FINANCIAL SYSTEM, MONEY & GENERAL PRICE LEVEL

5.1 Introduction to Money & The Barter System

What is the Barter System?

Before money existed, people produced goods for themselves. As human wants grew, they began exchanging surplus goods. This direct exchange of goods and services is called the Barter System.

Drawbacks of the Barter System

- Double coincidence of wants – both parties must want what the other has
- No common measure of value for goods and services
- Difficulty exchanging services (e.g. a haircut for a surgery)
- Problems dividing goods into smaller units
- Difficulty storing goods for future use
- Limitations on mobility of goods
- Limitations on the expansion of economic activities

Evolution of Money

Commodity Money	Metallic Money	Paper Money	Credit Money	Plastic Money	Crypto Currency	

5.1.2 – 5.1.5 What is Money? Characteristics, Functions & Types

What is Money?

Money is **anything that is generally acceptable in exchange for goods and services**. In the broader sense, money must be: (1) a generally accepted medium of exchange, and (2) fulfil the main functions of money.

Characteristics of Money

Characteristic	
Acceptability	Convenience to identify
Portability	Divisibility
Difficult to counterfeit	Uniformity
Intrinsic value ≤ face value	Stability of value
Relative scarcity	Durability

Functions of Money

Term	Definition / Explanation
Medium of Exchange	Removes barter problems. Allows specialization and division of labor.
Store of Value	Saves purchasing power for future use. However, inflation erodes this value.
Unit of Account	Provides a common measure of value. Prices expressed in money (e.g. pen = Rs.20, rice 1kg = Rs.100).
Standard of Deferred Payment	Allows borrowing and lending. Enables entering agreements for future payments.

> *Limits of Money Functions: (1) Inflation reduces value, (2) Risk of holding money, (3) Opportunity cost, (4) Availability of more convenient methods, (5) Technical progress.*

Types of Money

Term	Definition / Explanation
Fiat Money	Value by government order (legal tender). Not backed by a commodity. High liquidity. **E.g. notes and coins**.
Bank Money (Commercial)	Demand deposits at commercial banks. Withdrawable at any time via cheque, ATM, or online banking.
Near Money	**Highly liquid assets easily converted to money.** E.g. savings deposits, fixed deposits, treasury bills.
Money Substitutes	**Temporary medium of exchange; cannot store value**. E.g. credit cards, debit cards.
Electronic Money	**Exchanged only electronically via internet/computer networks**. E.g. EFT, direct deposits, Easy Cash.

5.2 Demand for Money and Money Supply

Demand for Money

Demand for money is the **preference or desire of people to hold coins, notes, or money balances in hand or at the bank.** People hold money for three motives:

Term	Definition / Explanation
Transaction Motive (Mt)	Holding money for **day-to-day transactions**. Positive relationship with income — Mt = f(Y). When income rises, transaction demand rises.
Precautionary Motive (Mp)	Holding money for **unplanned emergencies** (accidents, illness). Also positively related to income — Mp = f(Y).
Speculative Motive (Msp)	Holding money instead of other assets when returns on those assets are expected to fall **(Gain future returns).** Negative relationship with rate of interest — Msp = f(r). When interest rate rises, speculative demand falls.

Macroeconomic Variables Affecting Demand for Money

- **Real Income** – positive relationship (income ↑ → demand ↑)
- **Rate of Interest** – negative relationship (interest ↑ → people invest more → demand for money ↓)
- **Price Level** – positive relationship (prices ↑ → need more money → demand ↑)
- **Future Expectations** – if treasury bill prices expected to rise, people buy more → money demand ↓
- **Organizational Factors** – longer time between income receipts → higher demand for money
- **New Trends in Money Market** – new trends ↑ → people hold more money

Supply of Money – Monetary Aggregates

Term	Definition / Explanation
M_1 (Narrow Money)	Currency held by public + Demand Deposits held by public at commercial banks. **(M_1 = Cp + DDp)**
M_2 (Broad Money)	M_1 + Time and Savings Deposits (TSDcp). **(M_2 = M_1 + TSDcp)**
M_2b (Consolidated Broad)	M_2 + 50% of Non-resident Foreign Currency Deposits + Residents' Foreign Currency Banking Units. **($M_2b = M_2 + TSD_n^{Rfc} + RD_n^{cBU}$)**
M_4 (Financial Survey)	M_2b + Time & Savings Deposits in Licensed Specialised Banks (LSBs) + Registered Finance Companies (RFCs). Also: **(M_4 = M_2 b+ LSB + RFC)**

Base Money (High Powered Money) H = Cp + CB + RR + DoI
Base money is the reserve money issued by the Central Bank, which commercial banks use to create credit and deposits.

5.3 The Financial System of Sri Lanka

Components of the Financial System

- Financial Institutions (intermediaries + service providers)
- Financial Markets (Money Market + Capital Market)
- Financial Instruments (Treasury Bills, Bonds, Shares, Debentures, etc.)
- Financial Infrastructure
- Financial Institutions regulating the system

Money Market	Capital Market
Short-term assets (< 1 year)	**Long-term assets (> 1 year)**
Treasury bills, commercial paper, CDs	Treasury bonds, debentures, shares
Facilitates **liquidity management**	Facilitates **raising long-term funds**
Issuers: Govt, banks, private companies	Issuers: Govt, banks, private companies
Investors: Banks, insurance, provident funds	Investors: Pension funds, insurance companies

Classification of Financial Institutions (Central Bank)

- Central Bank of Sri Lanka
- Licensed Commercial Banks
- Licensed Specialized Banks
- Deposit-Taking Institutions
- Licensed Finance Companies
- Thrift & Credit Co-operative Societies
- Specialized Financial Institutions (Primary Dealers, Share Brokers, Unit Trust Cos.)
- Contractual Savings Institutions (Insurance, EPF, ETF, Provident Funds)

5.4 Central Bank of Sri Lanka – Objectives & Functions

The Central Bank was established under the Monetary Law Act No. 58 of 1949. It is the apex monetary authority of Sri Lanka with two core objectives, But later after Monetary Law Act in 2023, there only one core objective as primary objective and other was made secondary.

Primary Objective: Price Stability	Secondary Objective: Financial Stability
Maintaining economic and price stability	Maintaining financial system stability
Achieved through monetary policy	Stable financial markets and institutions
Low inflation = stable prices	Absence of banking/currency crises
Fosters long-term economic growth & employment	Requires effective regulatory framework

Functions of the Central Bank

- Management of Monetary Policy
- Management of currency issuance
- Employees' Provident Fund Management
- Public Debt Management
- Financial Intelligence
- Management of Official Foreign Reserves
- Management of Foreign Exchange Policy
- Micro Finance and Regional Development
- Lender of last resort

5.5 Monetary Policy & Its Impact on Business

Monetary Policy is the process of controlling the supply, availability, and cost of money (rate of interest) to achieve economic growth and stability.

Instruments of Monetary Policy

A) Quantitative (General) Control Instruments

Term	Definition / Explanation
Bank Rate Policy	The minimum rate at which the Central Bank lends to commercial banks. • Raising the bank rate → higher lending rates → less borrowing → money supply contracts. • Lowering the bank rate → cheaper credit → more borrowing → money supply expands.
Reserve Rate Policy	The required ratio of deposits commercial banks must keep as cash reserves. • Increasing reserve ratio → less money available to lend → money supply contracts. • Decreasing reserve ratio → more money to lend → money supply expands.
Open Market Operations (OMO)	Central Bank buys or sells government securities. • Selling securities → cash absorbed from banks → credit contracts → money supply contracts. • Purchasing securities → cash injected into banks → credit expands → money supply expands.

B) Qualitative (Selective) Control Instruments

These regulate the flow of credit for specific purposes or sectors.

- Setting maximum maturity periods for loans
- Setting preferential interest rates for specific sectors
- Setting limits for loan guarantees
- Setting limits for investments and loans
- Indirect Control (Moral Suasion) – influencing banks through cooperation

5.9 – 5.12 Price Level, Inflation & Control

Price Concepts

Absolute Price	Relative Price
The amount paid for a good/service	Price of a good relative to another product
Expressed in currency terms	The ratio of two prices
E.g. Rs. 100 for 1kg of rice	E.g. 1kg rice = 5 pens

General Price Level is a hypothetical measure of overall prices in an economy. • Inflation – continuous increase in general price level • Deflation – continuous decrease in general price level • Disinflation – decrease in the rate of inflation

Types of Inflation

Term	Definition / Explanation
Creeping / Mild	Price rise of **3% or less per year**. Benefits economic growth; boosts demand.

Walking	Price rise **between 3%–10% per year**. Harmful – heats economy too fast; goods become unaffordable.
Galloping	Price rise of **10% or more**. Severely damages economy; foreign investors leave.
Hyperinflation	Price rise **over 50% per month**. **Very rare.** E.g. Germany 1920s, Zimbabwe 2000s, Venezuela 2010s.
Stagflation	**Economic growth stagnant but prices still rising.**
Deflation	Inflation rate **falls below 0%** – general price level decreases; value of money increases.
Spiral Inflation	Self-sustaining upward price trend fuelled by a reinforcing vicious circle.
Headline Inflation	Total inflation **including food and energy prices (volatile).**
Core Inflation	Long-run price trend **excluding volatile items (food and energy).**
Suppressed Inflation	Existing inflation disguised by government controls (subsidies, rationing, price controls).

Causes of Inflation (How inflation Occurs?)

Demand-Pull Inflation	Cost-Push Inflation
Aggregate demand exceeds aggregate supply	**Rising cost of inputs pushes prices up**
When production cannot keep up with consumer demand	**E.g. rising import prices, labour costs**

Demand Pull Inflation

Draw the diagram in the recording

Quantity Theory of Money

It has two assumptions,

1. Velocity of money circulation (V) and volume of transactions (T) are constant.
2. Money Supply (M) and Price levels (P) have a positive relationship.

If the money supply increases by a certain amount, it will lead to increase the demand for goods and services in the market since people have money in their hands, and it will lead to increase the price levels by the same amount money supply increased, and inflation will take place.

$$M * \mathbf{V} = P * \mathbf{T}$$

Keynesian Theory

It says the inflation will occur due to **aggregate demand exceeding aggregate supply even after reaching full employment.**

Draw the diagram in the recording

Economic Effects of Inflation

- Unfavourable to savers (purchasing power erodes)
- Favourable to debtors but unfavourable to creditors
- Distorts economic decision-making
- Unfavourable income distribution
- Increases absolute poverty
- Reduces export competitiveness
- Increases cost of living
- Causes currency depreciation

Price Level and Interest

There is an inverse relationship between interest rates and the price level. When interest rates increase, borrowing becomes more expensive and people spend less. As a result, aggregate demand falls, reducing inflationary pressure and lowering the price level. Conversely, when interest rates decrease, borrowing and spending increase, aggregate demand rises, and the price level tends to increase.

Real Rate of Interest = Nominal Rate of Interest – Rate of Inflation

When the real interest rate is low or negative, it is unfavourable to savers and creditors because the purchasing power of their money decreases due to inflation. The interest they receive is not sufficient to compensate for the rise in prices. Conversely, when the real interest rate is high and positive, it is favourable to savers and creditors because the value of their savings and loan repayments increases in real terms.

- High real interest rate → Favourable to savers and creditors, unfavourable to borrowers
- Low or negative real interest rate → Unfavourable to savers and creditors, favourable to borrowers.

Measures to Control Inflation

- Limit the growth in aggregate demand
- Remove barriers to efficient distribution of resources
- Accelerate growth in aggregate supply