

UPSC 2021 Prelims
ECONOMY Answer Key with Explanation

1. Consider the following statements:

- 1) The Governor of the Reserve Bank of India (RBI) is appointed by the Central Government.
- 2) Certain provisions in the Constitution of India give the Central Government the right to issue directions to the RBI in public interest.
- 3) The Governor of the RBI draws his power from the RBI Act.

Which of the above statements are correct?

- (a) 1 and 2 only
- (b) 2 and 3 only
- (c) 1 and 3 only
- (d) 1, 2 and 3

Answer: C

Explanation

- **Statement 1 is Correct:** RBI Governor and Deputy Governors are appointed by **the Central Government**.
- **Statement 2 is incorrect:** The **Section 7 of the RBI Act** empowers the government to give directions to the central bank on matters of public interest. **The constitution has no such provision.**
- **Statement 3 is Correct:** The Governor draws his powers from Section 7(3) of the RBI Act.

https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/RBIAM_230609.pdf

2. With reference to casual workers employed in India, consider the following statements:

1. All casual workers are entitled for Employees Provident Fund coverage.
2. All casual workers are entitled for regular working hours and overtime payment
3. The government can by a notification specify that an establishment or industry shall pay wages only through its bank account

Which of the above statements are correct?

- (a) 1 and 2 only
- (b) 2 and 3 only
- (c) 1 and 3 only
- (d) 1,2 and 3

Answer: D

Explanation

Statement 1 is correct : The Supreme Court has ruled that casual workers are also entitled to social security benefits under the Employees' Provident Funds and Miscellaneous Provisions Act.

Statements 2 and 3 are correct.

<https://timesofindia.indiatimes.com/india/contractual-workers-also-entitled-to-pf-benefits-sc/articleshow/73364925.cm>

<https://www.thehindu.com/news/national/Wage-payment-through-banks-ordinance-gets-Presidents-nod/article16957912.ece>

3. Which among the following steps is mostly likely to be taken at the time of an economic recession?

- (a) Cut in tax rates accompanied by increase in interest rate
- (b) Increase in expenditure on public projects
- (c) Increase in tax rates accompanied by reduction of interest rate
- (d) Reduction of expenditure on public projects

Answer: B

Explanation

- A recession is a macroeconomic term that refers to a significant decline in general economic activity in a designated region.
- **Stimulating the economy by increasing government spending** was one of the philosophies given by one of the renowned economists John Maynard Keynes.
- He was of the view that the government's role is very important when the economy is in a recession or depression like situation and the government should increase spending to have a pickup in economic activity.

<https://www.elearnmarkets.com/blog/government-spending-affect-the-economy/>

4. Consider the following statements:

Other things remaining unchanged, market demand for a good might increase if

1. Price of its substitute increases
2. Price of its complement increases
3. The good is an inferior good and income of the Consumers increases
4. Its price falls

Which of the above statements are correct?

- (a) 1 and 4 only
- (b) 2,3 and 4
- (c) 1,3 and 4

(d) 1,2 and 3

Answer: A

Explanation

- The demand for a good increases, if the price of one of its substitutes rises. Hence **statement 1 is correct.**
- The demand for a good increases, if the price of one of its complements falls and vice versa. **Hence statement 2 is incorrect.**
- The demand for a normal good increases if income increases while demand for an inferior good decreases if income increases. Hence **statement 3 is incorrect.**
- If the price of a good falls, the demand for that good increases. Hence **statement 4 is correct.**

<https://www.investopedia.com/terms/i/inferior-good.asp#:~:text=An%20inferior%20good%20is%20one,increases%20even%20when%20incomes%20increase>

5. With reference to 'Urban Cooperative Banks' in India, consider the following statements

1. They are supervised and regulated by local boards set up the state Governments
2. They can issue equity shares and Preference shares.
3. They were brought under the purview of the Banking Regulation ACT, 1949 through an Amendment in 1966.

Which of the statements given above is/are correct?

- (a) 1 only
- (b) 2 and 3 only
- (c) 1 and 3 only
- (d) 1,2 and 3

Answer: B

Explanation

- **All urban and multi-State cooperative banks** are under the **direct supervision of the RBI.**
- Previously, these banks came under dual regulation of the RBI and the Registrar of Co-operative Societies. Hence **Statement 1 is incorrect.**
- The UCBs could raise share capital by issue of equity to persons within their area of operation enrolled as members and also through additional equity shares to the existing members. Primary urban cooperative banks (UCBs) can also augment its capital through issuance of preference shares and debt instruments. Hence **Statement 2 is correct.**
- They were brought under the purview of the Banking Regulation Act 1949 through an amendment in 1966. Hence **Statement 3 is correct.**

<https://www.papertyari.com/jaiib/legal-regulatory-aspects-banking/control-over-cooperative-banks/>

<https://www.thehindu.com/news/national/cabinet-decides-to-bring-all-cooperative-banks-under-the-rbi-through-an-ordinance/article31904864.ece>

https://www.business-standard.com/article/pti-stories/rbi-issues-draft-circular-on-allowing-ucbs-to-augment-capital-121071400994_1.html

6. Indian Government Bond Yields are influenced by which of the following?

1. Actions of the United States Federal Reserve
2. Actions of the Reserve Bank of India
3. Inflation and short – term interest rates

Select the correct answer using the code given below.

- (a) 1 and 2 only
- (b) 2 only
- (c) 3 only
- (d) 1,2 and 3

Answer: D

Explanation

- Changes in interest rates in the US have a bearing on the debt and equity markets, not just in the US but also in emerging economies such as India.
- A hike in interest rate in the US leads not only to an outflow of funds from equities into US treasury bonds, but also to an outflow of funds from emerging economies to the US. Hence **Statement 1 is correct**.

<https://indianexpress.com/article/explained/us-federal-reserve-rate-hike-indian-markets-sensex-7363972/>

- **Actions of RBI influences bond yield.** For example in the Operation Twist of RBI By purchasing longer-term bonds, the RBI can help drive the bond prices up and yields down (since prices and yields move in opposite directions).
- At the same time, selling shorter-term bonds should cause their yields to go up (since their prices would fall). In combination, these two actions twist the shape of the yield curve. Hence **Statement 2 is correct**

<https://www.livemint.com/opinion/online-views/decoding-operation-twist-the-act-of-rbi-during-covid-19-11599977343770.html>

- Higher wages due to inflation begin to eat away at profit margins, making them more vulnerable to slippage in economic growth. Inflation also raises the prices of things in the economy in general

terms, and as things become more pricey the ability to pay for them rises, and so credit risk increases—a positive pressure on yields.

- Inflation risk also leads central banks to raise target interest rates. When the risk-free rate of return rises, corporate bond yields must rise as well to compensate. The higher yields add to increased costs, creating even more vulnerability to economic stumbles. **Hence Statement 3 is correct**

<https://www.investopedia.com/ask/answers/051215/what-economic-factors-influence-corporate-bond-yields.asp>

7. Consider the following:

1. Foreign Currency convertible bonds
2. Foreign institutional investment
3. Global depository receipts
4. Non- resident external deposits

Which of the above can be included in Foreign Direct Investments?

- (a) 1, 2 and 3
- (b) 3 only
- (c) 2 and 4 only
- (d) 1 and 4

Answer: A

Statement 1 is correct

<https://blog.ipleaders.in/can-funds-received-drs-fccbs-treated-fdi/>

Statement 2 is correct

<https://www.thehindu.com/business/Economy/treat-foreign-investment-over-10-in-listed-firms-as-fdi-mayaram-panel/article6134174.ece>

Statement 3

<https://www.rbi.org.in/scripts/NotificationUser.aspx?Id=8104&fn=5&Mode=0#1>

Statement 4

- Non- resident external deposits are not considered as FDI.

8. Consider the following statements:

The effects of devaluation of a currency is that it necessarily

1. Improves the competitiveness of the domestic exports in the foreign markets
2. Increases the foreign value of domestic currency
3. Improves the trade balance

Which of the above statements is /are correct?

- (a) 1 only
- (b) 1 and 2
- (c) 3 only
- (d) 2 and 3

Answer: A

Explanation

- **Statement 1 is correct:** Devaluation of currency will make imports costlier and exports cheaper. Hence, it will result in improvement in competitiveness of domestic exports in foreign markets.
- **Statement 2 is incorrect:** Devaluation of currency will result in decrease of value of domestic currency.
- **Statement 3 is incorrect:** Trade balance need not be a compulsory outcome / necessarily resulting in improvement of trade balance.

<https://www.investopedia.com/terms/d/devaluation.asp>

9. Which one of the following effects of creation of black money in India has been the main cause of worry to the Government of India?

- (a) Diversion of resources to the purchase of real estate and investment in luxury housing
- (b) Investment in unproductive activities and purchase of precious stones, jewellery, gold, etc.
- (c) Large donations to political parties and growth of regionalism
- (d) Loss of revenue to the state Exchequer due to tax evasion

Answer: D

Explanation:

- Black money is money on which tax is not paid to the government, resulting in loss of revenue to the state exchequer.

<https://timesofindia.indiatimes.com/readersblog/santhosh-pens-down/black-money-a-serious-menace-to-be-tackled-24487/>

10. Which one of the following is likely to be the most inflationary in its effects?

- (a) Repayment of public debt
- (b) Borrowing from the public to finance a budget deficit
- (c) Borrowing from the banks to finance a budget deficit
- (d) Creation of new money to finance a budget deficit

Answer: D

Among all the given options, creation of new money is more inflationary in nature.

While additional money printing is likely to increase the demand for goods and services, it may lead to a sharp rise in inflation if the economic output fails to support demand. In turn, there will be a sharp increase in prices of existing goods and services as the demand will rise, but supply won't.

<https://www.indiatoday.in/business/story/will-printing-more-money-help-revive-indian-economy-all-you-need-to-know-1813138-2021-06-10>

11. The money multiplier in an economy increases with which one of the following?

- (a) Increase in Cash Reserve Ratio in the banks
- (b) Increase in the Statutory Liquidity Ratio in the banks
- (c) Increase in the banking habit of the people
- (d) Increase in the population of the country

Answer: C

An increase in the banking habit of the population will increase the lending, thereby will lead to more deposits in the banking system, hence increasing the money multiplier.

12. With reference to the Indian economy, demand – pull inflation can be caused/ increased by which of the following?

1. Expansionary policies
2. Fiscal stimulus
3. Inflation – indexing wages
4. Higher purchasing power
5. Rising interest rates

Select the correct answer using the code given below

- (a) 1, 2 and 4 only
- (b) 3,4 and 5 only
- (c) 1,2,3 and 5 only
- (d) 1,2,3,4 and 5

Answer: A

Inflation indexing wages shall always result in adjustment of price rise and not a necessary component of demand pull inflation .

Rising interest rate will result in absorption of liquidity , therefore purchasing power gets reduced which inturn is not a factor of demand pull inflation.

Expansionary policies, fiscal stimulus will result in excess money supply which leads to demand pull inflation.

<https://www.investopedia.com/terms/d/demandpullinflation.asp>

13. With reference to India, consider the following Statements;

1. Retail investors through demand accounts can invest in ‘Treasury Bills’ and Government of India Debat Bonds’ in the primary market.
2. The ‘Negotiated Dealing System- Order Matching’ is a government securities trading platform of the Reserve Bank of India.
3. The ‘Central Depository Services Ltd.’ Is jointly promoted by the Reserve Bank of India and the Bombay Stock Exchange.

Which of the statements given above is/are correct?

- (a) 1 only
- (b) 1 and 2
- (c) 3 only
- (d) 2 and 3

Answer: B

Explanation

- Central Depository Services Ltd. is promoted by BSE Ltd. jointly with leading banks such as State Bank of India, Bank of India, Bank of Baroda, HDFC Bank, Standard Chartered Bank. **Hence, statement 3 is incorrect.**

https://www.business-standard.com/article/finance/rbi-offers-hassle-free-trading-in-govt-bonds-for-retail-investors-121071201277_1.html

https://en.wikipedia.org/wiki/Central_Depository_Services

https://www.investopedia.com/terms/n/negotiated_dealing_system.asp

14. With reference to 'WaterCredit', consider the following statements:

1. It puts microfinance tools to work in the water and sanitation sector.
2. It is a global initiative launched under the aegis of the World Health Organization and the World Bank.
3. It aims to enable the poor people to meet their water needs without depending on subsidies.

Which of the statements given above are correct?

- (a) 1 and 2 only
- (b) 2 and 3 only
- (c) 1 and 3 only
- (d) 1,2 and 3

Answer: C

Explanation

- **Water.org is a global nonprofit organization** working to bring water and sanitation to the world and it has launched the water credit initiative. Hence **statement 2 is incorrect**.
- WaterCredit is a powerful solution and the first to put **microfinance tools to work in the water and sanitation sector**. Hence **statement 1 is correct**.
- WaterCredit helps bring small loans to those who need access to affordable financing and expert resources to make household water and toilet solutions a reality.

Here's how it works:

- We identify a region where people need access to water and sanitation and that is ready for a microfinance solution.
- We partner with carefully selected institutions to provide affordable financing for water and sanitation to families in need.
- These microfinance partners establish water and sanitation loans in their portfolio of offerings. We support them by providing technical assistance, connections and resources to get them started.
- People in need use these small, affordable loans to put a tap or toilet in their homes and access local resources to do the work.
- Every repaid loan can be lent to another family in need of safe water or sanitation.

<https://water.org/solutions/watercredit/>

15. In India, the central bank's function as the 'lender of last resort' usually refers to which of the following?

1. Lending to trade and industry bodies when they fail to borrow from other sources
2. Providing liquidity to the banks having a temporary crisis
3. Lending to governments to finance budgetary deficits

Select the correct answer using the code given below.

- (a) 1 and 2
- (b) 2 only
- (c) 2 and 3
- (d) 3 only

Answer: B

Explanation

- As a Banker to Banks, the Reserve Bank also acts as the 'lender of the last resort'.
- It can come to the **rescue of a bank that is solvent but faces temporary liquidity problems** by supplying it with much needed liquidity when no one else is willing to extend credit to that bank.
- The Reserve Bank extends this facility to protect the interest of the depositors of the bank and to prevent possible failure of the bank, which in turn may also affect other banks and institutions and can have an adverse impact on financial stability and thus on the economy.

https://m.rbi.org.in//scripts/FS_Overview.aspx?fn=2758#:~:text=As%20a%20Banker%20to%20Banks,lender%20of%20the%20last%20resort'