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MONEY & BANKING

Q What do you mean by money?

ans Money is anything which is generally ~~exp~~ accepted as a medium of exchange, measure of value, store of value and means of standard of deferred payment.

Q What do you mean by barter system? List limitations.

ans Barter system refers to exchange of goods for goods. An economy where there's direct barter of goods & services is called barter economy.

In case of barter system there were some limitations -

(a) Lack of Double Coincidence of Wants → Barter system can work only when both buyer and seller are ready to exchange each others goods.
For e.g. → A wants to give wheat in return for rice and B wants to give rice but inturn needs vegetables.

(b) Lack of Common measure of value → In barter system there's no common measure of value in which exchange ratios could be expressed.
For e.g. → 'A' has wheat & 'B' has rice. It's difficult to to decide how much wheat is needed in return of 1 kg of rice.

10,000,000 x $\frac{12}{100}$ = 12,00,000

n = 72,00,000 + 12,00,000

delay

(3) Lack of standard of ~~defur~~ deferred payment → Under barter system contracts involving future payments or credit transactions cannot take place easily because of certain issues like arranging same quality of goods at the time of repayment, the commodity to be repaid may gain or loose its value. So it was difficult to do deferred payments under barter system.

(4) Lack of store of value → Under barter system its difficult for people to store wealth for future use because most of the goods aren't durable and loose value over a period of time. Also it takes lots of efforts & time to store goods for a longer period. Because of this goods couldn't be stored to earn in future.

(5) Lack of Divisibility → Under barter system goods were exchanged for goods but in case of some goods divisibility wasn't possible. ∴ exchange was also not possible. For e.g. → A wants to give horse and 'B' wants to give elephant. Since, elephant is bigger and cannot be divided so the exchange wasn't possible.

Q What do you mean by 'money supply'?

ans Money supply refers to total volume of money ~~for~~ held by public at a particular point of time in an economy. Here public includes money using sectors i.e. individuals and business firms but it doesn't include - money creating sector i.e. Govt., banking system, etc.

Q. What are the different measures of money supply?

ans There're mainly 4 measures of money supply given by RBI. These include -

1. M_1
2. M_2
3. M_3
4. M_4

- M_1 → It's the first and basic measure of money supply which is also known as transactionary money since it can directly be used for making transactions. Here M_1 =

$$M_1 = CC + DD + OD$$

CC = currency and coins with public; DD = demand deposits of commercial banks; OD = Other deposits with RBI

M_1 is the most liquid measure of money value as all of its components can directly be used for making transactions. The currency included in M_1 is also termed as fiat money i.e. money under the order of the govt. It's also termed as legal ~~tender~~ tender money.

→ (Demand deposits are those deposits that can be encashed by issuing cheques.) like current account & saving account. It doesn't include interbank deposit.)

→ Other deposits include deposits held by RBI on behalf of other govts., banks, world bank, etc.

2. $M_2 \rightarrow$ It's a broader concept of money supply as compared to M_1. In addition to M_1, it includes saving deposit with post office saving bank.

So $M_2 = M_1 +$ saving deposit with post office saving bank

Here a point to be noted that saving deposits with post office is not withdrawable by cheques.

3. $M_3 \rightarrow$ This concept is also a broader concept as compared to M_1. In addition to M_1, it also includes net time deposits with banks. Here time deposits include deposits that aren't withdrawable on demand and they can only be withdrawn after a pre-decided time period. $M_3 = M_1 +$ time deposits

4. $M_4 \rightarrow$ This is again a broader concept of money supply which includes total deposit with post office saving bank along with M_3.

So, $M_4 = M_3 +$ total deposits with post office saving bank

Q. What are the important facts about measures of money supply?

ans 1. In terms of liquidity M_1 is the most liquid form of money supply and M_4 being the least.

2. M_1 and M_2 are considered as narrow concepts of money supply. M_3 and M_4 as broader concepts

3. M_3 is widely used as a measure of money supply & it's also known as aggregate monetary resources of the country.

Q, What do you mean by a cashless society?

ans It refers to an economic state where financial transactions aren't connected with money in the physical form of bank notes or coins but through the transfer of digital information between the parties.

For e.g. → UPI transfer, wallet transfer, online banking, etc.

Q What do you mean by commercial bank?

ans A commercial bank is a financial institution that accepts deposits and advance loans as main functions with an objective to earn profit

Q How has the introduction of plastic money enhanced the convenience of both the depositor & the bank. Explain.

ans The introduction of plastic money in form of debit and credit cards has enhanced the convenience of both the depositors & the bank. This is due to potability that the plastic money possess. Because of this, the popularity of plastic money has increased over and above the bank money (in form of cheques, etc). These cheques can be encashed in banks only and if issued to someone actual money is transferred not instantly but later on.

In today's date the online transfers have become even more convenient.

Q Explain different functions of a commercial bank.

ans The functions of a commercial bank can broadly be categorised into

(a) Primary Functions (b) Secondary Functions
(c) Agency Functions (d) Utility Functions

I Primary Functions –

① Accepting Deposits → It's the most important and traditional function of a commercial bank to accept deposits from public under various categories like –

(a) Saving A/c (d) Recurring deposits etc.
(b) Current A/c
(c) Fixed Deposit

(Advancing)
② Providing Loans – It's the second important function of any commercial bank in which it advances loan to the borrower under various heads like

① Cash credit → It refers to a loan given to borrower against his current asset like shares, stock, bonds, etc. In this kind of credit, a credit limit is sanctioned to the borrower and borrower may withdraw any amount within the limit. The interest is charged on the amount actually withdrawn.

For e.g → Limit sanctioned is ₹ 50,00,000 but borrower withdraws ₹ 20,00,000. He will be paying interest on ₹ 20,00,000 only and not the total amount

b. Demand Loans → It refers to those loans which can be recalled on Demand and their is no fixed maturity for these loans. The loan amount is paid in lumpsum by crediting the account of borrower. These loans are taken against personal and financial assets.

A point to be noted here is that the interest is paid on the whole amount unlike cash credit.

c. Short term Loans → These loans are given as personal loan against some security. The purpose of these loans may be financing working capital or other short term means. In this case also the entire sum is credited to the borrower's a/c. He can withdraw the amount he requires at any point of time but a point to be noted here is → the interest is chargeable on the entire amount.

II Secondary Functions →

(i) Overdraft Facility → It refers to a facility in which a customer is allowed to overdraw his current account upto to an agreed limit. This facility is given to some reliable and reputed customers for a short period of time. Customers have to give interest on the amount over withdrawn.

(ii) Discounting of bills of exchange → It refers to a facility in which the holder of bills of exchange can get his bills discounted with bank before maturity where bank gives the amount to the holder after deducting a certain amount of comission. on maturity bank gets payment from other party who had accepted the bill.

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III Agency Functions → Commercial banks perform certain functions on behalf of customers in the capacity of an agent. These function include transfer of funds.

1. Transfer of Funds → Bank provide this facility in which funds can be transferred from one place to another with the help of instruments like demand drafts, online transfers, etc

2. Collection & Payment of ~~Various~~ Certain Items → Commercial banks collects cheques, interest, dividend, ~~etc~~ subscription, etc. on behalf of customers and also make payments like taxes, insurance premium on instruction of customers.

3. Purchase and sale of Foreign Exchange → Some of the banks are authorised by central bank to deal in foreign exchange. They buy and sell foreign exchange on behalf of their customers and facilitate international trade.

4. Trustee and executor → Some banks keep the wills of their customers as trustee and execute them after their death as executor.

5. Letter of ~~Tra~~ Reference → In this, banks provide information about economic position of their ~~cu~~ ~~an~~ to traders ~~or~~ ~~supply~~ provide similar info. of traders to its customers.

IV Utility Functions

1. Locker facility → Banks provide facility of safety lockers to keep valuables of customers against certain charges

2. Travellers Cheques → Banks issues travellers cheques to their customers to avoid risk of carrying cash during their journey abroad.

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3. Letter of Credit - This letter is issued to customers to certify their credit worthiness so that trade is facilitated.

Q Explain the process of credit creation (money creation) by a commercial Bank.

ans Credit creation is one of the most important functions of ~~money creation~~ commercial bank, through the process of money creation. Commercial bank can create credit which is much more than the initial deposits. To explain the process following assumptions are taken -

1. The entire commercial banking system is one unit is termed as banks.

2. As the receipts and payments in an economy are done through banks only.

In a normal process of banking a bank accepts deposits from public which is used for giving loans, a point here to be noted is that the banks cannot use the whole deposits for lending and they have to keep certain percentage of deposit as reserves that percentage is defined by RBI as legal reserves ratio is LRR.

To understand the process of credit creation. let us suppose that there's an initial deposit of ₹1000 in the bank and LRR is 20%. Now banks have to keep 20% of 1000 i.e. 200 as reserves and it's free to lend ₹800 to others.

2. Now suppose it lends 800 which banks don't give in cash rather they open accounts in the name of borrower who can withdraw that much amount whenever they like.

3. Suppose that borrower uses this money and issues a cheque of ₹800 in favour of other person that person deposits this cheque in banks and banks got a fresh deposits of ₹800.

4. Now again it has to keep 20% of 800 i.e. 160 into reserves and it's free to lend 640. When it lends that amount a new deposit of 640 is created in the name of borrower.

5. This process of lending, creating deposits keeps on going until the whole amount is completely exhausted. This process can be understood with the help of following table.

	Deposits	Loans	Cash reserves (LRR is 20)
Initial	1000	800	200
Round I	800	640	160
Round II	640	512	128
	.		
	.		
	.		
	0		
Total	1000×5=5000	800×5= 4000	200×5=1000

As we can see in the table banks are able to create total deposits of ₹5000 with the initial deposits of ₹1000. So the total deposits have become 5 times of initial deposits. Here 5 is nothing but value of money multiplier.

~~Money~~ Money Multiplier $= \frac{1}{LRR}$

As in case LRR is 20% i.e 0.2

$$\text{So } M.M = \frac{1.0}{0.2}$$
$$= 5.$$

Q. Difference between Demand Deposit and Fixed Deposits?

	Demand Deposits	Fixed Deposits
Time Dimension	There's no fixed time dimension.	There's a time dimension.
Cheque facility	There're chequeable deposit.	They aren't chequeable deposit.
Interest	They carry less or no interest	They carry generally higher interest
No. of transactions	Generally large no. of transaction are allowed	There's hardly any transaction allowed.

$M.M = \frac{1}{LRR} \times I.D.$

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Q. Calculate the total deposit created if there's I.D of ₹1000 and LRR is 12.5%.

$T.D = \cancel{1000}^{8} \times \frac{1000}{\cancel{125}}$

$\boxed{\text{Total deposits} \rightarrow ₹8000}$ ans.

$\frac{125}{1000} \times 8$

Q. If T.D created is ₹10,000 at an initial deposit of x amt. Find out x if LRR is 20%.

$10,00\cancel{0} = x \times \frac{10\cancel{0}}{2\cancel{0}}$

₹ 2000 = x ans.

Q. If I.D is ₹5000 and T.D is ₹75,000 find LRR

$75,\cancel{000} = 5\cancel{000} \times \frac{1}{x}$

$\frac{75}{5} = \frac{1}{x}$

$15 = \frac{100}{x}$. 15

~~0.15 = x ans.~~

$x = \frac{100}{15}$ 20 / 3

$3 \overline{)20} \; 6.6$; 18; 20

$\Rightarrow$ x = 6.6% ans.

Q. If I.D ~~= F~~ changes into T.D of 10 times, find out LRR

Let ~~F~~ I.D = x

T.D = $x \times 10$

T.D = $10x$

$\cancel{x = 10x \times \frac{100}{LRR}}$

$\cancel{\frac{x}{10x} = \frac{100}{LRR}}$

$\cancel{\frac{1}{1000} = \frac{1}{LRR}}$

$\cancel{0.001 = LRR}$

$10x = x \times \frac{100}{LRR}$

$\frac{x}{10x} = \frac{1}{LRR}$

LRR = 0.1 ans.

LRR = 10% ans.

Q. If I.D creates T.D of 4 times. Find LRR

Let x = I.D

$4x = x \times \frac{100}{LRR}$

$\frac{4x}{100x} = \frac{1}{LRR}$

$LRR = \frac{100}{4}$

LRR = 25% ans.

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Q. If I.D increases the T.D by 100%. Find LRR.

Let I.D = x

$x + 100\% x = x \times \frac{100}{LRR}$ LR

$2x = x \times \frac{100}{d}$

$\cancel{\frac{x + 100}{x \times 100 \times 100} = \frac{1}{LRR}}$

$\cancel{\frac{x+100}{x \times 10000} = \frac{1}{LRR}}$

$\cancel{\frac{400x}{100} = \frac{200x}{LRR}}$

I.D = x T.D = 2x

$2\cancel{x} = \cancel{100x}\ \cancel{x} \times \frac{100}{LRR}$

LRR = 50% ans.

Q. Calculate the LRR if I.D of 200 Cr. leads to creation of T.D of 1600

$\cancel{1600}^{8} = \cancel{200} \times \frac{1}{LRR}$

$8 = \frac{100}{LRR}$

$\cancel{0.08}\ LRR = \frac{100}{8}$

LRR = 12.5%

ans.

$8 \overline{)100}\ 12.5$
8
20
16
40

Q How does money creation by commercial bank effects the national income?

ans. The process of money creation by commercial banks increases the national income since commercial banks lend money mainly to investors and rise in investment leads to more and more of prod^n of goods & services that leads to increase in national income by multiplier effect

Q Define Central Bank of a country.

ans Central Bank is a top most body in the banking system of a country that controlls, operates, regulates and directs the entire banking and monetary structure of the country. It occupies the supreme position in monetary and banking system of the country. India's central bank is RBI (Reserve Bank of India) that was established on 1st April 1935 under Reserve Bank of India Act passed in 1934.

Q What are different functions of central bank?

ans Main functions of central Bank are:-

① Bank of Note Issue → Central Bank has the sole authority to issue currency in the country. In India, RBI ~~is the~~ has the sole right of issuing paper currency notes except ₹1 and coins which are issued of Ministry of Finance of govt. of India. All currency issued is a kind of liability on central bank. It's obliged to back the currency with equal value of assets that can be gold coins, foreign securities, govt's local currency securities.

(2) Banker to Govt. → The RBI serves as a banker to govt. and in the capacity of a banker it acts as banker, agent as well as financial advisor.

- As a banker, it perform all banking activities like maintaing a current account on behalf of govt. ~~excep~~ accepting deposits & making payments for govt.. it also gives loans to Govt. Govt. takes loans from RBI by selling its treasury bills.

- As an agent, central bank manages public debt on behalf of Govt.

- As a financial advisor, Central bank advises Govt. on various economic issues like economic instability that may arise due to ~~reso~~ depression in market or inflation of prices

(3) Banker's Bank → There are no. of commercial banks in our country and their should be some organization to regulate and to supervise their proper functioning. being the top most bank central bank acts as a Banker to other banks. As a commercial bank has relationship with general public, central bank has similar kind of relation with commercial banks. As a banker to Bank it performs various functions that include

(i) Custodian of Cash Reserve → Commercial banks are required to keep a certain portion of their deposits with central bank according to CRR. In this way, central Bank maintains deposits of Commercial banks.

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(ii) Lender ~~of~~ Last Resort → When commercial bank fail to meet their financial requirements from other sources they approach central bank to give loans & advances as lender of last resort.
Central banks help these banks through discounting of approved bills of exchange.

(iii) Clearing house function → Central bank holds the cash reserves of all commercial banks, in other words it has accounts of all the banks so it's easy for it to act as a clearing house. Therefore central bank settle accounts of various banks with each other by just passing an entry in their accounts. ~~Last~~

(iv) Supervision → As the top most body in the banking system central Bank controls and regulates all the commercial banks in economy that maybe related to licensing as a bank, branch opening, winding up, etc. This supervision is done by time to time visits and inspections.

Q Differentiate between a commercial and central bank.

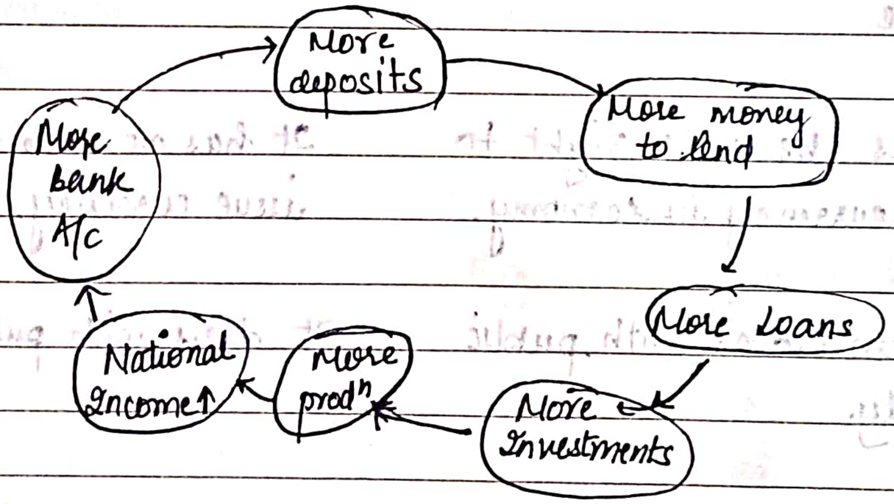
Basis	Central Bank	Commercial Bank
Meaning →	Defⁿ	Defⁿ
Status	It's the top most body in the banking system of a country.	It's just ~~the~~ a unit in banking system of the country and operates under the control of central bank.
Ownership	It's generally owned by Govt. of the country.	It's owned by private as well as Govt. sector in a country.
Objective	It's objective is to serve economy without profit motive	It's objective is to maximise profits.
Currency Issue	It has the sole right to issue currency in economy.	It has no such rights to issue currency.
Public Dealing	It doesn't deal with public directly.	It deals with public directly.
No. of banks.	There's only 1 central bank in country as RBI in India.	There are no. of commercial banks in a country like SBI, PNB, BOB, etc.

Q. The reserve bank of India aims to make credit costly for general public in order to reduce the availability of credit. What should be done?

ans. The RBI should increase the bank rate or repo rate that is the rate at which central bank lends to a commercial bank. With increase in this rate, the credit becomes costlier for commercial banks and inturn for general public. So by increasing the bank rate central bank can make credit costlier for general public.

Q Government of India has recently launched Jan Dhan Yojana aimed at every household in country to have atleast one bank account. Explain how deposits made under the plan are going to affect national income of the country?

ans.



The deposits made under this scheme are going to affect national income of the country in following way:-

1. More bank a/c's will create more deposits for banks
2. More deposits will increase the lending capacity of banks
3. More lending capacity will increase the loans in economy.
4. More loans will lead to higher amounts of investments.
5. Higher amt. of investments will lead to higher prodⁿ of goods & services

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⑥ Higher prodⁿ means higher national income in economy.

Q. How central bank plays the role of controller of credit in an economy?

ans. It's the most crucial function played by a central bank of an economy. It uses following techniques to control credit.

① Quantitative techniques → They affect the volume of credit in an economy and they include
a. Open market operations
b. Bank rate policy
c. Repo rate
d. Legal Reserve Ratio

② Qualitative Techniques → These techniques affect the direction of credit in an economy and include
a. Margin Requirement
b. Moral suasion

Q. Explain Quantitive techniques of central bank for controlling excess credit / Inflation in an economy.

ans. Quantitative techniques are as follows :-

① Bank rate → Long term It's the rate at which central bank lends money to commercial bank to meet their long term needs.
In case of excess credit central bank Increases this rate which leads to increase in lending rate by commercial banks and the general public get discouraged to take more loans which reduces the excess credit in economy.

Ch-3 National Income

(2) Repo Rate → It's the rate at which central bank lends money to commercial banks to meet their short term financial needs and increase in this rate increase the cost of borrowing from central bank that forces commercial bank to increase their lending rates. It discourages borrowers from taking loans that reduces their credit creation capacity.

(3) Open market Operations → It refers to buying and selling of securities of Govt. by central bank to public and commercial banks. When central bank sells such securities, it reduces the reserve of commercial banks that negatively affects their ability to create credit. On the other hand purchase of securities by central bank increases the reserves with commercial banks as well as their ability to create credit.

(4) Legal Reserve Requirements → As per legal reserve requirements, commercial banks are required to maintain reserves. It's a quick and direct method of controlling credit. A commercial bank is required to maintain reserves on 2 accounts — (a) Cash reserve ratio ~~(b) S~~ -

→ It represents the minimum percentage of net time & demand deposits to be kept by commercial bank with central bank & Increase in CRR reduces the ability of commercial banks to create credit, as it reduces their excess reserves.

→ (b) Statuatory Liquidity Ratio (SLR) → It's the minimum percentage of net time & demand deposits which commercial banks are required to maintain with themselves. It's maintained in the form of liquid assets like current account with other banks, Govt. securities, etc. An increase in SLR reduces the ability of banks to give credit as they have to keep ~~to it~~ extra amount with themselves.

Q What are qualitative tools of Central Bank to be used to control credit in economy?

ans. Following are qualitative tools:-

(a) Margin Requirements → It's the difference between amount of loan and the market value of security offered by borrower against the loans. For instance, the margin fixed by central bank is 40%., then the commercial bank will be allowed to give loan only upto 60% of value of security. By changing margin requirements, RBI can change the amount of loan that can be advanced by commercial banks. An increase in this margin requirement reduces the borrowing capacity and money supply in economy. RBI can prescribe different margins for different type of borrowers against security of same commodity.

(b) Moral Suasion → It's a combination of persuasion and pressure that central bank apply on other banks so that they work according to the guidelines of the central bank. This is exercised through discussions, letters, etc. Through this moral suasion central bank convinces commercial banks to control credit as per the requirement of time.

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c. Selective Credit control → here RBI give direction to other banks to give or not to give credit for certain purposes to a particular sector. It can be used in positive as well as negative manner. In positive manner priority is given to small scale sector whereas in negative manner, it restricts the flow of credit to certain sectors.