CBSE Test Paper-02

Chapter 02 Money and Banking

1. Calculate the money multiplier if LRR is 5%. **(1)**
   a. 20.0
   b. 1.0
   c. 10.0
   d. 5.0
2. Calculate money multiplier, if initial deposit of Rs. 200 cores lead to creation of total deposits of Rs. 1600 cores. **(1)**
   a. 4.0
   b. 3.0
   c. 6.0
   d. 8.0
3. Raising bank rate by the central bank in India during excess demand is **(1)**
   a. Inflationary
   b. Stabilisation
   c. Deflationary
   d. Destabilisation
4. What is the currency deposit ratio (cdr)? **(1)**
   a. ratio of money held in demand drafts to that of money held in treasury bonds
   b. ratio of money held by the public in currency to that of money held in bank deposits
   c. none of these
   d. ratio of money held by public in bank deposits to that of money held by public in currency
5. What is repo rate ? **(1)**
6. What is selective credit control? **(1)**
7. Define money supply. **(1)**
8. Mention the types of commercial banks in India. **(1)**

9. Explain how money has solved the problem of double coincidence of wants. **(3)**
10. How is quantitative credit control different from qualitative credit control? **(3)**
11. Describe the evolution of money. **(4)**
12. Explain how the repo rate can be helpful in controlling credit creation. **(4)**
13. What are the characteristics or features of money? **(4)**
14. Describe any two methods by which Reserve Bank of India can regulate money supply. **(6)**
15. What do you mean by credit/money creation? Explain the process of money creation by the commercial banks with the help of a numerical example. **(6)**

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Answers

1. a. 20.0

   Explanation: Here, LRR =0.05 , so money multipliar =1/0.05=20
2. d. 8.0

   Explanation: Use formula :Total deposits =1/lrr×initial deposits
3. c. Deflationary

   Explanation: Doing so would discourage investment and lead to deficient aggregate demand via multipliar process.
4. b. ratio of money held by the public in currency to that of money held in bank deposits

   Explanation: ratio of money held by the public in currency to that of money held in bank deposits
5. Repo rate is the rate at which RBI lends money to the commercial banks in the event of any shortfall of funds. An increase in repo rate increases the cost of funds.
6. It referes to the discriminatory policy of the central bank relating to select sectors of the economy. The central bank may seek to increase the flow of credit to priority sectors of the economy. with a view to stimulating production in these sectors. On the other hand, it can also restrict the flow of credit to certain non priority sectors, particularly those related to speculative business activity.
7. Money supply refers to the total volume of money held by public at a particular point of time in an economy.

   Currency held by public + Net Demand deposits.
8. i. Nationalised Banks

   ii. Private Sector banks.
9. Money can be exchanged for any kind of commodity of one's choice or need. It becomes easier to buy and sell goods and services with money to make transactions. In a barter system, commodities are directly exchanged with commodities without the use of money. But in such a system, two parties are required who are ready to sell and buy each other's commodities. This is called double coincidence of wants. With the

help of money, one buys a commodity of his choice. He need not wait for the other person to agree to exchange his goods with his own goods. Thus money eliminates the problem of double coincidence of wants. In modern times, the buyer and the seller exchange goods for money, due to a common measure of value function of money. It facilitates exchanges of goods and services and helps in carrying on trade smoothly.

10.

Quantitative Instruments	Qualitative Instruments
1. These are used to influence the total volume of credit in circulation. They are used in such a way that supply of money is reduced in tomes of inflation and money supply is increased in times of deflation.	1. These are used to regulate the direction of credit. They focus on select sectors of the economy. In this case the flow of credit is controlled not by varying any ratios but by sending advisories to the commercial banks.
2. Bank rate, Open Market operation and Legal Reserve Requirements are major instruments.	2. Margin requirements, Moral suasion, Selective credit control are major instruments.

11. The various forms that money took during the process of evolution are mentioned below:
    i. **Commodity Money:** All sorts of commodities like pearls, sea-shells, salt etc have been used as a medium of exchange.
    ii. **Animal Money:** Animals such as cow, goat etc were used as a medium of exchange.
    iii. **Metallic Money:** Money made from metals like gold, silver, copper etc was called metallic money. It is important to note that precious metals were used as money not because they were valuable but because they were scarce.
    iv. **Paper Money:** Precious metals were replaced by paper money. Paper money is the money made of paper. Paper money took the form of bank notes which were not mere substitutes but were considered as an addition to the supply of money.
    v. **Credit Money:** It refers to bank deposits with banks which are withdrawable through a cheque.
    vi. **Plastic Money:** It is the modem form of money in the form of debit and credit cards.

vii. **Cryptocurrency:** A cryptocurrency is a digital or virtual currency that uses cryptography for security. For eg, Bitcoin

12. Repo rate is the rate at which commercial banks can borrow money from RBI to overcome the shortage of money. By varying the repo rates, the RBI can increase or decrease the supply of money. This rate relates to the loan offered by RBI with securities and only short term borrowings by the commercial banks. It is quite an effective quantitative tool for controlling credit creation. If the RBI wants to decrease the level of credit creation in the country, then it increases the Repo Rate which makes the credit dearer. As the cost of borrowings increase, the people's demand for credit goes down. This also leads to a fall in liquidity. All this leads to falling in the rate of credit creation. On the other hand, if the RBI wants to increase the level of credit creation in the economy then it decreases the repo rate which makes the credit cheaper. As the cost of borrowings falls, people's demand for credit goes up. This leads to an increase in the rate of credit creation. Thus RBI uses Repo rate to control credit creation.
13. i. Durability: Money must be durable and not likely to deteriorate rapidly with frequent handling. Currency notes and coins are being used repeatedly and shall continue to be used for many years to come.
    ii. Medium of exchange: Money acts as a medium of exchange for the sale and purchase of goods and services.
    iii. Weight: Money must be light in weight. Paper money is better than metal coins because it is light in weight.
    iv. Measure of value: It not only serves as medium of exchange but also acts as a measure of value. The value of all the goods and services are expressed in terms of money and because of the existence of money as a common unit of value, we are able to construct consumer price index, wholesale price index, and rate of inflation in the country.
14. i. **Open Market Operations:** Open Market Operations is when the RBI involves itself directly and buys or sells short-term securities in the open market. This is a direct and effective way to increase or decrease the supply of money in the market. It also has a direct effect on the ongoing rate of interest in the market. Let us say the market is in equilibrium. Then the RBI decides to sell short-term securities in the market. The supply of money in the market will reduce. And subsequently, the

demand for credit facilities would increase. And so correspondingly the rate of interest would also see a boost. On the other hand, if RBI was purchasing securities from the open market it would have the opposite effect. The supply of money to the market would increase. And so, in turn, the rate of interest would go down since the demand for credit would fall.

ii. **Repo rate:** Repo rate is the rate at which Reserve Bank of India (RBI) lends funds to commercial banks for a period ranging from 1 day to 14 days. It is quite an effective quantitative tool for controlling credit creation. If the RBI wants to decrease the level of credit creation in the country, then it increases the Repo Rate which makes the credit dearer. As the cost of borrowings increase, the people's demand for credit goes down. This also leads to a fall in liquidity. All this leads to falling in the rate of credit creation. On the other hand, if the RBI wants to increase the level of credit creation in the economy then it decreases the repo rate which makes the credit cheaper. As the cost of borrowings falls, people's demand for credit goes up. This leads to an increase in the rate of credit creation.

15. Money creation is a process in which a Commercial Bank creates total deposits many times the initial deposits.

    The capacity of Commercial Bank to create depends on two factors:

    i. Amount of initial fresh deposit
    ii. Legal Reserve Ratio LRR

    Money Multiplier $= \frac{1}{LRR}$

    Money Creation = Initial Deposit × Money multiplier.

    Working : Suppose (i) Initial Deposit = Rs. 1000

    (ii) LRR = 20%

    As required, the bank keeps 20% i.e., Rs. 200 as cash reserve and lend the remaining Rs. 800. Those who borrow use the money for making payments. As assumed those who receive these payments put the money back into their bank accounts. This creates a fresh deposit of Rs. 800. The bank again keep 20% i.e., Rs. 160 and lend Rs. 640. In this way the money goes on multiplying leading to total money creation of Rs. 5000.

    Money Creation = Initial Deposit $\times \frac{1}{LRR}$

    $= 1000 \times \frac{1}{0.2} = Rs.5000$