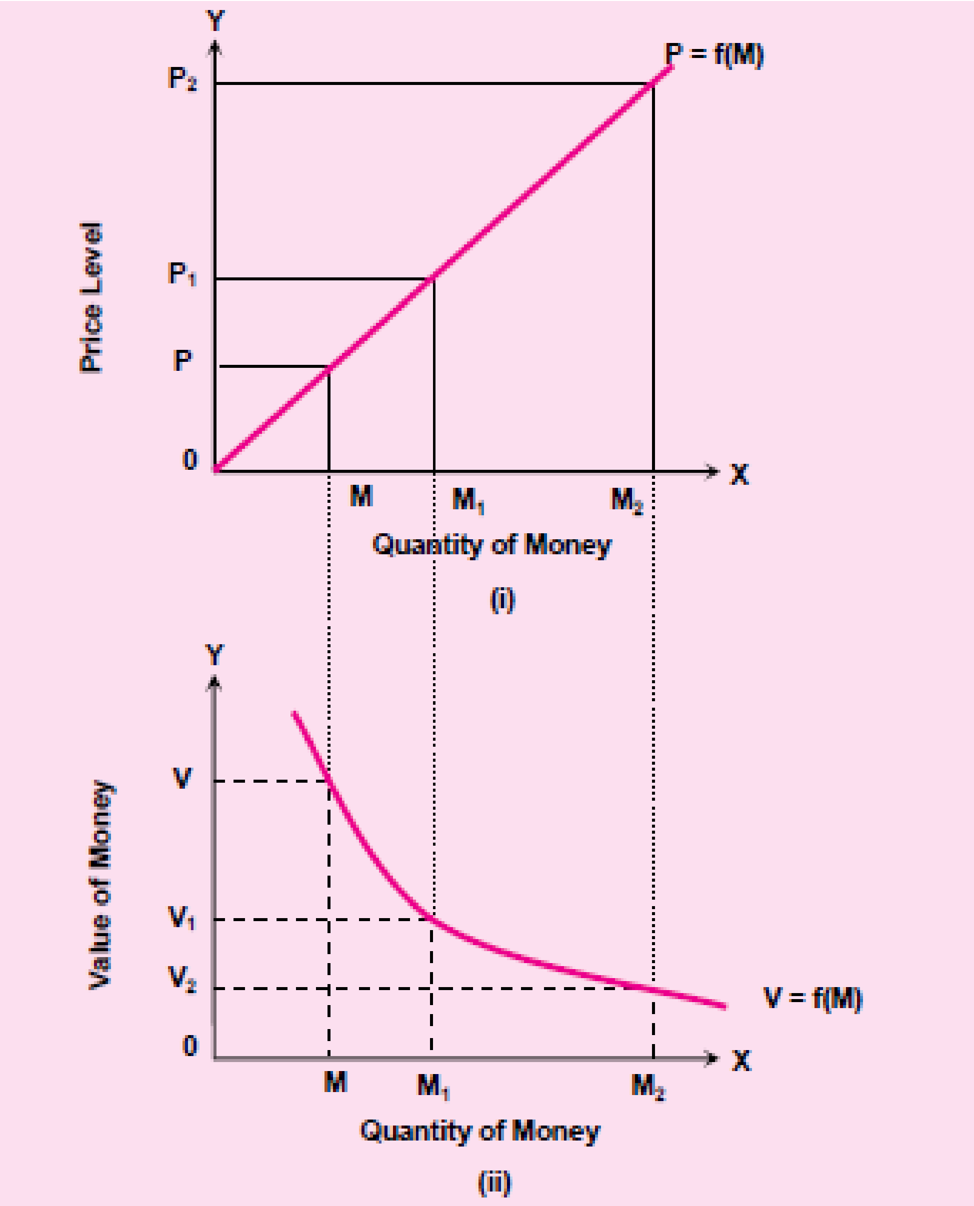
$$P = \frac{MV}{T} = \frac{2000 \times 20}{1000} = Rs. 4$$

VM=1/P = ¼ = 0.25

It proves that when the supply of money increases the price level also increases and as a result, value of money declines and vice versa.

Graphical Illustration

- In the upper panel of figure, quantity of money and price level are measured in X axis and Y axis respectively. When the quantity of money is OM, the price level is OP. when the quantity of money increases to OM_1 and OM_2, the price level increases to OP_1 to OP_2 respectively. The upward sloping straight line shows the direct and proportional relationship between quantity of money and price level.
- In the lower panel, quantity of money and value of money are measured in X axis and Y axis respectively. When the quantity of money is OM, the value of money is OV. Similarly, when the quantity of money increases to OM_1 and OM_2, the value of money decreases to OV_1 and OV_2 respectively. The downward sloping V =f(M) shows the negative relationship between the quantity of money and the value of money.



DETERMINANTS OF VALUE OF MONEY

- Reserve of foreign currencies, valuable assets i,e. Gold, silver etc.
- Supply and demand of money
- Velocity of Money
- Capital flow inside the country
- Inflation rate
- Interest rate
- Credit and worthy ness
- Intrinsic value

MONEY SUPPLY

- Money Supply is the amount of money which is produced by central monetary authority i.e, central bank, in a certain period of time. Theoretically, money supply is taken as exogenously determined variable but in practice, it is behavioral variable which is determined by the behavior of the people, banks, central bank etc. If money supply is analyzed at a particular moment of time, it is stock concept and if it is viewed over a period of time, it is flow concept.

TYPE OF MONEY SUPPLY

Type of money supply may be varied from economy to economy. There are three types of money supply in Nepal. They are discussed below:

1. Narrow money (M1):

- It is the sum of currency held by public, demand deposit held at commercial banks including other deposits held at central bank.

Symbolically, $M_1 = C + DD$

Where, C = currency held by public

DD = demand deposit at commercial bank

(Including other deposit held at central bank)

2. Broad money (M2):

It includes narrow money (M1) and money in time deposit. Symbolically,

$M2 = M1 + TD$

Or, $M2 = C + DD + TD$

Where, M1= narrow money supply

M2= Broad money supply

TD= Time deposit

3. Reserve money (M3 or M0 or, RM)

The total money supplied by the central bank is known as Reserve money. In other words, the entire monetary structure of an economy is called Reserve Money. It includes currency in circulation, bankers deposit with central bank, cash held by commercial bank and other deposit held at central bank.

RM (M0 or M3) = currency in circulation+ Banker's deposit with central bank + cash in vault of commercial bank + other deposits at central bank

INFLATION

- Inflation is defined as the continuous, sustained and persistent rise in the general price level (prices of entire goods and services in the economy).
- During inflation, the purchasing power of money or the value of money falls because there is an inverse relationship between the general price level and the value of money. It is usually measured as a percent per unit of time, say, a year or a month etc.

Features

1. Inflation is the real rise in the general price level.
2. Inflation is a monetary phenomenon and is generally caused by excessive money supply.
3. Inflation is not a temporary fluctuation but is a sustained and appreciable rise in the price level.
4. Inflation is not the increase in the individual prices but the increase in the general price level.

TYPES OF INFLATION

1. On the basis of speed.

a. Creeping inflation (Price rise up to 3% annually)

b. Walking inflation (Price rise from 3% to 7% or single digit)

c. Running inflation (Price rise from 10% to 20% per annum)

d. Hyper inflation (Price rise from 20% to 100% or even more price rise in a year)

2. On the basis of cause.

a. Demand-pull inflation (Due to excessive increase in aggregate demand over supply).

b. Cost-push inflation (Increase in cost of production, price of factors of production).

Demand-Pull Inflation

- When the aggregate or total demand for goods and services exceeds over aggregate supply of goods and services in an economy, the general price level rises, which is known as the demand-pull inflation.
- The causes of demand-pull inflation are as follows:

1. Increase in money supply and bank credit.
2. Increase in public expenditure.
3. Increase in private expenditure.
4. Reduction in taxation.
5. Increase in export.
6. Repayment of past internal debts.
7. Rapid growth of population.

Cost-push Inflation

- When the cost of production increases, the general price level rises, which is known as the cost-push inflation.
- The causes of cost-push inflation are as follows:

1. Increase in wage rate.
2. Increase in profit margins.
3. Increase in the price of key materials.
4. Shortage of raw materials.
5. Natural calamities and disaster.
6. Unfavourable monsoon .
7. Increase in interest rate etc.

CONSEQUENCES/ EFFECT OF INFLATION

1. **Economic effects**
   a. Effect on production (+ve)
   b. Effect on economic growth (+ve)
   c. Effect on employment (+ve)
   d. Effect on distribution (+ve)
2. **Non–Economic Effects**
   a. Social effects
   b. Moral effects
   c. Political effects

BANK

- A bank is an institution which deals with money and credit. It accepts deposits from the public, makes funds available to those who need them. In fact, a modern bank performs such a variety of functions that it is difficult to give a precise and general definition of it.
- Bank is an institution which buys money, sales money and produce money.

Features

- It deals with money.
- It accepts deposits and advances loans.
- It deals with credit and it has ability to create credit.
- Profit oriented.
- It manages (monetised) the payment system in the economy.

IMPORTANCE OF BANK

1. Capital formation
2. Monetization of the economy
3. Promotion of employment
4. Upliftment of the poorer
5. Promotion of entrepreneurship
6. Rapid economic growth

CLASSIFICATION OF BANK

On the basis of their functions, ownership, and purposes of establishment, banks can be classified as follows.

- Central bank
- Commercial banks
- Development banks

Central Bank

Central bank is the guardian of entire banking system, which manages the money supply, issues notes and controls credit.

Nepal Rastra Bank is the central bank of Nepal. It was established on April 26, 1956 (2013 B.S.) under the NRB Act 1955 (2012 B.S.). It started issuing currency notes in 1959 (2016).

Functions of Central Bank

1. Monopoly of note issue and currency.
2. Government's bank.
3. Bankers' bank.
4. Lender of the last resort.
5. Clearing house function.
6. Control of credit.
7. Custodian of valuable metals, reserve and international currency.
8. Development functions.

Commercial Bank

- Commercial bank is a financial institution which accepts deposits from the public, makes the funds available to those who need them. Generally it is established to promote trade and commerce.
- Nepal Bank Ltd. is the first commercial bank of Nepal. Now, there are 20 commercial banks in Nepal.

Functions of Bank

1. Primary Functions

a. Accepting Deposits
b. Providing Loans

2. Secondary Functions

a. Remittance of money
b. Collection and payment of credit instruments
c. Purchase and sale of securities
d. Income receiving and payments
e. Acting as trustee and executor

3. Contingent Functions

a. Locker facility
b. Traveller's cheque
c. Letter of credit
d. Dealing with foreign exchange
e. Collection of statistics

Development Bank

- Development bank is the specialized financial institution established to promote and develop a particular sector of the economy such as tourism, agriculture, infrastructure, industry and so on.
- In Nepal the function of development bank are quite similar with the commercial bank.

INTERNATIONAL TRADE

- International trade or foreign trade is the sale and the purchase of goods and services between the people of different countries. It involves export and import. International trade is also known as the foreign trade or external trade. It includes export and import of goods and services among the countries. Export refers to the selling of goods and services by one country to another country whereas import is the buying or purchase of goods and services by a country from another country.

IMPORTANCE OF INTERNATIONAL TRADE

- Availability of quality and cheaper goods at local market.
- Helpful for agricultural development.
- Helpful for industrial development.
- Development of competitive capacity in the economy.
- Modern and high standard of living.
- Increase in employment opportunities
- Increase in government revenue
- Expansion of market
- Benefit of technological progress

CONCEPT OF BALANCE OF TRADE

- Balance of trade is defined as the difference between the value of export and import physical goods of a country.

Features of Balance of Trade

The features of balance of trade are as follows:

1. The elements of balance of trade are export and import.
2. It includes only visible goods.
3. Non-material or invisible goods or services are not included in the balance of trade.

TYPES OF BALANCE OF TRADE

1. **Trade surplus**

   Trade surplus $\Rightarrow$ Export (X) > Import (M)

2. **Trade deficit**

   Trade Deficit $\Rightarrow$ Export (X) < Import (M)

3. **Balanced trade balance**

   Balanced Trade Balance $\Rightarrow$ Export (X) = Import (M)

CONCEPT OF BALANCE OF PAYMENT

Balance of payment is defined as the systematic record of receipt and payment of a country with the rest of the world.

- It includes all the transactions (i.e. Visible and invisible)
- It is annual statement
- It adopts double entry book keeping system
- It includes all the capital flows

TYPES OF BALANCE OF PAYMENT

There are two types of balance of payment account which are as follows:

1. **Favourable balance of payment**

Favourable Balance of Payment $\Rightarrow$ Total Receipts > Total Payments

2. **Unfavourable balance of payment**

Unfavourable Balance of Payment $\Rightarrow$ Total Receipts < Total Payments

Structure or Components of Balance of Payment

1. Current account
2. Capital account
3. Cash account

CONCEPT OF BALANCE OF PAYMENT CONTD.

1. Current account

- It is the current transaction of a country with other countries.
- It includes the transaction of various items like the value of export and import of goods and services, expenses on travels, transport and communication, payment of premium to the insurance companies, income received from investment, net remittances and transfers, etc. of a country with the rest of the world.
- If the balance is positive, it is called surplus and if it is negative, it is known as deficit.

2. Capital account

- It is related to the transaction of capital.
- It is the record of the exchange of financial assets.
- It indicates the inflow and the outflow of capital of a country with other countries.
- If the inflow of capital is more than outflow, the balance is surplus and if the outflow is more, it becomes deficit.
- Examples: Borrowing and lending of capital, repayment of capital,

CONCEPT OF BALANCE OF PAYMENT CONTD.

3. Cash account

- It is the record of foreign exchange reserve.
- When the current and capital accounts are positive, the cash reserve of foreign exchange increases.
- When there is deficit in current and capital accounts, the foreign currency reserve decreases.

IMPORTANCE OF BALANCE OF PAYMENT

The uses or importance of balance of payment can be pointed as follows:

- It measures the performance of the economy.
- It shows expenses made on imported goods and services.
- It shows foreign currency entering the country and going out of the country.
- It evaluates the success of the country in exporting goods and services to foreign countries.
- It helps to compare the entire transactions of an economy with other economies of the world.
- It is useful to formulate & implement economic policies like exchange rate policy, fiscal policy, monetary policy, etc.


Any
Questions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