

## **15. Money – Definition & functions of money; inflation – consequences & control.**

### **MONEY**

Money has made rapid economic progress possible in this modern age. In the early stages, exchange took the form of barter. Barter is the direct exchange of one good for another. For instance, the farmer gave paddy to the potter to get pots for cooking. As the number of goods to be exchanged increased, barter posed many difficulties. So precious metals like gold and silver were used as money. Then the paper currencies were used as legal money, i.e., an instrument of exchange, by the governments.

#### **j) Definition of Money**

Money is defined as anything that the public readily accepts in payment for goods and services and other assets and in the discharge of debt. Robertson defined money, “as anything that is acceptable in discharge of obligations”. According to Crowther, “Money is anything that is generally acceptable as a means of exchange”. The most commonly accepted view is that “all media of exchange and payment, whose acceptance the law requires in discharge of debts”, may be called money. Bank notes (Coins, currency and cheques) are generally accepted and are, therefore, money.

**ii) Functions of Money:** Money performs five important functions. They are:

**a) It serves as a medium of exchange:** On account of its general acceptability as a medium of payment, money has ready purchasing power and becomes circulating medium. Being generally acceptable medium of exchange, money facilitates the multiple exchanges of goods and services with minimum effort and time.

**b) It is a store of value:** Since money is a medium of exchange, it commands goods and services in the present as well as in future.

**c) Money is a standard measure of value:** Money acts as a unit of account. With money, it is easy to compare the relative values of commodities and services that are different from one another. E.g. the rupee is a unit of account in India while the dollar (\$) is the unit of account in U.S.A.

**d) Money serves as a standard of deferred payments:** It is a unit in terms of which debts and future transactions can be very easily settled. The rupee or unit of account is the standard of deferred payment or future payment. Thus, loans are advanced and future contracts are settled in terms of money.

**e) It transfers value:** One can sell out his immovable belongings (say, buildings) at one place and buy them elsewhere.

### **iii) The Quantity Theory of Money**

The quantity theory of money was put forward by David Hume in 1852. Money does not retain a constant value over a period of time, i.e., value of money increases or decreases over a period of time. Value of money means the purchasing power of money. Value of money is dependent on the general price level. A rise in the general price level means a fall in the value of money. On the other hand, a fall in the general price level means a rise in the value of money.

**a) Price level dependent on quantity of Money:** The quantity theory of money gives reasons for changes in the general price level. According to this theory, an increase in the quantity of money in country will lead to a rise in the price level. On the other hand, a decrease in the quantity of money in the country will lead to a fall in the price level. It is also asserted that, other things remaining the same, the value of money falls proportionately with a given increase in the quantity of money. Conversely, the value of money rises proportionately with a given decrease in the quantity of money. In other words, changes in the general price level, other things remaining the same, are directly proportional to changes in money supply.

Irving Fisher, an American Economist, has refined this theory by adding the velocity of circulation of money or the rate at which it is exchanged as a factor. According to Fisher, the general price level is dependent on supply of and demand for money.

**b) Supply of Money:** On any day, the supply of money is equal to the total amount of money in circulation in the country. Money in circulation in the country consists of (1) legal tender money and (2) bank money. Over a period of time, money changes from hand to hand. The number of times it is passed on from one person to another is called the velocity of circulation of money. Thus, to find out total money supply during a period of, say, one year, we have to take into account, (1) the amount of legal tender money and bank money and (2) the velocity of money circulation. The supply of money is given by: Supply of

Money =  $MV + M'V'$ , where,  $M$  = legal tender money,  $V$  = Velocity of circulation of  $M$ ,  $M'$  = bank money and  $V'$  = Velocity of circulation of  $M'$ .

**c) Demand for Money:** In order to find out the money demanded by people during one year period, we consider, (i) the total amount of goods purchased by people, that is, the total volume of transactions in the country ( $T$ ) and (ii) the general price level ( $P$ ). Therefore, the demand for money =  $PT$ .

Fisher says that demand for money will equal its supply, i.e.,  $PT = MV + M'V'$ .

$$P = \frac{MV + M'V'}{T}$$

Fisher assumes  $V'$ ,  $V$  and  $T$  to remain unchanged. He also assumes that the ratio between  $M$  and  $M'$  will remain unchanged. Hence, he concluded that wherever there is a change in money ( $M$ ), there would be a change in price level ( $P$ ). Thus,  $P$  (Price level) is dependent on money supply ( $M$ ). Thus, Fisher's equation of demand and supply of money leads us to the conclusion that with every increase in the quantity of money, the price level will increase and the value of money will fall.

### **C. INFLATION**

Inflation is defined as an increase in the average level of prices. When the supply of output is less, the rise in prices is described as inflationary. In Goulborn's words, it is a case of "too much money chasing too few goods". H.G. Johnson defines inflation as "a sustained rise in prices". Inflation is generally associated with an abnormal increase in the quantity of money resulting in abnormal rise in prices. Inflation thus, represents a situation whereby the pressure of aggregate demand for goods and services exceeds the available supply of output.

#### **i) Causes of Inflation**

a) Increase in demand and decrease in supply of goods cause inflation. Increase in demand is caused by increase in aggregate spending on consumption and investment goods. Decrease in output is due to deficiency of capital equipment, scarcity of factors of production and natural calamities like drought, flood, etc.

b) Inflation occurs during the war when the government creates additional money and circulates the same into the economy to meet war expenditures.

c) Also, when government resorts to deficit financing, inflation takes place.

d) Planning for rapid economic development is another cause of inflation. Huge investments are made which would yield results only after a period of five to ten years. This very long time lag between input and output results in inflation.

e) The activities of hoarders and speculators reduce the supply of goods to the market and push up prices.

f) The prevalence of black money or unaccounted money and also the existence of counterfeit money lead to inflation.

**g) Demand-pull inflation:** It refers to that rise in the price level, which takes place because consumers and investors with their rising income compete with each other for a relatively limited supply of available goods.

**h) Cost-push Inflation:** It refers to that rise in the price level, which takes place because wages increase to a greater extent than labour productivity. These costs (wages) are passed on to the consumers in the form of higher prices.

**ii) Types of Inflation:** The classification of inflation is based on the speed with which the price increases in the economy.

**a) Creeping inflation:** It is the mildest type of inflation, under which prices rise slowly, say, one per cent per annum.

**b) Walking inflation:** When the rise in prices is more pronounced as compared to a creeping inflation, it is called walking inflation. Roughly, the prices rise five per cent annually under this situation.

c) When the movement of price accelerates rapidly, “**Running inflation**” emerges. Under this, prices rise by more than ten per cent per annum.

**d) Hyperinflation:** This is an alternative term for run away or galloping inflation. There is such a tremendous expansion in the supply of money and eventually it becomes worthless. Hyperinflation results in a steep rise in prices (sometimes, the rise in prices is 100 per cent or more) and it disrupts normal economic relations.

**iii) Deflation:** It is the opposite of inflation. It means a fall in the general price level associated with a contraction of the supply of money and credit.

**iv) Effects of Inflation:** The effects of inflation are felt unevenly by different groups of individuals within the economy. Generally, inflation inflicts more harm on low and fixed income groups than high-income group of people. Some of the important effects of inflation are given below:

- a) Debtors gain and creditors stand to lose by inflation
- b) When prices rise, producers, speculators and entrepreneurs gain because prices rise at a faster rate than the cost of production.
- c) Property owners are benefited on account of increasing property value.
- d) The hardest hit are those who earn fixed income. Persons who live on post office savings, fixed interest and rent, pensioners, government employees and so on suffer because their incomes do not rise in proportion to rise in prices.
- e) Distortion in production and allocation of resources take place since producers prefer to produce goods consumed by the rich people.
- f) Inflation results redistribution of wealth favouring businessmen and hurting consumers, creditors, small investors and fixed income earners.

v) **Control of Inflation:** The following are the anti-inflationary measures:

**(a) Monetary measures**

- 1) The central bank i.e., the Reserve Bank of India can increase the market rate of interest that will reduce the aggregate spending.
- 2) If the RBI can reduce the cash available to the banking system, the capacity of the banks to lend money to the borrowers will be reduced.
- 3) The RBI can sell the Government securities to the banks or to the public so that cash available with bank or public can be reduced.
- 4) Consumer credit control can reduce money supply.

**b) Fiscal measures**

- 1) Reduction of government spending
- 2) Imposition of new taxes
- 3) Encouragement of savings or introducing compulsory saving schemes

**c) Physical or Non-monetary measures**

- 1) Increasing output, increasing imports and decreasing exports so as to increase the availability of goods which are in short supply.
- 2) Controlling money wages to keep down costs.
- 3) Price control and rationing.
- 4) Control over speculation, hoarding and black-marketing.
- 5) Import of essential commodities and distribution of such goods through fair price shops.

The monetary and fiscal measures will reduce the money supply in the country, whereas the physical and non-monetary measures will increase output and control prices of goods. Thus, inflation can be gradually controlled.