Money: Key Concepts in Brief

1. Meaning of Money: Commonly accepted medium of exchange.

    - Attributes: Anything universally accepted for goods/services payment or debt settlement.
    - Liquidity: Highly liquid, easily exchangeable for other commodities.

2. Functions of Money:

Primary Functions of Money	
Measure of Value: Common measure of value or unit of account for relative comparison of goods.	**Divisible:** Easily divided into small increments for precise value matching. (e.g., 4 notes of Rs.500 = 1 note of Rs.2000)
	Fungible: Ability to be interchanged with other goods or assets of the same type. (e.g., 1 note of Rs.500 can buy the same amount of goods as another Rs.500 note)
Medium of Exchange (Transaction): Facilitates easy exchange of goods and services.	**Readily Acceptable:** Legal tender acceptance.
	Durable: Long functional life.
	Recognizable: Identifiable by authorities and people.
	Hard to Counterfeit and Duplicate: Difficult to forge or duplicate.
Derivative Functions of Money	
Deferred Payment: Standard mode of deferred payments (e.g., Credit card, EMI).	Transfer of Value: Uniform value throughout the country, easily transferrable.
	Store of Value: Can be kept as savings, used for investment (e.g., buying property), with lower storage costs.

FUNCTIONS OF MONEY

Primary

- Medium of Exchange

- Measure of Value

Secondary

- Store of value

- Transfer of Value

- Standard of Differed Payments

Contingent

- Basis of credit creation
- Employing Factor Inputs
- Creation & Redistribution of National Income

- Liquidity

Exchange of goods without involving money, known as Barter Exchange

POSITIVES

- Simplest in form
- No foreign exchange regime
- No concentration of wealth

Difficulties under Barter System (NEGATIVES):

- Double Coincidence of Wants: Economic phenomenon requiring both parties to hold items the other wants.
- Lack of Information about Product Quality: Limited information about the quality of exchanged products.
- Impossibility of Subdivisions: Difficulty in subdividing goods for exchange.
- No Unit of Account: Lack of a standard unit to measure the worth of goods.

DOUBLE COINCIDENCE OF WANTS: It is an economic phenomenon where two parties each hold an item the other wants, so they exchange these items directly without any monetary medium.

- E.g. – shoemaker wants to buy wheat and the farmer wants to buy shoes then they both can exchange their commodities.

Barter System vs. Money: A Concise Comparison

Parameter	Barter System	Money
Perishable	Perishable goods; cannot be stored for a long time.	Not perishable; can be stored for an extended period.
Double Coincidence of Wants	Necessary for transactions.	Not needed for transactions.
Divisibility	Difficult to divide; lacks high divisibility.	Highly divisible; can be divided into small increments.
Storage Cost	High storage cost due to perishable nature.	Comparatively low storage cost.
Universal Acceptability	No universal acceptability.	Facilitates exchanges with common acceptance.
Deferred Payment	Not possible.	Temporary postponements of payment are possible.
Convertibility to Other Commodities	Difficult.	Easily convertible into other commodities.
Exchangeability	Poor exchangeability.	Easily exchangeable.
Liquidity	Poor liquidity; not easily available or tradable.	High liquidity; easily available and tradable.
Unit of Account	Does not act as a standard unit of account.	Acts as a standard unit of account.
Fungibility	Less fungible.	High fungibility; replaceable by another identical item.

Commodity Money Overview:

- Money derived from a commodity with intrinsic value.
- Composition: Objects with inherent value or utility, like gold, serving both as a medium of exchange and having practical use (e.g., jewelry).
- Historical Example: In India, cowries were utilized for exchanges in earlier times.

Problems of Commodity Money:

- Unequal Face Value: Face value varied across regions.
- Perishable Nature: Commodities used were often perishable.
- **Bulky and inconvenient** making transportation challenging.
- **Lacked fungibility (mutual interchangeability) and divisibility**.

Common Types of Money

1

Commodity Money

money value comes from a commodity of which it is made

not backed by a commodity, such as gold or silver

2

Fiat Money

3

inconvertible paper money made legal tender by a government law

Legal Tender Money

METALLIC MONEY: Currency composed of pure and high-quality metals such as gold and silver.

- Intrinsic value (metal value) equals the face value (inscribed value).
- Variants: Gold (Muhr): High value due to relatively lower gold supply; Silver (Rupaiya): Moderate value; Copper/Bronze (Dam, Paisa): Used for everyday purchases.

Aspect	Face Value	Intrinsic Value
Definition	Legally defined value relative to other units of currency.	Market value of the metal within a coin.
Fiat Money	Has the face value.	Does not have intrinsic value.
Derivation	Cannot be derived from selling the constituent metal/currency itself.	Derived from selling the constituent metal itself.

Paper Money (Fiat Money) Overview:

- Legal tender guaranteed by national governments.
- Recognized for settling debts and payments within territorial jurisdiction.

Central Bank Control: Gives central banks control over the economy by regulating the quantity of printed money.

Representative Money: Backed by gold or silver standard, termed "representative money."

- Central banks issue currency with promises to pay, resembling an anonymous bearer bond with zero interest. Examples: US dollar, Indian Rupee, Euro, etc.
- Issuing Authorities in India: Government issues coins and Rs.1 note under the Coinage Act 1909.
- RBI, empowered by the RBI Act 1934, issues other bank notes. Demonetization can be recommended by the RBI central board.

What is NOT Fiat Money?

- Money without government legal backing.
- E.g. Plastic coins, cards, and coupons from superstores. Shares, Bonds, Debentures, G-Sec, T-bill. DD, Cheques, Credit Card, ATM card. Bitcoin and other Digital currencies.

Problems of Fiat Money:

- Reduction in Value: Monetary policies leading to overprinting can reduce money value.
- Bulky and Prone to Theft: Still bulky, reducing movability. Prone to theft and counterfeit.
- Change Problem: Difficulty in dividing money into small increments, causing rounding off issues.
- Hyper-Inflation: Extreme rise in inflation, reaching rates like 50 to 300 times.

Aspect	Virtual Money	Fiduciary Money	Credit Money
Definition	Unregulated digital currency within blockchain, electronic form.	Money accepted as a medium due to trust (e.g., Cheques).	Money where money value > commodity value.
Characteristics	Held within blockchain, not controlled centrally.	Examples: Cheques, Banknotes, etc.	Money value surpasses commodity value.
Transaction Medium	Transacted through designated software, apps, or digital wallets.		
Subset of Digital Currency	Subset of digital currency group, includes cryptocurrencies in the blockchain.		
Differentiation from Digital Currency	Different from digital currency issued by banks in digital form.		

What are Monetary Aggregates?

- Monetary aggregates are different ways to measure the total money supply within an economy.
- The most common measure is "broad money" (M3).
- India's Reserve Bank of India (RBI) uses a system with four aggregates:
    - **M0 (Monetary Base):** Currency in circulation plus bank reserves with the RBI.
    - **M1 (Narrow Money):** M0 plus demand deposits with banks.
    - **M2:** M1 plus savings deposits with post office banks.
    - **M3 (Broad Money):** M1 plus time deposits with banks (most comprehensive measure).

Why are Monetary Aggregates Important?

Central banks like the RBI track monetary aggregates because they:

- Indicate the amount of money available in the economy.
- Help assess inflationary pressures.
- Guide monetary policy decisions.

Different Measures of Money Supply

M1→ CU+ DD
(Currency Notes and Coins +Demand Deposits of Commercial banks)

M2→ M1 +Savings Account with Post Office
(Currency Notes and Coins +Demand Deposits of Commercial Banks+ Savings Account of Post Office)

M3→ M1 + Net Time Deposit of Banks
(Currency Notes and Coins +Demand Deposits of Commercial Banks+ Term Deposits of Bank)

M4→ M3 + Total Deposits of Post Office (Excluding NSC)
(Currency Notes and Coins +Demand Deposits of Commercial Banks+ Term Deposits of Bank)+ All deposits of Post office

India's New Monetary Aggregates

- **M0 (Monetary Base/Reserve Money):** Components:
  - Currency in circulation
  - Banks' deposits with the RBI
  - Other deposits with the RBI (e.g., foreign central banks, international agencies)
- **M1 (Narrow Money):** Components:
  - Currency held by the public
  - Demand deposits with banks
  - Other deposits with the RBI
  - Significance: Reflects the most liquid portion of the money supply.
- **M2:** Components:
  - M1
  - Savings deposits with banks
  - Certificates of deposit issued by banks
  - Time deposits with banks (up to one year maturity)
- **M3 (Broad Money):** Components:
  - M2
  - Time deposits with banks (over one year maturity)
  - Borrowings from non-depository financial corporations by banks
  - Significance: The most comprehensive measure of the money supply.

Additional Liquidity Aggregates

- **L1:** NM3 + Post office savings bank deposits
- **L2:** L1 + Term deposits with financial institutions + Borrowings by financial institutions + Certificates of deposit issued by financial institutions
- **L3:** L2 + Public deposits with non-banking financial companies

Types of Money

- **Central Bank Money (M0):** Directly issued by a central bank. Includes:
  - Physical currency
  - Reserves held by commercial banks at the central bank
- **Commercial Bank Money (M1-M3):** Created by commercial banks through lending and deposit-taking activities. Includes:
  - Checking accounts
  - Savings accounts

Key Difference: Central bank money is a direct liability of the central bank, while commercial bank money is a liability of the individual commercial bank that created it.

Creation of Money Overview:

- Money Supply Definition: All currency and liquid instruments in a country's economy at a specific date.
- Composition of Money Supply: Composed of both cash and deposits that can be used almost as easily as cash.
- Components of Money Supply (Simplified M1): M1 = Consumer Unit (CU) + Demand Draft (DD).
- Factors Influencing Money Supply: Changes in components like CU, DD, or Time Deposits.

  Actions of the monetary authority (RBI) and commercial banks.

  Public preference for holding cash versus bank deposits.

- Key Ratios Influencing Money Supply:

Currency Deposit Ratio (CDR): Ratio of currency held by the public to bank deposits. (CDR = CU/DD).
Behavioral Parameter: Reflects people's liquidity preference, influenced by seasonal expenditure patterns.

Reserve Deposit Ratio (RDR) Overview:

- Definition: Proportion of total deposits that commercial banks keep as reserves.
- Composition of Reserve Money: Includes vault cash in banks and deposits of commercial banks with RBI.
- Utilization by Banks:
  - Banks hold a portion of money from bank deposits as reserves, using the rest for investment projects.
  - Reserves are utilized to meet cash demands from account holders.
- Regulatory Role of RBI:
  - RBI mandates commercial banks to keep reserves for a secure cushion to meet account holder payment demands.
- Policy Instruments for RDR:
  - Cash Reserve Ratio (CRR): Fraction of deposits banks must keep with RBI.
  - Statutory Liquidity Ratio (SLR): Requires banks to maintain a fraction of total demand and time deposits as specified liquid assets.
- Interest Rate Influence:
  - Bank Rate: RBI uses the Bank Rate to control the value of RDR.
  - Commercial banks, short of reserves, can borrow from RBI at the Bank Rate, with a high Bank Rate encouraging banks to maintain a healthy RDR.

Summary:

Reserve Deposit Ratio (RDR) represents the proportion of total deposits kept as reserves by commercial banks. Regulated by RBI through tools like CRR, SLR, and the Bank Rate, RDR ensures a secure cushion for banks to meet payment demands from account holders.

3. Policy Instruments:

- Cash Reserve Ratio (CRR): Fraction of deposits banks must keep with RBI.
- Statutory Liquidity Ratio (SLR): Fraction of total deposits in specified liquid assets.
- Bank Rate: Interest rate influencing RDR; high bank rate encourages healthy RDR.
- Borrowing from RBI: Banks can borrow at the bank rate when reserves are short.