Victoria University of Bangladesh

FINAL

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<u>Submitted To</u>

Joyeeta Datta

Lecturer of **BBA DEPT.**

Victoria University of Bangladesh

<u>Submitted By</u>

Riduan Mir Fahim

ID: 1518450031

1. **Define the term MONEY. Explain different Functions of Money.**

- Money is a commodity accepted by general consent as a medium of economic exchange. It is the medium in which prices and values are expressed. It circulates from person to person and country to country, facilitating trade and it is the principal measure of wealth.

  Money is something that people use every day. We earn it and spend it but don't often think much about it. Economists define money as any good that is widely accepted as final payment for goods and services. Money has taken different forms through the ages; examples include cowry shells in Africa, large stone wheels on the Pacific island of Yap, and strings of beads called wampum used by Native Americans and early American settlers. What do these forms of money have in common? They share the three functions of money:

- First: Money is a store of value. If I work today and earn 25 dollars, I can hold on to the money before I spend it because it will hold its value until tomorrow, next week, or even next year. In fact, holding money is a more effective way of storing value than holding other items of value such as corn, which might rot. Although it is an efficient store of value, money is not a perfect store of value. Inflation slowly erodes the purchasing power of money over time.
- Second: Money is a unit of account. You can think of money as a yardstick-the device we use to measure value in economic transactions. If you are shopping for a new computer, the price could be quoted in terms of t-shirts, bicycles, or corn. So, for instance, your new computer might cost you 100 to 150 bushels of corn at today's prices, but you would find it most helpful if the price were set in terms of money because it is a common measure of value across the economy.
- Third: Money is a medium of exchange. This means that money is widely accepted as a method of payment. When I go to the grocery store, I am confident that the cashier will accept my payment of money. In fact, U.S. paper money carries this statement: "This

note is legal tender for all debts, public and private." This means that the U.S. government protects my right to pay with U.S. dollars.

In order to appreciate the conveniences that money brings to an economy, think about life without it. Imagine I am a musician-a bassoonist in an orchestra-who has a car that needs to be repaired. In a world without money, I would need to barter for car repair. In fact, I would need to find a coincidence of wants-the unlikely case that two people each have something that the other wants at the right time and place to make an exchange. In other words, I would need to find a mechanic who would be willing to exchange car repairs for a private bassoon concert by 9 AM tomorrow so I can drive to my next orchestra rehearsal. In an economy where people have very specialized skills, this kind of exchange would take an incredible amount of time and effort; in fact, it might be nearly impossible. Money reduces the cost of this transaction because, while it might be very difficult to find a mechanic who would exchange car repairs for bassoon concerts, it is not hard to find one who would exchange car repairs for money. In fact, without money, every transaction would require me to find producers who would exchange their goods and services for bassoon performances. In a money-based economy, I can sell my services as a bassoon player in an orchestra to those who are willing to pay for orchestra concerts with money. Then, I can take the money I earn and pay for a variety of goods and services.

2. What do you know about demand for Money? Describe Classical theory of money.

- In monetary economics, the demand for money is the desired holding of financial assets in the form of money: that is, cash or bank deposits rather than investments. It can refer to the demand for money narrowly defined as M1, or for money in the broader sense of M2 or M3.

Money, in their view, was simply gold, silver and other precious metals. In this sense, the price of money was just like that of any other commodity: cost of production. Or, more explicitly, they regarded the long run value of money to be quite directly the costs of extracting from mines the precious metals that either constituted commodity money (coins) or the gold that underlay convertible paper money. Thus, fiat money, where notes are neither a commodity nor convertible to it, remain outside the scope of their theory. For instance:

"Gold and silver, like all other commodities, are valuable only in proportion to the quantity of labor necessary to produce them and bring them to market...The quantity of money that can be employed in a country must be depend on its value...Though [paper money] has no intrinsic value, yet, by limiting its quantity, its value in exchange is as great as an equal denomination of coin, or of bullion in that coin."

Do we have "neutrality" nonetheless? In a sense, that question cannot be asked as money is gold and gold is a good. We have neutrality only in the sense that the prices of all goods are determined by cost of production and a change in the supply of money is an effect and not a cause of changes in cost of production. There is neutrality only in this sense. Thus, when everything is adjusted to its long run values, the price of gold relative to other goods is different, i.e. P is higher, and that has been accompanied by a rise in money supply.

The only way the question can be asked properly in the short run and in the following terms: suppose C falls, profits in the gold business rise and that induces increases in money supply. The long-run law says P must rise so that 1/P will fall to equate C. But are we sure that this will happen in full? In other words, are we sure that the increase in the money supply will have no other effects on any *other* long-run prices (e.g. price of iron in terms of corn, or price of wheat in terms of beef, etc.)?

"It can, I think, be made manifest, that the rate of interest is not regulated by the abundance or scarcity of money but by the abundance or scarcity of that part of capital not consisting of money...It is only during the interval of the issues of the

Bank, and their effect on prices, that we should be sensible to an abundance of money; interest would, during that interval, be under its natural level; but as soon as the additional sum of notes become absorbed in the general circulation, the rate of interest would be as high...as before the additional issues."

3. Differentiate between Classical theory of money and Keynesian Theory.

- The following points highlight the six main points of differences between Classical and Keynes Theory. The differences are:

  Difference 1: Assumption of Full Employment-

  Classical theorists always assumed full employment of labor and other resources.

  To them, full employment was a normal situation and unemployment was an abnormal situation.

  According to Classicals, even if there is less than full employment in the economy, there is always a tendency towards full employment.

  By the term full employment of the available resources, the classical economists meant that 'there is no involuntary unemployment'. If there is unemployment in the economy, classicists felt that it was due to the existence of monopoly in industry and governmental interference with the free play of the forces of competition in the market or it may be due to the imperfections of the market owing to immobility of the factors of production.

  If these limitations could somehow be eliminated, full employment, according to classical economists, would always exist. Hence, the best way to ensure full employment for the Government was to pursue the policy of 'laissez faire' capitalism under which free competitive market forces were allowed to have full and free play.

  Difference 2: Emphasis on the Study of Allocation of Resources Only-

  The existence of 'full employment' being a normal situation in the classical scheme, it followed that factors of production are always fully employed and there is no further scope for additional employment of resources in new industries. The choice, according to classsicals, was not between employment and unemployment but between employment here and employment there, i.e., increase in production in one direction could be achieved only at the cost of some decrease in another direction in the economy.

In other words, classicals fell there could not be any significant misallocation of resources as the price mechanism, acting as an ‘invisible hand’ would achieve the best, the most efficient allocation of resources. Since the optimum allocation of a given quantity of resources was the main subject-matter of classical economics, it was but natural that they did not discuss the problem of national output, income or employment.

With their assumption of full employment, there obviously could not be any change in the real national income of the community through additional employment of resources. What could possibly be done, given, the composition and volume of the real national income, was a more efficient allocation of the given resources.

As such, they remained concerned with the special case of full employment and not with the general factors that determine employment at any time. In brief, the well-known theory of value, distribution and production formed the ‘core’ of classical economics. That unemployment of resources could also persist to pose a problem did not occur to them at all.

Difference 3: Policy of ‘Laissez Faire’-

Classicals had great faith in the philosophy of laisez-faire capitalism, which meant ‘leave alone’ or ‘let alone’ in business matters. Laissez-faire capitalism would not tolerate any kind of intervention by the Government in business matters; they rather considered it a positive hindrance in the free working of the market economy.

Classicals believed in Laissez-faire capitalism as it was the traditional model of study from the very’ beginning. Classicals had great faith in price mechanism, profit-motive, free and perfect competition and the self-adjusting nature of the system. They felt that if the system is allowed to work freely without any encroachments on the part of the state, it has potentialities to overcome the maladjustments in the economic system, if there are any.

Difference 4: Wage-Cut Policy as a Cure for Unemployed Resources-

Classicals further believed that involuntary unemployment could be easily cured by cutting wages down through office and perfect competition which always exists in the labour market. They argued that so long as labour does not demand more than what it is ‘worth’ or more than its marginal productivity, there in no possibility of persistent unemployment in the economy.

Classicals believed that employment is determined by the wage bargains between the workers and employers, therefore, wage-cuts will reduce unemployment; such a policy if pursued vigorously can restore full employment as well. Basing their reasoning on the existence of free and perfect competition in the product and labour markets, classicals argued that the unemployed workers will cut down wages leading to a fall in prices, which, in turn, will encourage demand giving a fillip to sales.

As a result of all this, more will be produced as more is demanded and employment would increase because workers are employed at lower wages to increase production. Wage-cuts, thus occupied a central place in the classical scheme of reasoning for automatic functioning of the capitalist economy at full employment.

Difference 5: Assumption of Neutral Money-

Classicals did not give much importance to money treating it only as a medium of exchange its role as a store of value was not considered. To them, money facilitated the transactions of goods but had no effect on income, output and employment. They considered it as a ‘veil’ which hides real things goods and services. In other words, they assumed that people have one motive for holding money, i.e. the transaction motive.

Classicals completely ignored the precautionary and speculative motives for holding money. In short, they never recognised that money could also influence the level of income, output and employment. In contrast to this view, Keynes considered money on as on active force that in influences total output.

<u>Difference 6: Interest Rate as the Equilibrating Mechanism between Saving and Investment-</u>

Classicals would give the pride of place to the rate of interest as the equalizer of saving and investment at full employment of resources. The implied assumption was that both saving and investment are highly sensitive to changes in the rate of interest.

The belief was firmly rooted that saving and investment can be equal only at full employment, and that ‘under employment equilibrium’ is a disequilibrium situation which would not last long in an atmosphere of wage price flexibility under the pressure of competition.

4. **Write short notes on the following (any 4): Cost-Push Inflation, Demand Pull Inflation, Labor Market, Product Market Equilibrium, Money Market Equilibrium, Financial Investment.**

   - <u>Cost-Push Inflation-</u>

     Cost-push inflation is a purported type of inflation caused by increases in the cost of important goods or services where no suitable alternative is available. As businesses face higher prices for underlying inputs, they are forced to increase prices of their outputs.

   - <u>Demand Pull Inflation-</u>

     Demand-pull inflation occurs to arise when aggregate demand in an economy is more than aggregate supply. It involves inflation rising as real gross domestic product rises and unemployment falls, as the economy moves along the Phillips curve. This is commonly described as "too much money chasing too few goods"

- Labor Market-

  Labour economics, or labor economics, seeks to understand the functioning and dynamics of the markets for wage labour. Labour is a commodity that is supplied by labourers, usually in exchange for a wage paid by demanding firms.

- Money Market Equilibrium-

  Money market equilibrium **occurs at the interest rate at which the quantity of money demanded equals the quantity of money supplied**. All other things unchanged, a shift in money demand or supply will lead to a change in the equilibrium interest rate and therefore to changes in the level of real GDP and the price level.