Money and Banking

Commercial Bank

Commercial bank is an institution which performs the functions of accepting deposits, granting loans and making investments, with the aim of earning profits.

Functions of a Commercial Bank

1. Primary Functions
2. Secondary Functions

Primary Functions

1. Accepting Deposits

It is the most important function of commercial banks. They accept deposits in several forms according to requirements of different sections of the society. The main kinds of deposits are:

(i) Current Account Deposits: These deposits refer to those deposits which are repayable by the banks on demand. Such deposits are generally maintained by businessman with the intention of making transactions with such deposits. Banks impose charges for running these accounts.

(ii) Fixed Deposits or Time Deposits or Term Deposits: Fixed deposits refer to those deposits, in which the amount is deposited with the bank for a fixed period of time. These accounts does not enjoy chequeable facility. These deposits carry a high rate of interest.

(iii) Saving Deposits: The depositors are given cheque facility to withdraw money from their account. But, some restrictions are imposed on number and amount of withdrawals, in order to discourage frequent use of saving deposits. They carry a rate of interest which is less than interest rate on fixed deposites.

2. Advancing of Loans

The deposits received by banks are not allowed to remain idle. So, after keeping certain cash reserves, the balance is given to needy borrowers & interest is charged from them, which is the main source of income for these banks. Different types of loans & advances made by Commercial banks are:

(i) Cash Credit: Cash credit refers to a loan given to the borrower against his current assets like shares, stocks, bonds, etc. A credit limit is sanctioned and the amount is credited in his account. The borrower may withdraw any amount within his credit limit and interest is charged on the amount actually withdrawn.

(ii) Demand Loans: Demand loans refer to those loans which can be recalled on demand by the bank at any time. The entire sum of demand loan is credited to the account and interest is payable on the entire sum.

(iii) Short-term Loans: They are given as personal loans against some collateral security. The money is credited to the account of borrower and the borrower can withdraw money from his account and interest is payable on the entire sum of loan granted.

Secondary Functions

1. Overdraft Facility: It refers to a facility in which a customer is allowed to overdraw his current account upto an agreed limit. This facility is generally given to respectable and reliable customers for a short period. Customers have to pay interest to the bank on the amount overdrawn by them.

2. Discounting Bills of Exchange: It refers to a facility in which holder of a bill of exchange can get the bill discounted with bank before the maturity. After deducting the commission, bank pays the balance to the holder. On maturity, bank gets its payment from the party which had accepted the bill.

3. Agency Functions: Commercial banks also perform certain agency functions for their customers. For these services, banks charge some commission from their clients. Some of the agency functions are:

(i) Transfer of Funds: Banks provide the facility of economical and easy remittance of funds from place-to-place with the help of instruments like demand drafts, mail transfers, etc.

(ii) Collection and Payment of Various Items: Commercial banks collect cheques, bills, interest, dividends, subscriptions, rents and other periodical receipts on behalf of their customers and also make payments of taxes, insurance premium, etc. on standing instructions of their clients.

(iii) Purchase and Sale of Foreign Exchange: Some commercial banks are authorised by the central bank to deal in foreign exchange. They buy and sell foreign exchange on behalf of their customers and help in promoting international trade.

(iv) Purchase and Sale of Securities: Commercial banks buy and sell stocks and shares of private companies as well as government securities on behalf of their customers.

(v) Income Tax Consultancy: They also give advice to their customers on matters relating to income tax and even prepare their income tax returns.

(vi) Trustee and Executor: Commercial banks preserve the wills of their customers as trustees and execute them after their death as executors.

(vii) Letters of Reference: They give information about the economic position of their customers to traders and provide the similar information about other traders to their customers.

4. General Utility Functions:

(i) Locker Facility: Commercial banks provide facility of safety vaults or lockers to keep valuable articles of customers in safe custody.

(ii) Traveller's Cheques: Commercial banks issue traveller's cheques to their customers to avoid risk of taking cash during their journey.

(iii) Letter of Credit: They also issue letters of credit to their customers to certify their creditworthiness.

(iv) Underwriting Securities: Commercial banks also undertake the task of underwriting securities. As public has full faith in the creditworthiness of banks, public do not hesitate in buying the securities underwritten by banks.

(v) Collection of Statistics: Banks collect and publish statistics relating to trade, commerce and industry. Hence, they advice customers on financial matters.

Money Creation

- Through the process of money creation, commercial banks are able to create credit, which is in far excess of the initial or Primary Deposits.

- This process can be better understood by making two assumptions:
  (i) The entire commercial banking system is one unit and is termed as 'Banks'
  (ii) All receipts and payments in the economy are routed through the Banks, i.e. all payments are made through cheques and all receipts are deposited in the banks.

- Legal reserve ratio refers to the minimum fraction of deposits which the banks are mandate to keep as reserves. The legal reserve ratio is fixed by Central bank.

- Primary Deposits are the cash deposits of the people with the Commercial Banks in different deposit account such as saving accounts, current accounts, term deposit accounts and other deposits.

- Secondary or Derivative Deposits are those deposits which arise due to loans given by the banks to the people.

- For Example: Initial Deposites - ₹ 100000, LRR- 25%

Rounds	Deposits (₹)	Loans (₹)	Cash Reserves (₹)
I	1,00,000	75,000	25,000
II	75,000	56,250	18,750
III	56,250	42,187	14,063
IV	42,187	31,641	10,546
V	-	-	-
VI	-	-	-

Total	4,00,000	3,00,000	1,00,000

Money Multiplier

Money multiplier is the number by which total deposits can increase due to a given change in deposits. It is inversely related to legal reserve ratio.

$$\textbf{Money Multipier (MM)} = \frac{1}{LRR}$$

Total Money Created = Initial Deposits x MM

At the end of this process, Total reserves = Initial Deposits

Why only Fraction of deposits are kept as Cash Reserves?

Banks keep a fraction of deposits as Cash Reserves because a prudent banker, by his experience, knows two things:

(i) All the depositors do not approach the banks for withdrawal of money at the same time and also they do not withdraw the entire amount in one go.

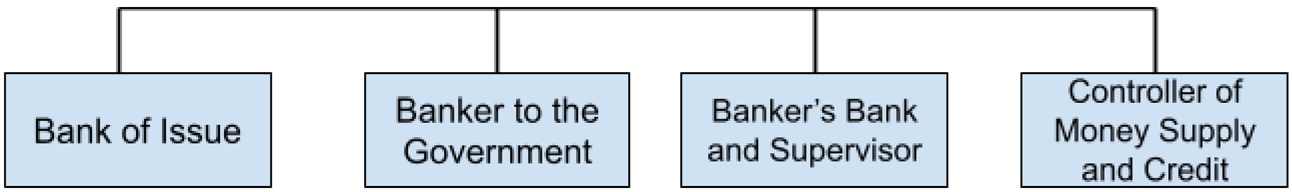
(ii) There is a constant flow of new deposits into the banks.

Central Bank

Central Bank is an 'Apex' body that controls, operates, regulates and directs the entire banking and monetary structure of the country.

All the financially developed countries have their own central bank. India's Central Bank is the Reserve Bank of India (RBI). RBI was established in April 1, 1935 under Reserve Bank of India Act passed in 1934.

Functions of Central Bank



1. Currency Authority (or Bank of Issue)

Central Bank has the sole authority for issue of currency in the country. In India, Reserve Bank of India (RBI) has the sole right of issuing paper currency notes (except one-rupee notes and coins, which are issued by Ministry of Finance). The One Rupee note bears the signature of Finance Secretary, while other currency notes bear the signature of Governor of RBI.

All the currency issued by the Central Bank is its monetary liability, i.e. Central Bank is obliged to back the currency with assets** of equal value, to enhance the public confidence in paper currency.

Advantages of Sole Authority of Note issue with RBI

(i) It leads to uniformity in note circulation.
(ii) It gives the central bank power to influence money supply because currency with public is a part of money supply.
(iii) It enables the government to have supervision and control over the central bank with respect to issue of notes.
(iv) It ensures public faith in the currency system.
(v) It helps in stabilisation of internal and external value of currency.

2. Banker to the Government

The Reserve Bank of India acts as a banker, agent and a financial advisor to the Central Government and all the State Governments.

- As a banker, it carries out all banking business of the government.

  - It maintains a current account for keeping their cash balances.

  - It accepts receipts and makes payments for the government and carries out exchange, remittance and other banking operations.

  - It also gives loans and advances to the government for temporary periods. The government borrows money by selling treasury bills to the Central Bank.

- As an agent, the central bank also has the responsibility of managing the public debt.

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

3. Banker's Bank and Supervisor

As the banker to banks, the central bank functions in three capacities:

(i) Custodian of Cash Reserves: Commercial banks are required to keep a certain proportion of their deposits (known as Cash Reserve Ratio or CRR) with the central bank. In this way, central bank acts as a custodian of cash reserves of commercial banks.

(ii) Lender of the Last Resort: When commercial banks fail to meet their financial requirements from other sources, i.e. in case of a financial emergency, they approach the central bank to give loans and advances as lender of the last resort. Central bank assists these banks through discounting of approved securities and bills of exchange.

(iii) Clearing House: As central bank holds the cash reserves of all the commercial banks, it becomes easier and more convenient for it to act as their clearing house. All commercial banks have their accounts with the central bank. Therefore, the central bank can easily settle claims of various commercial banks against each other, by making debit and credit entries in their accounts.

As a supervisor, central bank regulates and controls the commercial banks. The regulation of banks may be related to their licensing, branch expansion, liquidity of assets, management, merging, winding up, etc. The control is exercised by periodic inspection of banks and the returns filed by them.

4. Controller of Money Supply and Credit

The Reserve Bank of India (RBI) is empowered to regulate the money supply in the economy through its 'Monetary Policy'. It is the policy adopted by the Central Bank of an economy in the direction of credit control or money supply.

1. Repo (Repurchase) Rate: Repo rate is the rate at which the central bank of a country (RBI in case of India) lends money to commercial banks to meet their short-term needs.
An increase in repo rate increases the cost of borrowings from the central bank. It forces the commercial banks to increase their lending rates, which discourages borrowers from taking loans. It reduces the ability of commercial banks to create credit. A decrease in the repo rate will have the opposite effect.

2. Bank Rate (or Discount Rate): Bank rate is the rate at which the central bank of a country (RBI in case of India) lends money to commercial banks to meet their long-term needs.

RBI uses bank rate to control credit and it has the same effect as that of Repo rate, ie. an increase in Bank rate increases the cost of borrowings from the central bank, which leads to increase in lending rates by commercial banks. It discourages borrowers from taking loans, which reduces the ability of commercial banks to create credit.

3. Reverse Repo Rate (or Reverse Repurchase Rate): This is the exact opposite of Repo Rate. Reverse Repo Rate is the rate of interest at which commercial banks can deposit their surplus funds with the Central Bank, for a relatively shorter period of time.
When the reverse repo rate is raised, it encourages the commercial banks to deposit their funds with the central bank. This has the negative effect on the lending capability of the commercial banks. Lowering reverse repo rate has the opposite effect, which raises demand for borrowings from the commercial banks.

4. Open Market Operations: Open market operations (OMO) refer to buying and selling of government securities by the Central Bank from/to the public and commercial banks. RBI is authorised to sell or purchase treasury bills and government securities. It does not matter whether the securities are bought or sold to the public or banks because ultimately the amounts will be deposited in or transferred from some bank.

- Sale of securities by central bank reduces the reserves of commercial banks. It adversely affects the bank's ability to create credit and therefore decrease the money supply in the economy.

- Purchase of securities by central bank increases the reserves and raises the bank's ability to give credit.

5. Legal Reserve Requirements (Variable Reserve Ratio Method): According to Legal reserve requirements, commercial banks are obliged to maintain reserves. It is a very quick and direct method for controlling the credit creating power of commercial banks. Commercial Banks are required to maintain reserves on two accounts:

(i) Cash Reserve Ratio (CRR): It refers to the minimum percentage of net demand and time liabilities, to be kept by commercial banks with the central bank. An increase in CRR reduces the excess reserves of commercial banks and limits their credit creating power.

(ii) Statutory Liquidity Ratio (SLR): It refers to minimum percentage of net demand and time liabilities which commercial banks are required to maintain with themselves. An increase in SLR reduces the ability of banks to give credit and vice-versa.

6. Margin Requirements: Margin is the difference between the amount of loan and market value of the security offered by the borrower against the loan. An increase in margin reduces the borrowing capacity and money supply. A fall in margin encourages the people to borrow more.

Money

Money is anything which is generally accepted as a medium of exchange, measure of value, store of value and means for standard of deferred payment.

Legal Definition of Money

According to this definition, money is what the law says is money. So, anything which the government declares as money is money. On the basis of legal recognition, money is of two kinds:

(i) Legal Tender Money: Money which can be legally used to make payment of debts or other obligations is termed as legal tender money. A creditor is obliged by law to receive such money in payment of debt due to him. Legal tender money is of two kinds:

(a) Limited Legal Tender: It refers to that form of legal tender money, which can be paid in discharge of a debt up to a certain limit. Beyond this limit, a person may refuse to accept the payment and no legal action can be taken against him. In India, coins are limited legal tender. For example, as per Coinage Act, 2011, coins shall be a legal tender in case of coin of any denomination not lower than one rupee, for any sum not exceeding ₹ 1,000.

(b) Unlimited Legal Tender: It refers to that form of legal tender money, which can be paid in discharge of a debt of any amount. Legal action can be taken against a person who refuses to accept this money. In India, paper notes are unlimited legal tender.

(ii) Non-Legal Tender Money or Optional Money: It refers to that form of money, which is generally accepted, but legally, one is not bound to accept it. For example, cheques, bank drafts, bills of exchange, etc. do not have legal backing and their acceptance is totally optional.

Bank Money

Bank money refers to demand deposits created by the commercial banks. These deposits are repayable by the banks on demand. The depositors are given cheque facility to withdraw money from their account or to make payments. It must be noted that bank money is a Non-Legal Tender Money or Optional Money.

Functions of Money

1. Primary Functions
2. Secondary Functions

Primary Functions

Primary functions include the most important functions of money, which it must perform in every country.

(i) Medium of Exchange: Money, as a medium of exchange, means that it can be used to make payments for all transactions of goods and services. It is the most essential function of money. Money has the quality of general acceptability. So, all exchanges take place in terms of money.

(ii) Measure of Value (Unit of Value): Money as a measure of value means that money works as a common denomination, in which values of all goods and services are expressed.

Secondary Functions

These refer to those functions of money which are supplementary to the primary functions

(i) Standard of Deferred Payments: Money as a standard of deferred payments means that money acts as a 'standard' for payments, which are to be made in future.

(ii) Store of Value (Asset Function of Money): Money as a store of value means that money can be used to transfer purchasing power from present to future. Money is a way to store wealth. Although wealth can be stored in other forms also, but money is the most economical and convenient way.

Money Supply

Money Supply refers to total volume of money held by public at a particular point of time in an economy.

Features of Money Supply

1. It includes 'Money held by Public only'. The term 'public' signifies the money-using sector, i.e. individuals and business firms. It does not include Money-Creating Sector (or Producers/ Suppliers of Money), Le. Government and Banking System as cash balances held by them do not come into actual circulation in the country.

2. It is a 'Stock Concept, i.e. it is concerned with a particular point of time.

Components of Money Supply

The two main components of money supply are:

1. Currency with Public: It consists of paper notes and coins held by the public. It is the most liquid of all assets and includes coins of denominations of 10, 5, 2, 1, etc. and paper notes of denominations like 2,000, 500, 200, 100, etc.

2. Demand Deposits with Banks: It refers to demand deposits (or Bank Money) of the public with the commercial banks. Demand deposits are the deposits, which can be encashed by issuing cheques at any time by the account holders.

Measures of Money Supply

1. M1 : It is the first and basic measure of money supply. M1 is the most liquid measure of money supply as all its components are easily used as a medium of exchange.

M1 = Currency & Coins with Public + Demand Deposits of Commercial Banks + "Other Deposits with RBI”

2. M2 : It is a broader concept of money supply as compared to M1. In addition to M1, it also includes savings deposits with post office saving bank.

M2 = M1 + **Savings Deposits with Post Office Saving Bank**

3. M3 : This concept is broader as compared to M1. In addition to M1, it also includes net time deposits.

M3 = M +Net Time Deposits with Banks

4. M4 : This measure includes total deposits with post office saving bank in addition to M3.

M4 = M3 + Total Deposits with Post Office Saving Bank (Excluding NSC)
(NSC is National Saving Certificate)

High Powered Money

High Powered Money is money produced by the RBI and the government. It consists of two things:

(i) Currency held by the public
(ii) Cash reserves with the banks.

'Money (M)' Vs 'High Powered Money (H)'

'Money' consists of currency and demand deposits, while 'High Powered Money' consists of currency and cash reserves with banks. It means, 'Currency held by the public' is common in both of them. The only difference is that 'Money' includes demand deposits of banks,