Std : XII

Subject – Economics

Chapter 3 – Money and Banking (Macro Economics)

1. What is barter system? What are the drawbacks?

Barter system of exchange is a system in which goods are exchanged for goods. It is also called C-C economy. Money as a medium of exchange does not exist.

It has the following drawbacks:

a) Both sale and purchase should occur simultaneously implying double coincidence of wants.
b) There is no common unit of exchange in a barter system, accordingly, exchange remains limited.
c) It does not allow any convenient method of storage of value.
d) Division of goods in exchange may not be possible, so some wants may remain unsatisfied.

2. Define money.

Money can be defined as something that is generally accepted as a means of exchange and acts as a measure and as a store of value.

3. What are the functions of money?

a) Medium of exchange – It means that money acts as an intermediary for the exchange of goods and services.
b) Measure of value – It serves as a measure of value in terms of unit of account, i.e in monetary unit. Eg. Price of sugar
c) Standard of deferred payments – It refer to those payments which are made in future. It is more durable compared to other commodities. It has general acceptability and price remains stable.
d) Store of value – It is convenient to store value in terms of money because it has general acceptability and stability of value.

4. What is money supply?

It refers to the total quantity or stock of money available in the economy at a point of time. The components of money supply are currency held by the public and Demand Deposits with the commercial banks.

MS = CU + DD

5. What are the alternative definitions of money supply in India?

In India, there are four alternative measures of money supply, popularly known as M1, M2 , M3 and M4.

M1 = Currency with public + Demand Deposits + Other deposits

M2=M1 + Deposits with Post Office Saving Bank Account

M3= M1 + Net Deposits with the commercial banks

M4 = M3 + Total deposits with Post Offices (Other than in the form of National Saving Certificate)

6. Define Commercial bank.

Commercial banks are the banks which do banking business to earn profit. According to Culbertson – "Commercial banks are the institutions that make short term loans to business and in the process create money".

7. Explain the functions of a commercial bank.

a) Accepting deposits – A commercial bank accepts deposits from the public. People can deposit their cash balances as chequeable deposits or non – chequeable deposits.
b) Advancing loans – A bank advances loans both for productive purposes as well as consumption purposes. By advancing loans through credit creation it contributes to money supply in the economy.

8. Define CRR

Cash Reserve Ratio refers to the cash reserves of the commercial banks with RBI, as a percentage of their total deposits.

9. Define SLR

It refers to the liquid assets that the commercial banks must hold as a percentage of their total deposits.

10. Define LRR

It refers to CRR as well as SLR ratio as fixed by the central bank, and which the commercial banks are to accept as a legal binding.

11. Explain the process of money creation by the commercial banks with the help of a numerical example.

Money or credit creation is an important function of the commercial banks. By creating credit, commercial banks contribute to money supply in the economy. They create credit in the form of demand deposits.

Let us assume that all banks in the economy receive cash deposits of Rs. 10000. These are demand deposits of the people. The LRR is 10% then

Initial deposit = 10000 –(10% of 10000) = 9000

9000-(10% of 9000) =8100

8100- (10% of 8100) =………………..

Money creation = Initial deposit x 1/LRR

=10000 x 1 / 10%

= 10000 x 100/10

= Rs. 100000

It is important to note that loans are never offered in cash. These are always reflected as demand deposits in favour of the borrowers. Accordingly, when loans are offered worth Rs. 10000, Money creation in the economy is worth Rs. 100000.

12. Define Central bank.

A central bank is an apex institution of a country that controls and regulates the monetary and financial system of the country.

13. Explain the main functions of the central bank.

a) Monopoly of note issue – It is the sole note issuing authority in the country. This is called 'Currency Authority Function' of the central bank. It is the apex bank that controls the entire banking system of a country.
b) Banker to the Government – It acts as a banker, agent and financial advisor to the government. As a banker to the government it keeps the accounts of all government banks and manages government treasuries. It also transfers government funds. The loans are given to the government without any interest for short-term.
c) Banker's Bank – It performs the function of a banker to all other banks in the country. It keeps part of the cash balances of all commercial banks as deposits with a view to meeting liabilities of these banks in times of crisis.
d) Lender of the last resort – It also acts a lender of last resort for the other banks of the country. It means that if commercial bank fails to get financial accommodation from anywhere it approaches the central bank as a last resort. It advances loans to such a bank against approved securities.
e) Custodian of the Nation's Reserves of Foreign exchange – These reserves are regulated to stabilize exchange rate in the international money market and to promote exports.
f) Controller of credit. Credit control refers to the increase or decrease in the volume of credit money in accordance with the money requirement of the country. It seeks to contain credit money within reasonable limits.

14. How does the central bank perfume the function of controller of credit?

a) Bank rate – It is the rate at which the central bank offers loans to the commercial banks as a 'lender of last resort'. During inflation when supply of money is to be reduced, bank rate is increased. This reduces borrowing by the commercial banks, implying a reduction in their cash reserves and therefore a reduction in their capacity to create credit. Following increase in bank rate, market rate of interest is also raised implying a check on borrowings from the commercial banks. Thus overall, supply of credit is reduced in the economy. Exactly opposite is done to combat deflation, bank rate is lowered to increase the supply of credit.

b) Open Market Operations – This refers to sale and purchase of securities by the central bank in the open market. To increase money supply during deflation, securities are purchased by the central bank. On the other hand, to decrease money supply, securities are sold off.
c) Varying LRR - It refers to CRR as well as SLR ratio as fixed by the central bank and which the commercial banks are to accept as a legal binding. When LRR is raised during inflation, credit creation capacity of the commercial banks is curtailed. On the other hand, when LRR is lowered during deflation, credit creation capacity of the commercial banks is enhanced.
d) Margin requirements – A margin refers to the difference between market value of the security offered for loan and the amount of loan offered by the commercial banks. During inflation, supply of credit is reduced by raising the requirement of margin. During deflation, supply of credit is increased by lowering the requirement of margin. This measure is often used to discourage the flow of credit into speculative business activities.
e) Moral Suasion – It refers to moral pressure, exercised by the central bank on the commercial banks to be restricted and selective in lending during inflation and to be liberal in lending during deflation. This measure is used as a selective credit control instrument to channelize the flow of credit to priority.

Answer the following:

1. Distinguish between commercial and central bank.
2. Explain the money creation process of commercial process with the help of a numerical example.
3. What is meant by ideal money supply in India?
4. Define fiat and fiduciary money.
5. How does money overcome the shortcomings of a barter system?
6. Define credit multiplier