VIDYA BHAWAN BALIKA VIDYA PITH

शक्ति उत्थान आश्रम लखीसराय बिहार

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Teacher name – Ajay Kumar Sharma

Money and Banking (Q.A)

Question 6:

What is `liquidity trap'?

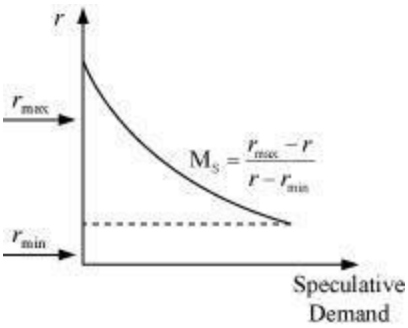
ANSWER:

Liquidity trap is a situation in which speculative demand function is infinitely elastic; it is explained as follows:

The price of a bond has an inverse relationship with the market interest rate. If the interest rate is very high and people expect it to fall in the future, then the bond prices will rise being inversely related to the interest rate. In order to earn capital gains in future, people will purchase bonds (as bonds are cheaper) and hence the speculative demand for money will become low. On the contrary, if the interest rate is low and people expect it to rise in future, then the bond prices will fall and in order to avoid capital loss, people will sell their bonds and convert their bonds into idle cash balances. Liquidity trap is an extreme case of the latter situation. When the interest rates are very low, then everyone expect interest rates to go up in future. Thus, to avoid capital loss, everybody prefers to maintain cash balance and not bond. Consequently, the speculative demand for money is infinitely elastic. In this situation, if the additional money is pumped into the economy, then, this will only satisfy the thirst for money, without increasing the demand for bonds. Pumping additional money in this situation will further exaggerate the condition as this will further reduce the interest rate below r_{min}.

The relationship between speculative demand for money and the rate of interest is given as

$$M_s^d = \frac{r_{max} - r}{r - r_{min}}$$



In the above diagram, interest rate is represented on the vertical axis and speculative demand on the horizontal axis. When $r = r_{min}$, the economy is in liquidity trap, where the speculative demand for money is infinite elastic.

Question 7:

What are the alternative definitions of money supply in India?

ANSWER:

The various definitions of money supply in India as prescribed by RBI are M_1, M_2, M_3 and M_4.

M_1, M_2, M_3 and M_4 are arranged in the descending order of liquidity. In other words, M_1 has the highest liquidity and M_4 has the least liquidity.

So,

$M_1 = C + DD + OD$

Where,

C = Currency held by public

DD = Net demand deposits of the bank

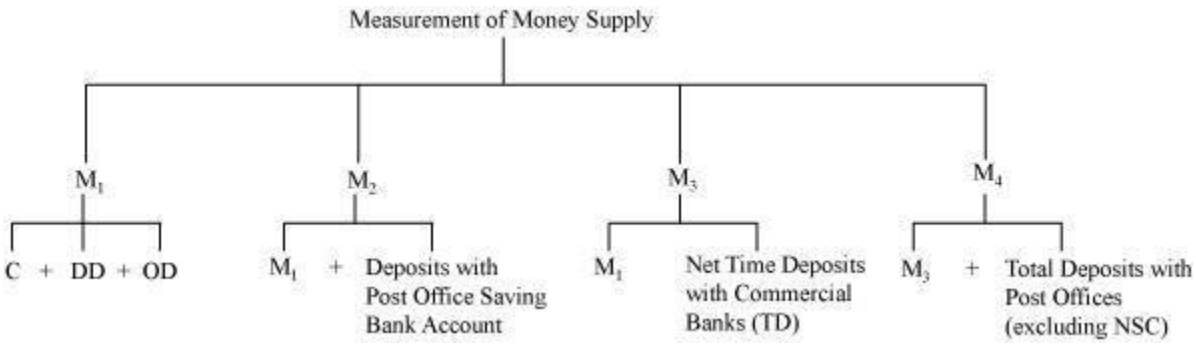
OD = other deposits held by RBI

$M_2 = M_1$ + Savings of the people with Post offices (M_2 includes the components of M_1 as well as the savings of people with Post office.)

$M_3 = M_1$ + Net time deposits with commercial banks (M_3 is the most commonly used measure of money supply. It includes the components of M_1 and net time deposits of commercial banks.)

$M_4 = M_3$ + Total deposits with post offices (excluding National Saving certificate)

All these definitions of money supply in India are represented in the flow chart given below.



Question 8:

What is a ‘legal tender’? What is ‘fiat money’?

ANSWER:

Legal tender refers to the currency notes and coins being issued by the monetary authorities of India (RBI and government of India) as a legal medium of payment. Fiat money derives its value only because of government order (fiat). The currency becomes fiat money when the government declares it to be the legal tender. This is not backed by reserves, but by faith or trust. This money does not have intrinsic value, i.e. the real value is not equivalent to the face value printed on the notes and coins.

Question 9:

What is High Powered Money?

ANSWER:

High powered money is the total liability of the monetary authority of the country. This is also called the monetary base and is created by the RBI. High powered money includes currency (notes and coins), deposits with the government and reserves of commercial banks with RBI. So, to sum up, high powered money is

$H = C + R$

Where

H − High powered money

C − Currency

R − Cash Reserves of commercial banks

Question 10:

Explain the functions of a commercial bank.

ANSWER:

Commercial banks perform various functions that are as follows:

1. Accepting deposits

The basic function of commercial banks is to accept deposits of the customers. These deposits are of the following types:

(i) *Saving Accounts*

Saving accounts cater to the needs of those individuals who wish to save a part of their income and earn interest on the amount saved. Account holders of saving accounts can deposit cheques, drafts, etc. However, there is a limit on withdrawal.

(ii) *Fixed deposit accounts*

As the name suggests, fixed deposit accounts imply deposits are kept for fixed periods of time; for example, Rs.500 per month for 5 years. The period has to be decided in advance, while opening the account. Holders of these accounts do not enjoy the cheque facility. Higher the time period, higher will be the interest rate, which is decided by RBI.

(iii) *Current deposits accounts*

Current deposit accounts are also called ‘demand deposits’ as the depositor can withdraw money at any time through cheques. Businessmen use this account to make many transactions in a single day; however, they do not earn interest on the deposits. Banks provide account statements to the current account holders at regular intervals.

2. Granting loans and advances

The second most important function of the commercial banks is to give loans and advances. The rate of interest charged by the banks on loans is higher than the rate of interest paid by the banks on demand deposits and saving deposits. Loans granted by commercial banks are generally for long term and are given against securities. Advances are given by a bank only for a short span of time.

3. Agency functions

The commercial banks perform various agency functions with the prime purpose of acceptance of deposits and granting of loans. Their functions include:

(i) Transfer of funds − The banks provide easy flow of funds from place to place via mail transfers, demand drafts, etc.

(ii) Collection of funds − The banks also collect funds on behalf of its customers through bills, cheques, etc.

(iii) Banks collect insurance premiums, dividends, interest on debentures, etc.

(v) Banks assist in the process of tax payment by the accountholders.

(vi) Banks also play the role of trustees or executors.

4. Discounting bills of exchange

Commercial Banks provide financial assistance to the business community by discounting bills of exchange. The banks purchase these bills, produced by customers, by deducting interest from the face value of the bill, thus providing easy finances to the business community when required.

5. Credit creation

Commercial banks create credit in the economy through demand deposits. Credit creation paves the path for the growth of the economy.

6. Other functions

(i) Providing locker facility

(ii) Purchase and sale of foreign exchange

(iii) Issue of gift cheques

(iv) Underwriting of shares and debentures

(v) Providing information and statistical data useful to customers