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## The role of money in the contemporary economy

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## THE ROLE OF MONEY IN THE CONTEMPORARY ECONOMY

### Abstract

Purpose – the aim of this article is to present chosen aspects of functioning and role of money in the contemporary economy.

Research methodology – the method of analysis and idiographic method were used as research methods. The idiographic method allows us to acquire information which reveals extraordinary, distinct, unusual features of the phenomenon of functioning of money in economy.

Result/findings – the historical background of influence and the role of money in the development and operation of economy and society were presented in the article. Four most important tendencies which influence negative assessment of the role of money in the modern economy were indicated. They include generation of economic crises; development of instruments of financial engineering which are used for speculations; detachment of money from the real economy as well as its drastic distribution. The final part of the article includes an attempt of specification of necessary changes in functioning and role of modern money for the elimination of indicated negative tendencies.

Originality/value – the indication and assessment of four most important negative tendencies in functioning of modern money. The proposal of recommendation of making some changes with the indication of new paradigms for functioning of money and financial spheres.

**Keywords:** analysis; money; contemporary economy; paradigms

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## Introduction

Money as economic category is described by economists as value of effort which is socially necessary and also as one of the phenomena of human activity. In various periods of its development, people were convinced that they managed secrets of endless multiplying money. People who drew such conclusions tried to convince others about it with the same certainty. However, the economic reality verifies the view concerning the phenomenon of money and the possibility of its endless multiplication, at the same time asking: Is the modern money reliable creation of human activity which may be accepted without any objections? Only a few decades ago, very few economists questioned its reliability. Nevertheless, nowadays critical opinions referring to the modern role of money in the economy are more common. Also this study may fall within this tendency. The main purpose of this article is to present chosen (negative) aspects of functioning of money and its role in the modern economy. In order to pursue the accepted objective, the method of analysis and idiographic method were used as research methods. The history of the role of money in the development and functioning of economy and society were presented in the article. Four major tendencies which influence the negative assessment, i.e. generation of economic crises; the development of instruments of financial engineering which are used for speculations; the detachment of money from the real economy as well as drastic inequality of its distribution were indicated on the basis of the conducted analysis. The attempt of presentation of modern money in the new role was conducted in the final part of the article. The role, which will enable to eliminate negative tendencies and to create a new financial order based on the redefinition of paradigms which are binding in the sphere of finance.

### **1. The historical background of the positive and negative role of money**

Money and its use have created positive and negative assessments since the dawn of the world. In the positive aspect, money improves and determines processes of market exchange through its functions, i.e. circular, financial/accounting, paying, saving and international settlements. It is the basis of operation and development of given states as well as of the whole global economy, including development of the

civilisation of humankind. It may be metaphorically stated that money is a heart of the financial system of economy.<sup>1</sup>

Financial markets created by money are the places of work of millions of well-educated and well-paid specialists who work in banks, pension and insurance funds, investment funds, consulting and supervising companies, etc. However, despite its positive role, it also creates negative associations. Money from its beginning, has been used to pursue any possible objectives through centuries of evolution, to the present day. An example from the history of Christianity. Almost 2000 years ago, Jesus, due to money, for the first time and only once in his life, used force casting away money traffickers from the temple in Jerusalem. Gaining control over buying and selling market of a special coin called “temple half-shekel” was an economic reason of throwing away the traffickers from the temple. It was the only one coin which was made of half of ounce of pure silver and it did not have the image of a pagan emperor and which could be used by the Jews to pay the tax temple, i.e. offer to God. Using the huge demand for “half-shekels” the money traffickers bought them monopolizing the market and afterwards they sold it with a huge profit. According to Jesus, it was a violation of sanctity of the house of God.<sup>2</sup> Whereas in the history of the biggest and most important states of the world, money was used to achieve military (making wars), economic as well as political targets. The overthrow of Stuarts dynasty in England, is a good example. The conflict between the English money traffickers with the kings from the dynasty caused financing the invasion of William III of Orange, who overthrew the Stuarts in 1688 and took the English throne. Financing of great wars was another aim of the use of money. “I know of absolute certainty, that the division of the United States into federations of equal force was decided long before the Civil War by the high financial powers of Europe. These bankers were afraid that the United States, if they remained in one block and as one nation, would attain economic and financial independence, which would upset their financial domination over Europe and the world,” Otto von Bismarck said about the American Civil War.<sup>3</sup> Also the First and the Second World War were

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<sup>1</sup> T. Gruszewski, *Teoria pieniądza i polityka pieniężna. Rys historyczny i praktyka gospodarcza*, Oficyna Ekonomiczna, Oddział Polskich Wydawnictw Profesjonalnych Sp. z o.o. Kraków 2014, p. 69.

<sup>2</sup> M. Sickler, *Władcy pieniądza*, [www.michaeljournal.org/WLADCYPIENIADZA.htm](http://www.michaeljournal.org/WLADCYPIENIADZA.htm) (accessed: 4.11.2014).

<sup>3</sup> *Ibidem*.

based on the phenomenon of the use of money. Hitler did not have any money for war. “The characteristic feature of our economic programme is that we do not have it at all,” he said.<sup>4</sup> The economists, Hjalmar Schacht and John Dulles, created the foundations of the military power of the Third Reich making financial fundamentals of the development of the newest and one of the biggest arms industry of that time through the implementation of the Mefo bills of a little-known company Metallurgische Forschungsgesellschaft guaranteed by the Reich’s bank and German companies. The companies which had Mefo bills could exchange them into discounted cash in each German bank. And in turn, each bank could sell it in the Reichsbank. There had been DM 12 billion in the bills before the annex of Austria. Hitler could only take over Austria, the Czech Republic and afterwards the remaining states of Europe and Africa to cover the bills.

## 2. Money in the contemporary economy

Despite the systematic economic development after the Second World War which has been due to the skilful use of money, more and more frequently its role is perceived in negative tendencies. The sources of these tendencies include:

- generation of economic crises by the financial systems, including the last from the beginning of 2008, which has been the most serious since the Great Depression,
- a very quick development of new instruments of financial engineering which is used for speculations, e.g. Subprime, CDS,
- detachment of money from the real economy,
- drastic inequality of the distribution of money.

The last economic crisis was a crisis of financial engineering. The usage of the new instruments of financial engineering such as *subprime* in the real estate sector in the US became a main reason of global economic crisis. The underlying cause may be seen in the monetary policy of the US. Since 1971, when president Nixon suspended convertibility of dollar into gold, each crisis which has appeared in the US was combated with the increase of available monetary base and low interest

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<sup>4</sup> H.J. Braun, *The German Economy in the Twentieth Century*, Taylor & Francis, Hamburg 2010, p. 67.

rates<sup>5</sup>. The increase of monetary base as well as seeking new instruments of financial engineering was a reason of deregulation made at the end of the 1990s of the 20th century. It enabled the creation, sale and marketing of *derivatives* which were created on the basis of illiquid primary instruments, such as loans and credits. It enabled securitisation of mortgages, which means its selling as well as issuing new securities secured with properties financed with mortgages. Banks sold mortgages to intermediaries such as: Federal National Mortgage Association as well as Federal Home Loan Mortgage Corporation, which in turn, issued on their basis liquid securities and sold them to other financial institutions, e.g.: investment banks, insurance companies, pension or investment funds. The sale of mortgages by banks allowed them to dispose them from their balance sheets and credit risk transfer to other financial institutions. Banks could provide subsequent loans thus increasing lending through numerous securitisation without the necessity of increasing its capital base. Hence, securities secured with credit assets were created. The main advantage of these securities was that one package of primary instruments could be used many times as the base of issuing. It caused a huge increase of the value of these securities on the financial markets. The free movement of capital enabled influx of foreign investors who recognised liquid securities as good and secure investments.<sup>6</sup> Nevertheless, they created “a finance bubble” which, sooner or later, had to have negative influence on whole global economy introducing it into one of the biggest economic crises in the history. In October 2008, there was the biggest fall on the London and Tokio Stock Exchange for 20 years. 2.3 trillion dollars evaporated only during four days in October 2008, whereas losses in 2008 were estimated for 8.3 trillion dollars. At the same time, states of the EU spent over 1.8 trillion euros on rescuing financial system (as guarantee and capital injection to the financial system).<sup>7</sup>

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<sup>5</sup> H. Simons, *33 sposoby na kryzys gospodarczy. Natychmiastowe rozwiązania dla twojej firmy*, Difin, Warszawa 2009, p. 18.

<sup>6</sup> M. Adamczyk, *Współczesny kryzys finansowy – przyczyny i konsekwencje dla gospodarki światowej*, Prace i Materiały IHZ Uniwersytetu Gdańskiego, Gdańsk 2012.

<sup>7</sup> W. Gajda, *Współczesny kryzys gospodarczy. Geneza, przebieg i jego wpływ na podstawowe wskaźniki makroekonomiczne oraz koniunkturę polskiej gospodarki*, w: *Ekonomia w ujęciu globalnym, regionalnym i lokalnym*, eds. A. Krzysztofek, A. Przybyłka, AT Wydawnictwo, Kraków 2014, p. 182.

That crisis was neither the first nor the last, whose cause was not overproduction, like the classics of economic cycles, but functioning financial system and development of derivative elements which created new, utopian money.

Detachment of money from the real economy is one of the biggest, negative results of the impact of money on the economy. The classical role of money in the economy is characterised with the use of the following functions: circular (exchange), financial/accounting (value measure), paying, saving and international settlements. Due to these functions, money improves and determines processes of market exchange but should also influence keeping the economic balance on the market. A rule which says that the value of the issued cash and the cash which is in circulation equals annual value of supply of products and services divided by the multiple of circulation of this cash in a year is an essential condition of the balance. According to this cardinal principle, annual increase of the value of supply of products and services should be balanced with the increased supply of money which is equal approximately to the value of economic growth. Hence, in balanced economy, overall value of financial transactions should be equal to annual overall of exchange of products and services as well as social benefits and taxes. According to Bojarski, maintaining the above-mentioned conditions of money and economy stability and having at the same time development stimulation is one of the most important principles of preserving balance between the supply of money and the real economy. Therefore, it should be sought to restore a close relation of issuance and circulation of financial settlement means with the real economy and creation of liquidity and solvency conditions with its increase.<sup>8</sup> Modern realities are completely different than the requested balance model. The data of 1970 indicated that 90% of cash flow corresponded to economic transactions connected with the real economy and only 10% to the speculative transactions. Nowadays only 3% corresponds to the real economy, whereas 97% to the speculative transactions. According to the Bank for International Settlements in Basel, which renders its services to over 140 central banks and national financial institutions, in 1989, daily financial transactions in the world constituted in total USD 740 billion, in 2007 it was USD 1.7 trillion. Whereas in 2013, the value of transactions was USD 5.3 trillion per day.

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<sup>8</sup> W. Bojarski, *Autonomiczne i prospołeczne systemy finansowe w warunkach kryzysu*, Konferencja Naukowa WSZ-SW i KRS (in print).

Progressive detachment of the processes and financial systems from the real economy and development of independent and uncontrolled, speculative capital involving international markets, sooner or later, will lead to tragic economic consequences and necessity of seeking a new financial order.

Drastic inequality of distribution of money is another negative result of the influence of money on the economy. The operation of modern financial systems reverses natural economic order connected with a fair division of effects of management. It leads to such negative consequences as a very big social stratification, serious impoverishment and even destitution of a part of society as well as hoarding huge wealth by small groups of people. According to data of 2014 given by Oxfam, organisation which is engaged into charity, and published by Forbes, 85 the richest people in the world have wealth which equals 3.5 billion of the poorest who constitute half of the population of the world. The wealth of 85 multibillionaires is estimated at 1.7 trillion dollars. Forbes also informs that 1645 billionaires accumulated, in 2014, property worth USD 6.5 trillion, i.e. almost one third of the biggest economy of the world, the US. In the last year, increase in value of the property of this group was USD 1 trillion. 1% of the population of the world accumulated the wealth which equals to USD 110 trillion (almost twice bigger as annual GDP of all economies of the world).<sup>9</sup>

Such a huge concentration of modern economic resources by a small number of people constitutes a risk for balanced growth of the global economy and coherence and stability of societies.

### 3. Necessity of changes on financial markets

A concept of changes referring to changes in functioning of money in its wider sense in the modern economy proposed in this study refers to two aspects. The former is related to the elimination of political dysfunction connected with the breach of financial and economic order by a state. Cicero in 55 BC indicated cardinal principles of functioning of finances of a state, i.e. budget of a state has to be balanced, payment deficit reduced and the public debt decreased; the authorities must

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<sup>9</sup> Forbes, *85-najbogatszych ma tyle pieniędzy co połowa świata*, [www.forbes.pl/85-najbogatszych-ma-tyle-pieniedzy-co-polowa-swiatea,artykuly,169784,1,1.html](http://www.forbes.pl/85-najbogatszych-ma-tyle-pieniedzy-co-polowa-swiatea,artykuly,169784,1,1.html) (accessed: 3.02.2015).



be controlled and their arrogance must be eliminated.<sup>10</sup> In spite of the lapse of time, these principles have been up-to-date. Almost in all states of the world cardinal rules of functioning of finances of a state mentioned by Cicero are not followed. The world debt constitutes over USD 61 trillion. According to the official data of the U.S. Treasury Department, the public debt of U.S exceeded, in 2014, USD 18 trillion and in the last year it was almost one trillion dollars bigger. In 2012, the relation of public debt to GDP in the US exceeded 100%. The public debt of Japan is USD 14 trillion. Taking into account its relation to GDP which is 237%, this debt is one of the biggest in the world. The debt of Italy reached a value of USD 2.7 trillion and the relation to GDP which is over 132.6%. France and Great Britain have debt which is 90% in relation to GDP with nominal value constituting USD 2.5 trillion and USD 2.3 trillion, respectively. Germany USD 2.8 trillion, China over USD 2 trillion, Canada USD 1.6 trillion, Brazil USD 1.5 trillion. The debt of Poland is USD 296 billion which equals to 57.48% of our GDP.

Existing lack of balanced budget as well as increasing public debt of most states of the world may result in: stopping the pace of growth of particular countries and, at the same time, the increase of GDP of the whole global economy, increase of costs of servicing the debts (absorbing money which could be spent on the development of economies through innovativeness and absorption of Union or world funds), existing of inflation processes, fall of credibility on the international financial markets (further increase of costs of servicing the debt) as well as potential increase of social tensions in particular states caused by the lack of pay rises in public sector, limited increase in pensions, social expenses as well as necessity to increase taxes by the governments of these states.

The latter aspect concerns only necessity of changes on the financial markets in order to eliminate described negative influence of money on the economy. In this matter, one may find various concepts in the literature on subject, even the ones which are radically connected with absolute and rapid liquidation of the financial markets as necessary condition to create new social system. The necessity of implementation of new solutions for functioning of money is indispensable. Nevertheless, it seems that the reasonable and possible to implement changes should be based on renewed science and common education rather than on the radical concepts

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<sup>10</sup> E. Mączyńska, *Ład gospodarczy. Pochwała ordo*, [www.pte.pl/pliki/2/12/16\\_maczynska.pdf](http://www.pte.pl/pliki/2/12/16_maczynska.pdf) (accessed: 3.11.2014).

which evoke to liquidation of the global financial markets (which are not possible to introduce due to present conditions). The present and future role of economic sciences concerns the creation of new financial structure (but not only financial), which may be created concurrently to the present by way of evolution. The new structure should be based on new paradigms. The process of devaluation of binding paradigms in economic sciences is perceived. However, most academic centres still create analyses of claimed benefits of the present economic and financial order. Technical progress has introduced societies into the epoch of abundance of products and services and it frees them from hard work very quickly. It causes that the paradigms accepted for the epoch of shortage are not binding any more. Also generation of more common worldwide crises which negatively influence economy and society by financial systems enforces changes of their principles. This new situation requires from science re-evaluation of bases and creation of a new financial system based on new paradigms. Hence, the determination of a new role of money is the basis. Taking into account scientific perspective, one should consider if a new redefinition of the role of money should not be based on the new paradigm negating money as goods. Money is abstraction, agreement of a person accepting it in its role, a symbol, information, it has a very low value therefore it should not be treated as goods. Thus, the role of intermediary of value and value measure should be restored. Eliminating the opportunity to create debt money, new means of payment as derivatives of real money, currency speculations, etc.<sup>11</sup> It will enable to limit or eliminate its negative role in causing crises or using instruments of financial engineering in its broad sense. It will undoubtedly influence the stability of particular economies and, at the same time, global economy. Another considered new paradigm should be to cover the value of money in goods, thus balancing the economy through maintaining balance between supply of money and its real economy and it was described above.

A proposed change of the financial system basing on renewed science and redefinition of its assumptions with newly adopted paradigms of its functioning must be supported by universal economic education. The education which will allow societies to make rational choices in compliance with their business not the business of markets and financial elites. Economically-educated societies will have opportunity to choose between the old and the appearing new economic and financial system.

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<sup>11</sup> I. Litwin, *Autonomiczne i prospołeczne systemy finansowe w warunkach kryzysu*, Konferencja Naukowa WSZ-SW i KRS (in print).

Paying special attention to notions connected with social and economic problems, focus on fairness and balance of financial systems, i.e. basic assumptions of properly working global economic system should be one of priorities in the system of universal economic education.

### **Final remarks**

The development of economics caused that the theory of money belongs to its best developed fields and it is one of the fastest growing fields of knowledge. New derivative instruments of money give more and more sophisticated and complicated opportunities of its creation. It causes that there are two spheres, real and financial, in the current economic reality. The real one is connected with real material products and services related to them, whereas the financial sphere refers mainly to transactions with money or its derivatives constituting subject matters. In practice, it causes detachment of money from the real economy and more common negative consequences for economy which are described in this article. Therefore, it seems necessary to indicate those unbeneficial tendencies and take measures which are to increase their effects and, in a longer term, target at their elimination. The recommendations of the changes of the role of money which result from this study are an attempt of such actions.

The proposed changes refer to three aspects:

1. Eliminating political dysfunctionality connected with the breach of the financial and economic order by a state.
2. Changes on financial markets through new paradigms for functioning of money worked out by science:
  - Paradigm 1 – negation of money as goods and a new redefinition of the role of money,
  - Paradigm 2 – money covered in goods, as a result balance of economy through maintaining balance between the supply of money and the real economy.
3. Universal economic education of societies.

The recommendations presented above (conclusions) concerning the necessity of making changes in functioning of money in its broad sense in the modern economy are neither a remedy nor ready-to-use solution, but the collection of desiderata for economics as proposal and attempt to rise discussion.

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## ROLA PIENIĄDZA WE WSPÓŁCZESNEJ GOSPODARCE

### Streszczenie

Cel – celem artykułu jest ukazanie wybranych aspektów funkcjonowania i roli pieniądza we współczesnej gospodarce.

Metodologia badania – wykorzystano metodę analizy i metodę idiograficzną pozwalającą na uzyskanie informacji ujawniających wyjątkowe, odrębne, niepowtarzalne, wyróżniające spośród innych cechy zjawiska, jakim jest funkcjonowanie pieniądza w gospodarce.

Wynik – przedstawiono rys historyczny wpływu i roli pieniądza w rozwoju i funkcjonowaniu gospodarki i społeczeństwa. Na podstawie analizy wskazano cztery najważniejsze tendencje wpływające na negatywną ocenę roli pieniądza we współczesnej gospodarce: generowanie kryzysów gospodarczych; rozwój instrumentów inżynierii finansowej służących spekulacjom; oderwanie pieniądza od realnej gospodarki oraz drastyczną nierówność jego podziału. W końcowej części artykułu podjęto próbę określenia koniecznych zmian w funkcjonowaniu i roli współczesnego pieniądza dla wyeliminowania tych negatywnych tendencji.

Oryginalność/wartość – wyodrębnienie i ocena czterech najważniejszych negatywnych tendencji w funkcjonowaniu współczesnego pieniądza. Propozycja rekomendacji przeprowadzenia zmian ze wskazaniem na nowe paradygmaty funkcjonowania pieniądza i sfer finansowych.

*Tłumaczenie Agnieszka Skorupa-Domagala*

**Słowa kluczowe:** analiza; pieniądz; współczesna gospodarka; paradygmaty

**JEL codes:** E42, E44, G01, G18, F38