MONEY AND BANKING

MONEY

Money refers to anything which is generally acceptable as a medium ofexchange by the society in settlement of debts or for making payments for goods and services.

Money includes bank notes and coins (currency), metals, commodities, and other risk-free liquid assets such as bill of exchange, Cheque, treasury bills and bonds etc.

Money in a particular country is legal tender, that is, by law it has to be accepted as a means of settling debts and for the exchange of goods and service within the country.

Medium Of Exchange:

Medium of exchange refers to a commodity, currency or a financial instrument used in settlement of commercial transactions between buyers and sellers as a measure and standard of value.

The two mediums of exchange include:

- Barter exchange
- Monetary exchange

Barter exchange is a system where goods are exchanged for goods or services.

Whereas monetary exchange is a system where goods and services are exchanged for money inform of bank notes, coins and other instruments of credit.

BARTER TRADE

This is a type of trade where goods are exchanged for goods or services.

It is the earliest form of exchange which dominated the world over beforethe inception of paper money and coins/legal tender.

Some elements of barter trade have spilled over to the modern monetary economy of bank notes and coins/legal tenders which is evident and more significant in the rural setting where people exchange agriculturalcommodities for other commodities.

Barter system can work when there exists 'double coincidence of wants'. Double coincidence of wants refers to the simultaneous fulfillment of mutual wants/needs of buyers and sellers. However, it is difficult to find double coincidence wants in real life.

Advantages / merits of Barter trade:

- It preserves scarce foreign exchange since goods are exchanged for goodsor services.
- It reduces imported inflation since currency money is not used.
- It minimizes balance of payment problems.
- It saves time since a lot of paper work and documentation is reduced.
- Effects of price fluctuation are avoided since physical quantities are usedas price in exchange.
- It promotes trade among LDC'S that experience shortage of foreignexchange because goods are exchanged for goods.
- It creates more jobs since many people are involved in handling physical commodities inform of exports and imports.
- Promotes good relationship among trading countries.

Disadvantages of Barter trade:

- There is no generally acceptable medium of exchange in effecting payment.
- It requires double coincidence of wants whereby a person has to get one who has what he wants and also wants what he has for exchange to take place which is difficult.
- The system is time consuming and tiresome since it involves physical goods.
- There is no unit of account to carry out business calculations and records.
- Transportation of physical goods from place to place is difficult. (No portability)
- There is a problem of indivisibility i.e. it's difficult to break down some commodities into small units to enable small transactions to take place.
- There is no convenient way of storing wealth/value since mostcommodities are bulky and perishable.
- There is no standard of deferred payment to facilitate settlement of debtsand transactions at a future date.
- Most commodities appear in plenty and therefore lose value easily. i.e. are not scarce.

Evolution of Money (Origin of Money):

Money was not invented overnight but rather is a result of a process of evolution through several hundreds of years. Money has passed through numerous historical stages which include the following;

- **Barter**. This was the earliest form of exchange where goods were exchanged for goods or services and services for goods.

The money used therefore, was referred to as commodity money. A variety of commoditiessuch as cattle/livestock, cowry shells, grains, tobacco, spears, hides and skins, precious stones, food stuffs etc as a medium of exchange. It was later discovered by people that they were missing some characteristics of money and there was a challenge of double coincidence of wants which made exchange difficult.

- It was then decided that **commodities of high value** were to be used asa medium of exchange. This included salt, tobacco, grains, hides and skins, livestock, cowry shells etc. These commodities were used to determine the value of other commodities and also served manypurposes hence their ability to satisfy human wants/needs. However, these commodities could not measure well the value of all commodities because they were bulky and perishable.

- Later **durable commodities** were used and these included; gold, iron, silver, beads, cowry shells. After sometime, it was later discovered that some of these commodities were in plenty and they would not act as a good medium of exchange.

- It was therefore decided that **precious metals i.e. gold and silver** should be the only ones to act as a medium of exchange. However as time went on people were inconvenienced with carrying metals, this prompted the emergency of goldsmith who would keep the gold in warehouse and issue receipts to the owners. The receipts had the samevalue as the gold kept in the warehouses. These receipts would be accepted as a medium of exchange since sellers would claim and obtainthe amount of gold against the receipts from goldsmith. This marked the beginning of paper money.

  In this case the receipts were used as money and this kind of money was known as gold standard money.

- **Gold standard money.** This was in form of currency notes/ paper money issued by the central bank and were backed by gold reserves. Itis freely convertible into gold at a fixed price and a country settles all its international trade transactions using gold. Because of gold being too scarce in some countries, it made it difficult for some countries with limited gold to import required goods. This was one of the causes of world Great economic depression in 1929. This made countries to rethink the gold standard money and adopted legal tender; money not backed by gold thus the present day banknotes and coins.

- **Legal tender.** This refers to bank notes and coins which are issued by the central bank and must be acceptable by law as a medium of exchange by people in a given country. Legal tenders are not backed by gold.
- Over time more developments have taken place and these include use cheques, credit cards and most recently financial systems have evolved electronic money (E-currency) e.g. mobile money, E-accounts e.tc.

Qualities of Good Money:

For anything to be used and acceptable as money it should have the following features/ attributes/ qualities:

- **Acceptability,** good money must generally acceptable by people in the settlement of transactions.
- **Divisibility,** good money should be capable of being divided into suitable units/denominations to enable purchase of goods in small and in large quantities without problem of change.
- **Portability,** good money should be convenient to carry from one place to another.
- **Durability,** good money should be able to last for a fairly long time to reduce the cost of frequent printing and minting.
- **Homogeneity/Uniformity,** same units of money/currency must be identical to be accepted. e.g all notes of 10,000/ shillings in circulationin the country must be uniform and have same value.
- **Scarcity,** good money should be relatively limited in supply so that it maintains its value.
- **Stability of value,** good money should have stable value for a long period of time. i.e. it should not lose its exchange value easily.
- **Recognisibility,** good money should be easy to be recognized/ identifiedas money by everyone in the country whether it is real or counterfeit money (fake money).
- **Malleability,** good money should be cheap and convenient to print.
- Good money should be difficult to forge otherwise if forged people would not accept it as a medium of exchange.

Characteristics of good money;

- Should be acceptable.
- Should be stable in value.
- Should be durable.
- Should be divisible.
- Should be relatively scarce.
- Should be portable.
- Should be homogeneous.
- Should be easily recognizable.
- Should be malleable.

Functions of money:

Money serves the following static functions:-

- It is a medium of exchange, it makes it possible for exchange of goods and services to take place.
- It is a measure of value, money is used to determine the relative valueof goods and services and makes it possible for goods and services tosold and bought.

- It is a store of value/wealth, money is the most convenient way of storing value since it is relatively durable than other goods and can be used later to buy goods when required.
- Unit of account, money is used as a unit to carry out business calculations and accounting procedures.
- It is a means of deferred payment, money makes it possible for credit transactions to take place and payment is made at a later date.
- It is a means of non-commercial payments such as taxes, fine, and gifts.

ROLE OF MONEY IN A MODERN ECONOMY

Money plays the following dynamic role in an economy;

Advantages of money as a medium of exchange;

- Leads to division of labour and specialization. Individuals specialize inthe production of goods and services in order to obtain money which theyuse in getting other commodities.

- Avails payments for goods and services. It facilitates exchange of goods and services which helps in carrying on trade smoothly.

- Enhances commercial production. The use of money enables an economyto transform from a subsistence sector to a commercial sector since individuals produce for sale/exchange which increases their incomes.

- Used as a valuable social economic instrument for promoting economic welfare. E.g. use of the monetary policy.

- Money allows deferred/ future payments to be made. These are payments to be effected in future and they can be easily estimated before hand by use of money.

- Money facilitates international trade. Countries can participate in international trade in order to earn foreign exchange which helps them to purchase the goods that they do not produce.

- Money act as an incentive/attraction for the factors of production .Many individuals offer their factors of production in order to earn money e.g. labour is offered to earn wages and salaries, land is offered to earn rent.

- Money is also used to demand for factors of production. This enables the production of goods and services to take place which increase economic growth.

- It measures the value of goods. Money helps in valuing goods andservices i.e. it determines the quality and quantity of goods to be produced.

- Money can be used as a substitute/ a solution to problems encounteredin barter trade. It is a way in which societies try to overcome the problems encountered in barter trade by using money as a medium of exchange.

- It encourages hard work and effort i.e. money encourages people to work harder to accumulate more of it.

- It encourages proper allocation of resources i.e. this is where people produce those commodities that are highly demanded.

Disadvantages of money as a medium of exchange;

- Leads to misallocation of resource. Usually the rich individual dictates the goods to be produced in their favour which leaves out those goods demanded by the poor who are always the majority.

- Money leads to overexploitation of resources in order to accumulate moreof it thus leading to their quick depletion.

- Money can lead to inflation. This is mainly experienced when there is too much money in circulation.

- It leads to income inequality. This is because people earn differently suchthat some individuals are earning more while others are earning less or nothing at all hence creating a gap between the rich and the poor.

- Money encourages rural urban migration and its associated problems/evils. This is mainly experienced when the labour force leaves rural areas to urban centers in search of high incomes. However some individuals are mainly unemployed which results into problems like congestion, creation of slums, robbery, prostitution etc.

- Money encourages corruption and embezzlement of funds. This comes about as individuals ask for bribes and other steal funds to accumulate more money.

- Money can lead to pride and hatred among the people. This kills social cohesion/unity in an economy

- Lack of money leads to poor standards of living, i.e. those who fail to earn enough money live under poor conditions.

TYPES/FORMS OF MONEY:

- **Fiduciary issue/money.** This refers to currency notes and coins issued by the central bank and are not backed by gold or foreign exchange reserves.
- **Full bodied money/ gold standard money.** This refers to currency notes and coins issued by the central bank and are backed by gold reserves. It is freely convertible into gold at a fixed price and a country settles all its international trade transactions using gold.
- **Legal tender.** This refers to bank notes and coins which are issued by the central bank and must be acceptable by law as a medium of exchange by people in a given country. Legal tenders are not backed by gold.
- **Fiat money/order money**. This is money issued on government orders or directive not backed by gold or foreign exchange reserves. Itis not convertible into other forms of money. I.e it is an inconvertible paper money.
  - **Hard currency/Convertible money**. This is money/currency that can be exchanged into other currencies without restrictions. For example, euro, British pound sterling, US dollar, Japanese yen e.t.c. Legal tender is convertible money.
- **Managed currency**. This refers to money which is used within one country only and is not fully convertible into other currencies.
- **Token money**. This refers to coins whose metallic value is less than face value. This is done to discourage people from melting the coins to sell metals.
- **Intrinsic money.** Is one whose metal value is equal to its face value.
- **Commodity money**. This refers to money inform of physical goods which are exchanged for other goods and services.
- **Deposit money**. This refers to money held in the bank by people as deposits on various accounts and made available on demand. This includes sight/ demand deposits held by people in banks.
- **E-money.** This refers to all types of money which people deal with electronically, far from the traditional ways of payment like banks, cheques, paper money and coins. E-money allows users through internet or wireless devices to pay the charges of their purchases directly from their bank accounts by electronic ways such as smart cards, digital wallets and mobile money payments e.t.c.
- **Quasi/ near money**. This refers to risk free liquid assets. i.e assetswhich can easily be converted into cash.

Quasi money includes:

- ✓ **A bill of exchange,** this is an unconditional order in writing by a creditor to a debtor instructing him to pay a specified amount of money to a named person and in a specified time period.
- ✓ **Treasury bill,** this is a financial security issued by government through the central bank when borrowing short term loans. It matures within a period less than one year.
- ✓ **Treasury bond,** this is a financial security issued by government through the central bank when borrowing long term loans.
- ✓ **Cheque,** this is a written order by a bank customer instructing his bank to pay a specified amount of money to a named person.

NB: Quasi money is also called credit money/ instruments of credit.

Instruments of credit refers to documents that enable the bearer to obtain cash or goods.