Unit 2

Money and Banking

6 Marks

CBSE Syllabus

- Money – meaning and supply of money – Currency held by the public and net demand deposits held by commercial banks
- Money creation by the commercial banking system
- Central bank and its functions (example of the Reserve Bank of India) : Bank of issue, Govt. Bank, Banker's Bank, Controller of Credit through Bank Rate, CRR, SLR, Repo Rate and Reverse Repo Rate, Open Market Operations, Margin requirement.

Money and Banking

INTRODUCTION

Money is the commonly accepted medium of exchange. In an economy which consists of only one individual there cannot be any exchange of commodities and hence there is no role for money. Even if there is more than one individual but these individuals do not take part in market transactions,example: family living on an isolated island, money has no function for them. However, as soon as there is more than one economic agent who engage themselves in transactions through the market, money becomes an important instrument for facilitating these exchanges. We need money in order to carry on daily lives, to pay for things such as riding on a bus, purchasing a bottle of water or soft drink, buying lunch and so on.

Economic exchanges without the mediation of money are referred to as barter exchanges. However, they presume the rather improbable double coincidence of wants. 'Double coincidence of wants' means what one person wants to sell and buy must coincide with what some other person wants to buy and sell. For example, if an individual has surplus of wheat and needs clothing, he looks for a person who needs wheat and at the same time possesses clothing. It is very difficult that such coincidence of wants may take place. The problem of double coincidence of wants arises when there is no medium of exchange. Money has solved the problem by working as a medium of exchange. The seller can sell the goods in the market in return for money and buy the goods he wants to buy in return for money.

In a modern economy, money comprises cash and bank deposits. Depending on what types of bank deposits are being included, there are many measures of money. These are created by a system comprising two types of institutions: central bank of the economy and the commercial banking system.

Central Bank is a very important institution in a modern economy. Almost every country has one central bank. India got its central bank in 1935. Its name is the 'Reserve Bank of India'. Central bank has several important functions. It issues the currency of the country. The Reserve Bank of India is the only institution which can issue currency in India. The RBI controls the money supply in the economy in various ways. The tools used by the Central bank to control money supply can be quantitative or qualitative. Quantitative tools, control the extent of money supply by changing the CRR, or bank rate or open market operations. Qualitative tools include persuasion by the Central bank in order to make commercial banks discourage or encourage lending which is done through moral suasion, margin requirement, etc. The Central Bank acts as a banker to the government. It is the custodian of the foreign exchange reserves of the economy. It also acts as a bank to the banking system.

The currency issued by the central bank can be held by the public or by the commercial banks, and is called the 'high powered money' or 'reserve money' or 'monetary base' as it acts as a basis for credit creation. Commercial banks are the other type of institutions which are a part of the money-creating system of the economy. They accept deposits from the public and lend out part of these funds to those who want to borrow. The interest rate paid by the banks to depositors is lower than the rate charged from the borrowers. This difference between these two types of interest rates, called the 'spread' is the profit appropriated by the bank. Since banks earn interest from loans they make, any bank would like to lend the maximum possible. However, being able to repay depositors on demand is crucial to the bank's survival. Depositors would keep their funds in a bank only if they are fully confident of getting them back on demand. A bank must, therefore, balance its lending activities so as to ensure that sufficient funds are available to repay any depositor on demand.

Commercial banks mediate between individuals or firms with excess funds and lend to those who need funds. People with excess funds can keep their funds in the form of deposits in banks and those who need funds, borrow funds in form of home loans,crop loans,etc. People prefer to keep money in banks because banks offer to pay some interest on any deposits made. Also, it may be safer to keep excess funds in a bank, rather than at home. In the modern context, given cheques and debit cards, having a demand deposit makes transactions more convenient and safer, even when they do not earn any interest. (Imagine having to pay a large amount in cash -for purchasing a house.)

2.1 Money and Supply of Money

Money — Its Meaning

Anything which is commonly accepted as a medium of exchange is called money.

It is usable for undertaking transactions, i.e., receipts and payments. In a modern economy, money comprises cash and bank deposits. Currency notes and coins can be used for settlement of any economic transactions. Bank deposits, e.g. the balance in savings and current account deposits with commercial banks, are also used to settle transactions through cheques, debit cards, etc.

Supply of Money

Meaning

Money supply refers to the total quantity of money in circulation in the economy at a given point of time.

Top Tip

Money supply is a stock variable since the total stock of money in circulation among the public is measured at a particular point of time.

Components

The basic measure of money supply (M1) has two components — Currency with public and demand deposits in commercial banks.

1. Currency held by the public (CU): Money supply consists of currency notes and coins held by the public outside the banks. The Reserve Bank of India (RBI) is the only institution which can issue currency in India. Currency notes are issued by the RBI. However, coins are issued by the Government of India.

- The currency issued by the central bank (Reserve Bank of India in India) can be held by the public or by the commercial banks, and is called the *high-powered money* or 'reserve money' or 'monetary base' as it acts as a basis for credit creation.
- Currency notes and coins are called *legal tenders* as they cannot be refused by any citizen of the country for settlement of any transaction.
- Currency notes and coins are called *fiat money* because every currency note bears on its face a promise from the Governor of RBI that if someone produces the note to RBI ,or any other commercial bank, RBI will be responsible for giving the person purchasing power equal to the value printed on the note. The same is also true of coins.

2. Net demand deposits held by commercial banks (DD): Demand deposits are the deposits which can be withdrawn on demand by the depositors from banks, e.g. current account and savings account deposits.

- Demand deposits are created by the commercial banks and are called *bank money*.
- The word *'net'* implies that only deposits of the public held by the banks are to be included in money supply. The inter-bank deposits, which a commercial bank holds in other commercial banks,are not to be regarded as part of money supply.

Top Tip

Commercial banks also hold time deposits of the public. *Time deposits are those deposits in banks which have a fixed period of maturity,e.g.,Fixed Deposits (FD).* However, the basic measure of money supply (M1) includes only demand deposits, not time deposits.

Key Terms

Money — Anything which is commonly accepted as a medium of exchange is called money.

Money supply — Money supply refers to the total quantity of money in circulation in the economy at a given point of time.

High powered money — The currency issued by the central bank (Reserve Bank of India in India) can be held by the public or by the commercial banks, and is called the high-powered money.

Demand deposits — Demand deposits are the deposits which can be withdrawn on demand by the depositors from banks, e.g. current account and savings account deposits.

Time deposits — Those deposits in banks which have a fixed period of maturity, e.g., Fixed Deposits (FD).

Bank money — Demand deposits are created by the commercial banks and are called bank money.