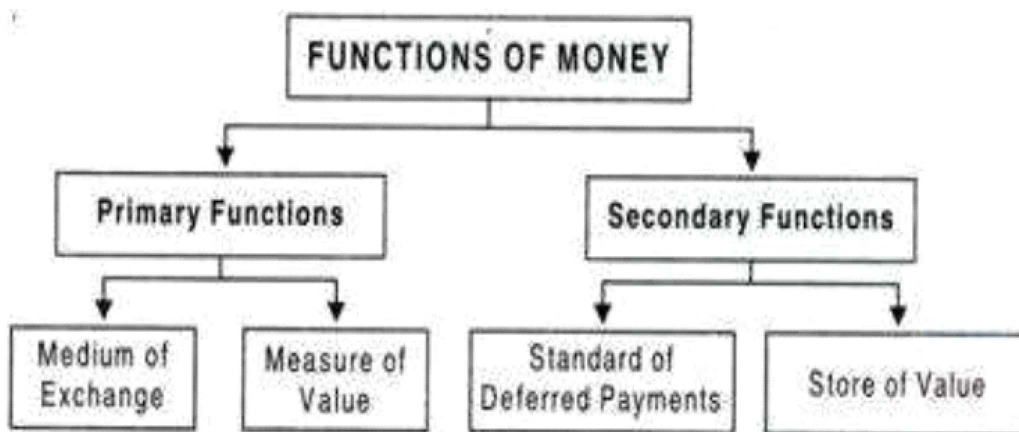
Money

Meaning of Money

- Money is a commonly accepted medium of exchange.
- Money is anything that can be generally accepted as payment for goods and services or settlement of debts.



Primary Functions of Money

- Measure of value: Money serves as a common measure of value or unit of account.
- Medium of exchange (transaction): people can easily exchange goods and services with money.

Money

Derivative Functions of Money:

- **Deferred Payment:** Money also serves as a standard mode of deferred payments.
- **Transfer of Value:** Money has the same value throughout the country and has its value is transferrable.
- **Store of Value:** It can be kept as savings (in bank account) and could be used for investment purpose e.g. Buying property.

Paper Money (Fiat Money)

- Paper money acted as money (Legal tender) because they are guaranteed by the national governments.
- Fiat money is legally recognized to settle all debts & payments within territorial jurisdiction.
- Fiat money gives central banks greater control over the economy because they can control how much money is printed.
- **Examples:** US dollar, Indian Rupee, Euro, etc.

Money

Liquidity of Money

- Money is the most liquid of all assets.
- Liquidity Order is as following:
  - Currency
  - Demand deposits in Banks
  - Savings deposits in Banks
  - Term (Time) deposits in Banks

Q. Consider the following liquid assets: (UPSC 2013)

1. Demand deposits with the banks
2. Time deposits with the banks
3. Savings deposits with the banks
4. Currency

The correct sequence of these assets in decreasing order of liquidity is

a) 1-4-3-2

b) 4-3-2-1

c) 2-3-1-4

d) 4-1-3-2

Money

Creation of Money

- Money supply: It is all the currency and other liquid instruments in a country's economy on the date measured.
- The money supply is roughly composed of both cash and deposits that can be used almost as easily as cash.

Currency Deposit Ratio (CDR)

- The currency deposit ratio (cdr) is the ratio of money held by the public in currency to that they hold in bank deposits
- It reflects people's preference for liquidity. It is a purely behavioural parameter which depends, among other things, on the seasonal pattern of expenditure.
- For example, cdr increases during the festive season as people convert deposits to cash balance for meeting extra expenditure during such periods.

Reserve Deposit Ratio

- Reserve deposit ratio (rdr) is the proportion of the total deposits commercial banks keeps as reserves.

Money

- Reserve money consists of two things:
  - Vault cash in banks and
  - Deposits of commercial banks with RBI.
- Banks hold a part of the money, that people keep in their bank deposits as reserve money and loan out the rest to various investment projects.
- RBI requires commercial banks to keep reserves in order to ensure that banks have a safe cushion of assets to draw on when account holders want to be paid.
- RBI uses various policy instruments to bring forth a healthy rdr in commercial banks. Example- Cash Reserve Ratio, Statutory Liquidity Ratio, Bank Rate, etc.

Q. When the Reserve Bank of India announces an increase of the Cash Reserve Rate, what does it mean? [CSE -2010]

a) The commercial banks will have less money to lend
b) The Reserve Bank of India will have less money to lend
c) The Union Government will have less money to lend
d) The commercial banks will have more money to lend

Money

Commercial Banks

- Commercial Banks accept deposits from the public and lend out this money to interest earning investment projects.
- The rate of interest offered by the bank to deposit holders is called the 'borrowing rate' and the rate at which banks lend out their reserves to investors is called the 'lending rate'
- The difference between the two rates, called 'spread', is the profit that is appropriated by the banks.
- Deposits are broadly of two types – demand deposits, payable by the banks on demand from the account holder, e.g. current and savings account deposits, and time deposits, which have a fixed period to maturity, e.g. fixed deposits.

Q. Which of the following is not included in the assets of a commercial bank in India?

(a) Advances

(b) Deposits

(c) Investments

(d) Money at call and short notice

Money

Function of Commercial Banks

- Primary Functions
  - Accepting deposit and Providing loans
- Secondary Functions
  - Collection and payment of various items e.g. Cheques, Bills
  - Purchase and sell of securities & remittance of money
  - Purchase and sell of foreign exchange
  - Acting as executors and trustees of wills & underwriting of shares
  - Lockers facility & Travellers' cheque and letter of credit

Q. The main functioning of the banking system is to__________ (CDS-2013)

a) Accept deposits and provide credit

b) Accept deposits and subsidies

c) provide credit and subsidies

d) accept deposits, provide credit and subsidies

Money

Value of Money

- By value of money, we mean the purchasing power of money.
- Purchasing Power is the amount of goods or services that can be purchased with a unit of currency.
- When the value of money rises i.e. its purchasing power increases, the general price level falls and vice versa. This means the value of money is inverse of the general price level.
- For instance, at a point of time, Rs. 10 were able to purchase 2 packets of biscuits, but on another times it can buy only one packet because of erosion of purchase power of that currency. This also results in increased purchase power of biscuit packet, it became Rs.7.

Demand For Money

- Money is the most liquid of all assets in the sense that it is universally acceptable and hence can be exchanged for other commodities very easily.
- On the other hand, it has an opportunity cost. If, instead of holding on to a certain cash balance, you put the money in a fixed deposits in some bank you can earn interest on that money.

Money

- Total demand for money in an economy is composed of transaction demand and speculative demand. Demand for money balance is thus often referred to as liquidity preference.
- People desire to hold money balance broadly for following motives:
  - Transaction Motive
    - The principal motive for holding money is to purchase goods and services in day to day life and carry out transactions
  - Speculative Motive
    - When people wish to hold money rather than buying assets/bonds/risky investment. An individual may hold her wealth in the form of landed property, bullion, bonds, money etc.
    - E.g. If interest rates are high, and people expect interest rates to fall, then there is likely to be greater demand for buying bonds and less demand for holding money. If interest rates fall, then the price of bonds will rise.

Money

- Precautionary Motive
  - The precautionary demand for money is the act of holding real balances of money for use in an emergency situation.
  - As receipts and payments cannot be perfectly foreseen, people hold precautionary balances to minimize the potential loss arising from a Contingency

Opportunity Cost of Money

- Opportunity cost refers to a benefit that a person could have received, but gave up, to take another course of action.

Determinants of Money Demand

- The prevalent price level
  - High interest rate or price level will reduce demand for money and vice versa.
- Inflation level in an economy
  - Inflation level reduces demand for money because people prefer to save instead of expenditure because of price rise.

Money

- Real income (Real GDP)
  - Real income is how much money an individual or entity makes after accounting for inflation.
- Disposable income
  - Higher the disposable income, there will be higher tendency to spend more.
- Innovation level in an economy.

Money Supply (Monetary Aggregates)

- The supply of money is a total stock of money in circulation among the public at a particular point of time.
- The measures of money supply in India are classified into four categories M1, M2, M3 and M4 along with M0.

Q. Which of the following measures would result in an increase in the money supply in the economy?
[CSE -2012]

Money

1. Purchase of government securities from the public by the Central Bank
2. Deposit of currency in commercial banks by the public
3. Borrowing by the government from the Central Bank
4. Sale of government securities to the public by the Central Bank

Select the correct answer using the codes given below:

a) 1 only
b) 2 and 4 only
c) 1 and 3
d) 2, 3 and 4

Reserve Money (M0)

- It is also known as High Powered Money, monetary base, base money etc.
- Reserve Money is the monetary base of the economy.
- M0 = Currency in circulation + Bankers' Deposits with the RBI + 'Other' deposits with the RBI.

Money

Narrow Money (M1 and M2)

- In banking terminology, M1 and M2 is called narrow money as it is highly liquid and banks cannot run their lending programmes with this money.
- M1 = Currency with the Public + Demand Deposits with the Banking System + 'Other' deposits with the RBI.
- M2 = M1 + Savings Deposits of Post-office Savings Banks

Broad Money (M3 and M4)

- The money component M3 and M4 is called broad money. With this money (which lies with banks for a known period) banks run their lending programmes.
- M3 = M1 + Time Deposits with the Banking System.
- M4 = M3 + All deposits with Post Office Savings Banks (excluding National Savings Certificates).

Money

Ques. Consider the following:
1. Currency with the public
2. Demand deposits with banks
3. Time deposits with banks
Which of these are included in Broad Money (M3)
a) 1 and 2
b) 1 and 3
c) 2 and 3
d) 1, 2 and 3

Ques. Following are some components of money supply in India:
1. Currency with the public
2. Aggregate demand deposits with banks
3. Aggregate time deposits with banks
4. 'Other' deposits with the Reserve Bank of India
Which of the aforesaid items are components of narrow money (M1) in India?
a) 1, 2 and3
b) 2 and 4 only
c) 1, 2 and 4
d) 1and 4 only

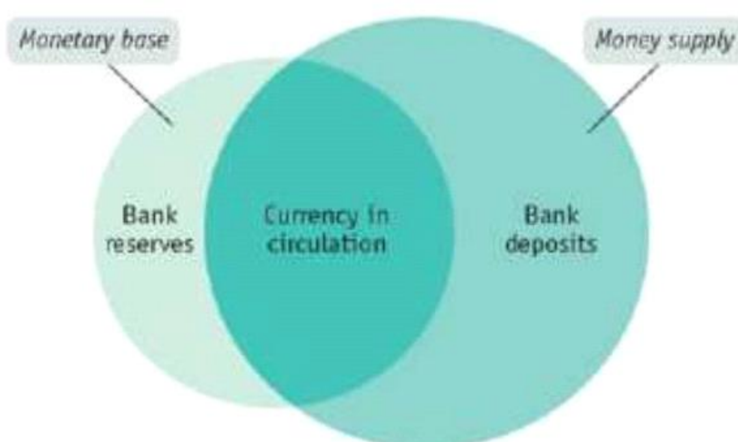
Money

Money Multiplier

- The money multiplier is maximum amount of broad money that could be created by commercial banks for a given fixed amount of base money and reserve ratio.
- Its value is determined in ratio of total money supply to the stock of the high-powered money in an economy.

$$\text{Money multiplier} = \frac{M}{H} = \frac{1 + cdr}{cdr + rdr} > 1$$

$$rdr < 1$$



Money Multiplier
=
Money Supply
÷
Monetary Base

Money

Q. The money multiplier in an economy increases with which one of the following?

a) Increase in the cash reserve ratio

b) Increase in the banking habit of the population

c) Increase in the statutory liquidity ratio

d) Increase in the population of the country

Monetary Policy Of RBI

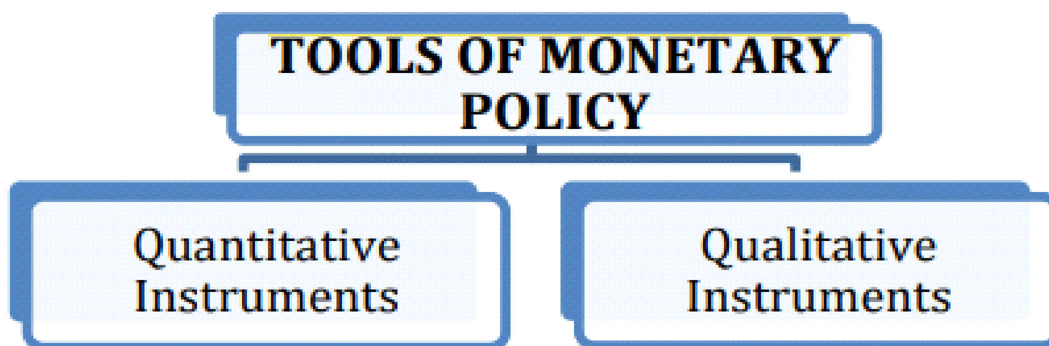
- Monetary policy refers to all those operations, which are used to control the money supply in the economy.
- The RBI implements the monetary policy through instruments like open market operations, bank rate policy, CRR, SLR, reserve system, credit control policy, moral suasion etc.

Objective of Monetary Policy

- To maintain economic and financial stability – by targeting healthy inflation range.
- To ensure adequate financial resources for the purpose of development
- Ensuring price stability in market by maintaining optimum inflation level.
- Adequate flow of credit to productive sectors.

Money

- Promotion of productive investments & trade by ensuring conducive monetary policy, E.g. by credit rationing tool.
- Promotion of exports and economic growth – by providing timely credit and favourable monetary stimulus through various monetary policy tools.



Quantitative Instruments	Basis	Qualitative Instruments
These are the instruments of monetary policy that affect overall supply of money/credit in the economy.	**Meaning**	These instruments are used to regulate the direction of credit.
Traditional methods of control	**Alternative Name**	Selective methods of control
(i) Bank rate (ii) Repo Rate (iii) Reverse Repo Rate (iv) Open market operation (v) Cash reserve ratio (vi) Statutory liquidity ratio	**Instruments**	(i) Marginal requirement (ii) Moral suasion (iii) Selective credit control

Money

Monetary Policy Committee (MPC)

- Monetary policy refers to the credit control measures adopted by the central bank of a country. RBI is the sole monetary authority which decides the supply of money in the economy.
- MPC is a statutory body created under Monetary Policy Framework Agreement 2015 between the RBI and Government in 2016.
- MPC is entrusted with the responsibility of fixing the benchmark repo rate (policy rate) required to contain inflation as defined in the Monetary Policy Framework Agreement.
- The meetings of the MPC are held at least 4 times a year and it publishes its decisions after each such meeting.
- MPC is 6-member body including 3 members from RBI and 3 members to be nominated by the Central Government.
- Chairperson of MPC – RBI Governor
- Quorum for meeting - 4 members
- Decisions are taken by majority with the Governor having the casting vote in case of a tie.
- To ensure transparency - Govt can send message only in writing.

Money

Inflation Targeting

- It is a monetary policy where a central bank follows an explicit target for the inflation rate for the medium-term and announces this inflation target to the public.
- The Government of India has notified a medium term inflation target of 4 %, with a band of +/-2%.
- If Target fail: If inflation not kept in 4% +/-2% zone for 3 consecutive quarters then the Committee must send report to Govt. with reasons and remedies.

Objective of MPC

- Price Stability for promoting economic development through ensuring optimum inflation level which will drive economic growth in long run.
- Controlled Expansion of Bank Credit with special attention to seasonal requirement (E.g. for agricultural purposes) for credit without affecting the output.
- Promotion of Fixed Investment to increase the productivity of investment by restraining nonessential fixed investment.

Money

- Promotion of Exports and Food Procurement Operations by paying special attention in order to boost exports and facilitate the trade. It is an independent objective of monetary policy.
- Desired Distribution of Credit: Monetary policy decides over the specified percentage of credit that is to be allocated to priority sector and small borrowers.
- Equitable Distribution of Credit to all sectors of the economy and all social and economic class of people.
- To promote economic efficiency in the financial system and tries to incorporate structural changes such as deregulating interest rates, ease operational constraints in the credit delivery system, to introduce new money market instruments etc.
- Reducing the Rigidity and encouraging more competitive environment and diversification.