KENDRIYA VIDYALAY RBNM SALBONI

HOLIDAY HOMEWORK

ECONOMICS CLASS XII

MONEY AND BANKING

**CBSE QUESTIONS (2013,2014,2015,2016,) & ANSWERS**

1.**What are demand deposits**? **CBSE Delhi 2013,2014;(F)16**

Ans. Demand deposits of commerical banks are those deposits which can be withdrawn from the bank on demand or by writing cheque any time.

2**.Expalin the problem of double coincidence of wants faced under barter system. How has money solved it? CBSE Delhi 2013**

Ans. Double coincidence of wants means that goods in possessionof two different individuals are needed by each other. But it is difficult to find a person who wants your goods and at the same time possesses a good that you want to buy.Accordingly , underthe barter system , exchange remained exteremly limited.

Money as a medium of exchange has removed the major difficulty of double coincidence of wants.It means that money acts as an intermediary for the goods and services in exchange transcations. In the monetary system , acts of sale and purchase of the goods and services are separated from each other .If one wants to buy goods,he can do so with money.And,if one wants to sell goods, he can sell these for money.

3. **Explain “ banker to the government “ function of the central bank.** **CBSE Delhi 2013; (AI) 2015**,

Ans. Central bank acts as a banker , agent and financial advisor to the government . As a banker to the government , it keeps the account of allgovernment banks and manages government treasuries. The loan are given to the government without any interest for short -term. It also transfers government funds.It also buy and sell securities, treasury bills on behalf of the government .Being the apex bank of ht e country , it advises the government from time on econmic, finacial and monetary matters.

**4.How do commercial banks create deposits ? Explain**. CBSE Delhi 2013

Ans- Deposit/ credit creation is an important function of the commercial banks followingobservation highlight how it happens:

1. Banks receive cash deposits from the people.
2. Banks lend many times more than their cash reserves.

(III) Lending is done not in cash but by way of opening demands deposit in favour of the borrowers. Thus, cash reserves of the banks are only a small percentage of their demand deposits.This is possible because, banks by way of their historical experienceknow that only a small percentage of deposits is withdrwal as cash during a period of time. Banks enjoy confidence of the people that their money is safe with the banks.

**(iv) Example:** If cash reserves of the commercial banks are ₹ 10,000 and their demand deposit ( total liability of the commercial banks towards the people) are ₹10,000 then the commercial banks have converted ₹ 10,000 into ₹1,00,000.Implying that the supply of money through deposit/credit amounts to ₹1,00,000,even when cash reserves of the banks are only ₹10,000.Credit multiplier = 1,00,000**/**10,000=10.

**(v**) In case of crisis of confidence ( when people strart making bulk withdrawals from the bank are not pushed in liquidity crises.

**(vi)** Cash reserve of commercial banks are governed by the central bank through CRR which is legally determined ratio of cash reserve to be kept by the commercial banks.These cash reserve ( according to CRR) are to be kept by the commercial banks with the central bank .Beyond these legally required cash reserve s, the commercial banks tend to keep some reserve with themselves. These are called ‘ chest cash’ .

**6. state the components of money supply. CBSE (AI) 2013, (F) 13**

**Ans-**The compnents of money supply are:

1. Currency held by the public,
2. Demand deposit of the people with the commercial banks, and
3. Other deposits (demand depoits with RBI of domestic and foreign institution other than that of the government of the country and commercial banks within the country)

**7. Expalin the ‘lender of last resort’ function of the central bank. CBSE Delhi 2014,(AI) 2013**

**Ans-**AS a lender of last resort, the central bank stands asa guarantor to the commercial bankd during financial emergencies. Acommercial bank may lose confidence of the depostiors prompting them to withdrawal their deposits enmanss. Since cash reserves of the commercial bank are only a fraction of its demand deposits, its reserve may run out, pushing the bank into financial crises.It is the cental bank during such timesthat stands by the commercial bank as a gurantor and saves it from insolvency.

**8.How does central bank control credit creation by commercial banks through open market operations? Explain. CBSE Delhi 2016**

**Ans-** Open market operations refers to sale and purchase of government securities in the open market by the central bank of country.By selling the securities, the central bank withdraw cash balances from the system and by buying the securities, the central bank injects cash balances into the system.

To control credit creation by the commercial banks, cash reserves needs to be reduced. For reducing cash reserves, securities are sold off by the central bank. Sale of securities sucks purchasing power from the money market, When liquidity is sucked ( as during inflation) , cash reserve of the commercial banks are squeezed. Implying a cut in their crdir creation capacity .Because any change in cash reserves of the banks causes a multiple change in the supply of money in the economY

**9.What are time deposits? CBSE(AI)2014;(F)2013**

**Ans-** Time deposits are those deposits which cannot be withdrawn from the bank as and when needed or by writing a cheque any time.These deposits involve a lock-in -period

**10.Explain “bankers’ bank and supervisor “ function of the central bank. CBSE (F) 2013**

**Ans**-As a bankers’ bank the central bank offer loans to the commercial banks to tide over their over their finacial crises. It also accepts surplus funds of the commercial banks as deposits .The rate at which the central bank offers loans to the commercial bank called Repo Rate and the rate at which the central bank acceptsdepositsfrom the commercial banks is called ‘Reverse Repo Rate’.

While disharging its supervisory functions, the central bank regulates and control credit creation activity of the commercial banks by fixing ‘2 ratios and 2 rates” which areto be followed in practice by the commercial banks as a matter of legal binding.

**11.Explain the bankers’bank function of the central bank. CBSE(AI)2014,2015;(F)2015,2016**

**Ans-**Centralbank is an apex bank of all banks in the country.The central bank has almost the Same relation

with other banks in the country as a commercial bank has with its customers. As a banker’s bank the

central bank offers loans to the commercial bank and also , accepts deposit from them.The central

bankkeeps some cash balances of the commercial banks as a compulsry deposit.Central bank uses thes

funds to offer loans to the commercial bank as a compulsory deposit.

Central banks uses these funds to offer loans to the commercial banks as and when they need it. For its short period loans bank also offers commercial banks the facility of parking their surplus funds with it.The interest paid to commercial banks for thes funds is called ‘reverse repo rate’.This is how the central bank of a country plays the role of banker’s bank.

**12.Government of India has recently launched “ jhan dhan yojna” aimed at every household in the**

**country to have at least one bank account. Explain how deposits made under the plan are going to**

**affect national income of the country. CBSE Delhi 2015**

**Ans-**With the introduction of “ Jhan –Dhan Yojna” by the Government of India , millions of households have

opened their bank account in the country. This has enhanced primary deposits of the commercial banks .It is

on the basis of their primary deposits (cash deposits) that the banks are able to crete secondary deposits.

Expansion of cash depoits leads to expansion of credit creation capacity of the commercialbanks.Increase in

the creation of credit impliesa increase in the availabilty of credit in the market. This is expected to raise the

demand for credit for investment purpose. Higher investment leads to increase leads to increase in national

income of the country.

**13.Currency is issued by the central bank , yet we say that commercial banks create money.Explain.**

**How is this money creation by commercial banls likely to affect the national income?Explain.**

CBSE (AI) 2015

**Ans-**Money supply has two components: currency and demand deposits.Currency is issued by the central

bank wheras demand deposits are created by the commercial banks.They create money

in the form of demand deposits related to the loans offered by them. Demand deposits of the commercial

banks are many times more than their cash reserves. This is based on the historical experience of the banks

that cash withdrawal of funds is only a small percentage of the total demand deposits.

The money created by the commercial banks in the form of demand deposits is mainly used for investment

or production purposes.Any rise in investment leads to many times more increases in the national income of

an economy ,via.,the multiplier effect.

**DETERMINATION OFINCOME AND EMPLOYMENT**

**1.Explain all the changes that will take place in an economy when aggregate demand is not equal to aggregate supply. CBSE(AI);F 2013.**

Ans-(i) If aggregate demand is greater than aggregate supply.i.e.,AD> AS, flow of good and services in the economy tends to be less than their demand . The existinh stocks of the producers would be sold out and the producers would suffer the loss of unfulfilled demand.To rebuild the desired stocks and avoid the loss of unfullflled to demand, the producers would plan greater production.AS would increase to become equal to AD. This is how AS converge with AD.

(ii) If aggregate demand is less than aggregate supply ,i.e., AD< AS, flow ofgoodsand services in the economy tends to exceed their demand. AS a result, some of the goods would remain unsold.Toclear unwanted stocks, the producer would plan a cut in production.Consequently, > would reduce to become equal to AD.This is how AS adapts itself to AD.

**2.Distinguish between inflationary gap and deflationary gap ,State two measures by which these can be corrected. CBSE (AI) 2013**

Ans.

|  |  |
| --- | --- |
| **Inflationary Gap** | Deflationary Gap |
| (i)Inflationary gap is the excess of AD over and above  Is level required to maintainfull employment in the  Economy. | Deflationary gap is the deficiency of AD required to maintain full employment equlibrium in the economy. |
| (ii) Inflatonary gap occurs when AD>AS (Corresponding to fullemployment level.) | (ii) Deflationary gap occurs when AD<AS (corresponding to full employment level) |
| (III) Inflationary gap points to a situation of rise in the general price level( owing to excess demand), without any rise in the level of output/employment in the economy. | (III)Deflationary gap points to a situation of excess capacity in the economy.The implies that the factors of production are not fully utilised,leading to unemployment in the economy. |

Inflationary gap and deflationary gap from the economy can be corrected by adpoting following two measures:

Government expenditure ( consumption as well as investment expenditure) should be increased to correct deflationary gap and decreased to correct inflatonary gap.

Repo rate should be increased to correct inflationary gap and decreased to correct deflationary gap.Ariae in repo rate is expected to cause a rise in market rate of interest ,leading to fall in demand for funds in the money market. Implying a fall in expenditure to release greater liquidity in the system, leading to a rise inAD which is expected to correct the deflationary gap.

4.Explain the working of investment multiplier with the help of a nyumerical example. (CBSE (F) 2013.)

**Ans**.Investment multiplier is the ratio between change in income and change in investment.

K=ΔY/ΔI

(Here, K= Multiplier;ΔY=change in income; ΔI= change in investment.)

It shows the number of times income would rise as a result of an intial rise in investment.

MPC, is the principal determinantof K: higher the value of MPC , higher shouldbe the value of K.

Keynes consider saving as a leakage from the process of income generation .

Followingg table explains how the multiplier process works.It is based on the assumption that I ( leading to increase in expenditure in the economy) =₹100 crore and that MPC=0.5

**Working of Multiplier ( ₹ in crore)**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Round | ΔI | ΔY | Induced change in consumption | Leakage/saving |
| 1 | 100 | 100 | 50 | 50 |
| 2 | − | 50 | 25 | 25 |
| 3 | \_ | 25  And so on.......... | 12.5 | 12.5 |
|  | ΔI=100 | ΔY=200 | 100 | 100 |

The table shows that in round-1, additional investment of ₹100crore lead sto additionalincome of ₹100 crore . But in every subsequent round half of additional income isspent (as consumption, because MPC=0.5) and the otherhalf leads to leakage/ saving (becauseMPS=0.5). Thus in round-2, additional income =₹50 crore,in round-3 it is =₹25 croree, in next round it is =₹12.5 crore, and so on till the sum total of additional income =ͅ₹200 crore.

The number of times income would increase consequent upon the intial increases in investment may be estimated by using the followingformula:

K= 1/1-MPC

=1/1-0.5=1/0.5 =2

Given that ΔI=100, and K= 2,

ΔY= 2×100=₹200 crore

**4.Outline the steps to be taken in deriving saving curve from the given consumotion curve.Use diagram**.

Ans-It involves the following steps:

We take OÀ= OA. BECAUSE OA=consumotion when Y=0, so that OÀ (=OA) is the negative saving when Y=0.It is indicated by -‾C in thesaving function.

Point P on the saving curve is marked corresponding to point Q on the consumotion curve. While Q indicates that Y=C , point P indicates thatS=0. Obviously , when Y=C, S=0

By joining points À and P stretching it to from a straight line, we get S curve.S –function is linear C- function.

NOTE: Since MPC+MPS=1,MPS=1-MPC. So that while in C –function MPC IS INDICATED BY b, in S- function it is indicated by 1-b.

**5.Explain the concept of inflationary gap.Explain the role of repo rate in reducing this gape. CBSE Delhi 2015**

**Ans-** Inflationary gap is the excess of aggregate demand over and above its level required to maintain full employment equlibrium in the economy .It causes excess demand in the economy. Owning to excess demand, price level tends to rise without any rise in the level of income or employment in the economy.

Repo rate is the rate at which the central banklends mney to the commercial banks. To crrect the situation of inflationary gap, repo rate is incresed. As a follow-up action , the commercial banks raise the market rate of interset( the rate at which commercial banks lend money to the consumer and investors.)This reduces demand for credit. Consequently, consumption expenditure and investment expenditure are reduced. Implying a reduction in aggregate demand, as required to correct inflationary gap.

**6.Explain the concept of deflationary gap and the role of “Open market operation” in reducing this gap.**

**CBSE Delhi 2015**

**Ans-**Deflationary gap is the shortfall in aggregate demand from the level required to maintain full employment equlibrium in the economy It causes deficient demandin the economy .Owing to deficient demand , planned level ofoutput is reduced .Along with reduction in the level of output, level of income an employment alsotend to reduce .The economy is driven into a state oflow level equlibrium trap.

Open market operation is the policy that focuses on increasing and decreasing the stock of liquidity ( or cash balances) with the people as well as with the commercial banks, through sale and purchse of securities by thcentral bank .Duringthe situation of deflationary gap , when cash balances need to be increased (to stimulate the level of aggregate demand), the central bank starts buyimg securities .Purchase of securities injects purchasing up,This enhance their capacity tocreate credit.Flow of credit increases , leading to increase inAD and deflationary gap is corrected.

**7.Explain the role of taxtataion in reducing excess demand . CBSE Delhi 2016.**

**Ans-**Taxes are imposed by the government .To correct the situation of excess demand , taxes ( direct or indirect) are increased. Increase in tax rate leaves lesser disposable income with th people. It reduces their capacity to spend, even when their propensity to spend remains the same.Lower dispoable income means lwoer level of aggregte demand .Accordingly , excess demand is reduced.

**8.What is aggregate demand ?Stae its components .**

**Ans-A**ggregate demand refers to the total expenditure on the gooods and services in an economy during the period of one year.

Components of aggregate demand are as these.

1. Consumption Expenditure
2. Private investment expenditure
3. Government expenditure.
4. Net export or difference between exports and imports.(X-M)

**AD=C+I+G+X-M**

**9.Explain how can government spending be helpful in removing deficient demand. CBSE (F) 2016**

**Ans-**In a situation of deficient demand, aggregate demand ( measured in terms of aggregate expenditure ) is less than the aggregate supply corresponding to the full employment level in the economy. Accordingly , aggregate demand needs to be raised . But because of poor market sentiments ( a characteristic feature of deficient demand ), private expenditure remains low. IT is in such a situation that the government spending (which is not driven by profit –motive ) can play a signifcant role. It will act as an injection of demand into the system and is expected to induce private expenditure.Accordingly , the situation of deficient demand will be corrected.

**GOVERNMENT BUDGET**

**1.What is the differecne between Revenue Budget and Capital Budget?**

Ans-The revenue budget consists of revenue receipts of the government and the expenditure met fromsuch revenues receipt includes tax revenue and non tax-reveneue.Whereas the capital budget consists of capital receipts and capital expenditure of the government .Capital receipts are the receipts of the government which create liabilty or reduce financial assets.They include market borrowing, foreign debts, repayment of loans and advances.Capital expenditure refers to the expenditure of the government, which leads to creation of assets or reduction in liabilities.

**2. How can a government’s budget help in reducing inequalities of income?Explain**.

Ans-Goverment’s budget can help in reducing inequalities of income.This objective can be achieved by adopting two fiscal measures.

(a)Government can levy higher rate of tax on the income and property of rich and also on the luxurous goods consumed by them .This measure will reduce their disposable income.

(b)Government can spend more amount on welfare maximization , like providing free servicec to the poor like free education ,health facilities etc.By adopting these measures, government can try to narrow down the gap between the rich and the poor.

**3.Explain the economic stability objective of a government budget.**

Ans-Government can through its budget bring about economic stability in the country.This would be possible only if the fluctution in prices be brought under control, otherwise it leads to uncertainty in the economy.Government can control these fluctuations through taxes and its expenditure.During period of excess demand governmentcan reduce its own demand and therby reduce its own expenditure its own expenditure.During period of deficient demand, government can encourage spendingby offering tax concessions, subsidies etc.

**4.Explain the basis of classifying government expenditure into revenue expenditure and capital expenditure.Give two example of each.**

Ans-Revenue expenditure is that expenditure of the government which neither results in creation of any asset nor reduction in liabilty. It is financed out of revenue receipts.

Example:Expenditure on paymentof salary, pension ,interestrt, etc.

Whereas Capital Expenditure is that expenditure which leads to creation of an asset or reduction in liabilities.Briefly it is the expenditure on creation of assets.It is financed out of borrowings from the public and foreign government bodies.Examples:mExpenditure on construction of roads, bridges, canals, grant of loans, etc.

**5.Explain “ fiscal deficit” in a government budget.What does it indicate?**

**Ans-Fiscal** deficit is defined as the excess of all expenditure over the sum of revenue receipts and non-debt capital receipts.Alarge fiscal defecit implies a large amountof borrowing.This creates a corresponding large burden of interest paymenta in the future.Alarge fiscal deficit may also lead to inflationary pressure inn the economy.