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Money and Banking (Q.A)

Question 11

What is money multiplier? What determines the value of this multiplier?

ANSWER:

Money multiplier is the ratio of the stock of money to the stock of high powered money in an economy

i.e.
$$M_M = \frac{M}{H}$$

Where, M_M is the money multiplier

M represents stock of money

H represents high powered money

The value of money multiplier is always greater than 1.

The value of money multiplier can be derived as follows:

We know that $M = C + DD = (1 + cdr) DD$

Where,

M = Money supply

C = Currency held by people

cdr = Currency deposit ratio

DD = Demand deposits

Let treasury deposits of government be D

We know, High powered money = Currency + Reserve money

Or, $H = C + R$

$= cdr D + rdr D$

$= D (cdr + rdr)$ (Taking D common)

Money multiplier $= \frac{M}{H}$

So, the ratio of money supply to high powered money $\frac{M}{H}$ becomes

$$\frac{M}{H} = \frac{1 + cdr}{cdr + rdr}$$

But $rdr < 1$

So, $\frac{M}{H} = \frac{1 + cdr}{cdr + rdr} > 1$

The currency deposit ratio (cdr) and the reserve deposit ratio (rdr) play an important role in determining the money multiplier.

The currency deposit ratio (cdr) is the ratio of the money (currency) held by public to that they hold in bank deposits.

That is, $cdr = \frac{C}{DD}$

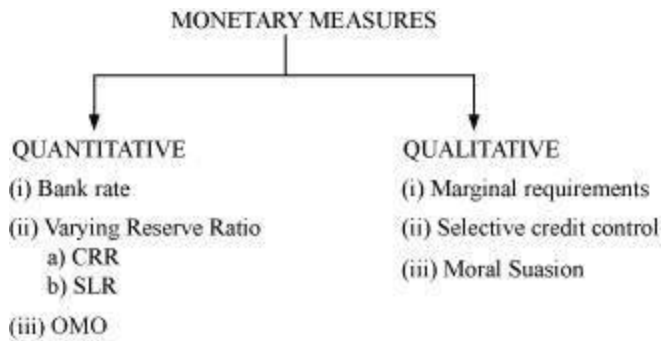
The reserve deposit ratio (rdr) is the proportion of the total deposits kept by the commercial banks as reserve

Question 12

What are the instruments of monetary policy of RBI?

ANSWER:

The monetary policy (credit policy) of RBI involves the two instruments given in the flow chart below:



Quantitative Measures

Quantitative measures refer to those measures that affect the variables, which in turn affect the overall money supply in the economy.

Instruments of quantitative measures:

1. Bank rate – The rate at which central bank provides loan to commercial banks is called bank rate. This instrument is a key at the hands of RBI to control the money supply.

Increase in the bank rate will make the loans more expensive for the commercial banks; thereby, pressurising the banks to increase the rate of lending. The public capacity to take credit will gradually fall leading to the fall in the volume of credit demanded. The reverse happens in case of a decrease in the bank rate. The increased lending capacity of banks as well as increased public demand for credit will automatically lead to a rise in the volume of credit.

2. Varying reserve ratios

The reserve ratio determines the reserve requirements, wherein banks are liable to maintain reserves with the central bank.

The three main ratios are:

(i) Cash Reserve Ratio (CRR)

It refers to the minimum amount of funds that a commercial bank has to maintain with the Reserve Bank of India, in the form of deposits. For example, suppose the total assets of a bank are worth Rs.200 crores and the minimum cash reserve ratio is 10%. Then the amount that the commercial bank has to maintain with RBI is Rs.20 crores. If this ratio rises to 20%, then the reserve with RBI increases to Rs.40 crores. Thus, less money will be left with the commercial bank for lending. This will eventually lead to considerable decrease in the money supply. On the contrary, a fall in CRR will lead to an increase in the money supply.

(ii) Statutory Liquidity Ratio (SLR)

SLR is concerned with maintaining the minimum reserve of assets with RBI, whereas the cash reserve ratio is concerned with maintaining cash balance (reserve) with RBI. So, SLR is defined as the minimum percentage of assets to be maintained in the form of either fixed or liquid assets with RBI. The flow of credit is reduced by increasing this liquidity ratio and vice-versa. In the previous example, this can be understood as rise in SLR will restrict the banks to pump money in the economy, thereby contributing towards decrease in money supply. The reverse case happens if there is a fall in SLR, as it increases the money supply in the economy.

3. Open Market Operations (OMO)

Open Market operations refer to the buying and selling of securities in an open market, in order to affect the money supply in the economy. The selling of securities by RBI will wipe out the extra cash balance from the economy, thereby limiting the money supply, whereas in the case of buying securities by RBI, additional money is pumped into the economy stimulating the money supply.

Qualitative Measures

The measures that affect the credit qualitatively are

1. Marginal Requirements

The commercial banks' function to grant loan rests upon the value of security being mortgaged. So, the banks keep a margin, which is the difference between the market value of security and the loan value. For example, a commercial bank grants loan of Rs.80,000 against security of Rs.1,00,000. So, the margin is calculated as $1,00,000 - 80,000 = 20,000$. When the central bank decides to restrict the flow of money, then the margin requirement of loan is raised and vice-versa in the case of expansionary credit policy.

2. Selective Credit Control (SCC's)

An instrument of the monetary policy that affects the flow of credit to particular sectors positively and negatively is known as selective credit control. The positive aspect is concerned with the increased flow of credit to the priority sectors. However, the negative aspect is concerned with the measures to restrict credit to a particular sector.

3. Moral Suasions

A persuasion technique followed by the central bank to pressurise the commercial banks to abide by the monetary policy is termed as moral suasion. This involves meetings, seminars, speeches and discussions, which explains the present economic scenario and thereby persuading the commercial banks to adapt the changes needed. In other words, this is an unofficial monetary policy that exercises the power of talk.

Question 13

Do you consider a commercial bank 'creator of money' in the economy'?

ANSWER:

Commercial banks play the important role of 'money creator' in the economy. They have the capacity to generate credit through demand deposits. These demand deposits make credit more than the initial deposits.

The process of money creation can be explained by taking an example of a bank XYZ. A depositor deposits Rs.10,000 in his savings account, which will become the demand deposit of the bank. Based on the assumption that not all customers will turn up at the same day to withdraw their deposits, bank maintains a minimum cash reserve of 10 % of the demand deposits, i.e. Rs.1000. It lends the remaining amount of Rs.9000 in the form of credit to other customers. This further creates deposits for the bank XYZ. With the cash reserve of Rs.1000, the credit creation is worth Rs.10,000. So, the credit multiplier is given by:

$$\text{Credit multiplier} = 1/\text{CRR} = 1/10\% = 10$$

The money supply in the economy will increase by the amount (times) of credit multiplier.

Question 14

What role of RBI is known as 'lender of last resort'?

ANSWER:

When a commercial bank faces financial crisis and fails to obtain funds from other sources, then the central bank plays the vital role of 'lender of last resort' and provides them with the financial assistance in the form of credit. This role of the central bank saves the commercial bank from bankruptcy. Thus, the central bank plays the role of guarantor for the commercial banks and maintains a sound and healthy banking system in the economy.
