2 Money and Banking

Fastrack Revision

Money

- **Barter System:** A system of economy in which goods are exchanged for another goods without the use of money is called Barter System. It is also known as C–C Economy, *i.e.*, exchange of commodity for commodity or simply commodity for commodity economy.
- **Drawbacks/Difficulties/Limitations of Barter System**
  - Lack of double coincidence of wants.
  - Lack of standard for deferred payments.
  - Lack of common measure of value.
  - Difficulty of storage and transfer of wealth.
  - Lack of divisibility.

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

- **Meaning of Money:** "Money is anything which is generally acceptable as means of exchange and at the same time acts as a measure of value and as a store of value." In other words, "Money is a matter of four functions: a medium, a measure, a store and a standard of deferred payments."

  "Money is what money does." —***Walker***

Knowledge BOOSTER

All commodities are expressed and valued in terms of money.

- **Functions of Money**
  - **Primary Functions of Money:**
    - **Money as a Medium of Exchange:** One of the primary functions of money is as a medium of exchange as it can be used for any or all transactions where in goods or services are purchased or sold. Therefore, one can buy or sell products in exchange for money.
    - **A Measure of Value:** Money can be treated as the parameter of measuring the value of a product or service. The value of every product or service can be expressed in monetary form. For example, the value of a pack of bread is around ₹ 50.
  - **Secondary Functions of Money:**
    - **Standard of Deferred Payments:** Money plays an important role in leading a borrowing. Money is taken as a loan and repaid after a time gap.
    - **Store of Value:** Money has a general acceptability and its value remains stable. It can be easily stored for future use. It is the most convenient and economical means to store earnings and wealth.

    Hence, it helps to shift the purchasing power from the present to the future.
- **Evolution of Money**

  In olden days, when the wants of people were limited, barter system was prevalent in the economy. However, when wants of people become multiple then barter system of exchange was proved to be ineffective and had many drawbacks or limitations. Then to overcome the problems faced in barter system, man then invented money.

  Money has evolved through different stages according to industrialisation. From time-to-time money was evolved as follows:
  - **Commodity Money:** In this form of exchange, salt, rice, wheat, furs, skins, weapons, etc., were commonly used as money.
  - **Metallic Money:** In this form of exchange, metal coins of gold, silver, copper, etc., were commonly used as money.
  - **Paper Money:** In this form of exchange, paper notes were invented and commonly used as money. For example, representative paper money, convertible paper money, inconvertible paper money.
  - **Credit Money:** In this form of exchange, cheques were commonly used as money.
  - **Plastic Money:** In this form of exchange, debit cards and credit cards are used as money. It is the latest type of money.
- **Money Supply:** It refers to total quantity or stock of money available in the economy at a particular point of time.

  "Which is widely accepted in payments of goods or in discharge of other kinds of business obligations is called supply of money." —***D.H. Robertson***

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Approaches of Money Supply

Narrow Approach : It includes M_1 and M_2 measures of money supply.

Broader Approach : It includes M_3 and M_4 measures of money supply.

- **Components of Money Supply**
  - **Currency Held by the Public (C):** It consists of the coins and paper currency held by public.
  - **Net Demand Deposit Held by the Commercial Bank (DD):** These are the deposits which are payable on demand. These can be withdrawn at any time. The bank provides cheque facility against demand deposits.
- **Measures of Money Supply:** In India, there are four alternative measures of money supply used by Reserve Bank of India – M_1, M_2, M_3 and M_4.

  $M_1 = C + DD +$ other deposits with RBI

  $M_2 = M_1 +$ Saving deposits with post office saving banks

  $M_3 = M_1 +$ Net time deposits with banks

  $M_4 = M_3 +$ Total deposits with the post office savings organisations (Excluding National Saving Certificates)

Practice Exercise

Multiple Choice Questions

Q 1. **The drawbacks of barter system:**
a. lack of transfer of value
b. lack of measure of value
c. lack of standard of deferred payments
d. All of the above

Q 2. **Which of the following is not a problem of barter system?**
a. Store of value
b. Double coincidence of wants
c. Unit of account
d. Unemployment

Q 3. **Read the following dialogue between two people:**

Gita: I want 1 kg of potatoes.

Reena: What will you give in exchange?

Gita: I can give you 2 litres of milk in return for the potatoes.

Reena: I don't need milk. I want a pair of shoes.

Which of the following problem is being faced by Gita and Reena in their exchange process?
a. Lack of double coincidence of wants
b. Absence of common unit of value
c. Lack of store of value
d. Lack of standard of deferred payments

Q 4. **Vivan has 2 litres of milk and he wants rice against it, then how much rice he should get? Which drawback of barter system is highlighted?**
a. Double coincidence of wants
b. Lack of common measure of value
c. Lack of store of value
d. Lack of standard of deferred payments

Q 5. **Which of the following is/are function (s) of money?**
a. Common measure of value
b. A standard of deferred payments
c. Double coincidence of wants
d. All of the above

Q 6. **Barter system means:**
a. indirect exchange of one commodity for another
b. direct exchange of one commodity for another
c. exchange of commodity for money
d. None of the above

Q 7. **In the barter system:**
a. goods are exchanged for goods
b. goods are exchanged for money
c. there is no exchange of goods
d. transaction of goods become very easy

Q 8. **Money is defined as:**
a. commonly accepted measure of value
b. a store of value
c. a standard of deferred payments
d. All of the above

Q 9. **Which of the following is not a function of money?**
a. Medium of exchange
b. Unit of account
c. Standard of deferred payments
d. Store of metal

Q 10. **Which function of money is known as unit of account?**
a. Medium of exchange
b. Measure of value
c. Standard of deferred payments
d. Store of value

Q 11. **Which function of money has overcome the problem of lack of double coincidence of wants?**
a. Measure of value
b. Medium of exchange
c. Standard of deferred payments
d. Store of value

Q 12. **Medium of exchange function of money suggests that:**
a. value of all goods and services can be measured in terms of money.
b. transfer of value can easily be performed with the help of money.
c. any commodity can be sold or purchased through the medium of money.
d. money can be used for future payments.

Q 13. **Which function of money has separated the acts of sale and purchase?**
a. Standard of deferred payments
b. Store of value
c. Measure of value
d. Medium of exchange

Q 14. **Money serves as a common denomination. The function of money highlighted is:**
a. store of value
b. standard of deferred payments
c. unit of account
d. medium of exchange

Q 15. **In a hypothetical economy, Mr Neeraj has deposited ₹ 100 in the bank. If it is assumed that there is no other currency circulation in the economy, then the total money supply in the economy will be ....**

(CBSE SQP 2021, Term-1)

a. zero b. ₹ 100 c. not defined d. ₹ 120

Q 16. **The maximum limit to accept payment in coins:**
a. ₹ 500 b. ₹ 1,000
c. ₹ 250 d. None of these

Q 17. **High powered money includes:**
a. currency and demand deposits
b. demand deposits and saving deposits
c. currency held by public and cash reserves with banks
d. None of the above

Q 18. **People desire to hold money balance for:**
a. transaction motive b. speculative motive
c. precautionary motive d. All of these

Q 19. Money supply includes:
a. all deposits in bank
b. only demand deposits in banks
c. only time deposits in banks
d. currency with the banks

Q 20. Supply of money refers to quantity of money:
a. as on 31st March
b. during any specified period of time
c. as at any point of time
d. during a fiscal year

Q 21. .... is the main source of money supply in an economy.
a. Central Bank
b. Commercial Bank
c. Both a. and b.
d. Government

Q 22. Money supply is a:
a. flow concept
b. stock concept
c. Both a. and b.
d. None of these

Q 23. "The value of all goods and services can be expressed in monetary units."
On the basis of the given statement, identify the function performed by money. *(CBSE SQP 2023-24)*
a. Medium of exchange
b. Store of value
c. Unit of account
d. Means of standard of deferred payments

Q 24. Which of the following is the component of M_1 measure of money supply of RBI?
a. Time deposit
b. Demand deposit
c. Treasury bill
d. None of these

Q 25. Money supply is defined in the economy as:
a. amount of money held by the public in an economy at any given time.
b. amount of money held by public during a period of time.
c. amount of money held by government at a point of time.
d. amount of money held by government during a period of time.

Q 26. Bank money is that money which is:
a. printed by RBI
b. printed by the Government
c. generated in the form of credit creation
d. None of the above

Q 27. Which items are not included in M_1?
a. Inter-bank deposits
b. Other deposits with RBI
c. Currency and coins with public
d. Net demand deposits with banks

Q 28. Money supply consists of:
a. currency
b. deposit
c. Both a. and b.
d. None of these

Q 29. Money supply in India increase if, ... (Choose the correct alternative) *(CBSE SQP 2022-23)*
1. Reserve Bank of India (RBI) injects more money in circulation.
2. the commercial banks expand their credit operation
3. tax rates are reduced by the Central Government
4. Reserve Bank of India increases the Bank Rate.

Alternatives:
a. 1, 2 and 3 are correct
b. 2, 3 and 4 are correct
c. 1, 3 and 4 are correct
d. 1, 2 and 4 are correct

Q 30. "Money is an asset which can be stored for use in future". In the light of given statement, identify the function of money. (Choose the correct alternative) *(CBSE 2023)*
a. A measure of value
b. A standard of deferred payments
c. A store of value
d. A medium of exchange

Q 31. Ms. Iqra Ansari, a teacher, was explaining in her class about various types of deposits with the commercial banks. She quoted that—
"These deposits form a part of M_1 measure of money supply and are payable on demand by the commercial banks."
Identify the type of deposits she was explaining about and choose the correct alternative.
(i) Demand Deposits
(ii) Time Deposits
(iii) Post Office Deposits *(CBSE 2023)*

Alternatives:
a. Only (i)
b. Only (ii)
c. (i) and (ii)
d. (i), (ii) and (iii)

Statement Based Questions

Q 32. Read the following statements carefully:
Statement I: The value of money multiplier is determined by the reserve ratio prevailing in the monetary system.
Statement II: The process of credit creation directly relates to the value of reserve ratio.
In the light of the given statements, choose the correct alternative. *(CBSE SQP 2021, Term-1)*
a. Both statements are true.
b. Both statements are false.
c. Statement I is true and statement II is false.
d. Statement II is true and statement I is false.

Q 33. Read the following statements carefully:
Statement I: Money is what money does.
Statement II: Money facilities exchange of goods and services.
In the light of the given statements, choose the correct alternative.
a. Statement I is true and statement II is false.
b. Statement II is true and statement I is false.
c. Both statements are true.
d. Both statements are false.

Q 34. Read the following statements carefully:
Statement I: Money supply (M_1) in India does not include 'demand deposits' with commercial banks.
Statement II: Money supply (M_1) refers to, assets available with the commercial banks during a particular period of time.
In the light of the given statements, choose the correct alternative. *(CBSE 2023)*
a. Statement I is true and statement II is false.
b. Statement I is false and statement II is true.
c. Both statements are true.
d. Both statements are false.

Fill in the Blank Type Questions

Q 35. The total stock of money in circulation among the public .... is called as 'money supply'. (Fill up the blank with correct alternative) *(CBSE 2021, Term-1)*

a. during a period of time
b. during a calendar year
c. during a fiscal year
d. at a particular point of time

Q 36. .... of wants refers to the simultaneous fulfilment of mutual wants of buyers and sellers by exchange of goods and services. (Choose the correct alternative to fill up the blank)

a. Supply
b. Double coincidence
c. Currency
d. None of these

Q 37. .... is the money produced by RBI and the government. (Choose the correct alternative to fill up the blank)

a. Deposit money
b. Legal tender
c. High powered money
d. Demand deposit

Q 38. Money consists of currency and .... whereas high powered money consists of currency and .... with banks. (Choose the correct alternative to fill up the blanks)

a. cash reserves, demand deposits
b. cash reserve, money supply
c. money supply, cash reserve
d. demand deposits, cash reserves

Q 39. Users of money include .... and .... (Choose the correct alternative to fill up the blanks)

a. banks, firms
b. households, firms
c. stock, bank
d. deposits, cash

Q 40. Producers or creators of money include ...., ... and .... (Choose the correct alternative to fill up the blanks)

a. Government, RBI, Commercial Bank
b. Firms, RBI, Government
c. Commercial Bank, Firms, RBI
d. Household, RBI, Commercial Bank

Q 41. .... refers to the total stock of money held by public at a particular point of time. (Choose the correct alternative to fill up the blanks)

a. Fund
b. Real money
c. Money supply
d. Money

True/False Type Questions

Q 42. Money was exchanged in barter system.

Q 43. Fiat money is a legal tender money which includes all currency and cheques which the people in a country are legally bound to accept as a medium of exchange.

Q 44. High powered money excludes cash reserves of commercial banks.

Q 45. Money is kept for transactory motive, precautionary motive but not for speculative motive.

Q 46. Demand deposit is treated as equal to currency.

Q 47. Demand deposits are those deposits which can be withdrawn from bank after a specified period of time.

Q 48. Money supply is a stock concept.

Q 49. Only gross demand deposits are included in money supply.

Q 50. Supply of money does not include money held by the Government, RBI and Commercial banks.

Q 51. M_1 measure of money supply is also referred to as transaction money.

Match the Column Type Questions

Q 52. Match the following statements in Column I and Column II, choose the correct pair of statement:

Column I	Column II
A. Double coincidence of wants	1. Barter system
B. High powered money	2. Money created by commercial banks in the form of demand deposits
C. Bank money	3. Huge trading costs
D. C-C Economy	4. Base money

	A	B	C	D
a.	3	4	2	1
b.	2	3	4	1
c.	4	3	1	2
d.	1	2	4	3

Q 53. Match the following statements in Column I and Column II, choose the correct pair of statement:

Column I	Column II
A. M_1 or M_2	1. Exclusive of inter-banking claims
B. M_3 or M_4	2. Lack of store of value
C. Net demand deposits	3. Narrow money
D. Barter system	4. Broad money

	A	B	C	D
a.	2	3	1	4
b.	3	4	1	2
c.	4	1	3	2
d.	2	1	4	3

Q 54. Match the following statements in Column I and Column II, choose the correct pair of statement:

Column I	Column II
A. M_1	1. M_1 + Net time deposits with the banks
B. M_2	2. Currency with public + Demand deposits of commercial banks + Other deposits with RBI
C. M_3	3. M_3 + Total post office deposits excluding national saving certificates
D. M_4	4. M_1 + Post office saving bank deposits

	A	B	C	D
a.	3	1	4	2
b.	2	4	1	3
c.	4	1	3	2
d.	1	4	2	3

Q 55. Match the following statements in Column I and Column II, choose the correct pair of statement:

Column I	Column II
A. Coins	1. Ministry of Finance Government of India
B. Coinage bill	2. ₹1,000
C. Maximum limit to accept payments in coins	3. Limited legal tender
D. ₹ 1 note and all coins are issued by	4. August, 2011

	A	B	C	D		A	B	C	D
a.	1	4	3	2	b.	2	4	3	1
c.	3	2	4	1	d.	3	4	2	1

Assertion & Reason Type Questions

Directions (Q.Nos. 56-65) : *There are two statements marked as Assertion (A) and Reason (R). Read the statements and choose the appropriate option from the options given below:*

a. Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
b. Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
c. Assertion (A) is true, but Reason (R) is false.
d. Assertion (A) is false, but Reason (R) is true.

Q 56. Assertion (A): Barter system is also known as C–C Economy.

Reason (R): Because the goods were exchanged for money.

Q 57. Assertion (A): Money supply is a stock concept.

Reason (R): Because it is related to a particular point of time.

Q 58. Assertion (A): Notes and Coins are the only source of money supply in the economy.

Reason (R): Demand deposits with commercial bank is also a component of money supply.

Q 59. Assertion (A): Double coincidence of wants is the limitation of barter system.

Reason (R): It was difficult and time consuming to find a person who is not only willing to exchange goods but also possess that particular commodity which is required by the first person.

Q 60. Assertion (A): M_1 = C + OD + Time deposits with the banks.

Reason (R): M_1 = C + OD + Demand deposits with the banks.

Q 61. Assertion (A): Cheque is known as fiduciary money.

Reason (R): It is accepted due to mutual trust between the payer and the payee.

Q 62. Assertion (A): Coinage Act was passed in 2011.

Reason (R): Anyone can make payments in coins but up to a limit of ₹1,000.

Q 63. Assertion (A): Paper currency is a limited legal tender.

Reason (R): Anyone can make payments in terms of paper currency up to any limit.

Q 64. Assertion (A): Money is what money does.

Reason (R): It is not accepted by everyone.

Q 65. Assertion (A): Demand deposits are considered as a convenient mode of payment for execution of even the high value transactions.

Reason (R): Demand deposits are non-withdrawable in nature and cannot be withdrawn against issue of cheques and other similar instruments of payment.

Answers

1. (d) All of the above
2. (d) Unemployment
3. (a) Lack of double coincidence of wants
4. (b) Lack of common measure of value
5. (d) All of the above
6. (b) direct exchange of one commodity for another
7. (a) goods are exchanged for goods
8. (d) All of the above
9. (d) Store of metal
10. (b) Measure of value
11. (b) Medium of exchange
12. (c) any commodity can be sold or purchased through the medium of money.
13. (d) Medium of exchange
14. (c) unit of account
15. (b) ₹ 100
16. (b) ₹ 1,000
17. (c) currency held by public and cash reserves with banks
18. (d) All of these
19. (b) only demand deposits in banks
20. (c) as at any point of time
21. (c) Both a. and b.
22. (b) stock concept
23. (c) Unit of account
24. (b) Demand deposit
25. (a) amount of money held by the public in an economy at any given time.
26. (c) generated in the form of credit creation
27. (a) Inter-bank deposits
28. (c) Both a. and b.
29. (a) 1, 2 and 3 are correct
30. (c) A store of value
31. (a) Only (i)

32. (c) Statement I is true and statement II is false.
33. (c) Both statements are true.
34. (d) Both statements are false.
35. (a) during a period of time
36. (b) Double coincidence
37. (c) High powered money
38. (d) demand deposits, cash reserves
39. (b) households, firms
40. (a) Government, RBI, Commercial banks
41. (c) Money supply
42. False: In barter system, goods were exchanged for other goods without the use of money.
43. False: Fiat money does not include cheques.
44. False: It includes coins, currency notes, cash reserves of commercial banks and vault cash of commercial banks.
45. False: Money is kept by the public for all three motives *viz.*, transactory motive, precautionary motive and speculative motive.
46. True: It is readily accepted as means of payment.
47. False: Demand deposits are those deposits which can be withdrawn from bank by the account holder at any time whenever he needs money.
48. True: Because it is related to a particular point of time.
49. False: Only net demand deposits are included in money supply.
50. True: Because RBI, commercial banks and Government are producers of money and money supply includes the money held by users of money *i.e.* public (household and firms).
51. True: It can be directly used for making transactions.

	A	B	C	D
52. (a)	3	4	2	1
53. (b)	3	4	1	2
54. (b)	2	4	1	3
55. (d)	3	4	2	1

56. (c) Assertion (A) is true, but Reason (R) is false.
57. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
58. (d) Assertion (A) is false, but Reason (R) is true.
59. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
60. (d) Assertion (A) is false, but Reason (R) is true.
61. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
62. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
63. (d) Assertion (A) is false, but Reason (R) is true.
64. (c) Assertion (A) is true, but Reason (R) is false.
65. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).

Case Study Based Questions

Case Study 1

Read the extract given below and answer the questions on the basis of the same:

In India, the Central Bank (RBI) has the monopoly right of note issue. The RBI issues promissory notes in the country. Each promissory note is a legal tender and contains the words— 'I promise to pay the bearer the sum of ₹.........', and is signed by the Governor of RBI. The face value of each promissory note is higher than its commodity value.

Q 1. Who has the monopoly right of note issue?

a. Government of India b. President of India
c. Prime Minister of India d. Reserve Bank of India

Q 2. When money value > commodity value, it is called:

a. full bodied money b. fiduciary money
c. credit money d. metallic money

Q 3. Promissory notes are:

a. limited legal tender b. unlimited legal tender
c. Both a. and b. d. None of these

Q 4. Paper currency notes of denominations 2, 5, 10, 20, 100, 200, 500 and 2000 are signed by:

a. Prime Minister b. Mahatma Gandhi
c. President d. Governor of RBI

Answers

1. (d) 2. (c) 3. (b) 4. (d)

Case Study 2

Read the extract given below and answer the questions on the basis of the same:

Suppose India's total money supply (M_3) stood at ₹ 17,50,000 crore as on August 15,2020, recording a rise of 9.5% over the same time last year.
Currency with the public stood at ₹ 25,75,000 crore, up by 19.5% over the year.
Demand deposits with banks were up by 7% at ₹14,70,000 crore. Time deposits with the banks were up by 8% at ₹1,25,00,000 crore. The bank credit to commercial sector rose by 4% on year to ₹1,05,00,000 crore.
Money supply in the economy has increased over the months. The currency with the public has increased by more than 15% and so have bank deposits. This has led to M_3 growing by over 8% since June.
Due to COVID-19 pandemic in India, people have started keeping money to safeguard themselves against salary cut or job losses.

However, money from abroad kept on coming in India. This leads to an increase in demand for the Rupee against Dollar. To maintain stability in foreign exchange rate. The RBI sold Rupees and brought Dollars adding to an increase in M_3.

Q 1. $M_3 = M_1 +$ ....

a. Fixed deposits
b. Demand deposits
c. Net time deposits with commercial banks
d. None of the above

Q 2. Money supply is a .... concept.

a. flow
b. stock
c. deposit
d. None of these

Q 3. Due to the COVID-19 pandemic, people have increased their savings due to .... motive.

a. transaction
b. flow
c. speculative
d. precautionary

Q 4. Money supply has increased due to:

a. inflow of foreign currency
b. uncertainty caused by COVID-19 pandemic
c. Both a. and b.
d. None of the above

Answers

1. (c) **2.** (b) **3.** (d) **4.** (c)

Case Study 3

Read the extract given below and answer the questions on the basis of the same:

India's total money supply (M_3) stood at ₹1,78,04,885 crore as on October 23rd, 2020, recording a rise of 11.60% over the same time last year. Currency with the public stood at ₹ 26,19,612 up by 21.2% over the year. Demand deposits with banks were up by 10% at ₹16,25,734 crore. Time deposits with banks were also up by 10% at ₹1,35,18,822 crore. The bank credit to commercial sector rose by 5.2% on year to ₹1,09,99,604 crore.

Money supply in the economy has increased over the months. We can look at money supply from the component side and the sources side. One of the ways of measuring money supply is M_3, which is a sum of the currency with the public, the demand deposits with the banking system, which include current deposits and savings deposits, the time deposits with the banking system, such as fixed deposits, recurring deposits, and other deposits of RBI. The currency with the public has grown by more than 21% since June and so have bank deposits. This has led to M_3 growing by over 12% since June.

Heightened uncertainty in India caused by the Corona Virus pandemic has led to a surge in currency in circulation as people hoard cash or park money in accessible deposits to safeguard themselves against salary cut or job losses.

Foreign money continuously keeps coming into India, leading to an increase in demand for the Rupee against the Dollar. To prevent the Rupee from appreciating, RBI sold Rupees and bought Dollars adding to the increase in M_3.

Q 1. What are the components of money supply?

Ans. The main components of money supply are as follows:

(i) Currency held by the public.
(ii) Net demand deposit held by the commercial bank.

Q 2. Explain the measures of money supply.

Ans. In India, there are four alternative measures of money supply used by Reserve Bank of India – M_1, M_2, M_3 and M_4.

M_1 = C + DD + other deposits with RBI

M_2 = M_1 + Saving deposits with post office saving banks.

M_3 = M_1 + Net time deposits with banks.

M_4 = M_3 + Total deposits with the post office savings organisations (Excluding National Saving Certificates)

TiP

Students should clear separately both the concepts, measures and components of money supply.

Case Study 4

Read the extract given below and answer the questions on the basis of the same:

India has witnessed various monetary standards in its monetary history. The present monetary system in India is managed and controlled by RBI. In India, rupee has been regarded as the standard currency and all transactions are made in terms of rupee. In India, the monetary authority is Reserve Bank of India. India follows the paper currency standards as currency followed in India is made up of paper. Coins are limited legal tender money and can be used for making small payments whereas paper notes are unlimited legal tender and be used for making payments of any amount. India follows the minimum reserve systems for note issue. Under this system, central bank is required to keep a minimum reserve of gold and foreign exchange worth ₹ 200 crore and on this basis RBI can issue any number of notes.

Q 1. Which is the main source of money supply in an economy?

Ans. Central Bank and Commercial Banks are the main source of money supply in an economy.

Q 2. What is a legal tender money?

Ans. Legal tender money refers to money which can be legally used to make payment of debt or other obligations.

Very Short Answer Type Questions

Q 1. What is barter system? *(NCERT)*

Ans. Barter system refers to a system of economy in which goods are exchanged for other goods without the use of money.

Q 2. What is the other name of barter system?

Ans. C–C Economy or Commodity for Commodity Economy is the other name of barter system.

Q 3. State the drawbacks of barter system.

Ans. The drawbacks of barter system are as follows:

(i) Lack of common measure of value.
(ii) Lack of transfer of value.
(iii) Lack of store of value.
(iv) Lack of double coincidence of wants.

Q 4. What is money? *(CBSE 2017, 2018, 2020)*

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

Q 5. What is bank money?

Ans. Bank money refers to money created by the commercial banks on the basis of demand deposits.

Q 6. What is meant by high powered money? *(NCERT)*

Ans. High powered money refers to the money produced by the Central Bank and the Government.

Q 7. What is fiat money?

Ans. Fiat money refers to the money issued by the order of government.

Q 8. What is fiduciary money?

Ans. Fiduciary money refers to the money accepted as a medium of exchange as per the mutual trust between the payer and the payee.

Q 9. What is full bodied money?

Ans. Full bodied money refers to that money whose face value is equal to the commodity value.

Q 10. What is credit money? *(NCERT)*

Ans. Credit money refers to that money whose face value is greater than commodity value. For example, face value of ₹50 note is ₹50, but the price of paper used in making it is much lower than ₹50.

Q 11. Write any two functions of money.

Ans. Two functions of money are:

(i) Medium of exchange (ii) Measure of value

Q 12. Who are the producers of money?

Ans. Government of India, Central Bank and Commercial Banks are the producers of money.

Q 13. Explain store of value function of money.

Ans. Money has a general acceptability, and its value remains stable. It can be easily stored for future use. It is the most convenient and economical means to store earnings and wealth.

Q 14. What is net demand deposit?

Ans. Net demand deposits are those deposits which exclude inter-banking claims.

Q 15. What are 'demand deposits'? *(CBSE 2019)*

Ans. Demand deposits are those deposits which can be withdrawn from bank by the account holder by writing a cheque any time.

Q 16. What are term deposits?

Ans. Term deposits are those deposits in which the amount is deposited in bank for a fixed period of time and cannot be withdrawn by the account holder by writing a cheque any time.

Q 17. What is legal tender money?

Ans. Money which is legally used to make payment of debts is known as legal tender money. For example, paper currency and coins.

Q 18. What is limited legal tender?

Ans. Limited legal tender is that type of legal tender money, which is used to make payment of debts up to a certain limit. For example, coins are limited legal tender.

Q 19. What is unlimited legal tender?

Ans. Unlimited legal tender is that type of legal tender money, which is used to make payment of debt of any amount. For example, paper notes are unlimited legal tender.

Q 20. What is non-legal tender money?

OR

What is optional money?

Ans. Optional money refers to cheques, bank drafts, bills of exchange, etc. Generally, these are accepted on the basis of mutual trust between the payer and the payee.

Q 21. What do you mean by liquid money?

Ans. Liquid money means coins, currency notes, bank money which can be used directly to purchase goods and services.

Q 22. What do you mean by near money?

Ans. Near money means those financial assets which can be easily converted into coins, currency, bank money. For example, fixed deposits, NSCs. They cannot be used directly to purchase goods and services.

Q 23. What is money supply? *(CBSE 2017)*

Ans. Money supply refers to the total stock of money held by the public at a particular point of time.

Q 24. State the components of money supply. *(CBSE 2018)*

Ans. The components of money supply are as follows:

(i) Currency, paper notes and coins.
(ii) Demand deposits of the people with the commercial banks.

Q 25. Out of gross demand deposits and net demand deposits which is a part of money supply?

Ans. Net demand deposits is a part of money supply.

Q 26. M_1 and M_2 measures are known as narrow money/ broad money.

Ans. M_1 and M_2 measures are known as narrow money.

Q 27. M_3 and M_4 measures are known as narrow money/ broad money.

Ans. M_3 and M_4 measures are known as broad money.

Q 28. State the two components of M_1 measure of money supply. *(CBSE 2018)*

Ans. M_1 = Currency held by the public + Demand deposits with commercial banks + Other deposits with RBI.

Short Answer Type-I Questions

Q 1. State the difference between Narrow Money and Broad Money.

Ans. Difference between Narrow Money and Broad Money are as follows:

S.No.	Basis of Difference	Narrow Money	Broad Money
(i)	Meaning	It is defined as currency notes, coins and demand deposits of banks.	It is defined as currency, coins, demand deposits, time deposits in banks as well as in post offices.
(ii)	Base	It is based upon medium of exchange payment as function of money.	It is based upon store of value as function of money.
(iii)	Other name	M_1, and M_2 are known as narrow money.	M_3, and M_4 are known as broad money.

Q 2. Give the meaning of: (i) Barter System (ii) Money and (iii) Money Supply.

Ans. (i) **Barter System:** It refers to a system of economy in which goods are exchange for goods without the use of money. It is also known as C—C Economy.

(ii) **Money:** It is a matter of four functions—a medium, a measure, a standard and a store.

(iii) **Money Supply:** It refers to the total stock of money held by the public at a particular point of time.

Q 3. Explain the significance of medium of exchange function of money.

Ans. One of the primary functions of money is as a medium of exchange as it can be used for any or all transactions wherein goods or services are purchased or sold. Therefore, one can buy or sell products in exchange for money.

Q 4. What is money supply? What are its components?

Ans. Money supply refers to the total stock of money held by the public at a particular point of time.

The components of money supply are as follows:

(i) Currency and coins.

(ii) Net demand deposits of commercial banks.

(iii) Other deposits with RBI such as deposits of foreign banks and government, world bank, IMF, etc.

Q 5. How is money supply measured by RBI in India?

OR

Elaborate the measures of money supply.

Ans. Since 1977, there are four measures of money supply, which are as follows:

(i) $M_1 = C + OD + DD$

where,

C = Currency held by the public.

OD = Other Deposits with RBI.

DD = Demand Deposits with the banks.

(ii) $M_2 = M_1$ + Post Office Saving Banks Deposits.

where, $M_1 = C + OD + DD$

(iii) $M_3 = M_1$ + Time Deposits with the Banks

where, $M_1 = C + OD + DD$

(iv) $M_4 = M_3$ + Total deposits with the post office savings (Excluding National Saving Certificates.)

where, $M_3 = M_1$ + Time Deposits with the Banks.

TiP

Differentiate between components and understand that money supply is classified into M_1, M_2, M_3 and M_4 by RBI based on liquidity.

COMMON ERROR

Generally students get confused and explain measures of money supply instead of its components.

Q 6. "Money supply includes public and excludes RBI, Commercial Banks and Government of India." Why?

Ans. Money supply includes money held with the public because public means individuals and firms. They are the users of money. On the other hand, money supply excludes RBI, Commercial Banks and Government because they are the producers or creators of money and the cash balance held by them do not come into actual circulation in the country.

Q 7. In the present era of growth of monetary economy, near money assets have came into existence. What you understand by near money assets? Give examples.

Ans. Near money assets refers to those financial assets which perform some of the functions of money like general acceptability, store of value etc., however it is not as liquid as cash. For example, cheques, credit cards. Due to growing credit transactions, importance of these near money assets have increased.

Q 8. Currency notes do not carry as much value as denominated on it . Explain.

Ans. The face value of currency notes is more than the materialistic value but still these are generally accepted due to the faith of people in the monetary system of the country.

Short Answer Type-II Questions

Q 1. Explain the evolution of money.

Ans. In olden days, when the wants of people were limited, barter system was prevalent in the economy.

However, when wants of people become multiple then barter system of exchange was proved to be ineffective and had many drawbacks or limitations. Then to overcome the problems faced in barter system, man then invented money.

Money has evolved through different stages according to industrialisation. From time-to-time money was evolved as follows:

(i) **Commodity Money:** In this form of exchange, salt, rice, wheat, furs, skins, weapons, etc. were commonly used as money.

(ii) **Metallic Money:** In this form of exchange, metal coins of gold, silver, copper, etc. were commonly used as money.

(iii) **Paper Money:** In this form of exchange, paper notes were invented and commonly used as money. e.g., representative paper money, convertible paper money and inconvertible paper money.

(iv) **Credit Money:** In this form of exchange, cheques were commonly used as money.

(v) **Plastic Money:** In this form of exchange, debit cards and credit cards are used as money. It is the latest type of money.

Q 2. Introduction of money has separated the acts of 'sale' and 'purchase'. How?

Ans. Under the Barter system of exchange, acts of sale and purchase of an individual were to occur at the same point of time. To buy a thing, an individual must at the same time sell something needed by the other person. Also, sale and purchase by an individual must be of equal value. But with the introduction of money, an individual can buy a commodity or service with money without selling anything at the same time.

Thus, with the introduction of money, acts of sale and purchase are separated.

Q 3. "Printing of new currency may not be a matter of concern always." Do you agree? Why?

Ans. Yes, it is correct that printing of currency is not always a matter of concern as new currency might by printed on the virtue of replacing older ones. Also with the growth of an economy, demand increases hence new currency are printed in accordance with the growth of the economy.

Q 4. Central Bank has the sole authority of printing currency notes. What are its advantages?

Ans. A Central Bank has the sole authority of printing currency notes, it has certain advantages which are as follows:

(i) Uniformity in the currency.

(ii) Control over the money supply.

(iii) Faith in Banking system.

(iv) Maintenance of reserves.

Numerical Type Questions

Q 1. If M_1 = ₹100 crore and net demand deposits with the commercial banks are ₹22 crore and other deposits with RBI are ₹18 crore. Calculate currency with the public.

Sol. We know that, $M_1 = C + OD + DD$

On putting the given values, we get

$$100 = C + 18 + 22$$
$$100 = C + 40$$
$$100 - 40 = C$$

Currency with the public = ₹60 crore

Q 2. From the given information:

(i) M_1 = ₹ 1,000 crore (ii) M_2 = ₹ 1,700 crore

(iii) M_3 = ₹ 2,300 crore (iv) M_4 = ₹ 3,000 crore

Identify the value of most liquid and least liquid measure of money supply. Also, tell the value of most commodity used measure of money supply.

Sol. (i) M_1 measure is the most liquid as it can be easily converted into cash. Therefore, M_1 = ₹1,000 crore (most liquid).

(ii) M_4 measure is the least liquid because it cannot be easily converted into cash. Therefore, M_4 = ₹ 3,000 crore (least liquid).

(iii) M_3 is the most commonly used measure of money supply. Therefore, M_3 = ₹2,300 crore (most commonly).

Q 3. Calculate the value of M_1 from the following data:

S. No.	Particulars	(₹ in crore)
(i)	Net time deposits with commercial banks	20
(ii)	M_2	180
(iii)	Post office saving bank deposits	80
(iv)	Currency with the public	40

Sol. We know that, $M_2 = M_1$ + Post office saving bank deposits

Therefore, $180 = M_1 + 80$

$M_1 = (180 - 80) =$ ₹100 crore

Q 4. Calculate M_1, M_2, M_3 and M_4 measures of money supply from the following data:

S. No.	Particulars	(₹ in crore)
(i)	Post Office Saving Bank Deposits (POSBD)	50
(ii)	Currency and Coins with Public (CC)	260
(iii)	Total Post Office Deposits (TPOD)	140
(iv)	Demand Deposits of Commercial Banks (DD)	160
(v)	Net Time Deposits with Commercial Banks (TDB)	100
(vi)	Other Deposits of RBI (OD)	240

Sol. (i) $M_1 = C + OD + DD = 260 + 240 + 160 =$ ₹660 crore

(ii) $M_2 = M_1 + POSBD = 660 + 50 =$ ₹710 crore

(iii) $M_3 = M_1 + TDB = 660 + 100 =$ ₹760 crore

(iv) $M_4 = M_3 + TPOD$ Excluding NSCs

$= 760 + 140 =$ ₹900 crore

Banking

- **Commercial Bank:** Commercial bank is a financial institution which conducts banking business. It accepts deposits from public and gives loans to household, firms and the government. The main aim of commercial bank is to earn profit.

Knowledge BOOSTER

If an institution does not receive deposits but only lends money. It will not be a bank it will be a money lending institution, e.g., LIC, UTI, etc.

- **Credit Creation (Money creation) by Commercial Banks:** Commercial banks create credit in the form of demand deposits. The demand deposit of commercial banks are many times more than their cash reserve.

The process of credit creation of commercial banks is based upon the following assumptions:

- That all depositors would not withdraw their total deposit at a point of time.
- That there is a constant flow of new deposit into the banks.

Therefore, to meet daily demand for withdrawal of cash it is sufficient for banks to keep only a fraction of deposits as cash reserve.

The process of credit creation by commercial banks has been explained as with the help of following example:

Suppose Mr. A deposit ₹100 in PNB.

Now, PNB does not keep the entire deposit with itself rather PNB will give ₹80 as loan and keeps a ₹20 as reserves.

PNB lends ₹80 to Mr. B but it will not give him a cheque or cash instead it opens an account of Mr. B and credits ₹80 in his account. Now, Mr. B can withdraw ₹80 as and when required.

Again, when PNB opens a loan account it becomes a secondary deposit with the bank. So, PNB can further lend ₹64 and keep ₹16 as reserve.

Again, PNB can lend ₹51.2 to another borrower and keeps 20% as reserves. This process continues until the last deposit near zero.

Thus, from above example, we conclude that with initial deposit of ₹100. PNB is able to create credit of ₹500 which is 5 times the initial deposits.

$$\text{Credit Creation} = \text{Initial Deposits} \times \frac{1}{\text{LRR}} = 100 \times \frac{1}{20\%}$$

$$= 100 \times \frac{100}{20} = 100 \times 5 = ₹500$$

TIP

The numerical illustration should be able to explain the concept of credit creation.

- **Credit Multiplier:** Ratio between initial deposits and legal reserves of the commercial banks is called credit-multiplier. It is also estimated as the reciprocal of Legal Reserve Ratio (LRR).

Thus, Credit Multiplier = 1/LLR

Knowledge BOOSTER

The banks give loans against deposits received. However, the banks are required to keep a certain minimum fraction of their deposits as reserves. This fraction is referred to as Legal Reserve Ratio *(LRR).*

- **Central Bank:** Central Bank is an apex body that controls, operates, regulates and directs the entire banking and monetary structure of the country. Reserve Bank of India (RBI) is the Central Bank of India. RBI was established on 1st April, 1935 under the Reserve Bank of India Act passed in 1934.
- **Functions of Central Bank**
  - **Issues Currency Notes:** Central Bank has the sole authority for issue of currency in the country. In India, RBI has the sole right of issuing paper currency notes. One rupee note and all coins are issued by RBI on behalf of Government of India.

All currency issued by RBI is its monetary liability. This means that Central Bank is obliged to back the currency with assets of equal value in order to upkeep the public's confidence in paper currency.

RBI follows minimum reserve system for the issue of notes.

  - **Banker to the Government:** Central Bank acts as a banker, agent and financial advisor to the government. As a banker, Central Bank carries out all banking business of the government. For example, RBI maintains current account for keeping cash balances of the government. RBI also gives loans and advances to government for temporary period.

As an agent, Central Bank buys and sells government securities in the open market.

As a financial advisor, RBI advises government from time-to-time on economic, financial and monetary matters.

- **Banker's Bank and Supervisor:** Central Bank (RBI) acts as a banker of all commercial banks in the country. Also, Central Bank acts as a supervisor of all commercial banks in the country.

As banker's bank, Central Bank has almost the same relation with other banks in the country as commercial banks has with its customers. Central Bank (RBI) accept deposits from commercial bank and offers them loan on the basis of LRR.

Central Bank gives loans to commercial banks for short period and rate of interest is called 'repo rate'.

Central Bank accepts deposits from commercial banks and pays interest to them and this rate of interest is called 'Reserve Repo Rate'. It also acts as a 'Clearing House' for all commercial banks.

  - **Custodian of Foreign Exchange Reserve:** Central Bank is the custodian of nation's foreign exchange reserve. All currencies of different countries are kept with the Central Bank (RBI). Central Bank (RBI) determines foreign exchange rate for the domestic currency (Rupee) in the international money market.

Central Bank (RBI) is responsible for maintaining stability of exchange rate of Indian Rupee in the international money market. For this, RBI exercises managed floating exchange rate system. Managed floating means sale and purchase of foreign exchange with a view to achieve stability of exchange rate.

- **Clearing House Function :** Central Bank (RBI) performs the function of clearing house. This function refers to the 'settlement of account' function.

  Central Bank (RBI) holds the cash reserves of all commercial banks so it becomes easy for the Central Bank to act as their clearing house.

  Central Bank can easily settle claims of various commercial banks against each other, by making debit and credit entries in their accounts.

  For example, 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. Now, both Bank A and Bank B have their accounts with the RBI. The cheques of both the banks are cleared through their account with the RBI. This is how acts as a clearing house.

Difference Between Central Bank and Commercial Bank

S.No.	Basis of Difference	Central Bank	Commercial Bank
(i)	Ownership	Central Bank is generally owned and governed by the government.	Commercial bank is under both private and public ownership.
(ii)	Role in Credit	It controls the credit.	Commercial bank create the credit.
(iii)	Number of Banks	There is only one Central Bank in a country.	There are many commercial banks in a country.
(iv)	Issue of Currency Notes	Central Bank has monopoly of issuing currency notes.	It cannot issue currency notes.
(v)	Dealings with Public	Central Bank does not deal with public rather, it deals with commercial bank.	It deals with public.

- **Central Bank Controls Credit through Bank Rate:** It is the rate of interest at which Central Bank lends funds (money) to commercial banks.
  - **Increase in Bank Rate:** During excess demand or inflationary gap, Central Bank increases the bank rate. Borrowing becomes costly and commercial banks borrow less from Central Bank. Increase in the bank rate forces commercial banks to increase their lending rates to the firms and general public. This makes credit costlier. As a result, borrowers borrow less from commercial banks for consumption and investment. This leads to fall in demand and level of inflation.
  - **Decrease in Bank Rate:** During deficient demand or deflationary gap, Central Bank decreases or lowers the bank rate. It is cheap to borrow from the Central Bank on the part of commercial banks. Commercial banks also decrease their lending rates. Businessmen and public are encouraged to borrow more. Investment is encouraged. Output, employment, income and aggregate demand starts rising. This reduces deflationary gap.
- **Central Bank Controls Credit through CRR:** CRR is the minimum percentage of banks' total deposits which they keep with the Central Bank as reserves.
  - **Increase in CRR:** During excess demand or inflation in the economy, Central Bank increases the cash reserve ratio. An increase in the CRR, decreases the credit giving capacity of the commercial banks. This will decrease the volume of investment and the level of aggregate demand will decrease in the economy.
  - **Decrease in CRR:** During deficient demand or deflation in the economy, Central Bank decreases the cash reserve ratio. A decrease in the CRR, increases the credit giving capacity of the commercial banks. This will increase the volume of investment and the level of aggregate demand will increase in the economy.
- **Central Bank Controls Credit through SLR:** SLR is the minimum percentage of banks' total deposits which they keep with themselves in the form of liquid assets like gold.
  - **Increase in SLR:** During excess demand or inflation in the economy, Central Bank increases the SLR. An increase in the SLR, decreases the credit giving capacity of the commercial banks. This will decrease the volume of investment and the level of aggregate demand will decrease in the economy.
  - **Decrease in SLR:** During deficient demand or deflation in the economy, Central Bank decreases the SLR. A decrease in the SLR, increases the credit giving capacity of the commercial banks. This will increase the volume of investment and the level of aggregate demand will increase in the economy.
- **Central Bank Controls Credit through Repo Rate and Reverse Repo Rate:** Repo rate is the rate of interest at which Central Bank lends money to commercial banks for short period. Raising repo rate makes borrowing by Commercial Banks costlier. So, these banks are forced to raise their lending rates, since, borrowing becomes costly for people, they borrow less. Banks, therefore, create less credit.
- **Central Bank Control Credit through Open Market Operation:** Open market operations refers to the sale and purchase of government securities and bonds by the Central Bank in the open market.
  - **Sale of Securities:** During excess demand or inflation in the economy, Central Bank sells government securities in the open market and specially to the commercial banks. This decreases the credit giving capacity of the commercial banks. This will decrease the volume of investment and the level of aggregate demand will decrease in the economy.
  - **Purchase of Securities:** During deficient demand or deflation in the economy, Central Bank purchases government securities from the open market and specially from the commercial banks. This increases the credit giving capacity of the commercial banks. This will increase the volume of investment and the level of aggregate demand will increase in the economy.
- **Central Bank Control Credit through Margin Requirement:** It refers to their limit which is deducted from the value of security provided by the borrower before granting them loans. Say, if margin requirement is 20%, then borrowers can get only up to 80% of loan of the value of security that borrower has provided. Increase in margin requirement leads to fall in money supply and *vice-versa*.

Practice Exercise

Multiple Choice Questions

Q 1. **Credit creation by commercial banks is determined by:** *(CBSE 2018)*

a. CRR
b. SLR
c. Initial deposit
d. All of these

Q 2. **Under SLR, commercial banks are required to keep a fraction of .... in the form of liquid assets.** *(CBSE 2020)*

a. total deposits
b. term deposits
c. Both a. and b.
d. current deposits

Q 3. **Which of the following agency is responsible for issuing ₹1 currency note in India?**

a. RBI
b. NITI Aayog
c. Ministry of Finance
d. Ministry of Commerce

Q 4. **Demand deposits include:** *(CBSE 2017)*

a. saving account deposits and fixed deposits
b. saving account deposits and current account deposits
c. current account deposits and fixed deposits
d. All of the above

Q 5. **Ms. Sakshi, an economics teacher, was explaining the concept of 'minimum' percentage of the total deposits to be kept by any commercial bank with the Central Bank of the country, as per norms and statute prevailing in the country.**

From the following, choose the correct alternative which specifies towards the concept explained by her? *(CBSE SQP 2021, Term-1)*

a. Cash Reserve Ratio
b. Repo Rate
c. Bank Rate
d. Statutory Liquidity Ratio

Q 6. **The ratio of total deposits that a commercial bank has to keep with Reserve Bank of India is called:** *(CBSE 2017)*

a. SLR
b. CRR
c. LRR
d. Deposit ratio

Q 7. **Which of the following is not the function of Central Bank?** *(CBSE 2018)*

a. Banking facilities to government
b. Lending to government
c. Banking facilities to public
d. Lending to commercial bank

Q 8. **In order to encourage investment in the economy, the central bank may:** *(CBSE 2019)*

a. reduce CRR
b. increase CRR
c. sell government securities in the open market
d. increase in bank rate

Q 9. **Find the missing figures and choose the correct alternative.**

Round	Deposits	Loans (80%)	Reserve Ratio (20%)
I	1,000	800	200
II	800	...(i)...	160
...	...	...	...
...	...	...	...
Total	...(ii)...	...(iii)...	...(iv)...

Alternatives: *(CBSE SQP 2023-24)*

a. 640, 1,000, 4,000, 5,000
b. 960, 5,000, 4,000, 1,000
c. 640, 4,000, 1,000, 5,000
d. 640, 5,000, 4,000, 1,000

Q 10. **Find the missing figures and choose the correct alternative.**

Round	Deposits	Loans (70%)	Reserve Ratio (30%)
I	1,000	700	300
II	700	...(i)...	210
Total	...(ii)...	...(iii)...	...(iv)...

Alternatives:

a. 490, 2,331, 3,330, 999
b. 999, 490, 2,331, 3,330
c. 490, 3,330, 2,331, 999
d. 3,330, 2,331, 999, 490

Q 11. **To reduce credit availability in the economy, the Central Bank may ....** *(CBSE SQP 2021, Term-1)*

a. buy securities in the open market
b. sell securities in the open market
c. reduce reserve ratio
d. reduce repo rate

Q 12. **Find the missing figures and choose the correct alternative:**

Round	Deposits	Loans (80%)	Reserve Ratio (20%)
I	2,000	1,600	400
II	1,600	(i)...	320
...	...	...	...
...	...	...	...
Total	(ii)...	(iii)...	(iv)...

Alternatives:

a. 1,820, 10,000, 8,000, 2,000
b. 1,280, 10,000, 8,000, 2,000
c. 1,280, 8,000, 10,000, 2,000
d. 1,280, 2,000, 8,000, 10,000

Q 13. Repo rate is the rate at which: *(CBSE 2017)*

a. commercial banks purchase government securities from central bank
b. commercial banks can take loans from the central bank
c. commercial banks can keep their deposits with central bank
d. short-term loans are given by commercial banks

Q 14. Find the missing figures and choose the correct alternative:

Round	Deposits	Loans (75%)	Reserve Ratio (25%)
I	2,000	1,500	500
II	1,500	(i)...	315
	...	...	...
	...	...	...
Total	...(ii)...	...(iii)...	...(iv)...

Alternatives:

a. 1,125, 8,000, 6,000, 2,000
b. 1,215, 8,000, 6,000, 2,000
c. 8,000, 6,000, 2,000, 1,125
d. 1,512, 8,000, 6,000, 2,000

Q 15. Find the missing figures and choose the correct alternative.

Round	Deposits	Loans (80%)	Reserve Ratio (20%)
I	3,000	2,400	600
II	2,400	(i)...	480
	...	...	...
	...	...	...
Total	...(ii)...	...(iii)...	...(iv)...

Alternatives:

a. 1,290, 15,000, 3,000, 12,000
b. 1,920, 12,000, 15,000, 3,000
c. 1,920, 15,000, 12,000, 3,000
d. 1,029, 15,000, 12,000, 3,000

Q 16. From the following functions of the Central Bank, identify the odd one out: *(CBSE 2021, Term-1)*

Functions of Central Bank

(A) Currency Authority
(B) Banker to the Public
(C) Banker's Bank
(D) Controller of Money Supply

Alternatives:

a. A b. B
c. C d. D

Q 17. If LRR is 20%, what is the money multiplier?

a. 2 b. 10 c. 5 d. 4

Q 18. In the context of commercial bank, which of the following alternatives is correct? *(CBSE 2021, Term-1)*

(i) Deposits are liabilities of banks.
(ii) Commercial banks are creator of money.
(iii) Commercial banks accept deposits of the general public.
(iv) Accept deposits of World Bank for Agriculture and Rural developments.

Alternatives:

a. (i) and (ii) b. (ii) and (iii)
c. (i), (ii) and (iii) d. (i) and (iv)

Statement Based Questions

Q 19. Read the following statements carefully:

Statement I: Reserve Bank of India keeps a certain percentage of deposit as reserve to avoid 'too much lending to public'.

Statement II: The reserve deposit ratio acts as a deterrence to the amount of credit created by the commercial banks. *(CBSE 2021, Term-1)*

In the light of the given statements, choose the correct alternative from the following:

a. Statement I is true, but statement II is false.
b. Statement II is true, but statement I is false.
c. Both statements are true.
d. Both statements are false.

Q 20. Read the following statements carefully:

Statement I: Currency held by public is a monetary liability of Central Bank.

Statement II: Central Bank control credit, whereas commercial banks create credit with the currency held by public.

In the light of the given statements, choose the correct alternative from the following:

a. Statement I is true, but statement II is false.
b. Statement II is true, but statement I is false.
c. Both statements are true.
d. Both statements are false.

Fill in the Blank Type Questions

Q 21. .... is an institution that accept deposits for lending purposes. (Fill up the blank with correct alternative) *(CBSE SQP 2022-23)*

a. Commercial Banks
b. Life Insurance Corporation
c. Reserve Bank of India
d. Government of India

Q 22. .... formulates the monetary policy in the economy. (Fill up the blank with correct alternative) *(CBSE 2023)*

a. Commercial Banks
b. International Monetary Fund
c. Central Bank
d. Central Government

Q 23. In the Indian economy, ... are issued by the Reserve Bank of India and acts as legal tender money. *(CBSE 2023)*

(i) Coins of all denomination
(ii) Currency notes of various denominations, except one rupee note
(iii) Demand deposits

Alternatives:

a. Only (i) b. Only (ii)
c. Only (iii) d. (i) and (ii)

Q 24. Statutory liquidity ratio states that banks are required to keep minimum percentage of their total deposits in the form of ....

(Choose the correct alternative to fill up the blank)

a. liquid assets
b. currency
c. gold
d. Both a. and c.

Q 25. Primary Deposits + Secondary Deposits = ... Deposits.

(Choose the correct alternative to fill up the blank)

a. Fiscal b. Demand
c. Monetary d. None of these

Q 26. .... is the difference between the rate of interest charged by bank and the rate of interest paid by banks.

(Choose the correct alternative to fill up the blank)

a. Margin b. Cash reserve ratio
c. Spread d. None of these

Q 27. .... requirements refers to the difference between the value of asset offered as security and the value of loan granted.

(Choose the correct alternative to fill up the blank)

a. Margin b. Primary
c. Secondary d. Qualitative

Q 28. .... deposits are those deposits which arise on account of loans by banks to the people.

(Choose the correct alternative to fill up the blank)

a. Margin b. Primary
c. Secondary d. Qualitative

Q 29. Repo rate is .... to increase the supply of money in the economy.

(Choose the correct alternative to fill up the blank)

a. increased b. decreased
c. equal d. None of these

True/False Type Questions

Q 30. When CRR decreases, credit giving capacity of commercial banks also decreases.

Q 31. When RBI sells government securities to commercial banks, the flow of credit decreases in the economy.

Q 32. In India, CRR and SLR are fixed by NITI Aayog.

Q 33. Demand deposits are equal to secondary deposits with the commercial banks.

Q 34. CRR and SLR are one and the same thing.

Q 35. Commercial banks are contributors and not controllers of money supply.

Q 36. Central Bank issues currency on the basis of demand deposits.

Q 37. Bank rate and market rate of interest are positively related to each other.

Q 38. Primary deposits are always greater than secondary deposits of commercial banks.

Q 39. Credit Creation $= \frac{1}{LRR}$.

Match the Column Type Questions

Q 40. From the following statements given in Column I and Column II, choose the correct pair of statements:

Column I	Column II
A. Rate charged by RBI from needy banks	1. Rationing of credit
B. Minimum percentage of deposits kept with RBI	2. Spread
C. Difference between rate charged and rate paid	3. CRR
D. Fixation of credit quotas	4. Repo rate

	A	B	C	D
a.	4	3	2	1
b.	3	2	4	1
c.	1	2	4	3
d.	3	2	1	4

Q 41. From the following statements given in Column I and Column II, choose the correct pair of statements:

Column I	Column II
A. One rupee note	1. Reciprocal of LRR
B. Credit multiplier	2. Aim is to earn profit
C. Commercial bank	3. Ministry of Finance
D. Open market operation	4. Sale and purchase of government securities by RBI in the open market

	A	B	C	D
a.	1	4	3	2
b.	3	2	1	4
c.	3	1	2	4
d.	4	1	2	3

Q 42. From the following statements given in Column I and Column II, choose the correct pair of statements:

Column I	Column II
A. Bank rate	1. Reserve Bank of India
B. Banker to government	2. Discount rate
C. Jan-Dhan Yojana	3. Credit multiplier
D. Money multiplier	4. Credit creation

	A	B	C	D		A	B	C	D
a.	4	3	1	2	b.	2	1	4	3
c.	2	3	1	4	d.	3	2	4	1

Q 43. From the following statements given in Column I and Column II, choose the correct pair of statements:

Column I	Column II
A. SBI, ICICI, PNB	1. Moral Suasion
B. Reserve Bank of India	2. Decreases credit giving capacity of commercial banks
C. Increase in CRR	3. Commercial banks
D. Appeal by RBI to Commercial Banks	4. Apex bank

	A	B	C	D		A	B	C	D
a.	1	3	4	2	b.	2	4	3	1
c.	4	1	3	2	d.	3	4	2	1

Q 44. From the following statements given in Column I and Column II, choose the correct pair of statements:

Column I	Column II
A. RBI keeps accounts of government	1. Clearing house function
B. RBI keeps cash reserve of commercial banks	2. Lender of the last resort
C. RBI helps commercial banks during financial crisis	3. Bankers bank
D. RBI settles claims of various banks	4. Banker to government

	A	B	C	D		A	B	C	D
a.	3	2	1	4	b.	2	4	1	3
c.	4	3	2	1	d.	1	3	4	2

Assertion & Reason Type Questions

Directions (Q.Nos. 45-54) : *There are two statements marked as Assertion (A) and Reason (R). Read the statements and choose the appropriate option from the options given below:*

a. Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).

b. Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).

c. Assertion (A) is true, but Reason (R) is false.

d. Assertion (A) is false, but Reason (R) is true.

Q 45. Assertion (A): RBI is the lender of the last resort.

Reason (R): Because when commercial banks fail to get money from anywhere they approach the Central Bank and gives financial help to them.

Q 46. Assertion (A): RBI decreases the cash reserve ratio to increase the flow of credit in the economy.

Reason (R): Because it decreases the credit giving capacity of commercial banks.

Q 47. Assertion (A): NABARD is the apex bank.

Reason (R): RBI does not deal directly with the public.

Q 48. Assertion (A): RBI is the banker of all commercial bank of the country.

Reason (R): Holds a part of cash reserves of banks.

Q 49. Assertion (A): Credit multiplier is inversely related to legal reserve ratio.

Reason (R): Greater the LRR, lower the credit multiplier.

Q 50. Assertion (A): Commercial banks create credit in the economy.

Reason (R): Commercial banks create credit on the basis of demand deposits.

Q 51. Assertion (A): Qualitative measures regulate the direction of credit.

Reason (R): It includes moral suasion, rationing of credit, margin requirement, etc.

Q 52. Assertion (A): Quantitative measures regulates the volume of credit.

Reason (R): It includes bank rate, open market operation, CRR, SLR, etc.

Q 53. Assertion (A): CRR and SLR are one and the same thing.

Reason (R): In CRR, banks keep reserve with RBI whereas in SLR banks keep reserve with themselves in the form of liquid assets like gold.

Q 54. Assertion (A): Increase in margin requirement decreases the flow of credit in the economy.

Reason (R): Increase in margin requirements increases the credit giving capacity of commercial banks.

Answers

1. (d) All of these
2. (a) total deposits
3. (c) Ministry of Finance
4. (b) saving account deposits and current account deposits
5. (a) Cash Reserve Ratio
6. (b) CRR
7. (c) Banking facilities to public
8. (a) reduce CRR
9. (d) 640, 5,000, 4,000, 1,000

10. (c) 490, 3,330, 2,331, 999
11. (b) sell securities in the open market
12. (b) 1,280, 10,000, 8,000, 2,000
13. (b) commercial banks can take loans from the central bank
14. (a) 1,125, 8,000, 6,000, 2,000
15. (c) 1,920, 15,000, 12,000, 3,000
16. (b) B
17. (c) 5
18. (b) (ii) and (iii)
19. (c) Both statements are true.
20. (c) Both statements are true.
21. (a) Commercial Banks
22. (c) Central Banks
23. (b) Only (ii)
24. (d) Both a. and c.
25. (b) demand
26. (c) Spread
27. (a) Margin
28. (c) Secondary
29. (b) decreased
30. False: When CRR decreases, credit giving capacity of commercial banks increases.
31. True: Because this will decrease the credit giving capacity of commercial banks.
32. False: In India, CRR and SLR are fixed by RBI.
33. False: Demand Deposits = Primary Deposits + Secondary Deposits
34. False: CRR and SLR are two different ratios. In CRR, commercial banks keep reserve with RBI. On the other hand, in SLR they keep reserves with themselves in the form of liquid asset like gold.
35. True: Because money supply is controlled by RBI.
36. False: Central Bank issues currency on the basis of minimum reserve system.
37. True: When bank rate increases, market rate of interest also increases in the economy.
38. False: Secondary deposits are many times more than the primary deposits of commercial banks because primary deposits are cash deposits only.
39. False: Credit Creation = Initial Deposits $\times \frac{1}{LRR}$

and Credit Multiplier $= \frac{1}{LRR}$

	A	B	C	D
40.	(a) 4	3	2	1
41.	(c) 3	1	2	4
42.	(b) 2	1	4	3
43.	(d) 3	4	2	1
44.	(c) 4	3	2	1

45. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
46. (c) Assertion (A) is true, but Reason (R) is false.
47. (d) Assertion (A) is false, but Reason (R) is true.
48. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
49. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
50. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
51. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
52. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
53. (d) Assertion (A) is false, but Reason (R) is true.
54. (c) Assertion (A) is true, but Reason (R) is false.

Case Study Based Questions

Case Study 1

Read the extract given below and answer the questions on the basis of the same:

The Central Bank of India (Reserve Bank of India) is the apex institution that controls the entire financial market. It's one of the major function is to maintain the reserve of foreign exchange. Also, it intervenes in the foreign exchange market to stabilise the excessive fluctuations in the foreign exchange rate. If the economy is moving slowly or going backward there are steps that central bank can take to boost the economy. These steps whether they are asset purchases or printing more money, all involve injecting more cash into the economy. The simple supply and demand economic projection occur and currency will devalue. When the opposite occurs, and the economy is growing, the central bank will use various methods to keep that growth steady and in-line with other economic factors such as wages and prices.

Whatever the central bank does in fact don't do, will affect the currency of that country. Sometimes, it is within the central bank's interest to purposefully affect the value of a currency. For example, if the economy is heavily reliant on exports and their currency value becomes too high, 'importers of that country's commodities will seek cheaper supply; hence directly affecting the economy.

Q 1. Which of the following tools are used by the Central Bank to control the flow of money in domestic economy?

a. Fiscal tools
b. Quantitative monetary tools
c. Qualitative monetary tools
d. Both b. and c.

Q 2. Money supply is a .... concept.

a. flow
b. stock
c. ratio of stock and flow
d. None of the above

Q 3. How does RBI promote growth process of country?

a. By controlling price level in country
b. By changing various interest rates and money supply
c. By increasing supply of products
d. All of the above

Q 4. Why does RBI fix the inflation target?

a. To make growth process fast
b. To make coordination with government
c. To manage exchange rate
d. To stabilise economy

Answers

1. (d) **2.** (b) **3.** (d) **4.** (a)

Case Study 2

Read the extract given below and answer the questions on the basis of the same:

In India, the currency is issued by RBI on the basis of minimum reserve system. For this, RBI maintains a minimum reserve of ₹200 crore. This minimum reserve consists of gold and foreign securities. Out of this ₹200 crore, the value of gold must be equal to ₹115 crore. RBI issues currency notes in the country. However, one rupee note and all coins are issued by the Ministry of Finance (GoI). RBI issues them on behalf of government.

Q 1. India follows .... reserve system.

Q 2. .... is responsible for issuing one rupee note.

Q 3. Minimum reserve consists of .... and ....

Q 4. .... has the monopoly right of issuing currency notes in the country.

Answers

1. minimum
2. Ministry of Finance
3. gold, foreign securities
4. Reserve Bank of India

Case Study 3

Read the extract given below and answer the questions on the basis of the same:

The Reserve Bank of India (RBI) is India's Central Bank, also known as the banker's bank. The RBI controls the monetary and other banking policies of the Indian government. The RBI was established on 1st April, 1935, in accordance with the Reserve Bank of India Act, 1934. The role of RBI has undergone a significant change after the introduction of the new economic policy in 1991. The RBI is India's central bank and regulatory body under the jurisdiction of the Minister of Finance, the RBI is responsible for the issue and supply of the Indian rupee and the regulation of the Indian Banking System. It also manages the country's main payment systems and works to promote its economic development.

On 8th November 2016, the Government of India announced the denomination of all ₹500 and ₹1,000 bank notes of the Mahatma Gandhi series on the recommendation of the Reserve Bank of India.

Q 1. Why RBI is said to be banker of the bank.

Ans. Because RBI acts as a bank for all the commercial banks in India. RBI holds their cash reserves, lends them short term funds and provides them the central clearing and remittances facilities.

Q 2. Define demonetisation.

Ans. Demonetisation refers to the process where currency notes of certain denominations are declared no longer as legal tender.

Case Study 4

Read the extract given below and answer the questions on the basis of the same:

Keeping in view the continuing hardships faced by banks in terms of social distancing of staff and consequent strains on reporting requirements, the Reserve Bank of India has extended the relaxation of the minimum daily maintenance of the CRR of 80% for up to 25th September 2020. Currently CRR is 3% and SLR is 18.50%

"As announced in the Statement of Development and Regulatory Policies on 27th March 2020, the minimum daily maintenance on CRR was reduced from 90% of the prescribed CRR to 80% effective the fortnight beginning 28th March 2020 till 26th June 2020, that has now been extended up to 25th September 2020," said the RBI.

Q 1. What do you mean by SLR?

Ans. SLR implies certain percentage of net total demand and time deposits has to be kept by the bank with themselves.

Q 2. What will lead to decrease in CRR?

Ans. Decrease in CRR will lead to rise in aggregate demand in the economy.

Case Study 5

Read the extract given below and answer the questions on the basis of the same:

On 30th September 2022, the Reserve Bank of India (RBI) raised Repo Rate for the fourth time in a row. The Monetary Policy Committee (MPC) decided to raise the policy rate by 50 basis points (1 basis point = $\frac{1}{100}$th of a percent). After this announcement, the new repo rate stands at 5.9%, while the reverse repo rate continues to stand at 3.35%.

Commercial banks borrow money from the Central Bank, when there is a shortage of funds. With the surge in the repo rate, borrowings by general public will become costlier. This is because, as RBI hikes its repo rate, it becomes costly for the banks to borrow short-term funds from the Central Bank.

As a result, the banks hike the rates at which customers borrow money from them to compensate for the hike in the repo rate. This happens because banks offer loans to retail consumers at an interest rate which is generally, directly proportional to the repo rate.

The increase of 0.50 percent in repo rate will lead to a higher interest rates on loans for borrowers, implying that the Equated Monthly Instalments (EMIs) for repaying the existing loans will also increase.

Source: https://www.businessstandard.com/article/economicpolicy/rbi-monetary-policy-repo-rate-up-by-50bps-here-s-how-it-will-impact-you-122093000267 (Edited). *(CBSE 2023)*

Q 1. Define 'Repo Rate'.

Ans. Repo rate is the interest rate at which the Central Bank of a country lends money to commercial banks.

Q 2. Outline the recent change made by the Monetary Policy Committee of Reserve Bank of India in the repo rate.

Ans. The Monetary Policy Committee (MPC) increased the repo rate by 25 basis points or the key rate at which the RBI lends short-term funds to commercial banks, to 6.50% from 6.25%.

Q 3. "Increase in repo rate is an important tool used by Monetary Policy Committee to combat the situation of inflation in the Economy." Justify the given statement.

Ans. In the event of inflation, Central Banks increase repo rate as this acts as a disincentives for banks to borrow from the central bank. This ultimately reduces the money supply in the economy and thus helps in arresting inflation.

Very Short Answer Type Questions

Q 1. What is a bank? *(NCERT)*

Ans. A bank is a financial institution engaged in banking business. It accepts deposits from the public and gives loans to the public in order to earn profit.

Q 2. What is a Central Bank?

Ans. Central Bank is an apex bank which regulates and controls the entire banking system of the economy.

Q 3. What are the two main types of bank?

Ans. The two types of bank are as follows:

(i) Commercial Banks (ii) Central Bank (RBI)

Q 4. What are quantitative measures?

Ans. These are those measures which regulate the total volume of credit.

Q 5. What are qualitative measures?

Ans. These are those measures which regulate the direction of credit.

Q 6. State the formula of credit creation.

Ans. Credit Creation $= \left(\text{Initial Deposits} \times \frac{1}{\text{LRR}}\right)$

Q 7. What is margin requirement?

Ans. It refers to the difference between 'the value of asset offered as security' and the 'value of loan granted'.

Q 8. What is open market operation?

Ans. It refers to the buying and selling of government securities by RBI in the open market.

Q 9. What is moral suasion?

Ans. It refers to the request, appeal, pressure, etc., by RBI to all commercial banks to follow the rules and regulations of RBI.

Q 10. What is Legal Reserve Ratio (LRR)?

Ans. LRR refers to the minimum percentage of banks' total deposit, they keep with RBI as well as with themselves.

Q 11. What is Statutory Liquidity Ratio (SLR)?

Ans. SLR refers to the minimum percentage of banks' total deposits, they keep with themselves in the form of gold and liquid assets.

Q 12. What is Cash Reserve Ratio (CRR)?

Ans. CRR refers to the minimum percentage of banks' total deposits which they keep with the Central Bank.

Q 13. What is reverse repo rate?

Ans. It refers to the rate at which commercial banks keep their surplus funds with the central bank.

Q 14. What is rationing of credit?

Ans. It refers to fixation of credit quotas for different economic activities.

Q 15. What is direct action?

Ans. It refers to the action taken by RBI against those commercial banks who do not follow the rules and regulations of RBI.

Q 16. State the relationship between LRR and credit multiplier.

Ans. There is an inverse relationship between LRR and credit multiplier.

Q 17. What is money multiplier?

OR

What is credit multiplier?

Ans. It is the reciprocal of LRR.

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

Q 18. What is spread?

Ans. It is the difference between the rate of interest charged by bank on loans given to the public and the rate of interest paid by banks on deposits of the public.

Q 19. What is bank rate?

Ans. It refers to the rate at which Central Bank gives long term loans to all commercial banks.

Q 20. What is repo rate?

Ans. It refers to the rate at which Central Bank gives short-term loans to needy commercial banks.

Short Answer Type-I Questions

Q 1. Explain 'Issue of Currency Notes' as a function of Central Bank.

Ans. Central Bank has the sole authority for issue of currency in the country.

In India, RBI has the sole right of issuing paper currency notes.

One rupee note and all coins are issued by RBI on behalf of Government of India.

All currency issued by RBI is its monetary liability. This means that Central Bank is obliged to back the currency with assets of equal value in order to upkeep the publics confidence in paper currency.

RBI follows minimum reserve system for the issue of notes. The main advantage of this function is that it brings uniformity in notes circulation and ensures public faith in the currency system.

Q 2. Explain 'Banker to Government' as a function of Central Bank.

OR

Explain the role of Central Bank as Governments' agent and advisor. *(CBSE 2023)*

Ans. Central Bank acts as a banker, agent and financial advisor to the government.

As a banker, Central Bank carries out all banking business of the government. For example, RBI maintains current account for keeping cash balances of the government. RBI also gives loans and advances to government for temporary period.

As an agent, Central Bank buys and sells government securities in the open market.

As a financial advisor, RBI advises government from time-to-time on economic, financial and monetary matters.

The main advantage of this function is that it helps to bring stability in the economy and helps to overcome inflation and deflation in the economy.

Q 3. Explain 'Banker's Bank' as a function of Central Bank.

OR

Elaborate the 'Banker's Bank and Supervisor' function performed by the Reserve Bank of India. *(CBSE SQP 2023-24)*

Ans. Central Bank (RBI) acts as a banker of all commercial banks in the country. Also, Central Bank acts as a supervisor of all commercial banks in the country.

As banker's bank, Central Bank has almost the same relation with other banks in the country as commercial banks has with its customers. Central Bank (RBI) accept deposits from commercial bank and offers them loan on the basis of LRR.

Central Bank gives loans to commercial banks for short period and rate of interest is called 'repo rate'. Central Bank accepts deposits from commercial banks and pays interest to them and this rate of interest is called 'Reserve Repo Rate'. It also acts as a 'Clearing House' for all commercial banks.

The main advantage of this function is that it helps to have a smooth functioning of entire banking system in the economy.

COMMON ERROR

Several students get confused between Banker to the government and Banker's bank.

Q 4. Explain 'Lender of the Last Resort' as a function of RBI.

Ans. RBI acts as a lender of last resort for all commercial banks of the country. This means that when commercial banks fail to get financial help from anywhere then they approach the Central Bank (RBI).

Central Bank (RBI) gives loans and advances to the needy commercial banks to come out of the financial crisis through discounting of approved securities and bills of exchange.

The main advantage of this function is that no business transaction is restricted due to shortage of funds'. Central Bank (RBI) stands as a guarantor of solvency of commercial banks.

Q 5. Explain clearing house function as a function of RBI.

OR

"Central Bank (RBI) holds the cash reserves of all commercial banks so it becomes easy for the central bank to act as their clearing house".

Do you agree with above statement? Give valid reason in support of your answer.

Ans. Central Bank (RBI) performs the function of clearing house. This function refers to the 'settlement of account' function.

Central Bank (RBI) holds the cash reserves of all commercial banks so it becomes easy for the Central Bank to act as their clearing house.

Central Bank can easily settle claims of various commercial banks against each other, by making debit and credit entries in their accounts.

For example, 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. Now, both Bank A and Bank B have their accounts with the RBI. The cheques of both the banks are cleared through their account with the RBI. This is how RBI acts as a clearing house.

The main advantage of this function is that it avoids transfer of cash between the banks and reduces the requirement of cash.

TiP

Students should learn the function of central Bank as banker's bank and also differentiate it with the central bank's function as Banker to the Government.

Q 6. What do you mean by overdraft facility?

Ans. Commercial banks allow a customer to draw cheques for a sum which is greater than the balance lying in their account. This is known as overdraft facility. This facility is given only in current account deposits.

Short Answer Type-II Questions

Q 1. Distinguish between Demand Deposits and Time Deposits.

Ans. Difference between Demand Deposits and Time Deposits are as follows:

S.No.	Basis of Difference	Demand Deposits	Time Deposits
(i)	Meaning	These are those deposits which are repayable by the bank on demand.	These are those deposits which are repayable after a fixed period of time.
(ii)	Cheque Facility	They are chequeable deposits.	They are non-chequeable deposits.
(iii)	Interest	They do not carry any interest.	They carry interest which varies directly with the period of time.
(iv)	No. of Transactions	The depositor can make any number of transactions for deposits or withdrawal of money.	Depositors generally make only two transactions: (a) Deposit of money in the beginning. (b) Withdrawal of money on maturity.

Q 2. Explain 'Custodian of Foreign Exchange Reserve' as a function of RBI?

Ans. Central Bank is the custodian of nation's foreign exchange reserve. All currencies of different countries are kept with the Central Bank (RBI). Central Bank (RBI) determines foreign exchange rate for the domestic currency (Rupee) in the international money market. Central Bank (RBI) is responsible for maintaining stability of exchange rate of Indian Rupee in the international money market. For this, RBI exercises managed floating exchange rate system. Managed floating means sale and purchase of foreign exchange with a view to achieve stability of exchange rate.

The main advantage of this function is that it helps to maintain foreign exchange rate of Indian Rupee in the international money market.

Q 3. Differentiate between Central Bank and Commercial Bank.

Ans. Difference between Central Bank and Commercial Bank are as follows:

S. No.	Basis of Difference	Central Bank	Commercial Bank
(i)	Ownership	Central Bank is generally owned and governed by the government.	Commercial bank is under both private and public ownership.
(ii)	Role in Credit	It controls the credit.	Commercial bank create the credit.
(iii)	Number of Banks	There is only one Central Bank in a country.	There are many commercial banks in a country.
(iv)	Issue of Currency Notes	Central Bank has monopoly of issuing currency notes.	It cannot issue currency notes.
(v)	Dealings with Public	Central Bank does not deal with public rather, it deals with commercial banks.	It deals with public.

(Any four)

Q 4. Explain how 'Repo Rate' can be helpful in controlling credit creation?

OR

Explain the role of repo rate in reducing money supply.

OR

Define Reverse Repo Rate. Discuss briefly, how this instrument helps in controlling credit creation by commercial banks. *(CBSE 2023)*

OR

"With an objective to reduce inflation, Reserve Bank of India may promote the commercial banks to park their surplus funds with it."
Discuss the rationale behind the step taken by the Reserve Bank of India. *(CBSE SQP 2023-24)*

Ans. Repo rate is rate of interest at which Central bank lends money to commercial banks for short period. Raising repo rate makes borrowing by commercial banks costlier.

So, these banks are forced to raise their lending rates, since, borrowing becomes costly for people, they borrow less. Banks, therefore, create less credit.

OR

Reverse Repo Rate: It refers to the rate at which commercial banks keep their surplus funds with the central bank.

Q 5. 'Reserve Ratio and Credit Creation are inversely related'. Do you agree with the given statement? Justify your answer with suitable numerical example. *(CBSE SQP 2022-23)*

Ans. Yes, there exists an inverse relation between reserve ratio and credit creation in the economy. The reserve ratio is the portion of deposits that commercial banks are required to hold in reserve, while credit creation is the process by which commercial banks create credit by making loans to customers.

The relationship between reserve ratio and credit creation can be obtained by the following example:

We know that:

$$\text{Money Multiplier} = \frac{1}{\text{Reserve Ratio}}$$

Credit Creation = Initial Deposits × Money Multiplier

Assuming that the value of initial deposit is ₹ 10,000 crore.

Reserve Ratio	Money Multiplier	Initial Deposit	Credit Creation (Initial Deposit × Money Multiplier)
10%	$\frac{1}{0.1} = 10$	10,000	1,00,000
25%	$\frac{1}{0.25} = 4$	10,000	40,000

Thus, we can see that an increase in the reserve ratio reduces the credit creation capacity of the commercial banks. This is because higher reserve ratio means that commercial banks have less money available for lending. Therefore, we can conclude that the reserve ratio and credit creation are inversely related.

Q 6. Read the following text carefully, discuss briefly the relevant function of the Central Bank, Indicated:

Recently, Reserve Bank of India (RBI) conducted a statutory inspection for supervisory evaluation against a commercial bank. The commercial bank was imposed with stringent penalties, owing to deficiencies in regulatory compliances.

As per the Central Bank, the inspection revealed non-compliances *vis-a-vis* different directions issued by RBI, on the following fronts:

(i) ATM Card frauds

(ii) Ensuring integrity and quality of data

(iii) Loans to small borrowers *(CBSE SQP 2022-23)*

Ans. The given text indicates the 'supervisory function' of the Central Bank, under which the Reserve Bank of India (RBI) regulates and supervises routine functioning of the commercial banks.

Under this function, the RBI may exercise periodic inspections/audits of commercial banks, filing of reports by commercial banks and other statutory compliances. Central bank may take necessary corrective and punitive actions against the banks owing to deficiencies in regulatory compliances.

Q 7. As per the following news published in 'The Hindu' on 6th August, 2022: 'The Monetary Policy Committee (MPC) of the Reserve Bank of India raised the Repo Rate by 50 basis points.'

Identify and explain the likely cause and consequences behind this type of action taken by the Reserve Bank of India. *(CBSE 2023)*

Ans. The main cause behind the Reserve Bank of India's decision to raise the Repo Rate by 50 basis points is to curb inflationary pressures in the economy. When the economy experiences high inflation, it means that the prices of goods and services are increasing at faster rate than the rate of growth of the economy. In order to control inflation, the Central Bank may increase the interest, which in turn, will reduce the demand for loans and credit and hence, reduce spending and investment.

The consequence of this action by the Reserve Bank of India is that it will make borrowing more expensive for businesses and consumers, which may reduce their spending and investment. This could, in turn lead to a slowdown in economic growth and a decrease in employment opportunities.

Long Answer Type Questions

Q 1. Explain the process of credit creation by commercial banks.

OR

"The process of credit creation by commercial banks comes to an end when the total of required reserves become equal to the initial deposits."

With the help of a numerical example, prove that the given statement is true. *(CBSE 2023)*

Ans. Commercial banks create credit in the form of demand deposits. The demand deposit of commercial banks are many times more than their cash reserve.

The process of credit creation of commercial banks is based upon the following assumptions:

(i) That all depositors would not withdraw their total deposit at a point of time.

(ii) There is a constant flow of new deposit into the banks.

Therefore, to meet daily demand for withdrawal of cash it is sufficient for banks to keep only a fraction of deposits as cash reserve.

The process of credit creation by commercial banks has been explained with the help of following example:

Suppose Mr. A deposit ₹ 100 in PNB.

Now, PNB does not keep the entire deposit with itself rather PNB will give ₹80 as loan and keeps a ₹20 as reserves.

PNB lends ₹80 to Mr. B but it will not give him a cheque or cash instead it opens an account of Mr. B and credits ₹80 in his account. Now, Mr. B can withdraw ₹80 as and when required.

Again, when PNB opens a loan account it becomes a secondary deposit with the bank. So, PNB can further lend ₹64 and keep ₹16 as reserve.

Again, PNB can lend ₹51.2 to another borrower and keeps 20% as reserves. This process continues until the last deposit near zero.

Thus, from above example, we conclude that with initial deposit of ₹100, PNB is able to create credit of ₹500 which is 5 times the initial deposits.

$$\text{Credit Creation} = \text{Initial Deposits} \times \frac{1}{LRR} = 100 \times \frac{1}{20\%}$$

$$= 100 \times \frac{100}{20} = 100 \times 5 = ₹500$$

Q 2. How does Central Bank controls credit through bank rate?

Ans. **Bank Rate:** It is the rate of interest at which Central Bank lends funds (money) to commercial banks.

(i) **Increase in Bank Rate:** During excess demand or inflationary gap. Central Bank increases the bank rate. Borrowing becomes costly and commercial banks borrow less from Central Bank. Increase in the bank rate forces commercial banks to increase their lending rates to the firms and general public. This makes credit costlier. As a result, borrowers borrow less from commercial banks for consumption and investment. This leads to fall in demand and level of inflation.

(ii) **Decrease in Bank Rate:** During deficient demand or deflationary gap. Central Bank decreases or lowers the bank rate. It is cheap to borrow from the Central Bank on the part of commercial banks. Commercial banks also decrease their lending rates. Businessmen and public are encouraged to borrow more. Investment is encouraged. Output, employment, income and aggregate demand starts rising. This reduces deflationary gap.

Q 3. How does Central Bank controls credit through open market operations?

Ans. Open market operations refers to the sale and purchase of government securities and bonds by the Central Bank in the open market.

(i) **Sale of Securities:** During excess demand or inflation in the economy. Central Bank sells government securities in the open market and specially to the commercial banks. This decreases the credit giving capacity of the commercial banks. This will decrease the volume of investment and the level of aggregate demand will decrease in the economy.

(ii) **Purchase of Securities:** During deficient demand or deflation in the economy. Central Bank purchases government securities from the open market and specially from the commercial banks. This increases the credit giving capacity of the commercial banks. This will increase the volume of investment and the level of aggregate demand will increase in the economy.

Q 4. How does Central Bank controls credit through CRR?

Ans. CRR is the minimum percentage of banks' total deposits which they keep with the Central Bank as reserves.

(i) **Increase in CRR:** During excess demand or inflation in the economy, Central Bank increases the cash reserve ratio. An increase in the CRR decreases the credit giving capacity of the commercial banks. This will decrease the volume of investment and the level of aggregate demand will decrease in the economy.

(ii) **Decrease in CRR:** During deficient demand or deflation in the economy. Central Bank decreases the cash reserve ratio. A decrease in the CRR, increases the credit giving capacity of the commercial banks. This will increase the volume of investment and the level of aggregate demand will increase in the economy.

Q 5. How does Central Bank controls credit through SLR?

Ans. SLR is the minimum percentage of banks' total deposits which they keep with themselves in the form of liquid assets like gold.

(i) **Increase in SLR:** During excess demand or inflation in the economy, Central Bank increases the SLR. An increase in the SLR, decreases the credit giving capacity of the commercial banks. This will decrease the volume of investment and the level of aggregate demand will decrease in the economy.

(ii) **Decrease in SLR:** During deficient demand or deflation in the economy, Central Bank decreases the SLR. A decrease in the SLR, increases the credit giving capacity of the commercial banks. This will increase the volume of investment and the level of aggregate demand will increase in the economy.

Numerical Type Questions

Q 1. If the size of money multiplier is 20. Find the LRR.

Sol. We know that Money Multiplier $= \frac{1}{LRR}$

On putting the values, we get

$$20 = \frac{1}{LRR}$$

Therefore, $LRR = \frac{1}{20} \times 100 = 0.05$

$LRR = (0.05) \times 100 = 5\%$

Q 2. If the size of money multiplier is 60. Find the LRR.

Sol. We know that Money Multiplier $= \frac{1}{LRR}$

On putting the values, we get

$$60 = \frac{1}{LRR}$$

Therefore, $LRR = \frac{1}{60} \times 100$

$LRR = (0.016) \times 100 = 1.6\%$

Q 3. If LRR is 12.5%. Calculate money multiplier.

Sol. We know that, Money Multiplier $= \dfrac{1}{LRR}$

On putting the values, we get

Money Multiplier

$$= \frac{1}{12.5\%} = \frac{100}{12.5} = \frac{100 \times 10}{12.5} = \frac{4 \times 10}{5} = 8$$

Q 4. If LRR is 0.10, find money multiplier.

Sol. We know that, Money Multiplier $= \dfrac{1}{LRR}$

On putting the values, we get

Money Multiplier $= \left(\dfrac{1}{0.10}\right) = \left(\dfrac{100}{10}\right) = 10$

Q 5. In an economy, Reserve Bank of India increases the legal reserve ratio from 20% to 25%. What will be its effect on credit multiplier or money multiplier?

Sol. We know that, Money Multiplier $= \dfrac{1}{LRR}$

Case I	Case II
When LRR = 20% Money Multiplier $= \dfrac{1}{LRR} = \dfrac{1}{20\%}$ Money Multiplier $= \dfrac{100}{20} = 5$	When LRR = 25% Money Multiplier $= \dfrac{1}{LRR} = \dfrac{1}{25\%}$ Money Multiplier $= \dfrac{100}{25} = 4$

Clearly, when RBI increases the LRR from 20% to 25% then size of money multiplier falls from 5 to 4. Thus, it indicates that there is an inverse relationship between LRR and money multiplier.

Q 6. In an economy, Reserve Bank of India decreases the legal reserve ratio from 10% to 7.5%. What will be its effect on credit multiplier or money multiplier?

Sol. We know that, Money Multiplier $= \dfrac{1}{LRR}$

Case I	Case II
When LRR = 10% Money Multiplier $= \dfrac{1}{LRR} = \dfrac{1}{10\%}$ Money Multiplier $= \dfrac{1}{10} \times 100$ $= 10$	When LRR = 7.5% Money Multiplier $= \dfrac{1}{LRR} = \dfrac{1}{7.5\%}$ Money Multiplier $= \dfrac{1}{7.5} \times 100$ $= 13.33$

Clearly, when RBI decreases the LRR from 10% to 7.5% then the size of money multiplier increases from 10 to 13.33.

Thus, it indicates that there is an inverse relationship between LRR and money multiplier.

Q 7. In an economy, initial deposits were ₹1,000 crore and legal reserve ratio is 20%. How much credit will be created by commercial banks?

Sol. Credit Creation = Initial Deposits $\times \dfrac{1}{LRR}$

$$= \left(1000 \times \frac{1}{20\%}\right) = \left(1000 \times \frac{100}{20}\right)$$

$$= 1000 \times 5$$

Credit Creation = ₹5,000 crore

Chapter Test

Multiple Choice Questions

Q 1. Which of the following statements is/are correct?

a. ₹1 note is issued by the RBI
b. Coins are issued by the Government of India
c. Both statements are true
d. Both statements are false

Q 2. Repo rate relates to ....

a. short-term borrowings by commercial banks
b. long-term borrowings by commercial banks
c. disinvestments
d. dissavings

Fill in the Blank Type Questions

Q 3. In order to curl inflation, repo rate is ....

(Choose the correct alternative to fill up the blank)

a. decreased
b. increased
c. balance
d. None of the above

Q 4. Money supply constitutes money held by public (or outside the banks) and ....

(Choose the correct alternative to fill up the blank)

a. demand deposits b. banks
c. RBI d. Government

True/False Type Question

Q 5. M_1 is the least liquid measure of money supply.

Match the Column Type Question

Q 6. Identify the correctly matched pair of the items in Column (I) to that of Column (II).

Column (I)	Column (II)
A. Money	1. Supply of Money
B. Commercial Bank	2. Store of value
C. Central Bank	3. Credit Control
D. M_4	4. Circulation of money

a. A-1 b. B-2 c. C-3 d. D-4

Assertion and Reason Type Questions

Directions (Q.Nos 7-8) : *There are two statements marked as Assertion (A) and Reason (R). Read the statements and choose the appropriate option from the options given below:*

a. Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
b. Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
c. Assertion (A) is true but, Reason (R) is false.
d. Assertion (A) is false but, Reason (R) is true.

Q 7. Assertion (A): Demand deposits are not legal tenders.
Reason (R): They are with the bank, so only can be used as a legal tender when cheques are issued for the transfer.

Q 8. Assertion (A): The Central bank used Open Market Operations as a Credit Control measures.
Reason (R): Open Market Operations are the method of qualitative credit control used by the Central Bank.

Case Study Based Question

Q 9. Read the extract given below and answer the questions on the basis of the same:

In a 40 minute long speech, Prime Minister Narendra Modi announced the demonetisation of existing notes of ₹ 500 and ₹ 1000 during a televised address on Tuesday evening.

Modi announced that the notes of ₹ 500 and ₹ 1,000 "Will not be legal tender from midnight" and these will be just worthless pieces of paper. P.M. also urged people to join this mahayojna against the ills of corruption.

"What is demonetisaton and why was it done"?
—The Economic Times, Nov. 09, 2016

(i) Under whose purview does the issue of new currency fall in?
a. Reserve Bank of India
b. Central Government of India
c. State Government
d. All of the above

(ii) Which two currency denominations were demonetised?
a. ₹ 100 and ₹ 500
b. ₹ 500 and ₹ 2,000
c. ₹ 1,000 and ₹ 2,000
d. ₹ 500 and ₹ 1,000

(iii) .... is issued by the government of India.
a. Coins
b. ₹500 note
c. ₹1,000 note
d. All of the above

(iv) ₹ 1 currency note is issued by ....
a. Finance Ministry
b. RBI
c. NITI Aayog
d. None of the above

Very Short Answer Type Questions

Q 10. State the two components of M_1 measures of money supply.

Q 11. Is money a commodity?

Q 12. How can Reserve Bank of India help in bringing down the foreign exchange rate which is very high?

Short Answer Type-I Questions

Q 13. State any two difference between Central Bank and Commercial Bank.

Q 14. Explain any two types of money.

Short Answer Type-II Question

Q 15. Bring out the role of Central Bank as the controller or money supply or credit.

Long Answer Type Question

Q 16. Explain the following functions of Central Bank:
(i) Custodian of foreign exchange reserves.
(ii) Lender of last resort.

Numerical Type Question

Q 17. Suppose a bond promises ₹ 500 at the end of two years with no intermediate return. If the rate of interest is 5% per annum, what is the price of the bond?