CHAPTER 12 Money

INTRODUCTION

Money plays an important role in any economy in the world. Without money, economic activities would be very cumbersome (i.e. very difficult).
The special features of modern money make it superior to the barter system where goods were exchanged for goods. In this chapter, we shall discuss the various characteristics of money, the demand and supply of money, the quantity theory of money as well as the determinants of money supply in an economy among other issues relating to money.

OBJECTIVES

At the end of the chapter, students should be able to:

- ◆ Define money;
- ◆ List and explain features of money;
- ◆ Define demand for money and supply of money;
- ◆ Explain reasons for holding cash;
- ◆ List factors affecting money supply.

12.1 Definition of Money

Money is any object that is generally accepted as payment for goods and services and repayment of debts in a given country. It is a legal tender that is used in transaction as a means of payment, medium of exchange, store of value and means of value.

12.2 Features of Money

a. **General Acceptability:** Before anything can be considered as money, it must be generally acceptable to all the people in the society or country as a medium of transaction. This means that the people must have confidence in it.
b. **Portability:** Another quality of money is that it must be something that can be carried about from one place to another. This means that it must be light in weight.
c. **Absolute Homogeneity:** The article considered as money must be the same in size, colour and quality in every part of the country before it can be accepted for transaction and as a medium of exchange.
d. **Divisibility:** It must be capable of being divided into smaller units e.g. N1000, N500, N200, N100, N50, etc so that it can purchase both high and low priced commodity.
e. **Relatively Scarce:** The value of anything called money is in its scarcity. So, money must not be abundantly supplied in order not to lose its value. What serves as money must not be easily reproduced by people and should be relatively scarce.
f. **Recognizability:** What serves as money must be recognized by the totality of people in the society. It must be easy for people to identify counterfeit ones.
g. **Durability:** The article that will serve as money must last long. This distinguishes money system from barter trade system where commodity

that is to be exchanged is perishable.

h. **Stability:** The value of money must be stable. The stability of money will help in making prediction in business and encourage lending and borrowing of money.

i. **Malleability:** Before any article can be recognized as money, it must be signed, stamped and designed to show its value and origin.

j. **No Intrinsic Value:** The commodity that will serve as money should have little or no value in itself as opposed to its value of exchange. Money therefore should be wanted not because of its face value but as a medium of exchange.

12.3 Functions of Money

a. **Mediums of Exchange:** When money is used as a means of exchange for goods and services, it is performing a function. It thereby avoids the inefficiencies of a barter system, such as the 'double coincidence of wants.

b. **Units of Account:** Money serves as a unit of account when it becomes possible for individuals, companies and government agencies to keep accounting record of their transactions in bank statements, ledgers and invoices.

c. **Stores of Value:** Money is used in storing wealth for present and future use, unless there is inflation when the value of money is depleted. The value of the money must also remain stable over time.

d. **Standards of Deferred Payment:** Since money can be stored, it can be accumulated to settle debts that are fixed in terms of money. The use of money makes it possible for postponement of payment to a future date. When debts are denominated in money, the real value of debts may change due to inflation and deflation.

e. **Commands of Variety:** With the use of money, varieties of wants are made. The existence of money encourages large quantity and variety purchases of goods and services.

f. **Measures of Value:** With money, the value of goods and service can be measured in term of price. This means that money provides yardstick for quantifying goods and services, and it helps us to compare commodities with prices.

12.4 Demand and Supply of Money

12.4.1 Demand for Money

The Demand for money means the quantity of money that an individual wishes to have at a particular time. It also means the desire to hold money in liquid cash for various reasons. Money is held with the aim of meeting financial challenges. In economics, the demand for money is known as liquidity preference.

12.4.2 Supply of Money

The supply of money refers to the total quantity of all forms of money in circulation available for use in the economy at a given period of time. The supply of money includes the total bank deposit, bank notes and coins circulating outside the banking system, as well as the bank deposits in current accounts, which can be withdrawn by cheque. In the developed countries like Australia, Canada, Britain and so on, more than 75% of their money is in bank deposits. The reason for Nigerian's poor use of bank deposits is not unconnected with the following:

i. Poor banking habits

ii. Lack of public confidence in the banks
iii. Inefficiency of our banking system
iv. Dishonesty among the people that give rise to issuing of bounced cheques, and so on.

12.5 Motives for Holding Money

a. **Transactional Motive:** People desire to hold and keep money for their day-to-day transactions such as buying shares and other daily family needs. The amount to be kept is determined by the income received and extent of ones needs.
b. **Speculative Motive:** People keep money with the aim of investing it in money-return ventures. For instance, money may be held with the hope of giving it out in form of loan if the rate of interest is high and at a short period of time, buying bonds with the view of earning dividend. The demand for money in this respect is elastic.
c. **Precautionary Motive:** This is when people demand for money in order to meet up with unforeseen circumstances or unexpected expenditures. These unforeseen circumstances may include sickness, unexpected visitors, breakdown or computer hard disk crashing, etc.

Due to uncertainties in life, people hold money against future emergencies that may require monetary expenditures.

12.6 Quantity Theory of Money

The quantity theory of money is the relationship between the quantity of money in circulation and the price level. The quantity theory of money explains what happens when there is imbalance between the supply of money and the demand for money by the households and firms. This theory says further that there would be a proportionate rise in the price of goods and services if there is an increase in the quantity of money in circulation. If people hold more money than they require (that is, if there is an excess supply of money in terms of increment in salary over demand), they will spend the surplus on currently produced goods and services. This will increase the price level.
Professor Irving Fisher was a renowned professor who propagates a concept known as the Velocity of Circulation of Money. The velocity of circulation of money refers to the rate at which money changes hands in the economy. This concept talks about how money circulates within the economy by changing from one hand to another. When there is an increase in the velocity of circulation of money, prices will increase leading to a lower value of money. For instance, assuming Garba who is a café manager paid N15,000 to Chinedu who is a teacher of his ward, and Chinedu spent the money on WAEC forms for his brother in-law from Joint Coaching Classes (JCC) while JCC used the same amount in paying his class rent from Oluomooba Estate agency. We can say that the N15,000 has done the work of N45,000 worth of transactions. The number of times that money changes hand over a period is what is called the velocity of circulation of money. In our example, the velocity of circulation of money is four times.
The quantity theory of money modified by Fisher is expressed in what is known as the quantity equation of exchange and is represented by this equation:
$MV = PT$
where M = Supply of money
V = Velocity of circulation of money
P = price level
T = Quantity of goods.

From the above quantity equation of exchange, we can conclude that the value of money and the price can be influenced by the following:
1. The quantity of money in circulation.
2. The rate at which money circulates that is, velocity of circulation of money.
3. The output of goods and services.
Meanwhile, it is possible for an increase in the velocity of circulation to cause increase in prices without any change in the quantity of money.
On the other hand, an increase in the quantity of money might not lead to an increase in prices if such increase corresponds with increase in output of goods and services.

12.7 Determinants of the Supply of Money

a. **The Central Bank Total Reserves:** The central bank total reserves affect the supply of money in a country. If the money supplied by the central bank is high, more money will be in circulation and vice versa.
b. **Demand for Excess Reserve:** The supply of money will increase when commercial banks demand for excess reserve and vice versa.
c. **The Bank Rate:** Bank rate is the rate of interest the central bank charges the commercial banks and other financial institutions for lending money to or borrowing from them and discounting their bills. If the bank rate is high, it will discourage financial institutions to borrow and discounting of their bills will be affected which will affect supply of money.
d. **Cash Reserve:** This is also known as Cash Ratio. It is the percentage of the deposits commercial banks are expected to keep with them. The higher the cash reserve, the lower the money supplied, while the lower the cash reserve, the higher the supply of money.
e. **Economic Situation:** At the period of inflation, the central bank withdraws cash from the circulation, while during the deflation, the supply of money to the economy is increased.

12.8 How Changes in Price affects the Purchasing Power of Money

Periods of rising prices are generally periods of business prosperity and of “good times” to the community as a whole. With a rise in prices business profits tend to increase and a general feeling of confidence spreads.
Confidence in the safety and profit of business ventures extends resulting in a larger production of wealth and an increase in the purchasing power.
However, at such times, there is grave danger that business confidence may lead to production beyond the normal needs of consumers and to an era of speculation that may result in a business crisis.
On the other hand, when prices are falling, i.e. when the value of money is rising, business is depressed and sluggish. The effect of falling prices generally follows the same order of progression from one economic group to another as was noted in the case of rising prices. If the supply of money does not keep pace with the demand, bank reserves are reduced, loans are called and interest rates, especially on call loans, tend to stiff en.
Dealers in stocks and bonds and speculative commodities begin to sell their holdings at a sacrifice. Lack of confidence and uncertainty spread to general businesses, sales of manufactured products begin to fall, buying of raw materials slackens, profits decline, and people begin to talk of the “hard times.” In periods of falling prices the wage-earner and the salaried man seem to be benefited because their wages are the last to fall. This benefit, however, is more apparent than real, because when industries slackens, great numbers of laborers are laid off .

Changes in the purchasing power of money affect all economic classes: wage-earners, capitalists and enterprises, producers and consumers, speculators and investors. The most marked effect of such changes can be seen between the debtor and creditor classes. It is generally understood that a fall in prices or a rise in the purchasing power of money benefits the creditor, while a rise in prices benefits the debtor.
When prices fall between the time of incurring a debt and the time for paying it, the debtor upon returning the amount of money borrowed has to return a larger amount of goods; when prices rise the debtor returns less in the way of goods.

Summary

This chapter has discussed:

- Money which is anything that is generally accepted as a means of payment for goods and services. The various features of money include general acceptability, portability, homogeneity, divisibility, scarcity etc.
- Demand for money which is the amount of money people are willing to hold without investing it. It is also known as liquidity preference. People hold money for transactional purpose, speculative purpose and precautionary motives.
- The supply of money which is the total quantity available in an economy for a given period of time. The main determinants of the supply of money are the central bank total reserves, demands for excess reserves, bank rates, cash reserves and economic situation.

Class Activity

Students should organize a debate on the need for government to keep eyes on the quantity of money in the circulation or not.

Revision Questions

Objective Questions

1. Money supply at any given point in time means:
(a) Bank notes, coins and demand deposits
(b) Notes and coins only
(c) Minted money
(d) Hoarded money
(e) Money received as gifts **(SSCE 1989)**
2. Which of the following is a reason for holding money instead of investing it?
(i) Transactional motive (ii) precautionary motive (iii) Speculative motive (iv) liquidity motive
(a) (i) and (ii) only
(b) (i) and (iii)
(c) (i), (ii) and (iii) only
(d) (i), (ii) and (iv) only
(e) (ii), (iii) and (iv) only **(SSCE 1990)**
3. Which of the following is a function of money?
(a) Portable
(b) A standard of deferred payment
(c) Relatively stable in value
(d) Generally acceptable
(e) Easily divisible item

4. Money becomes a very poor store of value in a period of?
(a) Deflation
(b) Depression
(c) Recession
(d) Inflation **(SSCE 2003)**
5. The motive for holding money for investing in securities is referred to as?
(a) Transactionary
(b) Speculative
(c) Accumulation
(d) Deflationary **(SSCE 2006)**

Essay Questions

1. (a) Discuss the quantity theory of money and its effects on economic activities.
(b) Why do people usually hold money in physical or liquid without investing it?
2. (a) What is:
(i) commodity money? **(ii)** token money
(iii) fiduciary issue **(iv)** quasi money
(b) State any **four** functions of money
3. (a) Explain:
(i) supply of money
(ii) value of money
(b) Highlight three motives for holding money **(SSCE 2007)**
4. (a) Explain the function of money as a:
(i) measure of value
(ii) store of value
(b) Show how inflation affects these two functions of money **(SSCE 2010)**

Glossary

Money: It is any object that is generally accepted as payment for goods and services and repayment of debts in a given country.
Malleability: This is a situation where any item recognized as money, must be signed, stamped and designed to show its value and origin.
Transactional Motives for holding money: It is the desire to hold and keep money for their day-to-day transactions such as buying shares and other daily family needs.
Speculative Motives for holding money: People keep money with the aim of investing it in money-return ventures.
Cash Reserve: This is also known as Cash Ratio. It is the percentage of the deposits commercial banks are expected to keep with them.
Demand for money: The keep or holding of money in cash form without investing it.
Supply of money: The total volume of money available in an economy at specific period.