

Money and Banking

Class 12 Handwritten Notes

Subject : Macro Economics

Chapter 2 Money & Banking

Board : CBSE

Session 2026-27

$$m = (1 + c) / (c + r)$$

<- Money Multiplier Formula

Topics : Functions, Forms, M1-M4 ,
Commercial Banks, RBI, Credit Creation ,
Monetary Policy, CRR, SLR, Repo, OMOs.

(Prepared by Collegedunia NCERT Notes)

Chapter Overview

Money is anything that is generally accepted as a medium of exchange. Banking is the system that creates, holds and circulates this money.

Why this chapter matters

- * Forms a base for Income Determination (Ch 3).
- * Heavy CBSE weightage : 8-10 marks every year.
- * Conceptual + 1 numerical of multiplier.
- * Easy to score if formulas + functions clear.

CBSE Weightage (last 5 yrs avg)

Question type	Marks	Common Topic
1 mark MCQ	1-2	Forms of money / CRR
3 mark SA	3	Functions / Instruments
4 mark SA-II	4	RBI role / Credit creation
6 mark LA	6	Money multiplier numerical

Roadmap

Functions ~~of~~ of money → Forms → M1..M4
 → Commercial Banks → Credit Creation
 → RBI → Monetary Policy Tools.

Functions of Money

Mnemonic : M U S S

(Medium , Unit , Store , Standard)

M - Medium of Exchange

Removes the need for double coincidence of wants seen under barter . Buyer pays money ; seller delivers good / service .

Ex : pay Rs 50 for ~~appte~~ an apple .

U - Unit of Account

Common yardstick to express the value of all goods and services .

Ex : car = Rs 5,00,000 ; book = Rs 200 .

S - Store of Value

Money can be saved now and used later .

Lets wealth carry across time periods .

S - Standard of Deferred Payment

Used for future / credit transactions .

Ex : EMIs , wages payable , bond coupons .

M U S S = 4 functions of money - Remember ?

Functions (deeper view)

Classification by NCERT

Category	Function	Why
Primary	Medium of Exchange	Removes barter pain
Primary	Unit of Account	Common value scale
Secondary	Store of Value	Saving across time
Secondary	Std of Defer Pay	EMI, bonds
Contingent	Basis of Credit	Banks lend on it
Contingent	Liquidity	Asset conversion

Barter (exchange w/o money) - problems

- * No double coincidence of wants .
- * No common measure of value .
- * Hard to store wealth (perishables) .
- * Difficult sub-division of goods .
- * No standard for deferred payments .

* Money solves all 5 above .

Hence money is rightly called the
' life blood of an exchange economy '
(Marshall ' s words , often quoted in CBSE)

Forms of Money

(a) Fiat Money

Backed only by govt order (' fiat ') ,
not by any commodity like gold .

Ex : Indian rupee notes & coins today .

(b) Fiduciary Money

Accepted because of trust ; cheques ,
drafts , promissory notes . Not legal
tender but commonly accepted .

(c) Full bodied / Commodity Money

Coins whose face value equals their
metal value (old gold mohurs) .

(d) Token / Credit Money

Face value $>$ intrinsic metal value .

All current Indian coins are token money .

Legal Tender vs Non-legal

* Legal tender : must be accepted by law .

(notes , coins issued by RBI / GOI)

* Non legal : cheques , bills - accepted

out of choice , not law .

Measures of Money Supply

RBI publishes 4 measures, narrow to broad :

$$M1 = C + DD + OD$$

<- narrowest /
<- most liquid

C = currency w/ public (notes + coins)

DD = demand deposits of public w/ banks

OD = other deposits at RBI (small) .

$$M2 = M1 + \text{post office savings}$$

<- + POSB

$$M3 = M1 + \text{Time Deposits w/ banks}$$

<- Aggregate
<- Monetary Res.

$$M4 = M3 + \text{total post office deposits}$$

<- broadest

Liquidity order

$M1 > M2 > M3 > M4$ (rising falling liquidity)

$M1$ - most liquid ; $M4$ - least liquid .

Key NCERT note

$M1$ and $M2$ are called narrow money .

$M3$ and $M4$ are called broad money .

$M3$ is the most popular measure for policy .

Commercial Banks

A commercial bank is a financial inst that accepts deposits from public and lends them to households / firms / gout at interest .

Primary Functions

- * (1) Accepting deposits :
Demand , Savings , Fixed , Recurring .
- * (2) Advancing loans :
Cash credit , overdraft , term loans .
- * (3) Credit creation (see next page) .

Secondary Functions

- * Agency : payment of bills , collection of cheques , buying / selling securities .
- * Utility : lockers , drafts , forex , underwriting , credit cards .

Sources vs Uses (balance sheet)

Liabilities (sources)	Assets (uses)
Deposits	Loans & Advances
Borrowings from RBI	Investments in G-Sec
Capital + Reserves	Cash + Bal w/ RBI

Credit Creation

Banks create credit several times the initial deposit by lending fresh money .

Assumptions

- * There is only one bank (or all banks) act as a single system .
- * Banks keep a fixed % as reserves (r) .
- * Public deposits all loaned money back .
- * No leakage to currency holdings .

Multiplier Formula

$$m = 1 / r$$

(simple version)

$$\text{Total Deposits} = (1 / r) \times \text{Initial Dep}$$

- <- Final =
- <- Geometric
- <- series sum

Worked example

Initial deposit = Rs 1,000 ; $r = 20\%$

Multiplier $m = 1 / 0.20 = 5$

Total deposit creation = $5 \times 1000 = \text{Rs } 5,000$

Total credit = $5000 - 1000 = \text{Rs } \del{5000} 4,000$.

Higher $r \Rightarrow$ smaller $m \Rightarrow$ less credit .

Credit Creation - Rounds Table

Reserve ratio $r = 20\%$; Initial = Rs 1,000

Round	New Deposit	Reserve	Loan
1	1000.00	200.00	800.00
2 *	800.00	160.00	640.00
3	640.00	128.00	512.00
4	512.00	102.40	409.60
5	409.60	81.92	327.68
...
Total	5000.00	1000.00	4000.00

Observation

- * Each round deposit shrinks by $(1 - r)$.
- * Sum of GP $= 1000 / r = \text{Rs } 5000$.
- * Total credit $= \text{Total deposit} - \text{initial}$.

Caution : if any leakage (~~the~~ hoarding) occurs, m falls below $1 / r$.

Central Bank (RBI)

Set up : 1 April 1935 under RBI Act 1934 ;
Nationalized 1 Jan 1949 . Head office : Mumbai .
Apex monetary authority of India .

Six functions (' Six RBI hats ')

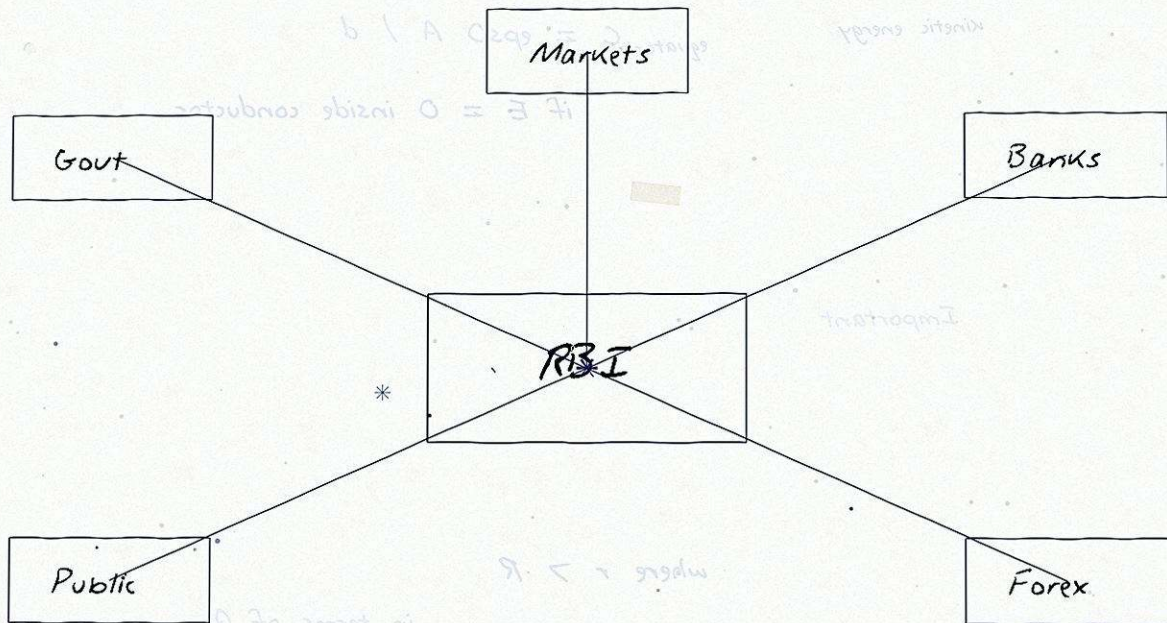
#	Function	One-liner
1	Note issuing	Sole right (excl. Re 1) *
2	Banker to Govt	Holds accts of GOI
3	Bankers ' bank	Holds reserves of banks
4	Lender of last resort	Bails out banks in crisis
5	Custodian of Forex	Manages foreign reserves
6	Controller of Credit	Monetary policy tools

Memory aid

N B B L F C = Note , Banker , Bankers ' ,
Lender , Forex , Credit .

Note : Re 1 note is issued by ~~RBI~~ Ministry of Finance .
(Signed by Finance Secretary , not RBI Gov.) .

RBI - Role Block Diagram



Read as

- * RBI \leftrightarrow Govt : banker , debt manager .
- * RBI \leftrightarrow Banks : reserves , rediscount .
- * RBI \leftrightarrow Public : notes , complaints .
- * RBI \leftrightarrow Forex : USD / EUR reserves .
- * RBI \leftrightarrow Markets : G-Sec , OMOs , bonds .

Every arrow is a function ; learn 5 above .

Instruments of Monetary Policy

Two big buckets : QUANTITATIVE (amt of credit) and QUALITATIVE (direction of credit) . Page 12-13 = quantitative .

CRR - Cash Reserve Ratio

% of net demand & time liabilities (NDTL) banks must keep in CASH with RBI itself .

CRR up \Rightarrow liquidity DOWN \Rightarrow rate UP

<- Anti-inflation tool

SLR - Statutory Liquidity Ratio

% of NDTL banks must keep as liquid assets : cash , gold , approved G-Sec .
* Kept with ~~RBI~~ the bank itself .

SLR up \Rightarrow less credit \Rightarrow curbs inflation

Quick diff

Tool	Held as	Held with
CRR	Cash only	RBI
SLR	Cash + Gold + G-Sec	Bank itself

Policy Rates

Repo Rate

Rate at which RBI LENDS to banks against G-Sec collateral, short term (overnight).

Repo up \Rightarrow borrowing costlier \Rightarrow loans dear

Reverse Repo Rate

Rate at which RBI BORROWS from banks.
Banks park surplus funds w/ RBI safely.

Rev Repo up \Rightarrow banks park more \Rightarrow less loans

MSF - Marginal Standing Facility

Emergency lending window (above repo).
Banks borrow O/N against SLR portfolio.
MSF $>$ Repo by ~~0.50~~ 0.25 % usually.

Bank Rate

Long term rate at which RBI rediscounts bills - typically $=$ MSF rate today.

Quick ladder (asc.)

Rev Repo $<$ Repo $<$ MSF $=$ Bank Rate

OMOs + Qualitative Tools

Open Market Operations (OMOs)

RBI buys / sells G-Sec in open market to change liquidity in the banking system .

RBI action	Liquidity	Aim
Buys G-Sec	Up	Boost credit / growth
Sells G-Sec	Down	Curb inflation

Qualitative Tools

Aim to STEER credit into selected sectors :

* **Margin Requirement :**

% of loan paid by borrower as security .

* **Credit Rationing :**

Caps on credit to specific industries .

* **Moral Suasion :**

Persuasion , advisories , letters to banks .

* **Direct Action :**

Penalty / refusal of loan from RBI .

* **Publicity :**

Public reports highlighting credit health .

Modern policy mainly uses repo + OMOs .

High-Powered Money (H)

Also called Monetary Base or Reserve Money . Total liability of the RBI .

$$H = C + R$$

$\leftarrow C =$ currency w/ public
 $\leftarrow R =$ bank reserves

Money multiplier (full version)

$$m = (1 + c) / (c + r)$$

$\leftarrow c = C / DD$ ratio
 $\leftarrow r = R / DD$ ratio

$$\text{Money Supply } M = m \times H$$

Worked sum

$$H = \text{Rs } 5,000 \text{ cr} ; c = 0.25 ; r = 0.15$$

$$m = (1 + 0.25) / (0.25 + \del{0.10} 0.15)$$

$$\hat{=} 1.25 / 0.40 = 3.125$$

$$M = 3.125 \times 5,000 = \text{Rs } 15,625 \text{ cr}$$

Higher c or $r \Rightarrow$ smaller $m \Rightarrow$ less M .

Sources of High-Powered Money

Asset side of RBI balance sheet

- * RBI credit to Govt (bonds held , WMA) .
- * RBI credit to commercial banks (repo) .
- * Net Foreign Exchange Assets (forex) .
- * Govt currency liabilities to public .

$$H = MFA + MDA$$

<- MFA = Net Forex Asset
<- MDA = Net Domestic Asset

*

Why HPM matters

- * Total money supply is a multiple of H .
- * Controlling H \Rightarrow controls inflation .
- * OMOs and CRR work via H + m .

Difference :: H us M

Aspect	H (base)	M (supply)
Issuer	Only RBI	RBI + Banks
Size	Smaller	Several x larger
Components	C + R	C + DD + TD
Linked by	Multiplier m	Multiplier m .

Memorize : $M = m \times H$.

Common Mistakes (!)

Students lose easy marks here every year .

* Mixing CRR vs SLR :

CRR is kept w/ ~~the bank~~ RBI ;

SLR is held by the bank itself .

* Saying RBI prints all currency :

Rs 1 note + coins come from ~~RBI~~ GOI .

* Using simple multiplier $m = 1 / r$

when ~~no~~ currency leakage exists .

Use full $m = (1 + c) / (c + r)$.

* Calling cheque a legal tender :

It is ~~legal~~ fiduciary , not legal tender .

* Mis-ordering M1 .. M4 :

M1 = narrowest , M4 = broadest .

* Reverse Repo direction :

RBI ~~tends to~~ borrows from banks .

Cross check each Q with these 6 pitfalls .

Formula Sheet

Money supply

$$M1 = C + DD + OD$$

$$M2 = M1 + POSB \text{ savings}$$

$$M3 = M1 + \text{Time Deposits}$$

$$M4 = M3 + \text{Total post office deposits}$$

Multipliers

$$m = 1 / r \quad (\text{simple})$$

$$m = (1 + c) / (c + r) \quad (\text{full})$$

Money supply identity

$$M = m \times H \quad ; \quad H = C + R$$

$$H = NFA + NDA$$

Symbols : $c = C/DD$, $r = R/DD$, $H = \text{base money}$.

PYQ Trend (last 6 years)

Most frequent questions from CBSE Class 12 :

Year	Marks	Topic
2024	1 + 3	MCQ on CRR + RBI Functions
2023	4	Credit creation worked sum
2022	3	Functions of money (MUS))
2021	6	Money multiplier numerical
2020	3	Repo vs Reverse Repo
2019	4	Forms of money + legal tender

What to expect 2026

- * 1 MCQ : M1 / M3 component .
- * 1 SA-I (3 mk) : Bank functions .
- * 1 SA-II (4 mk) : RBI vs CB diff .
- ** 1 LA (6 mk) : Credit creation OR

money multiplier numerical with c , r .

Tip : show formula \rightarrow substitution \rightarrow
arithmetic on separate lines .

Mnemonics & Quick Recall

MUSS - Functions of money

- * M edium of exchange
- * U nit of account
- * S tore of value
- * S tandard of deferred payment

Six RBI hats

- * N ote issue
- * B anker to Govt
- * B ankers' bank
- * L ender of last resort
- * F orex custodian
- * C redit controller

Tools - C S R O M (quantitative)

C - CRR , S - SLR , R - Repo + Rev Repo ,
O - OMOs , M - MSF + Bank Rate .

Direction reminder

All 'up' rates / ratios \Rightarrow tighter money ;

All 'down' rates \Rightarrow easier money .

Walk a problem with MUSS + 6 hats + CSROM .

Numerical Practice

Q1. Simple multiplier

If reserve ratio = 25% , initial dep = Rs 800 ,
find total deposit and total credit .

$$\text{Sol : } m = 1 / 0.25 = 4$$

$$\text{Total dep} = 4 \times 800 = \text{Rs } 3,200$$

$$\text{Credit} = 3200 - 800 = \text{Rs } 2,400$$

Q2. Full multiplier with leakage

$$c = 0.20 ; r = 0.10 ; H = \text{Rs } 4,000 \text{ cr .}$$

Find money supply M .

$$\begin{aligned} \text{Sol : } m &= (1 + 0.20) / (0.20 + 0.10) \\ &= 1.20 / 0.30 = 4 \end{aligned}$$

$$M = m \times H = 4 \times 4,000 = \text{Rs } 16,000 \text{ cr}$$

Q3. CRR change effect

RBI raises CRR from 4% to 5% . How does it
affect simple multiplier and total credit ?

$$\text{Sol : } m \text{ old} = 1/0.04 = 25 ; m \text{ new} = 1/0.05 = 20$$

m falls by ~~5~~ 5 units \Rightarrow credit shrinks .

Anti-inflation effect achieved .

Q4. Quick MCQ

Rs 1 note signed by Finance Secretary . (T)

Summary - Quick Look

Concept	Key Idea
Money Functions	MUSS
Forms	Fiat, Fiduciary, Token
Measures	$M1 < M2 < M3 < M4$
Multiplier	$m = (1 + c) / (c + r)$
H (base)	$C + R = NFA + MDA$
CRR	Cash w/ RBI
SLR	Liquid assets w/ bank
Repo	RBI lends to banks
Rev Repo	RBI borrows from banks
MSF	Emergency lending
OMOs	Buy / sell G-Sec
RBI 6 hats	N B B L F C

Last-minute checklist

- * Memorise CSROM tools order .
- * Practice / multiplier numerical .
- * Re / note = Fin. Sec , not RBI Gov .