**CHAPTER: 8**

**Monetary System**

There is no unanimity among economist over the definition of the money. Money has been defined differently by different economists. Some important definitions of money are given as:

1. According to Walker **“Money is what money does.”**
2. Robertson defines **“Money is anything which is widely accepted in payment for goods, or discharge of other kind of business obligations”.**
3. According to the Crowther **“Money is anything that is generally acceptable as a means of exchange and at the same time, acts as a measure and as a store of value.”**

Among these three definitions of the money Crowther definition is treated as suitable of the money. In simple words money is anything which performs four main functions (i) medium of exchange (ii) measure of value (iii) standard of deferred payments (iv) store of value

**Functions of Money**

The function of money viewed in the given Chart

**Primary Functions**

There are two primary functions of money

1. Medium of Exchange
2. Measure of Value

**I. Medium of Exchange**

It is very important function of money. Any commodity can purchase and sold through medium of exchange.

**II. Measure of Value**

Money serves as common measure of value or a standard of value. Value of all goods and services expressed in terms of money. For example price of pen as 5 S.R., price of book is 20 S.R., price of sugar is 5S.R per kg, Daily wages 20 S.R per hour etc. *Thus, when the value of all commodities is expressed in terms of money, it becomes easier for anyone to compare the relative values of two commodities.*

**SECONDARY FUNCTIONS OF MONEY**

There are three secondary functions of money

1. Standard of Deferred Payments
2. Store of Value
3. Transfer of Value
4. **Standard of Deferred Payments (Future Payments)**

In the modern economic system loans are generally given and taken and the repayment is generally postponed for the future date. Future payments cannot made in terms of physical goods because the value of goods liable to change. Money is therefore, used as standard of deferred payments.

1. **Store of Value**

Like other kind of wealth money can also be stored for the future. It is most economic and convenient way of hoarding. A person is accumulating money is really accumulating goods and services. A store of value implies the shifting of the purchasing power from present to future. It enables the people to save a part of their current income and store it for the future use. Thus money links between present and future.

1. **Transfer of Value**

Money helps us to transfer values from one person to another and from one place to another. Money is readily accepted by all, and in all places. These days, such transfers value does not take place through the currency notes only but through bank cheques or bank drafts.

**COTINGENT FUNCTIONS**

1. Distribution of National Income
2. Maximum Satisfaction to the Consumer
3. Maximum profit to the Producers
4. Basis of Credit
5. Liquidity
6. **Distribution of National Income**

Money helps to distribute national income among various factors in the form of money wages, interest, rents and profits.

1. **Maximum Satisfaction to the Consumer**

A consumer who aims at maximum satisfaction buys goods and services in such a way that the price of each commodity (expressed in money) is equal to its marginal utility.

1. **Maximum profit to the Producers**

A producer can maximize his profit if he so employs the various factors of production that the price of one unit of a factor is equal to the marginal productivity of that factor per unit.

1. **Basis of Credit**

Credit is the most important feature of modern business. The main supporting pillar of credit and financial system is money. The supply of credit is linked with supply of money. Thus in a modern economy, money serves as basis of credit.

1. **Liquidity**

Money is most liquid assets. Money can easily converted into any gold and assets such as land, machinery and equipment, stocks and shares, wheat, rice, books etc. it is because of the liquidity people desire to have a money.

**CLASSIFICATION OF MONEY**

Money assumed different forms during the course of evolution and even in modern times there exists various forms of money. We can classify money into three broad categories:

**A.METALLIC MONEY**

Money is made of some metal is called metallic money. Metals which were served as money were gold, silver, copper etc.

Metallic money further classified inti two parts full-bodied coins and token money coins

1. **Full-Bodied Coins**

Full-bodied money (or standard money) is that money whose value as commodity is equal to value as money. For example 1 SR coins has the one SR value of silver used in this coin then it is full bodied money.

1. **Token Coins**

Token coin is one whose value as money (face value) is significantly is greater than the market value of the commodity of which it is made (intrinsic value).

**B. PAPER MONEY**

Money made of the paper is known as paper money or currency notes. Paper money further classified three categories:

1. **Representative Paper Money**

A representative paper money is fully backed by metallic content. Representative paper money is circulated by government after keeping the 100% valuable metals like gold and silver in its treasury.

1. **Convertible Paper Money**

When government or central Bank gives guarantee for the conversion of paper money into gold or silver at fixed price, than this paper money is termed as convertible paper money.

1. **Inconvertible Paper Money**

In the inconvertible paper money the government does not bear any responsibility of its conversion into gold or silver on demand is known inconvertible paper money.

**C. CREDIT MONEY (OR BANK MONEY)**

Credit money refers to bank deposits by people with banks which they can withdraw at any time they like or transfer it to someone through a cheque.

**CENTRAL BANK**

In every country there is central bank. The central bank is the apex institution of the financial or the monetary system. In *Kingdom of the Saudi* Arab the central Bank is Saudi Arabian Monetary Agency (SAMA) is the central bank of the nation. It supervises, regulates and controls the activities of commercial banks and other financial institutions. The economist defines central bank in accordance with their function:

1. According to Hawtrey, “*Lender of the last resort is the essential function of the central bank*.”
2. In the opinion of the Vera Smith, *“The primary definition of the central banking is a banking system in which a central bank has a either a complete or a residuary monopoly in the note issue.”*

From the above statement the central bank defined as it is an apex institution which operates controls, directs and regulates the monetary and banking structure of a country.

**Function of Central Bank**

In the monetary and banking setup of a country, central bank occupies central position and perhaps, it is because of this fact that this called as the central bank. In this way, this bank works as an institution whose main objective is to control and regulate money supply keeping in view the welfare of the people. Central bank is an institution that fulfills the credit needs of banks and other credit institution, which woks as banker to the banks and the government and which work for the economic interest of the country.

1. **Monopoly of note issue**

Note issue primarily is the main function of a central bank in every country. These days, in all the countries where there is a central bank generally it has got the monopoly of the sole right of note issue. In the beginning this was not the function of central bank, but gradually all the central bank gas acquires this function.

There are many advantages of the note issue by central banks some important ones are as follow:

1.    Central bank controls the credit creating power of commercial bank. By controlling the amount of currency in circulation, the volume of credit can be controlled to quite a large extent.

2.    People have more confidence in the currency issued by the control bank because it has the protection and recognition of the government.

3.    In the event of monopoly of note issue of central bank, there will be uniformity in the currency system in the country.

4.    The currency of the country will be flexible if the central bank of the country has the monopoly of note issue because central bank can bring about changes very early in the volume of paper money according to the needs of business, industry and messes.

5.    The system of note issue has some advantages. If the central bank of the country has the monopoly of note issue, all such advantages will accrue to the government.

1. **Bankers, Agent and Adviser to the Government**

As banker to the government, central bank provides all those service and facilities to the government which public gets from the ordinary banks. It operates the account of the public enterprise. It mangers government departmental undertaking and government funds and where there is a need gives loan to the government. From time to time, central bank advices the government on monetary, banking and financial matters.

**3.    Custodian of Cash Reserve of Commercial Bank**

Central bank is the bank of banks. This signifies that it has the same relationship with the commercial banks in the country that they gave with their customers. It provides security to their cash reserves, gives them loan at the time of need, gives them advice on financial and economic matter and work as clearing house among various members bank.

1. **Custodian of Nation’s Reserve of International Currency**

Central bank is the custodian of the foreign currency obtained from various countries. This has become an important function of central bank. With help of the monetary policy it can stabilize the external value of the currency.

**5.    Lender of the Last Resort**

Central bank works as lender of the last resort for commercial banks because in the time of need it provides them financial assistance and accommodation. Whenever a commercial bank faces financial crisis, central bank as lender of the last resort comes to its rescue by advancing loans and the bank is saved from being failed.

**6.    Clearing House Function**

All commercial bank have their accounts with the central bank. Therefore, central bank settles the mutual transactions of banks and thus saves all banks controlling each other individually for setting their individual transaction.

**7.    Credit Control**

These days, the most important function of a central bank is to control the volume of credit for bringing about stability in the general price level and accomplishing various other socio economic objectives. The significance of this function has increased so much that for property understanding it. The central bank has acquired the rights and powers of controlling the entire banking.  
A central bank can adopt various quantitative and qualitative methods for credit control such as bank rate, open market operation, changes in reserve ratio selective controls, moral situation etc.

Besides the 7 functions explained above, central banks perform many other functions that are as follows:

**8.    Collection of Data**

Central banks in almost all the countries collects statistical data regularly relating to economic aspects of money, credit, foreign exchange, banking etc. from time to time, committees and commission are appointed for studying various aspects relating to the aforesaid problem.

**9.    Central Banking in Developing Countries**

The basic problem of underdeveloped countries is the problem of lack of capital formation whose main causes are lack of saving and investment. Therefore, central bank can play an important role by promoting capital formation through mobilizing saving s and encouraging investment.

**Commercial Bank**

In general, bank refers to a financial institution where we deposit our savings, withdraw our money in case of emergency and take loans.

The banker is under obligation to repay the money to the depositor as and when demanded by the depositor. The depositor can withdraw his money through cheques, drafts etc.  
Let us see some other definitions given by different experts-

According to Crowther, “A bank collects money from those who have it to spare or who are saving it out of their incomes, and it lends this money to those who require it”

According to John Paget, “Nobody can be a banker who does not (i) take deposit accounts, (ii) take current accounts, (iii) issue and pay cheques, and (iv)Collects cheques- crossed and uncrossed- for its customers”

The main functions of commercial banks are accepting deposits from the public and advancing them loans.

However, besides these functions there are many other functions which these banks perform. All these functions can be divided under the following heads:

**A. Primary Functions**:

**I. Acceptance of Deposits**

1. Current Deposits
2. Saving Deposits
3. Fixed Deposits

**II. Advancing loans**

1. Short Term Loans
2. Demand Loans
3. Cash Credit

**III. Credit Creations**

1. Overdraft
2. Discounting of Bills of Exchange

**B. Secondary Functions**

1. Agency Functions
2. Miscellaneous Functions

1. **Accepting Deposits:**

The most important function of commercial banks is to accept deposits from the public. Various sections of society, according to their needs and economic condition, deposit their savings with the banks.

For example, fixed and low income group people deposit their savings in small amounts from the points of view of security, income and saving promotion. On the other hand, traders and businessmen deposit their savings in the banks for the convenience of payment.

Therefore, keeping the needs and interests of various sections of society, banks formulate various deposit schemes. Generally, there are three types of deposits which are as follows:

(i) **Current Deposits:**

The depositors of such deposits can withdraw and deposit money when­ever they desire. Since banks have to keep the deposited amount of such accounts in cash always, they carry either no interest or very low rate of interest. These deposits are called as Demand Deposits be­cause these can be demanded or withdrawn by the depositors at any time they want. Commercial Bank generally allows the current account deposits to the businessman.

Such deposit ac­counts are highly useful for traders and big business firms because they have to make payments and accept payments many times in a day.

(ii) **Fixed Deposits:**

These are the deposits which are deposited for a definite period of time. This period is generally not less than one year and, therefore, these are called as long term deposits. These deposits cannot be withdrawn before the expiry of the stipulated time and, therefore, these are also called as time deposits.

These deposits generally carry a higher rate of interest because banks can use these deposits for a definite time without having the fear of being withdrawn.

(iii) **Saving Deposits:**

In such deposits, money up to a certain limit can be deposited and with­drawn once or twice in a week. On such deposits, the rate of interest is very less. As is evident from the name of such deposits their main objective is to mobilise small savings in the form of deposits. These deposits are generally done by salaried people and the people who have fixed and less income.

2. **Advancing Loans:**

The second important function of commercial banks is to advance loans to its customers. Banks charge interest from the borrowers and this is the main source of their income.

Banks advance loans not only on the basis of the deposits of the public rather they also advance loans on the basis of depositing the money in the accounts of borrowers. In other words, they create loans out of deposits and deposits out of loans. This is called as credit creation by commercial banks.

Modern banks give mostly secured loans for productive purposes. In other words, at the time of advancing loans, they demand proper security or collateral. Generally, the value of security or collateral is equal to the amount of loan. This is done mainly with a view to recover the loan money by selling the security in the event of non-refund of the loan.

At limes, banks give loan on the basis of personal security also. Therefore, such loans are called as unsecured loan. Banks generally give following types of loans and advances:

(i) **Cash Credit:**

In this type of credit scheme, banks advance loans to its customers on the basis of bonds, inventories and other approved securities. Under this scheme, banks enter into an agreement with its customers to which money can be withdrawn many times during a year. Under this set up banks open accounts of their customers and deposit the loan money. With this type of loan, credit is created.

(ii) **Demand loans:**

These are such loans that can be recalled on demand by the banks. The entire loan amount is paid in lump sum by crediting it to the loan account of the borrower, and thus entire loan becomes chargeable to interest with immediate effect.

(iii) **Short- Term loan:**

These loans may be given as personal loans, loans to finance working capital or as priority sector advances. These are made against some security and entire loan amount is transferred to the loan account of the borrower.

**3. Credit Creation**

(i). **Over-Draft:**

Banks advance loans to its customer’s up to a certain amount through over-drafts, if there are no deposits in the current account. For this banks demand a security from the customers and charge very high rate of interest.

(ii). **Discounting of Bills of Exchange:**

This is the most prevalent and important method of advancing loans to the traders for short-term purposes. Under this system, banks advance loans to the traders and business firms by discounting their bills. In this way, businessmen get loans on the basis of their bills of exchange before the time of their maturity.

**Secondary Functions:**

**1.** **Agency Functions:**

Banks function in the form of agents and representatives of their customers. Customers give their consent for performing such functions. The important functions of these types are as follows:

(i) Banks collect cheques, drafts, bills of exchange and dividends of the shares for their custom­ers.

(ii) Banks make payment for their clients and at times accept the bills of exchange: of their cus­tomers for which payment is made at the fixed time.

(iii) Banks pay insurance premium of their customers. Besides this, they also deposit loan installments, income-tax, interest etc. as per directions.

(iv) Banks purchase and sell securities, shares and debentures on behalf of their customers.

(v) Banks arrange to send money from one place to another for the convenience of their custom­ers.

**2.** **General Utility Functions:**

Besides the functions mentioned above, banks perform many other functions of general utility which are as follows:

(i) Banks make arrangement of lockers for the safe custody of valuable assets of their custom­ers such as gold, silver, legal documents etc.

(ii) Banks give reference for their customers.

(iii) Banks collect necessary and useful statistics relating to trade and industry.

(iv) For facilitating foreign trade, banks undertake to sell and purchase foreign exchange.

(v) Banks advise their clients relating to investment decisions as specialist

(vi)Bank does the under-writing of shares and debentures also.

(vii) Banks issue letters of credit.

(viii) During natural calamities, banks are highly useful in mobilizing funds and donations.

(ix) Banks provide loans for consumer durables like Car, Air-conditioner, and Fridge etc.

**Question Review**

**Multiple Choice Question A**

1. **“Money is what money does.”**

|  |  |
| --- | --- |
| A. Robertson | B.Walker |
| C. Crowther | D.Marshall |

1. **“Money is anything that is generally acceptable as a means of exchange and at the same time, acts as a measure and as a store of value.”**

|  |  |
| --- | --- |
| A. Robertson | B.Walker |
| C. Crowther | D.Marshall |

3. **The secondary function of the money is**

|  |  |
| --- | --- |
| A. Standard of Deferred Payments | B. Store of Value |
| C. Transfer of Value | D. All of the Above |

4. **There are how many Central Banks in one country**

|  |  |
| --- | --- |
| A. one | B. Two |
| C. Four | D. Three |

**5. Which one is not essential function of the Central Bank?**

|  |  |
| --- | --- |
| A. Lender of Last Resort | B. Power of Note Issue |
| C. Banker’s Bank | D. Advancing Loan to Businessman |

6. **Custodian of Nation’s Reserve of International Currency is**

|  |  |
| --- | --- |
| A. Central Bank | Commercial Bank |
| C. Development Bank | D. None of the Above |

7. **Which Bank is treated as Bankers, Agent and Adviser to the Government**

|  |  |
| --- | --- |
| A. Saudi Arab Monetary Agency(SAMA) | B.Samba Bank |
| C.Al Rajhi Bank | D. Arab National Bank |

**8. Monetary Policy of Kingdom is prepared by**

|  |  |
| --- | --- |
| A. Saudi Arab Monetary Agency(SAMA) | B.Samba Bank |
| C.Al Rajhi Bank | D. Arab National Bank |

9. **The primary function of the Commercial Bank is**

|  |  |
| --- | --- |
| A. Accepting the Deposits | B. Advancing Loans |
| C. Both | D. None of the Above |

10.  **Advancing loans consists of**

|  |  |
| --- | --- |
| A. Short Term Loans | B. Demand Loans |
| C. Cash Credits | D. All of the above |

**11. “A bank collects money from those who have it to spare or who are saving it out of their incomes, and it lends this money to those who require it” The statement is issued by**

|  |  |
| --- | --- |
| A. Robertson | B.Walker |
| C. Crowther | D.Marshall |

**12. The amount of the money which people can withdraw at any time they like or transfer it to someone through a cheque**.

|  |  |
| --- | --- |
| A. Credit Money | B. Inconvertible Money |
| C. Non Metallic Money | D. Paper Money |

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **QUES.** | **1** | **2** | **3** | **4** | **5** | **6** | **7** | **8** | **9** | **10** | **11** | **12** |
| **ANS.** | **A** | **C** | **D** | **A** | **D** | **A** | **A** | **A** | **C** | **D** | **C** | **A** |

**True and False B**

**Write T for True and F for False**

1. Crowther defines **“Money is anything which is widely accepted in payment for goods, or discharge of other kind of business obligations”.**
2. Medium of Exchange and Measure of Value are the secondary functions of the Money.
3. Distribution of National Income is the Contingent function of Money.
4. Full Bodied money coins are part of Non Metallic Money.
5. Hawtrey, stated that“*Lender of the last resort is the essential function of the central bank*.”
6. Credit Control in the responsibility of the Central Bank.
7. Salaried Income people are accountable to open current Account.
8. National Commercial Bank has not enjoying the facility of Saving Deposits.
9. **The Central Bank is not the Custodian of Cash Reserve of Commercial Bank.**
10. Central Bank does not hold any power to collect data relating to the economic issues.

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Question** | **1** | **2** | **3** | **4** | **5** | **6** | **7** | **8** | **9** | **10** |
| **Answer** | **F** | **F** | T | **F** | T | T | T | **F** | **F** | **F** |

**Matching Test**

|  |  |
| --- | --- |
| **Match A** | **Match B** |
| 1. **Lender of the Last Resort** | 1. Non Metallic Money |
| 1. Accepting Deposits | 1. Metallic Money |
| 1. Full Bodied Coins | 1. Commercial Bank |
| 1. Convertible Paper Money | 1. Central Bank |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Match A** | **1** | **2** | **3** | **4** |
| **Match B** | **D** | **C** | **B** | **A** |

**Ques.1. Explain the primary functions of Money**

**Answer:** There are two primary functions of money

1. Medium of Exchange
2. Measure of Value

**Ques.2: What is the Secondary function of the Money?**

**Answer: There are three Secondary functions of money**

1. Standard of Deferred Payments
2. Store of Value
3. Transfer of Value

**Ques.3: What is Credit Money?**

**Answer:** Credit money refers to bank deposits by people with banks which they can withdraw at any time they like or transfer it to someone through a cheque.

**Ques.4: What is Central Bank?**

**Answer:** The central bank is the apex institution of the financial or the monetary system. In *Kingdom of the Saudi* Arab the central Bank is Saudi Arabian Monetary Agency (SAMA). It is the central bank of the nation.

**Ques.5: Explain the Secondary function of money.**

**Answer:** There are three secondary functions of money

1. Standard of Deferred Payments
2. Store of Value
3. Transfer of Value

**Ques.6: Define the Liquidity as Money.**

**Answer:** Money is most liquid assets. Money can easily converted into any gold and assets such as land, machinery and equipment, stocks and shares, wheat, rice, books etc. it is because of the liquidity people desire to have a money.

**Ques.7: What is Full-Bodied Coins?**

**Answer:** Full-bodied money (or standard money) is that money whose value as commodity is equal to value as money. For example 1 SR coins has the one SR value of silver used in this coin then it is full bodied money.

**Ques.8: What is Representative Paper Money?**

**Answer:** A representative paper money is fully backed by metallic content. Representative paper money is circulated by government after keeping the 100% valuable metals like gold and silver in its treasury.

**Ques.9: What is a central Bank?**

**Answer:** Central Bank is an apex institution which operates controls, directs and regulates the monetary and banking structure of a country.

**Ques. 10: What is the role of Central Bank in Developing Countries?**

**Answer:** Central bank play an important role by promoting capital formation through mobilizing saving s and encouraging investment.

**Ques. 10: Define Discounting of Bills of Exchange.**

**Answer:** Under discounting bills of exchange, banks advance loans to the traders and business firms by discounting their bills. In this way, businessmen get loans on the basis of their bills of exchange before the time of their maturity.

**Ques.11: What are Demand loans?**

**Answer:** These are such loans that can be recalled on demand by the banks. The entire loan amount is paid in lump sum by crediting it to the loan account of the borrower, and thus entire loan becomes chargeable to interest with immediate effect.

**Ques. 12: What is** Fixed **Deposit?**

**Answer:** These are the deposits which are deposited for a definite period of time. This period is generally not less than one year and, therefore, these are called as long term deposits. These deposits cannot be withdrawn before the expiry of the stipulated time and, therefore, these are also called as time deposits.