SFG – FRC for CSE 2024 | Eco #3 – Solutions | ForumIAS

Q.3)

Exp) Option b is the correct answer.

In banking, 'spread' refers to the difference between the interest rate charged by a bank to a borrower and the interest rate paid by the bank to a depositor.

Option a is incorrect. The setting aside of funds for potential losses, with the goals of safeguarding bank stability and ensuring regulatory compliance, i**s called "provisioning."** Provisioning in the banking system is a risk management practice where financial institutions set aside a portion of their profits to create reserves, often called "loan loss provisions." These provisions act as a cushion against potential future losses due to non-performing loans, ensuring financial stability, regulatory compliance, and safeguarding depositor and shareholder interests.

Option b is correct. The '**spread' in banking is the gap between what a bank earns by lending money to borrowers (at higher interest rates) and what it pays to depositors (at lower interest rates)**. It's **the bank's profit** for connecting borrowers and savers in the financial system.

Option c is incorrect. In banking, "spread" does not refer to physical distance between branches. Instead, it typically relates to the difference between the interest rate at which banks lend money (the lending rate) and the interest rate at which they borrow money or attract deposits (the borrowing rate).

Option d is incorrect. The spread does not refer to the difference between the total assets and liabilities of a bank. The spread in banking typically refers to the difference between the interest rate at which a bank lends money (the lending rate) and the interest rate at which it borrows money or attracts deposits (the borrowing rate).

Q.4)

Exp) Option c is the correct answer.

Ways and Means Advances (WMA) Scheme was introduced in 1997. Its objective is to meet mismatches in the receipts and payments of the government.

Option 1 is correct: Ways and Means Advances (WMA) Scheme was introduced in 1997. These are **temporary loan facilities** provided by the **Reserve Bank of India** (RBI) to the ce**ntral and state governments** to meet mismatches in the receipts and payments. The limits for WMA are decided by the government and RBI mutually and revised periodically.

Option 2 is correct: WMA is currently at the existing repo rate and the tenure is for three months. However, if the tenure is extended, it will be treated as an overdraft which is charged above repo rate.

Option 3 is *incorrect*: Types of WMA:

(a) **Special WMA**: It is **extended against the collateral** of the government securities held by the State Government and

(b) **Normal WMA**: It is based on a three-year average of actual revenue and capital expenditure of the state. It is not collateral based.

The RBI determines limits for normal and special WMA for each state as multiples of the prescribed minimum balance required to be maintained with the RBI by that state. These limits have been revised periodically.

Option 4 is correct: WMA funding is much cheaper than borrowings from markets as it is charged at the repo rate. WMA can be an alternative to other tools of borrowing like raising longer-tenure funds from the markets, issue of State government securities or borrowing from financial institutions for short-term funding.

Q.12)

Exp) Option a is the correct answer.

A liquidity trap is an economic situation in which interest rates are very low and people are hoarding cash instead of investing or spending, even in the face of low interest rates. In a liquidity trap, traditional monetary policy tools, like reducing interest rates, become ineffective because interest rates are already near zero.

Option a is correct: In a Liquidity Trap, people and businesses **choose to keep their money in the form of cash at the times of lower interest rates.** It refers to a situation where the interest rates in an economy are at extremely low levels, and individuals prefer to hold their money in cash rather than investing it or depositing it in the banking system.

Option b is incorrect: In normal circumstances, people prefer to borrow more in the face of low interest rates. But in a Liquidity Trap, **people and businesses are reluctant to borrow** despite low interest rates.

Option c is incorrect: In a Liquidity trap **people are often reluctant to invest, especially in long-term financial instruments,** due to the prevailing uncertainty and low interest rates.

Option d is incorrect: A Liquidity Trap is typically associated with **low confidence** in the market. People and businesses are **hesitant to spend, invest, or borrow** because of economic uncertainty and expectations of prolonged low interest rates.

Q.13)

Exp) Option a is the correct answer.

Monetary policy is a set of measures used by the nation to control the money supply in an economy. It uses various tools to adjust interest rates to control inflation and promote economic growth of a nation.

Option a is correct: The Standing Deposit Facility (SDF) is the rate at which the Reserve Bank of India **(RBI) absorbs excess liquidity from banks without any collateral.** The SDF was introduced by the RBI to regulate the money supply in the economy.

Option b is incorrect: Unlike the Reverse Repo rate, the SDF does not necessitate the issuance of Government securities by the RBI to borrow funds from banks. Consequently, the **SDF rate is generally higher than the reverse repo rate. The SDF rate is generally lower than the Repo rates but higher than the reverse repo rate**.

Option c is incorrect: Sterilization is a monetary action wherein the Reserve Bank of India (RBI) aims to **control the impact of foreign currency on domestic money supply.** It typically involves the purchase or sale of financial assets by the RBI to counterbalance the effects of foreign exchange intervention.

Option d is incorrect: Statutory Liquidity Ratio (SLR) represents the minimum reserve that banks must maintain among themselves in the form of cash, securities, or gold. This requirement is instituted to enhance the ability of banks to address potential crises, particularly in the event of significant withdrawals by depositors.

Q.14)

Exp) Option d is the correct answer.

Capital Adequacy Norms typically specify the minimum amount of capital that banks and financial institutions must hold in relation to their risk-weighted assets. It is measured as follows:

Capital Adequacy Ratio = (Tier I + Tier II + Tier III (Capital funds)) /Risk weighted assets

Option a is incorrect: The increase in Capital Adequacy Ratio (CAR) for banks by RBI typically results in an **uptick in the prevailing interest rates for the public within a country**. This, in turn, escalates the cost of borrowing for the public, ultimately leading to a contraction in the money supply within the economy.

Option b is incorrect: As increased CAR for banks shoot up the **interest rate, people become reluctant to borrow and spend**. In such a scenario, people prefer **parking their money in banks in the face of high interest rates**. Hence increased level of domestic private consumption is not the most likely impact of increased CAR for banking institutions.

Option c is incorrect: Increasing the **CAR for banking institutions may not have a direct impact on the Current Account Deficit (CAD)**. The CAD is influenced by various factors such as trade balances, foreign exchange rates and capital flows. If there is any impact, it might actually lead to a **widening of the CAD,** possibly due to an increase in interest rates and a potential reduction in economic activity resulting from the higher CAR.

Option d is correct: It is true that increased CAR for banks can potentially attract more foreign capital into the Indian economy. With the increased CAR for banking institutions, the **interest rate** will be generally **high** and furthermore banks are perceived as more stable due to increased capital of banks. This incentivizes the foreign investors to invest more into India.

Q.23)

Exp) Option c is the correct answer.

Statement 1 is incorrect. Margin requirement is one of the Qualitative or selective methods of credit control used by RBI to stabilize the economy from inflation or deflation.

Statement 2 is incorrect. Margin requirement refers to the difference between the current value of the security offered for loan (called collateral) and the value of loan granted. Margin against a particular security is reduced or increased in order to encourage or to discourage the flow of credit to a particular sector. It varies from 20% to 80%. Higher the margin lesser will be the loan sanctioned.

Statement 4 is incorrect: The margin requirements against specific securities are determined by the Central Bank. Changes in margin requirements are designed to influence the flow of credit against specific commodities. A rise in the margin requirement results in a contraction in the borrowing value of the security and similarly, a fall in the margin requirement results in expansion in the borrowing value of the security.

Statement 3 is correct. In case of inflation, the margin requirement is increased so that demand for loans are decreased. In case of deflation, margin requirements are decreased so that demand for loans are increased.

Q.28)

Exp) Option b is the correct answer.

Inflation premium refers to the benefit brought by inflation to the borrowers. Banks generally charge a fixed percentage of interest on lending, which is called as nominal rate of interest. As inflation increases, banks tend to lose because the value of money decreases, but the borrowers pay only a fixed rate of interest. **On the other hand, borrowers benefit due to inflation as the real interest rate gets reduced** (due to higher inflation, but fixed nominal interest rate).

Q.30)

Exp) Option d is the correct answer.

Option a is incorrect: Moral Suasion is a **Qualitative** method of **credit control** in which the Central bank **advises, requests and persuades** the commercial banks to **cooperate** with it in implementing its **general monetary policy.** Through this method, the **central bank merely uses its moral influence** to make the commercial bank follow its policies.

For e.g The central bank may request the commercial banks not to grant loans for speculative purposes.

Option b is incorrect: The margin refers to the "proportion of the loan amount which is not financed by the bank". It refers to the difference between the current value of the security offered for loan (called collateral) and the value of loan granted. A change in a margin implies a change in the loan size. **Margin Requirements** is a **Qualitative** method of **credit control.**

Option c is incorrect: Regulation of Consumer Credit is a **Qualitative** method of **credit control** in which the Central Bank creates **rules regulating the terms and conditions** under which the **credit is repayable in instalments**. Under this method the down payment, instalment amount, loan duration, etc. is fixed in advance.

The central bank can control the consumer credit by **changing the amount** that can be **borrowed** for the purchase of the consumer durables by **changing the maximum period over which the instalments** can be extended.

This method seeks to check the excessive demand for durable consumer goods and, thereby, controls the prices of these goods.

Option d is correct: Credit Rationing is a **Qualitative** method of **credit control** in which the Central Bank selectively controls and regulates the **purpose for which credi**t is granted by the commercial banks. It may be done by

Fixing the central bank's r**ediscounting facilitie**s for any particular bank

Fixing the **minimum ratio regarding the capital** of a commercial bank t**o its total assets**.

This method controls even bill rediscounting. For certain purpose, upper limit of credit can be fixed and banks are told to stick to this limit. This may be used by the central bank to ensure banks are **not overleveraged in general** and to l**imit their over-exposure to risky sector**s like real estate, etc. This can help in lowering banks credit exposure to unwanted sectors.

Q.36)

Exp) Option b is the correct answer.

There are various parameters to measures different economic indicators. Some of them area given below.

Option a is incorrect: Inflation spiral is a continuous rise in prices that is sustained by the tendency of wage increases and cost increases to react on each other**. An inflationary spiral begins when there is an upward movement in price, thereby leading to people demanding a rise in wages.** As prices of goods begin to increase, employees mount pressure on employers for increased wages but as soon as wages increase, the costs of goods become higher.

Option b is correct: 'Base Effect' refers to the impacts of a previous year's price level or economic performance on the calculation and interpretation of current year data. It comes into play when comparing economic indicators, such as inflation rates or GDP growth, between different periods. It could result in major differences in percentage comparisons. If we chose a reference point that is too low, there could be an overestimation and if the reference point that is too high, it could result in gross underestimation of the situation.

Option c is incorrect: GDP Deflator is the ratio of the GDP at current prices to that of the constant prices. It is derived by using the following formula:

GDP Deflator = (GDP at Current Prices : GDP at Constant Prices) * 100

This shows the increase in the value of GDP due to increase in inflation in between the period - base year (i.e., the year of constant prices) and the current year. This is why it is used as a measure of inflation (also known as 'implicit price deflator').

Option d is incorrect: Skewflation is a type of inflation in which the prices of a single commodity or a set of commodities rise while the overall price level remains stable. It is a new term in economics that was coined in the aftermath of the financial crisis of 2009-2011.

Q.37)

Exp) Option b is the correct answer.

Statement 1 is incorrect. Core inflation excludes food and fuel items from headline inflation. Headline inflation refers to the change in value of all goods in the basket. Headline inflation reflects the prices of essential consumption goods. Inflation in these prices hurts people in lower-income groups more as they spend a higher proportion of their incomes on food and fuel items.

Statement 2 is incorrect. Core inflation excludes the prices of highly volatile food and fuel components. Headline inflation reflects the prices of essential consumption goods.

Statement 3 is correct. Core inflation is less volatile than headline inflation because the prices of fuel and food items tend to fluctuate and create 'noise' in inflation computation

Statement 4 is correct. Headline inflation is more relevant for developing economies than developed economies. In a developed economy, food & fuel account for 10-15% of the household consumption basket and in developing economies it forms 30-40% of the basket.

Q.38)

Exp) Option c is the correct answer.

The idea of the 'double-dip recession' is an extension of recession. A double-dip recession refers to **a recession followed by a short-lived recovery, and again followed by another recession**. The causes for such a recession are not fixed but often include a slowdown in the demand for goods and services because of layoffs (forced job cuts) and less government spending. A double dip is the worst-case scenario. It moves the economy into a deeper and longer recession and recovery becomes difficult.

Q.39)

Exp) Option d is the correct answer.

There are various drivers of inflation causing variations in the types of inflation.

Option d is correct. Structural inflation is the one **prevailing in most developing countries**. The situation is **due to the operation of the structural weakness** (supply bottleneck, lack of infrastructure, etc.) existing in a developing economy. Lack of adequate supply responses or production to increase in demand is the cause of structural inflation.

Option a is incorrect. Inflation is said to be 'open' when the government and the monetary authorities of a country do not take any measure to control the spending of the people.

Option b is incorrect. Inflation, on the other hand, becomes suppressed or repressed when the government and the monetary authorities do not allow the prices to rise to a high level.

Option c is incorrect. Core inflation is the change in the costs of goods and services but does not include those from the food and energy sectors.

Q.47)

Exp) Option b is the correct answer.

Pair 1 is correctly matched: Skewflation refers to uneven or disproportionate inflation across different sectors or categories. The example correctly illustrates this concept by noting a substantial increase in the prices of certain food items (vegetables, cereals, and pulses) compared to pharmaceutical products.

Pair 2 is incorrectly matched: Stagflation is an economic phenomenon marked by a combination of stagnant or slow economic growth, **increase in unemployment rates**, and high inflation. It represents a departure from the traditional economic relationship where inflation and unemployment are inversely related. In the given case, 'decrease in unemployment' is mentioned, which is not a characteristic of stagflation.

Pair 3 is correctly matched: The base effect is a statistical phenomenon that occurs when the comparison of current prices or inflation rates is made with a lower base period. It can lead to misleading interpretations of the inflation rate. The given example highlights a situation where the base effect influences the perception of inflation by comparing current prices with a lower base.

Q.51)

Exp) Option d is the correct answer.

Seigniorage refers to the profit made by a government when it issues currency. It is simply the difference in the value of the currency versus the cost of producing it. Seigniorage is a way for governments who mint their currency to make an economic profit. The cost of producing currency is generally lower than the face value of the currency itself. Monetary seigniorage can be used as an effective monetary policy tool. It can result in debt monetization. Debt monetization is when a central bank will buy interest-bearing debt with non-interest-bearing money. It can be a useful tool to control the debt level of an economy.

Q.59)

Exp) Option a is the correct answer.

The **Fisher Effect** is an economic theory created by economist Irving Fisher that **describes the relationship between inflation and both real and nominal interest rates.** The Fisher Effect states that the **real interest rate equals the nominal interest rate minus the expected inflation rate.** Therefore, **real interest rates fall as inflation increases**, unless nominal rates increase at the same rate as inflation.

The Fisher Effect can be seen each time you go to the bank; **the interest rate an investor has on a savings account is really the nominal interest rate.** For example, if the nominal interest rate on a savings account is 4% and the expected rate of inflation is 3%, then the money in the savings account is really growing at 1%. **The smaller the real interest rate, the longer it will take for savings deposits to grow substantially when observed from a purchasing power perspective.**