CBSE Test Paper-05

Chapter 02 Money and Banking

1. One of the various quantitative instruments used by the central bank in during deflation is **(1)**
    a. Block government securities
    b. Export government securities
    c. Sell government securities
    d. Buy government securities
2. Money supply is equal to **(1)**
    a. Total stock of money circulating in an economy.
    b. Money saved in post office savings bank only.
    c. Total stock of money held by government.
    d. Total flow of money circulating in an economy.
3. The fraction of deposits kept as Cash Reserves by the commercial banks are also called as **(1)**
    a. CRR
    b. LRR
    c. SLR
    d. PLR
4. Reducing margin requirements by the central bank in India during excess demand will be **(1)**
    a. Inflationary
    b. Stabilisation
    c. Destabilisation
    d. Inflationary
5. Define Barter system. **(1)**
6. Define Bank Rate. **(1)**

7. Define cash reserve ratio. **(1)**
8. What will be the effect of a rise in the bank rate on money supply? **(1)**
9. Explain 'Bank of issue' function of Central Bank. **(3)**
10. State any three points of distinction between Central Bank and Commercial Banks. **(3)**
11. Explain any two methods of credit control used by Central Bank. **(4)**
12. Explain 'government's bank' function of Central Bank. **(4)**
13. Explain the 'unit of account' function of money. How has it solved the related problem created by barter? (**4)**
14. Describe any two functions of Central Bank. **(6)**
15. What is Repo rate and Reverse repo rate? What are their implications? **(6)**

Answers

1. d. Buy government securities
   Explanation: Buying securities by government cause rise in money supply into the economy that indirectly cause increase in demand of people which cause demand pull inflation.
2. a. Total stock of money circulating in an economy .
   Explanation: Supply of money is a stock variable. Any money must circulate (used for transactions)to be called money .
3. b. LRR
   Explanation: LRR=SLR +CRR.Since, both SLR and CRR are imposed by central bank under law.
4. a. Inflationary
   Explanation: Doing so would increase the amount borrowed and encourage investment and thus increasing effective demand.
5. Barter system of exchanges is a system in which goods are exchanged for goods. An economy based on barter system is called C.C. economy , i.e. comoodity for commodity exchange economy.
6. The rate at which Central Bank lends to Commercial Banks without any collateral (security for the purpose of loans).
7. This refers to the proportion of total deposit of the commercial bank, which they must keep as cash reserves with central bank.
8. A rise in the 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 t he commercial banks.
9. Central bank of a country has the exclusive right of issuing notes or it is the only currency authority. It is the sole agency of note issuing in the country. Actually till the

beginning of 20th century, the central bank was known as ‘Bank of Issue’. The notes issued by the central bank are an unlimited legal tender. Because of its sole currency authority, it has the following merits:

- The central bank imparts uniformity to the monetary system.
- People’s confidence in the currency of the country remains high, because the central bank enjoys the support of the Govt.
- It implies a central check on the supply of money in the country.
- It imparts elasticity to the monetary system.
- It is a profitable business. When it is done by the central bank, the profit so earned goes to the state exchequer.

10. The three differences between Central Bank and commercial banks are given below:

Basis	**Central Bank**	**Commercial Banks**
Definition	Central Bank is the banker of all the banks. It is an apex body.	A commercial bank is an institution that provides services such as accepting deposits, providing business loans, and offering basic investment products. These Banks operate under the control of Central Bank.
Credit flow	Central Bank controls the flow of credit within the economy.	Commercial Banks create credit within the economy.
Objective	The objective of Central Bank is social welfare.	The objective of these banks is profit maximisation.

11. The Central Bank acts as a controller of money supply and credit, using the following methods:

i. **Margin requirement:** Changes in margin requirements are designed to influence the flow of credit against specific commodities. The commercial banks generally advance loans to their customers against some security or securities offered by the borrower and acceptable to banks. More generally, the commercial banks do not lend up to the full amount of the security but lend an amount less than its value. The margin requirements against specific securities are determined by the Central Bank. A change in margin requirements will influence the flow of credit. A rise in the margin requirement results in a contraction in the borrowing value of the security and similarly, a fall in the margin requirement results in an expansion in the borrowing value of the security.

ii. **Open market operations:** Under open market operations, RBI purchases or sells government securities to the general public for the purpose of increasing or decreasing the stock of money in an economy. The purchase or sale of securities controls the money in the hands of the public as they deposit or withdraw the money from Commercial Banks.
Thus, money creation by Commercial Banks gets affected. Suppose, the Central Bank purchases securities of Rs.1,000 from a bondholder with issuing a cheque. The seller of the bond produces this cheque of Rs.1,000 to his Commercial Bank. The Commercial Bank credits the account of the seller by Rs.1,000 and the deposits of the bank go up by Rs.1,000, which increase the credit creation capacity of the banks. Thus, the purchase of security increases the money creation of Commercial Banks and similarly, the sale of securities decreases the credit creation of Commercial Banks. Thus, the Central Bank controls the process of money creation by Commercial Banks by open market operations.

12. Central bank functions as a banker to the government—both central and state governments. It carries out all banking business of the government. Government keeps their cash balances in the current account with the central bank. Similarly, central bank accepts receipts and makes payment on behalf of the governments.

    Also, the central bank carries out exchange, remittance and other banking operations on behalf of the government. Central bank gives loans and advances to governments for temporary periods, as and when necessary and it also manages the public debt of the country. Remember, the central government can borrow any amount of money from RBI by selling its rupees securities to the latter.

13. **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 unit in which the values of other goods and services are measured in terms of money and expressed accordingly. Different goods produced in the country are measured in different units, e.g. cloth is measured in metre (i.e. length) while milk is measured in litres (i.e capacity). Without a common unit of measure, the exchange of goods and services becomes very difficult. Values of all goods and services can be expressed in a single common unit called money. Again without a measure of value, there can be no pricing process. Without a pricing process, organised marketing and production are not possible. Thus, the use of money as a measure of value is the basis of specialised production. The measuring rod of money is also indispensable to all forms of economic planning. Consumers compare the values of alternative purchases in terms of money. Producers compare the relative costliness of the factors of production in terms of money and also plan their output on the basis of the money yield. It is, therefore, highly important that the value of money should be stable.

    Thus, the evolution of money has solved the problem, and now every good or service can be measured in terms of money.

14. i. **Bank of issue** Central Bank of the country has the sole authority of currency issue in the country, which gives it a monopoly issuing currency. As in India, RBI issues the currency except for one rupee notes which are issued by the Ministry of Finance of the Government of India. However, both currency notes and coins are circulated by RBI, which gives RBI the power to control, supervise and enhance the money supply in the economy.
    ii. **Banker's bank** Central Bank keeps the cash balances of Commercial Banks and issues loans to them on requirements in the same manner as the Commercial Bank does for its customers. A Central Bank has almost the same relationship with the other Commercial Banks of the country that the Commercial Banks have with the common public. That is why the Central Bank is also called banker's bank. Further central bank is the lender of last resort for other banks in difficult times because on such occasions there is no hope of getting help from any competing institution.

15. Repo rate, also called repurchase rate, is the rate of interest that banks pay when they borrow money from the Central banks i.e. Reserve Bank of India to meet their short-term fund requirements. This is also called repurchase rate because when Commercial banks borrow money from the Central bank/RBI, they keep government securities with the Central Bank/RBI as collateral.
Reverse repo rate is the rate of interest that banks get when they keep their surplus money with the Central bank/RBI. Repo rate is always higher th an the reverse repo rate. By controlling these rates, the RBI controls the money supply in the economy They both are important monetary measures of RBI to control inflation or deflation. In case of an inflation, RBI will try to reduce the amount of money in circulation by increasing the Repo Rate. When repo rates are increased, banks will borrow less from RBI and hence the amount of money they will be lending to the public also decrease. In case of deflation, RBI injects more money into circulation and hence it will reduce the repo rate. Increase in repo rate can have serious impact on the growth since industries will find it difficult to raise money from the banks. Therefore, repo rates are only increased when rate of inflation become too high and that too only for a short period. The central bank will increase the reverse repo rate to decrease the money supply in the economy and vice versa. When the reverse repo rate is increased the commercial banks would park more funds with the central bank as they would get more interest. In case of deflation the central bank will reduce the reverse repo rate so as to increase the money supply.