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FINAL TERM

MONETARY ECONOMICS

ANSWER SHEET

Q2 (A): What is monetary policy? Who formulates it and what are the quantitative tools of monetary policy?

ANS: Monetary policy:

Monetary policy is the action and communication of a central bank that manages the money supply. The money offer includes forms of credit, money, checks and money market funds. The most significant of these methods of money is credit. Credit includes loans, bonds and mortgages.

Monetary policy increases liquidity to generate economic growth. Reduces liquidity to avoid inflation. Central banks use interest rates, bank reserve requirements and the number of Treasury bond banks to be held. All these instruments affect the amount of loans to banks. The dimensions of loans affect the money supply.

Formulation:

It is policy formulated by monetary authority i.e. central bank which happens to be State bank of Pakistan in case of Pakistan. These policies are implemented through a variety of instruments, including adjusting interest rates, buying or selling government bonds, and changing the amount of cash in the economy.

Quantitative Tools of Monetary Policy:

Central banks use various instruments to implement monetary policy. The most broadly used and common policy tools include:

1. Open Market Operations

2. Reserve Requirement

3. Discount Rate

1. Open Market Operations:

Open market operations are when central banks purchase or sell securities. These are bought or sold to private banks in the country. When the central bank purchases securities, it adds liquidity to the banks' reserves. This gives them more money to lend. When the central bank sells the securities, it places them on the bank balance sheets and reduces its cash. The bank now has less to lend. A central bank buys securities when it wants an expansionary monetary policy. It sells them when it's a contraction of monetary policy.

2. Reserve Requirement:

The second tool is the reserve requirement, in which central banks tell their members how much money they have to keep in reserves every night. Not everyone needs all their money every day, so it's safe for banks to borrow most of it. In this way, they have enough money to meet most buyback requests. They are two types of reserve requirement

Cash Reserve Ratio (CRR)

Statutory Liquidity Ratio (SLR)

3. Discount Rate:

The discount rate is the third tool. This is the interest rate that central banks charge its members to borrow from the discount window. Because it is higher than the rate of federal funds, banks only use it if they cannot borrow funds from other banks.

The use of the reduction window also has a stigma attached. The financial community assumes that any bank that uses the discount window is in trouble. Only a desperate bank rejected by others would use the discount window.

Q1 (B): What is the implication of Monetary Policy 2020 on our business activities in the recent pandemic situation?

ANS: <u>Implication of Monetary Policy 2020 on business during pandemic:</u>

According to recent study of Monetary policy, It is a central bank (CB) activity and communication that manages the money supply. The cash offer includes types of loans, cash, cheques and MONEY on the money market. The most important of these types of money is credit. The credit includes loans, bonds and mortgages.

Monetary policy increases liquidity to create economic growth, reduces liquidity to prevent inflation. Central banks use interest rates, bank reserve requirements and the number of government bonds that banks should keep. All these tools affect the value of loans given to banks. The volume of loans affects the provision of money.

Impact of interest rate on business:

Recently, the Central Bank of Pakistan cut the benchmark rate by 100 basis points to 8% to help people, businesses and the economy fight against the COVID-19 pandemic.

Interest rate (I) is a tool for the STATE BANK OF PAKISTAN (SBP) to balance inflation and domestic economic activities. The MPC highlight that the coronavirus outbreak poses a unique challenge to monetary policy due to the temporary deterioration of uneconomic resources and economic activities needed to combat the epidemic.

"According to my analysis, the impact of interest rate on business is very huge, furthermore if the interest rate is increase the people put their money in the bank and then earned through interest RATE, while decrease in interest rate the people invest their money in the business, which will directly impact on the economy, hence we conclude that the risk is decreases while investing in bank and the risk is increases when a person invest in business, but we believe in the concept of "high risk high return", the investing in business is create more and more opportunity. Increasing investing in business help the economy in the form of GDP."

While a simpler monetary policy cannot affect the rate of contagion transmission nor prevent a short-term decline in economic activity due to obstruction, it can provide liquidity support to households and businesses to help them penetrate the temporary phase of the economic disruption that follows.

"In particular, successive cuts in key interest rates and significant low-cost loans from improved refinancing opportunities under SBP have contributed to maintaining credit flows, boosting borrowers, cash flows and supporting asset prices." Coronavirus has severely affected economic

activity. Lower interest rates on low inflation forecasts will help the economy recover by 2-3% in the next financial year (FY21).

Q2 (A): What is Interest rate? Differentiate between nominal and real interest rate.

ANS: Interest rate:

An interest rate is defined as the percentage of a borrowed amount that a lender charges the borrower as interest, which is normally expressed as an annual percentage. This is the interest that a bank or other lender charges to borrow their money, or the interest that a bank pays its savers to keep money in an account.

Interest rates are often used for personal loans and mortgages, although they can be extended to loans for the purchase of cars, buildings and consumer goods. When interest rates rise, the economy can deteriorate due to a lack of affordable credit. Interest rates can affect corporate profits and government monetary policy.

Real interest rate:

Real interest rate is an interest rate that has been adjusted to eliminate the effects of inflation to reflect the actual cost of funds to the borrower and the actual return of the lender or investor.

A real interest rate is the interest rate that takes inflation into account. This means that it adapts to inflation and gives the real interest rate to a bond or loan. To calculate the real interest rate, you first need the nominal interest rate. The calculation used to find the effective interest rate is the nominal interest rate minus the actual or estimated rate of inflation.

EX: A bank loans an individual $400,000 to purchase a building at a rate of 5%—the nominal interest rate not factoring in inflation. Assume the inflation rate is 4%. The real interest rate the

debtor is paying is 2%. The real interest rate the bank is receiving is 2%. That means the purchasing power of the bank only increases by 2%.

Nominal interest rate:

The nominal interest rate refers to the interest rate before inflation is taken into account. The nominal may also refer to the advertised or declared interest rate of a loan, regardless of any fees or interest rate associations.

The nominal interest rate refers to the interest rate before inflation is occupied into account. This is the interest rate presented on bonds and loans. The nominal interest rate is a simple conception to understand. If you borrow $200 at a 8% interest rate, you can expect to pay $8 in interest without taking into account inflation. The drawback of using the nominal interest rate is that it does not regulate to the inflation rate.

Short nominal interest rates are determined by central banks. These interest rates form the basis for other interest rates charged by banks and other institutions to consumers. Central banks may decide to keep nominal interest rates low in order to stimulate economic activity. Low nominal interest rates encourage consumers to take on an increase in debt and increase spending.

Q2 (B): What are money markets? Explain functions and importance of Money markets in Pakistan.

ANS: Money market:

The money market refers in principle to a part of the financial market where high-liquidity financial instruments and short-term durations are traded. The money market has become part of the financial market for the purchase and sale of securities with short-term durations, no more than a year, such as promissory notes and trading card.

The money market consists of negotiable instruments such as promissory notes, commercial documents and certificates of deposit. It is used by many participants, including companies, to raise money by selling commercial documents on the market. The money market is considered a safe place to invest due to the high liquidity of securities.

The money market is an informal and unregulated and not structured market like capital markets, where things are systematized in an official way. The money market offers fewer returns to investors who invest in it, but provide a variety of products. Money market consists of several financial institutions and traders, who look for to borrow or loan securities. It is the finest source to invest in liquid assets.

Functions and Importance of Money markets in Pakistan:

The money market plays an important role in the economy of Pakistan. It acts as a market for trading for a short period of time. It should therefore provide for the possibility of adjusting the liquidity of companies, banks, financial institutions and non-investor financial institutions. The important functions of Money market are:

Provides Funds:

The money market provides short-term funds to borrow at a lower interest rate. Private and public institutions can borrow money from the money market to finance capital needs and finance business growth through the system of financial accounts and commercial paper. The government can also borrow money market funds by issuing treasury bills.

No Need to Borrow from Banks:

A developed money market helps commercial banks become self-sufficient. The existence of an established money market increases lending options for money at lower interest rates and helps commercial banks and the central bank. However, if there is a lack of liquidity in commercial banks and central banks, they can apply for part of their loans on the money market.

Helps in Monetary Policy:

The proper functioning of the money market helps the central bank to successfully implement monetary policies. Although the central bank can operate and influence the banking system in the absence of a money market, the existence of a developed money market contributes to the proper functioning and efficiency of central banks.

Promotes Liquidity and Safety:

This is one of the most important functions of the money market, as it provides the security and liquidity of capital. It also encourages savings and investment. These investment tools have shorter durations, which means they can easily be converted into cash. Money market instruments are issued by entities with good credit worthiness that make them safe investment rights.

Equilibrium between Demand and Supply of Funds:

The money market creates a balance between demand and the supply of capital loans. The money market contributes to the allocation of savings to investment channels. A money market makes it possible to better mobilize and make use of savings, allowing them to invest in the money market. It helps savers channel capital, leading to a productive use of money in the economy.

Use of Surplus Funds:

The money market provides a platform where banks and other banks can lend excess money for a short period of time and make profits. This meets the main objectives of commercial banks, namely the acquisition of reserve income, as well as the maintenance of liquidity to cover the money needed for day-to-day transactions. Institutions that can lend money market funds include not only commercial banks and other financial institutions, but also non-financial corporations, central, state and local administrations.

Importance:

The money market meets borrowers' short-term requirements and provides liquidity to lenders. These markets therefore provide information on the formulation and management of monetary policy. The state bank of Pakistan has a strategic position in the money market by changing the liquidity level of the economy through open market operations and by regulating banks' access to its homes.

- Money markets offer a place where participants, such as investors and borrowers of all sizes, will be treated fairly and appropriately.
- They give individuals, businesses and government agencies access to capital.
- Money markets are helping to reduce the unemployment rate due to the many employment opportunities offered by.

Q3 (A): What are foreign exchange markets and how it works?

ANS: <u>Foreign Exchange Markets:</u>

The foreign exchange market (also known as forex, FX or foreign exchange market) is an over-the-counter global market (OTC) that determines the exchange rate of currencies worldwide. Participants are able to buy, sell, trade and speculate on currencies. Foreign exchange markets are made up of banks, foreign exchange brokers, trading companies, central banks, investment management companies, hedge funds, foreign exchange traders and

investors. The foreign exchange market is a 24-hour over-the-counter market and a dealer market, which means that transactions are made between two participants using telecommunications technology. Foreign exchange markets are also divided into spot markets, which are set for two-day liquidations, and futures, futures and options futures.

How it works:

Foreign exchange market or Forex trading is not conducted on stock exchanges, but directly between two parties, in an over-the-counter (OTC) market. The foreign market is run by an international network of banks, spread over four major forex malls in each country, you can exchange forex 24 hours a day. Currencies are always traded in duos, so the "worth" of one of the currencies in that pair is comparative to the value of another.

There are three different types of forex market:

Spot foreign market:

The exchange of a currency pair, which takes place at the exact point where the transaction is, settled which is "on the spot" or in a short period of time.

Forward foreign market:

A contract must agree to buy or sell a fixed amount of a currency at a fixed price, payable on a fixed date in the forecast or within a series of future dates.

Future foreign market:

A contract is accepted to buy or sell a certain amount of a certain currency at a price and date set in the future. Unlike advanced contracts, a futures contract is legally permanent.

Q3 (B): Critically analyze the Federal Budget 2020-21.

ANS: Critically analysis Budget 2020-21:

With Covide-19 as a framework and the International Monetary Fund (IMF) program as a criterion, the government presented a budget built around austerity and tightening zone and increasing tax revenues of more than 27 percent to Rs 4.963 trillion, but without a distinct revenue plan behind it.

The budget reduces subsidies by 48pc, increases the oil rate by almost 73pc, freezes wages and pensions and still fails to capture the overall budget deficit in 2020-21, and is expected to remain almost unchanged at 7pc of GDP (7.2pc in the 2019-20 budget).

It is estimated that most of the costs will be reduced next year, with the exception of maintaining debt and defence spending, while around 70 billion R will be spent specifically on Covid-19 schemes to support the living conditions of the vulnerable.

An official explained that the budget would go through the challenge of the Financial Action Task Force (FATF) and put the IMF program online during the next quarter, combating economic tensions related to the pandemic, and then follow up with more than Rs700 billion revenue plans sometimes in September-October. Nominal economic growth of 2.1pc and inflation of 6.5pc are expected to be around RS 350 billion.

At the same time, the development budget of RS 650 billion would help to increase growth rates and create jobs and encourage the construction sector, which would give national defence and internal security importance and improve revenues without unnecessary tax changes. Defence spending was increased from 12pc to Rs1, 152 in this year's budget. The industrial sector has been offered facilities in the form of reduced customs lines.

Budget:

- **Total budget 2020-21 = 7294.9 billion**
- **Total Revenue 2020-21= 3699.5 billion**
- **Total expenditure 2020-21= 7294 billion**

So, the total federal budget of Pakistan is lowered 11% than the size of budget 2019-20

And the revenues are increased by 6.7% by 2019-20

Critical Analysis:

The 2020-2021 budget for Pakistan was presented in circumstances where there is a lack of leadership, coordination and a lack of clear vision. Similarly, COVID19-pendamic has strongly affected the 2020-21 budget, whose rupee shows a decline in the currency. New young people in Pakistan need 250 million jobs a year, but there are only 1.20 million jobs available during the year. The same revenue collection should be adjusted according to market conditions; the government is expected to have the target of 4.0 billion rupees in the federal budget 2020-21.