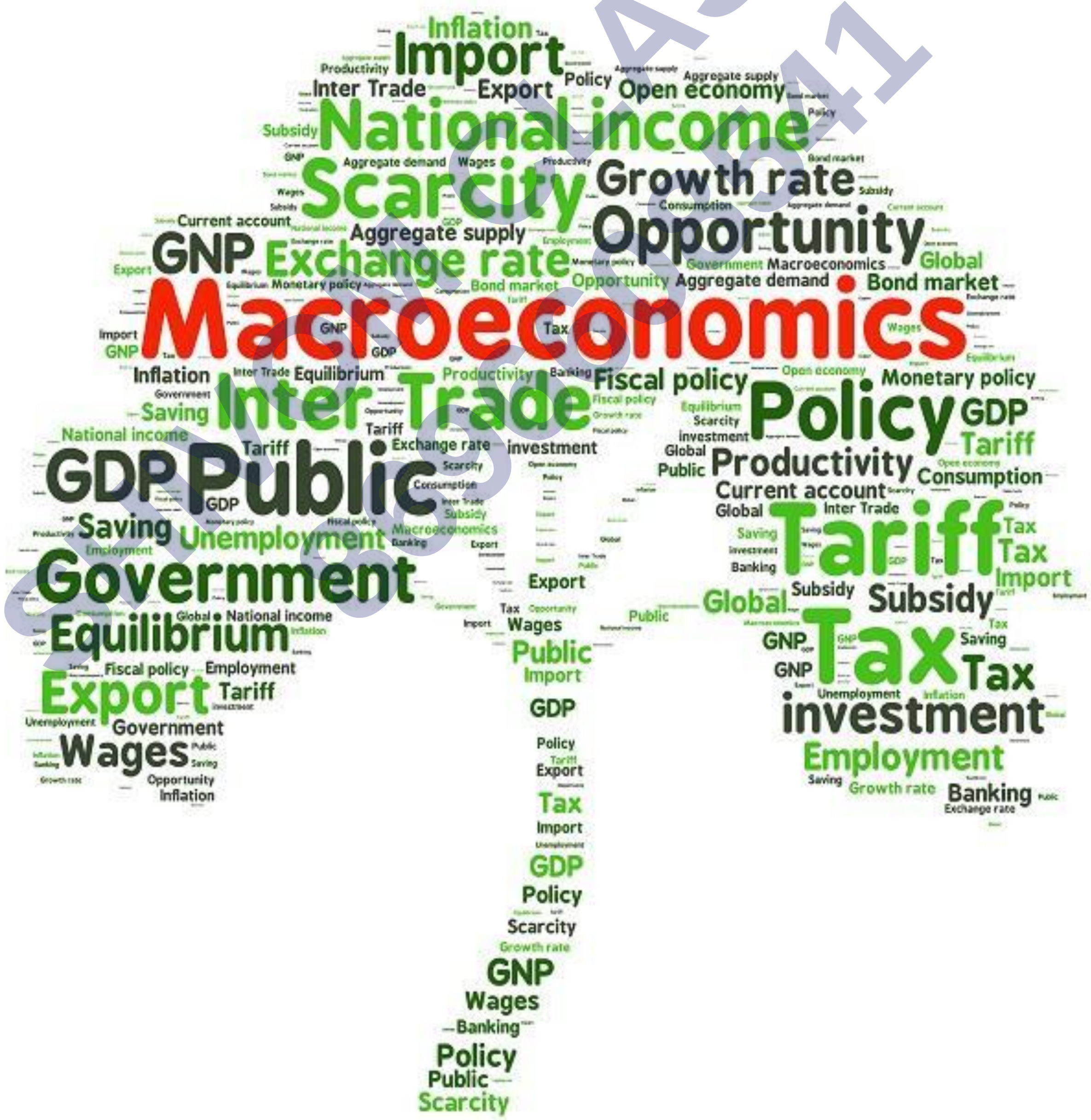
ECONOMICS

(Macro-Economics)

Chapter 3: Money and Banking



MONEY AND BANKING

Money

Money is a liquid asset used in the settlement of transactions. It is an economic unit that functions as a generally recognized medium of exchange for transactional purposes in an economy.

Function of money is based on the general acceptance of its value within a governmental economy and internationally through foreign exchange.

Money is commonly referred to as currency. Each government has its own money system.

It is a normally recognized medium of exchange that people and global economies intend to hold and are willing to accept as payment for current or future transactions.

Supply of Money:

The overall stock of money circulating in an economy or among the public is the money supply. This circulating money involves the currency, printed notes, money in the deposit accounts and in the form of other liquid assets.

Valuation and analysis of the money supply help the policy makers to frame the policy or to change the current policy of increasing or reducing the supply of money. The valuation of money is important as it ultimately affects the business cycle and thereby affects the economy.

The Reserve Bank of India publishes figures for four alternative measures of money supply, viz. M1, M2, M3 and M4.

- M1 = CU + DD   M2 = M1 + Savings deposits with Post Office savings banks
- M3 = M1 + Net time deposits of commercial banks
- M4 = M3 + Total deposits with Post Office savings organizations (excluding National Savings Certificates)
- CU is currency (notes plus coins) held by the public and DD is net demand deposits held by commercial banks

  Money deposits of the public held by the banks are to be included in the money supply.

  The interbank deposits, in which a commercial bank holds in other commercial banks, are not to be regarded as part of the money supply.
- M1 and M2 are known as narrow money. M3 and M4 are known as broad money.
- These gradations are in decreasing order of liquidity.
- M1 is most liquid and easiest for transactions whereas M4 is least liquid of all.
- M3 is the most commonly used measure of money supply. It is also known as aggregate monetary resources.

Money Creation By The Commercial Banking System:

Commercial banks create money through credit against deposits through the bank multiplier. Here credit means granting loans and advances made by banks to the public.

Credit creation by commercial banks refers to the multiplication of original bank deposits,

As every loan creates a deposit:

Commercial Banks create deposits via lending. Banks don't give loans in cash, instead they issue cheques against the name of the borrowers.

Now the borrower is free to draw money by drawing cheques upon the banks. Borrowers deposit the cheque in another bank. However, the bank knows that the amount of money that the depositors withdraw soon returns to the bank.

Banks keep a certain minimum fraction of the deposits made by customers as reserves. Rest of the deposits they lend. This fraction is called the Legal Reserve Ratio (LRR) and is fixed by the central bank.

Banks keep this fraction of deposits as Cash Reserves because all the depositors do not withdraw the entire amount in one go.

So, to meet the daily demand for withdrawal of cash, it is sufficient for banks to keep only a fraction of deposits as cash reserves. It means, if experience of the banks show that withdrawals are generally around 20% of the deposits, then it needs to keep only 20% of deposits as cash reserves (LRR).

Let's take an example:

Suppose, initial deposits in banks is Rs 20,000, now banks are required to keep only Rs 4,000 (20%) as cash reserve and are free to lend Rs 16,000.

Banks do not lend this money in cash. Rather, they open the accounts in the names of borrowers, who are free to withdraw the amount whenever they like.

Suppose borrowers withdraw the entire amount of 16,000, it will come back into the banks in the form of deposit accounts of those who have received this payment.

With these new deposits of 16,000, banks keep 20% as cash reserves and lend the balance Rs 12,800. Borrowers use this amount and deposits back.

In this manner the deposits keep on increasing in each round by 80% of the last round deposits. Simultaneously, cash reserves also go on increasing, each time by 80% of the last cash reserve.

This deposit creation comes to end when total cash reserves become equal to the initial deposit.

Characteristics or features of money:

a. **Durability:** Money must be durable and not likely to deteriorate rapidly with frequent handling. Currency notes and coins are being used repeatedly and shall continue to do so for many years.

b. **Medium of exchange:** Money is the thing that acts as a medium of exchange for the sale and purchase of goods and services.

c. **Weight:** Money must be light in weight. Paper money is better than metal coins because it is light in weight.

d. **Measure of value:** It not only serves as medium of exchange but also acts as a measure of value. The value of all the goods and services is expressed in terms of money.

Money has overcome the drawbacks of barter system: Barter system makes the exchange process very difficult and highly inefficient. Money has overcome the drawbacks of barter system in the following manners:

a) Medium of exchange

- Under barter system, there is lack of double coincidence of wants.
- With money as a medium exchange individuals can exchange their goods and services for money and then use this money to buy other goods and services according to their needs and conveniences.
- A buyer can buy goods through money and a seller can sell goods for money.

b) Measure of value

- Under barter system, there was no common measure of value. Money has also solved this difficulty.
- As Geoffrey Crowther puts it, "Money acts as a standard measure of value to which all other things can be compared." Money measures the value of economic goods.
- Money works as a common denominator into which the values of all goods and services are expressed.
- When we express the values of a commodity in terms of money, it is called price and by knowing prices of the various commodities, it is easy to calculate exchange ratios between them.

c) Store of value

- Under barter system it is very difficult to store wealth for future use.
- Most of the goods are perishable and their storage requires huge space and transportation cost.
- Wealth can be conveniently stored in the form of money.
- Money can be stored without loss in value.
- Money can easily be stored for future use.

d) Standard of deferred payments

- Under barter system, transactions on deferred payments are not possible.
- With money, the debtors make a promise that they will make payments on some future dates. In these situations money acts as a standard of deferred payments.
- It has become possible because money has general acceptability, its value is stable, it is durable and homogeneous.

Legal definition of money:

a) Legally, money is anything proclaimed by law as a medium of exchange.

b) Paper notes and coins (together called currency) is money as a matter of law.

c) Nobody can refuse its acceptance as medium of exchange.

d) In other words, it is legal tender. It means people have to accept it legally for different payments. Currency is also called FIAT money because it commands 'FIAT' (order/authority) of the government.

Functional definition of money: Functional definition of money refers to money as anything that performs four basic functions,

a) It serves as a medium of exchange.

b) It serves as a standard unit of value.

c) It serves as a means for future / contractual payments or standard of deferred payments.

d) It serves as a store of value.

e) According to this, definition of money includes both notes and coins as well as chequeable deposits with the banks.

Narrow definition of money: Functional definition of money is a narrow definition of money. It includes only notes, coins and demand deposits as money. In other words, in its narrow definition, money includes only those things that function as money in terms of:

a) Medium of exchange.

b) Measure of value.

c) Standard of future/Deferred payments.

d) Store of value.

Broad definition of money:

a) A broad definition of money also includes time deposits/term deposits with the banks or post offices as a component of money.

b) These deposits can be converted into demand deposits on a short notice, and are "Near money assets". Money assets and near money assets together make up a definition of money.

Money Supply And Measures Of Money Supply

- **Money supply:** The volume of money held by the public at a point of time, in an economy, is referred to as the money supply. Money supply is a stock concept.
- **Measures of money supply:** On the recommendation of the second working group on money supply, the RBI presented four measures of money supply in its 1977 issues of RBI Bulletin, namely M1, M2, M3 and M4.

  Measures of M1 include:

  a) Currency notes and coins with the public (excluding cash in hand of all commercial banks) [C]

  b) Demand deposits of all commercial and co-operative banks excluding inter-bank deposits. (DD),

  Where demand deposits are those deposits which can be withdrawn by the depositor at any time by means of cheque. No interest is paid on such deposits.

  c) Other deposits with RBI [O.D]

  M1 = C + DD + OD

  Where, Other deposits are the deposits held by the RBI of all economic units except the government and banks. OD includes demand deposits of semi¬government public financial institutions (like IDBI, IFCI, etc.), foreign central banks and governments, the International Monetary Fund, the World Bank, etc.

  Measures of M2:

  i. M1 [C + DD + OD]

  ii. Post office saving deposits

  Measures of M3:

  i. M1

  ii. Time deposits of all commercial and co-operative banks.

  Where, Time deposits are the deposits that cannot be withdrawn before the expiry of the stipulated time for which deposits are made. Fixed deposit is an example of time deposit.

  Measures of M4:

  i. M3

  ii. Total deposits with the post office saving organization (excluding national savings certificates).

- **High-powered money:** High-powered money is money produced by the RBI and the government. It consists of two things: (a) currency held by the public and (b) Cash reserves with the banks.

Words that Matter

1. **Barter system:** Barter system of exchange is a system in which goods are exchanged for goods.
2. **Double coincidence of wants:** It means that goods in possession of two different persons must be useful and needed by each other.
3. **Money:** Money is something which is generally acceptable as a medium of exchange and can be converted into other assets without loosing its time and value.
4. **Legal definition of money:** Legally, money is anything proclaimed by law as a medium of exchange. Paper notes and coins (together called currency) is money as a matter of law.
5. **FIAT Money:** It is defined as a money which is under the 'FIAT' (order/authority) of the government to act as a money.
6. **Functional definition of money:** Functional definition of money refers to money as anything that performs four basic functions. (Medium of exchange, standard unit of value, standard of deferred payments, store of value)
7. **Narrow definition of money:** Functional definition of money is a narrow definition of money. It includes only notes, coins and demand deposits as money.
8. **Broad definition of money:** A broad definition of money also includes time deposits/ term deposits with the banks or post offices as a component of money.
9. **Money Supply:** The stock of money held by the public at a point of time, in an economy, is referred to as the money supply. Money supply is a stock concept.
10. **High-powered money:** It is money produced by the RBI and the government. It consists of two things: (i) currency held by the public and (ii) Cash reserves with the banks.
11. **Demand deposits:** These are the deposits that can be withdrawn by the depositor at any time by means of cheque. No interest is paid on such deposits.
12. **Time deposits:** These are the deposits that cannot be withdrawn before the expiry of the stipulated time for which deposits are made. Fixed deposit is an example of time deposit.
13. **Other deposit measures of M1:** Other deposits are the deposits held by the RBI of all economic units except the government and banks. OD includes demand deposits of semi-government public financial institutions (like IDBI, IFCI, etc.), foreign central banks and governments, the International Monetary Fund, the World Bank, etc.

Central Bank And Its Functions

A central bank of any country (e.g., Reserve Bank of India) is an independent national authority that conducts monetary policy, regulates banks, and provides financial services including economic research.

Central bank's goals are to stabilize the nation's currency, keep unemployment low, and prevent inflation.

Most central banks are governed by a board consisting of its member banks. The central bank aligned with the nation's long-term policy goals. At the same time, it is free from political influence in its day-to-day operations.

Functions of Central Bank:

There are two kinds of functions of the Central bank.

Traditional Functions

Developmental Functions

❖ Traditional Functions:

The traditional functions of the central bank include the following:

- **Bank of issue:** Possesses an exclusive right to issue notes in every country of the world. The issue of notes by one bank has led to uniformity in note circulation and balance in money supply.
- **Government's banker, agent:** Central bank performs banking functions for the government as commercial banks performs for the public by accepting the government deposits and granting loans to the government. As an agent, the central bank manages the public debt.
- **Custodian of cash reserves:** Central bank takes care of the cash reserves of commercial banks.
- **Custodian of international currency:** Central bank maintains a minimum reserve of international currency to meet emergency requirements of foreign exchange and overcome adverse requirements of deficit in balance of payments.
- **Bank of re discount:** Serve the cash requirements of individuals and businesses by Re discounting the bills of exchange through commercial banks.
- **Lender of last resort:** The central bank provides loans against treasury bills, government securities, and bills of exchange.
- **Bank of settlement and transfer:** The central bank helps in settling mutual indebtedness between commercial banks.
- **Controller of Credit:** The central bank regulate the credit creation by commercial banks directly or indirectly.

❖ Developmental Functions:

Functions that are related to the promotion of banking system and economic development of the country.

- **Developing specialized financial institutions:** The central bank establishes institutions that serve credit requirements of the agriculture sector and other rural businesses.
- **Influencing money market and capital market:** Central bank deals in short term credit and capital market deals in long term credit. The central bank maintains the country's economic growth by controlling the activities of these markets.
- **Collecting statistical data:** Gathers and analyzes data related to banking, currency, and foreign exchange position of a country.

Bank of issue:

The central bank is the bank of issue. It issues notes and coins to commercial banks.

In addition to issuing currency to the banks, the central bank also issues currency to the central Government of the country.

Currency which are manufactured by the Government, they are put into circulation through the central bank.

However, the central bank has its monetary liability, it is obliged to back the currency issued by its asset of equal value such as gold and bullions.

Government Bank:

Government banks are also called Public Sector Banks (PSBs), where a majority stake is held by the Ministry of Finance of the Government of India or Ministry of Finance of various State governments of India.

Currently there are 12 Public Sector Banks in India are existing:

- State Bank of India
- Punjab National Bank
- Bank of Baroda
- Bank of India
- Central Bank of India
- Canara Bank
- Union Bank of India
- Indian Overseas Bank
- Punjab and Sind Bank
- Indian Bank
- UCO Bank
- Bank of Maharashtra.

Banker's Bank:

A bankers' bank is a specific type of bank that exist for the purpose of servicing the charter banks that founded them.

Their banking services are not open to the public. These institutions are designed to support community banks.

Bankers' banks can help community banks to effectively compete with larger banking entities.

- **Control of Credit Through Bank Rate:**

There are two methods of Credit Control through Bank Rate.

Quantitative or general methods, and

Qualitative or selective methods.

- **Quantitative or General Methods:**

  This methods is used by the central bank to influence the total volume of credit in the banking system.

  It regulates the lending ability of the financial sector of the whole economy and do not discriminate among the various sectors of the economy.

  The quantitative methods of credit control are:

  - Bank rate
  - Open market operations
  - Cash-reserve ratio.

- **Qualitative or Selective Methods:**

  These methods are used by the central bank to regulate the flows of credit into particular directions of the economy.

  The qualitative methods affect the types of credit extended by the commercial banks. They affect the composition rather than the size of credit in the economy.

  The qualitative methods of credit control are:

  - Marginal requirements
  - Regulation of consumer credit
  - Control through directives
  - Credit rationing
  - Moral suasion and publicity
  - Direct action

- **Bank Rate Policy:**

The bank rate or the discount rate is the rate at which a central bank is prepared to discount the first class bills of exchange.

The bank rate is different from the market interest rate. The bank rate is the rate discount of the central bank, while the market interest rate is the lending rate charged in the money market by the ordinary financial institutions.

An increase in the bank rate makes the credit costlier, reduces the volume of credit, discourages economic activity and brings down the price level in the economy.

A declining in the bank rate makes the credit cheaper, increases the volume of credit, encourages the businessmen to borrow and invest, and increases the levels of economic activity.

- **Bank rate policy aims at influencing:**
  - The cost and availability of credit to the commercial banks
  - Interest rates and money supply in the economy
  - The level of economic activity of the economy.

Cash Reserve Ratio (CRR):

Cash reserve ratio is a certain percentage or share that all banks have to keep with the RBI as a deposit as reserves in the form of liquid cash.

This percentage is fixed by the RBI, which changes from time to time. Currently, the CRR is fixed at 3%. That means for every Rs 100 worth of deposits, the bank has to keep Rs 3 with the RBI.

CRR keep inflation under control. During high inflation in the economy, RBI raises the CRR to sanction loans. It squeezes the money flow in the economy, reducing investments and bringing down inflation.

Statutory Liquidity Ratio (SLR):

SLR is the minimum percentage of the aggregate deposits that commercial banks has to maintains in the form of liquid cash, gold or other securities.

Basically, it is the reserve requirement that banks are expected to keep before offering credit to customers.

SLR is not reserved with the Reserve Bank of India (RBI), but with banks themselves. But the ratio is fixed by RBI. The SLR was prescribed by Section 24 (2A) of Banking Regulation Act, 1949.

CRR and SLR are the tools of the central bank's monetary policy to control credit growth, flow of liquidity and inflation in the economy.

Repo Rate and Reverse:

- **Repo Rate:**

  Repo rate refers to the rate at which commercial banks borrow money from Central bank (Reserve Bank of India) by selling their securities to maintain liquidity, in case of shortage of funds or due to some statutory measures.

  As you borrow money from the bank as a loan on interest, similarly, banks also borrow money from RBI during a cash crunch on which they are required to pay interest to the Central Bank. This interest rate is called the repo rate.

Repo stands for 'Repurchasing Option'. It is an agreement in which banks provide eligible securities such as Treasury Bills to the RBI while availing overnight loans.

Components of a Repo Transaction:

- **Control inflation:** The Central bank increases or decreases the Repo rate depending on the inflation, to control the economy by keeping inflation in the limit.
- **Hedging & Leveraging:** RBI aims to hedge and leverage by buying securities from the banks and provide cash to them
- **Short-Term Borrowing:** RBI lends money for a short period of time, maximum being an overnight post which the banks buy back their securities deposited at a predetermined price.
- **Collaterals:** RBI accepts collateral in the form of gold, bonds etc.
- **Cash Reserve (or) Liquidity:** Banks borrow money from RBI to maintain liquidity as a precautionary measure.

Affect Of Repo Rate:

Repo rate is a strong system of the Indian monetary policy that can regulate the country's money supply, inflation levels, and liquidity.

The levels of repo have a direct impact on the cost of borrowing for banks. If repo rate is higher then borrowing will be a costly affair for businesses and industries, which in turn slows down investment and money supply in the market.

On the other hand lowers the repo rate, industries find it cheaper to borrow money. It also boost the overall supply of money in the economy.

Reverse Repo Rate:

RBI borrows money from banks when there is excess liquidity in the market is called Reverse Repo Rate. In return the banks benefit out of it by receiving interest for their holdings with the central bank.

When levels of inflation is high in the economy, the RBI increases the reverse repo. It encourages the banks to keep more funds with the RBI to earn higher returns on excess funds. Banks are left with lesser funds to extend loans.

Open Market Operations

Open Market operations are purchases and sales of government securities and sometimes commercial paper by the central bank for the purpose of regulating the money supply and credit conditions on a continuous basis.

Under this system, when the central bank wants to reduce the money supply in the market, it sells securities in the market.

Similarly, when the central bank wants to increase the money supply, it purchase securities from the market. This step is taken to reduce the rate of interest and also to help in the economic growth of the country.

- **Margin Requirement:**

  Margin Requirement means the amount of money that you are required to deposit for entering into a Trade and maintaining an Open Position.

  It is the amount of equity, that an investor has in their brokerage account. A margin account is a account in which the broker lends the investor money to buy more securities than what they could otherwise buy with the balance in their account.

Words that Matter

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.
2. **Legal Reserve Ratio:** It is the minimum ratio of deposits legally required to be kept by the commercial banks with themselves (Statutory Liquidity Ratio) and with the central bank (Cash reserve Ratio).
3. **Money Multiplier or Credit Multiplier:** When the primary cash deposit in the banking system leads to multiple expansion in the total deposits, it is known as money multiplier or credit multiplier.
4. **Central Bank:** The central bank 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.
5. **Quantitative Instruments or General Tools of Monetary Policy:** These are the instruments of monetary policy that affect overall supply of money/credit in the economy.
6. **Qualitative Instruments or Selective Tools of Monetary Policy:** The instruments which are used to regulate the direction of credit is known as Qualitative Instruments.
7. **Bank rate:** It is the rate of interest at which central bank lends to commercial banks without any collateral (security for purpose of loan).
8. **Repo rate:** It is the rate at which commercial bank borrow money from the central bank for short period by selling their financial securities to the central bank.
9. **Reverse Repo rate:** It is the rate at which the central bank (RBI) borrows money from commercial bank.
10. **Open Market Operation:** It consists of buying and selling of government securities and bonds in the open market by central bank.
11. **Cash Reserve Ratio:** It refers to the minimum percentage of a bank's total deposits, which it is required to keep with the central bank.
12. **Statutory Liquidity Ratio:** It refers to minimum percentage of net total demand

and time liabilities, which commercial banks are required to maintain with themselves.

13. **Marginal requirement:** Business and traders get credit from commercial bank against the security of their goods. Bank never gives credit equal to the full value of the security. It always pays less value than the security. So, the difference between the value of security and value of loan is called marginal requirement.
14. **Moral suasion:** It implies persuasion, request, informal suggestion, advice and appeal by the central banks to commercial banks to cooperate with general monetary policy of the central bank.
15. **Selective Credit Controls (SCCs):** In this method the central bank can give directions to the commercial banks not to give credit for certain purposes or to give more credit for particular purposes or to the priority sectors.

Class : 12th Economics (Macroeconomics)
Chapter-3 : Money & Banking

Money & Banking

Central Bank

Function
- Issues currency on behalf of the Indian government.
- Banker's Bank.
- Government's Banker.
- Controls the credit.

Credit Control by Central Bank
- Bank rate.
- Repo rate.
- Reverse Repo rate.
- Open market operations,
- Cash reserve ratio,
- Statutory liquidity ratio.
- Margin requirements

Functions of Money
- Medium of exchange,
- Value measurement,
- Acts as a store of value
- Standard of Deferred Payments.

Money Creation By Commercial Banking System

Credit Created by Commercial banks

$$= \frac{1}{RR} \times \text{Cash Reserves}$$

where, RR=Reserve Requirements

Supply of Money

Narrow Money

M1
Currency held by public+ demand deposits with commercial banks.

M2
M1 + savings deposits with post office savings banks

Broad of Money

M3
M1 + net time deposits with commercial banks.

M4
M3 + total deposits with post office savings organisations.

Important Questions

Multiple Choice questions-

Q1. In order to encourage investment in the economy, the Central Bank may ……………..

(a) Reduce Cash Reserve Ratio

(b) Increase Cash Reserve Ratio

(c) Sell Government securities in the open market

(d) Increase Bank Rate

Q2. Banks are able to create credit many times more than initial deposits through

(a) secondary deposits

(b) providing overdraft facilities

(c) accepting deposits

(d) advancing loans

Q3. The creation is called credit creation.

(a) time deposits

(b) primary deposits

(c) secondary deposits

(d) None of these

Q4. The ratio of total deposit that a commercial bank has to keep with the Reserve Bank of India is called

(a) Statutory Liquidity Ratio

(b) Deposit Ratio

(c) Cash Reserve Ratio

(d) Legal Reserve Ratio

Q5. Credit creation by the commercial bank is determined by

(a) Cash Reserve Ratio

(b) Statutory Liquidity Ratio

(c) Initial Deposits

(d) all of the above

Q6. ……………. is the rate of interest charged by the central bank on loans given to the commercial bank.

(a) Bank Rate

(b) Cash Reserve Ratio

(c) Statutory Liquidity Ratio

(d) Reverse Repo Rate

Q7. …………….. is the main function of Central Bank.

(a) Notes issue

(b) Credit creation

(c) Accepting deposits from the public

(d) Advancing loans to public

Q8. The central bank can increase the availability of credit by:

(a) Rasing repo rate

(b) Raising reverse repo rate

(c) Buying government securities

(d) Selling government securities

Q9. Giving permission to withdraw money by an amount more than deposited to is known as ……………….

(a) Advance

(b) Overdraft

(c) Loan

(d) None of these

Q10. What are the alternative measures of money supply in India?

(a) M1

(b) M2

(c) M3 and M4

(d) All of these

Q11. Who circulates all mint and one rupee not in India?

(a) Ministry of Finance

(b) RBI

(c) Ministry of External Affairs

(d) State Government

Q12. Which of the following is the narrow measure of the money supply?

(a) M2

(b) M3

(c) M1

(d) M4

Q13. When was the minimum reserve system started in India?

(a) 1947

(b) 1948

(c) 1951

(d) 1957

Q14. Which is the most liquid measure of the money supply?

(a) M4

(b) M3

(c) M2

(d) M1

Q15. High Powered Money includes:

(a) C + DD + OD

(b) C + R + OD

(c) C + R + TD

(d) C + DD + TD

Very Short Questions-

Very Short Answers-

Short Questions-

1. Calculate the value money multiplier and the total deposit created if initial deposit is Rs. 500 crores and LRR is 10%.

2. Calculate LRR, if initial deposit of Rs. 200 crores lead to creation of total deposits of Rs. 1600 crores.

3. If total deposits created by commercial banks are Rs. 12,000, LRR is 25%, calculate initial deposit.

4. What do you mean by high powered money?

5. Bring out the role of Central Bank as the controller or money supply or credit.

Long Questions-

1. Explain the following functions of the Central Bank of India.

    1. Bank of Issue

    2. Banker's bank

2. Explain the leading functions of commercial banks.

3. State the functions of money.

4. How does money overcome the problems of barter system?

5. Why only a fraction of deposits is kept as Cash Reserves?

Case Study Based Question-

1. Read the following case study paragraph carefully and answer the questions based on the same.

   The central bank of India (Reserve Bank of India) is the apex institution that controls the entire financial market. It's one of the major functions is to maintain the reserve of foreign exchange. Also, it intervenes in the foreign exchange market to stabilise the excessive fluctuations in the foreign exchange rate. In other words, it is the central bank's job to control a country's economy through monetary policy.

   If the economy is moving slowly or going backward, there are steps that central bank can take to boost the economy. These steps, whether they are asset purchases or printing more money, all involve injecting more cash into the economy. The simple supply and demand economic projection occur and currency will devalue. When the opposite occurs, and the economy is growing, the central bank will use various methods to keep that growth steady and in-line with other economic factors such as wages and prices. Whatever the central bank does or in fact don't do, will affect the currency of that country. Sometimes, it is within the central bank's interest to purposefully affect the value of a currency. For example, if the economy is heavily reliant on exports and their currency value becomes too high, importers of that country's commodities will seek cheaper supply; hence directly affecting the economy.

   Questions:

   1. Which of the following tools are used by the central bank to control the flow of money in domestic economy?

      a) Fiscal tools

      b) Quantitative monetary tools

      c) Qualitative monetary tools

      d) Both (b) and (c)

   2. Money supply is a ------------- concept.

      a) Flow

      b) Stock

      c) Ratio of stock and flow

      d) None of above

   3. Which of the following steps should take by the central bank if there is excessive rise in the foreign exchange rate?

      a) Supply foreign exchange from its stock

      b) Demand more of other foreign exchange

      c) Allow commercial banks to work under less strict environment

d) Both (b) and (c)

4. Dear money policy of central bank, which is used to keep the growth steady and in-line with other economic factors, refers to

a) Tighten the money supply in the economy

b) Ease the money supply in the economy

c) Allow commercial banks to work under less strict environment

d) Both (b) and (c)

2. Read the following case study paragraph carefully and answer the questions on the basis of the same.

The Reserve Bank of India raised inflation forecasts on the back of higher oil and other raw materials while it maintained the growth forecast at 9.5% for FY22 despite anemic investment demand.

Governor Shaktikanta Das said inflation measured by the consumer price index (CPI) might remain close to the upper tolerance band of 6% up to September expecting easing of pressure thereafter on kharif harvest arrivals.

[RBI has fixed inflation rate target in between 2%-6 %.]

The central bank projected CPI at 5.7% for FY22 compared to its earlier projection of 5.1%. "The supply-side drivers could be transitory while demand-pull pressures remain inert, given the slack in the economy. A pre-emptive monetary policy response at this stage may kill the nascent and hesitant recovery that is trying to secure a foothold in extremely difficult conditions," Das said.

Crude oil prices are volatile with implications for imported cost pressures on inflation, RBI said. "The combination of elevated prices of industrial raw materials, high pump prices of petrol and diesel with their second-round effects, and logistics costs continue to impinge adversely on cost conditions for manufacturing and services, although weak demand conditions are tempering the pass-through to output prices and core inflation.

Questions:

1. How does RBI promote growth process of country:

a) By controlling price level in country

b) By changing various interest rates and money supply

c) By increasing supply of products

d) All of above

2. Why does RBI fix the inflation target?

a) To make growth process fast

b) To make coordination with government

c) To manage exchange rate

d) To stabilize economy

3. Why increasing crude oil prices are matter of concern:

   a) Increasing crude oil prices are increasing transportation cost.

   b) Increasing crude oil prices are making economy potentially unstable.

   c) Increasing crude oil prices are volatising growth process.

   d) Increasing crude oil prices are adversely affecting demand.

Assertion Reason Type Question-

1. **In these questions, a statement of assertion followed by a statement of reason is given. Choose the correct answer out of the following choices.**
   a. both (A) & (R) both are true and (R) is correct explanation of (A)
   b. both (A) & (R) both are true and (R) is not correct explanation of (A)
   c. (A) is true but (R) is false
   d. (A) is false but (R) is true

   Assertion: RBI gives licence to commercial banks and supervise them.

   Reason: RBI is the largest bank of country.
2. **In these questions, a statement of assertion followed by a statement of reason is given. Choose the correct answer out of the following choices.**
   a. both (A) & (R) both are true and (R) is correct explanation of (A)
   b. both (A) & (R) both are true and (R) is not correct explanation of (A)
   c. (A) is true but (R) is false
   d. (A) is false but (R) is true

   Assertion: when CRR is increased, credit creation capacity of commercial banks reduces.

   Reason: with increase in reserve ratios, banks have less funds available for loans.

MCQ Answers-

1. (a) Reduce Cash Reserve Ratio
2. (a) secondary deposits
3. (c) secondary deposits
4. (c) Cash Reserve Ratio
5. (d) all of the above
6. (a) Bank Rate
7. (a) Notes issue
8. (d) Selling government securities

9. (b) Overdraft

10. (d) All of these

11. (a) Ministry of Finance

12. (c) M1

13. (d) 1957

14. (d) M1

15. (b) C + R + OD

Short Answers-

Ans 1: Value of money multiplier = 1/LRR which is equal to 1/0.1 = 10

Initial deposit was Rs. 500 crores

Hence,

Total Deposit will be Initial Deposit × Money Multiplier

= 500 ×10

= 5000 Crores

Thus, the total deposit is 5000 crores.

Ans 2: Money Multiplier = Total Deposits / Initial Deposits

= 1600 / 200 = 8

Hence Money Multiplier = 1/LRR

8 = 1/LRR

LRR = 1.25 or 12.5

Ans 3: Money Multiplier = 1/LRR = 1/025 = 4

Initial Deposit = Total Deposit / Money Multiplier

= 12000 / 4

= Rs. 3000

Thus, the initial deposit is Rs. 3000.

Ans 4: It is the money that the RBI and the government have generated, in which the public holds the currency and banks keep the cash reserves. Money varies from cash reserves in that money is made up of demand deposits, whereas cash reserves are used to create demand deposits.

The equation is:

H = C + R

Where H = High Powered Money

C = Currency with the public (Paper money + coins)

R = Government and bank deposits with RBI

Thus, the sum total of money deposited with the public and the funds of banks are termed as powerful money. It is mainly created by the central bank.

Ans 5: The Central Bank will hike the bank rate if it wants to regulate lending. Market rates and other loan rates on the money market will increase as a result of this. Borrowing will be frowned upon. The expansion of credit will be hampered by a rise in the bank rate. Likewise, a decrease in the bank rate significantly decreases money market lending rates, which in turn stimulates commercial and industrial activity, requiring more credit from banks. As a result, the volume of bank credit will increase.

Long Answers-

Ans 1:

1. Bank of Issue: The central bank of a country, whose tasks include currency issuance, monetary policy administration, open market activities, and engaging in transactions that promote healthy business connections. For example, the Reserve Bank of India, the Bank of England, and the Federal Reserve banks of the United States. Simply put, a bank with the formal right to manufacture currency, which can include both paper money and coins. The Reserve Bank of India is the sole authority in India for issuing banknotes. The Reserve Bank, like other central banks across the world, periodically modifies the design of banknotes. Since 1996, the Reserve Bank has released banknotes of the Mahatma Gandhi Series, which include denominations of Rs. 5, Rs. 10, Rs. 20, Rs. 50, Rs. 100, Rs. 200, and Rs. 500.

2. Banker's bank: A bankers' bank is a type of bank formed by a collection of larger, more well-established banks. Bankers' banks exist to provide services to the charter banks that established them. These institutions are created to help community banks, even though their financial services are not normally open to the public in any way. Commercial banks have a current account with the central bank and are able to borrow money in the short term. As a result, banks that need to provide banknotes to their customers either over the counter or through automated teller machines get them from the central bank, which has a monopoly on issuing banknotes. In India, the Reserve Bank of India (RBI) serves as the banker's bank. This bank requires all commercial banks in India to maintain a cash reserve ratio. Credit is created by commercial banks. The RBI's role is to regulate credit via the CRR, bank rate, and open market activities.

Ans 2: The most essential components of the banking system are commercial banks. A commercial bank is a profit-driven financial organisation that provides loans, accepts deposits, and provides other financial services like overdrafts and electronic fund transfers. According to Culbertson, "Commercial Banks are the entities that establish short-term bans on business and create money in the process."

Commercial banks have divided their functionality into two sections, as seen in the diagram above: primary and secondary functions.

a. Primary Functions: The term "primary functions" refers to the basic functions of commercial banks, which include:

i. Accepting Deposits suggests that commercial banks rely on public deposits for the majority of their funding. Demand and time deposits are the two forms of deposits. Demand deposits are those that can be easily withdrawn by individuals without giving the bank prior notice. Deposits made for a specific length of time are known as time deposits. On these deposits, banks pay a greater rate of interest.

ii. Advancing Loans refers to the utilisation of public deposits by commercial banks to make loans to individuals and enterprises. Overdrafts, cash credit, and discounting bills of exchange are all examples of commercial bank loans.

b. **Secondary Functions:** The term "secondary functions" usually refers to critical activities performed by commercial banks. Agency functions, general utility functions, and other functions are the three types of secondary functions that can be classified.

i. **Agency Function** - Commercial banks act as agents for their customers by collecting checks, collecting income, and paying expenses, among other things.

ii. Providing Locker Facilities, Issuing Traveller's Checks, Dealing in Foreign Exchange, and Transferring Funds are examples of general utility functions.

iii. Other tasks include lending money to individuals and opening demand deposits, as well as electronic banking, which encompasses services such as debit cards, credit cards, and Internet banking, among others.

Ans 3: Money is typically described in terms of the three functions or services it provides. Money functions as a means of exchange, a store of value, and a monetary unit. It is a current means of trade in the form of coins and banknotes (together, coins and banknotes). In the words of Prof. Walker, "Money is as money does."

The following are the primary purposes of money:

i. Money as a Medium of Exchange: The basic or primary function of money is to serve as a medium of exchange. The medium of money is used to exchange commodities and services. Money serves as both a medium of commerce and a means of payment. Money has no value on its own. It's only a stepping stone.

ii. Money as a Unit of Account or Measure of Value: Money is used to represent a unit of account or a measure of value. Money serves as the yardstick by which the value of other goods and services is measured and expressed in monetary terms.

iii. Money as a Deferred Payments Standard: Deferred payments are payments that are made at a later date. Debts are typically expressed in terms of account money. Loans are taken out and repaid in monetary terms.

iv. Money as a Store of Value: Money can be used to store wealth for the future. It is used to store the worth of liquid items. We can receive any commodity in the future by spending it. This is a function of money that Keynes emphasises a lot. Because money can be quickly transformed into other things, it is akin to having a reserve of liquid assets.

v. Money's Liquidity: Money is entirely liquid. Liquidity refers to a currency's ability to be converted into cash. Liquidity of asset refers to the ability to turn an asset into money rapidly and without losing value. Modern economics places a premium on money availability.

Ans 4:

i. By separating the acts of sale and purchase, money, as a medium of exchange, resolves the problem of bartering's lack of double coincidence of wants.

ii. The absence of a common measure of value is solved by using money as a measure or unit of value or a unit of account. Money serves as a unit of account and a yardstick for determining the exchange value of all goods.

iii. Money as a store of value solves the challenge of storing wealth that plagues barter. It broadened people's purchasing power.

iv. Using money as a deferred payment standard helps to alleviate the barter problem of a lack of deferred payment standards. It also aids in the formation of contracts involving future payments.

v. The use of money allowed people to sell their excess commodities in exchange for cash and utilise the cash to purchase their necessities. Currency was invented during ancient wars because it was too difficult for warriors to carry chickens and beans around to exchange for what they needed.

vi. The indivisibility of goods was a significant issue. A severe problem of indivisibility of certain items arose under barter. Some articles were tough to break down into manageable chunks. As a result, one of the trade parties was forced to give up his entire indivisible thing in return for the other's goods.

vii. A major issue at the time was the difficulty in transferring wealth. The problem of transferring a person's wealth under barter emerges. When he wants to move his money, such as his house, property, or car from one location to another, it's nearly impossible to find someone in another location who can trade his property or wealth.

Ans 5: Deposits are accepted by banks, while loans are disbursed to lenders. As a result, banks can lend some of their depositors' money while having enough on hand to cover daily withdrawals. The fractional-reserve banking system is what it's called. Cash Reserves are a portion of deposits held by banks. Any seasoned banker knows two things based on his or her experience. For starters, depositors do not all go to the bank at the same time to withdraw money, nor do they withdraw the entire amount at once. Second, new deposits will continue to flow into banks on a daily basis.

Case Study Answer-

1. Answer:
    1. d) Both (b) and (c).
    2. b) Stock.
    3. a) Supply foreign exchange from its stock.
    4. a) Tighten the money supply in the economy.

2. Answer:
    1. b) By changing various interest rates and money supply.
    2. d) To stabilize economy.
    3. b) Increasing crude oil prices are making economy potentially unstable.

Assertion Reason Answer-

1. c) (A) is true but (R) is false
2. b) both (A) & (R) both are true and (R) is correct explanation of (A)