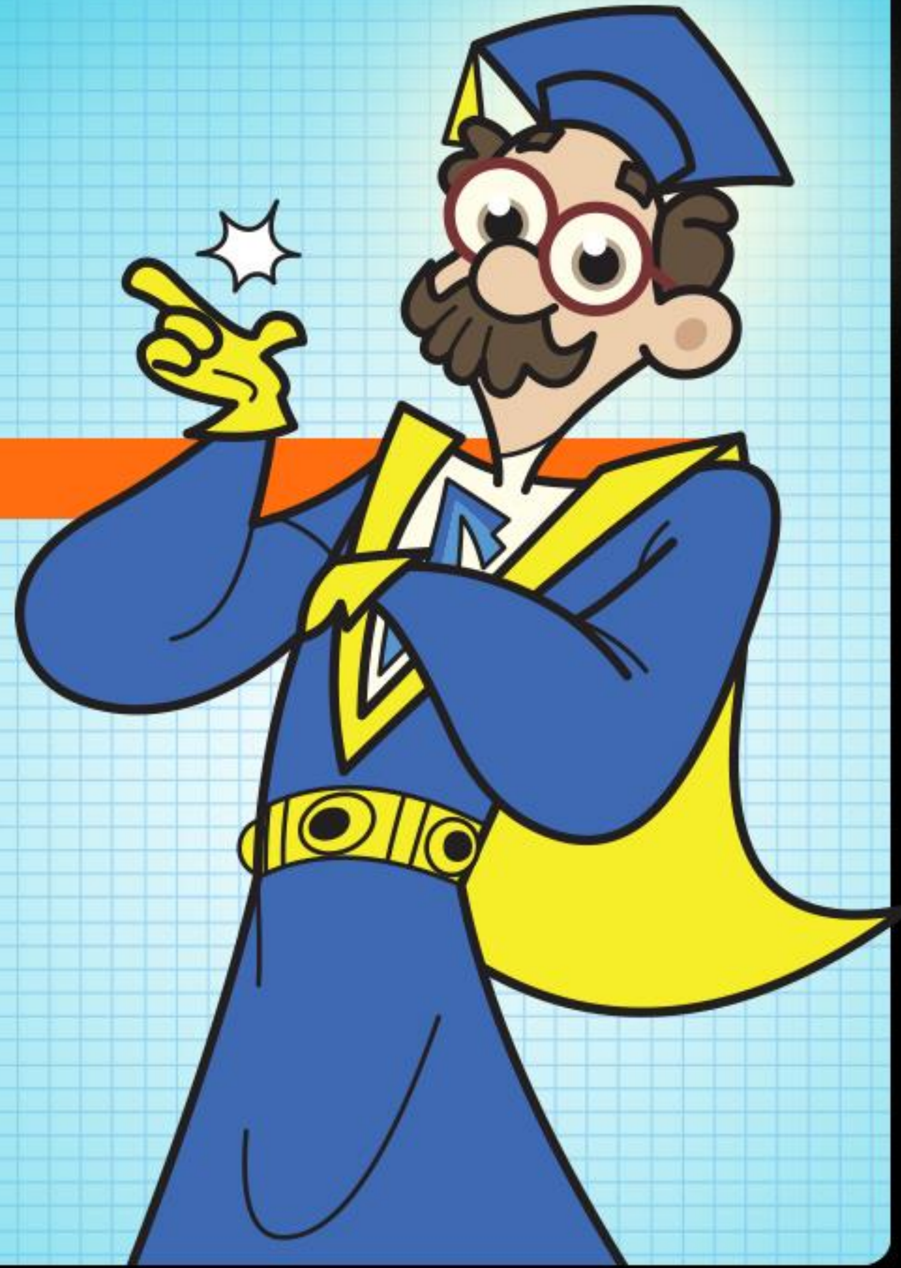
MONEY SUPPLY



Understanding Money Supply

– By Prof. Simply Simple

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- How is the money supply in the economy regulated?
- Who governs it?
- What are its implications on the economy?
- Let 's try and understand ?

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So how is money supply regulated?

- **What could cause increase in money supply?**
- **The answer seems simple. The government has the power to print notes, they can hence release more money into the economy.**
- **However it is only partly true. Such a process cannot be sustained as more notes for the same quantity of physical goods in the economy will only bring down the value of the currency and hence will not benefit anyone. After all increase in money supply should be done with an objective to benefit the economy as a whole by protecting the value of the currency. So, a government has to exercise restraint in printing notes.**

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Treasury Bills (T-Bills)

- But printing notes is not the only method to increase the supply of money in the economy

- Our banks also have the power to “create” money by their lending activities.

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So how do banks increase money supply?

- **Okay, let us take an example. Suppose you deposit Rs100 in your savings bank account. Your savings bank account will reflect the Rs100 as deposit. Although the Rs100 is deposited in the bank it still constitutes a part of the money supply because you still have the right to withdraw and spend it.**
- **Now, what is your bank going to do with the money you have deposited?**
- **It is surely not going to keep all of your money with tself till the time you come back to claim it. If it were to do that then your money instead of earning interest in the bank would actually depreciate.**

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- All our banks work on what is known as fractional reserve system.
- They keep part of the deposits as reserves for meeting the day-to-day redemption of other depositors and lend the remainder to their borrowers.
- This is how banks are able to earn money and share a part their earning with you which is popularly known as interest.

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- Now suppose the bank maintains a reserve of 10%, then it will keep Rs10 with itself and lend Rs90 to someone else.
- The borrower can either take the loan of Rs90 and utilize it for value creation. Perhaps he funds his working capital and after the designated period returns the money to the bank along with some interest for the money supplied to him. At the same time the borrower due to economic activities earns a profit as well which was made possible due to the loan that he received.

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Remember that all this while the lending of Rs90 by the bank in any way does not lead to reduction of Rs90 from your demand deposit, which also continues to be part of the money supply. After all you can always break your deposit and recover your money.

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- So how does the bank fund this redemption?
- It does through the help of the 10% reserves that it holds from all depositors.
- The aggregation of the 10% that it holds becomes a large enough reserve to fund some of the expected redemptions.

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What is the underlying principle that the banks use to increase money supply

- **Remember not all depositors break their deposits. The probability of depositors doing so is quite less.**
- **This is the key principle that is the engine for money supply**
- **Hence the 10% reserve of CRR as it is popularly known as is good enough to handle redemptions.**
- **Therefore the 90% that is given as loans to borrowers constitutes additional money supply for the economy.**
- **In other words money that would otherwise lie idle is made to sweat to achieve more action in the economy leading to the creation of more wealth without having to resort to printing additional currency**

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- Thus the Rs 100 which was deposited with the bank created Rs 190 for a borrower.
- Had the borrower deposited Rs 50 and used Rs 40, the bank would have kept Rs 5 (10%) as reserves and would have lent Rs 45 to another borrower. Thus money supply would have increased by another Rs 45 making the total supply equal to Rs 100 + Rs 90 + Rs 45 = Rs 235.
- This process at a macro level lands up in expanding the money supply substantially.

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Now I guess you understand how CRR becomes a tool to control money supply?

- **If not, let me explain.**
- **If the government increases the reserve ratio from 10% to 20%, the money available for lending will get reduced from 90% to 80%.**
- **Thus to the extent of 10% supply is reduced.**
- **Now when you aggregate all such deposits the reduction becomes substantial.**
- **Thus CRR becomes a much better tool for regulating money supply rather than simply printing notes.**

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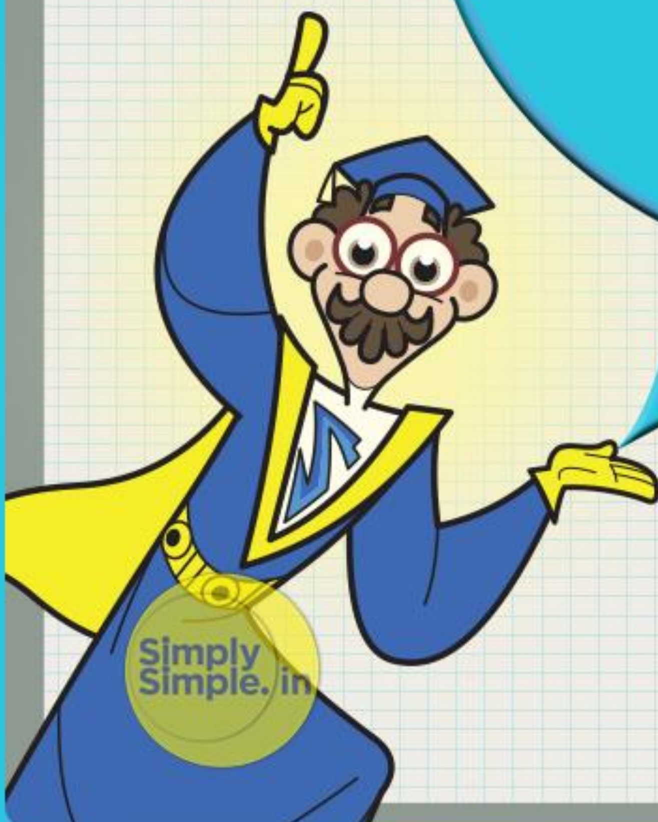
Hope you have now understood the concept of Money Market



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