NCERT SOLUTIONS

CLASS - 12th

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Subject : Economics

Chapter : 3

Chapter Name : Money and Banking

Q1 What is a barter system? What are its drawbacks?

Answer. Presently, money is the commonly accepted medium of exchange. Before the evolution of money, goods were exchanged through a system called barter system. In this system, people used to exchange goods in exchange for other goods without the involvement of money.

The major drawbacks of the barter system were as follows -

Lack of double coincidence - It was a major drawback of the system. Double coincidence refers to the arrangement under which the person who wants to purchase some goods must provide consideration required by the other person. Under the barter system, the person exchanging his goods may not have the requisites of the other person.

Lack of common measurement - There was absence of a common unit of measurement. The goods couldn't be valued without the presence of a common unit, which is why money was demanded.

Lack of standard for deferred payments - Deferred payment means payment at a future date. Since the values of commodities is fast changing, hence it wasn't possible to measure their value in future.

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Q2 What are the main functions of money? How does money overcome the shortcomings of a better system?

Answer. Money serves the following purposes and overcomes the difficulties of barter system -

1. It acts as a convenient unit of account. The value of all goods and services can be expressed in monetary units.

2. Money also acts as a medium of exchange in which the commodities can be exchanged.
3. Barter exchanges becomes extremely difficult in a large economy because of the high costs people would have to incur looking for suitable persons to exchange their surplus. Money overcomes this problem.
4. In the barter system, it is very difficult to measure the future value of commodities. Money solves this problem as it provides a standard unit of measurement.

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Q3 What is transaction demand for money? How is it related to the value of transactions over a specified period of time ?

Answer. The transaction demand for money refers to the requirement of money for making transactions at regular intervals. If a person is earning his income in the beginning of the month, then he makes many transactions everyday in satisfying his wants. This demand arises because the payments and receipts of people are never equal. They keep on changing from time to time and hence money acts as a medium of measurement of these transactions.

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Q4 What are the alternative definitions of money supply of india ?

Answer. There are four alternative definitions of money supply in India. These are explained as under -

M1 - It is a narrow concept of measuring the money supply. Under this, we get the total money supply in the economy by adding the currency held by the public and demand deposits kept with the commercial banks on behalf of the public.

M2 - It is calculated as follows - M1 + Savings deposits with Post Office savings banks.

It includes those deposits which the public deposits with the post offices by opening the savings accounts in addition to the money supply calculated in M1.

M3 - It is also known as broad money and aggregate monetary resources. Under this, we also include deposits with commercial banks in their fixed deposits accounts or the recurring deposits (together known as time deposits) accounts along with the money supply in M1.

M4 - It is also known as broad money. It is calculated as under -

M3 + Total savings of public held by the Post offices (excluding national savings certificate).

It combines all the money supply resources of the economy.

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Q5 What is a 'legal tender'? What is 'fiat money'?

Answer. The currency notes and coins don't have their own intrinsic value. Their value is determined by the purchasing power which they give to the holder of such currency. The value of money is printed on the notes or coins. This is known as fiat money.

The legal tender is the money which should be acceptable to all the citizens and no one can refuse to accept them in settlement of their transactions. These currency notes and coins are approved by the Reserve Bank of India and hence are the legal tender.

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Q6 What is High powered money?

Answer. High powered money is the currency issued by the Government of India and the Reserve Bank of India. It also consists of the reserves kept with the banks. It is the total liability of the monetary authority of the country. It can be calculated as -

Total currency circulated in the economy + reserves kept with the banks.

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Q7 Explain the functions of a commercial bank.

Answer. The commercial bank is the bank which directly deals with the public. There are two basic functions of a commercial bank which are accepting deposits from the public and lending money for various purposes.

A commercial bank accepts deposits in various forms like savings accounts, recurring deposits, fixed deposits and current account deposits. It also provides interest to the public on their deposits.

It also provides loan for various productive and non-productive activities. It may provide loan to public or to businesses. Bank charges interest on such loans.

Other than these services, banks provide several other services like locker facility, accepting deposits and payments made on behalf of customers, etc.

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Q8 What is money multiplier? What determines the value of this multiplier?

Answer. The money multiplier is the power of the commercial banks to increase their money supply by providing loans to its customers. The working of this multiplier can be under by the following example -

Suppose a person deposits ₹1000 in his bank account and bank after keeping 10% as CRR(Cash Reserve Ratio), lends the remaining ₹900 to Mr. A. Mr. A makes a payment to Mr. B who deposits the money in his account. So, again bank after keeping 10% CRR(₹90),lends the rest 810 to Mr. C. If he deposits the money in his account, then again it will be lent and this process goes on.

This is known as the multiplier. The multiplier is the ratio of total money supply in the economy and the high powered money.

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Q9 What are the instruments of monetary policy of RBI?

Answer. The major instruments of the monetary policy of RBI are categorised into two parts -

1. Quantitative measures
    a. Bank Rate - It is the rate at which the Reserve Bank of India lends money to the commercial banks. The cost of such money (i.e. the interest on it) determines the flow of credit in the economy.
    b. Open market operations - RBI may sale or purchase the government approved first class securities from the open markets to increase or decrease the money supply.
    c. Cash Reserve Ratio and Statutory Liquidity Ratio - Cash Reserve Ratio is the total amount of deposits which the banks have to keep in the form of cash. Statutory liquidity ratio is the ratio of the total deposits kept by the commercial banks in the form of cash, gold or other securities.
2. Qualitative measures
    - Margin requirement - The difference between the value of the security kept with the bank and the amount of loan issued against the security. More this difference, less will be the credit.
    - Rationing of credit - It fixes the quota for the amount of loan to be issued for every commercial activity.
    - Moral suasion - Reserve Bank of India to persuade the commercial banks to implement the general monetary policy of the country.

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Q10 Do you consider a commercial bank 'creator of money' in the economy?

Answer. Yes, the commercial bank is the creator of the money in the economy. Banks accept deposits from the general public and create credit by lending it to other people. It then expands the credit by credit multiplier. The credit multiplier is the ratio of total money supply in the economy and the high powered money. Higher the credit multiplier, higher is the credit that the commercial banks can create.

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Q11 What role of RBI is known as ‘lender of last resort’?

Answer. RBI is the apex banking institution. It lends money to the commercial banks to meet their short term and long term financial requirements. RBI provides funds to the commercial banks by discounting their first class securities or pledging of their securities. This function of RBI makes it a lender of last resort.

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