Monetary Systems

Explained

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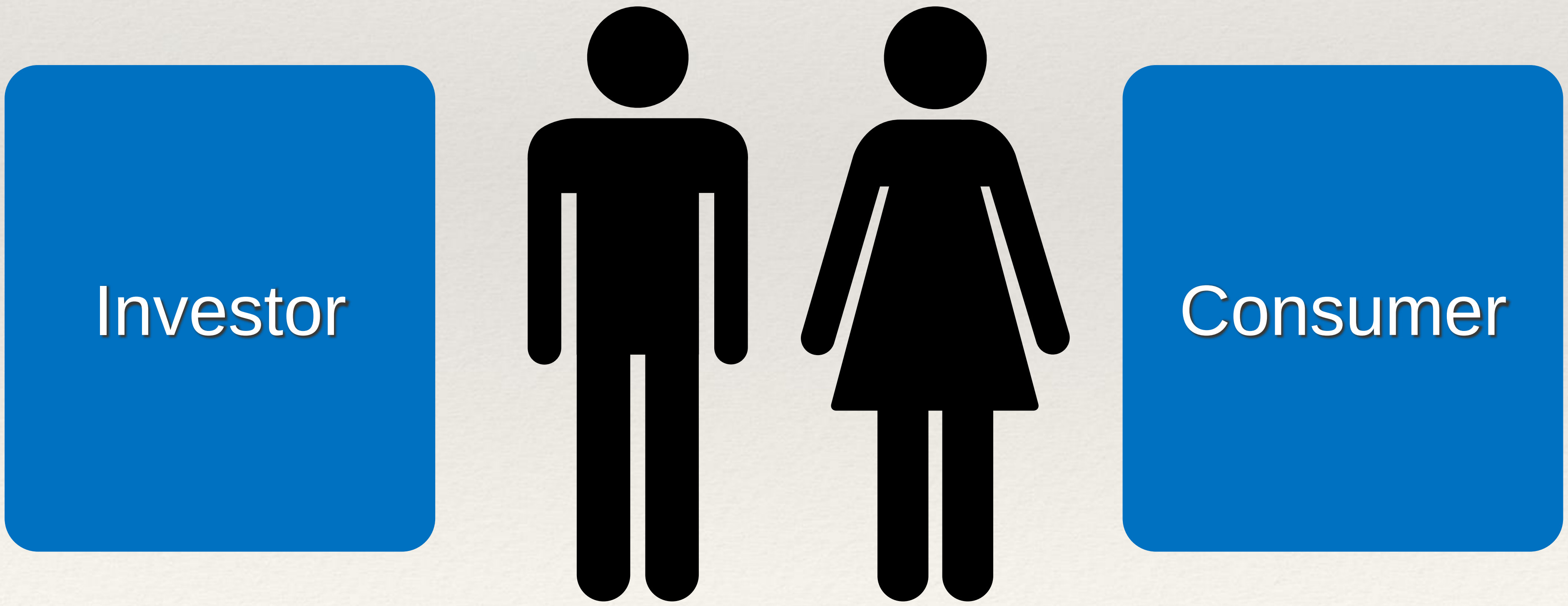
Outline

- Relevance of the topic
- Evolution of money and Monetary systems
- How current Monetary system works
- Monetary policy and Inflation targeting

Relevance of the topic

Today's monetary system combined with fractional reserve banking has lot of risks and is vulnerable to:
Bank runs, inflation and Economic bubbles to name a few.



Evolution of Money

Purpose of Money

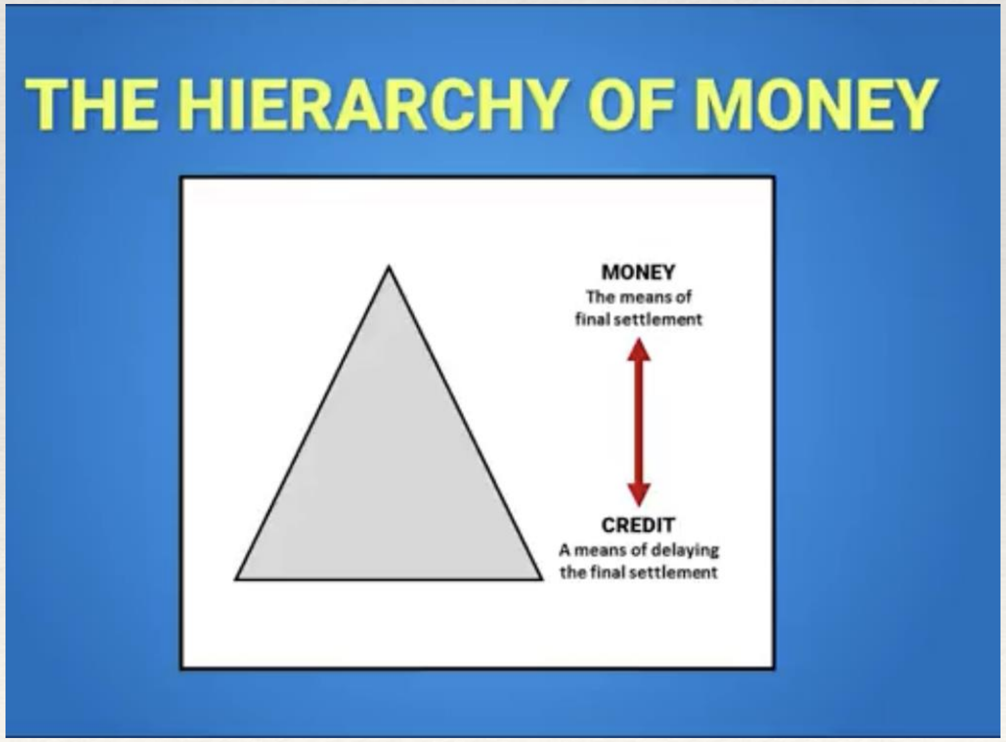
- It’s generally accepted **medium of exchange**
- **Store of value**
- Serves as a **unit of account** in which prices are quoted

Set of mechanisms used by a government to issue money in an economy.

Monetary Systems

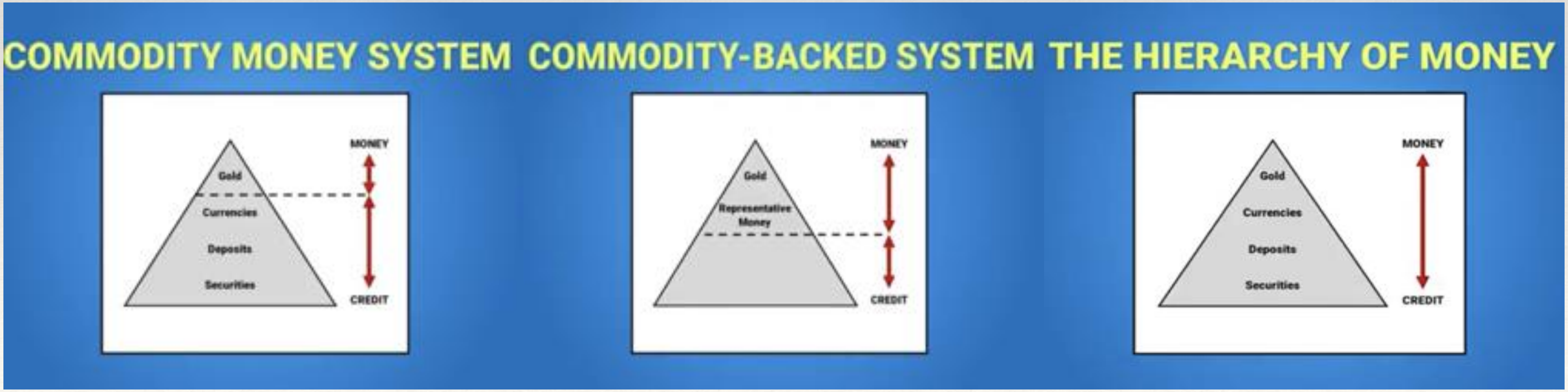
The process involves:

- Central Bank
- Scheduled and Commercial banks
- The Mint
- National treasury

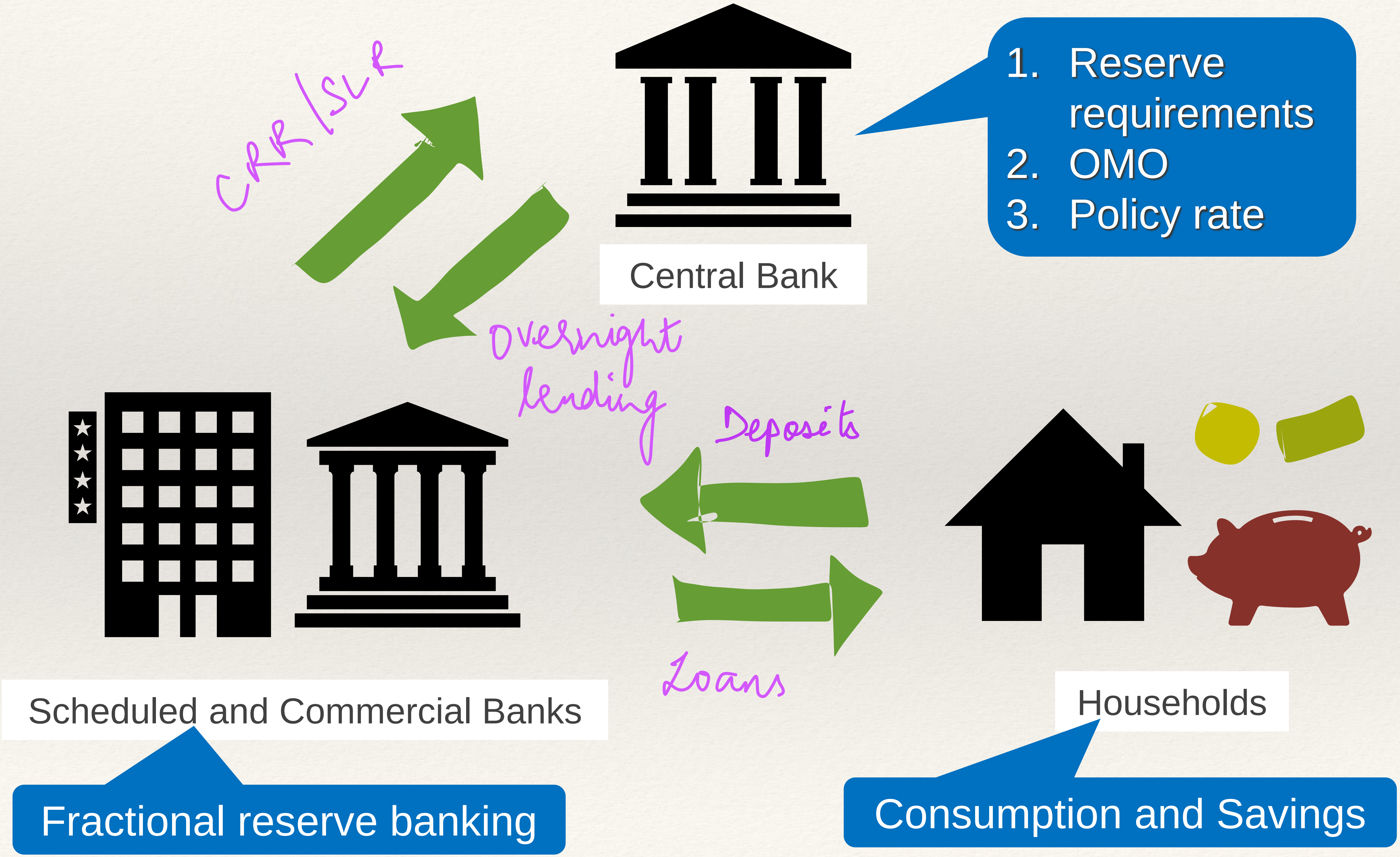


Types of Monetary Systems

Commodity system	Commodity backed system	Fiat system
Intrinsic value derived from the commodity physically	Representative money	By government decree is a legal tender
Barter system	Gold standard	Fiat/paper currency

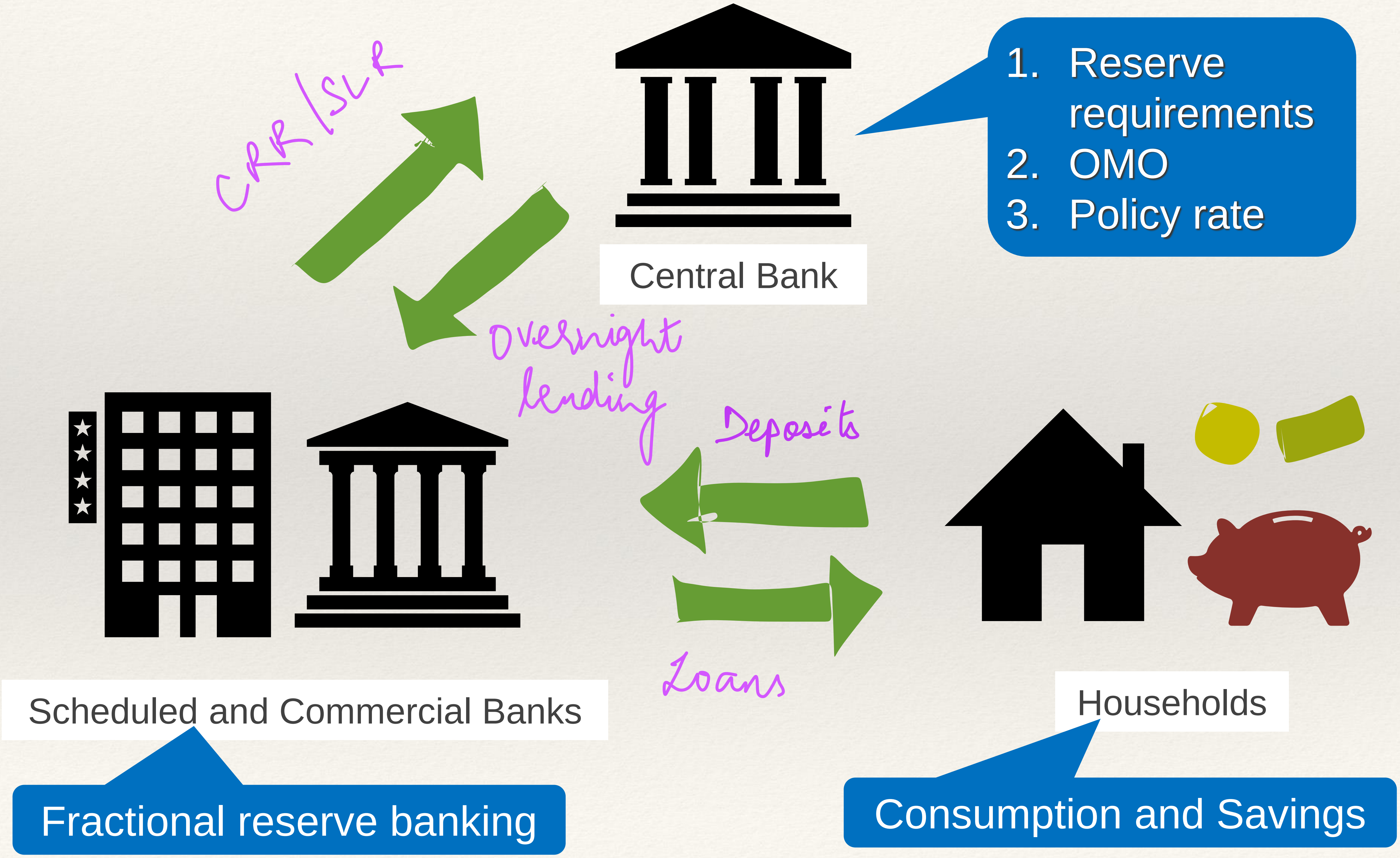


Major Stakeholders



THE MONEY MULTIPLIER

Major Stakeholders

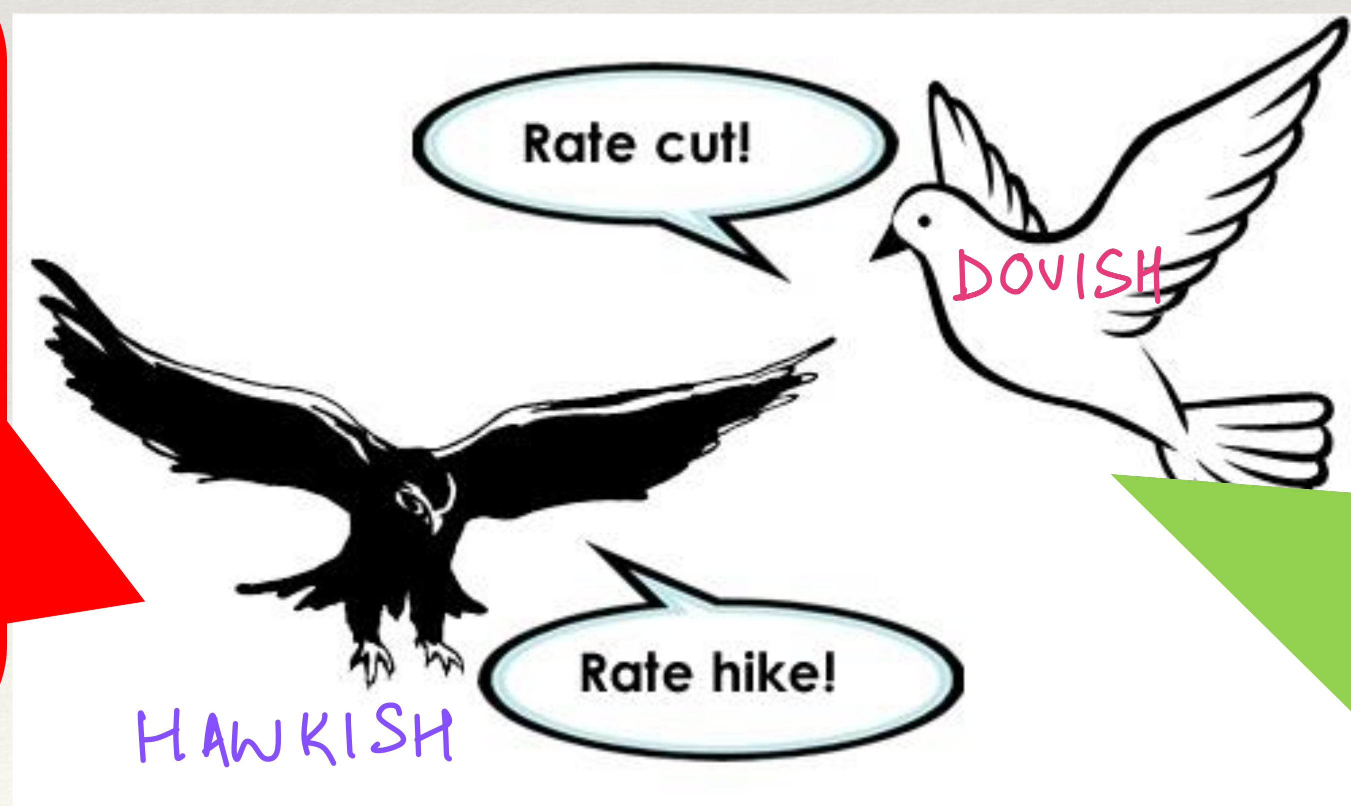


Monetary policy and Inflation Targeting

Monetary policy:

Refers to actions central banks take to pursue objectives such as price stability and maximum employment

- Positive for currency of country
- Slows economic growth
- Prevents excessive inflation



- Negative for currency of country
- Stimulates economic growth
- Prevents excessive deflation

Objectives of the Central Bank

To promote price stability conducive to a balanced and sustainable growth of the economy

- Common goal of central banks : to promote **price stability**
- **Inflation**: direct indicator of price stability in the economy

RBI keeps the inflation low and stable through the conduct of monetary policy which consists of decisions about: Money supply and cost of borrowing money to influence demand for goods and services

General price level of goods and services in the country moves at slow and predictable rate thus, preserving the value of your money.

When prices rise substantially and unpredictably — your money buys fewer goods and services

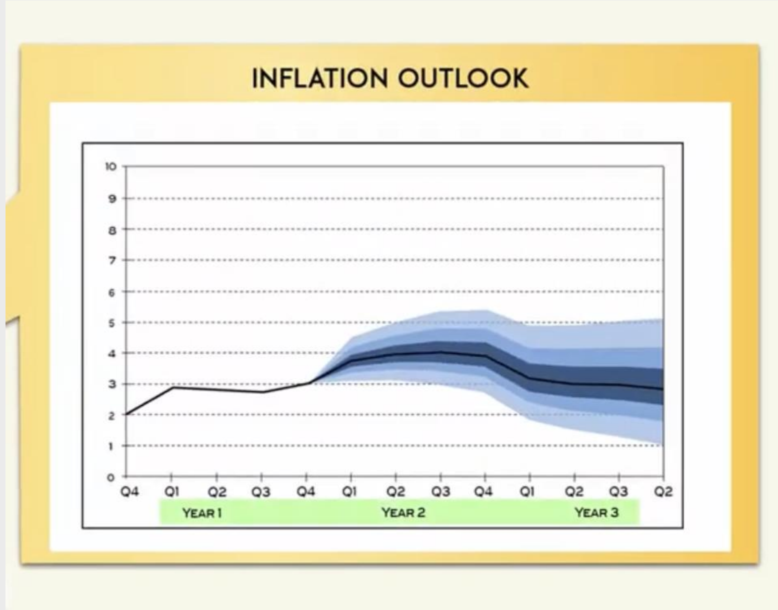
Price stability does not mean that prices are not changing.

It means the inflation or rate of change in prices of goods and services is low and predictable making it easier for HH and firms to plan ahead and make sound financial decisions

National government sets the inflation target and RBI announces and commits to achieve it.

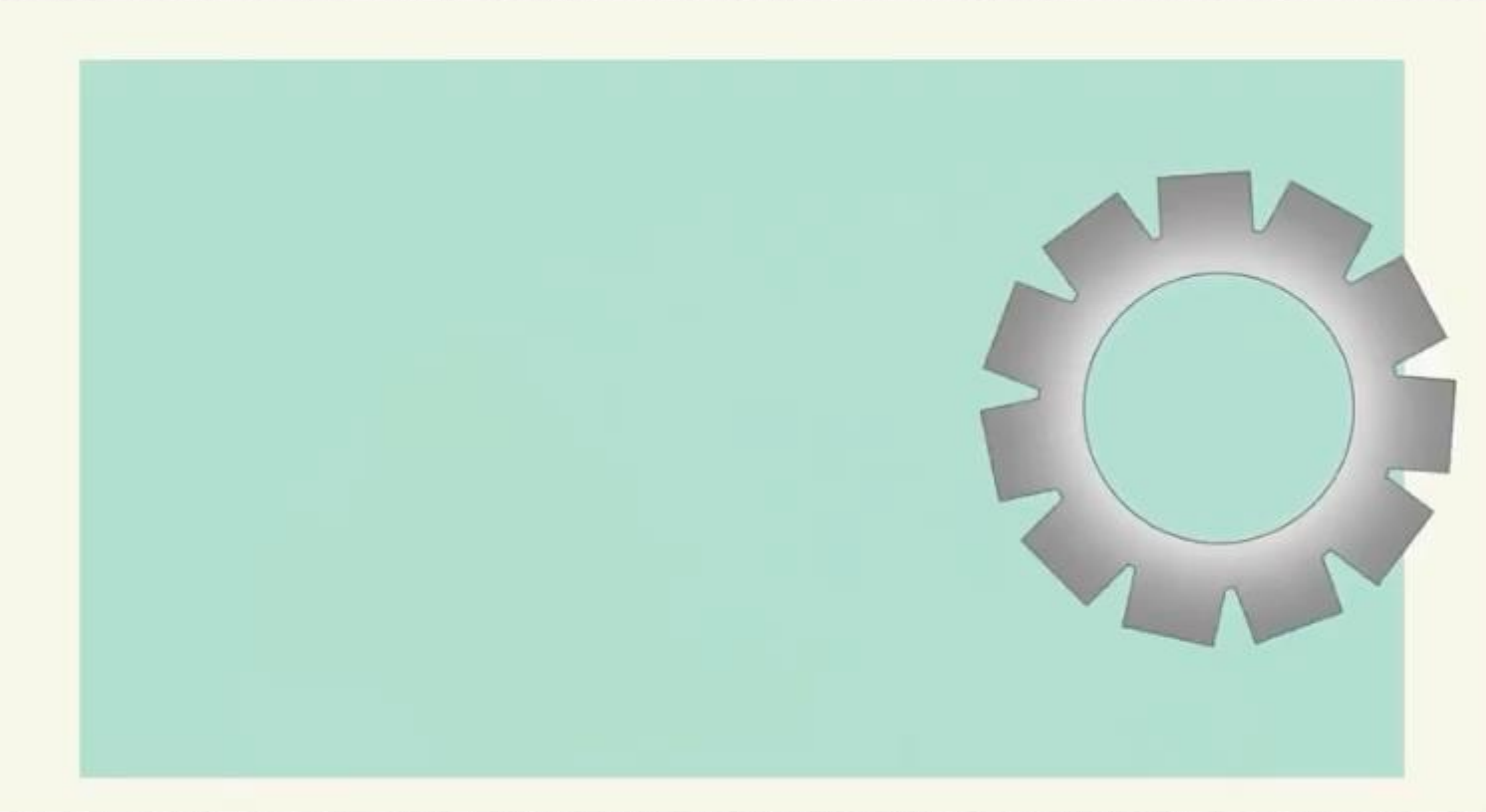
Instruments of Monetary policy

- Policy rate : Repo rate of RBI — signals the monetary policy stance
- Decision on Monetary policy stance considers the inflation outlook for the target period

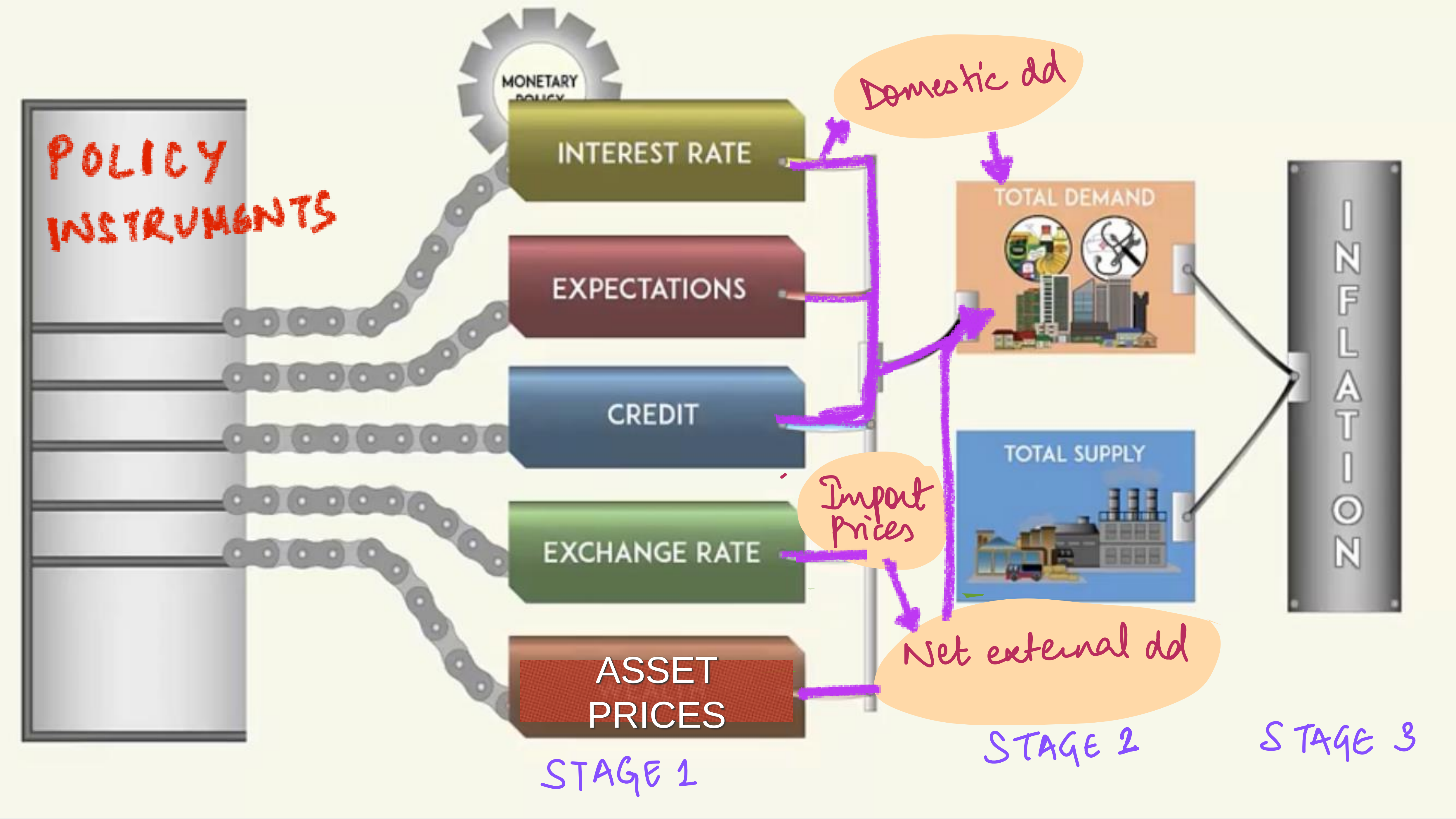


- MPC regularly assesses price and other developments to ensure monetary policy settings remain appropriate
- It generates inflation forecasts and compares it with inflation target

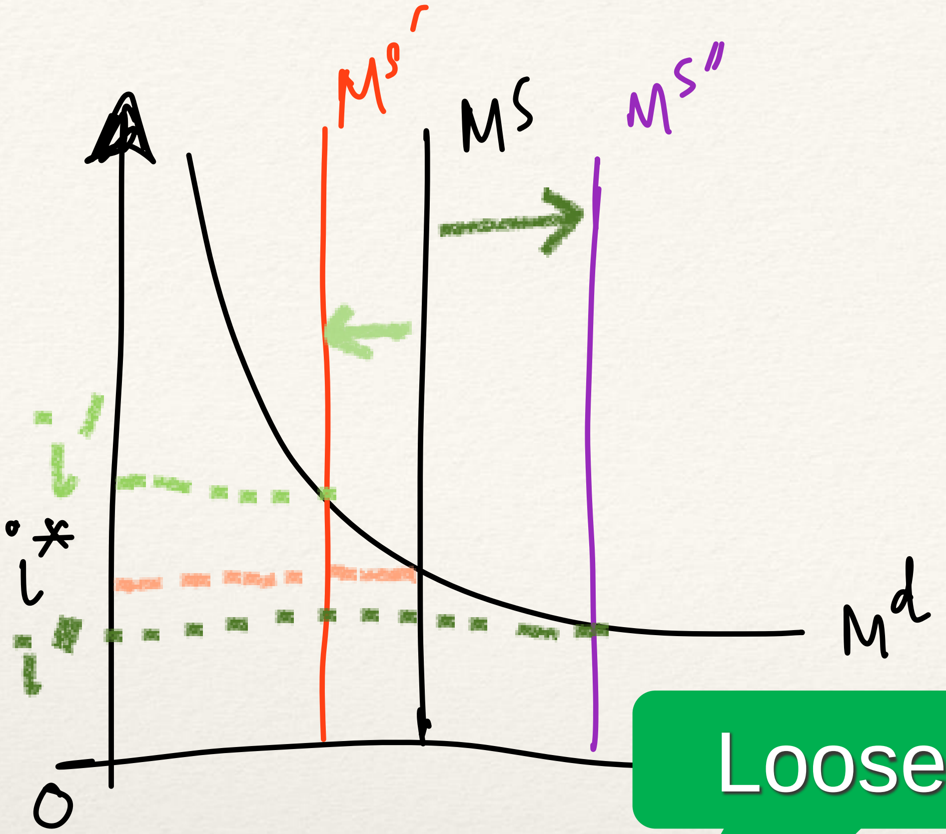
How does Monetary Policy work?

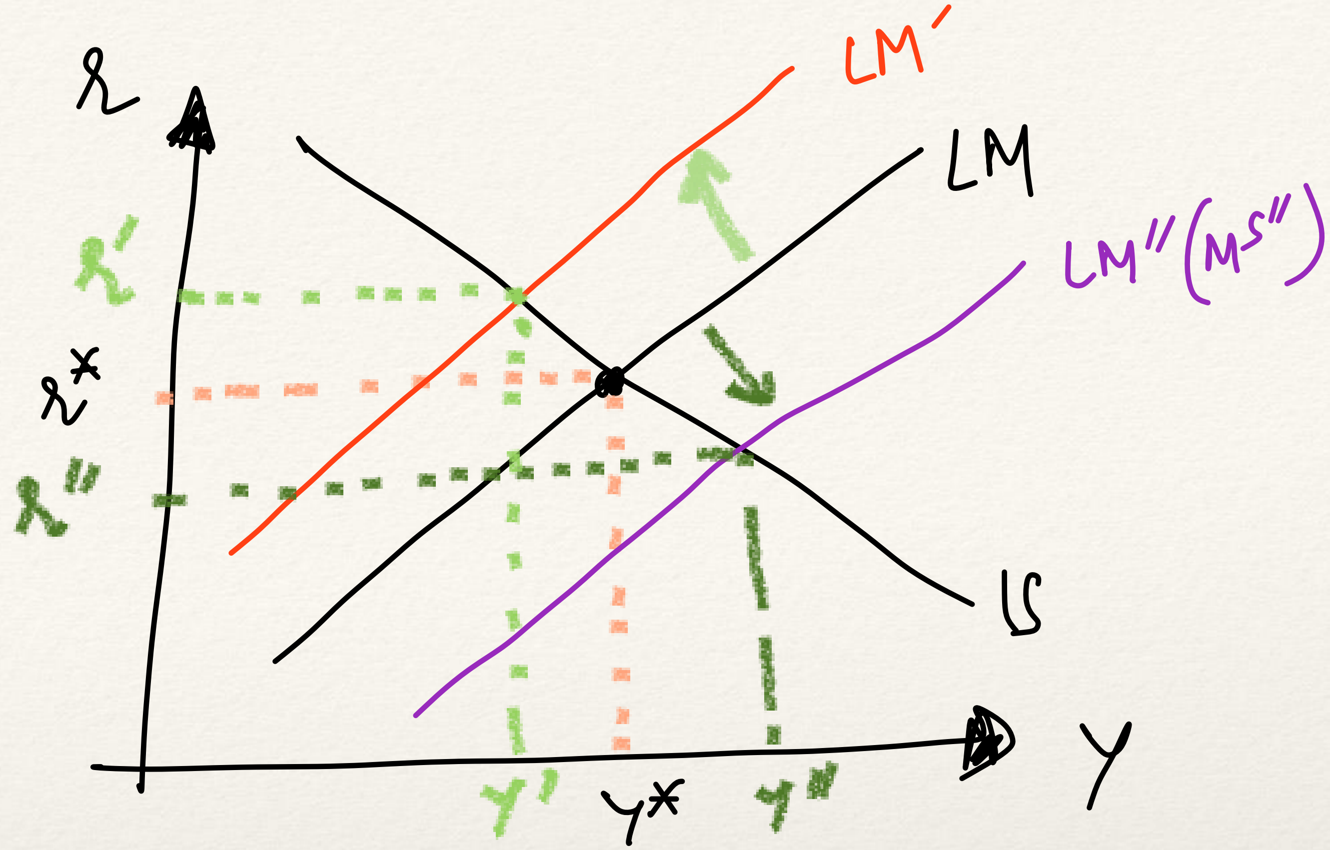


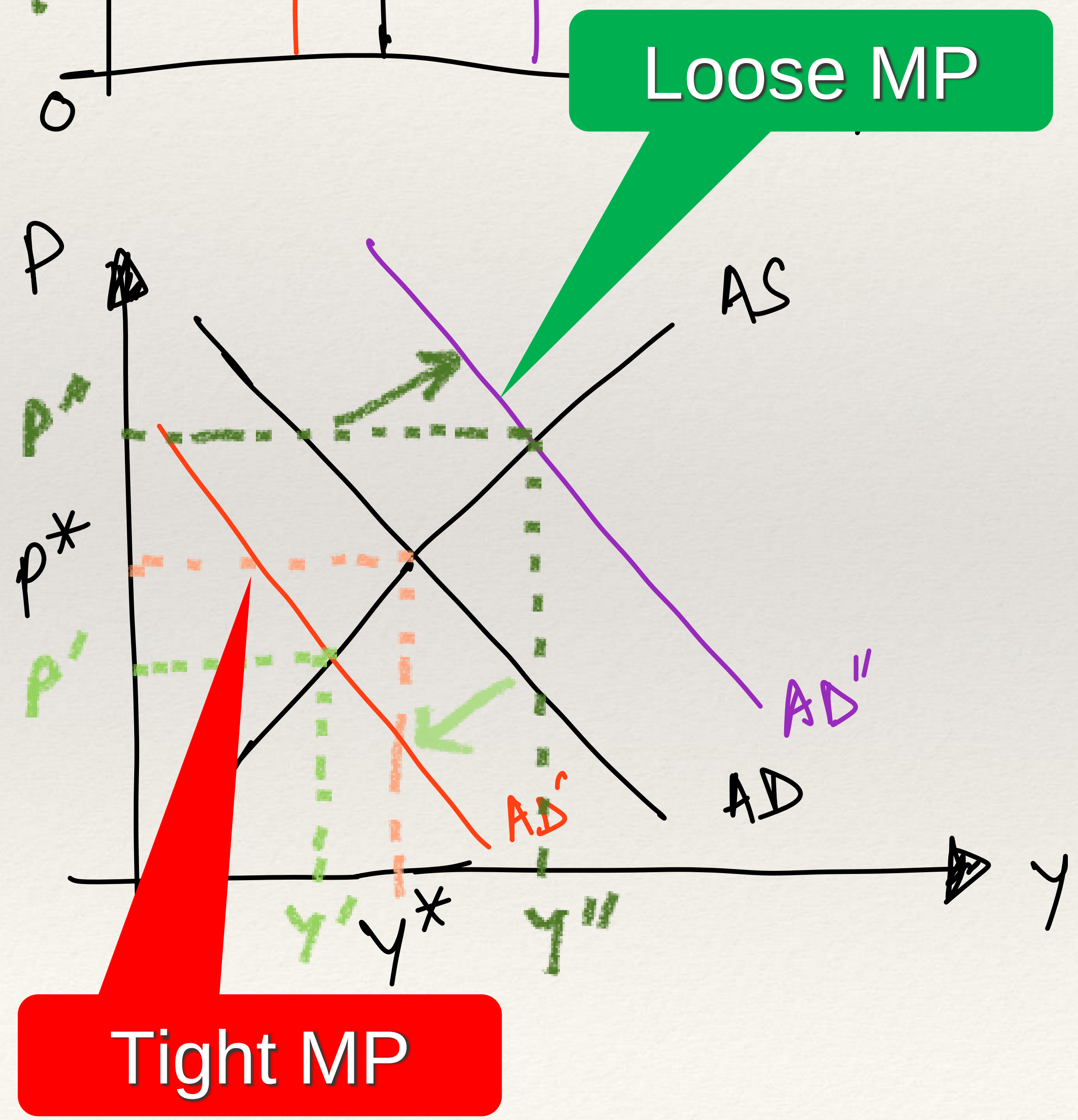
Channels impacting Inflation



Monetary policy transmission mechanism





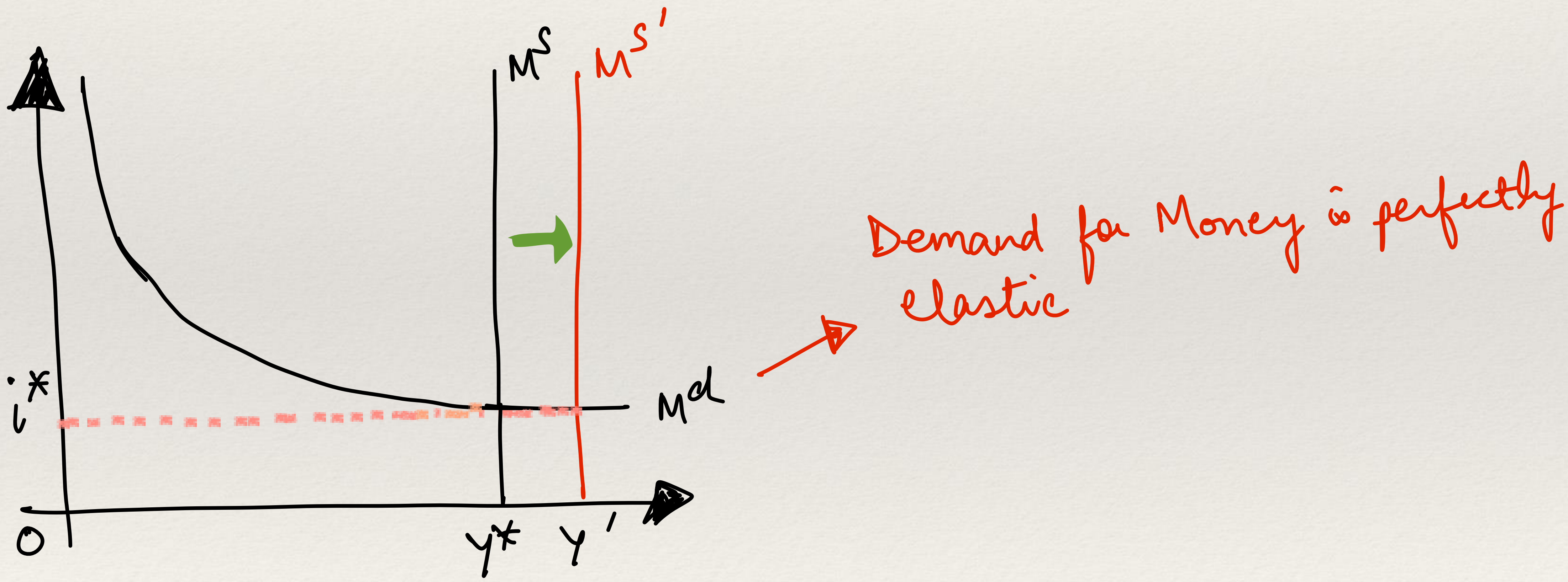


Stage 1	Policy rate impacts other interest rates in the market
Stage 2	Changes in cost of borrowing will affect the spending patterns of consumers and firms — effect on AD
Stage 3	Impact on AD changes GDP and inflation

When is Monetary policy ineffective?

Liquidity trap

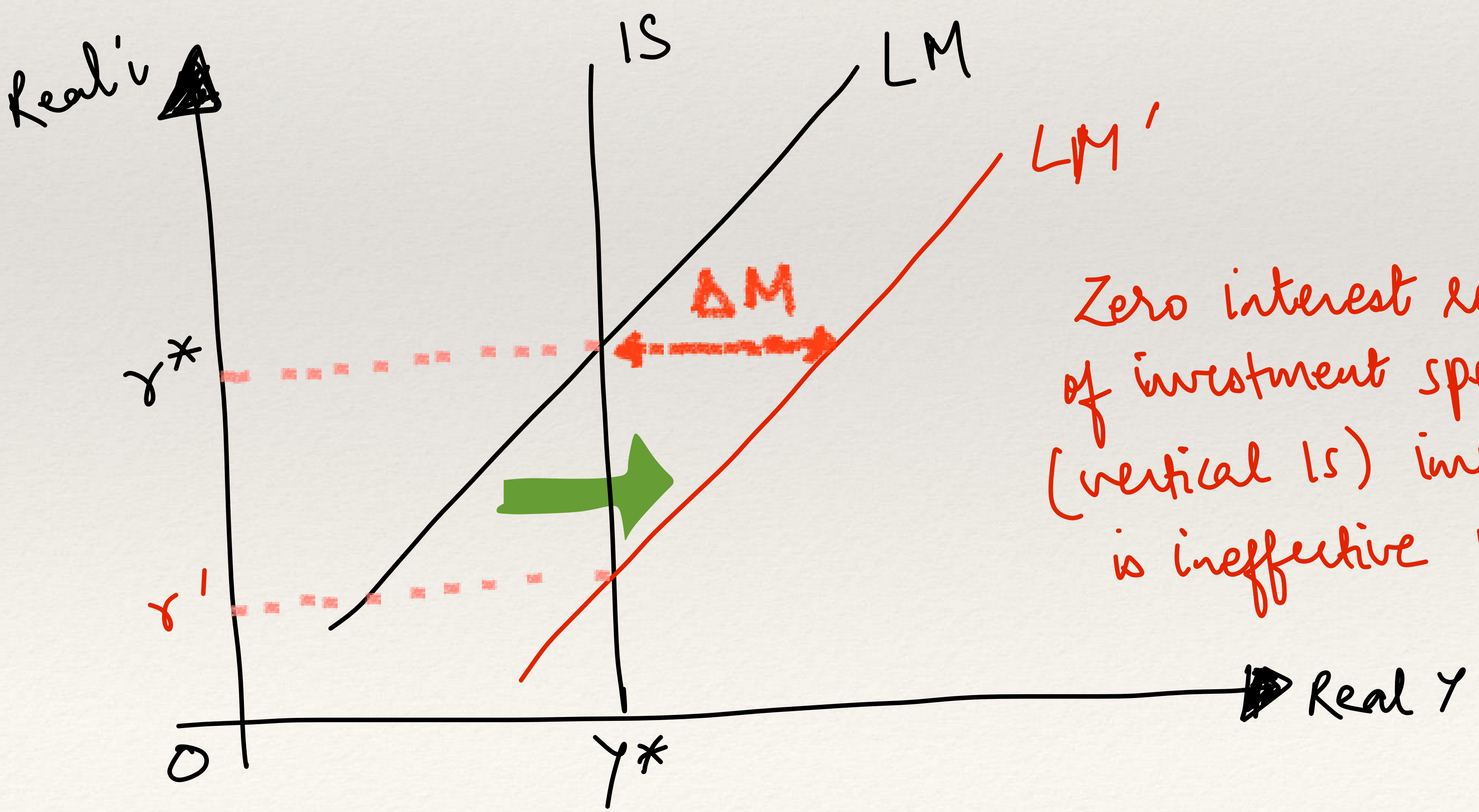
Liquidity trap is situation in which public is prepared at a given rate of interest to hold whatever money is supplied. It may occur at a **very low interest rate** and prevents the fall in rate of interest following the expansion in money supply.



Responsiveness of demand to change in interest rates

When changes in interest rate have insignificant impact on autonomous planned spending, especially investment expenditure.

This situation occurs when businesses/firms are **pessimistic about future prospects** of earning profits and so are reluctant to undertake any further investment in response to lower interest rate.



Zero interest responsiveness of investment spending (vertical IS) implies MP is ineffective in ΔY

Banks reluctant to lend

- This happened in US in 1991, 2008-10 when global financial crisis occurred. Similar situation seems to have occurred in India during GFC.
- Due to sub-prime lending crisis in US where banks had made bad loans to real estate. Instead of lending for private spending and investment, **banks went for safer options** like government bonds and securities.
- If due to **risk aversion** banks do not lend for private investment, the **link** in transmission mechanism that involves more private investment in response to lower interest rate **breaks down** to give boost to real national income.
- In India during 2008-09, RBI lowered its Repo rate and CRR for the banks, they were not much enthusiastic for lending to private firms for fear of default by them in repaying the loans. Therefore, to earn some return on their excess cash reserves due to easy monetary policy, some banks opted for investing in government securities beyond what was required under SLR.

“Paper money eventually returns to its intrinsic value - zero” — *Voltaire*

Thank you ☺