Revision Notes

Class - 12 Macro Economics

Chapter 3 - Money and Banking

Money: Money is the most often used means of exchange. There can be no exchange of commodities and thus no role for money in an economy consisting of only one person.

Barter Exchange: It is a trade in which one product or service is exchanged for another. It is the oldest form of commerce. Individuals and businesses exchange goods and services based on equivalent prices and good estimates.

Disadvantages of barter exchange:

1. A lack of a standardised means of measuring value.
2. There is a lack of desire for duplication.
3. A scarcity of common value measures.
4. Inadequate store of value.
5. Deferred payment standards are lacking.
6. Inability to divide.

Functions of Money: The functions of money are broadly classified as

1. Primary functions.

i. A mode of exchange.

ii. A common measure of value or a common unit of value.

2. Secondary functions:

i. Value storage.

ii. Value transfer.

iii. Deferred payment standard.

Demand of Money: It is referred to as an individual's liquidity preference, which is the decision of holding money in liquid form, i.e., cash, in order to earn interest or as a precaution.

i. Transaction Motive: The drive to hold cash amounts is referred to as the transaction's motive.

ii. Speculative Motive: It refers to funds retained by investors in order to capitalise on potential investment opportunities in the economy.

Aggregate Money Demand: In an economy, the entire demand for money is made up of transaction demand and speculative demand. The former is proportionate to real GDP and the price level, whereas the latter is inversely related to the market interest rate.

$M^d = M_T^d + M_s^d$

Where, M_d = Money demand

M_T^d = Transaction money demand

M_s^d = Speculative money demand

Fiat money: It is the currency that a government declares to be legal tender but is not backed by a physical asset. The value of fiat money is determined by the connection between supply and demand rather than the worth of the commodity used to make the money.

Supply of Money: It refers to the total money held by the public at a particular point in time in an economy. The supply of money does not include the cash balances held by the national and state governments, as well as the stock of money held by the country's banking system, because these are not in active circulation in the country.

Measures of Money Supply:

i. M_1: It is the first and basic measure of the money supply. It includes currency held by the public, demand deposits of commercial banks, and other deposits with the Reserve Bank of India (RBI).

M_1= Currency and coins with public (C) + Demand deposits of the public with the banks (DD) + Other deposits (OD)

ii. M_2: It is also known as narrow money along with M_1. It includes Savings deposits with Post Office saving banks.

M_2= M_1 + Savings deposits with Post Office saving banks

iii. M_3: It also includes time deposits with a commercial bank and is known as broad money.

M_3= M_1 + Net time deposits with commercial banks

iv. M_4: It includes the total deposits excluding National Saving Certificates and is also known as broad money along with M_3.

M_4= M_3 + Total post office deposits excluding National Saving Certificates (NSC)

Banking Systems:

1. Commercial Bank: A commercial bank is a type of financial organisation that handles all transactions involving the deposit and withdrawal of money for the public, as well as the provision of loans for investment purposes and other similar activities. These banks are profit-making enterprises that conduct business only for the purpose of making a profit. State Bank of India, Canara Bank are some examples.

2. Central Bank: In the banking system, the central bank is recognised as the highest financial institution. It is seen as an essential component of a country's economic and financial system. The central bank is an independent authority in charge of supervising, regulating, and stabilising the country's monetary and banking structures.

Money creation by Banks: If the value of any of its constituents, such as CU, DD, or Time Deposits, changes, the money supply will alter. The public's preference for maintaining cash balances as opposed to bank deposits has an impact on the money supply. The following major ratios summarise these influences on the money supply.

1. The Currency Deposit Ratio: The currency deposit ratio (cdr) depicts the amount of currency held by individuals as a percentage of total deposits. For instance, cdr rises over the holiday season as people convert deposits to cash balances in order to cover extra expenses.

cdr = CU/DD

2. The Reserve Deposit Ratio: Banks keep a portion of the money customers keep in their bank accounts as reserve money and lend the rest to various investment initiatives. Reserve money is made up of two components: vault cash in banks and commercial bank deposits with the RBI. Banks use this reserve to meet account holders' need for cash. The reserve deposit ratio (rdr) is the percentage of total deposits that commercial banks retain as reserves.

Measures to bring forth a healthy Reserve deposit ratio:

I. Qualitative Measures

1. Cash Reserve Ratio (CRR): It is a portion of a bank's total deposits that the Reserve Bank of India requires to be kept with the latter as liquid cash reserves.

2. Statutory Liquidity Ratio (SLS): It is essentially the reserve requirement that banks must maintain before extending credit to customers. It is essentially the reserve requirement that banks must maintain before extending credit to customers.

Bank Rate: A bank rate is the interest rate charged by a nation's central bank to its domestic banks in order for them to borrow money. The interest rates charged by central banks are meant to stabilise the economy.

High Powered Money: It is the money created by the RBI and the government, in which the public holds the currency, and the banks hold the cash reserves. It differs from money for that money consists of demand deposits, whereas cash reserves serve as a foundation for creating demand deposits.

II. Qualitative Measures

1. Open Market Operation: It refers to the central bank's selling and purchase of securities on the open market to and from commercial banks or the general public.

2. Bank Rate Policy: It refers to the central bank's manipulation of the discount rate in order to influence the economy's credit condition.

3. Sterilisation by RBI: The RBI's market-based strategy in neutralising a portion or whole of the monetary impact of foreign inflows is known as sterilising.