**Unit-VII Money and Banking**

Barter System of Exchange:

It is a system in which goods are exchanged for goods.

C-C Economy:

Commodity for commodity economy is the one in which commodities are exchanged for commodities.

Evolution of Money:

Money, as we know it today, is the result of a long process.

DIFFERENT STAGES OF EVOLUTION OF MONEY

1. COMMODITY MONEY: When different commodities were used as a medium of

Cow Heads, Goats, Axes, Dried Fishes etc were used as medium of exchange.

1. METALIC MONEY: The next step in the evolution was the discovery of precious metals like Gold, Silver, Copper.
2. PAPER MONEY:

* Paper Money can be:

1. Representative Paper Money.
2. Convertible Paper Money.

Representative Paper Money.

It is that money which is fully backed by equivalent metallic reserves.

Convertible Paper Money

Which is convertible into coins on demand.

Fiat Paper Money

It is accepted because it is declared legal tender by the issuing authority and has general acceptance as a medium of exchange. The intrinsic value of Fiat money is Nil.

1. ELECTRONIC MONEY: **Electronic money (also known as e-money, electronic cash, electronic currency, digital money, digital cash or digital currency) refers to money or scrip which is exchanged only electronically. Typically, this involves use of computer networks, the internet and digital stored value systems.**

**What is legal tender money?**

“Means of payment, which has state’s sanction behind it and can be used to settlement of Debt obligations”.

1. Unlimited Legal Tender.

Money in terms of which debt can be legally paid up to any amount.

Example, all type of Currency Notes.

1. Limited Legal Tender.

Money in which debt can be paid to a certain limit. Example,50 Paisa Coins.

**Fiduciary Money:**

It refers to money backed up by trust between the payer and the payee. E.g. Cheques.

**What is money value of money?**

It refers to what is inscribed on a coin or written on a paper note.

**What is commodity value of money?**

It refers to the value of the thing money is made of.

**What is full bodied money?**

It refers to money in terms of coins whose commodity value is equal to the money value as and when they are issued. E.g. A rupee coin issued during British period whose commodity value was equal to money value.

**What is Credit money?**

It refers to money which money value is greater than commodity value. Example, market value of the metal that the rupee coin is made is much lower than the money value of the rupee coin. Otherwise people would have melted the coins and sold the metal in the market at a price greater than one rupee.

**Drawbacks of Barter System:**

Barter system involves various difficulties and inconveniences which are discussed below:

**1.** Double Coincidence of Wants:

Under barter system, a double coincidence of wants is required for exchange. In other words, the wants of the two persons who desire to exchange goods must coincide. For example, if person A wants to acquire shoes in exchange for wheat, then he must find another person who wants wheat for shoes.

Such a double coincidence of wants involves great difficulty and wastage of time in a modern society, it rarely occurs. In the absence of a double coincidence of wants, the individuals under barter system are compelled either to hold goods for long periods of time, or to make numerous intermediary exchange ' ii order to get finally the goods of their choice.

***2.***Absence of Common Measure of Value:

Even if it is possible to have the double coincidence of wants, the absence of a common measure of value creates great problem because a lot of time is wasted to strike a bargain. Since there is no common measure in terms of which the value of a commodity can be expressed, the problem arises how much wheat should be exchanged for how many pairs of shoes.

In fact, under the barter system, every good must be expressed in terms of every other good. If, for example, there are 1000 goods in the economy, then, in the absence of monetary unit, every good can be exchanged for the remaining 999 goods. What is true for one good will be true for all other 999 goods.

### 3. The Problem of Storing Wealth:

Under a barter system, there is absence of a proper and convenient means of storing wealth or value, (a) As opposed to storing of generalized purchasing power (in the form of money) in a monetary economy, the individuals have to store specific purchasing power (in the form of horses, shoes, wheat etc.) under the barter system which may decrease in value in the due course of time due to physical deterioration or a change in tastes, (b) It is very expensive to store specific goods for a long time, (c) Again the wealth stored in the form of specific goods may create jealousy and enmity among the neighbors or relatives.

### 4. Difficulty of Deferred Payments:

The barter system does not provide a satisfactory unit in terms of which the contracts about the deferred (future) payments are to be written. In an exchange economy, many contracts relate to future activities and future payments. Under barter system, future payments are written in terms of specific goods. It creates many problems.

**Functions of Money:** functions of money are classified into two categories:

Primary or main functions, and

Secondary or Subsidiary functions

**Primary or main functions: money performs two primary functions, as under:**

### Medium of Exchange

THE primary function of money is to act as THE medium of exchange. People use money to buy and sell goods. Buyers give up money and receive goods. Sellers give up goods and receive money. Money makes transactions easier because everyone is willing to trade money for goods and goods for money.

To see why money makes transactions easier, consider a [barter](javascript:pop_dsp('pop_gls.pl?k=barter',500,400)) economy that has no money, where one good is traded directly for another. The key to successful barter trades is [double coincidence of wants](javascript:pop_dsp('pop_gls.pl?k=double%20coincidence%20of%20wants',500,400)), each trader has want the other wants and wants what the other has. Without double coincidence of wants, a barter economy can become exceedingly inefficiency. Traders spend more time seeking trades and less time producing goods.

Measure of value or unit of value

 The second function means that is money is being used as the common benchmark to designate the prices of goods throughout the economy. Unit of account, or measure of value, means money is functioning as the measuring unit for prices. In other words, prices of goods are stated in terms of the monetary unit.

**Secondary or Subsidiary functions**

**Store of value**

In order to be a medium of exchange, money must hold its value over time; that is, it must be a store of value. If money could not be stored for some period of time and still remain valuable in exchange, it would not solve the double coincidence of wants problem and therefore would not be adopted as a medium of exchange. As a store of value, money is not unique; many other stores of value exist, such as land, works of art, and even baseball cards and stamps. Money may not even be the best store of value because it depreciates with inflation. However, money is more **liquid** than most other stores of value because as a medium of exchange, it is readily accepted everywhere. Furthermore, money is an easily transported store of value that is available in a number of convenient denominations.

### Standard of Deferred Payment

This fourth function means money is used as a standard benchmark for specifying future payments for current purchases, which is, buying now and paying later.

A common example of deferred payments is a car loan. Rahul gets a loan to buy a car today, and then pay off the loan with payments deferred into the future. The amounts of those future payments are stated in terms of money.

Transfer of value:

Money also serves as a convenient mode of transfer of value. Goods are purchased from far off places both for consumption as well as investment. We need purchasing power at those places where goods are purchased. We need to transfer purchasing power from the place of our residence. Money performs this function very well. It can be easily transferred from one place to another. In fact, it is due to this function of money that the concept of global economy has come into existence.

**Supply of Money:**

Supply of money is a stock concept. It refers to total stock of money held by the people of a country at a point of time.

**Measurement of Money Supply:**

In India there are four alternative measures of money supply, known as M1,M2,M3 and M4.

M1 Measurement: M1=C+DD+OD

Here, C= currency and includes coins and paper notes held by the public.

DD= demand deposits of the people with the Commercial banks, are chequable deposits which can be withdrawn or transferred on demand.

OD= these are other deposits which include:

Demand deposits with RBI of public financial institutions like IDBI (Industrial Development Bank of India)

Demand deposits with RBI of foreign central banks and of the foreign governments.

Demand deposits of international financial institutions like IMF and World Bank.

M2 measurement: M2=M1+Deposits with post office saving Bank Account. It is a broader concept of the supply of money compared to M1.

M3 Measurement: M3=M1+net Time deposits with the Commercial banks.M3 is also a broader concept of money supply compared to M1.

M4 Measurement: M4=M3 +Total deposits with Post offices (other than in the form of National Saving Certificate).

**Who Supplies Money?**

In India one rupee note and coins are issued by Finance Ministry and other denominations notes are issued by RB1. The RBI keeps a minimum reserve of 200 cr out of which 115 cr is to be kept in gold and 75 cr in the form of foreign securities.

**Commercial bank**

**Meaning of a commercial bank:**

A commercial bank is that financial institution which accepts deposits from people and offers loans for the purpose of consumption or investment.

**Functions of Commercial banks:**

Functions of commercial banks can be divided into two parts:

Primary Functions and Secondary functions

**Primary Functions:**

1. Accepting deposits

The basic function of commercial banks is to accept deposits of the customers. These deposits are of the following types:

(i)*Saving Accounts*

Saving accounts cater to the needs of those individuals who wish to save a part of their income and earn interest on the amount saved. Account holders of saving accounts can deposit cheques, drafts, etc. However, there is a limit on withdrawal.

(ii)*Fixed deposit accounts*

As the name suggests, fixed deposit accounts imply deposits are kept for fixed periods of time; for example, Rs.500 per month for 5 years. The period has to be decided in advance, while opening the account. Holders of these accounts do not enjoy the cheque facility. Higher the time period, higher will be the interest rate, which is decided by RBI.

(iii)*Current deposits accounts*

Current deposit accounts are also called ‘demand deposits’ as the depositor can withdraw money at any time through cheques. Businessmen use this account to make many transactions in a single day; however, they do not earn interest on the deposits. Banks provide account statements to the current account holders at regular intervals.

1. Advancing loans:

The deposits received by the bank are not allowed to lie idle by the bank. After keeping a

certain portion of the deposits as reserves, the bank gives the balance to borrowers in the form of loans and advances. The different types of loans and advances made by banks are as follows :

* Cash Credit - In this arrangement an eligible borrower is first sanctioned a credit limit upto which he may borrow from the bank. This credit limit is determined by the bank’s estimation of the borrower’s creditworthiness. However, actual utilisation of credit by the customer depends upon his withdrawing power. The withdrawing power depends on the value of the borrower’s current assets, which comprise mainly of stocks of goods-raw materials, semi manufactured or finished goods, and bills receivable (dues) from others. The borrower has to pay interest on the ‘drawn’ or utilized portion of the credit only.
* Demand Loans - A demand loan is one that can be recalled on demand. It has no stated maturity. The entire loan amount is paid in lump sum by crediting it to the loan account of the borrower. Thus, the entire loan amount becomes chargeable to interest. Security brokers and others whose credit needs fluctuate day to day usually take these loans. The security against these loans may be personal, financial assets or goods.
* Short-term Loans - Short-term loans may be given as personal loans, loans to financeworking capital or as priority sector advances. These loans are secured loans, i.e. they are loans made against some security. The whole amount of the term loan sanctioned is paid in lump sum by crediting it to the loan account of the borrower. Thus, the entire loan amount becomes chargeable to interest. The repayment is made as scheduled. either in one instalment at the end of the loan period, or in a number of instalments over the period of the loan.

In addition, commercial banks extend the following facilities when they are demanded by their customers.

1. Discounting bills of exchange

Commercial Banks provide financial assistance to the business community by discounting bills of exchange. The banks purchase these bills, produced by customers, by deducting interest from the face value of the bill, thus providing easy finances to the business community when required.

1. Overdrafts: An overdraft is an advance given by allowing a customer to overdraw his current account upto an agreed limit. The security for overdrafts is usually financial assets of the account holdersuch as shares, debntures, life insurance policies etc. Overdraft is a termporary facility and the rate of interest charged on the amount of credit used is lower than that on cash credit because the risk involved and service cost of such credit is less - it is easier to liquify financial assets than physical assets.
2. Investment of funds: The banks invest their surplus funds in three types of securities - Government securities,other approved securities, and other securities.

Government securities are securities of both the central an state governments such as treasury bills, national savings certificates etc.

Other approved securities are securities approved under the provisions of the BankingRegulation Act, 1949. These include securities of state associated bodies like electricity boards,housing boards, debentures of Land Development Banks, units of UTI, shares of Regional Rural Banks etc.

Part of the bank’s investment in government securities and other approved securities aremandatory under the provisions of the Statutory Liquidity Ratio requirement of the RBI. However,banks hold excess investments in these securities because banks can borrow against these securities from RBI and others, or sell these securities in the open market to meet their need for cash. Banks hold them even though the return from them is lower than that on loans and advances because they are more liquid.

**Secondary Functions:**

1. Agency functions

The commercial banks perform various agency functions with the prime purpose of acceptance of deposits and granting of loans. Their functions include:

(i) Transfer of funds − The banks provide easy flow of funds from place to place via mail transfers, demand drafts, etc.

(ii) Collection of funds − The banks also collect funds on behalf of its customers through bills, cheques, etc.

(iii) Banks collect insurance premiums, dividends, interest on debentures, etc.

(v) Banks assist in the process of tax payment by the accountholders.

(vi) Banks also play the role of trustees or executors.

Credit creation

Commercial banks create credit in the economy through demand deposits. Credit creation paves the path for the growth of the economy.

1. Other functions

(i) Providing locker facility

(ii) Purchase and sale of foreign exchange

(iii) Issue of gift cheques

(iv) Underwriting of shares and debentures

(v) Providing information and statistical data useful to customers

**The Central bank**

It is the apex bank that controls the entire banking system of country. Reserve bank of India is the Central bank of our country. A central bank also acts as regulatory authority of a country's [monetary policy](http://www.investopedia.com/terms/m/monetarypolicy.asp) and is the sole provider and printer of notes and coins in circulation.

**Functions of the Central bank:**

**The Central Bank performs the following functions:**

1. Currency Authority:

Central bank of a country has the exclusive authority of issuing notes or currency. It issues currency to cope up with the demand for it’s which depends on the level of economic activity in the economy. While issuing currency central bank takes account of the fact that supply of money in the market does not disturb economic stability. Particularly, the bank ensures that supply does not trigger inflation in the economy.

2. Banker the government:

Central bank is a banker, agent and financial advisor to the government. As a banker to the government, it manages accounts of the government banks across the country. As an agent to the government, it buys and sells securities, treasury bills on behalf of the government. As an advisor to the government it helps the government in framing policies to regulate the money market.

3. Banker’s bank:

It is an apex bank of all banks in the country. The central bank has almost the same relation with other banks n the country as a commercial has with its customers. The central bank keeps some cash balances of the commercial banks as a compulsory deposit. This is to help them during financial crisis.

4. Supervision of the banks:

As a banker’s bank, the central bank also supervises the commercial banks. This supervision is concerning with licensing of the commercial banks, expansion of commercial banks in terms of their branches across different parts of the country and abroad, merger and acquisition of different banks and liquidation of banks.

5. Lender of the last resort:

It means that if a commercial bank fails to get financial assistance from anywhere, it approaches the central bank as a last resort. Central bank advances loan to such a bank against approved securities. By offering loans to the commercial banks, the central bank ensures that the banking system of the country does not suffer any set back and that money market remains stable.

6. Custodian of foreign exchange:

Central bank is the custodian of nation’s foreign exchange reserve. The central bank maintains foreign exchange reserves in order to promote international trade and stabilize exchange rate.

7. Clearing house function:

Central bank also performs the function of a clearing house. Let us take na example to understand this function. Supposing, bank A receives a cheque of ` 10,000 drawn on bank B, and Bank B receives a cheque of ` 15,000 drawn on bank A. Both, banks A and B have their accounts with the central bank. The cheques of both the banks are cleared through their accounts with the central bank. This is how central bank acts as a clearing house.

8. Control of credit:

The most important function of the central bank is to control credit in the economy. It means increase or decrease in the supply of money by regulation the creation of credit by the commercial banks. The government needs to control the supply of money to cope with the situations of inflation and deflation. During inflation, the supply of money is restricted and during the deflation the supply of money is increased.

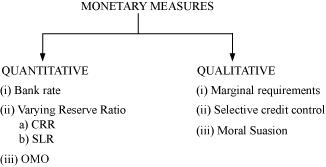
9. Collection of statistics:

Central bank collects statistical information relating to banking, currency and foreign exchange. This is useful in making policies and plans of growth and development.

**Instruments of Credit Control or flow of money supply in the economy by the Central bank**

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**Main instruments of monetary policy (credit policy) of RBI involves the two instruments given in the flow chart below:**



**Quantitative Measures**

Quantitative measures refer to those measures that affect the variables, which in turn affect the overall money supply in the economy.

**Instruments of quantitative measures:**

**1. Bank rate**− The rate at which central bank provides loan to commercial banks is called bank rate. This instrument is a key at the hands of RBI to control the money supply.

Increase in the bank rate will make the loans more expensive for the commercial banks; thereby, pressurising the banks to increase the rate of lending. The public capacity to take credit will gradually fall leading to the fall in the volume of credit demanded. The reverse happens in case of a decrease in the bank rate. The increased lending capacity of banks as well as increased public demand for credit will automatically lead to a rise in the volume of credit.

**2. Varying reserve ratios**

The reserve ratio determines the reserve requirements, wherein banks are liable to maintain reserves with the central bank.

The three main ratios are:

**(i) Cash Reserve Ratio (CRR)**

It refers to the minimum amount of funds that a commercial bank has to maintain with the Reserve Bank of India, in the form of deposits. For example, suppose the total assets of a bank are worth Rs.200 crores and the minimum cash reserve ratio is 10%. Then the amount that the commercial bank has to maintain with RBI is Rs.20 crores. If this ratio rises to 20%, then the reserve with RBI increases to Rs.40 crores. Thus, less money will be left with the commercial bank for lending. This will eventually lead to considerable decrease in the money supply. On the contrary, a fall in CRR will lead to an increase in the money supply.

**(ii) Statuary Liquidity Ratio (SLR)**

SLR is concerned with maintaining the minimum reserve of assets with RBI, whereas the cash reserve ratio is concerned with maintaining cash balance (reserve) with RBI. So, SLR is defined as the minimum percentage of assets to be maintained in the form of either fixed or liquid assets with RBI. The flow of credit is reduced by increasing this liquidity ratio and vice-versa. In the previous example, this can be understood as rise in SLR will restrict the banks to pump money in the economy, thereby contributing towards decrease in money supply. The reverse case happens if there is a fall in SLR, as it increases the money supply in the economy.

**3. Open Market Operations (OMO)**

Open Market operations refer to the buying and selling of securities in an open market, in order to affect the money supply in the economy. The selling of securities by RBI will wipe out the extra cash balance from the economy, thereby limiting the money supply, whereas in the case of buying securities by RBI, additional money is pumped into the economy stimulating the money supply.

**Qualtative Measures**

The measures that affect the credit qualitatively are

**1. Marginal Requirements**

The commercial banks’ function to grant loan rests upon the value of security being mortgaged. So, the banks keep a margin, which is the difference between the market value of security and the loan value. For example, a commercial bank grants loan of Rs.80,000 against security of Rs.1,00,000. So, the margin is calculated as 1,00,000 − 80,000 = 20,000. When the central bank decides to restrict the flow of money, then the margin requirement of loan is raised and vice-versa in the case of expansionary credit policy.

**2. Selective Credit Control (SCC’s)**

An instrument of the monetary policy that affects the flow of credit to particular sectors positively and negatively is known as selective credit control. The positive aspect is concerned with the increased flow of credit to the priority sectors. However, the negative aspect is concerned with the measures to restrict credit to a particular sector.

**3. Moral Suasions**

A persuasion technique followed by the central bank to pressurise the commercial banks to abide by the monetary policy is termed as moral suasion. This involves meetings, seminars, speeches and discussions, which explains the present economic scenario and thereby persuading the commercial banks to adapt the changes needed. In other words, this is an unofficial monetary policy that exercises the power of talk.

**Difference between Central bank and a commercial bank**

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| --- | --- | --- |
| S.No. | Central bank | Commercial bank |
| 1 | It is a bank of all the banks. | A commercial bank functions under the central bank. |
| 2. | It focuses on social welfare. | It focuses on profit maximization. |
| 3. | It controls the flow of credit. | It contributes to the flow of credit. |
| 4. | There is no public dealing with central bank. | There is a public dealing with a commercial bank. |
| 5. | It is a custodian of foreign exchange reserves of the country. | It is not. |
| 6. | It issues currency. | It does not. |
| 7. | It is an advisor to the government on the monetary matters. | It is not. |

Page of