1. Money Market and Banking System

❖ Important Concepts

- **Barter Exchange (or Barter):** Direct exchange of goods against goods without use of money is called barter exchange.
- **Money:** Anything which is generally acceptable by the people in exchange of goods and services or in repayment of debts is called money.
- **Producers of Money**: It refers to supplier of money. They are (1) Govt. of the country which issues all coins and One rupee notes and (ii) banking system which includes (a) Central Bank which issues currency and (b) commercial banks which create credit (money).
- **A cheque** is an instrument that instructs the bank to transfer funds from the cheque issuer's account to the cheque receiver.
- **Credit Money (or Bank Money)**: Money in the form of bank deposits used for exchange transaction through cheques, drafts and other credit instruments.
- **Fiat Money** is any money backed by the order or fiat of the government to act as money.
- **The Supply of Money** means the total stock of all forms of money (Paper money, coins and demand deposits of banks) which are held by the public at any particular point of time.
- **Bank is** an institution which borrows and lends money.
- **Liquidity**: Property (characteristic) of an asset to get it converted into cash without loss of time and value.
- **A Commercial Bank** is a financial institution which performs the functions of accepting deposits from the general public and giving loans for investment with the aim of earning profit.
- **Demand Deposit**: Deposits which are payable by banks on demand from depositors are called Demand Deposits.
- **Term Deposits**, also called time deposits, are payable only after the expiry of specified period.
- **Liabilities**: Liabilities of a bank are the claims on it owned by shareholders and depositors.
- **Central Bank** is the apex institution of monetary and banking system of a country.
- **Bank Rate (or Repo Rate)**: It is the rate of interest charged by Central Bank on loans given to commercial banks.
- **Reverse Repo Rate**: It is the rate at which banks park their surplus funds with Central Bank (RBI in India).
- **Open Market Operations**: Refers to the sale and purchase of govt. securities by the Central Bank of a country.
- **Cash Reserve Ratio**: CRR is the ratio (fraction) of bank deposits that a commercial bank must keep as reserve in cash with the Central Bank.
- **Statutory Liquidity Ratio**: SLR refers to that ratio (percentage) of bank's total demand deposits and time deposits which every commercial bank is required to keep with itself in the form of liquid assets (e.g. cash, govt. securities).
- **Margin Requirement**: It refers to amount of security that banks demand from borrower of loan.
- **Moral Suasion**: The Central Bank cautions, persuades, convinces the commercial banks to fall in line with its policies.
- **Clearing House**: Settlement of transactions between commercial banks by the Central Bank

❖ Evolution of Money

Need to facilitate exchange of goods led to evolution of money. Briefly, evolution of money was mainly through commodity money, metallic money, paper money and bank money. Money is the most important invention of modern times. It has undergone a long process of historical evolution. Human beings passed through a stage when money was not in use and goods were exchanged directly for one another. Such exchange of goods for goods was called Barter Exchange. The inconveniences and drawbacks of barter led to the gradual use of a medium of exchange

❖ Barter-Meaning and its Inconveniences

- **Meaning of Barter :**

'Direct exchange of goods against goods without use of money is called barter exchange.' Alternatively, it is a system of exchange in which transactions are made by exchange of goods. Economic exchanges without the medium of money are referred to as barter exchanges. An economy based on barter exchange (i.e., exchange of goods for goods) is called C.C. Economy. i.e., commodity for commodity exchange economy. In such an economy, a person gives his surplus good and gets in return the good he needs. For example, when a weaver gives cloth to the farmer in return for getting wheat from the farmer, this is called barter exchange.

- **Inconveniences (Problem) of Barter Exchange**
  - Lack of double coincidence of wants
  - Lack of Common Measure of Value
  - Lack of standard of deferred payment
  - Difficulty in storing wealth (or generaised purchasing power)
  - Lack of Divisibility

- **Money-Meaning and its Function**
  - Meaning of Money
  - Function of money

- **Function Of Money**
  - Money as the medium of Exchange.
  - Money as a Unit of Account or Measure of Value.
  - Money as the standard of Deferred payments.
  - Money as a store of Value.

❖ Legal definition of money

<u>Legal Tender Money (NCERT)</u>: Money that has a legal sanction by the government behind it, is called legal tender or legal tender money. Legal tender or legal money means money under the law of land. It is the money issued by monetary authority or government which cannot be refused by any person in payment for transactions. The tender or payment of it constitutes by law the sufficient discharge of debt. The government issues an order stating what is money and that becomes legal tender money. Everybody is bound to accept

it in exchange for goods and services and in discharge of debts. None can refuse to accept it because non-acceptance is an offence. For example, in India currency (notes) and coins are legal tender money which cannot be refused in payment of transactions. In this context, chequable demand deposit is not money because a person can legally refuse to accept payment through cheques. Legal tender status given by the government to money is of two types-limited legal tender and unlimited legal tender.)

(i) **Limited legal tender :** Wis the money which can be accepted only up to a certain maximum limit fixed by law. For instance, in India, coins are limited legal tender because coins of 5, 10, 20 and 25 paise are accepted up to maximum sum of ₹1000 as per Coinage Bill passed on 11th August, 2011. One could refuse payments in these small coins beyond a sum of small coins beyond this limit.) 1000. One can refuse payments by an individual in Small coins beyond this limit

(ii) **Unlimited legal tender:** It is the money for which there is no limit to the quantity of money offered in a payment at a time. For example, in India, paper notes are unlimited legal tender because all currency notes can be used to settle payments of unlimited value.

- Money and Near Money: A distinction between the two will be informatory. Money is anything which is used as a medium of exchange and has legal sanction of the government. It possesses 100% liquidity. Everybody is legally bound to accept it. For instance, money in India consists of coins and paper notes.

  Near money is a close substitute of money rather than cash and currency. It is as good as money but it is not real money because it has no legal sanction as money. Assets which are close substitutes of money are near money. Examples of near money are Bonds, Equity Shares, National Saving Certificates, Commercial Bills, etc. Near money cannot directly purchase goods and services as cash or bank money can, but it can be converted into ready money easily within a short period of time. That is why it is called near money.

❖ **Fiat Money**: Fiat money is any money backed by the order (fiat) of the government to act as money. People have to accept it in exchange for goods and services and in discharge of debt as the government has ordered it to be money. It is also called legal tender as it circulates in the country on the fiat (i.e., command) of the govt. For example coins and currency notes in India are fiat money. Fiat money is generally created and circulated at the time of crisis like war or emergency. Since it is issued without any backing of gold, silver or other reserves, therefore, it is not convertible into anything than itself. It has no fixed value in terms of any objective standard leading sometimes to doubts about its acceptability.

<u>Fiduciary Money</u> : Fiduciary money is the money which is accepted as money on the basis of trust the issuer commands.

❖ Meaning of a Commercial Bank

- **Definition of a Bank :**

Simply put, "Bank is an institution which borrows and lends money." A bank receives -deposits from those who want it to be kept safely and also earn some interest. In other words, it borrows money. It also lends money to merchants or manufacturers. The borrowing and lending of money are its essential functions.

Accordingly, if any financial institution (like Post Office) accepts deposits only but does not lend will not be called a bank. Since, purchase and sale or the use of money are credit operations, economists usually define banks as institutions dealing in credit and money. Thus, any institution which accepts deposits from the public withdrawable by cheques and advances loans of various sorts is called a bank.

Another definition:

"A bank is a financial intermediary, a dealer in loans and debts." by Cairncross.

- **What is Banking?**

"Banking means the accepting, for the purpose of lending or investments, of deposits of money from the public repayable on demand or otherwise, and withdrawable by cheques, draft, order or otherwise", by Banking Companies Act, 1949.

- **Meaning of Commercial Bank ?**

Commercial Bank is a financial institution which performs the functions of accepting deposits from the general public and giving loans for investment with the aim of earning profit. In fact,

Functions Of Commercial Bank's

Primary Functions:-

- **1). Acceptance of deposits**: A commercial bank accepts deposits in the form of current, savings and fixed deposits. It collects the surplus balances of the individuals, firms and finances the temporary needs of commercial transactions. The first task is, therefore, the collection of the savings of the public. The bank does this by accepting deposits from its customers. Deposits are the lifeline of banks.

- **Deposits are of three types as under:**

1. Current account deposits. Such deposits are payable on demand and are, therefore, called demand deposits. These can be withdrawn by the depositors any number of times depending upon the balance in the account. The bank does not pay any interest on these deposits but provides cheque facilities. These accounts are generally maintained by businessmen and industrialists who receive and make business payments of large amounts through cheques.

2. **Fixed deposits (Time deposits) (D2014C)**: Fixed deposits have a fixed period of maturity and are referred to as time deposits. These are deposits for a fixed term, i.e., period of time ranging from a few days to a few years. These are neither payable on demand nor they enjoy cheque facilities. They can be withdrawn only after the maturity of the specified fixed period. They carry higher rate of interest. They are not treated as a part of money supply. Recurring deposit in which a regular deposit of an agreed sum is made is also a variant of fixed deposits.

3. Savings account deposits: These are deposits whose main objective is to save. Savings account is most suitable for individual households. They combine the features of both current account and fixed deposits. They are payable on demand and also withdrawable by cheque. But bank gives this facility with some restrictions, e.g., a bank may allow four or five cheques in a month. Interest paid on savings account.

- **Difference between demand deposits and time (term) deposits :-**

  Two traditional forms of deposits are demand deposit and term (or time) deposit.

  Demand deposits: (D13,14) Deposits which can be withdrawn on demand by depositors (or by writing cheques) are called demand deposits, e.g., current account deposits are called demand deposits because they are payable on demand but savings account deposits do not qualify because of certain conditions on withdrawal. No interest is paid on demand deposits.

  Time deposits: Time deposits, also called fixed deposits or term deposits, are deposits which have fixed maturity, i.e. which are payable only after the expiry of the specified period.

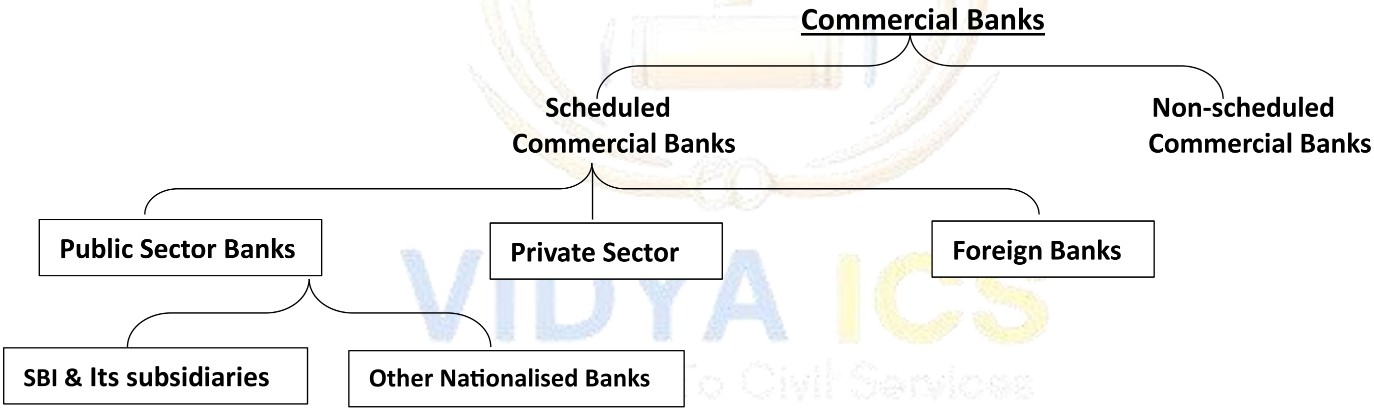
  Difference-

  (i) Demand deposits do not carry interest whereas time deposits carry a fixed rate of interest,

  (ii) Demand deposits are highly liquid whereas time deposits are less liquid,

  (iii) Demand deposits are chequable deposits whereas time deposits are not.

  2). It gives loans and advances: The second major function of a commercial bank is to give loans and advances particularly to businessmen and entrepreneurs and thereby earn interest. This is, in fact, the main source of income of the bank. A bank keeps a certain portion of the deposits with itself as reserve and gives (lends) the balance to the borrowers as loans and advances in the form of cash credit, demand loans, short-run loans, overdraft as explained under.



❖ Meaning of Central Bank

Meaning: The Central Bank is the apex institution of monetary and banking system of a country. All institutions which deal in money constitute a monetary system. Being an apex institution, it organises, supervises, regulates and develops the monetary system of the country. In India, the name of the Central Bank is Reserve Bank of India (RBI). Central Banks have been established in all financially developed countries. They are known by different names in different countries. In India the Central Bank is known as Reserve Bank of India which was established in 1935 as a Share Holders bank and nationalised on 1st January, 1949. In UK it is called Bank of England and in Russia it is known as the Gosbank.

❖ Functions of a Central Bank

The main function of a Central Bank is to act as governor of the machinery of credit in order to secure stability of prices. It regulates the volume of credit and currency, pumping in more money when market is dry of cash, and pumping out money when there is excess of credit. In India RBI has two departments, namely, Issue department and Banking department. We discuss below its main functions.

1. Issue of Currency: The Central Bank is given the sole monopoly of issuing currency in order to secure control over volume of currency and credit. These notes circulate throughout the country as legal tender money. It also brings about uniformity in note circulation. This is also called 'Bank of issue' function. Central Bank has to keep a reserve in the form of gold and foreign securities as per statutory rules against the notes issued by it. It may be noted that RBI issues all currency notes in India except one rupee notes. Again, it is under the directions of RBI that one rupee notes and small coins are issued by government mints. Remember, the central government of a country is usually authorised to borrow money from the Central Bank. When the central government expenditure exceeds government revenue and the government is unable to reduce its expenditure, then it borrows from the RBI. This is done by selling security bills to RBI which creates new currency notes for the purpose. This is called monetisation of budget deficit or deficit financing. The government spends new currency and puts it into circulation to meet its expenditure.

2. Banker to Government: Central Bank functions as a banker to the government like commercial banks are to the public. It means that Central Bank provides some banking facilities to the government which commercial banks give to the public. It accepts deposits from the government and gives loans to the government. It maintains the accounts of the government and carries out all its banking business. Government keeps their cash balances in the current account with the Central Bank. Similarly, Central Bank accepts receipts and makes payment on behalf of the governments. Also, Central Bank carries out exchange, remittance and other banking operations on behalf of the government. Central Bank gives loans and advances to government for temporary periods, as and when necessary, and it also manages the public debt of the country. Remember, the central government can borrow any amount of money from RBI by selling its rupees securities to the latter.

3. Banker's Bank and Supervisor: There are usually hundreds of banks in a country There should be some agency to regulate and supervise their proper functioning. This duty is discharged by the Central Bank. Central Bank acts as banker's bank in three capacities:

(I) It is the custodian of their cash reserves. Banks of the country are required to keep a certain percentage of their deposits with the Central Bank; and in this way the Central Bank is the ultimate holder of the cash reserves of commercial banks,

(II) Central Bank is lender of last resort. Whenever banks are short of funds, they can take loans from the Central Bank and get their trade bills discounted. The Central Bank is a source of great strength to the banking system,

(III) It acts as a bank of central clearance, settlements and transfers. Its moral persuasion is usually very effective so far as commercial banks are concerned.

4. Exchange Control : Another duty of a Central Bank is to see that the external value of For instance, in India, the Reserve Bank of India takes steps to ensure external value of a rupee. It adopts suitable measures to attain this object. The exchange control system is one such measure. Under exchange control system, every citizen of India has to deposit with the Reserve Bank of India all foreign currency or exchange that he receives. And whatever foreign exchange he might need has to be secured from the Reserve Bank by making an application in the prescribed form.

6. Lender of Last Resort: When commercial banks have exhausted all resources to supplement their funds s at times of liquidity crisis, they approach Central Bank as a last resort. As lender of last resort, Central Bank guarantees solvency and provides financial accommodation to commercial banks (1) by rediscounting their eligible securities and bills of exchange and (ii) by providing loans against their securities. This saves banks from possible failure and banking system from a possible breakdown. On the other hand, Central Bank, by providing temporary financial accommodation, saves the financial structure of the country from collapse.

7. Custodian of Foreign Exchange Reserves: The Central Bank also functions as custodian of country's foreign exchange reserves. Again it is the responsibility of the Central Bank to stabilise the external value of national currency. Therefore it keeps a certain minimum amount of gold and foreign currency (like US dollars and British pounds) against note issue and to meet emergency requirement of foreign exchange. At the Same time, in order to minimise fluctuations in the foreign exchange rates, Central Bank buys or sells foreign currencies in the market.

8. Clearing House Function: Banks receive cheques drawn on the other banks from their customers which they have to realise from drawee banks. Similarly, cheques on a particular bank are drawn and passed into the hands of other banks which have to realise them from the drawee banks. Independent and separate realisation to each cheque would take a lot of time and, therefore, Central Bank provides clearing facilities, i.e., facilities for banks to come together every day and set off their chequing claims. Collection and Publication of Data: It has also been entrusted with the task of collection and compilation of statistical information relating to banking and other financial sectors of the economy.

❖ LIQUIDITY MANAGEMENT BY RBI

Relevance of banking apart from meeting the growing needs of the economy is their strong linkage with inflation through their ability to increase liquidity in the economy. This is said to be as one of the major cause for buildup of inflationary pressures.

- **Liquidity**

A bank accepts deposits from the public which is lent in the economy. The money which can potentially' be lent by the banks is known to be liquidity. Bank leverages the deposit manifold for lending in the economy known as 'credit creation' by banks. This credit creation is almost like fresh money injected in the economy and contributes to inflationary pressures. Thus, liquidity in the economy should strike a balance between requirements of growth and at the same time keep the prices under check. Managing liquidity is a major aspect of the RBI functions.

Previously, it was mentioned that RBI was the apex central bank of the country functioning as banker to the government and banks, responsible for printing of currency' notes, overseeing the functioning of the banking sector and now its another important and critical role in liquidity management.

It is important to understand first that money deposited in the bank is a source of liquidity. Money deposited could either be 'demand' deposits (payable by the bank on demand by a customer like money retaining in your savings account in the bank can be withdrawn by you at any time) or, 'time' deposits (can be withdrawn after a fixed period only like fixed deposits). Both demand as well as time deposits is the liabilities of the bank as the bank has to pay it back to the customer

Thus, both are known as 'demand and time liabilities' of banks. These demand and time liabilities of the banking system are the source of increasing liquidity. If unchecked, it will be keep on increasing. RBI cannot question the public to not deposit money in the banks as it is the source of liquidity and neither can it direct banks to stop lending as if they do not lend they will not be able to meet the interest on deposits which the banks have to pay and also not able to earn profits for their future growth.

RBI thus has certain quantitative and qualitative tools through which it manages liquidity and they are as follows:

Cash Reserve Ratio (CRR): Every bank has to retain a certain percentage of its demands and time liabilities in cash with the RBI which can be raised by the RBI to drain out excess liquidity or reduced to release the liquidity in the economy. For example, on a public deposit base of over ₹ 50,00,000 crores in the banking system a 1 per cent increase in CRR would lead in overnight transfer 50,000 crores from the banking system to RBI or which cannot be leveraged for lending by the banks. Even a 0. 25 per cent increase would imply about ₹ 12,500 crores going out of the banking system. Such a large amount could lead to a drop in lending by banks dampening industrial growth or even triggering a recession in the economy. Thus, CRR as a monetary tool which has to be carefully used by the RBI keeping in view all aspects of the economy and not merely decreasing liquidity for fears of inflation. Frequent use of the CRR, especially their increase by any central bank of a country sends negative sentiments in the economy. Changes in CRR are necessary in exceptional circumstances or adverse developments in the economy rather than being frequently used as a monetary tool for managing liquidity. The other issue in its use is that it is applicable to all banks alike and does not allow banks to take a long-term lending decision as they are uncertain about when the RBI would raise CRR. The present CRR rate is 4.5% .

Statutory Liquidity Ratio (SLR): This is another monetary tool of the RBI, in terms of which every bank is required to set aside again a certain percentage of their demand and time liabilities and retain as cash with RBI, or in gold with the RBI or invested in government securities. The banks prefer to invest in government securities as it earns them interest.

At present, a minimum 18% of the demand and time liabilities are to be invested. Banks have, however, parked greater than the minimum stipulation in government securities and is thus today an in-effective tool to managing liquidity.

Bank Rate: It is the rate of interest charged by RBI for lending money to banks against eligible securities. In the era of controlled and regulated banking, bank rates were raised to discourage banks to borrow from RBI for increasing liquidity as a way to reduce liquidity. It also served as a bench mark for determining other rates of interest by the RBI. Bank rate though still continuing is not used as a tool for liquidity management by RBI as there is already a secondary market for such securities and it has lost its significance. It presently uses as a penalty rate imposed by RBI on banks for violations of RBI directives

Open market operations (OMO): This is sale/purchase of secondary government securities by RBI through the auction route and not binding on the banks unlike the CRR and SLR. In periods of excess liquidity RBI resorts to 'sale' of government securities to banks draining out the money from banks thus reducing liquidity. For increasing liquidity, It 'purchases' securities from banks thereby transferring money to banks to lend resulting in liquidity increase. These OMO are performed at quarterly intervals.

Repo auction (Re-purchase obligations): This is the most frequently used tool by the RBI for managing short-term liquidity even overnight. It is the same as the OMO except that there is an inbuilt clause of automatic 'repurchase' after a specified period. Banks can keep eligible government securities, over and above those kept for maintaining SLR, with RBI and borrow for a short period (generally overnight) and interest paid by banks on such borrowings is called as 'Repo Rate.'

RBI also has a window where it offers government securities, which banks can subscribe, and the rate of interest now paid by the RBI to banks is referred as 'Reverse Repo.' Both of these will involve repurchase after the contracted period automatically. Both these rates are determined by RBI. Repo rate and reverse repo rate are linked on a 25 bps and always repo rate (presently 6.5%) will be higher than the reverse repo rate (presently 3.35%).

Marginal Standing Facility: This is a new Liquidity Adjustment Facility (LAF) created by Reserve Bank of India in 2011. It is a window for banks to borrow from the Reserve Bank of India in an emergency situation when inter-bank liquidity dries up completely. The MSF rate is pegged 100 basis points or a percentage point above the Repo Rate. Under this facility, banks can borrow funds up to one percentage of their net demand and time liabilities (NDTL)

Moral Suasion: It refers to a method adopted by the Central Bank to persuade or convince the commercial banks to advance credit in the economic interest of the country. In this process, the Central Bank requests or persuade the commercial banks to lend or credit to other banks or institutes in compliance with the general monetary policy of the central.

Ideally short-term/volatile liquidity should be addressed through repo auctions, medium-term liquidity through OMO and long-term liquidity through the CRR.

Reserve Bank of India addresses liquidity management and changes made to the CRR, SLR, repo rates as part of the annual monetary policy reviewed on a quarterly basis and rates revised keeping in view the liquidity position. An area of concern of the RBI in its policy is to keep a watch on inflation. While RBI role, besides liquidity management, controlling inflation, also acts as bankers to all the commercial banks in the country.

Priority Sector includes the following categories:

(i) Agriculture
(ii) Micro, Small and Medium Enterprises
(iii) Export Credit
(iv) Education
(v) Housing
(vi) Social Infrastructure
(vii) Renewable Energy
(viii) Others

❖ **RURAL INFRASTRUCTURE DEVELOPMENT FUND (RIDF)**

Banks which are not able to meet their targets of priority sector lending are required to keep the shortfall in RIDF. The RIDF was set up by the government during 1995-1996 for financing ongoing rural infrastructure projects. The fund is maintained by the National Bank for Agriculture and Rural Development (NABARD). Domestic commercial banks contribute to the fund to the extent of their shortfall in stipulated priority sector lending to agriculture.

The prime objective of the fund is to provide loans to the state governments and state-owned corporations to enable them to complete the ongoing rural infrastructure projects. The scope of RIDF has been widened to include activities such as rural drinking water schemes, soil conservation, rural market yards, rural health centres and primary schools, mini hydel plants, shishu shiksha kendras, anganwadis and system improvement in the power sector. From RIDF V onwards, the ambit was extended to projects which are undertaken by panchayat raj institutions and projects in the social sector covering primary education, health and drinking water.

The activities to be financed also include minor irrigation projects/micro irrigation, flood protection, watershed development/reclamation of waterlogged areas, drainage, forest development, market yard/go down, apna mandi, rural haats and other marketing infrastructure, cold storage, seed/agriculture/horticulture farms, plantation and horticulture, grading and certifying mechanisms such as testing and certifying laboratories, etc., community irrigation wells for irrigation purposes for the village as a whole, fisheries, animal husbandry and modern abattoirs.