Economics Notes PDF

On

Money and Banking

(Class – 12)

MONEY

Money is the most often used means of exchange. It is an economic unit that serves as a universally accepted means of exchange in a transactional economy. Money offers the benefit of lowering transaction costs, particularly the double coincidence of wants. There can be no exchange of commodities and thus no role for money in an economy consisting of only one person.

FUNCTIONS OF MONEY

The functions of money are broadly classified as:

1. Primary functions:
(I) a mode of exchange.
(II) A common measure of value or a common unit of value.

2. Secondary functions:
(I) Value storage.
(II) Value transfer.
(III) Deferred payment standard.

BARTER SYSTEM

Barter system of exchange is a system in which goods are exchanged for goods.
For example, wheat may be exchanged for cloth; house for horses, etc., or a teacher may be paid wheat or rice as a payment for his/her services.
Such exchange exists in the C-C Economy (commodity to commodity exchange economy).
Note: In C-C Economy C stands for commodity. C-C economy is the one in which commodities are exchanged for commodities. C-C exchange refers to the barter system of exchange. Hence, C-C Economy is an economy dominated by a barter system of exchange.

Difficulties involved in the Barter Exchange:

- Lack of a common measure of value.
- Lack of double coincidence of wants
- Lack of standard of deferred payments.
- Lack of store of value.
- Lack of divisibility.
- Difficulty in exchange of services

DEMAND OF MONEY

It is referred to as an individual's liquidity preference, which is the decision of holding money in liquid form, i.e., cash, in order to earn interest or as a precaution. Money demand is impacted by a number of factors such as inflation, income, interest rates, and future uncertainty. The two important motives for the demand of money: transaction, and speculative motives, is commonly used to describe how these elements affect money demand.

i. Transaction Motive: The drive to hold cash amounts is referred to as the transaction's motive. The fact that most transactions involve an exchange of money is the transaction motive for demanding money. Money will be demanded because it is necessary to have money available for transactions. The aggregate quantity of transactions in an economy tends to increase as income grows. As a result, as income or GDP rises, so does the demand for money in transactions.

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ii. Speculative Motive: It refers to funds retained by investors in order to capitalise on potential investment opportunities in the economy. When retaining money is thought to be less hazardous than lending it or investing it in another asset, the speculative motive for demanding money emerges.

Aggregate Money Demand: In an economy, the entire demand for money is made up of transaction demand and speculative demand. The former is proportionate to real GDP and the price level, whereas the latter is inversely related to the market interest rate.
Md =MdT + Mds
Where,
Md = Money Demand
MdT = Transaction Demand
MdS = Speculative Money Demand

Fiat money: It is the currency that a government declares to be legal tender but is not backed by a physical asset. The value of fiat money is calculated by the link between supply and demand rather than the worth of the commodity used to make the money.

SUPPLY OF MONEY
Total stock of money (currency notes, coins and demand deposit of banks) in circulation is 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 the banking system of the 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
M_1 = C + DD + OD
C = Currency and coins with the public
DD = Demand deposits of the public with the banks
OD = Other deposits
M_2 = M_1+ Post office savings deposits
M_3 = M_1+ Time deposits of commercial banks
M_4= M_3+ Total deposits with the post office saving organisation excluding the deposits on NSC

BANKS

1. Commercial Bank: Commercial bank is a financial institution which performs the functions of accepting deposits from the public and making loans and investments, with the motive of earning profit.

Functions of Commercial Banks:
- Primary function
- Secondary functions:
  - Agency function
  - General utility function

2. The Central Bank: It is the apex institution of a country's monetary system. The design and the control of the country's monetary policy is its main responsibility. India's central bank is the Reserve Bank of India.

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 BY BANKS

If the value of any of its constituents, such as CU, DD, or Time Deposits, changes, the money supply will alter. The public's preference for maintaining cash balances as opposed to bank deposits has an impact on the money supply. The following major ratios summarise these influences on the money supply.

The capacity of banks to create money or credit depends on:

(i) Amount of primary deposits
(ii) Legal reserve ratio (LRR).

Legal Reserve Ratio (LRR):- It 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.

LIMITS TO CREDIT CREATION AND MONEY MULTIPLIER

Cash Reserve Ratio (CRR): It is a portion of a bank's total deposits that the Reserve Bank of India requires to be kept with the latter as liquid cash reserves. When computing the base rate, one of the reference rates is the cash reserve ratio. The base rate is the lowest lending rate at which a bank is not permitted to lend money. The Reserve Bank of India sets the base rate. The rate is fixed, ensuring openness in the credit market when it comes to borrowing and lending.

CONTROLLER OF MONEY SUPPLY AND CREDIT

1. The Statutory Liquidity Ratio (SLR): It refers to the minimum percentage of net total demand and time liabilities, which commercial banks are required to maintain with themselves. In a situation of excess demand leading to inflation, the central bank increases statutory liquidity ratio (SLR), which will reduce the cash resources of commercial bank and reducing credit availability in the economy.

2. Bank Rate (Discount Rate): Bank rate is the rate of interest at which the central bank lends to commercial banks without any collateral (security for purpose of loan). The thing, which has to be remembered, is that the central bank lends to commercial banks and not to the general public.

3. High Powered Money: It is the money created by the RBI and the government, in which the public holds the currency, and the banks hold the cash reserves. It differs from money for that money consists of demand deposits, whereas cash reserves serve as a foundation for creating demand deposits.
High-powered money is the sum of commercial bank reserves and currency, which denotes the notes and coins held by the general public. The increase of bank deposits and the creation of a money supply are both based on high-powered money.

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4. 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.

5. Reverse Repo Rate: It is the rate at which the Central Bank (RBI) borrows money from commercial banks. In a situation of excess demand leading to inflation, Reverse repo rate is increased, which encourages the commercial bank to park their funds with the central bank to earn higher return on idle cash. It decreases the lending capability of commercial banks, which controls excess demand.

6. Open Market Operation: It refers to the central bank's selling and purchase of securities on the open market to and from commercial banks or the general public. The open market operation is one of the quantitative techniques used by the Reserve Bank of India to smooth out liquidity conditions throughout the year and reduce the impact on interest and inflation rates. Changes in the Cash Reserve Ratio (CRR), bank rate, or open market operations are all examples of quantitative measures used to limit the size of the money supply.

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