CBSE Test Paper-01
Chapter 02 Money and Banking

1. The broad definition of money is based on **(1)**
   a. Medium of payment function
   b. Transferability of money
   c. Store of value function
   d. Cant' say
2. The process of money creation or credit creation is done by **(1)**
   a. commercial banks
   b. Central bank
   c. World bank
   d. Rural bank
3. Bank rate is for **(1)**
   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
4. One of the functions of Central Bank among the following is **(1)**
   a. Custodian of banks
   b. Custodian of deliveries
   c. Custodian of foreign exchange
   d. Custodian of securities
5. State the components of money supply. **(1)**
6. What is included in money supply? **(1)**
7. Give the meaning of cash reserve ratio. **(1)**

8. What is reverse repo rate? **(1)**
9. Explain any two functions of a Central Bank. **(3)**
10. Explain the "Bankers' Bank function" of the central bank. **(3)**
11. Explain how open market operations are helpful in controlling credit creation. **(4)**
12. Explain ‘banker to the government’ function of the Central Bank. **(4)**
13. What is meant by statutory liquidity ratio (SLR)? State the effect of rise in rate of SLR on creation of credit. **(4)**
14. Explain the problem of double coincidence of wants faced under barter system. How has money solved it? **(6)**
15. How does the Central Bank control credit creation in the economy through open market operation and bank rate? Explain. **(6)**

CBSE Test Paper-01 Chapter 02 Money and Banking (Answers)

1. c. Store of value function, **Explanation:** Broad money is less liquid. So ,based on store of value function.
2. a. commercial banks, **Explanation:** The LRR(Legal reserve ratio) allows commercial banks to keep a certain fraction of their deposits as reserve and use the rest for giving credit. The cycle of transations that happen in this proocess help create money.
3. b. Commercial banks by the central bank, **Explanation:** Central bank is a wholesaler of money and commercial bank is its retailer
4. c. Custodian of foreign exchange, **Explanation:** It stabilises foreign exchange rate via this function .
5. i. currency (coins and notes) with the public.
   ii. Demand Deposits with banks
6. Currency notes held by the public and demand deposits of Commercial Banks are included in the money supply.
7. The Cash Reserve Ratio refers to a certain percentage of total deposits the commercial banks are required to maintain in the form of cash reserve with the Central bank.
8. Reverse repo rate is the rate at which the central bank borrows from the commercial banks. It is a monetary policy instrument which can be used to control money supply in the country.
9. The two main functions of a Central Bank are:
   i. **Bank of issue:** The central bank is given the sole monopoly of issuing currency in order to secure control over the volume of currency and credit. These notes circulate throughout the country as legal tender money. It has to keep a reserve in the form of gold and foreign securities as per statutory rules against the notes issued by it.
   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.
10. As the banker to the banks, the central Bank is the custodian of the cash reserves of

commercial banks. From these reserves it lends to commercial banks when they are in need of funds. Central bank also provides cheque clearing and remittance facilities to the commercial banks. Central bank is the lender of last resort.

11. 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, purchase of securities increase 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. The Reserve Bank of India has frequently resorted to the sale of government securities to which the commercial banks have been generously contributing. Thus, open market operations in India have served, on the one hand as an instrument to make available more budgetary resources and on the other as an instrument to syphon off the excess liquidity in the system.
12. Central Bank acts as a banker, advisor and agent to the 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 the 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. Further, we should remember that the central government can borrow any amount of money from RBI by selling its rupees securities to the latter.
13. SLR refers to the minimum percentsge of net demand snd time liabilities which commercial banks are required to maintain with themselves. SLR is maintained in the form of designated liquid assets such as excess reserves, government and other approved securitues or current account balances with the banks. The reserve bank

can influence the credit creation power of the banks by making changes in SLR. Change in SLR affects the freedom of banks to sell government securities or borrow sgainst them from the Central bank. An increase in SLR reduces the ability of banks to give credit and a decrease in SLR increases the ability of banks to give credit.

14. i. "Money performs the following four functions: A medium, a measure, a standard, a store".

    ii. Money has overcome the short-coming of a barter system in the following manner:

    a. **Medium of exchange**
        - Under barter system, there was lack of double coincidence of wants. It was difficult to find a person who had the product that we meeded and who needed our product. So the exchange was verr much restricted.
        - With money as a medium exchange individual can exchange their goods and services for money and then use this money to buy other goods and services according to their needs and conveniences.
        - A buyer can buy goods for money and seller can sell goods for money.

    b. **Measure of value**
        - Under barter system, there was no common measure of value. The exact value of the commodities being exchaned could not be measured. Money has also solved this difficulty.
        - As Geoffrey Crowther puts it, "Money acts as a standard measure of value to which all other things can be compared." Money measures the value of economic goods.
        - Money works as a common denominator into which the values of all goods and services are expressed.
        - When we express the values of a commodity in terms of money, it is called price and by knowing prices of the various commodities, it is easy to calculate exchange ratios between them.

    c. **Store of value**
        - Under barter system it eas very difficult tc store wealth for future use.
        - Most of the goods are perishable and their storage requires huge space and transportation costs snd thry will get spoiled also.
        - Wealth can be conveniently stored in the form of money.

- Money can be stored without loss in value.
- Money can easily be stored for future use.

d. **Standard of deferred payments**
   - Under barter system, transactions on deferred payments are not possible.
   - With money, the debtors make a promise that they will make payments on some future dates. In those situations money acts as a standard of deferred payments.
   - It has become possible because money has general acceptability, its value is stable, it is durable and homogeneous.

15. i. **Open Market Operation**
   a. Buying and selling of government securities in the open market by the central bank is known as open market operations.
   b. Open market operations have a impact on the lending capacity of the banks.
   c. It is an important mean of controlling the money supply.
   d. During inflation or excess demand situation, the main motive of the Central Bank is to reduce the money supply. To suck excess liquidity from the market the Central Bank sells bonds, government securities and treasury bills.
   e. Due to low money supply, there is fall in the volume of investment, income and employment resulting in lower demand.
   f. During deflation the main motive of the Central bank is to increase the money supply and to increase the money supply the Central Bank buys bonds, government securities and treasury bills.

   ii. **Bank Rate Policy:**
   a. It refers to the rate at which the central bank lends money to commercial banks as the lender of the last resort.
   b. The central bank advances loans against approved securities or eligible bills exchange.
   c. An increase in bank rate increases the costs of borrowing from the central bank. It forces the commercial banks to increase their lending rates, which discourage borrowers from taking loans.
   d. It reduces the ability of commercial banks to create credit. A decrease in the bank rate will have the opposite effect.