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# UNIT 2 DEMAND FOR AND SUPPLY OF MONEY

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## 2.0 OBJECTIVES

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After studying this Unit, you should be able to:

- 6 explain the concepts of demand for and supply of money
- state why money is demanded
- identify the various determinants of demand for money
- 6 discuss the basic differences in the various theories relating to demand for money
- distinguish between the conventional and the modern concepts of money supply.

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## 2.1 INTRODUCTION

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In the previous unit you learnt about the nature and importance of money in modern complex economies. You also learnt that money performs four basic functions, viz., it is a medium of exchange, a unit of measurement, a standard of deferred payment, and a store of value. But the fundamental reason why money can be used for these functions is that the public considers money as an asset representing a claim over goods and services. Like any other asset, money is demanded and supplied. In this unit, we will discuss the concepts of demand for and supply of money, various theories relating to demand for money, and the conventional and modern concepts of money supply.

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## 2.2 MEANING OF DEMAND FOR MONEY

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Money is a stock variable. The money stock is the quantity of money at a point of time. As an asset, money is demanded because public desires to hold it. The motive for holding money and the time period for which it is held, of course, may differ from individual to individual. A person may hold cash for spending on goods and services. He may also demand money for hoarding it, i.e. keeping idle cash. **Demand for money in an economy is, thus, the sum total of money demanded by all individuals/households in that economy.**

The theory of demand for money addresses itself to the following two fundamental questions :

- 1) Why does an individual/household want money?
- 2) What are the main determinants of demand for money ?

Several explanations have been offered in reply to these questions, known as theories of demand for money. Let us discuss those theories now.

## 2.3 THEORIES OF DEMAND FOR MONEY

There are two main approaches to explain the demand for money : 1) the classical approach, and 2) the Keynesian approach. Related to classical approach is the neo-classical theory, which is based on the same assumptions but different determinants when compared to the classical theory.

### 2.3.1 The Classical Approach

This theory is often associated with economists like J.S. Mill and Irving Fisher. According to them, people demand money because every individual and business firm gets money by selling goods and services (including factor services) and in turn use this money for the purchase of goods and services produced by others. Hence, from the view point of classical economists, people wish to hold cash balances in order to carry out day-to-day transactions. The amount of money demanded by an individual or a business firm therefore, depends upon the volume of transactions. Since there is a fairly stable relationship between the level of income and the volume of transactions, the former is taken as an approximation for the latter.

### 2.3.2 The Neo-classical Theory

The early neo-classical theory of the demand for money was put forward by the Cambridge economists Alfred Marshall and A.C. Pigou. That is why the neo-classical theory is also called the 'Cambridge Equation Approach'.

According to Cambridge approach, a proportionate relationship exists between the 'demand for money' ( $M^d$ ) and the 'money value of national output' (Y). Demand for money function, therefore, takes the form:

$$M^d = KY \dots\dots\dots (1)$$

where K is a constant ( $0 < K < 1$ ).

It may be seen from Equation (1) that  $K = \frac{M^d}{Y}$ , i.e.

the demand for money per rupee of income (per unit of time). In other words, the Cambridge K would show the proportion of income which, on average, the public

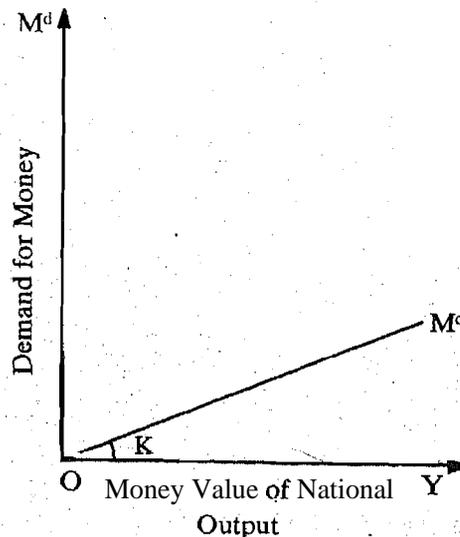


Fig. 2.1. Demand for Money Function

would like to hold in the form of Money. This is represented in Figure 2.1. where changes in demand for money are in direct proportion to the changes in Y — the proportion between them being equal to K. It may be noted that Cambridge Equation specifies the demand for money as a function of money income alone.

Equation (1) may be rewritten as

$$M^d = K \cdot P \cdot Y \dots\dots\dots (2)$$

where P = general price level

Y = real national income

Equation (2) gives us the demand function for real money. One of the key features of this equation is that it shows a proportionate relationship of  $M^d$  with P and y. It implies that any change in the general price level or in real national income would lead to an equal proportionate change in the demand for money, i.e., the income elasticity as well as the price elasticity of demand for money are both equal to unity. It may be noted that the neo-classicals have postulated a very simple function of demand for money which has been fruitfully applied in the development of quantity theory of money.

A comparison of the classical and neo-classical theories of demand for money reveals that, though the basic assumptions of these theories are similar, yet they differ from each other in one important way: the classical approach was concerned with the volume of total transactions, while the Cambridge approach focused primarily on the level of income.

Check Your Progress A

1) Explain the concept of demand for money.

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2) Point out similarities and dissimilarities of the classical and neo-classical theories of demand for money.

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3) Which of the following statements are True and which are False?

- i) Money is mainly demanded by the public.
- ii) The classical theory postulates that money is demanded because it functions as a medium of deferred payments.
- iii) According to the Cambridge approach demand for money changes in direct proportion to changes in the money value of national product.
- iv) Public considers money as an asset representing a claim over goods and services.

**233 Keynesian Theory**

John Maynard Keynes gave his own formulation of demand for money in his well-known book, *The General Theory of Employment, Interest and Money*. Some of the economists who agreed with the Keynesian framework of analysis helped in further development of Keynesian theory of demand for money.

Keynes began by asking the following two inter-related questions :

- i) Why is money demanded ?
- ii) What influences the demand for money ?

His answers to these questions gave us the Keynesian Theory of demand for money, Now let us study the answers to these questions.

Why Is Money Demanded ?

We know that money in hand does not earn any income. On the other hand, there are always certain competing non-money assets which give some returns to their holders. The fundamental question that arises, therefore, is: what is the motive of holding assets in the form of money? Its general explanation is that, money being the only commonly acceptable means of payment, it has the advantage of being perfectly liquid, which is not there in case of other assets. Keynes put this idea in more concrete form when he classified the motives for holding money into three categories: a) transactions motive, b) precautionary motive, and c) speculative motive.

In order to meet current transactions of all kinds, people hold some cash, known as transactions demand for money; while they demand money for precautionary purposes when they hold it to provide for contingencies and unforeseen profitable opportunities. Cash held over and above that needed for transaction and precautionary purposes is known as speculative demand for money. The detailed discussion of these three motives is given below.

The Determinants of Demand for Money

1) The transactions motive

The time of receiving income and the time of incurring expenditure by an individual/firm generally do not coincide. In order to meet the needs of transactions during this time gap some money is kept aside, known as the transactions demand for money. The smaller the time gap between a person's receipts and payments, lesser will be the transactions demand for money. Let us understand this with the help of an illustration. Two individuals, A and B who had the same salary per month say Rs. 4,000. Individual A is paid Rs. 4,000 on first day of every month, while B is paid Rs. 1,000 on first day of every week (making an aggregate of Rs. 4,000, assuming exactly four weeks in a month). Assuming that the each individual spends his income each day in such equal amounts that at the end of the income-period they are left with zero cash balance. The pattern of transactions balance of the two individuals is shown in Figure 2.2. The above assumption implies that the average transactions balance during the income-period would be equal to half of the income of that period. Individual A would therefore, have a transactions balance of Rs. 4,000 X 1/2 = Rs. 2000, while transactions balance of individual B would be Rs. 1,000 X 1/2 = Rs. 500.

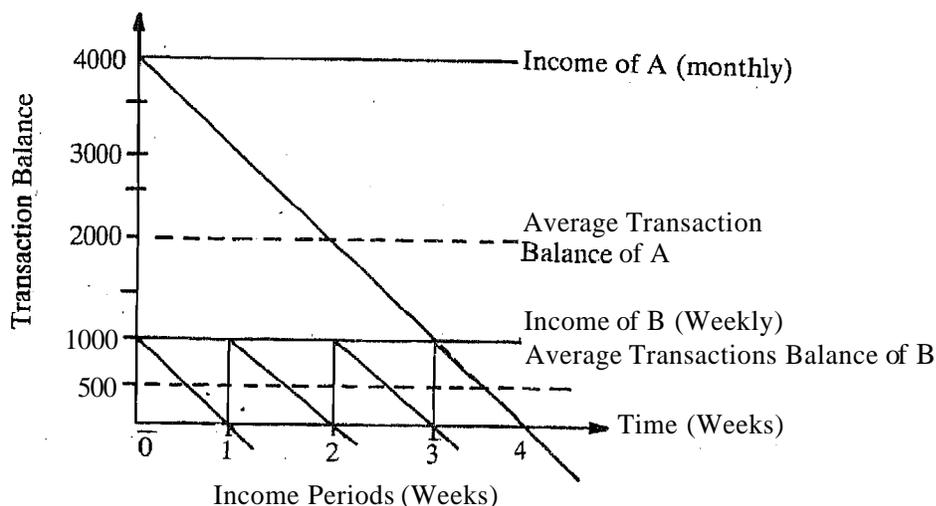


Fig. 2.2 The Transaction Demand for Money and the Income-period.

However, the assumption of an even distribution of expenditure over the income-period seems very simplistic. Certain payments like the monthly bills for electricity, water, telephone, house rent, children's school fee, etc., and other lump sum payments are generally made at the beginning of the month. Cash holdings, therefore, decline rapidly during the early part of the income period.

Business firms also need cash for meeting their day-to-day transactions. But their receipts and payments are not as regular as those of the households. Compared to households, therefore, the firms must keep relatively larger cash balances at any point of time.

From the above analysis, it is clear that the transactions demand for money depends upon the volume of transactions, which are directly related to the level of income. This relationship between the transactions demand for money ( $L_1$ ) and the level of money income ( $Y$ ) is expressed as :

$$L_1 = f(Y) \dots\dots\dots(3)$$

For simplification it is assumed that the relationship expressed in Equation (3) is stable over time. This is diagrammatically shown in Figure 2.3, where transactions demand for money increases in direct proportion to the increase in income.

Apart from income, certain other factors are also relevant to the transactions demand for money in the long run. For example, if a particular society decides to change its payment period from monthly to weekly, the average amount of cash held per day will decline significantly. In a similar manner, the level of monetisation in developing countries is yet another factor to be taken into account. As barter transactions decline, more cash is needed to facilitate transactions.

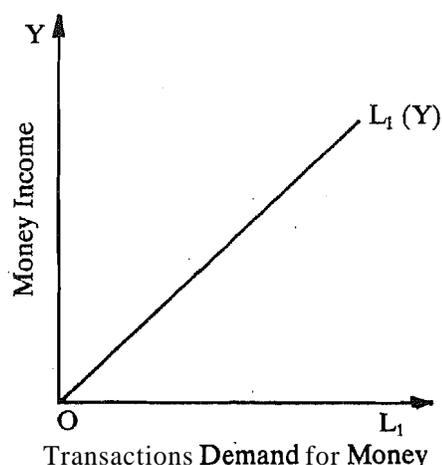


Fig. 2.3 Transactions Demand for Money Function

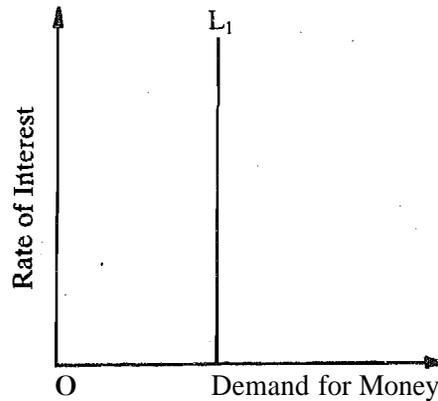
Keynes treated transactions demand for money as a function of income alone. However, later economists attempted to show that the transactions demand is affected by the changes in interest rate also. At higher rates of interest, transactions demand is interest-elastic, as a high rate of interest implies higher opportunity cost of holding money, i.e., higher sacrifice in terms of interest income. It is at very low rates of interest that transactions demand is interest-inelastic. However, Keynes believed that money for transactions purposes is held mainly for the sake of convenience and not for earning interest. The interest-inelastic transactions demand is shown in Figure 2.4.

## 2) The Precautionary Motive

The precautionary demand for money arises mainly due to the uncertainty of future receipts and expenses. The cash held by an individual/firm helps in meeting unexpected fall in receipts or rise in expenditure or both in future.

Like transactions demand, precautionary demand for money also is related to the level of income, and varies directly with it. Compared to a small firm, a firm having high turnover needs more cash in hand. In a similar manner, a rich man generally needs a larger amount of cash for precautionary purposes. A firm's precautionary demand for money is influenced not only by the level of income of the firm but also by factors like political situation and business conditions prevailing in the economy. If the political situation is unstable or the business conditions look bleak, there will be greater demand for precautionary balances, and vice versa. It may be noted that since precautionary demand for money is generally found to be directly related to the level

of income, **Keynes** clubbed such demand for **money** with the **transactions** demand for money.



**Fig. 24 Relation between interest and transaction demand for money.**

### 3) **The Speculative Motive**

The Keynesian proposition that the money is held for transactions and precautionary purposes does not **conflict** with the classical theory: a transactions balance is nothing but money serving as the medium of **exchange**. Same can be said for the precautionary balances **also**. However, the third motive **introduced** by Keynes, viz., the speculative motive for holding money, represents a distinct break from the **classical** theory. The **speculative** demand for money **is also sometimes** called the 'asset **demand for money**'.

According to the speculative motive, money is demanded as an **asset** to make speculation in bonds which are **long-dated** government securities. The speculative demand for money comes from the people who desire to make capital gains by buying bonds when their prices are low and selling them **when** their prices rise. **People** holding speculative balances keep anticipating about the behaviour of **bond** prices in future. If they expect bond prices to fall in future, they **hold speculative balances** so as to be able to buy the bonds when their prices actually fall and sell them when **their prices actually** go up.

The bond **prices** (or the capital value of bonds) are inversely related to the **rate of** interest. A fall in the interest rate will lead to an increase in the bond prices, and **vice versa**. Suppose a Rs. 100 bond yields an annual return of 5%. Let us say the market rate of interest goes up to 10%. Since the return on this **bond** has reduced to half compared to the market interest rate, the price of bond (or the capital value of bond) will naturally reduce to Rs. 50. Since the bond prices are affected by the interest rate changes, the speculative demand also becomes a function of the interest rates and there is an inverse relationship between the two. There are two reasons for this inverse relationship:

- 1) As mentioned earlier Keynes considered holding bonds as an alternative to holding cash. Given a choice between bonds and money, the higher the rate of interest, the greater is the opportunity cost of holding cash. Hence, at higher interest rates more bonds and less cash are held.
- 2) An important reason for the inverse relationship is the existence of expectations. At high interest rate it is expected that the interest rate will fall. A fall in interest rate would mean **an** increase in the price of bonds. If the price of bonds is expected to go up in future, people buy more bonds now, resulting in **decline** in cash balances. This inverse relationship between

speculative demand for money and rate of interest is shown in Figure 2.5. As rate of interest declines, the demand for speculative balances increase. Eventually a stage may come when rate of interest becomes so **low** that people prefer to hold the whole of their assets in cash only. In other words, Keynes suggested that at **a certain** very low rate of interest, the **speculative** demand for money becomes perfectly elastic. This is known as liquidity trap. In Figure 2.5 such a situation arises when the rate of

interest falls down to  $r^*$  — this is the limit below which the rate of interest cannot fall. The flat part of the curve indicates that the expectation about the future fall in bond prices is so universal that everyone will hold cash and not bonds. The situation is important from the point of view of the monetary policy. If the economy is in liquidity trap, it would mean that even the money supply is increased, the rate of interest will not fall as the economy is already operating at the minimum rate of interest

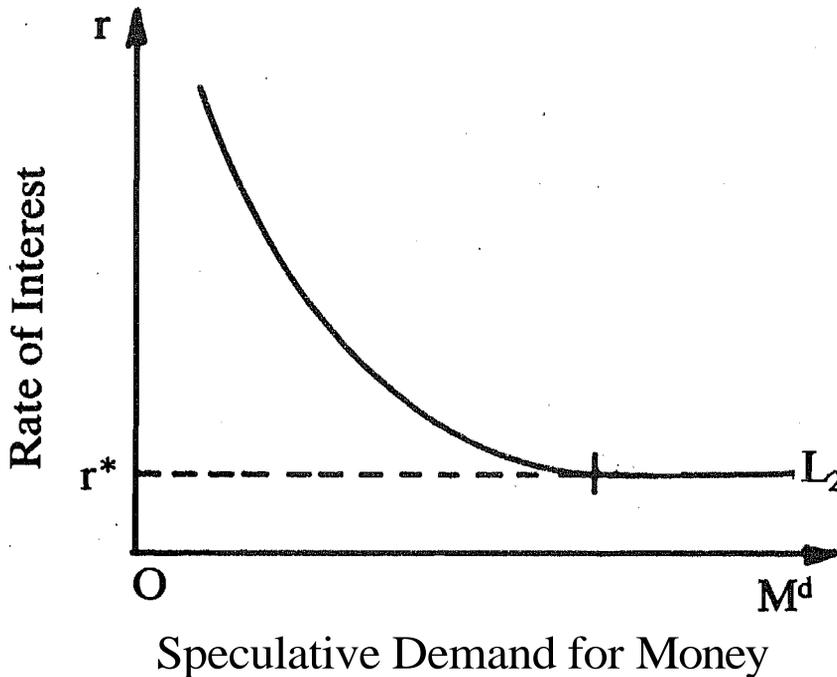


Fig. 2.5. Keynes' speculative demand for money.

Another important element in the Keynes' Theory of speculative demand is the concept of 'normal rate of interest'. According to Keynes, at any particular time period, there exists a certain 'r' which the speculators consider as 'normal', i.e., the rate of interest which will prevail in the market under normal conditions. It is in relation to this normal rate that the current rate of interest is judged as low or high. A rate higher than the normal rate of interest will produce expectations of its fall in future, and vice-versa. Hence, the speculative demand for money depends on the current rate of interest in relation to the normal rate.

It will be relevant here to make distinction between active and idle cash balances, as given by Keynes. The active balances are those which are used as means of payment for meeting transactions, while the rest are idle balances. The transactions and precautionary demand for money are sometimes called the demand for active balances, while money demanded for speculative purposes is called the demand for idle balances.

Total demand for money

According to the Keynesian Theory, the total demand for money  $M^d$  is composed of  $L_1$  and  $L_2$ ; i.e.

$$M^d = L_1(Y) + L_2(r) \dots\dots\dots (4)$$

Where,  $L_1(Y)$  represents the transactions and precautionary demands for money, both of them being an increasing function of the level of money income (Y). The third component, viz.,  $L_2(r)$ , represents the speculative demand for money which is a declining function of rate of interest (r). Equation (4) is an additive function of demand for money showing that the demand for money is the sum of interest-inelastic component of transactions and precautionary demands ( $L_1$ ) and interest-elastic

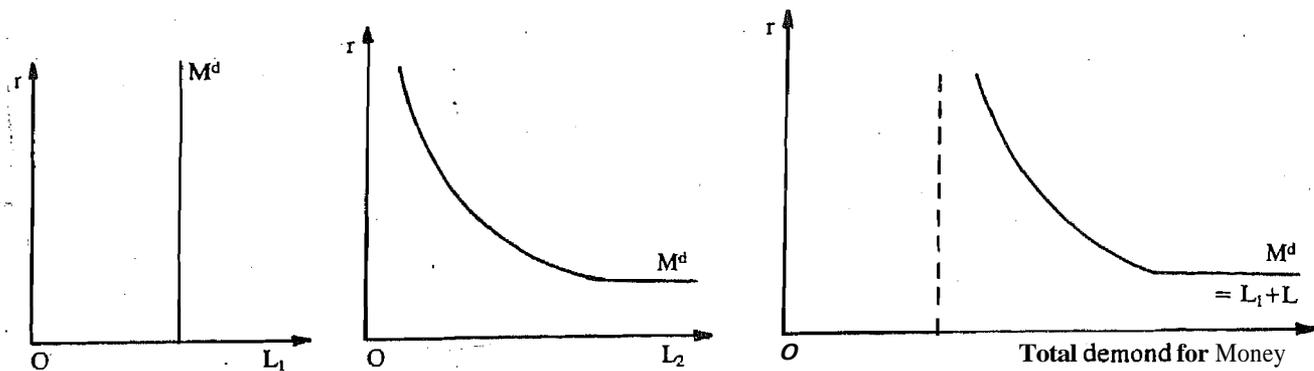


Fig. 2.6. Total Demand for Money (i.e.,  $L_1 + L_2$ )

However, the post-Keynesian economists believe that money is one asset only and the same unit of money can serve all the three motives. So the demand for money, cannot really be compartmentalized into different motives as shown by the additive function. Economists like **Tobin** and **Baumol** have tried to show that transactions demand for money is not only income-elastic but is also interest-elastic. The same argument can be given for the precautionary demand also. On the other hand, the speculative demand can be shown as an increasing function of the total wealth. Taking income as a proxy for wealth, the speculative demand can also be shown to depend upon both the rate of interest and the level of income. In the light of this, we can modify Equation (4) as:

$$M^d = L(Y, r) \dots\dots\dots (5)$$

In Equation (5) demand for money ( $M^d$ ) is positively related to Y and negatively related to r.

**Check Your Progress B**

- 1) What is the main difference between the classical and the Keynesian theory of demand for money?

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- 2) Explain briefly the speculative motive for holding money,

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- 3) What is a 'liquidity trap' ?

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- 4) Which of the following statements are True and which are False ?  
 i) Idle cash balances are used for meeting transactions.

- ii) There is a negative relationship between the level of income and the transaction balances.
- iii) The speculative demand for money is inversely related to the level of income.
- iv) Monetary policy works very effectively in the situation of liquidity trap.

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## 2.4 THE SUPPLY OF MONEY

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### 2.4.1 What is Supply of Money ?

Supply of money in an economy at any point of time refers to the volume of money held by the households and firms for transactions and settlement of debts. In the generally accepted measures of money supply we do not include the money held by the government and money lying with the commercial banking sector. This is done mainly to separate the producers of money (i.e. government and banking system) from the demands of it (i.e., the households, firms and institutions).

The supply of money at any point of time consists of:

- 1) Currency: It consists of both paper currency and the coins in circulation. The former is in terms of currency notes of the denomination of rupees two and above issued by the central bank, i.e. Reserve Bank of India, and rupee one notes issued by the Government of India.
- 2) Net demand deposits: Total demand deposits with banks include deposits from public and those deposits which one bank holds with other banks (viz., inter-bank deposits). Only the former component of total demand deposits are included in supply of money, as money, by definition, is something held by public.
- 3) 'Other deposits' with Reserve Bank of India: They include demand deposits of quasi-government institutions, foreign central banks, foreign governments, the World Bank, etc. This component of money has been a very negligible proportion of total money supply in India.

The conventional measure of money supply (known as M) includes coins and currency notes in circulation with the public and the net demand deposits. This measure is often referred to as a narrow measure of money supply.

In modern literature on money supply, distinction between money and liquidity has been emphasized. In this context, it may be found that it is not only money (in the conventional sense) but also near-money that is part of the liquid assets available with the public for spending. People's ability to spend, therefore, depends upon the amount of overall liquidity in the economy which depends both on the total stock of money as well as near-money assets. In the near-money assets we include:

- i) savings deposits with post office savings banks and commercial banks, and
- ii) time deposits of the banks (net of inter-bank deposits).

We know that cheque facility is available against the saving deposits, which adds to liquidity. Similarly, fixed deposits can be prematurely encashed or a loan can be taken against them. Both these options result in greater liquidity.

Till 1967-68, the Reserve Bank of India defined money supply only in the conventional manner (i.e., M). But from 1967-68, it also started publishing a broader measure of money supply and called it aggregate monetary resources (AMR). Since 1977, the RBI has added two other measures of money supply, called  $M_2$  and  $M_4$ . These four alternative measures of money supply, as given by the RBI, may be stated as:

$M$  or  $M_1$  = currency held by the public + demand deposits of the public

$M_2$  =  $M_1$  + savings deposits with post office

AMR or  $M_3$  =  $M_1$  + time deposits of banks held by the public

$M_4$  =  $M_3$  + total post office deposits

Both  $M_1$  and  $M_3$  are conceptually the same as M and AMR respectively. However, these differ in their coverage.  $M_1$  and  $M_3$  measures of money supply give a better coverage to the co-operative banking sector than do M and AMR.

Post office savings deposits are far less liquid than commercial bank savings. Savings

deposits with post office can be withdrawn on demand, but have the following restrictions :

- 1) Chequable portion of these deposits is very small.
- 2) There are restrictions on number of withdrawals in any week.
- 3) There is a maximum limit on the amount of any single withdrawal (unless an advance notice is given to the post office).

Consequently, post office savings deposits cannot serve as a medium of exchange and are less liquid than the savings deposits with the commercial bank. It is with a view to treating post office savings deposits as separate from the commercial bank savings deposits that  $M_2$  and  $M_4$  series of money supply are provided by the RBI.

## 2.4.2 Agencies Influencing Money Supply

Money supply with the public is influenced mainly by the central bank of the country and its commercial banks. Through its fiscal policy, the government also affects, to some extent, the supply of money.

**The Central Bank and Money Supply:** The central bank of a country affects money supply both directly as well as indirectly. It is directly responsible for the issue of currency notes and coins. On the other hand, it can indirectly influence the deposit component of the money supply. We know that a commercial bank can create deposits keeping in view its cash balances. If the central bank uses methods to reduce the supply of cash balances with the commercial banks, the latter will be able to give less loans and advances and create less deposits. The opposite will be the consequence if the central bank uses its power to increase the cash balances with commercial banks. In order to achieve this, the central bank uses various control instruments, like changes in statutory reserve requirements of commercial banks, changes in interest-rate structure of banks, open-market operations, lending policy towards commercial banks, etc.

**Commercial banks and money supply:** Commercial banks can create demand deposits or bank money. These deposits are created in two ways :

- 1) When people deposit their cash with the banking system, they convert their 'cash in hand' into demand deposits. These deposits are known as primary deposits.
- 2) The cash brought into the banking system through these primary deposits is then either used to buy financial assets from the market (e.g. bills, bonds, etc.) or lent to industry and business. We know that when any bank lends to a customer, it does not give cash to him; instead the bank credits the loan amount to the customer's account, thus creating demand deposits in his name. Since these deposits have been created on the basis of primary deposits these are known as derivative deposits. If banks are able to grant more loans on a given amount of primary deposits, it would result in more bank money. It must be noted that time deposits do not become the basis of credit creation because time deposits are not used as a means of payments — these are only savings for the specified period. The capacity of the banking system to create bank money depends upon the following factors;
  - i) Availability of cash with the banking system
  - ii) Willingness to borrow from the banking system
  - iii) Ratio of cash to bank deposits
  - iv) Credit control policy of the central bank of the country

**Government and money supply:** The Government also affects the supply of money. Whenever the government imposes taxes or borrows from the public, it reduces the volume of available money with the public. On the other hand, when government finds that its income through taxation and public borrowings falls short of its expenditure, it borrows from the central bank (against its own securities) to pay off its creditors. Consequently, the availability of cash with the public and the banking system will increase. As the availability of cash with the public and the banking system changes, so does the economy's capacity to expand or reduce credit.

It may, therefore, be concluded that the supply of money in an economy increases under the following situations :

- 1) when the public wants to hold less cash with themselves and is willing to borrow more from the banking system ;
- 2) when commercial banks expand their credit operations;

- 3) when the **central bank issues** more **currency** or follows a **monetary policy** that helps in expanding credit.

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## **2.5 THE VELOCITY OF MONEY**

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The discussion on supply of money referred to the quantity of money at a particular point of time. However, Irving **Fisher** and other exponents of Quantity Theory of Money were more interested in the concept of the supply of money over a period of time rather than at a point of time.

Fisher uses the concept of transactions velocity to find out the money value of total transactions during a given period. Transactions velocity is defined as the average number of **times** a unit of money changes hands for money's activities during a given period. For **example**, if a hundred rupee note **passes five** hands on average during a time period, it means that the hundred rupee note has served **transactions** worth Rs. 500. In **this** case, transactions velocity is equal to 5. Higher velocity of **circulation** implies smaller quantity of money required to meet a given money value of total transactions. Transactions velocity of money depends upon the payments practices and other structural features of the economy. Since these determinants are found to change slowly, the transactions velocity is also considered as slow changing.

With the development of national income accounting techniques, the transactions velocity gave place to income velocity of money. Income velocity of **money** is defined as the average number of times a unit of money is used for **making** payments for final goods and services only. Obviously income velocity of money will be smaller than transactions **velocity** because the latter refers to all transactions. Income velocity of money depends upon the structural factors like payments practices, the business organisation and the working of the mechanism for transferring payments in the economy. Income velocity of idle money balances (**e.g.** hoardings) in an economy is zero. Greater the share of idle balances in the total money stock, the smaller will be the share of the total money stock available to finance purchases of **final** goods and services, resulting in low income velocity of money.

### **Check Your Progress C**

- 1) Supply of money consists of

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- 2) Distinguish between the various measures of money supply given by the RBI,

$M_1 =$  .....  
 $M_2 =$  .....  
 $M_3 =$  .....  
 $M_4 =$  .....

- 3) Which of the following statements are True and which are False ?

- i) Total stock of money in an economy **determines** the overall liquidity in the **economy**.
- ii)  $M_1$  and  $M_3$  differ in coverage when compared to AMR.
- iii) Post **office** savings deposits are far more liquid than commercial bank savings deposits.
- iv) Commercial banks use primary deposits to create credit.
- v) The money held by the government is not included in the measure of money **supply**.

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## 2.6 LET US SUM UP

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Money forms an integral part of any modern economic system. The two major functions of money are : 1) as the medium of exchange and 2) as the store of values. The reason why people desire to hold cash in hand can be explained in terms of three motives, viz., the transactions, precautionary, and speculative motives. The first two motives relate to the medium of exchange characteristic of money, while the third (i.e. the speculative motive) to the store of value feature of money. The classical and the **neo-classical** economists concentrated only on the first two motives, whereas Keynesian theory of demand for money incorporated all the three motives. The third motive was solely introduced by Keynes and it represented a major breakthrough in monetary theory.

Money supply, or more precisely the stock of money in an economy, is the money held by the public (i.e. individual firms and institutions) at a point of time. Several measures of money supply have been introduced by the Reserve Bank of India, viz.,  $M_1$ ,  $M_2$ ,  $M_3$  and  $M_4$ . Of these,  $M_1$  had been the most commonly used measure of money supply prior to 1978. It consists of the currency and demand deposits held by the public. However, after 1978,  $M_3$  measure (which includes the net time deposits of banks) has replaced  $M_1$  as the popular measure. The former measure is called the narrow **definition** of money supply whereas the latter measure, i.e.  $M_3$ , is called the broader definition of money supply. However, it needs to be noted that these measures differ only in terms of their coverage but not the concept.

There are basically three agents that influence the money supply in an economy. These are : the central bank of an economy, the commercial banks and the government. The central bank affects money supply not only by issuing currency notes and coins but also through its monetary policy including its control over credit creation. Based on the amount of "primary deposits, the commercial banks create derivative deposits and create credit. Government of a country can also influence the money supply by following different taxation, public borrowing and expenditure policies.

Velocity of circulation refers to the number of time a unit of money **changes** hands to **fulfil** transactions needs during a given time period. Transactions velocity of money is the average number of times a unit of money changes hands for all kinds of transactions **in** an economy during a specified period. Whereas, income velocity of money refers to the number of times a unit of money is used for making payments for final goods and services only during the specified period of time. Velocity of **circulation** is considered as slow changing.

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## 2.7 KEYWORDS

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Active and **Idle** Cash Balances : The cash balances which are used as means of payment for meeting transactions are active balances. The rest are called idle balances.

Broader Definition of Money: The only difference between **the** narrow and broader definition of money is that of the net time deposits of the banks. The broader measure of money supply includes the net time deposits also.

Demand **for** Money: Money to hold on hand.

**Liquidity** Trap: A situation in the bonds market when the rate of interest falls to its lowest level and the speculative demand for money becomes perfectly elastic.

Narrow Definition of Money : A measure of money supply (given by **RBI**) which defines money as sum total of currency and demand deposits held by the public.

Normal Rate of Interest: The rate of interest that will prevail in the bonds market under normal conditions. It is in relation to this **normal** rate that the current rate is judged high or low.

**precautionary Demand for Money:** The amount of money demanded for meeting unforeseen increases in expenditures or delays in payments.

**Speculative Demand for Money:** Money demanded by the speculators to speculate in bonds so as to make capital gains by buying bonds when their prices fall and selling them when their prices rise.

**Transaction Demand for Money:** Money held to meet day-to-day or current transactions.

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## 2.8 ANSWERS TO CHECK YOUR PROGRESS

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- A 3 i) True, ii) False, iii) True, iv) True  
 B 4 i) False, ii) False, iii) True, iv) False  
 C 3 i) False, ii) True, iii) False, iv) True, v) True.

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## 2.9 TERMINAL QUESTIONS

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- 1) Why is money demanded ? How is the Keynesian approach different from the classical approach in this regard ?
- 2) Discuss the various motives for holding money. Is demand for money a function of the level of income and the rate of interest ?
- 3) What are the various measures of the money supply used in India? a Which of these measures is most commonly used at present ?
- 4) How is the narrow definition of money different from the broader definition of money ?

**Note:** These questions will help you to understand the unit better. Try to write answers for them, But do not submit your answers to the university for assessment These are for your practice only.