MONEY & BANKING

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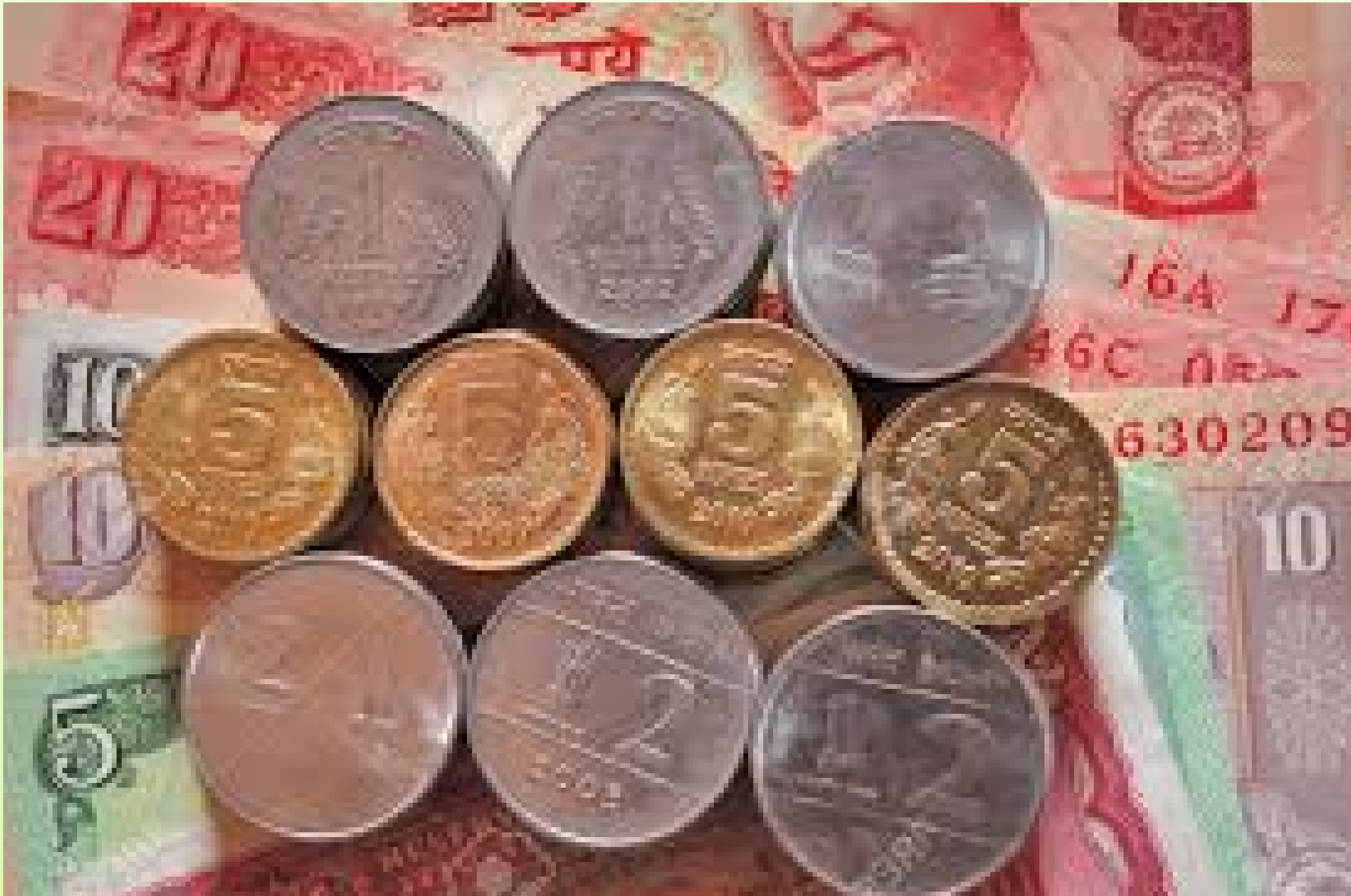
MONEY



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Money is what money does.

Anything which is used as

a medium of exchange,

store of value,

measure of value and

standard of deferred payments is called money.

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Barter System

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Barter system is a system in which goods and services are exchanged for other goods and services.

COMMODITY – COMMODITY ECONOMY

NON MONETARY SYSTEM OF EXCHANGE

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MONEY SUPPLY

Money supply refers to the total amount of money which is in circulation in an economy at a given point of time.

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Components of Money Supply

M_1 = Currency + Net Demand Deposits with Banks + Other Deposits with RBI.

$M_2 = M_1$ + Post Office Savings Deposits

$M_3 = M_1$ + Time Deposits with Commercial Banks

$M_4 = M_3$ + Post Office Savings Deposits

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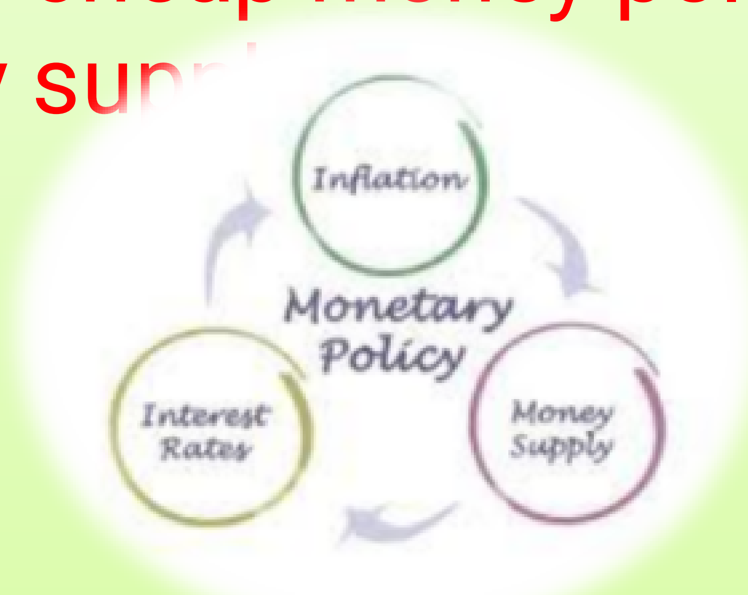
Factors that determine the Money Supply

(i) *Monetary Policy:* It is one of the most important determinants of money supply. The dear money policy leads to the decline in the money supply and cheap money policy leads to increase in money sup



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(ii) Policy of commercial Banks

If commercial Banks lend more, it will lead to increase in money supply. Lending activity of the Commercial Banks is determined by the cash reserve ratio.

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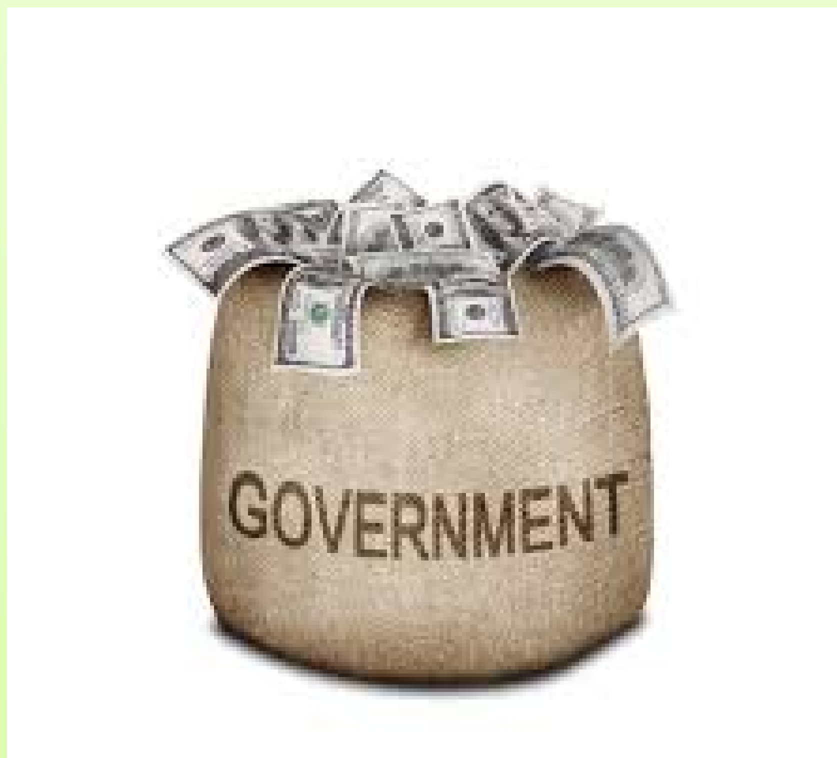
(iii) Fiscal Policy of the Government

If the Government spends more, money supply will increase and vice versa. Deficit financing leads to increase in money supply.



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COMMERCIAL BANK

A Commercial bank is a financial institution which performs the functions **of** **accepting deposits** from the public and **advancing loans.** The Bank acts as an intermediary between those who have surplus money and those who are in need of money.

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Types of deposits held by the Commercial Banks

a) *Current account deposits:* The depositor can withdraw his money at any time. Cheque facility is provided to the depositor. The Bank does not pay any interest.

b) Saving Account deposits: The depositor can withdraw his money at any time. However, the bank may impose some restrictions on withdrawal. Interest rate is low when compared to time deposits. The purpose of this deposit is to encourage small savings.

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c) Fixed or Time Deposits: Money is deposited for a fixed period of time. The depositor can withdraw money only after completing that term. Interest rate is high.

d) Recurring Deposit: It aims at encouraging regular savings by the people. The depositor can deposit money in installments for a given period of time. Withdrawal can be done only after completing the term.

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CENTRAL BANK

Central Bank is the monetary authority of a country

It controls, regulates and supervises all the monetary institutions.

The name of the Central bank in India is Reserve Bank of India (RBI). It was established in 1935.

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Functions of the Central Bank (RBI)

Issue of currency

The Central Bank alone can issue currency notes in India.

Coins and one rupee notes are printed by the Government. The RBI will put them into circulation. All other currency notes are printed and issued by RBI.

India follows minimum reserve system. RBI has to maintain gold and foreign exchange reserves of `200 crores out of which ` 115 crores should be gold.

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(ii) Banker to the government

The Central Bank receives and makes all the payments on behalf of the government. It is called “the ways and means loans”.

The Central Bank manages public debt. The Central bank has to manage all issues connected with public debt.

The Central Bank advises the government on banking and financial matters.

The government keeps its balances in the current account of the RBI.

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(iii) Bankers' Bank and supervisor:

All the commercial banks have to keep some percentage of their deposits with the RBI. This is called Cash Reserve Ratio (CRR).

The central Bank gives licences to start commercial banks, inspects the work of commercial banks periodically and sometimes asks the banks to wind up.

Every commercial bank is required to maintain a fixed percentage of its deposits in the form of cash with itself. This is called Statutory Liquidity Ratio. RBI fixes SLR.

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Lender of the Last Resort:-

When the Commercial Banks are in financial difficulties, they can get loans from the RBI. They can approach the RBI with discounted bills. RBI will rediscount them and advance loans.

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(v) Clearing house function

Representatives from different banks in a city meet at the clearing house office of the central bank. Wherever RBI is not there SBI office will have the clearing facility. Payments from one bank to another are adjusted in the accounts maintained by the commercial banks with the RBI or SBI.

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(vi)Custodian of foreign exchange reserves

The Central Bank buys and sells foreign currencies in the market. So, we say central bank is the custodian of foreign exchange reserves.

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(vii)Control of credit

Commercial banks create credit where as central bank controls credit. The central bank has two weapons to control credit in the country.

They are:

(A) Quantitative credit control measures.

(B) Qualitative credit control measures.

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a. **Quantitative measures :-**

- Bank Rate
- Repo Rate
- Reverse Repo Rate
- Open Market operations
- Cash Reserve Ratio (CRR)
- Statutory Liquidity Ratio (SLR)

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1. Bank Rate: Commercial Banks may take loans to meet their long term credit needs from the Central Bank. The interest charged on these loans is called Bank Rate.

During Inflation Bank Rate will be increased. The lending capacity of commercial banks will fall. They will advance less loans with high interest rate . Money supply will fall. Aggregate Demand will fall. Inflation will be reduced

During deflation, bank rate will be decreased. Lending power of banks will increase. They will advance more loans. Demand will increase . Deflation will be reduced.

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2. Repo Rate: Commercial Banks may take loans to meet their short term credit needs from the Central Bank. The interest charged on these loans is called Repo Rate.

During Inflation Repo Rate will be increased. The lending capacity of commercial banks will fall. They will advance less loans with high interest rate . Money supply will fall. Aggregate Demand will fall. Inflation will be reduced

During deflation, Repo Rate will be decreased. Lending power of banks will increase. They will advance more loans. Demand will increase . Deflation will be reduced.

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3. Reverse Repo Rate

Reverse Repo Rate: Sometimes, the Central Bank may borrow money from Commercial Banks. This interest paid for these loans is called Reverse Repo Rate. During Inflation, the Reverse Repo rate will be increased. The Commercial Banks will lend more money to Central bank. They will lend less to public. Money supply and Aggregate Demand will fall.

During deflation reverse repo rate will be reduced. Banks will lend less to RBI and more to public. Money supply will increase. Deflation will be controlled

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4. Open Market Operations:

During Inflation, the Central Bank will sell securities to the public and get money. Money supply will decrease and inflation will be controlled.

During deflation, the Central Bank will buy back securities and give money to public. Money supply will increase. Deflation will be controlled.

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5. Legal Reserve Ratio

Cash Reserve Ratio

Statutory Liquidity Ratio

LRR will be increased during inflation and reduced during deflation

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Qualitative credit control measures
(or)
Selective credit control measures:-

Margin Requirement: This can be explained with an example. A person gives a collateral security worth Rs 100 to a commercial bank and the bank may give him loan of Rs 80. This means the margin is 20%. During Inflation bank will increase margin requirement. During deflation margin requirement will be reduced.

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CREDIT CREATION BY COMMERCIAL BANKS

- Assumptions:
- Banking system is considered as one unit, namely Banks..
- All receipts and payments in the economy are through the banks.
- All payments are through cheques.
- The one who receives payment deposits the same in his account.

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- Suppose, Bank receives a deposit of Rs 1000. A part of this deposit Bank keeps as Statutory Liquidity Ratio (CRR and SLR). Suppose LRR is 20%. The Bank keeps Rs.200 as reserve and gives Rs. 800 as loans. The borrower is asked to open an account with the Bank and the loan amount is credited in his account. So, Bank receives a deposit of Rs. 800. Suppose, the man who takes loan withdraws the money, he pays it to another man and the other person will deposit that amount in the Bank. Every loan creates a deposit.

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- Now the Bank has Rs. 800 as deposit, it can keep 20% of the amount as reserve and lend the remaining Rs. 640. The deposit creation continues in the above manner. So, Bank can lend several times more than the amount that it receives as deposit.

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How many times more than the initial deposit can the Bank lend? It depends on the LRR.

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

Money Created = Initial deposit x Multiplier

= 1000 x $\frac{1}{0.2}$

= 1000 x $\frac{1}{0.2}$ = 5000

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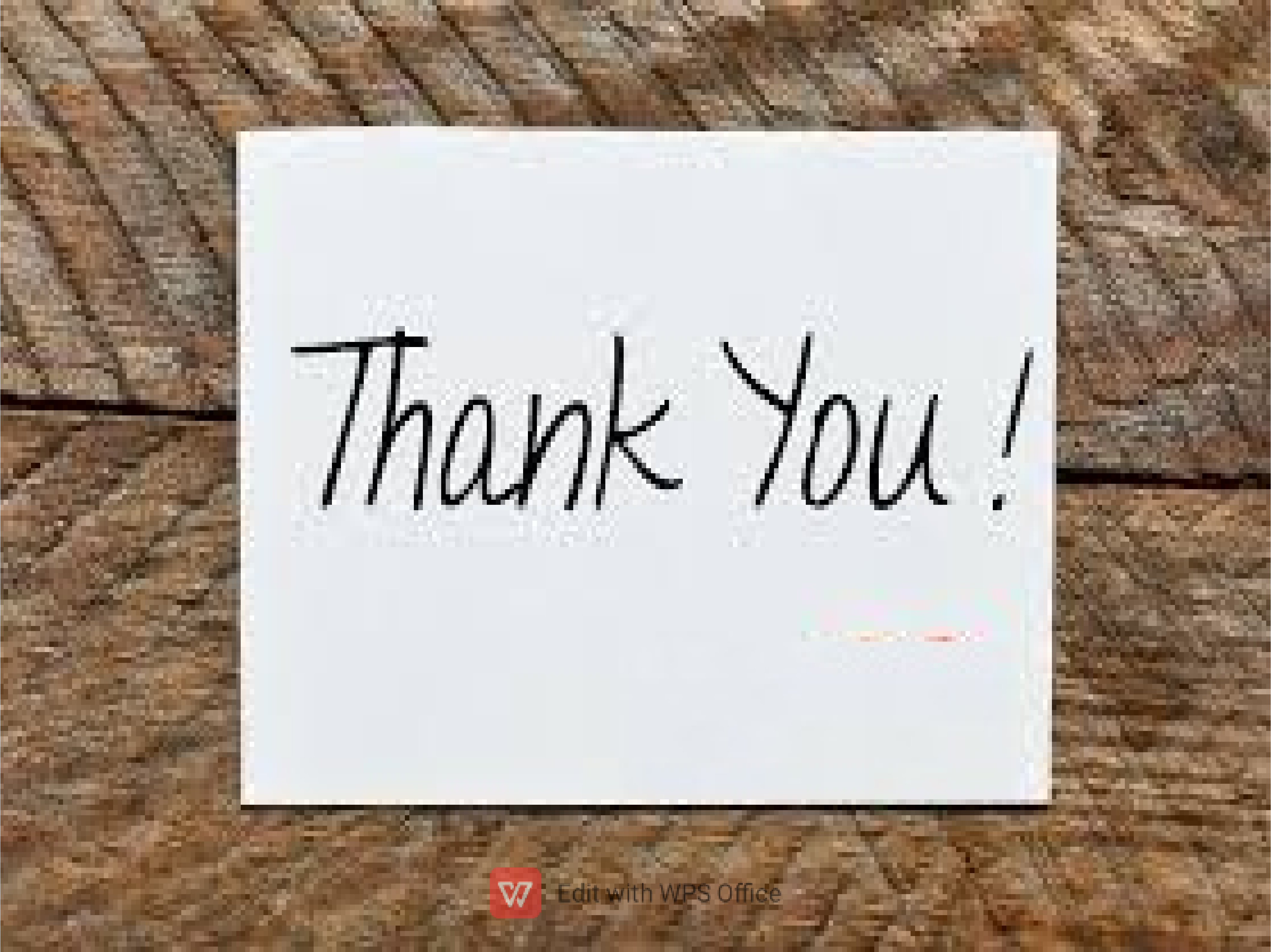

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