MONETARY SYSTEM

Money

- Anything which has general acceptance as means of payment.
- Functions of Money:-
  - Medium of Exchange
  - Common measure of value
  - Standard for deferred payments
  - Store of wealth
- Barter System – A commodity is exchanged for other commodities.
  - Problems of barter System are:-
    - Double coincidence of what is required
    - Valuation of commodities exchanged is a problem
    - There won't be a standard to serve as future monetary obligations
- **Gresham's Law –** Bad money drives out good money
- **Legal Tender Money** – This money cannot be denied in the settlement of monetary obligation
  - Limited Legal Tender Money : It is compulsory to accept upto a certain limit
    - E.g. A sum of ₹10 can be paid in denominations of 50 paisa coins and the recipient has to legally accept it.
  - Unlimited Legal Tender Money : This money can be used to make any amount of payment
- **Non Legal Tender Money –** There is no legal compulsion to accept this money. It is also called optional money or Fiduciary Money (on the basis of trust).
  - E.g. – Nepalese currency at India – Nepal border may be used as but recipient is not legally bound to accept it.
- **Fiat Money** – Serves as money on the order of the government. It is issued by government and theoretically may not be compulsory to accept.
- **Near Money** – Highly liquid financial assets like shares and bonds

Types of Money

1. Full-bodied money
   - It is the type of money whose value as money is equivalent to its value as commodity
   - E.g. – Gold coin
2. Token Money/Credit Money/Paper Money
   - Value as money is much more than the value as commodity
   - E.g. – Paper Currency
3. Representative full-bodied money
   - It is a kind of token money but is issued against the backing of equivalent value of bullion (gold and silver in bulk) with the issuing authority

MONEY SUPPLY

- **Money Supply is the total stock of all types money (currency + deposit money) held with public**
- Types of bank deposits
  - Current Account
  - Fixed deposit
  - Recurring deposit account

Public refers to everybody except Banks and Government

M1 = C + DD + OD (Narrow Money)

C - Currency held by the public
DD - Demand Deposits with Banks
OD - Other deposits (Demand Deposits held by RBI)

Demand Deposits (DD) – Can be withdrawn on demand from banks.
Time Deposits (TD) – Can be withdrawn only after a specific time.
DD+TD = Total Deposits

Other deposits include demand deposits with RBI. DD with RBI can be held only by Quasi-Governmental agencies, international agencies or former Governors of RBI

- M1 is known as narrow money as it includes only 100% liquid deposits which is a very narrow definition of money supply.

M2 = M1 + Savings account deposits with Post Offices

- M2 includes M1 and only saving account deposits with Post offices.
- Though the size of post office saving accounts is negligible M2 term is used as all the deposits in M2 are not liquid.

M3 = M1 + TD (Broad Money)

TD - Time Deposits with Banks
Includes fixed deposits, Recurring deposits and time liability of Savings accounts

- M3 is called Broad money as along with liquid deposits it also includes time deposits thus making it a broad classification of Money

M4 = M3 + Total Deposits with Post Office

- As the total deposits with post office is negligible there is not much difference between M3 and M4
- The most common measure used for money supply is M3
- Currently M3 is ₹76 lakh crore.

Current accounts cannot be opened in Post Offices

Types of accounts that can be opened are:-
- Savings account
- Fixed Deposit
- Recurring deposit

Government had appointed a committee for revising the measures of Money Supply

Committee was known as working group for the revision of Monetary Aggregates. The Chairman of the committee was Mr Y.V. Reddy

HIGH POWER MONEY/RESERVE MONEY/PRIMARY MONEY

- It is denoted by H or M0
- In simple terms it is currency held by public and banks
- It is called reserve money as banks have to keep reserves with RBI and this is the reserve money
- It is known as primary money as currency is called primary money and deposit is called secondary money. H includes currency only.

H or M0 is the total amount of money held by public and banks. Only the money held by government is excluded here.

Monetary System in India

- In India currency is printed as per the provisions of Minimum Reserve System.
- RBI has to maintain reserves of 200 crore in the form of
  - Gold - has to be at least 115 crore
  - Foreign Securities. - No minimum requirement
- RBI can print unlimited currency against the backing of Gold, Foreign Securities and Government Securities
- Till date RBI has printed 14.2 lakh crore
- Government borrows from RBI due to Deficit Financing.

Relation between Money Supply & High Powered Money

Money Supply = M x H

M = Money Multiplier
Its value depends on credit creation of banks means the more credit the bank can create more will be the money multiplier.

Credit Creation Capacity depends on:-
- Banking habits of the Public
- Monetary Policy

- If government prints more money, amount of physical goods will not increase but increase in money will lead to increase in prices of the goods which will result in Inflation.

Foreign Securities are any kind of financial assets. In India we maintain four currencies as Foreign Securities. These are:-
- USA Dollar
- UK Pound
- Japanese Yen
- Euro

Reserve Bank of India

- RBI is the Central Bank of the Country
- RBI was Established in 1 April 1935 under (RBI ACT 1934)
- Government Established RBI Recommendation of Hilton Young Committee
- RBI was Nationalised on 1 January 1949
- Governor is the Head of RBI
- Financial of RBI is 1st July to 30th June

Why is the financial year of RBI from 1st July to 30th June?

- The financial year of all the banks is from 1st Apr to 30th Mar.
- If RBIs financial year is also the same, it will not able to monitor and check the accounts of the banks.

Functions of RBI

- It is the only currency authority in India.
- It is the Government's Bank
- All financial transactions of the government are undertaken through the RBI
- It is Bankers Bank – Commercial banks have to keep reserves in RBI and RBI lends money to banks
- RBI is known as lender of the Last Resort
- It provides clearing house facility to banks – settlements of claims of one bank on other banks is done by RBI by the means of following facilities:-
  - NEFT (National Electronic Funds Transfer)
  - RTGS (Real Time Gross Settlement System)
- Supervisor of Banks and Non-banking finance institutions
- Custodian of Foreign Exchange reserves

Lower Denominations values of ₹1 and less are printed by the Finance Ministry, Government of India

Monetary Policy

- It is the Component of Economic Policy through Which Central Bank regulates Money Supply in an Economy
- It is the method through which the Central Bank regulates money supply in the market

Instruments of Monetary Policy

- Also known as Credit Control measures or Monetary Policy Measure
- Broadly classified into two types:-
  - Quantitative or General Measures
  - Qualitative or Selective Measures

Difference between Quantitative and Qualitative measures

1. Quantitative measures regulate the quantity of money supply
2. Qualitative measures are sector specific

Quantitative Measures

1. **Cash Reserve Ratio (CRR)**
   - Percentage of bank deposits which the bank has to keep with RBI

2. **Statutory Liquidity Ratio (SLR)**
   - Percentage of bank deposits which the bank has to keep with itself
   - Cash
   - Government Securities
   - Gold

Objectives of SLR

1. To ensure that bank should maintain sufficient cash with themselves
2. To Induce Banks to buy Government Securities

3. **Bank Rate**
   - Rate of interest at which RBI provides rediscounting facilities to Banks against their first class security
   - Commercial Paper is a First Class Security
4. **Open Market Operations (OMO)**
   - It is done by buying and selling Government Securities
   - This is done by an auction process
   - Another component of OMO is Liquidity Adjustment Facility.
   - This is used to regulate the money supply in the country
   - LAF is done by – Repo and Reverse Repo Rate
     - ✓ Repo Rate – RBI lends money to Banks by buying government securities
       - RBI only fixes Repo rate, Reverse Repo is automatically adjusted to 1% point below the Repo rate.
       - E.g. – If Repo Rate is changed to 8% Reverse Repo Rate will be automatically adjusted to 7%
     - ✓ Reverse Repo Rate – At this rate banks buy government securities from RBI

When Repo and reverse Repo increases, Money Supply in the market decreases and when Repo and reverses Repo decreases Money Supply in the market increases.

Per cent v/s Per cent Point

- 1 per cent point = 100 basis point
- i.e. 10% + 1% point = 10+1 = 11%
- whereas 10% + 1% = 10+0.1 = 10.1%

CURRENT KEY RATES

CRR	- 4.25%	**REPO RATE**	- 8.00%
SLR	- 23.0%	**ReREPO Rate**	- 7.00%
BANK RATE	- 9.00%	**MSF RATE**	- 9.00%

5. **Marginal Standing Facility (MSF)**
   - Banks can borrow loan up to 1% on their deposits.
   - Interests will be 1% point above Repo Rate and it will be based on day to day basis.
   - This facility is created to facilitate borrowing from RBI by banks who do not haven extra government securities and pledging the existing securities will affect their SLR requirements of 23%.
   - Objective was to overcome liquidity crunch with banks i.e. shortage of funds.

Qualitative Measures

1. **Credit Rationing**
   - Quota of credit, i.e. priority sector to get 40% of total credit.
   - Priority sector includes:-
     - ✓Agricultural Sector (18% of total credit)
     - ✓Weaker Sections
     - ✓Small Scale Industry
   - For Foreign banks priority sector cap is 32% of total credit

M.V Nair committee in 2012 recommended that quota for foreign banks should be increased to 40%

- ✓Priority sector includes Exports, Small Scale Industries, Housing Sector, Education Loan

2. **Margin Requirements**
   - Difference between the market value of a collateral security and the maximum amount of loan sanctioned against that security by a bank in a particular sector

3. **Differential Rate of Interest**
   - Different rate of interest for different sectors to increase the flow of credit to those sectors like agriculture sector, small scale industries

4. **Other Measures**
   - Moral Suasion
   - Direct Action like Penalty or Sanctions