MONEY

It is one of the most active and powerful economic instruments in use, anywhere, anytime. Money is such a natural and common element of every day life. Money is everything that serves as a universally accepted medium of exchange.

Functions of money

a) ***Basic medium of exchange***. Money enables people to exchange goods and services for other commodities – to make transactions.
b) ***Store of value***. It can be kept for spending at a later date. It is better to deposit financial assets with a bank. The money deposit then pays its owner interest. Money can also be stored in other forms of assets, the portfolio: securities, shares or bonds.
c) ***Measure of value***. It enables us to compare the value of various goods and services.

Evolution of money

a) Before money existed, people had to use the ***barter*** system to exchange their product and services. Barter meant the direct exchange of goods
b) Later people developed a more practical system of exchange. They used ***commodity money*** – goods which members of the society recognized as having value. They were for instance: cattle, skulls, tobacco, wine etc.
c) ***Precious metals*** (gold, silver) gradually took over because they had the basic qualities that money should possess: durability, divisibility, portability homogeneity.
d) ***Paper money*** developed from paper receipts that goldsmiths gave their clients as confirmation of accepting their gold for safekeeping in vaults.
e) Nowadays ***notes and coins*** are given denominations by the government irrespective of their metal content or precious metal backing. This money, officially declared by law, is called ***fiat money***.

Bank notes and coins made of various metals became legal tender. Paper money is well protected from counterfeiting by means of water marks, security threads, micro printing in the design, and use of reflective materials.

Money supply (money stock)

Economists in all countries closely watch the amount of money in circulation, the money supply or money stock. All movements of the money supply are important indicators of inflation, economic activity, and growth. The government intentionally regulates the money supply to influence the above mentioned phenomena for the sake of economic prosperity.

Basically, there are two types of “money” which the money supply consist of:

a) ***transaction money*** – used by firms, households, and individuals for the exchange of goods and services (coins and notes)
b) ***near money*** – is represented by term deposits. It cannot be withdrawn from the deposit account at call. Notice must be given to the bank.

Interest

Money deposited in savings or deposit accounts earns their owners interest. Long-term deposits often pay higher interest than short-term deposits.

Entrepreneurs sometimes need to borrow additional funds for their business. They get a loan form a bank which they have to repay plus the interest on the principal borrowed.

Exchange rate

The exchange rate expresses the price one must pay for a foreign currency. A currency has its market price and can be traded on foreign exchange markets.

Floating exchange rates

If a country's economy is doing well, the balance of payments is positive, the currency tends to appreciate. In countries with floating exchange rates, where exchange rates fluctuate day by day, appreciation or depreciation of currency is effected automatically by market forces. To stabilize the exchanger rate, a government can intervene by purchasing or selling the currency in question.

Fixed exchange rates

In countries with fixed exchange rates, where their currencies are pegged to one or more foreign currencies (currency basket) change in the exchange rate is done by the government.

Revaluation

Revaluation represents the increase in the price of a currency. It is advantageous for countries in a creditor position, but it may have a negative impact on export.

Devaluation

Devaluation is the opposite of revaluation and may lead to the encouragement of exports and the inflow of foreign capital.

Sometimes a government intentionally sets a lower or a higher official exchange rate in relation to another currency than that resulting from the normal functioning of market forces. The result of government intervention in this sphere may be ***undervaluation*** or ***overvaluation*** of a currency.

Purchasing power, purchasing power parity

The purchasing power of a currency tells how many goods it is possible to bay with one currency unit.

If the prices of consumer baskets of two different countries are compared, a nominal "exchange rate" called the purchasing power parity (PPP) can be calculated. This parity ignores the influence of supply and demand for the currencies, government interventions etc. Purchasing power parity assists in the comparing of important macroeconomic indicators of different countries.

Hot money

Hot money is the term used for speculative financial capital, deposited on a short-term basis, which it attracted to the country by high interest rates. Hot money may temporarily offset payment balance deficits.

Monetary policy

Instruments of monetary policy help to regulate the money supply in a country. When there is a danger of growing inflation, the government pursues the policy of tight money aimed at reducing the money supply and limiting investments. When there is a recession, on the other hand, easy money policy should be applied and the growth of aggregate demand encouraged.

The main instruments of monetary policy are interest rates and loan terms, increasing or decreasing the minimum reserve requirements, manipulation with the discount rates and open market operation with government securities.