

# Money Supply

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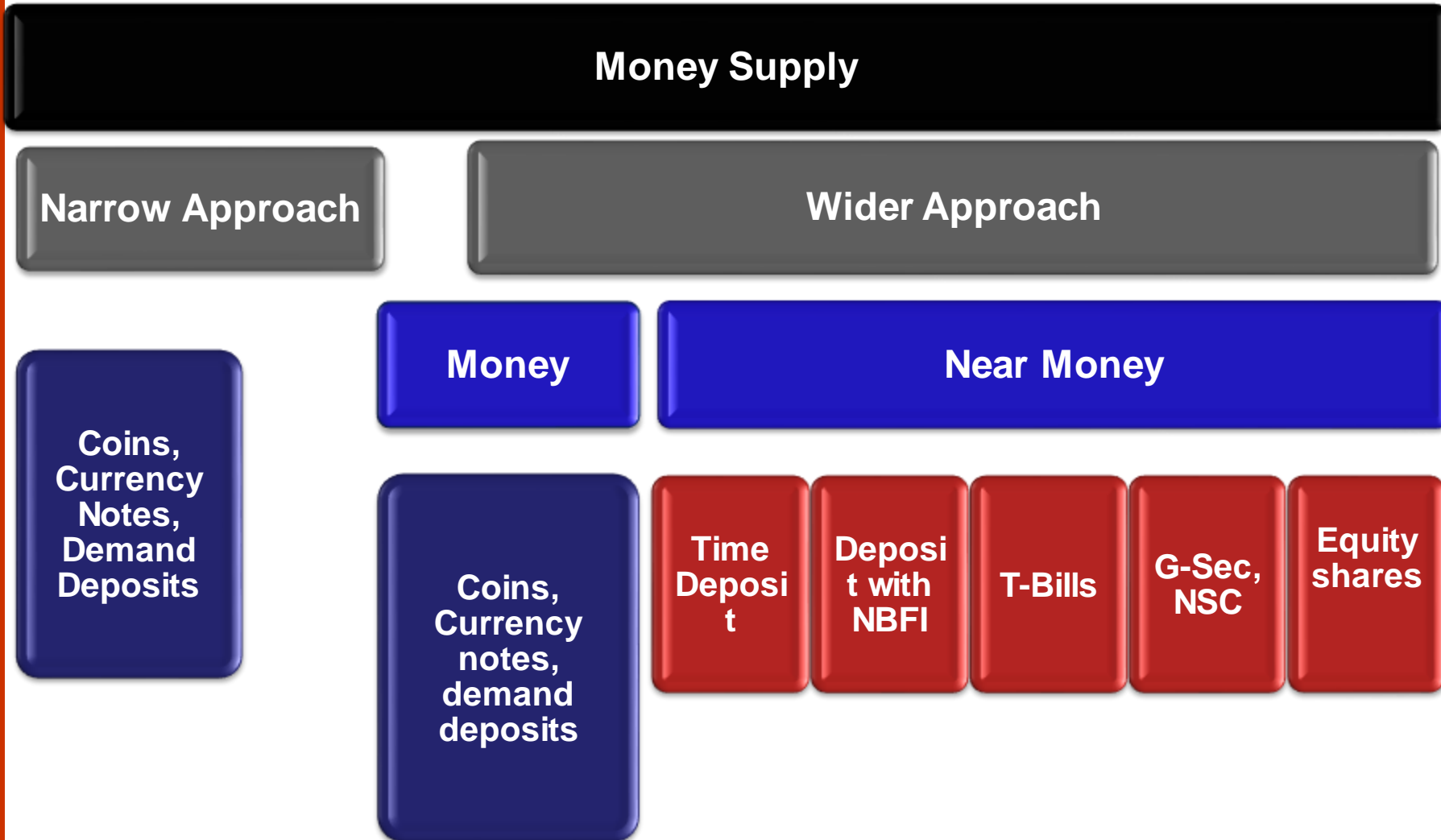
- **Define money supply**
- **Constituents of money supply**
- **RBI's definition of money supply**
- **Determinants of money supply**
- **Concept of money multiplier**
- **Velocity of circulation of money**

# Money Supply

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- Amount of money in circulation
- Stock of money held by public
- *Stock of money with RBI, commercial banks is not part of money supply*
- Fisher: Money Supply =  $MV$ ; where  $M$  = Stock of money held by public,  $V$  = Velocity of circulation of money

# Constituents of Money Supply



# Narrow Approach

- **Coins, Currency Notes & Demand deposits**
  - **Coins & Currencies: High Powered money**
    - **Legal tender**
    - **Issued by RBI**
  - **Bank Money**
    - **Secondary money**
    - **Transferrable by cheque for settlement of debts**

# Systems of Note Issues

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- **The Full Reserve System**

- **Currency Notes issued: backed by reserves of gold and silver**

- **Proportional Reserve System**

- **Notes issued in proportion: reserves of gold & silver; approved securities**

# Systems of Note Issues

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- **Minimum Reserve System**

- **Maintain only a minimum gold reserve**

- **RBI (Amendment) Act 1957**

- **Maintain the aggregate value of gold coin, gold bullion and foreign securities= Rs. 200 crore**

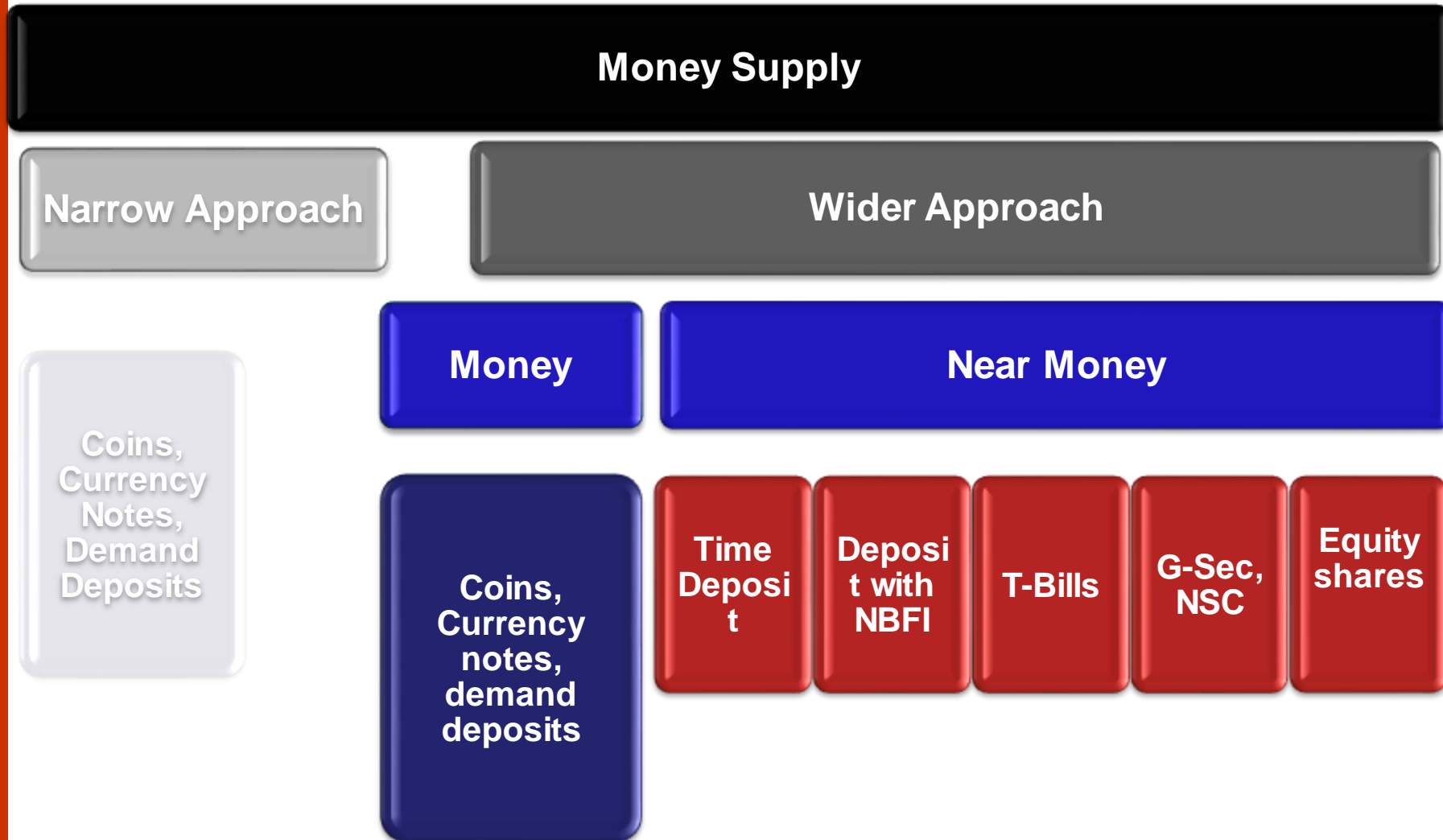
- **Gold holdings =Rs. 115 crores**

# Narrow Approach

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- **Money supply depends:**
- **on the degree of monetisation**
- **Banking habits**
- **Development of Banking systems**

# Wider Approach





# RBI's definition

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- **Two fundamental functions of money**
  - **Medium of exchange**
  - **Store of value**
- **Four measures of money**
  - **M1**
  - **M2**
  - **M3**
  - **M4**

# RBI's definition

- **Aggregate Monetary Sources**
  - **Currency (C)**
  - **Demand Deposits (DD)**
  - **Other Deposits of RBI(OD)**
  - **Post Office Savings Bank Deposits (POSBD)**
  - **Time deposits of banks (TD)**
  - **Time deposits of post office (TDPO)**

# M<sub>1</sub>

- **Base/Reserve/High Powered money**
- **Useful in devising monetary-fiscal policy**
  - **M<sub>1</sub> = C + DD + OD**
- **C = Notes and coins in circulation( does not include cash on hand with banks)**
- **DD = Demand deposits with banks (Inter-bank deposits not included)**
- **OD = Deposits of IDBI, IFCI, SFCs, NABARD, UTI held with RBI**

# M<sub>2</sub>

- **Extension of M<sub>1</sub>**
  - **M<sub>2</sub> = C + DD + OD + POSBD**  
**= M<sub>1</sub> + POSBD**
- **POSBD = Post Office Savings Deposits**
- **POSBD less liquid than demand deposits**
- **Greater public confidence for POSBD (rural areas)**

- **Broad Money**

- $M_3 = C + DD + OD + TD$

- $= M_1 + TD$

- **TD = Time Deposits with all banks**

- **Represents aggregate monetary resources**

# **M<sub>4</sub>**

- **Extended measure of M<sub>3</sub>**

- **M<sub>4</sub> = C + DD + OD + TD + TPOD**

- = M<sub>3</sub> + TPOD**

- **TPOD = Total Post Office Deposits**

- **Includes savings and time deposits of the public with the post offices**

# Summary

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- $M_1 = C + DD + OD$

- $M_2 = C + DD + OD + POSBD$

- $M_3 = C + DD + OD + TD$

- $M_4 = C + DD + OD + TD + TPOD$

# Determinants of Money Supply

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- **Monetary Base**
- **Community's Choice**
- **Extent of monetization**
- **CRR**
- **Government Budgetary Policy**



# Monetary Base

- **Group of assets which empowers RBI to issue high powered money.**
- **Money supply varies directly with change in base**
- **3 components:**
  - **Monetary Gold Stock**
  - **Reserve Assets- G-secs, bonds, bullion, forex reserves**
  - **Amount of Central Bank credit outstanding**

# Community's Choice

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- Amount of cash and demand deposits decides money supply.
- Transactions through cheques leads to greater money supply

# Extent of monetization

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- **Implies conversion of barter into the monetary economy**
- **A monetized economy needs more money supply than a partially monetised economy**
- **Demand for money rises with the growth of monetization**

# Cash Reserve Ratio

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- **Determines the quantity of money in a modern economy**
- **Credit creation depends on the CRR**

# Government Budgetary Policy

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- **Collection of taxes reduces  $M_s$**
- **Deficit Financing leads to an increase in  $M_s$ -  
increases monetary base**

# Money Multiplier

The Money Multiplier is the amount of money that the banking system generates with each unit of rupee reserves.

$$m = M/H$$

- $m$  = money multiplier
- $M$  = Total money
- $H$  = Reserve money = currency with the public + bank reserves (cash in hand with banks and their balances with RBI)

# Sources of Reserve Money

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- **RBI credit to the GOI**
  - **T- Bills, securities,**
- **RBI credit to commercial sector**
  - **Bank loans to Fis (NABARD, IDBI)**
- **RBI credit to the banking sector**
  - **Bills discounted**
- **Net foreign exchange assets of RBI**
  - **Gold coins, bullion, foreign securities**

# Velocity of Circulation of Money

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- **The average number of times money circulates from one hand to another**
- **Money supply=  $MV$** 
  - **Where  $M$ = Quantity of money**
  - **$V$ = average number of times that each unit of money is used for transactions of goods and services in a particular period.**



# Factors affecting Velocity of Circulation

- **Time unit of Income receipts**

- *Frequency of income more, shorter interval of holding money*

- **Methods and habits of payment**

- *Instalments: larger velocity*

- *Lumpsum payments: low velocity*

- **Degree of regularity of Income Receipts**

- *Income received at regular intervals: higher velocity*

# Factors affecting Velocity of Circulation

- **Distribution of National Income**
  - *Inequality: lower velocity*
- **Business Conditions**
  - *Prosperous/Inflationary condition: higher velocity*
  - *Recession/Deflationary condition: low velocity*
- **Development of Banking and Financial System**
  - *Well developed system: higher velocity*

# Factors affecting Velocity of Circulation

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- **Speed in Transportation of Money**
  - *Quick remittances through banks: higher velocity*
- **Liquidity Preference Function**
  - *Higher liquidity- hold cash: lower velocity*