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MONETARY ECONOMICS

ANSWER SHEET

Q1 (a) What is Money? And why it is important for any economy?

ANS) Money is an economic unit that functions as a currency generally recognized for transactional purposes in an economy. Money offers the service of reducing transaction costs. The money comes from the form of a raw material, with a physical property to be adopted by market participants as a trading chip.

OR

Money is a widely used and recognized commodity in transactions related to the transfer of goods and services from one person to another.
Economists distinguish between three types of money:

1. Commodity money
2. Fiat money
3. Bank money

- **Commodity money**:- Commodity money is a raw material whose value serves as the value of money. **Ex**:- Gold, Tobacco, foodstuffs, etc.

- **Fiat money**:- The Fiat money refers to a currency with no intrinsic value that has been declared a legal tender by a government. **Ex**:- Paper money.

- **<u>Bank Money</u>:-** The bank's money consists of accounting credit that banks extend to their depositors. Transactions with cheques issued for deposits held with banks include the use of bank money.

- **<u>Plastic money</u>:-** Plastic money is a term used primarily in relation to hard plastic cards that we use daily instead of real banknotes. They can come in many different styles, such as debit cards, credit cards, prepaid debit cards and store cards.

<u>Importance of money for an Economy</u>

Money plays an important role in the shaping of the economic life in a country

- **Eliminate the problem of barter system**
- **Life blood of an economy**
- **Understanding consumer behavior**
- **Helpful in transfer of wealth**
- **Helpful in capital formation**
- **Helpful in international payments**
- **Social importance of money**
- **Motivation to economic activities**

Q1 (b) What is Barter system and why it vanished?

ANS) Barter system is an old exchange method. The system was used for centuries and long before money was invented. People exchanged services and goods for other services and goods in return. Today, exchange has made a comeback using techniques that are more sophisticated to help trade; for example, the Internet. In ancient times, this system involved people in the same area, however, today bartering is global. The value of the barter elements can be negotiated with the other party. Bartering does not involve money, which is one of the advantages. You can buy items by swapping an item you have, that you don't want anymore.

Some of the drawbacks given below that vanished barter system

1) **Lack Store of Value:-** It is difficult for people to store generalized wealth or purchasing power for future use in the form of goods such as cattle, wheat, potatoes, etc. Holding the stocks of these goods results in costly deposits and depreciations.

2) **Indivisibility of goods:-** It is basically products of unequal value. If a household wants to sell its cow and end up in exchange for a rag equal to the value of half of its cow, it cannot do so without killing its cow. Therefore, the lack of divisibility of the goods makes it impossible

3) **Lack of a Common Measure of Value:-** In the barter system, not all goods have the same value and there is no common measure (unit) of the value of goods and services in which exchange relationships can be demonstrated. For example, if Ali has wheat and Bilal has rice, it is difficult to decide how much wheat is needed to trade with a kilogram of rice. In the absence of a common measure, the exchange rate should be fixed at random, in which one of the party must suffer.

4) **Lack of Deferred Payment:-** Under the exchange system, contracts relating to future payments or credit transactions cannot be easily executed for following reasons. Therefore, it is very difficult to make deferred payments in the form of goods.

Q2) Explain in detail the Primary and secondary functions of Money.

ANS) Primary Functions of Money:-

There are two primary function of money that are given below,

1) Medium of exchange
2) Measure of value

1) Medium of exchange:-

Medium of exchange is the main function of money to facilitate transactions. Without money, all transactions must be made by barter, involving the direct exchange of one good or service to another. The problem with a bartering system is that to get a certain good or service from a provider, you have to own a good or service of equal value, which the provider also wants. In other words, in a trading system or barter system, the stock exchange can only take place if there is a double confluence of desires between two parts of the transactions. However, the probability of a double will match is low and makes the exchange of goods and services quite difficult. Money effectively eliminates the double coincidence of the willpower problem by serving as an accepted bargaining chip in all transactions, by all parties, whether or not they need each other's goods and services.

2) **Measure of value**:-

Money also functions as a measure of value, providing a common account unit for traded goods and services. Knowing the value or price of an asset, in terms of money, allows both the supplier and the buyer of the asset to make decisions about how much of the asset to be provided and how much of the asset to buy.

Secondary Function of Money:-

There are three secondary function of money

1) Standard of deferred payments
2) Store of Value
3) Transfer of Value

1) Standard of deferred payments

Deferred payments involve future payments. When we don't immediately pay in cash for any kind of purchase and sale, but promise to pay in the future, we call it a credit transaction. This means that payments are postponed to a later date. In the case of deferred payments, some issues may be hampered. The value of money can change leading to an increase or decrease. This may be due to the decrease in the price level.

2) Store of Value

The storage of goods not only carries a certain cost, but also involves a loss of value. In addition, perishable foods cannot be stored for a long time. There is also a risk of theft and fire.

The introduction of money has eliminated all these difficulties. There are a number of benefits to save in the form of money for the future. The benefits are:

1. Today we use paper currency. Paper money doesn't require much space to store;

2. By saving money, people can benefit from changes in interest rates;

3. Money as a store retains value through time and space

4. When we save money, we transfer the purchasing power from the present to the future. Therefore, money is a link between the present and the future;

5. Money is the most liquid of all assets. This means that money can be easily exchanged for goods and services without any difficulty.

3) Transfer of value

1 . Money is generally accepted as a means of exchange. This makes it easier to transfer money from one place to another.

2. Currently, the money is stored as bank deposits. The depositor can transfer the amount of money deposited into his bank account into another man's account. This means that it is easier to transfer value in the form of money.

3. Money is a way by which the transfer of value from one place to another was easier and faster. Thus, the transfer of value in the form of money through space remains important. For example, an Orissa entrepreneur who sells his property and goes to Delhi and installs there is a case of transfer of value through space.

4. Money is portable. It can be easily taken from one place to another without any difficulty. On the other hand, it is also difficult and expensive to transport goods and goods from one place to another.

Q3(a) What are Financial Markets and what are their roles in economic development?

ANS) The financial market refers to a market in which financial assets such as stocks, bonds, bonds, currencies, etc. are created and traded, plays a key role in allocating limited resources to the country's economy. It acts as an intermediary between savers and investors by mobilizing funds between them.

The financial market provides a platform for buyers and sellers to meet, trading assets at a price determined by the forces of supply and demand.
Some different types of financial markets are

- **Stock market**
- **Bond market**
- **Commodities market**
- **Derivatives market**

Role of Financial Markets In Economic Development

It play an important role in the formation of capital and the production of goods and services

1. **Price determination:-**
   Demand and supply for the asset in the financial market help determine the price. Investors are the provider of money, while the industry needs money. Therefore, the interaction between these participants and other market forces helps to determine the price.
2. **Mobilization of saving:-**
   For an economy to succeed, it is crucial that money is not inactive. For example, a financial market helps connect people with money with those who demand money.
3. **Ensures liquidity:-**
   Assets traded by buyers and sellers in the financial market have high liquidity. This means that investors can easily sell these assets and convert them into cash whenever they want. One of the main reasons for investors is liquidity
4. **Save time and money:-**
   Financial markets serve as a platform where buyers and sellers can easily be found without overdoing or wasting time. Moreover, because

these markets handle so many transactions, it helps them achieve economies of scale. This translates into lower transaction costs and lower investor fees.

Q3(b) Inflation is one of the major economic problems in Pakistan. What are the causes of inflation and what are its remedies with reference to Pakistan?

ANS) There are some causes of inflation in Pakistan that are given below

CAUSES

- **INCREASE IN PUBLIC EXPENDITURE**
- **INCREASE IN POPULATION**
- **INCREASE IN EXPORT**
- **PROBLEM WITH FINANCIAL PLANNING**
- **TAX REDUCTION**
- **ASSOCIATIONS**
- **IMPOSITION OF INDIRECT TAX**
- **FOREIGN AID**
- **IMPROPER ECONOMIC POLICIES**

REMEDIES

- **INCREASE THE SUPPLY OF ESSENTIAL ITEMS**
- **TIGHT MONETARY POLICY**
- **REDUCE GOVERNMENT EXPENDITURES**
- **CONTROL DEFICIT FINANCING**
- **PROPER TAXATION CHECK**
- **CONTROL ON CORRUPTION**
- **INCREASE IN PRODUCTION**
- **PRICE CONTROL**