NET & SET Economics: Money and Banking

Prepared by Dr.A.Deepika

1. Components of Money Supply

Money: meaning and functions

- **Primary functions:** medium of exchange, measure of value (unit of account).
- **Secondary functions:** store of value, standard of deferred payments.
- **Contingent functions:** basis of credit, distribution of national income, equalising marginal utilities, liquidity.
- Kinds: commodity money, fiat money (legal tender), fiduciary money (cheques), near money (time deposits, bills, bonds), plastic and digital money, **Central Bank Digital Currency (e₹, RBI pilot from December 2022)**.
- Gresham's law: "bad money drives good money out of circulation."

Money supply concepts used by RBI

Measure	Components	Nature
M0 — Reserve money (high-powered money)	Currency in circulation + Bankers' deposits with RBI + Other deposits with RBI	Base money
M1 — Narrow money	Currency with the public + Demand deposits with banks + Other deposits with RBI	Most liquid
M2	M1 + Savings deposits with post office savings banks	
M3 — Broad money	M1 + Time deposits with banks	Most commonly used; called aggregate monetary resources
M4	M3 + All deposits with post office savings organisation (excluding NSCs)	Least liquid

- Liquidity declines from M1 to M4.
- **Fourth Working Group on Money Supply (Y.V. Reddy, 1998)** introduced new monetary aggregates (NM0, NM1, NM2, NM3) and liquidity aggregates (L1, L2, L3) including deposits with financial institutions and post offices.
- "Other deposits with RBI" include deposits of quasi-government bodies, foreign central banks and international agencies.

Determinants and sources

- **Money multiplier:** $M = m \cdot H$; $m = (1 + c)/(c + r)$, where c = currency–deposit ratio, r = reserve–deposit ratio.

- **Sources of reserve money:** net RBI credit to government, RBI credit to banks and commercial sector, net foreign exchange assets of RBI, government's currency liabilities to public, less net non-monetary liabilities of RBI.
- **Sources of broad money (M3):** net bank credit to government, bank credit to the commercial sector, net foreign exchange assets of the banking sector, government currency liabilities, less net non-monetary liabilities of the banking sector.
- Exogenous (central bank controlled) vs endogenous (demand-determined) money supply.

Exam pointers: components of M1 and M3; Reddy Working Group; money multiplier formula; sources of reserve money.

2. Central Bank

A central bank is the apex monetary institution that regulates money and credit, issues currency and supervises the banking system.

Reserve Bank of India

- Established **1 April 1935** under the RBI Act, 1934, on the recommendation of the **Hilton Young Commission (1926)**; nationalised on **1 January 1949**. Headquarters moved from Kolkata to Mumbai in 1937.
- Governed by a Central Board of Directors.

Functions

Function	Details
Issue of currency	Sole authority to issue notes (except ₹1 notes and coins, issued by Government of India); **Minimum Reserve System** since 1957 — ₹200 crore of gold and foreign assets, of which ₹115 crore gold
Banker to government	Manages accounts, public debt, ways and means advances for Centre and States
Bankers' bank	Holds cash reserves of banks; **lender of last resort**
Monetary authority	Formulates and implements monetary policy (inflation target)
Regulator and supervisor	Banking Regulation Act, 1949; Board for Financial Supervision (1994); prudential norms
Foreign exchange manager	Administers FEMA, 1999; manages reserves and exchange rate
Payment and settlement systems	Payment and Settlement Systems Act, 2007; RTGS, NEFT; oversees NPCI-run UPI
Developmental role	Financial inclusion, priority sector lending, institution building (IDBI, NABARD, NHB, EXIM Bank had RBI origins)

Central bank independence

- Independence enhances credibility and reduces inflation bias (time-inconsistency argument — Kydland–Prescott, Barro–Gordon, **Rogoff's conservative central banker**).

- RBI Act amended in 2016 for statutory **Monetary Policy Committee** and **flexible inflation targeting**.

Exam pointers: RBI founding dates; Hilton Young Commission; minimum reserve system; lender of last resort; central bank independence.

3. Commercial Banking

Functions

- **Primary:** accepting deposits (demand — current and savings; time — fixed and recurring) and lending (loans, cash credit, overdraft, discounting bills).
- **Secondary:** agency functions (collection, payments, portfolio management) and utility functions (lockers, letters of credit, remittances, underwriting).
- **Credit creation:** banks create derivative deposits through loans.

Credit creation

Deposit multiplier = 1/r; Total deposits = Initial primary deposit × 1/r

- With r = 10%, ₹100 of new reserves can support ₹1,000 of deposits.
- Limits: cash reserve ratio, currency drain (leakage into cash), excess reserves held by banks, availability of creditworthy borrowers, monetary policy.
- Theories: Walter Leaf (banks cannot create credit) vs Hartley Withers, Crowther (banks create credit).

Principles of bank management

- Liquidity, profitability, safety (solvency) — trade-off between liquidity and profitability.
- Theories of liquidity management: **commercial loan (real bills) theory**, **shiftability theory** (Moulton), **anticipated income theory** (Prochnow), **liability management theory**.

Structure and reforms in India

- Scheduled (in the Second Schedule of the RBI Act) and non-scheduled banks; public sector, private sector, foreign, regional rural banks (1975), cooperative, small finance banks and payments banks (2015).
- **Nationalisation:** Imperial Bank → State Bank of India (1955); 14 banks (19 July 1969); 6 banks (1980). Public sector banks consolidated from 27 to 12 (mergers effective 2019–2020).
- **Narasimham Committee I (1991)** and **II (1998):** lower CRR/SLR, deregulated interest rates, prudential norms (income recognition, asset classification, provisioning), capital adequacy, entry of new private banks.
- **Basel norms:** Basel I (1988), Basel II (three pillars — minimum capital, supervisory review, market discipline), Basel III (higher quality capital, capital conservation buffer, liquidity coverage ratio, net stable funding ratio, leverage ratio).
- **Non-performing assets (NPAs):** loan overdue for more than 90 days. Resolution tools: SARFAESI Act 2002, Debt Recovery Tribunals, **Insolvency and Bankruptcy Code (2016)**, asset reconstruction companies, NARCL (“bad bank”, 2021), Prompt Corrective

Action framework; Asset Quality Review (2015) and 4R strategy (recognition, resolution, recapitalisation, reforms).
- **Financial inclusion:** Lead Bank Scheme (1969), Pradhan Mantri Jan Dhan Yojana (2014), business correspondents, priority sector lending (40% of adjusted net bank credit for domestic banks).
- **Deposit insurance:** DICGC covers up to ₹5 lakh per depositor per bank (raised from ₹1 lakh in 2020).

Exam pointers: credit multiplier; Narasimham committees; Basel pillars; NPA definition; nationalisation years.

4. Instruments and Working of Monetary Policy

Monetary policy is the use of money supply, credit and interest rates by the central bank to achieve macroeconomic objectives.

Objectives

- Price stability, economic growth, financial stability, exchange-rate stability, employment.
- In India the primary objective is **price stability while keeping in mind the objective of growth**.

Instruments

Quantitative (general)	Qualitative (selective)
Policy repo rate (key policy rate under the Liquidity Adjustment Facility)	Margin requirements on loans against securities
Standing Deposit Facility (SDF, introduced April 2022 as floor of the corridor, replacing reverse repo)	Credit rationing / ceilings
Marginal Standing Facility (MSF, 2011 — ceiling of the corridor)	Regulation of consumer credit
Bank rate (aligned with MSF)	Moral suasion
Open Market Operations (OMOs), variable rate repo/reverse repo auctions	Direct action
Cash Reserve Ratio (CRR)	Publicity
Statutory Liquidity Ratio (SLR)	Priority sector directions
Market Stabilisation Scheme (MSS, 2004), forex swaps	

- Policy rates and reserve ratios change frequently; check RBI's latest Monetary Policy Statement for current values.

Monetary policy framework in India

- **Chakravarty Committee (1985):** monetary targeting with feedback (M3 growth).
- **Multiple indicator approach** (1998).
- **Urjit Patel Committee (2014):** flexible inflation targeting with CPI-Combined as anchor.
- **Monetary Policy Framework Agreement (2015)** and RBI Act amendment (2016): inflation target of **4% CPI with a tolerance band of 2–6%**, set by the Government for

five-year periods (first set in 2016, retained for 2021–26). Failure: inflation outside the band for three consecutive quarters → RBI reports reasons to Government.

- **Monetary Policy Committee (MPC):** six members — three from RBI (Governor as chair, with casting vote; Deputy Governor; one officer) and three external members appointed by Government; meets at least four times a year (in practice six).

Transmission mechanism

- Policy rate → money market rates → bank lending and deposit rates → consumption, investment → output and inflation.
- Channels: interest rate, credit, asset price, exchange rate, expectations.
- External benchmarking of loan rates (repo-linked lending rates, from October 2019) improved transmission over earlier MCLR (2016), base rate (2010) and BPLR systems.

Limitations in developing economies

- Large informal sector, underdeveloped money markets, fiscal dominance, supply-side inflation (food), weak transmission, capital flow volatility.

Exam pointers: LAF corridor (SDF–repo–MSF); inflation target 4% ± 2%; MPC composition; Urjit Patel Committee; CRR vs SLR.

5. Non-Banking Financial Institutions

Non-bank financial institutions (NBFIs) provide financial services but do not hold a banking licence; they cannot accept demand deposits or issue cheques drawn on themselves.

Types

- **Development Financial Institutions (DFIs):** IFCI (1948), ICICI (1955, converted into a bank in 2002), IDBI (1964, now a bank), SIDBI (1990), NABARD (1982), EXIM Bank (1982), NHB (1988), and **NaBFID** (National Bank for Financing Infrastructure and Development, 2021).
- **Non-Banking Financial Companies (NBFCs):** registered under the Companies Act and regulated by RBI — investment and credit companies, infrastructure finance companies, microfinance institutions (NBFC-MFIs), housing finance companies (regulated by RBI since 2019), core investment companies, factoring companies, account aggregators, peer-to-peer lenders.
- **Scale-Based Regulation (RBI, effective October 2022):** NBFCs placed in base, middle, upper and top layers with progressively stricter norms.
- **Insurance companies:** LIC (1956), GIC; regulated by IRDAI (1999).
- **Mutual funds:** UTI (1964), others regulated by SEBI.
- **Pension funds:** EPFO, National Pension System regulated by PFRDA.
- **Others:** chit funds, nidhis, venture capital, asset reconstruction companies, primary dealers.

Role and issues

- Mobilise savings, credit to under-served sectors (MSMEs, vehicle finance, rural areas), product innovation, competition to banks.

- **Gurley and Shaw (1960):** NBFIs reduce the effectiveness of monetary policy because they create near-money outside central bank control.
- **Radcliffe Committee (UK, 1959):** stress on overall liquidity of the economy, not just money supply.
- Risks: asset–liability mismatch (IL&FS crisis 2018, DHFL), shadow banking, interconnectedness with banks.

Exam pointers: DFIs and their years; NBFC vs bank; scale-based regulation layers; Gurley–Shaw thesis; Radcliffe Committee.

6. Capital Market and its Regulation

The financial market consists of the **money market** (short-term funds, up to one year) and the **capital market** (long-term funds).

Money market

- Instruments: call money (overnight), notice money (2–14 days), term money, treasury bills (91, 182, 364 days), commercial paper, certificates of deposit, repos, Tri-party repo (TREPS).
- Indian money market was characterised by dichotomy (organised vs unorganised) and was reformed following the **Sukhamoy Chakravarty (1985)** and **Vaghul (1987)** committees.

Capital market

Segment	Function
Primary market (new issue market)	Raising fresh capital through IPOs, follow-on offers, rights issues, private placements, qualified institutional placements
Secondary market (stock exchanges)	Trading in existing securities; provides liquidity and price discovery
Debt market	Government securities (G-secs) and corporate bonds
Derivatives market	Futures and options on equity indices, stocks, currencies, interest rates

- Stock exchanges: **BSE** (1875, oldest in Asia; Sensex 1986), **NSE** (1992, Nifty 50); depositories NSDL (1996) and CDSL (1999) enable dematerialised trading; rolling settlement moved to **T+1** (completed January 2023).
- Participants: retail and institutional investors, FPIs, mutual funds, merchant bankers, brokers, credit rating agencies (CRISIL, ICRA, CARE).

Regulation

- **SEBI** — established in 1988, statutory powers under the **SEBI Act, 1992**; replaced the Controller of Capital Issues. Objectives: protect investors, develop and regulate the securities market.
- Major steps: free pricing of issues, disclosure norms, book building, insider trading and takeover regulations, screen-based trading, demat, corporate governance norms (Clause 49 / LODR), investor protection fund, SCORES grievance redressal.
- Other regulators: RBI (G-secs, money and forex markets), IRDAI (insurance), PFRDA (pensions), IFSCA (international financial services centres, GIFT City).

- Market efficiency: **Efficient Market Hypothesis (Fama, 1970)** — weak, semi-strong and strong forms.
- Scams prompting reforms: Harshad Mehta (1992), Ketan Parekh (2001), Satyam (2009).

Exam pointers: money vs capital market instruments; primary vs secondary market; SEBI Act 1992; BSE/NSE dates; T+1 settlement; EMH forms.