**Money & Banking**

1. In the context of commercial bank, which of the following alternatives is correct? (Choose the correct alternative)

(i) Deposits are liabilities of banks.

(ii) Commercial banks are creator of money.

(iii) Commercial banks accept deposits of the general public.

(iv) Accept deposits of World Bank for Agriculture and Rural developments.

Identify the correct alternative from the following:

Alternatives:

(a) (i) and (ii)

(b) (ii) and (iii)

(c) (i), (ii) and (iii)

(d) (i) and (iv)

Ans. (c) (i), (ii) and (iii)

Explanation: As (i, ii and iii) points are the function of commercial bank where (iv) is related to agricultural sectors (NABARD).

2. The total stock of money in circulation among the public \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ is called as ‘money supply’.

(Fill up the blank with correct alternative)

(a) during a period of time

(b) during a calendar year

(c) during a fiscal year

(d) at a particular point of time

Ans. (d) at a particular point of time

3. Read the following statements carefully and choose the correct alternative:

Statement 1: Reserve Bank of India keeps a certain percentage of deposits as reserve to avoid ‘too much lending to public’.

Statement 2: The reserve deposit ratio acts as a deterrence to the amount of credit created by the commercial banks.

Alternatives:

1. Statement 1 is true and statement 2 is false.
2. Statement 2 is true and statement 1 is false.
3. Both the statements are true.
4. Both the statements are false.

Ans. (c) Both the statements are true.

4. Suppose money created by the banking system is 1,000 and the primary deposits is ₹ 250. The respective values of deposit multiplier and reserve ratio would be \_\_\_\_\_\_\_\_\_\_\_\_\_\_ and \_\_\_\_\_\_\_\_\_\_.

(a) 4,25%

(b) 8,12.5%

(c) 4,12.5%

(d) 5, 20%

Ans. (a) 4,25%

5. The ratio of total deposits that a commercial bank has to keep with Reserve Bank of India is called:

(a) Statutory liquidity ratio

(b) Deposit ratio

(c) Cash reserve ratio

(d) Legal reserve ratio

Ans. (c) Cash reserve ratio

6. Which of the following is not the function of the central bank?

(a) Banking facilities to government

(b) Banking facilities to public

(c) Lending to government

(d) Lending to commercial banks

Ans. (b) Banking facilities to public

7. The monetary policy generally targets to ensure \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_.

(a) Price stability in the economy

(b) employment generation in the country

(c) stable foreign relations

(d) greater tax collections for the government.

Ans. (a) Price stability in the economy

8. Which of the following agency is responsible for issuing ₹ 1 currency note in India?

(a) Reserve Bank of India

(b) Ministry of Commerce

(c) Ministry of Finance

(d) Niti aayog

Ans. (c) Ministry of Finance

9. In order to encourage investment in the economy, the Central Bank may \_\_\_\_\_\_\_\_\_ (Choose the correct alternative).

(a) Reduce Cash Reserve Ratio

(b) Increase Cash Reserve Ratio

(c) Sell Government securities in open market

(d) Increase Bank Rate Ratio

Ans. (a) Reduce Cash Reserve Ratio

10. Credit creation by commercial bank is determined by

(a) Cash Reserve Ratio

(b) Statutory Liquidity Ratio

(c) Initial Deposits

(d) all of the above

Ans. (d) all of the above

11. If legal reserve ratio is 20%, the value of money multiplier would be \_\_\_\_\_\_\_\_\_\_\_\_. (Choose the correct alternative)

(a) 2

(b) 3

(c) 5

(d) 4

Ans. (c) 5

12. Repo rate relates to \_\_\_\_\_\_\_\_\_\_\_\_\_\_. (Choose the correct alternative)

(a) Short-term borrowings by commercial banks

(b) Long-term borrowings by commercial

(c) Disinvestments

(d) Dissavings

Ans. (a) Short-term borrowings by commercial banks

13. What is a central bank?

Ans. A central bank is an apex body that controls, operates, regulates and directs the entire banking and monetary structure of the country.

14. State the role played by the central bank as the “lender of the last resort.”

Ans. When commercial banks fails to meet their financial requirements from other sources, i.e. in case of a financial emergency, they approach the central bank to give loans and advances as lender of the last resort.

15. What are time deposits in banks?

Ans. Time deposits refers to those deposits, in which the amount is deposited with the bank for a fixed period of time.

16. Define bank rate.

Ans. Bank rate refers to the rate at which the central bank lends money to commercial banks as the lender of time.

17. Define money.

Ans. Money can be defined as a generally acceptable medium that can be exchanged for goods and services, and can be used as a measure and store of value.

18. What are demand deposits?

Ans. Demand deposits are the deposits which are payable by the banks on the demand by the customers at any time.

19. Define money supply.

Ans. Money supply is the total stock of money of different types of money (currency in circulation and deposits) in an economy at any specific point of time.

20. What will be the effect of a rise in the bank rate on money supply?

Ans. Money supply will reduce.

21. What is meant by Cash Reserve Ratio?

Ans. Cash reserve ratio refers to the minimum percentage of time and demand deposits, required to be kept by every commercial bank with the central bank.

22. State the two components of M1 measure of money supply.

Ans. (a) Currency with public (b) Demand deposits with bank

23. What is meant by Statutory Liquidity Ratio?

Ans. Statutory liquidity ratio refers to the minimum percentage of time and demand deposits, required to be kept by commercial banks with themselves.

24. What is Reverse Repo rate?

Ans. It is the rate of interest at which the central bank (Reserve Bank) accepts deposits from the commercial banks.

25. State the formula used for calculating money multiplier.

Ans. Money Multiplier = $\frac{1}{Legal Reserve Ratio (LRR)}$

26. Calculate the value of money multiplier if the legal reserve requirements are 20%.

Ans. Money Multiplier = $\frac{1}{Legal Reserve Ratio (LRR)}$ = 1/0.2 = 5

27Read the following statements-Assertion (A) and Reason (R), choose the correct alternative from the alternatives given below:

Assertion (A): Notes and Coins are the only source of money supply in the economy.

Reason (R): Demand deposits with commercial bank is also a component of money supply.

Alternatives:

(a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).

(b) Both Assertion (A) and Reason (R) are true and Reason (R) is not the correct explanation of Assertion (A).

(c) Assertion (A) is true but Reason (R) is false.

(d) Assertion (A) is false but Reason (R) is true.

Ans. (d) Assertion (A) is false but Reason (R) is true. Explanation: Notes and coins are not the only source of money supply in the economy. There are other sources of money supply as well, such as time deposit cheques etc.

28. Number of times the commercial banks are able to create total deposits with the help of reserves ratio and initial deposits is known as \_\_\_\_\_\_\_\_\_\_\_\_\_\_(Fill up the blank with correct alternative):

(a) Investment multiplier

(b) Money multiplier

(c) Demonetisation

(d) Remonetisation

Ans. (b) Money multiplier

Explanation: Money multiplier measures the amount of money that the banks are able to create in the form of total deposits with every initial of deposit.

29. Two components of money supply are \_\_\_\_\_\_\_\_\_\_\_ and \_\_\_\_\_\_\_\_\_\_\_. (Fill the blank with correct answer.)

OR

The main aim of monetary policy is (Choose the correct alternative)

(a) to bring price stability in the economy.

(b) employment generation in the country.

(c) to increase trade surplus.

(d) to generate greater tax revenue.

Ans. Currency and Demand Deposit.

OR

(a) To bring price stability in the economy.

30. Loans offered by commercial banks \_\_\_\_\_\_\_\_\_\_\_ (increase/decrease) the money supply in the economy.

(Fill up the blank with correct alternative.)

Ans. Increase

31. Explain the function of Central Bank as 'Banker, Agent and Advisor' of the Government. [4]

OR

Elaborate, how does a Central Bank stabilize money supply through 'Bank Rate.'

Ans. Central Bank is a Banker, Agent and Advisor of the government. As a banker to the government it manages accounts of the government. As an agent to the government it buys and sales securities on behalf of the government. As an advisor to the government it frames policies to regulate the money market. The central bank also offers loans to the government against government security on treasury bills. In a situation when government revenue falls short of its expenditure the government often seeks loans from central bank.

OR

Bank rate is the rate at which commercial bank can borrow money from central bank.

A rise in bank rate would discourage the commercial banks to build their cash reserves for the creation of credit through loans. This reduces the supply of money by the commercial banks. During inflation, central bank increases bank rate when the supply of money needs to be curbed. On the other hand, a fall in a bank rate induces commercial banks to build their cash reserves for the creation of credit. During deflation central bank decreases the bank rate when the supply of money needs to be increased.

32. Illustrate with the help of an hypothetical numerical example the process of credit creation.

Ans. The money (or deposit or credit) creation by the commercial banks is determined by the amount of initial deposit and the legal reserve ratio (LRR). Suppose the amount of initial deposit is ₹ 10,000 and LRR is 0.20. The banks will keep 20% i.e. ₹ 2,000 as reserve and lend the remaining ₹ 8,000. Those who borrow will spend this money. It is assumed that ₹ 8,000 comes back to the banks. This raises total deposits to ₹ 18,000. Banks again keep 20% of ₹ 8,000, i.e. ₹ 1,600 as reserve and lend ₹ 6,400. This further raises the amount of deposits with the banks. In this way, deposits go on increasing @ 80% of the last deposit. The number of times, the total deposits will become, is determined by the deposit or money multiplier:

Money Multiplier = $\frac{1}{Legal Reserve Ratio (LRR)}$ = $\frac{1}{0.2}$ = 5

The total deposits will be: Initial deposit x Money Multiplier = 10,000 x 5 = 50,000.

33. Distinguish between cash reserve ratio and statutory liquidity ratio.

Ans. Cash Reserve Ratio (CRR) refers to the minimum percentage of net demand and time liabilities, to be kept by commercial banks with the central bank. On the other hand, statutory liquidity ratio (SLA) refers to minimum percentage of net demand and time liabilities in the form of designated liquid assets which commercial banks are required to maintain with themselves.

34. Government of India has recently launched Jan-Dhan Yojna' aimed at every household in the country to have at least one bank account. Explain how deposits made under the plan are going to affect national income of the country.

Ans. The deposits made under the plan are going to affect national income of the country in the following way’….

* Opening more bank accounts means more bank deposits.
* More deposits mean increase in the lending capacity of the commercial banks.
* More lending by banks means more investment in the country.
* More investment means more national income.

35. Currency is issued by the central bank, yet we say that commercial banks create money. Explain. How is this money creation by commercial banks likely to affect the national Income? Explain.

Ans. Money supply has two components: Currency and demand deposits with commercial banks. Currency is issued by the central bank, while deposits are created by commercial banks by lending money to the people. In this way, commercial banks also create money Commercial banks lend money mainly to investors. The rise in investment in the economy leads to rise in national income through the multiplier effect.

36. Discuss how the central bank plays the role of 'controller of credit in an economy?

Ans. This is the most crucial function played by any Central Bank in the modern times. Central Banks are supposed to regulate and control the volume and direction of the credit by using:

(i) Quantitative Techniques: These are those techniques which influence the quantum of credit in the economy like open market operations, bank rate policy, repo and reverse repo rate policy, etc.

(ii) Qualitative Techniques or Selective Credit Control techniques are the ones which influence the direction of credit in the economy, like margin requirements and moral suasion.

37. Explain the working of money multiplier with help of a numerical example.

Ans. Money multiplier is the number by which total deposits can increase due to a given change in deposits. It is inversely related to legal reserve ratio. It is calculated as:

Money Multiplier = $\frac{1}{Legal Reserve Ratio (LRR)}$

Suppose there is an initial deposit of ₹ 1,000 crores and the legal reserve ratio is 10%, then

Money Multiplier = $\frac{1}{0.1}$ = 10

Total Deposit Initial Deposit x Money Multiplier = 1,000 x 10 = 10,000 crores

38. Define Credit Multiplier. What role does it play in determining the credit creation power of the banking system? Use a numerical illustration to explain.

Ans. Credit multiplier measures the amount of money that the banks are able to create in the form of deposits with every initial deposit.

The credit creation by commercial banks depends on credit multiplier as it is inversely related to Legal Reserve Ratio (LRR). Higher the credit multiplier, higher will be the total credit created and vice-versa.

For Example: Suppose LRR is 0.2 and initial deposit is ₹ 1,000

Credit multiplier = 1/0.2 = 5

Total credit created = 5 X 1,000 = 5,000

Whereas, suppose LRR is 0.5 and initial deposit is 1,000

Credit multiplier = 1/0.5 = 2

Total credit created = 2 X 1,000 = 2,000

Thus, with the same initial deposit, total credit creation decreases with an increase in the value of credit multiplier.

39. Explain, using a numerical example, how an increase in reserve deposit ratio affects the credit creation power of the banking system.

Ans. Reserve Deposit Ratio or Reserve Ratio (RR) or Legal Reserve Ratio (LRR) is the minimum reserves that a commercial bank must maintain as per the instructions of the Central Bank. Credit creation is inversely related to the reserve deposit ratio.

Example: Suppose Reserve Ratio is 0.2 and initial deposit is 1,000

Total Credit Created = 1/(RR) X Initial Deposits = 1/0.2 X 1000 = 5000

Whereas, suppose Reserve Ratio is 0.5 and initial deposit is 1,000

Total Credit Created = 1/(RR) x Initial Deposits = 1/0.5 x 1,000 = 2,000.

40. Distinguish between demand deposits and time deposits.

Ans. (a) Demand Deposits: Demand deposits are not for any specific period. These can be withdrawn at any time and hence, are highly liquid. Also, demand deposits are chequable deposits. Cheques can be issued against these deposits.

(b) Time Deposits: Time deposits are always for a specific period of time, say, three years. Time deposits can be withdrawn only after a specific period and these are less liquid. Time deposits carry a fixed rate of interest. These are not chequable, that is, cheques cannot be issued against these deposits.

41. Give meaning of money supply. State its components.

Or

Explain the concept of money supply.

Ans. Money supply may be referred to as the total stock of money of various kinds at any particular point of time held by the public. Following are the main components of money supply:

(a) Currency with Public: Currency with public means coins and currency notes with the public outside the bank.

(b) Demand Deposits with Banks: Demand deposits are the deposits which can be withdrawn at any time by writing cheques.

42. What is legal reserve ratio? State its components.

Ans. Legal reserve ratio is a minimum ratio of total deposits which every bank legally is required to keep. There are two components of legal reserve ratio:

(a) Cash Reserve Ratio: The percentage of deposit that every bank is required to keep with the central bank in the form of cash.

(b) Statutory Liquidity Ratio: The percentage of deposits which banks are required to keep with it in the form of specified liquid assets.

If CRR or SLR is high, banks are required to keep more part of their deposits in the form of reserves or securities and will have fewer funds to lend. This will contract credit. Similarly, if CRR or SLR is low, banks are required to keep less part of their deposits in the form of reserves or securities and will have more funds to lend. This will expand credit.

43. Explain how open market operations are helpful in controlling credit.

Ans. Open market operation is the policy of Central Bank to sell and buy the government securities in the market. Commercial banks are required to purchase from or sell to the central bank the government securities. Open market operations affect the cash reserve with the commercial bank and thus, the overall capacity to lend. When there is a need to reduce the money supply in the economy, the central bank starts selling government securities. In this case, the money flows from commercial bank to the central bank. which thereby reduces the deposits held by commercial banks. Consequently, money supply as well as money creation power of the commercial banks is reduced.

44. Explain how repo rate can be helpful in controlling credit creation.

Ans. Repo rate is the rate of interest at which Central Bank lends money to commercial banks for short period against government securities. Repo rate is an important method of controlling credit creation. Increasing a repo rate discourages commercial banks to borrow from the central bank and thus, reduces the money supply in the economy. Higher repo rate makes borrowing by commercial banks costlier and therefore, commercial banks are forced to raise their lending rates. Since borrowing becomes costly for people, borrowings are reduced.

45 Explain the role of reverse repo rate in controlling money supply.

Ans. Reverse repo rate is the rate at which Central Bank of a country borrows money from commercial banks against government securities. Reverse repo rate is fixed by the central bank to control the money supply. An increase in the reverse repo rate implies that the bank will get a higher rate of interest from the RBI on their lending. As a result, the banks will lend more to the RBI and less to the public, thus, resulting in a decrease in the money supply. Similarly, in case the RBI decreases the reverse repo rate, the banks will get a lower rate of interest on their borrowings. As a result, they will lend more to public, which will in turn increase the money supply.

46. Explain 'bankers' bank' function of Central bank.

Ans. Central bank acts as banker to all other banks in the country just as commercial banks act as banker to the general public. It performs the following functions:

(a) Making polices and regulation for commercial banks

(b) Maintaining cash reserve as deposit by the commercial banks

(c) Providing financial assistance to commercial banks during crisis

47. Explain the role of central bank as a 'Banker to the government'.

Or

Explain 'Banker to the Government' function of the Central Bank.

Or

Explain 'Government's Bank' function of central bank.

Ans. As a banker to the government, the central bank makes transaction on the behalf of the government and government keeps its cash balance on current account with the central bank. It accepts receipts and makes payments for the government and carries out exchange, remittance and other banking operations.

48. Explain the 'lender of last resort' function of the central bank.

Ans. During crisis, if commercial banks fail to meet the obligations of their depositors, the central bank plays a crucial role. The central bank stands by the commercial banks as a guarantor and advances necessary credit to the commercial banks against securities to ensure the solvency of the latter. This saves the commercial banks from possible breakdown.

49. Explain the 'bank of issue' function of the central bank.

Or

Explain the function of the Central Bank as the 'Authority of currency issue'.

Ans. In almost all the countries, the Central bank has been entrusted with the responsibility of issuing currency. The central bank enjoys the sole monopoly for printing currency notes and coins. The central bank is legally bound to back currency with assets of equal value in the form of gold, local currency, and foreign and domestic government securities. The currency issued by the central bank is unlimited legal tender in the country. It brings uniformity in note issue and elasticity in the monetary system.

50. State the main functions of a central bank.

Ans. The following are the main functions of central bank:

(a) Bank of Note Issue: In the modern time, issuing of notes is the main function of the central bank of every country in the world. Central bank has the monopoly in this regard. In India, RBI issues notes as a central bank of the country except one rupee note, which his issued by the Ministry of Finance, Government of India.

(b) Banker, Agent and Advisor to the Government: The central bank acts as a banker, agent and advisor to the government.

(c) Banker's Bank: Central bank acts as a banker to all other banks in the country just as commercial banks act as a banker to general public.

(d) Lender of the Last Resort: During crisis, central bank acts as a lender of the last resort. The central bank stands by the commercial banks as a guarantor and extends loans to ensure the solvency of the latter. This saves the commercial banks from possible breakdown.

(e) Custodian of the Foreign Exchange Reserve: The central bank acts as a custodian of the foreign exchange reserves of the country.

(f) Custodian of Cash Reserve of the Commercial Banks: The central bank also keeps the cash reserves of the commercial banks.

(g) Bank of Central Clearance, Settlement and Transfer: Central bank is an i institution where all the transactions of commercial banks are cleared, settled and transferred very easily.

(h) Control of Credit: The central bank has got so many instruments to control credit like bank rate, open market operation, cash reserve ratio, credit rationing, moral suasion and direct actions.

51. (a) State any two components of M, measure of money supply.

(b) Elaborate any two instruments of Credit Control, as exercised by the Reserve Bank of India.

Ans. (a) The two components of M, measure of money supply are:

* Currency (coins and notes) held by the public
* Demand deposit held with commercial banks

(b) Two instruments of credit control exercised by the RBI are:

Repo Rate: It is the rate of interest at which central bank lends to commercial banks for the short-term requirements. An increase in repo rate will force commercial banks to increase their lending rates, which will make borrowings costlier for the public and vice-versa.

Open Market Operation: It refers to buying and selling of government securities by the central bank from and to general public. When central bank sells securities, it reduces liquidity with commercial bank and adversely affects the credit creation power of banks. During inflation, the government should sell securities and during deflation, government should buy securities.