

- Money
- Banking

Money

Definition of Money: Money is anything that is generally accepted as a medium of exchange and also acts as a common measure of value, store of value, and standard of deferred payment.

Money Supply: The total money (currency notes, coins, and demand deposits of banks) in circulation held by the public at a given point of time.

Measures of Money Supply: In India, the Reserve Bank of India (RBI) uses four measures of money supply: M_1 , M_2 , M_3 , and M_4 .

Narrow Approach of Money Supply: Includes only liquid assets that are easily acceptable for payments, comprising M_1 and M_2 .

Broad Approach of Money Supply: Includes currency held by the public, demand deposits, and time deposits, comprising M_3 and M_4 .

Components:

- **Currency with Public (C):** Currency issued by the Government or Central Bank, known as Legal Tender Money.

- **Demand Deposits (DD):** Public deposits with banks withdrawable on demand.
- **Other Deposits (OD):** Demand deposits of public financial institutions, international financial institutions, foreign governments, and central banks with the RBI.
- **Time Deposits (TD):** Deposits withdrawable only after a specified period.

Stock of Money: Money supply at a particular point in time.

Flow of Money: Money supply over a period of time.

High-powered Money or Reserve Money (H): Sum of currency held by the public (C) and cash reserves of banks (R).

$$H = C + R$$

Functions of Money

- **Medium of Exchange:** Facilitates buying and selling by being generally acceptable.
- **Measure of Value:** Acts as a unit of account to measure and express value of goods and services.
- **Store of Value:** Maintains purchasing power over time, allowing wealth storage.
- **Standard of Deferred Payment:** Used to settle debts payable in the future.

Factors Affecting Money Supply:

- Central Bank
- Commercial Banks
- Government
- Banking Habits
- Velocity of Circulation
- Volume of Trade
- Amount of Demand Deposits

Supplier of Money: The Central Bank of the country (RBI in India) supplies money; coins are issued by the Government of India.

Mnemonics for Factors Affecting Money Supply

Charles and Carla Bob gave some very good Variety of Antiques

- **C:** Central Bank
- **C:** Commercial Banks
- **G:** Government
- **B:** Banking Habits
- **V:** Velocity of Circulation
- **V:** Volume of Trade
- **A:** Amount of Demand Deposit

Banking

Money Creation by Commercial Banks: Commercial banks create money by lending more than the initial deposit, based on the Legal Reserve Ratio (LRR).

Money Multiplier Formula:

$$\text{Money Multiplier} = \frac{1}{\text{LRR}}$$

Total Deposits Formula:

$$\text{Total Deposits} = \text{Initial Deposit} \times \text{Money Multiplier}$$

Central Bank: The apex institution supervising and regulating commercial banks. In India, it is the Reserve Bank of India (RBI).

Functions of the RBI/Central Bank:

- Monopoly of Note Issue/Bank of Issue
- Banker to the Government
- Bankers' Bank
- Controller of Credit

Monetary Management: Regulation of money and credit to meet the demand for trade, business, and economic activities.

Methods of Credit Control: Divided into Quantitative and Qualitative tools.

Quantitative Tools

- **Cash Reserve Ratio (CRR):** Proportion of total deposits commercial banks must keep as cash reserves with the Central Bank.
- **Statutory Liquidity Ratio (SLR):** Proportion of liquid assets (gold, government securities) banks must maintain daily.
- **Repo Rate:** Rate at which Central Bank lends short-term loans to commercial banks against securities.
- **Reverse Repo Rate:** Rate at which Central Bank borrows money from commercial banks.
- **Bank Rate:** Rate at which Central Bank gives long-term loans to commercial banks without security.
- **Open Market Operations:** Buying and selling of securities by Central Bank to regulate liquidity.
- **Margin Requirements:** Difference between market value of securities and loan amount offered by banks.

Mnemonics for Functions of the Central Bank

Maria Blossom Baked Cake

- **M:** Monopoly of Note Issue/Bank of Issue
- **B:** Banker to the Government
- **B:** Bankers' Bank
- **C:** Controller of Credit

Example 1: Money Creation by Commercial Banks

If total deposits created by commercial banks are ₹10,000 crores and the legal reserve requirement is 10%, find the amount of initial deposits.

Solution:

Legal Reserve Requirement (LRR) = 10% = 0.1

Money Multiplier = $\frac{1}{0.1} = 10$

Total Deposits = ₹10,000 crores

Initial Deposits = **Math input error** crores

Practice Set

Level 1 – Easy

- Define money and list its functions.
- What is the difference between narrow and broad money supply?

Level 2 – Moderate

- Explain the process of money creation by commercial banks with a numerical example.
- Describe the functions of the Central Bank with examples.

Level 3 – Challenging

- Discuss the quantitative and qualitative methods of credit control used by the Central Bank.
- Analyze the impact of changing the Cash Reserve Ratio on the money supply in the economy.

Answer Key

Level 1

- **Money:** Anything generally accepted as a medium of exchange, measure of value, store of value, and standard of deferred payment.
- **Functions:** Medium of exchange, measure of value, store of value, standard of deferred payment.
- **Narrow vs Broad Money:** Narrow money includes liquid assets (M_1, M_2); broad money includes currency, demand deposits, and time deposits (M_3, M_4).

Level 2

- **Money Creation:** Commercial banks create money by lending multiples of initial deposits based on the legal reserve ratio. Example: With LRR 10%, money multiplier is 10, so ₹1,000 crore initial deposit creates ₹10,000 crore total deposits.
- **Functions of Central Bank:** Monopoly of note issue, banker to government, bankers' bank, controller of credit. For example, RBI issues currency and regulates banks.

Level 3

- **Credit Control Methods:** Quantitative tools like CRR, SLR, repo rate control money supply; qualitative tools like credit rationing influence credit distribution.
- **Impact of CRR Change:** Increasing CRR reduces money available for lending, decreasing money supply; decreasing CRR increases lending capacity and money supply.

Quick Reference

- Money Multiplier = $1 / LRR$
- Total Deposits = Initial Deposit \times Money Multiplier
- High-powered Money (H) = Currency with Public (C) + Reserves (R)

Glossary

- **Legal Tender Money:** Currency recognized by law as valid for meeting a financial obligation.
- **Cash Reserve Ratio (CRR):** Minimum fraction of deposits banks must keep as reserves with the Central Bank.
- **Statutory Liquidity Ratio (SLR):** Minimum percentage of deposits banks must maintain in liquid assets.
- **Repo Rate:** Rate at which Central Bank lends short-term funds to banks.
- **Reverse Repo Rate:** Rate at which Central Bank borrows money from banks.
- **Money Multiplier:** Factor by which initial deposit is multiplied to get total money supply.