

aglasem.com

CLASS XII ECONOMICS NOTES

MONEY and BANKING

Key Notes and Important Questions with Answers

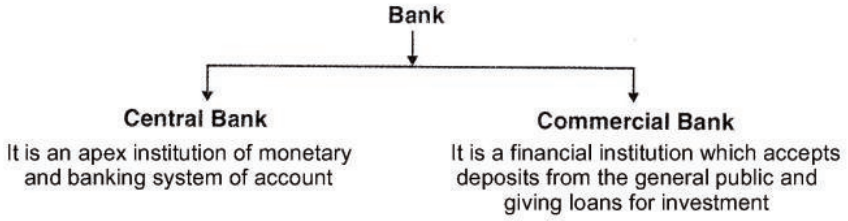
UNIT VI

MONEY AND BANKING

Points to Remember

- **Money :** Money may be defined as anything which is generally acceptable as a medium of exchange and also acts as common measures of value, store of value and standard of deferred payment.
- **Supply of Money :** Total stock of money (currency notes, coins and demand deposite of banks) in circulation are held by the public at a given point of time.
- **Measures of Money Supply = Currency held by Public + Demand Deposit of a Bank**

  M = C + DD
- **Commercial Bank :** Commercial Bank is a financial institution who accepts deposits from the general public and provide loans facilities for investment with the aim of earning profit.
- **Demand Deposit :** Demand deposit are those deposit which can be withdrawn from the bank on demand or by writing a cheque any time.
- **Central Bank :** The central Bank is an apex institution of monetary and banking system of country. It makes monetary policy of the country in public interest. It manages, supervises and facilitiates the banking system of the country.



MONEY CREATION OR CREDIT CREATION BY COMMERCIAL BANKS

Commercial Bank's demand deposits are a part of money supply. Commercial banks lend money to the borrowers by opening demand deposit account in their names. The borrowers are free to use this money by writing cheques. According to definition demand deposits are a part of money supply. Therefore, by creating additional demand deposits bank create money. Money creation depends upon two factor : Primary deposits and Legal Reserve Ratio (LRR). Deposit Multiplier = 1/LRR Total Deposit creation = Initial deposit × 1/LRR.

- **Functions of Central Banks**
  1. Bank of Issue
  2. Banker of the Government
  3. Banker's Bank and Supervisor.
  4. Controller of Credit.

TOOLS OF CREDIT CONTROL BY CENTRAL BANK AS RBI

- **Cash Reserve Ratio (CRR) :** This refers to the proportion of total deposit of the commercial bank which they must keep as cash Reserves with Central Bank.
- **Statutory Liquidity Ratio (SLR) :** This refers to liquid assest of the commercial banks which they must maintain (on daily basis) as a minimum percentage of their total deposits.
- **Repo Rate :** It is the rate of interest at which the Central Bank gives short-period loan to the commercial banks.
- **Reverse Repo Rate :** It is the rate of interest at which the central bank of a country borrows money from commercial banks.
- **Bank Rate :** It is the rate of interest at which the central Bank gives long-term loan to the commercial banks.

- **Open Market Operations :** Open market operations refer to the sale and purchase of securities in the open market by the central bank. By selling the securities (like, National Saving Certificates—NSCs), the central bank soaks liquidity (cash) from the economy. And, by buying the securities, the central bank releases liquidity.
- **Margin Requirement :** The margin requirement refers to the difference between the current value of the security offered for loan (called collateral) and the value of loan granted.

Exam. Oriented Questions with Answer

VERY SHORT ANSWER TYPE QUESTIONS (1 MARK)

Q. 1. What are demand deposits?

Ans. Demand deposits refers to those deposits which are repayable by the banks on demand.

Q. 2. Define cash reserve ratio.

Ans. This refers to the proportion of total deposit of the commercial bank, which they must keep as cash reserves with central bank.

Q. 3. Define money supply.

Ans. Money supply refers to the total volume of money held by public at a particular point of time in an economy.

Q. 4. State the components of money supply.

Ans. (1) Currency with public (coins and notes).
(2) Demand Deposits with Commercial Banks.

Q. 5. Define Bank Rate.

Ans. Bank Rate is the rate at which the central bank of a country lends money to commercial banks to meet their long term needs.

Q. 6. What is a Central bank?

Ans. Central Bank is an apex body that controls, operates, regulates and directs the entire banking and monetary structure of the country.

SHORT ANSWER TYPE QUESTIONS (3-4 MARKS)

Q. 1. Explain the "Bankers' Bank function" of the central bank.

Ans. As the banker to the banks, the central Bank holds a part of the cash reserves of commercial banks. From these reserves it lends to commercial banks when they are in need of funds. Central bank also provides cheque clearing and remittance facilities to the commercial banks.

Q. 2. Explain the "Issue function" of the Central Bank.

Ans. The central bank is the sole authority for the issue of currency in the country. It promotes efficiency in the financial system. It leads to uniformity in the issue of currency, and it gives Central Bank control over money supply.

Q. 3. Explain the 'Government's Banks' function of a Central Bank.

Ans. A Central Bank conducts the banking account of government departments. It performs the same banking functions for the government as Commercial Bank performs for its customers. It accepts their deposits and undertakes inter-bank transfer. It also gives loans to the government. A Central Bank also provides various services as agent of the government. It manages public debt. It also gives advice to the government regarding money market, capital market, government loans and economic policy matters.

LONG QUESTION TYPE QUESTION (6 MARKS)

Q. 1. What do you mean by credit/money creation? Explain the process of money creation by the commercial banks with the help of a numerical example.

Ans. Money creation is a process in which a Commercial Bank creates total deposits many times the initial deposits.

The capacity of Commercial Bank to create depends on two factors :

1. Amount of initial fresh deposit
2. Legal Reserve Ratio LRR

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

Money Creation = Initial Deposit × Money multiplier.

Working : Suppose (i) Initial Deposit = Rs. 1000

(ii) LRR = 20%

As required, the bank keeps 20% i.e., Rs. 200 as cash reserve and lend the remaining Rs. 800. Those who borrow use the money for making payments. As assumed those who receive these payments put the money back into their bank accounts. This creates a fresh deposit of Rs. 800. The bank again keep 20% i.e., Rs. 160 and lend Rs. 640. In this way the money goes on multiplying leading to total money creation of Rs. 5000.

$$\text{Money Creation} = \text{Initial Deposit} \times \frac{1}{\text{LRR}}$$

$$= 1000 \frac{1}{0.2} = \text{Rs.5000}$$