Unit-3: Macro Economics

Chapter-1: Banking System & Monetary Policy

A. Very short questions: For 1 mark

i. Define bank.

⇒ A bank is a financial institution that deals with money and credit. It accepts deposits of money from the public in different accounts and provides loan to needy persons.

ii. Define central bank.

⇒ A central bank is an ~~to~~ independent national authority that conducts monetary policy, regulates banks, and provides financial services. Its goals are to stabilize the nation's currency, keep unemployment low, and prevent inflation. Nepal Rastra Bank (NRB) is the central bank of Nepal.

iii. What is the meaning of commercial bank?

⇒ Commercial bank is a financial institutions established in order to earn profit doing its banking business. It accepts deposits of money from general public and advances loan for commercial purpose. Nepal Bank Limited is the first commercial bank of Nepal.

iv. State the meaning of foreign exchange bank.

⇒ Foreign exchange bank means any lender or any affiliate there of that is party to a Foreign Exchange Contract with a loan party. They are established to operate foreign exchange in the country. There are no such bank in Nepal.

V. List out the major classification of banks.

⇒ Based on the functions, banks are classified into following categories.

1) Central Bank
2) Commercial Banks
3) Development Banks
4) Finance Companies
5) Micro-credit Financial Institutions
6) Saving Banks
7) Foreign Exchange Bank
8) Infrastructure Development Bank

vi. Define credit creation.

⇒ Credit creation is the process by which commercial banks are able to create loans in the form of new deposits.

vii. Define ~~control~~ credit control.

⇒ Credit control is a function performed by the Central Bank to control the credit, i.e. the demand and supply of money in the economy. With this function, the central bank regulates the credit granted by the commercial banks to its customers.

viii. Clarify the meaning of demand deposit.

⇒ Those deposits that provide the depositor the liberty to withdraw money at any point of time. The account holder of the demand deposits can demand these deposits at any ~~time~~ point of time as per their discretion and convenience.

ix. Define time deposit.
⇒ Time deposit is a deposit that earns us an interest rate however it has to be kept for a fixed time period or maturity. It gives us a higher interest rate than demand deposits.

x. Define financial market.
⇒ The financial market is an organization which lends loan to business enterprises and public authorities. The financial market is the institution that deals in financial assets and credit instruments like currency, cheques, bill etc. Its main function is creation and allocation of credit and equity balanced economic growth.

xi. State the meaning of money market?.
⇒ The market mechanism through which short term funds are raised and provided to trade and commercial sector is called money market. In this market, lending and borrowing takes place for less than one year time period.

xii. What is meaning of capital market?
⇒ The market mechanism through which long-term funds are raised and provided to trade and commercial sector is called capital market. In this market, lending and borrowing takes place for more than one year time period.

xiii. Define monetary policy.

⇒ The macroeconomic policy of the government which is implemented by Central bank to manage the money supply to achieve predetermined goals is called monetary policy. In this policy, the central bank controls the money supply and interest rates to influence the level of economic activity is monetary policy.

xiv. What is expansionary monetary policy?

⇒ Expansionary monetary policy is a monetary policy that aims to increase the money supply in the economy by decreasing interest rates, purchasing government securities by central banks, and lowering the reserves requirement for banks.

xv. State the meaning of contractionary monetary policy.

⇒ Contractionary monetary policy is a monetary policy that is used by central bank to reduce the quantity of money supply in the economy. This policy aims at reducing the demand for money in the economy to control inflation by reducing demand for money for consumption and investment purposes in the economy.

B. Short questions: For 5 marks

i. Describe the major classifications of banks.

⇒ A bank is a financial institution that deals with money and credit. It accepts deposits of money from the public in different accounts and provides loans. Banks provide different facilities to the public and earn profit through the management of savings and credit.

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The banks are classified into following categories

1) Central Bank: The central bank is also called banker of banks. It controls the inflation and deflation of money in the country. In every country, there is one central bank which controls another sub bank like commercial bank, development bank, etc. Nepal Rastra Bank is the central bank of Nepal. It is publicly owned and directly governed by the Nepalese government.

2) Commercial Bank: The commercial bank is a financial institution which accepts, deposits, makes a business loan and offers related services. A commercial bank is also known as business bank. It is profit motive. Such bank is owned by a group of individual. It accepts the deposit of public as a saving and provides credit as loan.

3) Industrial Bank: The industrial bank has limited scope of service, they accept the customer's deposit and sell ~~it~~ investment shares labeled certificates. This bank deals with requirements of the industries.

4) Agriculture Bank: Agriculture banks are those bank that provides financial help to agricultural sectors. The main function of this bank is to provide loan to the farmer.

5) Development Bank: The development bank is a bank which is established to develop the specific sectors of the economy. Agriculture bank, rural development bank, industrial development bank, are some example of the development bank.

6) Exchange Bank: Exchange bank deals with foreign exchange. Their main function is to accept, collect and exchange the foreign currency. It facilitates the international payments through the sale ~~of~~ and purchase of bill of exchange. It provides a loan to the sectors which are involved in export and import. Nepal Rastra Bank manages the foreign exchange bank.

7) Saving bank: Saving banks are those banks that promotes saving habits among the general public and mobilizes those small savings. In Nepal, the postal saving bank is the saving bank.

ii. Explain the roles of banking system in the economy.
=> In this modernization, banking system plays a vital role in the economic development. Some of the important functions of banking system are as follows:

1) Money mobilization: The main role of the bank is to mobilize the money. Bank accepts the saving money of public and utilizes it as loan, overdraft, cash credit, etc. Most of the money are used in a productive sector like industries, organization, ~~businesses~~ business, etc. where a bank can have greater return and provides the interest to the public who saves money in the bank.

2) Promotion of Trade and Industry: Bankingsystem encourage specialization and accelerate the pace of industrialization by bringing revolution in the internal and external trade. The bank cheque, bank draft and the bill of exchange created a revolution of trade.

3) Capital Formation: Banking system collects small savings from various part of an economy and mobilizes it in business sectors. This helps to increase more output. Which means more incomes ~~and more~~ increases savings due to which more funds can be created for future investment. Therefore, banking system helps in capital formation.

4) Monetization of Economy: Banking system helps to develop the money market. Banks are creators as well as distributors of money. They spread the branches of the bank in rural areas which are unmonitored. This helps to increase the banking habit of the people. People keeps their money in the bank and withdraw them in necessity. This leads to monetization of an economy.

5) Employment Opportunities: Banking system increases the economic activities and promote employment opportunities by providing loans to businessman, entrepreneurs and farmers in different forms. Banks also helps by investing in various business sectors.

In addition to these, remittance of money, regional development etc. are also the roles of banking system for the economic development

iii. Distinguish between money market and capital market.

⇒ Money market is a mechanism through which short-term funds are raised and provided in trade, commerce, and institutional sector.

Capital market is a mechanism through which long-term funds are raised and provided in a business sector.

The differences between money market and capital market are:

Money Market	Capital Market
1) The maturity period of credit instruments of money market is less than one year.	1) The maturity period of credit instruments of capital market is more than one year.
2) This market provides short-term funds to the business sector.	2) This market provides long-term funds to the business sector.
3) The important credit instruments of money market are treasury bills, national savings papers, commercial bills etc.	3) The important credit instruments of capital market are shares, bonds, debentures, equities and so on.
4) Capital investment in this market is less risky than in capital market.	4) Capital investment in this market is more risky than in money market.
5) There is high liquidity in money market.	5) There is low liquidity in capital market.
6) There is less return on investment.	6) There is comparatively high return on investment.
7) Its purpose is to fulfill short term credit needs of the business.	7) Its purpose is to fulfill long term credit needs of the business.

iv. Describe the province wise distribution of commercial banks and development banks in Nepal.

⇒

The easy availability of commercial banks and development banks in all locality is one of the needs of public. When they are available in our surrounding, we can deposit and withdraw money easily. It helps for the business sector, trade and commerce. It increases the economic activities in the nation.

Province-wise distribution of commercial & development bank

Province	Commercial bank	Development Bank	Total
Province-1	752	188	940
Madhesh	564	84	648
Bagmati	1767	309	2076
Gandaki	593	186	779
Lumbini	730	250	980
Karnali	197	21	218
Sudurpaschim	327	48	375
Total	4930	1086	6016

Source: Nepal Rastra Bank, 2078(https://www.nrb.org.np)

The above table shows number of commercial bank and development bank in Nepal and in seven provinces. There are 27 commercial banks in Nepal and the total number of branches is 4930 throughout Nepal. Similarly, there are 17 development banks in Nepal and the total number of branches is 1086. Out of the total number of commercial banks, maximum are in Bagmati province and minimum are in Karnali province. The number of development banks are maximum in Bagmati Province and minimum in Karnali Province.

C. Long questions: For 8 marks

i. Explain the various functions of central bank.

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Central bank is the supreme bank of a country. It is the monetary authority. It is the apex of monetary and banking structure of a country. It performs as best as it can in the national economic interest. In every nation, a central bank is established in order to arrange for the circulation of currency throughout the country, develop the financial sector and to stabilize exchange rate.

Functions of Central Bank

Central bank performs its regular and development functions. Each type of functions is discussed below.

Regular Functions

There are various regular functions of the central bank. Some major functions are given below:

1) Monopoly of note issue: The primary function of a central bank is to issue notes and coins in the country. Bank issues the notes under the security of gold, silver, foreign currency and government. Only central bank is allowed to issue notes and coins.

2) Banker of the bank: Central bank performs as the bank of all other banks. Central bank accepts and ~~too~~ lends the money to another commercial, development and another bank, provides rules, regulations and direction to another bank.

3) Bank of Government: Central bank performs the role as a bank of government. Every government organizations deposit ~~m~~ their money in the name of their own organizations, a department in the central bank.

4) Lender of the last resort: The central bank is said as lender of last resort. It provides the loan to other bank adding some interest rate, called discount rate.

5) Control of credit: A commercial bank is profit ~~motive~~ motivate business. So, it lends money to a customer with profit gaining motive as interest if the bank faces the problem of inflation, then central bank controls the inflation by several monetary methods.

6) Custodian of foreign currency: The central bank is the custodian of the national reserves of foreign currencies. It keeps and manages the foreign exchange reserve of a country. It purchases and sells foreign exchange on behalf of the government.

6) Clearing house functions: Central bank also acts as a settler of the financial claims of a bank against others. Each commercial bank should maintain its account in the central bank. The central bank clears each other's claims from their respective accounts. ~~Wht~~ When any two commercial banks claim to settle their transactions, then central bank clears it.

Development Functions

Besides its traditional or regular functions, the central bank performs various development functions. They are:

1) The central bank collects data related to money, banking, and even real sectors of the economy, which are essential for the formulation and evaluation of plans and policies.

2) Help to develop money market and capital market by providing guidelines, regulations, supervision, and monitoring.

3) Promotion of agriculture sector by strengthening agriculture development bank, rural development bank, microfinance etc.

4) Promotion of foreign trade by providing the facility of foreign currencies.

5) Promotion of individual sectors by formulating provisions for sale.

Q11. Describe the various functions of commercial banks.

⇒

Commercial bank is a financial institution established in order to earn profit doing its banking business. It accepts deposits of money from general public and advances loans for commercial purposes to businessman traders, producers, individuals, etc.

Functions of Commercial Bank

A commercial bank performs ~~two~~ varieties of functions and plays an important role in the process of economic development. Functions of commercial banks are categorized into primary functions, secondary functions, and contingent functions. Some major functions of a commercial bank are discussed below.

Primary Functions

Basically, a commercial bank performs two primary functions, namely accepting deposits and advancing loans.

1. Accepting money as deposit: The primary function of a commercial bank is to accept the deposit of public as a saving and mobilize those amount. There are various types of deposit that bank receives, they are as follows:

- Current deposit: Current deposit is such deposit where the interest rate is zero is the amount deposited in this account is repayable on demand of owner without any restrictions. It is also called demand deposit. Such deposit can be withdrawn anytime by cheque.

• Saving deposit: Saving deposit is an account where an individual saves their some income for the future. Such type of account can be open with or without the facility of the chequebook. There is a restriction on the withdrawls in such type of account. In such types of account instead of money we can also deposit cheques, draft, dividend etc.

• Fixed deposit: Fixed deposit is such type of deposit where the fixed maturity period is mention on public deposit. The public can withdraw amount only after the maturity of their deposit during depositing it. The interest on such deposit is high and the rate allowed on it is governed by rules laid down by the Nepal Rastra Bank.

2. Providing loan: The second important function of the commercial bank is to lend money to the public in their need. The amount collected from the deposit is just not stored in total as liquid assets they invest it. They provide to public as a loan with high-interest rate than deposits. customer are given loan as a pledge. The major loans provided by commercial banks are as follows:

• Cash credit: Cash credit is generally granted on a bond of ~~either~~ credit or certain other securities. It is a popular method of lending money in a country Nepal. Bank agrees to lend money with certain limitation and interest rate.

• Overdraft: Overdraft facility is similar to cash credit. Overdraft facility is an agreement with a bank of an account holder where the account holder can withdraw a specified amount over and above the credit balance in his/ her account for a short period of time. The interest rate on overdraft is higher than that of loan.

• Term loans: Term loans are basically medium or long term loan. Such type of loan are granted for more than a year i.e. the loan are to be repaid over a period of 5 years and maximum upto ~~15~~ years. These loans are secured against mortgage of land, property, building, plant and machinery and other securities. The interest rate on such loan is quite high.

• Discounting of bills: A part from the granting loans, commercial bank also grant financial assistance to a customer by discounting bills of exchange. Bank purchases the bills at face value minus interest at the current rate of interest for the period of bill.

Secondary Functions

Besides the primary functions of accepting and lending, bank performs a number of other functions which can be categorized under secondary function.

- Foreign currency Transaction: Commercial bank not only accepts money but also accepts the foreign currency. Currency is directly not accepted by the public in the markets, so the commercial bank accepts and exchanges it.

- Remittance of money: A commercial bank does the work of remitting the money that means transferring money from ~~one~~ place to place through ~~level~~ travel cheques, draft computarized network, etc. This method helps from money being misplaced.

- Credit creation: Commercial bank issue different types of credit letters such as a bill of exchange, letter of the share, bond etc. Such letter acceptance helps national and international business.

- Work as agent: The commercial bank is an agent to the public because it does an important task as the collection of interest on capital, the sale of share by companies, etc. They receive a commission from the general public and organization for such type of commercial services.

- Investment in Different Sector: Commercial bank also invest in different sectors likewise in organizations, project, industry etc.

iii. Describe meaning, objectives and types of monetary policy.

→ Monetary Policy is the macroeconomic policy of the government which is implemented by central bank to manage the money supply to achieve predetermined goals. ~~is called monetary policy.~~ The policy in which central bank controls the money supply and interest rates to influence the level of economic activity is monetary policy.

These policies are implemented through different tools, including the adjustment of the interest rates, purchase or sale of government securities, and changing the amount of cash circulating in the economy.

Types of Monetary Policy

Monetary policy is classified as expansionary (easy/loose) and contractionary (tight).

1) Expansionary monetary policy: Expansionary monetary policy is also called easy or loose monetary policy. Such types of monetary policy is used by the supply, reduces the rate of interest, helps to increase the aggregate demand. In this policy,

1) Expansionary monetary policy: Expansionary monetary policy is also called easy or loose monetary policy. Such types of monetary policy is used by the central bank to stimulate the economic activities. Such policy increases the money supply, reduces the rate of interest, helps to increase the aggregate demand. In this policy, government increases the volume of government expenditure and reduces the rate of tax. Expansionary monetary policy aims at increasing money supply in the economy to stimulate consumption (C) and investment (I) activities in the economy.

2) Contractionary monetary policy: Contractionary monetary policy is also called tight monetary policy. The policy that is used by central bank to reduce the quantity of money supply in the economy is called contractionary monetary policy. This policy reduces the money supply in the economy, increases the rate of interest and reduces the aggregate demand in the economy. Government increases the taxes, reduces the government spending. This policy aims at reducing the demand for money in the economy to control inflation by reducing demand for money for consumption and investment purposes in the economy.

Objectives of Monetary Policy.

As monetary policy is one of the components of overall macroeconomic policy of a nation, its objectives should support the macroeconomic policy and hence are consistent with them. The objectives of monetary policy are as follows:

1) To stabilize money market: The main objectives ~~of money market is to~~ of monetary policy is to stabilize the money market and to reduce the fluctuations in the interest rates to the minimum. The neutral monetary policy should be introduced to achieve the equilibrium in the demand and supply of money.

2) To stabilize the exchange rate: The unstable exchange rate in the international market is not favourable for the foreign trade of a country. The central tries to bring stability in foreign exchange rate through controlling credit creation activities of commercial banks.

3) To stabilize the price level: Price stability is an important objective of monetary policy. The fluctuation in price level leads to ups and downs in business. The NRB, through its monetary policy controls the inflationary situations.

4) To control business or trade cycles: The Business cycles are ups and downs in business. Existence of business cycle brings instability in economy. It is one of the objectives of monetary policy of NRB to control business cycles and bring stability.

5) Full employment: The economic stability with full employment and high per capita income has been considered as an important objective of monetary policy. In order to achieve the objective of full employment, cheap monetary policy should be made applicable.