

MEASUREMENTS OF MONEY SUPPLY



vEcoSys

Understanding the Measurements of Money Supply

– By Prof. *Simply Simple*



MEASUREMENTS OF MONEY SUPPLY



- ❑ We had earlier covered 'Velocity of money' – which is a term used to denote the number of times a unit of money in an economy changes hands during a certain period, say, one year.
- ❑ Here, by money, economists generally mean currency and coins in circulation and bank reserves with the central bank.

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The life of money looks so simple when it is just moving from one hand to another.

But what about the actual economy, where countless number of people are using different units of money for small and big transactions? How do we actually calculate the velocity of money in a real economy?



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- ❑ First of all, the velocity of money can be known only after all buy and sell transactions are over.
- ❑ There is no way we can directly know about the velocity of money on a real-time basis.
- ❑ We calculate velocity of money by dividing the value of the Gross Domestic Product, or GDP, which represents the total value of all goods and services produced by an economy, by the value of money supply.
- ❑ Mathematically, it can be expressed as:

$$\text{Velocity of Money} = \text{GDP} / \text{Value of Money Supply}$$



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Remember...

- Different measurements of money supply would show different velocity.**
- But if you are not too comfortable with the nuances of money supply, then you can just think of money as the value of the total stock of currency notes and coins available in an economy.**



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Now...

- ❑ The different types of money are typically classified as M's.
- ❑ In the money supply statistics, central bank money (in our case RBI) is M0 while commercial bank money (other national banks) is divided up into M1-M3 components.



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- ❑ **M0: currency (notes and coins) in circulation and in bank vaults. M0 is usually called the monetary base - the base from which other forms of money are created - and is traditionally the most liquid measure of the money supply**
- ❑ **M1: currency in circulation + demand deposits + traveler's cheques. M1 represents the assets that can be used to pay for a good or service or to repay debt.**
- ❑ **M2: The sum of M1 + savings deposits, small denomination deposits & retirement accounts.**
- ❑ **M3: The sum of M2 + large deposits, Euro-dollar deposits & dollars held in foreign offices of banks.**



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But how does one calculate the different measurements of money supply such as M0, M1, M2, M3 and so on?



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Here's how...

- ❑ You can choose any of the different measurements of money supply such as M0, M1, M2, M3 and so on.
- ❑ But since different measurements of money supply would show different values, you would get different velocities of money.
- ❑ So if the value of GDP is, say, Rs10 lakh and the value of the base money or M0 is, say, Rs1 lakh, then the velocity of money would be 10. Likewise, if the value of M3 is, say, Rs2 lakh, then the velocity of money would be five.



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But you may ask, which one is the true velocity of money,
10 or five?

- It is both.
- In the present example, 10 is the velocity of money in its most liquid form—the currency and coins actually in circulation.
- As we move up the ladder of M1, M2, and M3, the liquidity of money decreases and so does its velocity.



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Which brings me to my original point...

- ❑ From one wallet to another, from one shopper to the next, that is the life of money.
- ❑ But we often forget that money is like a lubricant that makes the economy move smoothly.
- ❑ Therefore, if the money is parked in our pocket, and we don't spend it, in effect the economy slows down.
- ❑ Thus money needs to move and therefore needs velocity (velocity is another word for speed) as shown in the next slide...



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How Money Moves!

Barber buys bread
from the baker

Rs. 100



Baker buys clothes
from the
cloth merchant

Rs. 100



Rs. 100

Cloth merchant
gets a haircut
from the barber



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To Sum Up

- ❑ **What:** ‘Velocity of money’ is a term used to denote the number of times a unit of money in an economy changes hands during a certain period.
- ❑ **How:** Velocity of money is calculated by dividing the value of GDP with the value of money in circulation.
- ❑ **Why:** Money needs to move or have velocity for the economy to move ahead smoothly.



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Hope you have now
understood the concept of
Measurements of Money Supply



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