INDIAN SCHOOL AL WADI AL KABIR

Class: XII	**Department: Commerce**
Notes: Macro Economics	**Topic: Money and Banking**

Part A: MONEY

Introduction: Money is the most important discovery of modern times. It is the foundation stone around which all economic activities revolve. It is difficult to imagine an economy without money because it is the basic necessity of all economies.

ANSWER THE FOLLOWING:

Q1. Define money.

A: Money can be defined as a generally acceptable medium that can be exchanged for goods and services, and can be used as a measure and store of value.

Q2. What is barter?

A: Barter is a system of exchange in which goods and services are directly traded for other goods and services without the mediation of money.

Q3. Give a historical background of the evolution of money:

A:

- ❖ Before money was invented, the primitive world's trade was carried out according to the barter system of exchange. In the beginning of civilization, human needs were simple and limited. People used to exchange goods with each other to satisfy their wants. Barter exchange refers to exchange of goods for goods. An economy where there is direct barter of goods and services is called a barter economy or a C-C economy where C refers to commodity.
- ❖ Barter system can only work when there is double coincidence of wants. Double coincidence of wants refers to simultaneous fulfillment of mutual wants of buyers and sellers.
- ❖ With rise in economic activities, the exchange through barter system became difficult because it was not possible to satisfy the principle of Double coincidence of wants.
- ❖ As a result, barter system was replaced by monetary exchange i.e. buying and selling of goods by money.

Note: The term money is used to cover all such things such as coins, currency notes, cheques etc. which are used to conduct business transactions and settlement of business claims.

Q4. In terms of evolution, what are the different of money that we came across?

A:

- ❖ Initially a commonly used good was used as money. (rice, wheat etc.)
- ❖ Then subsequently alloy metal was used for coinage and coins of gold and silver were introduced.
- ❖ More recently, the modern times is the age of plastic money in the form of debit cards, credit cards or e-money in the form of electronic money.

Note: The origin and evolution of money is related to the need to facilitate <u>exchange.</u>

Q5. Define Money Supply:

A: It refers to total volume of money held by the public at a particular point of time.

Q6. What are the various features of money?

i. It includes 'money held by public only'. The term 'public' signifies money using sectors, i.e. individuals and business firms. It does not include money creating sector i.e. Government and banking system because cash balances held by them do not come into actual circulation of the country.
ii. It is a stock concept because it is concerned with a particular point of time.

Q7. Who are the producers or suppliers of money?

A: Producers of money refer to the suppliers of money. They include:

i. The government of the country
ii. The banking system of the country including both the Central Bank and the Commercial Banks.

Q8. What are the various measures of money supply?

A: Till 1967-68, Central Bank of our country used only the narrow measure of money supply. Since 1977 onwards 4 alternative measure of money supply has been evolved. (M1, M2, M3, M4).

Q8. What is M1 Measure of Money Supply? Explain its various components.

A: It is the first and basic measure of money supply. It includes:

M1 = Currency and coins with the public + Demand Deposits of commercial banks + other deposits with the Central Bank.

i. Currency held with the public:
   - ❖ It consists of paper notes and coins held by the public.

     (Note: Any currency held with the government and the banks are not to be included)
   - ❖ It includes coins of denominations 10,5,2,1 and paper notes of denominations 2000, 500, 200, 100, 50, 20, 10, 5 etc.
ii. Demand deposits of commercial banks:
   - ❖ It refers to Demand deposits of public with the commercial banks. Demand deposits are the deposits which can be encashed by issuing cheques at any time by the account holders. A DD deposit is treated as equal to currency held because it is readily accepted as means of payment.

   Note: DD deposits are taken on net basis i.e. interbank deposits are excluded. Interbank deposits are deposits held by banks on behalf of other banks. Such deposits do not form part of money supply because they do not belong to the public.

iii. Other deposits with the central bank:
- ❖ It includes deposits held by the central bank on behalf of foreign banks and governments, public financial institutions like NABARD, World Bank, IMF etc.
- ❖ However, it does not include deposits of the Indian Government and commercial banks with RBI.

Q9. Why currency money is also termed as 'Fiat Money'?

A: Fiat money is defined as the money which is under fiat or order from the government to act as money i.e. under law it must be accepted for all debts. So, currency money is also termed as 'Fiat Money".

Q10. Why currency money is also termed as 'Legal tender Money"?

A: It is also termed as 'Legal tender money' because it can be legally used to make payments of debts or other obligations.

Q11. What is High Powered Money?

A: It is the money produced by the RBI and the Government. It consists of two things:
i. Currency held by the public and
ii. Cash Reserves with the bank.

Q12. Why is High Powered Money more high powered than money?

A:
- ❖ Money consists of currency and demand deposits while High Powered Money consists of currency and cash reserves with the bank. It means currency held by the public is common in both. The only difference is that money includes demand deposits while high powered money includes cash reserves with the banks.
- ❖ High powered money (H) is high powered compared to money (M) because cash reserves (part of H) serve as actual base for the generation of demand deposits.

Q13: Complete the following sentences with regard to M1:
i. M1is the first and basic measure of <u>money supply.</u>
ii. M1 is known as 'Transaction money' as <u>it can be directly used for making transactions.</u>
iii. M1 is the most liquid measure of money supply <u>as all its components are easily used as a medium of exchange.</u>

Part B: BANKING

Q14. What is banking?

A: Banking is an industry that handles cash, credit and other financial transactions.

Q15. What are banks?

A: Banks provide a safe place to store extra cash and credit. They offer savings accounts. They also offer loans.

Q16. What does the monetary system of a country comprise of?

A: Monetary system includes central bank, commercial banks and the government of the country.

Q17: Complete the following sentences with regard to the banking system of India.

i. India has witnessed different <u>monetary standards in its monetary history.</u>

ii. The present monetary system in India is managed by <u>RBI and is known as Inconvertible Paper Currency Standard.</u>

iii. Rupee is regarded as <u>the standard of currency and all transactions are made in rupee.</u>

iv. India follows paper currency standard because <u>currency followed is made of paper.</u>

v. India follows <u>the minimum reserve system for the note issue.</u>

vi. Under this system RBI is required to keep <u>a minimum reserve of gold and foreign exchange worth 200 crores of rupees and on this basis, RBI can issue any number of notes.</u>

Q18. Name the two pillars of Indian banking system.

A: The Central Bank and the Commercial Banks.

Q19. Define commercial bank.

A: It is the primary unit of the banking system. It is an institution which perform the function of accepting deposits, granting loans and making investment with the aim of earning profits.

E.g. SBI, PNB etc.

Q20. Explain the two primary functions of commercial banks.

A: Two primary functions of the Commercial banks:

i. Accepting deposits: It is the most important functions of the commercial banks. They accept deposits in several forms according to requirements of different sections of the society.

a. Current account deposits or Demand deposits

b. Fixed deposits or Time deposits

c. Saving deposits

Note: Current account deposits and saving deposits are chequable deposits whereas fixed deposits are not chequeable.

ii. Advancing loans: The deposits received by the banks are not kept idle. So, after keeping certain cash reserves, the balance is given to needy borrowers and interest is charged from them which is the main source of income for these banks.

Q21. Explain the Money Creation or Credit Creation function of the commercial banks:
(Done in class in detail)

Q22. How do commercial banks raise national income?
A: They lend money mainly to investors. Rise in investment in the economy increases national income.

Q23. Define the central bank of a country.
A: It is the apex body that controls, regulates, operates and directs the entire banking and monetary structure of the country.

Q24. What is the central bank of India known as?
A: In India central bank is called Reserve Bank of India.

Q25. When was RBI established and under which act?
A: It was established in India on 1 April, 1935 in Kolkata under RBI Act, 1934.

Q26. What are the five categories of functions of the central bank?
A:
1. Currency Authority
2. Banker to the Government
3. Banker's bank and Supervisor
4. Controller of Money Supply and Credit
5. Custodian of Foreign Exchange Reserves
6. Lender of the last resort

Q27. Explain the Currency Authority function of the central bank (Bank of Issue).
A: RBI has the sole authority for issue of currency in the country (except one rupee notes and coins which are issued by Ministry of Finance).
Advantages of sole authority of note issue by the monetary authority:
- It leads to uniformity in note circulation.
- It gives the central bank power to influence money supply because currency with public is a part of money supply.
- It enables the government to have supervision and control over the central bank with respect to issue of notes.
- It ensures public faith in the currency system.
- It helps in stabilization of internal and external value of currency.

Q28. Explain the Banker to the Government function of the central bank.

A: RBI acts as a banker, agent and a financial advisor to the Central Government and the State Government (except Jammu n Kashmir).

- ❖ As a banker it carries out all banking business of the government:
- It maintains a current account for keeping all their cash balances
- It accepts receipts and makes payment for the government and carries out exchange, remittances and other banking operations.
- It also gives loans and advances to the government for temporary periods.
- ❖ As an agent it has the responsibility of managing the public debt.
- ❖ As a financial advisor, the central bank advises the government from time to time on economic, financial and monetary matters.

Qn29. Explain the Banker's bank and Supervisor function of the central bank.
A:

- ❖ Central Bank regulates and supervises all the commercial banks of our country. Being the apex bank, RBI acts as banker to other banks. In this sense, it bears the same relationship with other banks as the latter maintains with the public.

- ❖ As a banker's bank Central Bank functions in three capacities:

  i. Custodian of cash reserves:
  Commercial banks are required to keep a certain portion of their deposits (known as cash reserve ratio) with the central bank. In this way Central Bank acts as a Custodian of cash reserves of the commercial banks.

  ii. Lender of the last resort:
  When commercial banks fail to meet their financial requirements from other sources, they approach the central bank to give loans and responses as a lender of the last resort.

  iii. Clearing House:
- ❖ As central bank holds cash reserves of the commercial banks, it is easier and more convenient for it to act as clearing house.
- ❖ All commercial banks have their accounts with the central bank.
- ❖ Therefore, the central banks can easily settle claims of various commercial banks, by making debit and credit entries in their accounts.

As a supervisor:

- ❖ Central bank regulates and controls the commercial banks.
- ❖ The control is exercised by periodic inspection of banks and returns filed by them.

Qn30. Discuss the Custodian of Foreign Exchange Reserves function of RBI.
A: It also acts as Custodian of the country's stock of gold and Foreign Exchange Reserves.

- ❖ This function enables the central bank to exercise a reasonable control on foreign exchange.
- ❖ According to regulation of foreign exchange, all foreign exchange transactions must be routed through central bank.
- ❖ It also exercises managed floating to ensure stability of exchange rate in the international money market.

Q 31. Explain the lender of last resort' function of the Central Bank.
A: When a commercial bank faces financial crisis and fails to obtain funds from other sources, then the central bank plays the vital role of 'lender of last resort' and provides them with the financial assistance in the form of credit. This role of the the central bank saves the commercial bank from bankruptcy. Thus, the central bank plays the role of guarantor for the commercial banks and maintains a sound and healthy banking system in the economy.

Q 32. Distinguish between 'Qualitative and Quantitative tools' of credit control as may be used by a Central Bank. (C.B.S.E Outside Delhi 2019)
Answer:
Two types of methods are adopted by the central bank to control credit. These are quantitative methods and qualitative methods.
(a) Quantitative methods aim at controlling the cost and volume of credit created by commercial banks by using instruments like bank rate, open market operation and legal reserve ratios.

(b) Qualitative methods regulate the direction of flow of credit among various users rather than influencing just the availability of credit. Example: margin requirement, credit rationing, direct action and moral suasion.

Q 33. Explain any two methods of credit control used by Central Bank.
Answer:
Methods of credit control used by central bank are as follows:
(i) Bank Rate: Bank rate is the minimum rate at which the central bank discounts the first class bills of exchange and provides credit to the commercial banks.

The central bank increases the bank rate to correct the situation of inflationary gap or excess demand in the economy, Higher bank rate reduces the lending capacity of the commercial banks as they get funds at a higher interest rate from the central bank.

Consequently, money supply contracts in the economy as the public borrows less at high rate of interest. Similarly, the central bank decreases the bank rate to correct the situation of deflationary gap or deficient demand in the economy, Lower bank rate increases the lending capacity of the commercial banks as they get funds at a lower interest rate from the central bank Consequently, money supply expands in the economy as public borrows more at low rate of interest.

(ii) Open Market Operations: Open market operation is the policy of the central monetary authority to sell and buy the government securities in the market. The central bank sells government securities to commercial -banks and general public in a bid to correct the situation of inflationary gap or excess demand.

This decreases the stock of high powered money in the economy. Similarly, the central bank-purchases government securities from commercial banks and general public in a bid to correct the situation of deflationary gap or deficient demand. This increased the stock of high powered money in the economy.

Q 34. Explain the role of reverse repo rate in controlling money supply. (C.B.S.E 2017)
Answer:
Reverse repo rate is the rate at which the RBI or Central Bank borrows from other commercial

banks. It plays an effective role in controlling the money supply. For example, an increase in the reverse repo rate implies that the bank will get a higher rate of interest from the RBI on their lending.

As a result, the banks will lend more to the RBI and less to the public thus, resulting in a decrease in the money supply. Similarly, in case the RBI decreases the reverse repo rate, the banks will get a lower rate of interest on their borrowings. As a result, they will lend more to public, which will in turn increase the money supply.

Qn35. Why the commercial banks are always eager to lend money to the central bank?
A: Commercial banks are always happy to lend money to the central banks because

- they feel that their money is in safe hands.
- An increase in reverse repo rate induces the banks to transfer more funds to RBI due to attractive interest rates.

Qn 36. Define Credit Multiplier. Explain it with a numerical example.

A: Credit multiplier measures the amount of money that the banks are able to create in form of deposits with every initial deposit. Through the process of money creation, the commercial banks are able to create credit which is in excess of initial deposits.

Example: Initial Deposit: Rs 1000. LRR 20%, we will find Money Multiplier and Total Deposits created.

	Deposits (Rs)	**Loans (Rs)**	**Cash Reserves (Rs) LRR = 20%**
Initial Deposit	**1000**	**1000-200=800**	**1000x20%=200**
Round 1	**800**	**800-160=640**	**800x20%=160**
Round 2	**640**	**640-128=512**	**640x20%=128**
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Total	**5000**	**5000-1000=4000**	**5000x20%=1000**

$$\textbf{Money Multiplier} = \frac{1}{20\%}$$
$$= 100/20 = 5$$

Total deposits created = Money Multiplier X Initial Deposits = 5 X 1000 Rs = 5000Rs

Q 37. What role does the credit multiplier play in determining the credit creation power of the banking system? Explain with an example. (C.B.S.E 2019)
Answer:
Credit multiplier measures the amount of money that the banks are able to create in form of deposits with every initial deposit. Through the process of money creation, the commercial banks are able to create credit which is in excess of initial deposits.

- The credit creation by banks depends on credit multiplier as it is inversely related to legal reserve ratio. It is legally compulsory for the banks to keep a certain minimum fraction of their deposits as reserve. The fraction is called legal reserve ratio and it is fixed by the central bank. Higher the credit multiplier, higher will be the total credit created and vice-versa.

Example: Suppose the legal reserve is 10% or 0.1 and initial deposit is ₹ 1,000.
Credit Multiplier =1/0.1=10
Thus,
Total credit created = 10 x 1,000 = ₹ 10,000
Now suppose legal reserve is 50% or 0.5 and the initial deposit is ₹ 1,000.
Credit Multiplier =1/0.5=2
Thus,
Total credit created = 2 x 1,000 = ₹ 2,000
It can be seen that with the same initial deposit, total credit creation decreases with a fall in the value of credit multiplier.

Qn 37. What is meant by the supply of money? Discuss the factors which determine the supply of money.
Answer:
Money supply refers to the amount of money, which is in circulation in an economy at any given point of time.

Following factors determine the money supply:

- Monetary Standard: Money supply is affected by the monetary standard. If gold standard is adopted, there will be less supply of money. On the other hand, if paper currency system is adopted, money supply can be increased on the basis of demand.
- Production Volume: Volume of production also determines the money supply. If the level of production is high, the money supply will be more.
- Monetary Policy: Monetary policy of the government also affects the money supply. If the Central Bank increases the Cash Reserve Ratio there will be contraction in money supply.
- Fiscal Policy: Fiscal policy of the government determines the money supply. If government prepares deficit budget, money supply will increase.
- Other Factors: Banking habits, velocity of money, liquidity preference and the volume of money multiplier also determine the supply of money.