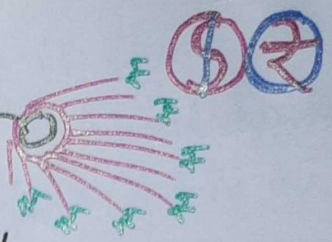
IV MODULE

13. MONEY SUPPLY



Q:1 Explain the Concept Money supply.
Explain Components/ Constitutents of money supply?

(A) **MONEY SUPPLY** – " Money supply means the amount of money which is in Circulation in an economy during a Period of Time"

" Money supply means the stock of money held by the People in spendable form"

Money supply is a Stock as well as Flow Concept. The money supply held by Public at a Point of time is known as Stock.
When money is used for any Consumption or Investment Purpose, It becomes Flow.

The Flow of money supply is measured as –

MONEY SUPPLY = M X V

M = Money stock
V = Velocity of Circulation

The RBI has Identified Four measures of Money Stock

1) M1 = C + DD + OD
2) M2 = M1 + Post Office Saving Bank Deposit
3) M3 = M2 + Time Deposits with Bank
4) M4 = M3 + Total Post Office Deposits.

(B) Constitutents / Components OF Money Supply

(A) **Traditional (Narrow)**
- ★ Currency
- ★ Demand Drafts

(B) **Modern (Broad)**
- ★ Currency
- ★ Demand Drafts
- ★ Saving Deposits in Post office
- ★ Time Deposit
- ★ Govt. Securities
- ★ Credit.

(A) **The Traditional Approach :-** Money is commonly used as Medium of Exchange. So in Traditional approach include that money which can be easily spend in the market. (e.g) i) Currency Notes and Coins.
ii) Demand Deposits in banks.

Both types of money supply is available in Liquid form, which can be easily accepted as Medium of Exchange. But Time Deposits are excluded from traditional supply of money.

The Traditional Money is also called 'Narrow Money' or 'Transaction Money'.

Thus Traditional Money = M_1

$$M_1 = C + DD + OD$$

OD = other Deposits.

(B) **Modern Measures or Broad Money :-** Modern money is also called Broad Money. In modern money supply include all Very Close-Substitutes of money.

1) According to Milton Friedman → Money supply is a wider Concept and it include Saving and ~~Time~~ Time Deposits with Commercial Banks

2) According to Gurley Shaw → Money supply include Shares, Securities, bonds and transactions with Non-Banking Financial Institutions which affect Aggregate Expenditure

3) According to Radcliff Committee → Money supply include all Funds Lend by ~~Financi~~ Financial Institutions.

Thus $$\text{Modern Money } (M_2) = M_1 + a + b + c + D$$

a → Post Office Saving bank Deposits
b → Time Deposits with Bank

c → Govt. securities, bonds and other financial assets

d → Credit which include all Debts (Borrowing & lending) of Non financial organisations.

(3) Money supply Does not include :—

i) Cash balance held by Central Govt. and State Govt with the Central bank.

ii) Time Deposits held by Public with Commercial Banks.

iii) Overdrafts until they are Used by People

iv) Monetary Gold held in Reserves by Central Bank.

v) Cash balance held by Central Bank and by Commercial Bank as Reserves to support Demand Deposits.

(e.g) CRR

Thus money supply is the stock of money Flow in economy during a given Period of time.

Qe:2 What are the determinants of Money supply?

(A) Money Supply — Definition from Qe:1

(B) Determinants of money supply :-

- Externally By RBI
- Internally by Changes in Eco. Activities

Various Determinants are —

1) High Powerd Money (Size of Monetary Base) :- Size of monetary base is determined by Central Bank. It means High-Powered money (H) which include Currency (C) and Reserves of Bank (R) and other Deposits (OD) with Reserve Bank.

Thus = $H = C + R + OD$

2) Choice of the Community :- The amount of cash and Demand deposits held by people determine Money supply. If People Prefer to make Payments by Cheque instead of cash, then Volume of money supply will be more and Vice Versa

The Choice of Community is affected by-

i) Price Level
ii) Income Level
iii) Banking Habits
iv) Methods of Taxation
v) Distribution of NI
vi) Volume of Trade
vii) Nature of Market etc.

3) Cash Reserve Ratio :- CRR is the amount of cash kept aside by bank to meet daily cash Obligations.

If Central Bank reduce CRR %, then amount of money supply is more available and Vice Versa.

4) Monetary Policy :- Monetary Policy is prepared by RBI to control supply of money among Commercial banks. It follows Various Quantitative and Qualitative measures which directly affect supply of money.

5) Fiscal Policy :- The Policy Prepared by Govt. also affect- supply of money as Under -

i) Budgetory Policy :- A Surplus Budget of Govt. will Reduce supply of money.
A Deficit Budget of Govt. will increase supply of money.

ii) Public Borrowing :- When Govt. borrow funds from Public, the volume of money with Public reduce.

iii) Public Expenditure :- An increase in govt. Expenditure may increase the income and volume of money with People

iv) Tax Policy :- Higher Tax will reduce money supply & Lower Tax will Increase money supply.

(6) Velocity of Circulation :- Higher the Velocity of Circulation, Higher is money supply and Vice Versa. It is also affected by Saving, Pricelevel, Payment Habits etc.

(7) Rate of Interest :- Rate of Interest has a Positive effect on money supply. At High rate of Interest People Prefer to keep Less Liquidity (Cash) with them. Hence it increase money supply.

(8) Currency Deposit Ratio :- High powered money is demanded by People as Currency (C) and by banks as Reserves (R). If more cash is demanded by People, then Less will be available with banks and Thus Lower will be Credit Creation.

(9) Currency System :- The supply of money is also affected by Currency system adopted by Govt.

(10) Extent of Monetisation :- Monetisation means Use of money for buying goods and services. When Extent of monetisation is high, demand for money would be high. As a result ~~Need~~ there is great need to supply more money in economy.

Q:3 What is Velocity of Circulation of money? Explain the Factor affecting / influencing Velocity of Circulation Of money?

(A) VELOCITY OF CIRCULATION OF MONEY :-

Meaning :- "The Average number of times money Circulates from one hand to another is called Velocity of Circulation of money"

$$\text{Supply of money} = M \times V$$

The Total amount of money in Circulation (M) is multiplied by Velocity of Circulation of money (V) is called Supply of money.

Example :- Suppose One note of ₹100 denomination is Circulated among 15 different People over a week. Then Total Supply money —

$$\text{Supply of Money} = M \times V$$
$$= 100 \times 15$$
$$= ₹1500$$

(B)

Velocity of Money

- (I) Transaction Velocity
- (II) Income Velocity.

(I) Transaction Velocity :- = $\frac{\text{Volume OF Transaction}}{\text{Stock of money}}$

"Transaction Velocity means a Ratio of Annual Volume of Transaction to Supply of money"

It shows Speed at which a unit of money moves from income to Payments of goods and Services & back again to income.

(II) Income Velocity of Money :- = GNP / National Income / Stock of Money

"Income Velocity means Average number of times of money used for making payment of Final goods and services"

(e.g) GNP is ₹ 50,000 Crores money supply = ₹10,000 Crores.

$$\text{Income Velocity} = \frac{50000}{10,000} = 5 \text{ times}$$

Income Velocity is Lower than Transaction Velocity.

(C) Factors Affecting Velocity of Circulation of Money :-

1) Method and Habit of Payment :- Lumpsum payment would require Large cash balance which reduce Velocity of Circulation. On the other hand Installment Payment will increase velocity of Circulation.

2) Volume of Production and Trade :- With increase in the Volume of Production and Trade, Velocity of money would be more in Transaction.

3) Change in Price-level :- During Inflation, Circulation of money is faster and during deflation, Circulation of money will be reduced.

4) Development of Banking and Financial System :- The Velocity of Circulation of money will be high in advanced countries due to well developed banking and Financial Institutions and Vice Versa.

5) Savings :- If People increase their saving and spent Less money on consumption, then it will reduce Velocity of money in Circulation.

6. Regular Income Receipt :- If the income received is very regular, then individuals will feel free to spend and Velocity of circulation is high & Vice Versa.

7. Time Period of Income Receipt :- If income is received in Quick intervals then Velocity of money is High & Vice Versa.

8. Liquidity Preference :- psychological conditions attitudes and habits of People towards consumption and Saving also influence the Velocity of Circulation of money. higher Liquidity Preference, Lower is the Velocity of money in Circulation & Vice Versa.

9. Propensity to Consume and Save :- The Velocity of Circulation of money also depend on consumption and Saving Pattern of People.
(e.g) higher the Propensity to Consume, Higher will be the Velocity of Circulation of money and Vice Versa.

10. Trade Cycles :- Business Conditions also affect Velocity of Circulation of money.
(e.g) During Prosperity, transaction are Fast which result in High Velocity of Circulation of money.
But During Recession, Velocity of Circulation money is Less.

11. Distribution of Income & wealth :- Unequal distribution of income and wealth in economy will reduce the Velocity of Circulation of Money.

12. Economic Development :- The Velocity of Circulation of money is more in Developed and Industrialised Country and Less in Agricultural Countries.