Unit 3: Money and Banking

◆ Textual Questions and Answers (NCERT-based)

Q1. What is Barter System? Why was it replaced?

Ans: The barter system is a system of exchange in which goods are exchanged directly for other goods without the use of money.
It was replaced due to its major limitations like:

- Lack of double coincidence of wants
- Difficulty in storing wealth
- No standard measure of value
- Indivisibility of certain goods

Q2. Define money. What are its main functions?

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

- Medium of exchange
- Measure of value
- Store of value
- Standard of deferred payments

Q3. What is the difference between Narrow Money (M1) and Broad Money (M3)?

Ans:

- **M1 (Narrow Money):** Currency with the public + Demand deposits in banks
- **M3 (Broad Money):** M1 + Time deposits with banks

Q4. What is High Powered Money?

Ans: High powered money is the total liability of the monetary authority (RBI) of the country. It consists of currency in circulation with the public and vault cash with banks and deposits of commercial banks with the RBI.

Q5. What is a Commercial Bank? Mention any two functions.

Ans: A commercial bank is a financial institution that accepts deposits from the public and gives loans for the purpose of consumption and investment.
Functions:

1. Accepting deposits
2. Advancing loans

Q6. What is Credit Creation by Commercial Banks?

Ans: Credit creation is the process by which commercial banks generate credit (money) by giving loans based on the deposits received. Banks keep only a fraction as reserves and lend out the rest, which becomes deposits again, thereby creating multiple credit cycles.

Q7. Define Central Bank and state its two major functions.

Ans: A central bank is the apex monetary institution that regulates the money supply and oversees the functioning of the banking system of a country.
Functions:

1. Issuer of currency
2. Controller of credit

Q8. What is CRR and SLR?

Ans:

- **CRR (Cash Reserve Ratio):** Percentage of total deposits that commercial banks must keep with the RBI in cash form.
- **SLR (Statutory Liquidity Ratio):** Percentage of total deposits that banks must maintain in the form of liquid assets like cash, gold, or government-approved securities.

📌 Additional Short Answer Questions (2–3 Marks)

1. **What is the role of money in a modern economy?**
   It simplifies transactions, facilitates trade, serves as a standard of value, and aids in saving and investing.

2. **What is Fiduciary Money?**
   Fiduciary money is accepted as a medium of exchange based on the trust of the issuer, like paper currency.
3. **What is the difference between demand deposits and time deposits?**
   Demand deposits can be withdrawn anytime, while time deposits are fixed for a particular period.
4. **Why is money called a legal tender?**
   Because it is backed by law, and people are bound to accept it in exchange.
5. **Explain credit multiplier.**
   It refers to the multiple by which the total deposit increases with every unit of reserve.
   Formula: Credit Multiplier = 1 / CRR
6. **Mention two quantitative tools of credit control used by the RBI.**
   1. Bank Rate
   2. Open Market Operations
7. **Mention two qualitative tools of credit control.**
   1. Margin requirement
   2. Moral suasion
8. **Why is the central bank called the 'lender of last resort'?**
   Because it provides financial assistance to commercial banks when they fail to meet obligations.

9. **What is the main objective of monetary policy?**
   To control inflation, ensure stability in exchange rates, encourage employment, and promote economic growth.
10. **State two differences between commercial and central bank.**

- Central bank regulates money supply; commercial bank handles deposits and loans.
- Central bank does not deal with the public directly.

📌 Additional Long Answer Questions (4–6 Marks)

1. **Explain the major functions of money.**
   - Medium of exchange
   - Unit of account
   - Store of value
   - Standard for deferred payments
     Money facilitates smooth operation of economic activities and promotes efficiency.
2. **Describe the process of credit creation by commercial banks.**
   Banks receive deposits, keep a small portion as reserves (CRR), and lend the rest. These loans, when spent, become deposits again, enabling banks to lend more, creating a multiplier effect.
3. **Discuss the functions of the Central Bank.**
   - Issuer of currency

- Banker to the government
- Banker's bank
- Custodian of foreign exchange
- Controller of credit
- Maintains price stability and supports economic growth

4. **How do CRR and SLR help in controlling credit?**
    - Increasing CRR or SLR reduces lending capacity, controlling inflation.
    - Decreasing them increases money supply, encouraging growth.
5. **Explain the difference between quantitative and qualitative credit control measures.**
    - Quantitative: Controls the volume of credit (e.g., CRR, SLR, bank rate)
    - Qualitative: Controls direction and purpose of credit (e.g., moral suasion, margin requirement)
6. **What are the components of money supply in India?**
   M1 = Currency + demand deposits + other deposits
   M2 = M1 + Post Office Savings
   M3 = M1 + Time deposits
   M4 = M3 + Post Office Time Deposits
7. **How does RBI use Open Market Operations to control inflation?**
   By selling government securities to reduce liquidity during inflation, or buying them during deflation to inject money.

8. **Explain the role of commercial banks in economic development.**
    - Mobilizes savings
    - Provides loans for investment
    - Promotes trade and industry
    - Facilitates financial inclusion
9. **How does monetary policy help in economic stability?**
   By adjusting interest rates, reserve ratios, and using credit control tools to manage inflation and boost growth.
10. **Write a short note on monetary aggregates.**
    Monetary aggregates measure the money supply using terms like M1, M2, M3, and M4. They help the RBI in policy formulation.