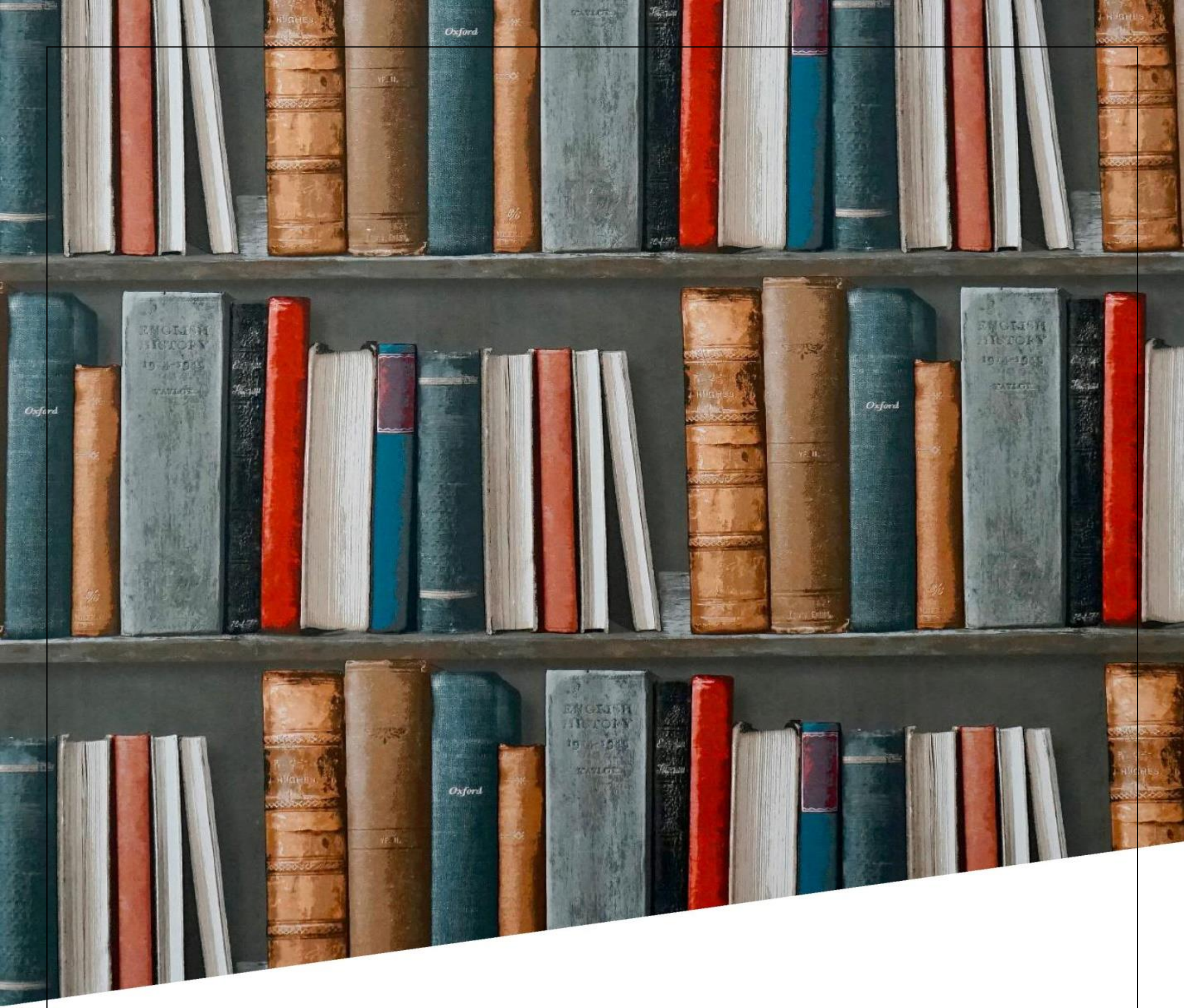


VALUE ADDED NOTES

ILP-2020

IASBABA

Contents

INTRODUCTION

INTRODUCTORY NOTE:

- Economy Modules are designed from Basic to Standard level. Do not worry about coverage or do not be judgmental saying this is covered, that is not covered. You must understand the intention behind our coverage.
- Since Economy is dynamic, we want later VAN's to be more contemporary in nature. Ultimately UPSC is interested more in contemporary aspects but basics must be done to understand and master contemporary concepts and its inter-relations.
- Secondly, we have Babapedia where day to day important concepts often in news will definitely come. Hence, coverage won't be an issue at all.
- If you see previous years questions asked in Prelims- You will definitely relate to it gradually.
- Everything won't be served at once, so patient study is required along with multiple revisions to gain confidence.
- Topics like Mobilization of resources, growth & development, Inclusive growth and issues arising from it are nothing but word play by UPSC. These will anyway be covered through Mainspedia because of its contemporary relevance and need.
- We have provided a basic understanding of the same in the end chapters.

FINANCIAL MARKET

MONEY

- Money is a commonly accepted medium of exchange.
- Money is not useful if there are no individuals to participate in market transactions.

What is Barter Exchange?

- Exchange of goods without the mediation of money.
- Example – Suppose X has 2 kg rice and he want 1 kg tomato so; he has to search for the person who has tomato and needed rice in place of tomato.

	Barter system	Money
Perishable	Yes	No
Storage cost	High	Low
Double coincidence of want	Yes	No
Universal acceptability	No	Yes
Easy convertibility to other commodities	No	Yes

Barter System

Exchange of goods to satisfy wants

Limitations of Barter System

Lack of Double Coincidence of Wants
Eg: A and B both should have what other wants

Lack of Common measure of value
Eg: How of much wheat for 1 kg rice?

Lack of Standard of Deferred Payments
Difficulty in future payments and credits

Lack of Store of value
Difficult to store wealth for future use

Impossibility of sub division of goods
Eg: Can't cut cow into pieces and sell for lower value goods!!

Money

Buy with money & sell for money

Functions of Money

Medium of Exchange
Removed difficulty of double coincidence of wants

Measure of Value
Money now serves as a common measure of value

Standard of Deferred Payments
Possibility of borrowings and savings

Store of value
Money can be held as an asset and can be stored

Liquidity

It is the measure of ability and ease with which assets can be converted to cash

High powered Money (H)
(Simply the entire coins and notes printed by RBI and the Government)
Includes notes & coins held with people **(CU)** and **cash reserves (R)** with banks
High powered money is also called as "Reserve money"

Liquidity is a relative term

Least Liquidity
More time & effort required to convert to cash

Highest Liquidity
Lesser time & effort required to convert to cash

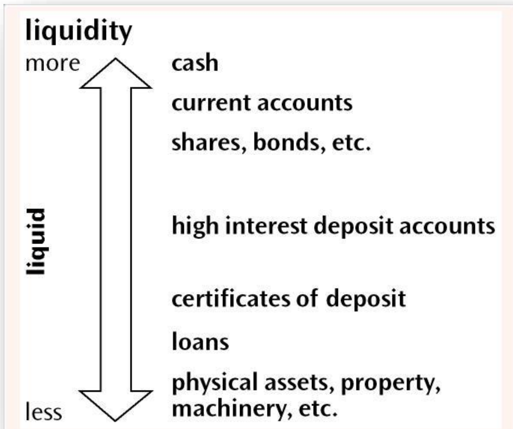
Narrow Money		Broad Money	
M1	**M2**	**M3**	**M4**
= Currency (C) + Demand Deposits (DD) + Other Deposits (OD)	= M1 + Post Office (Only Savings)	= M1 + Time Deposits (TD)	= M3 + Post Office (Total)

Highest Liquidity to Least Liquidity

Demand Deposits means the amount saved in banks which can be taken out anytime (Eg: saving account)
Time deposits (eg: Fixed deposits) generally can be taken only after certain period of time

Money is the most liquid of all assets. What does that mean?

As water takes shape of any container in which it is poured similarly money has universal acceptability and so, can be exchanged for other commodities very easily.



Opportunity Cost

- Let's try to understand it with an example. Suppose you have 10000 rupees. If you put this money into bank, then you can earn interest on it but you would not be able to purchase anything. In addition, if you purchase a tab or any other thing then you lost the opportunity of earning interest.

Liquidity Preference

- This means preference of asset in liquid i.e. cash.

Liquidity Order

- Currency
- Demand deposits in Banks
- Savings deposits in Banks
- Term deposits in Banks

People hold money for three reasons -

- The Transaction motive.
- The Speculation motive.
- The Precautionary motive.

Consider the following liquid assets: (UPSC 2013)

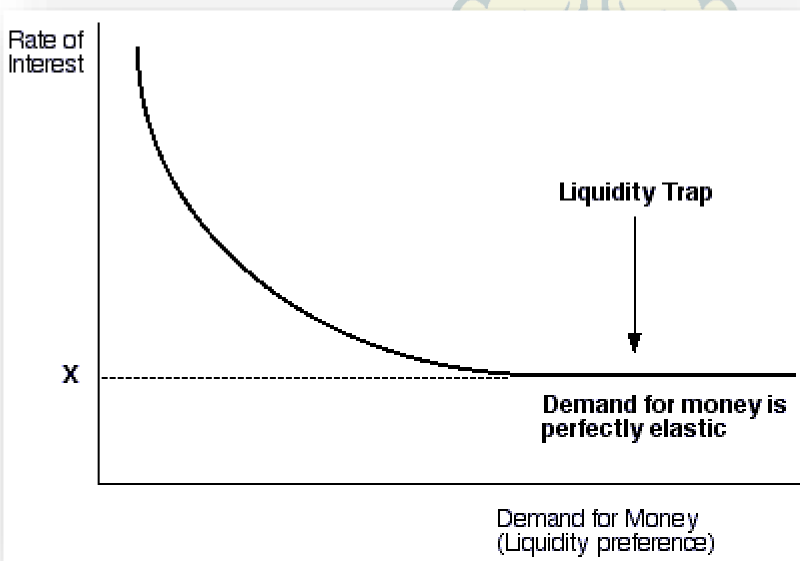
1. *Demand deposits with the banks*
2. *Time deposits with the banks*
3. *Savings deposits with the banks*
4. *Currency*

The correct sequence of these assets in decreasing order of liquidity is

a) *1-4-3-2*
b) *4-3-2-1*
c) *2-3-1-4*
d) *4-1-3-2*

Liquidity Trap

A liquidity trap means consumers' preference for liquid assets (cash) is greater than the rate at which the quantity of money is growing. So any attempt by policymakers to get individuals to spend more (and policymaker do this by increasing the money supply) to create demand will not work.



Try to remember the following with the help of this diagram for better interlinking.

- Suppose in an economy at one point of time (see the highest point of rate of interest in graph) the rate of interest is so high that everyone expects it to fall in future and are sure that they can made capital gains by holding bonds. Therefore, everyone starts investing his or her deposit account money into bonds.

- Now suppose, at another point (area where liquidity trap is written), the economy is in liquidity trap. Everyone is sure of a future rise in interest rate and a fall in bond prices. Therefore, everyone in the economy will hold their wealth in money balance and if additional money is injected within the economy, it will be saved for future use without increasing the demand for bonds and without further lowering the rate of interest.
- **This situation is called a liquidity trap.**

Why do Liquidity Traps Occur?

- **Expectations of deflation** - If there is deflation or people expect deflation (fall in prices) then real interest rates can be quite high even if nominal interest rates are zero. - If prices are falling 2% a year, then keeping cash under your mattress means your money will increase in value. The difficulty is in having negative nominal interest rates (banks would be paying you to borrow money). There have been attempts to create negative interest rates (e.g. destroy money in circulation but in practice, it is rarely implemented.
- **Preference for saving -** Liquidity traps occur during periods of recessions and a gloomy economic outlook. Consumers, firms and banks are pessimistic about the future, so they look to increase their precautionary savings and it is difficult to get them to spend which is necessary to create demand so that economy can revive once again. This rise in the savings ratio means spending falls.
- **Credit Crunch -** Banks lost significant sums of money in buying sub-prime debt, which defaulted. Therefore, they are seeking to improve their balance sheets. They are reluctant to lend so even if firms and consumers want to take advantage of low interest rates, banks will not lend them the money.
- **Unwillingness to hold bonds.** If interest rates are zero, investors will expect interest rates to rise sometime. If interest rates rise, the price of bonds falls. Therefore, investors would rather keep cash savings than hold bonds.
- **Banks Don't pass Base Rate cuts onto consumers**

THE SUPPLY OF MONEY

- In our Indian economy RBI, monetary authority of India, issues the currency notes while Government of India (GoI) issues the coins.
- Up to Re. 1 note and coins are issued by Govt of India (Ministry of Finance). Rest are issued by RBI.

The balance in savings or current account deposits is also considered money. Why?

As cheques, which are drawn on these accounts, are used to settle transaction.

All of us have used this note. Have you ever wondered that it is just a piece of paper but still everyone accepts it? Why?

Because the note is guaranteed by RBI. In the image you can see the promise (highlighted in box) from the Governor of RBI. The promise guarantees that if someone produces the note to RBI, or any other commercial bank, RBI will be responsible for giving the person purchasing power equal to the value printed on the note. It is same for coins as well. (The given currency is only for example)

Q. Which one of the following statements correctly describes the meaning of legal tender money?

a) The money which is tendered in courts of law to defray the fee of legal cases

b) The money which a creditor is under compulsion to accept in settlement of his claims.

c) The bank money in the form of cheques, drafts, bills of exchange, etc.

d) *The metallic money in circulation in a country*

Fiat Money

- Currency notes and coins do not have any intrinsic value. They have value because of above explained reasons. **Therefore, they are called as Fiat money**. They are legal tenders (they cannot be refused by any citizen of the country for settlement of any kind of transaction)

Can cheques be refused to settle any kind of transaction? If yes, Why?

- Cheques are drawn on savings or current accounts, however, can be refused by anyone as a mode of payment as they are not legal tenders. (Demand Deposits are not legal tender)
- Cheques or instruments like commercial bills can't be used as legal tender money. Similarly, a virtual currency like Bitcoin is different from bank notes mainly because the Bitcoin is not legal tender money.

Legal definitions: Narrow and Broad Money or Monetary aggregates

- Monetary aggregates are related only to monetary liabilities of the RBI and depository corporations i.e. the banking system.

The new monetary aggregates are of four types. They are:

- Reserve money or Base money (M_0)
- Narrow money (M_1)
- Intermediate money (M_2) and
- Broad money (M_3)

Reserve Money or Base Money (M_0): The total liability of the RBI is called the **monetary base or high-powered money.** It consists of Currency in Circulation + Bankers' Deposits with RBI + Other Deposits with RBI.

The financial assets in M_0 category is called as Reserve money because these are held by public and banks (Currency in circulation) or by the RBI (Bankers deposits with RBI + Other deposits with RBI). **These are not available for lending purposes.**

M_0 = Currency in Circulation + Bankers Deposits with the RBI + Other Deposits with the RBI

Currency in circulation - Total amount of the Rupee notes issued by RBI and the Rupee coins and small (paisa) coins issued by GoI. It is held by both public and banks.

Bankers deposit with RBI - Cash Reserve Ratio (CRR) and excess reserve. The banks keep CRR with RBI as stipulated by the RBI. Some banks keep more cash reserve with RBI than stipulated amount. It is called **Excess Reserve**.

Other deposits with RBI – It include –

- Deposits of quasi-government and other financial institutions including primary dealers (financial intermediaries operating in Government securities (G-Secs) and other financial instruments)
- Balances in the accounts of foreign central banks and governments
- Accounts of international agencies such as the IMF etc., and
- Provident, gratuity and guarantee funds of RBI staff

Narrow Money (M_1)

The financial assets it includes are fewer than the M_2. This means it defines money in narrower sense and hence called as Narrow money.

M_1 = Currency with public + Demand deposits with the banking system + other deposits with RBI

OR

In short – CU + DD + Deposits with RBI

Currency with the public - currency in circulation –(minus) cash on hand with the banking system

Demand deposits are those deposits that can be withdrawn by depositor at any point of time. There are two major types of demand deposits viz., current deposits and saving deposits. The saving deposits have two components namely demand liability and time liability. Most part of the saving deposits is demand liabilities only. However, few saving deposits can be withdrawn only on some performance or on some happenings, for example, a saving deposit made in the name of a child may be deposited with a condition that it can be withdrawn only after the child became a major. In M1 only demand liability portion is included.

Intermediate Money (M2)

- It is called intermediate money for the reason financial assets included in this category are more than those included in M1 but less than those included in M3.
- In short – M1 < M2 < M3
- M2 = M1 + Time Liabilities portion of savings Deposits with the Banking system + Certificates of Deposit issued by Banks + Term Deposits (excluding Foreign Currency Non-Resident (Bank) (FCNR (B)) Deposits) up to one-year maturity with the Banking system.

Broad money (M3)

The financial assets it includes are more than the M2. This means it defines money in a wider sense and so called as Broad money.

M3 = M2 + Term Deposits (excluding FCNR (B) Deposits) over one-year maturity with the Banking system + Call borrowings from 'Non – Depository' Financial corporations by the banking system.

RBI followed the following method since 1979 until implementation of above (current) method.

M1 (Narrow Money)

M1 = Currency with the Public + Demand Deposits of banks + Other demand deposits with RBI

M2 (Intermediate money)

M2 = M1 + Post office Savings Deposits

M3 (Broad Money)

M1 = M1 + Time Deposits of the Public with Banks.

M4

M4 = M3 + Total Post office deposits.

NOTE- Up to Re. 1 note and coins are issued by Govt of India (Ministry of Finance). Rest are issued by RBI

Q. Consider the following:

1. *Currency with the public*
2. *Demand deposits with banks*
3. *Time deposits with banks*

Which of these are included in Broad Money (M3) in:

a) *1 and 2*
b) *1 and 3*
c) *2 and 3*
d) *1, 2 and 3*

Q. Following are some components of money supply in India:

1. *Currency with the public*
2. *Aggregate demand deposits with 'banks*
3. *Aggregate time deposits with banks*
4. *'Other' deposits with the Reserve Bank of India*

Which of the aforesaid items are components of narrow money (M1) in India?

a) *1 , 2 and 3*
b) *2 and 4 only*
c) *1, 2 and 4*
d) *1 and 4 only*

BITCOINS AND CRYPTOCURRENCY- IN NEWS

Bitcoin is a web based crypto-currency. Blockchain technology is behind crypto currencies like Bitcoin. A blockchain is a digitized, decentralized, public ledger of all cryptocurrency transactions. It is the first decentralized peer-to-peer payment network that is powered by its users **with no central authority or middlemen.**

- **The authenticity of each transaction is protected by digital signatures.**
- **India has not recognized the bitcoin as a legal tender**

Q. With reference to 'Bitcoins', sometimes seen in the news, which of the following statements is/are correct?

1. *Bitcoins are tracked by the Central Banks of the countries.*
2. *Anyone with a Bitcoin address can send and receive Bitcoins from anyone else with a Bitcoin address.*
3. *Online payments can be sent without either side knowing the identity of the other.*

Select the correct answer using the code given below.

a) *1 and 2 only*
b) *2 and 3 only*
c) *3 only*
d) *1, 2 and 3*

Q. Which of the following statements about Bitcoin is / are correct?

1. *It is a decentralized virtual currency.*
2. *It is generated through complex computer software systems.*
3. *The Reserve Bank of India recognized it as a legal tender in January 201 6.*

Select the correct answer using the code given below.

a) *1 only*
b) *1 and 2 only*
c) *2 and 3 only*
d) *1, 2 and 3*

Functioning of Bank and Money circulation

Suppose assume that the currency notes in supply is 10 cr

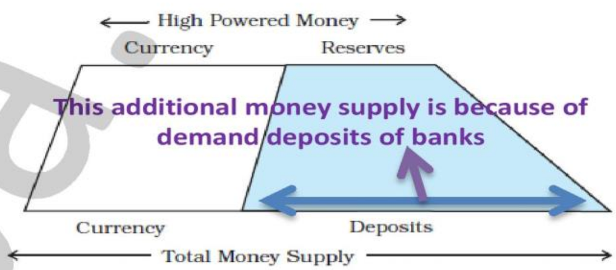
Currency with public (CU) — Demand Deposits (DD) — Cash reserve (R) — Money Supply (M)

Situation (All the money figures are in crores)	Money in hand with People	Demand Deposits in Bank	Actual Money in bank	Total Money supply = Money with people + demand deposits
All the 10 cr is with people	10	0	0	10
People put 7 cr in banks as both demand deposits and time deposits *(Total People's money is still same)*	3	7	7	3 + 7 = 10
Bank gives 5 cr as loans *(Although the money in bank will reduce, people's savings remain the same)*	8	7	2*	8 + 7 = 15
Some people withdraw 2 cr in total from banks	10	5	0	10 + 5 = 15

***In case bank gives loans to someone, bank is still liable to pay the 7 cr demand deposits to people when they ask.**

Money Multiplier = M/H

Even though RBI gave only 10 cr for supply, because of banks, money supply in economy is higher than 10 cr. This ratio of Total Money Supply (M) and High powered money (H) is called Money Multiplier



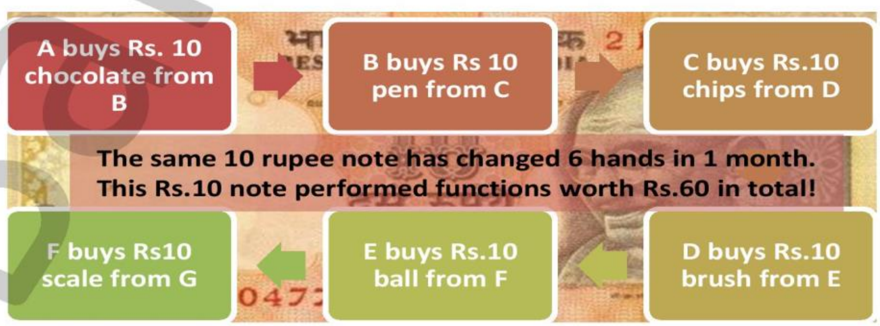
Velocity of Money

Frequency at which the average unit of currency is used to purchase newly domestically-produced goods and services within a given time period.

High Velocity – Higher money supply
Low Velocity – Lower money supply

Generally represented as ratio of GDP to money supply

High velocity can lead to inflation



Legal Tender Money: Money which can be used legally to payments and cannot be denied legally.

- **Limited Legal Tender Money:** Compulsory upto a certain limit. After this limit, he can deny. **Eg: Coins in India**
- **Unlimited Legal Tender Money:** No limit. Can be used in any number legally. **Eg: Notes in India**

Non- Legal Tender Money: Money which is generally accepted but one is not bound to accept. **Eg: Cheques**

Cash deposit Ratio & Reserve deposit ratio

Cash Deposit Ratio (cdr):
Ratio of cash held in hand (CU) to money stored in bank (DD)

$$cdr = \frac{CU}{DD}$$

Reserve Deposit Ratio (rdr):
Ratio of cash kept as reserves (R) to total demand deposits (DD)

$$rdr = \frac{R}{DD}$$

If the cash reserve is zero, what if a person asks for withdrawal of his money? What if all the people try to withdraw all their money? To avoid such situations, RBI has some measures, we will look at them soon..

MONEY MULTIPLIER

The Money Multiplier refers to how an initial deposit can lead to a bigger final increase in the total money supply. For example, if the commercial banks gain deposits of 1 million and this leads to a final money supply of 10 million. The money multiplier is 10.

The money multiplier is a key element of the fractional banking system.

- There is an initial increase in bank deposits (monetary base)
- The bank holds a fraction of this deposit in reserves and then lends out the rest.
- This bank loan will, in turn, be re-deposited in banks allowing a further increase in bank lending and a **further increase in the money supply.**

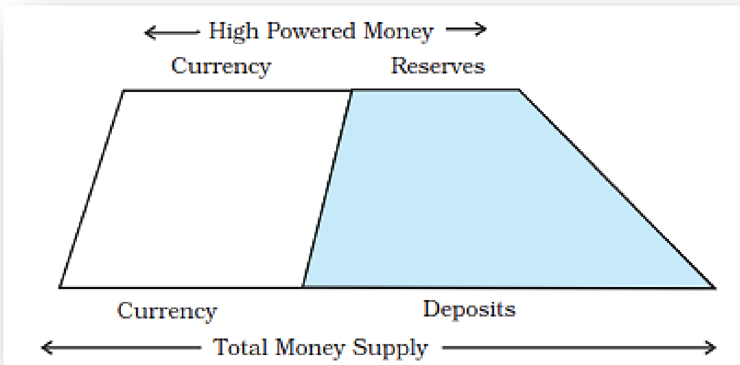
The money multiplier in an economy increases with which one of the following? UPSC PRELIMS 2019

a) Increase in the cash reserve ratio
b) Increase in the banking habit of the population
c) Increase in the statutory liquidity
d) Increase in the population of the country

High Powered Money

- Total liability of RBI is known as **monetary base or high-powered money.**
- It consists of currency and deposits held by GoI and commercial banks.
- The currency notes and demand deposits are liabilities on RBI.
- Liabilities are claims by public, government and banks on RBI.
- Example – suppose RBI purchases 100 rupees gold from market. To purchase gold RBI paid in 100 rupees note. So now 100 rupees note is liability on RBI and Gold is asset for RBI.
- See similar examples in below table –

RBI	
Liability	Assets
Rupees 5	Gold
Currency issued to government	Debt bonds/securities issued by GoI
Loans to commercial banks	Collaterals by commercial banks



Q. Supply of money remaining the same when there is an increase in demand for money, there will be (2013)

a) a fall in the level of prices
b) an increase in the rate of interest
c) a decrease in the rate of interest
d) an increase in the level of income and employment

INDIAN MONEY MARKET

Definition - Market of an economy where funds are transacted between the fund-surplus and fund-scarce individuals and groups.

Money Market

- Controlled by RBI.
- Sources which meet short term requirements of money are the constituents of the money market

Capital/Security Market

- Controlled by SEBI.
- Sources which meet medium- and long-term requirements of money are the constituents of the capital market.
- It has two type Primary market and secondary market

Primary Market- It is a market of new issue. Since securities are new hence, they create capital formation.

Secondary Market- It provides market ability for the securities coming for sale in stock market. There is no profit for company. When price of securities is increased, capitalization of company increased.

Bull Market

- Where prices are rising.
- A bull investor has a very optimistic view of the market. He aggressively buys and sells stocks quickly.

Bear Market

- Where prices are falling
- A bear investor is pessimistic about the market and may make more conservative stock choices.

Q. In the parlance of financial investments, the term 'bear' denotes (UPSC 2010)

a) An investor who feels that the price of a particular security is going to fall

b) An investor who expects the price of particular shares to rise

c) A shareholder or a bondholder who has' an interest in a company, financial or otherwise

d) Any lender, whether by making a loan or buying a bond