Lesson - 28

Money and Banking

SUMMARY

Money is an economic unit that functions as a generally recognized medium of exchange for transactional purposes in an economy. Money originates in the form of a commodity, having a physical property to be adopted by market participants as a medium of exchangeThe discussion of money and banking is a central component in the study of macroeconomics. At this point, you should have firmly in mind the main goals of macroeconomics from Welcome to Economics - Economic growth**,** low unemployment, and low inflation. We have yet to discuss money and its role in helping to achieve our macroeconomic goals. This chapter discusses what economists mean by money, and how money is closely interrelated with the banking system. Monetary Policy and Bank Regulation furthers this discussion.

Failure of barter system and the need for money.

People used to exchange goods for goods to satisfy their wants without the use of money.Such a system was called barter system. However with passage of time the barter system had to be abandoned because of its inherent problems. Some of the demerits of barter system are as follows –

- Search Cost
- Lack of double coincidence of wants
- Lack of division of goods
- Lack of common unit of measurement
- Problem of Storage
- Loss of Value

Meaning of money

Money is anything which is generally accepted as a means of exchange, a measure and store of value and which also acts as standard of deferred payments.

Functions of money

Primary or Basic Functions

- Medium of Exchange
- Measure of Value

Secondary Functions

- Store of Value or Wealth
- Standard of Deferred Payments
- Transfer of Value

Other functions of Money

- Distribution of National Income
- Liquidity and Uniformity of Value

Measures of Money Supply in India

The money supply in Indian economy is generally measured in following forms –

M1 = Currency (notes and coins) with the public + Demand deposits + otherdeposits held with the Reserve Bank of India.

M2 = M1 + Post Office saving deposits

M3 = M1 + Time deposits of all commercial banks and co-operative banks(excluding interbank time deposits)

M4 = M3 + Total deposits with the Post Office Saving Organization (excludingNational Saving Certificate)

Of all the concepts of money supply stated above, M1 is referred to as narrow measure and M3 the broader measure of money supply.

High Powered Money

The High Powered Money refers to the currency held by the public (C), cash reserves of banks (R) and other deposits of the R.B.I. High Powered Money is produced by the R.B.I. and the Government of India and held by the public and the banks.

banks.

Commercial Bank

Meaning -The commercial bank is a financial institution which is primarily concerned with accepting deposits from public and lending to the public besidesothers. These banks operate both under the public as well private sectors.

Functions of Commercial Banks

a. Acceptance of deposits
   - Current Account Deposits or Demand Deposit
   - Savings Account Deposits
   - Fixed Deposit or Time Deposit or Term Deposit
b. Extending Loans and Advances
c. Transfer of Funds
d. Agency Functions
e. Sale and Purchase of Foreign Exchange
f. General Utility Services

Creation of Credit by Commercial Bank

Credit creation is one of the most important functions of a commercial bank. Banks create credit out of the deposits that is mobilized by them.

The process of credit/money creation

- The money is created by granting loans and advances

to public and making relevant entries into the books of accounts of the lending banks.
- Loans are granted out of the deposits received bythe banks. Normally, the amount of loan granted by a bank is greater than theamount of deposits received by it.
- This is mainly because of the fact that when money is deposited by the depositors in a bank, the bank by its experience knowsthat not all the money would be withdrawn by the depositors at once at any pointof time
- The banks keepcertain proportion of its total deposits in form of cash to honor the demand of itscustomers.
- Every commercial bank is required to keep certain proportionof its total deposits with the R.B.I. which is known as Cash Reserve Ratio (CRR).
- The bank is also required statutorily to maintain certain proportionof its total deposits as liquid assets in form of cash, gold, and certain governmentapproved securities. This is known as Statutory Liquidity Ratio (SLR).
- The CRRand SLR together form the Legal Reserve Ratio (LRR)which is determined by the central bank of a country.
- When LRR is increased by the central bank the capacity of the commercial banks to create deposit or credit decreases and when LRR is decreased the capacity to create more credit increase

Formula

Total quantity of money created = Quantity of deposits × 1/LRR.

Thus, a higher LRR would create lessamount of money and a lower LRR would create a higher amount

Central Bank

Central Bank is an apex bank in an economy which is entrusted with the task to control, regulate and supervise the entire banking operation so far the commercial banks including formulation and implementation of monetary policy in the economy. The central bank of India is Reserve Bank of India (R.B.I.).

Functions of Central Bank

- Banker to the banks
- Banker to the government
- Custodian of the stock Bank of issuing or of gold and foreign exchange reserves of the nation
- Controller of credit and money supply
- Bank of issuing or currency

Methods of credit control

- Quantitative methods of credit control
- Qualitative or selective method of credit control

Quantitative methods

Bank Rate Policy -Bank rate is the rate at which central bank provides loanto the commercial banks

Open Market Operations -Open market operations refer to the policy ofsale and purchase of government securities in the open market by the central bank.

Variable Legal Reserve Ratio - The central bank can influence the creditcreating power of commercial banks by varying CRR and SLR. Increase in LRR reduces credit creation capacity of commercial banks and

Qualitative or selective method

Margin Requirements - The commercial banks grant loan to borrowersagainst some collateral securities whose value is more than the value ofloans granted.

Moral Suasion - Under this method central bank persuades and pressurizes the commercial banks to adopt a credit policy which is in line with the overall objectives of the economy.

Credit Rationing- Under this method central bank fixes maximum ceiling of loans to be granted by the commercial banks.

Evaluate Yourself

Q. List out demerits of barter system.

Q. Explain the process of credit creation of commercial bank.

Q. Mention functions of commercial bank.

Q. "Instruments of credit control policy help R.B.I. to keep a control on commercial banks." How ?