CBSE Class–12 economics

Important Questions - Macro Economics 03

Money and Banking

VERY SHORT ANSWER QUESTIONS (1 Mark)

Q1. Central Bank is an

a) Apex bank

b) Rural bank

c) Regional bank

d) Commercial bank

Ans. (a)

Q2. Money is a medium of

a) Communication

b) Barter

c) Exchange

d) Speculation

Ans. (c)

Q3. The functions of money is that it is a

a) Store of currency

b) Store of stocks

c) Store of a value

d) None of the above

Ans. (c)

Q4. Money overcomes the problems of barter system.

a) Can't say

b) Seldom

c) 0

d) 1

Ans. (d)

Q5. One of the measures of money supply is

a) O1

b) N1

c) M1

d) P1

Ans. (c)

Q6. The process of money creation or credit creation is done by

a) Rural bank

b) World bank

c) Central bank

d) Commercial bank

Ans. (d)

Q7. Money is something that is

a) Universally accepted

b) Locally accepted

c) Accepted by banks

d) Regionally accepted

Ans. (a)

Q8. One drawback of barter exchange is

a) Lack of trust

b) Lack of coincidence of wants

c) Lack of double coincidence of wants

d) Lack of goods

Ans. (c)

Q9. What do you mean by credit creation by commercial banks?

a) It is the process of loan creation

b) It is the process of creation of foreign exchange

c) It is the process of total withdrawal creation

d) It is the process of total deposit creation

Ans. (d)

Q10. Bank rate is for

a) Commercial banks by the government

b) Commercial banks by the central bank

c) Central banks by the central bank

d) Central bank by the commercial banks

Ans. (b)

Q11. Lending rate is for

a) Public by the commercial banks

b) Central bank by the commercial banks

c) Central banks by the central bank

d) Commercial banks by the government

Ans. (a)

Q12. Open market operations is

a) Buying and selling of currency by the central bank

b) Buying and selling of securities by the central banks

c) Buying and selling of securities by the commercial banks

d) Buying and selling of foreign exchange by the central bank

Ans. (b)

Q13. Money supply is equal to

a) Money saved in post office savings bank only.

b) Total stock of money held by government.

c) Total stock of money circulating in an economy.

d) Total flow of money circulating in an economy.

Ans. (c)

Q14. The lender of last resort is a function of

a) Rural bank

b) Post office

c) Central bank

d) Commercial bank

Ans. (c)

Q15. Legal reserve ratio is equal to

a) CRR÷SLR

b) CRR-SLR

c) SLR-CRR

d) CRR+SLR

Ans. (d)

SHORT ANSWER QUESTIONS (3/4 Marks)

Q16. Calculate the value money multiplier and the total deposit created if initial deposit is Rs. 500 crores and LRR is 10%.

Ans. Value of money multiplier = 1/LRR which is equal to 1/0.1 = 10

Initial deposit was Rs. 500 crores

Hence Total Deposit will be Initial Deposit × Money Multiplier

= 500 ×10

= 5000 Crores

Q17. Calculate LRR, if initial deposit of Rs. 200 crores lead to creation of total deposits of Rs. 1600 crores.

Ans. Money Multiplier = Total Deposits / Initial Deposits

= 1600 / 200 = 8

Hence Money Multiplier = 1/LRR

8 = 1/LRR

LRR = 1.25 or 12.5

Q18. If total deposits created by commercial banks are Rs. 12,000, LRR is 25%, calculate initial deposit.

Ans. Money Multiplier = 1/LRR = 1/025 = 4

Initial Deposit = Total Deposit / Money Multiplier

= 12000 / 4

= Rs. 3000

Q19. What do you mean by high powered money?

Ans. High powered money or powerful money refers to that currency that has been issued by the Government and Reserve Bank of India. Some portion of this currency is kept along with the public while rest is kept as funds in Reserve Bank.

The equation is:

H = C + R

Where H = High Powered Money

C = Currency with the public (Paper money + coins)

R = Government and bank deposits with RBI

Thus the sum total of money deposited with the public and the funds of banks is termed as powerful money. It is mainly created by the central bank.

Q20. Bring out the role of Central Bank as the controller or money supply or credit.

Ans. If the Central Bank wants to control credit, it will raise the bank rate. As a result, the market rate and other lending rates in the money-market will go up. Borrowing will be discouraged. The raising of bank rate will lead to contraction of credit. Similarly, a fall in bank rate mil lowers the lending rates in the money market which in turn will stimulate commercial and industrial activity, for which more credit will be required from the banks. Thus, there will be expansion of the volume of bank Credit.

LONG ANSWER QUESTIONS (6 Marks)

Q21. Explain the following functions of the Central Bank of India.

1. **Bank of Issue**
2. **Banker's bank**

Ans.

1. **Bank of Issue –**

A country's main bank whose responsibilities include the issue of currency, the administration of monetary policy, open market operations, and engaging in transactions designed to facilitate healthy business interactions. For e.g. Reserve Bank of India, Bank of England or the U.S. Federal Reserve banks. In simple words, a bank that has the official right to produce currency, it can be paper money and coins, etc. In India, The Reserve Bank has the sole authority to issue banknotes in India. Reserve Bank, like other central banks the world over, changes the design of banknotes from time to time. The Reserve Bank has introduced banknotes in the Mahatma Gandhi Series since 1996 and has so far issued notes in the denominations of Rs.5, Rs.10, Rs.20, Rs.50, Rs.100, Rs.200 and Rs.500 in this series.

2. Banker's bank –

A bankers' bank is specific type of bank that a group of larger, more established banks create. Bankers' banks exist for the purpose of servicing the charter banks that founded them. While their banking services are not generally open to the public in any fashion, these institutions are designed to support community banks. The commercial banks maintain a current account with the central bank and can borrow money in the very short term. Thus, the banks which have to supply banknotes for their customers (either over the counter or through automatic teller machines) obtain them from the central bank which has an issuing monopoly. In India, RBI as an apex bank acts as the banker's bank. All the commercial banks in India are supposed to keep a cash reserve ratio with this bank. Commercial banks create credit. It is the duty of the RBI to control the credit through the CRR, bank rate and open market operations.

Q22. Explain the leading functions of commercial banks.

Ans. Commercial banks are the most important components of the whole banking system. A commercial bank is a profit-based financial institution that grants loans, accepts deposits, and offers other financial services, such as overdraft facilities and electronic transfer of funds. According to Culbertson, "Commercial Banks are the institutions that make short term bans to business and in the process create money."

Functions of Commercial Banks

Primary Functions

1. Accepting Deposits
2. Making Advances
3. Credit Creation

Secondary Functions

1. Clearance of Cheque
2. Sale / Purchase of Shares / Bonds
3. Transfer of Money
4. To work as Trusty
5. To work as a representative
6. To give / accept money
7. To provide letter of credit

As per above illustration, commercial banks has divided its functionality in two divisions, viz, Primary and Secondary functions.

(a) <u>Primary Functions</u> mainly refer to the basic functions of commercial banks that include the following:

i. Accepting Deposits implies that commercial banks are mainly dependent on public deposits. There are two types of deposits mainly demand and time deposits. Demand deposits refer to kind of deposits that can be easily withdrawn by individuals without any prior notice to the bank. Time deposits refer to deposits that are for certain period of time. Banks pay higher interest on this deposits.

ii. Advancing Loans means the public deposits are used by commercial banks for the purpose of granting loans to individuals and businesses. Commercial banks grant loans in the form of overdraft, cash credit, and discounting bills of exchange.

(b) <u>Secondary Functions</u> mainly refer to crucial functions of commercial banks. The secondary functions can be classified under three heads, namely, agency functions, general utility functions, and other functions.

i. Agency Functions means commercial banks act as agents of customers by performing various functions, which includes, Collecting Checks, Collecting Income, and Paying Expenses.

ii. General Utility Functions which includes Providing Locker Facilities, Issuing Traveller's Checks, Dealing in Foreign Exchange, Transferring Funds.

iii. Other functions include Creating Money by lending money to individual and opening demand deposit, Electronic Banking which includes services, such as debit cards, credit cards, and Internet banking, etc.

Q23. State the functions of money.

Ans. Money is often defined in terms of the three functions or services that it provides. Money serves as a medium of exchange, as a store of value, and as a unit of account. It is a current medium of exchange in the form of coins and banknotes; coins and banknotes collectively. According to Prof. Walker, 'Money is as money does.'

The main functions of money are as follows:-

i. Money as the Medium of Exchange - Medium of exchange is the basic or primary function of money. People exchange goods and services through the medium of money. Money acts as a medium of exchange or as a medium of payments. Money by itself has no utility. It is only an intermediary.

ii. Money as a Unit of Account or Measure of Value - Money serves as a unit of account or a measure of value. Money is the measuring rod, i.e., it is the units in terms of which the values of other goods and services are measured in money terms and expressed accordingly Different goods produced in the country are measured in different units like cloth m metres, milk in litres and sugar in kilograms.

iii. Money as the Standard of Deferred Payments - Deferred payments are payments which are made some time in the future. Debts are usually expressed in terms of the money of account. Loans are taken and repaid in terms of money.

iv. Money as a Store of Value - Wealth can be stored in terms of money for future. It serves as a store value of goods in liquid form. By spending it, we can get any commodity in future. Keynes places great emphasis on this function of money. Holding money is equivalent to keeping a reserve of liquid assets because it can be easily converted into other things.

v. Liquidity of Money - Money is perfectly liquid. Liquidity means convertibility into cash. Thus, the ability to convert an asset into money quickly and without loss of value is called liquidity of asset. Modern economists are laying stress on liquidity of money.

Q24. How does money overcome the problems of barter system?

Ans. Money can overcome the problems of barter system in following ways:

i. **Money as medium of exchange solves the barter's problem of lack of double coincidence of wants as money has separated the acts of sale and purchase.**
ii. **Money as measure or unit of value or a unit of account solves the barter's problem of absence of common measure of value. Money serves as a unit of value or unit of account and acts as a yardstick to measures exchange value of all commodities.**
iii. **Money as store of value solves the barter's problem of difficulty in storing wealth. It generalised purchasing power.**
iv. **Money as standard of deferred payments helps to solve the barter problem of lack of standard of deferred payment. Again, it helps to make contracts which involve future payments.**
v. **The use of money meant that people could sell their surplus of goods in exchange for money and use the money earned to buy their needs. During ancient wartime, currency was created as it was just too difficult for soldiers to carry around chickens and beans around to swap for what they needed.**
vi. **Indivisibility of goods was a major problem. Under barter, a serious problem of indivisibility of certain articles was arisen. Some articles were impossible to divide into small parts. So, that one of the trading party was compelled to give his indivisible item in full in exchange for the other's product.**
vii. **Difficulty in transfer of wealth was also main problem during that time. Under barter, the difficulty of transferring of a person's wealth arises. When he intend to shift his wealth like house, property, car from one place to another, because it is almost impossible to find a person in another place, who can exchange his property or wealth.**

Q25. Why only a fraction of deposits is kept as Cash Reserves?

Ans. Banks operate by taking in deposits and making loans to lenders. Thus, banks can lend out some of their depositors' money, while keeping some

on hand to satisfy daily withdrawals by depositors. This is called the fractional-reserve banking system. Banks keep a fraction of deposits as Cash Reserves. Any experienced banker from his or her experience, knows two things. Firstly, all the depositors do not approach the banks for withdrawal of money at the same time and also they do not withdraw the entire amount in one go. And secondly, there will be constant flow of new deposits into the banks every day. So, to meet the daily demand for withdrawal of cash, it is sufficient for banks to keep only a fraction of deposits as cash reserve. It means, if experience of the banks show that withdrawals are generally around 20% of the deposits, then it needs to keep only 20% of deposits as cash reserves (LRR).