Study Note - 5

BANKING

5.1 BANK

- A bank is said to be a financial intermediary.
- It stands midway between the savers and the users of fund.
- There are different types of bank having some common and some special functions.
- Banks may be of various types such Central Bank, commercial banks, development banks, cooperative banks, rural banks etc.
- The Central Bank, the commercial banks and the development banks are of primary importance.

5.1.1 Commercial Banks

- A commercial bank is a financial intermediary.
- Its central objective is commercial that is, profit making.
- It takes money from a surplus unit by paying a low rate of interest and lends the same fund to a deficit unit at a higher rate of interest and thus makes profit.
- It is said to be a dealer in credit.
- It may be organized privately or by the Government.
- The two primary functions of such a bank are Deposit function and Loan function.
- Deposits may be of three types: Demand or current, Savings and Fixed or Time deposit.
- The funds thus obtained from various classes of people are pooled together and lend to users of capital.
- Banks do not lend the entire sum of deposit. But a portion is kept in the form of cash. This is called Cash Reserve Ratio (CRR) in order to meet the unforeseen demand of some depositors.
- In its loans and advances, banks maintain a diversified portfolio in order to seek a balance between liquidity and profitability.
- Banks perform some other functions that enhance their yield. They keep valuables in their custody, collect chequable amounts, the purchase and sell of shares, debenture, they act as agents of their customers. Besides they act as trustee and executors of wills, pay bills of customers.

5.1.1.1 Functions of a Commercial Bank

- Modern commercial banks perform a variety of functions and provide a number of services to their customers.

- They are regarded as departmental - store banks because they provide a wide variety of services to their customers.

Various functions performed by commercial banks are as follows:

1. Acceptance of deposits — People who have surplus funds with them would like to deposit these with commercial banks. Banks accept mainly three types of deposits:

Current Account	• Deposits in current account are payable on demand. • Current accounts are also known as demand deposits. • These accounts are mostly held by traders and businessmen. • Bank does not pay any interest on these accounts. • Banks provide various services to the current account holders, such as making payment through cheques, collection of payment of cheques, issuing drafts on behalf of the account holders etc. • Banks, in fact, levy certain service charges on the customers for the services rendered by them.
Savings Bank Account	• Here deposits are payable on demand and money can be withdrawn by cheques. • Banks impose a limit on the amount and number of withdrawals during a particular period. • These accounts are held by households who have idle cash for a short period. • Deposits in this account earn interest at nominal rates.
Fixed Deposits	• The money is deposited for a fixed period, viz., 6 months, one year, two years, five years or more. • These deposits are not payable on demand. • These deposits are also known as time deposits since the money deposited in them cannot be withdrawn before the maturity of the period for which the deposit is made. • These are interest-earning deposits. • The rate of interest varies with the length of time for which the deposit has been made. • Recurring (or cumulative) deposits are one type of fixed deposits. A depositor makes a regular deposit of a given sum for a specified period. • Recurring deposits are designed to motivate the small savers to save a particular amount regularly.

2. Advancing of Loans — The second primary function of the commercial banks is to extend loans and advances. Lending is the most profitable business of a bank. Banks charge interest from the borrowers which are more than the interest they pay to their depositors. Banks these days extend loans and advances to their customers in the following ways:

Outright Loans (Term Loans)	• Banks provide outright loans for a fixed period. • The entire amount of the loan sanctioned is credited to the borrower's current account. • The borrower pays interest on the entire amount he has borrowed.

Cash credit	• The entire sanctioned amount of loan by the bank is not given to the borrower at a particular time. • The bank opens an account of the borrower and allows him to withdraw the borrowed amount as and when he required the money. • The bank charges interest, not on the amount of loan sanctioned, but on the actual amount withdrawn from the bank.
Overdraft facilities	• The customer is allowed to draw cheques in excess of the balance standing to his credit to the extent of the amount of overdraft. • For a businessman, the overdraft facility is the easiest and most convenient method of borrowing from banks.
Discounting Bills of Exchange	• A bill of exchange is drawn by a creditor on the debtor specifying the amount of debt and also the date when it becomes payable. • Such bills of exchange are normally issued for a period of 90 days. • The creditors cannot get it encashed from the debtors before the maturity of the 90 - days period. • If the creditor needs money before the expiry of this 90—days period, he can get it discounted from a commercial bank. • The bank makes payment to the creditor after deducting its commission. • When the bill matures, the bank will get payment from the debtor.

3. Facilitation of payments through cheques — Banks have provided a very convenient system of payment in the form of cheques. The cheque is the principal method of payment in business in recent times. It is convenient, cheap and safe means of making payments.

4. Transfer of funds — Banks help in the remittance or transfer of funds from one place to another through the use of various credit instruments like cheques, drafts, mail transfers and telegraphic transfers.

5. Agency Functions — Banks provide various agency functions for their customers. The banks charge commission or service charge for such functions. The main agency functions are :

(i) The commercial banks collect cheques, drafts, bills of exchange, hundies and other financial instruments for their customers.

(ii) They make and collect various types of payments on behalf of their customers, such as insurance premia, pensions, dividends, interest, etc.

(iii) The commercial banks act as agents for the customers in the sale and purchase of securities. They provide investment services to the companies by acting as underwriters and bankers for new issues of securities to the public.

(iv) They render agency services of various types, such as obtaining foreign currency for customers and sale of foreign exchange on their behalf, sale of national savings certificates and units of U.T.I.

(v) The commercial banks act as trustees and executors. For instance, they keep the wills of their customers and execute them after their death.

6. Miscellaneous Services – Commercial banks provide various miscellaneous services, such as provision of locker facilities for safe custody of jewellery and other valuables, issue of travelers cheques, gift cheques, provision of tax assistance and investment advice, etc.

7. Credit Creation — A very important and unique function of the commercial banks is that they have the power of credit creation. In the process of acceptance of deposit and granting of loans,

commercial banks are able to create credit. This means that they are able to grant more loans than the amount of initial or primary deposits made by the customers. This function is discussed below in detail.

In short, commercial banks perform a large variety of functions in the modern economics.

5.1.1.2 Principles of Commercial Banks

1. Principles of liquidity	Deposits are repayable on demand or after expiry of a certain period. Everyday depositors either deposit or withdraw cash. To meet the demand for cash, all commercial banks have to keep certain amount of cash in their custody.
2. Principles of profitability	The driving force of commercial enterprise is to generate profit. So it is true in case of commercial bank also.
3. Principles of solvency	Commercial bank should have financially sound and maintain a required capital for running the business.
4. Principles of safety	While investing the fund, banks are to be cautions because bank's money is depositor's money.
5. Principles of collection of savings	This is a very important principle for today's banking business. Commercial banks always seek huge amount of idle money from the clients. Now a day's banks fix up the target for their employees to generate more savings from the people.
6. Principles of loan and investment policy	The main earning sources of commercial banks are lending and investing money to the viable projects. So commercial banks always try to earn profit through sound investment.
7. Principles of economy	Commercial banks never go for any unnecessary expenditure. They always try to maintain their functions with economy that increase their yearly profit.
8. Principles of providing ser-vices	A better service brings great reputation for the bank.
9. Principles of secrecy	Commercial bank maintains and keeps the clients accounts secretly. Nobody except the legitimized person is allowed to see the accounts of the clients.
10. Principles of modernization	It is the age of science and technology. So to cope up with the advanced world the commercial bank has to adopt modern technical services like online banking, credit card etc.
11. Principles of specialization	It is an age of specialization. Here commercial banks segments their whole functions into various parts and place their human resources according to their efficiency.
12. Principles of location	Commercial banks choose a suitable site where the availability of customers is large.

13. Principles of relation	Commercial banks always try to maintain a good relation with their clients and potential customers.
14. Principles of publicity	It is an age of publicity. If you would like to earn more money, you have to give more advertisement through various media. In that case, commercial banks follow this kind of principles to increase their customers.

5.1.2 Essentials of a Sound Banking System

A sound banking system promotes all round economic development of an economy. A good bank must have the following features : —

(a) **Adequate Liquidity —** A bank must keep sufficient cash in hand to meet the claim of depositors, otherwise they would be insolvent. A bank failure not only affects depositors but banks also. People would not more keep funds with bankers. It ensures safety of a bank. Unless a bank is safe it cannot render its social services.

(b) **Expansion of banking —** Banking facilities should spread throughout the economy. It must also cover all sections of people in need of funds and all productive activities. The less-developed regions should get more banking facilities than others. Thus, diffusion of banking offices is essential.

(c) **Investment and Loan policies –** A sound banking system must have a sound investment policy whereby it can optimize the twin goals of liquidity and profitability. If loan and investments are wrong, a bank suffer loss or face liquidity shortage. A prudent banker should carefully determine the composition and character of its loans and advances so as to optimize earning without endangering safety and solvency.

(d) **Human Factor —** The soundness of a bank depends much on the quality of banker. Banking being a practical affair, rigid application of bank laws are not always fruitful. Much depends on the discretion of men piloting the ship. Sound banking thus, depends more on banking personnel than on banking laws.

5.1.3 Credit Creation by Commercial Bank

- A commercial bank is called a dealer of credit.
- It can create credit i.e. can expand the monetary base of a country.
- It does so not by issuing new money but by its loan operations.
- Banks create money on the basis of the cash deposits.
- The process of credit creation is that the depositors think they have so much money with banks and borrowers from bank say they have so much money with them.
- Summing the two, we find an amount more than the cash deposit.
- Suppose a bank receive a sum of ` 1,000 as deposit, keeps with it 20% (` 200) as CRR (cash reserve ratio) and lends and rest.
- Depositor will claim he has ` 1,000 and bank borrower too possesses ` 800.
- Thus total money supply appears to be ` 1,800 only. It is the credit creation by a single bank.
- The above example can be extended to cover the banking system as whole. Suppose ` 800 is deposited to another bank.
- This bank's base will now expand. It will keep 20% of ` 800 (` 160) as cash reserve and will lend ` 640.
- This sum is redeposited to a third bank which keeps 20% of ` 640 (` 128) and grants a loan of ` 512.
- This process will continue and the amount of fresh deposit will go on falling.

- A time will come when deposited sum will be equal to CRR.
- The process will then come to an end.

5.1.3.1 Limitations of Credit Creation :

The multiple credit creation process depends on some factors :

(i) Much depends on the size of the cash reserve ratio. If it is cent percent multiplier will be zero. Thus an inverse relation exists between CRR and the size of the multiplier. So credit creation is inversely related to CRR.

(ii) Credit creation depends upon the amount of loan given. If society does not borrow, as it happens in a period of economic depression, bank can neither lend, nor can create credit. If borrowers cannot offer security against loan, bank cannot lend.

(iii) Size of the cash deposit is also important in this context. The smaller the cash base the smaller scope a bank gets for credit creation. If people prefer physical assets or prefer to keep cash in their hand, bank deposits suffer much. So bank cannot lend much.

(iv) A bank can lend money against acceptable securities. A borrower gets a loan from a bank only against some securities the value of which must be equal to the amount of the loan. If a bank does not get an acceptable security it cannot lend money even though it may have large amount of cash money for credit creation.

(v) The Credit creating power of commercial banks is substantially controlled by the Central Bank. A Central Bank possesses certain instruments by the use of these it can increase or decrease the volume of credit created by banks. It can also control the purpose and direction of credit given by banks. The banks accept the Central Banks directions because the Central Bank is their lender of last resort.

5.2 CENTRAL BANK

Central Bank may be defined as an institution charged with the responsibility of managing the expansion and contraction of the volume of money supply for general Economic Welfare. The Central Bank is the apex institution in the banking and financial structure of the country.

5.2.1 Functions of Central Bank

Central Bank plays a leading role in organizing, running, supervising, regulating and developing the banking and financial structure of the country.

(i) Monopoly of Note Issue :

The Central Bank enjoys the exclusive power of note issue. In India the RBI issues all notes except Re 1 notes and coins. Re 1 notes are issued by the Government of India under the guidance of RBI. The currency notes issued by the Central Bank are declared unlimited legal tender throughout the country. The Central Bank has to keep reserve of Gold, Silver and foreign securities for issuing notes.

(i) Banker, agent, advisor to the Government :

The Banking A/c of the government both central and state are maintained by the Central Bank as the commercial bank does for its customers. As a banker and to the government it helps the government in short term loans and advances for temporary requirements and floats public loans for the government.

(iii) Banker's Bank :

All commercial banks keep part of their cash balances as deposits with the Central Bank of the country. This is either because of convention or legal compulsion. The commercial banks regularly draw currency during the busy season and paying in surplus during the slack season. Part of these balances are meant for clearing purposes i.e.; all commercial banks keep deposit account with the Central Bank. The deposit balances of the Central Bank is considered as cash reserves for general purpose.

Under the Banking Regulations Act of 1949, the Central Bank of India have been empowered with the right to supervise and control the activities of various scheduled commercial banks. These powers are related to licensing, branch expansion, liquidity of assets and methods of working of the Bank.

(iv) Clearing House Facility :

By virtue of its unique position in dealing with domestic and foreign funds the Central Bank has a special position for conducting :

(a) Clearing house operation;

(b) Inter bank transfer of funds;

(c) Settlement of accounts.

Clearing house facility means providing an opportunity to member commercial banks to settle their claims on each other mutually. E.g. : Indian Bank has to pay to SBI a sum of ` 2 lakh and SBI has to pay to Indian bank ` 1,50,000. This can be settled with a check of ` 50,000 by Indian Bank on the RBI in favour of SBI. As a result Indian Banks accounts will be debited and SBI's account will be credited.

(v) Custodian of Foreign Exchange Reserves :

Under this system the RBI controls both receipts and payments of foreign exchange. A country have in its foreign trade favourable or unfavourable balance.

Favourable balance helps to bring foreign exchange to the country while unfavourable balance means paying foreign exchange out. As custodian of Foreign Exchange, Central Bank keeps a constant watch on the same so that the value of the home currency does not rise or fall adversely in relation to foreign currency.

During times of emergency the Central Bank may impose restrictions to control on buying or selling of foreign currencies in the market.

(vi) Credit Control :

In order to ensure price stability and Economic growth of a country, the Central Bank undertakes the responsibility of controlling credit. The Central Bank ensures price stability and avoids inflationary and deflationary tendencies by several monetary methods such as regulation of Bank rate, open market operation, change in variable reserve ratio, etc.

5.2.2 Credit Control by Central Bank

- Credit money created by commercial banks and other non-banking financial institutions constitutes a significant portion of total money supply in an economy.
- Their shortages and excesses may have profound impact upon an economy.
- The flow of credit should be regulated in such a way that they may raise or fall according to the needs of an economy. This is what we generally means by credit control.
- This is done by the central bank in its role of a banker's bank.

- The objective of credit control is generally two fold.
- A central bank may encourage member banks to expand credit, known as expansionary monetary policy, which is adopted to lift an economy out of depression and unemployment.
- It may restrict credit-creating power of banks and non-banks which is known as restrictive policy to fight inflation and to achieve financial stability
- In the context of growth with stability a central bank is to deal with both aspects - increasing credit flow for more investment and, at the same time, restrict flow of credit so that it may not generate inflation.

5.2.2.1 Control Weapons

- A central bank possesses a number of instruments for controlling credit money.

- These are of two types -Quantitative and Qualitative.
- Quantitative techniques seek to regulate total quantity of credit while qualitative measures affect the availability of credit.

A. Quantitative Methods:

Bank Rate Policy	• As a banker's bank, a central bank lends money or rediscounts the bills of commercial banks. • The rate of interest charged by the central bank is known as Bank Rate or Discount rate. • By manipulating Bank Rate central Bank can regulate the credit creating power of member banks. • If Bank rate is raised by the Central Bank, commercial banks are to borrow at a higher cost. • Then they will increase their lending rate. This rate is known as the Market Rate. • The difference between Market Rate and Bank Rate is the profit margin of commercial banks. • When bank rate rises market rate also rises and vice versa. • Demand for bank loan will reduce. • On the other hand, for credit expansion, Bank Rate is reduced. • The effectiveness of this technique depends on the extent to which commercial banks depend on central bank for loan and rediscounting. • If banks can collect funds from other sources at relatively cheaper rate, they need not depend on central bank credit. • Again if investment opportunities are not present, the market demand for credit will weak, a fall in the bank rate may not raise the level of bank credit.

Open market operations	• It implies purchase and sale of securities in the stock market. • When the central bank appears in the market as a seller of Government securities, people buy such securities by withdrawing money from banks or the banks themselves invest in such securities instead of granting loan to public. • In either case the powers of creating credit will be restricted. • On the other hand, if central bank buys securities money flows out thus enlarging the cash base of members banks. • Credit expansion depends upon external business environment and borrower's attitudes over which banks have no influence.
Variation of Reserve Ratio	• Commercial banks are legally bound to keep a portion of their deposits in the form of Cash Reserve. • It is the most liquid asset in their hand and at the same time it is zero earning assets. • Naturally by altering the CRR, the central bank can expand or reduce the funds bank can lend. • There exists an inverse relation between the size of cash reserve and the amount of credit given by a bank, assuming a given amount of deposit. • In underdeveloped money market this technique is more suitable than open market operation or Bank Rate policy.

B. Qualitative Credit Controls:

- A central bank also possesses certain techniques by which it can control the direction and distribution of credit — purpose wise or areas wise.
- The purpose of selective controls is the rational allocation of scarce bank credit and its economic utilization.
- Further sectorial deployment of credit and controlling in other directions serve the purpose of preventing speculative activities with the help of bank finance and favouring productive activities.
- These techniques are very helpful in a less-developed economy where overall credit restriction may hinder 'growth by preventing the flow of credit for investment'.

5.2.3 Moral Suasion

- Moral suasion is a qualitative technique.
- The central bank 'requests' banks to lend more or not to lend in some sectors.
- There is no legal compulsion behind their acceptance.
- Generally if a request is not carried out by the member bank, the guardian of the banking system may take such steps as banks are forced to accept.
- The central bank is often empowered to issue directives to member banks.
- Such direct orders are in the form of directional control, prohibiting loans of particular type or giving advice to grant loan to priority sectors.

5.2.4 Distinction between the Central Bank and the Commercial Bank –

Basis Of Distinction	Central Bank	Commercial Bank
Monetary Authority Enjoyed	Enjoys supreme monetary authority with wide powers	No authority, hence no such power is enjoyed

Profit Motive	It does not exist to make profits for its for owners	It exists and is organized for profits their owners
Money supply to the economy	It is the ultimate source of money supply to the economy	No such function is performed by it.
Services rendered	It acts as a banker to the government	It acts as a banker to private industries and institutions
Chances of failure	It is the lender of last resort and hence never fails	It often undertakes risky business activities and sometimes may fail.
Service to the public	It neither does accept deposits from public, nor lends money to the public.	Accepting deposits and lending money to the public are the most important functions of commercial banks.
Ownership and Managing Authority	It is generally subordinate to the state, i.e. state owned and state managed	It is mostly privatelyowned and privately managed.
Nature of Operation	It issues paper notes in fact it enjoys the monopoly power in this matter	Its nature operation is credit creation and cannot issue paper notes.
Basis of operation	The basis of cash money issued is gold and foreign reserve.	The basis of credit money generated is cash deposit

5.3 FINANCIAL INSTITUTIONS

- With the introduction of planned development in India in the early 50s, need for specialized financial institutions for supplying credit to industry, agriculture, etc. was felt essential and necessary.
- These institutions are known as Development Banks as they grant long-term development finance.
- Their spheres of activity are limited.
- They are said to be non-bank financial intermediaries as they cannot raise money in the form of demand deposits.
- These banks are owned and managed by Government.
- Through these institutions Government offers fund to private economic activities for development.
- They also underwrite or subscribe to shares and debentures of the public limited companies.
- Besides finance they offer technical and managerial advices.

5.3.1 Industrial Finance Corporation of India (IFCI)

About:

- It was set up in July 1, 1948.
- It is the pioneer development bank in India.
- The authorized capital of the corporation as per IFCI Act, 1948 was ` 10 crores. It was raised to ` 20 crores after amendment in 1972.
- The scheduled banks, insurance companies, investment trusts, cooperative banks are its share holders.

- After the establishment of Industrial Development Bank of India (IDBI) in 1964 it became a subsidiary of IDBI.
- On 24th March, 1993 the IFC (Transfer of undertaking and repeal) bill was passed in order to privatize the IFC.
- It would now be free to raise resources from the open market.

Functions:

Over the years the activities of IFC have progressively increased. It is authorized to perform the following functions: -

(a) granting loans and advances,

(b) subscribing to the shares and debentures floated by industrial concerns,

(c) guaranteeing loans taken from capital market,

(d) granting loans in foreign currencies,

(e) guarantee deferred payment in respect of imports of capital goods by approved concerns.

Financing Policies:

The policies pursued by the IFC in granting loans and advances show a preference to finance—

(i) a new project,

(ii) projects exploring new areas of technology,

(iii) projects involved in producing inputs for agriculture,

(iv) projects producing essential goods for consumption,

(v) It grants assistance sector wise, industry wise, state/territory wise, and to less developed areas.

5.3.2 Industrial Credit and Investment Corporation of India (ICICI)

Objectives :

The objective behind the establishment of this corporation were :-

(a) to provide foreign currency loans

(b) to develop underwriting facilities

(c) to help private sector units

The ICICI differs from two other All-India development banks, mainly, the IFCI and IDBI in respect of ownership, management and lending operations. The ICICI is a private sector development bank. It provides underwriting facilities.

Functions :

The main function of the ICICI are :—

(i) expansion of private sector industries

(ii) to give loans or guarantee of loans either in Rupees or foreign currency,

(iii) to underwrite shares and debentures and subscribe directly to share issues

(iv) to encourage and promote private capital

(v) to promote private ownership of industrial investment along with the expansion of investment markets.

5.3.3 Industrial Development Bank of India (IDBI)

About:

- In July 1964 the Industrial Development Bank of India was set up.
- It was a wholly owned subsidiary of the Reserve Bank of India till 1976.
- But it was delinked from the Bank and was taken over by the Government of India.
- Since then it is working as an autonomous corporation.
- It is now managed by a separate Board of Directors.
- Its members are representatives of public sector banks, other financial institutions and experts from different fields.
- IDBI was to act as a central development institution for providing dynamic leadership in the field of institutional finance of industries.

Functions:

(a) IDBI is working as a central coordinating agency for establishing a harmonious relationship among the term lending agencies.

(b) It provides direct finance by granting loan and advances, guarantees loans taken from banks, subscribes or underwrites share, bond, and debentures. Besides it can convert its loans into equity shares of the concerned industry.

(c) When an industrial unit cannot procure funds in the normal course, the IDBI assists such units from a special fund known as Development Assistance Fund.

(d) To assist in the creation, expansion and modernization of industrial units lying within private sector.

(e) To encourage and promote private ownership of industrial investment along with the expansion of investment markets.

(f) It provides export finance through the scheme of direct participation, overseas buyer's credit etc.

5.3.4 State Financial Corporations (SFC)

About:

- SFC was established in 1951 after three years of the establishment of IFCI.
- SFCs were set-up in various states as regional institutions to cope with the requirements of medium and small scales industries.
- The first SFC was in Punjab, set up in 1953.
- The authorised capital shall not be less than fifty lakhs of rupees, or exceed five hundred crores of rupees (as per the State Financial Corporations Act, 1951).
- The public can hold can hold 25% of the share and the rest is held by State.
- These corporations can sell bonds and debentures, and accept term deposits from public.

Functions:

Some important functions of the SFCs are -

(i) to guarantee loans raised by industrial units to be repaid within 20 years,

(ii) to grant loans and advances repayable within 20 years,

(iii) to subscribe, shares bonds and debentures of industrial concerns.

5.3.5 State Industrial Development Corporations (SIDC)

- There are 24 State Industrial Development corporations in India established with the objective of rapid industrialization of the State.
- These institutions are providing assistance to small entrepreneurs and those industrial undertakings that are setup in backward regions.

5.3.6 Industrial Reconstruction Bank of India (IRBI)

About:

- Industrial Reconstruction Corporation of India (IRCI) was established to provide financial assistance as well as to revive and revitalize sick industrial units in public and private sector.
- IRCI was set up in 1971 with a share capital of ` 10 cores.
- In March 1985, it was converted into a statutory corporation called the Industrial Reconstruction Bank of India (IRBI).
- The authorized capital of IRBI was ` 200 cores.

Functions:

(a) providing financial, managerial and technical assistance to the sick enterprises directly;

(b) providing merchant banking services for merger, amalgamation etc

(c) Securing finance from other institutions and government agencies for the revival of sick industries.

5.3.7 Board of Industrial and Financial Reconstruction (BIFR)

About:

- BIFR was set up In January 1987 under the Sick Industrial Companies (Special Provision) Act, 1985.
- The Board became operational on May 15, 1987.
- The Board consists of seven members.
- At the end of 1991, public sector enterprises were brought within its purview.

Function:

It is obligatory on the part of management of a sick unit to inform the BIFR about sickness. The Board will then enquiry. If found sick, it will —

(a) Change management or sale or leasing out of a part or the entire unit,

(b) Take measures for merger or amalgamation with sound unit

(c) Give the sick unit time for overcoming the problem on its own.

5.3.8 Unit Trust of India (UTI)

Under the Unit Trust Act, 1963, the Unit Trust of India was set up on 1st February, 1964.

Objectives:

The two objectives of the UTI are:—

(a) to mobilize the savings of the relatively small investors and

(b) to make available the benefits of equity investment to small investors through indirect holding of securities.

Organisation:

- The UTI is managed by a Board of Trustee.
- The chairman of the Board is appointed by the central government in consultation with the IDBI.
- The Executive Trustee is appointed by IDBI.
- RBI nominates one Trustee, and four trustees by IDBI.

Thus, the UTI occupies a pivotal position in the Indian capital market in mobilizing savings of heterogeneous investors and channeling into productive investment the savings it mobilizes, providing support to new issue market.

5.3.9 Export Import Bank of India (EXIM Bank)

About:

- The Export Import bank of India commenced operations on March 1, 1982.
- It is a non-bank financial intermediary.
- It confined its area of operations to foreign trade of India.
- It is a fully statutory company owned by the Government of India.
- It is empowered to borrow from RBI and also from foreign economies.
- It is a lead bank in the finance and promotion of exports.
- It is also an apex body for coordinating the working of similar organization engaged in promoting our export and import trade.

Functions:

Except export financing, the other program include –

(a) Export Bills Re-discounting
(b) Refinance of suppliers credit
(c) Bulk Import finance
(d) Foreign currency Pre shipment credit
(e) Product equipment finance program
(f) Business Advisory and technical Assistance (BATA).

5.3.10 National Bank for Agriculture and Rural Development (NABARD)

About:

- The NABARD was setup in July 1982.
- It is the apex body in the sphere of rural credit system.
- It took over the functions of agricultural credit department of the RBI and Agricultural Refinance and Development Corporation (ARDC).
- It has got the power to borrow from Union Government.
- It is also empowered to borrow foreign currency.

- It operates through 16 Regional offices.

Functions:

(a) It provides all sorts of reference to cooperatives, commercial banks and also Regional Rural Banks (RRB).

(b) It inspects the above three agencies and advises the government thereon.

(c) It makes loans to State Governments to enable them to subscribe to the share capital of cooperative Banks.

(d) It helps in prompting research in agriculture and rural development.

(e) NABARD undertakes evaluation and monitoring projects financed by it.

(f) It is responsible for the development operation and coordination relating to rural credit.

5.3.11 Life Insurance Corporation of India (LICI)

- LICI was set up in 1956 by nationalizing 245 insurance companies.
- The objectives of nationalization —
  — to protect the interest of policy holders against misuses and embezzlement of funds by private insurance companies
  — to direct investment of funds in government securities, leaving a meager part for the private sector.
- Basically LIC is an investment institution.
- Its policy holders view the LIC as a trustee of their funds, a source of emergency fund to guard against any financial misfortune and a way to accumulate funds by the time of retirement from work.
- The LIC plays an important role in the securities market in India.

- It purchases even when the market is dull (bearish) and prices are low in order to reap the benefit of future price appreciation.

5.3.12 General Insurance Companies (GIC)

- The General Insurance Corporation of India (GIC) was formed as a government company in 1972 under the General Insurance Business (Nationalisation) Act 1972.
- Before nationalization a few big companies and about 100 small companies were in this business.
- All these units were merged together and reorganized into four subsidies of GIC. They are —
  (i) National Insurance Company
  (ii) New India Assurance Company
  (iii) Oriental Fire and general Insurance Company
  (iv) United India Fire and General Insurance Company.
- It sells insurance service against some forms of risk like loss of physical assets of various kinds from fire or accident and against personal sickness and accident.
- The insurer just purchases a service and not any financial asset.
- The companies can invest in the shares and debentures of the corporate sector. But shall not exceed 5% of the subscribed capital of a single company.
- It also participates in the underwriting of new issues and in granting term loans to industries.

5.3.13 Securities and Exchange Board of India (SEBI)

SEBI was set up in 1988. It got statutory recognition in 1992.

Purposes:

(a) Regulating the business in Stock Markets and other securities markets,

(b) Prohibiting fraudulent and unfair trade practices relating to securities markets,

(c) Regulating the working of collective investment schemes, improving Mutual Funds

(d) Prohibiting insider trading insecurities,

(e) Regulating large acquisition of shares and takeover of companies

Powers:

(1) All stock exchanges in the country have been brought under the annual inspection of SEBI for orderly growth of stock markets and also to protect the interest of investors.

(2) To oversee the constitution as well as the operations of mutual funds of both private sector and joint sector.

5.3.14 The Asian Development Bank (ADB)

- ADB started functioning in December 1966.
- It is engaged in promoting the socioeconomic progress of its member countries in Asia and Pacific.
- It is owned by the governments of 37 countries from the region and 16 from outside the region.
- It's head quarters is in Manila, Philippines.
- The bank's highest policy making body is the Board of Governors.
- Bank's activities comprise lending activities, and technical assistance.

Objectives:

- Poverty reduction
- promoting economic growth
- supporting human development
- protecting the environment
- improving the status of women

Functions:

(a) to make loans and equity investment for the socioeconomic advancement of its member countries

(b) to provide technical assistance for the preparation and execution of development projects, and advisory services

(c) to promote investment of private and public capital for development purposes

(d) to respond to requests for assistance in coordinating development plans and policies of member countries.

5.3.15 The International Monetary Fund (IMF)

IMF was created to secure the international monetary cooperation. It commenced operation in March, 1947.

Objectives:

(a) To foster international monetary cooperation through joint action of its members

(b) To promote foreign trade by avoiding restrictive currency practices.

(c) To secure stability of foreign exchange rate.

(d) To recur multilateral convertibility i.e., a borrower nation can borrow the currency of any other member nation.

Functions:

(a) It provides short term credit

(b) It functions as a leading institution in foreign exchange.

(c) It grants loans for current transactions and not capital transaction.

(d) It helps for the orderly adjustment of exchange rates

(e) It acts as a store house of foreign exchange rates which is likely to improve the balance of payment position of member countries.

Special Drawing Rights (SDR):

- The SDR, new international money was first introduced in 1969 for two reasons.
  - — to overcome the shortage of gold in the world economy leading to fall in international reserves;
  - — to avoid the movement of gold across national boundaries.
- Each member of the fund was assigned an SDR quota that was granted in terms of a fixed value of gold.
- Hence they have been aptly described as “Paper Gold”.
- The use of SDR would mean a reduction in the country’s foreign reserve and a corresponding increase in the SDR holding of the country receiving it.

5.3.16 The World Bank

The World Bank has the following objectives before it :-

(i) To help reconstruction of member countries damages due to the Second World War.

(ii) To facilitate the investment of foreign capital for productive purpose.

(iii) To promote balanced growth of international trade and to maintain equilibrium in the balance of payment.

(iv) To promote private foreign investment by means of guarantee to loans and investments made by private investors. It will make loans out of its resources when private loans are not sufficient. Thus the bank supplements rather than replace private investment.

5.3.17 International Development Association (IDA)

- The IDA was started in 1960.
- It is affiliated to World Bank.
- The Capital Funds of the IDA come from subscription of member countries, special contribution from its richer members, transfer from the net earnings of the World Bank and general replenishment from its more industrialized members.
- The IDA loans can be used to finance both foreign exchange and local currency costs.

EXERCISE

1. What is a Bank?
2. What are the different types of Banks?
3. (a) 'The Process of multiplication of bank deposits through extension of loans and advances' refers to which functions of commercial Banks?

   (b) Give two factors imitating the volume of credit creation by commercial banks.
4. Explain the main functions of commercial banks.
5. Discuss the role of commercial banks in economic system.
6. Explain the main functions of commercial bank
7. Explain the role of commercial banks as the controller of credit.
8. Critically examine the process of credit creator by commercial banks.
9. Discuss the functions and activities of the Industrial Finance Corporation of India. Why was it established and when?
10. Discuss the rational behind the establishment of Industrial Development Bank of India. State the functions it is to discharge and discuss the services rendered by it.
11. Discuss the composition and functions of Asian Development Bank. Explain the objective and functions of International Monetary Fund.
12. Give an account of the structure of the World Bank. What are its objective and functions.
13. Why was the International Finance Corporation was established?
14. Write short notes on : -

    (a) Asian Development Fund

    (b) International Development Association

    (c) Special Drawing Rights

MACRO-ECONOMICS-I (*DENOTES ANSWERS)

1. Intermediate goods are excluded from GDP because
   a. intermediate goods go into inventories, and hence are not sold
   *b. their inclusion would lead to double counting
   c. they remain within the business sector
   d. none of the above
2. Let us consider that in 1950 the GDP was `500 billion while in 1960 GDP reached `700 billion, both in current (nominal) dollars. If the price index was 100 in 1950, 125 in 1960, what was the change in real GDP from 1950 to 1960? billion.
   a. zero
   b. `15
   c. `30
   d. `45
   *e. `60
3. Rent and interest are used to calculate
   a. indirect business taxes
   b. undistributed corporate profits
   *c. GDP by the income approach
   d. GDP by the expenditure approach
4. The sales tax is held to be a regressive tax because the:
   a. sales tax is an indirect, rather than a direct, tax
   b. tax tends to reduce the total volume of consumption expenditures
   c. percentage of income paid as taxes is constant as income rises
   d. administrative costs associated with the collection of the tax are relatively high
   *e. percentage of income paid as taxes falls as income rises
5. A common characteristic of pure public goods is that
   a. people pay for them in proportion to the benefits received
   b. the costs of producing them are less than if they were private goods
   *c. their benefits cannot be withheld from anyone, regardless of whether he pays for them or not
   d. their benefits can be withheld from anyone who does pay for them
   e. they are produced only by the public sector, not by the private sector
6. The best estimate of about the current natural rate of unemployment is:
   a. 2 percent
   b. 3 percent

*c. 6 percent

d. 9 percent

e. 0 percent

7. Inflation which is unexpected will most likely benefit:

a. holders of cash

b. creditors who lend funds to others

c. those who have fixed incomes

*d. people owing debts

e. holders of U.S. Treasury bonds

8. Wendy Clark has stopped looking for a job, feeling that there are not any jobs available for professional women television sportcasters like herself. She is

a. frictionally unemployed

b. cyclically unemployed

*c. a discouraged worker

d. a member of the labor force

Use the table below to answer question number 9

Disposable Income (`)	Consumption (`)
400	405
450	450
500	495
550	540
600	585

9. The MPS is:

a. 0.05

b. 0.25

c. 0.2

d. 0.15

*e. 0.1

10. The 45-degree line on a chart which relates consumption and income shows:

a. the amounts households will plan to consume at each possible level of income

b. the amounts households will plan to save at each possible level of income

*c. all the points at which consumption and income are equal

d. all points at which saving and income are equal

11. Assume the current equilibrium level of income is ` 200 billion as compared to the full employment income level of ` 240 billion. If the MPC is 5/8, what change in autonomous expenditures is needed to achieve full employment?

*a. an increase of ` 15 billion

b. an increase of ` 40 billion

c. an increase of ` 10 billion

d. an increase of ` 25 billion

e. a decrease of ` 12 billion

12. The inequality of intended (planned) saving and intended (planned) investment:

a. is of no consequence because actual saving and investment will always be equal

b. is of no consequence because a compensating inequality of tax collections and government spending will always occur

*c. may be of considerable significance because of the subsequent changes in income, employment, and the price level

d. is attributable to a low MPC

13. If the MPC = 2/3 and if the government lowers taxes by ` 10 and increases government expenditures by ` 5, then income would

a. decrease by ` 5

b. increase by ` 5

*c. increase by ` 35

d. decrease by ` 35

e. increase by ` 45

14. Keynesian economics would attack demand pull inflation by:

a. decreasing the tax rates and/or decreasing government spending

b. decreasing the tax rates and/or increasing government spending

c. increasing the tax rates and/or increasing government spending

*d. increasing the tax rates and/or decreasing government spending

15. Suppose the economy is operating far below its full employment level. Now the government increases its spending without an increase in taxes. Given time, this will most likely result in:

*a. output rising by a multiple of the increase in government spending and inflation may increase a little

b. a fall in output due to the initial position being one with idle resources

c. no change in output but an increase in inflation

d. a lowering of the rate of inflation

16. Assume Company X deposits ` 100,000 in cash in commercial bank A. If no excess reserves exist at the time this deposit is made and the reserve ratio is 20 percent, Bank A can safely increase the money supply by a maximum of:

a. ` 100,000

b. ` 500,000

*c. ` 80,000

d. ` 180,000

e. ` 50,000

17. If the public finds ways of making the same amount of money perform a larger amount of transactions than before

    a. the demand for money must have risen

    *b. velocity must have risen

    c. incomes and prices must have risen

    d. the supply of money must have risen

18. The "crowding-out effect" refers to possibility that

    *a. borrowing by the federal government crowds out private borrowing

    b. larger expenditures by the federal government simply crowd-out state and local spending

    c. Congress has replaced the Federal Reserve System as the body mainly responsible for monetary policy

    d. low income individuals are crowding middle income individuals out of the central city into the suburbs

19. In the equation of exchange, if M = ` 200, P = ` 2, and Q = ` 400, then

    *a. V must be 4

    b. V must be one-half

    c. V must be 1

    d. V cannot be calculated with the available information

    e. the value of the goods and services produced in the economy must be ` 400

20. Which of the following best describes the Keynesian cause-effect chain of an easy money policy?

    *a. an increase in the money supply will lower the interest rate, increase investment spending, and increase GDP

    b. an increase in the money supply will raise the interest rate, decrease investment spending, and decrease GDP

    c. a decrease in the money supply will raise the interest rate, decrease investment spending, and decrease GDP

    d. a decrease in the money supply will lower the interest rate, increase investment spending, and increase GDP

21. Open-market purchases of government securities by the Fed will have the tendency to

    a. increase interest rates, the money supply, and national income

    b. increase interest rates and the money supply, but decrease national income

    c. increase interest rates, but decrease the money supply and national income

    *d. decrease interest rates, but increase the money supply and national income

    e. decrease interest rates, the money supply, and national income

22. The Federal Funds market has reference to the market where:

    a. the federal government finances its debt

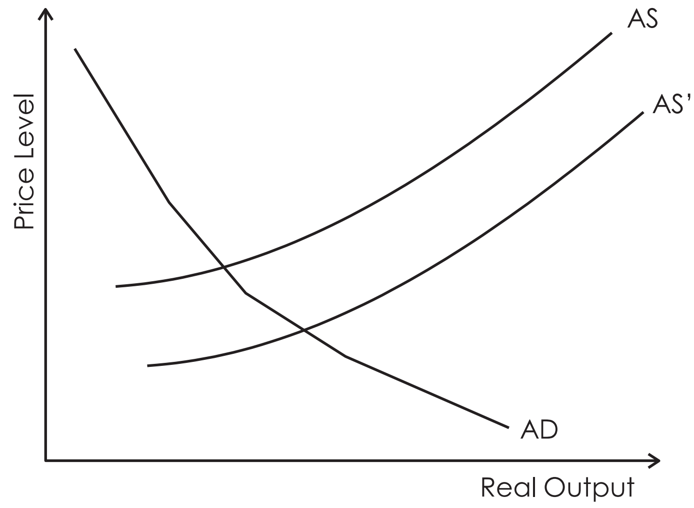
    *b. banks borrow reserves from other banks

    c. newly printed currency gets into circulation

d. banks deposit the majority of their legal reserves

e. checks are cleared

Use the graph below to answer question number 23



23. The shift in the Aggregate Supply curve from AS to AS' shown here, could be caused by all of the following except one. Which is the EXCEPTION?

 a. increased preference for work

 b. development of new technology

 c. eductions in the availability of unemployment compensation, welfare, etc.

 d. immigration of foreign nationals into the U.S.

 *e. increased bargaining power of unions

24. Which of the following statements best describes the relationship between total output, total spending, and the general price level?

 a. prices are stable until full employment is reached; then any additional spending will be purely inflationary

 b. spending, output, and prices will always increase proportionately

 *c. for a time increases in spending will cause large increases in output and little or no increase in prices; but as full employment is approached prices begin to rise more rapidly

 d. spending and output are directly related; but spending and prices are inversely related

25. Which of the following is not essential for the classical model to be valid?

 a. wage-price flexibility

 b. interest rate flexibility

 c. long-run full employment

 *d. fixed money supply

26. To say that a country has a comparative advantage in the production of wine is to say that

 a. it can produce wine with fewer resources than any other country can

 b. its opportunity cost of producing wine is greater than any other country's

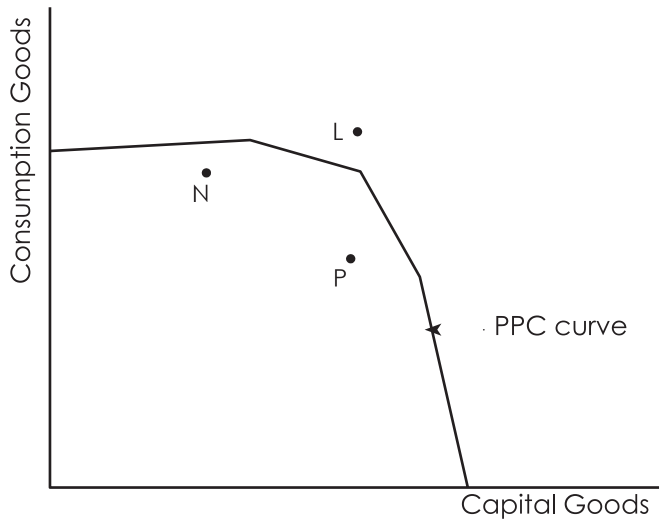
*c. its opportunity cost of producing wine is lower than any other country's
d. the relative price of wine is higher in that country than in any other

27. When India's exports exceed India's imports this has the effect of acting:
   a. to raise the Indian unemployment rate
   b. as a net leakage
   *c. in a manner similar to other injections as investment and government spending
   d. to weaken the rupee exchange rate - i.e. - the rupee depreciates
   e. to cause Indian producers to lose profits

MACRO-ECONOMICS-II (*DENOTES ANSWERS)

1. The main concern of economics is
   a. how to organize and run a business
   *b. how individuals and societies organize their scarce resources
   c. how to protect the consumer
   d. government spending and taxing
2. The most basic institution of a market system is:
   a. the existence of capital
   *b. private property
   c. the use of money
   d. production for the benefit of society, not individuals
   e. democracy
3. Which of the following is the primary incentive in determining WHAT to produce in a free market price system? Produce those products that
   a. enjoy maximum freedom from government controls
   b. are needed by the masses of people
   c. are easiest to produce
   *d. will provide maximum profits for the producer

Use the graph below to answer question number 4



4. Other things being equal, society's current choice of point P on the curve will:

   *a. allow it to achieve more rapid economic growth than would the choice of point N

   b. entail a slower rate of economic growth than would the choice of point N

   c. entail the same rate of growth as would the choice of point N

   d. be unobtainable because it exceeds the productive capacity of the economy

5. The production possibilities curve demonstrates the basic principle that

   *a. given full employment of all of a nation's resources, producing more of one good necessarily entails producing less of another

   b. in a mixed capitalistic system with free markets, the economy will automatically employ all of its resources

   c. exchange is a necessary corollary of specialization

   d. given full employment, to produce more of one good a nation will EVENTUALLY, but not immediately, be forced to forgo production of other goods

6. The curvature in a production possibilities curve illustrates the law of

   a. comparative advantage

   *b. increasing costs

   c. constant costs

   d. decreasing costs

   e. of large numbers

7. If an increase in the price of product A results in an increase in the demand for product B, one may conclude that products A and B are

   *a. substitute goods

b. complementary goods

c. unrelated goods

d. inferior goods

8. Assume that Ford reduces the price of their subcompact and observes that their sales rise while sales of Chevy's subcompact falls. Which of the following statements is correct?

a. Both Ford and Chevy experience an increase in the demand for their cars

*b. Ford experiences an increase in quantity demanded while Chevy experiences a decrease in demand

c. Both Ford and Chevy experience changes in quantity demanded

d. Ford experiences an increase in demand while Chevy experiences a reduction in quantity demanded

9. With an increase in profits in a particular industry, we might expect

a. firms to leave the industry

b. firms to produce less

*c. firms to enter the industry

d. people to buy less

e. profits don't have anything to do with what firms do

10. Which of the following will NOT change the demand for a good? A change in

a. the number of consumers in the market

b. the prices of related goods

*c. the price of the good itself

d. expectations about future prices

11. From an economic perspective, the complaint that there are not enough parking spaces in downtown areas indicates that

a. cities should build more parking places

b. everyone should ride mass transit into the city

c. the "market" for parking places is in equilibrium

*d. the price of parking in downtown areas is below the market-clearing price

12. If supply and demand both decrease, we can say that equilibrium quantity:

a. and equilibrium price must both decline

*b. must decline, but equilibrium price may either rise, fall, or remain unchanged

c. price must fall, but equilibrium quantity may either rise, fall, or remain unchanged

d. and equilibrium price must both increase

e. and equilibrium price must both decrease

13. Dairy price supports (floor) which raise milk prices received by farmers, are likely to:

a. lower the price of milk

b. result in shortages of milk

c. help consumers

*d. cause increased production of milk

e. reduce inflation

MACRO-ECONOMICS-III (*DENOTES ANSWERS)

1. Macroeconomics is:
   a. is concerned with details in the economy and does not generalize
   *b. the analysis of economic aggregates
   c. the study of individual economic units and specific markets
   d. is the basis for the 'after this, therefore because of this' fallacy (post hoc ergo propter hoc)
2. Which of the following is a positive, rather than a normative, statement?
   *a. if the price of gasoline is allowed to rise, people will buy less of it
   b. Americans must learn to conserve energy
   c. the government should reduce spending
   d. the United States should reduce its dependence on Arab Oil
3. The principal economic function of price is to
   a. make certain only worthy people get products
   b. make people work in order to buy things they want

   *c. allocate scarce resources in the economy
   d. make sure all businessmen make the same amount of profit
   e. prevent overproduction of important goods
4. Being on the production possibilities frontier for guns and butter means that:
   *a. more guns can be produced only by doing without some butter
   b. if society becomes more productive in producing butter, then we can have more butter, but not more guns
   c. it is impossible to produce any more guns
   d. it is impossible to produce any more butter
5. The law of increasing opportunity costs states that:
   a. the sum of the costs of producing a particular good cannot rise above the current market price of that good
   *b. if society wants to produce more of a particular good, it must sacrifice larger and larger amounts of other goods to do so
   c. if the prices of all the resources devoted to the production of goods increase, the cost of producing any particular good will increase at the same rate
   d. if the sum of the costs of producing a particular good rises by a specified percent, the price of that good must rise by a greater relative amount
6. An item which is not a factor of production (economic resource) is:
   a. Busch Stadium

b. Alan Greenspan

*c. money

d. land

e. trees

7. Assuming a normal, downward sloping demand curve, one can expect a decrease in price to result in

*a. an increase in quantity demanded

b. a decrease in quantity demanded

c. an increase in demand for the product

d. a decrease in demand for the product

e. no change in quantity demanded

8. If an increase in the price of product A results in an increase in the demand for product B, one may conclude that products A and B are

a. unrelated goods

b. inferior goods

*c. substitute goods

d. complementary goods

9. The market demand curve represents

*a. the sum of the quantities demanded by all individuals at each price

b. a steeper curve than would be obtained by adding all the individual demands

c. points at which the quantity supplied equals the quantity demanded

d. none of these

10. Which of the following factors could <u>not</u> cause the supply curve for product X to shift?

a. A change in technology

b. A change in the number of suppliers of X

c. A change in the cost of factors of production

*d. A change in the price of X

11. The complaint that there are not enough parking spaces in downtown areas indicates that

a. the "market" for parking places is in equilibrium

*b. the price of parking in downtown areas is below the market-clearing price

c. cities should build more parking places

d. everyone should ride mass transit into the city

12. Given an upward sloping supply curve for lamb chops, a reduction in the price of pork chops will tend to:

a. raise the price of lamb chops

*b. lower the price of lamb chops

c. shift the demand curve for lamb chops to the right

d. shift the demand curve for pork chops to the left

13. Dairy price supports (floor) which raise milk prices received by farmers, are likely to:

a. help consumers

*b. cause increased production of milk
c. lower the price of milk
d. result in shortages of milk
e. reduce inflation

14. The difference between GDP and GNP is essentially the difference between:
a. goods that are exported and goods that are imported
*b. location of production and ownership of resources
c. production of consumer goods and production of capital goods
d. production of final goods and production of intermediate goods

15. Real income differs from money income in that real income:
*a. reflects constant dollar purchasing power, while money income reflects current dollar purchasing power
b. represents the income value used in determining income taxes, while money income is the gross income actually received before taxes
c. refers to earned income, while money income refers to unearned income
d. refers to income minus the amount put into savings, while money income includes savings

16. In the national income accounts, the capital consumption allowances (depreciation) represents
a. net investment minus depreciation
b. the difference between net national product and national income

c. income to the suppliers of capital
d. interest payments plus distributed corporation profits
*e. repayment for capital used up in production

17. A proportional tax means that someone earning ` 20,000 would:
a. pay a proportionally higher tax on income than someone who has a lower income
*b. pay just as much tax in percentage terms as someone earning ` 10,000
c. pay just as much tax as someone earning ` 10,000
d. none of the above

18. A common characteristic of pure public goods is that
*a. their benefits cannot be withheld from anyone, regardless of whether he pays for them or not
b. their benefits can be withheld from anyone who does pay for them
c. people pay for them in proportion to the benefits received
d. the costs of producing them are less than if they were private goods
e. they are produced only by the public sector, not by the private sector

19. Which of the following statements is <u>correct</u> about unanticipated inflation?
a. It increases the real value of savings
*b. It imposes costs on or "taxes" groups with fixed incomes

c. It benefits creditors at the expense of debtors

d. It increases the purchasing power of the dollar

20. In the official statistics, a worker who is so discouraged that he has stopped looking for employment is counted as:

a. underemployed

*b. not in the labor force in exactly the same way as a spouse who works exclusively at home

c. unemployed

d. in the labor force, but not employed

e. none of the above

21. The relative shares of income spent on particular components of a typical consumer's market basket of commodities are used to compute

*a. the CPI

b. the IPI

c. the GDP deflator

d. the PPI

e. all of these

22. The inequality of intended saving and intended investment:

*a. may be of considerable significance because of the subsequent changes in income, employment, and the price level

b. is attributable to a low MPC

c. is of no consequence because actual saving and investment will always be equal

d. is of no consequence because a compensating inequality of tax collections and government spending will always occur

23. The unplanned accumulation of inventory is a sign that:

a. planned investment equals planned saving

*b. current national income exceeds aggregate expenditure

c. aggregate expenditure exceeds current national income

d. planned investment exceeds planned saving

24. If a family's MPC is .7, it is

*a. spending seven-tenths of any change to its income

b. operating at the "breakeven" point

c. spending 70 percent of its income on consumer goods

d. necessarily dissaving

25. Assume the current equilibrium level of income is ` 200 billion as compared to the full employment income level of ` 240 billion. If the MPC is 0.6, what change in autonomous expenditures is needed to achieve full employment?

*a. an increase of ` 16 billion

b. an increase of ` 25 billion

c. an increase of ` 10 billion

d. an increase of ` 12 billion

e. an increase of ` 40 billion

26. During times of unemployment, the use of full-employment fiscal policy calls for

a. excise taxes to be raised

*b. a deficit in the government's budget

c. a surplus in the government's budget

d. a decrease in government expenditures

27. Which of the following best describes the built-in (automatic) stabilizers as they function in the United States?

a. personal and corporate income tax collections and transfers and subsidies all automatically vary inversely with the level of national income

b. personal and corporate income tax collections automatically fall and transfers and subsidies automatically rise as the national income rises

c. personal and corporate income tax collections and transfers and subsidies all automatically vary directly with the level of national income

*d. personal and corporate income tax collections automatically rise and transfers and subsidies automatically decline as national income rises

e. the size of the balanced budget multiplier varies inversely with the level of national income

28. Suppose the economy is operating far below its full employment level. Now the government increases its spending without an increase in taxes. Given time, this will most likely result in:

a. no change in output but an increase in inflation

b. a lowering of the rate of inflation

*c. output rising by a multiple of the increase in government spending and inflation may increase a little

d. a fall in output due to the initial position being one with idle resources

29. To say that money is used as the medium of exchange means that:

a. money and total spending are the same

b. people can use money to carry over wealth from one time period to the next

c. money and income are one and the same thing

d. money serves as a unit of account

*e. money is used in transactions, rather than goods exchanging for goods

30. One would definitely expect the quantity of money demanded to increase if:

*a. interest rates were decreasing and total spending was increasing

b. the supply of money was decreasing

c. interest rates were increasing and total spending was falling

d. everyone were paid daily instead of once or twice a month

31. According to the Classical (crude) quantity theory of money, doubling of the supply of money in a fully employed economy will cause the price level to

a. be halved

b. remain unchanged

*c. double

d. the theory makes no definite prediction in such a situation

32. Suppose that the banking system holds ` 10 lakhs in demand deposits and ` 300,000 in statutory reserves. If the required reserve ratio is 25 percent, the maximum amount by which the banking system can expand the money supply is:

a. ` 10,00,000

b. ` 15,00,000

*c. ` 2,00,000

d. ` 3,00,000

e. ` 20,00,000

33. Keynesians argue that when the FED uses monetary policy to stimulate the economy, it can ________ bonds in the open market which causes interest rates to__________and ____________ investment spending.

a. buy / increase / stimulates

b. buy / decrease / decreases

c. sell / decrease / stimulates

*d. buy / decrease / stimulates

34. Generally recognized as a sign of a policy favoring tighter money is a

a. rise in the money supply

*b. rise in the discount rate

c. reduction of the required reserve ratio

d. rise in government bond purchases by the Fed

35. By purchasing government securities in the open market, the Federal Reserve authorities hope ultimately to accomplish:

a. a decrease in member-bank Reserves

b. an equal increase in member-bank Reserves and Federal Reserve notes

c. an increase in member-bank Reserves larger than the original purchases by the appropriate multiple

*d. an increase in member-bank Reserves by the amount of the original purchases

e. an increase in Federal Reserve notes larger than the original purchases by the appropriate multiple

36. All except one of the following will cause a shift in Aggregate Demand. Which will not shift the curve?

a. decreased investment due to higher business confidence

b. increased government spending due to policy changes

c. increased exports due to higher foreign incomes

d. increased imports due to perceptions of higher quality

*e. reduction of government regulations of business production

37. Which of the following would result in an increase in potential GDP?

a. A movement down the Aggregate Supply curve

b. A movement up the Aggregate Demand curve

*c. Aggregate Supply shifts right

d. Aggregate Supply shifts left

e. none of the above

38. Which of the following is not essential for the classical model to be valid?

a. long-run full employment

*b. fixed money supply

c. wage-price flexibility

d. interest rate flexibility

39. A nation has a comparative advantage when it:

a. finds a new way to improve existing goods

b. can produce a good without using up any of its capital stock

*c. can produce a good at a lower opportunity cost than another nation

d. can produce a good with fewer resources than another nation

40. The value of net exports is:

a. always positive

b. always larger than government expenditures

*c. an injection into the economy if exports exceed imports

d. an injection into the economy if imports exceed exports