The Supply of Money

Meaning, Measures and Determinants

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Introduction

The process of income determination in an economic system apart from real variables like saving, investment and productivity is also significantly influenced by the monetary forces (i.e. the demand for and supply of money).

The supply of money (Meaning)

The supply of money at any moment is the total amount of money in the economy. So the term "the supply of money" is synonymous with term as 'money stock', 'stock of money', 'money supply' and 'quantity of money'.

Debate on Measures of Money Supply

There has been no unanimity among the economists on the issue of what constitutes the supply of money. There are three alternative views regarding the definition or measures of money supply. The most common view is associated with the traditional and Keynesian thinking which stresses the medium of exchange function of money. According to this view, money supply is defined as the currency with the public and demand deposits with commercial banks **(M_1)**. Demand deposits are savings and current accounts of depositors in a commercial bank. But this is regarded as to narrow definition of the money supply.

The second viewpoint is broader and is associated with the modern quantity theorists headed by Milton Friedman. Prof. Friedman defines money supply at any moment of time as "literally the number of dollars people are carrying around in their pockets, the number of dollars they have to their credits at banks or dollars they have to their credit at banks in the form of demand deposits, and also commercial banks time deposits." This definition includes **M_1** plus time deposits of commercial banks in the supply of money. This wider definition is characterised as **M_2** in America and **M_3** in Britain and India which stresses the store of value function of money.

The third definition is the broadest and is associated with Gurley and Shaw. They include in the supply of money **M_2** plus deposits of savings banks, societies, loan association, and deposits of other credit and financial institutions.

But the controversy still goes on unabated on this issue and the economists have still to arrive at the most satisfying workable definition of money stock.

Determinants

There are two theories of the determination of the money supply. According to the first view, the money supply is exogenously by the central bank. The second view holds that the money supply is determined endogenously by changes in the economic activity which affect people's desire to deposits the rate of interest etc.

Thus the determinants of money supply are both exogenous and endogenous described below:-

1. Required Reserve Ratio:- The required reserve ratio (or the minimum cash reserve ratio or the reserve deposit ratio) is an important determinant of the money supply. An increase in the required reserve ratio reduces the supply of money with commercial banks and a decrease in required reserve ratio increases the money supply. The required reserve ratio is the ratio of cash to current and time deposit liabilities which is determined by law. Every commercial bank is required to keep a certain percentage of these liabilities in the form of deposits with the central bank of the country.

But the short-term assets along with the cash are regarded as the liquid assets of a commercial bank. In India the *Statutory Liquidity Ratio* **(SLR)** has been fixed by law as an additional measure to determine the money supply.

2. Amount of Bank Reserves:- The variations in the amount of reserves of Commercial banks have their effect upon the supply of money. The total measures of the commercial banks are comprised of the *Required Reserves* **(RR)** of commercial banks that they are required to keep with the central bank and those reserves which they hold themselves. The Central Bank can bring about changes in commercial banks' reserves and changes in the bank rate.

Purchase of securities by the central bank can raise the reserves of commercial banks while the central bank can reduce the reserves of commercial bank through the sale of securities in the open market. The increase in the **Bank rate** or rate of discounting results in the reduction in the commercial bank reserves. On the opposite, the reduction in bank rate brings about an increase in the excess reserves of commercial banks.

3. Cash or Deposit Holding:- Peoples desire to hold currency or cash relative to deposits in commercial banks also determines the money supply. If people are in the habit of keeping less in cash and more in deposits with the commercial banks, the money supply will be large. This is because banks can create more money with larger deposits. On the contrary, if people do not have banking habits and prefer to keep the money holdings in cash, credit creation by banks will be less and the money supply will be at a low level.

4. High Powered Money:- The current practice is to explain the determinants of the money

supply in terms of the monetary base or high-powered money. The *high powered money* **(H)** or monetary base is constituted by currency held by the public **(C)** and the commercial bank reserves **(R).**

H=C+R

High powered money is the base for the expansion of bank deposits and creation of the money supply. The supply of money varies directly with changes in the monetary base, and inversely with the currency and reserve ratios.

5. Other Factors:- The money supply is a function not only of the high-powered money determined by the monetary authorities but of interest rates, income and other factors. The latter factors change the proportion of money balances that the public hold as cash. Changes in business activity can change the behaviour of banks and the public and thus affect the money supply.

Conclusion: We have discussed above what is supply of money and the factors which determine money supply and came to the conclusion that money supply is not only an exogenous controllable item but also an endogenously determined item.