MGT411 FINAL TERM
SUBJECTIVE
BY ADNAN AWAN

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Question No: 49 (Marks: 3)
Give brief explanation of the following.
What Discount rate is?
Answer
Interest rate charged by the central bank on loans to commercial banks

How is it controlled?
Answer
Set as a premium over the target federal funds rate

What is its impact on economy?
Answer
Provides short-term liquidity to bank in times of crisis and aids in controlling the federal funds rate

Question No: 50 (Marks: 3)
Why the aggregate demand curve slopes down?
ANSWER
There are two reasons why the aggregate demand curve slopes down:
1. First, because higher inflation reduces real money balances (thus reducing purchases),
2. Second, because higher inflation induces policymakers to raise the real interest rate, depressing various components of aggregate demand.

Question No: 51 (Marks: 5)
"Central bank can stabilize the economy". Discuss.

Answer
Central bank can play a very important role in the economic development of any country because
1. It is responsible for conducting monetary policy.
2. Monetary policy controls money supply and also determines price level.
3. This inflation control can impact employment and hence it impacts the economic growth in the country.
4. Economic development of Pakistan is also possible because Central bank also maintains the stability of the national currency and improves trade balance by impacting positively on exports.
5. The central bank has been described as "the lender of last resort", which means that it is responsible for providing its economy with funds , in this way the central bank prevents the country's banking system from failing.
6. Central bank is also the sole provider and printer of notes and coins in circulation.

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Question No: 52 (Marks: 5)
How in the long run current output equals potential output?
Answer
1. In the long run, since current output equals potential output, real growth must equal growth in potential output.

2. Ignoring changes in velocity, in the long run, inflation equals money growth minus growth in potential output.
3. Though central banks focus on controlling short term nominal interest rates, they keep an eye on money growth
4. When they try to adjust level of reserves in banking system to maintain interest rate, it affects money growth. This in turn determines inflation

Question No: 53   (Marks: 5)
Aggregate Govt.'s Net Demand = Consumption + Investment + Purchases + Exports
Which of the components of aggregate demand are sensitive and are not-sensitive to the aggregate demand?

Answer

Investment
1. Investment is the most important of the components of aggregate demand that are sensitive to changes in the real interest rate.
2. An investment can be profitable only if its internal rate of return exceeds the cost of borrowing.

Consumption
1. Consumption also responds to the real interest rate as sensitive.
2. Consumption decisions often rely on borrowing, and the alternative to consumption is saving (higher rates mean more saving).

Net Exports
As for net exports, when the real interest rate in a country rises, her financial assets become attractive to foreigners, causing local currency to appreciate, which in turn means more imports and fewer exports (lower net exports)
So considering consumption, investment, and net exports, an increase in the real interest rate reduces aggregate demand (the effect on government spending, is small enough to be ignored).

Question No: 43 (Marks: 3)
What is the source of Trading risk, Credit risk and Liquidity risk?

Answer

Liquidity risk
Liquidity risk is the risk of a sudden demand for funds and it can come from both sides of a bank's balance sheet (deposit withdrawal on one side and the funds needed for its off-balance sheet activities on the liabilities side
If a bank cannot meet customers' requests for immediate funds it runs the risk of failure; even with a positive net worth, illiquidity can drive it out of business

Trading risk
Banks today hire traders to actively buy and sell securities, loans, and derivatives using a portion of the bank's capital in the hope of making additional profits
However, trading such instruments is risky (the price may go down instead of up); this is called trading risk or market risk
Managing trading risk is a major concern for today's banks, and bank risk managers place limits on the amount of risk any individual trader is allowed to assume
Banks also need to hold more capital if there is more risk in their portfolio

Credit risk
This is the risk that loans will not be repaid and it can be managed through diversification and Credit-risk analysis
Credit-risk analysis produces information that is very similar to the bond-rating systems and is done using a combination of statistical models and information specific to the loan applicant

Question No: 50 (Marks: 3)
Give an account of different components of aggregate demand?
Answer

Aggregate demand is divided into four components:

1. Consumption,
2. Investment,
3. Government purchases,
4. Net exports

Investment is the most important of the components of aggregate demand that are sensitive to changes in the real interest rate. Consumption and net exports also respond to the real interest rate;
Aggregate Govt.'s Net Demand = Consumption + Investment + Purchases + Exports

Question No: 57 (Marks: 5)
Discuss different types of insurance companies in detail.
Answer

Insurance companies
Accept premiums, which they invest in securities and real estate in return for
Promise to compensate the policy holder incase of any events occurs like fire,
Accident, death etc
There are two type of in Insurance companies
1. **Life insurance**
2. **Property and casualty insurance**
Which makes a payment to the insured's beneficiaries upon the death of the
policy holder. Company can get group insurance for their employees.
Whole life insurance
It is combination of life insurance and fix saving account.
We pay fix amount for a fixed period of time and in case of death of
Policy holder his/her beneficiary gets the money.
If the policyholder decides to discontinue the policy
Property and casualty Insurance
The policyholder pays fixed amount in exchange for protection to its property or
Assets. For example Insuring the building against the fire. Insurance of house for theft.
auto insurance.
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Question No: 56 (Marks: 5)
What is the difference between corporate banking and Enterprise banking?
Answer

Corporate Banking
Corporate banking means Financing to corporate institutions which have been declared as corporate entity. Corporate entity means if more than one company falls in the same line of business, financing terms will be same to all the corporate institution as whole.
Enterprise banking
Enterprise banking **means** each individual business units will be covered separate, according to the specific requirements for financing. Though more than one company falls in the same group, the financing terms will differ according to each enterprise demands and needs

Question No: 52 (Marks: 5)
A well-designed policy framework helps policymakers establish credibility. Discuss the principles of central bank design.
Answer
A well-designed policy framework also helps policymakers establish credibility.
The Principles of Central Bank Design

- **Independence**

To keep inflation low, monetary decisions must be made free of political influence

- **Decision making by committee:**

Pooling the knowledge of a number of people yields better decisions than decision making by an individual

- **Accountability and transparency**

Policy makers must be held accountable to the public they serve and clearly communicate their objectives, decisions and methods

- **Policy framework:**

Politicians must clearly state their policy goals and the tradeoffs among them

Question No: 49 (Marks: 3)
What is the effect of an increase in potential output on inflation and output?
Answer

An increase in potential output shifts the LRAS curve to the right. In the short run, current output remains unchanged. But since current output is now below potential output, the resulting recessionary gap places downward pressure on inflation and output eventually begin to rise.

Question No: 50 (Marks: 3)
Give an account of different components of aggregate demand?
Answer
Aggregate demand is divided into four components:
1. Consumption:
Consumption decisions often rely on borrowing, and the alternative to consumption is Saving (Higher rates mean more saving).
2. Investment:
Investment is the most important of the components of aggregate demand that are sensitive to changes in the real interest rate
3. Government purchases:
While changes in real interest rate may have an impact on the government's budget by raising the cost of borrowing, the effect is likely to be small and ignorable
4. Net exports:
As for net exports, when the real interest rate in a country rises, her financial assets become attractive to foreigners, causing local currency to appreciate, which in turn means more imports and fewer exports (lower net exports)
Aggregate Govt.'s Net Demand = Consumption + Investment + Purchases + Exports

Question No: 47 (Marks: 5)
Central bank can control the size of the monetary base. What are central bank monetary policy tools? Name them.
Answer

Central bank controls the quantity of reserves that commercial banks hold. Besides the quantity of reserves, the central bank can control either the size of the monetary base or the price of its components.

The central bank has three monetary policy tools, or instruments:
The target federal funds rate:
What is it?
Interest rate charged on overnight loans between banks
How is it controlled?
Supply of reserves adjusted through open market operations to meet expected demand at the target rate
What is its impact?
Changes interest rates throughout the economy
The discount rate:
What is it?
Interest rate charged by the central bank on loans to commercial banks
How is it controlled?
Set as a premium over the target federal funds rate
What is its impact?
Provides short-term liquidity to bank in times of crisis and aids in controlling the federal funds rate

What is it?
Fraction of deposits that bank must keep either on deposit at the central bank or as cash in their vaults
How is it controlled?
Set by the central bank within a liquidity imposed range
What is its impact?
Stabilizes the demand for reserves

Question No: 53 (Marks: 5)
"Monetary policy makers react to changes in current inflation by changing the real interest rate". Discuss.
ANSWER
Monetary policy makers react to changes in current inflation by changing the real interest rate. Increases in current inflation lead them to raise the real interest rate, while decreases lead them to lower it. The monetary policy reaction curve is located so that the central bank's target inflation is consistent with the long-run real interest rate, which equates aggregate demand with potential output.
When policymakers adjust the real interest rate they are either moving along a fixed monetary policy reaction curve or shifting the curve. A movement along the curve is a reaction to a change in current inflation; a shift in the curve represents a change in the level of the real interest rate at every level of inflation.

Question No: 53 (Marks: 5)
Why monetary base is called as high powered money? What are the factors on which the amount of excess reserves depends that a bank holds ?
Answer

Currency in the hands of the public and the reserves of the banking system are the two components of the monetary base, also called high-powered money.
Bank Reserves = Vault Cash plus Deposits at the central bank
The central bank can control the size of the monetary base and therefore the quantity of money

Question No: 43 (Marks: 3)
What is the source of Trading risk, Credit risk and Liquidity risk?
Answer
Source of trading risk bank , credit risk bond rating agencies , bank , financial institution and liquidity risk source bank

Question No: 55 (Marks: 3)
What is term life insurance?

ANSWER
Term life insurance or **term assurance** is life insurance which provides coverage at a fixed rate of payments for a limited period of time, the relevant term. After that period expires coverage at the previous rate of premiums is no longer guaranteed and the client must either forgo coverage or potentially obtain further coverage with different payments and/or conditions. If the insured dies during the term, the death benefit will be paid to the beneficiary. Term insurance is the most inexpensive way to purchase a substantial death benefit on a coverage amount per premium dollar basis.

Question No: 51 (Marks: 5)
Give brief explanation of the following.
a)What is Target funds rate?
ANSWER

The target federal funds rate is the central bank's primary policy instrument. It is Interest rate charged on overnight loans between banks

b**) How it is controlled?**
ANSWER

The central bank chooses to control the federal funds rate by manipulating the quantity of reserves through open market operations: the central bank buys or sells securities to add or drain reserves as required.

c)What will be the impact of target federal rate on economy?
ANSWER

Changes interest rates throughout the economy
When central bank targets the quantity of reserves, a shift in reserve demand causes the market federal funds rate to move. An increase in reserve demand forces the interest rate up, while a fall in reserve demand forces the interest rate down

Question No: 51 (Marks: 5)

a. **What does the slope of aggregate demand curve show?**
b. **In which situations aggregate demand curve will be flat and steep?**

Answer
The link between Current Inflation and Aggregate Demand
When current inflation rises , policy makers react by raising the real interest rate, which reduces consumption, investment, and net exports. The result is a reduction in aggregate demand.
When the monetary policy reaction curve is steep, the central bank is aggressive in keeping current inflation near its target level; the aggressive demand curve is flat.
When the monetary policy reaction curve is flat, the central bank is less concerned about keeping current inflation near its target level; the aggregate demand curve is steep.

Question No: 45 (Marks: 3)
Name the factors that affect the transaction demand for money.
The quantity of money people hold for transactions purposes depends on
Their nominal income
Nominal money demand raises with nominal income, as more income means more spending, which requires more money
The cost of holding money
Holding money allows people to make payments, but has cost of interest foregone.
The availability of substitutes
THE SUBSTITUTES CAN ALSO EFFECT the transaction demand for money

Question No: 45 (Marks: 3)
Why the aggregate demand curve slopes down?

Answer

There are two reasons why the aggregate demand curve slopes down:
First
Because higher inflation reduces real money balances (thus reducing purchases),
Second,
Because higher inflation induces policymakers to raise the real interest rate,
depressing various components of aggregate demand rising inflation also reduces wealth, which lowers consumption and drives down
Aggregate demand

Question No: 42 (Marks: 5)
In what ways monetary and fiscal policy differs? Discuss.
Fiscal Policy
Can have more supply side effects on the wider economy to reduce
Inflation, higher tax and lower spending would not be popular and the government may be reluctant to purse this. Also lower spending could lead to reduced public services and the higher income tax could create disincentives to work**.**
MONETARY POLICY
Targeting inflation is too narrow. This meant Central banks ignored an
unsustainable boom in housing market and bank lending. Liquidity Trap In a recession, cutting interest rates may prove insufficient to boost demand because banks don't want to lend and consumers are too nervous to spend. Even quantitative easing – creating money may be ineffective if banks just want to keep the extra money in their balance sheets.
Government spending directly creates demand in the economy and can provide a kick start to get the economy out of recession. Thus in a deep recession, relying on monetary policy alone, may be insufficient to restore equilibrium in the economy.

Question No: 46 (Marks: 5)
Differentiate between the Foreign exchange risk and the Sovereign risk.
Answer

Foreign exchange risk
(The risk from unfavorable moves in the exchange rate) Banks manage their foreign exchange risk by attracting deposits denominated in the same currency as the loans and by using foreign exchange futures and swaps to hedge the risk

Sovereign risk
(The risk from a government prohibiting the repayment of loans) Banks manage sovereign risk by diversification, by refusing to do business in a particular country or set of countries, and by using derivatives to hedge the risk

Question No: 56 (Marks: 5)
Discuss the impact of inflation shock on output and inflation.
Answer

Inflation shock is a change in the cost of producing output which causes the short run aggregate supply curve to shift. It can be the result of change in the cost of raw materials or change in price of energy. A positive inflation shock causes the short run aggregate supply curve to shift upward, and cause the inflation to rise

Question No: 55 (Marks: 3)
Why banks are there in an economy?
Answer

- Banks monitor Stabilizes the Economy

- Control the availability of money and credit in so it can keep low inflation, high growth, and stability of the financial system
- A stable economy grows faster than an unstable one so bank plays vital role
- Banks mitigate risk by taking deposits from a large number of clients and make numerous of loans, thus giving each depositor a small stake in each of the loans. So it provide economic of scale.

Question No: 45 (Marks: 3)
Give an account of different components of aggregate demand?

Answer
Aggregate demand is divided into four components:
1. Consumption:
Consumption decisions often rely on borrowing, and the alternative to consumption is Saving (Higher rates mean more saving)
2. Investment:
Investment is the most important of the components of aggregate demand that are sensitive to changes in the real interest rate
3. Government purchases:
While changes in real interest rate may have an impact on the government's budget by raising the cost of borrowing, the effect is likely to be small and ignorable
4. Net exports:
As for net exports, when the real interest rate in a country rises, her financial assets become attractive to foreigners, causing local currency to appreciate, which in turn means more imports and fewer exports (lower net exports)
Aggregate Govt.'s Net Demand = Consumption + Investment + Purchases + Exports

Question No: 41 (Marks: 5)
Discuss by how many ways borrowing can be done by banks?

Answer
Banks borrow from the central bank (discount loans) They can borrow from other banks with excessive reserves in the inter-bank money market. Banks can also borrow by using a repurchase agreement which is a short-term
Collateralized loan
A security is exchanged for cash, with the agreement that the parties will reverse The transaction on a specific future date (might be as soon as the next day)

Question No: 46 (Marks: 5)
"Principal function of Commercial banks is to receive demand deposits and to make short-term loans". Discuss
Answer

Commercial banks:
They accept deposits and use the proceeds to make consumer, commercial and real estate loans. Banks obtain funds from individual depositors and business as well as by borrowing from other financial institutions and through the financial markets. They use these funds to make loans, purchase marketable securities and hold cash

Receiving Deposits:
This is the main function of commercial banks to collect savings of individuals and firms. They offer different types of deposits for the facility of the customers.

Current Account
Any amount can be withdrawn from this account any time without any notice. No interest is allowed on this type of account.

Saving Account:
This type of deposit account which is usually held by the middle class group. The saving account carries lower rate of interest.

Fixed Deposit:
Amount cannot be withdrawn before the fixed future date in this type of deposit. High interest is allowed in fixed deposit which is different according to period.

Types of loans granted by commercial banks
A **secured loan** is a loan in which the borrower pledges some asset as security for the loan
A **mortgage loan** is a very common type of debt instrument, used to purchase real estate
Unsecured loans are monetary loans that are not secured against the borrowers assets

Question No: 49
If Excess reserves are not available how a bank manages Liquidity risk?
Answer:

One way of managing liquidity risk is to keep excess reserves but this is not profitable as reserve is interest free. There are two other ways through which a bank can manage liquidity risk.
- **Adjusting other assets of balance sheet**
- **Adjusting liability side**

In adjusting assets banks can instead of paying through reserves, fulfill withdrawal requirements by adjusting other assets. Banks can either
- **sell their securities**
- **sell their loans**
- **refuse a loan renewal**

The second option banks have is to adjust their liabilities.
- **Borrow from other banks or central bank**
- **Attracting more deposits**

Question No: 59 (Marks: 5)
a) Distinguish between illiquidity and insolvency. Why is it difficult for a lender of last resort to tell insolvency from illiquidity? Does the distinction matter?
Answer
Insolvent mean bankrupt or someone who has insufficient assets to cover their debts
Insolvent is not in position to pay its due bills
Illiquidity
In such a position where assets are not immediately or easily be converted into cash.
Illiquid assets can be converted into cash, but usually only after a time or at lower value.
Insolvent is in hard time or not a position to revive its working condition compared to insolvency illiquidity is position where business has enough assets only thing is not immediately available. Lender of last resort can take those assets as security to provide the funds.

Question No: 55 (Marks: 3)
Why banks are there in an economy?
Answer

Banks monitor Stabilizes the Economy
Control the availability of money and credit in so it can keep low inflation, high growth, and stability of the financial system
A stable economy grows faster than an unstable one so bank plays vital role
Banks mitigate risk by taking deposits from a large number of clients and make numerous Of loans, thus giving each depositor a small stake in each of the loans. So it provide economic of scale.

Question No: 44 (Marks: 3)
"Monetary policy can be used to stabilize economy" Discuss
Answer

Monetary policy Control over the money supply and interest rates by a central bank or monetary authority to stabilize business cycles, reduce unemployment and inflation, and promote economic growth. Stability exists when fluctuations in prices, production, and employment have been eliminated. While stability for all aspects of the economy are important, monetary policy tends to be most concerned with price stability, that is, keeping the price level in check and eliminating inflation. Inflation erodes the purchasing power of financial wealth

Question No: 43 (Marks: 3)
Give a single line definition of the following.

Answer:

1) **Credit risk:**
This is a risk which arises when loans are not repaid. It is avoided by diversification and checking credit worthiness.

2) **Interest-rate risk:**
The assets and liabilities of a bank are sensitive to interest rate but liabilities are of short term and assets of long term so by an increase in interest rate banks have the risk that value of assets fall more than that of liabilities affecting the net worth or capital of bank.

3) **Liquidity risk:**
It is a risk associated with a sudden increase in demand of funds. If bank can not meet the withdrawal requirement of all its customers, bank is considered illiquid and it may fail.

REMEMBER IN YOUR PRAYERS

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