

Unit - 2

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Money:

Money is anything that is generally acceptable as a means of payment in the settlement of all transactions, including debt. It is the commonly used medium of exchange or means of transferring purchasing power.

Functions of Money:

The functions of money have been summed up below:

(a) As a medium of exchange:

The primary and unique function of money is that it is acting as a medium of exchange. This distinguishing characteristic of money, will help separate money from other assets (near money or non-money). The use of money as a common medium of exchange has facilitated

exchange greatly. Without money exchange will involve a direct barter of goods and services for goods and services. This could be highly wasteful of time and resources in a large, complex society. The use of money as medium of exchange avoids much of this waste by economising on the use of scarce real resources in carrying out exchange. In addition, the use of money also promotes allocational efficiency by making it possible to exploit potential gains from specialisation in trade and production and emergence of specialised markets in every type of goods and services.

(b) As a Unit of Account:

Money customarily serves as a common unit of account or measure of value in terms of which the values of all goods and services are expressed. This makes possible meaningful ~~and~~ accounting systems by adding up the values of a wide variety of goods and services whose physical quantities are measured in different units. Important examples of value totals are the national income estimates of a country, total money cost of a project, total sale proceeds of a multi-product firm etc.

(c) As a Standard of Deferred Payment:

Money also serves as a standard or unit in terms of which deferred or future payments are stated. This applies to payments of interest, rents, salaries, pensions, insurance premia etc. Loans, interest, rents, wages etc.

Stipulated in kind are not unknown. Large fluctuations in the value of money make money not only a poor measure of value but also a poor standard of deferred payment. This is because the value of money is not something intrinsic to it, but a social phenomenon.

(d) As a store of value :

Money also serves as a store of value. This function is derived from the use of money as a medium of exchange in a two-fold manner. First, the use of money as a medium of exchange decomposes a single barter transaction into two separate transactions of purchase and sale. Then, in a money using system, it comes in the form of a store of value.

Interest and profits are money payment received discontinuously.

Money is unique as a store of value in that it alone is perfectly liquid.

Measures of Money Supply:

Money is something measurable. At the outset, two things must be noted about any measure of money supply. First, that the supply of money refers to its stock at any point of time. Second, the stock of money always refers to the stock of money held by the public.

The measurement of money supply is an empirical matter. RBI has published four measures of money supply denoted by M_1 , M_2 , M_3 and M_4 .

where,

$$M_1 = C + DD + OD$$

$C \rightarrow$ Currency held by the public

DD → Net Demand Deposits of banks

OD → other deposits of RBI

$M_2 = M_1 +$ Saving deposits with
post office savings bank

$M_3 = M_1 +$ Net time deposits of
banks

$M_4 = M_3 +$ Total deposits with the
post office savings organization

Quantity Theory of Money:

There are two formulations of quantity theory of money.

- ① Fisher's transaction version
- ② Cambridge Cash-balance version.

① Fisher's transactions approach:

Fisher's quantity theory is explained with the help of his famous equation of exchange

$$MV = PT \quad \text{--- (1)}$$

Where, M is the money, V is the velocity of circulation, P is the price level and T is the time period.

Each side of the equation gives the money value of total transactions during a period. Let us first

consider the right side of the equation. In case of a single (say n) transaction, with its price p_i and quantity t_i , its money value will be given by $p_i \cdot t_i$.

When money value of all such transactions, whether of goods, services, or assets, etc. are added up, we get $\sum_i p_i t_i$.

Taking 'P' as a suitably chosen average of all prices p_i and 'T' as a suitably chosen aggregate of all quantities transacted t_i , we have

$$P \cdot T = \sum_i p_i t_i \quad \text{--- (11)}$$

Now, consider the left hand side of the equation (1). In it, M is the ~~velocity~~ total quantity of money in the economy and V is the velocity of circulation of money. Then MV will also give the money value of total transactions during the same period. Hence, ex post both MV and $P \cdot T$ measure the same total, the two must be equal to each other. Hence, equation (1)

is also called the equation of exchange.

We begin with assumptions of the Quantity Theory of Money (QTM) with respect to individual factors (T , M , V and P) assembled in the equation.

Transaction (T): In the QTM it is assumed that the physical volume of transactions (T) is determined by the basic physical and operational characteristics of the system, such as the real resources available to the economy, the efficiency with which they are used, the degree of business integration of the economy.

Money (M): It is assumed that the factors determining the stock of M depend critically on the monetary system and are largely independent of the forces determining T .

Velocity of circulation (V): The QTM is often associated with the assumption of ~~the~~ a constant V - that V is something of a natural constant. This is not fully correct. No doubt, the transaction approach emphasises payment practices, such as the frequency with which people are paid, the irregularity of receipts and payments, as its key determinant.

Prices (P): P refers to the average price of market transactions of all kinds, whether in currently-produced final goods or services or intermediaries, or old goods, or transactions of a purely financial nature. In the QTM , P is treated as the dependent variable.

Assuming T and V to remain unchanged, or rather autonomous of changes in M , it makes P alone as the factor that absorbs all changes in M .

So, in equation (1), to solve the value of P

$$P = \frac{MV}{T} \quad \text{————— (111)}$$

In the rigid version of the QTM presented above, P is seen to be a proportional function of M , a doubling of the quantity of M will lead to the doubling of P . Also, since changes in M are assumed to be autonomous of P , the former are made the cause of changes in the latter. This sums up the theoretical content of the QTM in transaction approach.

①

The Cambridge Cash-Balance Approach:

An alternative formulation of the QTM has been provided by the Cambridge economists, Marshall and Pigou, in the form of their cash-balance equation.

$$M = KPY, \quad 0 < K < 1 \quad - (1)$$

where, K is assumed to be a behavioural constant and other symbols are as defined already. This equation is the equilibrium condition for the money market, which makes the demand for money equal to its supply. The demand function for money of the Cambridge equation is as follows,

$$M^d = KPY, \quad 0 < K < 1 \quad - (2)$$

It is assumed that the supply of money is given exogenously by the monetary authority, so that

$$M^s = \bar{M} \quad - (3)$$

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Then in equilibrium when the quantity of money demanded by the public is equal to the amount of money supplied by the monetary authority, we have the equation (1).

k in the equation (1) gives the ratio of money income (flow) the public likes to hold in the form of money (stock) and is measured in time units. Therefore its reciprocal will give turnover per time period.

The cash-balance approach stresses equally the store-of-value function of money which enables separation of sale from purchase. Cash-balance approach is behavioural in nature, it is built around the demand function for money. Unlike Fisher's V, k is a behavioural ratio. As such it can easily lead to stress

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(b)

being placed on the relative usefulness of money as an asset, on the costs and return from holding money instead of other assets, the uncertainty of the future, etc.

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