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**PERIYAR UNIVERSITY
SALEM - 636 011.**

**B.B.A. BANKING
FIRST YEAR
PAPER – II : MONEY AND BANKING**

Prepared by :

V. ALAMELU

Reader Dept. of Management

Alagappa University

Karaikudi

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Lesson 1

EVOLUTION AND FUNCTIONS OF MONEY

In the beginning of human existence, needs were simple and every individual produced all that was necessary to sustain life—he provided his own food of animal flesh and vegetables, prepared his own clothing and found his own shelter. In course of time people settled down in different occupations; and with specialisation, trade came into existence. Initially, trade was direct, i.e., exchange of goods for goods. Such exchange was known as barter. For instance, the person who had plenty of food but no clothes exchanged a part of his food with the person who had plenty of clothes but no food. In this method of direct exchange, there were many difficulties and inconveniences.

Inconveniences of Barter System

(i) The main inconvenience of barter or direct exchange of goods was the necessity for a double coincidence of demand—a man having one commodity to trade should be able to find another who, not only wanted the same commodity, but had something acceptable to offer in exchange.

(ii) The amount of goods which the two parties wanted to trade should be equal in value to each other.

(iii) They should know how to calculate the value of the goods exchanged. Suppose a shepherd and a farmer wanted to exchange sheep against wheat, they should first decide in what proportion the two goods should be exchanged. This was not easy, as transactions were isolated and there were no agreed exchange rates or prices. Since there was no common measure in terms of which the value of different goods and services could be expressed or measured, the exchange ratio or price would be fixed in an arbitrary manner depending upon the intensity of each other's demand. It was obvious that where each exchange was an isolated transaction, one party must suffer.

(iv) Barter would be impossible if the possessions or wealth of a person could not be subdivided without loss. For example, if a person's wealth consisted to sheep, it would be almost impossible for him to exchange them for articles of small value by direct exchange. In fact, when a sheep or cow or horse is divided into two or more parts, it loses its identity and value as a sheep or cow or horse.

(v) The exchange of services would be far more difficult than the exchange of goods. How much worth, for instance, would be the services of a teacher or a priest? How would these persons be paid?.

(vi) Under barter, it is very difficult to store wealth for future use. Most of the goods like wheat, rice and cattle lacked sufficient durability and deteriorated with time and, therefore, they could not be conveniently stored for future use.

Thus, almost from the very beginning of civilization, man had to give up direct exchange and had to make use of an intermediate commodity which

was used to buy and sell all goods and services. This intermediate commodity would have to be familiar, easily recognizable and generally acceptable because it would be used as the medium of exchange. This medium of exchange was known as money.

What is Money?

Money may be any commodity chosen by common consent as a medium or instrument of exchange of goods and services. It is widely accepted in payment for goods and services and in settlement of debts. Money is given and received without reference to the standing of the person who offers it in payment. Moreover, money is a commodity which is accepted customarily without assay and other special tests of quality and quantity.

Money has been defined differently by economists. Some have defined it in terms of its functions as, for instance, “Money is what money does” (Walker). Some have attempted to define money in terms of its general acceptability, as for example, “anything which is widely accepted in payment for goods, or in discharge of other kinds of business obligations” (D.H. Robertson); “the essence of money is that it can be passed from hand to hand in one act of circulation after another” (G.D.H. Cole) ; or simply “one thing that possesses general acceptability” (Seligman). It may be noted that these definitions of money are either too vague or too narrow. Correctly, money can be defined as any generally accepted material-even a piece of paper, embodying a promise i.e., a currency note-which is used as a means of exchange and as a measure of value.

Evolution of Money

Growing inconvenience of barter in the complex economic societies necessitated the invention of money. Some writers however, opine that money seems to have been discovered rather than invented in the progress of economic civilization of mankind. According to Crowther, money was undoubtedly an invention; “it needed the conscious reasoning power of man to make the step from simple barter to money accounting.” Whatever it may be, the fact remains that with the increased volume of trade and growing process of division of labour and specialization, barter became more and more difficult in its direct exchange phenomenon. Hence, to overcome the basic difficulties of barter such as want of double coincidence, want of means of subdivision, etc., it was thought that exchange of goods should be made indirect by using some medium in between. Thus, money came into the picture as a medium of exchange.

Crowther observes that, in the beginning, in a simple exchange of goods for goods, the terms of exchange were fixed with reference to one standard commodity. Values of different goods being measured in terms of this standard commodity, in the exchange process, it came to be accepted as a medium of exchange. This standard commodity used as a medium of exchange was known as money.

Etymologically, term “money” is derived from the Latin word Moneta, the name of the Roman goddess Juno, in whose temple coins were being minted. Use of money as a medium of exchange and a unit of account is, however, much older than coinage. Numerous things like shells and sheep, grains and stones, tea and tobacco, ivory and iron, gold and silver have been used as money at different times and different places before the invention of modern day’s metallic and paper money. The origin of money as such is difficult to trace for want of record. Lord Keynes puts that the origin of money is deep-rooted in antiquity, and it is a far more ancient institution.

No doubt, the evolution of money has been a secular process. Like several other economic institutions, money, in its present form, has passed through several phases and developed through the centuries.

Development of Money in Different Stages

The development of money has passed through various stages in accordance with time, place and circumstances with the progress of economic civilization of mankind. Economists have recognized five such stages in the evolution of money ;

- I. Animal Money
- II. Commodity Money
- III. Metallic Money
- IV. Paper Money
- V. Credit Money

I. Animal Money. Animals were being used a common medium of exchange in the primitive hunting stage. History records that cattle occupied a place of pride as money in the earliest of human civilization. In temperate regions of Europe, Asia and Africa cattle was regarded as the most standard unit of barter for quite a long time in the primitive era. In the ancient Indian civilization the concept of Go-Dhan (cattle-wealth) as a form of money is also referred to in Arth-Veda. In the fourth century B.C., the Roman State had officially recognized cows and sheep as money to collect fines and taxes.

II. Commodity Money. In certain communities, early primitive money, in its crudest sense, also took the form of commodity money. A large number of commodities from axes to yarn have been adopted as money. The particular commodity chosen to serve as money depended upon various factors like location of the community, climatic environment of the region, cultural and economic standard of society, etc. For example, people living by the seashore adopted shells and dried fish as money. People of the cold regions in Alaska and Siberia preferred skins and furs as a medium of exchange. African people used ivory and tiger jaws as money. Besides, commodities such as precious stones, rice, tea, tobacco, etc. also served as money during the primitive days of human civilization. Professor Paul Einzig has recorded some 172 commodities in the list of primitive money.

III. Metallic Money. Commodity money gradually transformed into metallic money when precious metals like gold, silver, copper bronze, etc. were discovered and used as a medium of exchange with the growth of economic civilization from the pastoral to the commercial stage of society. Use of metals as money in the course of time paved the way for the development of coinage system in the economy.

As historian Toynbee narrates, the coin age began around 700 B.C. in Lydia, a Greek city state. Imperfections of the metallic money in size, shape and weight, etc. have been removed with the minting of coins by states.

Metallic money had, however, the following drawbacks :

1. On account of its bulkiness, a large sum of money in terms of coins was not easily portable.
2. It was unsafe to carry and could be easily lost or stolen.
3. Rapid transactions were not feasible by using coins as a mode of payment.

The coin era, however, lasted till the 17th century.

IV. Paper Money. In the 17th and 18th centuries, paper currency emerged as “token money”. In modern era, paper money has become popular. It originally came as paper receipts against metallic money which was found unsafe to carry by itinerant merchants. Then with the shortage of metals, state authorities thought in introducing paper currency – a representative paper money – which was convertible. In the later stages, however, it became “fiat money”, i.e., inconvertible legal tender. Being a representative money, paper currencies, thus, economise the use of standard coins or metals.

V. Bank Money. In the final stage, along with paper money, another form of convertible money developed in the form of credit money or bank money, owing to the growth of banking institutions and credit creation activities and cheque system of payments in modern era. In modern commerce, large transactions are carried on through cheques and only small transactions are managed through currency money.

In modern economy, coins, paper notes and bank money, i.e., cheques issued against demand deposit, all serve as money. But even today, sometime other things have also served as money. In Germany, for example, in the post-war period (1945-46), cigarettes and cognac were used as money when its financial and economic condition had greatly deteriorated. Some time back, due to shortage of token coins in India, coupons and stamps were used as money.

In short, anything and everything can serve and has served as money provided it is generally recognized and accepted as means of payment. But all things cannot serve as a good money. Good money should possess the attributes of general acceptability, cognisability, portability, divisibility, malleability, durability, uniformity, adequacy and stability of value.

Functions of Money

“Money is what money does”. In modern times, money performs a number of functions. It is customary to classify these functions under three heads:

- (a) Primary functions – these are basic or fundamental functions of money.
- (b) Secondary functions – these functions are derived from the primary functions.
- (c) Contingent functions – these are not really functions of money; but they may be regarded as certain incidental uses of money in a modern economy.

Let us describe each one of them briefly.

Primary Functions of Money

Medium of Exchange: Money facilitates the buying and selling of goods, i.e., it serves as the common medium of exchange. Everything is bought and sold through the help of money. This is the basic function of money and all others are secondary and are derived from it. Some economists argue that money is not only the medium of exchange but a general medium of payments also. They seem to think that medium of payment is a separate function of money. However, it is not, since payment is inherent in every transaction. When a commodity is exchanged, that is bought and sold with the help of money, it means automatically that it is paid for in money. Thus the function of medium of payment is implied in the function of medium of exchange.

Measure of Value : Money is a measure of value. It serves as a common denominator and as such every transaction is referred to a common unit. For instance,

1 chair	costs	Rs. 200
1 quintal of wheat	“	Rs. 400
1 table	“	Rs. 800
1 cinema ticket	“	Rs. 5

When we say the price of a chair is Rs. 200, we mean that the value of a chair is Rs. 200. In the same way, the value of a quintal of wheat is equal to Rs. 400, and so on. Since money serves as the common denominator of all values, it serves as a measure of value. When all values are expressed in terms of money, it is comparatively easy for any one to compare the value of two goods. The value of a table is equivalent to the value of four chairs, the value of a quintal of wheat is equal to the value of two chairs and so on. Money, as a measure of value, thus, facilitates a comparison of relative values of all things.

It may be observed here that the second function of money as measure of value flows naturally from the first function. As money is used to exchange goods, each commodity gets a value in terms of money which is called price.

Thus the two primary functions are closely related and, therefore, the question whether it is possible to have these two functions performed separately – that is, whether it would be possible to have a medium of exchange which does not serve as a measure of value – may seem improper. However, it is possible to give instance from past experience of two types of money existing side by side in the same country – one serving as medium of exchange and payments (unit of currency) and the other as a measure of value (unit of account). For instance, in 1923-24, when prices rose by millions of times in Germany, exchange was entered into in U.S. dollars or Swiss francs, but the actual payment was made in German marks. In this instance, the mark served as the medium of exchange but the U.S. dollar and the Swiss franc served as measure of value. Such instances, however, are rare. Normally, the same money performs both these functions simultaneously.

Secondary Functions of Money

There are three secondary functions of money : standard of deferred payments, store of value and transfer of value. They may be described briefly as follows:

Standard of Deferred Payments : Just as money facilitates current transactions of goods and services through its functions as a medium of exchange, it facilitates credit transactions too, that is, exchange of present goods against future payments. This function of money commonly called as standard of deferred payments – “deferred” means payment to be made at a future date. It is better to regard this function of money as part of its function as a medium of payment. Money has always been used as a standard of deferred payments from the earliest times but it has attained great significance these days, for there is extensive borrowing by the Government and others, and trade is based on credit.

Store of Value : Money represents goods and services and the person who accumulates money is really accumulating goods and services. Money, therefore, serves as a store of value. A store of value implies the shifting of purchasing power from the present to the future.

At one time, gold and silver coins served as store of value and still later currency notes performed that function. Nowadays bank deposits represent people’s savings. Bank deposit is money since a person who has a bank account can spend it at any time and in any way he likes.

Money is desired not only as a store of value but also to serve as a liquid asset. Money is a liquid asset as it can be used by the possessor to buy any other asset at any time. All other assets – landed property, commodities, securities, etc. – can be purchased through money. The advantage of money as a liquid asset over all other assets is that while money can be converted into any asset at a moment’s notice, other assets cannot be so easily converted and besides these assets may not have same prices. Everyone, therefore, likes to hold sufficient amount of cash reserves either to meet day-to-day expenses or to tide over unexpected emergencies or for purposes of speculation (as, for

instance, buying an asset such as shares in a company at a lower price to sell it later at a higher price). The demand for money as a liquid asset may be considered as part of the function of money as a store of value.

Transfer of Value : Money helps to transfer value from one person to another and from one place to another. Money is readily accepted by all and in all places and there is no difficulty in transferring even a crore of rupees from a person or institution in Delhi to another in Bombay or Madras. Such transfers of value do not take place through currency notes but through bank cheques or bank drafts.

All the above three secondary functions are actually derived from the primary or main functions of money, viz., medium of exchange and measure of value.

Contingent Functions of Money

Some writers have mentioned certain incidental functions of money – known as contingent functions. These are :

(a) Distribution of National Income : Money helps in the division of national income among people. In a modern society, people join together as workers, owners of capital, landlords, etc., and produce goods and services. This output is jointly produced and will have to be distributed among all of them. Money helps to distribute the gross national product through the system of money wages, interests, rents and profits.

(b) The Equalization of Marginal Utility : It is money which helps consumers and producers to maximize their satisfaction. A consumer who aims at maximum satisfaction buys goods and services in such a way that the price of each commodity (expressed in money) is equal to its marginal utility. Beyond the point of equilibrium, price will be higher than marginal utility which is declining. Likewise, every producer employs factor units in such a way that the price of a factor unit will be equal to the marginal utility (or marginal productivity) of that factor unit.

(c) Basis of the Credit System : The modern economy is based on credit, i.e., promises to pay. The entire economy is dependent on “promises to pay” to such an extent that present-day money is nothing but only “promise to pay” or promissory notes. Every currency note carries the legend “On demand I promise to pay Rs.” etc. The bank cheque or the bank draft is based on the promise of a bank to pay.

(d) Imparts Liquidity and Uniformity of Wealth : Money is an important asset in which wealth is held. In fact, all types of wealth can be converted into money. For instance, land, machinery and equipment, stocks and shares, etc., can always be bought and sold in terms of money. Thus, it is money which imparts liquidity to all varieties of wealth.

Money occupies a central position in our modern economy. Money is every-where and for everything in the modern economic life. Money has become the religion of the day in the ordinary business of life.

Every branch of economic activity in a money economy is basically different from what it would have been in a barter economy. Money has created a far reaching effect on all facets of economic activities; consumption, production, exchange and distribution, as also on public finance and economic welfare.

Money and Consumption

Money enables a consumer to generalize his purchasing power. It gives him command over a wide variety of goods. It enables him to canalize his purchasing power and get what he wants. In fact, it is money through its immense purchasing power that makes a consumer sovereign in a capitalist economy. The consumer's sovereignty can be expressed through money spending. Money provides freedom of choice of consumption. Money and the price mechanism help a consumer to allocate his income over goods in such a way so that he derives maximum satisfaction from their consumption.

Money and Production

“In the modern world, industry is closely enfolded in the garment of money”, says Pigou. The institution of money has made present day mass production possible. Without money, production on a large scale would be impossible. For :

- (i) Money has made extreme division of labour possible. Intensive specialization is necessary for large scale production.
- (ii) Money is the sine qua non for modern enterprise. Entrepreneurs are concerned, while planning their production activities, with the cost of production and selling prices together with the resulting profit, all calculated in terms of money.
- (iii) The use of money enables a producer to concentrate on the organization of the production process. Money provides a basis for supporting more complex methods of organizing production.
- (iv) Money has facilitated borrowing and lending and these are essential in present day production. Credit is the main pillar of modern business.
- (v) Money is the most liquid and general form of capital which is highly mobile between different regions and industries.
- (vi) Money helps the producer to discover through the price mechanism what buyers want and how much they want, so that he can produce and supply accordingly. In fact, money has changed the basic characteristics of production.

Money and Exchange

Money overcomes the difficulties of a barter system of exchange. In a money economy, it is a simple matter to ascertain the market price in terms of monetary units. Money facilitates trade by serving as a medium of exchange. Thus, rapid exchange in a modern economic system is possible because of

money. Money is the basis of the pricing mechanism through which economic activities are adjusted.

Money and Distribution

Money eases the process of distribution of factors rewards like wages, interests and profits which are all measured and disbursed in terms of money. It is with the help of money that the shares of different factors of production are properly adjusted. Accounting, receiving and storing of its share of income by any factor-unit in kind is most inconvenient. Here money comes to the rescue.

Money and Public Finance

In a modern economy, government, plays a very important role. Government receives income in the form of taxes, fees, prices of public utility services, etc. and uses this income for administrative and developmental purposes. But the great magnitude of public revenues and public expenditure in a modern state would become impossible without money. Further, fiscal devices like public borrowing and deficit financing for economic development can be adopted only in a monetary economy.

In recent times, the fiscal policy of a government acquired very great importance in economic life, since economic activities can be regulated through budgetary operations that are facilitated by the institution of money.

Money, thus, plays an important role in the shaping of the economic life of a country. The growth of money has made the growth of economic liberalism and, hence, of the present day free enterprise or capitalist system possible. In fact, the pattern of economic life has changed in accordance with the changes in the economic progress. For better performance of an economy, a country's monetary system should be operated in such a manner as to maintain high levels of employment and avoidance of business fluctuations. The economic history of the Great Depression in the thirties reminds us of its importance.

Money occupies a strategic position in the culture of a modern society. The smooth functioning of the money economy enables society to raise its standard of living by increasing production and equitable distribution through the medium of exchange. Thus, money helps in widening the materialistic base of culture and civilization.

Above all, money is the measuring rod of economic welfare. Macro-economic goals of a welfare state are expressed and their realization is tested in terms of money. Money serves as an index of economic growth. National income, and per capita income are measured in terms of money. Again, physical planning for economic development has its counterpart of financial planning expressed in terms of money.

Money also influences international economy. International economic relations and foreign trade transactions are carried out through internationally accepted money – key currency.

In the final analysis, we cannot think of a well organized social, economic and political life in the present day without money.

Self Assessment Questions:

1. What is Money?
2. Trace the evolution of Money.
3. Explain the functions of Money.
4. Emphasise the importance of Money in a modern economy.

Lesson 2

QUANTITY THEORY MONEY

The value of money – say, the value of a rupee note – consists of the amount of goods and services which it helps to buy. Sometimes money buys more and sometimes less. If a kilo of rice costs 50 paise, one rupee will buy 2 kilos of rice; if on the other hand, a kilo of rice costs Rs. 2, a rupee will buy only half a kilo of rice. Thus, money buys more when the prices of goods and services are low; it buys less when prices are high. The value of money, meaning its purchasing power, depends upon the level of prices. The value of money can never be found out directly but only indirectly, through the price level.

The index number of prices helps us to compare changes in prices in a particular year or month with the prices in a base period. The price index number does not tell us what the value of money is – it tells us only how much the value of money has changed between two periods of time. The computation of price index numbers, involving the comparison of price levels over a series of years, is necessarily a task requiring the greatest possible care. In India, we have the wholesale price index (WPI) and consumers price index (CPI). Normally we use WPI to measure the purchasing power of the rupee.

QUANTITY THEORY OF MONEY

Generally, the value of money – or its reverse, the price level – does not remain constant but fluctuates often. Whenever the price level rises, the value of money declines, and when the price level declines the value of money rises. Why does the value of money change? Or, why does the price level change? The quantity theory of money attempts to answer this question in a simple and direct way :

(a) the value of money depends upon the supply or quantity of money in the country, and

(b) it will change whenever there is a change in the quantity of money.

The theory is called the quantity theory of money because the value of money is explained in terms of changes in the quantity of money or the supply of money in the country.

Substance of Quantity Theory of Money

The quantity theory can be stated either in a strict way or in a broad way. In the strict and narrow version, the quantity theory states :

If the quantity of money is doubled, other things being equal, the price level will also be doubled but the value of money will be halved ; if the quantity of money is halved, the price level will also be halved but the value of money will be doubled.

For instance, if the supply of money in a country is raised by 50 per cent, the price level will also rise by 50 per cent ; the value of money will fall by 50 per cent. In the opposite direction, a fall in the supply of money by 50 per

cent will be followed by a fall in the price level by 50 per cent but rise in the value of money by 50 per cent. In other words, the value of money rises or falls by the same percentage as the decrease or increase in the quantity of money.

In a broad sense, however, the quantity theory of money states that the value of money is influenced, among other factors, by the quantity of money, though the change in the quantity of money and the price level may be not be by the same percentage.

Till the 1930's the quantity theory of money was used to explain the changes in the price level in a country and was also the basis of monetary policy of governments and central banks. Whenever a country experienced a rise in the general price level, it was assumed that there was an increase in money supply ; to reduce the price level, the monetary authorities used to reduce volume of money in the country. On the other hand, a fall in the price level was assumed to be the result of a fall in the quantity of money supply in the country ; to raise the price level, the monetary authorities used to increase the volume of money supply. Those who believed in the quantity theory of money, therefore, argued that ;

(a) changes in the price level in a country (i.e. changes in the value of money) were due to changes in the supply of money ;

(b) changes in the price level were responsible for all changes in the level of economic activity in the country ; and

(c) the price level and the level of economic activity in the country could be influenced by the monetary authorities through changing the supply of money in the country.

Defects of the Quantity Theory of Money

The quantity theory of money which was most popular at one time came in for severe attack during the Great Depression of 1929- 33. During that period, price levels were declining rapidly, followed by severe business depression and unemployment in all countries. Monetary authorities everywhere attempted to check the depression by increasing the quantity of money in the country, but the price level actually declined. This showed that the price level was not a function of money supply alone and that it was influenced by a number of factors, both monetary and non-monetary.

The quantity theory of money assumes that the changes in the price level (or the value of money) are due to changes in the supply of money. It is no doubt true that whenever there is a change in the quantity of money there is a change in the price level also. For instance, an increase in the printing and circulation of currency notes in a country will lead to rise in prices. But it is definitely wrong to assume, as the quantity theory of money does, that changes in the price level are caused only by changes in the quantity of money. There can be other causes also. For instance, the starting of a war can push up prices. Once prices rise and the number of transactions increase, more money may be

required and the monetary authorities may put in more money. In this case, it is the rise in prices which has preceded the increase in the quantity of money.

The quantity theory of money asserts that the change in the supply of money is the cause and the change in the price level (or the value of money) is the effect. But, as Keynes has shown clearly both of them are the effects of more important causes, viz., changes in income and expenditure and changes in the relation between savings and investment. The quantity of money is regarded as a secondary factor compared with the volume of expenditure. Changes in the level of prices are not regarded the most important phenomenon of the economic system ; they are regarded as effects of more important causes. It is the lack of spending, the lack of income rather than lack on money that produces a depression. The quantity of money, in short, is not a dominant cause of the changes in the price level and is a very imperfect guide to the cause of the trade cycle.

The quantity theory has not been useful as a guide to monetary policy. Monetary policy consists of increasing or decreasing the quantity of money in the country so as to raise or reduce the price level. Monetary policy is based on the assumption that there is a direct relation between the quantity of money and the price level. It is true that there may be times when the amount of money and prices have changed together ; but normally they have not. Whether prices or the volume of money do or do not move together depends on many other conditions, such as weather and the size of harvest, inventions, foreign trade, Government spending, taxes, wages and the general attitude of business. When people are venturesome and expect good times, their demand rises and this tends to raise prices. On the other hand, when people are discouraged and expect things to go badly, they tighten their belts and buy as little as possible. The demand for goods declines and prices fall. Usually other things have a greater influence on prices than the amount of money.

Merits of the Quantity Theory

In spite of all these criticisms, the quantity theory of money has certain merits. First of all, the validity of the theory has been brought out in the innumerable instances when large issues of money has pushed up prices to unprecedented levels. Examples are hyper inflation in Germany and Central European countries in 1929-24 and Kuomintang China in 1947-48.

Secondly, in the past as well as these days, monetary policy has always aimed at controlling prices through management and regulation of the volume of money in the country. The bank rate policy and open – market operations are based on the assumption that large supply of money will lead to higher prices and revival of economic activity and vice versa.

Thirdly, in a broad sense, the quantity theory asserts that the rapidity of circulation of money, the volume of bank deposits, issue of paper currency as well as improvements in industries resulting in increased output of goods should all be emphasized in the determination of the price level. In considering the effect of any one of these influences on price level, it is necessary to watch

and determine the effect of other factors which may influence or even outweigh the particular influence under consideration. Thus, in a broad sense, the theory has considerable merit, even though in a strict sense the quantity theory, meaning that every change in the quantity of money will result in an equivalent change in the value of money (or its inverse, the price level) may not be correct.

AMERICAN AND CAMBRIDGE QUANTITY EQUATIONS

The quantity theory of money has two approaches : one is known as the American version or the cash – transactions version and the other is known as the Cambridge version or the cash – balances version. Let us describe these two approaches clearly.

A. Cash – transactions Version of the Quantity Theory

The quantity theory of money was popularized through the well-known equation of the American economist, Irving Fisher. Money has only one use, and that is to help buy and sell goods and services and, therefore, whatever be the volume of money in the country, it will have to buy all the available goods and services. In other words, the total volume of money in a country will, therefore, be equal to the total value of all goods and services during the given period of time.

The Supply of Money (MV)

The supply of money or quantity of money in a country consists of two variables, viz, the quantity of cash (M) and the velocity of circulation of that cash (V). The quantity of cash with the public is partly in the form of cash and partly in the form of bank deposits. This cash does not remain idle but circulates over time. By velocity of circulation we mean the number of times money circulates and is used for transactions. For instance, I may spend a 10-rupee note early in the morning to buy some rice ; the dealer in rice may use the same currency note to pay the school fees of his children ; and the school may pay the currency note as salary to the clerk in the school. The 10 rupee note has thus performed three functions and has bought Rs. 30 worth of goods and services. Money does not remain idle, but it circulates. Some currency notes may circulate fast, while some may not circulate at all (as when money is hoarded). Thus when we consider the total supply of money in a country during a given period of time, we should take into account not only the quantity of cash but also the velocity of circulation of that cash. Suppose that the total amount of cash in India is Rs. 20,000 crores during 1992 and the average velocity of circulation of money during this period is 3, then the total money supply in India during 1992 is Rs. 60,000 crores [i.e. money (M) x velocity of circulation of money (V) or MV].

Demand for Money (PT)

Money is demanded for the purpose of buying goods and services. The total demand for money is the same as the total value of all goods and services bought, viz., the volume of goods and services transacted (T) multiplied by the

average of prices of these goods and services (P). In other words, the total value of goods and services during a given period is equal to P x T or PT. Fisher's quantity equation is as follows :

Total value of money = Total value of all goods and services

$$\text{i.e., } MV = PT$$

The equation can also be written as

$$PT = MV$$

$$\text{Or } P = \frac{MV}{T}$$

in which P is the price level,

M is the quantity of money,

V is velocity of circulation of money, and

T is volume of all goods and services transacted during a given period

The equation states that the price level (P) at any time can be found out by dividing the supply of money by the volume of goods and services transacted. The inverse of the price level is the value of money.

Fisher's Assumptions

Fisher's quantity equation is based on the following assumptions:

(a) V and T are independent factors or variables, i.e., they are not affected or influenced by changes in the quantity of money (M) or the price level (P). The velocity of circulation depends upon the availability of goods to be bought and sold, the rate of turnover, the amount of money which people will like to hold with themselves and, so on, and it is assumed that these factors have nothing to do with changes in the value of money. Likewise, T depends upon the size of natural resources, the technique of production, transportations, and other physical capacities and techniques and all these, it is assumed, have nothing to do with the changes in the quantity of money. Thus the first assumption is that the two variables V and T are independent and that they do not change whenever there is a change in M. Besides, V and T are assumed to be constant.

(b) P is a passive factor, i.e., P does not change by itself nor does it cause changes in the other factors of the equation. But P is changed or affected by other factors in the equation.

(c) Fisher assumes the existence of full employment in the country. Full employment implies that no idle resources are available to increase the production of goods and services. The assumption of full employment is in fact implicit in the assumption that the volume of goods and services (T) will be constant or relatively fixed.

The quantity equation of Fisher, thus, leads to a very simple conclusion:

(i) P (Price level) is determined by three factors, viz., M, V and T;

(ii) **V** and **T** can be ignored in the long period and that **P** does not change by itself ; and, therefore,

(iii) a change in **M** will be followed by an equivalent change in **P**.

Cash-Balances Version of the Quantity Theory

It was J.S. Mill, the 19th century English economist, who actually gave us the well-known equation $MV = PT$. But the equation was later expanded and popularized by Irving Fisher, the American economist, and came to be known as Fisher's equation or American equation. As this equation attempted to show the relation between the volume of money on the one hand and the volume of goods transacted on the other, it came to be called also as Cash Transactions Version of Quantity Theory. Some English economists, following Marshall, popularized a slightly different version of the quantity theory. As these economists, particularly, Pigou, Robertson and Keynes, belonged to the Cambridge University in England the equation has come to be known as the Cambridge equation or the Cash-Balances Version of the quantity theory (from its emphasis on cash balance).

According to the Cambridge version, the value of money (or its inverse, the price level) depends upon the demand for money. But money is demanded not for transactions but to serve as a store of value or to be kept as cash. At any given time, the public can be assumed to hold a certain amount to cash balances sufficient to purchase a given volume of goods and services which may be thought of as a fraction of national income.

Marshall explains this clearly : "In every state of society, there is some fraction of their income which people find it worthwhile to keep in the form of currency; it may be a fifth or a tenth or a twentieth Let us suppose that the inhabitants of a country, taken one with another. . . . find it just worth while to keep by them on the average ready purchasing power to the extent of a tenth part of their annual income together with fifteenth part of their property; then the aggregate value of the currency of the country will tend to be equal to the sum of these amounts." Marshall's equation is

$$M = PKY$$

in which

M stands for the quantity of money with the people

Y stands for the real income, and

K stands for the proportion of real income over which people wish to keep

cash.

P is the price level

The influence of cash balances upon the price level can be illustrated as follows:

Suppose at any one time, people normally have cash balances to represent or buy one-tenth of the annual income of the community. But they now want to have cash balances representing one-eighth of the national income. This means that they want to hold more cash with themselves ($1/8 - 1/10 = 1/40$ additional cash). But the only way the public can have larger cash holding will be by contracting their expenditure on goods and services. Thus, demand for large cash holding will mean lesser demand for goods and services and hence decline in their prices. The price level will fall sufficiently so that the cash balances with the public (being a fixed amount at any particular time) will buy one-eighth instead of one-tenth of the national income. Likewise, if people wish to hold less cash balances with themselves, they will spend more. (The demand for cash will be less which means demand for goods and services will be larger). As a result, the price level will be pushed up. Thus, according to the cash-balances version of the quantity theory, the value of money depends upon the demand for money to be kept as cash.

Let us take a simple numerical example to illustrate this point.

Suppose that :

- (a) The current money supply in the form of cash and bank deposits (M) = Rs. 100 crore
- (b) The annual national output (Y) = 2,000 crore units
- (c) The goods which the community wants to buy (K) say $[1/10 \text{ of } Y] = 200$ crore units.
- (d) The value of 1 rupee = $\frac{200 \text{ crore units}}{\text{Rs.}100 \text{ crore}} = 2$ units of goods
(purchasing power of the rupee)
- (e) The price level = $\frac{\text{Rs.}100 \text{ crore}}{200 \text{ crore units}} = 50$ paise per unit.

It will be clear that the purchasing power of money (or the value of money) is found out by dividing the total amount of goods which the community wants to hold out of total income (KY) by the amount of cash held by the public (M). On the other hand, the price level is found out by dividing the money supply by the amount of goods which the community wants to hold.

Pigou's Quantity Equation

Pigou gives a slightly different cash-balances equation, viz.,

$$P = \frac{KR}{M} ; \text{ in which}$$

P stands for purchasing power of money (or value of money).

M stands for cash with the public

R stands for national income of the community, and

K stands for the proportion of R over which people wish to keep cash.

Pigou's equation shows clearly that the value of money (P) is equal to the amount of goods and services which people want to buy KR divided by the amount of cash balances which they have.

We should note here that the symbol P in this equation is the exact opposite of P in Fisher's equation. Here it stands for purchasing power which, we know, is the inverse of the price level. This explains also why M comes here as denominator while in Fisher's equation it appears as numerator. In terms of price level, Pigou's equation will be

$$\frac{1}{P} = \frac{M}{KR} \text{ in which } \frac{1}{P} \text{ is the price level}$$

Robertson's Quantity Equation

D.H. Robertson's equation is the same as that of Pigou, with only minor differences. His equation is

$$M = PKT \text{ or } P = \frac{M}{KT}$$

in which

P stands for price level (the reverse of the value of money)

T stands for total amount of goods and services

(the same as Rs. R of Pigou and Y of Marshall)

K stands for the fractional part of T over which people wish to keep cash.

This equation is actually preferred to that of Pigou because of its easy comparability with that of Fisher.

Criticism of Fisher's Quantity Equation

The first criticism against Fisher's quantity equation is that it is based on highly unrealistic assumptions. For instance, Fisher assumes that V and T are independent variables and are unaffected by changes in money (M). In practice, however, a change in the quantity of money will affect immediately the velocity of circulation (V) and then the total amount of output (T). Again, Fisher assumes that the price level (P) is passive and is dependent upon changes in M. But it is easy to give examples of the price level being active and bringing about changes in the quantity of money and the velocity of circulation of money. Fisher's assumptions are thus highly unrealistic because changes in one factor may, and often do, induce changes in others. As a matter of fact, all factors in Fisher's equation are in a state of continuous flux.

Secondly, there are various causes outside the equation of exchange which enter into the determination of price level (P). Fisher himself mentions many such factors – as, for instance, changes in the volume of trade, the facilities of transportation, the velocity of circulation which itself depends upon

the habits of people, import and export and export of gold and the corresponding increase and decrease of money and extension of the banking system and the expansion of bank credit – all these factors will influence the level of prices in a country. Obviously, too much reliance should not be placed on the quantity equation.

Thirdly, P and T in Fisher's equation lack significance. The price level (P) represents all sorts of prices, such as the prices of commodities, of wages, interests, rents, profits, etc. some of the prices are flexible and some are rigid; some of them move in one direction but some move in the opposite direction, or may not move at all. Total goods and services (T) which enter into trade and exchange consist of anything and everything. Some are expensive and some are cheap. Thus, P and T do not have much significance.

Fourthly, Fisher's equation does not explain clearly the processes which bring out the changes in the price level. For instance, in Fisher's equation P is determined directly by changes in M, since other variable V and T are held constant. But the processes and the steps by which a change in the volume of money brings about a change in the price level, are not explained by Fisher's quantity equation. As Prof. A.W. Marget has stated Fisher's equation is more or less a shorthand expression designed to indicate the nature of the variables whose operation can be shown to influence prices.

Fifthly, Fisher's equation considers money only as a medium of exchange needed for transactions purposes. In this sense, money is not needed for its own sake and is not held as idle cash balance. Fisher's equation completely ignores the important role of money in society as store of value and for satisfying the speculative motive.

Sixthly, Fisher's equation is static, for it applies during a period and in a world where other things remain constant. But in a dynamic world all things are constantly changing. Naturally Fisher's quantity equation may at best be of some help in explaining normal long – run tendencies but for short-run changes in prices and business activity, it is not of much use. The theory is, therefore, inadequate in explaining cyclical activity in business.

Finally, Fisher's equation is regarded as a worthless mathematical truism, i.e., something which is obviously true. For instance, MV, meaning supply of money, will always be equal to PT, i.e., demand for money. The quantity equation of Fisher does not tell us anything new.

DEMAND FOR MONEY

People demand commodities such as rice, wheat, cloth, shoes, etc., because these goods possess utility. But money does not possess utility to satisfy consumers directly. Why do people demand money then? Money is demanded for two reasons: (a) to help in the exchange of other goods, and (b) to be held as asset (i.e., to serve as a store of value). The first is known as the transactions demand for money and the second is known as the asset demand for money.

Transactions Demand vs. Asset Demand for Money

The demand for money for transactions purposes is for buying and selling of all types of goods and services; this is the demand for money as medium of exchange. Now, the transaction-demand for money is the amount of money required during a given period of time for buying and selling of goods and services.

Money is stored as a form of wealth and it can be conveniently converted into other forms of wealth. Being the most liquid asset, money serves as a store of value and, therefore, it is demanded for its own sake. The asset demand for money, at a particular time, refers to the demand of households, firms and the government for money to be kept as cash balance. It is to this asset-demand for money that Keynes gives the name liquidity preference.

The Classical and the Keynesian Views

The demand for money comes from different sets of people and for different reasons. For example:

(a) Consumers – i.e., households, institutions, companies and the Government – demand money to buy goods and services: in other words, they want money to serve as a medium of exchange, for purposes of transactions.

(b) Producers demand money for purposes of investment, i.e., for buying capital goods of all types and for producing and distributing goods and services.

(c) People demand money as a cash balance so that they could buy securities later.

The classical writers as well as Keynes talked of all these three motives for demanding money but the former emphasized the investment demand for money, while Keynes emphasized the transactions and speculative demand for money.

Lord Keynes and other Cambridge economists have given three important reasons for people demanding money or for holding money, viz., transactions motive, precautionary motive and speculative motive. Others have added a few more. We shall explain each one of these motives for holding money in some detail.

(i) **Transactions Motive**

The transactions motive of individuals and institutions to hold money – a motive, much emphasised by the American economists, Irving Fisher – refers to the demand for money for the conduct of day-to-day transactions. Most people settle their transactions with money and hence they have to carry some money with them. Expenditure is continuous in the sense that a large number of wants arise and have to be met. On the other hand, the income which a person gets is not continuous or regular but periodic, i.e., once a week or once a month. Accordingly, with both individuals and business units, income and expenditure do not balance in any short period of time; the greater the interval

between income and expenditure, the greater is the necessity to hold more money with oneself. This money may be in the form of cash with oneself or in the form of a bank account or bank deposit. The amount of cash balances that a person would like to hold for transaction purposes at any time will depend upon the size of his income, the nature of his transactions, the length of the interval of the receipt of incomes, and the method followed in regard to payments. The total amount of money required by the economy as a whole for transaction purposes will depend upon the level of national income and employment and the general price level. As employment and output or the general price level or both rise, the total volume of money needed for buying and selling will also rise. In other words, the amount of cash held to meet transactions will vary directly with the size of national income and the level of economic activity. For instance, increase in the size of national income and the level of economic activity will result in increased amount of transactions and, therefore, will necessitate increased volume of cash.

(ii) Precautionary Motive

In addition to the amount needed for meeting normal and foreseen expenditures, individuals and business firms will have to keep additional sums of money on hand to provide protection in the event of emergency – this is known as the precautionary motive for holding money. Failure to have sufficient amount of money to meet emergencies might force in individual or business firm into liquidation. For instance, illness reduces income on the one hand and increases expenditure on the other ; it will necessitate emergency borrowing and thus impair a person's credit standing as well as his ability to meet other emergencies. A business firm may need additional cash to meet certain emergencies (such as breakdown of machinery and equipment) or to buy additional raw materials (when their prices are lower), and so on. The volume of money required to satisfy the precautionary motive will differ widely with individuals and business firms, according to the nature of their business, their access to the credit market, the ease with which their other securities can be converted into money when emergency arises, and so on.

The precautionary motive is similar to the transactions motive for holding money, for in both cases money is demanded to meet transactions. But in the case of transactions motive, money is held for ordinary transactions, while in the case of precautionary motive cash balance is kept to meet unforeseen and unexpected transactions. While transactions motive is based on the fact that holding of money is very convenient and that the value of money in terms of other goods is relatively certain, precautionary motive of holding money depends upon the degree of uncertainty in personal and other conditions. In the event of a war or rumour of a war, or in times of financial crisis, people like to hold more money to meet unforeseen contingencies. In general, the cash balances held for the transactions and precautionary motives are directly dependent on the level of national income and are a stable function of the latter.

(iii) Speculative Motive

People like to hold those securities or assets whose prices they anticipate to rise and they hesitate to hold those whose prices they fear will decline. Here is the speculative motive for holding money or securities and all who have cash become speculators.

Suppose that a government servant has saved Rs. 10,000. He has to decide as to what he should do with his savings. He may prefer to keep it with him, and thus lose interest income (for cash is a liquid asset and does not earn any interest). Or, he may prefer to convert his saving into a fixed deposit with a bank and earn interest income of 10 per cent per annum. He may decide to buy debentures of a company and get an interest of 14 per cent per annum.

Suppose people anticipate a rise in the price of securities. Naturally, those who have securities would wish to hold on to them so that they could sell them later at a higher price and earn profit. At the same time, those who have cash with them may use it to buy securities at lower prices now so as to sell them later at higher prices. Thus, if people anticipate rise in the price of securities they would hold less money with them but would buy and hold more securities. On the other hand, if people anticipate a fall in the price of securities they would dispose of their securities now at higher prices, and hold money so as to buy the securities in the near future at lower prices.

We can show the relation between the speculative motive and the other motives for holding money :

(a) The speculative motive for holding cash depends upon the psychology of the speculators and their anticipation regarding the future. The amount of money held for speculative purposes will thus be varying according to circumstances. On the other hand, transactions and precautionary motives for holding money are constant at any given time.

(b) Speculative demand for money depends upon the rate of interest – interest-elastic – while the other motives are not dependent upon the rate of interest and are, therefore, interest-inelastic.

(c) There may be circumstances when it will be difficult to distinguish between speculative and precautionary motives. For instance, a fall in the prices of all types of securities may result in a stock market crash. People will like to hold more by disposing of their securities. This can be explained in terms of either precautionary motive or in terms of speculative motive.

Demand for Money Under Static and Dynamic Conditions

While the transactions demand for money is demand over a period of time, the asset demand for money is demand at a point of time. The transactions demand for money is based on the assumption of static conditions, since it relates to a period of time. The asset demand is demand for money at a point of time (which may differ from one point of time to another) and, therefore, relates to dynamic conditions.

Under static conditions, there are no changes in the economy or whatever changes occur, they are known and accounted for in advance. On the other hand, under dynamic conditions, changes of all kinds are taking place in the economy – and these changes are often uncertain and difficult to forecast and particularly their effects cannot be clearly anticipated.

Now, in static conditions, demand for money – whether it is for transactions or for asset purposes – will be a stable or constant function of the size of national income ; it will change in the same proportion as the change in the size of the national income. For example, if the community's demand for money is 20 per cent of the national income, it will be 20 per cent at all levels of income ; if the national income increases, the community's demand for money will also increase proportionately.

Under dynamic conditions, on the other hand, there is no constant or stable relationship between the demand for money and national income. Actually, the demand for money as a percentage of national income may vary disproportionately. Movement in the general price level is an important dynamic change that affects the demand for money. For example, during a period of rapidly rising prices, the value of money falls rapidly and accordingly people do not like to hold money; instead they would like to convert money into goods. In such periods, therefore, the volume of national income may rise but the fraction of it that the people would like to hold in the form of money may decline. At the same time, during periods of general prosperity, there would a general feeling of optimism when people's expenditure on consumer goods and investment would increase but the community's demand for money, people will prefer money to goods and other assets and, therefore, the demand for money as a percentage of national income will rise. Besides, during business depression there is general feeling of pessimism, fear and insecurity and, accordingly, people would prefer to hold cash than other assets.

Self Assessment Questions

1. Explain the Quantity theory of Money and point out its limitations.
2. Explain the concept of Money supply.
3. What factors determine the money supply in an economy?

Lesson 3

COMMERCIAL BANKS

Commercial banks are the most important source of institutional credit in the money market.

A commercial bank is a profit-seeking business firm, dealing in money and credit. It is a financial institution dealing in money in the sense that it accepts deposits of money from the public to keep them in its custody for safety. So also, it deals in credit, i.e., it creates credit by making advances out of the funds received as deposits to needy people. It thus, functions as a mobiliser of saving in the economy.

A bank is, therefore, like a reservoir into which flow the savings, the idle surplus money of households and from which loans are given on interest to businessmen and others who need them for investment or productive uses.

A bank is an important institution of the money market as it gives short-term loans to its customers.

Definition of Bank

On account of the multifarious activities of a modern bank, it becomes very difficult to give a precise definition of the word "Bank". The Oxford Dictionary defines a bank as "an establishment for the custody of money, which it pays out on a customer's order. This, however, is not a very satisfactory definition, since it ignores the most important function of a bank, that of creating money or creating credit.

Most commonly, then, banks have been defined as dealers in debt. This definition, of course, more aptly describes a bank's activities. Sayers more clearly states: "We can define bank as an institution whose debts (bank deposits) are widely accepted in settlement of other people's debts to each other. Growth, thus, puts it : The banker's business is then, to take debts of other people, to offer his own in exchange and thereby to create money.

A banking company in India has been defined in the Banking Companies Act, 1949 as one "which transacts the business of banking which means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise.

Primary functions

The primary functions of the commercial banks include the following:

A. Acceptance of Deposits

1. Time Deposits. These are deposits repayable after a certain fixed period. These deposits are not withdrawable by cheque, draft or by other means. It includes the following.

(a). Fixed Deposits : The deposits can be withdrawn only after expiry of certain period say 3 years, 5 years or 10 years. The banker allows a higher

rate of interest depending upon the amount and period of time. Previously the rates of interest payable on fixed deposits were determined by Reserve Bank. Presently banks are permitted to offer interest as determined by each bank. However, banks are not permitted to offer different interest rates to different customers for deposits of same maturity period, except in the case of deposits of Rs. 15 lakhs and above. These days the banks accept deposits even for 15 days or one month etc. In times of urgent need for money, the bank allows premature closure of fixed deposits by paying interest at reduced rate. Depositors can also avail of loans against Fixed Deposits. The Deposit Receipt cannot be transferred to other persons.

(b) Recurring Deposits : In recurring deposit, the customer opens an account and deposit a certain sum of money every month. After a certain period, say 1 year or 3 year or 3 years or 5 years, the accumulated amount along with interest is paid to the customer. It is very helpful to the middle and poor sections of the people. The interest paid on such deposits is generally on cumulative basis. This deposit system is a useful mechanism for regular savers of money.

(c) Cash Certificates : Cash Certificates are issued to the public for a longer period of time. It attracts the people because its maturity value is in multiples of the sum invested. It is an attractive and high yielding investment for those who can keep the funds for a long time. It is a very useful account for meeting future financial requirements at the occasion of marriage, education of children etc. Cash certificates are generally issued at discount to face value. It means a cash certificate of Rs. 1,00,000 payable after 10 years can be purchased now, say for Rs. 20,000.

2. Demand Deposits. These are the deposits which may be withdrawn by the depositor any time without previous notice. It is withdrawable by cheque/draft. It includes the following:

(a) Savings Deposits : The savings deposit promotes thrift among people. The savings deposits can only be held by individuals and non-profit institutions. The rate of interest paid on savings deposits is lower than that of time deposits. The savings account holder gets the advantage of liquidity (as in current a/c) and small income in the form of interests. But there are some restrictions on withdrawals. Corporate bodies and business firms are not allowed to open SB Accounts. Presently interest on SB Accounts is determined by RBI. It is 3.5 per cent per annum. Co-operative banks are allowed to pay an extra 0.5 per cent on its savings bank deposits.

(b) Current Account Deposits: These accounts are maintained by the people who need to have a liquid balance. Current account offers high liquidity. No interest is paid on current deposits and there is no restrictions on withdrawals from the current account. These accounts are generally in the case of business firms, institutions and co-operative bodies. Nowadays, banks are designing and offering various investment schemes for deposit of money. These schemes vary from bank to bank.

It may be stated that the banks are currently working out with different innovative schemes for deposits. Such deposit accounts offer better interest rate and at the same time withdrawal facility also. These schemes are mostly offered by foreign banks.

B. Advancing of Loans

The commercial banks provide loans and advances in various forms. They are given below:

1. Overdraft: This facility is given to holders of current accounts only. This is an arrangement with the bankers whereby the customer is allowed to draw money over and above the balance in his/her account. This facility of overdrawing his account is generally pre-arranged with the bank upto a certain limit. It is a short-term temporary fund facility from bank and the bank will charge interest over the amount overdrawn. This facility is generally available to business firms and companies.

2. Cash Credit: Cash Credit is a form of working capital credit given to the business firms. Under this arrangement, the customer opens an account and the sanctioned amount is credited with that account. The customer can operate that account within the sanctioned limit as and when required. It is made against security of goods, personal security etc. On the basis of operation, the period of credit facility may be extended further. One advantage under this method is that bank charges interest only on the amount utilized and not on total amount sanctioned or credited to the account. Reserve Bank discourages this type of facility to business firms as it imposes an uncertainty on money supply. Hence this method of lending is slowly phased out from banks and replaced by loan accounts. Cash credit system is not in use in developed countries.

3. Discounting of Bills: Discounting of Bills may be another form of bank credit. The bank may purchase inland and foreign bills before these are due for payment by the drawee debtors, at discounted values, i.e., a little lower than the face values. The Banker's discount is generally the interest on the full amount for the unexpired period of the bill. The banks reserve the right of debiting the accounts of the customers in case the bills are ultimately not paid, i.e., dishonoured. The bill passes to the Banker after endorsement. Discounting of bills by banks provide immediate finance to sellers of goods. This helps them to carry on their business. Banks can discount only genuine commercial bills, i.e., those drawn against sale of goods on credit. Banks will not discount Accommodation Bills.

4. Loans and Advances : It includes both demand and term loans, direct loans and advances given to all type of customers mainly to businessmen and investors against personal security or goods of movable or immovable in nature. The loan amount is paid in cash or by credit to customer account which the customer can draw at any time. The interest is charged for the full amount whether he withdraws the money from his account or not. Short-term loans are granted to meet the working capital requirements where as long-term loans are

granted to meet capital expenditure. Previously interest on loan was also regulated by RBI. Currently, banks can determine the rate themselves. Each bank is, however required to fix a minimum rate known as Prime Lending Rate (PLR).

Classification of Loans and Advances

Loans and advances given by bankers can be classified broadly into the following categories :

- (i) Advances which are given on the personal security of the debtor, and for which no tangible or collateral security is taken ; this type of advance is given either when the amount of the advance is very small, or when the borrower is known to the Banker and the Banker has complete confidence in him (Clean Advance).
- (ii) Advances which are covered by tangible or collateral security.
- (iii) Advance which are given against the personal security of the debtor but for which the Banker also holds in addition the guarantee of one or more sureties. This type of advance is often given by Banker to persons who are not known to them but whose surety is known to the Banker. Bankers also often take the personal guarantee of the Directors of a company to whom they agree to advance a clean or unsecured loan.
- (iv) Loans are also given against the security of Fixed Deposit receipts.

Credit Creation

Credit creation is one of the primary functions of commercial banks. When a bank sanctions a loan to the customer, it does not give cash to him. But, a deposit account is opened in his name and the amount is credited to his account. He can withdraw the money whenever he needs. Thus, whenever a bank sanctions a loan it creates a deposit. In this way the bank increases the money supply of the economy. Such functions is known as credit creation.

Secondary Function

The secondary functions of the banks consist of agency functions and general utility functions.

A. Agency Functions

Agency functions include the following :

(i) Collection of cheques, dividends, interests : As an agent the bank collects cheques, drafts, promissory notes, interest, dividends etc., on behalf of its customers and credit the amounts to their accounts. Customers may furnish their bank details to corporates where investment is made in shares, debentures, etc. As and when dividend, interest, is due, the companies directly send the warrants / cheques to the bank for credit to customers account.

(ii) Payment of rent, insurance premiums etc : The bank makes the payments such as rent, insurance premiums, subscriptions, on standing

instructions until further notice. Till the order is revoked, the bank will continue to make such payments regularly by debiting the customer's account.

(iii) Dealing in foreign exchange : As an agent the commercial banks purchase and sell foreign exchange as well for customers as per RBI Exchange Control Regulations.

(iv) Purchase and sale of securities : Commercial banks undertake the purchase and sale of different securities such as shares, debentures, bonds etc., on behalf of their customers. They run a separate 'Portfolio Management Scheme' for their big customers.

(v) Act as trustee, executor, attorney, etc. : The banks act as executors of Will, and as trustees and attorneys. It is safe to appoint a bank as a trustee than to appoint an individual. Acting as attorneys of their customers, they receive payments and sign transfer deeds of the properties of their customers.

(vi) Act as correspondent : The commercial banks act as a correspondent of their customers. Small banks even get travel tickets, book vehicles, receive letters etc. on behalf of the customers.

(vii) Preparations of Income – Tax returns : They prepare income-tax returns and provide advices on tax matters for their customers. For this purpose, they employ tax experts and make their services available to their customers.

B. General Utility Services

The General utility services include the following :

(i) Safety Locker facility : Safekeeping of important documents, valuables like jewels is one of the oldest services provided by commercial banks. 'Lockers' are small receptacles which are fitted in steel racks and kept inside strong rooms known as vaults. These lockers are available on half-yearly or annual rental basis. The bank merely provides lockers and the key but the valuables are always under the control of its users. Any customer cannot have access to vault. Only customers of safety lockers after entering into a register his name, account number and time can enter into the vault. Because the vault is holding important valuables of customers in lockers, it is also known as 'Strong Room'.

(ii) Payment Mechanism or Money Transfer : Transfer of funds is one of the important functions performed by commercial banks. Cheques / Drafts and credit cards are two important payment mechanism through banks. Despite an increase in financial transactions, banks are managing the transfer of funds process very efficiently. Cheques / Drafts are also cleared through the banking system. Correspondent banking is another method of transferring funds over long distance, usually from one country to another. Banks, these days employ computers to speed up money transfer and to reduce cost of transferring funds. Electronic Transfer of funds is also known as 'Chequeless banking' where funds are transferred through computers and sophisticated electronic

system by using code words. They offer Mail Transfer, Telegraphic Transfer (TT) facility also.

(iii) Travellers' cheques : Travellers Cheques are used by domestic travellers as well as by international travellers. However the use of travellers cheques is more common by international travellers because of their safety and convenience. These can be also termed as a modified form of travellers letter of credit.

A bank issuing travellers cheques usually have banking arrangement with many of the foreign banks abroad, known as correspondent banks. The purchaser of travellers cheques can encash the cheques from all the overseas banks with whom the issuing bank has such an arrangement. Thus travellers cheques are not drawn on specific bank abroad. The cheques are issued in foreign currency and in convenient denominations of ten, twenty, fifty, one hundred dollar, etc. The signature of the buyer / traveller is written on the face of the cheques at the time of their purchase. The cheques also provide blank space for the signature of the traveller to be signed at the time of encashment of each cheque. A traveller has to sign in the blank space at the time of drawing money and in the presence of the paying banker. The paying banker will pay the money only when the signature of the traveller tallies with the signature already available on the cheque.

A traveller should never sign the cheque except in the presence of paying banker and only when the traveller desires to encash the cheque. Otherwise it may be misused. The cheques are also accepted by hotels, restaurants, shops, airlines companies for respectable persons. Encashment of traveller cheque abroad is tantamount to a foreign exchange transaction as it involves conversion of domestic currency into a foreign currency.

(iv) Circular Notes or Circular Letters of Credit : Under Circular Letters of Credit, the customer / traveller negotiates the drafts with any of the various branches to which they are addressed. Thus the traveller can obtain funds from many of the branches of banks instead only from a particular branch. Circular Letters of Credit are therefore a more useful method for obtaining funds while travelling to many countries.

It may be noted that travellers letter of credit are usually paid for in advance. In other words, the traveller first, make payments to the issuing bank before obtaining the Circular Notes.

(v) Letters of Credit : Letter of Credit is a payment document provided by the buyer's banker in favour of seller. This document guarantees payment to the seller upon production of document mentioned in the Letter of Credit evidencing dispatch of goods to the buyer. The Letter of Credit is an assurance of payment upon fulfilling conditions mentioned in the Letter of Credit. The letter of credit is an important method of payment in international trade. There are primarily 4 parties to a letter of credit. The buyer or importer, the bank which issues the letter of credit, known as opening bank, the person in whose favour the letter of credit is issued or opened (The seller or exporter,

known as 'Beneficiary of Letter of Credit'), and the credit receiving / advising bank. The Letter of Credit is generally advised / sent through the seller's bank, known as Negotiating or Advising bank. This is done because the conditions mentioned in the Letter of Credit are, in the first instance, have to be verified by the Negotiating Bank. It is mostly used in international trade.

(vi) Acting as Referees : The banks act as referees and supply information about the business transactions and financial standing of their customers on enquiries made by third parties. This is done on the acceptance of the customers and help to increase the business activity in general.

(vii) Provides Trade Information : The commercial banks collect information on business and financial conditions etc., and make it available to their customers to help plan their strategy. Trade information service is very useful for those customers going for cross-border business. It will help traders to know the exact business conditions, payment rules and buyers' financial status in other countries.

(viii) ATM facilities : The banks, today have ATM facilities. Under this system the customers can withdraw their money easily and quickly and 24 hours a day. This is also known as 'Any Time Money'. Customers under this system can withdraw funds i.e., currency notes with a help of certain magnetic card issued by the bank and similarly deposit cash / cheque for credit to account.

(ix) Credit cards : Banks have introduced credit card system. Credit card enables a customer to purchase goods and services from certain specified retail and service establishments upto a limit without making immediate payment. In other words, purchases can be made on credit basis on the strength of the credit card. The establishments like Hotels, Shops, Airline Companies, Railways etc., which sell the goods or services on credit forward a monthly or fortnightly statements to the bank. The amount is paid to these establishments by the bank. The bank subsequently collects the dues from the customers by debit to their accounts. Usually, the bank receives certain service charges for every credit card issued. Visa Card and BOB card are some examples of credit cards.

(x) Gift Cheques : The commercial banks offer gift cheque facilities to the general public. These cheques received a wider acceptance in India. Under this system by paying equivalent amount one can buy gift cheque for presentation on occasions like Wedding, Birthday.

(xi) Accepting Bills : On behalf of their customers, the banks accept bills drawn by third parties on its customers. This resembles the letter of credit. While banks accept bills, they provide a better security for payment to seller of goods or drawer of bills.

(xii) Merchant Banking : The commercial banks provide valuable services through their merchant banking divisions or through their subsidiaries to the traders. They underwrite a portion of the public issue of shares,

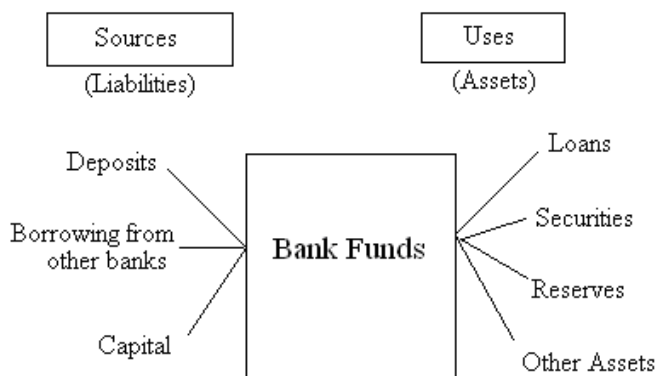
debentures and bonds of Joint Stock Companies. Such underwriting ensures the expected minimum subscription and also convey to the investing public about the quality of the company issuing the securities.

(xii) Advice on Financial Matters : The commercial banks also give advice to their customers on financial matters particularly on investment decisions such as expansion, diversification, new ventures, raising of funds etc.

(xiv) Factoring Service : Today the commercial banks provide factoring service to their customers. It is very much helpful in the development of trade and industry as immediate cash flow and administration of debtors' accounts are taken care of by factors.

One of the best ways to learn about the business of banking is through a perusal of a typical banks' balance sheet. Balance sheet of a commercial bank is a statement of its assets and liabilities at a particular point of time. It throws light on the financial health or otherwise of the bank.

Another way of viewing a balance sheet is as a statement of the sources and used of bank funds. Banks obtain funds in the form of deposits (fixed, savings and current) by borrowing from other banks (RBI, commercial banks, etc.) and by obtaining equity funds from the owners (i.e., the shareholders of the bank) through the capital account. All these constitute the liabilities of the bank. Banks use these funds to grant loans, invest in securities, purchase equipment and hold cash items such as currency and deposits in other banks. All these are the assets of the bank. The figure following depicts sources and uses of funds :



Sources and Uses of Commercial Bank Funds

According to section 29 of the Banking Regulation Act, 1949, at the expiration of each calendar year (or at the expiration of a period of twelve months ending with such date as the Central Government may, by notification in the official gazette, specify in this behalf), every banking company incorporated in India, in respect of all business transacted by it, and every banking company incorporated outside India, in respect of all business transacted through its branches in India, shall prepare with reference to that year or period, as the case

may be, a balance sheet and profit and loss account as on the last working day of the year or the period, as the case may be, in the forms set out in the third schedule or as near thereto as circumstances admit.

The balance sheet and profit and loss account shall be signed :

- (i) in the case of a banking company incorporated in India, by the manager or the principal officer of the company. Where there are more than three directors of the company, by at least three of those directors. Where there are not more than three directors, by all the directors, and
- (ii) in the case of a banking company incorporated outside India by the manager or agent of the principal office of the company in India.

Format of Balance Sheet of a Bank

The balance sheet of a commercial bank like any other balance sheet comprises two sides ; conventionally the left side shows liabilities and capital, while the right side shows assets. A bank’s assets are indications of what the bank owns or the claims that the bank has on external (non-bank) entities : individuals, firms, governments, etc. A banks liabilities are indications of what the bank owes as claims which are held by external entities of the bank. The net worth or capital is calculated by subtracting total liabilities from total assets.

$$\text{Assets} - \text{Liabilities} = \text{Net worth}$$

or

$$\text{Assets} = \text{Liabilities} + \text{Net worth}$$

A much simplified format of a bank’s balance sheet may be illustrated as follows:

Table 1
The Format of Balance Sheet of a Bank

Liabilities	Assets
1. Share capital	1. Cash in hand
2. Reserve funds	” with central bank
3. Deposits:	” with other banks
(a) Time deposits	2. Money at call and short notice
(b) Demand deposits	3. Bills discounted, including treasury bills.
(c) Saving deposits	4. Investments
4. Borrowings	5. Advances
5. Other items	6. Other items.

Many institutions offer financial services. It is the taking of deposits and granting of loans that single out a bank from other financial institutions. Deposits are liabilities for banks, which must be managed if the bank is to maximize profits. Likewise they need to manage the assets created by lending. The liabilities and assets of a bank are explained below.

Liabilities of a Bank

Liabilities of a commercial bank are claims on the bank. They represent the amounts which are due from the bank to its shareholders, depositors, etc. Bank liabilities are the funds that banks obtain and the debts they incur, primarily to make loans and purchase securities. The major components of the liabilities of a bank are as follows :

Capital : The paid up share capital implies the liability of the bank to its shareholders. It is the amount actually received by the bank out of the total subscribed capital. Adequate share capital is considered as a source of strength for the bank as it provides confidence to the depositors about the solvency of the bank.

Reserve fund : Reserves are created out of the undistributed profits which are retained over a period of years by the bank . Creation of reserve fund is a statutory requirement in most of the countries of the world. Reserve requirements limit the portion of the bank's funds that it can use to give loans and purchase securities. Banks build up reserves to strengthen their financial position and also to meet unforeseen liabilities or unexpected losses. Reserve fund, together with capital represents the capital structure or net worth of the bank. Net worth is a residual term that is calculated by subtracting total liabilities from total assets.

Deposits : Deposits constitute the major sources of funds for banks. What the customer regards as an asset, the same bank deposit is a liability for the bank as the customer gains claim over them. Banks get funds from investment and these are indirectly the source of its income. Banks keep a certain percentage of its time and demand deposits in cash and after meeting the liquidity requirement, they lend the remaining amount on interest. Indian banks accept two main types of deposit, demand deposits and term deposits, Demand deposits, as the name suggests, are repayable on demand and term deposits are repayable after the expiry of a particular period. The prosperity, growth and goodwill of the bank depend upon the amount of these deposits. Term deposits have specific maturity and so can be used by bank to earn income. Demand deposits can be further subdivided into current and savings. Current deposits are chequeable accounts with no restriction on the number of withdrawals. It is possible to obtain clean or secured overdraft on these accounts. Saving deposits are more liquid than fixed deposits as money can be withdrawn when needed, though some banks restrict the number of withdrawals per-month or per-quarter.

Borrowing from other sources : In case of need, banks can borrow from the Reserve Bank of India, other commercial banks, development banks,

non-bank financial intermediaries like LIC, UTI, GIC, etc. Secured loans are obtained on the basis of some recognized securities whereas unsecured loans are out of its reserve funds lying with the central bank.

Other liabilities : Other liabilities include bills payable, bills sent for collection, acceptance, endorsement, etc. The amounts of all such bills are shown on the liability side of the balance sheet.

Contingent liabilities : Contingent liabilities are those liabilities which may arise in future but cannot be determined accurately, e.g., guarantee given on behalf of others, outstanding forward exchange contracts, etc. These are shown on the liability side as a rough estimate.

Profit or Loss : Profit is unallocated surplus or retained earnings of the year after paying tax and dividends to shareholders. As shareholders have claim over the bank's profit, it is shown as a liability. In case of loss, the figure will be shown on the assets side.

Assets of Bank

Like all other business firms banks also strive for profit. Commercial banks use their funds primarily to purchase income earning assets, mainly loans and investments. These assets are shown in the balance sheet of the bank in decreasing order of the liquidity. The major assets of the bank include:

Cash : Cash in hand and cash balances with the Reserve Bank of India are the most liquid assets of a bank. Cash assets provide bank funds to meet reserve requirements and the liquidity to meet the withdrawals of deposits and to accommodate new loan demand. Maintaining of cash reserve ratio with RBI is a statutory requirement for the banks.

Money at call and short notice : This is the money lent by the banks to other banks, bill brokers, discount houses and other financial institutions for a very short period of time varying from 1 to 14 days. When these funds are repayable on demand without prior notice, it is called **money at call**. On the other hand, if some prior notice is required, it is known as **money at short notice**. In the balance sheet, both are shown as a single item on the asset side. Banks charge very low rate of interest on these. If the cash position continues to remain comfortable, these loans may be renewed day after day.

Loans and advances : Loans and advances are the bank's earning assets. The interests earned from these assets generate the bulk of commercial bank revenues. Loans may be demand loans or term loans which may be repayable in single or in many instalments. Advances are usually made in the form of cash credit and overdraft.

Investments / securities : Commercial banks use funds for investment in various types of securities like the gilt edged securities of the central and state government as well as shares and debentures of corporate undertakings. The securities issued by government are safe from the risk of default though they are subject to risk from change in rate of interest. These securities include treasury bill, treasury deposit certificates and postal obligations such as national

savings certificate, etc. The long-term investments have the greatest profitability.

Bills receivable : Bills receivable and other credit instruments accepted by the commercial banks on behalf of their customers are also shown on the asset side of the balance sheet. The reason is that the bank has a claim on the payee, on whose behalf it has accepted the bills. Thus, the same amount appears on assets as well as liabilities sides of the balance sheet of the bank.

Other assets : These include the physical assets of a bank like the bank premises, furniture, computers, machines equipment, etc. These also include the collaterals which the bank has repossessed from the borrowers in default.

The basic aim of a commercial bank, like any other business enterprise, is to make profit. The capacity of a bank to earn profit depends upon its investment policy. The investment policy of a bank, in turn, depends on the manner in which it manages its investment portfolio. Portfolio management refers to the management of a bank's assets and liabilities in order to seek optimum combination of profit, liquidity and safety.

The three main objectives of portfolio management are safety, liquidity and profitability and these three attributes are interrelated. To achieve one, the banker will have to sacrifice other objectives. So, a prudent banker is one who follows a wise investment policy which brings maximum profits to shareholders and provides maximum security to the depositors.

Motives for Investment Policy

Profit consideration. The basic aim of a commercial bank is to make as much profit as possible for the shareholders. Hence in acquiring assets, the banker is influenced by the consideration of profit. If assets yield higher returns, the profits for the bank will also be greater. But, as mentioned above, the bank acquires assets mainly out of the deposits of the public. The working of the bank, its survival and continued existence, will, therefore, depend upon the confidence of the depositing public in the soundness of the bank.fore, depend upon the confidence of the depositing public in the soundness of the bank.

Safety and Security . The second consideration of a bank, therefore, is its own safety and security. Since the business of a bank depends upon the confidence of the depositing public (who will feel confident about a bank only when it can produce cash on demand), every prudent banker should maintain adequate cash to honour every cheque presented. In other words, every bank should have enough liquid resources or assets : Liquidity is the capacity to produce cash on demand.

Apart from keeping sufficient amount of cash, a bank should have assets which can be quickly converted into cash in time of need, that is, assets which can be shiftable or transferable. Shiftability implies that the type of assets acquired by a bank should be easily shiftable to other banks or to the central bank of the country, obviously, to acquire cash. In time of emergency

and crisis which a particular bank may face or in times of a general run on banks, shiftability of assets to the central bank of the country assumes great importance. An asset is shiftable to the central bank if it fulfils certain eligibility rules or eligibility canons. In general, a banker will prefer those securities which can be quickly disposed of in the market or which are easily shiftable to the central bank, to those which are highly risky and are more profitable but cannot be sold to other banks or to the central bank of the country. While acquiring assets, therefore, the banker has to keep two basic considerations in mind.

(a) The assets of the bank should be so distributed that they should bring in maximum amount of profit for the shareholders.

(b) There should always be adequate amount of cash and the non-cash assets should be easily convertible into cash so as to meet the depositors demand for cash at all times and in full.

It is easy to show that these two considerations of security and profitability are in a sense contradictory. For instance, the commercial bank works on the basis of the confidence of the depositing public. In order to get and retain this confidence, the banker should have adequate cash reserves to meet in full the demands of all depositors. Maximum safety, therefore, can be attained if the bank keeps a high proportion of cash reserves against deposits. But cash is a barren asset and will not bring in any income for the bank. Thus, if the bank goes for maximum safety as its primary objective, it will have to sacrifice its profits.

On the other hand, if the bank uses all its funds in giving loans and advances since they bring in large interest income, it will not be able to meet the cash requirements of depositors and hence may be forced to close down. In such an event, the shareholders do not get any profit: rather, they are ruined.

It is necessary that the bank should reconcile these two conflicting considerations and distribute the funds at its disposal in such a way that both these considerations would be complied with at all times. In other words, a good banker should keep adequate cash balances to meet day-to-day and seasonal demands of the depositors for cash and also keep additional cash balances to meet any cyclical variations in demand. At the same time, he should make such loans and investments which are safe and which promise good earnings.

B. General Principles

Besides the above basic principles, the banks have to follow certain other general principles in order to make a safe lending. They are:

(i) **Principle of Diversity** : Another important principle of good lending is the diversification of advances. An element of risk is always present in every advance, however secure it might appear to be. In fact, the entire banking business is one of taking calculated risks and a successful banker is an expert in assessing such risks and avoiding or minimizing it in its operation. The bank is

keen on spreading the risks involved in lending over a large number of borrowers, over a large number of industries and areas, and over different types of securities. For example, if it has advanced too large a proportion of its funds against only one type of security, it will run a big risk if that class of security steeply depreciates. The bank has numerous branches spread over the country, it gets a wide assortment of securities against the advances. Slump does not normally affect all industries and business centers simultaneously. Unless there is a general recession in the economy. The principle of diversity is simply do not put all your eggs in a single baskets to avoid total loss.

(ii) Principle of Purpose or End use : A banker must closely scrutinize the purpose for which the money is required, and ensure as far as he can, that the money borrowed for a particular purpose is applied by the borrower accordingly. The purpose should be productive so that the money not only remains safe but also provides a definite source of repayment. The purpose should also be short –termed so that it ensures liquidity. Banks discourage advances for hoarding stocks or for speculative activities. There are obvious risks involved therein apart from the anti-social nature of such transactions. Purpose has assumed a special significance in the present day concept of banking. This principle ensures end use of funds. In fact as per RBI guidelines, banks should ensure end use of funds in respect of large advances.

(iii) Principle of Security : It has been a practice of banks not to lend as far as possible except against security. Security is considered as an insurance or a cushion to fall back upon in case of an emergency. The bankers carefully scrutinize all the different aspects of an advance before granting it. Thus the security serves as a safety value for an unexpected emergency. This is commonly accepted prudent lending policy.

(iv) Principles of National Interest and Suitability : The consideration of national interest serves as a good principle of lending and investment. The Reserve Bank of India has issued directives prohibiting banks to allow certain particular type of advances. For example, banks are not permitted to lend money to speculation in share or for real estate business. It is because that these activities are considered socially not desirable. The law and order situation at the place where the borrower carries on his business may not be satisfactory. The advance may be on the security of manufactured goods of which proper valuation is not possible. There may be other reasons of a like nature for which it may not be suitable for the bank to grant the advance.

Commercial banks play a dynamic role in the economic development of a nation. It may not be an exaggeration to assert that without the evolution of commercial banks in the 18th and 19th centuries industrial revolution would not have occurred in Europe. It is equally true that without the development of sound commercial banking, underdeveloped countries can not hope to join the group of advanced countries.

Sayers has remarked that the banking system as a whole has an important influence on the tempo of economic activity.

Schumpeter, the first modern economist, regarded the banking system as one of the two key agents (the other being entrepreneurship) in the whole process of development.

Role of Commercial banks in Economic Development

The economic development may be defined as a process whereby an economy's real national income is carried on from a lower to a higher level over a long period. The process of economic development needs development of capital resources besides other structural changes like improvement in skill and efficiency of manpower, better organization, better health, education etc. Capital formation is the most significant variable of economic development. The capital formation can be divided into three stages i.e., savings, financing and investment. It is through the three stages of capital formation, banking contributes to economic development.

Mobilisation of Savings

The commercial banks are important agencies for generation of savings of the community. Such savings may be made by individuals, business houses and public authorities. By inspiring confidence in people, banks make them willing to keep their surplus with them. By offering a number of incentives viz., interest on deposit, free or cheap remittance of funds, safe custody of valuables etc., they stimulate savings. Banks have a network of branches far and wide. They accept funds on current, savings and fixed accounts. Thus they mobilize savings from all strata of society at all places and are continuously fighting against the old traditional habits of investment on gold and foster habit of saving in the people. They make them conscious of the avoidable waste in the present social life.

Creation of Credit

Banks are the heart of our financial structure. They create credit and add to the money supply. In a modern society, money supply does not consist only of metallic coins and paper notes but also of bank deposits. Bank credit has an important bearing on the level of economic activity especially in underdeveloped countries. Credit expansion provides more funds to entrepreneurs which lead to more investment and more production. The expansion of bank credit, thus, offers more financial resource to industries to contribute for greater economic development.

Channelising the Funds into Productive Investment

Finance alone is not sufficient for economic development unless accompanied by investment. Banks provide not only funds, the basic fuel for economic growth but also channelise it into productive investment. A developing economy requires continuous process of investment and this in turn requires aggregate rise in money-cash, credit-supply. Banks divert and employ the funds in such avenues which are aimed to develop country's economy and adds to national wealth.

Banks Facilitate Uniform Growth of all Regions

Banks are not merely creators but also regulators of credit. The flow of credit is very much like the circulation of blood. Just as its circulation has to be uniform and smooth, credit flows steadily and evenly through various regions and sectors of the economy. Banks transfer the funds from regions where it is available in plenty to where it can be efficiently utilized. The distribution of funds between regions paves way for the development of backward regions.

Fuller Utilisation of Resources

Commercial banks are catalytic agents which can create opportunities for the development of national resources and provide employment on a large scale. The growth of underdeveloped economy calls for full employment of men and material. Naturally emphasis is laid on small scale industries. The small scale industries employ labour intensive method of production and so employment potential is greater. These industries could be started in a short period and the gestation period is relatively small. Banks offer necessary finance to set up and run the industries. Recently banks have evinced greater interest in financing agriculture. They help promotion of big industries by way of underwriting shares, direct subscription and arranging for deferred payment etc. Thus banks make possible fuller utilization of resources of the nation.

Encourage Right Type of Industries

Generally banks prefer to advance loans only to those entrepreneurs whose products are greatly needed by the public. Indian banks give priority to those industries which have social objectives. Besides, bank loans enable the manufacturers to adopt new methods, to introduce better machinery and to improve working conditions. Thus banks encourage the growth of right type of industries.

Banks not only make use of the productive utilization of idle funds but also see to it that funds are utilized in a manner to obtain optimum productivity. Thus they act as directors in determining the path along which businessmen and industrialists should tread. They have power to influence the way in which such resources might be invested. They encourage the industrious, prudent and punctual and discount the spendthrift, gambler, liar and knave. Hence bankers are regarded as public conservators of commercial virtues.

Finance to Government

Government is the promoter of industries in underdeveloped countries. In addition to the developmental activities, it needs money for setting up of industries. Banks provide long term credit to Government by investing their funds in Government securities and short term finance by purchasing Treasury Bills. Thus banks lend to individuals, firms, companies and Government to start industries and keep it running and to produce wealth.

Banks are Entrepreneurs

In recent years, banks have assumed the role of developing entrepreneurship especially in developing countries. Development of entrepreneurship is a complex process. It includes, in addition to the traditional functions of providing loans and working capital, the formation of project ideas, identification of specific projects suitable to local conditions, inducing new entrepreneurs to take up these well formulated projects and provision of counseling services including technical and managerial guidance. In case of scheme of entrepreneurial development, all that the banks require is a worthwhile project, technically feasible and economically viable coupled with technical competence and ability to manage, apart from character and integrity. Credit is no problem for such projects and in some cases 100% credit is provided by banks. Thus commercial banks help for the development of entrepreneurship in the country.

In some countries banks were established by the government to exploit mineral resources and to build power plants on behalf of government, to promote production in all sectors of the economy and to obtain credit from abroad. The importance of banks in speeding up economic growth is evident from the fact that in some countries their government had to establish banks to expedite the development projects. In India the 20 major banks were nationalized to speed up the tempo of economic development.

Self Assessment Questions :

1. Explain the role of Commercial Bank in economic development.
2. Explain the different functions of commercial banks.
3. Explain the investment policy of commercial banks.
4. What is balance sheet?
5. Explain the constituents of a balance sheet of commercial banks.
6. What are the different types of deposits accepted by Commercial banks?
7. List down the Subsidiary Services of a bank.

Lesson 4

UNIT BANKING AND BRANCH BANKING

Unit Banking

Unit banking is originated and developed in U.S.A. In this system, small independent banks are functioning in a limited area or in a single town i.e., the business of each bank is confined to a single office, which has no branch at all. It has its own board of directors and stockholders. It is also called as “localized Banking”.

Advantages of Unit Banking

The Unit banking system has the following advantages :

- (i) Easy Establishment
- (ii) Easy Management and control
- (iii) Quick – decisions
- (iv) Local Development
- (v) Personalised services
- (vi) No chance for regional disparities
- (vii) Promotes efficient working
- (viii) Inefficient banks cannot survive
- (ix) No chance for monopoly
- (x) Suitable for the countries aiming at unity in diversity

Let us discuss these items one by one.

(i) Easy establishment : The unit bank operates on small scale basis. Hence, it requires less capital to promote a unit bank. Besides, the formalities, rules and regulations are comparatively easier than branch banking.

(ii) Easy management and control : The size and operations of the bank under unit banking system will be small. Therefore, management, supervision and control will be easier.

(iii) Quick decisions : Under unit banking system, the manager can take quick decisions regarding loan sanctioning, etc, and he need not wait for the instructions and approval from the head office.

(iv) Satisfaction of local needs : Unit banking is the localized banking. The entire operations of the unit bank are confined to a particular area. Therefore, banks have the specialized knowledge of the local problems, their requirements, etc., and can serve to fulfill those needs. In this way local needs are better satisfied than branch banking.

(v) Personalised services : The unit banking gives an opportunity for the bankers to intimately know his customers. The manager has personal knowledge of each of his customers and established greater personal contact.

This ensures personalized service which is not possible in the case of branch banking where the staff are frequently transferred.

(vi) No chance for monopoly : Under unit banking, the size of the bank will be small and limited to a small area. Each bank is independent by itself. Therefore, monopolistic trend in banking cannot arise.

(vii) Promotes efficient working : Too much expansion as in the case of branch banking leads to a reduction in efficient working. The overall control on all branches becomes difficult. It may result in red-tapism, mismanagement and corruption in branches. But it is not so in the case of unit banking since, the size of operation is limited. It ensures efficient working through effective control and supervision.

(viii) Inefficient banks cannot survive : Under branch banking system, the running of one branch leads to the running of all other branches. A weak branch cuts into the profit of the concern as a whole. The loss arising from the weak branch will be adjusted against the profits from other branches. This type of adjustment is known as cross-subsidisation. Hence, the weakness or inefficiency of a branch can be carried forward for years. But, it is not possible in the case of unit banking. In this system efficient banks can only survive, i.e., the survival of the fittest.

(ix) No chance for regional disparities : Unit banks have no country wide branches. Hence, the funds collected in one place will not be transferred to other places. The funds collected from the people in an area will be utilized for the benefit and development of that area only. In this way, the unit banking system ensures regional balance and there is no chance for regional disparities.

(x) Suitable for the countries aiming at unity in diversity : Unit banking is more suitable for the countries where there are differences in local laws, languages spoken, habits and customs, etc.

Disadvantages of Unit Banking

The following are the disadvantages of the Unit Banking System.

(i) No ability to face crisis: Limited resources, limited area of operation and non-diversification of investments reduce the ability of unit banks to withstand losses. They cannot face any financial crisis.

(ii) No geographical distribution of risks : Under unit banking system the area of operations of a bank is limited to a particular place only. If there is any business depression in that place, the bank also suffers losses. Because of its localized operations, the unit bank cannot distribute the risks over a wider area.

(iii) Variation of interest rates : There may not be uniformity of interest rates under unit banking. Different banks may charge different rates of interest, since there is no possibility for the transfer of funds to other areas, the availability of funds influence the rates of interest.

(iv) Lack of diversification of deposits and assets : The main factor that affects the survival of a unit bank is its lack of diversification of deposits and assets, loans and advances will be concentrated in the industries located in the area, any difficulty in these industries will automatically affect the bank also.

(v) Not able to provide adequate banking facilities : Because of its restricted areas of operations and limited financial resources, unit banks are not able to provide the entire range of banking facilities as provided by branch banking.

(vi) Inconvenience in the remittance of funds : The unit banks have no branches in other place. Therefore, transfer of funds from one place to another becomes costly and inconvenient.

(vii) No importance to backward areas : Unit banking banks may not be started in places where they do not have enough business opportunities because it is unprofitable and uneconomic. But under branch banking, branches can be opened even if it is uneconomical because the losses in one place can be compensated by profits in another place.

(viii) Weaker sections may be neglected : Even in the towns and cities where the unit banks are operating, the weaker sections of the society i.e., poor people may be neglected because of limited resources of the banks.

(ix) Influence of local pressures : The unit banker, being a local man may have to follow local considerations, etc., in granting loans and advances. Because of his legitimacy with the local customers, he may be compelled to violate the basic economic principles.

(x) Lack of division of labour and specialization : Generally the size of unit bank is small. So there is not much scope for the introduction of division of labour and specialization. Because of this, it cannot adopt the modern methods of banking. Thus, the efficiency of the bank will be affected which in turn affects the profitability of the bank.

(xi) Unhealthy Competition : The unit banks are run by different groups of people i.e., the multiplicity of ownership. This may create unhealthy competition among them which will affect the economy adversely.

Branch Banking

The Banking system of England originally offered an example of the branch banking system, where each commercial bank has a network of branches spread throughout the country. In the initial stages of banking development, each bank in England consisted of a single office with few branches. In the process of evolution, banking organization developed in the direction of branch banking. As a result of continuous process of amalgamations and consolidation, today there exist only a few banks, of which the “Big Five” – the Midland, the Lloyds, the Barclays, the Westminster and the National Provincial” – are most important. The Big Five of England have more than 10,000 branches and cover about 75% of the banking resources of the country.

Most of the Indian Banks are falling under this category. They are having large number of branches. All the Public Sector banks, i.e. nationalized banks and State Bank of India and its subsidiary banks put together have nearly 60,000 branches. Banks in India require a licence from Reserve Bank of India under Banking Regulation Act to open a branch as well as to start a bank itself.

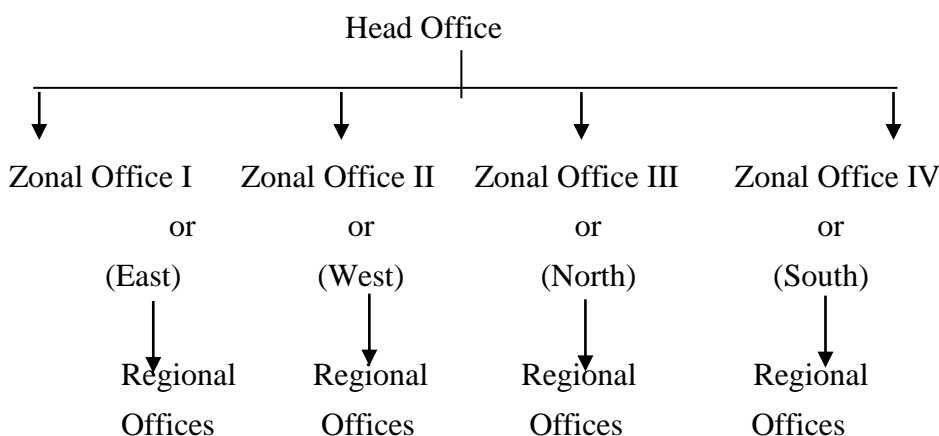
Thus, branch banking consists of a few big banks with numerous branches spread over wide geographical areas. These branch banks operate under their head offices. Branch banking is also known as “delocalized banking”. In India, the State Bank of India has emerged as one of the biggest banks with large number of branches all over the country.

Organisational Structure of Branch Banking

The organisational structure of the branch banking in the country is given below:



It can be explained on a different way as follows :



Advantages of Branch Banking

The following are the advantages of branch banking :

(i) Benefits of large-scale operations : A branch bank has all the advantages of large scale operations. It has large resources when compared to unit bank. It can appoint experts paying high salary and it can use modern mechanical devices in its offices for efficient working.

(ii) Wider spreading of risks : A branch bank operates over a wide area with different types of economic development. The losses of branches of one

region if any can be set off against the profit of branches in other regions. In this way this risks are distributed geographically. Thus, its capacity to withstand times of depression is more than that of unit banks.

(iii) Efficient management : The branch banking system makes for greater efficiency in management. The staff members of branch bank are more efficient and more experienced when compared to those of a unit bank. The head office arranges transfers of staff from branch to branch. Each staff member has the opportunity to work in various branches, understanding men and matters of different localities. Besides the above, the expertise at head office will be made available to all branches. In this way, the system of branch banking ensures efficient management.

(iv) Economy in remittance : Branch banking has the benefit of economy in remittance of funds. As it has branches in different localities, it need not physically transfer cash from one place to another. It can provide remittance facilities to its customers by mere transfer entries in the books of its branches. It makes the operation easy, quick and cheap.

(v) Economy of cash reserves : Branch banking has the merit of economy of cash reserves. Cash can be transferred from one branch to another whenever necessary. Therefore, branch can operate with lower cash balances and they avoid large amount of idle reserves / balances.

(vi) Diversification of deposits and assets : Under branch banking system, there is greater diversification of deposits and assets because of wider geographical coverage. Diversification here means that a bank need not specialize in any particular area or particular industry. Deposits are mobilized from the areas where savings are in plenty and loans are extended in the areas where funds are scarce and interest rates are high.

(vii) Uniformity of interest rates : Branch banking system ensures uniformity in interest rates. Uniformity in banking policies and easy transfer of funds to places where there is demand, results in uniform interest rates.

(viii) Reduce seasonal stringency : In agricultural countries like India, there is greater demand for funds during the seasons of agricultural operations. By a wide network of branches and transfer of funds, branch banking will be in a position to relieve such seasonal scarcity of funds.

(ix) Fullest and proper use of resources : Under branch banking, there is great scope for economic use of funds. The head office analyses the demand for funds in various localities and freely transfers its resources among its branches. At no branch, funds are kept idle. This enables it to earn high profits by employing its funds most economically and profitably.

(x) Extension of banking facilities to backward areas and weaker sections : Under branch banking, the banking facilities are not restricted to profitable localities only but they are extended to the backward areas also. The loss arising from such localities can be compensated by the profits from other

developed areas. Besides, because of the availability of resources, the requirements of weaker sections of the society are also satisfied.

(xi) Acquiring diverse types of securities : Branch banking has the advantage of acquiring diverse types of securities from different regions in employing funds. It can invest its funds by lending against securities of agricultural commodities, industrial goods, gold, stock, etc. It can choose a variety of securities from different localities. But a unit bank does not have this facility.

(xii) Provide long-term loans and advances : Due to its wider area of operations, they may mobilize large resources which can be used to provide loans and advances on long-term basis which is not possible in case of unit banking.

(xiii) Greater mobility of organization : The branch banking has the greater mobility of organization. It can spread its activities to new localities by opening branches with ease.

(xiv) Loans and advances made on merit : Under the system of branch banking loans and advances are made purely on merit and not on other considerations. The branch managers is not influenced by local pressures in granting loans and advances. He can refuse a loan to an undesirable person, without any obligation, fixing the responsibility on the head office. This is not possible in the case of a unit bank.

(xv) Possibility of division of labour and specialization : Because of the availability of large resources and large scale operations it is possible to adopt division of labour which leads to specialization. In this way branch banking ensures the overall efficiency of the organization.

(xvi) Economic conditions can be studied better : Under branch banking, a network of branches is spread all over the country. Thus, it can have a comprehensive knowledge of the entire economic conditions of the country. It helps the banks to make proper investments.

(xvii) Banks failures will be minimized : In the case of heavy withdrawal of funds in one branch, it can be met by transferring funds from other branches. Thus, bank failures can be avoided.

(xviii) Effective control by Central Bank : Branch banking does not make the control by Central Banking more difficult, as it has to deal only with the Head Offices of Banks, and not with each branch.

(xix) Greater convenience to trade : The trade of one area can get in touch with traders in other parts of the country with ease. If the bank has branches in foreign countries, they can contact the traders in foreign countries also. The helps them to promote their business considerably.

(xx) Public confidence : The large scale operation and the financial viability of branch banking gains public confidence which is the foundation stone for the banking business.

(xxi) Equitable distribution of employment opportunities : A vast network of bank branches at various places offer local employment opportunities and help local people in getting jobs.

Disadvantages of Branch Banking

Even though, the branch bank has many advantages as mentioned above, it is not free from criticisms. The following are the disadvantages of Branch Banking:

(i) Difficulty in management and control : Since the bank has many branches, spread over different places, supervision, management and control becomes more difficult.

(ii) Less initiative : The branches of the bank are not allowed to make their independent decisions. They have to follow the directives of the head office. Besides they have to refer to the matters to the head office for approval. Therefore, the branch managers cannot take initiative.

(iii) Regional disparities : In the case of unit banking system the funds are used for the particular locality alone. It cannot be transferred to other places. But, in the case of branch banking funds collected from backward areas and the villages may be transferred to the places where the profitability is high. This tendency creates regional imbalances in the country.

(iv) Adjustment of losses : In branch banking, the losses of one branch may be adjusted against the profit earned by another branch. This will affect the profitability of the organization as a whole, as loss making branches will continue to eat into the profits of efficient branches.

(v) Concentration of economic power : Under branch banking system, the financial resources may accumulate in the hands of a few who control big banks with large number of branches. This will cause concentration of economic powers in few big banks. It leads to monopoly.

(vi) Continuance of inefficient branches : Under unit banking system, the inefficient branches cannot survive. But, in the case of branch banking, the inefficient branches may continue to operate because the losses of these branches are compensated by the profits of some other strong branches. In this way, under this system, inefficiency is protected.

(vii) Heavy overhead charges : Establishment of branches in new areas incurs heavy overhead charges. This will affect the operational efficiency of the banks.

(viii) Unhealthy competition : Under branch banking, many banks may operate the branches in a particular locality where business prospects are very bright. It may create unhealthy competition among various branches of banks.

(ix) Delayed decision-making : In branch banking the manager of a branch cannot take the decision on his own. He has to refer to the matter to the head office seeking permission or approval. This creates red-tapism in the organization.

(x) Local needs may not be satisfied in full : As the branch manager is not connected or familiar with local conditions, the local needs may not be attended and satisfied in full.

(xi) Other defects:

- (i) Preferential treatment may be shown to firms situated near head offices.
- (ii) The lower rates charged in developing regions may be adjusted by charging high rates of interest in developed regions.
- (iii) There are possibilities for mismanagement in branches, like frauds, misappropriation of funds, etc.

As Sayers remarks, “a comparison between unit banking and branch banking is essentially a comparison between small scale and large scale operations”. The natural growth is always towards large scale branch banking. Branch banking has more advantages than unit banking. That is why, it is adopted by most of the countries in the world.

Deposit Banking Vs. Mixed Banking

Deposit Banking

Pure deposit banking has its origin in England. Banks in England were only confined to accepting deposits and lending for short periods to industries and trade. Receiving deposits and making advances for short period is called deposit banking. The underlying principle of this system is that banks can not lock up their deposits in long term investment as the deposits are repayable on demand. Banks were custodians as well as trustees to keep safe the deposits of the public. This principle made them completely free from supplying fixed capital requirement of industries.

Industrial or Investment Banks

Industries require finance not only for short periods but also for long periods. Long term funds are required for acquisition of fixed assets, modernization, expansion of business and re-organisation of the industry. The banks which provide long term finance are called industrial banks or investment banks. In Germany the banks provided long term funds to industries before 1914. The banks in Germany, in addition to financing, helped the industrialization of the country by floating new companies.

Mixed Banking

The banking system which combines deposit banking with investment banking is known as Mixed Banking. The mixed bank receives deposits from public and provides short term, medium term and long term loans to industries.

Self Assessment Questions :

1. What is Unit banking? State its advantages.
2. What is branch banking?
3. Explain the Organisational Structure of branch banking.
4. What is mixed banking?

Lesson 5

CREDIT CREATION BY COMMERCIAL BANKS

The stability of price level is an essential condition for the economic development. It highly depends upon the demand and supply of money. The supply of money includes the legal tender money and bank money. The legal tender money is issued by the Central Bank or the Government of the country in the form of Bank / currency notes while the bank money is created by the banks. The bank money consists of bank deposits. Cheques drawn on bank deposits act as the legal tender money, i.e., with cheques payment obligation can be settled. Thus, banks are not merely purveyors of money but also the manufacturers of money.

Bank deposits may be arrived in the following two ways :

1. Primary deposit and
2. Derivative deposits

1. Primary Deposits

It is also known as cash deposit or passive deposits. Deposits also arise when customers take actual cash and deposit it with bank, it is known as the primary deposit.

2. Derivative Deposits

It is also called active deposits or creative deposits. Deposits also arise when customers are granted accommodation in the form of loans. These deposits add to the supply of money.

When a bank grants a loan to a customer it does not usually pay the amount in cash, instead it credits an account with the amount of loan. That is, the bank places a deposit at the borrower's disposal and he can freely withdraw the amount as he likes. He can draw cheques against the deposits created in his favour for settling his transactions. Thus, cheques against bank deposits become purchasing power in the hands of the public in addition to the legal tender money. But more often, the loan is utilized over a long time gradually and till such time it forms as deposit. Hence, the loan which a banker grants to a customer usually large corporates creates additional deposits, i.e., by advancing loans, banks create deposits and thus, create money. So "money is said to be created when the banks, through their lending activities, make a net addition to the total supply of money in the economy".

The customer may retain the loan amount with the bank as deposits or can issue cheques against this deposit to settle his dues. The receiver of the cheque may deposit it in the same bank in which case his deposits increase while the givers deposit decreases. In case the borrower has account in some other bank the deposit of that bank increases.

MANNER OF RAISING DEPOSITS

The deposits are raised in the following manner. When a customer goes to his bank for a loan, generally he provides “collateral security”. The banker grants a loan and credit to his account with the amount of the loan. The customer is entitled to draw cheques up to the amount of the loan and these cheque can be used to buy goods and to discharge business obligations. In this way additional money comes into existence and the process is virtually equivalent to the creation of additional supplies of money. It should be noted that primary deposits do not create credit and they go to increase the cash reserve of the bank as actual cash is paid into the bank. But the derived deposits decrease the cash ratio of the bank because that are created without, receiving any cash from the customers. Thus, when a loan is granted to a customer a deposit arises.

We can explain the technique of credit creation with the help of the following examples :

Let us assume ;

- (i) There are number of banks exist and operating in the economy.
- (ii) The banks have to keep 10% of the deposits as cash reserves as per law.
- (iii) The customer Mr. X deposits the amount of Rs.10,000 into his bank say ABC Bank.

This existing Balance sheet of ABC Bank appears as follows :

Balance Sheet			
Liabilities	Rs.	Assets	Rs.
Deposits	10,000 -----	Cash and balances with RBI	10,000 -----
Total	10,000 -----		10,000 -----

The deposit of Rs. 10,000 is a liability for the bank and the bank has an obligation to repay it on demand. And at the same time, it is an asset to the bank as it can use the deposit to lend / invest to earn income (interest). As a legal obligation the bank has to keep 10% of the total deposits as reserve with RBI. Thus, it has a surplus of Rs. 9,000 for advancing loans.

Now, the banks lend Rs. 9,000 to Mr. Y. Then the position of the balance sheet will be as follows :

Balance Sheet

Liabilities	Rs.	Assets	Rs.
Deposits	10,000	Cash and balances with RBI	10,000
		Advances	9,000
	-----		-----
Total	10,000		19,000
	-----		-----

The receiver of the loan Mr. Y. has the option to deposit the money with the ABC itself or into his bank say XYZ Bank. Let us assume that, Mr. Y gets the money from ABC bank and deposits it into his bank, XYZ Bank.

XYZ Bank has to keep a reserve of 10% of the deposit and is free to lend the balance. Assume that the bank has purchased the bills from Mr. Z for the balance 90%, i.e., Rs. 8,100. Now the balance sheet of XYZ Bank will be as follows:

Balance Sheet of XYZ Bank

Liabilities	Rs.	Assets	Rs.
Deposits	9,000	Cash and balances with RBI	900
		Investments	8,100
	-----		-----
Total	9,000		9,000
	-----		-----

If we assume that Mr. Z deposits the money Rs. 8,100 received into his bank Bank of Mysore.

Here, the Bank of Mysore also has to keep a reserve of 10% of the deposits and can lend the balances. If it lends the balance 90% to a customer "S" then the balance of sheet of Bank of Mysore will be as follows :

Balance Sheet of Bank of Mysore

Capital and Liabilities	Rs.	Assets	Rs.
Deposits	8,100	Cash and balances with RBI	810 7,290
	-----	Advances	-----
Total	8,100		8,100
	-----		-----

If this process is continued till the original deposit of Rs.10,000 is fully exhausted, the total amount of deposits so made will be calculated as follows :

$$= 10,000 + 9,000 + 8,100 + 6561 \dots \text{etc.}$$

Total amount of deposits = Rs. 1,00,000

This is the process of multiplication of deposits through credit creation.

The Formula for Credit Creation

The credit creation depends upon the mandatory per cent of cash reserve to the total deposits.

Thus, the deposit multiplier is,

$$K = 1/r$$

where k = Deposit multiplier ; r = ratio of cash reserve to deposits.

If the cash reserve ratio is 20% or .2, the deposit multiplier will be,

$$K = 1/r = 1/0.2 = 5$$

If the percentage of reserves to the total deposits decrease, the multiplier will increase, i.e., higher the cash reserve ratio the lower will be the deposit multiplier and vice versa.

If we assume that the total percentage of cash reserve is 20% and the commercial banks get fresh additional cash of Rs.100 crore, as a result of government spending, they would be able to create deposits through loans and investment to the extent of Rs.500 crore. This is calculated as follows:

$$\text{Credit creation} = K \times 100 \text{ crores} = 5 \times 100 = 500 \text{ crores}$$

Thus, banks are able to create deposits because of the activities of 3 parties.

- The public who are willing to keep its money in the banks as deposits
- The banks, keeping only a fraction of deposits as cash reserves.
- The borrowers from the banks.

MULTIPLE EXPANSION OF CREDIT

A single bank cannot create huge deposits. If we take several banks together, there is scope for multiple expansion of bank deposits. They lend many times more than the actual cash held by them and it is possible by mere entries in the books of banks. In this way banks can create credit to a large extent and adds to the total money supply in the country. However the ability of banks to create such additional money supply is curtailed by prescribing higher Cash Reserve Ratio for banks. Assumptions of Credit Creation

1. The banks, while granting loans, do not give the amount in cash, instead it credits the accounts of the customers with the amount of loan.
2. The customers do not withdraw the entire amount of loan.
3. While drawing the money from his account he uses cheque system.
4. The persons who are receiving the cheques against their claims from others also deposit the money into their respective banks.
5. The accounts are settled with mere book entries.

CREDIT CONTRACTION

Commercial banks are able to multiply creation of credit, when deposits are made with them. If cash is removed from the banking system, it results in multiple contraction of credit.

Let us trace withdrawal of cash with the help of the following example.

The “Bank B” has a cash reserve of 10,000 at 20% of total deposits of Rs. 50,000 and Rs. 40,000 as investments. Now the position of the bank will be as follows :

Balance Sheet of “Bank B”

Capital and Liabilities	Rs.	Assets	Rs.
Deposits	50,000	Cash and balances with RBI	10,000
	-----	Investments	-----
Total	50,000		50,000
	-----		-----

Let us assume that a depositor withdraws his deposit of Rs. 5,000 permanently from the bank. Now the balance sheet of the bank will be,

Balance Sheet of 'Bank B'

Capital and Liabilities	Rs.	Assets	Rs.
Deposits	45,000	Cash and balances with RBI	5,000 40,000
	-----	Investments	-----
Total	45,000		45,000
	-----		-----

From the balance sheet, it could be seen that the cash reserve is below the legal minimum and it should be Rs. 9000, i.e., 20% of Rs. 45,000. Therefore the bank must sell Rs. 4,000 worth of investments. When the bank sells its securities there will be a chain of reaction. The buyer of the security may withdraw Rs. 4,000 from his bank say Vijaya Bank to pay for it. Then the Vijaya Bank will find its cash reserves fallen by Rs. 4,000. It will therefore sell some of its securities. And so it goes on until all the effects are exhausted. And the original withdrawal of Rs. 5,000 has produced a chain "Killing off" Rs. 25,000 worth of deposits throughout the whole banking system. the process of contraction of bank deposits is the same as that of credit expansion – but in the opposite direction.

LIMITATIONS ON CREDIT CREATION

Bank cannot expand deposits to an unlimited extent by granting loans and advances even though this process of granting loans and advances is profitable to them. Their power to create credit is subject to the following limitations :

(i) Total amount of cash in the country : The banks have power to create deposits depending upon the total supply of cash. The Central Bank of a country has the monopoly power to issue currency notes. The quantity of money in circulation increases with the issue of more currency and vice versa. Hence, the increased money supply or circulation enables the banks to create more credit. If the supply decreases the banks capacity to create credit will be decreased.

(ii) Cash reserve ratio : The actual cash reserve held by a bank and the cash ratios considered safe in the banking circles, set the limit for creation of credit. Every bank must be keep sufficient cash balances to meet the demands of the customers across the counter, and settle the inter-bank indebtedness arising out of the clearing house. The need for keeping adequate cash reserves to meet the claims that arise from currency withdrawal sets a limit to the capacity of a bank to create money. Banks have to maintain the required cash ratios either according to the custom prevailing in the market or as required by law. In India it is decided by the RBI under Reserve Bank of India Act. This is the minimum cash required to be maintained by a bank with RBI. As per Sec. 42 of RBI Act,

this ratio can vary from a minimum of 3 per cent to a maximum of 15 per cent of net demand and time liabilities (deposits) of a bank. Higher the ratio less is the opportunity for credit creation and vice versa. CRR is an instrument of monetary control.

(iii) Banking habits of people : The banking habits of the people also sets the limit for the capacity of banks to create credit. The volume of employed population, monetary habits, etc., determine the amount of cash that the public wishes to hold. The amount of loan given to a customer should again come back to the bank in the form of primary deposits. Then only there can be credit creation. This is possible only when the banking habits among the people are well developed and they keep their money in the banks as deposits and use cheques for the settlement of their claims.

(iv) Policy of other banks : The credit creation is possible if all the banks in the industry follow the uniform policy regarding maintenance of cash reserves. If certain banks follow the conservative loan policy and keeping high rate of cash reserves while others are freely lending with minimum cash reserves, the creation of credit will not be up to the extent as determined above i.e., the volume of the credit created will not be up to the extent of the credit multiplier.

(v) The availability of good securities : The availability of good securities, i.e., the securities acceptable to bank places a limit on credit creation by the banks. While lending, the banks insist upon the securities from the customers. All type of assets are not acceptable to banks as securities. They lend only on liquid assets such as gold, bills, raw materials, etc. As Sayers said, the banks do not create credit by lending to everybody “but to those individuals who can offer to the banks the kind of assets which the bank thinks attractive”.

(vi) Policies of central bank : The capacity of credit creation by banks is largely depends upon the policies followed by the Central Bank from time to time. The total supply of cash depends upon the policy of the Central Bank. As the Central Bank can control the supply of cash through various weapons of credit control such as bank rate, open market operations and variation of cash reserves the upper limit of the volume of bank deposits is absolutely determined. Thus, the Central Bank can control the creation of credit by increasing or reducing the total supply of cash in the economy.

(vii) Initiative of businessmen : The banks can create credit if only the customers are willing to borrow from them. The capacity of the banks to create credit depends upon the psychology and initiative of businessmen and general market conditions for good business activities.

(viii) Effects of trade cycles : The effects of trade cycles also place the limitation on the credit creation, i.e., the conditions of inflation and deflation set a limit on the creation. During the period of economic prosperity there will be greater demand for bank loans and therefore, they can create greater volume of credit. But in times of recession, there is no prosperity and the business

people will hesitate to borrow. Therefore, the volume of bank credit will be low.

(ix) Liquidity preference by the people : If the general public are highly driven to keep more amount of cash with them, the banks cannot get adequate deposits to create credit and thus, the liquidity preference by people place a limitation on the creation of credit.

(x) Leakages : The credit creation by the banks is subject to certain conditions. If there is any leakage in this process the credit creation by the banks will be limited. In credit creation it is expected that the banks lend the entire amount of excess deposits over the minimum statutory reserve. And if there is any down fall in such lending, it will affect the creation of credit to that extent. Likewise it is expected that people who borrow money will deposit the same in their respective banks. If, they do not deposit the loan borrowed, the capacity of the banks to create credit will be limited.

Self Assessment Questions :

1. Can banks create credit? What are the limits, if any, of their powers to do so?
2. “Loans Create deposits.” Explain this statement and bring out clearly the process of credit by banks.
3. How do banks Create deposits? Are there any dangers in such excessive Creation? How is the danger kept under control.

Lesson 6

FUNCTIONS OF CENTRAL BANK

Central banking is a comparatively new phenomenon. In most countries, except England, the central bank is a twentieth century financial institution. In the U.S.A., the Central Bank of the Federal Reserve System, was established in 1913; in India, the Reserve Bank of India was set up in 1935.

CENTRAL BANK : AN APEX FINANCIAL AUTHORITY

The essential feature of a central bank is its discretionary control over the monetary system of the country. A bank is called a central bank because it occupies a pivotal position in the monetary and banking structure of the country in which it operates. Thus, the central bank acts as the leader of the money market and in that capacity, it supervises, controls and regulates the activities of the commercial banks. It is recognized as the apex monetary institution or the highest financial authority.

The central bank has been defined by R.P. Kent as “institution charged with the responsibility of managing the expansion and contraction of the volume of money in the interest of the general public welfare. Thus, we may define the central bank as an institution whose main function is to help, control and stabilise the monetary and banking system of the country in the national economic interest.

The above stated definition of a central bank clearly justifies its need and importance. The banking system can work as a system only if there is an institution at the top to direct its activities. Without such a direction, the system would be nothing but a collection of unconnected units, each following an independent policy, often contradictory to one another. Thus, the central bank is essential to regulate the activities of commercial banks, integrate them, and direct their policies according to the best national economic interest.

FUNCTIONS OF A CENTRAL BANK

The powers and range of functions of central banks vary from country to country. But there are certain functions which are commonly performed by the central banks :

1. It issue the currency notes of the country
2. It is the custodian of the foreign exchange reserve of the country
3. It serves as banker to the government
4. It serves as banker to commercial banks
5. Being a monetary authority, it regulates the banks credit creation activity and performs the function of a controller of credit
6. It promotes the economic development of the country

1. Central Bank as a Bank of Note Issue

The central bank is legally empowered to issue currency notes – legal tender. Commercial banks cannot issue currency notes. The central bank's right to issue notes gives it the sole or partial monopoly of note issue, while in India, the Reserve Bank of India has a partial monopoly of note issue, for example, one rupee notes are issued by the Ministry of Finance, but the rest of the notes are issued by the Reserve Bank.

According to De Kock, following are the main reasons for the concentration of the right of note issue in the central bank :

- (a) It leads to uniformity in note circulation and its better regulation
- (b) It gives distinctive prestige to the note issue
- (c) It enables the State to exercise supervision over the irregularities and malpractices committed by the central bank in the issue of notes.
- (d) It gives the central bank some measure of control over the undue credit expansion by the commercial banks, since expansion of credit obviously leads to an increased demand for note currency.

The central bank keeps three considerations in mind while issuing currency notes, namely, uniformity, elasticity and security. The right of note issue is regulated by law. According to law, every note issued must be matched with an asset of equal value (assets such as, government securities, gold and foreign currencies, and securities). This is necessary to inspire public confidence in paper currency.

2. Central Bank as a Custodian of Foreign Exchange Reserves

The central bank holds all foreign exchange reserves – key currencies such as U.S. dollars, British pounds, and other prominent currencies, gold stock, gold bullion, and other such reserves – in its custody. This right of the central bank enables it to exercise a reasonable control over foreign exchange, for example, to maintain the country's international liquidity position at a safe margin and to maintain the external value of the country's currency in terms of key foreign currencies.

3. Central Bank as Banker to Government

As the government's banker, the central bank maintains the banking accounts of government departments, boards, and enterprises and performs the same functions as a commercial bank ordinarily performs for its customers. It accepts deposits of commercial banks and undertakes the collection of cheques and drafts drawn on the bank; it supplies government with the cash required for payment of salaries and wages to their staff and other cash disbursements and transfer funds of the government from one account to another or from one place to another. Moreover, it also advances short – term loans to the government in anticipation of the collection of taxes and raises loans from the public. It also makes extraordinary advances during periods of depression, war, or other

national emergencies. In addition, the central bank renders a very useful banking service required to meet the repayment of debts and service charges or for the purchase of goods and other disbursements abroad, and by buying any surplus foreign exchange which may accrue to the government from foreign loans or other sources.

The central bank also serves as an agent and adviser to the government. As agent of the government, it is entrusted with the task of managing the public debt and the issue of new loans and treasury bills on behalf of the government. It also underwrites unsold government securities. Moreover, the central bank is the fiscal agent to the government and receives taxes and other payments on government account. By acting as financial adviser to the government, the central bank discharges another important service; it advises the government on important matters of economic policy such as deficit financing, devaluation of currency, trade policy and foreign exchange policy.

The central bank also functions as a representative of the State in international financial matters. It is entrusted with the task of maintaining the nation's reserves of international currency.

4. Central Bank as Banker to Commercial Banks

Broadly speaking, the central bank functions as banker to commercial banks in three capacities; (i) as custodian of cash reserves of commercial banks; (ii) as lender of last resort; and (iii) as clearing agent.

Thus, the central bank acts, as a conductor and leader of the banking system of the country. It acts as a friend, philosopher, and guide to commercial banks.

(i) Custodian of cash reserves of commercial banks : Commercial banks find it convenient to keep their reserve requirements with the central bank because its notes command the greatest confidence and prestige and the government's banking transactions are conducted by this institution. Thus, in every country, commercial banks keep a certain percentage of their cash reserves with the central bank by custom or by law.

In fact, the establishment of central banks makes it possible for the banking system to secure the advantages of centralized cash reserves. The significance of centralized cash reserves lies in the following facts :

- (a) Centralisation of cash reserves in the central bank is a source of great strength to the banking system of the country as it inspires the confidence of the public in the commercial banks.
- (b) Central cash reserves can form the basis of a much longer and more elastic credit structure than those scattered among numerous individual commercial banks.
- (c) Centralised cash reserves enable the central bank to provide additional funds to those banks which are in temporary difficulties.

In fact, the central bank can function as lender of the last resort on the basis of the centralized cash reserves with it.

- (d) Centralisation of cash reserves is conducive to the growth of the economy and it leads to the increased elasticity and liquidity of the banking system in particular and of the credit structure in general.
- (e) Centralisation of cash reserves also enables the central bank to influence and control credit creation of commercial banks by increasing or decreasing the cash reserves of the latter, that is, through the technique of the variable reserve ratio.

(ii) Lender of the last resort : As lender of last resort, in periods of credit stringency, the central bank gives temporary financial accommodation to commercial banks by rediscounting their eligible bills. The central bank is the ultimate source of money in the modern credit system. The function of the lender of last resort implies that the central bank assumes the responsibility of meeting directly or indirectly all reasonable demands for accommodation from commercial banks. The central bank's function as lender of last resort has evolved out of its rediscounting function during emergency periods. The real significance of rediscount function, lies in the fact that it increases the elasticity and liquidity of the entire credit structure. By providing a ready medium for the conversion in cash of certain assets of banks, it helps to maintain their liquidity. It also makes possible a considerable degree of economy in the use of cash reserves, since commercial banks can conduct a large volume of business with the same reserve and capital.

(iii) Clearing Agent : As the central bank becomes the custodian of cash reserves of commercial banks, it is but logical for it to act as a settlement bank or a clearing house for other banks. As all banks have their accounts with the central bank, the claims of banks against each other are settled by simple transfers from and to their accounts. This method of settling accounts through the central bank, apart from being convenient, is economical as regards the use of cash. Since claims are adjusted through accounts, there is usually no need for cash. It also strengthens the banking system by reducing withdrawals of cash in times of crisis. Furthermore, it keeps the central bank informed about the state of liquidity of commercial banks in regard to their assets.

5. Central Bank as Promoter of Economic Development

The modern central bank accomplishes a number of development and promotional functions. Today, the central bank is regarded as an inevitable agency for promoting the economic growth of a country. It is an institution responsible for the maintenance of economic stability and for assisting the growth of the economy within the framework of the general economic policy of the state. Thus, the central bank has to take all such steps as are necessary, to meet the economic requirements of economic development of the country. It is responsible for the development of an adequate and sound banking system to cater to the needs not only of the trade and commerce but also of agriculture and industry. The central bank has to ensure, in the interest of economic

progress, that the commercial banks operate on a reasonably sound and prudent basis. Thus, the major task of the central bank lies in the development of highly organized money and capital markets that many help accelerate economic progress by assisting the huge investment activities in capital formation and other productive sectors. During the planning era, the central bank's role as adviser to government on economic matters in general, and on financial matters in particular, is of considerable importance.

Self Assessment Questions :

1. State the functions of a central bank.
2. Explain the role of central bank as banker to commercial banks.
3. Explain the term lender of the resort.
4. What are the uses of centralized cash reserves?
5. Explain the role of the Central bank in the promotion of economic development.

Lesson 7

QUANTITATIVE METHODS OF CREDIT CONTROL

Central Bank as Controller of Credit

By far the most important of all functions of the central bank in modern times is that of controlling credit operations of commercial banks. Credit, the source of many blessings in a modern economy, also may become, unless we control it, a source of confusion and peril. The social and economic consequences of changes in the purchasing power of money are serious and since credit plays a predominant part in the settlement of business transactions, it is essential that it should be subjected to control. Monetary policy is implemented by the central bank through the weapon of credit control.

Under the monetary management of the central bank, credit control stimulates expansion of credit at one time and checks it at another. The principal instruments of credit control, at the disposal of the central bank, may be classified as : (1) quantitative or general, and (2) qualitative or selective.

The general instruments are directed towards influencing the total volume of credit in the banking system, without special regard for the use of which it is put. Selective or qualitative instruments of credit control, on the other hand, are directed towards the particular use of credit and not its total volume.

Quantitative weapons of credit control consists of (a) bank rate policy ; (b) open market operations ; and (c) variable reserve ratios.

These methods have a quantitative or a general effect on credit regulation. They are used for changing the total volume of credit or the terms on which bank credit is available, without regard for the purpose for which credit is used by borrowers. But the central bank today, also, makes use of certain qualitative or selective methods by which it controls, in addition to the aggregate volume of credit, the flow of credit in particular directions.

Selective credit control aims at regulating (stimulating or restricting) the uses to which credit is put. The main methods of selective credit control are : (a) margin requirements ; (b) regulation of consumer's credit ; (c) control through directives ; (d) rationing of credit ; (e) moral suasion and publicity ; and (f) direct action.

We shall discuss below the quantitative measures of credit control.

Bank Rate policy (BRP)

The bank rate is a traditional weapon of credit control used by a central bank. In order to perform its function as lender of last resort to commercial banks, it will discount first-class bills or advance loans against approved securities.

A specific idea regarding the technique of bank rate can be had from the Reserve Bank of India's definition of the bank rate policy which consists of varying the terms and conditions under which the market may have temporary

access to the central bank through discounts of selected short-term assets or through secured advances. Thus, the bank rate policy seeks to influence both the cost and availability of credit to members of the bank. Cost, of course, is determined by the discount rate charged, and the availability depends largely upon the statutory requirements of eligibility of bills for discounting and advances, as also the maximum period for which the credit is available.

The bank rate obviously is distinct from the market rate. The former is the rate of discount of the central bank, while the latter is the lending rate charged in the money market by the ordinary financial institutions.

The “Modus Operandi” of Bank Rate

The bank rate policy signifies manipulation of the rate of discount by the central bank in order to influence the credit situation in the economy. The principle underlying the bank rate policy is that changes in bank rate are generally followed by corresponding changes in the money market rates, making credit costlier or cheaper, and affecting its demand and supply.

If the bank rate is raised, its immediate effect is to cause an increase in bank's deposit and lending rates. The prices which bankers are prepared to pay on the amounts deposited with them by their customers increase, so that the volume of the bank deposits increases. Commercial banks employ a substantial proportion of the funds deposited with them to form the basis of loans and advances that they make to their customers, and in as much as the banks are now paying more for these deposits, they must charge higher rates for loans and advances made to their customers. So when the central bank raises the bank rate, the cost of borrowing of the commercial banks will increase, so that they will also charge a higher rates for loans and advances made to their customers. So when the central bank raises the bank rate, the cost of borrowing of the commercial banks will increase, so that they will also charge a higher interest rate on loans to their customers and, thus, the market rate of interest will go up. This means that the price of credit will increase. As many business operations are normally conducted on the basis of bank loans, the price (interest) which has to be paid for this accommodation is, of course, a charge against profit to the business. In consequence, the sudden increase in the interest rate will reduce or wipe out the profit of the business, so that industrial and commercial borrowers reduce their borrowings. In other words, increased market rate or increase in the cost of borrowing will discourage business activity, i.e., their demand for credit falls. As a result of the contraction of demand for credit, the volume of bank loans and investment activity fall so that unemployment will ensue. Consequently, income in general will fall, people's purchasing power will decrease and aggregate demand will fall. This, in turn, will affect the entrepreneurs adversely. When demand falls, prices will come down, and, as a result, profit will decline. The rate of investment is basically determined by the rate of profitability, and thus, in view of falling profits, investment activities will contract further. So, a cumulative, downward movement in the economy sets in.

In brief, an increase in the bank rate leads to a rise in the rate of interest and contraction of credit, which, in turn, adversely affects investment activities and consequently, the economy as a whole.

Similarly, a lowering of the bank rate will have a reverse effect. When the bank rate is lowered, the money market rates fall. Credit, then, becomes cheaply available and the business community will come forward to borrow more. Thus, the expansion of credit will increase investment activities, leading to an increase in employment, income and output. Aggregate demand will increase, prices will rise, and profits will increase which, in turn, will boost production and investment activities further. Consequently, a cumulative upturn of the economy will develop.

Limitations of Bank Rate Policy

The following are the chief limitations of bank rate policy :

- (i) **Existence of an Organised and Developed Money Market:** Efficacy of the bank rate in controlling credit requires a close correspondence between the bank rate and the structure of interest rates in the money market, so that changes in the bank rate will be followed by changes in the market rates. This presupposes the existence of a highly organized money market. Unfortunately, most underdeveloped countries do not have an organized money market. The wide range and multiplicity of money rates in such an organized money market will make the success of the bank rate policy doubtful. The absence of any conventional relationship between the central bank and other segments of the money market will further add to the ineffectiveness of the bank rate policy.
- (ii) **Bank's Need for Rediscounting :** The need for commercial banks to approach the central bank for rediscounting facilities is an important factor in determining the successful working of the bank rate policy. But commercial banks will have no need to approach the central bank when they have ample liquid resources at their disposal, i.e., when they have enough excess resources.
- (iii) **Business Expectations :** The psychological reaction to a change in the bank rate should also be considered for the effectiveness of the bank rate policy. If, in a boom period, businessmen are unduly optimistic, their demand for credit will be interest-inelastic and the bank rate will be ineffective. Similarly, during a depression, when businessmen are pessimistic, they will not respond favourably to the incentive of low interest rates.
- (iv) **Interest-inelasticity of Deposits :** The axiom that a rise in the bank rate and, thus a rise in interest rates payable on deposits by commercial banks will cause an increase in bank deposits is

questionable. A large majority of people save because of the precautionary motive, and their savings depend on their earning capacity, i.e., their income. These savers do look for a rise in the interest rates on deposits, but they usually deposit with banks for the purpose of safety. Thus, it is actually the increases in income rather than interest rate that promotes savings by the people which augment bank deposits.

In conclusion, although it must be admitted that the bank rate policy has very limited significance in underdeveloped as well as developed money markets in view of the present day conditions and government policies, it has nevertheless a useful function to perform in conjunction with other measures of credit control. Central banks of the present day, however, have to rely more upon other instruments of credit control than the bank rate policy alone in regulating the cost, availability and supply of credit money.

Open Market Operations

Open market operations imply deliberate direct sales and purchases of securities and bills in the market by the central bank on its own initiative to control the volume of credit. In a broad sense, open market operations simply imply the purchase or sale by the central bank of any kind of eligible paper like government securities or any other public securities, or trade bills, etc. In practice, however, the term is applied, in most countries, to the purchase or sale of government securities (short-term as well as long-term) only by the central banks.

Working of Open Market Operations : When the central bank sells securities in the open market, other things being equal, the cash reserves of the commercial banks decrease to the extent that they purchase these securities; by selling securities, the central bank also reduces, other thing being equal, the amount of customers' deposits with commercial banks to the extent that these customers acquire the securities sold by the central bank. In effect, the credit-creating base of commercial bank is reduced and hence credit contracts. In short, the open market sale of securities by the central bank leads to a contraction of credit and reduction in the quantity of money in circulation. Conversely, when the central bank purchases securities in the open market, it makes payments to the sellers by cheques drawn on itself, the sellers usually being commercial banks or customers of commercial banks. The banker's accounts are credited and, therefore, there is an increase in the commercial banks' cash reserve (which is the base of credit creation) and as also an increase in the customers' deposits with commercial banks (which is the principal constituent of money supply).

In short, open market purchases of securities by the central bank lead to an expansion of credit made possible by strengthening the cash reserves of the banks. Thus, on account of open market operations, the quantity of money in circulation changes. This tends to bring about changes in money rates. An increase in the supply of money lower money rates, while a decrease of money

supply raises money rates. Open market operations, therefore, directly affect the loanable resources of the banks and the rates of interest. Changes in rates of interest in turn tend to bring about the desired adjustments in the domestic level of prices, costs, production and trade.

In short, the central bank follows a policy of open market selling of securities when contraction of credit is desired, especially during a boom period when the stability of the money market is threatened by the over-expansion of credit by commercial banks. Conversely, during a depression when the money market is tight and expansion of credit is desired, the central bank follows the policy of open market buying of securities.

Limitations of Open Market Operations

The following are the major limitations of open market operations :

1. Lack of well-developed securities market : There must be a broad, strong and active securities market for large-scale and successful open market operations. Lack of such a market renders open market policy ineffective.

2. Contradictions between bank rate and open market operation : The scale of securities by the central bank may prove ineffective in curbing the loanable resources of the banks so long as the possibility of rediscounting leaves the door open to replenish the reserve as before.

3. Restricted dealings : The success of open market operations is limited by the preparedness of the central bank to incur losses. In the case of short-term securities, the loss is relatively less. Therefore, open market operations are often restricted to dealings in short-term securities only.

4. Difficulties in execution : To execute a purchase policy by the central bank is not as difficult as the sale of securities in open market operations. Similarly, for commercial banks, a policy of credit contraction is easier to implement than a policy of expansion. Thus, by the operation of money factors alone, open market operations can stop booms but cannot prevent slumps.

5. Precautions for stabilizing the government securities market : Another drawback of the open market operations policy is that when a large-scale of securities is effected by the central bank, the prices of securities adversely affect bank assets and upset the government's borrowing programme. In such conditions, the central bank has to stabilize the securities market and, to that extent, the scope of open market operations to influence the credit situation is limited.

Usefulness of Open Market Operations

The open market operations policy of the central bank can serve the following purposes :

(1) As a complementary to the bank rate policy it tends to enhance the efficacy of the bank rate. It may be used to prepare the ground for changes in the bank rate. When credit contraction is desired, the central bank may raise

bank rates as well as sell securities in the open market, so that the cash reserves (credit base) of banks is also reduced. Conversely when expansion is desired, central bank may lower bank rates and at the same time, buy securities in the open market and, thus, provide additional cash to commercial banks to enable them to increase their advances.

(2) It assist government borrowings. By purchasing government bills and bonds and such other securities when the prices are low and selling them when their prices are high, the central bank can maintain stability in the prices of government securities and thereby promote public confidence in the instruments of public debt.

(3) It may be useful in contracting extreme trends in business by buying securities during periods of slack business and selling them in period of inflationary boom.

(4) It may be adopted to influence the balance of payments position favourably. Open market sales operations, for instance, will have a contractionary effect on credit and a deflationary situation will develop so that the domestic price level will fall. Exports will be encouraged due to increased foreign demand on account of lower prices, whereas, imports will be restricted due to high costs of foreign goods. Thus, a favourable balance of payments will follow.

On these accounts, open market operations have come to be recognized as an important technique of monetary management. The growing importance of open market operations is due to the decline of bank rate as an instrument of credit control after the first war and the consequent need for another, and more direct method. In the thirties, open market operations became necessary in order to implement the policy of cheap money.

Superiority of Open Market Operations

As a method of influencing money supply, open market operations are superior to bank rate because the initiative lies in the hands of the monetary authority in the case of the former, while it rests with the commercial banks in the case of the latter. In other words, while bank rate policy is only an indirect way of controlling credit, open market operations are more direct. Moreover, the bank rate directly affects only short-term interest rates ; long-term rates are affected only indirectly. Open market operations, on the other hand, have a direct influence on the prices of long-term securities and, therefore, on long-term interest rates. They have a direct and immediate effect on the supply of money and credit and, therefore, on money and interest rates. Thus, this method is largely used nowadays to influence interest rates in the country and prices of government securities in the market.

Variable Cash Reserve Ratio (VCRR)

The variable cash reserve ratio is comparatively new method of credit control used by central banks in recent times. In 1935, the U.S.A.'s Federal Reserve System adopted it, for the first time. In countries where the money

market is unorganized or underdeveloped, increasing recourse is now taken to this method of credit control.

The variable reserve ratio device springs from the fact that the central bank, in its capacity as Bankers' Bank, must hold a part of the cash reserves of commercial banks. The minimum balances to be maintained by the member banks with the central bank are fixed by law and statutory powers have been conferred on the central bank to alter the quantum of these minimum reserves. The customary minimum cash reserve ratio is an important limitation on the lending capacity of banks. Thus, variations in the reserve ratio reduce or increase the liquidity and, consequently, the lending power of the banks also. Therefore, the cash reserve ratio is raised by the central bank when credit contraction is desired and lowered when credit is to be expanded.

Thus, like other techniques of monetary control, the variation of cash reserve requirements has a dual purpose; requirements can be lowered as well as increased. A reduction of reserve requirements immediately and simultaneously augments the lending capacity of all the banks. Conversely, raising a cash reserve ratio immediately and simultaneously reduces the lending capacity of all member banks. The fundamental assumption of this method is that the excess cash reserve (being the base of credit) realized through the lowering of the minimum reserve ratio, results in the expansion of credit, and similarly, the contraction of cash reserve due to the raising of minimum cash reserve requirements will result in the contraction of credit.

Therefore, the reserve requirement ratio is a powerful instrument which affects the volume of excess reserve with commercial banks as well as credit creation multiplier of the banking system. To clarify the point, suppose commercial banks have Rs.10 crores of total reserve funds with the central bank and that the legal cash reserve ratio is 10 per cent of the total deposits. If, with the existing deposits, the required reserves of the banks are Rs. 3 crores, the excess reserves amounting to Rs. 7 crores will support a tenfold (the multiplier being ten, as the reserve ratio is ten per cent) increase in the deposits, i.e., Rs. 70 crores of credit creation (Rs. 7 x $\frac{100}{10}$ crores). If, on the other hand, the reserve ratio is doubled, i.e., if it is raised to 20 per cent, the required cash reserves are Rs. 6 crores, and the excess reserves would be Rs. 4 crores only. This excess reserve of Rs. 4 crores, with the 20 per cent reserve requirements, would obviously support only a fivefold (the multiplier now being 5) increase in the bank deposits i.e., Rs. 20 crores of credit creation only (i.e., Rs. 4 x $\frac{100}{10}$ crores). Thus, raising of the reserve requirements affect credit contraction, and conversely, a reduction in the reserve ratio brings about credit expansion.

Uses of VCRR

The variable reserve ratio, as an instrument of monetary control, is regarded as decidedly superior to open market operations in the following particulars:

- (i) The variable reserve ratio is a straight direct method of credit control. It can give results more promptly than open market operations. The cash reserves of a bank can be altered by just a stroke of the pen.
- (ii) The successful working of open market operations requires a broad based developed, securities market. The variable reserve ratio has no such limitations. Thus, in countries where the securities market is not extensively developed, the variable reserve ratio has greater significance as a technique of monetary control.
- (iii) Large-scale open market operations may affect the value of government securities and, thus, there are chances of loss being incurred by the central government and commercial banks, because their assets consist of a large stock of government securities. The variations in reserve ratios, on the other hand, yield the desired results in the controlling credit, without fear of any such loss.
- (iv) The variable reserve ratio is applicable simultaneously to all commercial banks in influencing their potential credit-creating capacity. Open market operations affect only those banks which deal in securities.

Limitation of the Variable Reserve Ratio

This method of credit control has a number of limitations as stated below:

1. Large excess reserves : When commercial banks have large excess reserves, the change in the reserve brought about by the method is comparatively ineffective. In such circumstances, when the reserve ratio is raised, the banks will satisfy the legal minimum reserve, but their existing credit creation activities will not be contracted.

2. Determination of bank-credit policy : Banks do not determine their lending policy on the basis of their cash reserves alone. For instance, they may determine their credit policy on the basis of their foreign funds or on the basis of the ratios of advances to total deposits. To this extent, variations in the reserve ratio may have limited effects.

3. Demand for bank credit : The exact effect depends also on the demand for credit. A change in the credit-creation capacity of commercial banks may not have the desired effect if the demand does not change in the way the central bank wants it to change. A lowering of the reserve ratio may not be very effective in credit expansion particularly during a depression.

4. Distortions caused by frequent use : Frequent change in reserve requirement are very disturbing . The method, therefore, can be used only when a large change in credit is necessary and that too on special occasions.

Thus, this method, cannot be used to make small adjustments in the supply of credit because changes in the reserve ratio in terms of percentage always involve a large magnitude of available cash reserves of member banks. Therefore, it cannot be used for frequent and delicate adjustments in current changes in money supply.

5. Discriminatory effect: As noted above, the method is said to be clumsy and discriminatory in its effect and inflexible. Its discriminatory effect is seriously criticized because its application is confined to commercial banks. Non-banking financial remain outside its purview. Non-banking financial intermediaries, like development banks, co operative credit societies, specialist financial intermediaries institutions, land mortgage banks, insurance companies, etc. are not influenced by the operation of the variable reserve ratio, while they are active competitors of commercial banks, in a way. Thus, the technique is unjust.

6. Involving an element of uncertainty : It may causes an adverse psychological reaction by breeding an element of uncertainty in the banking sector. Changes in it are unpredictable and shocking, and so in order to avoid the situation of peril and hardship, the variation in the reserve ratios should be made only after prior notice had been given to the banks concerned and it should be of small magnitude.

Despite these limitations, the variable reserve ratio is considered a very powerful, important and necessary weapon for monetary management. Thus, we may conclude with Prof. Sayers that “It is a weapon which should always be placed in the hands of a central bank whose technique is circumscribed by the conditions hindering the effective utilisation of open market operations. Given such power, the central bank can perform useful functions that commercial banks cannot be expected to perform.

Self Assessment Questions :

1. What is Bank Rate?
2. Explain the quantitative methods of Credit Control.
3. Explain the working of open market operations.
4. Write the merits of open market operations.
5. What is VCRR?

Lesson 8

SELECTIVE CREDIT CONTROL METHODS

Selective methods of credit control are a comparatively recent development in monetary management by the central bank. The measures of selective control are sharply distinguishable from the general instruments of credit control in that they are directed towards particular uses of credit and towards total volume of credit. In fact, selective instruments are designed to influence specific sectors of the economy, which are most vulnerable to fluctuations and require to be controlled, without affecting the economy as a whole. It is because of this specific particularized application that they are called “selective” controls. This rationale behind the operations of selective credit control has been to discriminate between various uses of credit, various economic sectors or channels in which the credit flows from the stream of banking system, thereby reinforcing factors that help in the stability of the entire economy. The flow of credit has to be denied to those channels which do not help growth and endanger the stability of the whole country.

Thus, quantitative credit control, non-discriminatory in its effects and influencing as it does the total volume of credit, fails to check undesired expansion and contraction in certain specific sectors of economic activity, while selective credit controls draw a distinction between desirable and essential uses and undesirable and non-essential uses to which credit can be put with discrimination in favour of the former. Its object is to diversify the flow of credit from undesirable uses to more important, desirable, and productive uses. Though selective controls are designed to check the conduct of lenders only, they also influence the attitude of the borrowers, by prescribing the term on which certain kinds of loans may be made. Thus, under selective credit controls, the monopoly of credit becomes, in fact, a discriminating monopoly.

In advanced countries, the instrument of selective credit controls is adopted with a view to reducing the amplitude of the business cycle, and the chief motive of such controls has been to prevent demand for durable consumer goods from outrunning supply, and generating inflationary pressure on the economy.

Objectives of Selective Credit Controls

The following are the main objectives underlying selective credit control.

1. To discriminate against non-essential lines of production in bank advances, and to diversify credit towards more essential productive uses.
2. To tackle only the sensitive spot of the economy, without affecting the economy as a whole.
3. To discourage excessive consumer demand for certain goods, induced by hire-purchase schemes and the instalment payments business. The regulation of consumer hire-purchases or instalment-buying during an inflationary period constitutes a highly serviceable form of credit control.

4. To influence the balance of payments position of the country, discriminations can be made in favour of export industries while advancing or rediscounting bills of exchange. In order to strengthen the foreign exchange position, by discouraging imports, the central bank may charge a higher rate of rediscount on import bills and not on export bills.

5. Broadly speaking a notable objective of selective credit is control of all types of credit, commercial and financial, as against quantitative control, which is confined to banks credit only.

Measures of selective credit control

For the purpose of selective credit control, the central bank generally uses the following forms of control, from time to time.

1. Securing Loan Regulation by Fixation of Margin Requirements

The practice of margin requirement is adopted by all the bankers to determine the loan value of a collateral security offered by the borrower.

The loan value of the security = The market value of the security – The Margin

Thus, the loan value of an equity share having market value of RS. 120, at 20 percent margin requirement is : $120 - 24 = 96$. Hence the maximum of loan of Rs.96 can be granted on this security by a commercial bank.

The system of margin requirement is also to be followed by other security dealers in the course of their lending.

The central bank is empowered to fix the “margin” and thereby fix the maximum amount which the purchaser of securities may borrow against those securities. Thus, when the margin requirements are changed, the amounts of loan available are altered. If the margin is fixed at 50 per cent, the buyer of stock, with a current market value of Rs. 1,000, would have to pay Rs. 500 in cash and the securities could be used as collateral for a loan of up to Rs. 600 from a bank or a security dealer. Now, if the margin is raised to 60 per cent, the loan value of the security is reduced to Rs. 400 only. Thus, the raising of margin curbs the borrowing capacity of the security holder. It is, thus clear that the method of fixing margin requirement differs from other instruments of credit control because it directly affects the demand for credit, rather than the quantity or the cost of credit.

This is a very effective selective device to control credit in the speculative sphere without, at the same time, limiting the availability of credit in other productive fields like industry, trade, agriculture, etc. This device is also useful to check inflation in certain sensitive spots of the economy without influencing the other sectors. In underdeveloped countries like India, therefore, central banks often lay down margin requirements for loans against certain goods, e.g., agricultural commodities, especially foodgrains, with a view to discouraging hoarding of such essential commodities and thus, prevent a rise in their prices.

2. Consumer Credit Regulation

The regulation of consumer credit consist in laying down rules regarding payments and maximum maturities of instalment credit for the purchase of specified durable consumer goods. Thus, this form of selective control employs two devices : minimum down payment, and maximum period of payment. Both are applied to consumer loans on listed articles. Raising the required down payment limit tends to reduce the demand for credit for this purpose, as well as to reduce the amount that can be legally supplied for it. Shortening of maximum period of payment, with increased required instalment payments, also tends to reduce the demand for such loans and thereby check consumer credit.

This method is an extremely useful supplementary tool for controlling inflation and maintaining economic stability. However, this method has great significance in advanced countries, where there is large scale consumer credit through instalment payments and hire purchase.

3. Issue of Directive

Recently, in many countries, selective restraints have been put into effect through “directives” issued by the central bank to commercial banks, as well as through certain informal and voluntary agreements between the former and the latter. The prestige and status of the central bank bear a high significance in determining the efficacy of directives. Their effectiveness also depends upon the banking structure – branch banking will have a quicker response than the unit banking system.

“Directives” may be in the form of oral or written statements, appeals or warnings, particularly to curb individual credit structures and to restrain the aggregate volume of loans.

An overall appraisal of the actual results of “directives” and such informal agreements with commercial banks is difficult. Many times the banks under highly competitive conditions do not obey the central bank’s “directives” for controlling credit. Therefore, “directives” are usually supplemented by more enforceable, traditional tools of credit control.

4. Rationing of Credit

Rationing of credit is a selective method adopted by the central bank for controlling and regulating the purpose for which credit is granted or allocated by commercial banks. It secures diversion of financial resources into the desired channels of public authority, in furtherance of the objectives of planning.

Credit rationing may assume two forms : (i) the central bank may draw the ceiling on the aggregate portfolios of commercial banks so that loans and advances do not exceed this ceiling. This is called variable portfolio ceiling. (ii) The central bank may prescribe minimum ratios regarding the capital of commercial bank to its total assets or specific categories thereof. The central bank is empowered to vary such minimum ratio at any time. This method is

called “variable capital assets ratio”. Both these methods of credit rationing are quantitative-cum-qualitative in effect.

This method, however, is very much condemned by bankers because it tends to be discriminatory and does not allow the banks to formulate an independent policy since the routes of investment for them are fixed and pre-determined. It also clashes with the function of the central bank as the lender of last resort. It is, thus, justified only in totalitarian planning and as a temporary expedient in other economics.

5. Moral Suasion and Publicity

Moral suasion implies persuasion and request made by the central bank to the commercial banks to co-operate with the general monetary policy of the former. The central bank may also persuade or request commercial banks not to apply for further accommodation from her or not finance speculative or non – essential activities. Thus, moral suasion is effected in many forms. The central bank may call in the leading bankers for hear-to-heart talks. An appeal to their patriotism and nationalistic spirit may be made. Thus, it creates a very good psychological effect. In fact, moral suasion is a psychological means of controlling credit. It is purely informal and, therefore, its use is not subject to any law.

Moral suasion is, however, a milder form of selective credit control, with less unfavourable psychological reactions because it is unaccompanied by administrative compulsion or threats of punitive action. It makes it easier for the central bank to secure the willing and active co-operation of the commercial banks. Moral suasion can also be extended to institutions like indigenous bankers, investment houses, etc., which generally remain out of the purview of the central bank.

However, moral suasion will bring good results only if the central bank can secure full co-operation and respect for its words from other bankers. Moreover, it can effectively work under the branch banking system only. Further, it is not a reversible instrument since credit can be more easily restricted by it than liberalized.

6. Direct Action

The most extensively used method of qualitative as well as quantitative credit control is direct action by the central bank. It is often used as an alternative to, or relation with, the bank rate policy or open market operations.

Direct action taken by the central bank may be in the following forms :

- (i) The central bank may refuse rediscount facilities to those commercial banks whose credit policy is not in line with its general monetary policy.
- (ii) The central bank may refuse to give any more credit to those banks whose borrowings are found to be in excess of their capital and reserves.

- (iii) The central bank may charge a penal rate of interest, over and above the bank rate, for the credit demanded, beyond a prescribed limit.

In practice, however, direct action has not proved very effective for the purpose of qualitative control for the following reasons :

- (a) The fear and force contained in it generally come in the way of achieving positive results.
- (b) Commercial banks find it difficult to channelise credit, as it is not in their hands to regulate the ultimate purposes for which borrowers will use the credit.
- (c) Moreover, in practice, there is no easy way to demarcate between essential and non-essential uses, or productive and unproductive borrowings, or between legitimate and excessive speculation.

Direct action also finds itself in a situation of conflict when it has to be asked to refuse credit to member banks, when the central bank is the lender of the last resort.

Self Assessment Questions :

1. What do you meant by Selective Credit Control?
2. What are the objectives of Selective Credit Control?
3. What is moral suasion? How does it differ from directives?
4. Explain the various methods of Selective Credit Control.

Lesson 9

MONEY MARKET

Money market refers to the activity rather than a place. This activity covers lending and borrowing of short-term funds. The market deals in call and notice deposit, short-term bills, promissory notes and government papers, etc., which are drawn for short-periods. These days money market instruments are many, such as Treasury Bills, Commercial Papers, Certificate of Deposits, Commercial Bills, etc. However, these securities and instruments should have maturity period of less than one year.

Definitions of Money Market

According to G. Crowther, “it is the collective name given to the various firms and institutions that deal in the various grades of near money”.

According to RBI report, “Money market is the centre for dealings mainly of short-term character, in money assets, it meets short-term requirements of borrowers and provide liquidity or cash to the lenders”

It is the place where short-term surplus investible funds at the disposal of financial and other institutions and individuals are bid by borrowers, again comprising institutions and individuals and also the government itself.

We can define money market as the market in which the highly liquid short-term bills are dealt with mainly by government, business concerns and private individuals.

Components of Money Market

The various institutions in the money market generally includes the following :

1. Central Bank : It is naturally to be the leader of all banks. It is the bank, which is entrusted with the task of controlling the issue of money and funds to the market and regulated credit facilities provided by various other institutions.

2. Commercial Banks : They play a vital role in the money market. They make advances, discount bills and lend against the promissory notes and the like. They also take help of the market in solving their liquidity problems.

3. Discount Houses : Discount houses are special institutions for rediscounting the bills of exchange. They usually deal in three kinds of bills.

(a) the domestic bills

(b) the foreign bills and

(c) the government treasury bills

The discount house borrow huge funds for short periods from the commercial banks and RBI and invest them in discounting bills. But before discounting a trade bill of exchange, the Discount House insists that it should be accepted by an Acceptance House.

taken back when needed.
andise, etc.

_ Earn interest by quick
lending of idle cash.

_ Promote stock exchange transaction.

CHARACTERISTICS OF A DEVELOPED MONEY MARKET The developed money market as in the countries of England and U.S.A. have the following characteristics:

(i) Existence of Central Bank : In the developed money market, the role of Central Bank is notable. It controls the entire money market operations by making the availability of funds depending upon the economic cycles. It can be done through its open market operations.

(ii) Highly organised Banking System : As they are the main dealers in short-term funds, the commercial banks are considered as nervous system of the money market. Therefore, a well developed money market will have a highly organized and developed commercial banking system.

(iii) Existence of sub-markets : In a developed money market the various sub-markets existed and functioning smoothly. That is, the money market will have a developed sub-markets such as bill market, call money market, acceptance market, discount market, etc. It can be said that the larger the number of sub-markets, the broader and more developed will be the structure of money market.

(iv) Prevalence of healthy competition : In each sub-market there should be a reasonable and healthy competition. That is, in a developed money market, there are a large number of borrowers, lenders and dealers. Then only each market will be active enough to achieve the purpose of its existence.

(v) Integration of sub-markets : In the developed money market there will be a perfect integration among various sub-markets of the money market. Their functioning are interdependent. The funds flow from one sub-market to another and the activities of one sub-market should create effects in the other markets also.

(vi) Availability of proper credit instruments : The developed money market should have the necessary credit instruments such as treasury bills, promissory notes, bills of exchange, etc. They should be freely available.

(vii) Flexibility and adequacy of funds : In a developed money market, there must be ample resources. The flow of funds into the money market should also be flexible enough, i.e., the flow of funds can be increased or decreased depending upon the demand for funds.

(viii) International attraction : The developed money markets attract funds from foreign countries also. The dealers, borrowers and lenders of foreign countries are eagerly coming forward to participate in the activities of developed money market.

(ix) Uniformity of interest rates : Prevalance of uniformity in interest rates in different parts of the country is the characteristic feature of a developed money market.

(x) Stability of prices : Stability of prices all over the country will be an outcome of the effective functioning of a developed money market.

(xi) Highly developed Industrial system : The money market will function smoothly and can achieve the basic purpose of its existence only when there is a highly developed industrial system. Developed money market demands for such a system.

Importance of a Developed Money Market

A developed money market is essential for the economic progress of a country. The significance of the developed money market can be summarized as follows :

- (a) It provides finance to trade and industry when needed
- (b) It provides profitable outlet for the short-term funds of the commercial banks.
- (c) It helps the govt. to raise necessary short-term funds by sale of treasury bills.
- (d) It helps the Central Bank in the following ways :
 - (i) helps to formulate and implement the monetary policy
 - (ii) helps to carryout its open market operations on a large scale
 - (iii) provides commercial bills to the Central Bank for rediscount
 - (iv) helps in the regulation of the movement of funds in the money market
- (e) Attracts foreign funds.

Self Assessment Questions :

1. Define Money Market
2. Explain the components of money market.
3. Explain the sub-markets of the money market.
4. Elaborate the characteristics of a developed money market.

Lesson 10

INDIAN MONEY MARKET AND CAPITAL MARKET

The Structure of the Indian Money Market

The Indian money market is composed of two categories of financial agencies :

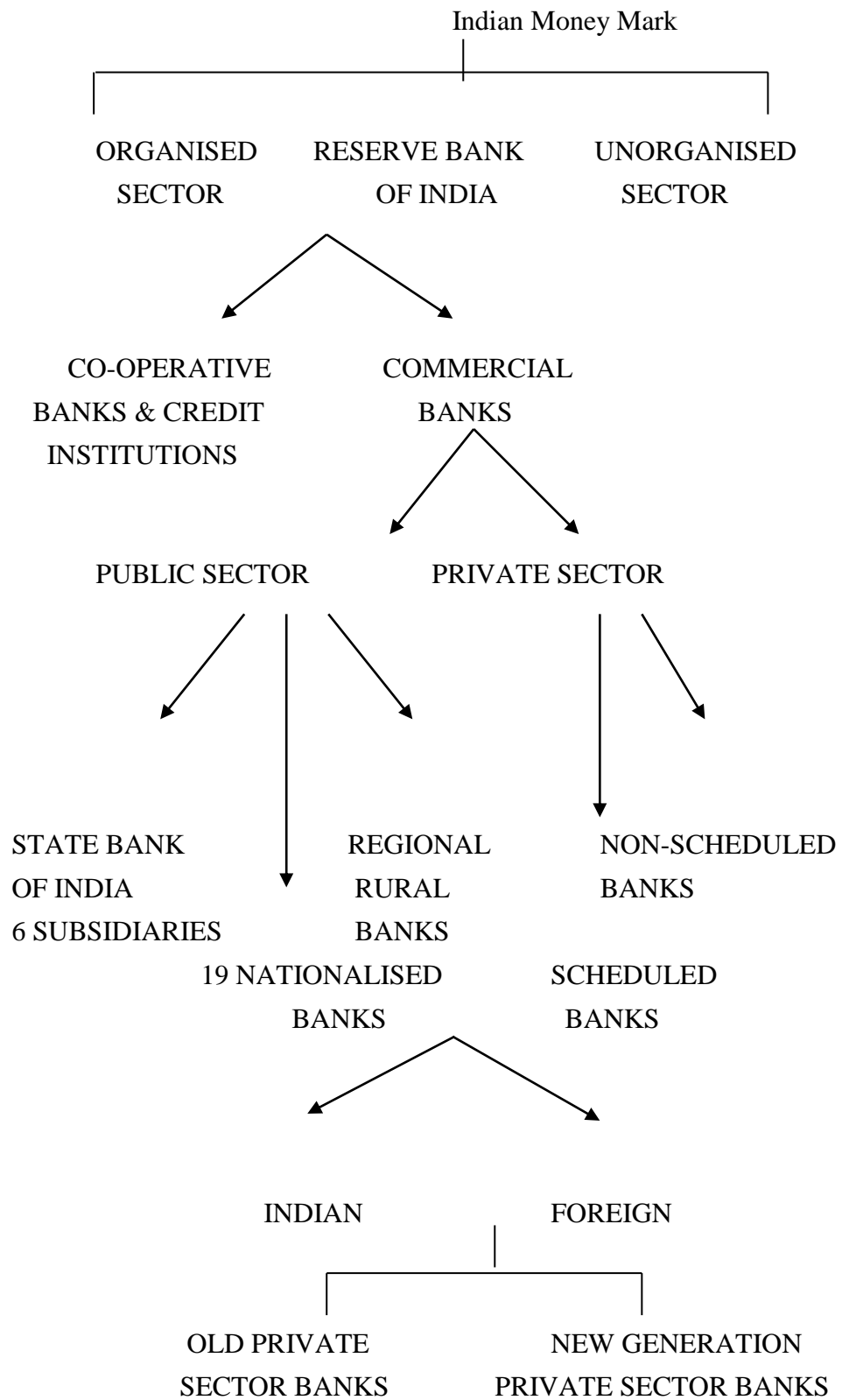
(i) organised , and (ii) unorganised.

(i) The Organised Sector : The organized sector contains well-established, scientifically managed, financial institutions. At the apex, there is the Reserve Bank of India, which is the lender of the money market and controls the banking sector. There are a joint-stock commercial banks. These commercial banks are of two types : (i) scheduled; and (ii) non-scheduled. In 1969, fourteen major commercial banks were nationalized. In 1980, six more commercial banks were nationalized. The State Bank of India and its subsidiaries are also owned by the central government. Thus, 91 per cent of the banking institutions are in the public sector. There are many foreign exchange banks in the country. There are co-operative banks and post-office savings banks which mobilize the savings of small holders.

(ii) The Unorganised Sector : The unorganised sector contains agencies which have diverse policies, lack of uniformity and consistency in the lending business. It includes indigenous bankers, money-lenders and chit funds. There are nearly 2,500 indigenous bankers in the country. They are known as shroffs, multanis, chettiars, etc. Money-lenders and indigenous bankers provide nearly 50 per cent of rural finance. In South India, nidhis and chit funds are the common non-institutional sources of finance. Nidhis are essentially loan societies registered under the Indian Companies Act. There are many nidhis doing a regular business of finance, many of which are well-organised, but some are mismanaged. Nidhis are mutual loan associations. Chit funds are voluntary but loose associations for mobilizing rural savings. There are hundreds of chit funds operating in a big or small scale in many villages of South India.

Chart 1 pinpoints the structure of the Indian money market.

Chart 1



COMPARISON OF LONDON, NEW YORK AND INDIAN MONEY MARKETS

London Money Market	New York Money Market	Indian Money Market
<p>London money market has enjoyed the supreme position till the beginning of First World War period.</p> <p>Highly organized and well developed</p>	<p>1. Period of Development</p> <p>It has come into prominence only during the second World War period.</p> <p>2. Nature of Growth</p> <p>Organised and well developed but next to London Money Market</p>	<p>It has become popular after independence specifically after nationalisation of banks in 1969.</p> <p>Fast catching up with matured market since 1992.</p>
3. Control over the Money Market		
The Bank of England controls the money market through traditions, conventions and persuasion.	The Federal Reserve Banks control the money markets through statutory powers.	RBI has control over the market and regulates liquidity through DHFI, Primary Dealers, Open Market Operations, (OMO) etc.
4. Weapons used to Control Money Market		
Bank rate and open market operations.	The Federal Banks use more direct weapons of credit controls as variation of cash reserve ratios, etc.	CRR, 'Repo' transactions, Moral suasion, OMO of Treasury Bills, etc.

5. Specialised Institutions		
The acceptance houses, etc. are playing main role in the money market	It does not have such institutions. Commercial banks perform these functions.	DFHI, Primary Dealers Development Financial Institutions, Money Market Mutual Funds, etc.
6. Competition among Institutions		
The functions of the specialised institutions like discount houses, acceptance houses, Bill brokers, Commercial banks, etc., are all complementary and these institutions do not compete among themselves for funds.	In this market various institutions function independently and hence compete for funds in the money market. But the competition is healthy.	Healthy competition is gaining ground. RBI determines the players in the market-large number of lenders, including financial institutions, mutual funds, big corporates (through DFHI, etc.). However borrowers are restricted to commercial Banks and few institutions like DFHI and primary dealers.
7. System of Banking		
In U.K. branch banking prevails. The banking system is mainly under the control of "Big five" Banks. All banks have their branches in London.	In U.S.A. unit banking is prevailing, since there are numerous banks of small size, they do not have their banks in Washington.	In India branch banking is popular. Even then many private sector banks are small in size.

8. Number of Central Banks		
In England there is only Central Bank "The Bank of England" for the entire country.	In U.S.A. there are 12 "Federal Reserve Banks" for different regions. With Federal Reserve System at the apex level.	In India there is only "RBI" for the entire central banking operations.
9. Operation of Bill Market		
In U.K. there is a well developed bill market. Commercial banks do not directly discount the bills from customers.	In U.S.A. there is no well developed bill market. Commercial banks directly discount their bills from the customers.	Bill market is not developed in India. Commercial Banks discount the bills of the customers but rediscounting of bills are not popular.
10. Variation of Interest Rates		
There is no big variation in interest rates in the market. It is mainly due to the market aligning its interest rates. Closer to the Central Bank discount rates.	No variation in interest rates. There is close relation between the rates of Federal Banks and market rates.	Since the control of RBI over the money market is not adequate there is no close relation between the RBI rates and the market rates. Hence, there is variation of interest rates in the market. Interest rates are sometimes highly volatile due to few players and lack of depth of the market.

11. Attraction of Foreign Funds		
Highly developed and attracts the foreign funds.	More attraction of foreign funds.	Underdeveloped due to the restrictions over foreign exchange transactions. Capital account convertibility is required to attract foreign funds.

MEANING AND FUNCTIONS OF CAPITAL MAREKT

Capital market is a growing component of the financial system in India. the capital market differs from the money market in terms of maturity, structure and liquidity. The money market comprises financial instruments having a maturity period of one year or less than one year. It involves short-term transactions.

Capital market contains financial instruments of maturity period exceeding one year. It involves long-term transactions. Capital market instruments are relatively less liquid in comparison to the money market instruments. Capital market in a broad sense encompasses all kinds of arrangements and financial institutions involved in long term funding. Capital market, is however, commonly referred to the stock markets in the country. From the stock markets point of view, capital market comprises both primary and secondary market. The primary market deals with new issues made by the companies. The secondary market relates to the trading in the existing securities. An investor can buy securities in the primary market, but can sell only in the secondary market.

Functions of Capital Markets

Capital market is the financial pillar of industrialized country. It is the catalytic agent of development. It renders several functions, such as:

- **Transformation of savings into investment.** Capital market mobilizes savings from the households to the producers who are the investors. It provides inter-mediation between savers and investors and investors on a long-term basis.
- **Flow of funds.** It channelises the allocation of the funds from less profitable to more profitable channels. It thus leads to optimum utilization of resources. It enables surplus and idle funds to be used more effectively, efficiently and productively.

- **Macro-economics financial balancing.** Capital market mobilises funds from surplus units to deficit units through appropriate financial inter-mediation.
- It facilitates the project financing and growth of corporate sector.
- It provides better returns to the savers by offering numerous alternatives in the portfolio investments.

India is heading on to the growing private sector in its mixed economy. As such, private savings and capital play a pivotal role in its growth process. A healthy growth of capital market is, therefore, essential to promote expanding savings and investment in the country.

STRUCTURE OF THE INDIAN CAPITAL MARKET

Usually, capital markets are classified in two ways :

- On the basis of issuer,
- On the basis of instruments

In terms of issuer type, these are :

- (a) Markets for corporate securities, and
- (b) Markets for government securities

In terms of instruments, these are :

- (a) Equity markets, and
- (b) Debt markets.

Over the years, there has been a substantial development of the Indian capital market. It comprises various sub-markets. In recent years, its structure has grossly changes. Various new instruments and new institutions have cropped in. Broadly speaking, there are the following sub-markets:

- (1) Corporate market for both securities (both new and old);
- (2) Government securities market ;
- (3) Debt instrument markets ; and
- (4) Market for institutional schemes . (such as mutual funds, etc).

There are both primary and secondary markets for all kinds of these markets. The primary market is the source of raising funds directly from the public. The secondary market is meant to provide liquidity and trading facilities.

The Indian secondary market structure comprises :

- Regular stock exchanges.
- Over the Counter Exchange of India (OCEI). This is meant for smaller companies. It has no trading ring.
- National Stock Exchange

Self Assessment Questions :

1. Explain the Structure of the Indian Money Market.
2. what are the features of the New York Money Market?
3. Write a note on the London Money market.
4. What do you know about the Indian Capital Market?

Lesson 11

INFLATION

Meaning of Inflation

Inflation is commonly understood as a situation of substantial and rapid general increase in the level of prices and consequent deterioration in the value of money over a period of time.

The behaviour of general prices is measured through price indices. The trend of price indices reveals the course of inflation or deflation in the economy. As Lerner says, a price rise which is unforeseen and uncorrected is inflationary.

Thus, inflation is statistically measured in terms of percentage increase in the price index, as a rate per cent per unit of time – usually a year or a month.

Usually, the wholesale price index (WPI) numbers are used to measure inflation. Alternatively, the consumer price index (CPI) or the cost of living index number can be adopted in measuring the rate of inflation.

Inflation is like an elephant to the blind men. Different economists have defined inflation differently. We may, thus, enlist a few important definitions of inflation as under which would give us a comprehensive idea about this intricate problem.

Harry Johnson defines inflation as a sustained rise in prices.

Crowther, similarly defines inflation as “a state in which the value of money is falling. i.e., prices are rising.

The common feature of inflation is a price rise, the degree of which may be measured by price indices. Edward Shapiro, puts it thus : ‘Recognising the ambiguities our words contain, we will define inflation simply as a persistent and appreciable rise in the general level of prices.

Prof. Samuelson puts it thus: “Inflation occurs when the general level of prices and costs is rising.

There are, at least, two distinct views on the concepts of inflation. To some economists, inflation is a pure monetary phenomenon, while to others, it is a post full employment phenomenon.

Types of Inflation

On different grounds, economists have classified inflation into various types. A few important categories are discussed below.

Chart 1

Classification or Types of Inflation

(1)	(2)	(3)	(4)	(5)
According to The Rate of Inflation:	According to the nature of time-period of Occurrence:	According to the scope or coverage:	According to the Govern- ments reaction:	According to the causes :
1. Moderate Inflation (a) Creeping (b) Walking	1. War-time Inflation	1. Comprehen- sive Inflation	1. Open Inflation	1. Credit- Inflation
2. Running Inflation	2. Post-war Inflation	2. Sporadic Inflation	2. Repressed Inflation	2. Deficit Inflation
3. Galloping Inflation	3. Peace-time Inflation	3. Scarcity- Inflation		
4. Hyper Inflation	4. Profit- Inflation			
5. Foreign- Inflation				Trade Inflation
	6. Tax-Inflation			
	7. Cost or wage Inflation			
	8. Demand Inflation			

1. Moderate , galloping and hyperinflation

The severity of inflation is often measured in terms of the rapidity of price rise, i.e., the rate of inflation. On the basis, a quantitative distinction of inflation may be made into three categories, viz.:

- Moderate inflation;
- Running and galloping inflation; and
- Hyperinflation

(a) Moderate inflation

It is a mild and tolerable form of inflation. It occurs when prices are rising slowly. When the rate of inflation is less than 10 per cent annually, or it is a single digit annual inflation rate, it is considered to be a moderate inflation in the present day economy.

Prof. Samuelson observes that moderate inflation is typical today in most industrialized countries.

The following are the major characteristics of moderate inflation:

- (i) There is a single digit inflation rate (less than 10 per cent) annually.
- (ii) It does not disrupt the economic balance.
- (iii) It is regarded as stable inflation in which the relative prices do not get far out of line.
- (iv) People's expectation remain more or less stable under moderate inflation.
- (v) Under a low inflation rate, the real interest rate is not too low or negative, so money can serve its role as a store of value without difficulty.
- (vi) There are modest inefficiencies associated with moderate inflation.

Economist have arbitrarily laid down that a 3-4 per cent price rise per annum is a tolerable rate of inflation in modern economies. Even the Chakravarthi Report of the Reserve Bank of India has accepted 4 per cent rate of inflation annually to be an efficient and tolerable norm for the Indian Economy.

Incidentally, some economists have described up to 3 per cent annual rate of inflation as 'creeping inflation' and if it exceed 10 per cent, it is called 'walking inflation'.

(b) Running and galloping inflation

when the movement of price accelerates rapidly, running inflation emerges. Running inflation may record more than 100 per cent rise in prices over a decade. Thus, when price rise by more than 10 per cent a year, running inflation occurs.

Economists have not described the range of running inflation. But, we may say that a double digit inflation of 10-20 per cent per annum is a running inflation. If it exceeds that figure, it may be called 'galloping' inflation.

According to Samuelson, when prices are rising at double or triple digit rates of 20, 100 or 200 per cent a year, the situation may be described as 'galloping' inflation.

Indian economy has witnessed a sort of 'running' and 'galloping' inflation to some extent (not exceeding 25 per cent per annum) during the planning era, since the second plan period. Argentina, Brazil and Israel, for instance, have experienced inflation rates over 100 per cent in the eighties.

Gallop inflation is really a serious problem. It causes economic distortions and disturbances.

(c) Hyperinflation

In the case of hyperinflation, prices rise every movement, and there is no limit to the height to which prices might rise. Therefore, it is difficult to measure its magnitude, as prices rise by fits and starts.

In quantitative terms, when prices rise over 1000 per cent in a year, it is called a hyperinflation. Austria, Hungary, Germany, Poland and Russia witnessed hyperinflation in the wake of World War I. Hyperinflation notably took place in Germany in 1920-1923. The German price index rose from 1 to 10,00,000,000 during January 1922 to November 1923. believe it or not, it is a fact!

Features of hyper inflation are :

- (i) During hyperinflation, the price rise is severe. The price index moves up by leaps and bounds. It is over 1000 per cent per year. There is at least a 50 per cent price rise in a month, so that in a year it rises to about 130 times.
- (ii) It represents the most pathetic deterioration in people's purchasing power.
- (iii) It is apparently generated by a massive fiscal dislocation.
- (iv) It is amplified by wage-price spiral.
- (v) Hyperinflation is a monetary disease.
- (vi) The velocity of circulation of money increases very fast.
- (vii) The structure of the relative prices of goods become highly unstable.
- (viii) The real wages tend to decline fast.
- (ix) Inequalities increase.
- (x) Overall economic distortions take place.

It must be remembered that the difference between all these four types of inflation is one of degree than of kind.

2. War, Post-War and Peace-time Inflation

On the basis of the nature of time-period of occurrence, we have :

- War-time inflation;
- Post-war inflation ; and
- Peace-time inflation

(a) War-time inflation

It is the outcome of certain exigencies of war, on account of increased government expenditure on defence which is of an unproductive nature. By such public expenditure, the government apports a substantial production of goods and services out of total availability for war which causes a downward shift in the supply; as a result, an inflationary gap may develop.

(b) Post-war inflation :

It is a legacy of war. In the immediate post-war period, it is usually experienced. This may happen when the disposable income of the community increases, when war-time taxation is withdrawn, or public debt is repaid in the post-war period.

(c) Peace-time inflation

By this is meant the rise in prices during the normal period of peace. Peace –time inflation is often a result of increased government outlays on capital projects having a long gestation period; so the gap between money income and real wage goods develops. In a planning era, thus, when government's expenditure increase, prices may rise.

3. Comprehensive and Sporadic Inflation

- From the coverage or scope point of view, we have:
- Comprehensive or economy-wide inflation, and
- Sporadic inflation.

(a) Comprehensive Inflation

When prices of every commodity throughout the economy rise, it is called economy-wide or comprehensive inflation. It is a normal inflationary phenomenon and refers to a rise in the general price level.

(b) Sporadic Inflation

This is a kind of sectional inflation. It consists of cases in which the averages of a group of prices rise because of increases in individual prices due to abnormal shortage of specific goods. When the supply of some goods become inelastic, at least temporarily, due to physical or structural constraints, sporadic inflation has its sway. For instance, during drought conditions when there is a failure of crops, food grain prices shoot up.

Sporadic inflation is a situation in which direct price control, if skillfully used, is more likely to be beneficial to the community at large.

4. Open and Repressed Inflation

An inflation is open or repressed according to the government's reaction to the prevalence of inflationary forces in the economy.

(a) Open Inflation

When the government does not attempt to prevent a price rise, inflation is said to be open. Thus, inflation is open when prices rise without any interruption. In open inflation, the free market mechanism is permitted to fulfil its historic function of rationing the short supply of goods and distribute them according to consumer's ability to pay. Therefore, the essential characteristics of an open inflation lie in the operation of the price mechanism as the sole distributing agent. The post-war hyper-inflation during the twenties in Germany is a living example of open inflation.

(b) Repressed Inflation

When the government interrupts a price rise, there is a repressed or suppressed inflation. Thus, suppressed inflation refers to those conditions in which price increases are prevented at the present time through an adoption of certain measures like price controls and rationing by the government, but they rise on the removal of such controls and rationing. The essential characteristic of repressed inflation, in contrast to open inflation, is that the former seeks to prevent distribution through price rise under free market mechanism and substitutes instead a distribution system based on controls. Thus, the administration of controls is an important feature of suppressed inflation.

However, many economists like Milton Friedman and G.N.Halm opine that if there has to be any inflation, it is better open than suppressed. Suppressed inflation is condemned as it breeds a number of evils like black market, hierarchy of price controllers and rationing officers, and uneconomic diversion of productive resources from essential industries to non-essential or less essential goods industries since there is a free price movement in the latter and hence are more profitable to investors.

5. Types of Inflation based on the causes inducing inflation

According to the cause of rising prices, one can consider several types of inflation as follows :

(a) Credit Inflation

Inflation which is caused by excessive expansion of bank credit or money supply is referred to as credit or money inflation.

(b) Deficit Inflation

It is the inflation caused by deficit financing.

When the government budgets contain heavy deficit financing, through creating new money, the purchasing power in the community increases and prices rise. This may be referred as to as deficit-induced inflation. During a planning era, when government launches upon heavy investment, it usually resort to deficit financing. An inflationary spiral develops due to deficit financing, when adequate resources are not found. An inflationary spiral develops due to deficit financing, when the production of consumption goods fails to keep pace with the increased money expenditure.

(c) Scarcity Inflation

Whenever scarcity of real goods occurs or may be artificially created by the hoarding activities of unscrupulous traders and speculators which may result into black-marketing, thereby causing prices to go up, such type of inflation may be described as scarcity inflation.

(d) Profit Inflation

The concept of profit inflation was originated by Keynes in his Treatise on Money. According to Keynes, the price level of consumption goods is a

function of the investment exceeding savings. He considered the investment boom as a reflection of profit boom. Inflation is unjust in its distribution effect. It redistributes income in favour of profiteers and against the wage-earning class. During inflation, thus, the entrepreneur class may tend to expect an upward shifting of the marginal efficiency of capital (MEC); hence, entrepreneurs are induced to invest more even by borrowing at higher interest rates. Eventually, investment exceeds savings and economy tends to reach a higher level of money income equilibrium. If economy is operating at full employment level or if there are bottlenecks of market imperfections, real output will not rise proportionately, so the imbalance between money income and real income is corrected through rising prices.

(e) Foreign – Trade Induced Inflation

For an international economy, we may categorise the following two types of inflation as being caused by factors pertaining to the balance of payments :

- (i) Export-Boom Inflation ; and
- (ii) Import Price-hike Inflation

(i) Export-Boom Inflation : When a country having a sizeable export component in its foreign trade experiences a sudden rise in the demand for its exportables against the inelastic supply of exportables in the domestic market, it obviously implies an excessive pressure of demand which is revealed in terms of persistent inflation at home.

Again, trade gains and sudden influx of exchange remittances may lead to an increase in monetary liabilities, which is further reflected in the rising pressure of demand for domestic output causing an inflationary spiral to get further momentum. Such a permanent case for an export-boom inflation is, however, ruled out in the Indian economy, because neither export trade is a significant portion of Domestic National Product nor is there a continuous boom of export-demand, causing terms of trade to move up favourably all the time.

(ii) Import Price-hike Inflation : When prices of import components rise due to inflation abroad, the domestic costs and prices of goods using these imported parts will tend to rise. Such an inflation is referred to as imported inflation. For instance, hike in oil prices by the Arab countries was responsible for accelerating inflationary price rise in many oil-importing countries, including India to some extent.

(f) Tax Inflation

Year to year increase in commodity taxation such as excise duties and sales tax may lead to rise in prices of taxed goods. Such an inflation is termed as tax inflation or tax-induced inflation.

(g) Cost Inflation

When inflation emerges on account of a rise in cost factor, it is called cost inflation. It occurs when money incomes (wage rate, particularly) expand more than real productivity. Cost inflation has its course through the level of money costs of the factors of production and in particular through the level of wage rates. Due to a rising cost of living index, workers demand higher wages, and higher wages in their turn increase the cost of production, which a producer generally meets by raising prices. This process of spiraling may reach higher and higher levels. In this case, however, cyclical anti-inflation remedies of monetary controls are not relatively effective.

Wage inflation is an important variant of cost inflation. Wage push inflation occurs when money wages are raised without corresponding improvement in the productivity of the workers.

(h) Demand Inflation

When there is an excess of aggregate demand against the available aggregate supply of goods and services, prices tend to rise. It is called demand-induced inflation. Population-growth, rising money income, etc. play a significant role in generating demand inflation.

Causes of Inflation

Inflation is complex phenomenon which cannot be attributed to a single factor. We may summarise the major causes of inflation thus :

1. Over-expansion of Money Supply

Many a times, a remarkable degree of correlation between the increase in money supply and the rise in the price level may be observed.

2. Expansion of Bank Credit

Rapid expansion of bank credit is also responsible for the inflationary trend in a country.

3. Deficit Financing

The high dose of deficit financing which may cause reckless spending, may also contribute to the growth of the inflationary spiral in a country.

4. Ordinary Monetary Factors

Among other monetary factors influencing the price trend in an economy, the major ones are listed here :

(a) High Non-development Expenditure : The continuous increase in public expenditure, and especially the growth of defence and non-development expenditure.

(b) Huge Plan Investment : The huge planned investment and its high rate of growth in every plan may lead to an excess demand in the capital goods sector, so that industrial prices may rise.

(c) **Black Money** : Some economists have condemned black money in the hands of tax evaders and black marketers as an important source of inflation in a country. Black money encourages lavish spending, which causes excess demand and a rise in prices.

(d) **High Indirect Taxes** : Incidence of high commodity taxation. Prices tend to rise on account of high excise duties imposed by the Government on raw materials and essential goods.

Consequence of Inflation

On Production and Employment

Inflation affects both production and distribution of income in a country. Inflationary rise in prices, it may be argued, may not affect adversely production of national income. All available men and materials are employed. The stock of real wealth in the form of land, buildings, etc., is not diminished and the total real income or output available for distribution between the different sections of people remains the same. Thus, inflation may have no adverse effect on national income or on the level of employment. But in course of time when inflation has gone beyond a certain limit, it may lead to reduction in production and increase in unemployment. This may be because –

- (a) firms may find it profitable to hoard rather than produce and sell;
- (b) agriculturists may refuse to sell their surplus stocks in the hope of getting higher prices; and
- (c) production may be interrupted by bitter labour strikes.

Beyond a certain stage, therefore, surplus stocks accumulate, profits decline, investment, production and income fall, and unemployment comes into existence.

On Distribution of Income

It is a truism that in time of general rise in the price level, if all groups of prices – such as agricultural prices, industrial prices, price of minerals, wages, rent, profit, etc. – rise in the same direction and by the same extent, there will be no net effect on any section of people in the community. For example, if the prices of goods and services which a worker buys rise by 50 per cent and if the wage of the worker (i.e., the price of labour services) rises also by 50 per cent, there is no change in the real income of the worker; his standard of living will remain constant. However, in practice, all prices do not move in the same direction and by the same percentage. Hence, some classes of people in the community may be affected more favourably than other.

(i) **On Producing Classes** : All producers, traders and speculators gain during inflation because of the emergence of windfall profits. For one thing, prices of goods rise at a far greater rate than costs of production; for wages, interest rates, insurance premia, etc., are all more or less fixed. For another, there is a time-lag between a rise in the prices and rise in the cost of production. Lastly, stocks appreciate in value to the precise extent that the value of money

is falling. Besides, the producers keep such assets, as commodities, real estate, etc., whose prices rise much more than the general level of prices. Thus, the producing and trading classes gain enormously during an inflationary period. but farmers may gain only if their output is maintained or is increased.

(ii) On Fixed Income Groups : Inflation is very severe on those who are living on past savings, fixed interests and rents, on pensioners and other fixed income groups – generally called the middle classes. Those persons who are working in government and in private concerns find their money incomes more or less fixed while the prices of the goods and services which they buy generally are rising very rapidly. Those with absolutely fixed incomes derived from interest and rent – known as the rentier class – find that their money income is absolutely worthless in the face of mounting prices and their past savings have insignificant value. In fact, the worst sufferers in an inflation are the middle classes who are considered as the backbone of any stable society.

(iii) On Working Classes : During inflation, the working classes also suffer since normally wages do not rise as much as the prices of those commodities and services which the workers buy and also because of the time-lag between the rise in the price level and rise in wages. However, these days, many groups of workers are organized in trade unions, and their wages may rise simultaneously with rise in the cost of living. It can, therefore, be presumed that organized workers may not suffer much during an inflation. But there are many groups of workers who are not organized – for example, the agricultural labourers – and who find no way of pushing up their wages in the face of rising prices and rising cost of living.

Inflation, thus, brings about shifts in the distribution of income between different sections of people in the country. The producing classes – the agriculturists, the manufacturers and the traders – gain at the expense of salaried and working classes. The rich become richer and the poor, poorer. There is, thus, a unjust. Besides those who are hard hit by inflation are the young, the old, the invalid, the widows and the small savers – i.e., all those who are unable to protect themselves.

But the most unfortunate thing is that monetary and fiscal authorities who are entrusted with the task of maintaining price stability are often responsible for creating inflationary conditions. A country at war resorts to printing of currency notes as one of the methods of financing the war. Similarly, the government of a developing economy may resort to deficit financing as one of the methods of financing development projects. In these cases, inflationary finance, like taxation, brings in additional revenue to the public authorities. But while taxation cannot destroy an economy and, except in rare cases, cannot eliminate whole groups of people, inflation can affect the fixed income group, pauperise the middle classes and affect the very foundations of an economy. No wonder then that inflation has been termed as “a species of taxation, cruelest of all” and “open robbery”.

Inflation, particularly the hyper-inflation, will, therefore, endanger the very foundations of the existing social and economic system. It will create a sense of frustration and distrust, of injustice and discontent and may force people to revolt against the government. It is, therefore, “economically unsound, politically dangerous and morally indefensible”. It should be avoided, if possible, and if it occurs, should be controlled somehow.

Inflation in a developing economy

Basically, inflation is supposed to occur after the stage of unemployment, for till that stage is reached an increase in effective demand and price level will be followed by increase in output, income and employment. It is after the stage of full employment when all men are employed that a rise in the price level will not be accompanied by an increase in production and employment. Theoretically, therefore, it is not possible to imagine an inflationary situation existing side by side with full employment. It is in this context that the question of inflation in an under-developed country like India which has both widespread unemployment and underemployment is raised. Can India experience inflation, as it has not reached full employment?

It is interesting to observe that Keynes himself visualized the possibility of an inflationary situation even before full employment was reached. Such a situation can arise even in advanced countries, if there are difficulties to achieve perfect elasticity of supply of goods and services. It is possible that full employment is not reached but even then there is no scope for increased production. The difficulties which are responsible for imperfect elasticity of supply may arise because of the operation of the law of diminishing returns and the absence of homogeneous factors. Or, there may be unemployed resources in the country but there may be no scope for increased production. As aggregate monetary demand increases with the increase in money supply, supply of goods does not increase in the same proportion, due to imperfect elasticity. The difficulties which prevent supply from increasing in the face of rising demand are known as bottlenecks. The result is that the cost of production is pushed up and the price level is raised. Apart from these general bottlenecks which may exist even in advanced countries, there are some special forms of bottlenecks which cause relative rigidity in the supply of goods and services in developing countries. Some of these bottlenecks may be explained as follows:

(i) There are many market imperfections in developing countries, such as imperfect knowledge on the part of both producers and consumers, imperfect mobility of factors, imperfect divisibility of factors and lack of specialization. All these are responsible for the failure to have optimum use of resources. There is, thus, imperfect elasticity of supply in an underdeveloped country.

(ii) Developing economies are faced with the shortage of technical labour, capital equipment, transport system, power facilities, etc. These economies are unable to grow fast enough because of these bottlenecks.

(iii) Unemployment and underemployment are extensively present in an underdeveloped country. The existence of unemployment in the advanced

country helps to increase output, whenever there is increased demand. But this is not so in a country like India with a large magnitude of disguised unemployment and open unemployment.

(iv) Developing countries generally have a high marginal propensity to consume. This factor prevents an increase in the supply of goods and services. For instance, in the field of agriculture, increased production may be consumed at home and, therefore, less may be forthcoming to the market.

(v) A special feature of developing countries is that a large volume of primary production is exported. To that extent, the supply available for home consumption is reduced. The problem of inflationary rise in prices is worsened wherever the income earned from exports is spent on domestic goods and not on imports.

(vi) Since World War II many of the underdeveloped countries have started resorting to extensive borrowing from the banking system and to deficit financing with the idea of speeding up economic development. For one thing, much of this expenditure is on social and economic overheads (like education, transport, power, etc.) or on capital goods industries such as the development of iron and steel industry. This implies that there is an increase in the production of consumption goods. For another, the volume of purchasing power with the general public is increased resulting in increased demand for consumption goods.

All these factors explain the existence of inflationary pressure in a developing country, even though the stage of full employment has not yet been reached. The existence of bottlenecks such as shortage of technical knowhow, scarcity of capital equipment, etc., is worsened by the various problems especially to developing countries. It is, therefore, correct to use the concept of inflation even in developing countries, provided we can remember the existence of special bottlenecks.

Self Assessment Questions :

1. Define Inflation.
2. Explain the various kinds of Inflation.
3. What are the causes of Inflation? Explain its consequences.
4. Explain the relevance of Inflation in a developing economy.

Lesson 12

DEFLATION

Deflation

Deflation is just the opposite of inflation. It is essentially a matter of falling prices. Deflation, according to Prof. Paul Einsig “is a state of disequilibrium in which a contraction of purchasing power tends to cause, or is the effect of, a declining of the price level.” Deflation is that state of falling price when the output of work by productive agents increases relatively to money income. Deflation arises when the total expenditure of the community is not equal to the value of output at existing prices. Consequently, the value of money goes up, and prices fall. In short, deflation is a condition of falling prices, accompanied by the decreasing level of employment, output and income.

Effects of Deflation

Though the effects of deflation are just the opposite to those of inflation, deflation also poses its own menacing threat to economic stability in a system.

Effects of Production

Deflation adversely affects the level of production, investment activity, employment, and income level in an economy. During deflation, when prices are falling rapidly but the cost of production does not fall correspondingly, producers incur heavy losses and curtail employment and output. This causes aggregate income to fall and aggregate demand to decrease, with prices falling further and so on. Business pessimism emerges and gradually is commonly described as “poverty in the midst of plenty” because economic activity, income, output, and, employment diminish miserably and ample resources remain unutilized or underemployed. Much of the poverty during deflation is due to deficiency of demand. Lack of effective demand causes poverty in the midst of plenty.

Effects on Distribution

Deflation has also an adverse effect on the distribution of wealth and income in the community. The share of profit earners in total income declines while that of wage earners increase. Thus, deflation, favours the consumer class and not to producer class. During deflation, creditors tend to gain at the expense of debtors. Investors in fixed-interest bearing securities, rentiers etc., and fixed-income earners gain by the rising value of money. In general, all fixed-income earners gain and all flexible-income earners lose in times of deflation. During deflation there will be a stimulus for savings but as the general income level is low, the ability to save will get reduced.

Deflation benefits the middle class at the expense of the richer classes. But its dampening effect on production is bad from the society’s point of view, as it reduces the level of employment. Increasing unemployment leads to further social discontent. In this sense, deflation is worse than inflation.

Methods of Control

Anti-deflation measures are the opposite of those which are used to combat inflation.

Monetary policy aimed at controlling deflation consists of using the discount rate, open-market operations and other weapons of control available to the central bank of a country to raise the volume of credit of commercial banks. This policy is known as cheap money policy. The idea is that, with the increase in the volume of credit, there will be an increase in investment, in production and in employment. But monetary policy is weak basically, for it assumes that the volume of credit can be expanded by the central bank. This may not be so, because even when commercial banks are prepared to lend more to business to enable them to expand their investment, the latter may not be willing to do so for fear of possible failure of their investments.

Fiscal policy to fight deflation is known as deficit financing (expenditure is in excess of tax revenues). On the one side, the government attempts to reduce the level of taxation so as to leave a larger amount of purchasing power with the public; on the other hand, the government increased its expenditure on what is now commonly called as public works programme such as irrigation works, construction of roads and railways, etc. By this method the government will (a) provide employment to those who may be thrown out of employment in the private sector, (b) add to national wealth, and (c) counteract the deficiency of private demand for goods and services by means of an increase in its own demand. The budget deficit should be financed through borrowing from the public of their idle cash balances, or borrowing from the banks. The basic idea of fiscal policy is to expand demand for goods or to counteract the decline in private demand. Fiscal policy is, thus, considered the most important policy for economic stabilization.

Other measures to control deflation include price support programmes (to prevent prices from falling beyond certain levels) and lowering of wage and other costs so as to bring about adjustment between price and cost of production. Price support programme has been extensively used in the U.S.A in recent years but it is very difficult to carry it through. The government will have to fix the prices below which the commodities will not be sold and also undertake to buy the surplus stocks. It is difficult for the government to secure the necessary funds for such transactions as well as to devise ways and means to dispose of the surplus stocks in other countries.

It is generally held that the best solution for deflation is to have a ready programme of public works to be implemented as and when unemployment makes its appearance.

Self Assessment Questions :

1. What is deflation?
2. Analyse the effects of deflation
3. What are the methods of deflation control?

