Money And Banking

1. Identify the incorrect feature(s) of money supply (M_1) from the following : (2024)

(i) It is measured at a point of time.

(ii) It does not include stock of money held by the government.

(iii) It is always the currency in the hands of the Central Bank of a nation.

Alternatives :

(A) (i) and (ii)

(B) (ii) and (iii)

(C) (ii) only

(D) (iii) only

Ans. (D) (iii) only

2. Justify the following statements with valid arguments : (2024)

(a) The Central Bank is the sole currency issuing authority of an economy.

Ans. The Central Bank has the sole authority for issuing currency in the economy. This ensures uniformity in the issue of currency and it gives the Central Bank control over the money supply in the economy.

(b) Money serves as a measure of standard of deferred payments.

Ans. Deferred payments are contracted to be made at some future date. Money facilitates such transactions of borrowing and lending. Hence, money serves as a standard of deferred payments.

Previous Years' CBSE Board Questions

3.1 Money : Meaning, Functions and Supply

MCQ

1. 'Money is an asset which can be stored for use in future.' In the light of given statement, identify the function of money.
   (a) A measure of value
   (b) A standard of deferred payment
   (c) A store of value
   (d) A medium of exchange (2023) An

2. Read the following statements carefully.
   Statement I : Money supply (M_1) in India does not include 'demand deposits' with commercial banks.
   Statement II : Money supply (M_1) refers to, assets available with the commercial banks during a particular period of time.
   In the light of the given statements, choose the correct alternative from the following.
   (a) Statement I is true but statement II is false.
   (b) Statement I is false but statement II is true.
   (c) Both statements I and II are true.
   (d) Both statements I and II are false. (2023)

3. Read the following statements carefully and choose the correct alternative.
   Statement I : All the coins are issued by Finance Ministry in India.
   Statement II : All the currency notes are issued by Reserve Bank of India.
   (a) Both the statements I and II are true.
   (b) Both the statements I and II are false.
   (c) Statement I is true but statement II is false.
   (d) Statement II is true but statement I is false.
   (Term-I, 2021-22) U

4. ______ 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 (2021 C)

5. Which of the following is not a function of money?
   (a) Capital (b) Income
   (c) Investment (d) Depreciation
   (AI 2015 C)

VSA (1 mark)

6. State whether the following statement is true or false.

7. Two components of money supply are ______ and ______. (2020) R

8. State the two components of M_1 measure of Money Supply. (2018)

SA I (3 marks)

9. Explain the "store of value" function of money. (Delhi 2017)

10. State the meaning and components of money supply. (Delhi 2017) R

11. Explain how controlling money supply is helpful in reducing excess demand? (AI 2016)

12. Explain the significance of 'medium of exchange' function of money. (Delhi 2014)

SA II (4 marks)

13. Explain the 'unit of account' function of money. How has it solved the related problem created by barter? (Delhi 2016)

14. Explain the 'standard of deferred payments' function of money. How has it solved the related problem created by barter? (AI 2016)

15. Explain any two functions of money. (AI 2015 C)

3.2 Commercial Banks

MCQ

16. Process of credit creation by commercial banks comes to an end when ______.
   (a) Fresh deposits with banks become zero.
   (b) Reserve Ratio become zero.
   (c) Money multiplier become zero.
   (d) Total money reserves become equals to initial deposit. (Term-I, 2021-22) U

17. If the Legal Reserve Ratio is 20% and initial deposits is ₹2,000, then value of money multiplier and total money creation will be ______ and ______.
   (a) 5 and ₹ 10,000 (b) 4 and ₹ 8,000
   (c) 4 and ₹ 10,000 (d) 6 and ₹ 2,000
   (Term-I, 2021-22)

18. Given below are two statements, one labelled as Assertion (A) and the other as Reason (R).
   Assertion (A) : Reserve Ratio and credit creation power of commercial banks are directly related.
   Reason (R) : Credit Creation is the product of the reciprocal of Reserve Ratio (RR) and Primary deposit.
   In the context to the above two statements, which of

(b) Both A and R are true but R is not the correct explanation of A.
(c) A is true but R is false.
(d) A is false but R is true. *(Term-I, 2021-22)*

19. Credit creation by commercial banks is determined by
(a) Cash Reserve Ratio (CRR)
(b) Statutory Liquidity Ratio (SLR)
(c) Initial Deposits
(d) All of the above. *(2018)* R

SA II (4 marks)

20. Using a hypothetical numerical example, explain the process of credit creation by a commercial bank. *(2020)* Ap

21. 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. *(AI 2015)*

LA (5/6 marks)

22. Define credit multiplier. What role does it play in determining the credit creation power of the banking system? Use a numerical illustration to explain. *(2019)*

3.3 Central Bank and its Functions

MCQ

23. The Reserve Bank of India (RBI) ________ government securities in a bid to ________ the stock of money in the economy.
(a) sells, decrease
(b) purchases, decrease
(c) sells, increase
(d) purchases, not change *(2023)*

24. Central Bank as ________, manages public debt of the government.
(a) Custodian of Foreign Exchange
(b) Agent
(c) Financial Advisor
(d) Supervisor *(Term-I, 2021-22)*

25. Which of the following statements does not support the function of RBI as supervisor to the commercial banks?
(a) Regulates the expansion, merger, acquisition, etc. of the bank
(b) Formulates all rules and regulations for commercial bank
(c) Extend loans to the commercial bank
(d) Inspection of operations of banks *(Term-I, 2021-22)* Ap

26. Statutory Liquidity Ratio implies to that percentage of ________.
(a) total deposits of the commercial banks which must be kept in the current account, with the Reserve Bank of India.
(b) total deposit of the commercial banks which must be kept in the form of liquid assets, with the Reserve Bank of India.
(c) net time and demand deposit liabilities of the commercial banks which must be kept in the form of cash, with the Reserve Bank of India.
(d) net time and demand deposit liabilities of the commercial bank which must be kept with themselves in the form of liquid assets. *(Term-I, 2021-22)*

27. In order to control the money supply in the economy, the Central Bank may ________.
(a) Buy securities in the open market
(b) Sell securities in the open market
(c) Reduce Cash Reserve Ratio
(d) Reduce Repo Rate *(Term-I, 2021-22)* Ap

28. 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 *(Delhi 2017)*

29. Who regulates money supply ?
(a) Government of India
(b) Reserve Bank of India
(c) Commercial Banks
(d) Planning Commission *(AI 2015 C, Delhi 2015 C)* R

VSA (1 mark)

30. Define Cash Reserve Ratio. *(AI 2015 C, AI 2014 C)* R

31. What are Demand Deposits? *(AI 2015 C, Delhi 2014)*

32. What are Time Deposits? *(AI 2015 C, Delhi 2014 C, AI 2014)*

33. What is Statutory Liquidity Ratio? *(AI 2014 C)*

34. What is meant by Bank Rate? *(AI 2014 C)*

SA I (3 marks)

35. Elaborate any two instruments of Credit Control, as exercised by the Reserve Bank of India. *(2019)*

36. Explain the 'lender of last resort' function of the Central Bank. *(Delhi 2014)* Ap

SA II (4 marks)

37. Read the following text carefully.
"After setting up a working group to study the possibility of a Central Bank Digital Currency (CBDC) in India 2020, the RBI revealed a concept note on digital rupee (e-Rupee) on 7^{th} October 2022."
"The e-Rupee will provide an additional option to the currency available forms of money. It is substantially not different from bank notes, but being digital it is likely to be easier, faster and cheaper."

RBI said that it broadly defines CBDC as the legal tender issued by a central bank in a digital form. It is akin to paper currency in a different form.

On the basis of the above text and common understanding, answer the following questions.

(a) Identify and discuss the function of Central Bank indicated in the above text.

(b) State any two advantages of digital rupee.

(2023) Ap

38. Explain the role of Central Bank as Governments' agent and advisor. *(2023)*

39. Explain the role of Repo Rate in controlling money supply. *(Delhi 2017, AI 2016)*

40. Explain 'banker to the government' function of the Central Bank. *(Delhi 2017, AI 2015, 2014)*

41. What is monetary policy? State any three instruments of monetary policy. *(2018)* U

42. Explain how open market operations are helpful in controlling credit creation? *(Delhi 2016, Delhi 2014)* U

43. Explain how 'bank rate' is helpful in controlling credit creation. *(Delhi 2016)*

44. Explain how 'Margin requirements' are helpful in controlling credit creation. *(Delhi 2016)*

45. Explain the 'bank of issue' function of the Central Bank. *(AI 2015)*

46. Explain the 'Banker's Bank' function of the Central Bank. *(AI 2015, 2014)*

CBSE Sample Questions

3.1 Money : Meaning, Functions and Supply

MCQ

1. Money supply in India may increase if, ________

I. Reserve Bank of India (RBI) injects more money in circulation.

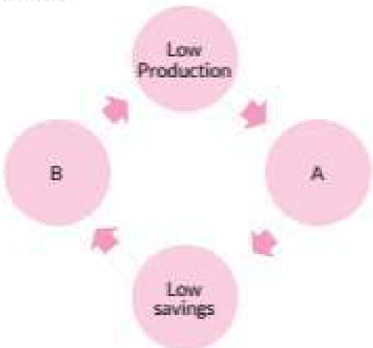
II. The commercial banks expand their credit operation.

III. Tax rates are reduced by the Central Government.

IV. Reserve Bank of India increases the Bank Rate.

(a) I, II and III are correct.
(b) II, III and IV are correct.
(c) I, III and IV are correct.
(d) I, II and IV are correct. *(2022-23)*

2. Choose the correct alternative to be filled in given blanks A and B.



(a) Low level of income and Low level of investment
(b) Low level of income and Low level of Income
(c) Low Mobilisation of savings and Low level of investment
(d) Low level of Investment and Low savings

(Term-I, 2021-22) U

3. In a hypothetical economy, Mr. Neeraj has deposited ₹100 in the bank. If it is assumed that there is no other currency circulation in the economy, then the total money supply in the economy will be ________.

(a) Zero (b) ₹100
(c) Not defined (d) ₹120

(Term-I, 2021-22) U

4. Demand Deposits include ________ and ________.

i. Saving Account Deposits
ii. Fixed Deposits
iii. Current Account Deposits
iv. Post Office Savings

(a) i and ii (b) ii and iii
(c) i and iii (d) i and iv

(Term-I, 2021-22)

5. Given below are two statements, one labelled as Assertion (A) and the other as Reason (R).

Assertion (A): Demand Deposits are considered as a convenient mode of payment for execution of even the high value transactions.

Reason (R): Demand Deposits are withdrawable in nature and cannot be withdrawn against issue of cheques and other similar instruments of payments.

In the context to the above two statements which of the following is correct?

(a) Both A and R are true and R is the correct explanation of A.
(b) Both A and R are true but R is not the correct explanation of A.
(c) A is true but R is false
(d) A is false but R is true *(Term-I, 2021-22)*

6. Supply of money refers to ________.

(a) currency held by the public
(b) currency held by Reserve Bank of India (RBI)
(c) currency held by the public and demand deposits with commercial banks
(d) currency held in the government account

(2020-21) R

SA II (4 marks)

7. Read the following news report and answer the questions on the basis of the same.
The Reserve Bank of India (RBI), cut Repo Rate to 4.4%, the lowest in at least 15 years. Also, it reduced the Cash Reserve Ratio (CRR) maintained by the banks for the first time in over seven years. CRR for all banks was cut by 100 basis point to release ₹ 1.37 lakh Crore across the banking system. RBI governor Dr. Shaktikanta Das predicted a big global recession and said India will not be immune. It all depends how India responds to the situation. Aggregate demand may weaken and ease core inflation.

The Economic Times; March 27^{th}

(2020-21)

(i) Cut in Repo Rate by RBI is likely to ______ (increase/decrease) the demand for goods and services in the economy.

(ii) Decrease in Cash Reserve Ratio will lead to ______.
(a) fall in Aggregate Demand
(b) no change in Aggregate Demand
(c) rise in Aggregate Demand
(d) fall in general price level

(iii) The difference by which actual Aggregate Demand exceeds the Aggregate Demand, required to establish full employment equilibrium is known as ______ (inflationary gap/deflationary gap).

(iv) The impact of 'Excess Demand' under Keynesian theory of income and employment, in an economy are:
(a) decrease in income, output, employment and general price level
(b) decrease in nominal income, but no change in real output
(c) increase in income, output employment and general price level
(d) no change in output/employment but increase in general price level.

3.2 Commercial Banks

MCQ

8. ______ is an institution that accept deposits for lending purposes.
(a) Commercial Banks
(b) Life Insurance Corporation
(c) Reserve Bank of India
(d) Government of India *(2022-23)*

9. Read the following statements carefully and choose the correct alternative.
Statement I : The value of money multiplier is determine by the reserve ratio prevailing in the monetary system.
Statement II : The process of credit creation directly relates to the value of legal reserve ratio.
(a) Both the statements are true.
(b) Both the statements are false.
(c) Statement I is true but statement II is false.
(d) Statement II is true but statement I is false.

(Term-I, 2021-22) Ap

SA II (4 marks)

10. (a) Define money multiplier.
(b) 'Credit creation is inversely related to the reserve deposit ratio'. Justify the given statements using a hypothetical example.

(2020-21)

3.3 Central Bank and its Functions

MCQ

11. Identify which of the following bank does not interact directly with the general public?
(a) Bank of India
(b) State Bank of India
(c) Central Bank of India
(d) Reserve Bank of India *(Term-I, 2021-22)*

12. Identify which of the following is not a function of the Reserve Bank of India?
(a) To act as the banker to the Government of India.
(b) To act as the custodian of the gold reserve of India.
(c) To act as the financial advisor to the Government of India.
(d) To issue coins and one rupee note.

(Term-I, 2021-22)

13. Ms. Sakshi, an economics teacher, was explaining the concept of 'minimum percentage of the total deposits to be kept by any commercial bank with the Central Bank of the country, as per norms and statute prevailing in the country'.
From the following, choose the correct alternative which specifies the concept explained by her?
(a) Cash Reserve Ratio
(b) Repo Rate
(c) Bank Rate
(d) Statutory Liquidity Ratio

(Term-I, 2021-22) Ap

VSA (1 mark)

14. In the present COVID-19 times, many economists have raised their concerns that Indian economy may have to face a deflationary situation, due to reduced economic activities in the country.
Suppose you are a member of the high powered committee constituted by the Reserve Bank of India (RBI).
You have suggested that as the supervisor of commercial banks, ______ (restriction/release) of the money supply be ensured, by the Reserve Bank of India (RBI). *(2020-21)* U

SA II (4 marks)

15. As per the following news published in *The Economic Times on 26th December 2021* :
'Reserve Bank of India has sold government securities worth ₹8710 crore in the secondary market over the last four weeks to drain out excessive liquidity'.
Identify the likely cause and the consequences behind, this type of action plan of the Reserve Bank. *(2022-23)*

16. Read the following text carefully, discuss briefly the relevant function of the Central Bank, indicated :
Recently, Reserve Bank of India (RBI) conducted a stationary inspection for supervisory evaluation against a Commercial Bank. The commercial bank was imposed with stringent penalties, owing to deficiencies in regulatory compliances.
As per the Central Bank, the inspection revealed non-compliances vis-a-vis different directions issued by RBI, on the following fronts:
i. ATM card frauds
ii. Ensuring integrity and quality of data
iii. Loans to small borrowers (*adapted/moderated-livemint.com*) *(2022-23)*

Detailed SOLUTIONS

Previous Years' CBSE Board Questions

1. (c) : A store of value
2. (d) : Both statements I and II are false.
3. (d) : Statement II is true but statement I is false.
4. (c) : Ministry of Finance
5. (d) : Depreciation
6. True
7. Currency held with public and Demand deposits with commercial bank.
8. M_1 = Currency notes and coins with public (C) + Demand Deposits of the people with commercial banks (DD) + Other Deposits with RBI (OD) such as deposits of public financial institutions, etc.
Thus, $M_1 = C + DD + OD$.
9. Store of value function of money : Store of value implies store of wealth. Storing wealth has become considerably easy with the introduction of money. Wealth can be stored just in terms of paper like FDR (Fixed deposit receipts.).
10. Money supply refers to the total stock of money in circulating among the public at a particular point of time.
RBI publishes figures for four alternative measures of money supply *viz.* M_1, M_2, M_3 and M_4 which are explained as :
(i) $M_1 = C + DD + OD$
where, C = Currency (including coins and paper notes) held by public.
DD = Demand deposits of the people with commercial bank which can be withdrawn on demand (it excludes inter-bank deposits).
OD = Other deposits with RBI which includes demand deposits of :
(a) Public financial institutions like IFCI.
(b) Foreign central banks and of the foreign governments.
(c) International financial institutions like IMF and World Bank (Note : OD does not include deposits of country's banking system and government of the country with RBI).
(ii) $M_2 = M_1$ + Savings deposits with Post Office Saving Banks.
(iii) $M_3 = M_1$ + Net time-deposits with commercial banks.
(iv) $M_4 = M_3$ + Total deposits with Post Office Saving of Organisations (excluding NSC).
M_1 and M_2 are known as Narrow money.
M_3 and M_4 are known as Broad money.
M_3 is also known as aggregate monetary resources. It is the most commonly used measure of money supply.

Commonly Made Mistake

- Supply of money includes only that stock of money which is held by the people, not by those, who supply money.

11. Excess demand : It is when aggregate demand is greater than aggregate supply at full employment level.
Excess demand can be reduced by controlling money supply. Money supply is controlled through monetary policy executed by Central Bank of a country. By increasing bank rate, cash reserve ratio, statutory liquidity ratio, selling off security to commercial bank, money supply can be controlled which will lead to reduction in aggregate demand. In this way, excess demand can be reduced.
12. Money serves as a medium of exchange or medium of payments. Money helps is buying and selling of goods. Goods are exchanged for money and this money can be used for buying any other good that we need. Thus, money acts as an intermediary and facilitates trade. Money has removed the difficulty of double coincidence of wants. Now, a person *A* can sell his goods to another person *B* for money and then he can use that money to buy the goods he wants from others. Money has made the exchange of goods easy.
13. Lack of common measure of value : The second main drawback of barter is the absence of a common unit of measurement in which the value of goods and services can be measured. In the absence of common unit, proper accounting is not possible.
But money has solved this problem. Money serves as a unit of value in terms of which the value of all goods and services are measured. The prices of all goods and services can be fixed in terms of money. Thus, the problem

of a common measure of value under barter system can be avoided/removed by the use of money.

14. Lack of standard for deferred payments : The third drawback of the barter system is that it lacks any satisfactory unit to engage in contracts involving future payments. In a barter economy, future payments would have to be stated in specific goods or services which may involve disagreement over the quality of goods or even on the commodity used for repayment. Deferred payments refer to those payments which are made in future. When we borrow money from somebody in the present, we have to return both the principal as well as interest amount at some future date. It is easy to make such payments in terms of money because its price remains relatively stable compared to other commodities.

15. The functions of money :

(i) Money acts as a medium of exchange : Money serves as a medium of exchange or medium of payments. Money helps is buying and selling of goods. Goods are exchanged for money and that money can be used for buying any other good that we need. Thus, money acts as an intermediary and facilitates trade. Money has removed the difficulty of double coincidence of wants. Now, a person A can sell his goods to another person B for money and then he can use that money to buy the goods he wants from other. Money has made the exchange of goods easy.

(ii) Unit of value : Money serves as a unit of value or common measure of value in terms of which the value of all goods and services are measured. This help in measuring the exchange values of commodities. The prices of all the goods and services can be fixed in terms of money and the problem of expressing of the value of each commodity in terms of quantities of other goods can be avoided. Unit of value function of money makes possible of keeping business accounts. It would not be possible to keep business accounts unless all business transactions are expressed in money.

16. (d) : Total money reserves become equals to initial deposits.

17. (a) : 5 and 10, 000

Concept Applied

- Money multiplier $=\frac{1}{LRR}=\frac{1}{20\%}=5$
  and Total deposits = Initial deposit × Money Multiplier = 2000 × .055 = ₹10,000

18. (d) : A is false but R is true.

19. (a) : Cash Reserve Ratio (CRR)

20. 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 is inversely related to LRR. Higher the credit multiplier, higher will be the total credit created and vice-versa.

The credit creation by commercial banks is determined by :

(a) The amount of the initial deposit.

(b) The Legal Reserve Ratio (LRR).

Suppose the initial deposits are ₹1000 and LRR is 10%, the banks will keep 10% of the deposit *i.e.* ₹100 as reserves and will lend the remaining amount of ₹900. Those who borrow will spend the money for making payments.

It is assumed that the entire ₹900 comes back as secondary deposits to the banking system. Now, the banks will again keep 10% of ₹900 *i.e.* ₹90 as reserve and lend out ₹810. This process continues till total reserves become equal to initial reserves.

Total money creation = initial deposits $\left(\frac{1}{LRR}\right)$

$= 1000\left(\frac{1}{10\%}\right)$ = ₹10,000

Hence, the initial deposit of `1000 has led to the total money supply of ₹10,000.

21. We know that RBI prints new money, while on the other hand, commercial banks multiplies money supplied by the RBI through the process of credit creation. People deposit money in their respective bank accounts. As per the central bank guidelines, the commercial banks are required to maintain a portion of total deposits in form of cash reserves. With the help of the past experiences, the commercial banks know that not all the depositors will turn-up for withdrawal at the same day. Consequently, the commercial banks lends the remaining portion (left after maintaining cash reserves) of the total deposits to the general public in form of credit, loans and advances. It is the second portion of the total deposits that is responsible for the credit creation (credit money). The process of creation of credit money begins as soon as the commercial banks start the lending process. The amount of the credit money increases as the banks lend loans to more and more number of people in the economy. The deposit of money by the people in the banks and the subsequent lending of loans by the commercial banks is a recurring process. This lending process of the commercial banks increases the rate of investment and production in the economy, which in turn helps in improving the national income in the economy.

22. 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 LRR. Higher the credit multiplier, higher will be the total credit created and vice-versa.

For example, suppose the LRR is 0.2 and initial deposit is ₹1000

Credit multiplier $=\frac{1}{0.2}=5$

Total credit created = 5 × ₹1,000 = ₹5, 000

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

Credit multiplier $=\frac{1}{0.5}=2$

Total credit created = 2 × ₹1000 = ₹2,000

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

Related Theory

- Total demand deposits = Primary deposits of Commercial bank + Secondary Deposits of Commercial bank.
  Here, Primary deposits indicate savings of depositors and secondary deposits indicate borrowings of depositors.

23. (a) : Sells, decrease

24. (c) : Financial Advisor

25. (a) : Regulates the expansion, merger, acquisition etc. of the bank.

26. (d) : Net time and demand deposit liabilities of the commercial bank which must be kept with themselves in the form of liquid assets.

27. (b) : Sell securities in the open market.

28. (c) : Cash Reserve Ratio.

29. (b) : Reserve Bank of India

30. Under CRR, the banks are required to deposit with the Central Bank a percentage of their net demand and time liabilities in terms of cash.

31. DD = Demand deposits are the deposits of the people with commercial bank which can be withdrawn on demand (it excludes inter-bank deposits).

32. Time Deposits refers to those deposits that are held for a fixed (specific) period of time (Called maturity period).

33. SLR requires the banks to maintain a specified percentage of their net total demand, time liabilities in the form of liquid assets.

34. Bank rate is the rate at which the Central Bank advances loans to the commercial banks against approved securities.

35. Two instruments of credit control are:
(i) Repo rate – It is rate of interest at which Central Bank lends to commercial banks for their short term requirements. An increase in repo rate will force commercial banks to increase their lending rates. It will make borrowings costlier to general public.
(ii) Open market operations refer to buying and selling of government securities by the central bank from and to the general public. When central bank sells it securities, it reduces liquidity (deposits) with commercial banks and adversely affects credit creating power of banks.

36. The Central Bank acts as a lender of the last resort for commercial banks. When commercial banks fail to meet obligations of their depositors, the Central Bank comes to help them. The Central Bank advances necessary credit against eligible securities subject to certain terms and conditions. This saves banks from a possible breakdown. Central Bank never refuses to accommodate any eligible bank and help them in need. Professor Sayers regards this function of the Central Bank as the basic important function of Central Banking System.

37. (a) The function of RBI indicated in the given source is "Bank of Issuing Notes". Central Bank is the sole authority to issue currency in the country. Since no other authority is allowed, this ensures uniformity in issue of currency. Since currency with public is a part of money supply, it gives the central Bank some control over money supply in the economy.
(b) Advantages of digital rupee–
(i) As a digital rupee it is easier to make payments.
(ii) Digital money is faster and cheaper medium of payment.

38. Central Bank as government's bank - The Central Bank acts as a banker to both Central as well as State government. The Central Bank accepts receipts and make payments for the government and carries out exchange, remittance and other banking operations. It advances credit/loan to the government to meet its requirements in case of crisis. It also acts as an agent to buy and sell government securities & advises the government on various financial matters.

39. Repo rate is the rate at which commercial banks can borrow money from the RBI to tackle the shortage of liquidity (Cash). By varying these rates the RBI can increase or decrease the supply of money in three ways as under:
(i) Rise in Bank rate/Repo rate → Discourage the commercial banks to build cash reserves for the purpose of credit creation → Reduces the supply of money by the commercial banks → inflation is combated.
Fall in Bank rate/Repo rate → Encourages the commercial banks to build cash reserves for the purpose of credit creation → Increase the supply of money by the commercial banks → Deflation is combated.
(ii) Increase in bank rate/repo rate acts as a warning-signal to the commercial banks to maintain healthy reserves of their vault cash (caution money to sustain their liabilities related to demand deposits). When the vault cash increases, the capacity to create credit is reduced. Accordingly, supply of money is reduced. On the other hand, when bank rate/repo rate is reduced, the banks are induced to lower their vault cash. This increases their capacity to create credit, accordingly supply of money is increases.

40. Banker to the government: Central bank is a banker agent and financial advisor to the government. As a banker to the government it manages accounts of the government. As an agent to the government it buys and sells 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 securities or treasury bills. In a situation when its revenue falls short of its expenditures *i.e.*, in a situation of deficit government budget, government often seeks loan from the central bank (RBI).

41. Monetary policy is the policy which is concerned with the money supply and availability of credit in an economy. It is regulated by the central bank of the country.
The three instruments of monetary policy are :
Quantitative measures like :
(i) Bank rate
(ii) Open market operations
(iii) Cash reserve ratio

Answer Tips

- While answering for theoretical subjects, always pay attention and stick to the word limit.

42. Open market operations refer to the purchase and sale of government securities in the open market by the Central Bank. By selling the government securities, the Central Bank loses equivalent amount of cash reserves thereby restricting their capacity to lend. By buying government securities, the Central Bank injects additional purchasing power into the system which results in the expansion of credit. Thus, depending on the situation of excess demand (or deficient demand), the Central Bank may resort to sale (or purchase) of government securities resulting in fall (or a rise) in the availability of credit.

43. Bank rate is the minimum rate at which the central bank of a country gives credit to the commercial banks. The increase in bank rate increases the rate of interest, *i.e.*, cost of borrowings goes up. Higher cost of borrowings discourages borrowers for demanding loan. Thus, the volume of credit is decreased. On the other hand, a decrease in bank rate lowers the rate of interest, *i.e.*, cost of borrowing goes down. Lower cost of borrowing encourages borrowers to demand more loans. Thus, the volume of credit is expanded. Thus, depending on the situation of excess demand (or deficient demand), the central bank may raise the bank rate (or lower the bank rate) resulting in fall (or a rise) in the availability of credit.

44. Margin requirements refer to the percentage of down payment on borrowings. In other words, margin requirements refer to the difference between the values of the security offered for levies and the value of loans granted. Suppose a person mortgages goods worth ₹ 10,000 with a bank and the bank gives him loan worth ₹ 8,000, the margin requirement in this case would be 20%. To curb excess demand, the Central Bank raises the margin requirement. The borrowers are now given less money in the form of loans against the mortgaged goods. Thus, credit contracts and aggregate demand declines.
To correct the situation of deficient demand, margin is reduced to encourage borrowing. Commercial Banks can now start more advances against the mortgaged goods. Thus, credit expands and aggregate demand increases.

45. Issue of Currency Authority : The Central Bank is the sole authority for the issue of currency in the country. Notes issued by it are circulated as legal tender money. It has its issue department which issues notes and coins. Coins are manufactured in the government ministry but they are put into circulation through the Central Bank. While issuing currency notes, a minimum fixed amount of gold and foreign currencies is kept by the Central Bank. The monopoly of issuing notes vested in the Central Bank ensures uniformity in the notes issued which helps in facilitating exchange and trade within the country. By having a monopoly of note issue, The Central Bank can restrict or expand the supply of cash according to the requirements of the economy.

46. Banker's bank and supervisor : The Central Bank acts as a banker and supervisor to commercial banks in various ways : (a) It provides financial assistance to banks by discounting their bills and through loans and advances against approved securities. (b) The commercial banks are required to maintain a certain percentage of liabilities with the Central Bank. The sole aim of these reserves is to enable the Central Bank to provide financial assistance at the time of financial emergency. (c) It supervises, regulates and controls the activities of commercial banks. (d) It provides centralised clearing and remittance facility to the commercial banks.

CBSE Sample Questions

1. (a) : I, II and III are correct **(1)**
2. (a) : Low level of income and Low level of investment **(0.80)**
3. (b) : ₹ 100 **(0.80)**
4. (c) : (i) and (iii) **(0.80)**
5. (c) : A is true but R is false. Demand Deposits are withdrawable in nature and cannot be withdrawn against issue of cheques and other similar instruments of payments. **(0.80)**
6. (c) : Currency held by the public and demand deposits with commercial banks **(1)**
7. (i) Increase **(1)**
(ii) (c) : rise in Aggregate Demand **(1)**
(iii) Inflationary gap **(1)**
(iv) (d) : No change in output/employment but increase in general price level. **(1)**
8. (a) : Commercial Banks **(1)**
9. (c) : Statement I is true but statement II is false. The process of credit creation inversely relates to the value of legal reserve ratio. **(0.80)**
10. (a) Money multiplier is the process by which the commercial banks create credit, based upon the reserve ratio and initial deposits. **(1)**
(b) Reserve deposit ratio is the minimum reserve which a commercial bank must maintain as per the instructions of the Central Bank.

$$\text{Credit Creation} = \frac{1}{\text{reserve ratio}}$$

Thus, credit creation is inversely related to the reserve deposit ratio.
For Example: Suppose the Reserve Ratio is 0.2 and initial deposit is ₹1000 Crore.

$$\text{Total Credit Created} = \frac{1}{\text{reserve ratio}} \times \text{initial deposits}$$

$$= \frac{1}{0.2} \times 1000 = ₹5{,}000 \text{ Crore.}$$

Now, suppose reserve ratio is increased to 0.5.

$$\text{Total Credit Created} = \frac{1}{\text{reserve ratio}} \times \text{initial deposits}$$

$$= \frac{1}{0.5} \times 1000 = ₹2{,}000 \text{ Crore.}$$

Thus, on the basis of the above illustration we can say that there exists an inverse relation between reserve and credit creation. (3)

11. (d) : Reserve Bank of India (0.80)

12. (d) : To issue coins and one rupee note (0.80)

13. (a) : Cash Reserve Ratio (0.80)

14. Release (1)

15. The given instance where, Reserve Bank of India has sold government securities in the secondary market indicates towards inflation as a possible cause behind the action taken by RBI.

By selling off the government securities, RBI withdraws money from circulation and thereby reducing the lending capacity of the commercial banks. In this process, the economy will experience contraction of credit, leading to reduction in consumption and investment demand. Consequently, the inflationary pressure in the economy will get eased out. (4)

16. Central bank accepts the deposits from commercial banks and also advances loans to them as and when required. It maintains reserves of all commercial banks and utilizes it to settle inter-bank claims.

Being the supreme authority of the banking system, it acts as the financier of last resort to the commercial banks. It forwards short-term credit to the commercial banks against approved securities.

The Central Bank supervises, regulates and controls the commercial banks. The regulation of banks may be related to their licensing, branch expansion, liquidity of assets, management, amalgamation and liquidation. (4)