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KVS – PGT

Economics

Kendriya Vidyalaya Sangathan (KVS)

Volume - 2

SIERRA INNOVATIONS

INDEX

1 CHAPTER

Money and Banking

Money - Meaning, Nature and Functions

1. Introduction: Why Money Is Central to Macroeconomics

- Money is the **most pervasive institution of a modern economy**. It connects production with consumption, saving with investment, and present decisions with future outcomes. While goods and services satisfy wants, **money facilitates the entire economic process**. In macroeconomics, money is not merely a medium of exchange; it is a **policy instrument**, a **store of value**, and a **measure through which national income and output are expressed**.

For KVS PGT Economics, questions on money are rarely factual. PYQs test:

- Conceptual distinction between functions
- Logical reasoning (why money reduces barter problems)
- Assertion-Reason on "money as a unit of account"
- Identification of primary vs secondary functions

Hence, money must be understood as an **economic institution**, not just a commodity.

2. Meaning of Money: Economic Perspective

Conceptual Meaning

- In economics, **money is anything that is generally accepted as a medium of exchange**, a **measure of value**, and a **store of value**.

The phrase *"generally accepted"* is crucial:

- Acceptance is social, not individual
- Legal backing strengthens acceptability
- Trust in issuer (state/central bank) sustains value

Thus, money derives its power from **collective confidence**, not intrinsic worth.

3. Money vs Income vs Wealth (Conceptual Distinction)

A frequent source of confusion in exams is treating money, income, and wealth as identical. They are fundamentally different.

- **Money**: A medium facilitating transactions
- **Income**: Flow of earnings over a period
- **Wealth**: Stock of assets at a point of time

Money may be:

- A part of wealth
- A form in which income is received

But money itself is **neither income nor wealth by definition**.

4. Evolution of Money: Analytical Background

Money evolved to overcome the limitations of the barter system. Barter required:

- Double coincidence of wants
- Lack of common measure of value
- Indivisibility of goods
- Difficulty in storing value

Money emerged as a **social innovation** to resolve these inefficiencies.

5. Barter System and Its Limitations

- Understanding barter is essential to appreciate the **functions of money**.

Key Limitations of Barter

1. **Double Coincidence of Wants**
2. Exchange required mutual desire for each other's goods.
3. **Absence of Common Measure of Value**
4. No standard unit to express worth of goods.
5. **Indivisibility of Goods**
6. Many goods could not be divided without loss.
7. **Difficulty in Deferred Payments**
8. Credit transactions were impractical.
9. **Lack of Store of Value**
10. Perishable goods could not preserve purchasing power.

These limitations logically lead to the **functions of money**, which directly address them.

6. Functions of Money: Conceptual Framework

Functions of money are traditionally classified into:

- **Primary functions**
- **Secondary functions**
- **Contingent functions**

This classification helps in **analytical clarity** and is a frequent basis of MCQs.

7. Primary Functions of Money

- Primary functions are the **core and indispensable functions** without which money cannot exist.

7.1 Money as a Medium of Exchange

Meaning

- Money acts as an **intermediate instrument** in exchange, separating the act of sale from the act of purchase.

Instead of:

- Goods → Goods (barter)

We have:

- Goods → Money → Goods

Economic Significance

- Eliminates double coincidence of wants
- Simplifies exchange
- Expands market size
- Encourages specialisation and division of labour

Conceptual Insight

- This is the **most fundamental function**. If money fails as a medium of exchange, all other functions collapse.

PYQ Trap

Medium of exchange is often confused with:

- Means of payment (credit context)
- But medium of exchange refers to **immediate transactions**.

7.2 Money as a Measure of Value (Unit of Account)

Meaning

- Money provides a **common denominator** to express the value of diverse goods and services.

All prices are expressed in terms of:

- Rupees, dollars, etc.

Economic Significance

- Enables price comparison
- Facilitates accounting
- Allows calculation of profit and loss
- Makes national income measurement possible

Conceptual Insight

Without money as a unit of account:

- National income accounting becomes impossible
- Economic calculation collapses

This is why **money is indispensable for macroeconomics**.

PYQ Focus

Assertion-Reason questions often test:

- "Money is a unit of account but not wealth."

8. Secondary Functions of Money

- Secondary functions arise because money performs primary functions efficiently.

8.1 Money as a Store of Value

Meaning

- Money acts as a **temporary store of purchasing power**.

It allows:

- Postponement of consumption
- Transfer of purchasing power over time

Economic Significance

- Encourages saving
- Facilitates capital formation
- Supports financial markets

Limitation

- Money is a store of value **only if it is stable in value**. Inflation erodes this function.

PYQ Trap

Storing money is not same as:

- Storing wealth in general (gold, land, shares)

8.2 Money as a Standard of Deferred Payments

Meaning

- Money serves as a **unit in which future payments are contracted and settled**.

Economic Significance

- Enables credit transactions
- Supports banking and financial systems
- Facilitates long-term contracts

Conceptual Insight

This function is possible only when:

- Money has stable value
- Legal system enforces contracts

9. Contingent Functions of Money

- These functions arise under specific conditions and are not universal.

Examples of Contingent Functions

- Basis of credit creation
- Transfer of value
- Distribution of national income
- Measurement of marginal productivity

These functions highlight the **macro-financial role of money**.

10. Money as a Link Between Present and Future

Money allows:

- Saving today
- Investment tomorrow

Thus, money links:

- Consumption and investment
- Present income and future output

This linkage is central to **monetary policy and banking**.

11. Money and Measurement of National Income

Money is indispensable for:

- Expressing GDP, GNP, NDP, etc.
- Comparing output across time and space

Without money:

- National income becomes immeasurable

Hence, money is the **language of macroeconomics**.

12. Characteristics of Good Money (Conceptual Insight)

For money to perform its functions efficiently, it should possess:

- General acceptability
- Durability
- Divisibility
- Portability
- Stability of value
- Uniformity

These characteristics explain why **paper money backed by authority** dominates today.

13. Common Conceptual Traps in Exams

- Confusing medium of exchange with store of value
- Treating money as wealth
- Ignoring inflation effect on money's functions
- Mixing up unit of account and standard of deferred payment

These traps are **deliberately designed** for MCQs.

14. Pedagogical Relevance for KVS PGT

For classroom teaching:

- Explains why money replaced barter
- Builds conceptual clarity for banking topics
- Links money with national income and policy

For exams:

- High-frequency conceptual MCQs
- Assertion-Reason
- Function identification questions

15. Examination Orientation (KVS PGT)

Most frequently tested:

- Primary vs secondary functions
- Money vs income vs wealth
- Role of money as unit of account
- Inflation and store of value

Supply of Money

Meaning, Components: Currency Held by Public and Net Demand Deposits with Commercial Banks

1. **Introduction: Why Money Supply Is a Core Macroeconomic Variable**

   While money performs vital economic functions, its **quantity in circulation** determines the actual impact of those functions on prices, output, employment, and stability. The concept of **money supply** lies at the heart of:

   - Inflation and deflation
   - Monetary policy transmission
   - Credit creation by banks
   - Central bank control mechanisms

   For KVS PGT Economics, money supply is a high-yield conceptual area because PYQs repeatedly test:

   - Components of money supply
   - Role of public and banks
   - Currency vs deposits logic
   - Identification-based and assertion-reason MCQs

   Hence, this topic must be understood with **absolute conceptual clarity**, not numerical shortcuts.

2. **Meaning of Money Supply**

   Conceptual Meaning

   - **Money supply** refers to the **total stock of money available in an economy at a particular point of time**.

   Important clarifications:

   - It is a **stock concept**, not a flow
   - It refers to **actual money in circulation**, not potential
   - It is measured at a **specific point of time**

   Thus, money supply answers the question:

   - *"How much money is actually available for transactions in the economy right now?"*

3. **Money Supply vs Supply of Money (Conceptual Precision)**

   Although used interchangeably, in strict macroeconomic logic:

   - **Money supply** refers to the **quantity**
   - **Supply of money** refers to the **conceptual availability**

   In practice, both denote the **same macroeconomic variable**, but exam questions may test **stock vs flow confusion**.

4. **Who Determines the Money Supply?**

   Money supply is jointly determined by:

   - **Central Bank** (issue of currency, reserve requirements)
   - **Commercial Banks** (credit creation)
   - **Public** (currency-deposit preference)

   Thus, money supply is **not controlled by a single authority**.

   This interaction is critical for understanding **monetary policy effectiveness**.

5. Components of Money Supply (KVS-Specific Focus)

As per KVS PGT syllabus and NCERT framework, money supply consists of:

1. **Currency held by the public**
2. **Net demand deposits held by commercial banks**

This definition corresponds to **narrow money**.

6. Currency Held by the Public

Meaning

Currency held by the public refers to:

- Notes and coins in circulation
- Held by individuals and firms
- Excluding cash held by banks

Why Cash with Banks Is Excluded

Cash held by banks:

- Is not available for transactions
- Is used to meet withdrawal demands
- Is part of banking reserves

Thus, only **currency with the public** forms part of money supply.

Conceptual Trap (Very Common)

- Currency issued by the central bank ≠ currency in circulation.

Only that part which:

- Actually lies with the public
- Is usable for transactions

Is included in money supply.

7. Demand Deposits: Meaning and Nature

Meaning

Demand deposits are deposits:

- Withdrawable on demand
- Without prior notice
- By cheque, ATM, or transfer

Examples:

- Current account deposits
- Savings account deposits (to a large extent)

Why Demand Deposits Are Money

Demand deposits:

- Are highly liquid
- Are accepted as means of payment
- Can be transferred through cheques

Thus, they perform **medium of exchange function**, qualifying as money.

8. Net Demand Deposits with Commercial Banks

Meaning

Net demand deposits refer to:

- Total demand deposits of the public with commercial banks
- minus inter-bank deposits

Why "Net" Is Used

Inter-bank deposits are excluded because:

- They do not represent money with the public
- Including them leads to double counting

Thus, net demand deposits reflect **actual purchasing power of the public**.

9. Role of Commercial Banks in Money Supply

Commercial banks:

- Accept demand deposits
- Create credit
- Expand money supply beyond currency

Thus, banks convert:

- Primary money → Broad money
- This role is developed fully ahead (Money Creation).

10. Narrow Money (M1): Conceptual Framework

Under the narrow definition:

- **Money Supply (M1) = Currency with Public + Net Demand Deposits**

This is the transactional money, used for:

- Daily purchases
- Settlement of debts

KVS PGT questions mostly revolve around **this definition**.

11. Why Time Deposits Are Excluded from Money Supply (Here)

Time deposits:

- Cannot be withdrawn on demand
- Require notice or maturity
- Lack direct transaction use

Hence, they are:

- Near money
- Not money in strict sense

This distinction is a **classic elimination MCQ area**.

12. Role of Public in Determining Money Supply

Public influences money supply through:

- Currency-deposit ratio
- Preference for cash vs bank deposits

If public prefers:

- More cash → lower deposit base → lower credit creation
- More deposits → higher money expansion

Thus, public behaviour affects **money multiplier**.

13. Money Supply as a Policy Variable

Central bank targets money supply to:

- Control inflation
- Stabilise economy
- Influence credit availability

However, actual money supply depends on:

- Bank behaviour
- Public confidence
- Economic conditions

This explains why money supply control is **not perfectly precise**.

14. Measurement of Money Supply: Conceptual Issues

Measurement challenges include:

- Informal cash holdings
- Shadow banking activities
- Digital transactions

Despite these, narrow money remains:

- Most liquid
- Most policy-sensitive aggregate

15. Money Supply vs Liquidity

More money supply does not always mean:

- More liquidity in practice

Liquidity depends on:

- Distribution of money
- Willingness to spend
- Banking efficiency

This conceptual nuance is sometimes tested indirectly.

16. Common Conceptual Traps in Exams

- Including time deposits in narrow money
- Including cash with banks
- Ignoring “net” in net demand deposits
- Treating money supply as a flow

These traps are **deliberately used** in KVS-level MCQs.

17. Pedagogical Relevance for KVS PGT

For classroom teaching:

- Builds clarity on money definition
- Prepares students for banking topics
- Links money supply with inflation

For exams:

- High-frequency MCQs
- Assertion-Reason
- Component identification questions

18. Examination Orientation (KVS PGT)

Most frequently tested:

- Components of money supply
- Role of currency and demand deposits
- Public vs bank-held money
- Narrow money logic

Mastery of this part ensures **error-free handling of money supply and banking questions**.

Money Creation by Commercial Banking System

Credit Creation, Deposit Multiplier, Assumptions and Limitations

1. Introduction: Why Money Creation Is the Most Tested Banking Concept

Among all banking topics, **money (credit) creation by commercial banks** is the **most conceptually tested** in KVS PGT examinations. Questions rarely ask for numerical multipliers; instead, they probe:

- **Logical sequence of deposit expansion**
- **Role of banks vs role of central bank**
- **Assumptions and limits of credit creation**
- **Difference between currency creation and credit creation**

Understanding this topic correctly ensures clarity in:

- Money supply determination
- Monetary policy effectiveness
- Inflationary tendencies in the economy

2. Meaning of Money Creation (Credit Creation)

Conceptual Meaning

- **Money creation** refers to the process by which **commercial banks create additional money in the form of demand deposits** over and above the initial cash deposits received from the public.

Key clarification:

- Banks **do not create currency**
- Banks create **deposit money**
- Deposit money performs **money functions**

Thus, money creation means **creation of purchasing power**, not printing of notes.

3. Why Commercial Banks Can Create Money

Commercial banks can create money because:

- They operate on the **principle of fractional reserve banking**
- Not all depositors withdraw money simultaneously
- Banks keep only a **fraction of deposits as reserves**
- Remaining amount is **lent out**

This lending becomes the basis of **multiple deposit expansion**.

4. Fractional Reserve System: Core Foundation

Meaning

Under the fractional reserve system:

- Banks keep a fraction of deposits as cash reserves
- The remaining portion is used for loans and advances

The reserve ratio is determined by:

- Central bank regulations (CRR)
- Prudential banking norms

This system is the **institutional foundation of credit creation**.

5. Credit Creation vs Credit Allocation

A critical conceptual distinction:

- **Credit allocation**: Transfer of existing money
- **Credit creation**: Generation of new deposit money

When banks lend:

- They do not hand over existing deposits
- They **create a new deposit account** in the borrower's name

This new deposit becomes **money**.

6. Process of Money Creation: Step-by-Step Logic

- The process can be understood through **deposit expansion**, not arithmetic.

Step 1: Initial Cash Deposit

Suppose:

- A person deposits cash in a bank
- This becomes a **primary deposit**

Bank keeps:

- A fraction as reserve
- Remainder is available for lending

Step 2: Loan Creation

The bank:

- Grants a loan
- Creates a **deposit in borrower's account**

No physical cash is issued at this stage.

Step 3: Redeployment of Loan

The borrower:

- Spends the loan
- The amount gets deposited in another bank

This becomes a **secondary deposit**.

Step 4: Repetition of the Process

Each bank:

- Keeps required reserves
- Lends the rest

Thus, **multiple deposits are created from one initial deposit**.

7. Deposit Multiplier: Conceptual Understanding

Meaning

The deposit multiplier refers to the multiple by which:

- An initial deposit leads to a total increase in deposits in the banking system.

Conceptual Formula (Logic Only)

Deposit Multiplier depends on:

Reserve ratio

- Lower reserve ratio → Higher deposit creation
- Higher reserve ratio → Lower deposit creation
- Exams focus on directional logic, not numerical calculation.

8. Creation of Money Is a Systemic Process

Important insight:

- A single bank cannot create unlimited money
- Money creation occurs through the **entire banking system**

This distinction is frequently tested through **statement-based MCQs**.

9. Role of Central Bank in Money Creation

Commercial banks create money, but:

- Central bank **controls and limits** this creation
- Through:
  - CRR
  - Repo rate
  - Open market operations

Thus, money creation is:

Controlled decentralised expansion

10. Assumptions of Credit Creation

- Credit creation operates under certain assumptions.

(a) Banking Habits of the Public

Assumes:

- Public redeposits cash in banks
- Cash leakages are minimal

If people hoard cash, credit creation weakens.

(b) Availability of Excess Reserves

Banks must have:

- Excess reserves after meeting CRR

Without excess reserves, lending stops.

(c) Absence of Excess Demand for Cash

Assumes:

- Depositors do not withdraw large amounts simultaneously

High withdrawals disrupt credit expansion.

(d) Sound Banking System

Requires:

- Trust in banks
- Stable financial system

Loss of confidence halts money creation.

11. Limitations of Money Creation

- Despite theoretical expansion, money creation faces real limits.

(a) Cash Drain Ratio

If public:

- Prefers cash over deposits
- Withdraws money frequently

Deposit expansion gets restricted.

(b) Statutory Reserve Requirements

Higher:

- CRR
- SLR

Reduce lendable funds.

(c) Availability of Creditworthy Borrowers

Banks can lend only if:

- Borrowers are willing and creditworthy

Low demand for loans limits money creation.

(d) Central Bank Policy

Tight monetary policy:

- Raises interest rates
- Discourages borrowing

Thus, limits credit creation.

12. Credit Creation and Inflation

Excessive money creation may lead to:

- Excess demand
- Inflationary pressures

Hence, **regulated credit creation** is essential for price stability.

13. Credit Creation and Economic Growth

Controlled money creation:

- Promotes investment
- Encourages production
- Supports growth

Thus, money creation has a dual role:

- Growth-enhancing
- Potentially inflationary

14. Difference Between Currency Creation and Credit Creation

Basis	**Currency Creation**	**Credit Creation**
Authority	Central Bank	Commercial Banks
Form	Notes & coins	Demand deposits
Legal tender	Yes	No
Limit	Policy-based	Reserve-based

- This table is a **frequent MCQ base**.

15. Common Conceptual Traps in Exams

- Saying banks "print money"
- Treating loans as transfer of deposits
- Ignoring role of reserves
- Confusing single bank with banking system

These are **classic KVS distractors**.

16. Pedagogical Relevance for KVS PGT

For classroom teaching:

- Explains inflation mechanism
- Links banking with money supply
- Builds macro-financial reasoning

For exams:

- Assertion-Reason
- Logical sequence MCQs
- Conceptual elimination questions

17. Examination Orientation (KVS PGT)

Most frequently tested:

- Meaning of credit creation
- Role of reserves
- Assumptions and limitations
- Central bank control

Mastery of this part ensures **complete command over banking-money interaction**.

Central Bank

Meaning and Functions (RBI as Example): Bank of Issue, Government's Bank, Banker's Bank

1. **Introduction: Central Bank as the Apex Monetary Authority**
   - In a modern monetary economy, the **central bank occupies the highest institutional position in the financial system**. While commercial banks deal directly with the public and operate for profit, the central bank operates **in the public interest**, acting as the **custodian of monetary stability and financial discipline**.

   For KVS PGT Economics, the topic of the central bank is not examined at a descriptive level. PYQs repeatedly test:
   - Conceptual distinction between central bank and commercial banks
   - Functional logic behind each role of the central bank
   - Identification-based MCQs (bank of issue, banker's bank, government's bank)
   - Assertion-Reason questions on RBI's autonomy and responsibilities

   Hence, this topic must be understood as a **system of functions**, not a list of roles.

2. **Meaning of Central Bank**

   Conceptual Meaning

   A central bank is the supreme monetary and banking authority of a country, entrusted with:
   - Issuing currency
   - Regulating money supply and credit
   - Acting as banker to the government and banks
   - Ensuring monetary and financial stability

   Unlike commercial banks, a central bank:
   - Does **not operate for profit**
   - Does **not deal directly with the general public**
   - Functions as a **controller, regulator, and custodian**

   Thus, the central bank is the **pivot of the monetary system**.

3. **Why a Central Bank Is Necessary**

   The necessity of a central bank arises from structural weaknesses of a free banking system:
   - Unregulated note issue causes inflation
   - Uncontrolled credit expansion leads to instability
   - Absence of lender of last resort creates panic
   - Lack of coordination weakens monetary policy

   The central bank emerged historically to:
   - Ensure uniformity, stability, and discipline in the banking and monetary system.

4. **Reserve Bank of India (RBI): Contextual Overview**
   - The Reserve Bank of India (RBI) is the central bank of India.

   Conceptually important points:
   - RBI represents the **monetary authority**, not merely a bank
   - It functions as a **planner, regulator, supervisor, and controller**

- Its actions directly influence:
  - Inflation
  - Credit flow
  - Growth
  - Financial stability

  In exams, RBI is treated as the **model central bank**.

5. Central Bank vs Commercial Bank (Core Distinction)

- Understanding this distinction is essential for eliminating wrong MCQ options.

Basis	**Central Bank**	**Commercial Bank**
Objective	Public welfare	Profit maximisation
Authority	Apex monetary authority	Subordinate
Note issue	Monopoly	No
Dealing with public	No	Yes
Credit creation	Regulates	Creates
Lender of last resort	Yes	No

- This conceptual contrast is frequently tested.

6. Functions of the Central Bank: Analytical Classification

Central bank functions are broadly classified into:

1. **Bank of Issue**
2. **Government's Bank**
3. **Banker's Bank**
4. **Custodian of Cash Reserves**
5. **Controller of Credit** (detailed later)
6. **Custodian of Foreign Exchange**
7. **Clearing House of Banks**

For here we focus on the **core institutional functions** that define the central bank's identity.

7. Central Bank as Bank of Issue

Meaning

- The **bank of issue** function refers to the **exclusive authority of the central bank to issue currency notes** in the economy.

Economic Logic Behind Monopoly of Note Issue

The monopoly of note issue ensures:

- Uniform currency system
- Public confidence in money
- Prevention of over-issue
- Control over money supply

If multiple agencies issue currency:

- Monetary chaos results
- Inflationary pressures intensify

Hence:

- **Monopoly of note issue is the foundation of monetary stability.**

RBI as Bank of Issue

In India:

- RBI has sole authority to issue currency notes
- Notes are backed by **legal authority**, not gold alone
- This ensures **flexibility and stability**

PYQ Focus

Questions often test:

- Why monopoly of note issue is necessary
- Whether RBI issues coins (it does not; coins are issued by government)

8. Central Bank as Government's Bank

Meaning

- The central bank acts as the **banker, agent, and financial advisor to the government**.
- This role highlights the **fiscal-monetary coordination** in an economy.

(a) Banker to the Government

The central bank:

- Maintains government accounts
- Receives and makes payments on behalf of government
- Manages public debt

Thus, it performs banking functions **without profit motive**.

(b) Agent of the Government

As an agent, the central bank:

- Manages public loans
- Issues treasury bills
- Handles internal and external debt

This ensures **professional debt management**.

(c) Financial Advisor to the Government

The central bank:

- Advises on monetary and banking matters
- Helps formulate economic policy
- Provides technical expertise

This advisory role is **conceptually important**, though often understated.

PYQ Trap

- Government is a **customer** of RBI, not its controller in routine banking operations.