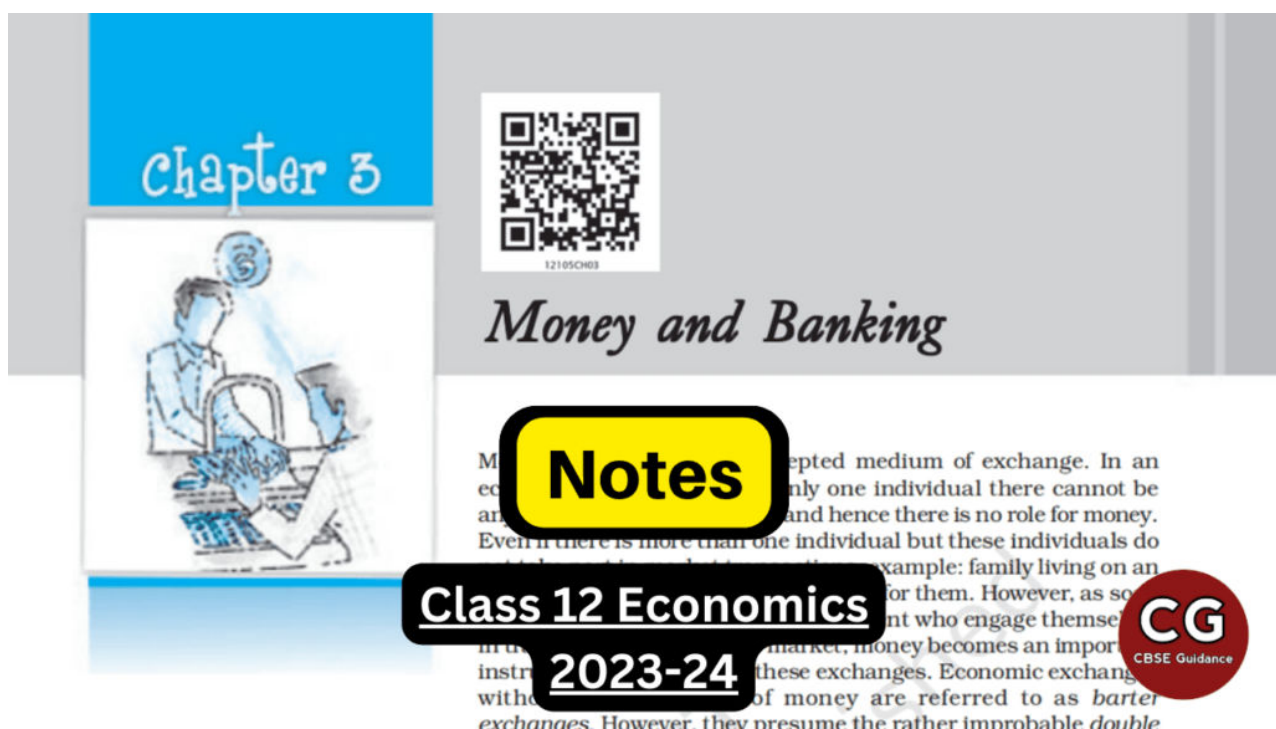


# Money and Banking: Class 12 Notes Everything You Need to Know

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If you're a student of Class 12, you may be looking for simplified and comprehensive Notes on Class 12 Macroeconomics Chapter 3 Money and Banking that can help you to understand complex concepts and theories. These detailed notes cover all the important topics, from the functions of money to the role of central banks in the modern economy. Whether you're studying for an exam or just trying to deepen your understanding, these notes are a valuable resource.



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“The only way to do great work is to love what you do. If you haven’t found it yet, keep looking. Don’t settle.”

– Steve Jobs

## The Ultimate Guide to Money and Banking Class 12 Economics Notes

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### Barter Exchange

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**Meaning:** Economic exchanges without the mediation of money are referred to as barter exchanges.

#### Disadvantages of Barter Exchange

1. Lack of double coincidence of wants: A common problem with the barter system is the lack of double coincidence of wants which means that if one wants to exchange some good with another person then the latter must also be willing to exchange his/her good with the former. For example, let a person wants cloth and he has a stock of wheat with him to exchange for it. In such a case the person can exchange wheat for cloth with another person who has cloth and who also wants wheat.
2. Search cost is high.
3. Lack of division of goods.
4. The problem of storage.
5. Loss of value.

### Money

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

#### Functions of Money

1. Medium of Exchange: Money acts as a medium of exchange for all goods and services. The use of money has greatly facilitated the process of exchange by dividing it into two parts i.e. sale and purchase.
2. Unit of Account: The value of all goods and services can be expressed in monetary units. When we say that the value of a certain wristwatch is ₹ 500 we mean that the wristwatch can be exchanged for 500 units of money, where a unit of money is rupee in this case.
3. Store of Value: Money is not perishable and its storage costs are also considerably lower. It is also acceptable to anyone at any point of time. Thus money can act as a store of value for individuals. Wealth can be stored in the form of money for future use.

4. Standard of Deferred Payments: Deferred payments are payments to be made at some future date. Money serves as a standard of such deferred payments. This function has facilitated borrowing and lending. The function has also led to the creation of financial institutions.

## Demand for Money

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**Meaning:** The demand for money tells us what makes people desire a certain amount of money. It is a stock concept.

### Demand for money depends on:

- i. Quantum of transactions: Since money is required to conduct transactions, the value of transactions will determine the money people will want to keep. Since the quantum of transactions to be made depends on income, it should be clear that a rise in income will lead to a rise in demand for money.
- ii. Interest rates: When interest rates go up, people become less interested in holding money since holding money amounts to holding less of interest-earning deposits, and thus less interest received. Therefore, at higher interest rates, money demand comes down.

## Supply of Money

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**Meaning:** The total stock of money in circulation among the public at a particular point of time is called money supply.

- The money supply is a stock concept.
- In a modern economy, the money supply comprises *cash* (currency notes and coins) and *bank deposits*.
- In India currency notes are issued by the Reserve Bank of India (RBI), except coins and ₹ 1 note.
- Coins and ₹ 1 notes are issued by the Government of India (Ministry of Finance).
- ₹ 1 note bears the signature of the Finance Secretary of India.
- Demand Deposit: The balance in savings, or current account deposits, held by the public in commercial banks is also considered money since cheques drawn on these accounts are used to settle transactions. Such deposits are called demand deposits as they are payable by the bank on demand from the account holder.
- Time Deposit: Other deposits, e.g. fixed deposits, have a fixed period to maturity and are referred to as time deposits.
- Every currency note bears on its face a promise from the Governor of RBI that if someone produces the note to RBI, or any other commercial bank, RBI will be responsible for giving the person purchasing power equal to the value printed on the note. The same is also true of coins. Currency notes and coins are therefore called fiat money. They do not have intrinsic value like gold or silver coin. They are also called legal tenders as they cannot be refused by any citizen of the country for settlement of any kind of transaction.

- Cheques drawn on savings or current accounts, however, can be refused by anyone as a mode of payment. Hence, demand deposits are not legal tenders.

Depending on what types of bank deposits are included, there are many measures of money.

### Measures of Money Supply:

RBI publishes figures for four alternative measures of money supply, viz. M1, M2, M3 and M4. They are defined as follows:

1.  $M1 = CU + DD$
2.  $M2 = M1 + \text{Savings deposits with Post Office savings banks}$
3.  $M3 = M1 + \text{Net time deposits of commercial banks}$
4.  $M4 = M3 + \text{Total deposits with Post Office savings organizations (excluding National Savings Certificates)}$

Here, CU is currency (notes plus coins) held by the public and DD is net demand deposits held by commercial banks. The word 'net' implies that only deposits of the public held by the banks are to be included in the money supply. The interbank deposits, which a commercial bank holds in other commercial banks, are not to be regarded as part of the money supply.

- M1 and M2 are known as narrow money.
- M3 and M4 are known as broad money.
- These measures are in decreasing order of liquidity. M1 is the most liquid and easiest for transactions whereas M4 is the least liquid of all.

**High-Powered Money:** The currency (notes + coins) is created by the central bank (Reserve Bank of India in India) and is called the **High-Powered Money**/Reserve money/Monetary base.

**Bank Money:** Demand deposits are created by commercial banks and are called **Bank money**.

### Commercial Banks

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**Meaning:** The commercial bank is a financial institution that is primarily concerned with accepting deposits from the public and lending to the public besides others.

- These banks operate both under the public as well private sectors.
- Some public sector banks include the State Bank of India, Punjab National Bank, and Bank of India among others.
- The private sector commercial banks may include the banks namely HDFC Bank, ICICI Bank, and Axis Bank among others.

### Credit Creation by Commercial Banks/The Process of Money Creation:

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## Basic Terms:

1. Cash Reserve Ratio (CRR): Percentage of deposits which a bank must keep as cash reserves with the Central bank (RBI). It is also known as the 'Required Reserve Ratio' or the 'Reserve Ratio'. [*It is kept with the Central Bank (RBI)*]
2. Statutory Liquidity Ratio (SLR): The bank is also required statutorily to maintain a certain proportion of its total deposits as liquid assets in the form of cash, gold, and certain government-approved securities. This is known as Statutory Liquidity Ratio (SLR). [*It is kept with the bank itself*]
3. Legal Reserve Ratio (LRR): The CRR and SLR together form the LRR which is determined by the central bank of a country (R.B.I. in the case of India)

**Why are the banks required to keep only a fraction of deposits as cash reserves?**

**What will banks do if the demand for cash withdrawn is more than cash reserves at some point of time?**

There are two reasons:

1. First, the banking experience has revealed that not all depositors approach the banks for withdrawal of money at the same time, and also that normally they withdraw a fraction of deposits.
2. Secondly, there is a constant flow of new deposits for withdrawal of cash, it is sufficient for banks to keep only a fraction of deposits as cash reserve.

## Assumptions:

1. Let us assume that the entire commercial banking system is one unit. Let us call this one unit simply "banks".
2. Let us also assume that all receipts and payments in the economy are routed through the banks. One who makes payment does it by writing a cheque. The one who receives payment deposits the same in his deposit account.

Let us now explain the process. Suppose the initial deposit in banks is ₹ 100 and the LRR is 20% (Note:  $20\% = \frac{20}{100} = 0.2$ ). Further, suppose that banks keep only the minimum required i.e. ₹ 20 as cash reserve. Banks are now free to lend the remainder ₹ 80. Suppose they lend ₹ 80. What banks do is to open deposit accounts in the names of the borrowers who are free to withdraw the amount whenever they like. Suppose they withdraw the whole of amount for making payments.

Now, since all the transactions are routed through the banks, the money spent by the borrowers comes back into the banks into the deposit accounts of those who have received this payment. This increases demand deposits in banks by ₹ 80. It is 80% of the initial deposit. These deposits of ₹ 80 have resulted on account of loans given by the banks. In this sense, the banks are responsible for money creation. With this round increase in total deposits is now ₹ 180 ( $=100+80$ ).

When banks receive a new deposit of ₹ 80, they keep 20% of it as cash reserves and use the remaining ₹ 64 for giving loans. The borrowers use these loans for making payments. The money comes back into the accounts of those who have received the payments. Bank deposits again rise but by a smaller amount of ₹ 64. The Total deposits now increase to ₹ 244 (=100+80+64).

The deposit creation continues in the above manner. The deposit creation comes to an end when total cash reserves become equal to the initial deposit. The total deposit creation comes to ₹ 500, five times the initial deposit as shown in the table below:

Round	Deposits (₹)	Loans (80%) (₹)	Cash Reserve (LRR = 20% = 0.2)
Initial	100	80	20
I	80	64	16
II	64	51.20	12.80
—	—	—	—
—	—	—	—
—	—	—	—
Total	500	400	100

**Money Multiplier:** It tells us how many times the total deposits would be of the initial deposit.

$$\text{Money Multiplier} = 1/LRR$$

$$\text{Total Money Created} = \text{Initial Deposit} \times \text{Money Multiplier} = \text{Initial Deposit} \times 1/LRR = \text{Initial Deposit} / LRR$$

In our above illustration, the LRR is 0.2,

$$\therefore \text{Money multiplier} = 1/0.2 = 5$$

$$\text{Total Money created} = \text{Initial Deposit} / LRR = 100 / 0.2 = ₹ 500$$

## Central Bank

The Central Bank is the apex institution of a country's monetary system. Almost every country has one central bank. India got its central bank in 1935. Its name is the 'Reserve Bank of India'.

## Functions of Central Banks

**1. Bank of Issue:** The Central Bank is the sole authority for the issue of currency in the country. It promotes efficiency in the financial system. Firstly, this leads to uniformity in the issue of currency. Secondly, it gives the Central Bank direct control over the money supply.

## **2. Banker to the Government:**

The Central Bank acts as a banker to the government – both Central as well as State governments. It carries out all the banking business of the government, and the government keeps its cash balances in a current account with the Central Bank.

As the banker to the government, the Central Bank accepts receipts and makes payments for the government, and carries out exchange, remittance, and other banking operations. The Central Bank also provides short-term credit to the government, so that the government can meet any shortfalls in receipts over disbursements. The government borrows money by selling treasury bills to the Central Bank. The government carries on short-term borrowings by selling ad-hoc treasury bills to the Central Bank.

As the government's banker, the Central Bank also has the responsibility of managing the public debt. This means that the Central Bank has to manage all new issues of government loans.

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

## **3. Bankers' Bank**

As the banker to banks, the Central Bank holds a part of the cash reserves of banks, lends them short-term funds, and provides them with centralized clearing and remittance facilities. The banks are required to deposit a stipulated ratio of their net total liabilities (the CRR) with the Central Bank. The purpose of this stipulation is to use these reserves as an instrument of monetary and credit control. In addition to this, the bank holds excess reserves with the Central Bank to meet any clearing drains due to settlement with other banks or net withdrawals by their account holders. The pool of funds with the Central Bank serves as a source from which it can make advances to banks temporarily in need of funds, acting in its capacity as a lender of last resort.

The Central Bank supervises, regulates, and controls the commercial banks. The regulation of banks may be related to their licensing, branch expansion, liquidity of assets, management, amalgamation (merging of banks), and liquidation (the winding up of banks). The control is exercised by periodic inspection of banks and the returns filed by them.

## **4. Controller of Credit**

The Central Bank controls the money supply and credit in the best interests of the economy. The bank does this by taking recourse to various instruments. These are:

1. **Bank Rate Policy:** The bank rate is the rate at which the central bank lends funds to banks. The effect of a change in the bank rate is to change the cost of securing funds from the central bank. An increase in the bank rate increases the costs of borrowing from the central bank. This will reduce the ability of banks to create credit. A rise in the bank rate will then cause the banks to increase the rates at which they lend. This will then discourage businessmen and others from taking loans, thus reducing the volume of credit. A decrease in the bank rate will have the opposite effect.
2. **Open Market Operations:** OMO is the buying and selling of government securities by the Central Bank from/to the public and banks. It does not matter whether the securities are bought or sold to the public or banks because ultimately the amounts will be deposited in or transferred from some bank. The sale of government securities to banks will have the effect of reducing their reserves. When the bank gives the Central Bank a cheque for the securities, the Central Bank collects the amounts by reducing the bank's reserves by a particular amount. This directly reduces the bank's ability to give credit and therefore decreases the money supply in the economy. When the Central Bank buys securities from the banks it gives the banks a cheque drawn on itself in payment for the securities. When the cheque clears, the Central Bank increases the reserves of the bank by a particular amount. This directly increases the bank's ability to give credit and thus increases the money supply.
3. **Cash Reserve Ratio:** Banks are obliged to maintain reserves with the Central Bank. The banks are required to deposit with the Central Bank a percentage of their net demand and time deposits. This minimum percentage is fixed by the Central Bank and is called Cash Reserve Ratio. Varying the CRR is a tool of monetary and credit control. An increase in the CRR has the effect of reducing the bank's excess funds and thus curtails its ability to give credit.
4. **Statutory Liquidity Ratio:** Banks are also required to maintain a specified percentage of their net total demand and time deposits in the form of designated liquid assets with themselves. This specific percentage is called Statutory Liquidity Ratio (SLR).
5. **Margin Requirements:** A margin is the difference between the amount of the loan and the market value of the security offered by the borrower against the loan. If the margin imposed by the Central Bank is 40%, then the bank is allowed to give a loan only up to 60% of the value of the security. By altering the margin requirements, the Central Bank can alter the amount of loans made against securities by the banks.
6. **Repo Rate:** When commercial banks are in need of funds for a short period, they can borrow from the Central Bank. The rate of interest charged by the Central Bank on such lending is called Repo Rate. Raising Repo Rate makes such borrowings by commercial banks costly. As such when Repo Rate is raised, banks are also forced to raise their lending rates. This has a negative effect on demand for borrowings from commercial banks. Lowering Repo Rate has the opposite effect.



7. **Reverse Repo Rate:** When the commercial banks have surplus funds they can deposit the same with the central bank and earn interest. The rate of interest paid by the Central Bank on such deposits is called Reverse Repo Rate. When this rate is raised, it encourages commercial banks to park their funds with the central bank. This has a negative effect on the lending capability of commercial banks. Lowering Reverse Repo Rate has the opposite effect which raises demand for borrowings from commercial banks.

## Demonetization

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Demonetization was a new initiative taken by the Government of India in November 2016 to tackle the problem of corruption, black money, terrorism, and the circulation of fake currency in the economy.

Old currency notes of ₹ 500, and ₹ 1000 were no longer legal tender. New currency notes in the denomination of ₹ 500 and ₹ 2000 were launched.

### Negative Impacts

1. There were long queues outside banks and ATM booths.
2. The shortage of currency in circulation had an adverse impact on the economic activities.

### Positive Impacts

1. It improved tax compliance as a large number of people were brought in the tax ambit.
2. The savings of an individual were channelized into the formal financial system. As a result, banks have more resources at their disposal which can be used to provide more loans at lower interest rates.
3. It is a demonstration of the State's decision to put a curb on black money, showing that tax evasion will no longer be tolerated.
4. Households and firms have begun to shift from cash to electronic payment technologies.

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