

I. Meaning and Functions of Money

Money is defined as the commonly accepted medium of exchange. In a simple economy with only one individual or a self-sufficient family, money has no role.

However, in a modern economy where millions of economic agents engage in market transactions, money becomes an essential instrument to facilitate exchange.

Before the advent of money, societies relied on the barter system, which involves the direct exchange of goods and services.

The barter system suffers from a critical drawback: the double coincidence of wants. This occurs only when two individuals possess surplus goods that the other specifically desires, making the search costs for a trade partner prohibitive as the economy grows.

Money acts as an intermediate good acceptable to all parties, thereby smoothing transactions.

The primary functions of money include:

- **Medium of Exchange:** This is the foremost role of money, allowing individuals to sell their produce for money and use that money to buy needed commodities, thus avoiding the inefficiencies of barter.
- **Unit of Account:** Money serves as a yardstick for measuring and comparing the value of all goods and services. For example, if a pen costs ₹10 and a pencil ₹2, the relative price of a pen is 5 pencils.
- **Store of Value:** Money allows individuals to transfer purchasing power from the present to the future. Unlike perishable goods like rice, money is durable, has lower storage costs, and is universally acceptable. However, for this function to be effective, the value of money must remain stable; high inflation can erode its purchasing power.

- **Standard of Deferred Payments:** (Implied through store of value and unit of account functions) Money facilitates contracts involving future payments.

Modern Forms of Money:

- **Fiat Money:** Currency notes and coins are called fiat money because they have no intrinsic value (the paper of a ₹100 note is worth far less than ₹100). Their value is derived from the guarantee of the issuing authority.
- **Legal Tender:** These are forms of money that cannot be legally refused by any citizen for the settlement of transactions. In India, currency notes and coins are legal tender, but cheques are not, as they can be refused as a mode of payment.

II. The Supply of Money

Money supply is a stock variable, representing the total stock of money in circulation among the public at a specific point in time. In India, the Reserve Bank of India (RBI) publishes four alternative measures of money supply:

1. **M1 (Narrow Money):** Includes currency (notes and coins) held by the public (CU) and net demand deposits held by commercial banks (DD). It is the most liquid measure.
2. **M2:** M1 + Savings deposits with Post Office savings banks.
3. **M3 (Broad Money):** M1 + Net time deposits of commercial banks. This is the most commonly used measure of money supply and is also known as aggregate monetary resources.

4. M4: M3 + Total deposits with Post Office savings organisations (excluding National Savings Certificates).

High-Powered Money: This consists of the total liability of the monetary authority (RBI), including currency held by the public and the cash reserves kept by commercial banks with the RBI. It serves as the monetary base for credit creation.



III. Money Creation and the Money Multiplier

Commercial banks act as mediators between individuals with excess funds (depositors) and those who need funds (borrowers). They create money by using the deposits they receive to extend loans.

The Process of Money Creation: Banks do not expect all depositors to withdraw their funds simultaneously.

Therefore, they keep only a fraction of their deposits as reserves and lend out the rest.

When a bank grants a loan, it does not typically give cash; instead, it opens a new deposit account in the borrower's name.

Since demand deposits are treated as money, the total money supply increases.

The Money Multiplier: The ability of the banking system to create credit is limited by the Reserve Ratio set by the Central Bank.

- **Cash Reserve Ratio (CRR):** The percentage of deposits that banks must legally keep as cash reserves with the RBI.
- **Statutory Liquidity Ratio (SLR):** The fraction of total demand and time deposits that banks must invest in specified liquid assets (like government bonds).

Mathematical Illustration: If a person deposits ₹100 and the CRR is 20%, the bank keeps ₹20 as reserves and lends ₹80. This ₹80 eventually returns to the banking system as a new deposit, of which the bank keeps 20% (₹16) and lends the rest (₹64). This process continues until the total deposits created are a multiple of the initial deposit. The Money Multiplier formula is:

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

In this example, the multiplier is $1/0.2=5$. Thus, an initial deposit of ₹100 can support total deposits of ₹500.

IV. The Central Bank and its Functions (RBI)

The Central Bank is a statutory body that pursues public goals defined by law rather than private profit. The Reserve Bank of India (RBI), established in 1935, is India's central bank.

Key Functions of the RBI:

1. **Issue of Currency:** The RBI is the sole authority for issuing currency notes in India (though coins are issued by the Government of India).
2. **Banker to the Government:** The RBI manages the accounts and financial operations of the government.

3. **Banker's Bank and Supervisor:** It acts as a bank for the commercial banking system.
4. **Custodian of Foreign Exchange Reserves:** The RBI maintains the country's reserves of foreign currencies to ensure stability in international transactions.
5. **Lender of Last Resort:** When commercial banks face a liquidity crisis and cannot find funds in the market, the RBI provides a guarantee of solvency by lending to them.
6. **Controller of Money Supply and Credit:** The RBI regulates the volume of money in the economy to maintain price stability.

1. Quantitative Tools: These tools affect the overall volume of credit in the system.

- **Bank Rate:** The interest rate at which the RBI provides long-term loans to commercial banks. Increasing the Bank Rate makes borrowing more expensive for banks, reducing their reserves and the money supply.
- **Open Market Operations (OMO):** This involves the buying and selling of government bonds by the RBI.
 - **Purchase of Bonds:** RBI injects money into the economy, increasing reserves and money supply.
 - **Sale of Bonds:** RBI withdraws money from the economy, reducing reserves and money supply.



- **Liquidity Adjustment Facility (Repo and Reverse Repo):**
 - **Repo Rate:** The rate at which the RBI lends money to commercial banks against government securities, with an agreement to repurchase them. It is a primary tool for injecting liquidity.
 - **Reverse Repo Rate:** The rate at which the RBI borrows money from commercial banks. It is used to withdraw excess liquidity from the system.
- **Variable Reserve Ratios (CRR and SLR):** Increasing CRR or SLR reduces the amount of funds available for lending, thereby decreasing the money multiplier and the total money supply.

V. Policy Tools to Control Money Supply

The RBI uses various tools, categorised as quantitative and qualitative, to regulate the money supply and interest rates.

2. Qualitative Tools: These tools are used to regulate the flow of credit to specific sectors.

- **Moral Suasion:** The RBI uses persuasion and informal pressure to encourage commercial banks to align their lending policies with the central bank's objectives.

- **Margin Requirements:** The difference between the value of the security provided for a loan and the loan amount itself. By increasing margin requirements, the RBI can discourage borrowing against certain assets.

Sterilisation: This is a specific intervention where the RBI uses OMOs to offset the impact of large foreign exchange inflows on the domestic money supply, keeping it stable against external shocks.

