Chapter 9

MONEY

9.1 Barter System

History tells us that money did not exist in early days of economic evolution and there was no measure to be used as money which could be acceptable to all. Thus, in the beginning, people used to exchange goods for goods to fulfill their needs/wants. This practice 'of direct exchange of goods with goods, without usage of a measurable medium' is termed as barter system. It can, therefore, be defined as, **"Barter system means the direct exchange of one good for another, without using money as a medium of exchange".**

Before advent of money, human civilization was simple, but backward. The people used to satisfy their wants by exchange of their surplus goods with each other. For example, a farmer would exchange his agriculture produce with a weaver for cloth woven by him and for foot-ware made by a cobbler.

With the evolution of human civilization, human needs/wants kept on increasing and it was realized that exchange through barter was not satisfactory. Use of barter system declined due to its inherent difficulties and lost its position as the only medium of exchange.

Difficulties of Barter System

1. Lack of Double Coincidence of Wants

The major problem faced in the barter system was absence of corresponding demand of goods to be exchanged between people. One has to find a person who could exchange his goods with the goods he required. For example, if Mr. A has cloth and want wheat for his family, he will have to find out a person who has surplus wheat and at the same time would need cloth. Mr. A shall have to face a number of difficulties in finding a person who would be ready to exchange cloth for wheat. It is because he might find a person having surplus wheat, the other person might not be ready to exchange it with cloth because he did not need it but is ready to exchange it for ghee. Therefore, barter system simply failed due to lack of double coincidence of wants for exchange of goods.

2. Lack of Common Measure of Value

Under the barter system, there was no common yardstick to measure value of various goods. For example, if two persons are ready to exchange their goods, there rises an issue as to what quantity of one item shall be exchanged with how much volume of other item. For more clear understanding of the issue, consider that Mr. X has wheat and Mr. Y has a cow and they both agree to exchange their goods with each other. Now, an issue rises that how much wheat has to be given by Mr. X to have the cow. It is quite possible that Mr. Y wants more wheat to exchange his cow that Mr. X is ready to offer. Under these circumstances, transaction could not be completed due to lack of some common measure to determine value of goods, even after having double coincidence of wants.

3. Difficulty in Store of Value

During the barter system era, goods could not be stored since majority of those were perishable and could not be stored for a long time. For example, agricultural produce, vegetables, fruits and milk etc. Such commodities were always exposed to risks of losses because of lack of proper storage facilities. It was also one of the major reasons because of which barter system lost its importance and people ultimately discarded it.

4. Indivisibility of Goods

Indivisibility of certain commodities was another important difficulty in barter system. Exchange of such goods was a problematic task for the people. For example, if a person has a horse and wanted to buy a pair of shoes, he will either have to exchange his horse for it or live without having a foot-ware. Therefore, people have to face difficulties in easy and smooth exchange of goods.

5. Difficulty in Collection of Government Revenue

In the absence of a common currency, the Government has to receive/accept its revenue in the form of goods. Therefore, the Government treasury was in the form of commodities including perishable items. Due to lack of proper storage arrangements/facilities, the Government has to face loss even after collection of its revenue. Further, the Government has to face severe difficulties while remunerating its employees in the form of goods.

6. Problem in Transfer of Wealth

In barter economy, the people used to have their wealth/capital in the form of goods, which could not be easily transferable from one place to another. For instance, if a person wanted to migrate from a city to another by selling his property, he will receive sale proceeds of his property in shape of animals, agricultural produce etc, which he could not easily shift to his new place of residence. It was due to such innumerable shortcomings of barter system that it failed miserably.

9.2 Evolution of Money

Failure of barter system, due to its inherent difficulties, was the mother of money. Various goods were tried at various times as money. These include skins/hides, animals, stones, metals etc. However, all these items have some serious shortcomings that none of these items could survive as acceptable mode of money for a long period of time. At last, paper money was put into practice which may be called very important invention of modern economy. It not only resolved all problems faced under barter economic system, but also helped the economy to progress and prosperity. Modern monetary system has fostered the commercial activities and strengthened the economy.

9.3 Definition of Money

In the world of today, no country can progress without having a price system. Fluctuation in prices affects all segments of an economy. Money is an excellent expression to describe change in prices. Money is as important for our economy as is blood for our body. The whole economic system will collapse without circulation of money. It is very much similar to what will happen to our body if there is no blood circulation.

Hence, it is very important to define money comprehensively. Various economists have defined it in their own words. Definitions of money by some eminent economists are as under:

Professor Walker states, **'Money is what money does'**. It means that anything that performs the function of money is money. In the words of J.M. Keynes, **'Money is that by delivery of which debt and price contracts are discharged'**. According to Professor Morgan, '**Money is anything that is generally used in the payment of debts**'.

A better definition of money is given by Geoffrey Crowther, renowned British economic expert as **'Anything that is generally acceptable as a medium of exchange and that at the same time acts as a measure and store of value'**. A more careful examination of this definition reveals that anything acting as money should have the following properties:

1. It should have general acceptability as a general medium of exchange.
2. It should act as a measure of value to exchange goods.
3. It should work as unit of account, so that the prices of goods may be measured by it. For instance, Rupees is unit of account in Pakistan.
4. it should work as store of value. It should make it possible to store and preserve wealth in form of medium of exchange.

9.4 Functions of Money

Money performs the following important functions:

1. Medium of Exchange

It is the most important function of money. It acts as medium of exchange in the transactions of goods and services. During barter system era, goods were exchanged with goods. This causes very serious inconvenience for the general public due to lack of double coincidence of wants and satisfaction. As a medium of exchange, money cleared all shortcomings of barter system. Now, there is no need for double coincidence of wants because everyone gets money upon selling the products in the market and can buy a commodity by paying money to satisfy his wants. In this way, money has performed its function excellently and it has made economic activities of production, distribution and exchange of wealth quite easy and convenient.

2. Common Measure of Value

Money also acts as a measuring unit to determine value of goods and services. For instance, keeping the prevailing prices in view, we can ascertain that price of one liter of milk is Rupees thirty five. Under barter system, it was very difficult to compare/determine value of various commodities due to absence of a common measure of value. Therefore, under barter system, a person may have to exchange a large quantity of same commodity for exchange of one liter milk. However, money has now removed all such difficulties because we are now in a position to determine real value of any commodity or service with the yard-stick of money.

3. Store of Value

Another important function of money is its ability to store value of our wealth and keeps it intact for a long period of time. Whenever we need to buy some commodity or service, we can do it by paying equivalent sum of money. Contrarily, we could not store value of our goods under barter economy because most of the goods were perishable and lose their value with the passage of time. Money is not a perishable commodity. It is either in the form of metallic coins or currency-notes, which can be stored for a long period of time without having a risk of loss of value.

4. Transfer of Value

Under barter system, people had their wealth in form of goods in large quantities which were not conveniently portable and therefore could not be easily transported from one location to another. Creation of money has solved this problem. Now, one can sell his moveable and immoveable property/belongings at one place and get money. He can easily buy assets at some other location with the help of money he received from previous transaction. The money has, in this way, made transfer of wealth easy and one can conveniently transfer his immoveable assets from one place to the place of his choice.

5. Convenience in Government Revenue Collection and Payments

During the time of barter system, the Government used to collect its revenue in form of goods and make payments to its employees in form of goods. Therefore, the Government had to face a lot of difficulties in collection of revenue and thereafter releasing payments to its employees. Money has done away with this difficulty, too. Now, the Government easily collects its revenue in the form of money and makes payments to its employees in the shape of money.

6. Miscellaneous Functions

Besides, above-stated functions of money, its another important function is to serve as a standard of debts repayments. Now, people use money as a standard measure of deferred payments. It has made lendings and borrowing much easy and less risky. Under barter economic system, lending and borrowings used to be made in the form of goods which were not equal in size, shape and quality. It often caused inconvenience to the concerned parties in entering into debt contracts and afterwards discharge of such contracts. Additionally, money also acts as unit of account to express prices of goods and services to be transacted. During barter system era, there was no measure of value to express price of a commodity or service and therefore, there was no common unit of account to record business transactions.

9.5 Kinds of Money

Followings are the main kinds of money which remained in use at different times of the history:

1. Metallic Money
   a. Standard money or full bodied coins   b. Token money or legal tender
2. Paper Money
   a. Convertible paper money   b. Inconvertible paper money
3. Legal Tender
   a. Limited legal tender   b. Unlimited legal tender
4. Credit Money
5. Near Money

Different kinds of money are explained in the following text:

1. Metallic Money

Coins made of different metals are called metallic money. In the beginning, coins used as money were made of pieces of various precious metals of specific forms and weights. Afterwards, rulers of different states set up mints to make coins. These coins had denominations engraved thereon, along with names and figures of the concerned rulers.

a. Standard Money or Full Bodied Coins

It refers to that type of money that serves as a unit of account in the monetary system of an economy. It means that standard or full-bodied money whose face value is equal to its real value. In other words, representative value of a standard coin is equal to its intrinsic value, which is actual value of the precious metal (gold, silver etc) a coin is made of. Before 1883, coin in practice in undivided sub-continent was a standard coin which used to have an equal face and real value. For example, a silver was coin Rupee coin used to contain silver of equivalent amount in it. However, use of standards abandoned in the world due to limited availability and shortage of precious metals. In current age, no country issues standard coins.

b. Token Money

The metallic money with much higher face value than its real or intrinsic value is termed as token money. For example, coin of Rupee 5 has face value equal to Rupees 5 but its intrinsic value is quite less. It means that the value of metals used in its making is quite less than its representative value. Now-a-days, token coins are used all over the world. However, its proportion as compared to the total money is quite small.

2. Paper Money

It refers to currency notes issued by the Government or by the Central bank of a country. These currency notes have characteristic of general acceptability and no one can refuse to accept it. Therefore, paper money is used as a perfect medium of exchange in all transactions having money value. It has two following categories:

a. **Convertible Paper Money**

It is paper money which could be converted into equal value of silver/gold or foreign exchange on demand of the bearer.

b. **Inconvertible Paper Money**

This type of money is issued by the Government but the central bank does not take responsibility of its conversion into equal value of silver/gold or standard coins etc. So, it is inconvertible paper money which is currently in practice all over the world, including Pakistan.

3. Legal Tender

Legal tender is the type of money which one has to accept under the law in discharge of debts and all other transactions as a medium of exchange. In Pakistan, all coins and currency notes are legal tender and nobody can refuse to accept it, because it is backed by the Government. Legal tender is also called as 'fiat money'. It is of two types:

a. **Limited Legal Tender**

It is a type of money which everybody has to accept legally as mode of payment up to a specific value or limit and one can refuse to accept it if it exceeds already specified limit or value. In Pakistan, all coins of lower denominations come under this category. Government has specified different limits for payment using these coins. One may refuse accepting payment if it exceeds prescribed limits because of inconvenience in counting larger sums.

b. **Unlimited Legal Tender**

It is a type of money which everybody has to accept legally as mode of payment up to any limit. Nobody can refuse accepting unlimited tender for any amount or limit.

One has to accept it in any quantity. In Pakistan all currency notes and coins of higher denominations are unlimited legal tender.

4. Credit Money

Credit money circulates in monetary system on the basis of trust. Credit money includes cheques drawn on banks, hundies, drafts and credit cards etc. Credit money normally circulates among the business communities which enjoys a certain degree of credibility and trust among themselves. It is to be noted that accepting credit money is the sole discretion of the person to whom it is paid. He may or may not accept it as a mode of payment. This is why credit money is also named as 'optional money'. Total money circulation in Pakistan comprises of aggregate of credit money and legal tender.

5. Near Money

It refers to that money which is not in cash and can not be readily acceptable as medium of exchange; for example, bonds, government securities, insurance policies, investment instruments etc. Near money can be easily liquidated into cash. Shares of well established business entities, listed on stock exchange, are also considered as near money because those can easily be sold for cash at any time. Similarly, government securities, postal certificates and gift coupons are types of instruments which are not money but are easily convertible into cash. That is why such instruments are called near money.

9.6 Value of Money

Value of money means its purchasing power which it can realize for instance, if Rupees 30 can be exchanged for one kilogram of sugar; it would mean that value of Rupees 30 is equal to one kilogram of sugar. If price of sugar rises, lesser quantity of sugar could be bought from the same amount of money, which means the value of money (its purchasing power) has reduced. Contrarily, fall in price of sugar means an increase in value of money because same amount of money can purchase more quantity of sugar.

From the above example, we can conclude that there is an inverse relationship between value of money and price level. It means that a rise in price level shall reduce value of money whereas a decrease in price level shall increase value of money. It is to be remembered that there is a direct relationship between supply of money and price level. An increase in money supply increases price level and a fall in supply of money reduces price level. We can conclude from this discussion that an increase in quantity of money causes prices to rise, which ultimately reduces purchasing power (value) of money. Conversely, a contraction in the quantity of money results in fall in prices which causes a rise in purchasing power (value) of money.

The fact can be illustrated with the help of a simple example. Assume that Rupees 100 are issued in a country having 10 items available for buying. It means that price of each item is Rupees 10 because:

$$\text{Price} = \frac{\text{Total quantity of money}}{\text{Total commodities}} = \frac{100}{10} = \text{Rupees } 10$$

Considering the above example, if we double the quantity of money from Rupees 100 to Rupees 200 without changing the availability of commodities, price level shall shoot up to Rupees 20, as under:

$$\text{Price} = \frac{\text{Total quantity of money}}{\text{Total commodities}} = \frac{200}{10} = \text{Rupees } 20$$

It means that if we double the quantity of money without change in supply of goods, prices will be doubled and purchasing power of money will be reduced to half. We could buy goods for Rupees 20, which were previously available for half of the price (Rupees 10). Similarly, if we cut down quantity of money to Rupees 50 from Rupees 100, price of commodities fall down to Rupees 5, provided that there is no change in quantity of goods available for sale:

$$\text{Price} = \frac{\text{Total quantity of money}}{\text{Total commodities}} = \frac{50}{10} = \text{Rupees } 5$$

It is very clear from the above example that if quantity of money is halved, price level is also reduced in the same proportion and value of money is doubled. It means that a commodity which was previously available for Rupees 10 could now be purchased for Rupees 5.

Factors Causing Changes in Value of Money

1. Supply of Money

There is direct relationship between supply of money and price level. An increase in supply of money causes prices to rise and reduces value of money, whereas a decrease in supply of money (quantity of money) reduces price level and increases value of money.

2. Quantity of Production

If quantity of money remains constant, an increase in production brings a reduction in prices and strengthens value of money. On the other hand, a fall in production increases prices and value of money reduces.

3. Circulation of Money

The number of times a certain amount of money is used in buying activity or number of times money changes hands as a mode of payment of prices is termed as velocity of circulation of money or circulation of money. Increase in circulation of money increases price level and value of money decreases. Conversely, decrease in circulation of money causes prices to decrease and value of money gets strength.

4. Population Growth

Price level rises if rate of increase in production of goods, (such as food, shelter and clothing etc) is less than the rate of population growth. According to economists, one of the major causes for increasing prices is rapid increase in population. Due to aforesaid factor, quantity of goods and services falls short of the rising demand of increasing population. It is the main cause of rising prices in Pakistan.

5. Unfavourable Circumstances

Normally demand for goods and services increases in cases of natural calamities or other adversaries like outbreak of diseases, disaster of war, earthquake, floods etc. This was the situation in Pakistan during wars of 1965 and 1971 when prices increased abnormally and value of money took a nosedive.

6. Rate of Tax

In case of rise in rate of taxes, the burden of additional indirect taxes (sales tax, custom duty, excise duty etc.) is passed on to end-consumer. It brings about increase in prices and value of money weakens. However, if Government reduces rate of indirect taxes, prices of goods falls and value of money rises.

7. Foreign Trade

A country has to face unfavorable balance of payments if its exports are lesser than imports. The Government has to impose more taxes to arrange foreign exchange. It directly affects prices with ultimate decrease in value of money. On the other hand, an increase in prices of imported raw material and machinery it also increases prices of domestically produced goods and therefore value of money also reduces. Hence, value of money can only be stabilized by striking a balance in imports and exports.

Exercise

Q. 1: Each statement has four possible options. Tick (✓) the best one:

1. Which of the following is not included in the functions of money?
   - a. Medium of exchange
   - b. Standard of value
   - c. Store of value
   - d. Indivisibility
2. Which of the following economy does not use money as a medium of exchange?
   - a. Open
   - b. Barter
   - c. Islamic
   - d. Close
3. Which authority issues currency notes in Pakistan?
   - a. Commercial banks
   - b. Central bank
   - c. Agriculture bank
   - d. Industrial bank
4. Prices are increased with an increase in quantity of money; how value of money is affected in such cases:
   - a. falls
   - b. rises
   - c. remains constant
   - d. remains normal
5. Which kind of money has to be accepted legally in discharge of debt and routine business transactions?
   - a. Paper money
   - b. Credit money
   - c. Monetary goods
   - d. Near money

Q. 2: Complete the following statements by filling in the missing words or phrases:

1. In ...., goods are exchanged for goods.
2. Money having equal face value and real value is called ....
3. Money consisting of cheques, drafts, hundies and credit cards issued by banks is called ....
4. Money having more face value than its real value is termed as ....
5. Value of money .... with increase in its quantity/supply.

Q. 3: Match the statement in column A with statement in column B; choose the best answer to write it in column C:

A	B	C
Postal certificates	value of money	
Fiat money	is legal tender	
Source of transaction of goods	are near money	
Purchasing power of money means	is medium of exchange	
Easy transfer of wealth means	Easy transfer of the place	

Q. 4: Answer the following questions in three sentences:

1. Explain/Write down important features of G. Crowther's definition of money.
2. What is meant by paper money?
3. Differentiate between convertible and inconvertible paper money.
4. What is meant by value of money?

Q. 5: Answer the following questions in detail:

1. Define barter system. Also state difficulties faced by this system.
2. Define money and describe its important features.
3. Explain functions of money with the help of examples.
4. Describe in detail the following kinds of money with Examples:
   a. Credit money b. Near money c. Paper money
   d. Metallic money e. Token money
5. Explain in detail the factors causing changes in the value of money.