UPSC Civil Services Examination

UPSC Notes [GS-III]

Topic: Money Supply [UPSC Economy Notes]

The money supply is the total amount of money (currency + deposit money) present in an economy at a particular point in time. The standard measures to define money usually include currency in circulation and demand deposits.

The record of the total money supply is kept by the Central Bank of the country. The change in the supply of money in an economy can affect the price level of securities, inflation, rates of exchange, business policies, etc.

Types of Money

The types of money circulated in an economy are as follows:

Full-bodied money

It is the type of money whose value as money is equivalent to its value as a commodity. E.g. – Gold coin

Token Money/Credit Money/Paper Money

Value as money is much more than the value as a commodity. E.g. – Paper Currency

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.

To know about the different monetary systems in the economy, refer to the linked article.

Monetary aggregates Concept – Money Supply

Types of bank deposits

1. Current Account
2. Fixed deposit
3. Recurring deposit account

M1 = C + DD + OD (Narrow Money)

- Where C denotes 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Demand Deposits (DD) can be withdrawn on demand from banks.

Time Deposits (TD) can be withdrawn only after a specific time.

Total Deposits = DD+TD

Other deposits (OD) include demand deposits with the RBI.

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

M1

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

M2

M2 includes M1 and only saving account deposits with Post offices

M2 = M1 + Savings account deposits with Post Offices

Note- Post offices have no facility for the opening of current accounts. The types of accounts that can be opened are – Savings account, Fixed deposit and Recurring deposit.

Though the size of post office saving accounts is negligible M2 term is used as all the deposits in M2 are not liquid.

M3

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

M3 = M1 + TD (Broad Money)

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

The most common measure used for money supply is M3

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

Money Supply Control

Money supply in the economy can be influenced by the Central Bank of the country. The money supply can be increased in an economy by purchasing government securities such as treasury bills and government bonds.

The reverse happens when the central bank tightens the money supply, by selling securities on the open market, drawing liquid funds out of the banking system. The prices of such securities fall as supply is increased, and interest rates rise.

Cash reserve ratio is an essential monetary policy tool used for controlling the money supply in the economy. It is a regulation implemented in almost every nation by the Central Bank of that country.