318en28

28

MONEY AND BANKING

Money is one of the most important discoveries of the human civilization. It is difficult to think about the world without money. Everybody needs money for various purposes; starting from day – to – day transactions to saving for future. But if you go back to history, you will find that before money came into existence there was barter system to facilitate transactions among individuals in the society. With development of civilization over time, barter system lost its ground and was replaced by money.

OBJECTIVES

After completing this lesson, you will be able to:

- know the meaning and limitations of barter system;
- understand the need for money;
- define money;
- explain the functions of money;
- tell the different measures of money supply in India;
- know the concept of High Powered Money;
- explain the meaning and functions of commercial banks;
- understand the process of credit creation;
- explain the meaning and functions of central bank; and
- know the methods of credit control.

28.1 FAILURE OF BARTER SYSTEM AND THE NEED FOR MONEY

In ancient days when there was no money, people used to exchange goods for goods to satisfy their wants without the use of money. Such a system was called barter system. However with passage of time the barter system had to be abandoned because of its inherent problems. Some of the demerits of barter system are as follows:

1. Search Cost

A common problem of barter system was that, one had to spend a lot of time in searching for the person who is willing to exchange the good at the given terms and conditions. In the early period of human civilization, this was a very difficult task as there was no proper facility with regard to transport and communication.

2. Lack of double coincidence of wants

A common problem with the barter system is the lack of double coincidence ofwants 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 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. In practical life, such situation may or may not arise. If the person who has cloth does not want wheat, then exchange of wheat for cloth will never take place and both the individuals cannot satisfy their wants. This is an example of lack of double coincidence of wants. So barter system will work when there is double coincident of wants, otherwise it will not work.

3. Lack of division of goods

Certain goods are not physically divisible into small pieces. Suppose, a person possesses a buffalo and he wants items, such as food grains. Then how much of buffalo can be traded for food grains? It was very difficult to determine because, a buffalo cannot be divided into several pieces.

4. Lack of common unit of measurement

Under barter system, it was difficult to equate the values of different goods which were traded because of lack of common unit of measurement.Taking the example in the previous paragraph, it will be verydifficult to determine the amount of buffalo required to trade for some specific amountof food grains. Also it sounds absurd. This happens because a buffalo can never become a common measure of value. This problem is same for all other goods.

5. Problem of Storage

Another problem of barter system is that a person must store a large volume of his own good in order to exchange for his/her desired goods with others on day to day basis. Take the example of a farmer who has produced wheat. Obviously, he will use some amount of wheat for his own consumption and keep some amount to get other necessary items by trading with others. If he wants furniture, then he will go to a carpenter who is willing to trade furniture in return of his wheat. Similarly, if he wants cloth, then he has to trade with a weaver who is ready to give cloth by receiving wheat and so on. So the farmer must construct a warehouse first to keep a stock of his wheat in order to carry out the transactions at the time of need for his desired good. But constructing and maintaining a warehouse was itself a very difficult task in early days of civilization.

6. Loss of Value

Finally, a major problem of barter system is that, a good looses its original quality and value if it is stored for a long period. Many goods, such as salt, vegetables etc., are perishable. Hence, goods were never accepted for trading in future because they could not be used as store of value. This also implies that no good could be used for the purpose of lending and borrowing.

Due to above problems, the barter system could not continue for long. As human civilization progressed, people realized that there has to be some common medium of exchange which can be easily carried, stored, and used to express the value of a good. So money came into being. Hence the need for money arose due to the failure of bartersystem.

INTEXT QUESTIONS 28.1

1. Under barter system a good was exchanged for coins. (True or False)
2. Simran wants to have 6 pencils in exchange of a note book from Kavita. But Kavita is not agreeing to this condition. The problem may be related to lack of double coincidence of wants. (True or False)
3. Ahmed took 10 kg of rice from Asghar last year as loan. Now he is willing to return the same. But Asghar is not accepting it. Give one possible reason for it.

28.2 MEANING OF MONEY

Money has been defined differently by different economists. But the most acceptable definition of money can be stated in terms of all the functions of money.

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

28.3 FUNCTIONS OF MONEY

The use of money has removed the drawbacks of barter system. Broadly speaking the functions of money may be classified into *primary (basic)* and *secondary* functions.

Primary or Basic Functions:

(i) Medium of Exchange

Money acts as a medium of exchange of all goods and services. The use of money has greatly facilitated process of exchange by dividing it into two parts i.e. sale and purchase. It has removed the difficulty of double coincidence of wants found under the barter system. Therefore, in modern world we hardly find any evidence of exchange of goods and services without the use of money.

Example: You pay ₹ 10 to buy a pen. The seller receives ₹ 10 from you by selling the pen. So a pen is exchanged for ₹ 10.

(ii) Measure of Value

Money helps to measure value of goods and services in terms of price. The use of money has completely removed the confusion regarding value of one good/service vis-a-vis the other. This function has greatly facilitated the process of exchange of different goods and services. The value of a good is determined by multiplying its price with the quantity purchased. Since the price is expressed in monetary units, the value of a good is also expressed in monetary terms.

Example: Let price of rice be ₹ 20 per Kilogram. One bag full of rice weighs 25 Kilograms. Then the value of the bag of rice is ₹ 20X25= ₹ 500

Secondary Functions:

(i) Store of Value or Wealth

Money is the most convenient and economical means to store wealth which does not lose its value so quickly over time. Thus, it is the most accepted means to store wealth or value. As medium of exchange you can pay money to buy goods. This means if you have money, you have the power to purchase a good or a service. So money has purchasing power. The value of the good is contained in that purchasing power. Hence value of good is indirectly stored in money, you hold. Similarly, as a seller of good, you receive the money which means value of good you sold, comes back to you through money.

Example: Harpreet sells furniture to a buyer for ₹ 2500.This means a value of ₹ 2500 was exchanged. The buyer, who purchased the furniture, has the purchasing power to give ₹ 2500 as value. Hence a value of₹ 2500 was stored in the money received by Harpreet as a seller. Harpreet could not have stored furniture but she can definitely store money which in turn has stored the value of ₹ 2500.

(ii) Standard of Deferred Payments

Deferred payments are those payments which are promised to be made in future. Money acts as a means of deferred payments mainly because it has general acceptability. Its value remains relatively constant over time and it is more durable as compared to other goods. In case of borrowing and lending activities only money is normally acceptable to be paid at a future date. Goods loose their value over time and due to possibility of lack of double coincident of wants they are not acceptable to settle debts in future.

(iii) Transfer of Value

This function of money is derived from the store of value function of money. Money is used to transfer value from one place to another or from one person to another. As a traveller when you move from one place to another, you can easily carry money to make necessary transactions on the way and in your destination place. You can also transfer the money through bank. Now people carry ATM card and withdraw cash wherever the facility is available.

Other functions of Money

(i) Distribution of National Income

Income is generated by the factors of production engaged in the production process. The factors are land, labour, capital and entrepreneurship. For the supply of these factor services to the production units, the supplier of labour gets wage, the supplier of land gets rent, the supplier of capital gets interest and the supplier of entrepreneurship gets profit. It should be noted that wage, rent, interest and profit are paid by the firms in money terms and received by the respective suppliers as factor incomes. Thus national income is measured by using income method.

(ii) Liquidity and Uniformity of Value

Money can be easily carried and is easily divisible into smaller units as per convenience. The liquidity feature of money is manifested at the time when it can be withdrawn from the bank account repeatedly in certain amount in each transaction. For example, your father has ₹10,000 deposited in his bank account. You want to purchase a shoe worth ₹600. Your father can withdraw the amount from the bank to give you. The balance of ₹9,400 will remain in your father's account.

Money brings uniformity in value of different goods and services which are not comparable physically due to their differences in the units of measurement.

For example a Kg. of rice and a liter of cooking oil cannot be added together as these are given in different units. But they can be added together if expressed in monetary units. If a Kg. of rice is worth ₹25 and a liter of cooking oil is worth ₹75, the combined value of rice and oil comes out to be ₹100.

28.4 MEASURES OF MONEY SUPPLY IN INDIA

Money supply refers to the total quantity of money held by public in various forms at any point of time in an economy. The main components of money supply are currency held by the public and net-demand deposits held by the commercial banks. The money supply in Indian economy is generally measured in following forms:

(i) M_1 = Currency (notes and coins) with the public + Demand deposits + other deposits held with the Reserve Bank of India.

(ii) M_2 = M_1 + Post Office saving deposits.

(iii) M_3 = M_1 + Time deposits of all commercial banks and co-operative banks (excluding interbank time deposits).

(iv) M_4 = M_3 + Total deposits with the Post Office Saving Organisation (excluding National Saving Certificate).

Of all the concepts of money supply stated above, M_1 is referred to as *narrow measure* and M_3 the *broader measure* of money supply. M_1 is the most important measure of money supply. M_1 is most liquid whereas M_4 is least liquid.

28.5 HIGH POWERED MONEY (H)

The HighPowered Money refers to the currency held by the public (C), cash reserves of banks (R) and other deposits of the R.B.I. High Powered Money is produced by the R.B.I. and the Government of India and held by the public and the banks.

INTEXT QUESTIONS 28.2

1. Which of the following statements are true and which are false?

   (i) M_1 is a narrow measure and M_3 is a broader measure of money supply.

   (ii) Currency notes and coins are not an important component of money supply.

   (iii) Supply of money is measured over a period of time.

   (iv) High powered money consists of cash with public, reserves with banks and other deposits with R.B.I.

(v) Government has no role in producing high powered money in an economy.

28.6 COMMERCIAL BANKS

Meaning: The commercial bank is a financial institution which is primarily concerned with accepting deposits from 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 HSBC bank among others.

Functions of Commercial Banks: The commercial banks normally perform the following functions in an economy:

(i) **Acceptance of deposits:** Every commercial bank accepts deposits from different sections of society including the general public, business entities and other institutions. Commercial banks accept following types of deposit:

- **Current Account Deposits or Demand Deposits:** This type of account is generally maintained by the business entities and money under these deposits are payable on demand of the depositor. The depositors are free to deposit or withdraw money from their account any number of times without any restrictions.
- **Savings Account Deposits:** This type of account is generally maintained by the households or individuals. The depositor can deposit or withdraw money deposited under this account only for a limited number of times. This account also attracts a nominal rate of interest payable to the account holder.
- **Fixed Deposit or Time Deposit or Term Deposit:** Under this account money is deposited for a fixed period and the rate of interest is relatively higher than other accounts depending on the tenure of the fixed deposit.

(ii) **Extending Loans and Advances:** This is another important function of a commercial bank. This is also the main source of income of any commercial bank. Banks grant loans and advances out of the surplus money after keeping certain percentage of their total deposit called as reserves. Some important forms of loans and advances are *ordinary loans*, *overdraft facility* and *discounting of bills of exchange*.

(iii) **Creation of Credit:** This function is derived from the earlier two functions of the commercial banks. This unique function has direct impact on the supply of money in an economy.

(iv) Transfer of Funds: The banks provide the facility of fund transfer to its customers through the instruments of cheque, demand draft or electronic transfer from one place to another or one person to another.

(v) Agency Functions: Banks receive and collect different types of payments on behalf of their clients through the instruments of cheques, drafts, bills and promissory notes etc. Banks also buy and sell gold, silver and other securities on behalf of their customers.

(vi) Sale and Purchase of Foreign Exchange: This is another important function of a commercial bank which has increased tremendously with increasing volume of international trade particularly in the era of globalization.

(vii) General Utility Services: In modern days the banks also perform some very useful functions for the benefit of its customers and the economy like collection and publication of data, advisory functions, issue of lockers and underwriting of loans, shares and debentures issued by the government.

28.7 CREATION OF CREDIT BY COMMERCIAL BANKS

Credit creation is one of the most important functions of a commercial bank. Banks create credit out of the deposits that is mobilized by them. Credit creation is also called money creation or deposit creation. Therefore, commercial banks are also known as creator of money or credit.

The process of credit/money creation: Money is not created by commercial banks by actually printing of notes or minting of coins. The money is created by granting loans and advances to public and making relevant entries into the books of accounts of the lending banks.Loans are granted out of the deposits received by the banks. Normally, the amount of loan granted by a bank is greater than the amount of deposits received by it. This is mainly because of the fact that when money is deposited by the depositors in a bank, the bank by its experience knows that not all the money would be withdrawn by the depositors at once at any point of time. This peculiar habit of the depositors leaves the bank with huge amount of surplus fund which in turn is used to create loans by the banks. The banks keep certain proportion of its total deposits in form of cash to honour the demand of its customers. Further, every commercial bank is required to keep certain proportion of its total deposits with the R.B.I. which is known as *Cash Reserve Ratio* (CRR). Besides CRR, the bank is also required statutorily to maintain certain proportion of its total deposits as liquid assets in form of cash, gold, and certain government approved securities. This is known as *Statutory Liquidity Ratio* (SLR). The CRR and SLR together form the *Legal Reserve Ratio* (LRR) which is determined by the central bank of a country (R.B.I. in case of India). When LRR is increased by the central bank the capacity of the commercial banks to create deposit or credit decreases and when LRR is decreased the capacity to create more credit increases.

Thus, there exists an inverse relationship between LRR and the quantity of money created in an economy. Given the quantity of deposits and LRR at any point of time, the total quantity of money created in an economy during a given period of time would be as follows:

Total quantity of money created: Quantity of deposits × 1/LRR. Let us understand the process of money or credit creation in an economy with the help of an example. Let us assume that the bank receives an initial deposit of ₹ 1000 and the LRR is 10%. It means the bank has an excess reserve of ₹ 1000 – (1000 x 10%) = ₹ 900 to lend to the borrowers. It must be noted that the borrowers are not paid the amount of loan as cash but the same is credited in their account. Thus in the first round an extra deposit of ₹ 900 is created out of which the bank is free to advance loan worth ₹ 900 – (900 × 10%) = ₹ 810. In the second round an extra deposit of ₹ 810 is created and the total amount of money in the economy becomes ₹ 1000 + 900 + 810 = ₹ 2710. If the process continues the total amount of money created in the economy with ₹ 1000 would be ₹1000 × 1/10% = 1000 × 1/0.1 = ₹ 1000 × 10 = 10,000 (Ten Thousand). If the amount of LRR is 20% then the initial deposit of ₹ 1000 would create the total amount of money in the economy worth ₹ 1000 × 1/0.2 = ₹ 5000 (Five Thousand). **Thus, a higher LRR would create less amount of money and a lower LRR would create a higher amount of money in the economy.**

It should further be noted that only a fraction of total deposits is kept as cash reserves by banks because of two reasons. *First*, Banks by their experiences know that all depositors are not going to withdraw their money at the same time so the surplus money could be used to create loans and extra deposits. *Second*, there is a continuous flow of deposits in the banks, so banks are comfortable with their cash reserves.

INTEXT QUESTIONS 28.3

1. Which of the following statements are true and which are false?
   (i) Commercial banks are controlled and operated only by the public sector.
   (ii) Rate of interest on savings account deposits is less than fixed deposits.
   (iii) Functions of commercial banks are rising day by day in modern economy.
   (iv) Overdraft facility is an important form of granting loan to the public by banks.
   (v) Increase in legal reserve ratio reduces credit creating power of commercial banks.

28.8 CENTRAL BANK

Central Bank is an apex bank in an economy which is entrusted with the task to control, regulate and supervise the entire banking operations of all the commercial banks including formulation and implementation of monetary policy in the economy. The central bank of India is Reserve Bank of India (R.B.I.).

Functions of Central Bank

(i) **Bank of issuing or currency:** Every central bank of an economy is the sole authority to issue currency. The currency issued by the central bank is backed by minimum receive of assets like gold coins, gold bullions and foreign exchange etc. kept with the central bank. The Minimum Reserve System in India represent the minimum backing of Rs 200 crores by RBI out of which Rs 115 crores worth of gold and Rs 85 crores worth of foreign exchange securities are kept under RBI, the Monetary Authority of India. The authority of sole issue of currency has certain benefits like uniformity in currency, better monitoring and control over money supply and public trust and confidence in the currency issued and circulated.

(ii) **Banker to the banks:** The central bank acts as a banker to the commercial banks in the following manner:

- Custodian of the cash reserves of the commercial banks (CRR).
- Lender of the last resort in the sense that if commercial banks fail to generate enough cash from its own sources it approaches the central bank as a last resort. The central bank in turn may grant loans and advances to the needy banks.
- The central bank also acts as central clearing house for the commercial banks.

(iii) **Banker to the government:** As a banker to the government the central bank carries out all banking businesses on behalf of both the central government and the state governments. It maintains current account of the government for keeping cash balances and also making and receiving payments on behalf of the government. It provides loans and advances to the government. It also acts as financial advisor to the government.

(iv) **Custodian of the stock of gold and foreign exchange reserves of the nation:** This function helps in maintaining stability in exchange rate as fixed by the government and also enforcing exchange control and other regulations for a favourable balance of payments for the economy.

(v) **Controller of credit and money supply:** Credit control and control of money supply is probably the most important function of a central bank. Through various methods/instruments of credit control the central bank aims to achieve growth with stability in an economy. All the instruments of credit control may broadly be divided into following two categories. These are called instruments of monetary policy. Monetary policy is the policy of the central bank to control and regulate money supply and credit in the economy.

(A) Quantitative methods of credit control and

(B) Qualitative or selective methods of credit control.

The Quantitative methods include those instruments which affect the total volume of credit and affect all sections of the economy. It includes the following instruments:

(i) **Bank Rate Policy:** Bank rate is the rate at which central bank provides loan to the commercial banks. The increase in bank rate by the central bank increases the cost of funds to the commercial banks which in turn is passed on to their customers. High rate of interest reduces demand for loan and thus the quantity of credit/money in the economy which squeezes aggregate demand in the economy. Bank rate is increased to control inflation in an economy and it is reduced to fight deflationary situation in the economy.

(ii) **Open Market Operations:** Open market operations refer to the policy of sale and purchase of government securities in the open market by the central bank. The central bank sells and purchases these securities mainly to and from the public and commercial banks. If the central bank wants to control inflation it sells securities in the market so that the excess liquidity may be transferred from public to the central bank. This measure controls the aggregate demand and inflation in the economy. The central bank starts purchasing securities in the market to boost aggregate demand and fight deflation in the economy.

(iii) **Variable Legal Reserve Ratio:** The central bank can influence the credit creating power of commercial banks by varying CRR and SLR. Increase in LRR reduces credit creation capacity of commercial banks and decrease in LRR increases this power of the banks. LRR is increased during inflation and decreased during deflation.

The qualitative or selective credit control does not influence the quantity of credit/money in totality but it is directed towards controlling credit in a particular use of credit. The qualitative methods of credit control are as follows:

(i) **Margin Requirements:** The commercial banks grant loan to borrowers against some collateral securities whose value is more than the the value of loans granted. The difference between the value of collateral securities and the amount of loan is called margin. Increase in margin requirement reduces loan eligibility of the borrower which central uses at the time of inflation. During deflationary situation margin requirement is reduced to promote the growth of volume of credit/money in the economy.

(ii) **Moral Suasion:** Under this method central bank persuades and pressurises the commercial banks to adopt a credit policy which is in line with the overall objectives of the economy.

(iii) **Credit Rationing:** Under this method central bank fixes maximum ceiling of loans to be granted by the commercial banks either on aggregate basis or for a particular use. The rate of interest may vary across sectors or uses.

INTEXT QUESTIONS 28.4

1. Which of the following statements are true and which are false?
   (i) Central Bank is an apex bank in an economy.
   (ii) Central bank has little role in controlling and regulating the operations of commercial banks.
   (iii) Central bank acts as banker to the government.
   (iv) Central bank plays an important role in controlling and regulating money supply in an economy.
   (v) Quantitative methods of credit control influences the overall supply of money in an economy.
   (vi) Increase in bank rate reduces supply of money in an economy.
   (vii) During inflation the central bank increases bank rate and during deflation it reduces the bank rate.
   (viii) During inflation the central bank starts purchasing securities in the market.
   (ix) Selective credit control measures influence supply of money only in some sectors of the economy.
   (x) Credit rationing is an important form of selective credit control.

WHAT YOU HAVE LEARNT

- Barter system is a system of exchange under which goods are exchanged for goods without the use of money.
- Barter system suffered from many difficulties like lack of double coincidence of wants, lack of common measure of value, absence of standard of deferred or future payments and difficulty and wastage in the storage of wealth.
- Money is anything which is generally accepted as a means of exchange.
- Money also acts as measure and store of value and as standard of deferred payments.

- There are four measures of money supply viz. M_1, M_2, M_3 and M_4 of which M_1 is a narrow measure of money supply and M_3 is broader measure of money supply.
- The High Powered Money is the currency held by public (C), cash reserves of banks (R) and other deposits of the R.B.I .
- Commercial bank is a financial institution which is primarily concerned with accepting deposits from public and lending to the public.
- Functions of Commercial Banks mainly include acceptance of deposits, extending loans and advances, creation of credit and sale and purchase of foreign exchange:
- Higher LRR reduces commercial bank's power to create credit and vice-versa.
- Total quantity of money created: Quantity of deposits x 1/LRR.
- Central Bank is an apex bank in an economy which is entrusted with the task to control, regulate and supervise the entire banking operations of all the commercial banks.
- Important functions of central bank include credit control, issue of currency, banker to the bank, custodian of the cash reserves of the commercial banks, lender of the last resort.
- Central bank also acts as central clearing house for the commercial banks, banker to the government, custodian of the stock of gold and foreign exchange reserves of the nation, controller of credit and money supply.
- Central bank broadly uses two categories of instruments of credit control viz. quantitative methods and qualitative or selective methods of credit control.
- Quantitative methods include bank Rate Policy, open Market Operations and variable legal reserve ratio.
- Qualitative or selective credit control includes margin requirements, moral suasion and credit rationing.

TERMINAL EXERCISE

1. What is barter system of exchange?
2. What were the difficulties of barter system of exchange?
3. Define Money.
4. How money could solve difficulties related to barter system?
5. Explain different measures of money supply.
6. What is a commercial bank?
7. Explain important functions of commercial banks.
8. What are different types of deposits accepted by commercial banks?

9. What is credit creation?
10. Briefly explain the process of money creation or credit creation.
11. What is high powered money?
12. What is central bank?
13. What are the important functions of central bank?
14. Distinguish between quantitative and qualitative methods of credit control.

ANSWERS TO INTEXT QUESTIONS

28.1

(i) False (ii) True

(iii) Quality of rice may be lower/loss of interest.

28.2

(i) True (ii) True (iii) False (iv) True (v) True

28.3

(i) False (ii) True (iii) True (iv) True (v) True

28.4

(i) True (ii) False (iii) True (iv) True (v) True
(vi) True (vii) True (viii) False (ix) True (x) True