

CBSE Class–12 Economics
Macro Economics
Chapter 3 – Money and Banking
Revision Notes

Money: Money may be defined as anything which is generally acceptable as a medium of exchange and at the same time acts as a measure, store of value and standard of deferred payment.

Functions of Money:

1. Primary Functions

- a. Medium of exchange
- b. Common measure of value or unit of value

2. Secondary Functions

- a. Standard of deferred payment
- b. Store of value
- c. Transfer of value

3. Contingent Functions

- a. Basis of credit
- b. Liquidity
- c. Basis of price mechanism
- d. Maximum profit to the producers
- e. Maximum satisfaction to the consumers
- f. Basis of distribution of income

Barter Exchange: It implies the direct exchange of goods for goods without the use of money.

Difficulties involved in the Barter Exchange:

- 1. Lack of a common measure of value.

2. Lack of double coincidence of wants
3. Lacks of standard of deferred payments.
4. Lack of store of value.
5. Lack of divisibility.
6. Difficulty in exchange of services

Supply of Money: Total stock of money (currency notes, coins and demand deposit of banks) in circulation are held by the public at a given point of time.

Supply of money does not include cash balance held by central and state govt. and stock of money held by banking system of country as they are not in actual circulation of the country.

Measures of Money Supply = Currency held by Public + Net Demand Deposits held by commercial banks

$$M1 = C + DD + OD$$

C = Currency and coins with the public

DD = Demand deposits of the public with the banks

OD = Other deposits

$$M2 = M1 + \text{Post office savings deposits}$$

$$M3 = M1 + \text{Time deposits of commercial banks}$$

$$M4 = M3 + \text{Total deposits with the post office saving organisation excluding the deposits on NSC}$$

Banks and Banking System:-

Commercial Banks: Commercial Banks are financial institution who accepts deposits from the public and provide loans facilities for investment with the aim of earning profit.

Functions of Commercial Banks:-

1. Primary functions:-

- (a) Accepting deposits
- (b) Advancing loans
- (c) Discounting bill of exchange.

2. Secondary functions:-

- (i) **Agency function**

- (a) Transfer of fund
- (b) Collection of funds
- (c) Purchase and sale of shares and securities on behalf of the customers
- (d) Collection of dividend and interest
- (e) Payment of bills and insurance premium on behalf of customers
- (f) Acting as executor and trustee of will
- (g) Acting as correspondent and representative of customer and provide letter of credit to the customer.

(ii) General utility function

- (a) Purchase and sell of foreign exchange.
- (b) Issuance of traveller's cheque.
- (c) Safe custody of valuable goods in lockers.
- (d) Underwriting of securities.

Central Banks: The central Bank is the apex institution of monetary and financial system of a country. It makes monetary policy of the country in public interest. It manages, supervises and facilitates the banking system of the country.

Functions of Central Banks

1. Bank of Issue
2. Banker to the Government
3. Banker's Bank and Supervisor.
4. Controller of credit.
5. Lender of last resort
6. Custodian of foreign exchange reserves

MONEY CREATION OR CREDIT CREATION BY COMMERCIAL BANKS

CREDIT is defined as finance made available by one party to another party on a certain rate of exchange.

The capacity of banks to create money or credit depends on (i) Amount of primary deposits and (ii) Legal reserve ratio (LRR).

Legal Reserve Ratio (LRR):- is fixed by the central bank of a country and it is the minimum ratio of deposit legally required to be kept as cash by banks.

Cash Reserve Ratio (CRR):- It is a part of LRR which is to be kept with the central bank.

Statutory Liquidity Ratio (SLR):- It is a part of LRR which is to be kept with the bank themselves.

Commercial bank's demand deposits are a part of money supply. Commercial banks lend money to the borrowers by opening demand deposit account in their names. The borrowers are free to use this money by writing cheques. According to definition demand deposits are a part of money supply.

Therefore, by creating additional demand deposits bank create money. Money creation depends upon two factor:

Primary deposits and Legal Reserve Ratio (LRR).

Deposit Multiplier = $1/\text{LRR}$ Total Deposit creation = Initial deposit $\times 1/\text{LRR}$.

Repo rate: Repo rate is the rate at which the central bank of a country (Reserve Bank of India in case of India) lends money to commercial banks in the event of any shortfall of funds. Repo rate is used by monetary authorities to control inflation.

Description: In the event of inflation, central banks increase repo rate as this acts as a disincentive for banks to borrow from the central bank. This ultimately reduces the money supply in the economy and thus helps in arresting inflation.

Reverse repo rate: Reverse repo rate is the rate at which the central bank of a country (Reserve Bank of India in case of India) borrows money from commercial banks within the country. It is a monetary policy instrument which can be used to control the money supply in the country.

Description: An increase in the reverse repo rate will decrease the money supply and vice-versa, other things remaining constant. An increase in reverse repo rate means that commercial banks will get more incentives to park their funds with the RBI, thereby decreasing the supply of money in the market.

Fiat Money: - Fiat money is currency that a government has declared to be legal tender, but it is not backed by a physical commodity. The value of fiat money is derived from the relationship between supply and demand rather than the value of the material from which

the money is made.

Fiduciary Money: - Money that depends for its value on confidence that it is an accepted medium of exchange. It originated as a paper certificate that was a promise to pay a certain amount of gold or silver to the bearer. From the Latin **fiducia** meaning confidence or trust.

High Powered Money: - This is the monetary aggregate that the Federal Reserve has control over through its monetary policy. Also called High Powered Money because the effect of changes in monetary base on money supply is magnified by money multiplier.