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Financial System, Money & General Price Level

AAT Level I

ECN - Economics

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CHAPTER 05

FINACIAL SYSTEM, MONEY GENERAL PRICE LEVEL

Barter System

The goods were exchanged for the goods in the time when money was not introduced. Excess production was exchanged with others and it is also known as direct exchange system.

Problems of Barter System

- Absence of double coincidence of wants between two parties.
- Absence of standard measure of value.
- Difficulty in dividing goods / No divisibility
- No easy Transportation.
- Diffiulty in exchanging services
- Perishability of goods
- Limitation of the expansion of economic activitites

Evolution of money

1. Commodity money
2. Metallic money
3. Paper money
4. Credit money
5. Plastic money
6. Crypto money

Money

Money is a common medium, that is anything generally accepted by people to exchange goods and services in an economy.

Good Characteristics of Money

- ✓ Acceptability
- ✓ Durability
- ✓ Uniformity
- ✓ Portability
- ✓ Stability of Value
- ✓ Discourages Forgery
- ✓ Relative scarcity
- ✓ Convenience to identify
- ✓ Intrinsic value is NOT greater than face value

Function of Money

1. Medium of Exchange

Money acts as a common medium in the common transaction which has perfect liquidity that is accepted by all public in an economy. Therefore Money allows people to exchange goods exchange without need for barter system.

2. Unity of Account

It acts as a common unit in the measurement of exchanging value of goods and services. Therefore it enables us to compare the relative prices of goods and services.

3. Store of Value

Money enables us to save to increase our spending power in future. Therefore people are willing to save their wealth in terms of money for the future purpose.

4. Standard of deferred payment

It allows for goods and services consumed today and payment in the future time period. Therefore credit transactions and agreements are simplified and also it leads to the expansion of banking and insurance services as well as trade among countries too.

Limitation of functions money

- ✓ The decrease in value of money due to inflation
- ✓ Risk of holding money
- ✓ The opportunity cost of money
- ✓ Availability of more convenient methods
- ✓ Technical progress

Note:

Types of money

1. Fiat money

The notes and coins which is declared by the government

2. Bank money

Commercial bank money or demand deposits are money which can be withdrawn at any time by cheque

3. Near money

Anything which could be transferred to money very easily and without any economic losses within a period of time

Ex: saving deposits, fixed deposits. Treasury bills

4. Money substitutes

Temporary medium of exchange instead of using money in any transaction.

Ex: debit cards, credit cards

5. Electronic money

It refers to money or scrip which is exchanged only electronically. Electronic fund transfer and direct deposits are examples of E money.

How E Money can be used

1. Fund transfer between accounts at the same institutions
2. Transfer fund to tour account at another branch
3. Transfer fund to stock market
4. Pay person to person
5. Settle any bill

Reasons of using E Money

1. Easy and quick settlements
2. Safer than currency
3. International payment can be made
4. Can be linked to interbank of banks
5. Completion among commercial banks

Advantages of E Money

1. Portability and easy usage
2. Quick settlements and saves time'
3. Low risk
4. Can settle money from any part of the world
5. More social recognition

Disadvantages E Money

1. Lack of legal acceptance
2. Technical problems
3. Wide spread of information technology is required

Demand for Money

It is the amount of money that the public are willing to keep with them for the different purposes in the given period of time. Simply it means the willingness of public to keep money with them. There are three different purposes of holding money.

1.

2.

3

Transaction Motive

The Willingness of keeping the amount of money with the motive of purchasing goods and services for their regular life activities in the given period of time.it is affected by the factors of income and income earning time period.

Precautionary Motive

The amount of money that the people are willing to keep for their future unexpected event / risk such as medical bills, accidents, loss of work. It is affected by the factors of income and income earning time period.

Speculative Motive

The amount of money that the people are willing to keep in present with an intention to earn future income by an investment made on financial securities. It is affected by an interest rate of an economy.

Macro-economic variables affect demand of money

- ✓ Real income
- ✓ Rate of interest
- ✓ Price level
- ✓ Future expectation
- ✓ Organizational factors

Supply of Money

The total amount of money available among public in an economy in the particular time period is known as money supply.

Types of Money Supply

M_0 = Notes and Coins (fiat money)

M_1 = M_0 + Demand deposits in the licensed commercial banks

M_2 = M_1 + saving deposits and Time deposits in the licensed commercial banks (LCBs)

M_2b = M_2 +50% of saving deposits and Time deposits of non-residence foreign currency (NRFC) units and deposits of foreign currency banking units (FCBU) in LCBs.

$M_4 = M_2b$ + Saving deposits and Time deposits in the licensed savings banks(LSBs) and Registered finance specialized institutions.

<u>Diagram of Supply of Money</u>

<u>Diagram of Equilibrium in money market</u>

Increase in money demand while no change in money supply

Increase in money supply while no change in money demand

Factors affecting money supply

- ✓ Net domestic assets by banking system
- ✓ Net foreign assets held by banking system

Value of Money

The amount of goods and services that can be purchased by one unit of currency in the given period of time is known as value of demand.

1. Internal value of demand
   - Internal official value
   - Internal real value
2. External value of demand
   - External official value
   - External real value

<u>Definitions</u>

- Internal official value

Face Value of money which is stated on the notes and coins

- Internal real value

The quantity of goods and services that can be purchased in the domestic market by using on unit of domestic currency.

- External official value

The number of foreign currency units that will be exchanged for a unit domestic currency. Simply it is known as exchange rate.

- External real value

The quantity of goods and services that can be purchased in the foreign market by using on unit of domestic currency.

Velocity of Money

The number of times a unit of money exchanges among people over a given period of time.

$$\frac{\text{Nominal GDP}}{\text{Broad Money Supply}}$$

General Price Level

The weighted average price level of all goods and services in an economy during the given period of time is general price level.

Inflation

The long term continuous increase in the general price level of on economy is inflation.

Deflation

The long term continuous decrease in the general price level of on economy is Deflation

Price Index

It is used to measure the changes in general price level of an economy

E.g.: New Colombo Consumer Price Index
National Consumer price index
Producer's Price index

Inflation Rate

$$\frac{\text{Current year PI} - \text{Previous year PI}}{\text{Previous year PI}} * 100$$

Example:

Types of Inflation

- Creeping / Moderate /mild Inflation

Continues increase in the general price level of an economy rise in the normal rate. Generally less the 3% per year.

- Walking inflation

Continues increase in the general price level of an economy rise in the normal rate. Generally 3% to 10% per year.

- Galloping Inflation

Continues increase in the general price level of an economy rise in the higher rate. Generally in the double or triple digit range per year.

E.g.: Increase from 10% to 100% or 200% in the year.

- Hyper Inflation

Continues increase in the general price level of an economy rise that is monthly 50% in the speed.

- Spiral Inflation

Continues increase in the general price level of an economy because of increase in the production cost through the increase in the wage rate of the labourers therefore living cost increases again because of price level increases in the economy and it leads for increase in the labour cost repeatedly and occurring as a cycle.

- Suppressed inflation

Increase in the general price level in the economy through black market activity because of government interventions and price control policy.

- Stagflation

When economic growth is stagnant but there is still price inflation

- Core inflation

- Headline inflation

Reasons for Inflation

Increase in Aggregate Demand
Decrease in Aggregate Demand

1. <u>Demand Pull Inflation</u>

The general price level will be increased by the situation where there is an excess demand through the increase in aggregate demand of goods and services while the economy is in the full employment.

2. <u>Cost push Inflation / wage Push Inflation / Supply Push Inflation</u>

It is the situation where there is a decrease in the aggregate supply due to an increase in the cost of production of goods and services of an economy while Aggregate Demand remains constants, therefore it leads to increase in general price level.

Reasons

- Increase in price of raw material prices
- Increase in price of Import Prices
- Increase in price of wages Price.

Economic costs of inflation

- Decrease in the value of money (Purchasing Power)
- Real value of saving will be decreased.
- Creditors are suffered.
- Leads public for higher tax rate
- Increase in nominal interest rate therefore investment will be decreased.
- In transactional cost
- Constant income earners are suffered.

NOTE:
Real rate of interest = nominal rate of interest – rate of inflation

Financial System

It is the system that includes the decision of markets, financial institutions, financial instruments and financial infrastructures by economic agents of domestic and foreign households, business firms and the government

It consists of following components,

1. Financial institutions
    - Banking system
        - Central bank
        - Licensed commercial banks
        - Licensed specialized banks
        - Deposit taking institutions
        - Licensed finance companies
        - Thrift and cooperative societies
    - Specialized financial institutions
        - Primary dealers
        - Specialized leasing companies
        - Share brokers
        - Unit trust management companies
        - Market intermediaries
        - Investment trust companies
    - contractual savings institutions
        - Insurance companies
        - Employees provident fund
        - Employees trust fund
        - Approved private provident fund
        - Public service provident fund
2. Financial markets
    - Money market

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    - Capital market

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3. Financial instruments
    - Debt securities Issued by government
        - Treasury bills
        - Treasury bonds
        - Government debt securities
    - Debt securities Issued by companies
        - Commercial papers
        - Debentures
    - Debt securities Issued by commercial banks
        - Certificate of deposits
        - Assets backed securities
        - Hire purchase
        - Interbank call money market
        - shares
4. Financial infrastructures
5. The regulatory bodies which supervise the financial institutions

<u>CENTRAL BANK</u>

The CBSL is established under the monetary law act in 1949. It is established to govern the monetary policy of Srilanka.

The main function of central bank of Srilanka is managing the financial instruments in order to lead interest rate and money supply of the country.

<u>The objectives of Central Bank of Srilanka</u>

01. Maintain economic and price stability
    - It mainly focuses on establishing the stability of domestic price level
    - It means keeping the inflation level in the minimum level.
    - It expects that price stability enhances strong long term economics growth and full employment level.
02. Maintaining Financial system stability
    - It is the maintenance of stability in economics, financial, political & other sectors from the internal & external shocks.

The Reasons for financial stability

1. Effective performance of financial institutions & financial markets.
2. Removal of problems in Balance of payment.
3. Ensuring asset prices
4. Maintenance of market liquidity

Core Functions of CBSL

- Conduct of monetary policy
- Conduct of exchange rate policy
- Management of official foreign reserve
- Currency Issue
- Licensing, regulating, supervising banks and selected non-bank financial institutions
- Banker and financial advisor of the government
- Banker to commercial banks
- Employees' Provident Fund Management
- Foreign Exchange Management
- Public Debt Management
- Micro finance and Regional development

The central Bank has many different types of relationship with commercial banks. The key relationships are as follows.

- The regulator and supervisor of the commercial banks
- The banker to the commercial banks.
- The lender of the last resort
- Provider of facilities to manage liquidity of commercial banks
- The advisor to commercial banks.

<u>Commercial Banks</u>

The financial institutions which specially accept demand deposits from the public which permit their customers to convert their deposits into the cash by writing the cheque is known as commercial banks.

<u>The Main Functions of Commercial Bank</u>

1. Primary functions
    - Attract deposits from public.
    - Lending money in the form of loans or overdraft.
2. Secondary functions
    - Collections of cheques and bills
3. Agency functions
    - Issuing letter of credit
    - Issuing letter of references
    - Issuing travelling cheques
    - Safety locker facility

- Electronic fund transfer
- Automated teller machines
- Issuing debit cards and credit cards

<u>The objectives of the Commercial Banks</u>

1. Maintenance of High Liquidity
2. Maintenance of High profitability

1. Maintenance of High Liquidity

It is the capability of the commercial banks to return the money at any time with any amount to the customers when they require from their deposits.

They must to maintain liquidity to maintain the trust worthiness the customers keep on the bank.

2. Maintenance of High Profitability

The aim of the commercial banks are earning the profit. Therefore they earn main income by interest through providing loans and investments therefore they must to organize their business Functions in the effective way in order to earn the maximum profit.

<u>NOTE</u>

These 02 objectives are opposed to each other, therefore if they maintain high liquidity there will be the problem in the profitability & vice versa.

<u>MONETARY POLICY</u>

It is the management of financial instruments in order to guide and influence on interest rate and money supply to achieve the macro economic objectives of maintaining economic price stability and maintaining stability of financial system.

Central Bank influences on expenditures on load and liquidity with the support of monetary policy.

<u>Instruments of Monetary Policy</u>

01. <u>Quantitative Instruments</u>

- Bank Rate
  CBSL provides loan to the commercial bank as the lender of the last resort

- Statutory reserve ratio
  Central bank stipulates that the commercial banks should keep a certain proportion of their deposit liabilities as reserves with the central banks.

- Open market operation
  It refers to the purchase and sale of treasury bills by the central bank in the open market

02. <u>Qualitative Instruments (Selective tools)</u>

- Moral Suasion
  Tactics used to influence and pressure by closed door meetings with bank directors, severity of inspections etc.
- Fixing maturity period for commercial bank credit
- Portfolio ceiling
- Provision of refinance facilities
- Fixing selective interest rates

<u>Role of banks in financial inclusion and business expansion</u>

Bank accept deposits and make loans and generate a profit from the difference in the interest raid paid and charge to depositors and borrowers respectively. The process performed by banks of taking in funds from a depositors and then lending them out to a borrower is known as financial intermediation.

Through the process of financial intermediation, certain assets are transformed into different assets or liabilities. Accordingly, financial intermediaries channel funds from people who have extra money or surplus savings (savers) to those who do not have enough money to carry out a desire activity (borrowers)