

Chapter 2 · Money and Banking

CBSE Class 12 Economics (030) · Part A Macroeconomics · Unit 2 = 6 marks · Ultimate Revision Sheet

60-SECOND RECALL

Money supply	$M1 = \text{Currency with public} + \text{Demand deposits} + \text{Other deposits with RBI}$
Money multiplier	$1 \div LRR$ ($LRR = CRR + SLR$)
Total deposit creation	$\text{Initial Deposit} \times 1/LRR$
4 functions of money	Medium of exchange · Measure of value · Store of value · Standard of deferred payment
To CONTROL inflation	RAISE CRR, SLR, Repo · SELL securities → money supply falls
To fight deflation	LOWER CRR, SLR, Repo · BUY securities → money supply rises

1. Money — Meaning and Functions

DEFINITION Money is anything that is generally accepted as a medium of exchange and that acts as a measure of value, a store of value and a standard of deferred payment.

Functions

Function	Meaning
Medium of exchange (primary)	Solves the double coincidence of wants problem of barter
Measure of value (primary)	Provides a common unit in which all goods are priced
Store of value (secondary)	Purchasing power can be carried into the future
Standard of deferred payment (secondary)	Makes future/credit transactions possible

Problems of barter that money solves: lack of double coincidence of wants · lack of a common measure of value · lack of a store of value · lack of a standard for deferred payments · indivisibility of goods.

2. Supply of Money

THE MEASURES

$M1 = \text{Currency with the public} + \text{Demand deposits with banks} + \text{Other deposits with RBI}$

$M2 = M1 + \text{Savings deposits with Post Office savings banks}$

$M3 = M1 + \text{Net time deposits with commercial banks}$

$M4 = M3 + \text{Total deposits with Post Office savings organisations}$

M1 and M2 are narrow money. M3 and M4 are broad money. M3 is the most commonly used aggregate.

TRAP Money supply counts only money held by the **public**. Cash held **by banks themselves** and **inter-bank deposits** are **excluded** — otherwise it would be counted twice.

3. Money Creation by Commercial Banks

CONCEPT Banks keep only a **fraction** of deposits as reserves (the **Legal Reserve Ratio**) and lend the rest. The borrower spends it, it returns to the banking system as a fresh deposit, and the process repeats. This is **credit creation**.

THE FORMULA

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

$$\text{Total Deposit Creation} = \text{Initial Deposit} \times (1 \div \text{LRR})$$

$$\text{LRR} = \text{CRR} + \text{SLR}$$

WORKED EXAMPLE Initial deposit ₹10,000, LRR = 20%.

$$\text{Money multiplier} = 1 / 0.20 = 5$$

$$\text{Total deposits created} = 10,000 \times 5 = ₹50,000$$

$$\text{Total credit created} = 50,000 - 10,000 = ₹40,000$$

Round 1: deposit 10,000, keep 2,000, lend 8,000

Round 2: deposit 8,000, keep 1,600, lend 6,400 ... and so on until it dies out.

TRAP The multiplier and **LRR** move in opposite directions. A **higher** LRR gives a **smaller** multiplier and therefore **less** credit creation. If the question raises the CRR, credit creation must fall.

4. Central Bank — Functions

1. **Bank of issue** — monopoly over issuing currency notes (except the one-rupee note and coins, issued by the Ministry of Finance).
2. **Banker to the government** — maintains government accounts, gives advances, manages public debt.
3. **Banker's bank and supervisor** — holds banks' reserves, supervises and regulates them.
4. **Lender of last resort** — lends to commercial banks in a crisis when no one else will.
5. **Clearing house** — settles inter-bank claims.
6. **Custodian of foreign exchange reserves.**
7. **Controller of money supply and credit** — see below.

5. Instruments of Monetary Policy

QUANTITATIVE INSTRUMENTS

Instrument	Meaning	To fight INFLATION
CRR Cash Reserve Ratio	% of total deposits banks must keep with the RBI	INCREASE

SLR Statutory Liquidity Ratio	% of deposits banks must keep with themselves in liquid form	INCREASE
Repo Rate	Rate at which RBI lends to commercial banks	INCREASE
Reverse Repo Rate	Rate at which RBI borrow s from commercial banks	INCREASE
Bank Rate	Rate at which RBI lends long term without collateral	INCREASE
Open Market Operations	RBI buys/sells government securities in the open market	SELL securities

QUALITATIVE INSTRUMENTS *Margin requirement* — the gap between the value of security and the loan given. *Raise it to reduce credit.*

Moral suasion — persuasion, advice and requests by RBI to banks.

Selective credit controls — restricting credit to specific sectors (e.g. speculation).

THE ONE THING TO REMEMBER *Excess demand / inflation → TIGHT money policy → RAISE every rate and ratio, SELL securities.*

Deficient demand / deflation → EASY money policy → LOWER every rate and ratio, BUY securities.

Every monetary policy question in the paper reduces to this one line.

6. Question Triggers what the wording is really asking

If the question says...	Answer
"there is excess demand / inflationary gap"	Raise CRR, SLR, Repo; sell securities
"there is deficient demand / deflationary gap"	Lower CRR, SLR, Repo; buy securities
"LRR is 25%, initial deposit ₹X"	Multiplier = 4; total deposits = $X \times 4$
"RBI raised the CRR"	Multiplier falls → credit creation falls
"rate at which RBI lends to banks"	Repo rate
"rate at which RBI borrows from banks"	Reverse repo rate
"RBI lends when no one else will"	Lender of last resort
"cash held by banks in their own vaults"	Not part of money supply
"time deposits included"	M3 , not M1
"margin requirement raised"	Qualitative instrument → credit falls

MOST-ASKED BOARD QUESTIONS

1. [4-6M] Explain the process of money creation by commercial banks with an example.
2. [3-4M] Explain how the RBI controls credit / the instruments of monetary policy.
3. [3M] Explain any three functions of the central bank.
4. [3M] Calculate total deposit creation given the initial deposit and LRR.
5. [1M] Define money multiplier. → $1 \div \text{LRR}$
6. [1M] Which is the primary function of money? → **Medium of exchange**

THE HABIT THAT SCORES — For any policy question, state the **direction** and the **reason** together: “RBI should **raise** the repo rate, because costlier borrowing reduces credit, which reduces money supply and therefore aggregate demand.” The direction alone is half the mark.