Karnataka State Open University
Manasagangothri, Mysore - 570 006

ಕರ್ನಾಟಕ ರಾಜ್ಯ ಮುಕ್ತ ವಿಶ್ವವಿದ್ಯಾನಿಲಯ
ಮಾನಸಗಂಗೋತ್ರಿ, ಮೈಸೂರು - ೫೭೦ ೦೦೬

COURSE:5 **M.A.(PREVIOUS)**

MONEY-BANKING AND FINANCIAL MARKETS

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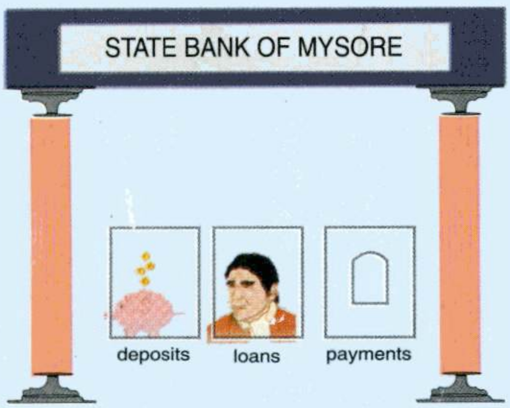

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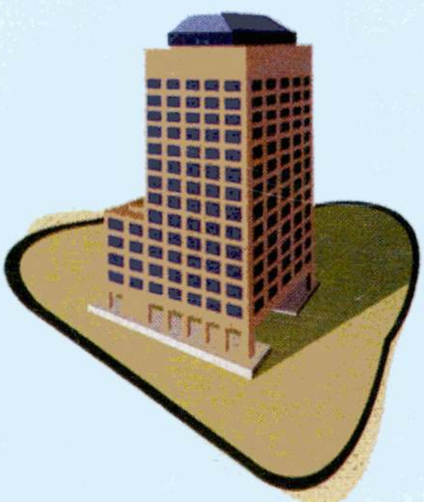

SHARE MARKET
BOMBAY

SHARE MARKET

Karnataka State Open University

Course 5
Block 1

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Karnataka State Open University

M.A. Economics (Previous)
Course-V
Money, Banking and Financial Markets

Block - I

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M.A., Previous
ECONOMICS

Course -5 : MONEY, BANKING AND FINANCIAL MARKETS

Block I : MONEY AND ITS FUNCTIONS

UNIT 1: Money concepts -Near Money, Inside Money, Outside Money, Kinds of Money -Functions of Money.

UNIT 2: Role of Money in Different Economic Systems (Capitalistic, Socialistic and Mixed Economies) Dynamic Role of Money in Modern World -Significance of Money and It's Limitations.

BLOCK 1: MONEY AND IT'S FUNCTIONS

Block Introduction

Block 1 explains certain very essential and significant things about money in a modern world. It has two units. Unit I explains in detail the concept of money and its varieties, various definitions of money, varied functions of money and the different types of money. Alternatively stated the unit provides brief historical and monetary analysis of the evolution, growth and dynamic role of money. Further, the unit II provides a comprehensive analysis of the role of money in a modern economy across capitalistic; socialistic and mixed or planned economies. Such an analysis, in fact, throws light on the role of money in developed and developing economies of the world. Today's economy is a money economy. The advent of money and its many transformations to its current form is, infact, the story of man's effort to create an rational exchange economy. Thus, Block I provides certain very useful insights into the institution of money in a modern economy and society.

UNIT 1: MONEY -CONCEPTS AND FUNCTIONS

Structure:

1.0 OBJECTIVES

After a careful study of unit 1 you will be able to understand the following:

- To describe the evolution, growth and significance of money.
- To discuss the major significant functions of the money;
- To describe the various concepts of money;
- To explain the different types (or classification) of money and emphasise their usefulness.

1.1 INTRODUCTION

The advent of money is as old as human civilization. Money is the key for facilitating and promoting economic growth, trade, consumption, savings and investment. It is very difficult to imagine an economic, system without a money system. Thus, money has become inseparable from the working of an economic system. There are various concepts and types of money in a modern economy. All of them influence the money supply function in a country. A money system enhances economic growth, it causes fluctuations in economic activities; it affects the economic welfare differently at different times. Money in reality performs a set of socially and economically useful functions. Let us learn certain very preliminary but very significant things about money. According to Benjamin Israeli: " The only thing that has driven more men mad than love is the currency question". Money is something fascinating; it is embodiment of purchasing power for today and tomorrow. The human societies have passed through many stage's with advent and use of money.

Barter Vs the use of Money :

The barter system represents exchange of commodities against commodities. Based on the demand for and supply of goods, their relative real prices are determined. Barter system to be operative requires the coincidence of human wants, divisibility of goods etc. Wherever these conditions are not fulfilled the barter system does not operate.

According to Paul A. Samuelson and Nordhaus : "Inconvenient as barter obviously is, it represents a great step forward from a state of self -sufficiency in which every person had to be a jack -of -all -trades and master of none. Nevertheless simple barter operates under "grave disadvantages. An elaborate division of labor would be unthinkable without the introduction of a great improvement –the use of money".

There are four major disadvantages of a barter exchange system:

i) The lack of common unit of determining relative prices or value of goods and services for exchange:
ii) The lack of a double coincidence of wants.
iii) The lack of any satisfactory unit of measure in terms of which to write contracts requiring future payments.
iv) Lack of any method of storing generalized purchasing power. This limitation arises from the first two.

1.2 MONEY -MEANING AND DEFINITION

Money, along with fiscal policy, is an important determinant of output, unemployment and inflation in a modern economy. Money affects the economy in three logical steps: changes in the money supply affect interest rates and the amount and terms of credit; interest rates and credit conditions affect interest -sensitive items of spending (like housing or business investment); and changed aggregate demand leads to changes in equilibrium output and prices.

According to P.A. Samuelson and Nordhaus : "Money arose as a lubricant to facilitate trade. Early money was composed of commodities, but was superseded by paper and bank money. Unlike other economic goods, money is valued because of social convention, because it is valued. We value money indirectly for what it buys, not for its direct utility". Money is variously defined by different economists. Let us consider some of them here: "Anything is money which functions generally as a medium of exchange". -**W.T. Newlyn**. "Money is what money does, that which does the money work is the money thing". -**Walker, F.A.** "Money is a commodity which is used to denote anything which is widely accepted in payment for goods, or in discharge of other kinds of business obligation". **D. H. Robertson.** For most purposes money can be defined as anything that is generally acceptable as a means of exchange (i.e., as a means of settling debts) and at the same time acts as a measure and as a store of value". –Geoffrey Crowther. There is, however, a broad consensus among economists that any good definition of money shall reflect the functions of money. The most wider definition of money include the near money assets or money assets. The significance of money is brought out very clearly by Geoffrey Crowther : "Money is one of the most fundamental of all man's inventions. Every branch of knowledge has its fundamental discovery. In mechanics it is the wheel, in science it is the fire, in politics it is the vote. Similarly, in economics, in the whole commercial side of man's social existence, money is the essential convention on which all the rest is based".

1.3 MONEY -DIFFERENT CONCEPTS

There are three concepts of money. They are namely, the near –money assets (or money substitutes), inside money and outside money. Let us now briefly explain these concepts of money.

1.3.1 Near -Money Assets (or money substitutes)

There are certain types of financial assets or claims which embody varying degrees of liquidity or money ness in a modern economy. Thus, they are used as substitutes of money in various forms of economic and business transactions in a modern economy. Hence these near –money assets are broadly treated as part of the money supply at a point of time.

The rational basis for the origin of near money assets actually originates from the store of value or wealth function of money. The means of payment "Vary from place to place and time to time but within any given community at given time there is usually a clearly defined group of things which serve as means of payment and nothing outside the group is, for the purpose, a substitute for anything within it. With money as a means of holding wealth the situation is very different. The things which serve as means of payment are also ways of holding wealth, but for this purpose they are far from...... ; in a modern community the owner of property has an almost bewildering variety of ways in which he may hold it. The manifold ways of holding wealth can all be divided into two classes; objects which call 'real wealth' and debts. From the point of view of a closed community, of course, only things in the first class count as wealth. From that of an individual, however, a debt owed to him by his government, by a company or by one of his fellow citizens is as much a part of his wealth as land or buildings. The man who has a million pounds in government securities is no less of a millionaire than the man who owns a factory worth a million pounds; indeed if they needed to realize a portion of their wealth quickly, the man who owned the debt might be in much the better position". (E. Victor Morgan, 1969,pp 57 -58). Further, according to E. Victor Morgan (1969 : pp 80 -81) : "The owner of property, whether a person or an institution, now has a choice not only between money and real estates but between money, real estates and a whole spectrum of financial assets of varying degrees of liquidity. Some of these are convertible into money so quickly, with so little cost and so little risk of loss that, as means of holding wealth, they are almost perfect substitutes for money and, from these, one can proceed by very gradual steps to less and less liquid assets. The operations both of financial intermediaries and of the government (as manager of the public debt) can affect both the relative amounts of more or less liquid assets in existence and their ownership pattern and so influence what the Radcliff Committee called 'the general liquidity' of the economy".

1.3.2. Inside money :

The inside money is also called the endogenous money. It is that part of the money supply which is created inside the economic system by the banking sector, as opposed to being 'put into' the system from outside by the government (exogenous money). The creation of bank deposits is a good example of inside money.

1.3.3. Outside Money

The outside money is alternatively called exogenous money. It is that part of money supply placed into economic system by an outside agency like government. In other words the outside money is government issued currency and coins which form part of narrow money. The outside money provides the monetary base for the inside money. In other words, the central bank issued money (outside money) would flow into banks as primary deposits based on which the inside money (bank deposits / credit) is created by the commercial banks.

1.4 VARIOUS KINDS OF MONEY

Money, in general, is classified into various types. The metal money, commodity money, Paper currency, bank credit and special drawing rights are some of the major kinds of money.

Classification of Money:

According to S.M. Goldfed and L.V. Chandler (19/8: pp 20-21) "Money can be classified on several different bases, such as the following:

1) The physical characteristics of the materials on which money is made;
2) The nature of the issuer; such as a government, central bank or com mercial bank ; and
3) The relationship between the value of money as money and the value of money as a commodity".

Let us now briefly explain the various kinds of money below:

1.4.1. Full- Bodied Money:

This form of money is one whose value as a commodity for non monetary transactions purposes is always equal to its value as money. For example the commodities like cattle, rice, wool, and boats were full -bodied monies. This form of money was in existence under different types of metallic standards.

According to S.M. Gold fed and L. V. Chandler (1978 : pp 21 -22):

"Full -bodied coins were typically issued by governments. Three steps were involved:

1. Define the gold value of the monetary unit. This may be done in either of two ways, but both amount to the same thing: stipulate the gold content of the monetary unit or stipulate the money price of each unit of gold.
2. At the stipulated price, purchase all the metal that is offered and coin it without limit and virtually without charge. This prevents the market price of gold from falling below the mint buying price.
3. Permit the melting of coins to get gold for non monetary uses and or stand ready to sell, at the fixed price, all of the commodity that is demanded. It is usually unnecessary to give permission to melt coins; people do it anyway if they find that it is the cheapest way to get gold. The effect of this is to prevent the market price of gold from rising above the mint price as long as gold can be acquired for non monetary uses".

However, the full- bodied money has failed to last long since it was not possible parity between monetary and non monetary values of gold as a commodity used for creating money. The gold standard or silver standard or bimetallic standards were very rigid systems of money supply. The supply of gold, silver or any other precious metal do not expand corresponding to an increase in the money demand in a expanding modern economy. Thus, modern economies have moved from full–bodied monies to representative money (convertible paper currency) and then on to credit money (i.e., inconvertible paper currency).

1.4.2. Representative Full- Bodied Money (or , Convertible Paper, Currency).

The convertible paper currency is also called representative full-bodied money. Currency here denotes its equivalent value in terms of gold or silver at market prices. The "representative full -bodied money itself has no significant value as a commodity, but it "represents" in circulation an' amount of metal with a commodity value equal to the value of the money. ...The main advantage of representative over full -bodied money is that the latter, involving as it did a physical commodity, typically became quite inconvenient when large sums were transacted. In all other respects, the two types of full - bodied money are equivalent".(S.M. Gold fed and L.V. Chandler, 1978, PP.22)

Check your progress:

1. Explain briefly the various kinds of money. Why were they continuously replaced by a new money?

2. Write short -notes on the following:
   a) Metallic money
   b) Inconvertible paper currency

1.4.3. Credit Money (or Inconvertible, Paper Currency / Token Coins):

The credit money is alternatively known as debt money. Because it is the debt issued or credit borrowed by the issuing authority like the central government, central bank and for the commercial banks. The credit or debt money excludes the representative full -bodied money, but includes the all other forms of in convertible currency or coins or bank credit. Thus, the credit or debt money is put into circulation at a greater value than the market value of the material. or commodity from which it is made. It is important to note that the material used to make credit money is regulated to make it very scarce to avoid counterfeiting in money.

The credit or debt money may take the following forms:

a) Token coins;
b) Representative Token Money;
c) Circulating Promissory Notes issued by governments;
d) Circulating Promissory Notes issued by private banks;
e) Circulating Promissory Notes issued by the Central Banks; and
f) Checking Deposits at Banks.

Let us now briefly explain them as under:

1. Token coins: The token coins are issued in very very small denominations to facilitate economic transactions. They would constitute very small fraction of the total money supply in a country. Token coins are called "small change" money and are generally issued by the government. The token coins cannot be converted into any precious metal like gold or silver. Thus, the issuing authorities shall take proper care so as the Gresham's Law do not operate in the economy. The famous Gresham's Law implies that "bad money drives good money out of circulation". A bad money is one which has a less valuable metallic content. Such a token money driving out a token money made up of a good metallic content.

2.Representative token money: This is a form of paper money obtained for having deposited token coins or precious bullions with the government. This is not in circulation now in any country.

3.Circulating promissory notes issued by governments: These are made up of paper and sometimes called 'fiat money'. Under this system of money, government enjoys substantial statutory and discretionary powers to issue money. This power is abused by many governments in the past. Thus, some caps are set about the government's power to issue their promissory notes.

4. Circulating promissory notes issued by private banks. These are currency notes circulated by American banks before 1935 which had state chartering. This is not a global practise.

5.Circulating promissory notes issued by central banks: In practice a greater part of money supply (M1) includes mostly the currency and coins issued by the central banks. This money is called base money.

6. Checking deposits at banks: Here the word 'Banks' includes commercial bank, savings loan associations, mutual savings banks, and credit unions in the context of advanced countries. Because in advanced countries the functions of all kinds of financial institutions are becoming increasingly similar due to deregulation. The deposits with these financial institutions constitute the major part of money supply in an advanced country. These deposits, according to S.M. Goldfed and L.V. Chandler (1978: pp 25 -26): "are claims of creditors against a bank which can be transferred from one person or firm to another by means of cheque or other orders to pay. These claims-against banks are generally acceptable in payment of debts and for goods and services. The popularity of checking deposits can be traced to their advantages: (a) They are not so liable to loss or theft as other types of money; (b) They can be transported very cheaply, regardless of the amount of the payment or the distance between payer and payee ; (c) Because cheque can be written for the exact amount of the payment, there is no need to make change and count bills and coins; (d) When endorsed by the payee, cheque serve as a convenient receipt for payment. The principal disadvantage of checking deposits is that cheques drawn on them may not be accepted from an unknown person, but this is largely remedied by such devices as certified cheque, cashier's cheque, and travelers cheque, which in effect guarantee payment to the payee or to anyone to whom the or the transfers the claim".

Therefore, we may say that the above types of monies all played a very useful role in the functioning of modem economic systems. We may conclude the discussion of the classification of money with the following observation of P.A. Samuelson and Nordhus. "Limitation in the supply of money is the necessary condition if money is to have value. If currency is so unlimited in amount as to become practically a free good, people would have so much of it to spend as to bid up all prices, wages, and incomes sky -high. For this reason, the power to control the money supply is reserved to the government".

Check your progress:

1. Define the concept of 'money'. Bring out its significance in a modern economy.

2. What is a 'barter economy? What are its important limitation?

3. Explain the various concepts of money. What are their implications for money supply function?

4. Describe the different types of near -money assets or money substitutes.

5. Distinguish between inside money and outside money.

1.4.4 Special Drawing Rights (SDR's):

The special Drawing Rights (SDR's) are the new form of international money issued by the International Monetary Fund (IMF) since 1970. They are also called 'Paper Gold' because the SDR's are used as international means of payment as the gold used to be under different forms of gold standard earlier. Thus, the SDR's have become an important form of international liquidity during last 33 years.

The major features of Special Drawing Rights (SDR's) are as follows:

1. The SDR's are 'invisible money' created by the IMF with general consensus of all its member countries. Thus they are accepted as international money or means of payment by all members of the IMF.
2. The SDR's do not have any physical form (invisible) and thus, they are expressed as 'uniits' which are stated as equivalent of U.S. Dollars. Thus, the value or conversion rates of SDR's are directly linked with the external value of the US dollar.
3. SDR's as a means of international liquidity perform all the major functions of modern money.
4. The issue of SDR's is regulated by the IMF, its creator. Generaly the concurrence of all member countries is obtained while creating or issuing SDR's periodically based on the needs for increasing international liquidity keeping in view the growth in world trade. Each round of creation or issue of SDR's shall raise the share of each member country in relation to its quota in the IMF. Thus with every new issue of SDR's each member country of the IMF shall benefit from the SDR's which are used as 'reserve' assets in international transactions.
5. SDR's are the international reserve assets. They are used as international means of payment to settle the obligations arising out of balance of payments deficits by the member countries of the IMF.
6. SDR's are used as unit of account in all IMF transactions.
7. The issue of SDR's is very strictly regulated by the Fund being linked to the growth of world trade.

Operational Process of the SDR's:

The SDR's being 'invisible money', its operational process is very interesting and rather complex. This aspect may briefly explained as follows:

Once the IMF takes a decision to create (or issue) an stipulated sum of SDR's (say between 190 – 73 IMF created 3.3 billion SDR's), the allocation of the individual shares of the new reserve asset of the member countries begins. The shares of member countries are determined based on their quotas in the IMF. Quotas, however, are determined based on the external value of the national currency of each member country enjoyed from time to time. This stage is called "Allocation of SDR's" by the IMF.

The second stage is 'purchase of SDR's' by the member countries when they need additional international liquidity to overcome their balance of payments deficits. This stage is nothing but taking a loan from IMF. Here the member country shall designate in different proportions in which the various foreign exchange is required to avail the loan assistance from IMF. At this stage IMF from its own corpus would release the loan amount in different forms of foreign currencies as equivalent to American dollars. This process is called the purchase of SDR's in technical language of the IMF. During the time of releasing the loan if IMF do not have the required national currency it can borrow it from the concerned central bank of the country.

The third stage of operational process of the SDR's is known as 'Repurchase Stage'. This is nothing but the loan repayment process by the borrower member country. The borrower member country shall repay the principal amount of the loan and the interest thereupon only in terms of either US dollars or the kind of foreign currencies in which it had taken loan. Soon after the loan is repaid, the purchase of SDR's stands cancelled. This is widely known as repurchase activity of the IMF.

Finally, a word about value determination of SDR's . The value of SDR's as is already said is always expressed in American dollars. For this purpose the IMF has prepared a basket of high value foreign exchange (or national currencies) and an average (or mean or mediam) value of all those currencies vis-à-vis us doller is taken as the value of us dollars for conversion of SDR's. So the fate of SDR's fluctuate with the composite value of the US dollar enjoyed with other leading foreign exchanges in the international economy. Therefore, the SDR's have come to stay, and rather grow in importance in the globalization era in future.

1.5. FUNCTIONS OF MONEY.

Before we deal with the functions of money please consider the following citation from Federal Reserve Bank of Philadelphia's observation?: (Business Review, August 1957, p.2.). "Money bewitches people. They fret for it and they sweat for it. They devise most ingenious ways to get it, and most ingenious ways to get rid of it. Money is the only commodity that is good for nothing but to be gotten rid of. It will not feed you, clothe you, shelter you, or amuse you unless you spend it or invest it. It imparts value only in parting. People will do almost anything for money, and money will do almost anything for people. Money is a captivating, circulating, masquerading puzzle". Money performs, in general, four functions: i) it is a medium of exchange ii) it acts as a standard of value; iii) it is a store of value; and iv) it is a means of deferred payments. Let us now briefly explain these functions of money:

1.5.1. MONEY AS A MEDIUM OF EXCHANGE

The first and foremost function performed by money is serving as a medium of exchange. It is used as a means to buy and sell goods and services. Money as a medium of exchange helps to overcome the difficulties of barter exchange system and thus helps to realise the benefits of geographical and human specialization. According to S.M. Goldfed and L.V. Chandler (1978: pp. 9): "The fact that money is often referred to as generalised purchasing power or as a bearer of options emphasises the freedom of choice that the use of money affords. The owners of goods or services need not secure their supplies from the people to whom they trade those goods or services; they can use their money to buy the things they want most, from the people who offer the best bargain, and at the time they consider most advantageous. Here, again, money can function properly only if it maintains a relatively stable purchasing power.

1.5.2. MONEY AS A STANDARD (UNIT) OF VALUE

The money is to serve as a standard of value is its first function. This function of money is variously called viz., unit of value, unit of account, common measure of value, and common denominator of value. These phrases denote the same thing. That is money serves as a unit in terms of which the value of all goods and services are expressed or measured. This function of money help us to resolve the problem of exchange value of commodities and services in the markets. Thus, by using money we will only compare the relative prices of goods in money terms.

1.5.3. MONEY AS A STORE OF VALUE

Money serves as a embodiment of value. This is a very useful function of money. As we all know money is the most liquid of all assets, it is very advantageous to store wealth in the form of money. On account of its function as a store of value, money helps to create a debt or credit market.

1.5.4. MONEY AS A STANDARD OF DEFERRED PAYMENTS

Money also functions as a means of deferred payments. This means future payments mechanism. In a modern economy there will be a large variety of contracts dealing with lonable funds and the payment of interest. Some such agreements are only for few days or few weeks; some contracts are for few months or a year; and other contracts are for more than one year. The money is also useful to settle transactions like payments of dividends on preferential shares, long -term leases on real estate and other property and pensions.

The changes in the value of money also cause changes in the value of future incomes or returns for holders of various contracts involving deferred payments. If there is sizeable deflation, it hurts that group of people who have payment obligations and benefits who receive payments. Where as during inflation, the value of money declines and thus affects adversely the receivers of payments and lightens the (reduces) burden of payment for payers.

Thus, a good money shall perform all the four above discussed functions. Money is a significant thing, because people and institutions are interested in the determination of value of money and in the stability of value of money.

Check your progress:

1. Describe the various functions of money.
2. Write short -notes on the following:
   a) Money as a medium of exchange
   b) Money as means deffered payment
   c) Money as a store of value
   d) Features of good money

SUMMARY

In unit 1 we have explained the meaning and definition of money, the concepts of money viz inside money and outside money and also near money assets ; various types of money and the major functions of money. We shall briefly summaries these aspects of the study of money.

Money is what money does ! This is the most generalised definition of money. The significance of money is stated in terms of its liberating influence on the lives of ordinary people during all times in all economic systems. It is widely recognized that if money performs its functions well ,like an efficient lubricant, it enables the economic machinery run smoothly.

According to S.M. Goldfed and L. V. Chandler: "The direct barter of goods and services is wasteful of time and effort in carrying out trade. The primary inefficies of barter stem from the need for a double coincidence of wants" and the lack of any common unit in which to measure and state the value of goods and services. Money serves the critical function of a medium of exchange, there by facilitates trade in goods and services. Money enables society to overcome the inefficiencies of barter, permits more trade to take place, and hence enhances our standard of living. Money also functions as a unit of value, a standard of deferred payment, and a store of value".

Money substitutes, as is explained already are called near money assets. They possess varying degree of liquidity. They are not called money because there is a transaction cost to convert them into cash or liquidity. bank deposits, shares, government bonds, securities are different forms of near -money assets.

Money is classified into various types. Money includes full-bodied money,' representative full -bodied money, credit money issued by the government (token coins, representative token money, circulating promissory notes) and money issued by the commercial banks (currency issued by the central bank, bank credit and savings deposits). The money issued by the central bank which is inconvertible and the credit created by the commercial banks are 20th century innovations in money history.

The central bank and commercial banks also have played a very innovative role in changing the form and substance of money during the modern times.

1.7 KEYWORDS

Near Money's: The near monies are also called money substitutes because they substitute for the use of central bank issued base money (currency). The near money assets are generally financial assets like bank deposits, treasury receipts, government bonds, shares and debentures etc.,

Inside Money: It is that part of the money supply which is created inside the economic system by the banking sector. Thus, inside money is created by the commercial banks in a economy.

Outside Money: The 'outside money' is created and placed in the economy for circulation by the government in a country. For instance money circulated on account of deficit financing.

Medium of Exchange: Money performs the role of facilitator of the exchange of real goods and services. It serves as a measure of value.

Store of Value: Money also performs the function of serving as a asset. In other words money acts as a store of value for future. So it promotes capital accumulation, savings and investment.

Paper currency: It is a form of money. It was having two forms earlier. One is called convertible paper currency and the other is called inconvertible paper currency. Convertible paper currency existed under gold standard where currencies were converted into gold and vice -versa. This was abandoned since 1932 throughout the world including England, the country of its origin. So today all countries are on inconvertible paper currency.

1.8. BOOKS FOR SELF-STUDY

1. Sayers, R.S. Modern Banking.

2. Hanson, J.L., (1970) Monetary Theory and Practice Fourth Edn., (London: The ELBS and Macdonald & Evans, Ltd).

3. Hajela, T.N. (1998). Monetary Economics, 9thRevised Edn. (Delhi: Konark Publishers Pvt. Ltd.)

1.9. QUESTIONS FOR SELF STUDY

1. Distinguish between various concepts of money in a modern economy.

2. Explain the various types of money.

3. Describe the functions of money. How do they promote trade and economic growth?

4. Write short -notes on the following:

   a) Inside and outside money
   b) Functions of money
   c) Near money assets
   d) Different kinds of money

UNIT 2: ROLE OF MONEY AND IT' SIGNIFICANCE

Structure:

2.0 OBJECTIVES

A careful study of unit 2 will enable you to do the following:

- To explain the process of circular flow of money in all kinds of economic systems;
- To describe the role of money in capitalistic, socialistic and mixed (or planned) economies;
- To bring about the dynamic role of money in a modern economy; and
- Finally to explain the significance and limitations of money.

2.1 INTRODUCTION

The invention of money is major step in the evolution and growth of human civilization. Money has underwent many changes in its form and substance. However, money has helped the civilized world to overcome the difficulties of barter system.

Money performs certain useful functions like a) it serves as a medium of exchange b) it serves as a unit of account; c) it serves as a store of value. In the evolution of money goods, metals and bank instruments are used as money at different times in various countries.

Money is universally used in all types of economic systems. However, its role differs considerably between developed and developing countries; its role also differs between capitalistic, socialistic and mixed economies. In brief the role of money is quiet prominent in promoting economic growth, consumption and welfare. Let us examine all these aspects now.

2.2 ROLE OF MONEY IN DIFFERENT ECONOMIC SYSTEMS

Al: modern economies are monetary economies. Because they use money very widely; they have innovated a highly diversified near - money assets used for various economic and business purposes.

Money plays a very useful role in all economic systems – whether they are developed or developing economies; whether they are capitalistic, socialistic and mixed (or planned) economies. Let us now explain the role of money in different types of economic systems:

2.2.1 ROLE OF MONEY IN CAPITALISTIC ECONOMIES

A capitalistic economy is, in principle, a free -enterprise and laissez-faire economy. The role of money in a capitalist economy is supposed to be very innovative and dynamic. Let us now try to know how it is so?

Let us now list out the major features of a capitalist economy:

a) It is a free enterprise economy;

b) The means of production i.e., the factors of production are privately owned i.e., ultimately by the house hold sector.

c) There exists substantial economic freedom under capitalism in matters relating to production, exchange, consumption, saving and investment.

d) A capitalist economy is characterized by the institution of private property.

e) An capitalist economy is motivated by earning profits;

f) All economic transactions are undertaken in terms of money;

g) An capitalist economy is a laissez-faire, market economy.

Under capitalism, money is regarded as a lubricant of economic life. In this sense money has a socially useful role in all types of economic systems. This point of view is clearly expressed by Alfred Marshall, A.C. Pigou and Moultan and others. Let us consider now these opinions as under: "The breaking up of traditions, no doubt destroyed some defences with which custom had covered the conditions of the 'inferior' orders of the people. Some of its immediate effects were injurious; but it was a necessary step toward their liberation from servile or semi –servile conditions. Its chief instrument was the substitution of values expressed in terms of money for obligations expressed in terms of customs". (Alfred Marshall, (1913), Money, credit and commerce, pp 264).

According to A.C. Pigou (Industrial fluctuations, pp. 117) : "In the modern world "industry is closely enfolded in a garment industry".

H.G. Moulton observes that: "Money is the indispensable pre-requisite to the assembling of the concrete instruments of production. The business man uses money, or its equivalent, to purchase materials for the construction of his factory; he uses his money in buying the supplies and materials necessary for its equipments; he bids competitively in the markets of the world for the raw materials used in the process of manufacturing and he employs money as a means of attracting to his organisation, the requisite labour force and corps of administrative officials".(H.G. Multon, the Financial Organisation of Society, Third edn, p.3)

Thus, in brief, the socially relevant role of money include:

a) Money facilitates the mass production, increases consumption and promotes trade;

b) The use of money has helped to expand markets, encourage division of labor and increase the large -scale production;

c) Money helps to monetize all economic transactions;

d) Money facilitates the process of product pricing and factor pricing ; and

e) The use of money helped to increase the savings and invest -ment and the growth of various types of financial intermediaries

The modern economic life is characterized by dynamism made possible by the use of money. In a money economy the circular flow of income also assumes circular flow of money payments. Consider chart to understand the circular flow of money and goods.

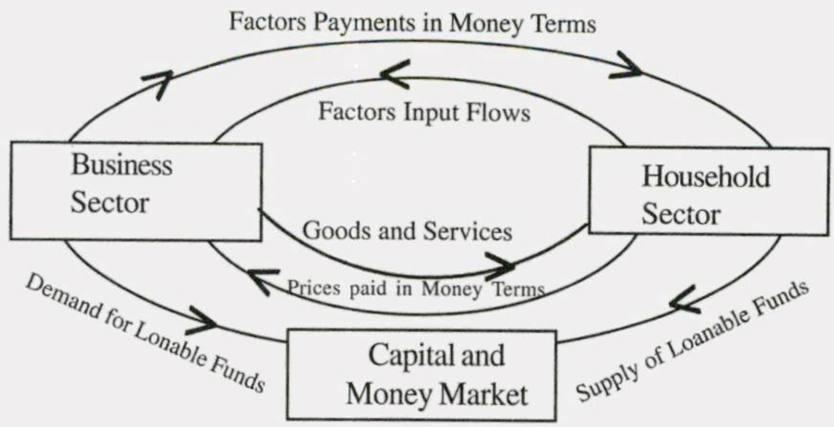

Chart -1 : Circular flow of money, goods and factors

There has to be a balance between the real flows viz., flows of output and factors of production and money flows. However, this is not a easy task. Any lapse in this balancing process may lead to deflation and inflation.

Money is a powerful factor that is liable to stimulate or hinder economic and cultural progress. Intelligent and progressive application of the monetary system tends to result in fuller utilization of natural resources and of technological inventions leading to a higher standard of living. On the other hand, a too narrow and rigid application of the monetary system is apt to lead to grave setbacks through the destructive consequences of a run -away inflation or even of a relatively moderate but persistent creeping inflation.

Check your progress:

1. Explain the role of money in a capitalistic economy.

2.2.2. ROLE OF MONEY IN SOCIALIST ECONOMIES

The socialists and communists including Karl Marx and Lenin were against the use of money under socialism. Because according to Karl, Marx, the use of money facilitated the creation of surplus value and its appropriation by the capitalists. Thus, in principle the idea of using money was dropped from the economic constitution of socialism soon after October 1917 revolution. But communists had failed to create an 100 percent barter exchange economy in Russia of 1920's. So Communist Russia had adopted money in 1924. Money plays an significant role under socialism in matters of resource allocation through pricing process. Irrespective of the nature of ownership and presence / absence of economic controls, the two functions of money viz., being functioning as a means of payment and standard of value have no substitutes. The economists like Abba P. Lerner and Oscar Lange were also expressed the idea that socialism too requires an money system.

Further an socialist country needs money to undertake international trade. However, the role of money under socialism is definitely very passive; money has no life; the governments central planning machinery has substituted for money. But time has shown that centralized planning is a poor substitute for capitalism, and thus for money with collapse of Communist Russia in December 1991.

2.2.3. ROLE OF MONEY IN A MIXED ECONOMIES

A mixed economy is one in which the private and public sectors co-exist. India provides a good example of a mixed economy. Now the issue is : in what way the role of money is different under mixed economies compared to capitalism and socialism? Are there any real differences?

A mixed economy is characterised by the existence of a central planning authority, administered pricing policy, a dominant role assigned for public sector and the presence of economic controls. All these features would to certain extent impose barriers on the free play of market forces, thus, the role of money may also be constrained in a mixed economy. But it is also true that an mixed economy shall have a sizeable market economy and private sector. This means money has a significant role even under mixed economies.

All mixed economes in the world are less developed countries. Thus, money is indispensable for promoting and expanding production, exchange and consumption as well as savings and investment even in mixed economies. Further a good form of money is necessary to create an money and capital market in mixed economy based under developed country's. Money is also required for the complete manetization of the economic transactions. Thus, we may say that there is no substantial difference in the role of money between capitalist and mixed economic systems.

2.3 SIGNIFICANCE OF MONEY

Money's presence is ubiquitous in a modern economy. It is necessary everywhere or every economic transaction is expressed in money terms. According to Alfred Marshall (1913): "Money is the pivot around which economic science clusters...... the major part of the subject matter of economics is concerned with the functioning and malfunctioning of money". D.H. Robertson had stated that: "The existence of a monetary economy helps society to discover what people want and how much they want it and so to decide what shall be produced and in what quantities, and to make the best use of its limited productive power. And it helps each member of society to ensure that the means of enjoyment to which he has access yield him the greatest amount of actual enjoyment which is within his reach". Thus, we may say that the effects of money encompass each and everything of economic life. Money influences the acts of production, exchange, consumption, distribution, and public finance and thus, ultimately economic welfare.

According to Mc Connel (Economics, 1987 print, pp 335) : "Money -one of our truly great inventions -constitutes a most fascinating aspect of economic science. Money is also one of the most crucial elements of economic science. It is much more than a passive component of the economic system -a mere tool for facilitating the economy's operation. When operating properly, the monetary system is the life blood of the circular flows of income and expenditure which typify all economies. A well -behaved money system is conducive to both full production and full employment. Conversely a malfunctioning monetary system can make major contributions to severe fluctuations in the economy's levels of output, employment, and prices."

Check your progress:

1) Describe the role of money in a socialist economy. How does it differ from capitalist economy?

2) Explain the role of money in a mixed or planned economy. Is it different from market or socialist economy?

2.4 LIMITATIONS OF MONEY

Money, however, suffers from certain limitations. Some of them are inherent in it and some of them originate from the way how money is managed in a economy. Now we shall briefly state some important limitations of money.

1. The management of money is a very tough and complex task. J .S. Mill has long ago recognised this when he said that the money is frequently "Out of order". Thus, to regulate the behaviour of money we need' an agency like central bank.

2. The value of money fluctuates enormously due to several monetary and non monetary factors. Any sharp decline in money's value or general purchasing power during inflation is anti-poor. Further deflation due to an artificial shortage in money supply causes growth arresting effects. Both the effects are socially bad. Thus, the money supply and money demand functions shall be regulated properly. The value of money shall be relatively stable.

3. Money should be scarce. Otherwise the abuse of money material shall lead to counterfeiting and thus, cause instability. According to D.H. Robertson: "Money, which is a source of so many blessings to mankind, becomes also, …..less we can control it, a source of peril or confusion.

4. The practices of bankers and non-bankers who deal in money matters affect the liquidity of the money substitutes which have implications for monetary policy. So it is very difficult to analyze the 'money ness' of real assets and other semi -financial claims.

5. Money may have highly depressing effects on the moral and cultural fabric of the society, since it is believed that money makes man more and more greedy.

2.5 DYNAMIC ROLE OF MONEY IN A MODERN ECONOMY

The standard functions of money is termed as passive functions of money, all of them mostly originating from money's function of serving as medium of exchange. This is the view expressed by J .L. Hanson. However, the government may change the price and outputs by changing the consumer behaviour by using monetary policy. The monetary policy can make credit either costly or cheap by invoking appropriate changes in interest rate structure.

The advent of modern money has facilitated the deficit financing by the governments. A deficit budget is one which has uncovered revenue deficits. Deficit financing is a very useful instrument of capital formation in countries where unemployed resources exist.

Therefore, money has certain dynamic functions too. Money through its dynamic role stimulates the growth rate, price level, resource use and helps to redistribute wealth and income.

Check your progress:

1. Bring out the significance and limitations of money.

2. Explain the dynamic role of money in a modern economy.

3. Explain the following concepts in 3 or 4 sentences.

   a) Capitalistic economy.
   b) Mixed economy.
   c) Socialistic economy.
   d) Moinetization process.
   e) Resource activation.

2.6 SUMMARY

The role of money in a modern economy is very dynamic and unique. Money is found everywhere; it is there in all kinds of economic systems. It - is necessary to ensure right amount of money for the use in various parts of economic machinery to make them work efficiently.

It is necessary to remember the fact that the pricing process can exist only in a monetary economy. During modern times all economies are monetary economies. The pricing process is a focal point in a capitalistic economy, directing production, consumption, saving and investment. Thus, the use of money helps to determine: a) What is to be determined? b) How much has to be produced? c) How to restore equilibrium between demand and supply of goods and services and also demand for and supply of money.

Money is an indispensable condition for the development of money and capital market in capitalistic and mixed (or planned) economies. In these economies, money acts through, interest rate. Thus, the role of money under a centralized planned economies. (or socialist countries) tends to be very passive as against the dynamic role of money under capitalism.

The significance of money may be stated as under:

Money is a powerful factor that is liable to stimulate or hinder economic and cultural progress. Intelligent and progressive application of the monetary system tends to result in fuller utilization of natural resources and of technological inventions leading to a higher standard of living. On the other hand, a too narrow and rigid application of the monetary system is apt to handicap progress. And the misuse of facilities provided by the monetary system is apt to lead to grave set-backs through the destructive consequences of a run-away inflation or even of a relatively moderate but persistent creeping inflation. So money potentially very useful shall very carefully used.

2.7 KEY WORDS

Capitalistic Economy. This is a form of economy dominated by free enterprises and laissez -faire. Under capitalism the market forces play a dominant role in the determination of output, prices, factor rewards. It is a competitive economy.

Mixed Economy: An economic system characterised by the co-existence of private and public (state) enterprises. There will be form of planning and government intervention to guide the working of the economy. India is a good example for mixed economy.

Socialistic Economy: It is a state dominant economic system. State owns the resources, decides the production, distribution and consumption patterns. It is an alternative to capitalism.

Monetization Process: An increased use of money and its substitutes (or near money assets) to transact and clear the claims and counter -claims is called the monetization process. It facilitates production, exchange, capital accumulation and borrowing & lending.

Resource Activization: All attempts to use productively and economically the resources is called 'resource activization'. This is generally achieved through an intensive use of money and near money assets.

Dynamic Role of Money: The Growth facilitating effects of the well managed money is called dynamic role of money. It promotes economic growth, monetization process and the growth of money and capital markets.

2.8 BOOKS FOR STUDY

L. V. Chandler and S.M. Goldfed (1977) . Economics of Money and Banking (Newyork: Harper and Row).

Dudley Luckett, Banking Theory

Sundharam, K.P.M. Money and Banking

J.L. Hanson (1970). Monetary Theory and Practice (London: The ELBS and Harcourt In)

2.9 QUESTIONS FOR SELF STUDY

1. Explain the role of money in a capitalistic and socialistic economy.
2. Compare and contrast the role of money in different types of modern economic systems.
3. Write short notes on the following:
   a) Role of money in a mixed economy.
   b) Passive role of money in a socialistic economy.

NOTE

NOTE

ಆದೇಶ ಸಂಖ್ಯೆ : ಕರಾಮುವಿ/ಸಿಪಾವಿ / 4/520/2006-2007 ದಿನಾಂಕ : 05-09-2006
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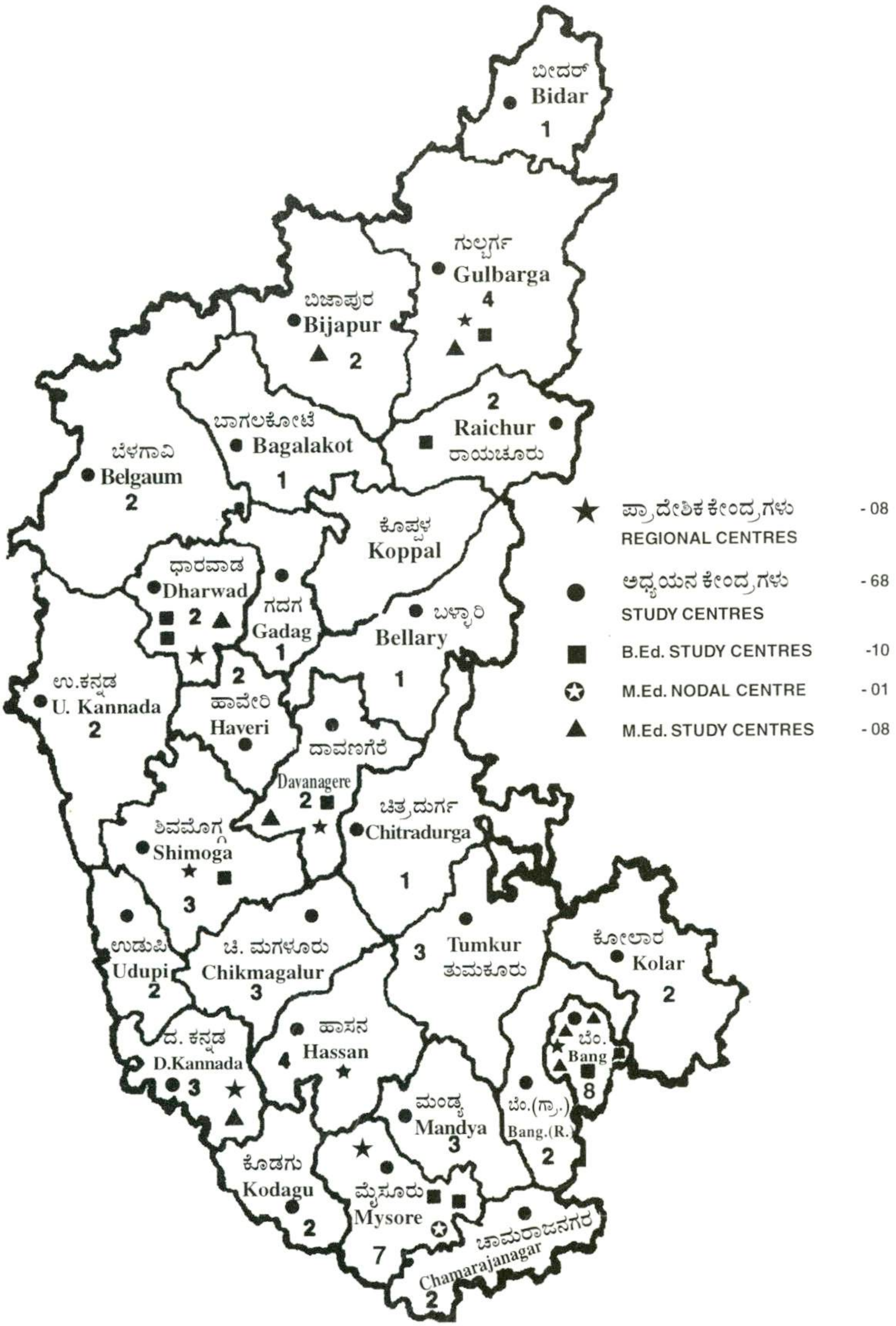
Regional and Study Centres of Karnataka State Open University



(ನಮೂದಿಸಿರುವ ಅಂಕಿ - ಜಿಲ್ಲೆಯಲ್ಲಿರುವ ಒಟ್ಟು ಅಧ್ಯಯನ ಕೇಂದ್ರಗಳ ಸಂಖ್ಯೆಯನ್ನು ಸೂಚಿಸುತ್ತದೆ.)

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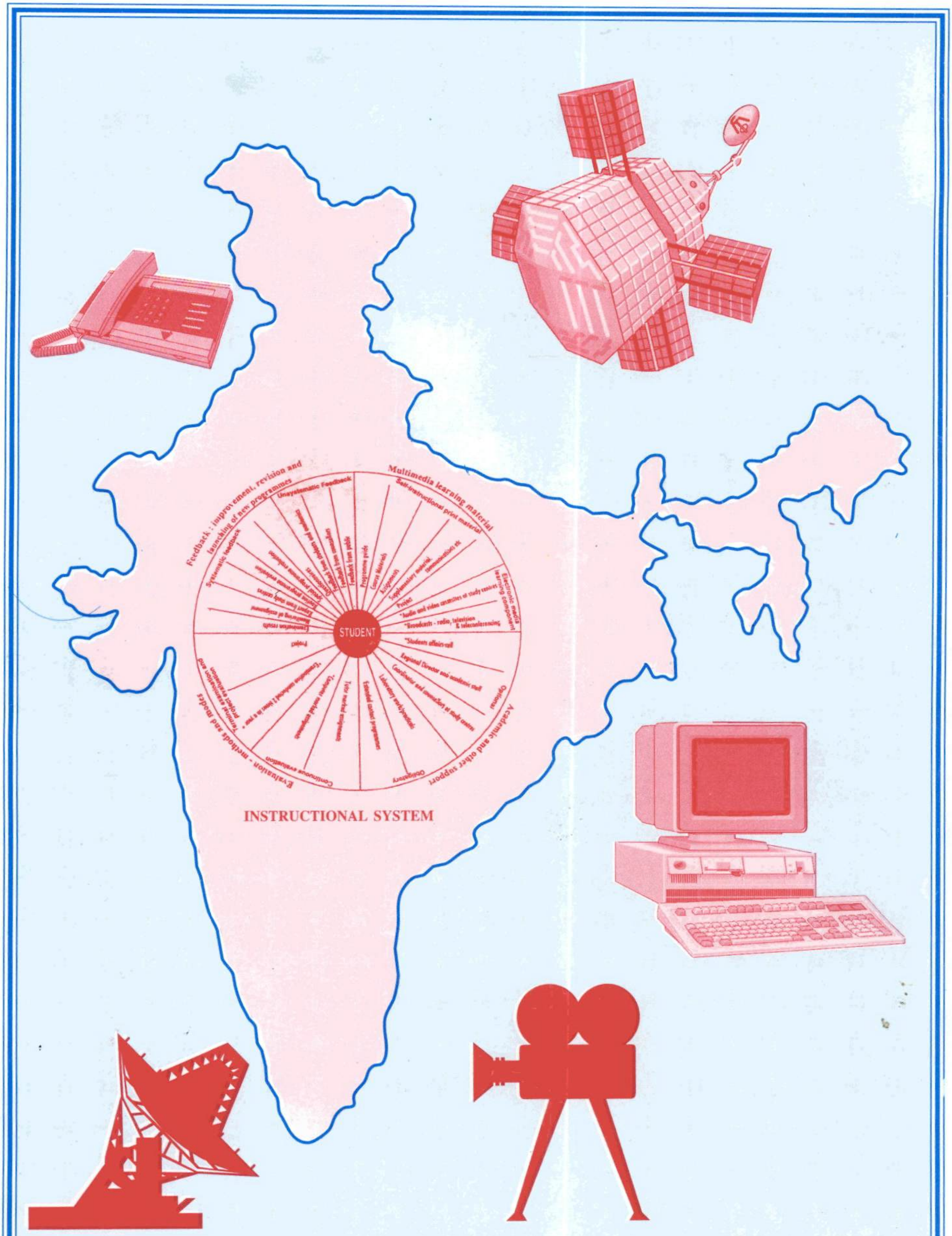
Feedback : improvement, revision and launching of new programmes
Multimedia learning material
Self-instructional print material
Electronic media learning component
Academic and other support
Evaluation - methods and modes
Unsystematic Feedback
Systematic feedback
Programme guide
Course Materials
Assignments
Supplementary material
Project
Broadcasts - radio, television & teleconferencing
Students affairs cell
Regional Director and academic staff
Coordinator and counsellors at study centres
Laboratory work/practicals
Extended contact programmes
Obligatory
Optional
Continuous evaluation
Examination results
Project
STUDENT
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