CHAPTER 3

MONEY AND BANKING

- **Barter system** is the system used for exchange of one commodity for another before the money came in existence. **For example,** if a person having rice wants tea, then he can exchange rice with a person who needs tea.
- **Drawbacks of Barter System**
  - Problem of double coincidence of wants
  - Lack of common unit of value
  - Difficulty in wealth storage
  - Lack of standard of deferred payments.
- **Money** is commonly used as a medium of exchange.
- **Functions of money**
  - Medium of exchange
  - Unit of value
  - Store of value
  - Standard of deferred payments
  - Transfer of value
- **Legal tender** refers to the currency notes and coins being issued by the monetary authorities of a country. In India, (RBI and government of India together comprises of monetary authorities) issues legal tender.
- **Fiduciary money** is the money that is backed by trust between payer and payee.
- **Fiat money** is money that derives its value only because of government order (fiat). The currency becomes fiat money when the government declares it to be a legal tender
- **Full bodied money** refers to that money whose intrinsic value (value of the metal) is equal to the face value of the engraved on the currency.

- **Credit money** refers to the money whose money value is more than commodity value, like a Rs 1000 note.
- **Transaction demand for money** refers to the demand of money for meeting day to day transactional needs.

The transaction demand for money in an economy ($M^d{}_T$) can be written as

$M^d{}_T = K\,T$

or $\frac{1}{K}\,M^d{}_T = T$

or $v\,M^d{}_T = T$

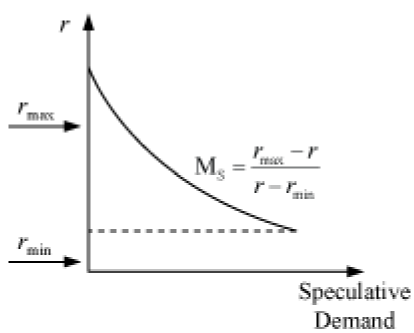
where, $v = \frac{1}{K}$, represents velocity of circulation of money

T = Total value of transactions in the economy over a period of time

K = a positive fraction

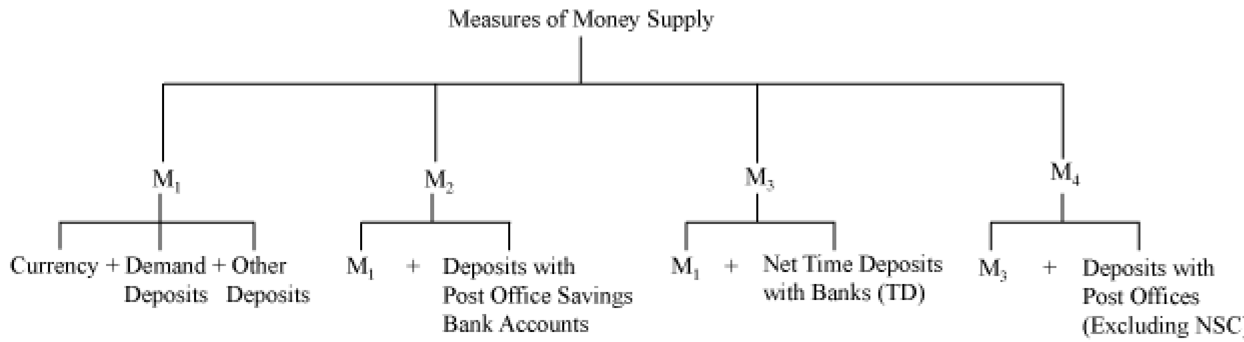
$M^d{}_T$ = Stock of money that people are willing to hold at a particular point of time for transactions.

- **Speculative demand for money** is the demand for money for meeting the speculative needs.
- **Liquidity trap** is such a situation in which speculative demand function is infinite elastic.



When $r = r_{min}$, the economy is in liquidity trap

- **Money supply** refers to the total stock of money held by the people at a point of time.



M_1, M_2, M_3, M_4 are arranged in the descending order of liquidity.

- **Commercial banks** are those institutions which receive deposits from and forward loans to the public for meeting various needs.
- **Functions of commercial banks**
  - Accepting deposits
  - Granting loans and advances
  - Agency functions
  - Discounting bills of exchange
  - Credit creation
  - Other functions
- **High powered money** is the total liability of the monetary authority of the country.

  $H = C + R$

  Where, H represents high powered money

  C represents currency

  R represents cash reserves of banks
- **Money multiplier** is the ratio of the stock of money to the stock of high powered money in an economy

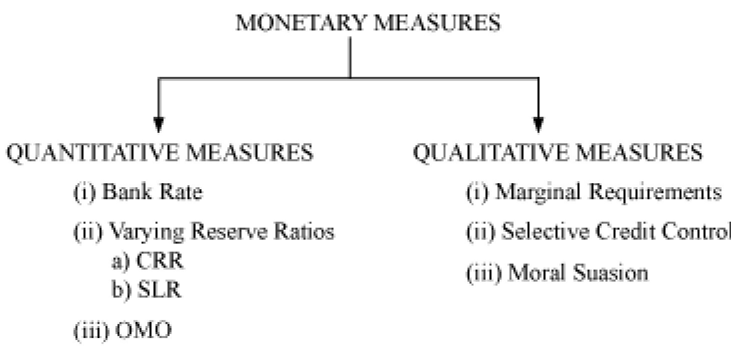
  i.e. $M_M = \dfrac{M}{H}$

  Where, M_M is money multiplier

  M represents stock of money

  H represents high powered money

- **Central Bank** is the apex institution of a country's monetary system. In India, RBI is the central bank.
- **Functions of Central bank**
  - Issues currency
  - Banker's bank
  - Banker to government
  - Custodian of foreign exchange reserves
  - Lender of last resort
  - Controller of credit
- **Instruments of monetary policy**



  - **Bank rate** is the rate at which central bank provides loans to the commercial banks.
  - **Cash reserve Ratio (CRR)** refers to the minimum amount of funds that the commercial banks have to maintain with RBI in the form of deposits.
  - **Statutory Liquidity Ratio (SLR)** is defined as the minimum percentage of assets to be maintained by the commercial banks with the central bank in the form of either fixed or liquid assets.
  - **Open Market Operations (OMO)** refers to the buying and selling of securities either to the public or commercial banks in an open market, in order to vary money supply in the economy.
  - **Selective Credit Control** is the flow of credit to particular sectors in the positive and negative aspect.

- **Margins** (difference between the market value of security and loan value) are kept by the central bank to grant loans against the securities being mortgaged.
- **Moral suasions-** The central bank morally persuades and requests the commercial banks to expand or contract credit and also advices them regarding various policy measures and changes (if required).

➢ **Effect of money supply** on instruments of monetary policy

VARIOUS INSTRUMENTS OF MONETARY POLICY	BR (Bank Rate)	CRR (Cash Reserve Ratio)	SLR (Statutory Liquidity Ratio)	OMO (Open Market Operations)
EFFECTS ON MONEY SUPPLY	$\uparrow$ BR$\rightarrow M_s \downarrow$	$\uparrow$CRR$\rightarrow M_s \downarrow$	$\uparrow$ SLR$\rightarrow M_s \downarrow$	Buying of securities$\rightarrow M_s \downarrow$
	$\downarrow$BR$\rightarrow M_s \uparrow$	$\downarrow$CRR$\rightarrow M_s \uparrow$	$\downarrow$SLR$\rightarrow M_s \uparrow$	Selling of securities$\rightarrow M_s \uparrow$

$\rightarrow$ represents leads to

$\downarrow$ represents decreases

$\uparrow$ represents increases

➢ The instruments of money creation used by the RBI for stabilising the stock of money in the economy to protect from external shocks are referred as **sterilisation policy**.