

NCERT Solutions for Class 12 Macro Economics

Chapter 3 – Money and Banking

1.

What is a barter system? What are its drawbacks?

Ans: Ancient people traded items using barter. Thus, before the monetary system, this system exchanged commodities. Someone with rice can trade it for tea with someone who has tea and needs rice. Bartering was called a 'C-C economy' because commodities were exchanged. Here are some barter system drawbacks:

1. Double wish coincidence Double coincidence of wants means two people's needs must match to exchange. In the preceding scenario, the second individual needs rice for tea.
2. No common currency There was no standard unit for measuring the worth of one commodity in terms of another for barter. Horses cannot be quantified in rice when exchanged.
3. Trouble storing riches Keeping commodities for exchange was challenging. Grain, milk, and meat cannot be preserved for future exchange. Thus, wealth storage was a basic system challenge.
4. No deferred payment standard Since wealth cannot be saved, a C-C economy (barter system) could not meet future payments. It was hard to repay loans.

2.

What are the main functions of money? How does money overcome the shortcomings of a barter system?

Ans: These are the main things that money is used for:

1. Money used for trade: If you want to trade something for something else, you can use money as a means of exchange. To put it another way, money makes it easier to buy and sell things. One person can sell their things to someone else for money, and that other person can use the money to buy anything they want. When two wants happen at the same time, money can solve the problem.

2. Value Unit: Money can be used to figure out how much something is worth. It's a straightforward way to figure out how much each good is worth. The price is how much money

something is worth. One big problem with the barter system was that there wasn't a standard way to measure the value of things.

3. Value Storage: This function talks about how important money is as a way to store value. In other words, money as a form of wealth can be easily saved and used again in the future. Banks are one place where money can be kept for emergencies and for later use.

4. The standard of deferred payments: Money makes it easy to send and receive payments. If you borrow money in the form of things and services, it is hard to repay the debt. Having money, on the other hand, makes it easy to pay back loans or interest.

The problems with the barter system can be fixed in the following ways:

1. Money can fix the problem of having two wants at the same time. Say someone wants to trade tea for wheat. That person must look for someone who is willing to trade tea for wheat. Money took away the need for these kinds of hunts.
2. It was hard to figure out how much one good was worth in terms of another in the barter system. For instance, it's hard to figure out how much a cow is worth in terms of wheat.
3. It was tough to store things, especially things that went bad quickly, like meat, fruits, and vegetables. This is what money is for.
4. It's harder to make payments that are due in the future or under a contract in a barter system. For instance, someone who was hired on a contract could not be paid in rice or chairs.

3.

What is transaction demand for money? How is it related to the value of transactions over a specified period of time?

Ans: It is the sum of money necessary for doing daily transactions. It is often referred to as the sum that individuals reserve to fund future expenses. There are two reasons for retaining transactional currency. The income motivation pertains to individuals seeking to cover home expenses, whereas the business motive applies to entrepreneurs requiring funds to operate their enterprises.

The correlation between transaction demand and transaction value is as follows:

$$M_t^d = KT$$

$$\text{or } \frac{1}{K} M_t^d = T$$

$$\text{or } vM_t^d = T$$

Where

$V = 1/K$, which represents the velocity of circulation of money

T = Total transaction value over time in an economy

K = A positive fraction

M_t^d = Money stock that people were willing to hold at a time

4.

What are the alternative definitions of money supply in India?

Ans: M1, M2, M3, and M4 are the four definitions of the money supply in India. They are ranked in decreasing order of liquidity, meaning that M1 has the most liquidity and M4 has the least.

Now,

$$M1 = C + DD + OD$$

Where,

C is the currency held by the public of the nation

DD is the demand deposit present in banks

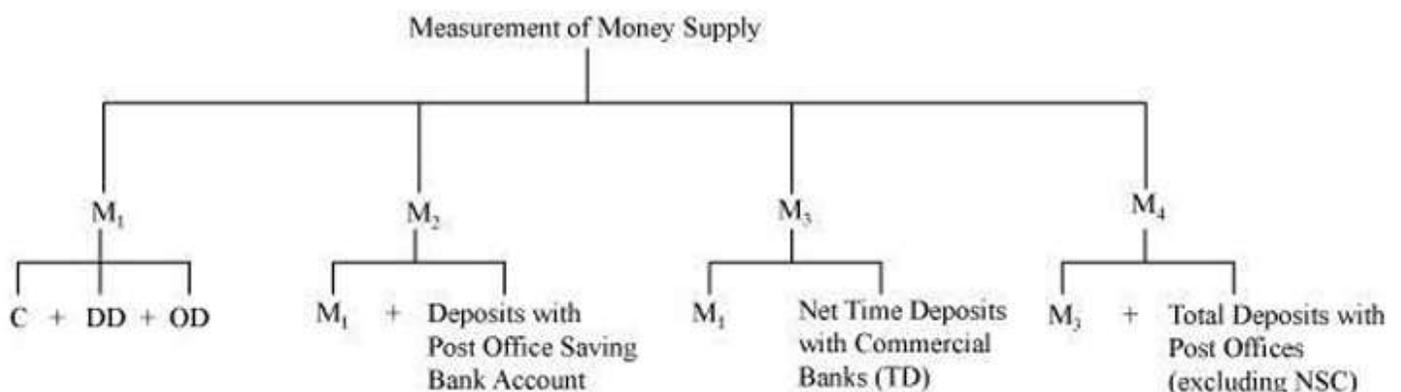
OD is the other type of deposit present in the RBI

Also

$$M2 = M1 + \text{Savings done by people in post offices}$$

$$M3 = M1 + \text{Net time deposits of the banks}$$

$$M4 = M3 + \text{Total deposit held in post offices excluding NSC (National Savings Certificate)}.$$



5.

What is a 'legal tender'? What is 'fiat money'?

Ans: The term "legal tender" describes the coins and banknotes that the Indian government and RBI have issued as a legitimate form of payment. Only government order (fiat) gives fiat money its value. When the government designates the currency as legal tender, it becomes fiat money. This is supported by faith or trust rather than reserves. This currency lacks intrinsic value, meaning that its true worth is not equal to the face value shown on the coins and notes.

6.

What is High Powered Money?

Ans: When it comes to the monetary authority of the government, high-powered money is the whole liability of the country. This is made by the Reserve Bank of India (RBI), which is also known as the monetary basis. In addition to currency (notes and coins), high-powered money consists of deposits with the government and reserves held by commercial banks with the Reserve Bank of India (RBI). That being said, to summarize, high-powered money is

$$H = C + R$$

Where,

H – High powered money

C – Currency

R – Cash Reserves of commercial banks

7.

Explain the functions of a commercial bank.

Ans: Commercial banks carry out a number of tasks, including the following: **1. Taking deposits:** Commercial banks' primary duty is to take deposits from its clients. The following categories apply to these deposits:

- i. **Conserving Accounts:** The needs of those who want to set aside a portion of their income and earn interest on that amount are met by savings accounts. Savings account customers have the ability to deposit checks, drafts, and other documents. There is a withdrawal cap, though.
- ii. **Accounts with fixed deposits:** Fixed deposit accounts, as their name implies, hold deposits for predetermined lengths of time, such as Rs. 500 every month for five years. When opening an account, the period must be chosen beforehand. The check facility is not available to holders of these accounts. The RBI determines the interest rate, which will increase with the length of time.

iii. Accounts with current deposits: 'Demand deposits' are another name for current deposit accounts because the depositor can take money out of the account at any moment using checks. Although they do not receive interest on their deposits, businessmen use this account to do numerous transactions in a single day. Current account customers receive account statements from banks on a regular basis.

2. Granting advances and loans: The provision of loans and advances is the second most significant role of commercial banks. The interest rates that banks charge on loans are higher than the interest rates that they pay on savings and demand deposits. Commercial banks typically offer long-term loans that are secured by securities. Banks only offer advances for a limited period of time.

3. Functions of agencies: With the primary goal of accepting deposits and making loans, commercial banks carry out a variety of agency responsibilities. Among their duties are:

- i. Fund transfers: The banks facilitate the simple movement of money between locations through demand drafts, mail transfers, and other means.
- ii. Funds collection: Banks also collect money on behalf of their clients by issuing checks, bills, and other documents.
- iii. Banks get dividends, interest on debentures, insurance premiums, and other payments.
- iv. Banks help account holders with the tax payment process.
- v. Banks can also act as executors or trustees.
- vi. Banks help account holders with the tax payment process.
- vii. Banks can also act as executors or trustees.

4. Terminating Exchange Bills: Discounting the bills of exchange to give firms financial support. This is accomplished by buying customer-generated bills and subtracting interest from the bill's face value.

5. Establishment of Credit Demand: deposits are one way that banks contribute to the economy's credit supply. It contributes to an economy's expansion.

6. Additional Roles: The bank also offers gold loans, forex buying and selling, gift checks, share and debenture underwriting, locker facilities, and more.

8.

What is money multiplier? What determines the value of this multiplier?

Ans: According to the money multiplier, the quantity of money that banks create as deposits is the amount of money that is retained as a reserve for each individual unit of money. It is found

by dividing the total amount of money in circulation by the amount of high-powered money in circulation.

$$M_M = \frac{M}{H}$$

Where, M_M is the money multiplier

M-represents the stock of money

H-represents high powered money

Now

$$\frac{M}{H} = \frac{1 + cdr}{cdr + rdr} > 1$$

As a result, the current deposit ratio (cdr) and the reserve deposit ratio (rdr) are both significant factors that contribute to the calculation of the money multiplier.

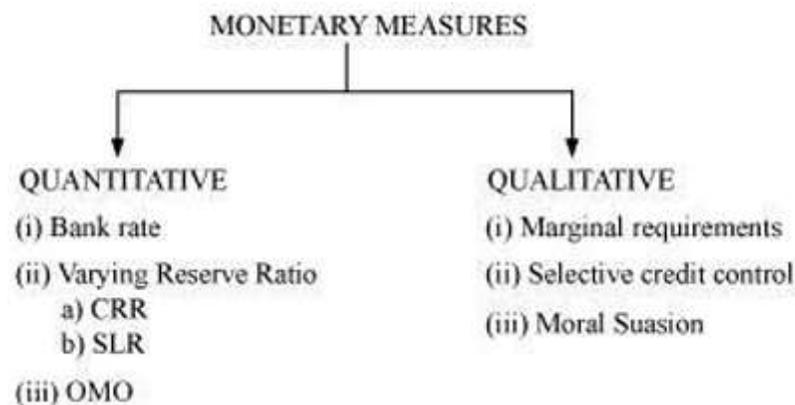
9.

What are the instruments of monetary policy of RBI?

Ans: Monetary policy tools include the following:

1. Qualitative

2. Quantitative



The following elements are part of the qualitative measures:

a. Marginal Requirements: Commercial banks base their loan approvals on the value of a security held as a mortgage. The discrepancy between the loan value and the market value of a mortgaged security is constantly maintained by banks. The marginal need for loans increases when the central bank restricts the flow of money, and vice versa when it comes to credit regulation.

b. Selective Credit Control (SCC): This monetary policy tool is crucial for both favorably and negatively influencing a sector's credit flow. While limiting credit flow to a specific sector is a negative element, the positive aspect focuses on improving credit flow to sectors that require priority.

c. Moral Suasion: This is a sort of persuasive strategy used by central banks to maintain pressure on commercial banks to follow the established monetary policies. It is accomplished through holding meetings, seminars, and speeches.

The following are the quantitative measures:

a. Bank Rate: This is the interest rate at which a central bank, like the RBI, lends money to a commercial bank. A rise in bank rates will result in higher loan costs for commercial banks, which will raise lending rates and limit the public's ability to obtain credit. The converse occurs when bank rates drop, making borrowing more easily accessible.

b. Open Market Operations: The economy's money supply is impacted by the buying and selling of assets on the open market. While the RBI's sale of assets will reduce the economy's excess cash balance and result in a smaller money supply, the central bank's purchase of securities will stimulate the economy.

c. Variable Reserve Ratios: The RBI uses two different kinds of ratios to control the money supply. These are the Cash Reserve Ratio (CRR) and the Statutory Liquid Ratio (SLR). SLR addresses the minimal proportion of liquid or fixed assets that must be kept in reserve with the RBI. The flow of liquidity falls when SLR rises and vice versa. The minimum amount of money that must be kept in reserve with the RBI is the subject of CRR. The economy is impacted by changes in the value of CRR. If CRR rises, there will be less money available for lending; if CRR falls, the opposite will occur.

A commercial bank will deposit the currency to the RBI, which suffers an increase in liabilities and assets, when foreign currency enters India through bond purchases made by foreigners who exchange the foreign currency for rupees. The RBI sells securities on the open market to fight such a scenario and shield the adversary from shocks.

10.

Do you consider a commercial bank 'creator of money' in the economy?

Ans: The main function of commercial banks in an economy is to create credit or money. This is predicated on the idea that not every depositor will take their money out of the bank all at once. In this manner, the funds can be utilized to create credit through demand deposits by lending credit to others.

11.

What role of RBI is known as 'lender of last resort'?

Ans: The central bank fulfills the crucial role of "lender of last resort" and gives commercial banks loans when they are experiencing financial difficulties and are unable to secure funding from other sources. The central bank's function prevents the commercial bank from going insolvent. Therefore, the central bank keeps the financial system in the economy sound and healthy by acting as a guarantor for the commercial banks.