

MONEY MULTIPLIER

Important IAS Exam Topics by Shashank Sajwan

INTRODUCTION

- In an economy money flows between citizens, businesses, banks and the government through taxes, salaries, loans, interest payments, purchases etc.
- This **circulation of money is very important to control to promote growth, inflation and employment.**
- To control this circulation it is important to know the amount of money (money supply) in the economy.
- Using money supply one can calculate the **money multiplier** that refers to the amount by which the money supply is increased as a result of a given increase in bank reserves.

MONEY SUPPLY

- The money supply is the total value of money available in an economy at a point of time. Money Supply is **also known as Money Stock.**
- As money supply is connected with '**circulating money**', only the highly-liquid forms of money like currency and bank deposits are usually considered.
- Money Supply is measured and expressed using different monetary aggregates like **M1, M2, M3, M4** etc.
- **M1 (Narrow Money)**
 - Currency with public
 - Demand deposits with the banking system
 - Other deposits with the RBI
- **M2 (Narrow Money)**
 - M2 consists of M1 plus post office savings bank deposits.
- **M3 (Broad Money)**
 - It consists of M1 plus time/term deposits with commercial and cooperative banks.
- **M4 (Broad Money)**
 - M4 consists of M3 plus total post office deposits comprising both time deposits and demand deposits.
 - It must be noted that M4 is the broadest measure of money supply.
 - Out of all M3 is of special significance as it is taken into account while formulating macroeconomic objectives of the economy every year.

MONEY MULTIPLIER

- The money multiplier is a concept in economics that refers to the amount by which the money supply is increased as a result of a given increase in bank reserves. It is used to explain how changes in the amount of money held in bank reserves can affect the overall money supply in an economy.
- The Money Multiplier indicates how quickly the money supply will grow as a result of bank lending.
- The higher the reserve ratio, the fewer deposits available for lending, resulting in a lower Money Multiplier.
- The money multiplier is calculated by dividing the amount of money in circulation (M3) by the amount of bank reserves (M0).
 - For example, if the total amount of money in circulation is Rs. 10 Crore and the amount of bank reserves is Rs.1 Crore, the money multiplier would be 10. This means that for every Re.1 increase in bank reserves, the money supply would increase by Rs.10.

$$\text{Money Multiplier} = \frac{\text{Broad Money (M3)}}{\text{Reserve Money (M0)}}$$

or

$$\text{Money Multiplier} = \frac{1}{\text{Reserve Ratio}}$$

CONCLUSION

- The central bank of a country can use changes in bank reserves and interest rates to influence the money supply and the overall level of economic activity.
- The **higher the reserve ratio is, the less deposits will be available for lending**, resulting in a smaller money multiplier and vice versa.
- Thus, **higher the value money multiplier, higher will be liquidity in the market** and Vice-Versa.