Monetary Economics

Q1a. What is money and why it is important for any economy?
Ans. Money is an economic unit that functions as a generally recognized medium of exchange for transactional purposes in an economy.

Importance of Money in an Economy:

In modern economics, money has been considered as the most dynamic element in the economy as well as a link between the present and the future. It influences not only the level of prices but also the cyclical behavior of consumption, savings, investment and employment. Money plays an important role in the shaping of the economic life in a country. Money acts as a medium of exchange; unit of account; as a standard of deferred payments; store of value; as an aid to specialization, production and trade; money has an influence on income and consumption; money is an instrument of making loans; money is a tool of monetary management; an instrument of economic policy; it plays an important function of distribution of national income; money is the basis of credit system; measure of marginal productivity; liquidity of property.

b. What is barter system and why it vanished?

Ans. Definition:

Barter system is a method of trade in which goods are exchange without the use of money.

Evolution:

- History can be traced back to 6000 BC.
- First introduced by the tribes of Mesopotamia.
- Initially used to trade weapons, food items, tea and spices.
- Even Roman soldiers salaries was paid in barter by offering salt.
- There have been proofs that purest form of barters were existing till 1874.

Why it vanished?

In barter system goods were exchanged through goods. For this process wants of both buyers and sellers must coincide. Here arises the problem called lack of coincidence of wants which created difficulty in barter system. Each trader had to have something the other wanted. This is known as double coincidence of wants.

Secondly, in barter system it was not possible to store goods for a long time because some goods are perishable they perish in a short period.

Another issue was that in barter system we cannot divide all the commodities into small units like we divide money.

In barter system the value of every commodity can be measured in terms of other commodity but it is not possible to measure the commodity value with other commodity.

There was difficulty in making deferred payments as in barter system future payments for present transaction was not possible. So to overcome these difficulties money was invented and here the barter system ends.

Q2. Explain in detail the primary and secondary functions of money.

Ans. **Primary Functions**

Money as a medium of exchange:

Money facilitates transactions of goods and services as a medium of exchange. e.g. producers sell their good to the wholesaler in exchange of money. Wholesaler sell the same goods to the consumers in exchange of money.

Money has removed the major difficulty of double coincidence of wants and inconveniences associated with barter system.

Use of money allows purchase and sale of to be conducted independently of one another.

Money as a unit of account:

Money measures the value of various goods and services which are produced in an economy.

Money works as unit of value or standard of value.

Money works as common measure of value by expressing exchange value of all goods and services in money in the exchange market.

Secondary Functions

Money as a standard of deferred payments:

Modern economic setup is based on credit and credit is paid in the form of money only.

Money, besides being the basis of current transactions, is also the basis of deferred payments.

Only money is such a commodity in whose form accounts of deferred payments can be maintained in such a way so that both creditors and debtors do not stand to lose.

Money as a store of value:

It was virtually impossible to store surplus value under barter system, the discovery of money has removed this difficulty.

With the help of money people can store surplus purchasing power and use it whenever they want.

Saving money is not only secure but its possibility of being destroyed is very less. Besides, it can be used whenever needed.

Money has become the only basis of promoting capital formation.

Money as a transfer of value:

Money helps to transfer the value of assets, properties and also the income of the person to another person. It makes the transfer or transaction of goods and services simpler.

Q3a. What are Financial Markets and their role in economic development?

Ans. Financial Markets:

Financial markets refer broadly to any marketplace where the trading of securities occur, including the stock market, bond market, commercial papers, T-bills and currencies. The purpose of the financial market is to set prices for global trade, raise capital and transfer liquidity and risk.

Role in Economic Development:

The financial system of a country is an important tool for economic development of the country. It helps in creation of wealth by linking the savings with investments. It also facilitates the flow of funds from the households (savers) to business firms (inventors) to aid in wealth creation and development of both both the parties. Not only that, the financial system of a country is concerned with the allocation of savings, provision of funds, facilitating the financial transactions, developing the financial markets, provision of legal financial framework and provision of financial and advisory services in the country. Financial system play a vital role in facilitating the smooth operation of capitalist economies by allocating resources and creating liquidity for businesses and entrepreneurs. The markets make it easy for buyers and sellers to trade their financial holdings. Financial markets create securities products that provide a return for those who have excess funds (investors/lenders) and make these funds available to those who need additional money (borrowers).

b. What are the causes of inflation and what are its remedies with reference to Pakistan?

Ans. Causes of Inflation:

Cause of inflation are of two types.

A. INCREASE IN DEMAND
    1. Increase in money supply:
       The major cause of increase in the price level is an increase in money supply. It may be due to increase in currency or credit money. Increase in the stock of money induces people to demand more and more of goods and services.
    2. More investment:
       Investments also play an important role in producing inflation. At the moment of investment the economy's stock of wealth and money expands and it results in inflation.
    3. Non-productive expenditures:

Government of Pakistan has to make alot of Non-productive expenditures like defence etc. Such unproductive expenditures lead to the wastage of economy's precious resources and also lead to inflation.

4. Corruption and black money:
   These evils increase aggregate demand and import volume which is cause of inflation.
5. Deficit Financing:
   It increases the money supply and leads to inflation.
6. Foreign remittances:
   Increase in foreign remittances is increase in money supply and increase in money supply leads to inflation.
7. Foreign aids:
   Foreign aids are also a source of mobilization of resources form rich countries to poor countries. It is also a cause of inflation in Pakistan.
8. Consumption trends:
   Due to demonstration effect people of our country want to copy the styles of people of rich countries. In this way there is an increase in consumption trends that leads to inflation.
9. Increase in population:
   Population of Pakistan is increasing day by day. Increasing population is demanding more and it creates inflation.

B. DECREASE IN SUPPLY

1. Slow agricultural development:
   Low growth rate of agricultural sector caused in shortage of productivity. It results in low supply and increase in price level.
2. Slow industrial growth:
   Our industrial sector is not developed due to use of backward techniques of production. Its less production also create shortage in market and causes inflation.
3. Increase in prices of imports:
   If there is an increase in the prices of imported products such as oil or raw materials then it will cause reduction in supply.
4. Devaluation:
   The value of our currency is decreased due to devaluation. It makes imported goods more expensive and it leads to shortage of supply.
5. Indirect taxes:
   The imposition of indirect taxes is a reason for increase in prices. Sometimes government imposes taxes on some particular commodities. In this case producer may start to decline the production of those goods.

Solution to overcome inflation

Following measures are suggested to control high inflation:

1. Increase in growth rate of output.
2. Government should control the supply of money through effective monetary policy.
3. Highly increasing unproductive expenditures must be controled.
4. Government should check the corruption first to eliminate the inflation.
5. Control on population is also necessary to control inflation.
6. Reduction in budget surplus.
7. Reduction in monetary expansion.
8. Effective tax system will be helpful to control the inflation.
9. Improvement in balance of payment.
10. Developments of agricultural and industrial sector will helps to control the inflation