RBI & ITS ROLE

What is money supply?

The total stock of money in circulation among the public at a particular point of time is called money supply. The Stock of money consist of currency notes and coins and the balance in savings, or current account deposits, held by the public in commercial banks.

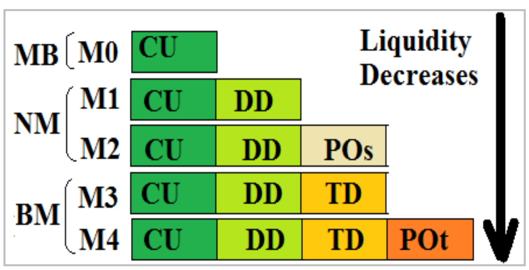
How RBI measures size of Money supply!

Money supply-total stock of moneys

M0= CU+ deposits with RBI
M1 = CU+DD
M2 = M1+ Savings deposits with Post Office
M3 = M1 + Net time deposits of commercial banks
M4 = M3 + Total deposits with Post office
CU is currency held by the public. DD is net demand deposits by banks.

M0 **monetary base** compiled from balance sheet of RBI. M1 and M2 are **narrow money**. M3 and M4 are **broad money**.

These gradations are in decreasing order of **liquidity**.
M0 > M1 > M2 > M3 > M4



Why we need to measure money supply?

Size of money supply should be in balance with size of production in an economy. Larger Money supply means more money in circulation. If people have more money to spend in comparison to production of good & services, it can lead to price rise (inflation). So RBI need to measure Money supply to overall stability in an economy & to bring policy changes accordingly.

How Does the RBI Controls Money Supply? RBI uses a number of tools to control money supply. Broadly we can categorise these tools in two parts

A. Quantitative B. Qualitative tools

Instruments of monetary policy

Quantitative

Reserves

1. CRR
2. SLR

Policy rate

1. Bank rate (BR)
2. LAF
   - Repo rate
   - Reverse repo
3. MSF

OMO -open market operations

Qualitative

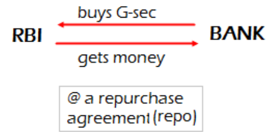
1. Selective credit control
2. Rationing of credit
3. Credit authorisation scheme
4. Moral suasion

Net Demand and Time Liabilities

Demand Liabilities include all liabilities which are payable on demand and they include current deposits, savings bank deposits, Demand Drafts (DDs), etc. Time Liabilities are those which are payable after a fixed period of time and they include fixed deposits, cash certificates, recurring deposits, etc.

Tools **Definition**	**Effects**
Reserves	
CRR CRR is ratio of total deposits (NDTL) of a bank keep with RBI in cash. In India , RBI keep it around 5%. Means if Bank has NDTL of 100cr, it has to keep 5 cr in cash with RBI	If RBI **increases** CRR → banks has to deposit more cash with RBI→less funds with banks → less loans/credit to people → Less money for expenditure→ inflation in control If RBI decreases reverse of above happens
SLR SLR is ratio of total deposits (NDTL) of a bank keep with itself . it can be in form of cash, gold or govt securities. In India , RBI keep it around 25%. Means if Bank has NDTL of 100cr, it has to keep 25 cr with itself in various forms.	Same effects as discussed above can be observed in an economy
Policy rates	
Bank rate **Bank rate-** rate of interest (ROI) at which RBI provide money to banks for long terms	
Liquidity adjustment facility (LAF) banks to borrow money through repurchase agreements. There are tow instruments under this 1) repo 2) reverse repo	

Tight monetary policy	**CRR↑ SLR↑ BR↑ RR↑ RRR↓ OMO (selling)**	**Money supply(↓)**	**Effects on Inflation GDP growth Exchange rate**

Repo Rate **Repo Rate** – repo means repurchase. It is a repurchase agreement between a bank & RBI. Bank agree to repurchase Govt securities at a future date, which bank sells at present to RBI. Means effectively RBI **buys** g-sec and gives money to banks . see image	 **If RBI increases Repo rate**→ getting money for banks become costly → banks take lesser money from RBI → less funds with banks → less loans/credit to people → Less money for expenditure→ inflation in control
Reverse Repo rate It is the reverse of above process. RBI **sells** g-sec for short terms to banks.RBI borrows money in the process while bank receives	Reverse the above process
NOTE: repo & reverse repo comes under liquidity adjustment facility **(LAF**) of RBI. Means RBI uses this facility for liquidity adjustment in economy via banks	
(MSF) **Marginal Standing Facility - rate at which banks borrow funds** overnight from (RBI) in situation of an acute cash shortage, against their excess (SLR) holdings. Additionally, they can also avail funds on overnight basis below the stipulated SLR up to 1 per cent of their respective (NDTL)	

LAF	MSF
Liquidity adjustment facility	Marginal standing facility
Minimum bidding amount is 5 cr.	1 cr.
All clients of RBI are eligible to bid.	Only scheduled commercial banks can bid.
Bank cannot sell Government security to RBI that is part of bank's SLR quota.	bank can sell the Government security from its SLR quota to RBI.
Bank can borrow any amount of money as long as it has the securities to sell.	Bank can maximum borrow upto 2% of its NDTL.

Open Market operations-

RBI buys or sells govt securities to banks. Liquidity

LAF or MSF,	OMO
one party buys Government security from second party with (repurchase) agreement. So Government security is not "permanently" sold, it is only used as a collateral.	But in case of OMO, first party permanently sells the Government security to second party. Second party is free to do whatever it wants with that security.

Financial Intermediation

The key business of the banks is to accept different types of deposits from the public and then lend these funds to the borrowers. This is called Financial intermediation.

Acceptance of Deposits

Banks accepts deposits from public and channelizes this money in economy via loans to businesses. There are mainly two types of deposits viz. Time deposits (Term Deposits) and Demand Deposits.
Loans and Advances

Payment System s

A **paymentsystem** is any **system** used to settle financial transactions through the transfer of monetary value. The basic method of financial transactions is by negotiable instruments such as cheques and drafts.

In modern times, the electronic banking, wire transfers, real time settlements, internet banking etc. are various modes of financial transactions. Banks also enable the internal remittances, foreign exchange transactions, telegraphic transfers of money.

Financial Services

Apart from the above, Banks impart various financial services such as investment banking, insurance-related services, government-related business, foreign exchange businesses, wealth management services, etc.

Agency services

Banks also provide agency services to their customers which includes: Collection and payment of cheques and bills on behalf of customers. Collection of dividends, interest, rent etc. on behalf of customers, if so instructed by them.

Purchase and sale of shares and securities on behalf of customers. Payment of rent, interest, insurance premium, subscriptions, on behalf of customers, if so instructed. Acting as a trustee or executor.

Other functions

Various other functions of banks are as follows: Banks work as trustees for certain requirements of the businesses, governments and public. They issue Letter of credit for the purpose of facilitating trade. They help in the disbursement of the pension to pensioners. Enable Government to Government (G2G), Government to Corporate (G2C) transactions. Banks liaison with local government departments and government treasury.