CHAPTER 3

Money and Banking

CBSE Class 12 · Macroeconomics · Chapter 3

CBSE · Macroeconomics · Class 12

WHAT THIS CHAPTER DOES

A State the four functions of money and why money beats barter.

B Define money supply measures M1, M2, M3, M4 and high-powered money.

Boards prep that builds confidence, not anxiety.

TODAY'S MISSION

Today's mission

1. State the four functions of money and why money beats barter.
2. Define money supply measures M1, M2, M3, M4 and high-powered money.
3. Explain credit creation and compute the money multiplier (1/LRR).
4. List the RBI's functions and its quantitative + qualitative policy tools.

WHY THIS MATTERS

Why this chapter matters

1. 6-8 marks every CBSE board paper — one of the highest-yield chapters.
2. Credit creation + monetary-policy instruments are repeat 4-6 mark questions.
3. Real-world relevance: this is the chapter behind every RBI repo-rate news headline.

TOPIC

A

What is money? Functions of money

THEOREM · LOAD-BEARING RESULT

Money and the barter problem

> Money is anything generally accepted as a medium of exchange and a measure of value. It replaced the BARTER system, in which goods were directly exchanged for goods.

STATEMENT

Barter required a DOUBLE COINCIDENCE OF WANTS — each party must want exactly what the other offers. Barter also lacked a common measure of value, a store of value, and easy divisibility.

WHY THIS MATTERS

- Without money, exchange is slow and costly: a wheat farmer wanting cloth must find a cloth-maker who happens to want wheat
- Money breaks the trade into two easy halves — sell wheat for money, buy cloth with money.

WATCH OUT FOR

NOTE The single biggest barter problem is the LACK OF DOUBLE COINCIDENCE OF WANTS — name it explicitly in answers; vague 'barter was difficult' loses the mark.

TOPIC

4 functions of money (2 primary + 2 secondary)

MEDIUM OF EXCHANGE (PRIMARY)

The PRIMARY and most important function: money is generally accepted in buying and selling goods, services, and factors. It splits a single barter transaction into two independent acts — a sale (good for money) and a purchase (money for good) — so the buyer and seller need

MEASURE/UNIT OF VALUE (PRIMARY)

The second PRIMARY function: money acts as a common MEASURING ROD of value (the unit of account). All prices — of onions, of a laptop, of an hour of labour — are expressed in one unit (the rupee), so values become directly comparable, accounts can be kept, and the

STORE OF VALUE (SECONDARY)

A SECONDARY (derived) function: money can be HELD to carry purchasing power forward in time — a person can sell goods today, hold the money, and buy later. Money is the most LIQUID store of value (instantly spendable) compared with land, gold, or shares.

STANDARD OF DEFERRED PAYMENT (SECONDARY)

The fourth function, also SECONDARY: future or CREDIT payments — loans, EMIs, salaries, contracts, and debts — are stated and settled in money terms. This enables borrowing and lending across time, which is the foundation of banking and credit. Barter made deferred

TOPIC

B

Supply of money

THEOREM · LOAD-BEARING RESULT

Measures of money supply

> Money supply is the total stock of money (currency + deposits) held by the PUBLIC at a point in time. The RBI publishes four measures of increasing breadth: M1, M2, M3, M4.

STATEMENT

M1 = Currency with public + Demand deposits with banks + Other deposits with RBI. M2 = M1 + Savings deposits with Post Office savings banks. M3 = M1 + Net time (fixed) deposits with banks (this is

WHY THIS MATTERS

- Different measures suit different policy needs
- M1 captures the most liquid, transaction-ready money
- M3 is the broad aggregate the RBI watches most closely for monetary-policy purposes.

WATCH OUT FOR

NOTE Money supply is a STOCK (measured at a point in time), and it is money held by the PUBLIC — it EXCLUDES money held by the government and the banking system itself. Time deposits enter only from M3, NOT M1.

TOPIC

Measures + high-powered money

M1 — NARROW MONEY

M1 is the narrowest and most LIQUID measure: M1 = Currency (notes and coins) held by the public + Demand deposits with commercial banks (current and savings account balances withdrawable on demand) + Other deposits with the RBI (a small item held by quasi-government bodies). M1

M2 AND M4 — POST-OFFICE MONEY

M2 and M4 widen the measures by adding Post Office savings: M2 = M1 + Savings deposits with Post Office savings banks; M4 = M3 + Total deposits with the Post Office savings organisation (excluding National Savings Certificates). These reflect the historical

M3 — BROAD MONEY (AGGREGATE MONETARY RESOURCES)

M3 is the most important measure for monetary policy: M3 = M1 + Net time (fixed) deposits held by the public with commercial banks. By adding time deposits, M3 captures the public's near-money savings as well as liquid cash, which is why it is called 'aggregate monetary

HIGH-POWERED MONEY (H)

High-powered money, also called RESERVE MONEY or the MONETARY BASE, is the money created and issued by the RBI: H = Currency held by the public + Cash reserves of commercial banks (vault cash + their balances with the RBI). It is 'high-powered' because each unit supports a

TOPIC

C

Commercial banks and credit creation

THEOREM · LOAD-BEARING RESULT

Credit (money) creation by commercial banks

> "Commercial banks create DEPOSIT money by lending. Because depositors do not all withdraw at once, a bank keeps only a fraction of deposits as reserve (the Legal Reserve Ratio, LRR) and lends the rest, which returns to the system as a new deposit, and the cycle repeats.

STATEMENT

Money multiplier = 1 / LRR. Total deposits created = Initial deposit × (1/LRR). With LRR = 20% (0.20): multiplier = 1/0.20 = 5, so an initial deposit of ₹1,000 expands to ₹1,000 × 5 = ₹5,000 of total

WHY THIS MATTERS

- This is why the banking system, not just the RBI, controls the money supply
- By multiplying the base, banks turn a small amount of high-powered money into a much larger total money supply.

WATCH OUT FOR

NOTE A bank lends only the EXCESS over its required reserve, not the whole deposit. The full multiple is created by the WHOLE banking system across many rounds, not by one bank at once. Memorise: 1/0.20 = 5, total = ₹5,000.

WORKED EXAMPLE

Money multiplier — LRR 20%, deposit ₹1,000

1. Given: Initial deposit = ₹1,000; Legal Reserve Ratio (LRR) = 20% = 0.20.
2. Round 1: Reserve kept = 20% × 1,000 = ₹200. Loan given = ₹800. The ₹800 is re-deposited.
3. Round 2: Reserve kept = 20% × 800 = ₹160. Loan given = ₹640. Re-deposited.
4. Round 3: Reserve kept = 20% × 640 = ₹128. Loan given = ₹512. The rounds shrink geometrically.
5. Money multiplier = 1/LRR = 1/0.20 = 5.
6. Total deposits created = Initial deposit × multiplier = ₹1,000 × 5 = ₹5,000. (Total reserves end at ₹1,000 = 20% of ₹5,000 — check.)

TOPIC

D

The Central Bank (RBI)

TOPIC

4 functions of the Central Bank

BANK OF ISSUE (CURRENCY AUTHORITY)

The RBI has the SOLE MONOPOLY to issue currency notes in India (the Government issues only ₹1 notes and all coins). Centralising note-issue with the central bank gives the currency uniformity, public confidence, and elasticity (the supply can be adjusted to the

BANKER, AGENT AND ADVISER TO GOVERNMENT

The RBI is the BANKER TO THE GOVERNMENT — it keeps the central and state government deposit accounts, receives and makes payments on their behalf, manages the PUBLIC DEBT (issuing and servicing government securities), and advises the government on

BANKERS' BANK AND LENDER OF LAST RESORT

The RBI is the BANKERS' BANK: commercial banks keep a portion of their reserves (CRR) with it, it acts as the clearing house for inter-bank settlements, and it supervises and regulates the banks. Crucially, it is the LENDER OF LAST RESORT — in a liquidity crisis, when a sound

CONTROLLER OF CREDIT / MONEY SUPPLY

The RBI's most exam-relevant function: it CONTROLS the volume and direction of CREDIT to manage money supply, inflation, and growth. It uses QUANTITATIVE tools — Bank Rate / Repo Rate, Cash Reserve Ratio (CRR), Statutory Liquidity Ratio (SLR), and Open Market Operations

TOPIC

E

Instruments of monetary policy

TOPIC

Quantitative + qualitative instruments

BANK RATE / REPO RATE

The REPO RATE is the rate at which the RBI lends short-term funds to commercial banks against securities; the BANK RATE is the rate for longer-term RBI lending. Both work the same way: RAISING the rate makes RBI credit costlier, so banks borrow and lend less and charge higher interest — money

CRR AND SLR

Two reserve ratios reduce banks' lendable funds. CRR (Cash Reserve Ratio) is the fraction of net deposits a bank must keep as CASH with the RBI. SLR (Statutory Liquidity Ratio) is the fraction it must keep WITH ITSELF in liquid assets — cash, gold, and approved government securities

OPEN MARKET OPERATIONS (OMO)

OMO are the RBI's purchase and sale of government securities in the open market to adjust liquidity. When the RBI SELLS securities, it absorbs cash from banks and the public → reserves fall → money supply CONTRACTS. When the RBI BUYS securities, it injects cash

QUALITATIVE TOOLS

Qualitative (selective) instruments affect the DIRECTION rather than the total quantity of credit. MARGIN REQUIREMENT is the gap between the value of collateral and the loan granted — raising the margin reduces lending against that asset (used to curb speculation in, say, food-grains or

WORKED EXAMPLE

Money supply — what counts where

1. Currency (notes/coins) held by the public ⇒ part of M1 (and all broader measures).
2. Demand deposits in a savings/current account ⇒ part of M1 (liquid, withdrawable on demand).
3. A 2-year fixed (time) deposit ⇒ NOT in M1; it enters M3 (M3 = M1 + net time deposits).
4. Cash reserves of banks held with the RBI ⇒ part of high-powered money (H), NOT counted again in public money supply.
5. Rule: money supply is money held by the PUBLIC; it excludes the government's and the banking system's own holdings.

TOPIC

CRR vs SLR

TRAP → TRUTH

× **MISTAKE** CRR and SLR are the same thing — both money banks keep idle.

✓ **CORRECT** CRR (Cash Reserve Ratio) = the fraction of net deposits a commercial bank MUST keep as CASH with the RBI. SLR (Statutory Liquidity Ratio) = the fraction a bank must keep with ITSELF in LIQUID assets (cash, gold, approved government securities). CRR is held at the RBI; SLR is held by the bank in specified safe assets. Both reduce lendable funds but are distinct legal ratios.

TOPIC

M1 components

TRAP → TRUTH

× **MISTAKE** M1 includes time/fixed deposits.

✓ **CORRECT** M1 = Currency with public + Demand deposits with banks + Other deposits with RBI. M1 is the most LIQUID measure and does NOT include time (fixed) deposits. Time deposits enter only from M3 onward (M3 = M1 + net time deposits with banks). Confusing M1 with M3 is a common –1 mark.

TOPIC

Money multiplier

TRAP → TRUTH

× **MISTAKE** A bank can lend out the entire deposit it receives.

✓ **CORRECT** A bank can lend only the EXCESS over its required reserve. With LRR = 20%, a ₹1,000 deposit lets the bank lend ₹800 and keep ₹200. That ₹800 is re-deposited, ₹640 re-lent, and so on. Total deposits created = Initial deposit × 1/LRR = 1000 × 5 = ₹5,000. The bank does NOT create the full multiple at once — it emerges across the banking system.

TOPIC

Who creates money

TRAP → TRUTH

× **MISTAKE** Only the RBI (central bank) creates money.

✓ **CORRECT** The RBI issues CURRENCY (high-powered money / reserve money). But COMMERCIAL BANKS create DEPOSIT money (credit) through the credit-creation process, expanding the money supply by a multiple of the high-powered money. Both contribute: RBI controls high-powered money; banks multiply it.

TOPIC

Repo rate direction

TRAP → TRUTH

× **MISTAKE** Raising the repo rate increases money supply.

✓ **CORRECT** Raising the repo rate makes RBI lending to banks COSTLIER → banks borrow less and lend less → money supply CONTRACTS (anti-inflation, 'dear money'). Lowering repo expands money supply ('cheap money'). The relationship is INVERSE: repo up → money supply down.

TOPIC

Functions of money

TRAP → TRUTH

× **MISTAKE** Money's only function is to buy things.

✓ **CORRECT** Money has FOUR functions: (1) medium of exchange (buying/selling, solves double coincidence), (2) measure/unit of value (common measuring rod for prices), (3) store of value (wealth held over time), (4) standard of deferred payment (debts/credit contracts in money terms). The first two are PRIMARY; the last two are SECONDARY.

TOPIC

High-powered money

TRAP → TRUTH

× **MISTAKE** High-powered money is the same as total money supply M3.

✓ **CORRECT** High-powered money (H) = reserve money = currency held by public + cash reserves of banks (with RBI). It is the BASE issued by the RBI. Total money supply (M) is a MULTIPLE of H via the money multiplier (M = H × multiplier). H is small; M is large. They are not equal.

TOPPER TEMPLATE · MARK-BY-MARK

5-6 mark: 'Explain the process of money/credit creation by commercial banks.'

1	**SET-UP + LRR** 1 m	Commercial banks create DEPOSIT money (credit) using the Legal Reserve Ratio (LRR). Banks know from experience that all depositors do not withdraw at once, so they keep only a fraction (LRR) as reserves and lend out the rest. Let LRR = 20% and an initial deposit = ₹1,000.
2	**ROUND-BY-ROUND LENDING** 2 m	Round 1: Bank keeps ₹200 (20% of 1,000) as reserve, lends ₹800. The ₹800 is spent and re-deposited in the banking system. Round 2: Bank keeps ₹160 (20% of 800), lends ₹640. Round 3: keeps ₹128, lends ₹512. The process continues in ever-smaller rounds.
3	**MONEY MULTIPLIER FORMULA** 2 m	Total deposits created = Initial deposit × Money multiplier, where Money multiplier = 1/LRR = 1/0.20 = 5. Therefore total deposits = ₹1,000 × 5 = ₹5,000. The banking system as a whole has multiplied the initial deposit five-fold.
4	**LIMIT + CONCLUSION** 1 m	Credit creation is LIMITED by the LRR — a higher LRR means a smaller multiplier and less credit. The expansion stops when total reserves equal LRR × total deposits. Thus banks create money many times the initial deposit, but the multiple is capped by the reserve ratio set by the RBI.

TOPPER TEMPLATE · MARK-BY-MARK

4-mark: 'Explain any four functions of the Central Bank (RBI).'

1	**BANK OF ISSUE** 1 m	CURRENCY AUTHORITY (bank of issue): The RBI has the sole monopoly to issue currency notes (except ₹1 notes/coins issued by the Government). This ensures uniformity and public confidence in the currency.
2	**BANKER TO GOVERNMENT** 1 m	BANKER, AGENT AND ADVISER TO THE GOVERNMENT: The RBI keeps the government's accounts, manages public debt, and advises on monetary and fiscal matters.
3	**BANKERS' BANK + LENDER OF LAST RESORT** 1 m	BANKERS' BANK AND LENDER OF LAST RESORT: The RBI holds the reserves of commercial banks, clears their inter-bank transactions, and lends to them in a crisis when no one else will — the lender of last resort.
4	**CONTROLLER OF CREDIT** 1 m	CONTROLLER OF CREDIT / MONEY SUPPLY: Through quantitative tools (Bank Rate/repo, CRR, SLR, Open Market Operations) and qualitative tools (margin requirements, moral suasion), the RBI controls the volume and direction of credit in the economy.

TOPPER TEMPLATE · MARK-BY-MARK

3-mark: 'Explain the functions of money / distinguish primary and secondary functions.'

1	**PRIMARY FUNCTIONS** 1 m	PRIMARY (main) functions are two: (a) MEDIUM OF EXCHANGE — money is accepted in buying and selling, removing the barter need for a double coincidence of wants; (b) MEASURE/UNIT OF VALUE — money provides a common measuring rod (the rupee) so prices of all goods can be compared.
2	**SECONDARY FUNCTIONS** 1 m	SECONDARY (derived) functions are: (c) STORE OF VALUE — money can be held to carry purchasing power into the future; (d) STANDARD OF DEFERRED PAYMENT — future/credit payments and debts are stated in money terms, enabling borrowing and lending.
3	**WHY MONEY BEATS BARTER** 1 m	Money solves the THREE barter problems: lack of double coincidence of wants, lack of a common measure of value, and lack of a store of value/divisibility. This is why money is the foundation of a modern exchange economy.

PYQ PATTERNS

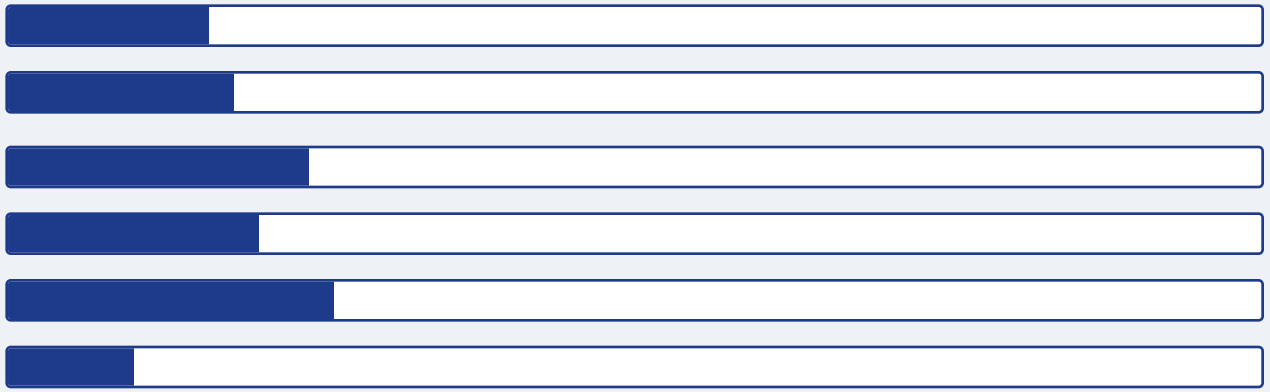
Top PYQ patterns to drill

#1	Explain the process of credit/money creation by commercial banks (with money multiplier). (4-6 marks)	2018, 2020, 2022, 2024
#2	Explain any two/four functions of the Central Bank (RBI). (3-4 marks)	Most years
#3	How does an increase in CRR / repo rate affect money supply? (quantitative instruments) (3-4 marks)	2019, 2021, 2023
#4	Explain the functions of money / distinguish primary from secondary functions. (3 marks)	2017, 2019, 2022
#5	Calculate total credit created given LRR and initial deposit (money multiplier). (3-4 marks)	2018, 2021, 2024

MARKS DISTRIBUTION

10-year marks distribution

10-YEAR PYQ MARKS DISTRIBUTION



RECAP · MEMORISE THESE

Recap

1 Money + functions — Money solves barter's double-coincidence problem. 4 functions: medium of exchange + measure of value (primary); store of value + standard of deferred payment (secondary).

2 Money supply + creation — M1 (liquid, no time deposits) ⊂ M3 (adds net time deposits). High-powered money H is the RBI-issued base. Banks create credit: multiplier = 1/LRR; LRR 20% → 5 → ₹1,000 becomes ₹5,000.

3 RBI + policy tools — RBI = bank of issue, banker to govt, bankers' bank/lender of last resort, controller of credit. Quantitative: repo/ Bank Rate, CRR, SLR, OMO. Qualitative: margin requirement, moral suasion. Tighten → money supply falls.

WHAT'S NEXT

What's next

→ Chapter 4 — Determination of Income and Employment (how money/AD set output).

→ Sit the 15-MCQ Quick Drill, then re-do the money-multiplier numerical.

→ Then the full Board-Pattern Paper — 25 marks.

You've mastered Money and Banking.

Functions of money, money supply, credit creation, RBI tools — now prove it.

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