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INDIAN ECONOMY

CHAPTER 4

Money & Money Supply

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CHAPTER 4

Money & Money Supply

Forms, Measures and Sources of Money

IN THIS CHAPTER

- Meaning of Money
- Forms of Money
- Supply of Money
- Sources of Money Supply
- Determinants of Money Supply

Meaning of Money

Anything that is **commonly accepted as a medium of exchange** is called **money**.

Forms of Money

1. Metallic Money

Money made of metal such as gold or silver. It exists in the form of **coins**. It has two types:

- **Full Bodied Coins:** Face value of the coin = value of the metal in it. Example: gold and silver coins of old times.
- **Token Money:** Face value of the coin is **greater** than the value of the metal in it. In India, **all coins are token money** (e.g., ₹10 coin).

2. Paper Money

Notes of different values made of paper, issued by the **central bank or government**. Example: ₹100 note.

3. Bank Money (Credit Money)

The most modern form of money. It consists of:

- **Cheque:** An unconditional order by a customer to his bank to pay a certain sum to himself or to any other party.
- **Bill of Exchange:** An order by the drawer to the drawee to pay a sum of money to the drawer or any other party.
- **Draft:** A cheque drawn by a bank on its own branch or another bank, asking it to pay a specific amount on demand to the person named in it.

4. Legal Tender Money

Money that a person **must accept** as a means of payment and in discharge of debt. All notes and coins issued by the government and the central bank are legal tender.

5. Plastic Money

Credit cards and smart cards.

6. Standard Money

The **Rupee** is the standard money of India.

7. Near Money

Assets that can **easily be converted into money**, such as deposits and government bonds.

8. Fiduciary Money

- Its value depends on the **confidence** that it will be generally accepted as a medium of exchange.
- Unlike fiat money, it is **not declared legal tender**, so people are not legally required to accept it.
- The issuer promises to exchange it for a commodity or fiat money on request.
- Examples: cheques, banknotes, drafts.

9. Commodity Money

A commodity with **intrinsic value** that is used as a medium of exchange. Examples: salt, animals, gems, beads, gold, silver.

Supply of Money

Money supply is the total quantity of monetary assets circulating in an economy at a given time.

- It includes the forms of money used by individuals, businesses and governments for transactions, investment and saving.
- It is a crucial economic indicator because it affects **inflation, interest rates** and overall economic activity.

Measures of Money Supply

Money supply is measured using aggregates M0, M1, M2, M3, M4, based on **liquidity**:

Measure	Name	Includes
M0	Reserve Money / High-Powered Money / Base Money / Monetary Base	Currency (coins and notes) in circulation + reserves of commercial banks with the central bank
M1	**Narrow Money**	Currency in circulation + Demand Deposits (M1 = C + D)
M2	**Broad Money**	M1 + Savings Deposits + Time Deposits + Money Market Mutual Funds
M3	Broad Money	M2 + large time deposits, institutional money market funds and other large liquid assets
M4	Broadest measure	M3 + all other deposits

> **REMEMBER**
>
> **M1 = Narrow Money** (most liquid). **M3 = Broad Money**. **M0 = High-Powered Money**.

Sources of Money Supply

Central Bank (RBI)

- The RBI has the authority to issue **currency notes**.
- The RBI is the **principal supplier** of money.
- Through monetary policy tools (interest rates, open market operations, reserve requirements), it influences the money supply.

Ministry of Finance

It issues only the **₹1 note and all coins**.

Commercial Banks

- Commercial banks **create money through lending**: when a bank gives a loan, it creates a new deposit in the borrower's account, increasing the money supply.
- Banks also hold reserves with the central bank.
- Money created by commercial banks in the form of demand deposits is called **bank money**.

Determinants of Money Supply

Factor	How it affects money supply
Central Bank Policy	**Open Market Operations** (buying/selling government securities) and **Reserve Requirements** (share of deposits banks must keep, which limits lending)
Commercial Bank Actions	**Lending practices** – how much banks lend to businesses and individuals
Public Preferences	Preference for holding **cash** versus keeping money in interest-bearing deposits
Economic Activity	**Velocity of money** – the speed at which money circulates
Government Influence	**Government spending** and fiscal policy, especially when financed by borrowing
Financial Innovation	New financial products and instruments

QUICK REVISION

1. Money = anything commonly accepted as a medium of exchange.
2. All coins in India are token money (face value > metal value).
3. Legal tender must be accepted for payment of debt.
4. Rupee is the standard money of India.
5. Ministry of Finance issues the ₹1 note and all coins; RBI issues all other notes.
6. M0 = high-powered money; M1 = narrow money; M3 = broad money.
7. Commercial banks create money through lending (bank money).
8. Money supply is affected by central bank policy, bank lending, public preference, velocity of money and government spending.