Chapter

Money and Banking

BARTER SYSTEM:

The system in which one commodity is exchanged for another is called the Barter system. The barter system suffers from the following limitations.

1. Lack of Double Coincidence of Wants: The barter system can work only when both buyer and seller are ready to exchange each other's goods.

2. Lack of Common Measure of Value: In the barter system, all commodities are not of equal value and there is no common measure (unit) of the value of goods and services, in which exchange ratios can be expressed.

3. Lack of Standard of Deferred Payment: In the barter system, contracts involving future payments or credit transactions cannot take place with ease.

4. Lack of Store of Value: Under a barter system, it is difficult for people to store wealth for future use.

MONEY: It is very difficult to give a precise definition of money. Various authors have given a different definition of money. According to Crowther, "Money can be defined as anything that is generally1 acceptable as a means of exchange and that at the same time acts as a measure and a store of value". Professor D H Robertson defines money as "anything which is widely accepted in payment for goods or discharge of other kinds of business obligation

FUNCTIONS OF MONEY: The major functions of money can be classified into three. They are The primary functions, secondary functions, and contingent functions.

I. Primary functions of money

The primary functions of money are;

• Medium of exchange and

• Measure of value

i. The medium of exchange The most important function of money is that it serves as a medium of exchange. In the barter, economic commodities were exchanged for commodities. But it had experienced many difficulties with the exchange of goods and services.

ii. The measure of value: Another important function of money is that the money serves as a common measure of value or a unit of account. Under the barter system, there was no common measure of value and the value of different goods was measured and compared with each other.

II. Secondary functions

The secondary functions of money are;

(i) Standard of deferred payments Another important function of money is that it serves as a standard for deferred payments. Deferred payments are those payments that are to be made in the future. If a loan is taken today, it would be paid back after some time.

(ii) Store of value: Money acts as a store of value. Money being the most liquid of all assets is a convenient form in which to store wealth. Thus money is used to store wealth without causing deterioration

III. CONTINGENT FUNCTIONS

The important contingent functions of money are;

i. Basis of credit: It is with the development of the money market the credit market began to flourish.

ii. Distribution of national income Being a common measure of value, money serves as the best medium to distribute the national income among the four factors of production.

iii. Transfer of value: Money helps to transfer value from one place to another.

iv. Liquidity

v. Guarantor of Solvency

DEMAND FOR MONEY

The desire of people to hold Money in hand is called Demand For Money. It is otherwise called liquidity preference. The desire of people to hold money can generally be classified into three motives. They are the following.

1. Transactive Motive: People hold Money in hand for meeting their day to day expenses is2 called Transactive Motive. The transaction depends on the volume of transactions. When the volume of transaction increases, Transactive Demand For Money also increases. Transactive Demand For Money is a fraction of the volume of transactions in the economy over some time. It can be written as follows.

   $\boldsymbol{M^dT} = \boldsymbol{K}T$

   Here M^dT = Transaction demand for money.

   T= Total volume of transaction

   K = A positive fraction.

   In other words, K is the inverse of the velocity of circulation of money. The velocity of money is the number of times a unit of money changes hands during a period. It can be written as follows.

   $$M^dT = KT \because \frac{1}{K} M^dT = T \therefore \; VM^dT = T \therefore M^dT = \frac{T}{V}$$

   In a real Economy Transactive Demand For Money depends on the GDP. If GDP increases, Transactive Demand For Money also increases. Then the equation can be written as follows.

   $M^dT = KPY$ $Here\ k = positive\ fraction,\ P = Price\ level,\ Y = Real\ GDP$

2. SPECULATIVE MOTIVE: The desire of people to hold money to gain from bonds is called a speculative motive. Here bonds mean any assets like gold, land, etc. Also bonds. The relationship between the interest rate and the bond price is inverse.ie when the market rate of interest is high the bond price will be less. Suppose the market rate of interest is high, then the price of the bond will below. Expecting a fall in the market rate of interest in the future, people will invest in bonds now to make a profit in the future. Then the Speculative Demand For Money will below here. On the other hand3 suppose the market rate of interest is very low now. Expecting a rise in the market rate of interest in

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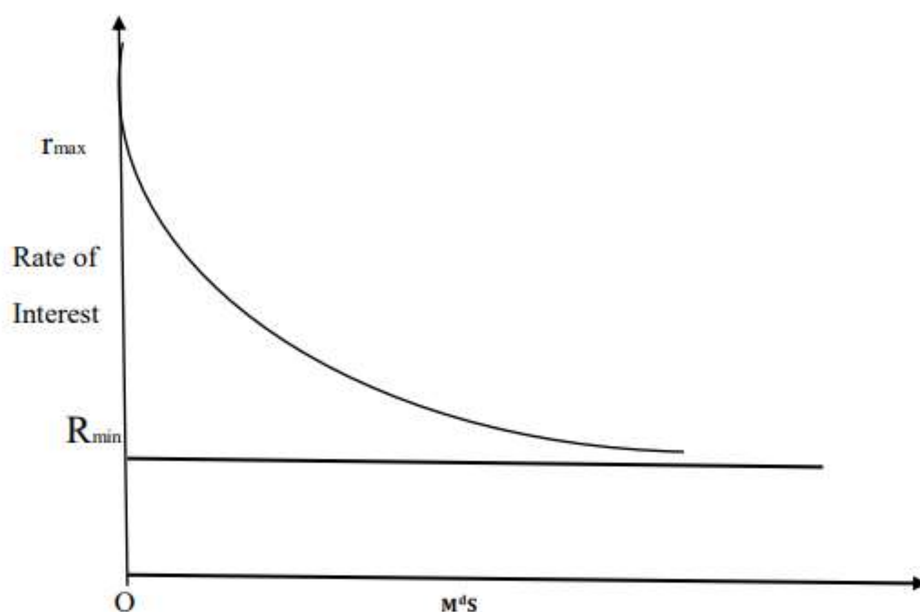
the future people will keep Money with them. Here Speculative Demand For Money will be infinity. Such a situation Speculative Demand For Money is perfectly elastic, it is called a Liquidity Trap. The speculative demand for money can be written as follows.

$$\mathbf{M^dS = \frac{rmax-r}{r-rmin}}$$

$$\boldsymbol{here\ rmax\ \&rmin = \ maximum\ \&minimum\ rate\ of\ interest,}$$
$$\boldsymbol{r = \ currenrt\ rate\ of\ interest.}$$

It can be shown diagrammatically as follows.



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The Total money Demand in an Economy can be written as follows.

$$M^d = M^dT + M^dS \ OR \ M^d = KPY + \frac{rmax-r}{r-rmin}$$

3. PRECAUTIONARY MOTIVE: People often demand money as a precaution against an uncertain future. Unexpected expenses, such as medical or car repair bills, often require immediate payment. The need to have money available in such situations is referred 4 to as the precautionary motive for demanding money.

SUPPLY OF MONEY: The total amount of money available in the Economy at a specific point of time is called Money Supply. From 1st April 1977, RBI publishes 4 alternative Money Supply in India. They are the following.

$M1$ = CU + DD CU = Currency DD = Demand Deposits.

M2 = M1+ saving bank deposits with the post office.

M3= M1 + Net time deposits with Commercial Banks.

M4= M3+ Total Post Office deposits except for the National Savings certificate.

M1 and M2 are together called Narrow Money. M3 and M4 are together called Broad Money. M1 is the most liquid money and M4 is the Least liquid money. M3 is referred to as aggregate monetary resources.

CURRENCY DEPOSIT RATIO [cdr]: It is the ratio between money held by the public in currency to the deposits they hold in banks. It can be written as follows.

$cdr = CU/\text{DD}$

$If\ a\ person\ get\ one\ rupee,\ deposits$ 1/1+cdr in the bank and cdr/1+cdrin cash.

RESERVE DEPOSIT RATIO [rdr]: The ratio between the reserve money and the total deposits of the commercial banks is called Reserve Deposit Ratio. It can be written as follows.

$$rdr = \frac{R}{DD}\ or \frac{resrves}{total\ deposits}$$

Reserve Deposit Ratio are two types

1. Cash Reserve Ratio (CRR): The fraction of reserve money kept in RBI by commercial banks as a ratio of their deposits.
2. STATUTORY LIQUIDITY RATIO [SLR]: A given fraction of total deposits of the commercial banks invested in the form of specified liquid assets. It is called SLR.

HIGH POWERED MONEY: The total liability of the Monetary Authority of a Country is called High powered money. It consists of Currency in circulation and the Reserves held by the commercial banks and Government in RBI. It can be written as follows.

MONEY CREATION BY BANKING SYSTEM: Commercial Banks play an important role in the process of money creation. Suppose an Economy with CDR is 1 and RDR is 0.1, then the monetary authority wants to increase the supply of money by ₹ H. For this RBI purchase bonds from the market and issues a cheque worth ₹ H to the seller of the bond. Then he keeps ₹ $H/2$ In Bank and ₹ $H/2$ in the form of cash. The bank gives loan from the deposit amount after the reserves. This process is explained with the help of a table

Rounds	Currency (CU)	Deposits (DD)	Money supply (CU+DD)
1	₹$\frac{H}{2}$	₹$\frac{H}{2}$	₹$\frac{H}{2}+\frac{H}{2}=H$
2	₹$\frac{0.9H}{4}$	₹$\frac{0.9H}{4}$	₹$\frac{0.9H}{4}+\frac{0.9H}{4}=\frac{0.9H}{2}$
3	₹$\frac{0.81H}{8}$	₹$\frac{0.81H}{8}$	₹$\frac{0.81H}{8}+\frac{0.81H}{8}=\frac{0.81H}{4}$
4	………	……………	……………………
SUM			$\frac{H}{0.55}=\frac{20H}{11}$

Here the total money supply $= H+\frac{0.9H}{2}+\frac{0.81H}{4}+\cdots\cdots+\infty$

$$= H\left[1+\frac{0.9}{2}+\frac{0.81}{4}+\cdots\cdots+\infty\right]$$

$$= H\left[1+\frac{0.9}{2}+\left(\frac{0.9}{2}\right)^2+\cdots\cdots+\infty\right]$$

$$= H\left[\frac{1}{1-0.45}\right]$$

$$= \frac{H}{0.55}=\frac{20H}{11}$$

MONEY MULTIPLIER: The ratio of the stock of money to the stock of high powered money in the Economy is called Money 5Multiplier. We can calculate the value of the money Multiplier using the following equation.

$$Money\ Multiplier = \frac{M}{H} = \frac{1+cdr}{cdr+rdr} > 1\ as\ rdr < 1$$

MONETARY POLICY: Monetary policy is an important instrument of economic policy to achieve multiple objectives. Monetary policy is concerned with the measures taken to regulate the supply of money, the cost, and availability of credit in the economy. It also deals with the distribution of credit between uses and users and also with both the lending and borrowing rates of interest of the banks.

Instruments of Monetary Policy

The various instruments of monetary policy are;

1. **Bank Rate Policy:** Bank rate or rediscount rate is the rate fixed by the central bank at which it rediscounts the first class bills of exchange and government securities held by the commercial banks. The bank rate is the interest rate charged by the central bank at

which it provides rediscount to banks. The central bank controls credit by making variations in the bank rate. When the economy is in Inflation RBI increases the Bank rate and then the credit facility of commercial banks will decrease and Inflation is to be controlled. When the economy is in deflation RBI Decreases Bank rate and then the credit facility of commercial banks will increase and deflation is to be controlled.

2. **Open Market Operation:** Open market operations are another quantitative method of credit control. This method refers to the sale and purchase of securities, bills, and bonds of government and private financial institutions by the central bank from the open market. During the inflation time, RBI Sells securities and the time of deflation RBI purchase securities.
3. **VARYING RESERVE RATIO:** Every commercial bank is required by law to maintain a minimum percentage of its deposits with the central bank. It may be either a percentage of its time and demand deposits separately or of total deposits. During the inflation time, RBI increases the Reserve Ratio and during deflation time RBI decreases reserve ratios.

FUNCTIONS OF RBI: The following are the major functions of a central bank.

1. NOTE ISSUING AGENCY: The central bank of the country has the monopoly of issuing notes or paper currency to the public. Therefore, the central bank of the country exercises control over the supply of currency in the country. In India except for one rupee notes which are issued by the Ministry of Finance of the Government of India, the entire note is done by the Reserve Bank of India.

2. BANKER TO THE GOVERNMENT: The central bank acts as a banker, agent, and adviser to the government. It keeps the banking accounts of the government. All the balances of the government are kept with the central bank. But it pays no interest on these balances.

3. CONTROL OF CREDIT: The chief objective of the central bank is to maintain price and economic stability. For controlling inflationary and deflationary pressures in the economy the central bank adopts quantitative and qualitative measures of credit control.

4. BANKERS' BANK: In India, scheduled banks have to keep deposits with the Reserve Bank not less than 5% of their current demand deposits and 2% of their fixed deposits as reserves. In

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return, they enjoy 6 the privilege of rediscounting their bills with the Reserve Bank as well as securing loans against approved securities when needed.

5. LENDER OF THE LAST RESORT: The central bank helps the commercial banks when they face any difficulty. Even a well managed commercial bank can run into difficulty if there is a great rush of demand for cash by the depositors. During such occasions, it will not be able to meet a sudden and large demand for cash. The central bank must, therefore, come to their rescue at such times. Thus the central bank is the last source of supply of credit.

6. CUSTODY AND MANAGEMENT OF FOREIGN EXCHANGE RESERVES: The central bank keeps and manages the foreign exchange reserves of the country. An important function of a central bank is to maintain the exchange rate of the national currency.

FUNCTIONS OF COMMERCIAL BANKS: Commercial banks perform a variety of functions. They can be categorized as Primary function, agency functions, and miscellaneous functions.

I) PRIMARY FUNCTIONS

1. Accepting deposits: banks borrow in the form of deposits. This function is important because banks mainly depend on the funds deposited with them by the public. The deposits received by the banks can be of three types; Savings Bank Deposit, Current Deposit, and Fixed Deposits.

2. ADVANCING LOANS: One of the primary functions of the commercial bank is to advance loans to its customers. A bank lends a certain percentage of the cash lying in deposits on a higher interest rate than it pays on such deposits. Thus the bank earns profits and carries on its business. The bank advances loans in the following ways:

a) Cash credit b) Call loans C) Overdraft. D) Discounting Bills Of Exchange.

3. CREDIT CREATION: Credit creation is one of the most important functions of commercial banks. Like other financial institutions, they aim at earning profits. For this purpose, they accept deposits and advance loans by keeping a small amount of cash as a reserve for day-to-day7 transactions. When a bank advances a loan, it opens an account in the name of the customer and does not pay him in cash but allows him to draw the money by cheque according to his needs. By granting a loan, the bank creates credit or deposit.

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4.FINANCING FOREIGN TRADE: A commercial bank finances foreign trade of its customers by accepting foreign bills of exchange and collecting them from foreign banks. It also transacts other foreign exchange business and sells foreign currency.

5. INVESTMENT: Commercial banks must invest a part of their funds in approved securities. Other optional avenues of investments are also available. Investments in government securities are useful in two ways. One is that the commercial banks can get income from their surplus funds. The other is that the liquidity, that is, the encash ability of securities is higher than that of loans.

II) AGENCY FUNCTIONS: Commercial bands act as an agent of its customers in collecting and paying cheques, bills of exchange, drafts, dividends, etc. It also buys and sells shares, securities, debentures, etc. for its customers. Further, it pays subscriptions, insurance premium, rent, electric and water bills, and other similar charges on behalf of its clients. It also acts as a trustee and executor of the property and will of its customers. Moreover, the bank acts as an income tax consultant to its clients. For some of these services, the bank charges a nominal fee while it renders others free of charge.

III) MISCELLANEOUS FUNCTIONS Besides the above-noted services, the commercial bank performs several other services. It acts as a custodian of the valuables of its customers by providing them lockers where they can keep their jewelry and valuable documents. it issues various forms of credit instruments, such as cheques, drafts, travelers' cheques, etc. which facilitate transactions. The bank also issues letters of credit and acts as a referee to its clients. It underwrites shares and debentures of companies and helps in the collection of funds from the public. ATM stands for Automated Teller Machine. It is also depicted as Any Time Money as it provides the customers to withdraw money 24 hours subject to certain restrictions.

STERILISATION: RBI, protects our currency from external shocks it is called sterilization. sterilization is the intervention by the monetary authority (like RBI) of a country in the money market to keep the money supply stable against exogenous or sometimes external shocks as an increase8 e in foreign exchange inflows.

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