TUTOR MARKED ASSIGNMENT

Course Code	**:**	**ECO - 09**
Course Title	**:**	**Money, Banking and Financial Institutions**
Assignment Code	**:**	**ECO – 09/TMA/2016-17**
Coverage	**:**	**All Blocks**

Maximum Marks: 100

Attempt all the questions.

1. What do you mean by money? Explain its functions. Point out the role of money in an economy.

(20)

2. What do you mean by international liquidity? Discuss various proposals for raising international liquidity.

(20)

3. Describe the objectives and functions of World Bank.

(20)

4. What is Central Bank? Explain credit control function of a Central Bank.

(20)

5. Write short notes on the following:
   (a) World Bank
   (b) Special Drawing Rights
   (c) NABARD
   (d) Exchange Rate Regime

(4×5)

ASSIGNMENT SOLUTIONS GUIDE (2016-2017)

E.C.O.-9

Money, Banking and Financial Institutions

Disclaimer/Special Note: These are just the sample of the Answers/Solutions to some of the Questions given in the Assignments. These Sample Answers/Solutions are prepared by Private Teachers/Tutors/Authors for the help and guidance of the student to get an idea of how he/she can answer the Questions given in the Assignments. We do not claim 100% accuracy of these sample answers as these are based on the knowledge and capability of Private Teacher/Tutor. Sample answers may be seen as the Guide/Help for the reference to prepare the answers of the Questions given in the assignments. As these solutions and answers are prepared by the private teacher/tutor so the chances of error or mistake cannot be denied. Any Omission or Error is highly regretted though every care has been taken while preparing these Sample Answers/ Solutions. Please consult your own Teacher/Tutor before you prepare a Particular Answer and for up-to-date and exact information, data and solution. Student should must read and refer the official study material provided by the university.

Attempt all the questions.

Q. 1. What do you mean by money? Explain its functions. Point out the role of money in an economy.

Ans. Many economists have defined money in their own ways based on the analysis of their definitions, money is said to have the following basic features:

- Money can be anything, even a piece of paper, which is chosen by the common consent as a medium of exchange or means of transferring purchasing power.
- It is widely accepted in payment for goods and services and in settlement of all transactions including future payments.
- Money is received customarily by all without any special tests of quality or quantity.
- It is a perfectly liquid asset and the most convenient form in which wealth can be stored.

Functions of Money

Primary Functions:

- Money as a medium of exchange, as it facilitates the sale and purchase of goods and services and also helps in covering up for the drawback caused due to the Barter System.
- Money as a measure of value, that is, it acts as a measuring stick for all the other goods and services in terms of money.

Secondary Functions:

- Money as a standard of deferred payments by facilitating credit transactions apart from current transactions of goods and services.
- Money as a store of value for future use as money acts as a representative of generalised purchasing power of an individual.
- Money as a means of transferring purchasing power which can be transferred from one person or place to another in a convenient and easy way with its feature of low cost of transfer.

Contingent Functions:

- Distribution of national income amongst the people who have contributed in its production that is the society at large.
- Basis of credit system, by being a promise to pay. Money also helps the banking system to create more money with the help of credit creation.

- Maximization of utility and profits by being allocated and spread across various goods and services, which increases the consumer's utility.
- Money imports liquidity and uniformity to assets as money being the most liquid form of all assets helps in the purchase of any kind of asset and *vice-versa*.

Significance of Money

The various functions performed by money are inclusive of the following:

- **In Consumption:** Monetary income helps the individuals in fulfilling and prioritizing their needs and desires and fulfilling them accordingly.
- **In Production:** Usage of money helps in the expansion of goods and services thereby leading to large scale production and technological improvements.
- **In Trade:** By affecting the forces of demand and supply money facilitates trades by being the basis of price mechanism.
- **In Economic Progress:** There has increase in the desire for accumulation of capital and newer techniques of production due to the introduction of large scale production techniques led in by money.
- **In Public Finance:** Money received by the government in the way of taxes and other fees is used for the smooth running of its administrative functions.
- **In Foreign Trade:** Money has led to the increase in the levels of consumption as well as in the expansion of foreign trade world over.

Q. 2. What do you mean by international liquidity? Discuss various proposals for raising international liquidity.

Ans. The International Monetary Fund was established in 1944 at the Bretton Woods Conference that the International Monetary Fund was established and was considered as the leading international institution which helps its members in overcoming their short-term balance of payments problems.

It has promoted international monetary cooperation, facilitated international trade and assisted its member countries to correct their balance of payments disequilibrium.

International liquidity refers to the gold and foreign exchange reserves position at the international level. It was in September 1967 that with the creation of new reserve asset in the form of SDRs was created to meet the steadily increasingly demand for international liquidity.

It is since then that the reserve assets which presently constitute the international liquidity include:

- The Official gold and foreign exchange reserves of the various countries.
- Gold and foreign exchange reserves with the IMF.
- The SDRs.

The various proposals for raising international liquidity include:

- **Raising the Price of Gold:** In the opinion of Roy Harrod and Jacques Rueff, Economic Adviser to President de Gaulle of France in the year 1950s and 1960s, the price of gold which was pegged at $35 per ounce be raised as the price was unrealistic and was discouraging the gold supply to increase and which created a shortfall in the international liquidity.

However, the drawback that was attached with this scheme was that an upward revision in the price of gold could induce speculation in gold which was not considered as a desirable development. Based on which USA and some other leading industrial countries never favoured it.

- **The Triffin Plan:** This proposal was recommended by Robert Triffin who suggested that the centralisation of foreign exchange reserves was necessary for tackling the problem of international liquidity. In his opinion any attempt to augment a system base on one or two reserve currencies was very fragile.

Therefore he proposed to IMF that it should assume the character of the central banks and the members of the IMF should be asked to deposit their foreign exchanges reserves with it, keeping in mind the fact that most of the countries would not like to surrender their foreign exchange reserves with the IMF as it would result to a compromise on their economic freedom. It was based on these reasons that Triffins plan being utopian was not considered to be of a wider support so was not adopted.

- **The Bernstein Plan:** According to E.M.Bernstein who was associated with the IMF, his plan could be carried on in the basic framework of the IMF, which had two aspects.

First, it recommended IMF quotas of each country should be integrated with its official reserves and the second with respect to creating a Reserve Unit Account in the IMF which the members could subscribe create by additional reserves. However, this plan also augmented the international liquidity like other plans but failed to get adequate support and therefore was not adopted.

Q. 3. Describe the objectives and functions of World Bank.

Ans. The basic objectives of the World Bank are:

Financing Reconstruction of the War-Devastated Economies: It also decided at the Bretton Woods Conference that the World Bank would provide finance for the reconstruction of the war devastated economies of Europe which had suffered heavily in terms of destruction of their infrastructure and industries during the Second World War.

Though they did receive financial aid from USA as it was the only developed country at that time however it was not enough, therefore the decision of the World Bank was taken.

Financing Development of Economically Backward Countries: The World Bank was expected to provide long-term financial help for the development projects in the underdeveloped countries.

As post-World War second the economically backward countries had inadequate domestic resources and were in great need of private foreign capital and foreign aid which would put them on the path of economic development. Therefore, the decision of assistance was taken at the Bretton Woods Conference.

Promotion of Private Foreign Investment: The principles of sound international private lending were not followed between World War First and second because of which the international credit structure was in mess at the time of Bretton Woods Conference.

The foreign loans were obtained for non-viable projects, the short-term credits were used for long-term investments which further created repayment problems. It was based on these issues that the World Bank was given the responsibility of promoting private foreign investment by means of guaranteed or participations in loans and other investments made by the private investors.

Promotion of Long-term Balanced Growth of International Trade: According to the experts at the World Bank, the less developed economies should overcome their structural handicaps by developing their productive resources and acquire export capabilities which would help them in maintaining equilibrium in their balance of payments as their quantum of foreign trade increases. And this view is highly encouraged by the World Bank.

Assisting Member Countries in Bringing about an Easy Transition from a War Time Economy to a Peace Time Economy: The founders of the World Bank decided that it would assist the member countries in brining a smooth transition from their war time economies were consciously oriented to the requirements of the war and after the war the industries which produced consumer goods and machines to be used in consumer goods were not able to meet the required capacities which otherwise could have created serious unemployment and recessionary problems if the World Bank had not steeped in.

Evaluation of the Performance of The World Bank

The World Bank has been a source of finance and other services which has also increased the importance of international finance in economic development. It assists in the arrangement of financial resources from capital surplus developed countries to capital deficit developing countries apart from rendering technical services at reasonable rates to its member countries.

The World Banks Contribution

- The World Bank directed its attention to the development needs of the relatively underdeveloped countries.
- The World Bank has become a major channel for the developing countries which have acquired an access to the international bond market and other financial markets.
- The Private foreign investment has also played an important role in the World Banks catalytic role in the international capital flows.
- The World Bank has played an important role in the area of poverty alleviation.

Failures of the World Bank

- The World Bank generally attempts to tie its loan with a particular project.
- The World Bank has become an instrument in the hands of non-imperialists.
- The structural adjustment lending is being done with the objective of influencing the domestic policies of the borrowing countries.

FUNCTIONS OF THE WORLD BANK

The World Bank performs the following functions:

1. Lending and guaranteeing private loans.
   - Loans out of the World Banks own resources.
   - Loans out of the World banks borrowed resources.
   - Loans on the guarantee of the World Bank.
2. Technical Assistance.
3. Stimulating Private Investment.

Lending and Guaranteeing Private Loans

By channelising the transfer of funds from developed countries to developing countries through the transfer of resources, the World Bank helps the member countries in obtaining loans in the following ways:

Loans out of the World Bank's own resources.

Loans out of the World Bank's borrowed resources.

Loans on the guarantee of the World Bank.

It is the paid up capital and the retained earnings which form part of the World Bank's own resources. It is the share capital of the World Bank which is allocated to the member countries.

However, the own resources of the World Bank are very small as compared to the amounts of loans that it is required to provide, therefore, for which it augments by borrowing from the capital markets of the countries in whose currency it is expected to provide the loan.

Technical Assistance

The World Bank is required to provide technical assistance to its member countries as it is important for providing effective utilisation of financial aid.

It can also be added that, this is done by the World Bank because usually most of the developing countries lack technical capabilities in terms of evaluation of the feasibility of the development projects, therefore, they cannot judiciously determine the priorities of the various projects. This causes the World Bank to step in.

Q. 4. What is Central Bank? Explain credit control function of a central Bank.

Ans. There have been various definitions which have been provided by various economists based on which it can be concluded that:

‘A Central Bank is that highest financial institution of a country whose main function is to regulate, coordinate, integrate and guide the monetary and banking structure so as to realize certain desired goals of national and public welfare.’

It can also be said that a central bank is in close touch with the government for effective implementation of the country’s economic policy which further helps in the realisation of rapid economic growth with stability of internal prices and foreign exchange rates. The Governor and other higher officials of the central bank are also appointed by the government.

The Central Bank can also be differentiated from the Commercial Banks on the basis of their objectives and the area of functioning. That is, the Commercial Banks act as a link between the public and the Central Bank with the aim of profits where as the Central Bank’s main objective is national economic welfare.

To add more, the central bank has the monopoly of note issue, apart from being the leader of the entire monetary system.

Functions of a Central Bank

The functions of the central bank can be classified as follows:

- Traditional functions
- Promotional functions

Traditional Functions

- **Monopoly of Note Issue:** It is the exclusive right of the central bank to issue currency notes. This is because of the reason that it brings about uniformity in note issue apart from ensuring a reasonable supply of money in the economy.
- **Banker, Agent and Financial Adviser to the State:** The central bank acts as the custodian of the government funds, that is, as a banker to the government it is responsible for accepting deposits on behalf of the government and maintaining its accounts as well.

As an agent it is required to conduct transactions on behalf of the government pertaining to purchase and sale of foreign currencies, national debt and sale and purchase of government securities in the open market.

It is the Reserve Bank of India which advices the government on various economic policy measures like the stability of prices, funding of national debt, etc.

- **Bankers’ Bank:** The Central Bank acts as a banker to the Commercial Banks.
- **Custodian of Gold and Foreign Currency Reserves:** By being the custodian of gold and foreign reserves the Central Bank provides strength to the country in terms of international financial dealings as gold is accepted internationally as the medium of payment.
- **Controller of Credit:** This is regarded as the most important function of the central bank as it is its responsibility to authorise the control and regulation of credit creation activities of the Commercial Banks.
- **Bank of Central Clearance, Settlements and Transfer:** By being responsible for all these activities, the Central Bank provides economies in the use of money apart from providing convenience in the individual system of clearance and settlement for all the commercial banks.
- **Lender of the Last Resort:** The central bank is regarded as the lender of the last resort as it is regarded as the apex bank of the country which is responsible for meeting all the reasonable demands of the commercial banks either directly or indirectly.1

Promotional Functions

- Helps in creating, developing specialised institutions of agricultural finance in the country.
- Setting up of specialised institutions of industrial finance so as to ensure adequate supply of funds to industries.
- Expansion of banking facilities in addition to supervision and regulation of banking institutions.
- Promotion of well organised and well integrated institutions and agencies of money market and capital market.
- It undertakes the function of collection, compilation and publication of statistical data pertaining to the banking and financial sectors of the economy.

Role of a Central Bank as a Controller of Money Supply and Credit

The Central Bank takes care of the money supply and the bank credit in the economy. It does this by ensuring the total supplies of money and bank credit especially during the inflationary periods.

For accelerating the economic growth of the economy the central banks uses the monetary policies which are formulated in a way that they help in accelerating the economic growth with adversely affecting the distributive justice of the economy.

Q. 5. Write short notes on the following:

***(a)* World Bank**

Ans. The International Bank for Reconstruction and Development (IBRD) or World Bank was founded at the International Economic Conference and began its operations in June 1946.

The purposes of the IBRD stated in its Articles of Agreement:

- To encourage the development of productive facilities and resources in less developed countries.
- To assist in the reconstruction and development of territories of members of facilitating investment of capital for productive purposes.
- To create conditions conducive to international trade between countries.
- To provide resources to countries devastated by war.
- To promote the long range balanced growth of international trade and the maintenance of equilibrium in balance of payments by encouraging international investment.
- To promote private foreign investment by means of grants or participation in loans and investment made by private investors.

The Affiliates of the World Bank

The two affiliates of the World Bank are:

***(i)* The International Development Association:** The purposes of IDA are:

(a) To lead and promote development through the world.
(b) To develop poor people of poor countries.
(c) To provide financial support to aid the development in countries.
(d) To play a key role in laying the ground work for long term development in poorest countries in the world.

***(ii)* The International Finance Corporation:** Its main purposes are:

(a) To invest in private productive enterprises in association with private investors without Government guarantee of repayments.
(b) To encourage productive investment of private capital both foreign and domestic.
(c) To serve as a clearing house to bring together the investments of both foreign and domestic origin.

***(b)* Special Drawing Rights**

Ans. It was in 1969 that the Board of Governors of the IMF had decided to create a new reserve asset in their annual meeting to be known as the Special Drawing rights (SDRs) so as to meet the growing demand for international liquidity.

And it was in 1967 that various amendments were made in the Articles of Agreements for the implementation of SDRs. The allocations of SDRs aggregating 9.3 billion were done in 1970, 1971 and 1972 with fresh allocations of SDRs totalling 12 billion began in 1979.

It can also be said that SDRs are mere book-keeping entries at the IMF in accounts of member countries and the IMF itself, that is, they are not directly usable. They need to be converted into national currencies before they can be used for meeting foreign debt obligations.

Currently SDRs account for about 5% of the international liquidity. The value of SDRs has been fixed so the basis of a currency basket which is composed of the currencies of the world's five largest exporting countries.

***(c)* NABARD**

Ans. NATIONAL BANK FOR AGRICULTURE AND RURAL DEVELOPMENT (NABARD)

NABARD came into existence in June 1982 to extend refinance facilities to the agricultural cooperatives, rural banks and commercial banks for short, medium ad long-term requirements.

It is only by measuring the transformation that NABARD can bring in by shaping the rural credit system into an effective instrument for the welfare of poor peasants that its performance can be judged.

NABARD is entitled with the power of extending production and credit over periods not exceeding 18 months to State Cooperative Banks, Regional Rural Banks, etc. This extension includes refinancing of loans and advances repayable.

This power is entitled to NABARD for:

- Agricultural Operations.
- Marketing of Crops.
- Marketing and distribution of agricultural inputs.
- Marketing activities of artisans.
- Marketing the products of small scale industries, etc.

However, according to the guidelines of the Reserve Bank of India, the State Cooperative Banks, Regional Rural Banks and RBI's approved financial institutions, can convert these short-term loans into medium term if they have faced any natural calamity. This period of 18 months would increase to 7 years.

Therefore, NABARD has been creating refinance facilities not only for the short-term but also for the long-term finance.

***(d)* Exchange Rate Regime**

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