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Barter System/ Barter Exchange System:

In the beginning of civilization, human needs were simple and limited. People used to exchange goods with each other to satisfy their wants. Barter exchange refers to eh exchange of goods for goods.

example: When a farmer gives wheat and gets cloth from the weaver in return, it is known as barter system.

⇒ An economy, where there is a direct barter of goods and services, is called Barter Economy or C-C Economy.

Barter System can work where there exists "Double Coincidence of Wants":

"Double Coincidence of wants" refers to the simultaneous fulfillment of mutual wants of buyers and sellers. In the above example, want for clothing by the farmer coincides with the weaver for wheat. However, it is very difficult to find double coincidence of wants in real life. It leads to huge "Trading Costs". With rise in economic activities, the exchange through barter become more difficult and complicated.

Inconvinence faced during Barter system:

1) Lack of double coincidence of Wants: Barter system only works only when both buyer and seller are ready to exchange each other's goods.

2) Lack of Common measure of value: In barter system, all commodities are not of equal value and there is no common measure (unit) of value of goods & services, in which exchange ratios can be expressed. Barter system can work with few commodities in the primitive society. However, it is very difficult in the modern economy, where we need millions of exchange ratios for a large number of goods and services.

3) Lack of Standard of Deferred Payment:
⇒ The borrower may not be able to arrange goods of exactly same quality at the time of repayment.
⇒ There may be conflicts regarding which specific commodity to be used for repayment.
⇒ The commodity to be repaid may lose or gain its value at the time of repayment.

4) Lack of Store of value:
⇒ Most of the goods do not possess durability; their quality deteriorates with passage of time.
⇒ Storage of goods requires time & effort.

Money:

The money came into existence to overcome the drawbacks of the barter system. Earlier, people use to exchange goods and services as a form of commerce.

Definition ⇒ A medium of exchange that is centralized, generally accepted, recognized, and facilitates transactions of goods and services and is called money.

⇒ Money is a medium of exchange of various goods and services in an economy.

⇒ The money system varies with the governments and countries.

⇒ Different countries have different currencies.

⇒ The central authority is responsible for monitoring the monetary system.

Characteristics of Money:

i) Durable: A good currency is durable enough to be used more than just one time. It should not be perishable. A perishable good or article should not be used as a currency because it cannot be used multiple times and also cannot be stored for future transaction.

ii) Easy recognizable: The users of the money must be ascertained of it's authencity. The currency must be univerally recognized.

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iii) Stability: A currency must be stable in terms of value. Money should have a constant or increasing value. Money cannot be ~~us~~ unstable whose value keeps drastically changing.

iv) Portable: Currency must be portable and can be conveniently transported from one place to another. The money must be divisible into various quantities making it's use better.

Functions of money:

Primary functions:

i) Medium of exchange ⇒ To avoid the difficulity of barter system, a common medium of exchange was sought. This led to the invention of money so as to enable and facilitate exchange without any wastage of time. Then ~~money~~ commodities were exchanged for money and with money one can go for anything he requires.

ii) Measure of value ⇒ Money has been designed to serve as a common measure of value. The values of various commodities and services are expressed in terms of money. So, each good gets a value in terms of money and we call it price.

* Secondary Functions:

i) Standard of Deferred Payments:

Deferred payments imply future payments. When we do not pay in terms of cash for any kind of buying and selling immediately but promise to pay in future, we call it credit transaction. It means payments are deferred to a future date. So, money enables both current buying and selling with immediate cash payments and current and present transactions to be discharged in future.

ii) Store of value: People keep a part of their present income to meet unforeseen future. It is widely recognised that it is convenient to store money than to store goods and commodities. Storage of goods not only involves certain amount of costs but also involves loss of value. Further, perishable goods cannot be stored for a long period of time. There is also the danger of theft and fire.

Advantages:

i) Nowadays, we use paper money. Paper money does not require much space to be stored.

ii) By storing in the form of money, people can take advantage of the changes in the rate of interest.

iii) Money as a store preserves value through time and space.

iv) Money is an asset or form of wealth.

So, money acts as a good store of value.

iii) Transfer of value:

i) Money has general acceptability as a means of exchange. So, it is easier to transfer money from one place to another.

ii) At present, money is stored in the form of bank deposits. Depositor can transfer the amount of money deposited in his bank's account to the account of another man.

iii) Money is a mean through which transfer of value from one place to another has been easier and quicker. So, transfer of value in the form of money through space continues to be important.

iv) Money is portable. It can be easily taken from one place to another place without any difficulity.

(A) Contingent Functions:

i) Distribution of Income: The contribution of all factors of Production like Land, Labour, Capital and Organization constitutes of national product. This national product is also known as national income. So, this national income is to be distributed among the above stated factors of production. Money makes the distribution of this joint production among the various factors of production easy. The relative shares of factors are also calculated through money.

ii) Measurement and Maximisation of Utility: Utility is measured in terms of money. A consumer measures the utility of different consumer goods with the help of money. Similarly, a producer measures the utilities of different factors of production with the help of money. A producer maximises his return by substitut[ing] one factor in the place of another for productivity gain. It is done through money by comparing the marginal productivi[ty] of each factor.

iii) Basis of Credit: Money constitutes the basis of credit. Banks create credit with the help of money. Any increase or decrease in money supply leads to a commensurate increase or decrease in the availability of credit money in the economy.

iv) Liquidity of Wealth: Money gives liquidity to various form of capital/wealth. So, it is convenient to store wealth in the form of money because money is the most liquid of all assets. Money can be put to any use readily.

Money helps in transforming other forms of capital into the most liquid form of wealth which have strong bearing on the process of development of a country.

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Classification of money:

i) Full bodied money ⇒ Any unit of money whose face value and intrinsic value are equal, is known as a full bodied money
i.e. Money value = Commodity Value.
For example, during the British period, one rupee coin was made of silver and its value as money was same as its value as a commodity.

ii) Legal Tender ⇒ legal tender is anything recognized by law as a means to settle a public or private debt or meet a financial obligation, including tax payments, contracts and legal ~~fith~~ fines or damages.
The national currency is legal tender in practically every country. A creditor is legally ~~obgl~~ obligated to accept legal tender toward repayment of a debt.

⇒ Legal tender is a coin or a banknote that is legally tenderable for discharge of debt or obligation.
⇒ Legal tender serves the economic functions of money plus a few additional functions, such as making monetary policy and currency manipulation possible.

Sectors of Economy:

The 3 main sectors of the economy are the primary sector, the secondary or manufacturing sector, and the tertiary or sector.

The primary sector involves extracting raw materials for industries. The secondary sector involves the manufacture and production of finished goods, and the tertiary sector is concerned with the offering of intangible goods and services related to production such as tourism, retail, entertainment etc.

i) Primary Sector: The activities in the primary sector are carried out using natural resources and serve as the basis ~~of~~ for all other goods. This includes mining, agriculture, forestry, dairy, fishing etc. The primary sector is also known as agriculture and allied sector as agriculture, forestry, dairy, and fishing are the major sources of raw material consumption.

ii) Secondary Sector: The secondary sector includes the work of manufacturing i.e. it includes the business which is responsible for the production of finished or usable products. This means that secondary sector takes raw materials from the primary sector and converts it into products that are sold to consumers.

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III) Tertiary Sector: The tertiary sector is not responsible for the production of goods. Instead the tertiary sector refers to the services of the other two sectors. Services are included are guidance, experience, outreach, meditation, emotional labour, retail, tourism, banking, IT, and entertainment services for firms and end users.

Money Supply:

⇒ The money supply is the sum total of all of the currency and other liquid assets in a country's economy on the data measured.

⇒ The money supply includes all cash in circulation and all bank deposits that the account holder can easily convert to cash.

⇒ Governments issue paper currency and coins through their central banks or treasuries, or a combination of both.

⇒ In order to keep the economy stable, banking regulators increases or reduce the available money supply through policy changes and regulatory decisions.

⇒ Variations of the money supply number take into account non-cash items like credit and loans.

⇒ It controls interest rates by setting the key rates that it charges to the nation's banks for the overnight loans of government money that keeps the banking system running. The rates for all other loans are derived from those federal lending rates.

Effect of Money Supply on the Economy:

⇒ An increase in the supply of money typically lowers interest rates, which in turn, generates more investments and plus more money in the hands of consumers, thereby simulating spending.
⇒ Businesses respond by ordering more raw products and increasing products. The increased business activity raises the demand for labour.
⇒ The opposite can occur if the money supply falls or when it's growth rate declines. Banks lend less, businesses put off new projects, and consumer demand for home mortgages and car loans declines.

4 alternative measures of money supply used by RBI:

Since the supply of money is an important economic parameter, governments constantly monitor and regulate it. Therefore, they measure the amount of money frequently to keep it in check. Standard measures of money supply include M1, M2, M3 and M4.

The measurement of the supply begins with the M0 or monetary base. It denotes the amount of currency in circulation i.e. currency bills, coins, and bank reserves.

i) M1 supply: Also called the "narrow money". It includes M0 and other highly liquid deposits in the banks.

ii) M2 supply: It ~~su~~ is perhaps the most commonly ~~acepe~~ accepted measure because it consists of M1 in addition to marketable securities and less liquid deposit.

iii) M3 supply: Known as "broad money". it constitute M2 and money market funds like mutual funds, repurchase agreements, commercial papers.

iv) M4 supply: It comprises M3 and all other least liquid assets, usually outside commercial bank.

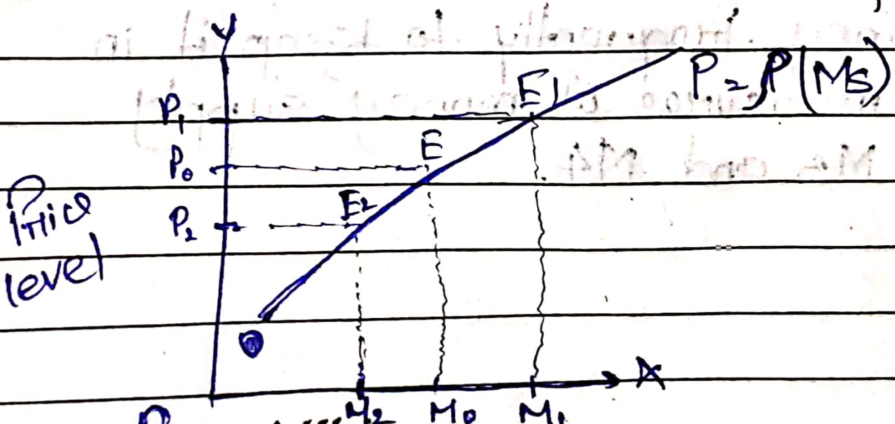
M0 = currency notes + coins + bank reserve

M1 = M0 + demand deposits

M2 = M1 + marketable securities + other less liquid bank deposit.

M3 = M2 + money market funds.

M4 = M3 + least liquid assets.



OE represents the direct proportional relationship between money supply & general price level.

Evalution of Money:

i) Barter Economy ⇒ Barter is an economic system in which the members trade goods and services for other goods and services without using a medium of exchange. It was hard for trade to happen, as it would require both sides to want exactly what the other person had to offer.

ii) Commodity money ⇒ As bartering was difficult for trade, some common commodities slowly took ~~dou~~ the function of money. Commodity money is an economic good that acts as money. Examples of commodity money throughout history included cocoa beans, tea, Tobacco salt, Seashells.

iv) Paper money ⇒ The switch to paper is known to have originated in different parts of the world in different circumstance. In other parts of the world, paper currency was backed by gold or silver

iii) Metallic money ⇒ As societies and economies evolved, they found better ways to facilitete their trade and transaction. Metals such as gold, silver and copper were used instead of commodity money. Metallic money were later standradized and certified in form of coinage.

v) Electronic money: In today's economy, money has taken an intangible form through electronic money. Electronic money is money that is stored electronically and can be accessed through devices to complete transactions. Electronic transfer allow for money to be transferred from one party to another without the use of paper money.

Quantity Theory: The quantity theory of money, sometimes called "Fisherian Theory" simply states that a change in price can be related to a change in the money supply.

→ It states that the quantity of money available (money supply) in the economy and the price levels have same growth rates in the long run.

→ When there is a fall in interest rates or a decrease in taxes and there is little restriction on how money can be accessed. Consumers become less sensitive to changes in price; have a higher propensity to consume.

→ The quantity theory of money is said to be a framework that is used to understand how price changes affect the supply or circulation of money in a economy.

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→ It's most common version is called "Neo-quantity Theory" or "Fisherian Theory".

Irving Fisher Model:

M(money supply) × V(velocity of money)
= P(average price level) × T(volume of transaction in the economy)

Despite the ~~money~~ many strengths of the Fisher model which includes it's simplicity and compatibility with mathematical models, it's false assumptions usage to arrive at it's simple nature which includes, proportional supply of money, independent variables and price stability raise doubts.

Keynesian Economy:

Keynesian economics is a macroeconomic theory of total spending in the economy and it's effective on outputs, employment, and inflation.

The central belief of Keynesian economist is that government intervention can stabilize the economy. Keynes" theory was the first to sharply separate the study of economic behaviour and individual incentive from the study of broad aggregate variables and constructs.

⇒ Keynes developed this theories in response to the Great Depression and was highly critical of previous economic theories.

⇒ How much of his income or resources will be a person hold in form of ready money and how much will he ~~led~~ lend depends upon his liquidity preference.

⇒ Demand of money is also called Liquidity Preference which means demand for money to hold or the desire of the public to hold money in form of cash.

⇒ According to Keynas, the desire to hold money arises because of three motives;

i) Transactive motive
ii) Precautionary motive
iii) Speculative motive

Keynes Equation:

$n = PK$ or $P = n/K$

where,

n = total quantity of money in circulation
P = the general price level of consumption goods.
K = proportion of consumption goods for which the purchasing power is kept by the people in the form of cash.

Keynes refer to "K" as the real balance. So long as "K" is a constant, a change in "n" causes proportional change in "P".

Keynes expanded his equation to include bank deposits.

$$n = P(K + rK') \quad \text{or} \quad P = n/(K + rK').$$

where,

n = total quantity of money, that is legal tender money and bank deposits.

P = the general price level of consumption goods.

K = proportional of consumption units which the people decide to keep in the form of cash.

K' = proportion of consumption units that the people keep in the form of bank deposit.

r = ~~is~~ proportion of cash reserves of banks to their public deposit.

Commercial Bank: A commercial bank is a financial ~~ban~~ institution which accepts deposite from public and gives loans for purposes of consumption and investment.

There are 2 essential functions that a financial institution must perform to become a commercial bank:

i) Acceptance of demand deposites

ii) Lending

Functions of Commercial Bank:

1) Accepting Deposits: The primary function of every commercial bank is to accept deposit from the public. To attract savings, the banks accept mainly three types of deposit
   a) demand deposit
   b) fixed deposit
   c) saving deposit.

a) Demand deposit: Demand deposits are those deposits which are repayable by banks on demand. They are chequable deposits. These can be ~~with~~ withdrawn by any number of times. No interest is paid on such deposits.

b) Fixed deposit: Fixed deposits are those deposits which can be withdrawn only after the expiry of certain fixed period. The longer the period, the higher will be the interest rate.

c) Saving deposit: Saving account deposits have the feature of both demand deposit and saving deposit. Cheque facility is provided to the depositors. But some restrictions are imposed on number and amount of withdrawals.

ii) Advancing ~~notes:~~ loans: Giving loans is another primary function of the commercial banks. They advance loans and earn interest income. Banks give loans mostly for productive purposes against collateral securities. The amount of loan is generally less than the value of the security offered.

a) Cash credit: Under this loan, a credit limit is sanctioned by the bank. The borrower may withdraw any amount within this sanctioned limit. The borrower is charged interest against only on the amount of money that has been actually drawn and not on the amount that has been actually drawn and not on the amount that has been sanctioned.

b) Demand loans: Demand loans refer to those loans which can be recalled on demand by the bank at any time.

c) Short term loans: They are given as personal loans against some collateral security. The money is credited to the account of borrower and the borrower can withdraw money from his account and interest is payable on the entire amount of loan granted.

Money Creation by Commercial Banks:

Money creation is one of the most important functions of commercial banks. Commercial banks are important source of money supply in economy. They add to money supply by creating demand deposit.

Money creation is the process of expansion of credit through derivative deposits. It is also known as "Deposit Creation" and "Credit creation".

→ Money creation by banks is determined by:

i) The amount of initial deposits or primary deposit.

ii) Legal Reserve Ratio (LLR) is the minimum ratio of deposits legally required by the commercial bank to be kept as cash.

Process:

i) Starts when people deposit money in their respective.

ii) After receiving the deposits, as per the central bank's guidelines, the commercial banks maintain a portion of total deposit in form of cash reserves.

iii) The remaining portion left after maintaining cash reserves of the total deposits is then lend by the commercial banks to the general public in form of credit.

iv) Now assuming that all transaction in the economy are routed through the commercial bank, then the money borrowed by the borrowers again comes back to the banks.

v) The commercial banks again keep a portion of the deposits as reserves and lend the rest.

$$\text{Money Multiplier} = 1/LLR$$

$$\text{Total demand deposits} = \text{Money Multiplier} \times \text{Cash reserve}$$

⊛ Assumptions:

i) All the depositors do not approach the banks for withdrawal of cash at the same time and also they do not withdraw entire amount.

ii) All receipts and payments in the economy are made through banks.

▪ Central Bank: Central bank is an apex of the monetary and banking structure of a country. It controls the supply of money and credit in the country.

⇒ It is called central bank because it occupies a central position in the monetary and banking structure of the country.

⇒ It supervises, regulates, and controls the whole banking system.

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Functions of Central Bank:

i) Issue of currency ⇒ The central bank enjoys the sole legal right to issue currency notes. The currency so created is called "high powered money". That is why it is called "Bank of Issue". These notes circulate throughout the country as legal tender money. Like any other central bank, the RBI has the sole right to issue currency notes.

ii) Banker, Agent and Advisor to the Government: Central Bank everywhere in the world acts as banker, agent and advisor to the government.

iii) Bankers to the Banks:
⇒ Commercial banks are required to keep a part of their deposits with the central bank in form of cash. The central bank is the custodian of cash reserves of the commercial bank.
⇒ The central bank uses these reserves to meet the cash requirements of individual commercial bank.

iv) Leader of Last Resort: When a commercial bank fails to meet the obligations of it's depositors from all sources, it can finally approach to central bank. It comes to it the rescue and gives loans as leader of last resort.

v) Clearing house function: As the custodian of cash reserves of the commercial banks, the central bank acts as clearing house function. Since, all banks has their account with the central bank, the central bank can easily settle the claims of various banks against each other simply by book entries of transfers from and to their accounts.

vi) Custodian of Nation's Foreign Exchange Reserve: Central bank is the custodian of nation's foreign exchange reserves. The central bank maintains foreign exchange reserves in order to promote internation trade and stabilise exchange rate.

Central Bank	Commercial Bank
i) Supreme institute of monetary and banking structure	i) Deals in money and credit for the purpose of earning profit.
ii) Acts as public interest	ii) Main objective is to earn profit.
iii) Has sole monopoly over note-issue.	iii) Have no legal power over note-issue.
iv) Government owned.	iv) Both in private & govern
v) Only one.	v) Several.

III Monetary Policy:

Monetary Policy is a set of tools used by a nation's central bank to control the overall money supply and promote economic growth and employ strategies such as revising interest rates and changing bank reserve requirements.

→ Types of Monetary Policy:

I) Contradictory: Increases interest rates and limits the outstanding money supply to slow growth and decrease inflation.

II) Expansionary: During times of slowdown or recession, an expansionary policy grows economic activity by lowering interest rates and consumer ~~buy~~ spending and borrowing increase.

IV Tools of Monetary Policy:

I) Open Market Operations: The RBI buys bonds from investors or sells additional bonds to investors to change the number of outstanding government securities and money available to the economy as a whole.

The objective of OMO to adjust the level of reserve balance to manipulate the short term interest rates and that affects other interest rate.

ii) Interest Rate: The central bank may change the interest rates or the required collateral that it demands.

iii) Reserve Requirements: Authorities can manipulate the reserve requirements. In the funds that banks must retain as a proportions of the deposits made by their customers to ensure that they can meet their liabilities.

Lowering this reserve requirement releases more capital for the banks to offer loans or buy other assets. Increasing the requirements banks lending and slow growth.