

MONEY & BANKING

Barter system :- It is a system in which goods are exchanged for goods.

OR

C.C economy – 'C' stands for 'Commodity'. It is the one in which commodities are exchanged for commodities.

Drawback/ Problems of the Barter System:-

- Lack of double co-incidence of wants – An act of sale and purchase of an individual were to occur at the same point of time.
- Lack of common unit of value :- Different goods and services are of different values. There is no common measure of value.
- Difficulty of storage and transfer of wealth :- Wealth is stored in terms of goods which can't be stored for long nor can they be moved long distances.
- No system for future payments or contractual payments.

Definition of money :- It means anything that is generally acceptable as

- As medium of exchange
- A measure of value
- A store of value
- A standard for deferred payments.

Narrow concept of money :-

Money = currency notes + coins + demand deposits .

Brood concept of money :-

Money = money assets + near money assets (Assets which can be converted into money on a short notice like fixed deposits).

Classification of money :

1. Fiat money :- Money issued by gov. Of India such as notes and coins.
2. Fiduciary money :- money backed up by trust between the payer and payee.
For Eg: cheque.
3. Money value of money : It refers to the value inscribed on a coin or written on a paper note. For eg : Re 1 coin, Rs. 500 note . etc.
4. Commodity value of money :- it refers to value of the thing the money is made of. For eg :- gold and silver coin.

5. Full bodied money :- It refers to money in terms of coins whose commodity value is equal to the money value as and when they are issued.
6. Credit money:- it refers to that money of which money value is more than commodity value. For eg:- value of metal of which coin is made up of is much lower than money value of rupee.

Types of credit money:

- 1) Token money:- all the coins in circulation in India. For eg:- Re. 1 coin, Rs.2 coin etc.
- 2) Representative token money:- it is in the form of paper issued by the gov. With the backing of equivalent amount of token money.
- 3) Circulating promissory notes issued by central bank :- It includes all the currency notes issued by the central bank (RBI).
- 4) Demand deposits :- It is also known as chequeable deposit. These are claims of creditors against bank which can be transferred by means of cheques.

Functions of money:-

- 1) Primary functions:-
 - a) Medium of exchange :- It acts as a medium for the purchase and sale of goods and services
 - b) Measure of value:- value of the goods and services can easily be expressed in terms of money i.e. common unit of value.
- 2) Secondary functions:
 - a) Standard of deferred payment :- Deferred payment are those payment which can be made in future. Such payment can not be made in terms of physical goods because their value liable to change. Money is used as standard of deferred payment.
 - b) Store of value:- it serves as a store of value. Money can be stored without loss in value.
 - c) Transfer of value:- It helps us to transfer value from one person to another and from one place to another, easily, quickly and efficiently.

Supply of money :- It refers to total stock of money held by the people of a country at a point of time.

It does not include

- Stock of money held by the gov.
- Stock of money held by the banking system of a country.

Measurement of money supply

M_1 , M_2 , M_3 and M_4 are the four measures of money supply in India.

$M_1 = C$ [currency] + DD [Demand deposits] + OD [other deposits with RBI].

$M_2 = M_1$ + deposits with post office saving bank account.

$M_3 = M_1$ + net time deposits with the commercial banks.

$M_4 = M_3$ + total deposits with the post office (other than in form of national saving certificate).

High powered money = $R + C$

Here, R = cash reserve of banks.

C = Currency with the public.

Term deposits	Demand deposits
These are always for a specific period of time	These are not for any specific period of time
Money can not withdrawn as and when needed.	Money can be withdrawn as and when required.
These are not chequeable deposits.	These are chequeable deposits.

According to Indian banking companies act, "Banking company is one which transacts the business of banking which means the accepting for the purpose of lending or investment of deposits of money from the public repayable on demand or otherwise and withdraw able by cheque, draft, order or otherwise.

A commercial bank is that financial institution which accepts from the people and gives loans for the purpose of consumption or investment.

Functions of commercial banks :

1) Primary function :-

a) Accepting deposits :- A bank accepts deposits from the public. People can deposit their cash balances, according to their convenience in either of the following:-

- Fixed or time deposit account :- cash is deposited in this account for a fixed period. The depositor gets the receipt which contains the name of depositor amount deposited, rate of interest and the period of deposit. Such deposit attract high rate of interest. Longer the period, higher is the rate of interest. It is also called time liability.
 - Current or demand deposit account :- a depositor can deposit or withdraw his funds any no of times. No interest is paid by the bank on such account. Rather the bank demands some charges on it. It is also called demand liability.
 - Saving deposit account :- it is meant for encouraging small saving. Restrictions are imposed by the bank on the amount to be withdrawn. Such deposit has low rate of interest.
 - Home safe saving account :- in this a small portable safe is provided to the depositor at his place. Depositor puts his small savings in it and hands over the same to bank. Interest paid on this account is less than on saving account.
 - Recurring deposit account :- In this a specified amount is deposited every month for a specific period such as 12,24,36 or 60 months. This amount can not be withdrawn before the expiry of the given period except under exceptional circumstances. Interest paid on this is higher than saving account.
- b) Advancing loans :- bank advance loans on the basis of the security. Such amount of loan is generally less than the value of security.

Types of Loans:-

- a) Cash credit :- A credit limit is sanctioned upto a certain amount. the debtor withdraws the amount within this limit. he has to pay interest on the amount actually withdrawn.

- b) Overdraft :- clients who have current account with the bank are granted with the facility of withdrawing more money than actually lying in their account. it is called overdraft.
- c) Demand loans :- Such loans are offered against personal security or against the security of financial assets. interest is charged on the whole amount from the day the loan is sanctioned.
- d) Short terms loan:- It includes:-
- personal loans.
 - loan to finance working capital .

These are offered against some security.

- e) Discounting of bill of exchange :- In this holder of a bill of exchange can get it discounted by the bank. after making some marginal deductions, the bank pays the value of the bill to the holder.

2. Secondary Functions:

- 1) agency functions :- Bank acts as agents to their customer in different ways:-

- a) collection and payment of various items :- Bank collect, rent interest etc on behalf of their customers and also make payment of taxed, insurance premium etc. on their behalf.
- b) Purchase and sell of securities :- Bank buys, sells and keep in safe the securities on behalf of their customers.
- c) Trustee and Executor:- Bank also acts as trustees and executor of the property of their customer on their advice.
- d) Underwriting :- Bank underwrite the sale of new shares.
- e) Purchase and sale of foreign exchange on behalf of their customers.
- f) Remitting of money:- Bank remit money at distant places through bank draft, RTGS, NEFT etc.

2) General utility services:-

- a) locker facilities :- Bank provides locker facilities to their customers to keep their valuables and other important documents. annual locker rent is charged.
- b) Traveler's cheque and letter of credit :- Bank issue traveler's cheque and letter of credit to their customer to avoid risk of carrying cash during journey.

- c) Business information and statistics :- Bank give advice to their customers on financial matters on the basis of business information and statistical data collected by them.

NOTE:

A financial institution is a banking institution only if it performe

- Accepting chequeable deposits.
- Making advances or offering loans.

Thus,

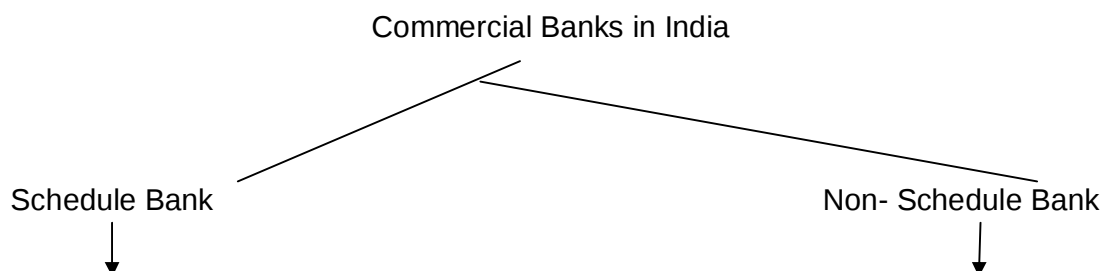
- LIC is a financial institution and not a bank as it offers loans but doesn't accept chequeable deposits from the public.
- Post offices are not banks, since they accept deposits from the public but do not offer loans.

Primary Deposits :- These are cash deposits with the commercial banks by the people. t
points to the saving of the depositors with the banks.

Secondary deposits :- These are those deposits which arise on account of loans by the
banks to the people. it points to the borrowings of the depositors from the banks. it
is
also known as Derivative deposits.

Banks are an important agent of investment.

- It serves as a channel between savers & investors.
- Savers deposit their funds with the banks and investors borrow the funds from the banks.



- Relatively bigger
- Included in II schedule of RBI.

Relatively smaller
Not Included.

For Eg: - Public sector bank - SBI and nationalized bank

Private sector Bank - HDFC bank.

Foreign bank - CITI bank.

Role of banks in Economic Development.

1. Capital formation :- It mobilize the saving of the people and contributes to capital formation.
2. Innovations :- By Providing credit to the entrepreneurs, bank encourage innovations by developing new products and contributes towards growth and development.
3. Development of Rural sector :- bank provides loan at concessional rate of interest to the farmers for the purpose of seeds, agricultural tools and equipments.
4. Market demand :- By providing consumer credit bank helps in pushing up the market demand.

Credit creation by the commercial banks :-

- commercial banks are an important source of money supply in the economy by creating credit in the form of demand deposits .
- cash reserves with the banking system are not a part of money supply and demand deposit are a part of money supply.
- commercial banks know by way of their experience that all the depositors would not withdraw all their deposits at a point of time.
- experience shows that withdrawals are generally around 10% of the deposits. the bank need to keep only 10% of the deposits as cash reserves.
- if CRR = 10%, cash reserves = 1000 then the bank can offer the loan upto Rs. 10,000.
- demand deposit = $\frac{1}{\text{CRR}} \times \text{cash reserves}$
 $= \frac{1}{10\%} \times 1000$
 $= \text{Rs. } 10,000.$
- loans are never offered in cash. these are always reflected as demand deposits in favor of the borrowers
- Deposits of the bank are 10 times it's cash reserves.
- while cash reserve with the bank is Rs. 1000 it is creating credit worth Rs. 10000.

$$\begin{aligned}\text{Credit multiplier} &= \frac{1}{\text{CRR}} \\ &= \frac{1}{10\%} = 10.\end{aligned}$$

$$\text{Credit multiplier} = \frac{\text{Demand deposits}}{\text{Cash reserves}}$$

cash reserves.

$$= \frac{10000}{1000} = 10$$

- This is how cash reserve of Rs. 1000 with the banks are converted into demand deposits of Rs. 10,000.

Factors effecting credit creation.

1. Primary cash deposits :- Large the availability of cash the larger will be the credit creation.
2. Banking habits of people - people in a country prefer to deal through banks. thus, cash reserves to be high.

THE CENTRAL BANK :- It is the apex bank that controls the entire banking system of a country.

- It operates to control economy, supply of money and credit.
- It is the sole agency of note issuing in a country.

CENTRAL BANK	COMMERCIAL BANKS
it is the bank of all the banks.	it functions under the control of the central bank
it focuses on social welfare	it focuses on profit maximization.
it controls the flow of credit	it contributes towards the flow of credit
it is the custodian of forex reserves of the country.	it is not.
it issues currency	it has no such authority.
it does not	it accepts deposits from the general public and advances loans to the individuals and household.
it is an advisory to the gov. on the monetary	it is not
it is a monitoring authority of the country's entire banking system	it is an element or unit of the banking system.

Functions of the central Bank :-

1. Issuing Notes :- it has the exclusive right of issuing notes. the notes issued by the central bank are an unlimited legal tender.
2. Banker to the Gov. :- It is a banker, agent and financial adviser to the gov. as banker it manages accounts of the gov. banks and manages gov. treasuries. as agent it buys and sells securities treasury bill on behalf of the gov. as adviser it advises the gov. from time to time on economic financial and monetary matters.

3. **Banker's Bank:-** It is an apex bank of all the banks in the country. the central bank has almost the same relations with other banks in the country as a commercial bank has with its customers. it keeps some cash balances of all commercial banks as a deposit to help them during financial crisis.
4. **Supervision of the Banks :-** The central bank also supervise the commercial banks in relation to their.
 - Licensins
 - Expansion
 - Merger
 - Liquidation.
5. **Custodian of Foreign Exchange :-** It is the custodian of nation's foreign exchange reserve. it maintains foreign exchange reserves in order to promote international trade and stabilize exchange rate.
6. **Clearing House Function :-** It also performs the function of clearing house. every bank keeps cash reserve with RBI. the claims of banks against one another can be easily settled by simply transfer from and to their account. for Eg:- bank 'A' receives a Cheque of Rs. 10,000 drawn on Bank 'B' and bank 'B' receives a cheque of Rs. 15,000 drawn on Bank 'A'. A sum of Rs 5,000 will be debited to the account of Bank 'A' and credited to the account of bank 'B'. There is no need of cash transactions.
7. **Control of Credit :-** It increases or decreases the money supply in an economy. during inflation the supply of money is restricted and during deflation, the supply of money is liberalized.
8. **collection of statistics :-** It collects statistical information relating to banking, currency and foreign exchange which is useful in making policies, plans of growth and development.

How does the central bank control flow of credit (money supply) in the economy ?

OR

What are the principal instruments of monetary policy of the central bank?

1. **Quantitative Instruments :**
 - a) **Bank rate :-** It is the rate at which the central bank gives credit to the commercial banks. the increase in bank rate increase the rate of interest and credit becomes dear. the decrease in bank rate decrease the interest rate and credit becomes cheap. RBI adopts 'Dear money policy' during inflation and 'Cheap money policy' during deflation.
 - b) **Open market operations :-** It is the sale and purchase of securities in the open market by the Central bank. by selling the securities, the central bank withdraws cash balances from the economy. by buying the securities, the central bank adds to cash balances in the economy.

- c) Cash reserve ratio (CRR) :- It refers to the minimum % of a bank's total deposits required to be kept with the central bank. commercial banks have to keep with the central bank, a certain % of their deposits in the form of cash reserves as a matter of law. for eg :- if CRR is 10% and total deposits of a certain bank are Rs. 100 crore, then it will have to keep Rs. 10 crore with the central bank as 'minimum reserve'.

when the flow of credit is to be increased CRR is reduced and when the flow of credit is to be reduced, CRR is increased.

- d) Statutory liquidity ratio (SLR) :- Every bank is required to maintain a fixed % of its assets in the form of cash or other liquid assets called SLR. the central bank increases this liquidity ratio to reduce the flow of credit and for increasing the flow of credit the liquidity ratio is reduced.

2. Qualitative instruments :-

- a) margin requirements :- Margin requirement of loan refers to the difference between the current value of the security offered for loans and the value of loans granted. for eg:- A person mortgages an article worth Rs. 100 with the bank and the bank gives him loan of Rs. 80. margin requirement of loan is reduced.
- b) rationing of credit :- It means fixation of credit quotas for different business activities it is introduced to check the speculative activities in the economy. the central bank fixed credit quotas for different activities and the commercial banks can't exceed the quota limits while granting loans.
- c) Direct actions :- The central bank may initiate direct actions against the member bank in case these do not comply with its directives.
- d) Moral suasion :- The central bank makes the member banks agree through pervasion or pressure to follow its directives on the flow of credit.