

CUET · ECONOMICS · CLASS XII · CODE 309

Money and Banking

CUET unit: Money and Banking

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Snapshot

- Money is the commonly accepted medium of exchange that resolves the "double coincidence of wants" problem of barter; it has four core functions.
- Demand for money arises from transaction and speculative motives; supply of money is measured as M1, M2, M3, M4 (narrow vs broad).
- Commercial banks create credit, illustrated through a balance sheet; the money multiplier = $1/\text{Reserve Ratio}$.
- The RBI's quantitative tools are CRR, SLR, Bank Rate and Open Market Operations (outright and repo/reverse repo); its qualitative tools are margin requirement and moral suasion.
- High-yield CUET territory: definitions, formulas, instrument-classification and a numerical calculation on the money multiplier.

Detailed Notes

2.1 Core concepts

- **Barter and the need for money.** Direct exchange of commodities without money is barter; it presumes the improbable "double coincidence of wants" and search costs rise as the number of agents increases, making an intermediate good — money — necessary (NCERT introduction, p. 36).
- **Four functions of money.** Medium of exchange (primary), unit of account (values of all goods expressed in monetary units), store of value (money is non-perishable, low storage cost, universally acceptable), and a standard for deferred contracts; a rising price level erodes the purchasing power of money (NCERT §3.1, pp. 36–37).
- **Cashless economy and financial inclusion.** A cashless society uses digital transfers instead of physical notes/coins; India's Jan Dhan, Aadhaar-enabled payments, e-wallets and NFS have advanced financial inclusion (NCERT §3.1, p. 37).
- **Demand for money — transaction motive.** Money is held to bridge the gap between receipt of income and expenditure; transaction demand rises with the value of transactions and, via stable links, with nominal GDP: $M^d_T = k \cdot P \cdot Y$ (NCERT §3.2.1 and Box 3.1, pp. 37, 43–45).
- **Velocity of circulation.** $v = 1/k$ is the number of times a unit of money changes hands in unit time; $v \cdot M^d_T = T$ (NCERT Box 3.1, p. 44).

- **Demand for money — speculative motive.** Arises from expectations about future interest-rate movements; bond price is inversely related to the rate of interest (PV calculation), so speculative demand is inversely related to interest rate. At r_{\min} the economy is in a **liquidity trap** — speculative demand is infinitely elastic (NCERT Box 3.1, pp. 45–47).
- **Supply of money — institutions.** Money supply is created by the central bank (RBI, established 1935) and the commercial banking system; RBI issues currency, controls money supply, is banker to the government, custodian of foreign-exchange reserves and a bank to the banking system (NCERT §3.2.2, p. 38).
- **High-powered money / monetary base.** Currency issued by the central bank held by the public or commercial banks; it acts as the basis for credit creation (NCERT §3.2.2, p. 38).
- **Commercial banks and "spread".** Banks accept deposits and lend; the difference between the lending and deposit interest rates is the "spread" — the bank's profit (NCERT §3.2.2, p. 38).
- **Balance-sheet view of a bank.** Assets = Reserves + Loans; Liabilities = Deposits; Net Worth = Assets – Liabilities. Reserves are deposits banks keep with the RBI plus cash (NCERT §3.3, pp. 39–40).
- **Money creation by banks.** When a bank lends, a new deposit is created in the borrower's name, so money supply = old deposits + new deposit (+ currency); the goldsmith Lala parable illustrates this (NCERT §3.3, pp. 38–39).
- **Reserve Ratio (CRR) limits credit creation.** CRR is the percentage of deposits a bank must compulsorily keep as cash reserves with the RBI; banks also keep liquid short-term reserves as **SLR (Statutory Liquidity Ratio)** (NCERT §3.3.2, p. 40).
- **Money multiplier.** With CRR = 20%, Rs 100 of reserves can support Rs 500 of deposits; money multiplier = $1/\text{Reserve Ratio} = 1/0.20 = 5$. Reserves of Rs 100 create deposits of Rs 500 (NCERT §3.3.2 and Table 3.2, pp. 40–42). If RBI raises the reserve ratio to 25%, money supply falls (multiplier becomes 4).
- **Quantitative tools of monetary policy.** Change in CRR, change in Bank Rate, and Open Market Operations control the **extent** of money supply (NCERT §3.4, p. 42).
- **Qualitative tools.** Moral suasion, margin requirement and credit rationing — persuasion-based tools to discourage or encourage particular kinds of lending (NCERT §3.4, p. 42).
- **Open Market Operations (OMO).** RBI's buying/selling of government bonds in the open market. Buying bonds → reserves and money supply rise; selling bonds → reserves and money supply fall. Two types: **outright** (permanent, no promise to reverse) and **repo/reverse repo** (with pre-specified date and price of reversal); repo rate is the rate on RBI's repurchase agreements, reverse repo rate is on reverse repurchase agreements. Repo/reverse repo at various maturities (overnight, 7-day, 14-day) is now the main tool of RBI monetary policy (NCERT §3.4, pp. 42–43).

- **Bank Rate.** The rate at which RBI lends to commercial banks; raising it makes bank borrowing costlier, reduces their reserves and decreases money supply; lowering it expands money supply (NCERT §3.4, p. 43).
- **Lender of last resort.** RBI's readiness to lend to banks at all times when they need funds (NCERT §3.4, p. 42).
- **Fiat money and legal tender.** Currency notes and coins are fiat money — their value derives from the issuing authority's guarantee (RBI for notes, Gol for coins), not from any intrinsic metal value. They are legal tenders and cannot be refused for settlement; cheques on demand deposits are NOT legal tenders (NCERT "Supply of Money: Various Measures", pp. 47–48).
- **Measures of money supply.** RBI publishes M1, M2, M3, M4. $M1 = CU + DD$; $M2 = M1 + \text{Post Office savings deposits}$; $M3 = M1 + \text{Net time deposits of commercial banks}$; $M4 = M3 + \text{Total Post Office deposits (excluding NSCs)}$. M1 and M2 are **narrow money**; M3 and M4 are **broad money**. M1 is most liquid, M4 the least. **M3 is the most commonly used measure** — also called "aggregate monetary resources" (NCERT "Legal Definitions: Narrow and Broad Money", p. 48).
- **Demonetisation (Nov 2016).** Old Rs 500 and Rs 1000 notes were demonetised to tackle corruption, black money, terrorism and counterfeit currency; new Rs 500 and Rs 2000 notes were introduced; aimed at tax compliance and shifting transactions to formal payment systems (NCERT Box 3.2, p. 49).

2.2 Definitions to memorise

Term	Definition	Page
Barter exchange	Exchange of commodities without the mediation of money; suffers from lack of double coincidence of wants	36, 50
Fiat money	Currency notes/coins whose value derives from the guarantee of the issuing authority, not intrinsic metal value	48
Legal tender	Money that cannot be refused by any citizen for settlement of any transaction (currency notes and coins are; cheques are not)	48
High-powered money	Currency issued by the central bank, held by the public or commercial banks; basis for credit creation; also called reserve money/monetary base	38
Demand deposits	Bank deposits payable on demand of the account holder (e.g., savings, current)	47
Time deposits	Deposits with a fixed maturity period (e.g., fixed deposits)	47
CRR	Cash Reserve Ratio — percentage of deposits a bank must keep as cash reserves with the RBI	40
SLR	Statutory Liquidity Ratio — short-term reserves banks must keep in liquid form	40
Money multiplier		42

Term	Definition	Page
	1 / Reserve Ratio; the factor by which reserves get multiplied into deposits	
Bank Rate	Rate at which RBI lends to commercial banks	43
Open Market Operations	RBI's buying and selling of government bonds in the open market	42
Repo rate	Interest rate at which RBI lends through a repurchase agreement	43
Reverse repo rate	Rate at which RBI withdraws money through a reverse repurchase agreement	43
Lender of last resort	RBI's function of being ready to lend to banks whenever they need funds	42
Liquidity trap	Situation at very low interest (r_{min}) where speculative money demand is infinitely elastic	47
Narrow money	M1 and M2 — most liquid measures of money supply	48
Broad money	M3 and M4 — less liquid measures; M3 is the commonly used aggregate monetary resource	48
Spread	Difference between bank's lending and deposit interest rates — bank's profit	38

2.3 Diagrams / processes to remember

- **Table 3.1 — Balance Sheet of a Bank (initial):** Assets: Reserves Rs 100; Liabilities: Deposits Rs 100; Net Worth Rs 0 (p. 40).
- **Table 3.2 — Money Multiplier Process:** Round 1 Deposit Rs 100 → Required Reserve Rs 20 → Loan Rs 80; Round 2 Deposit Rs 180 → Required Reserve Rs 36 → Loan Rs 64; ... final round Deposit Rs 500 → Required Reserve Rs 100 → Loan Rs 400 (p. 41).
- **Table 3.3 — Final Balance Sheet:** Reserves Rs 100 + Loans Rs 400 = Rs 500; Deposits Rs 500 (p. 41).
- **Fig. 3.1 — Speculative Demand for Money:** Downward-sloping in (M^d_S, r) plane; vertical at $r = r_{max}$ ($M^d_S = 0$) and horizontal (infinitely elastic) at $r = r_{min}$ — the liquidity trap (p. 46).
- **Goldsmith Lala parable** — illustrates how fractional reserve banking creates "money out of thin air" (pp. 38–39).

2.5 Key formulas

Formula	Meaning	NCERT page
$M^d_T = k \cdot P \cdot Y$	Transaction demand for money ($k =$ Cambridge cash-balance parameter)	44

Formula	Meaning	NCERT page
$v = 1 / k$	Income velocity of circulation	44
$v \cdot M^d_T = T$	Quantity-theory identity (volume of transactions)	44
Money multiplier = $1 / \text{Reserve Ratio}$	Factor by which reserves create deposits	42
Required reserves = Reserve Ratio \times Deposits	Cash banks must hold	40
Maximum loans = $(1 - \text{Reserve Ratio}) \times \text{Deposits}$	Lending capacity given reserves	40
Spread = Lending rate – Deposit rate	Bank's profit margin	38
$M1 = \text{Currency with public} + \text{Demand deposits}$	Narrow money	48
$M2 = M1 + \text{Post Office savings deposits}$	Narrow money	48
$M3 = M1 + \text{Net time deposits of banks}$	Broad money — main aggregate	48
$M4 = M3 + \text{Total Post Office deposits (excl. NSCs)}$	Broadest measure	48
Bond price $\propto 1/r$	Speculative demand for money is inverse to r	45–46

2.4 Common confusions / NTA trap points

- **CRR vs SLR.** CRR is held as cash reserves **with the RBI**; SLR is held by the bank in **liquid form** (cash, gold, approved securities) in the short term. Both limit credit but are distinct.
- **Money multiplier = $1/r$, not r.** Students reflexively multiply by r — the multiplier is the **reciprocal** of the reserve ratio.
- **Narrow vs Broad money ordering.** $M1 < M2 < M3 < M4$ in size (broadly); liquidity decreases in the same order (M1 most liquid, M4 least). M3 — NOT M1 — is the most commonly used measure.
- **Coins issuer.** Coins are issued by the **Government of India**, not RBI. Only **currency notes** are issued by RBI.
- **Legal tender scope.** Demand deposits / cheques are NOT legal tender — they can be refused.
- **OMO direction.** RBI **buying** bonds **injects** money (expansionary); **selling** bonds **withdraws** money (contractionary). Students often flip this.

- **Bank Rate vs Repo Rate.** Bank Rate is the basic rate at which RBI lends to commercial banks; Repo Rate is the rate on RBI's repurchase agreements — both rate hikes contract money supply.
- **Outright OMO vs Repo.** Outright is permanent; repo/reverse repo have a pre-specified date and price of reversal.

Practice MCQs

Q1. The principal defect of a barter system, which money primarily overcomes, is:


- A. Absence of a banking system
- B. Lack of double coincidence of wants
- C. Absence of legal tender laws
- D. Lack of velocity of circulation

Q2. Which of the following statements about fiat money and legal tender is correct?

- A. Fiat money has intrinsic metallic value equal to its face value.
- B. Cheques drawn on demand deposits are legal tender in India.
- C. Currency notes and coins are fiat money and legal tender; demand deposits are not legal tender.
- D. Only coins issued by the Government of India are legal tender; notes are not.

Q3. Which of the following is ****not**** classified as narrow money?

- A. M1
- B. M2
- C. M3
- D. Currency held by the public plus demand deposits

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PYQ Alignment

Money and Banking is one of the most consistently tested macro units in CUET Economics, typically yielding around 8–12 MCQs per year split across the Class XII Introductory Macroeconomics paper. Recurring question types include direct recall (functions of money, definitions of M1–M4, narrow vs broad money), instrument-classification of monetary-policy tools (quantitative vs qualitative — CRR, SLR, Bank Rate, OMO, repo/reverse repo, moral suasion, margin requirement), assertion–reason on OMO and bank-rate effects on money supply, and at least one numerical on the money multiplier ($1/\text{CRR}$) or on maximum lending given a deposit and CRR.

CUET 2024 — Actual PYQs from this chapter

Q.12 (CUET 2024) Nominal interest rate =

- A) Real interest rate \times inflation rate B) Real interest rate – inflation rate C) Real interest rate / inflation rate D) Real interest rate + inflation rate **Tests:** Nominal vs real interest rate (Fisher relation) **Answer:** Not in extracted key

Q.17 (CUET 2024) Identify correct statements about monetary policy tools: (A) Quantitative tools control money supply via CRR (B) Open market operations include outright and upright (C) Fall in bank rate decreases money supply (D) RBI selling bonds reduces reserves (E) RBI influences money supply via lending rate Options:

- A) A, C, D B) A, B, D C) B, D, E D) A, D, E **Tests:** Quantitative monetary policy tools - CRR, OMO, bank rate **Answer:** Not in extracted key

Q.18 (CUET 2024) Match List-I with List-II List-I List-II (A) Bank Rate Minimum rate for long-term funds (B) Marginal Standing Facility Penal interest rate (C) Repo Rate Securities pledged for repurchase (D) Reverse Repo Rate RBI borrows from banks Options:

- A) A-I, B-II, C-III, D-IV B) A-II, B-III, C-I, D-IV C) A-I, B-II, C-IV, D-III D) A-III, B-IV, C-I, D-II **Tests:** Policy rates - Bank Rate, MSF, Repo, Reverse Repo **Answer:** Not in extracted key

Q.19 (CUET 2024) Which is NOT a function of the central bank?

- A) Control money supply B) Banker to government C) Accept deposits from public D) Issue currency **Tests:** Functions of the central bank (RBI) **Answer:** Not in extracted key

Q.36 (CUET 2024) During the festive season, the currency-deposit ratio:

- A) Decreases B) Increases C) Has no impact D) First decreases then increases **Tests:** Currency-deposit ratio (festive season) **Answer:** Not in extracted key

Q.44 (CUET 2024) Which of the following is not a function of money?

- A) Medium of exchange B) Store of value C) Standard of deferred payments D) Means of production **Tests:** Functions of money **Answer:** Not in extracted key

Q.45 (CUET 2024) Which policy is used to control inflation in an economy?

- A) Expansionary fiscal policy B) Contractionary monetary policy C) Increasing subsidies D) Increasing government expenditure

Tests: Anti-inflationary policy

Answer: Not in extracted key

Q.48 (CUET 2024) Which of the following is a qualitative monetary policy tool?

- A) Bank rate B) Repo rate C) Selective credit control D) Open market operations

Tests: Qualitative monetary policy tools **Answer:** Not in extracted key

