Chapter 4: Banking and Monetary Policy GSEB Class 12 Economics — Complete Board Exam Notes

Chapter Index

INTRODUCTION

All of us may be aware of the word bank. We may have deposited domestic savings in a bank in the form of term deposits or savings deposits. Parents may have opened accounts for business transactions and receive LPG subsidies in their bank accounts. We have paid school fees by cheque, withdrawn money for buying TV or refrigerators, or borrowed money as a loan from a bank to purchase a house. Thus, in modern times **most of our monetary transactions take place through banks**.

4.1 EVOLUTION AND MEANING OF BANKS

Etymology of the word 'Bank':

- In English language, the word bank means **'heap' or 'mass'**.
- In Sanskrit language, the word akin to bank is **'bhanda'** which means collection of capital/fund.
- The word **'bhandod'** is derived from 'bhanda'.
- The English word bank originated from the Italian word **'banca'** or from the French word **'banque'**. Both these words meant a 'Bench' for money exchange.
- In olden days, European money lenders used to display coins of different countries in **big heaps on benches or tables** for the purpose of lending or exchanging. Thus, they were exchangers of various coins.
- It can be concluded that the word bank is related to **collection/fund of money**.

The **'Bank of Barcelona'** set up in Spain in **1401** is known to be the first real bank established in the world. With the introduction of currency money, people started using money not only as a measuring rod of value, unit of account or medium of exchange, but also as a store of value and standard of deferred payments.

In short, in economic systems dependent on money, there arose the need for an institutional arrangement for safety of money, transfer of money and maintaining the value of money — and the role of such an institution is played by banks.

Meaning of a Bank:

A bank is that institution which provides services of banking. That is:

- A bank is an institution authorised to collect peoples' savings/deposits with the purpose of lending those under the condition of returning the same when the depositor demands.
- A bank is a commercial organization functioning for profit which accepts peoples' savings in the form of deposits and pays interest in return, ensures the safety of these deposits, lends money from these deposits

to people who need money by charging interest, and invests the surplus funds in various sectors for development of the nation.

■ **Banks are instrumental in mobilizing money. Value of idle/un-mobilized money tends to fall at a future date. Value of circulating money tends to increase.**

4.2 CLASSIFICATION OF BANKS (MAJOR TYPES)

Banks are broadly classified in two categories: **(1) Commercial Bank (2) Central Bank**

4.2.1 COMMERCIAL BANK

According to the **Banking Company Act, 1949**:

> ***"Commercial bank is one which transacts the business of banking, that is, accepting deposits from the people for the purpose of lending or investment; repayable on demand or otherwise and withdrawable by cheque, draft, pay-order or otherwise."***

A commercial bank is a **business unit which provides banking services for profit**. People entrust their savings with the banks which banks handle in the form of deposits. Banks also use some of these deposits for other economic activities and therefore give interest to the depositors.

Banks may use deposits for investment in agricultural and industrial sectors, buy government securities, or lend some proportion of the deposits to people who need money. The lending rate of interest is higher than the rate of interest given on deposits — the difference is the profit. Hence, banks are called **commercial institutions**.

4.2.1.1 Functions of Commercial Banks

Commercial banks perform several functions which are divided into:

(A) PRIMARY FUNCTIONS:

(1) Accepting Deposits:

A bank accepts money from the people (savers) in the form of deposits. It gives safety to the deposits of its customers by acting as a custodian of funds. **Deposits are mainly of three types:**

(1) Current Account Deposits:

A current account is opened with a bank in the name of a business, firm, or an individual. The deposits in this account are **more liquid** than deposits in any other account. Withdrawal can be made any number of times during a day. The customers get a cheque book but **do not get interest** on current account deposits. On the contrary, certain times banks may impose some kind of service charges. A customer may even obtain **overdraft facility** for business purpose on this account.

(2) Savings Account Deposits:

People usually deposit savings for a short period in this account for which banks give them interest. Upon requirement, they can withdraw with a cheque or withdrawal slip. In present times they can also withdraw money using debit card or credit card.

Facility of Recurring Account (Recurring Deposit):

These deposits are also a type of savings deposits. People who do not wish to or cannot save bigger sums of money, save and deposit small amounts each month for some period of time. Thus, the savings gradually increase and interest is paid on the accumulated money. By rules of some banks, if a person skips depositing some month's money, she/he may have to pay a penalty along with some interest loss.

Fixed/Long Term Deposits:

These deposits are for a **fixed period of time** and usually people who want to deposit money for a long period of time choose such deposits. Banks pay the **highest rate of interest** on such deposits among all types of deposits. Customers get overdraft facilities on such deposits.

Type of Deposit	Interest Paid	Withdrawal	Special Feature
Current Account	No interest (may charge service fee)	Any number of times per day	Overdraft facility; for businesses
Savings Account	Yes (low rate)	Cheque, ATM, debit/credit card	Most common; for individuals
Recurring Deposit	Yes (on accumulated amount)	After maturity	Fixed monthly deposits; small savers
Fixed/Long Term Deposit	Highest rate among all	After fixed period (overdraft possible)	For long-term savers

Table: Types of Bank Deposits

(2) Providing Credit Facilities:

When individuals or businesses require money for personal or investment purposes, they borrow from banks and banks provide credit by charging a rate of interest. In terms of time period, borrowing/credit can be:

- **Short term:** Period up to 1 year
- **Medium term:** Period between 1 and 5 years
- **Long term:** Period between 5 and 15 years

In the context of purpose, credit can be for personal reasons, for agricultural activity or for business activity. The rates of interest charged vary with purpose.

(3) Payment and Withdrawal Facilities:

A bank provides easy payment and withdrawal facility to its customers in the form of **cheques, withdrawal slips, drafts, pay order, ATM facilities (Automatic Teller Machines), credit and debit cards, internet banking**, etc.

(4) Credit Creation:

Banks undertake the activity of credit creation to ensure that the supply of money in the economy fulfils the demand for money. **Banks create money from the existing stock of money (deposits)** — thereby add to the supply of money in the economy.

When a bank lends money from primary deposits, the borrower has to open an account with the same bank or another branch in order to deposit the cheque of the loan. When the cheque is credited in the new account, it becomes a **derived deposit** for the bank. From this derived deposit, the bank can create still another loan account for a third person. Thus, a bank can create several deposits from a primary deposit.

No bank can lend the full amount of a deposit. From every deposit, the bank has to keep aside some proportion of money in the form of cash reserves known as **cash reserve ratio**. Thus they can lend only the remaining money.

Example: If a bank has a primary deposit of ■1,000 and the cash reserve ratio is 20%, then the bank can create credit up to ■1,000 × (1/20%) = ■5,000. So primary deposit of ■1,000 can create a money supply of ■5,000 and new credit of ■4,000 is created.

Bank	Net Deposits (■)	Required Reserves (■) @ 20%	New Loans (■)
A	1,000	200	800
B	800	160	640
C	640	128	512
...	...	...	...
Total	5,000	1,000	4,000

Table 4.1: Credit Creation with 20% Cash Reserve Ratio

Credit Creation = Primary Deposit × (1 / Cash Reserve Ratio)

When customers withdraw more money than the deposited amount from their current account, it is called **over draft facility** and this also leads to credit creation.

(5) Inter-Banking Transactions:

Banks provide short term and long term credit to one another from time to time. Short term credit is provided by one bank to another through the central bank and is called **'call money'**. The interest rate on call money is called the **'call money rate'**.

(B) SECONDARY / OTHER FUNCTIONS OF COMMERCIAL BANKS:

(1) Agency and Utility Services:

A bank provides various utility and agent banking facilities to its customers. For example, a bank can act as a mediating agent by providing a letter of credit to the exporter on behalf of the importer. Banks also provide underwriting services to various businesses. Banks also provide facilities to pay tax challans and provide **safe deposit vaults** on rent to customers to safely store precious jewellery, documents etc. Banks provide **micro finance facilities** for very small businesses which are important for development of communities. When some payments are to be made with full proof security, banks provide service to the payer by issuing draft or pay order.

(2) Provide Various Facilities with Changing Times:

Banking is an evolutionary concept. In present times, electronic transfer of money from the account of one customer to that of any other customer of any bank (without using cash or cheque) is done through facilities like:

- **NEFT** (National Electronic Fund Transfer)
- **RTGS** (Real Time Gross Settlement)

Both these are possible because of **CORE banking** (Centralized Online Real Time Exchange). Besides, customers can get various details of their account and make payments, buy goods, book tickets etc. on their computer or mobile phone through internet banking and mobile banking app. Banks also provide safe deposit vaults and facilities of **DEMAT account** (Dematerialized account) — an account where shares, debentures, bonds etc. can be held in electronic form.

4.2.1.2 Presence of Commercial Banks in India

Commercial banks in India operate in the public as well as private sectors. After the economic reforms of 1991, foreign banks have entered the private sector. Besides, there are financial companies which function like banks in the unorganized and organized money markets of India, and there is also the existence of co-operative banks.

By the official definition of banks in India, only those companies which are listed in the **2nd schedule of the RBI Act, 1934** are called **scheduled banks** and are the real banks. All rules and regulations of the Reserve Bank of India apply to these banks.

SCHEDULED BANKS IN INDIA				
Public Sector Commercial Banks	Private Sector Commercial Banks	Foreign / Multinational Banks in India	Regional Rural Banks (RRBs)	Co-operative Banks

The above chart gives a classification of scheduled banks in India.

4.2.2 CENTRAL BANK

There exists a central bank in all countries of the world which manages, evaluates and regulates the banking activities in the entire country. Besides, a central bank protects the interests and rights of customers of various banks and of the general public.

> *"The institution charged with the responsibility of managing the expansion and contraction of the volume of money in the interest of the general public welfare."*
>
> **— R. P. Kent**

Hence, central bank is the **Apex bank of the country** whose function is to aid, regulate and promote the entire money market and the banking sector; as well as to maintain monetary/financial stability for overall economic good of the nation. Mobilization of money has several macroeconomic implications which impact economic growth and development of a nation. A central bank also provides monetary/financial advice and suggestions to the government.

4.2.2.1 Reserve Bank of India (RBI)

- The central bank in India is known as **Reserve Bank of India (RBI)**.
- Under the Reserve Bank of India Act of **1934**, the Reserve Bank of India was established on **April 1, 1935** with a private paid up capital of **■5 crores**.
- RBI was **nationalized on January 1, 1949**.
- RBI is the **Apex bank of India** which supervises and regulates the entire banking sector as well as formulates the monetary policy of India.
- In order to fulfil this responsibility, a central bank formulates a **monetary policy**. In short, a central bank assumes the responsibility of maintaining economic stability.

4.2.2.2 Functions of Reserve Bank of India

As the Apex bank of India, the RBI performs functions in two broad categories:

(A) MONETARY FUNCTIONS (MONETARY RESPONSIBILITIES):

(1) Currency Issue:

Reserve Bank of India has the **sole right to issue notes** of denominations starting from ■2 and above. Currency note of ■1 and all currency coins are issued by the **Finance Ministry of Government of India**. But the distribution of one rupee notes and currency coins is done by the RBI as an agent of the Government of India.

(2) Banker to the Government:

The RBI is a **banker, advisor and agent** of the central government and of all state governments. It manages government bonds, government accounts, currency coins and notes of ■1, and also provides loans to the government.

(3) Bankers' Bank and Lender of Last Resort:

The RBI is a banker and regulator of all the scheduled banks in the country. It manages the Cash Reserves of banks, determines the direction of credit as well as directs the credit policy and rate of interest for all banks. It is also the **lender of last resort** for the scheduled banks in case of emergency.

(4) Credit Control:

The RBI controls the process of credit creation and money supply in the economy with the help of various tools of monetary policy.

(5) Custodian of Foreign Exchange Reserves:

The RBI has the responsibility of maintaining the value of rupee vis-a-vis other currencies. Under free exchange rate system, RBI maintains the value of Indian currency by buying and selling foreign exchange in the open market as and when required. The RBI is also the custodian of India's reserves of foreign currencies. It also administers foreign exchange reserves by checking the inflow or outflow of foreign exchange.

(B) NON-MONETARY FUNCTIONS OF RESERVE BANK OF INDIA:

(1) Regulatory and Supervisory Functions:

RBI supervises the functioning of the entire financial and money markets which include **branch expansion and methods of working of scheduled banks, working of non-banking finance companies and of**

co-operative banks.

(2) Promotional Functions:

Even today, there are many people in India who do not hold a bank account. They depend on unorganized money market for their credit needs, make business related payments in cash rather than by cheques. Hence RBI tries to create **banking awareness** among people, encourages branch expansion in rural areas and promotes setting up of co-operative banks in the interest of the people. It makes efforts to get more and more people under the organized money market.

(3) Financial Inclusion and Development:

India is a country with huge degree of economic diversity and rural-urban divide. Whenever major economic reforms and changes come about, it is necessary that people and economic units of all segments receive benefits. For such inclusion, RBI continuously makes efforts in the banking sphere. It provides special credit facilities to priority sectors like **agriculture, small scale industries, self-employed people, traditional and cottage industries** etc.

RBI also works towards protecting the interests and rights of customers. It publishes all types of banking related information and statistics as well as experts' articles in order to promote research related to banking and monetary improvement in the country. In the present times, RBI manages the Prime Minister's **'Jan Dhan Yojana'**.

Function	Category	Key Detail
Currency Issue	Monetary	Issues ■2 and above notes; ■1 issued by Finance Ministry
Banker to Govt.	Monetary	Manages govt. bonds, accounts, loans to govt.
Bankers' Bank & Lender of Last Resort	Monetary	Regulates all scheduled banks; emergency lending
Credit Control	Monetary	Controls money supply using monetary policy tools
Custodian of Forex Reserves	Monetary	Maintains rupee value; manages forex reserves
Regulatory & Supervisory	Non-Monetary	Supervises all banks, NBFCs, co-operative banks
Promotional	Non-Monetary	Banking awareness, rural branch expansion, co-op banks
Financial Inclusion	Non-Monetary	Jan Dhan Yojana; credit to agriculture, SSI, cottage industries

Table: All Functions of RBI

4.3 MONETARY POLICY

In economic theory, monetary policy is the policy which **regulates the demand for money and supply of money in the economy**. It is essential to regulate these as an imbalance between demand for money and supply of money can result in inflation or deflation, can impact the value of Indian currency and destabilize the economy. Hence monetary policy is also known as one of the **stabilization policies**.

In earlier times, the purpose of monetary policy in India was more to regulate the volume of money, value of money and nature of money. In the present times, the monetary policy is used more for credit creation.

'Monetary policy constitutes the conscious steps undertaken by the monetary authority which bring about changes in the stock of money, source/generation of money, and cost of money.'

'The policy which entrusts various tools of regulating supply of money in the hands of the apex bank with the purpose of achieving general economic objectives is called monetary policy.'

'In simple terms, the policy undertaken by the apex bank for regulating the supply of money in order to maintain economic stability keeping into consideration the process of economic development and

interest of the public is called monetary policy.'

4.3.1 INSTRUMENTS OF MONETARY POLICY

The important instruments of monetary policy can be explained as:

(A) QUANTITATIVE MEASURES (GENERAL MEASURES)

The quantitative measures are aimed at impacting the entire economy in a general/common way and hence these are also called **general measures**.

(1) Bank Rate:

When commercial banks have shortage of funds, they borrow from the RBI. The rate at which **RBI lends to the commercial banks for long term** is called the **bank rate**.

How it controls inflation: If the bank rate is increased, commercial banks will borrow less (expensive to borrow). When they borrow less and at higher rate, they give lesser amount of loans at higher rate to the general public. When people get fewer loans, their demand for goods and services falls. There is lesser creation of money, lower demand for goods, and lower circulation of money. Thus, bank rate is increased to control inflation.

Conversely: low bank rate = cheap money policy; high bank rate = dear money policy.

Note: RBI has stopped using bank rate as an instrument to regulate money supply since last few years and is using **repo rate and reverse repo rate** instead. Bank rate is for long term and hence cannot be changed in the very short period, while repo and reverse repo rates can be altered in very short periods also.

Year	Bank Rate (in %)
1953	3.5
1981	10
1991	12
2016	7

Table 4.2: Trends of Bank Rate in India (Source: www.rbi.org)

(2) Repo Rate and Reverse Repo Rate:

When commercial banks need funds for very short period (sometimes for 1 day, 7 days, 15 days, etc.) they sell some securities which are held by them to RBI with a **repurchase agreement** at a particular rate. This rate is called the **repo rate**. (The word 'repo' is used for the term 'repurchase rate'.) Banks sell government securities to RBI in order to raise money for a very short term with a condition to repurchase them at some discount.

In the event of inflation: Central banks increase repo rate as this acts as a disincentive for banks to borrow from the central bank. Subsequently they lend to the general public at higher rate and ultimately people borrow less — thus money supply and inflation are arrested.

Reverse Repo Rate means the agreed upon rate at which the RBI repurchases its securities from the commercial banks when the RBI has to borrow short term funds from the commercial banks by parking its securities with the commercial banks. An increase in reverse repo rate means commercial banks will get more incentives to park their funds with the RBI by lending more to RBI, thereby decreasing their lending to general public and ultimately reducing the supply of money in the market.

Year	Repo Rate (%)	Reverse Repo Rate (%)
January 2006	6.50	5.50
March 2010	5.0	3.50

Year	Repo Rate (%)	Reverse Repo Rate (%)
April 2016	6.5	6

Table 4.3: Repo and Reverse Repo Rates (Source: www.rbi.org)

■ **Key: Bank Rate = Long term lending rate (RBI→banks) | Repo Rate = Short term (banks sell securities to RBI) | Reverse Repo Rate = RBI borrows from banks | Bank Rate > Repo Rate > Reverse Repo Rate**

(3) Stabilization under Emergency Situation (Marginal Standing Facility):

There is a special window for banks to borrow from RBI against approved government securities in an **emergency situation like acute cash shortage**. This rate is higher than Repo rate. In 2016, this rate was **7%**. (This is called **marginal standing facility**.)

(4) Cash Reserve Ratio (CRR):

Under the RBI Act, 1934, all commercial banks have to keep certain minimum cash reserves with the RBI. Initially CRR was decided to be 5% of demand deposits and 2% of time deposits. Since 1962, **CRR is variable between 3% and 15%** of the total deposits of individual banks.

CRR fulfils the need of a comfortable amount of cash reserves with the banking system, in case many customers start withdrawing their deposits simultaneously.

As instrument to control inflation: When CRR is higher, commercial banks have lesser deposit money to create credit. Thus, they give fewer loans to people and hence money supply and inflation are curtailed. CRR is **reduced in times of deflation and depression** to increase money supply.

(5) Statutory Liquidity Ratio (SLR):

Apart from and in addition to CRR, under the **Banking Regulation Act, 1949**, all banks have to maintain equal to and not less than **25% of their total deposits** (demand and time deposits) in the form of **cash, gold and unencumbered approved securities**.

A higher SLR diverts bank funds from loans and advances to approved government securities and helps to meet government expenditures — but on the other hand, it reduces the capacity of banks to create loans and raise money supply. A lower SLR increases the capacity of banks to create loans and raise money supply by credit creation. If SLR is higher people get lesser credit and vice-versa.

(6) Open Market Operations (OMOs):

Open market operations refer to **sale or purchase of government securities/bonds by the RBI in the open market**. When the RBI purchases government bonds from the market, the supply of money in the economy rises. The supply of money in the economy falls when RBI sells such bonds in the open market. Such operations are undertaken to regulate inflation and depression. This instrument was **not used in India prior to 1991**.

(7) Sterilization of RBI accounts against shocks arising from excessive increase or decrease in amount of foreign exchange:

When there is excessive inflow of foreign exchange in India owing to trade and foreign investment, the RBI indulges in open market sale of government securities equal to the amount of inflow of foreign exchange. This is done to keep its balance sheet unchanged owing to excessive foreign exchange. Thus, it **sterilizes its balance sheet against external shocks**. It buys government bonds if there is excessive outflow of foreign exchange.

(B) SELECTIVE (QUALITATIVE) MEASURES OF CREDIT CONTROL

Besides the general measures, the RBI uses certain selective measures to **direct credit for development of certain sectors or sections of the economy**. These measures have unique impact on some sectors and are not meant to impact all sectors similarly.

(1) Security Requirement:

Banks must ensure that public returns the loans given to them. Hence, they lend money against some security deposits from the borrowers. In case the borrower is not able to repay the loan, the bank uses the security to recover its dues. For example, a bank can take **jewellery, deposits, car, house, land** etc. as security. Security specifications are different for different segments of the population so that all sections of the population can have the opportunity to obtain bank credit. A **poor farmer may be granted a loan without much security** while a rich business person may be required to keep more as security with the bank for a loan.

(2) Margin Requirement:

The RBI also sets margins for granting loans against security. An individual is given only a certain percentage as loan of the total value of assets offered as security. Banks are directed to selectively keep different margins for different purposes.

(3) Ceiling on Credit:

The RBI also prescribes ceilings for credits for different purposes.

(4) Discriminatory Interest Rate:

RBI suggests differential rates of interest for different types of lendings. This is called the **policy of discriminatory interest rate**. For example, a relatively lower rate of interest is charged from needy farmers than what is charged from rich business persons to buy a car or a house.

Instrument	Category	To Control Inflation	To Control Depression
Bank Rate	Quantitative	Increase bank rate	Decrease bank rate
Repo Rate	Quantitative	Increase repo rate	Decrease repo rate
Reverse Repo Rate	Quantitative	Increase reverse repo rate	Decrease reverse repo rate
CRR	Quantitative	Increase CRR	Decrease CRR
SLR	Quantitative	Increase SLR	Decrease SLR
OMOs	Quantitative	Sell govt. securities (reduce money supply)	Buy govt. securities (increase money supply)
Security Requirement	Qualitative	Tighten security norms	Relax security norms
Margin Requirement	Qualitative	Increase margin (give less loan)	Decrease margin
Ceiling on Credit	Qualitative	Lower credit ceiling	Raise credit ceiling
Discriminatory Interest Rate	Qualitative	Higher rates for non-priority	Lower rates to boost sectors

Master Table: Instruments of Monetary Policy and Their Use

EXERCISE — QUESTIONS AND ANSWERS

Section 1 — MCQs

(1) What is the meaning of the word 'bank'?

Options: (a) Money supply (b) Stock of money (c) Investment (d) Commerce

✓ Answer: (b) Stock of money — the word 'bank' relates to a heap/mass/collection/fund of money.

(2) How many major types of deposits exist in banks in India?

Options: (a) 2 (b) 6 (c) 10 (d) 3

✓ Answer: (d) 3 — Current Account, Savings Account, Fixed/Long Term Deposit (Recurring is a sub-type of savings).

(3) Short term lending in theoretical sense is for what period?

Options: (a) Up to 1 year (b) 1 to 3 years (c) 1 to 5 years (d) 5 to 15 years

✓ Answer: (a) Up to 1 year

(4) What is a central bank?

Options: (a) A private bank (b) An apex bank (c) A cooperative bank (d) A foreign bank

✓ Answer: (b) An apex bank — Central bank is the apex bank of the country.

(5) What is the rate at which RBI borrows funds for very short term from the commercial banks called?

Options: (a) Repo rate (b) Bank rate (c) Reverse repo rate (d) Open market rate

✓ Answer: (c) Reverse repo rate

Section 2 — One Line Answers

(1) Give the meaning of a bank.

A bank is a commercial organization functioning for profit which accepts peoples' savings in the form of deposits, pays interest in return, ensures the safety of these deposits, lends money from these deposits to people who need money by charging interest, and invests the surplus funds for development of the nation.

(2) Give the meaning of a commercial bank.

Commercial bank is one which transacts the business of banking, that is, accepting deposits from the people for the purpose of lending or investment; repayable on demand or otherwise and withdrawable by cheque, draft, pay-order or otherwise. (Banking Company Act, 1949)

(3) Give the meaning of a central bank.

Central bank is the Apex bank of the country whose function is to aid, regulate and promote the entire money/financial market and the banking sector; as well as to maintain monetary/financial stability for overall economic good of the nation.

(4) Give the meaning of monetary policy.

The policy undertaken by the apex bank for regulating the supply of money in order to maintain economic stability keeping into consideration the process of economic development and interest of the public is called monetary policy.

(5) What is meant by quantitative tools of monetary policy?

Quantitative (general) tools of monetary policy are aimed at impacting the entire economy in a general/common way. They include Bank Rate, Repo Rate, Reverse Repo Rate, CRR, SLR, Open Market Operations, and Sterilization.

(6) What is meant by qualitative tools of monetary policy?

Qualitative (selective) tools of monetary policy are used to direct credit for development of certain specific sectors or sections of the economy. They include Security Requirement, Margin Requirement, Ceiling on Credit, and Discriminatory Interest Rate.

Key Detailed Q&A; (Sections 4 & 5)

Difference between Commercial Bank and Central Bank:

- Commercial Bank: accepts public deposits, provides loans, provides credit facilities, aims for profit, multiple banks exist in a country.
- Central Bank: does NOT accept public deposits directly, regulates commercial banks, issues currency, formulates monetary policy, ONE per country, acts as lender of last resort, non-profit oriented (works for general public welfare).
- Examples: Commercial banks — SBI, HDFC, ICICI. Central bank in India — Reserve Bank of India (RBI).

Primary and Secondary Functions of Commercial Banks (Brief):

- PRIMARY: (1) Accepting Deposits — Current (no interest, overdraft), Savings (interest, withdrawal), Recurring (monthly small amounts), Fixed (highest interest, long term).
- (2) Providing Credit — Short (<1yr), Medium (1-5yr), Long (5-15yr); for personal, agricultural, business purposes.
- (3) Payment & Withdrawal — cheques, ATM, NEFT, RTGS, credit/debit cards.
- (4) Credit Creation — creates new money from deposits using formula: Credit = Primary Deposit × (1/CRR).
- (5) Inter-Banking Transactions — call money through central bank.
- SECONDARY: (1) Agency & Utility Services — letter of credit, tax payments, safe deposit vaults, microfinance, drafts, pay orders.
- (2) Changing Times Facilities — NEFT, RTGS, CORE banking, internet banking, DEMAT accounts.

Quantitative Measures of Monetary Policy (Detailed):

- (1) Bank Rate: Rate RBI lends to commercial banks for LONG TERM. High bank rate = dear money policy (reduces credit). Low bank rate = cheap money policy. RBI now uses repo rate instead.
- (2) Repo Rate: Rate at which commercial banks SELL securities to RBI for SHORT TERM (with repurchase condition). High repo rate → banks borrow less → give fewer loans → money supply falls → inflation controlled.
- (3) Reverse Repo Rate: Rate at which RBI SELLS securities to commercial banks (RBI borrows from banks). High reverse repo → banks park more funds with RBI → less lending to public → money supply falls.
- (4) CRR (Cash Reserve Ratio): % of total deposits banks must keep with RBI (variable 3%-15%). High CRR → less money to lend → less credit creation → money supply falls.
- (5) SLR (Statutory Liquidity Ratio): Banks must maintain min 25% of total deposits in cash, gold, approved securities. High SLR → less money for lending.
- (6) OMOs: RBI buys/sells govt. bonds. Buys → money supply increases. Sells → money supply decreases. Not used in India before 1991.
- (7) Sterilization: RBI sells govt. securities during excessive forex inflow to neutralize the effect on money supply.

GLOSSARY (From Textbook)

Bank	A commercial organization functioning for profit which accepts peoples' savings in the form of deposits and pays interest in return, ensures the safety of these deposits, lends money from these deposits to people who need money by charging interest, and invests the surplus funds for development of the nation.

Credit Creation	The policy process of banks for lending money from primary deposits and thereby creating new deposits and increased money supply is called credit creation.
Scheduled Banks	Banking companies which are listed in the 2nd schedule of the RBI Act, 1934 (are established accordingly) are called scheduled banks.
Central Bank	Central bank is the Apex bank of the country whose function is to aid, regulate and promote the entire money/financial market and the banking sector; as well as to maintain monetary/financial stability for overall economic good of the nation.
Monetary Policy	The policy undertaken by the apex bank for regulating the supply of money in order to maintain economic stability keeping into consideration the process of economic development and interest of the public is called monetary policy.
Primary Deposits	Deposits in the form of initial public savings with banks are called primary deposits.
Secondary Deposits	Additional deposits derived by banks when loans created from primary deposits are accounted in banks are called secondary deposits.
Government Securities	Interest bearing bonds floated by government in the market to raise money, which are purchased by people and are repurchased by the government after a fixed period are called government securities in simple terms.
Store of Value Function of Money	Store of value function of money implies that money is stored, exchanged with other currencies or mobilized to enhance its own worth or to enhance wealth.

■ BOARD EXAM QUICK REVISION — CHAPTER 4: BANKING AND MONETARY POLICY

1. Word 'Bank' comes from Italian 'banca' / French 'banque' meaning BENCH for money exchange. Sanskrit: 'bhanda' = collection/fund.

2. FIRST REAL BANK IN WORLD = Bank of Barcelona, Spain, 1401.

3. TWO TYPES OF BANKS: (1) Commercial Bank (2) Central Bank (apex bank).

4. Commercial Bank definition: Banking Company Act 1949. Accepts deposits for lending/investment; repayable on demand; withdrawable by cheque/draft/pay order.

5. THREE TYPES OF DEPOSITS: Current (no interest, overdraft), Savings (interest, cheque/ATM), Fixed/Long Term (highest interest). Recurring = sub-type of savings.

6. Credit Creation formula: Credit = Primary Deposit × (1 / CRR). Example: ■1,000 deposit + 20% CRR = ■5,000 total credit created.

7. CALL MONEY = Short-term credit from one bank to another through central bank. Rate = Call Money Rate.

8. CORE Banking = Centralized Online Real Time Exchange. NEFT = National Electronic Fund Transfer. RTGS = Real Time Gross Settlement. DEMAT = Dematerialized account.

9. SCHEDULED BANKS = Banks listed in 2nd schedule of RBI Act 1934. Types: Public sector + Private sector + Foreign (Multinational) + Regional Rural Banks (RRBs) + Co-operative Banks.

10. Central Bank definition — R.P. Kent: 'Institution charged with responsibility of managing expansion and contraction of volume of money in interest of general public welfare.'

11. RBI FACTS: Established 1 April 1935 | Capital ■5 crores | Nationalized 1 January 1949 | Apex bank of India.

12. RBI issues notes of ■2 and ABOVE. ■1 note and ALL COINS issued by Finance Ministry of Govt. of India.

13. MONETARY FUNCTIONS OF RBI (5): Currency Issue | Banker to Govt. | Bankers' Bank + Lender of Last Resort | Credit Control | Custodian of Forex Reserves.

14. NON-MONETARY FUNCTIONS OF RBI (3): Regulatory & Supervisory | Promotional | Financial Inclusion (Jan Dhan Yojana).

15. Monetary Policy = Policy of Apex Bank to regulate money supply for economic stability.

16. QUANTITATIVE TOOLS (7): Bank Rate | Repo Rate | Reverse Repo Rate | MSF | CRR | SLR | OMOs | Sterilization.

17. Bank Rate = Long term RBI lending rate. Repo = Short term (banks sell securities to RBI). Reverse Repo = RBI borrows from banks.

18. CRR = 3% to 15% of deposits (variable since 1962). SLR = minimum 25% of total deposits in cash/gold/securities.

19. OMOs = RBI buys govt. bonds → money increases; RBI sells bonds → money decreases. Not used in India before 1991.

20. QUALITATIVE TOOLS (4): Security Requirement | Margin Requirement | Ceiling on Credit | Discriminatory Interest Rate.

21. To CONTROL INFLATION: Increase Bank Rate / Repo Rate / CRR / SLR / Sell OMOs / Raise security norms.

22. To CONTROL DEPRESSION: Decrease Bank Rate / Repo Rate / CRR / SLR / Buy OMOs / Relax security norms.

MCQ ANSWER KEY

Word bank → Stock of money | Major deposit types → 3 | Short term lending → up to 1 year | Central bank → Apex bank | RBI borrows from banks → Reverse Repo Rate
RBI established → 1 April 1935 | Nationalized → 1 Jan 1949 | Capital → ■5 crores | Issues ■2+ notes → RBI | Issues coins → Finance Ministry

Notes prepared from GSEB Class 12 Economics Textbook, Chapter 4 — Complete Board Exam Coverage.