BARTER ECONOMY

Exchange of surplus between parties could be referred to as Barter System in simple.

BARTER ECONOMY

- Barter can be taken place in 3 forms;
  - Goods to Goods
  - Goods to Services
  - Services to Services
- Shortcomings of Barter System
  - Double co-incidence of wants.
  - Difficult to store
  - Indivisible
  - Portability problems

THE BEGINNING OF MONEY & BANKING

Section 01

MONEY AND BANKING

Unit 07

The solution taken by people to overcome the lapses they faced in Barter System is

Money

MONEY

"Money is any item that is generally acceptable in exchange for goods and services."

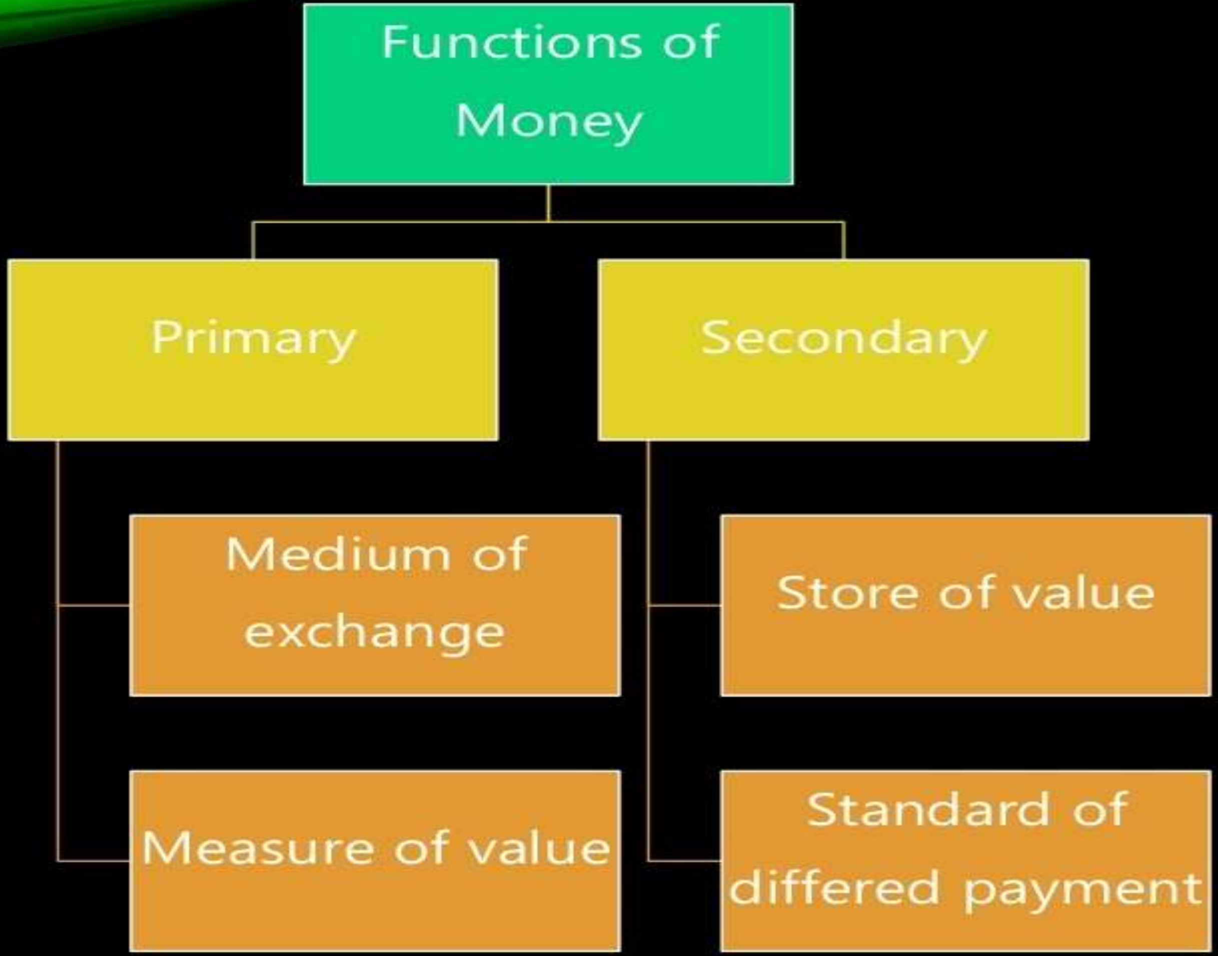
Economists define it as something that serves as a medium of exchange, a unit of accounting, and a store of value.

QUALITIES OF MONEY

- General acceptability
- Durability
- Portability
- Divisibility
- Limited in supply
- Stability
- Homogeneous or Identical

TYPES OF MONEY

- Cash/currency/legal tender
- Money in current account/bank money
- Near money
- Money substitutes
- E-cash
- Digi-cash
- E-wallet/electronic cash purse
- Quasi money
- Token money
- Black money


Functions of Money
Primary
Secondary
Medium of exchange
Measure of value
Store of value
Standard of differed payment

FUNCTIONS OF MONEY

- As a unit of account/ measure of value.

  (Primary Function)

  - Money acts as a measure of value and it can be used to compare the value of goods and services and factor rewards.
  - Facilitates efficient allocation of limited resources.
  - It helps to measure the price level and changes of them
  - Facilitates accounting/ calculations
  - Helps to set prices for products

FUNCTIONS OF MONEY

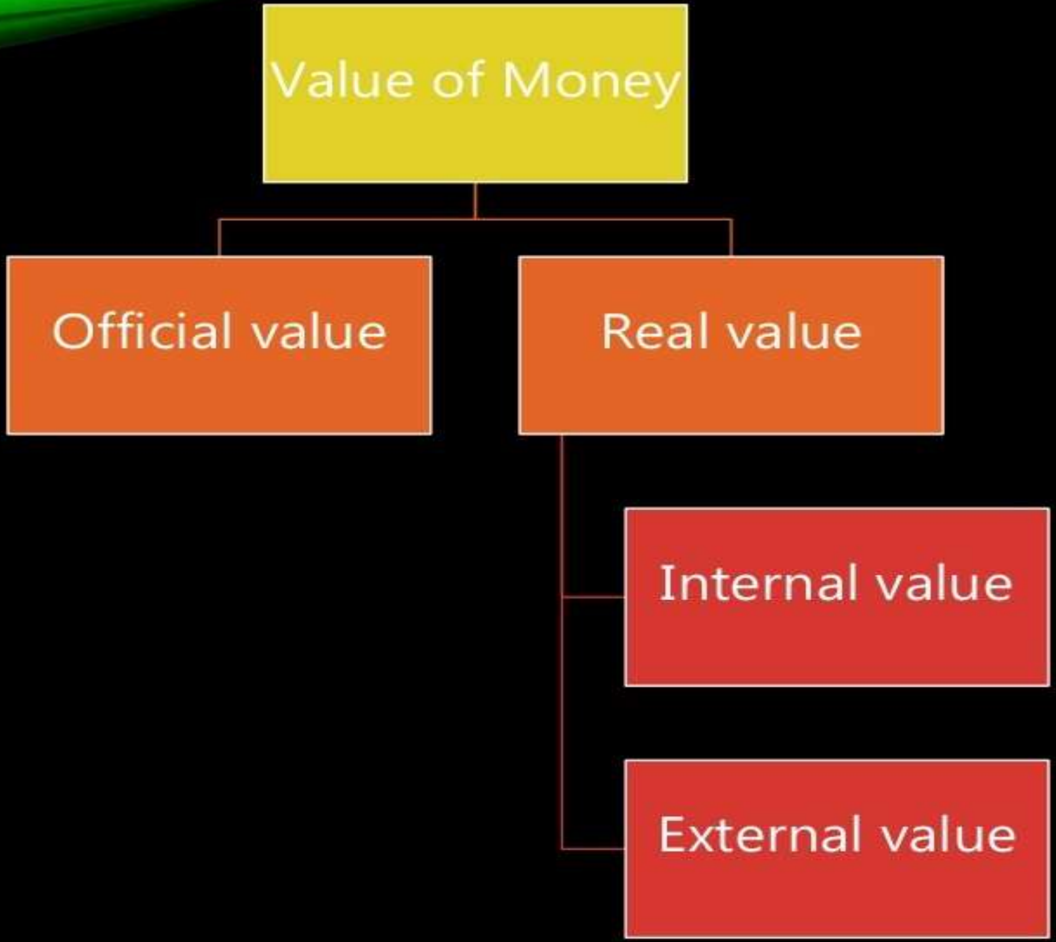
- As a store of value. (Secondary Function)
  - This means holding wealth in the form of money for future transaction and investment purposes. Thus money links present and future through this function.
  - Promotes savings
  - Investments increases
  - Production gets expanded due to increase in investments
  - Accelerates economic growth due to increase in production
  - In times of inflation this function of money is distorted.
  - An opportunity cost is involved here

FUNCTIONS OF MONEY

- As a standard for differed payment. (Secondary Function)
  - Money enables people to borrow and lend agreed amounts.
  - Easier and convenient way of measuring debt and repaying debt
  - This function links present and future
  - Facilitates the growth of trade
  - Stimulates the growth of money market

FUNCTIONS OF MONEY

- As a medium of exchange.
  (Primary Function)
  - This facilitates trade.
  - It removes the problem of double coincidence of wants.
  - It facilitates modern production aspects like division of labor, specialization etc.


Value of Money
Official value
Real value
Internal value
External value

VALUE OF MONEY

Official value/face value

This is the value indicated on the face of notes and coins. This is imputed by the government.

VALUE OF MONEY

Real value/ purchasing power- This is the amount of goods and services that can be bought within the given amount of money or per unit of money. The real value highly depends on the general price level of goods and services

Internal/domestic value- This is the quantity of goods and services that can be bought with the particular unit of currency within a country. This depends on the general price levels in a country. i.e. when the domestic price levels falls, internal value of money rises

External/foreign value- This is the rate at which one currency is exchanged to another. In other words it is the exchange rate between countries.

LIQUIDITY

" Liquidity refers to the ease in which an asset can be converted into cash without delay at little or no cost."

Liquidity describes the degree to which an asset or security can be quickly bought or sold in the market without affecting the asset's price.

- Assets according to the range of liquidity
  - Cash
  - Demand deposits
  - Time and savings deposits
  - Money substitutes
  - Financial and physical assets

- Reasons why people keep wealth in the form of money rather than other forms
  - Money is perfect liquid
  - It is easy to store and portable
  - Uncertainty in the market value of no monetary assets

DEMAND FOR MONEY

Section 02

DEMAND FOR MONEY

John Maynard Keynes distinguished three different reasons for people to hold money instead of alternative assets.

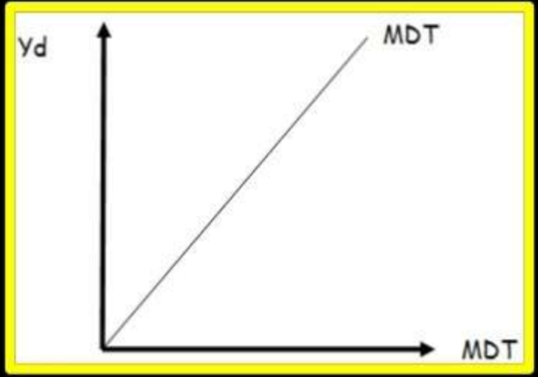
- Transaction demand for money (MDT)
- Precautionary demand for money (MDP)
- Speculative demand for money (MDS)

DEMAND FOR MONEY

Transaction demand for money (MDT)

The amount of money that people want to keep to meet their regular or day to day transactions could be simply known as transaction demand for money.

The major determinant of MDT is income.



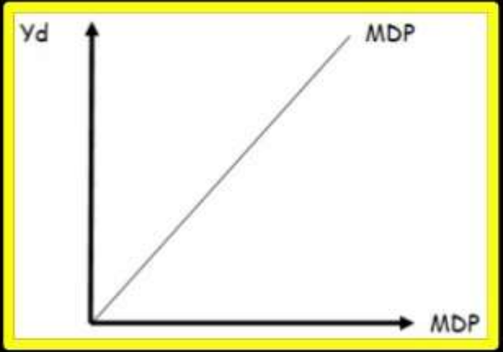
- Factors determining MDT
  - Income- positively
  - Time interval of the receipt of income- positively
  - General price levels in the economy- negatively
  - Financial innovations / substitutes- negatively

DEMAND FOR MONEY

Precautionary demand for money (MDP)

The amount of money people want to hold to meet their unforeseen or unplanned emergencies relating to time interval of receipts of income and payments. E.g. Sicknesses, accidents.

The major determinant of MDP is income

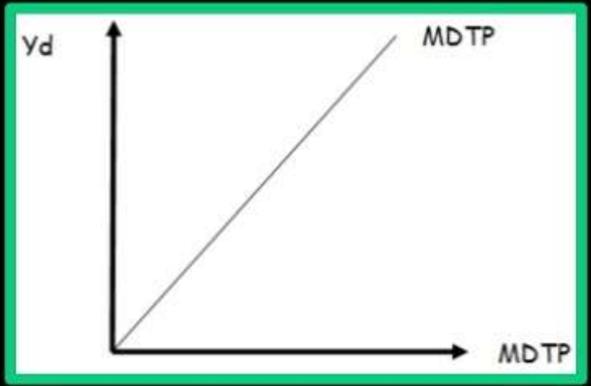


- Factors determining MDP
  - Income- positively
  - Time interval of the income receipt- positively
  - General price levels in the economy-positively
  - Nature of the unexpected emergency- negatively

DEMAND FOR MONEY

Demand for active money balance (MDTP)

This is the sum of transaction demand for money and precautionary demand for money. The major determinant of active money balance is income.



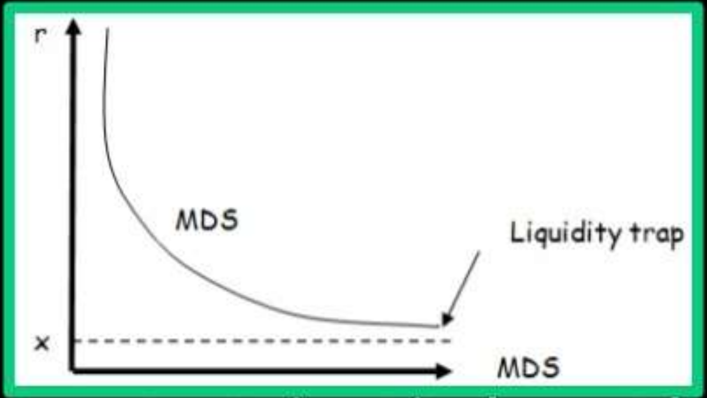
DEMAND FOR MONEY

Speculative demand for money (MDS)

It refers to the amount of money people want to hold in order to buy financial assets such as shares, bonds with the view of earning income like dividends, interest etc. The major determinant of MDS is the interest rate.

Interest is the cost of holding money. Thus higher the rate of interest the greater will be the cost of holding money.

Therefore it could be said that higher the rate of interest, the lower will be the demand for money and vice versa.



Here when the interest rate is at its lowest level (x), speculative demand for money will be infinite. At this level there will be a liquidity trap. So the government can not use monetary policy through reducing interest rate to stimulate AD.

- Relationship between interest rates and price of bonds
  - There is an inverse relationship between interest rate and price of bonds. If interest rates rises the price of bonds will fall and vice versa.
  - If the interest rate is low at present, price of bonds will be high now. People will expect the future interest rate to rise and price of bonds to fall in future. Thus, in order to buy bonds at lower prices in future, people will hold more money with them.

SUPPLY OF MONEY

Section 03

SUPPLY FOR MONEY

"Money supply is the amount of currency in circulation at a given time."

In other words it is the stock of liquid assets held by general public of an economy.

The operating target of money supply is reserve money whereas the intermediate target is broad money. The final target is meant to be the price stability of the economy.

CLASSIFICATION OF MONEY SUPPLY

1. Currency outstanding
   1.1. Currency held by public
   1.2. Currency with commercial banks
2. Commercial banks deposits with the central bank
3. Government agencies deposits with the central bank
4. **Reserve money(1 + 2 + 3)**
5. Demand deposits held by the public with commercial banks
6. **Narrow money supply(1.1 + 5)**
7. Time and savings deposits held by the public with commercial banks/ quasi money/ time and savings deposits held by public with domestic banking units
8. **Broad money supply(6 + 7)**
9. Foreign currency deposits/ RFC + NRFC /time and savings deposits held by public with domestic banking units and offshore banking units of commercial banks in foreign currency
10. **Consolidated broad money supply(8 + 9)**
11. Deposits with licensed specialized banks and finance companies
12. **Extremely broad money supply(10 + 11)**

Reserve money/high powered money/base money

These are sight liabilities of central bank and are created and injected to the economy by CBSL and serve as the operating target of monetary policy. The base money provides the basis for the country's money supply

Money multiplier

Money multiplier is the ratio between base money and money supply.

Money Multiplier = Money Supply / Base Money

Relationship between reserve money and money multiplier

Money supply = money multiplier x monetary base

Neutrality of money

It is the theory which states that a change in the quantity of money in the economy will only be affected due to changes in price levels but not real variables such as unemployment.

MONEY SUPPLY AND GENERAL PRICE LEVELS

Quantity theory of money explains the relationship between money supply and general price level

Quantity theory of money (QTM)

This theory states that increase in price is caused only by increase in money supply. That is the price level is directly proportional to money supply. QTM can be presented in two forms

- Equation of exchange-This was formulated by an American economist Irvin Fisher at this was formulated by an American economist Irvin Fisher at Yale University in 1920

$$MV = PT$$

- According to the monetarists, V and T are constant in short run. So a change in money supply will cause a direct and proportionate change in price level.

- Cash balance equation of Cambridge school- This theory was formulated by Alfred Marshall and A.C.Pigou

$$M = K P T$$

- K- Cash balance or the percentage of income people want to hold in the form of money

$$K = 1 / V$$

- In the short run both K and T are constant. Therefore changes in money supply will have a direct and proportional change in price, that is M and P are positively related

VELOCITY OF CIRCULATION OF MONEY

It is the average number of times a unit of money changes hands over a period of time. This measure is also termed as income velocity of money

$$V = PT/M$$

$$V = GDP/M$$

$$V = Y/M$$

Importance of velocity of circulation of money

- It indicates the size of the average expenditure generated per unit of money
- Indicates the value of income for finished goods generated per unit of money
- It helps to evaluate future inflation conditions of the economy

Determinants of velocity of circulation of money

- General price levels
- Money supply
- Real output of the economy
- Speculation demand for money

COMMERCIAL BANKS

Commercial banks are financial intermediaries which link those have surplus funds and those who have shortage of funds.

A commercial bank undertakes money from general public on non interest bearing demand deposits and interest bearing savings and time deposits and uses this money for lending, investment or other operations.

Only commercial banks can maintain demand deposits. Any bank which maintains demand deposits are known as commercial banks. So they have the ability to do credit creation.

- Commercial banks- due to the profit motive nature of these banks we call them commercial banks
- Joint stock banks- as most of these banks are private companies and have limited liability we call them joint stock banks
- Retail banks- as these banks sell most of the banking services we call them retail banks
- High street banks- as these banks are often found in towns or cities we call them high street banks

FUNCTIONS OF COMMERCIAL BANKS

- Primary function/traditional function
  - Accepting deposits from public
    - Current accounts
    - Savings accounts
    - Fixed and term deposits
  - Providing loans and advances
    - Bank loans/advances
    - Bank overdraft
- Secondary function/sub function
  - Protecting customer deposits
  - Agency services
    - Collecting income from clients on behalf of them and depositing in their accounts. E.g.-dividends, interest
    - Making payments on behalf of the customers. E.g.-electricity
    - Buy and sell shares
    - It also acts as a trustee and executor of the property and will of its clients.
    - Provides consultancy services for business clients.
  - Financing foreign trade
    - Accepting foreign bills of exchange and collecting them from foreign banks.
    - Transacts other foreign exchange business and buys and sells foreign currency.
    - Provide safety lockers
    - Issues various forms of credit instruments such as cheques, drafts.
    - Issues letter of credits.
    - Pawning services

STRUCTURE OF ASSETS AND LIABILITIES OF COMMERCIAL BANKS

Balance sheet of a commercial bank

Capital account	Cash in hand
Total deposits	Due from central bank
Total borrowings	Due from domestic banks
	Cash in the process of collection
	Foreign currency denominated assets
	t- bills
	t- bonds
	commercial bills
	other investments
	loans and overdrafts
	fixed and other assets

Liquidity of commercial banks- Liquidity refers to the existence of sufficient funds to make day to day payments of the bank. Cash and other liquid assets which can easily converted into cash are held for this purpose.

Sources of funds of commercial banks-Sources of funds show the composition of funding of licensed commercial banks. i.e. the share of each component in the total resource basis.

Uses of funds- Uses of funds show the resource utilization of commercial banks.

Reserves of commercial banks- Reserves indicate the most liquid assets held by commercial banks. They include,

- Cash in hand
- Due from central bank
- Foreign currency in hand

Excess reserves of commercial banks- Excess reserves are the reserves in excess of required reserve. It is obtained by deducting required reserves from the reserves.

FINANCIAL INSTRUMENTS

Section 04 part 02

FINANCIAL INSTRUMENTS

Financial Instruments are tradable assets of any kind. They can be cash, evidence of an ownership interest in an entity or a contractual right to receive or deliver cash or another financial instrument.

- Deposits-Deposits are sums of money placed with a financial institution.
  - Demand deposits
  - Savings deposits
  - Fixed and time deposits

- Loans-A loan is a specified sum of money provided by a lender, usually a financial institution, to a borrower on condition that it is repaid, either in installments or all at once, on agreed dates and at an agreed rate of interest.

- **Treasury bills-** Treasury bills are government securities that have a maturity period of up to one year. Treasury bills are issued by the Public Debt Department of Central Banks on behalf of the government.

- **Treasury bonds-** Are medium and long term government securities and are issued in maturities ranging from 2 to 20 years.

- Repurchase agreements- Repurchase agreements (repo) are arrangements which involve the sale for cash of securities (usually government securities) at a specified price with a commitment to repurchase the same or similar securities at a fixed price on a future date.

- Commercial paper- Commercial papers are short term, non collateralized debt securities issued by private companies to raise funds for their own use, by banks and other financial intermediaries.

- Corporate bonds and debentures- Corporate bonds are medium or long term securities of private sector companies which obligate the issuer to pay interest and redeem the principal at maturity. Corporate bonds that are not backed by a specific asset are called debentures.

- Asset-backed securities- Asset-backed securities are bonds collateralized by mortgages, loans or other receivables.

- **Financial leases**- Financial leases are accommodations provided to finance the purchase of capital or durable equipment in which the legal owner (lessor) lends the equipment to the lessee for payments that cover the full principal payment and interest cost.

- **Shares**- Shares are securities representing a portion of the ownership of a company that are a claim on the company's earnings and assets. Shareholders are paid dividends which are a percentage of the profits of the company.

- Financial derivatives- A financial derivative in a financial instrument that is linked to another specific instrument, indicator or commodity and through specific financial risks (such as interest rate risk, exchange rate risk, equity and commodity price risk) can in their own right, be traded in financial markets.

REGULATORY POLICES AND AUTHORITIES

Section 04 part 03

MONETARY POLICY

Monetary policy is the means by which a Central Bank of Sri Lanka seeks to achieve its objective of price stability by influencing the cost (interest rate) and availability of money (money supply).This is done through interest rate and credit availability mechanism.

- Monetary policy framework consists,
  - Policy variables, monetary aggregates
  - Institutions
  - Targets and instruments

There are several channels through which monetary policy changes are transmitted through the economy. They are,

- Interest rate channel
- The credit channel
- Exchange rate channel
- The wealth channel
- Expectations

Objectives or aims of monetary policy

- Price stability and economic stability
- Full employment
- Equality
- Economic growth and development

MONETARY POLICY INSTRUMENTS OR TOOLS

- Quantitative controls

These are the instruments used to control the overall quantity/volume of money supply

Statutory reserve ratio/reserve requirement (SRR/RRR)

This is the proportion of deposits of commercial banks that are required to keep as cash deposits with the central bank. At present, demand, time and saving deposits of commercial banks denominated in rupees are subject to a reserve ratio.

Bank interest rate

This is the interest rate at which central bank lends money to commercial banks that have liquidity difficulties. When the bank rate is raised by central bank, commercial banks have to pay higher interest for the loans taken from the central bank. The commercial banks will charge higher interest on loans given by them to the public.

Open market operations(OMO)/policy interest rates

This operation involves the purchase or sale of government securities (treasury bills and treasury bonds) or the sale or retiring of central bank securities in the open market to affect the liquidity in the banking system.

- Qualitative controls/Selective controls

These controls the direction of the loans. That is the flow of loans to various sectors of the economy.

  - Fixing a maximum maturity period for loans
  - Ceiling on interest rate
  - Imposing maximum limits on investment and loans
  - Imposing maximum limits on securities
  - Moral suasion
  - Foreign exchange operations
  - Communication policy

CREDIT RATING AGENCIES

A credit rating evaluates the credit worthiness of an issuer of specific types of debt, specifically, debt issued by a business enterprise such as a corporation or a government.

- Importance of credit rating
    - Credit rating allows a lender or a credit granter to evaluate the ability of the borrower top repay a loan.
    - The higher rating, the more likely a country to qualify, as well as to get higher loan amounts and lower interest rates.
- Sovereign credit rating- The credit rating of a country or sovereign entity is a sovereign credit rating.
- Credit rating agencies
    - Standard and poor's
    - Fitch
    - Moody's