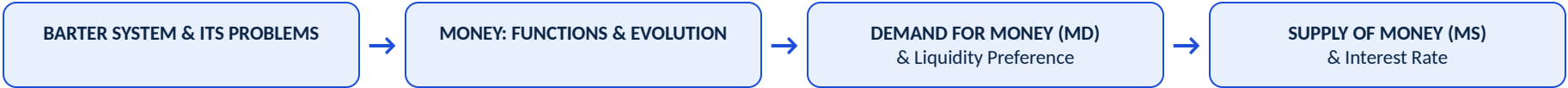


1 CHAPTER ROADMAP



Theme: money evolved to solve barter's problems and now serves four core functions. Households, businesses and government all demand money for different motives (Keynes' liquidity preference); this demand, interacting with a centrally-controlled money supply, determines the market rate of interest.

2 KEY DEFINITIONS

Barter The exchange of one economic good or service directly for another, without money.	Money (Prof. Crowther) Anything generally acceptable as a means of exchange, which also acts as a measure and store of value.
Fiat Money Has NO intrinsic value; government-issued currency not backed by a commodity, accepted only due to government order.	Credit Money Any monetary claim against a physical/legal person that can be used to purchase goods/services (verbal, written agreement, or financial instrument like a bond).
Demand for Money (MD) All else equal, the amount of money people wish to hold at a given time, at different interest rates – the desire to hold cash or liquid assets.	Liquidity Trap A situation where interest rates are already very low and liquidity preference is high, making monetary policy ineffective.
Bond An investment bought upfront by an investor, which pays a fixed amount in return at regular intervals (usually annually).	Supply of Money (MS) Total stock of money in circulation in a country at a given time – includes currency notes, coins, and bank demand deposits.

3 DISADVANTAGES OF THE BARTER SYSTEM

- **Coincidence of wants:** both parties must simultaneously want what the other offers (rice-for-cotton example)
- **Rate of exchange:** no easy way to agree a fair exchange rate between very different goods
- **Indivisibility of goods:** many goods (chair, table) can't be split for smaller trades
- **Store of value:** perishable goods (sugarcane) can't be stored for future wealth
- **Transfer of wealth:** immovable goods (land, house) are hard to transfer/relocate
- **Difficulties in tax collection:** taxes collected in goods (e.g. wheat) can't fund infrastructure (roads, hospitals)

4 FOUR FUNCTIONS OF MONEY

MEDIUM OF EXCHANGE

- Lets agents trade goods without needing to barter

UNIT OF ACCOUNT

- Allows comparing relative prices via a common denomination

STORE OF VALUE

- Lets people forgo consumption now and retrieve resources later

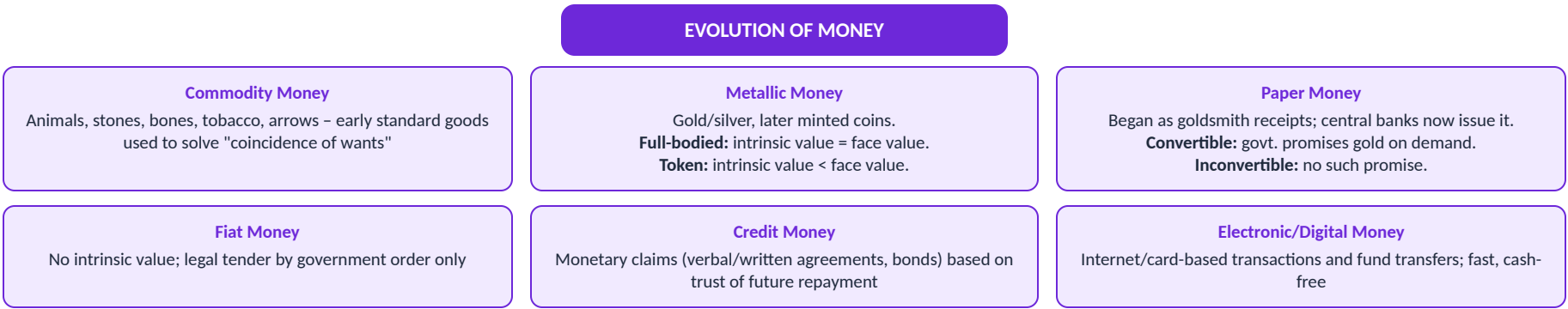
STANDARD OF DEFERRED PAYMENTS

- Allows consuming now while paying in future periods

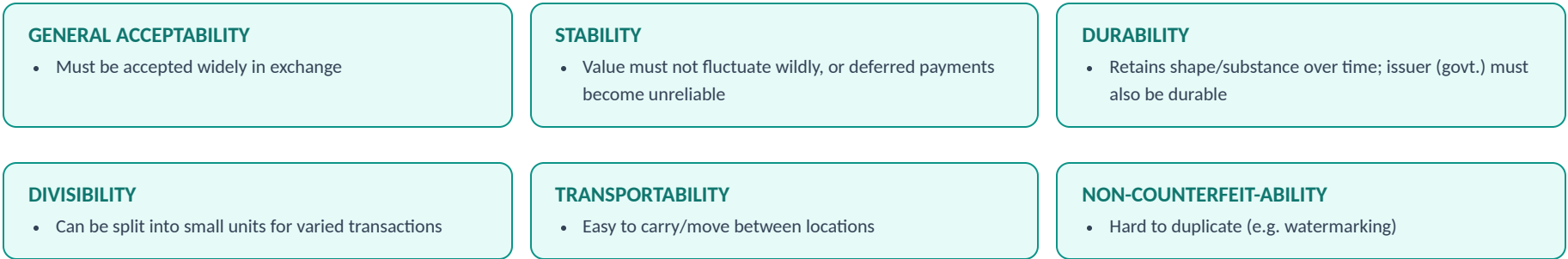
5 THREE VIEWS ON THE ROLE OF MONEY

School	View
Classical economists	Money is a passive "lubricant" – markets balance supply & demand on their own; money is neutral
Keynesian economists	Money also acts as a STORE OF VALUE, not just a trade facilitator – this contradicts the classical "neutral money" view
Monetarists	Money affects AGGREGATE EXPENDITURE via the interest rate – can boost SHORT-RUN output, but expanding money supply ultimately causes inflation and affects LONG-RUN unemployment

6 EVOLUTIONARY STAGES OF MONEY



7 CHARACTERISTICS OF GOOD MONEY

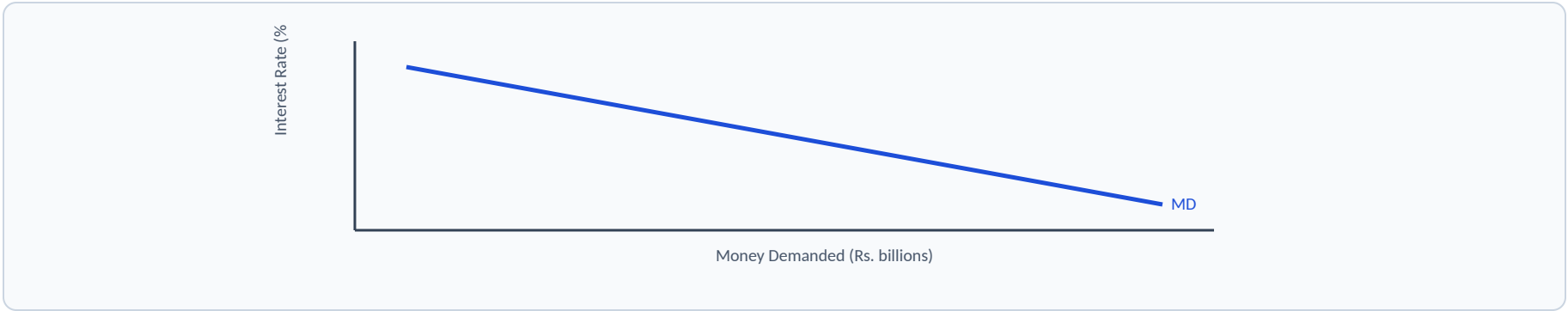


8 DETERMINANTS OF DEMAND FOR MONEY

Interest rate ↑	→	Demand for money ↓ (opportunity cost of holding cash rises)
Price level ↑ (inflation)	→	Demand for money ↑ (need more cash for same purchases)
Real national output (GDP) ↑	→	Demand for money ↑ (higher income → higher spending)
Financial innovation ↑ (ATMs, cards, online transfer)	→	Demand for money ↓ (less need to hold physical cash)

9 DEMAND FOR MONEY: SCHEDULE & CURVE

Interest Rate (%)	10	8	6	4	2
MD (Rs. billions)	100	200	300	400	500



Downward-sloping MD curve: inverse relationship between interest rate and quantity of money demanded – as interest falls, holding cash becomes relatively more attractive.

10 SHIFT OF THE DEMAND FOR MONEY CURVE

Income ↑ or Price level ↓	→	MD curve shifts RIGHT (MD ₀ →MD ₁)
Financial innovation ↑	→	MD curve shifts LEFT (MD ₀ →MD ₂)

Any factor OTHER than the interest rate itself causes a SHIFT of the whole MD curve; a change in the interest rate causes only a MOVEMENT along the existing curve.

11 KEYNESIAN LIQUIDITY PREFERENCE – THREE MOTIVES

TOTAL DEMAND FOR MONEY

MD = Transactional Demand + Precautionary Demand + Speculative Demand

Keynes: people prefer holding liquid cash over illiquid assets, but need a "premium" (interest) to be persuaded to give up liquidity

Motive	Purpose	Sensitivity to Interest Rate
Transactional	Day-to-day regular payments; directly proportional to nominal national income	UNAFFECTED by interest rate
Precautionary	Held for emergencies (accident, disease)	Inversely related, but relatively INELASTIC
Speculative	Held to invest later (e.g. in stocks) when conditions are favourable	Inversely related, and relatively ELASTIC

Exam clue: Speculative demand is the MOST interest-sensitive of the three; Transactional demand is completely UNaffected by the interest rate.

12 LIQUIDITY TRAP

At a very low "critical" interest rate (ro), further increases in money supply (MS1→MS2→MS3) fail to lower the interest rate any further – the MD curve turns flat (perfectly elastic) at ro, and people simply absorb the extra money as idle cash, waiting for bond prices to fall.

MEASURES TO OVERCOME THE LIQUIDITY TRAP

- **Fiscal policy:** e.g. running a larger budget deficit to raise demand directly
- **Raise inflation expectations:** makes hoarding cash less attractive (its real value falls), boosting consumption
- **Raise interest-rate expectations:** government borrowing from banks pushes rates up, encouraging bond purchases and pulling the economy out of the trap

13 SUPPLY OF MONEY – THE LIQUIDITY SCALE (M0–M3)

MONEY SUPPLY CLASSIFICATION

M1 = M0 + Demand Deposits | M2 = M1 + Time Deposits | M3 = M2 + Long-Term Securities

Ordered from MOST liquid (M0) to LEAST liquid (M3)

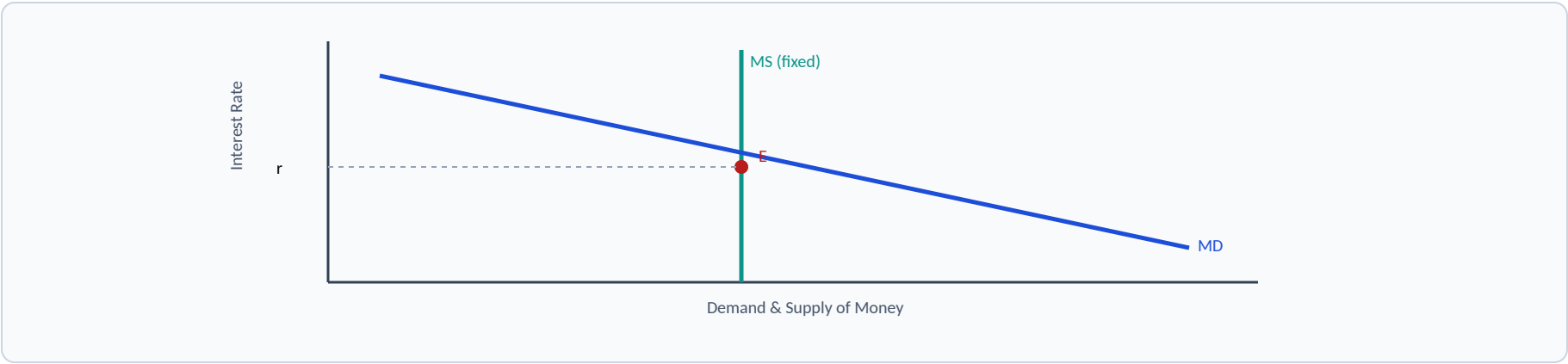
Category	Includes	Liquidity
M0 (Transactional money)	Currency notes & coins	Fully liquid
M1 (Checking accounts)	M0 + money in accounts with immediate access	High
M2 (Savings deposits)	M1 + time deposits (not immediately accessible)	Medium
M3 (Large time assets)	M2 + mutual funds & long-term securities	Most illiquid

Key rule: for money to hold value, its supply must be FINITE – unlimited production would bid up prices to unsustainable levels. This is why control over money supply is kept with the central bank/government.

14 IMPORTANCE OF MONEY SUPPLY

An increase in money supply LOWERS the interest rate at which people can borrow – directly affecting the level of both investment and consumption in the economy.

15 DETERMINATION OF THE MARKET INTEREST RATE



Money supply (MS) is VERTICAL – fixed at a point in time by the central bank, independent of interest rate. It intersects the downward-sloping MD curve at point E, determining the equilibrium market rate of interest, *r*.

16 HOW THE CENTRAL BANK SHRINKS MONEY SUPPLY (ANTI-INFLATIONARY)



Conversely, in a deflationary situation the central bank BUYS securities from the open market – reserves & lending power rise, money supply expands, and the interest rate FALLS.

17 EFFECT OF MS SHIFTS ON INTEREST RATE

Change	MS Curve Shift	Effect on Interest Rate	Effect on Money Held
Money supply INCREASES	MS → MS1 (right)	Falls ($r \rightarrow r_1$)	Rises ($M \rightarrow M_1$)
Money supply DECREASES	MS → MS2 (left)	Rises ($r \rightarrow r_2$)	Falls ($M \rightarrow M_2$)

18 EXAM PATTERNS & MCQ QUICK CLUES

"Intrinsic value less than face value"	→	Token money
"No intrinsic value, legal tender only"	→	Fiat money
"Held for day-to-day payments, unaffected by interest"	→	Transactional demand for money
"Most sensitive to interest rate changes"	→	Speculative demand for money
"Mutual funds / long-term securities"	→	M3
"Interest rate at critical low, MS increase has no effect"	→	Liquidity trap
"Central bank sells securities"	→	Money supply shrinks, interest rate rises

⚠ ECONOMICS EXAM TRAPS

Trap: Confusing Full-Bodied Money (intrinsic value = face value) with Token Money (intrinsic value < face value).
Trap: Mixing up Convertible (govt. promises gold) with Inconvertible (no such promise) paper money.
Trap: Treating all three demand-for-money motives as equally interest-sensitive – only precautionary & speculative are interest-related, and only speculative is highly ELASTIC.
Trap: Assuming money supply (MS) responds to interest rate – it is a VERTICAL (fixed) curve set independently by the central bank.
Trap: Reversing the M0-M3 order – M0 is the MOST liquid, M3 is the LEAST liquid (each tier adds a less-liquid asset).

19 COMPLETE CHAPTER DECISION TREE

QUESTION GIVEN → Money form/evolution, demand for money, or supply of money question? → Identify the specific concept (motive, money type, M-category) → Apply relevant definition/rule → For MD/MS: identify whether it's a movement (interest rate change) or shift (other factor) → Interpret & select final answer
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PRC-3 ECONOMICS – CHAPTER 9 IN 60 SECONDS

- **Money's 4 functions:** medium of exchange, unit of account, store of value, standard of deferred payments.
 - **Evolution:** Commodity → Metallic (full-bodied/token) → Paper (convertible/inconvertible) → Fiat → Credit → Electronic.
 - **MD determinants:** interest rate (↓ MD), price level (↑ MD), real GDP (↑ MD), financial innovation (↓ MD).
- **3 Keynesian motives:** Transactional (income-driven, interest-independent), Precautionary (inelastic), Speculative (elastic).
 - **Liquidity trap:** at critical low interest, MS increases can't lower it further.
 - **M0<M1<M2<M3** in liquidity terms (M0 most liquid).
 - **Interest rate** determined where MD (downward-sloping) meets MS (vertical, fixed).
 - **Sell securities** → MS ↓ → interest rate ↑ . **Buy securities** → MS ↑ → interest rate ↓ .

20 CHAPTER MEMORY MAP

