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The Ultimate NCERT Revision Guide for Class 12 Economics

Chapter 2 (Macro): Money and Banking

Class 12 Economics • Syllabus 2026-27

Step-by-step chapter notes for CBSE board exams

Chapter Overview

Money is the universal medium of exchange that makes a modern economy possible. This chapter develops, in order, why barter fails, what money does, how the RBI measures money supply in India (M_1, M_2, M_3, M_4), what high-powered money H is, why commercial banks “create” money under fractional reserve banking, the money-multiplier formula, and the instruments RBI uses to run monetary policy.

Why this chapter matters

Money-supply identities and the multiplier link RBI's balance sheet to broad money in the economy. Every later macro chapter (income determination, government budget, BoP) uses these.

1 Barter and the Need for Money

A **barter system** exchanges goods directly for goods without any common medium. It requires a *double coincidence of wants*: each side must hold exactly what the other wants, and must agree on the exchange ratio. Barter fails for four reasons: (i) finding a double match is rare, (ii) there is no common unit of account (n goods need $\frac{n(n-1)}{2}$ price ratios), (iii) most goods spoil or are bulky to store, and (iv) future contracts have no stable price unit.

Common Mistake

Students often write only “double coincidence of wants” as the drawback. CBSE markers want at least three: write all of double-coincidence, no unit of account, no store of value, and no standard of deferred payment.

2 Functions of Money

The four standard functions of money each cure one barter drawback:

- **Medium of exchange:** universally acceptable, removes the need for double coincidence of wants.
- **Unit of account** (measure of value): prices quoted in money, only n prices needed instead of $\frac{n(n-1)}{2}$.
- **Store of value:** holds purchasing power over time at near-zero storage cost.
- **Standard of deferred payment:** loans, wages and rents specified in money, enabling a credit market.

NCERT groups the first two as *primary* functions and the last two as *secondary*.

Mnemonic

“M.U.S.S.” = Medium of exchange, Unit of account, Store of value, Standard of deferred payment.

3 Demand for Money

Transaction demand (L_T) is the cash balance held to finance day-to-day purchases. The standard linear relation is

$$L_T = kT, \quad k = \frac{1}{V},$$

where T is the value of transactions in the period and V is the velocity of money. **Precautionary demand** (L_P) covers unforeseen needs; **speculative demand** (L_S) varies inversely with the interest rate i .

Total demand for money

$L = L_T + L_P + L_S = kT + L_S(i)$ where L_S falls when i rises.

4 Supply of Money: M_1 to M_4

RBI publishes four progressively broader money-supply measures:

Measure	Composition
M_1	Currency with the public + Demand deposits with banks + Other deposits with RBI (<i>narrow money</i>)
M_2	M_1 + Savings deposits with post office savings banks
M_3	M_1 + Time deposits with the banking system (<i>broad money</i>)
M_4	M_3 + All deposits with post office savings organisations (excl. NSCs)

Quick Tip

RBI's main policy target is M_3 because it captures total purchasing power. M_1 is too volatile to anchor policy.

5 Legal Tender and Fiat Money

Legal tender is any form of money the law mandates a creditor to accept. RBI notes are *unlimited* legal tender; Government coins are limited legal tender (limit set by statute).

Fiat money has value purely by government decree, with no commodity backing. The Indian Rupee today is both fiat and legal tender. A bitcoin is fiat-like (no commodity backing) but not legal tender in India.

6 High-Powered Money

High-powered money H (also *monetary base* or *reserve money*) is what RBI alone can create. In India:

$$H = \text{Currency with the public} + \text{Cash reserves of banks with RBI} + \text{Other deposits with RBI.}$$

H is "high powered" because each rupee supports many rupees of broad money through fractional-reserve banking.

7 Commercial Banks and Credit Creation

A commercial bank's *primary* functions are accepting deposits (demand, savings, time) and advancing loans / overdrafts; its *secondary* functions are agency (collect cheques, remit funds) and general utility (lockers, forex, cards). Banks "create money" by holding only a fraction of deposits as reserves and lending the rest. Each loan disbursed becomes a new deposit somewhere in the system, so the money supply expands without any extra H .

Money multiplier

$m = \frac{M_s}{H} = \frac{1+c}{c+r}$ where r = reserve-to-deposit ratio (CRR-driven) and c = currency-to-deposit ratio of the public.

Simple case ($c = 0$): $m = 1/r$. With $r = 0.04$, $m = 25$.

$$M_s = m \cdot H.$$

Real-World Connection

During Diwali, cash demand rises (people withdraw for spending and gifts). c rises, m falls, M_s would contract unless RBI offsets with open-market purchases to raise H .

8 Monetary Policy Instruments of RBI

Quantitative (affect M_s as a whole):

- **Bank rate:** rate at which RBI lends long-term to banks.
- **Repo rate:** primary policy rate; RBI lends overnight to banks against G-Secs.
- **Reverse repo rate:** floor of the LAF corridor.
- **Cash Reserve Ratio (CRR):** fraction of liabilities banks must keep with RBI in cash.
- **Statutory Liquidity Ratio (SLR):** fraction of liabilities held in approved liquid securities.
- **Open-Market Operations (OMO):** RBI's purchase / sale of G-Secs.

Qualitative (direct the flow of credit):

- Margin requirements on loans.
- Moral suasion.
- Selective credit controls.
- Direct action / penalties.

9 RBI as Lender of Last Resort

When a solvent bank faces a liquidity squeeze (depositors withdraw faster than the bank can sell illiquid loans), RBI advances short-term cash against good collateral, usually at a penalty rate (MSF). This prevents a contagious bank run. Bagehot's rule summarises the principle: *lend freely, against good collateral, at a penalty rate, to solvent institutions.*

10 Quick Reference

Memorise these three identities

1. $M_s = m \cdot H$ where $m = (1 + c)/(c + r)$ is the money multiplier.
2. $M_1 < M_2 < M_3 < M_4$ in magnitude; $M_1 > M_2 > M_3 > M_4$ in liquidity.
3. RBI's six quantitative tools: bank rate, repo, reverse repo, CRR, SLR, OMO.

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