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RESEARCH METHODOLOGY

Lessons - 1 to 10

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Course No. **ECONA311**
Course title: **Money and Banking**
Nature of Course: **SEC – 7**
Number of credits: **4**
Number of Lectures (L): Practical (P): Tutorial (T):): 44:0:16

Course Description

This course exposes students to the theory and functioning of the monetary and financial sectors of the economy. It highlights the organization, structure and role of financial markets and institutions. It also discusses interest rates, monetary management and instruments of monetary control. Financial and banking sector reforms and monetary policy with special reference to India are also covered. The course does not require any prior knowledge of economics.

Course Outline

Unit	Title	Credits L	Credits T
I.	**Money: Theory and Approaches** Money: Meaning, functions and classification, Role of money in capitalist, socialist and mixed economies, Monetary standards – Metallic and paper standards, Principles and System of Note Issue. Qualities of Good Monetary Standard. Grasham's law. Measures of Money Supply.	10	4
II.	**Financial Markets: Money Market and Capital Market** Financial markets and institutions; Money and capital markets: organization, structure, importance and role in economic development of India; financial crises.	10	4
III.	**Commercial Banking** Banking: Meaning and types of Banks. Indian banking system: Changing role and structure; banking sector reforms. Functions of Commercial banks. Process of credit creation. Purpose and limitations. Commercial banking in India. Nationalization of commercial banks in India. Recent reforms in banking sector in India.	12	4
IV.	**Central Banking and Monetary Policy** Central Bank: Functions of Central Bank. Quantitative and qualitative methods of credit control. Role and functions of the Reserve Bank of India. Monetary Policy: goals, targets, indicators and instruments of monetary control; success and limitation of monetary policy in India.	12	4

Suggested Readings:

1. F. S. Mishkin and S. G. Eakins, Financial Markets and Institutions, Pearson Education, 6th edition, 2009.
2. F. J. Fabozzi, F. Modigliani, F. J. Jones, M. G. Ferri, Foundations of Financial Markets and Institutions, Pearson Education, 3rd edition, 2009.
3. L. M. Bhole and J. Mahukud, Financial Institutions and Markets, Tata McGraw Hill, 5th edition, 2011.
4. M. Y. Khan, Indian Financial System, Tata McGraw Hill, 7th edition, 2011.
5. Various latest issues of R.B.I. Bulletins, Annual Reports, Reports on Currency and Finance and Reports of the Working Group, IMF Staff Papers.

LESSON 1
MONEY-I

STRUCTURE

1.0 Objectives

After going through this lesson you will be able to

- Define money
- List and explain the stages in the evolution of money
- Identify the function of money
- List the different types of money

1.1 Introduction

The word 'money' is derived from the Latin word 'Moneta' which was the surname of the Roman Goddess of Juno in whose temple at Rome, money was coined. The origin of money is lost in antiquity. Even the primitive man had some sort of money. The type of money in every age depended on the nature of its livelihood. In a hunting society, the skins of wild animals were used as money. The pastoral society used livestock, whereas the agricultural society used grains and foodstuffs as money. The Greeks used coins as money.

1.2 Stages in the evolution of money

The evolution of money has passed through the following five stages depending upon the progress of human civilization at different times and places.

1.2.1. Commodity money

Various types of commodities have been used as money from the beginning of human civilization. Stones, spears, skins, bows and arrows, and axes were used as money in the hunting society. The pastoral society used cattle as money. The agricultural society used grains as money. The Romans used cattle and salt as money at different times. The Mongolians used squirrel skins as money. Precious stones, tobacco, tea shells, fishhooks and many other commodities served as money depending upon time, place and economic standard of the society.

The use of commodities as money had the following defects.

- All the commodities were not uniform in quality, such as cattle, grains, etc. Thus lack of standardization made pricing difficult.
- It is difficult to store and prevent loss of value in the case of perishable commodities.
- Supplies of such commodities were uncertain.
- They lacked in portability and hence were difficult to transfer from one place to another.
- There was the problem of indivisibility in the case of such commodities as cattle.

1.2.2. Metallic money

With the spread of civilization and trade relations by land and sea, metallic money took the place of commodity money. Many nations started using silver, gold, copper, tin, etc. as money. But metal was an inconvenient thing to accept, weigh, divide and assess in quality. Accordingly, metal was made into coins of predetermined weight. This innovation is attributed to King Midas of Lydia in the eighth century B C. But gold coins were used in India many centuries earlier than in Lydia. Thus coins came to be accepted as convenient method of exchange.

As the price of gold began to rise, gold coins were melted in order to earn more by selling them as metal. This led governments to mix copper or silver in gold coins since their intrinsic value might be more than their face value. As gold became dearer and scarce, silver coins were used, first in their pure form and later on mixed with alloy or some other metal.

But metallic money had the following limitations.

- It was not possible to change its supply according to the requirements of the nation both for internal and external use.
- Being heavy, it was not possible to carry large sums of money in the form of coins from one place to another by merchants.
- It was unsafe and inconvenient to carry precious metals for trade purposes over long distances.
- Money was very expensive because the use of coins led to their debasement and their minting and exchange at the mint cost a lot to the government.

1.2.3. Paper money

The development of paper money started with goldsmiths who kept strong safes to store their gold. As goldsmiths were thought to be honest merchants, people started keeping their gold with them for safe custody. In return, the goldsmiths gave the depositors a receipt promising to return the gold on demand. These receipts of the goldsmiths were given to the sellers of commodities by the buyers. Thus receipts of the goldsmith were a substitute for money. Such paper money was backed by gold and was convertible on demand into gold. This ultimately led to the development of bank notes.

The bank notes are issued by the central bank of the country. As the demand for gold and silver increased with the rise in their prices, the convertibility of bank notes into gold and silver was gradually given up during the beginning and after the First World War in all the countries of the world. Since then the bank money has ceased to be representative money and is simply ‘fiat money’ which is inconvertible and is accepted as money because it is backed by law.

1.2.4. Credit money

Another stage in the evolution of money in the modern world is the use of the cheque as money. The cheque is like a bank note in that it performs the same function. It is a means of transferring money or obligations from one person to another. But a cheque is different from a bank note. A cheque is made for a specific sum, and it expires with a single transaction. A cheque is not money. It is simply a written order to transfer money. However, large transactions are made through cheques these days and bank notes are used only for small transactions.

1.2.5. Near money

The final stage in the evolution of money has been the use of bills of exchange, treasury bills, bonds, debentures, savings certificates, etc. They are known as ‘near money’. They are close substitutes for money and are liquid assets. Thus, in the final stage of its evolution money became intangible. It’s ownership in now transferable simply by book entry.

1.3 Definition of Money

To give a precise definition of money is a difficult task. Various authors have given different definition of money.

According to Crowther, “Money can be defined as anything that is generally acceptable as a means of exchange and that at the same time acts as a measure and a store of value”.

Professor D. H. Robertson defines money as “anything which is widely accepted in payment for goods or in discharge of other kinds of business obligations.

From the above two definitions of money two important things about money can be noted. Firstly, money has been defined in terms of the functions it performs. That is why some economists defined money as “money is what money does”. It implies that money is anything which performs the functions of money.

Secondly, an essential requirement of any kind of money is that it must be generally acceptable to every member of the society. Money has a value for ‘A’ only when he thinks that ‘B’ will accept it in exchange for the goods. And money is useful for ‘B’ only when he is confident that ‘C’ will accept it in settlement of debts. But the general acceptability is not the physical quality possessed by the good. General acceptability is a social phenomenon and is conferred upon a good when the society by law or convention adopts it as a medium of exchange.

1.4. Functions of Money

The major functions of money can be classified into three. They are: The primary functions, secondary functions and contingent functions.

1.4.1. Primary functions of money

The primary functions of money are;

- Medium of exchange and
- Measure of value

1. Medium of exchange

The most important function of money is that it serves as a medium of exchange. In the barter economy commodities were exchanged for commodities. But it had experienced many difficulties with regard to the exchange of goods and services. To undertake exchange, barter economy required ‘double coincidence of wants’. Money has removed this problem. Now a person A can sell his goods to B for money and then he can use that money to buy the goods he wants from others who have these goods. As long as money is generally acceptable, there will be no difficulty in the process of exchange. By serving a very convenient medium of exchange money has made possible the complex division of labour or specialization in the modern economic organization.

2. Measure of value

Another important function of money is that the money serves as a common measure of value or a unit of account. Under barter system there was no common measure of value and the value of different goods were measured and compared with each other. Money has solved this difficulty and serves as a yardstick for measuring the value of goods and services.

As the value of all goods and services are measured in terms of money, their relative values can be easily compared.

1.4.2. Secondary functions

The secondary functions of money are;

1. Standard of deferred payments

Another important function of money is that it serves as a standard for deferred payments. Deferred payments are those payments which are to be made in future. If a loan is taken today, it would be paid back after a period of time. The amount of loan is measured in terms of money and it is paid back in money. A large amount of credit transactions involving huge future payments are made daily. Money performs this function of standard of deferred payments because its value remains more or less stable. When the price changes the value of money also changes. For instance, when the prices are falling, value of money will rise. As a result, the creditors will gain in real terms and the debtors will lose. Conversely, when the prices are rising (or, value of money is falling) creditors will be the losers. Thus if the money is to serve as a fair and correct standard of deferred payments, its value must remain stable. Thus when there is severe inflation or deflation, money ceases to serve as a standard of deferred payments.

2. Store of value

Money acts as a store of value. Money being the most liquid of all assets is a convenient form in which to store wealth. Thus money is used to store wealth without causing deterioration or wastage. In the past gold was popular as a money material. Gold could be kept safely without deterioration.

Of course, there are other assets like houses, factories, bonds, shares, etc., in which wealth can be stored. But money performs as a different thing to store the value. Money being the most liquid of all assets has the advantage that an individual or a firm can buy with it anything at any time. But this is not the case with other assets. Other assets like buildings, shares, etc., have to be sold first and converted into money and only then they can be used to buy other things. Money would perform the store of value function properly if it remains stable in value.

In short, money has removed the difficulties of barter system, namely, lack of double coincidence of wants, lack of division and lack of measure and store of value and lack of a standard of deferred payment. It has facilitated trade and has made possible the complex division of labour and specialization of the modern economic system.

1.4.3. Contingent functions

The important contingent functions of money are;

1. Basis of credit

Basis of credit is with the development of money market the credit market began to flourish.

2. Distribution of national income

Being a common measure of value, money serves as the best medium to distribute the national income among the four factors of production.

3. Transfer of value

Money helps to transfer value from one place to another.

4. Medium of compensations

Accidents and carelessness cause damage to the property and life. Compensation can be paid to such damages in terms of money.

5. Liquidity

Liquidity means the ready purchasing power or convertibility of money in to any commodity. Money is the most liquid form of all assets.

6. Money guide in production and consumption.

Utility of goods and services can be expressed in terms of money. Similarly, marginal productivity is measured in terms of prices of goods and factors. Thus money becomes the base of measurement and which directs the production and consumption.

7. Guarantor of solvency

Solvency refers to the ability to pay off debt. Persons and firms have to be solvent while doing the business. The deposit of money serves as the best guarantor of solvency.

1.5. Types of money

1.5.1. Money of account

Money of account is the monetary unit in terms of which the accounts of a country are kept and transactions settled, i.e., in which general purchasing power, debts and prices are expressed. The rupee is, for instance, our money of account. Sterling is the money of account if Great Britain and mark that of Germany. Money of account need not, however, be actually circulating in the country.

During 1922-24 the mark in Germany depreciated in such an extent that it ceased to be the money of account.

1.5.2 Limited and unlimited legal tender

Money which has legal sanction is called legal tender money. So its acceptance is compulsory. It is an offence to refuse to accept payment in legal tender money. Thus a legal tender currency is one in terms of which debts can be legally paid. A currency is unlimited legal tender when debts upon any amount can be paid through it. It is limited legal tender when payments only up to a given limit can be made by means of it. For example, rupee coins and rupee notes are unlimited legal tender in India. Any amount of transaction can be made by using them. But coins of lower amounts like 25 or 50 paisa are only limited legal tender (up to Rs.25/-). One can refuse to receive beyond this amount.

When a coin is worn out and become light beyond a certain limit, then it ceases to be a legal tender. When one rupee and half-rupee coins are more than 20% below the standard weight they are no longer legal tender.

1.5.3 Standard money

Standard money is one in which the value of goods as well as all other forms of money are measured. In India prices of all goods are measured in terms of rupees. Moreover, the other forms of money such as half-rupee notes, one rupee notes, two rupee notes, five rupee notes etc. are expressed in terms of rupees. Thus rupee is the standard money of India.

Standard money is always made the unlimited legal tender money. In old days the standard money was full-bodied money. That is its face value is equal to its intrinsic value (metal value). But now-days in almost all countries of the world, even the standard money is only a token money. That is, the real worth of the material contained in it is very much less than the face value written in it.

1.5.4 Token money

Token money is a form of money in which the metallic value of which is much less than its real value (or face value). Rupees and all other coins in India are all token money.

1.5.5 Bank money

Demand deposits of banks are usually called bank money. Bank deposits are created when somebody deposits money with them. Banks also creates deposits when they advance loans to the businessmen and traders. These demand deposits are the important constituent of the money supply in the country.

It is important to note that bank deposits are generally divided into two categories: demand deposits and time deposits. Demand deposits are those deposits which are payable on demand through cheques and without any serving prior notice to the banks. On the other hand, time deposits are those deposits which have a fixed term of maturity and are not withdrawable on demand and also cheques cannot be drawn on them. Clearly, it is only demand deposits which serve as a medium of exchange, for they can be transferred from one person to another through drawing a cheque on them as and when desired by them. However, since time or fixed deposits can be withdrawn by forgoing some interest and can be used for making payments, they are included in the concept of broad money, generally called M3.

1.5.6 Inside money

Inside money is a term that refers to any debt that is used as money. It is a liability to the issuer. The net amount of inside money in an economy is zero. At the same time, most money circulating in a modern economy is inside money.

1.5.7 Outside money

Outside money is a term that refers to money that is not a liability for anyone "inside" the economy. It is held in an economy in net positive amounts. Examples are gold or assets denominated in foreign currency or otherwise backed up by foreign debt, like foreign cash, stocks or bonds. Typically, the private economy is considered as the "inside", so government issued money is also "outside money."

Exercise 1.1

Q1. Define money?

Q2. Explain the primary and secondary function of money?

1.6 Summary

In this unit we studied about money. Money can be defined as anything that is generally acceptable as a means of exchange and that at the same time acts as a measure and a store of value. We were also introduced to the different stages in the evolution of money. We also came to know about the different functions of money which were broadly categorised into primary, secondary and contingents' functions. Lastly we studied the different types of money.

1.7 Glossary

1. **Money: Money** can be defined as anything that is generally acceptable as a means of exchange and that at the same time acts as a measure and a store of value.
2. **Unlimited legal tender:** A currency is **unlimited legal tender** when debts upon any amount can be paid through it. It is limited legal tender when payments only up to a given limit can be made by means of it. For example, rupee coins and rupee notes are unlimited legal tender in India. Any amount of transaction can be made by using them.
3. **Legal tender money:** Money which has legal sanction is called **legal tender money**. So its acceptance is compulsory. It is an offence to refuse to accept payment in legal tender money. Thus a legal tender currency is one in terms of which debts can be legally paid.
4. **Standard money:** Standard money is one in which the value of goods as well as all other forms of money are measured. In India prices of all goods are measured in terms of rupees.

5. **Token money** Token money is a form of money in which the metallic value of which is much less than its real value (or face value). Rupees and all other coins in India are all token money.
6. **Bank money:** Demand deposits of banks are usually called bank money. Bank deposits are created when somebody deposits money with them. Banks also creates deposits when they advance loans to the businessmen and traders.
7. **Inside money:** Inside money is a term that refers to any debt that is used as money. It is a liability to the issuer. The net amount of inside money in an economy is zero.
8. **Outside money:** Outside money is a term that refers to money that is not a liability for anyone "inside" the economy. It is held in an economy in net positive amounts. Examples are gold or assets denominated in foreign currency or otherwise backed up by foreign debt, like foreign cash, stocks or bonds. Typically, the private economy is considered as the "inside", so government issued money is also "outside money."

1.8 Answers to Self Check Exercises

Exercise 1.1

Answer 1. Refer to section 1.3.

Answer 2. Refer to section 1.4.1 and 1.4.2.

1.9 Suggested Readings

1. Edward Shapiro – 'Macro-economic Analysis' Oxford University press.

2. Gregory Mankiw – 'Macro economics' – 6th Edition Tata McGraw Hill.

3. Richard T. Frogmen – 'Macro economics', Pearson education.

4. Eugene Diutio – Macro economic Theory, Shaum's Outline series. Tata McGraw Hill.

5. Errol D'Souza – 'Macro Economics' – Pearson Education 2008.

1.10. Terminal Questions

Q1. Define money? Explain the different Stages in the evolution of money?

Q2.Write a short notes on

i. Legal Tender money

ii. Outside money

iii. Near money

iv. Token money

Q3. What are the different functions of money?

LESSON 2
MONEY-II

STRUCTURE

2.0 OBJECTIVES

After going through this unit you will be able to;

- Define money supply
- Identify the constituents of money supply
- Explain the measures of money supply in India.
- Elucidate the determinants of money supply.
- Discuss the relation between money supply and high-powered money.

2.1. INTRODUCTION

Money supply refers to the amount or stock of money held by people in spendable form. Money supply plays an important role in the formulation of economic policy. It refers to the total stock of domestic means of payment owned by the public in a country. This definition includes money held by the public and in circulation but it does not include money held by the central Bank, Commercial Banks and the state treasury because they are money-creating agencies. Money held by them is not in actual circulation in the country. So the stock of money held by the public in a spendable form alone constitutes the money supply at a given point of time.

2.2. DEFINITIONS OF MONEY SUPPLY

The supply of money is a stock at their particular point of time, though it conveys the idea of a flow over time. The term the supply of money: is synonymous with such terms as money stock', 'stock of money', 'money supply' and 'quantity of money'. The supply of money at any moment is the total amount of money in the economy. There are three alternative views .regarding the definition or measures of money supply. "The most common view is associated with the traditional and Keynesian thinking which stresses the medium of exchange function of money. According to this view money supply is' defined as currency with the public and demand deposits with commercial banks. Demand deposits are savings and current accounts of depositors in a commercial bank. They are the liquid form of money because depositors can draw cheques for any amount lying in their accounts and the hank has to make immediate payment on demand. Demand deposits with commercial banks plus currency with the public are together denoted as M1 the money supply. This is regarded as a: narrower, definition of the money supply.

The second definition is broader and is associated with the modern quantify theorists headed by Friedman. Professor Friedman defines the money supply at any moment of time as "literally the number of dollars people are carrying' around in their pockets, the number of dollars they have to their credit at banks or dollars they have their credit at banks in the form of demand deposits, and also commercial bank time deposits." Time deposits are fixed deposits" of customers in a commercial bank:. Such deposits earn a fixed rate of interest varying with the time period for which the amount is deposited. Money can be withdrawn before the expiry of that period by paying a penal rate of interest to the bank. So time deposits possess liquidity and are included in the 1.1l0ney supply by Friedman. Thus this definition includes M1 plus time deposits of commercial banks in the supply of money. This wider definition is characterized as M2 in America and M3 in Britain and India. It stresses the store of value function of money or what Friedman says, 'a temporary abode of purchasing power.

The third definition is the broadest and is associated with Gurley and Shaw. They include in the supply of money, M2 plus deposits of savings banks, building societies, loan associations, and deposits of other credit and financial institutions. The choice between, these alternative definitions of the money supply depends on two considerations: One "a particular choice of definition may facilitate or blur the analysis of the various motives for holding cash;"2 and two from the point of view of monetary policy an appropriate definition should include the area over which the monetary authorities can have direct influence. If these two criteria are applied, none of the three definitions is wholly satisfactory.

The first definition of money supply may be analytically better because M_1 is a sure medium of exchange. But M_1 is an inferior store of value because it earns no rate of interest, as is earned by time deposits. Further, the central bank can have control over a narrower area if only demand deposits are included in the money supply.

The second definition that includes time deposits (M_2) in the supply of money is less satisfactory analytically because "in a highly developed financial structure, 'it is important to consider separately the motives for holding means of payment and time deposits." Unlike demand deposits, time deposits are not a perfect liquid form of money.

This is because the amount lying in them can be withdrawn immediately by cheques. Normally it cannot be withdrawn before the due date of expiry of the deposit. In case a depositor wants his money earlier, he has to give a notice to the bank which allows the withdrawal after charging a penal interest rate from the depositor. Thus time deposits lack perfect liquidity and cannot be included in the money supply. But this definition is more appropriate from the point of view of monetary policy because the central bank can exercise control over a wider area that includes both demand and time deposits held by commercial banks.

The third definition of money supply that includes M_2 plus deposits of non bank financial institutions is unsatisfactory on both the criteria. Firstly, they do not serve the medium of exchange function of money. Secondly, they almost remain outside the area of control of the central bank. The only advantage they possess is that they are highly liquid store of value. Despite this merit, deposits of non-bank financial institutions are not included in the definition of money supply.

2.3. THE CONSTITUENTS OF MONEY SUPPLY

Money supply refers to the amount or stock of money held by people in spendable form. Money supply plays an important role in the formulation of economic policy. It refers to the total stock of domestic means of payment owned by the public in a country. This definition includes money held by the public and in circulation but it does not include money held by the central Bank, Commercial Banks and the state treasury because they are money-creating agencies. Money held by them is not in actual circulation in the country. So the stock of money held by the public in a spendable form alone constitutes the money supply at a given point of time.

The main constituents of money supply are as follows:

Economists are not unanimous about the constituents of money supply. There are different views about it. Yet, they can be broadly classified into the following two parts:

(i) Traditional measure - (Narrow money)

(ii) Modern measure (Broad money)

i) Traditional Measure or Narrow Money: Money is basically a medium of exchange or means of payment. Hence, according to the traditional approach, the stock of money should include such items that can be spent immediately. On this basis, the components of money supply can comprise only of those things which are readily accepted as a medium of exchange. Currency (coins and notes) and demand deposits with the bank are the liquid form of money which are readily accepted by everyone as a medium of exchange. Demand deposits only in the banks are treated as money because payments can be done by drawing cheques against them. Time deposits are not included in the traditional measure of money supply because cheques cannot be drawn against them.

The traditional money is also called as 'narrow money.' It is called narrow money because components of money supply are confined to currency and demand deposits only. Some economists call it 'transaction money' because it is used for transaction.

The traditional measure of money supply is expressed as follows:

M1 = C+DD

Where M1 = Traditional measure or Narrow Money.

C = Currency (coins & Notes)

DD = Demand deposits (Cheque able deposits)

ii) Modern Measure or Broad Money: The broad money concept includes all the very close substitutes of money in the measure of money supply. Economists like Milton Friedman, Gurley John G, Shaw Edwards and Radcliff committee are closely associated with the modern approach.

a) **Milton Friedman:** According to him the money supply concept is wider and includes savings and time deposits with Commercial banks, because, time deposits can be made available for spending purposes with limited cost.

b) **Gurley - Shaw:** According to him money supply is measured as weighted average of currency, demand deposits and near-money assets.

c) **Central Bank**: According to the Central Bank approach, all the funds lent by a number of financial institutions are included in the total money supply.

The modern measure of money consists of M1 and other liquid assets or near money. It consists of saving deposits with restriction on the amount and number of withdrawals. In India they are in the form of the following:

a) Post Office Saving Bank deposits,

b) Time deposits with banks which can be withdrawn with prior notice and penalty interest,

c) Government securities, bonds and other financial assets,

d) Credit, representing all debt of domestic non-financial sectors in the form of mortgages, bonds and similar instruments since the broad money concept includes all the aspects mentioned above, it can be expressed as;

M2 = M1 + a + b + c

where M2 = modern measure or broad money. The items included in M2 differ in liquidity as the liquidity declines from a to d. Accordingly the broad money can be sub-divided into M2, M3 and M4

M2 = M1 + a + b

M3 = M2 + c

M4 = M3 + d

It should be noted that there is no unanimity about the exact components of modern measure of money. Monetary authorities of each country decide the items to be included depending upon their impact on economic activities.

2.4. RESERVE BANK OF INDIA'S MEASURES OF MONEY SUPPLY

Since 1977 the Reserve Bank of India, India's Central Bank adopted a new measure of money supply. Before that, till 1967-68 its measure of money included only currency and demand deposits (M). From 1967-68 to 1977 it adopted a broader measure of money supply which was called as Aggregate Monetary Resources (AMR).

The new measure of money supply is stated as follows:

a) M1 = C + DD + OD

where C = Currency held by the public (Currency in circulation and cash in hand of all banks)

DD = Demand deposits with all commercial and institutions, foreign Central Banks, foreign government and the World Bank.

OD = other deposits with all RBI.

The part of OD in total money supply is very small, M1 has the highest liquidity.

M1 is useful in formulation of monetary and fiscal policies.

b) M2 = M1 + SD

SD = Savings bank deposits with past offices. SD are more liquid than time deposits

c) M3 = M1 + TD

TD = Time deposits with all Commercial banks and Co-operative banks (Excluding inter banking deposits). M3 is a broad money concept.

d) M4 = M3 + TDP

TDP = Total deposits with the post offices (excluding National Saving Certificates)

The RBI has taken a broad measure of money supply by bringing in total deposits from post offices, but Post Office deposits are less liquid than the deposits of Commercial banks. RBI's M1 measure is conceptually the same as the traditional concept of money supply. For all policy decisions M3 is a more relevant measure of money supply.

RBI's measure of money supply - 1998: The working group of RBI since 1998 has redefined the parameters for measuring money supply. A change is introduced in M2 and M4 is totally abolished. Accordingly, now there are only three monetary aggregates that is - M1, M2 and M3.

M1 = C + DD + OD

M2 = M1 + time liability portion of savings deposits with banks + CDs issued by bank + term deposit maturing within one year.

M3 = M2 + Term deposits over one year maturity + call / term borrowings of banks.

RBI introduced a new concept of liquid resources on the line of broad money. They are as follows:

Liquidity Aggregate:

Liquidity aggregates consist of L1+L2+L3 that is L_A = L1 + L2 + L3

where L_A = Liquidity Aggregates.

L1 = New M3 + All deposits with Post offices savings banks (excluding NSCs)

L2 = L1 + term deposits with term lending institutions + term barrowings of FIs + CDs issued by FIs

L3 = L2 + public deposits of NBFCs.

The concept of LA is wider than the revised money supply measure.

2.5. High-powered money (H) and the Money Multiplier

The high-powered money consists of the currency (notes and coins) issued by the government and the RBI. A part of the currency issued is held by the public, which we designate as Cp and a part is held by the banks as reserves which we designate as R. A part of these currency reserves of the bank is held by them in their own cash vaults and a part is deposited in the Reserve Bank of India in the reserve accounts which banks hold with RBI.

Accordingly, the high-powered money can be obtained as sum of currency held by the public and the part held by the banks as reserves. Thus,

H = Cp + R...(2)

Where H = the amount of high-powered money

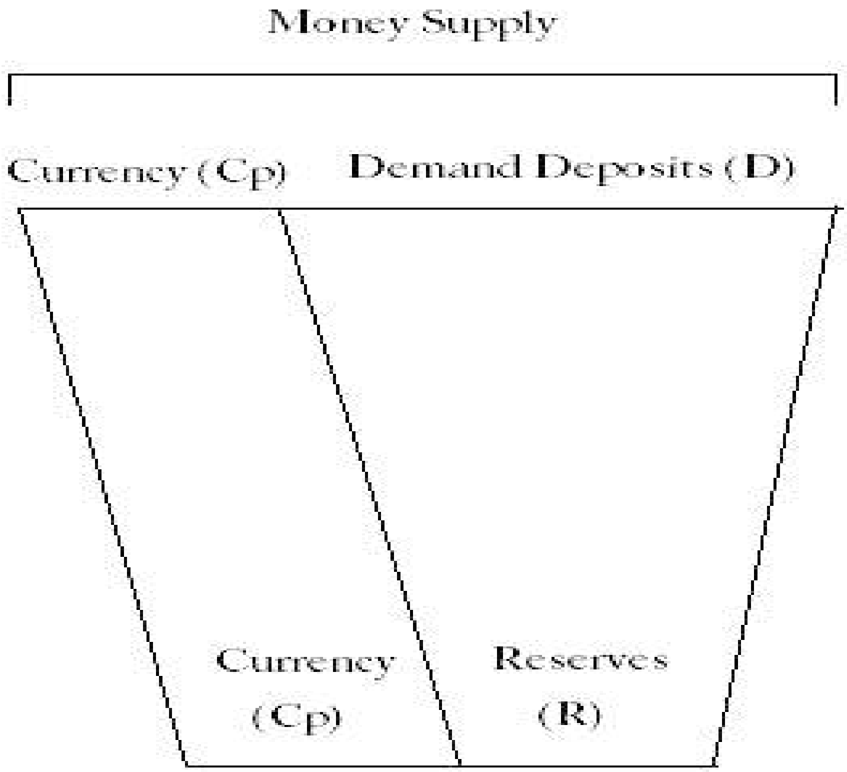
Cp = Currency held by the public

R = Cash reserves of currency with the banks.

It is to be noted that RBI and Government are the producers of the high-powered money and the commercial banks do not have any role in producing this high-powered money (H).

However, the commercial banks are producers of demand deposits which are also used as money like currency. But for producing demand deposits or credit, banks have to keep with themselves cash reserves of currency which have been denoted by R in equation (2) above. Since these cash reserves with the banks serve as a basis for the multiple creations of demand deposits which constitute an important part of total money supply in the economy. It provides high poweredness to the currency issued by the Reserve Bank and the Government.

The theory of determination of money supply is based on the supply of and demand for high powered money. Some economists call it 'The H Theory of Money Supply'. However, it is more popularly called 'Money Multiplier Theory of Money Supply' because it explains the determination of money supply as a certain multiple of the high powered money. How the high powered money is related to the total money supply is graphically depicted in the following figure.



The base of the figure shows the supply of high powered money (H) while the top of the figure shows the total stock of money supply. It will be seen that the total stock of money supply is determined by a multiple of the high powered money. It will be further seen that where as currency held the public (Cp) uses the same amount of high powered money, ie, there is one-to-one relationship between currency held by the public and the money supply. In contrast to this, bank deposits are a multiple of the cash reserves of the banks (R) which are part of supply of high powered money. That is, one rupee of high powered money kept as bank reserves give rise to much more amount of demand deposits. Thus the relationship between money supply and the high powered money is determined by the money multiplier.

The money multiplier which we denote by ‘m’ is the ratio of total money supply (M) to the stock of high powered money. That is;

$$m = \frac{M}{H}$$

The size of money multiplier depends on the preference of the public to hold currency relative to deposits (i.e., ratio of currency to deposits which we denote by K) and bank’s desired cash reserves ratio to deposits (which we call r) It follows from above that if there is increase in currency held by the public which is a part of the high powered money, with demand deposits remaining unchanged, there will be direct increase in the money supply in the economy. If currency reserves held by the banks increase, this will not change the money supply immediately but will set in motion a process of multiple creation of demand deposits of the public in the banks. Although banks use these currency reserves held by them, which constitute a part of the high powered money, to give more loans to the businessmen and thus create demand deposits, they do not affect either the amount of currency held by the public or the composition of high powered money. The amount of high powered money is fixed by the RBI by its past actions.

Money Multiplier

As we stated above, money multiplier is the degree to which money supply is expanded as a result of the increase in high powered money. Thus

$$m = \frac{M}{H}$$

Rearranging this we have

$$M = H.\ m$$

Thus money supply is determined by the size of money multiplier (m) and the amount of high powered money (H).

2.6 DETERMINANTS OF MONEY SUPPLY

There are two theories of the determination of the money supply. According to the first view, the money supply is determined exogenously by the central bank. The second view holds that the money supply is determined endogenously by changes in the economic activities which affect people's desire to hold currency relative to deposits, the rate of interest, etc.

Thus the determinants of money supply are both exogenous and endogenous which can be described broadly as: the minimum cash reserve ratio, the level of bank reserves, and the desire of the people to hold currency relative to deposits. The last two determinants together are called the monetary base or the high powered money.

1. The Required Reserve Ratio

The required reserve ratio (or the minimum cash reserve ratio or the reserve deposit ratio) is an important determinant of the money supply. An increase in the required reserve ratio reduces the supply of money with commercial banks and a decrease in required reserve ratio increases the money supply. The RRI is the ratio of cash to current and time deposit liabilities which is determined by law. Every commercial bank is required to keep a certain percentage of these liabilities in the form of deposits with the central bank of the country. But notes or cash held by commercial banks in their tills are not included in the minimum required reserve ratio.

But the short-term assets along with the cash are regarded as the liquid assets of a commercial bank. In India the statutory liquidity ratio (SLR) has been fixed by law as an additional measure to determine the money supply. The SLR is called 'Secondary reserve ratio in other countries while the required reserve ratio is referred to as the primary ratio. The raising of the SLR has the effect of reducing the money supply with commercial banks for lending purposes, and the lowering of the SLR tends to increase the money supply with banks for advances.

2. The Level of Bank Reserves

The level of bank reserves is another determinant of the money supply. Commercial bank reserves consist of reserves on deposits with the central bank and currency in their tills or vaults. It is the central bank of the country that influences the reserves of commercial banks in order to determine the supply of money. The central bank requires all commercial banks to hold reserves equal to a fixed percentage of both time and demand deposits. These are legal minimum or required reserves. Required reserves (RR) are determined by the required reserve ratio (RRr) and the level of deposits (D) of a commercial bank: RR= RRr x D. If deposits amount of Rs 80 lakhs and required reserve ratio is 20 per , cent, then the required reserves will be 20% x 80=Rs 16 lakhs. If the reserve ratio is reduced to 10 per cent, the required reserves will also be reduced to Rs 8 lakhs. Thus the higher the reserve ratio, the higher the required reserves to be kept by a bank, and vice versa. But it is the excess reserves (ER) which are important for the determination of the money supply. Excess reserves are the difference between total reserves (TR) and required reserves (RR): ER=TR-RR.

If total reserves are Rs 80 lakhs and required reserves’ are Rs 16 lakhs, then the excess reserves are Rs 64 lakhs (Rs 80 - 16 lakhs). When required reserves are reduced to Rs 8 lakhs, the excess reserves increase to Rs 72 lakhs. It is the excess reserves of a commercial bank which influence the size of its deposit liabilities. A commercial bank advances loans equal to its excess reserves Which are an important component of the money supply. To determine the supply of money with a commercial bank, the central bank influences its reserves by adopting open market operations and discount rate policy. Open market operations refer to the purchase and sale of government securities and other types of assets like bills, securities, bonds, etc., J both government and private in the open market. When the central bank buys or sells securities in the open market, the level of bank reserves expands or contracts. The purchase of securities by the central bank is paid for with cheques to the holders of securities who, in turn, deposit them in commercial banks thereby increasing the level of bank reserves. The opposite is the case when the central bank sell securities to the public and banks who make payments to the central bank through cash and cheques thereby reducing the level of bank reserves.

The discount rate policy affects the money supply by influencing the cost and supply of bank credit to commercial banks. The discount rate, known as the bank rate in India, .is the interest rate at which commercial banks borrow from, the central bank. A high discount rate means that commercial banks get fewer amounts by selling securities to the central bank. The commercial banks, in turn raise their lending rates to the public thereby making advances dearer for them.

Thus there will be contraction .of credit and the level of commercial bank reserves. Opposite is the case when the bank rate is lowered. It tends to expand credit and the consequent bank reserves. It should be noted that commercial bank reserves are affected significantly only when open market operations and discount rate policy supplement each other. Otherwise, their, effectiveness as determinants of bank reserves and consequently of money supply is limited.

3. Public's Desire to Hold Currency and Deposits

People's desire to hold currency (or cash) relative to deposits in commercial banks also determines the money supply. If people are in the habit of keeping less in cash and more in deposits with the commercial banks, the money supply will be large. This is because banks can create more money with larger deposits. On the contrary, if people do not have banking habits and prefer to keep their money holdings in cash, credit creation by banks will be less and, the money supply will be at a low level.

4. High Powered Money and the Money Multiplier

The current practice is to explain the determinants of the money supply in terms of the monetary base or high powered money .High-powered money is the sum of commercial bank reserves and currency (notes and coins) held by the public. High-powered money is the base for the expansion of bank deposits and creation of the money supply. The supply of money varies directly with changes in the monetary base, and inversely with the currency and reserve ratios.

5. Other Factors

The money supply is a function not only of the high-powered money determined by the monetary authorities, but of interest rates; income and other factors. The latter factors change the proportion of money balances that the public holds as cash. Changes in business activity can change the behaviour of banks and the public and thus affect the money supply. Hence the money supply is not only an exogenous controllable item but also an endogenously determined item.

2.7. Summary

In this lesson we studied about the money supply. Money supply refers to the amount or stock of money held by people in spendable form. The constituents of money are broadly classified into traditional measure and modern measure. The traditional measure is also called as narrow money and the modern measure is termed as broad money. The RBI's measure of money supply consists of three monetary aggregates namely M1, M2 and M3. RBI also introduced a new concept of liquid resources on the lime of broad money that is LA = L1 + L2 + L3. Hence in summary we can state Walker's definition of money "Money is what money does."

2.8. Glossary

1. **Supply of money:** The total stock of domestic means of payment owned by the public in a country.

2. **Narrow Money:** It includes components of money supply which comprise only of those things which are readily accepted as a medium of exchange.

3. **Broad Money:** It includes all very close substitutes of money in the measure of money supply.

4. **High-powered money:** The high-powered money consists of the currency (notes and coins) issued by the government and the RBI. Accordingly, the high-powered money can be obtained as sum of currency held by the public and the part held by the banks as reserves.

2.9. Answers to Self Check Exercises

Exercise 8.1

Answer 1. Refer to section 2.3.

Answer 2. Refer to section 2.4.

Answer 3. Refer to section 2.5.

2.10. Suggested Readings

1. Modern Economics - H. L. Ahuja, (2010) S. Chand & Company New Delhi.

2. Edward Shapiro – 'Macro-economic Analysis' Oxford University press.

3. Gregory Mankiw – 'Macro economics' – 6th Edition Tata McGraw Hill.

4. Richard T. Frogmen – 'Macro economics', Pearson education.

5. Eugene Diutio – Macro economic Theory, Shaum's Outline series. Tata McGraw Hill.

6. Errol D'Souza – 'Macro Economics' – Pearson Education 2008.

2.11. Terminal Questions

Q1. Explain the various components of the money supply.

Q2. Discuss the determinants of the money supply. Should time deposits be included under the supply of money?

Q3. In how many ways is the broad money divided?

Q4. In which year did RBI redefine the parameter of measuring M money supply?

Q5. Write short note on high powered money and money multiplier?

LESSON 3
THEORIES OF MONEY SUPPLY

STRUCTURE

3.0 OBJECTIVES

After going through this unit you will be able to

- Explain the cash balance Approach
- Elucidates the cash transaction Approach
- Indicate out the similarities between two approaches
- Make out the difference between the two approaches

3.1 INTRODUCTION

The word 'money' is derived from the Latin word 'Moneta' which was the surname of the Roman Goddess of Juno in whose temple at Rome, money was coined. The origin of money is lost in antiquity. Even the primitive man had some sort of money. The type of money in every age depended on the nature of its livelihood. In a hunting society, the skins of wild animals were used as money. The pastoral society used livestock, whereas the agricultural society used grains and foodstuffs as money. The Greeks used coins as money.

3.2 The Quantity Theory of Money - Fisher's Equation of Exchange – Cash Balance Approach

The Quantity Theory of Money seeks to explain the factors that determine the general price level in a country. The theory states that the price level is directly determined by the supply of money. The quantity theory of money is based directly on the changes brought about by an increase in the money supply. The quantity theory of money states that the value of money is based on the amount of money in the economy. Thus, according to the quantity theory of money, when the supply of money increases the, the value of money falls and the price level increases. We know that inflation is persistent rise in the price level. Hence, on the basis of this definition, the quantity theory of money also states that growth in the money supply is the primary cause of inflation.

3.2.1 Value of Money

The basic causal relationship between the price level and the value of money is that as the price level goes up, the value of money goes down. The "value of money" refers to what a unit of money can buy whereas the "price level" refers to the average of all of the prices of goods and services in a given economy. A unit of money has its denomination printed on it known as the "face value," but the unit only has tangible value in relation to what a person can buy with it. This is called its "purchasing power." The purchasing power of a given currency changes over time due to variations in supply and demand, but in general it slowly loses value as the price level rises.

3.2.2 Price Level

In contrast to the value of money, which is expressed in units, the price level is an aggregate. Because it is difficult, confusing and nearly impossible to accurately average all prices for all goods and services in an economy, the price level is most commonly analyzed by finding the price of a theoretical collection of goods and services. The price level inevitably increases over time due to inflation, though in most economies this increase is gradual.

3.2.3 Relationship

As the price level increases over time, the value of money decreases. In most countries, the price level increases slowly with inflation and changes in supply and demand. Like most things in economics, there is a market for money. The supply of money in the money market comes from the Central Bank. The Central Bank has the power to adjust the money supply by increasing or decreasing it. The demand for money in the money market comes from consumers. The determinants of money demand are infinite. In general, consumers need money to purchase goods and services. If there is an ATM nearby or if credit cards are plentiful, consumers may demand less money at a given time than they would if cash were difficult to obtain. The most important variable in determining money demand is the average price level within the economy. If the average price level is high and goods and services tend to cost a significant amount of money, consumers will demand more money. If, on the other hand, the average price level is low and goods and services tend to cost little money, consumers will demand less money. The value of money is ultimately determined by the intersection of the money supply, as controlled by the Central Bank and money demand, as created by consumers. The value of money, as revealed by the money market, is variable. A change in money demand or a change in the money supply will yield a change in the value of money and in the price level. The change in the value of money and the change in the price level are of the same magnitude but in opposite directions.

3.2.4 Velocity

The most important variable that intervenes the effects of changes in the money supply is the velocity of money. Velocity of money is defined simply as the rate at which money changes hands. If velocity is high, money is changing hands quickly, and a relatively small money supply can fund a relatively large amount of purchases. On the other hand, if velocity is low, then money is changing hands slowly, and it takes a much larger money supply to fund the same number of purchases. The velocity of money is not constant. Instead, velocity changes as consumers' preferences change. It also changes as the value of money and the price level change. If the value of money is low, then the price level is high, and a larger number of bills must be used to fund purchases. Given a constant money supply, the velocity of money must increase to fund all of these purchases. Similarly, when the money supply shifts due to the Central Banks policy, velocity can change. This change makes the value of money and the price level remain constant.

3.2.5 The relationship between velocity, the money supply, the price level, and output

The relationship between velocity, the money supply, the price level, and output is represented by the equation M * V = P * Y where M is the money supply, V is the velocity, P is the price level, and Y is the quantity of output. P * Y, the price level multiplied by the quantity of output, gives the nominal GDP. This equation can thus be rearranged as V = (nominal GDP) / M. Conceptually, this equation means that for a given level of nominal GDP, a smaller money supply will result in money needing to change hands more quickly to facilitate the total purchases, which causes increased velocity. The equation for the velocity of money, while useful in its original form, can be converted to a percentage change formula for easier calculations. The velocity equation can be used to find the effects that changes in velocity, price level, or money supply have on each other. When making these calculations, remember that in the short run, output (Y), is fixed, as time is required for the quantity of output to change.

Let's try an example. What is the effect of a 3% increase in the money supply on the price level, given that output and velocity remain relatively constant? The equation used to solve this problem is (percent change in the money supply) + (percent change in velocity) = (percent change in the price level) + (percent change in output). Substituting in the values from the problem we get 3% + 0% = x% + 0%. In this case, a 3% increase in the money supple results in a 3% increase in the price level. Remember that a 3% increase in the price level means that inflation was 3%.

In the long run, the equation for velocity becomes even more useful. In fact, the equation shows that increases in the money supply by the Central Bank tend to cause increases in the price level and therefore inflation, even though the effects of the Central Bank‘s policy is slightly dampened by changes in velocity. This results a number of factors. First, in the long run, velocity, V, is relatively constant because people's spending habits are not quick to change. Similarly, the quantity of output, Y, is not affected by the actions of the Central Bank since it is based on the amount of production. This means that the percent change in the money supply equals the percent change in the price level since the percent change in velocity and percent change in output are both equal to zero. Thus, we see how an increase in the money supply by the Central Bank causes inflation.

The velocity of money equation represents the heart of the quantity theory of money. By understanding how velocity mitigates the actions of the Fed in the long run and in the short run, we can gain a thorough understanding of the value of money and inflation. There are two versions of the Quantity Theory of Money:

(1) The Transaction Approach and

(2) The Cash Balance Approach.

Let us discuss them in detail.

3.3 Fisher's Equation of Exchange or the Transaction Approach

3.3.1 Introduction

Irving Fisher an American economist put forward the Cash Transaction Approach to the quantity theory of money. He in his book The Purchasing Power of Money (1911) has stated that the value of money in a given period of time depends upon the quantity of money in circulation in the economy. It is the quantity of money which determines the general price level and the value of money. Any change in the money supply directly affects the general price level and the value of money inversely in the same proportion. In Fisher's words, ―Other things remaining unchanged, as the quantity of money in circulation increases, the price level also increases in direct proportion and the value of money decreases and vice versa‖. For example, if the quantity of money in circulation is doubled other things being equal the general price level will be doubled and the value of money is halved. Similarly if the quantity of money is halved the price level will be halved and the value of money doubled. In Fisher's Cash Transactions Version of Money, the general price level in a country, like the prices of commodities, is determined by the supply of and demand for money.

3.3.2 Supply of Money

The supply of money consists of the quantity of money in circulation (M) and the velocity of its circulation (V) i.e., the number of times the money changes hands. Thus MV refers to the total volume of money in circulation during a period of time. For example, if the total money supply in Pakistan Rs. 5,000 billion and its velocity per unit of time is 10 times, then the total money supply would be Rs.5,000 x 10 = Rs.50000 billion.

3.3.3 Demand for Money

People demand money not for its own sake. They demand money because it serves a medium of exchange. It is used to carry every day transactions. In short, the demand for money is for the exchange of goods.

3.3.4 Assumptions of the theory

(1) Full employment: The theory is based on the assumption of full employment in the economy

(2) T and V are constant: The theory assumes that volume of trade (T) ii the short run remains constant. So is the case with velocity of money (V) which remains unaffected.

(3) Constant relation between M and M1: Fisher assumes constant relation between currency money M and credit money (M1).

(4) Price level (P) is a passive factor: The price level (P) is inactive or passive in the equation. P is affected by other factors in equation i.e., T, M, M1, V and V1 but it does not affect them.

3.3.5 Equation of Exchange:

The Cash transaction version of the quantity theory of money was presented by Irving fisher in the form of an equation. Thus Fisher's transaction approach to the

Quantity Theory of Money may be explained with the following equation of exchange.

$$MV = PT$$

Where,

M is the total supply of money

V is the velocity of circulation of money

P is the general price level

T is the total transactions in physical goods.

This equation is an identity, that is, a relationship that holds by definition. It means, in an economy the total value of all goods sold during any period (PT) must be equal to the total quantity of money spent during that period (MV). Fisher assumed that (1) at full employment total physical transactions T in an economy will be a constant, and (2) the velocity of circulation remain constant in the short run because it largely depends on the spending habits of the people. When these two assumptions are made the Equation of Exchange becomes the Quantity Theory of Money which shows that there is an exact, proportional relationship between money supply and the price level. In other words, the level of prices in the economy is directly proportional to the quantity of money in circulation. That is, doubling the total supply of money would double the price level.

It may be noted that the above Fisher's Equation include only primary money or currency money. But modern economy extensively uses demand deposits or credit money. It was on account of the growing importance of credit money that Fisher later on extended his equation of exchange to include credit money. Thus, the equation of exchange can be represented as follows:

$$P = MV + M1\ V1/T \quad \text{or} \quad PT = MV + M1V1$$

Here,

P is the price Level

M is the quantity of money

V is the velocity of circulation of M

M1 is the volume of credit money

V1 is the velocity of circulation of M1

T is the total volume of goods and Trade

Fisherian relation between M and P can be explained with the help of a diagram. The figure below shows equi-proportionate changes between M and P. As quantity of money increases from M_0 to M_1, price level rises from P_0 to P_1. Similarly, when the quantity of money increases from M_1 to M_2, the price level increases from P_1 to P_2 making the changes in the quantity of money equal to the changes in the price level.

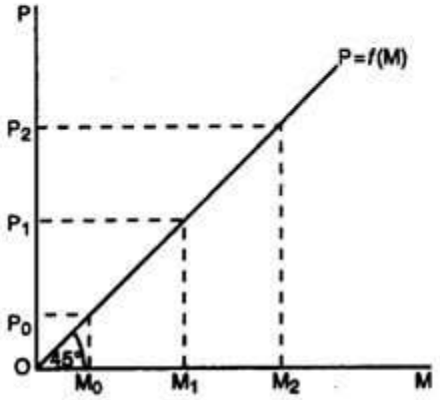


Figure 3.1 Relationship between Quantity of Money and Price Level

Fisher's Transaction Approach can explain the causes of hyperinflation that occurs during war or emergency. It can also explain certain long term trend in prices. But it cannot explain normal peace time inflation. This shortcoming has been modified by the Cambridge version or the Cash-Balance Approach.

3.3.6 Criticism of the theory

The quantity theory s subjected to the following criticism.

(1) Unrealistic assumptions: The theory is based on unrealistic assumptions. In this theory P is considered as a passive factor. T is independent. M1, V, V1, are constant in the short run. All these assumptions are covered under ―Other things remaining the same.‖ In actual working of the economy, these do not remain constant; hence, the theory is unrealized and misleading.

(2) Various Variables in the transaction are not independent. The various variables in transaction eqi4ation are not independent as assumed in the theory The fact is that they very much influence each other For example when money supply (M) increases the velocity f money (V) also goes up Take another case. Fisher assumes (P) is a passive factor and has no effect on trade (T). In actual practice, when price level P) rises, it increases profits and promotes trade (T).

(3) Assumption of full employment is wrong. J. M. Keynes has raised en objection that the assumption of full employment is a rare phenomenon in the economy and the theory is not real.

(4) Rate of interest ignored. In the quantity theory of Fishers, the influence of the rate of interest on the money supply and the level of prices have been completely ignored. The fact is that an increase or decrease in money supply has an important bearing on the rate: of interest. An increase in money supply leads to a decline in the rate of interest and vice versa.

(5) Fails to explain trade cycles. The theory fails to explain the trade cycles. It does not tell as to why during depression, the increase in money supply has little impact on the price level, Similarly, in boom period the reduction in money supply or tight money policy may not bring down the price level G. Crowther is right in saying, ―The quantity theory is at best an imperfect guide to the cause of the business cycle‖.

(6) Ignores other factors of price level. There are many determinants other than M, V, and T which have important implication on the price level. These factors such as income, expenditure, saving, investment, population consumption etc have been ignored from the purview of the theory.

3.4 The Cash Balance Approach (Cambridge Approach)

3.4.1 Introduction

Fisher's approach can be viewed as deterministic. Essentially, Fisher argued that, given the full employment volume of transactions and the speed with which the financial system could process payments, the quantity of money that agents required to hold was effectively determined. Alfred Marshall, A.C. Pigou, D.H. Robertson and J.M. Keynes at Cambridge School made an alternative formulation of the quantity theory of money which is known as Cash Balance equation. Like Fisher, the Cambridge School assumed that money was only held to expedite transactions and had no further purpose. Thus, if the money supply increased, agents holding the increased money stock would seek to get rid of it. However, the emphasis in this approach concentrated on establishing the quantity of money that agents would voluntarily desire to hold. The Cambridge school were in effect attempting to set out a theory of the demand for money.

The Cambridge approach emphasises that there are alternatives to holding money in the shape of shares and bonds. These assets yield a return which can be viewed as the opportunity cost of holding money. As interest rates rise, agents will economise on money holdings and vice versa. Another factor that will influence money holdings is the expected rate of inflation. If inflation is expected to be high, then the purchasing power of money will fall. This will prompt agents to buy securities or commodities as a hedge against inflation. The Cambridge economists regarded the determination of value of money in terms of supply and demand. The supply of money is exogenously determined by the banking system. Therefore, the concept of velocity of circulation is altogether discarded in the cash balances approach. On the other hand, the concept of demand for money plays the major role in determining the value of money. The demand for money is the demand to hold cash balance for transactions and precautionary motives. Thus, the cash balance approach considers the demand for money not as a medium of exchange but as a store of value. The Cambridge equations show that given the supply of money at a point of time, the value of money is determined by the demand for cash balances. When the demand for money increases, people will reduce their expenditures on goods and services in order to have larger cash holdings. Reduced demand for goods and services will bring down the price level and raise the value of money. On the contrary, fall in the demand for money will raise the price level and lower the value of money.

9.4.2 Marshall's Equation

We may express the idea of Marshall in the form of an equation as follows:

M = kPY where M stands for the exogenously determined supply of money, k is the fraction of the real money income (PY) which people wish to hold in cash and demand deposits, P is the

$P = \frac{M}{kY}$ or the value of money (the reciprocal or price level) is $\frac{1}{P} = \frac{kY}{M}$

3.4.3 Pigou's Equation

Pigou was the first Cambridge economist to express the cash balance approach in the form of an equation and his equation can be expressed as: $P = \frac{kR}{M}$ where P is the purchasing power of money (the value of money which is the reciprocal of the price level), k is the proportion of total real resources or income (R) which people wish to hold in the form of titles or legal tender, (Real Income), and M refers to the number of actual units in legal tender money.

The demand for money, according to Pigou, consists not only of legal money or cash but also bank notes and bank balances. In order to include bank notes and bank balances in the demand for money, Pigou modifies his equation as:

$$P = \frac{kR}{M} \{c + h(1 - c)\}$$

Where, c is the proportion of total real income actually held by people in legal tender including token coins, (1-c) is the proportion kept in bank notes and bank balances, and *h* is the proportion of actual legal tender that bankers keep against the notes and balances held by their customers.

Pigou's equation explains the reason behind the value of money and also the motive behind people keeping larger or smaller proportions of their income in the form of money. During a period of rising prices, as the value of money decreases, people want to hold smaller proportion of their income in the form of cash while during the period of depression, as the value of money is rising; people want to keep larger proportion of their income in the form of cash.

3.4.4 Criticisms of Cash Balance Approach

The main drawbacks of the cash balance theory are as under:

(1) Use of Purchasing Power for consumption goods. The Cambridge economists give undue importance the purchasing power of money in term of consumption goods. The theory ignores speculative motive of demand for money.

(2) Role of rate of interest ignored. The cash balance theory excludes the role of rate of interest in explaining the changes in the price Level which is very important in 1nf the demand for money.

(3) Unitary elasticity of demand. The Cambridge equation assumes that the elasticity demand for money is unity. This is not realistic in the dynamic society of today.

(4) Real income not the sole determinant of K. According to the Cambridge equation, real income only determines the value of K i.e., the cash held by people. The fact is that other factors as price level; banking and business habits of the people, political conditions in the country can influence the value of K.

(5) Simple Truism. The Cambridge equation, like the Fisherian equation establishes proportionate relationship between the quantity of money and the price level. M = KPY. The theory does not explain as to how and why this relationship between the two is established.

(6) K and T assumed constant. The Cambridge economist like Irving Fisher also assumes that K and T remain constant. This is possible in a static situation but not in dynamic conditions.

(7) No explanation of business cycles. The Cambridge equations do not provide any explanation for the business cycles.

3.5 Comparison between Transactions and Cash Balance Approaches

There are similarities as well as dissimilarities between the Transactions and Cash balance approaches.

3.5.1 Similarities

1. Same conclusion about M and P: The basic conclusion in both the approaches is the same that the value of money or the price level is a function of the quantity of money.

2. Similar Equations: The two approaches use almost similar equations.

3. Both approaches consider that money serves as a medium of exchange in the economic system.

3.5.2 Dissimilarities

There are a lot of differences between the Transactions approach and Cash Balance approach of the quantity theory of money which are given below.

1. Functions of Money: The Fisherian approach lays emphasis on the medium of exchange function of money while the Cambridge approach emphasises the store of value function of money.

2. Flow and Stock: In Fisher‘s approach money is a flow concept while in the Cambridge approach it is a stock concept.

3. V and k Different: In Fisher‘s equation V refers to the rate of spending and in Cambridge equation k refers to the cash balances which people wish to hold.

4. Nature of Price level: In Fisher‘s equation, P refers to the average price level of all goods and services. But in the Cambridge equation P refers to the prices of final or consumer goods.

5. Nature of T: In Fisher‘s equation, T refers to the total amount of goods and services exchanged for money, whereas in the Cambridge equation T refers to the final or consumer goods exchanged for money.

3.5.3 Superiority of Cash Balance Approach over Transactions Approach

The Cash Balance approach to the Quantity Theory of Money is superior to the Transaction Approach on the following grounds.

1. The Transaction approach emphasizes the medium of exchange function of money only. On the other hand, the Cash Balance approach stresses equally the store of value function of money. Therefore, this approach is consistent with the broader definition of money which includes demand deposits.

2. In its explanation of the determinants of V, the Transaction approach stresses the mechanical aspects of the payments process. In contrast, the Cash Balance approach is more realistic as it is behavioral in nature which is built around the demand function for money.

3. As to the analytical technique, the Cash Balance approach fits in easily with the general demand-supply analysis as applied to the money market. This feature is not available in the Transaction approach.

4. The Cash Balance approach is wider and more comprehensive as it takes into account the income level as an important determinant of the price level. The Transaction approach neglected income level as the determinant of the price level.

5. According to the Transaction approach, the change in P is caused by change in M only. In the Cash Balance approach P may change even without a change in M if k undergoes a change. Thus k, according to the Cash Balance approach is a more important determinant of P than M as stressed by the Transaction approach.

6. Moreover, the symbol k in the Cash Balance approach proves to be a better tool for explaining trade cycles than V in Fisher's equation.

3.6 Summary

In this chapter we have studied the two versions of the Quantity Theory of Money: (1) The Transaction Approach and (2) The Cash Balance Approach. According to the classical view of demand for money or the Fishers' version, money is demanded for transaction purposes. Fisher explains the transaction demand for money in the following form MV = PT Md = PT/V. It means that the demand for money is the product of the volume *of* transaction (T) over a period of time multiplied by the average price level (P) and divided by the velocity (V). 3. Fisher assumes V and T1 to remain constant during the short period. Hence, the demand for money varies with changes in 'P'. The Cambridge economists gave importance to the store of value function of money. According to the neo-classical or Cambridge economists, the demand for money is the amount of money people desire to hold. The demand for money can be expressed as Md = KPY. The demand for money is a constant proportion (K) of y. wherever there is a change in the price level or in the real national income, the demand for money also changes in equal proportion.

3.7 Glossary

1. **Money** can be defined as anything that is generally acceptable as a means of exchange and that at the same time acts as a measure and a store of value.
2. **The Quantity Theory of Money** states that the quantity of money is the main determinant of the price level or the value of money. Any change in the quantity of money produces an exactly proportionate change in the price level.
3. The "**value of money**" refers to what a unit of money can buy.
4. The "**price level**" refers to the average of all of the prices of goods and services in a given economy.
5. A unit of money has its denomination printed on it known as the "**face value.**
6. **Velocity of money** is defined simply as the rate at which money changes hands.

3.8 Answers to self Check exercises

Exercise 3.1

Answer 1 Refer to section 3.3.

Answer 2 Refer to section 3.4.

3.9 Suggested Readings

1. Edward Shapiro – ‘Macroeconomic Analysis’ Oxford University press.

2. Gregory Mankiw – ‘Macro economics’ – 6th Edn. Tata McGraw Hill

3. Richard T. Frogmen – ‘Macro economics’, Pearson education.

4. Eugene Diutio – Macro economic Theory, Shaum’s Outline series. Tata McGraw Hill

5. R.D.Gupta & A.S. Rana-Keynes Post-Keynesian Economics. Kalyani Publishers,1997.

6. Ramesh Singh- Indian Economy for Civil Services Examinations Tata McGraw Hill, 2012

3.10 Terminal Questions

Q1. Distinguish between Cash transaction and Cash balance approach to demand for money?

Q2. Explain the neo-classical or the cash balances approach to the demand for money?

Q4. Explain the transaction approach?

Q5. Explain the cash balance approach?

LESSON 4
ROLE OF MONEY

STRUCTURE

4.0 Objectives

After going through this lesson you will be able to:

- Explain theRole of Money in Capitalistic Economy
- Understand the Role of Money in Socialistic Economy
- Elucidate the Role of Money in Mixed Economy
- Identify different kinds of Monetary Standards
- Explain the system of note issue in India

4.1 Introduction

Money is one of the fundamental inventions of mankind. It has become so important that the modern economy is described as money economy. Modern economy cannot work without money. Even in the early stages of economic development, the need for exchange arose. At first, the family or village was a self-sufficient unit. But later on, with development of agriculture and application of the division of labor, that is, the division of the society into agriculturists, carpenters, merchants and so on, the need for exchange arose. Exchange took place first in the form of barter. Barter is the direct exchange of goods for goods. Barter is a system of trading without the use of money. At first when wants of men were few and simple, the barter system worked well. But as days passed by, it was found to be unsuitable. It has many difficulties.

4.2 ROLE OF MONEY IN CAPITALISTIC ECONOMY

Today money is considered one of the outstanding inventions of the entire history of mankind. The introduction of money has eliminated all the difficulties of barter system in which goods have to be exchanged for goods. Money facilities trade by acting as a medium of exchange and standard of value. It has made easy to save wealth for future. It has played a significant role for the specialization in business through division of labour. Although money itself creates nothing but it is very helpful in the process of production, consumption and exchange.

Capitalism is the most prominent in our current global economic system. Its main characteristic is that it most means of production and property are privately owned by individuals and companies. The government has a limited role in such an economy limited to management and control measures. So a capitalist economy is a liberal economy. This means only the free market will determine the supply, demand, and prices of the products. There is no direct government intervention other than to control monopolistic practices in the economy.

Therefore, Capitalism is an economic system in which capital goods are owned by private individuals or businesses. The production of goods and services is based on supply and demand in the general market (market economy), rather than through central planning (planned economy or command economy). As we said earlier a capitalist economy is the most predominant in the current global economy. USA, UK, Germany, Japan, Singapore all are classic examples of capitalist economies.

1. Importance for Producer:-

The use of money enables entrepreneur to concentrate attention upon the technical problems of his business. Without money it is not easy for the producer to distribute product which is not divisible like "Bus" or motor car among the four factors of production.

The price mechanism controls the capitalistic economy. In a free enterprise economy many decisions like " What to produce , how to produce, where to produce and for whom to produce are guided by the profit motives. Money prices reflect the aggregates of individual demands and supplies."

2. Importance for Consumer:-

People can sell and buy the goods and services which they need by parting with money. In the absence of money a great variety of things would never have entered in our consumption list and our satisfaction would have been at the lowest level.

3. Exchange Transaction:-

The use of money has successfully removed the disadvantage of barter. Money has greatly stimulated the exchange of goods.

4. Distribution of National Income:-

Every year we produce the certain amount of goods and services by combining the four factors of production. The reward of each factor like rent, wages, profit and interest is paid in terms of money.

5. Importance inthe Field Of Public Finance:-

Money performs valuable services in the field of public finance. The government can easily increase the revenue through the medium of money and can spend it for the betterment of the society.

6. Attainment of High Level of Production andEmployment:-

If the money is properly managed, it ensures rising level of production, income and employment in the country.

4.3 ROLE OF MONEY IN SOCIALISTIC ECONOMY

A socialistic economy also cannot operate smoothly and with maximum efficiency without money. After the revolution of 1917 in Russia, Govt. experimented for a short period with a moneyless system but it was found that the system could not work at all and it was given up soon after.

The basic feature of socialistic economy is that all means of production are owned and managed by state. The individuals can not possess profit earning properties. The operation of the economy is controlled by the state and not by the price mechanism. As a matter of fact-socialistic economy will remain a monetary economy. In a socialistic society persons would be paid money wages for their services. These wages would be used for the purchase of Govt. produced goods. Prices would be fixed by the Govt. which would ensure that total demand would be equal to the total supply. In order to determine the order of priority and for the selection of the most efficient and economical method for the production, the importance of various projects and costs of various methods of production must be determined. The calculations of such costs can only be made in monetary terms.

Lenin has rightly stated, "The entire structure of capitalistic economy would collapse if you withdraw money. If all the money suddenly disappears from the economy the wheels of economy would halt."

Marshall says, "That money is pivot around which economic science clusters."

Various functions of money in a socialist economy are given below.

1. **Measure of Value:**

   The value of all products and services is expressed in terms of money. Thus, money acts as the measure of socially necessary labour embodied in commodities.

2. **Medium of Circulation:**

   In a socialist society, money performs the function of circulation. All buying and selling is done through money.As distinct from capitalism, under socialism, money in its function as a medium of circulation does not create crisis of over-production because of the planned nature of commodity and money circulation.The process of circulation, in a socialist economy, serves as an important form of checking how far planned production corresponds to the needs of society.

3. Means of Payments:

All payments, which do not involve buying and selling of commodities, are made through money. For example, money provides the means of payment when wages are paid to the workers, when enterprises receive or pay back loans, when cash income is distributed among collective farm workers.

4. Means of Accumulation:

Under socialism, money functions as the medium of saving and of the formation of cash reserves. Working people keep their saving in the form of deposits in the banks.These savings are used by the state to expand production, lay up reserves and provide credit for other enterprises and organisations.

5. Instrument of Distribution:

Money, under socialism, serves as the instrument of distribution. The working people receive a share of the national product in terms of money according to their quantity and quality of labour they expended.

6. Monetary Incentives:

In addition to basic wage rate, bonuses arc paid to the workers in terms of money in order to induce them to work more. These bonuses help in motivating people to put in extra effort for extra gain.

7. Freedom of Choice:

The individuals have the freedom to spend their money earning on any consumption goods of their choice. The freedom of choice is, however, restricted to the range of goods produced under the plan.

8. Evaluating Economic Activity:

Money helps the state to evaluate the economic activity of an enterprise. Although the pricing system does not influence the basic economic decisions, it helps in the rational allocation of resources by determining opportunity cost.And all opportunity cost calculations are made in terms of money. "Control of the operation of socialist enterprises through money is the most flexible method of controlling the economy"

9. Influence on Output:

Pricing system and hence money can also to some extent influence output in a socialist economy. Prices, which are set by the central planners, cannot be changed by plant managers.

4.4 ROLE OF MONEY IN MIXED ECONOMY

Mixed economy, which has been regarded as a golden mean between capitalism and socialism, is a compromise between these two opposite economic systems.The rational for such a compromise is to integrate the good features of capitalism and socialism, i.e., to take advantage of the market forces while keeping its bad effects under check.

In a mixed economy, private and public sectors co-exist. The private sector operates on capitalist lines, guided by the market mechanism and the principle of maximum profit.But its activities are subject to government controls and regulation to ensure that this sector grows in a manner that would be beneficial to the economy.In this way, the economy is not left entirely to the market forces, but is regulated by fiscal, monetary and direct controls to achieve the national goals.

In a mixed economy of the type prevailing in developed countries, like England, the public sector plays a regulatory role of compensatory spending and pump priming in order to remove the imperfections of the economy and to achieve its stability.

On the other hand, in a mixed economy of a developing nation, like India, the public sector has to play a dynamic role to achieve the objective of planned economic development.

1. Money as a Mobilising agent

Apart from performing the conventional functions, i.e., as a medium of exchange, as a measure of value, as a standard of deferred payment and as a store of value, money, through the expansion of monetary economy and the development of money market, plays an active and developmental role in a developing and mixed economy.

Money acts as a great mobilising agent in these economies in a number of ways by increasing resources, generating new resources and channelizing resources into productive uses.

2. **Mobilisation of Saving:**In the developing economies, saving and investment habits of the people are very poor. Expansion of money market promotes liquidity and safety of financial assets and thus encourages saving and investment.

3. Allocation of Resources:

Money market allocates savings into productive investment channels and thus helps in achieving equilibrium between the demand for and supply of loanable funds. In this way, it leads to rational allocation of resources.

4. Resource Mobility:

Expansion of money economy increases the mobility of financial resources by enabling the transfer of funds from one sector to another. Such flow of funds is essential for the growth of the economy and commerce.

5. Increase in Investible Profits:

Expansion of money, through its inflationary effect, redistributes income and wealth in favour of the entrepreneurial classes who have high propensity to save.With this redistribution, the profits and savings in the economy increase. The increase in savings is used for investment purpose.

6. Resource Generation through Deficit Financing:

Deficit financing or inflation tax (i.e., covering the budget deficit through printing new money) can provide adequate funds to the government for financing development programmes in underdeveloped countries.

In an underdeveloped country, where there is little scope for additional taxation due to low income of the people and public borrowing is limited due to low levels of saving, the government can resort to deficit financing to cover the deficit in the budget.

7. Mobilisation of Human Resources:

Monetisation of the economy by facilitating system of payments encourages the mobilisation of human resources.Money, through its inflationary role, increases the aggregate demand and thus permits fuller utilisation of manpower. This leads to quicker achievement of the objective of full employment.

8. Implementation of Monetary Policy:

A well-developed money market is a precondition for the effective and successful implementation of the monetary policy of the central bank aiming at mobilisation and channelization of essential resources for economic development.

9. Role in Private Sector:

Money, through market mechanism, influences the decisions regarding produc-tion and resource allocation in the private sector of the developing mixed economies because these decisions are solely guided by profit motive.

10. Monetisation of the Economy:

An important feature of a less- developed economy is the prevalence of a vast non-monetised sector. As the economy develops, more and more money and monetary institutions are needed for the monetisation of the economy.

4.5 Monetary Standard

The term “monetary standard” refers to the monetary system of a country. Prof. Halm defines monetary standard as the “principal method of regulating the quantity and the exchange value of standard money.” When the standard money of a country is chosen in the form of some metal, then the country is said to have metallic standard. There are three main types of monetary standards. They are:

1. Monometallism or Single Standard
2. Bimetallism or Double Standard
3. Paper Currency Standard (Managed Currency Standard)

4.5.1. Monometallism or Single Standard

When only on metal is adopted as the standard money and is made legal tender for all payments, the system is known as monometallism or single standard. For example, now many countries have the Gold Standard. Suppose a country has adopted silver as the standard money, then it is said to have Silver Standard. For example, England was on Silver Standard until 1816.

4.5.2. Bimetallism or Double Standard

If two metals are adopted as standard money and if a legal ratio is established between the value of the two metals, then the system known as bimetallism or double standard. In other words, under this system, gold and silver circulated as legal tender money and there was a legally fixed ratio of exchange between them. Usually, two metals used under bimetallism are gold and silver. Bimetallism was adopted in France in 1803. Later on, it was adopted by other countries like Belgium, Switzerland and Holland. Bimetallism has certain advantages and disadvantages.

Advantages

1. It would secure greater stability of prices. It there is monometallism, the supply of only one metal could not satisfy the monetary demand satisfactorily. The increasing demand for money should be accompanied by an increase in the supply of money. Otherwise, there cannot be a stable price level. Therefore, if there is bimetallism, the supply of two metals put together will be steadier than that of any one of them. Just as two drunkards might walk more

steadily when they walk hand in hand, the supply of two metals under bimetallism will make price level more stable.

2. Bimetallism would promote stable exchange rates between countries using gold and countries using silver.
3. The supply of gold would not be sufficient for the currency requirements if all countries adopted gold standard, that is, if they adopted universal monometallism.
4. Bimetallism will keep world prices stable.

Disadvantages

1. There is a great difficulty in maintaining the mint ratio (legal ratio) between the two metals because market ratio will often fluctuate.
2. Gresham's law that bad money drives out good money will operate.
3. Bimetallism cannot work if only one country adopted it. All countries in the world should adopt it.
4. It may result in a lot of confusion, particularly, if there are differences between the legal ratio and market ratio of the two metals. So bimetallism may not remedy the defects of gold standard; it may increase the difficulties.

4.5.3.Paper Currency Standard (Managed Currency Standard)

Under the system, as the name indicates, the currency of the country will be in paper. Paper money consists of bank notes and government notes. Generally, under the system, the currency system will be managed by the Central Bank of the country. Hence, the system sometimes is referred to as managed paper currency standard. Almost all countries in the world have managed currency standard. The paper currency has certain advantages and disadvantages.

Advantages of Paper Money

Paper money is economical. Its cost of production is negligible. It is convenient to handle and it is easily portable. It is homogeneous. Its supply can be made elastic. And its value can be kept stable by proper management. Paper currency can function very effectively as money, provided, there is proper control of it by the managing authority. It is ideal for internal trade. But for international trade and payments, gold is still found necessary.

Disadvantages of Paper Money

However, paper money has two great disadvantages.

There is the danger of over-issue of paper money by the managing authorities. Over-issue of currency will result in a rise in prices, adverse foreign exchange rates and many other evils. The over-issue of paper money has ruined many countries in the past. Another disadvantage of paper money is that it will not have universal acceptance. It is recognized as money only in the country where it is issued. For others, paper money is just bits of paper. Gold, on the other hand, has universal acceptance.

4.6.System of Note Issues inIndia

The Reserve Bank has the sole right to issue currency notes, except one rupee notes which are issued by the Ministry of Finance.The RBI follows a minimum reserve system in the note issue. Initially, it used to keep 40 per cent of gold reserves in its total assets. But, since 1957, it has to maintain only Rs. 200 crores of gold and foreign exchange reserves, of which gold reserves should be of the value of Rs. 115 crores. As such, India has adopted the "managed paper currency standard."

As a currency authority, the Reserve Bank provides different denominations of currency for facilitating the transactions of the Central and State Governments, and caters to the exchange and remittance needs of the public, banks as well as the government departments.

The bank has established 14 offices of the Issues Department for the discharge of its currency functions. At all the other centers of the country, the currency requirements are met by the bank through currency chests. Currency chests are maintained by the bank with the branches of the SBI group, Government Treasuries and Sub-Treasuries, and public sector banks.

Currency Chest:

A currency chest is a pocket edition of the Issue Department. The stock of notes and coins kept in the currency chests varies as per the needs of the respective areas served by the Treasury or an agency of the bank.

The following advantages are claimed for maintaining currency chests by the bank:

1. The currency chests provide remittance facilities to banks and the public.
2. They facilitate Treasuries and bank branches to function by keeping relatively small cash balances.
3. They facilitate the exchange of rupee coins for notes, as well as the issue of new for old/soiled notes.

Above all, the Banking Department of the Reserve Bank manages seasonal variations in currency circulation. In the busy season, the currency flow is expanded, in the slack season, it is contracted. During the busy season when there is an increased demand for cash from the public.It is first reflected in the depletion of the cash balances of the commercial banks and through them in the cash balances of the Banking Department. The Banking Department then transfers eligible securities to the Issue Department, on the basis of which the Issue Department issues more currency notes. This is how the currency expansion takes place. During the slack season, the process is reversed.

The following are the important provisions made under the RBI Act, 1934 regarding the issue of currency notes by the Reserve Bank:

(i) The Issue Department of the Bank alone can issue notes of Rs. 2 and those of higher denominations.

(ii) The assets of the Issue Department should be completely segregated from those of the Banking Department of the Reserve Bank.

(iii) All the notes issued by the Reserve Bank of India are legal tender and are guaranteed by the Central Government.

(iv) The design, form and material of the notes issued by the RBI should have the approval of the Central Government.

(v) The Central Government is empowered to demonetise any series of the notes issued by the RBI.

(vi) No stamp duty is payable by the RBI in respect of notes issued by it.

(vii) The Central Government has to circulate rupee coins through the RBI only.

(viii) The RBI is obliged to supply rupees coins in exchange for bank and currency notes or bank and currency notes in exchange for coins.

Exercise 4.1

Q1. What is importance of money in socialist economy? Discuss.

Q2. Write a note on monetary standards.

4.7.Summary

In this chapter we have discussed the importance of money in socialist economy, capitalist economy and mixed economy. In this chapter we have gone through the different monetary standards and have discussed each in detail. In the last section of this chapter we have explain the system of note issue in India.

4.8.Glossary

1. In a **mixed economy**, private and public sectors co-exist. The private sector operates on capitalist lines, guided by the market mechanism and the principle of maximum profit. But its activities are subject to government controls and regulation to ensure that this sector grows in a manner that would be beneficial to the economy.

2. The term **“monetary standard”** refers to the monetary system of a country.

3. **Monometallism or Single Standard;** When only on metal is adopted as the standard money and is made legal tender for all payments, the system is known as monometallism or single standard.

4. **Bimetallism or Double Standard;**If two metals are adopted as standard money and if a legal ratio is established between the value of the two metals, then the system known as bimetallism or double standard.

5. **Paper Currency Standard (Managed Currency Standard);** Under the system, as the name indicates, the currency of the country will be in paper. Paper money consists of bank notes and government notes.

4.9. Answers to Self-Check Exercises

Exercise 2.1

Answer 1. Refer to section 2.3.
Answer 2. Refer to section 2.5.

4.10. Suggested Readings

1. Hajela, T.N., (2009) Money and Banking, Ane Books Pvt Ltd., New Delhi.
2. Sundharam KPM, Banking: Theory, Law and Practice, Sultan Chand and Sons, New Delhi.
3. M.R. Baye, D.W. Jansen (1996), Money, Banking and Financial Markets, AITBS (Indian ed.)
4. K.C. Sekhar: Banking – Theory and Practice, Vikas Publishing House, New Delhi.
5. S.B. Gupta, Monetary Economics, S. Chand Publications, New Delhi.
6. M. L. Seth, Monetary Economics, Vikas Publications, New Delhi
7. R. R. Paul, Money, Banking & International Trade, Kalyani Publications, Ludhiana.

4.11 Terminal Questions

Q1. Discuss the role of money in capitalist economy and mixed economy.

Q2. What do you understands by monetary standard? What is a system of note issue in India?

LESSON-5

ROLE OF FINANCIAL MARKETS

STRUCTURE

5.0 OBJECTIVES

After going through this lesson you will be able to

- Define financial market
- State the types of financial market

5.1 INTRODUCTION

In an economy, money flows in circles. One very important aspect of this is turning savings into investment. Every business needs funds to get started and to run in the long term. These funds will be made available to them through various functions of the financial market.

5.2 FINANCIAL MARKETS

When we talk about markets we think about a place to sell and buy goods and services. However, in reality, the term has a much wider scope. A market is basically a sum total of demand and supply of any particular commodity or service.

So a financial market is a market, or an arrangement or an institution that facilitates the exchange of financial instruments and securities. These instruments include shares, stocks, bonds, debentures, commercial papers, bills, cheques etc. The price of these instruments is determined by the laws of demand and supply in the market.

5.2.1 The Concept of Financial Market

To understand the structure and the importance of financial markets, we must first understand their role in our economy. Now every economy has two basic sectors when it comes to funds – savings and investment. Savings is what we refer to when individual households save money. And investment is the capital that industries require to start and run their businesses.

Now the economy must provide a link between savings and investments. One obvious way to convert savings into investment is via banks. Alternatively, savings can be turned into investments through financial markets. Households will use their savings to buy financial instruments and commodities such as shares, stocks, debentures etc. This is the whole concept of the financial market.

This way a financial market serves an allocative function and mobilizes idle funds to be put to more productive use. When the allocation of funds is done well, there are some added benefits, such as

- The rate of return on their savings will be higher for householders, than what a bank offers.
- The resources will be invested in firms that have high productivity and show great promise in the economy.

The financial market promotes the savings of the economy, providing an effective channel for transmitting the financial policies. Technically speaking, a financial market facilitates:

1. Raising of capital (in the capital markets);

2. Transfer of risk (in the derivatives markets);

3. International trade (in the currency markets).

5.3 TYPES OF FINANCIAL MARKET

A Financial Market can be defined as the market in which financial assets are created or transferred. As against a real transaction that involves exchange of money for real goods or services, a financial transaction involves creation or transfer of a financial asset. Financial Assets or Financial Instruments represent a claim to the payment of a sum of money sometime in the future and/or periodic payment in the form of interest or dividend.

1. Money Market: The money market is a wholesale debt market for low-risk, highly-liquid, short-term instrument. Funds are available in this market for periods ranging from a single day up to a year. This market is dominated mostly by government, banks and financial institutions.

2. Capital Market: The capital market is designed to finance the long-term investments. The transactions taking place in this market will be for periods over a year.

3. Forex Market: The Forex market deals with the multicurrency requirements, which are met by the exchange of currencies. Depending on the exchange rate that is applicable, the transfer of funds takes place in this market. This is one of the most developed and integrated market across the globe. 4. Credit Market: Credit market is a place where banks, FIs and NBFCs Purvey short, medium and long-term loans to corporate and individuals.

5.4 FUNCTIONS OF FINANCIAL MARKETS

1. Mobilizing Funds

In a successful economy, money should never sit idle. Investors that have savings must be linked with industries that require investment. So financial markets will enable this transaction, where investors can invest their savings according to their choices and risk assessment. This will utilize idle funds and the economy will boom.

2. Price Determination

The financial commodities traded in a financial market get their prices from the rules of demand and supply. The investors or the household are the suppliers of the funds, and the industries are the ones demanding them. The interaction between the two and other market factors will help determine the prices.

3. Liquidity

The instruments sold in the financial market tend to have high liquidity. This means at any given time the investors can sell their financial commodities and convert them to cash in a very short period. This is an important factor for investors who do not want to invest long term.

4. Easy Access

Both investors and industries need each other. The financial market provides a platform where both the buyers and sellers can find each other easily without spending too much time, money or effort.

5.5 INTRODUCTION FINANCIAL INSTITUTION

Financial sector plays an indispensable role in the overall development of a country. The most important constituent of this sector is the financial institutions, which act as a conduit for the transfer of resources from net savers to net borrowers, that is, from those who spend less than their earnings to those who spend more than their earnings. The financial institutions have traditionally been the major source of long-term funds for the economy. These institutions provide a variety of financial products and services to fulfil the varied needs of the commercial sector. Besides, they provide assistance to new enterprises, small and medium firms as well as to the industries established in backward areas.

5.5.1. Definition of Financial Institutions

A financial institution is an institution that provides financial services for its clients or members. Any institution that collects money and puts it into assets such as stocks, bonds, bank deposits, or loans is considered a financial institution.

There are two types of financial institutions primarily, viz.,

1. Depository institutions and

2. Non-depository institutions

1.Depository institutions pay you interest on your deposits and use the deposits to make loans.

Examples: 1. Banks

2. Credit unions

3. Trust companies

4. Mortgage loan companies.

2.Non-depository institutions, on the other hand undertake the function of selling financial products. In other words, those government or private that serve as an intermediary between savers and borrowers, but do not accept time deposits, are known as non-depository institutions. Such institutions fund their lending activities either by selling securities or insurance policies to the public. Their liabilities (depending on the liquidity of the liability) may fall under one or more money supply definitions, or may be classified as near money.

Examples: 1. Insurance companies

2. Pension funds

3. Brokerage firms

4. Underwriting firms

5. Mutual fund companies

6. Investment trust

Many financial institutions provide both depository and non-depository services.

Probably the most important financial service provided by financial institutions is acting as financial intermediaries. Most financial institutions are highly regulated by government bodies.

Finance companies typically enjoy high credit ratings and are hence able to borrow at the lowest market rates, enabling them to make loans at rates not much higher than banks. Even though their customers usually do not qualify for bank credit, these companies have experienced a low rate of default. Finance companies in general tend to be interest rate-sensitive-increases and decreases in market interest rates affect their profits directly.

5.6. ROLE IN ECONOMIC DEVELOPMENT

Financial institutions have been there in the world markets for a long time now. They have also made significant contributions. The two main reasons for the existence of financial institutions are:

1. Economic development
2. Financial stability.

If we penetrate a little, we will find that the second reason for the existence of financial institutions leads to the first again. In the first place, banks offer deposits that claim to be capital certain. If this promise is to be honoured, then there must be limits to the range and nature of assets that a bank can reasonably take on to its balance sheets. More generally, financial institutions perform a plethora of activities through their provision of liquidity, divisibility, informational efficiencies and risk pooling services which broaden the spectrum of risks available to investors. In this way, they encourage and improve the efficiency of investment and savings in the economy. Through the provision of a broader range of financial instruments, they are able to foster a risk management culture by attracting customers who are not as much able to bear risks.

Also, from the view of financial stability, in an economy in which the institutions are comparatively less developed, banks will inevitably be required to assume risks that otherwise might be borne by the stock market, collective investment schemes or insurance companies. One way of minimizing financial fragility in the developing economies is to encourage a diversity of financial institutions, where investors are able to assume a variety of risks outside the banking system itself. Without this diversity, there is a tendency for all risks to be bundled within the balance sheet of the banking system, which more likely may lead to severe financial crises.

The financial institutions play an important role in complementing the facilities offered by the banks in an economy. In fact, the existence of Banking Financial Institutions (BFIs) and Nonbanking Financial Institutions (NBFIs) supported by efficient money and capital markets, keep the financial sector complete and enhance the overall growth of the economy.

Financial institutions are the key players in the development of the capital market in any economy. But even after their great performance, there generally remain some sectors comparatively more challenging. For them there developed a special need for special financial institutions. In fact, the need for establishing such financial institutions arose mainly because of the following causes:

1. It has been difficult for industry in general to procure sufficient long- term funds in the capital markets. There has been a lack of financial institutions to supply long-term finance to industry. AS we know, traditionally, and more popularly, commercial banks provided only short term finance. Thus some Special Financial Institutions (SFIs) were established to ensure that industry got sufficient long-term funds in the desired sectors. And that too in accordance with the priorities determined.

2. Certain specific sections of the industry faced greater difficulties as compared with the others in procuring long-term finance. Some such sections were:

(a) Small and medium sized organisations

(b) Specific industries requiring funds for modernisation

(c) New concerns set up by new entrepreneurial groups

(d) Concerns involved in innovation and new technological developments

(e) Concerns requiring extra-ordinarily large amounts of finance for a long gestation period (f) Concerns in backward areas. One of the very important needs for SFIs was to meet the long-term financial requirement of such organisations on economic and social grounds.

In general it can be said that the gap between the demand for and supply of finance in general and industrial finance more specifically, is sought to be filled through term loans being offered by various financial institutions. And this makes itself as the most important need for financial institutions.

5.6 Summary

Financial market serves an allocate function and mobilizes idle funds to be put to more productive use. When the allocation of funds is done well, there are some added benefits, such as the rate of return on their savings will be higher for householders, than what a bank offers and the resources will be invested in firms that have high productivity and show great promise in the economy.

5.7 Glossary

1. Financial markets: Financial market is a market, or an arrangement or an institution that facilitates the exchange of financial instruments and securities. These instruments include shares, stocks, bonds, debentures, commercial papers, bills, cheques etc.

2. Money Market: The money market is a wholesale debt market for low-risk, highly-liquid, short-term instrument. Funds are available in this market for periods ranging from a single day up to a year. This market is dominated mostly by government, banks and financial institutions.

3. Capital Market: The capital market is designed to finance the long-term investments. The transactions taking place in this market will be for periods over a year.

4. Forex Market: The Forex market deals with the multicurrency requirements, which are met by the exchange of currencies. Depending on the exchange rate that is applicable, the transfer of funds takes place in this market. This is one of the most developed and integrated market across the globe. 4. Credit Market: Credit market is a place where banks, FIs and NBFCs Purvey short, medium and long-term loans to corporate and individuals.

5.8 **Answers to Self Check Exercises**

Exercise 5.1

Answer 1. Refer to section 5.2.

Answer 2. Refer to section 5.4 and 5.5

5.9 Suggested Readings

1. Hajela, T.N., (2009) Money and Banking, Ane Books Pvt Ltd., New Delhi.

2. Sundharam KPM, Banking: Theory, Law and Practice, Sultan Chand and Sons, New Delhi.

3. M.R. Baye, D.W. Jansen (1996), Money, Banking and Financial Markets, AITBS (Indian ed.)

4. K.C. Sekhar: Banking – Theory and Practice, Vikas Publishing House, New Delhi.

5. S.B. Gupta, Monetary Economics, S. Chand Publications, New Delhi.

6. M. L. Seth, Monetary Economics, Vikas Publications, New Delhi

7. R. R. Paul, Money, Banking & International Trade, Kalyani Publications, Ludhiana.

5.10 Terminal Questions

Q1. Explain the types of financial market.

Q2. Write a note on Financial institution

LESSON 6
MONEY MARKET

STRUCTURE

6.0 Objectives

After going through this unit you will be able to;

- Define money market
- Identify the constituents of Indian Money market
- Recognize the importance of money market
- Explain the measures to strengthen the Indian Money Market

6.1 Introduction

Money market does not refer to a particular place where money is borrowed and lent by the parties concerned. Mostly, transactions between takes place over phone or mail or through agents. No personal contact or presence of the two parties is essential. Thus money market refers to the institutional arrangements facilitating borrowing and lending of short term funds.

6.2 Meaning of Money Market

Market is a place where goods are bought and sold. It is aggregate of buyers and sellers of a certain good or service and the transactions between them. Financial market is a type of market that deals in financial assets and credit instruments such as currency, cheques, bank deposits, shares, debentures, govt. securities, treasury bills, bill of exchange etc.

On the basis of maturity of assets that is dealt with, financial market is divided into two categories viz., money market & capital market. Money market deals in highly liquid short term financial assets (maturity ranging between several days to one year) whereas capital market deals in long term financial instruments (say, with a maturity of more than one year) like equity shares.

But money market does not refer to a particular place where money is borrowed and lent by the parties concerned. Mostly, transactions between takes place over phone or mail or through agents. No personal contact or presence of the two parties is essential. Thus money market refers to the institutional arrangements facilitating borrowing and lending of short term funds.

1. According to Crowther "Money Market is the collective name given to the various firms and institutions that deal in various grades of near money".

2. RBI defined money market as "a market for short term financial assets that are close substitute for money, facilitate the exchange of money, in primary and secondary markets"

6.3 Constituents of Indian money market

Main constituents of money market are the lenders who supply funds and borrowers who demand short term credit. Suppliers of funds may belong to either

1. Unorganised sector whose activities are not controlled or coordinated by RBI (comprising of indigenous bankers and village money lenders) or

2. Organised sector (comprising of RBI, commercial banks, Development Financial Institutions, co-operative banks and other financial institutions such as LIC).

6.3.1. Un-organised Sector of Money Market:-

The economy on one hand performs through organised sector and on other hand in rural areas there is continuance of unorganised, informal and indigenous sector. The unorganised money market mostly finances short-term financial needs of farmers and small businessmen. The main constituents of unorganised money market are:-

1. Indigenous Bankers (IBs)

Indigenous bankers are individuals or private firms who receive deposits and give loans and thereby operate as banks. IBs accept deposits as well as lend money. They mostly operate in urban areas, especially in western and southern regions of the country. The volume of their credit operations is however not known. Further their lending operations are completely unsupervised and unregulated. Over the years, the significance of IBs has declined due to growing organised banking sector.

2. Money Lenders (MLs)

They are those whose primary business is money lending. Money lending in India is very popular both in urban and rural areas. Interest rates are generally high. Large amount of loans are given for unproductive purposes. The operations of money lenders are prompt, informal and flexible. The borrowers are mostly poor farmers, artisans, petty traders and manual workers. Over the years the role of money lenders has declined due to the growing importance of organised banking sector.

3. Non - Banking Financial Companies (NBFCs)

They consist of:-

1. Chit Funds

Chit funds are savings institutions. It has regular members who make periodic subscriptions to the fund. The beneficiary may be selected by drawing of lots. Chit fund is more popular in Kerala and Tamil Naidu. RBI has no control over the lending activities of chit funds.

2. Nidhis :-

Nidhis operate as a kind of mutual benefit for their members only. The loans are given to members at a reasonable rate of interest. Nidhis operate particularly in South India.

3. Loan or Finance Companies

Loan companies are found in all parts of the country. Their total capital consists of borrowings, deposits and owned funds. They give loans to retailers, wholesalers, artisans and self-employed persons. They offer a high rate of interest along with other incentives to attract deposits. They charge high rate of interest varying from 36% to 48% p.a.

4. Finance Brokers:

They are found in all major urban markets specially in cloth, grain and commodity markets. They act as middlemen between lenders and borrowers. They charge commission for their services.

6.3.2 Organised Sector

The main borrowers of short term funds are central government, state governments, local authorities (such as municipal corporations), traders and industrialists, farmers, exporters, importers and general public. Sub- markets of organised money market

1. Call/Notice/Term money market

Call/Notice money is an amount borrowed or lent on demand for a very short period say, a few hours to 14 days. If the period is less than 24 hours it is ‘Call money'. They can be recalled on demand and that is why it is known as call money. If the period of loan is more than one day and up to 14 days it is called 'Notice money'. Term money refers to borrowing/lending of funds for a period exceeding 14 days. No collateral security is required to cover these transactions. Banks are the major borrower and lender of call money. Banks with temporary deficit of funds, to meet their CRR requirements, form the demand side and banks with temporary excess of funds from the supply side of call money market. In India major suppliers of call money are Non-Banking Financial Institutions like LIC, GIC etc. It is a completely inter-bank market hence non-bank entities are not allowed access to this market. Interest rates in the call and notice money market are ‘market determined’. In view of the short tenure of such transactions, both the borrowers and the lenders are required to have current accounts with the RBI.

2. Commercial bill market

A bill of exchange is a written, unconditional order by one party (the seller of goods/the drawer) to another (the buyer/the drawee) to pay a certain sum, either immediately (a sight bill) or on a fixed date (a term bill), for payment of goods and/or services received. These bills are called trade bills. These trade bills are called commercial bills when they are accepted by commercial banks. Maturity of the bill is generally three months. If the bill is payable at a future date and the seller needs money during the currency of the bill then he may approach his bank for discounting the bill. The maturity proceeds (face value of discounted bill), from the drawee, will be received by the bank. If the bank needs fund during the currency of the bill then it can rediscount the bill already discounted by it in the commercial bill rediscount market at the market related discount rate. The bill discounting market is not so popular in India. It barely constitute 10% of total bank credit. The establishment of Discount and Finance House of India (DFHI) in 1988 has been an important step towards the development of an active discount market in India.

In India, the major reason cited for the non-development of bill financing is the hesitation of the industry and trade to subject themselves to the rigours of bill discipline.

3. Banker’s acceptance

Bankers' acceptances date back to the 12th century when they emerged as a means to finance uncertain trade, as banks bought bills of exchange at a discount. A short-term debt instrument issued by a firm that is guaranteed by a commercial bank. Banker's acceptances are issued by firms as part of a commercial transaction. It is a promised future payment which is accepted and guaranteed by a bank and drawn on a deposit at the bank. The banker's acceptance specifies the amount of money, the date, and the person to which the payment is due. After acceptance, the draft becomes an unconditional liability of the bank. The party that holds the banker's acceptance may keep the acceptance until it matures, and thereby allow the bank to make the promised payment, or it may sell the acceptance at a discount today to any party willing to wait for the face value payment of the deposit on the maturity date. Banker's acceptances make a transaction between two parties who do not know each other safer because they allow the parties to substitute the bank's credit worthiness for that who owes the payment.

4. Treasury bill (T bill) market

Treasury Bill Market refers to the market where treasury bills are bought and sold. T Bill is a promissory note issued by RBI on behalf of central/state government. It is issued to meet short term requirements of the govt. TBs are highly secured and liquid as repayment is guaranteed by RBI. Treasury bills are available for a minimum amount of Rs.25000 and in multiples of Rs. 25000.

Treasury bills are issued at a discount and are redeemed at par.

Types of T-bills

In India, there are 2 types of treasury bills viz

1. Ordinary or regular

2. 'Ad-hoc' known as 'ad hocs'.

Ordinary are issued to the public and other financial institutions for meeting the short-term financial requirements of the Central Government. These are freely marketable and they can be bought and sold at any time and they have a secondary market also.

On the other hand, 'ad-hocs' are always issued in favour of the RBI only. They are not sold through tender or auction. They are purchased by the RBI and the RBI is authorised to issue currency notes against them. They aren't marketable in India. Holders of these bills can always sell them back to the RBI.

On the basis of periodicity, Treasury bills may be classified into three

1. 91-day (3 months) T bill- maturity is in 91 days. Its auction is on every Wednesdays of every week.

2. 182-day (6 months)T bill- maturity is in 182 days. Its auction is on every alternate Wednesdays preceding non-reporting Fridays. (Banks are required to furnish various data to RBI on every alternate Friday, called reporting Fridays).

3. 364-Day (1 year) T bill- maturity is in 364 days. Its auction is on every alternate Wednesdays preceding reporting Fridays. A considerable part of the government's borrowings happen through T Bills of various maturities. Based on the bids received at the auctions, RBI decides the cut off yield and accepts all bids below this yield.

All entities registered in India like banks, financial institutions, Primary Dealers, firms, companies, corporate bodies, partnership firms, institutions, mutual funds, Foreign Institutional Investors, State Governments, Provident Funds, trusts, research organisations, Nepal Rashtra bank and even individuals are eligible to bid and purchase Treasury bills. These T bills which are issued at a discount can be traded in the market. The treasury bills are issued in the form of promissory note in physical form or by credit to Subsidiary General Ledger (SGL) account or Gilt account in dematerialised form.

Advantages of investment in TB

1. No tax deducted at source

2. Zero default risk being sovereign paper

3. Highly liquid money market instrument

4. Better returns especially in the short term

5. Transparency

6. Simplified settlement

7. High degree of tradability and active secondary market facilitates meeting unplanned fund requirements.

5. Certificates of Deposits

Certificate of Deposit (CD) is a negotiable money market instrument issued against funds deposited at a bank or other eligible financial institution for a specified time period. After treasury bills, this is the next lowest risk category investment option.

Allowed in 1989, CD is a negotiable promissory note, secure and short term in nature. The maturity period of CDs issued by banks should not be less than 7 days and not more than one year, from the date of issue. The maturity most quoted in the market is for 90 days. The FIs can issue CDs for a period not less than 1 year and not exceeding 3 years from the date of issue. A CD is issued at a discount to the face value, the discount rate being negotiated between the issuer and the investor.

CDs in physical form are freely transferable by endorsement and delivery. CDs in demat form can be transferred as per the procedure applicable to other demat securities. There is no lockin period for the CDs. It can be issued to individuals, corporations, companies, trusts, funds, associations, etc. Non-Resident Indians (NRIs) may also subscribe to CDs. The minimum issue of CD to single investor is Rs.1 lakh and additional amount in multiples of Rs.1 lakh each.

CDs are issued by banks and FIs mainly to augment funds by attracting deposits from corporates, high net worth individuals, trusts, etc. Those foreign and private banks which do not have large branch networks and hence lower deposit base, use this instrument to raise funds.

6. Commercial Paper Market: Introduced in 1990, CPs are negotiable, short-term, unsecured promissory notes with fixed maturities, issued by well rated companies. Subsequently, primary dealers and all-India financial institutions were also permitted to issue CP to enable them to meet their short-term funding requirements for their operations. Companies having a net worth of Rs.4 crores and whose shares are listed in a stock exchange can issue CPs either directly to the investors or through merchant banks. All eligible participants shall obtain the credit rating for issuance of Commercial Paper from a credit rating agency as notified by RBI such as CRISIL. These are basically instruments evidencing the liability of the issuer to pay the holder in due course a fixed amount (face value of the instrument) on the specified due date. These are issued for a fixed period of time at a discount to the face value and mature at par.

CP can be issued for maturities between a minimum of 7 days and a maximum of up to one year from the date of issue. These instruments are normally issued in the multiples of five lakhs for 30/ 45/ 60/ 90/ 120/ 180/ 270/ 364 days. CP can be issued either in the form of a promissory note or in a dematerialised form through any of the depositories approved by and registered with SEBI. Banks, FIs and PDs can hold CP only in dematerialised form.

Funds raised through CPs do not represent fresh borrowings for the corporate issuer but merely substitute a part of the banking limits available to it. Hence a company issues CPs mostly to save on interest costs i.e. it will issue CPs only when the CP rate is lower than the bank’s lending rate.

Individuals, banking companies, other corporate bodies (registered or incorporated in India) and unincorporated bodies, Non-Resident Indians (NRIs) and Foreign Institutional Investors (FIIs) etc. can invest in CPs. However, investment by FIIs would be within the limits set for them by Securities and Exchange Board of India (SEBI) from time-to-time. The maximum amount a company can raise through CP is up to 75 % of its total working capital limit. Fixed Income Money Market and Derivatives Association of India (FIMMDA), may prescribe, in consultation with the RBI, any standardised procedure and documentation for operational flexibility and smooth functioning of CP market.

On October 15 1997, total outstanding amount on Commercial paper transaction in Indian money market was Rs. 3377 crore. This outstanding amount increased substantially to Rs. 1,28,347 crore on July 15, 2011. This growth of Commercial paper market may be attributed to the rapid expansion of corporate manufacturing and financial companies in liberalized and Globalized Indian economy.

7. REPO Market

A repurchase agreement, also known as a repo, is the sale of securities together with an agreement for the seller to buy back the securities at a later date.

Predominantly, repos are undertaken on overnight basis, i.e., for one day period. The repurchase price should be greater than the original sale price, the difference representing interest, sometimes called the repo rate. The party that originally buys the securities effectively acts as a lender and the original seller is acting as a borrower.

Different instruments can be considered as collateral security for undertaking the ready forward deals and they include Government dated securities, Treasury Bills, corporate bonds, money market securities and equity. Legal title to the collateral security which is used in repo transaction, passes to the buyer during the repo period. As a result in case the seller defaults the buyer does not require to establish right on the collateral security.

The Repo/Reverse Repo transaction can only be done at Mumbai between parties approved by RBI and in securities as approved by RBI. The repo rate is the rate at which the banks borrow from RBI, while the reverse repo rate is the rate offered by RBI for funds borrowed from banks.

A reverse repo is the mirror image of a repo. For, in a reverse repo, securities are acquired with a simultaneous commitment to resell. Hence whether a transaction is a repo or a reverse repo is determined only in terms of who initiated the first leg of the transaction. As part of the measures to develop the corporate debt market, RBI has permitted select entities (scheduled commercial banks excluding RRBs and LABs, Primary Dealers, all-India FIs, NBFCs, mutual funds, housing finance companies, insurance companies) to undertake repo in corporate debt securities. This is similar to repo in Government securities except that corporate debt securities are used as collateral for borrowing funds. Only listed corporate debt securities that are rated ‘AA’ or above by the rating agencies are eligible to be used for repo. Commercial paper, certificate of deposit, non-convertible debentures of original maturity less than one year are not eligible for the purpose.

8. Collateralised Borrowing and Lending Obligation: CBLO is another money market instrument operated by the Clearing Corporation of India Ltd. (CCIL), for the benefit of the entities who have either no access to the interbank call money market or have restricted access in terms of ceiling on call borrowing and lending transactions. CBLO is a discounted instrument available in electronic book entry form for the maturity period ranging from one day to ninety days (up to one year as per RBI guidelines). In order to enable the market participants to borrow and lend funds, CCIL provides the Dealing System through Indian

Financial Network (INFINET), a closed user group to the Members of the Negotiated Dealing System (NDS) who maintain Current account with RBI and through Internet for other entities who do not maintain Current account with RBI.

i. Membership to the CBLO segment is extended to entities who are RBI- NDS members, viz., Nationalized Banks, Private Banks, Foreign Banks, Co-operative Banks, Financial Institutions, Insurance Companies, Mutual Funds, Primary Dealers, etc. Associate Membership to CBLO segment is extended to entities who are not members of RBI- NDS, viz., Co-operative Banks, Mutual Funds, Insurance companies, NBFCs, Corporates, Provident/ Pension Funds, etc. By participating in the CBLO market, CCIL members can borrow or lend funds against the collateral of eligible securities. Eligible securities are Central Government securities including Treasury Bills, and such other securities as specified by CCIL from time to time. Borrowers in CBLO have to deposit the required amount of eligible securities with the CCIL based on which CCIL fixes the borrowing limits. Defects /Features of Indian money market A well-developed money market is a necessary pre-condition for the effective implementation of monetary policy. RBI controls and regulates the money supply in the country through the money market.

However, unfortunately, the Indian money market is inadequately developed, loosely organised and **suffers from many weaknesses**. Major defects are discussed below:

1. Existence of unorganized money market: unorganised money market comprises of indigenous bankers and money lenders. Substantially higher rate of interest prevails in unorganised sector. They follow their own rules of banking and finance. RBI's attempt to bring them under control has failed many times.

2. Absence of integration: Different sections of money market are loosely connected with one another. Organised and unorganised sector of money market do not have any contact between them. With the setting up of RBI and passing of BRA 1949, the conditions have improved.

3. Multiplicity in rates of interest: The immobility of funds from one section to another creates diversity in interest rates. Immobility arises due to difficulty of making cheap and quick remittance of funds from one centre to another. At present wide divergence does not exist.

4. Seasonal stringency of funds: The demand for money in Indian money market is seasonal in nature. During busy season from October to April money is needed for financing and marketing of agricultural products and seasonal industries such as sugar. RBI attempt to lessen the fluctuations in money rates by increasing money supply during busy season and withdrawing the same in lean season.

5. Absence of bill market: a well organised bill market is essential for smooth functioning of a credit system. An important shortcoming of Indian Money Market is the absence of a well developed bill market. Though both inland and foreign bills are traded in Indian Money Market yet its scope is very limited. In spite of the efforts of Reserve Bank in 1952 and in 1970, only a limited bill market exists in India. Thus, an organised bill market in the real sense of the term has not yet been fully developed in India. The establishment of DFHI has improved the situation now. The main obstacles in the development of bill market appear to be the following:

1. The lack of uniformity in drawing bills in different parts of the country,

2. The large use of cash credit as the main form of borrowing from commercial banks,

3. Presence of Inter-call money market and

4. The pressure of cash transactions. Thus, Bill Market is relatively underdeveloped.

6. Absence of Acceptance and Discount Houses; There is almost complete absence of acceptance and discount houses in the Indian money market. This is due to the underdeveloped bill market in India.

7. No contact with foreign money market: Indian money market is an insular one with little contact with money market in other countries. Indian money market does not attract any foreign fund as western money markets do.

8. Limited instruments: Supply of money market instruments like bills, TBs etc. is very limited and inadequate in nature considering the varied requirements of short term funds.

9. Limited secondary market: Secondary market is very limited in the case of money market instruments. Practically it is restricted to rediscounting of commercial and treasury bills. In India banks have the tendency to hold these bills till maturity, thus preventing an active trade in these bills.

10. Limited participants: participants in Indian money market are also limited. Entry into the market is strictly regulated. In fact there are a large number of borrowers but a few lenders. Hence, the market is not very active.

11. Absence of specialized financial institutions: Specialised institutions are lacking to carry out specialised jobs in certain fields like bank for tourism, bank for financing SSIs. etc.

12. Underdeveloped Banking Habits: In spite of rapid branches expansion of banks and spread of banking to unbanked and rural centres, the banking habits in India are still underdeveloped.

There are several reasons for it.

- Whereas in U.S.A. for every 1400 persons there is a branch of a commercial bank, in India there is a branch for every 13,000 people,
- The use of cheques is restricted,
- The majority of transactions are settled in cash,
- The hoarding habit is widespread.

6.4 Importance of Money Market

If the money market is well developed and broad based in a country, it greatly helps in the economic development. The central bank can use its monetary policy effectively and can bring desired changes in the economy for the industrial and commercial progress of the country. The importance of money market is given, in brief, below:

1. **Financing Industry:** A well-developed money market helps the industries to secure short term loans for meeting their working capital requirements. It thus saves a number of industrial units from becoming sick.

2. **Financing trade:** An outward and a well-knit money market system play an important role in financing the domestic as well as international trade. The traders can get short term finance from banks by discounting bills of exchange. The acceptance houses and discount market help in financing foreign trade. Profitable investment: The money market helps the commercial banks to earn profit by investing their surplus funds in the purchase of Treasury bills and bills of exchange, these short term credit instruments are not only safe but also highly liquid. The banks can easily convert them into cash at a short notice.

3. **Self sufficiency of banks:** The money market is useful for the commercial banks themselves. If the commercial banks are at any time in need of funds, they can meet their requirements by recalling their old short term loans from the money market.

4. **Encourages economic growth:** If the money market is well organized, it safeguards the liquidity and safety of financial asset. This encourages the twin functions of economic growth, savings and investments.

5. **Effective implementation of monetary policy:** The well-developed money market helps the central bank in shaping and controlling the flow of money in the country. The central bank mops up excess short term liquidity through the sale of treasury bills and injects liquidity by purchase of treasury bills.

6. **Proper allocation of resources:** In the money market, the demand for and supply of loan able funds are brought at equilibrium. The savings of the community are converted into investment which leads to pro allocation of resources in the country.

7. **Help to government:** The organized money market helps the government of a country to borrow funds through the sale of Treasury bills at low rate of interest The government thus would not go for deficit financing through the printing of notes and issuing of more money which generally leads to rise in an increase in general prices.

6.5 Reforms/Measures to Strengthen the Indian Money Market:-

On the recommendations of S. Chakravarty Committee and Narasimhan Committee, the RBI has initiated a number of reforms.

1. Deregulation of Interest Rates:-

RBI has deregulated interest rates. Banks have been advised to ensure that the interest rates changed remained within reasonable limits. From May 1989, the ceiling on interest rates on call money, inter-bank short-term deposits, bills rediscounting and inter-bank participation was removed and rates were permitted to be determined by market forces.

2. Reforms in Call And Term Money Market:-

To provide more liquidity RBI liberalized entry in to call money market. At present Banks and primary dealers operate as both lenders and borrowers. Lenders other than UTI and LIC are also allowed to participate in call money market operations. RBI has taken several steps in recent years to remove constraints in term money market. In October 1998, RBI announced that there should be no participation of non-banking institutions in call / term money market operations and it should be purely an interbank market.

3. Introducing New Money Market Instruments:-

In order to widen and diversify the Indian Money Market, RBI has introduced many new money market instruments like 182 days Treasury bills, 364 days Treasury bills, CD3 and CPs. Through these instruments, the government, commercial banks, financial institutions and corporates can raise funds through money market. They also provide investors additional instruments for investments.

4. Repo:-

Repos were introduced in 1992 to do away. With short term fluctuations in liquidity of money market. In 1996 reverse repos were introduced. RBI has been using Repo and Reverse repo operations to influence the volume of liquidity and to stabilise short term rate of interest or call rate. Repo rate was 6.75% in March 2011 and reverse repo rate, was 5.75%.

5. Refinance by RBI:-

The RBI uses refinance facilities to various sectors to meet liquidity shortages and control the credit conditions. At present two schemes of refinancing are in operations :- Export credit refinance and general refinance. RBI has kept the refinance rate linked to bank rate.

6. MMMFs:-

Money Market Mutual Funds were introduced in 1992. The objective of the scheme was to provide an additional short-term avenue to the individual investors. In 1995, RBI modified the scheme to allow private sector organisation to set up MMMFs. So far, three MMMFs have been set up one each by IDBI, UTI and one in private sector.

7. DFHI:-

The Discount and Finance House of India was set up on 25th April 1988. It buys bills and other short term paper from banks and financial institutions. Bank can sell their short term securities to DFHI and obtain funds in case they need them, without disturbing their investments.

8. The Clearing Corporation of India Limited (CCIL):-

CCIL was registered in 2001 under the Companies Act, 1956 with the State Bank of India as Chief Promoter. CCIL clears all transaction in government securities and repos reported on NDS (Negotiated Dealing System) of RBI and also Rupee / US $ foreign exchange spot and forward deals.

9. Regulation of NBFCs:-

In 1997, RBI Act was amended and it provided a comprehensive regulation for non-bank financial companies (NBFCs) sector. According to amendment, no NBFC can carry on any business of a financial institution including acceptance of public deposit, without obtaining a Certificate of Registration from RBI. They are required to submit periodic returns to RBI.

10. Recovery of Debts:-

In 1993 for speedy recovery of debts, RBI has set up special Recovery Tribunals. The Special Recovery Tribunals provides legal assistance to banks to recover dues.

Exercise 6.1

Q1. Define money market? What are the constituents of money market?

Q2. What are the weaknesses from which Indian Money market suffers?

6.6 Summary

Money Market Concerned with short term funds, for a period not exceeding one year. It meets short term requirements of govt. &working capital requirement of business concerns. Money Market’s Instruments are TBs, BoEs, CPs, CDs & govt.

Bonds etc. Major players Money Market of are central bank and commercial banks. Central bank and other banks are working as part of money market. Transactions are of larger amount. Instruments do not have an active secondary market. Transactions normally take place over phone and there is no formal place. Transactions have to be conducted without the help of brokers.

6.7 Glossary

1. Money Market is the collective name given to the various firms and institutions that deal in various grades of near money.

2. **Unorganised sector** whose activities are not controlled or coordinated by RBI.

3**. Organised sector** (comprising of RBI, commercial banks, Development Financial Institutions, co-operative banks and other financial institutions such as LIC).

4. **Indigenous bankers** are individuals or private firms who receive deposits and give loans and thereby operate as banks. IBs accept deposits as well as lend money.

5. **Money Lenders (MLs);** They are those whose primary business is money lending.

6. **Chit funds** are savings institutions. It has regular members who make periodic subscriptions to the fund. The beneficiary may be selected by drawing of lots.

7. **Nidhis** operate as a kind of mutual benefit for their members only. The loans are given to members at a reasonable rate of interest.

8. **Call/Notice money** is an amount borrowed or lent on demand for a very short period say, a few hours to 14 days. If the period is less than 24 hours it is ‘Call money'. They can be recalled on demand and that is why it is known as call money.

9. **A bill of exchange** is a written, unconditional order by one party (the seller of goods/the drawer) to another (the buyer/the drawee) to pay a certain sum, either immediately (a sight bill) or on a fixed date (a term bill), for payment of goods and/or services received. These bills are called trade bills. These trade bills are called commercial bills when they are accepted by commercial banks.

10. **Treasury Bill Market** refers to the market where treasury bills are bought and sold. T Bill is a promissory note issued by RBI on behalf of central/state government. It is issued to meet short term requirements of the govt.

11. Repo Market; A repurchase agreement, also known as a repo, is the sale of securities together with an agreement for the seller to buy back the securities at a later date. Predominantly, repos are undertaken on overnight basis, i.e., for one day period. The repurchase price should be greater than the original sale price, the difference representing interest, sometimes called the repo rate.

6.8 Answers to Self Check Exercises

Exercise 8.1

Answer 1. Refer to section 8.2 & 8.3.

Answer 2. Refer to section 8.4.

6.9 Suggested Readings

1. Hajela, T.N., (2009) Money and Banking, Ane Books Pvt Ltd., New Delhi.

2. Sundharam KPM, Banking: Theory, Law and Practice, Sultan Chand and Sons, New Delhi.

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5. S.B. Gupta, Monetary Economics, S. Chand Publications, New Delhi.

6. M. L. Seth, Monetary Economics, Vikas Publications, New Delhi

7. R. R. Paul, Money, Banking & International Trade, Kalyani Publications, Ludhiana.

6.10 Terminal Questions

Q1. Explain the measures taken by Indian govt. to strengthen the Indian Money Market.

Q2. Write a note on

i. constituents of Indian Money market

ii. Importance of money market

LESSON 7

CAPITAL MARKET

STRUCTURE

7.0 Objectives

After going through this lesson you will be able to;

- Define capital market
- Identify the constituents of capital market
- Explain the factor influencing the capital market
- Understand the role of capital market in India
- Recognize the development of capital market in India

7.1 Introduction

The dynamic and efficient financial system plays a very pivotal role for any economy for efficient allocation of resources from surplus segment to deficit segment. The financial system consists of financial markets, financial intermediation and financial products or instruments. A thriving and vibrant economic system requires a well developed financial structure with multiple intermediaries operating in the market with different risk profiles. The financial sector in India is characterised by progressive liberal policies, vibrant equity and debt markets and prudent banking norms. Further, a financial system helps to increase output by moving the economic system towards the existing production frontier. This is performed by transforming a given total amount of wealth into more productive forms. It induces public and investors to hold fewer saving in the form of precious metals, real estate land, consumer durables and ideal cash balances and to replace these assets by financial instruments such as bonds, shares, preference shares, units etc. A financial system also helps to increase the volume of investments. It becomes possible for the deficit spending units to undertake more investment because it would enable them to command more capital. It encourages the investment activity by reducing the cost of finance and risk. This is done by providing insurance services and hedging opportunities and by making financial services such as remittances, discounting, acceptance, and guarantees available. Finally, it not only increases greater investment but also raises the level of resource allocational efficiency among different investment channels.

7.2 Capital Market

Capital market refers to the institutional arrangements for facilitating borrowing and lending of long term funds. It is the organised mechanism for effective and efficient transfer of money capital from individuals and institutional savers to entrepreneurs engaged in industry of commerce in both private sector and public sector. Modern capital markets are almost invariably hosted on computer-based electronic trading systems.

For a long time, the Indian capital market was considered too small to warrant much attention. However, this view has changed rapidly as vast amounts of international investment have poured into our markets over the last decade. The Indian market is no longer viewed as a static universe but as a constantly evolving market providing attractive opportunities to the global investing community.

7.3 Role / Functions of Capital Market:

Capital market plays an important role in mobilising resources, and diverting them in productive channels. In this way, it facilitates and promotes the process of economic growth in the country. It ensures better coordination between the flow of savings and the flow of investment that leads to capital formation and directs the flow of savings into most profitable channels.

In addition to resource allocation, capital markets also provide a medium for risk management by allowing the diversification of risk in the economy. A well-functioning capital market tends to improve information quality as it plays a major role in encouraging the adoption of stronger corporate governance principles, thus supporting a trading environment, which is founded on integrity.

Following are the main role or functions of capital market.

1. Link between Savers and Investors:

The capital market acts as a link between savers and investors. It plays an important role in mobilising the idle savings of people and diverting them in productive and profitable investment. In this way, capital market plays a vital role in transferring the financial resources from surplus and wasteful areas to deficit and productive areas, thus increasing the productivity and prosperity of the country.

2. Encouragement to Saving:

With the development of capital market, the banking and non-banking institutions provide facilities to invest money in stock market, which encourage people to save more. In the less developed countries, in the absence of a capital market, there are very little savings and those who save often invest their savings in unproductive and wasteful areas such as real estate, gold etc.

3. Capital Formation:

The capital market facilitates lending to the businessmen and the government and thus encourages investment. It helps to mobilise the huge capital required for business. It is an important and efficient means to channel and mobilize funds to enterprises, and provide an effective source of investment in the economy.

4. Promotes Economic Growth:

The capital market not only reflects the general condition of the economy, but also smoothens and accelerates the process of economic growth. The proper allocation of resources results in the expansion of trade and industry in both public and private sectors, thus promoting balanced economic growth in the country. It plays a critical role in mobilizing savings for investment in productive assets, with a view to enhancing a country's long-term growth prospects, and thus acts as a major catalyst in transforming the economy into a more efficient, innovative and competitive marketplace within the global arena

5. Stability in Security Prices:

The capital market tends to stabilise the values of stocks and securities and reduce the fluctuations in the prices to the minimum. The process of stabilisation is facilitated by providing capital to the borrowers at a lower interest rate and reducing the speculative and unproductive activities.

6. Assists to Government:

Capital market assists the Government to close resource gap, and complement its effort in financing essential socio-economic development, through raising long-term project based capital.

7. Benefits to Investors:

Capital market is beneficial to the investors in many ways:

a) Liquidity of Investment: Shares and bonds are easily transferable at low transaction cost as compared to other assets such as real estate. Therefore an investor can buy and sell at considerable convenience.

b) Hedge against inflation: Securities prices over the long term tend to outperform inflation, therefore investment in securities can be a reliable hedge against inflation in the long term.

c) Higher Return: Capital market provides comparatively higher return in the long run than other invest avenues such as real estate, gold, and bank deposits.

d) Collateral: Securities represent stocks of wealth, and can be used as collateral to secure financing such as loans from lending institutions.

e) Flexibility: Shares and bonds are traded in units and lots that are affordable by investors of different income levels. As such, investment in securities can be customized to the specific incomes of investors.

f) Tax advantage: The government offers many tax advantages to the long term investment in equity market.

7.4 Important Financial Instruments in Capital Market:

1. Shares:

According to the Companies Act 1956, 'a share is the share in the share capital of a company'. It is a portion of capital which is divided among number of people. It is a unit of ownership interest in a corporation and offered for sale. Shares are of two types, Preference shares and Equity shares.

(i) Preference shares:

Preference shares are those shares which have a preferential right for the payment dividend during the life time of the company and for the return of capital at the time of winding up. Preference shares carry fixed rate of dividend that are paid to shareholders before equity stock dividends are paid out.

(ii) Equity shares (Ordinary shares or Common shares):

Equity shares are the ordinary shares of a company which have no preferential rights. They are the shares representing the ownership interest. Equity shares give their holders the power to share the earnings in the company as well as a vote in the Annual General Meetings of the company. Such a shareholder has to share the profits and also bear the losses incurred by the company. Equity share holders are the real owners of the company.

2. Debenture / Bond:

A debenture is an acknowledgement of the debt of the Company. It is a long term debt instrument yielding a fixed rate of interest issued by a company. A debenture is like a certificate of loan or debt evidencing the fact that the company is liable to pay a specified amount with interest. Debenture is not secured by the physical asset of the company. Debenture holders are the creditors of the company and hence they have no voting right in the company.

Bonds are the debt instruments secured by the physical asset of the company. In some countries, the term denture is used interchangeably with 'bond'.

7.5 Components of Capital Market:

Capital market can be classified into two;

1. Primary market

2. Secondary market.

Primary market is the market where the securities are issued for the first time. It is the primary market in which the companies issue their securities. Secondary market is the market for already issued (second hand) securities. Secondary market enables the further buying and selling of issued securities.

7.5.1 Primary Market

It is also called New Issue Market. It is the market where securities are issued for the first time. These securities are never traded before elsewhere. Both new companies and existing companies approach primary market for raising capital. The main function of primary market is to facilitate transfer of funds from willing investors to the entrepreneurs setting up new business or diversification, expansion or modernisation of existing business.

A new issue market is of paramount importance for economic growth and industrial development as it supplies necessary long term capital. Though the functions of primary market are so different from that of secondary market, the sentiments in the secondary market do affect the primary market activities.

Primary market Intermediaries

A number of intermediaries play a critical role in the process of issue of new securities. They are

1. Merchant bankers/lead managers: it is an institution that extends a number of services in connection with issue of capital. Their services include management of security issues, portfolio management services, underwriting of capital issues, credit syndication, financial advice and project counseling etc. It has now made mandatory that all public issues should be made by merchant bankers acting as lead managers.

2. Underwriters: underwriter guarantee that the securities offered for the public will be subscribed if it is not subscribed by the public. It is insurance to the issuing company against the failure of issue. In case, the public fails to subscribe, the underwriter will have to take them up and pay for them. They charge a commission called underwriting commission for their service. It should not exceed 5 percent in case of shares and 2.5 percent for debentures.

3. Bankers to an issue: Banker to an issue accepts applications and application money, refund application money after allotment and participate in the payment of dividend by companies. No banker can act as a banker to an issue unless it possesses a registration with SEBI. SEBI grants registration only when it is satisfied that the bank has enough infrastructure, communication and data processing facilities and requisite man power to discharge such duties. The banker is required to maintain documents and records relating to the issue for a period of 3 years. It is also required to furnish information to the SEBI regarding the number of applications received, number of issues for which it has acted as a banker to an issue, date on which applications from investors were forwarded to registrar of issue, date and amount of refund to investors etc

4. Registrar to an issue: It is an intermediary who performs the function of collecting application from investors (through bankers), keeping record of applications, keeping record of money received from investors, assisting companies in allotment and helping dispatch of allotment letters, refund orders etc.

5. Share transfer agents: They maintain the record of holders of securities on behalf of companies and deals with all activities connected with transfer or redemption of securities.

6. Debenture trustees: A debenture is an instrument of debt issued by the company acknowledging its obligation to repay the sum along with an interest. In the case of public issue of debentures, there would be a large number of debenture holders on the register of the company. As such it shall not be feasible to create charge in favour of each of the debenture holder. A common methodology generally adopted is to create Trust Deed conveying the property of the company. A Trust deed is an arrangement enabling the property to be held by a person or persons for the benefit of some other person known as beneficiary. It has been made mandatory for any company making a public/rights issue of debentures to appoint one or more debenture trustees before issuing the prospectus or letter of offer and to obtain their consent which shall be mentioned in the offer document.

7. Brokers to an issue: Brokers are the persons who procure subscriptions to issue from prospective investors spread over a larger area. A company can appoint as much number of brokers as it wants.

8. Portfolio managers: Portfolio construction, formulation of investment strategy, evaluation and regular monitoring of portfolio is an art that requires skill and high degree of expertise. Any person who pursuant to a contract or arrangement with a client, advises or directs or undertakes on behalf of the client [whether as a discretionary portfolio manager or otherwise(adviser)] the management or administration of a portfolio of securities or the funds of the client, as the case may be is a portfolio manager.

7.5.2 Secondary market/Stock market

Secondary Market refers to a market where securities are traded after being initially offered to the public in the primary market and/or listed on the Stock Exchange. Majority of the trading is done in the secondary market. Secondary market comprises of equity markets and the debt markets. It is the organized mechanism for purchase and sale of existing securities. Investors in new issue market who do not want to hold the securities up to maturity can approach stock market to sell their securities. Similarly those who want to become an investor in an existing company which does not offer new issue of securities at present, approach stock market for purchasing securities.

Definition

Securities Contract & Regulation Act 1956 defines secondary market as 'anybody of individuals whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling of securities'.

Stock Exchange

Stock exchange is an organized market for buying and selling corporate and other securities. In Stock exchange, securities are purchased and sold out as per certain well-defined rules and regulations. It provides a convenient and secured mechanism or platform for transactions in different securities. Stock exchanges are indispensable for the smooth and orderly functioning of corporate sector in a free market economy. A stock exchange need not be treated as a place for speculation or a gambling. It acts as a place for safe and profitable investment.

Characteristics of a Stock Exchange

1. It is the place where securities are purchased or sold

2. It is an Association of Person whether incorporated or not

3. Trading is regulated by rules & regulations prescribed by SEBI and itself.

4. Both genuine investors and speculators buy and sell shares

5. Securities or corporations, trusts, governments, semi govt. bodies etc. are allowed to be dealt at stock exchanges.

Investors and Speculators:

Stock market participants consist of Investors and Speculators. Investor is a person or institution who makes investment in securities with the intention of getting a fair return from the investment. But the Speculator makes investment in risky securities in an attempt to profit from short and medium term fluctuations in the market value of shares.

Types of Speculators in Stock market:

Bull (Tejiwala): Bull is a speculator who is hopeful of price rise in the near future. He makes purchases of securities with the intention of selling them at a higher price in future.

Bear (Mundiwala): Bear is a speculator who expect fall in prices. He sells securities with the intention of buying them at a lower price in future.

Lame Duck: When the bear fails to meet his obligations, he is called Lame Luck. Generally a bear agrees to dispose of certain shares on specific date. But sometimes he fails to deliver due to non availability of shares in the market.

Stag: Stag is a speculator who purchases shares to sell them above par value to earn premium. He rapidly buy and sell stocks in quick succession.

Jobber: Jobber is a professional speculator who has complete information regarding the particular shares he deals. He conducts the securities in his own name. He is the member of the stock exchange and he deals only with the members.

Stock Exchanges in India

There are twenty two stock exchanges in India (2013) out of which seven are permanent. Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE) are the main stock exchanges in India.

Bombay Stock Exchange (BSE):

It was established in 1875 as "The Native Share & Stock Brokers' Association". BSE Ltd. (formerly known as Bombay Stock Exchange Ltd.) is Asia's first Stock Exchange and one of India's leading exchange groups located in Dalal Street, Mumbai.. BSE is a corporatized and demutualised entity, with a broad shareholder-base which includes two leading global exchanges, Deutsche Bourse and Singapore Exchange as strategic partners. BSE provides an efficient and transparent market for trading in equity, debt instruments, derivatives, mutual funds. More than 5000 companies are listed on BSE. The companies listed on BSE Ltd command a total market capitalization of USD 1.32 Trillion as of January 2013. BSE's popular equity index - the S&P BSE SENSEX is India's widely tracked stock market benchmark index.

National Stock Exchange (NSE)

The National Stock Exchange of India Ltd. (NSE) is one of the country's leading stock exchanges located in Mumbai. National Stock Exchange (NSE) was established in the mid 1990s as a demutualised electronic exchange. NSE has a market capitalisation of more than US$989 billion and 1,635 companies listed as on July 2013. NSE's flagship index, the S&P CNX Nifty, is used extensively by investors in India and around the world to take exposure to the Indian equities market.

Stock Index

An Index is basically an indicator of stock prices. It gives us a general idea about whether the prices of stocks have gone up or gone down. The Dow Jones Industrial Average (DJIA), Standard & Poor's 500 (S&P 500), Wilshire 5000, Nasdaq Composite Index etc are the examples of world's top stock market indices. BSE-Senex and NSE-Nifty are the main stock

Indices in India

BSE-SENSEX

The S&P BSE SENSEX is a stock market index of 30 well established and financially sound companies listed in Bombay Stock exchange. These 30 component companies which are some of the largest and most actively traded stocks, are representative of various industrial sectors of the Indian economy. Published since 1 January 1986, the BSE SENSEX is regarded as the pulse of the domestic stock markets in India. The base value of the BSE SENSEX is taken as 100 on 1 April 1979, and its base year as 1978–79. Other popular indices of BSE are S&P BSE 100, S&P BSE 200, S&P BSE MIDCAP, S&P BSE SMALLCAP etc.

NSE-NIFTY

The CNX NIFTY, also called the NIFTY 50 or simply the NIFTY, is National Stock Exchange of India's benchmark index for Indian equity market. It is a stock market Index of 50 companies of 22 sectors of the Indian economy. NIFTY, is used extensively by investors in India and around the world to take exposure to the Indian equities market. The base period for the CNX NIFTY is November 3, 1995 and base value of the index has been set at 1000. Besides CNX NIFTY there are many other stock market Indices for NSE such as CNX NIFTY JUNIOR, LIX 15, CNX MIDCAP, INDIA VIX, CNX SMALLCAP etc. 15, CNX MIDCAP, INDIA VIX, CNX SMALLCAP etc.

Listing of securities

Listing of securities means the enrolment of a name of company in an official list of the Stock exchange. Listing means admitting for trading on a recognized stock exchange. It facilitates buying and selling of securities in the exchange. Listing provides an exclusive privilege to securities in the stock exchange. Only listed shares are quoted on the stock exchange. Stock exchange facilitates transparency in transactions of listed securities in perfect equality and competitive conditions. Listing is beneficial to the company, to the investor, and to the public at large.

A company, desirous of listing its securities on the Exchange, shall be required to file an application, in the prescribed form, with the Exchange before issue of Prospectus by the company, where the securities are issued by way of a prospectus or before issue of 'Offer for Sale', where the securities are issued by way of an offer for sale. The company shall be responsible to follow all the requirements specified in the Companies Act, the listing norms issued by SEBI from time to time and such other conditions, requirements and norms that may be in force from time to time.

Advantages / Importance of Listing

- **Fund Raising:** Listing provides an opportunity to the corporate / entrepreneurs to raise capital to fund new projects/undertake expansions/diversifications and for acquisitions.
- **Liquidity and Ready Marketability of Security:** Listing brings in liquidity and ready marketability of securities on a continuous basis adding prestige and importance to listed companies.
- **Ability to raise further capital:** An initial listing increases a company's ability to raise further capital through various routes like preferential issue, rights issue, Qualified Institutional Placements and ADRs/GDRs.
- **Supervision and Control of Trading in Securities:** The transactions in listed securities are required to be carried uniformly as per the rules and bye-laws of the exchange. All transactions in securities are monitored by the regulatory mechanisms of the stock exchange, preventing unfair trade practices. It improves the confidence of small investors and protects them.
- **Fair Price for the Securities:** The prices are publicly arrived at on the basis of demand and supply; the stock exchange quotations are generally reflective of the real value of the security.
- Thus listing helps generate an independent valuation of the company by the market.

- **Tax advantage:** The listed companies are treated as widely held companies under the income tax act and all the tax advantages available to a widely held company is available for listed companies.
- **Protect the Interest of Investors:** The listing agreement signed with the exchange provides for timely disclosure of information relating to their assets, dividend, bonus and right issues, facilities for transfer, other company related information etc by the company. Thus providing more transparency and building investor confidence.
- **Collateral Value of Securities:** Listed securities are acceptable to lenders as collateral for credit facilities. A listed company can also borrow from financial institutions easily as it is Domestic Institutional Investors (DII) and Foreign Institutional Investors (FII) Institutional investors are organizations which pool large sums of money and invest those sums in securities, real property and other investment assets. They can also include operating companies which decide to invest their profits to some degree in these types of assets. Typical investors include banks, insurance companies, retirement or pension funds, hedge funds, investment advisors and mutual funds.

Domestic institutional investors (DII)

DII are those institutional investors established or incorporated in India which undertake investment in the financial markets of India. These are institutions or organizations such as banks, insurance companies, mutual funds etc. An institutional investor that has met certain qualifications to invest in securities outside its home country is called Qualified Domestic Institutional Investor (QDII).

An investor or investment fund that is established or registered in a foreign country and investing in the financial markets of India is called Foreign Institutional Investor (FII).

International institutional investors must register with the Securities and Exchange Board of India to participate in the market. FIIs are investing huge amounts in the Indian stock exchanges and it reflects their high confidence and a healthy investor sentiment for our markets. However, the ceiling for overall investment for FIIs is 24 per cent of the paid up capital of the Indian company and 10 per cent for NRIs/PIOs. The limit is 20 per cent of the paid up capital in the case of public sector banks. The ceiling of 24 per cent for FII investment can be raised up to sectoral cap/statutory ceiling, subject to the approval of the board and the general body of the company passing a special resolution to that effect. In December 2013, there are more than 1700 Foreign Institutional Investors registered with SEBI.

Securities and Exchange Board of India (SEBI)

The Securities and Exchange Board of India (SEBI) is the regulatory authority for the securities market in India. It was established in the year 1988 under a resolution of the Government of India and given statutory powers on 12 April 1992 through the SEBI Act, 1992. Its headquarters is located at Mumbai. It has four regional offices in New Delhi, Kolkata, Chennai and Ahamedabad. Controller of Capital Issues derived from the Capital Issues (Control) Act, 1947 was the regulatory authority in capital market before SEBI came into existence.

The SEBI is managed by a chairman and eight members. The chairman is nominated by Union Government of India. Two members are selected from the officers of the Union Finance Ministry and one member from The Reserve Bank of India. The remaining 5 members are nominated by Union Government of India, out of them at least 3 shall be whole-time members.

Functions of SEBI

The Preamble of the Securities and Exchange Board of India describes the basic functions of the Securities and Exchange Board of India as "...to protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto". SEBI adopts the following measures to protect the interest of investors and to regulate and promote the securities market in India.

(a) Regulating the business in stock exchanges and any other securities markets

(b) Registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and such other intermediaries who may be associated with securities markets in any manner

(c) Registering and regulating the working of the depositories, Depository Participants (DP) custodians of securities, foreign institutional investors, credit rating agencies and such other intermediaries.

(d) Registering and regulating the working of venture capital funds and collective investment schemes including mutual funds.

(e) Promoting and regulating self-regulatory organisations.

(f) Prohibiting fraudulent and unfair trade practices relating to securities markets.

(g) Promoting investors' education and training of intermediaries of securities markets.

(h) Prohibiting insider trading in securities.

(i) Regulating substantial acquisition of shares and take-over of companies.

(j) Calling for information from, undertaking inspection, conducting inquiries and audits of the stock exchanges, mutual funds, other intermediaries and self regulatory organisations associated with the securities market.

(k) Performing such functions and exercising such powers under the provisions of the Securities Contracts (Regulation) Act, 1956 as may be delegated to it by the Central Government;

(l) Levying fees or other charges for carrying out the purposes of the Act.

(m) Conducting research for the above purposes

(n) Performing such other functions as may be prescribed.

Powers of SEBI

For the discharge of its functions efficiently, SEBI has been vested with the following powers:

1. Power to regulate the matters relating to the issue of capital, transfer of securities etc

2. Power to issue directions to the parties and intermediaries associated with securities market.

3. Approve by−laws of stock exchanges.

4. Inspect the books of accounts and call for periodical returns from recognized stock exchanges.

5. Power to investigate the affairs of intermediaries or persons associated with securities market.

6. Inspect the books of accounts of financial intermediaries.

7. Compel certain companies to list their shares in one or more stock exchanges.

8. Registration of intermediaries

Exercise 7.1

Q1. Identify the major functions of capital market.

Q2. Discuss the functions of SEBI. Defines the significant steps of the SEBI to develop the Indian Equity Market?

7.6 India Capital Market

The Indian capital market is the market for long term loanable funds as distinct from money market which deals in short-term funds.

It refers to the facilities and institutional arrangements for borrowing and lending 'term funds', medium term and long term funds. In principal capital market loans are used by industries mainly for fixed investment. It does not deal in capital goods, but is concerned with raising money capital or purpose of investment.

7.7 Constituents of Capital Market

Capital market is classified in two ways

7.7.1 Classification of capital market in first way; The first way in which capital market is classified is as follows

7.7.1.1 Gilt - Edged Market:-

Gilt - Edged market refers to the market for government and semi-government securities, which carry fixed rates of interest. RBI plays an important role in this market.

7.7.1.2 Industrial Securities Market:-

It deals with equities and debentures in which shares and debentures of existing companies are traded and shares and debentures of new companies are bought and sold.

7.7.1.3 Development Financial Institutions:-

Development financial institutions were set up to meet the medium and long-term requirements of industry, trade and agriculture. These are IFCI, ICICI, IDBI, SIDBI, IRBI, UTI, LIC, GIC etc. All These institutions have been called Public Sector Financial Institutions.

7.7.1.4 Financial Intermediaries:-

Financial Intermediaries include merchant banks, Mutual Fund, Leasing companies etc. they help in mobilizing savings and supplying funds to capital market.

7.7.2 Classification of capital market in second way; The Second way in which capital market is classified is as follows:-

7.7.2.1 Primary Market:-

Primary market is the new issue market of shares, preference shares and debentures of non-government public limited companies and issue of public sector bonds.

7.7.2.2 Secondary Market

This refers to old or already issued securities. It is composed of industrial security market or stock exchange market and gilt-edged market.

7.8 Factors Influencing Capital Market:

The firm trend in the market is basically affected by two important factors:

(i) Operations of the institutional investors in the market; and

(ii) The excellent results flowing in from the corporate sector.

New Financial Intermediaries in Capital Market:

Since 1988 financial sector in India has been undergoing a process of structural transformation. Some important new financial intermediaries introduced in Indian capital market are:

Merchant Banking:

Merchant bankers are financial intermediaries between entrepreneurs and investors. Merchant banks may be subsidiaries of commercial banks or may have been set up by private financial service companies or may have been set up by firms and individuals engaged in financial up by firms and individuals engaged in financial advisory business. Merchant banks in India manage and underwrite new issues, undertake syndication of credit, advice corporate clients on fund raising and other financial aspects.

Since 1993, merchant banking has been statutorily brought under the regulatory framework of the Securities Exchange Board of India (SEBI) to ensure greater transparency in the operation of merchant bankers and make them accountable. The RBI supervises those merchant banks which were subsidiaries, or are affiliates of commercial banks.

Leasing and Hire-Purchase Companies:

Leasing has proved a popular financing method for acquiring plant and machinery specially or small and medium sized enterprises. The growth of leasing companies has been due to advantages of speed, informality and flexibility to suit individual needs.

The Narasimhan Committee has recognised the importance of leasing and hire-purchase companies in financial intermediation process and has recommended that: (i) a minimum capital requirement should be stipulated; (ii) prudential norms and guidelines in respect of conduct of business should be laid down; and (iii) supervision should be based on periodic returns by a unified supervisory authority.

Mutual Funds:

It refers to the pooling of savings by a number of investors-small, medium and large. The corpus of fund thus collected becomes sizeable which is managed by a team of investment specialists backed by critical evaluation and supportive data.

A mutual fund makes up for the lack of investor's knowledge and awareness. It attempts to optimise high return, high safety and high liquidity tradeoff for maximum of investor's benefit. It thus aims at providing easy accessibility of media including stock market in country to one and all, especially small investors in rural and urban areas.

Mutual funds are most important among the newer capital market institutions. Several public sector banks and financial institutions set up mutual funds on a tax exempt basis virtually on same footing as the Unit Trust of India (UTI) and have been able to attract strong investor support and have shown significant progress.

Government has now decided to throw open the field to private sector and joint sector mutual funds. At present Securities and Exchange Board of India (SEBI) has authority to lay down guidelines and to supervise and regulate working of mutual funds.

The guidelines issued by the SEBI in January 1991, are related in advertisements and disclosure and reporting requirements etc. The investors have to be informed about the status of their investments in equity, debentures, government securities etc.

The Narasimhan Committee has made the following recommendations regarding mutual funds: (i) creation of an appropriate regulatory framework to promote sound, orderly and competitive growth of mutual fund business: (ii) creation of proper legal framework to govern the establishments and operation of mutual funds (the UTI is governed by a special statute), and (iii) equality of treatment between various mutual funds including the UTI in the area of tax concessions.

Global Depository Receipts (GDR):

Since 1992, the Government of India has allowed foreign investment in the Indian securities through the issue of Global Depository Receipts (GDRs) and Foreign Currency Convertible Bonds (FCCBs). Initially the Euro-issue proceeds were to be utilised for approved end uses within a period of one year from the date of issue.

Since there was continued accumulation of foreign exchange reserves with RBI and there were long gestation periods of new investment the government required the issuing companies to retain the Euro-issue proceeds abroad and repatriate only as and when expenditure for the approved end uses were incurred.

Venture Capital Companies (VCC):

The aim of venture capital companies is to give financial support to new ideas and to introduction and adaptation of new technologies. They are of a great importance to technocrat entrepreneurs who have technical competence and expertise but lack venture capital. Financial institutions generally insist on greater contribution to the investment financing, in which technocrat entrepreneurs can depend on venture capital companies. Venture capital financing involves high risk.

According to the Narasimhan Committee the guidelines for setting up of venture capital companies are too restrictive and unrealistic and have impeded their growth. The committee has recommended a review and amendment of guidelines.

Knowing the high risk involved in venture capital financing, the committee has recommended a reduction in tax on capital gains made by these companies and equality of tax treatment between venture capital companies and mutual funds.

Other New Financial Intermediaries:

Besides the above given institutions, the government has established a number of new financial intermediaries to serve the increasing financial needs of commerce and industry is the area of venture Capital, credit rating and leasing etc.

(i) Technology Development and Information Company of India (TDICI) Ltd., a technology venture finance company, which sanctions project finance to new technology venture since 1989.

(ii) Risk Capital and Technology Finance Corporation (RCTFC) Ltd., which provides risk capital to new entrepreneurs and offers technology finance to technology-oriented ventures since 1988.

(iii) Infrastructure Leasing and Financial Services (IL&FS) Ltd., set up in 1988 focuses on leasing of equipment for infrastructure development.

(iv) The credit rating agencies namely credit rating information services of India (CRISIS) Ltd., setup in 1988; Investment and Credit Rating Agency (ICRA) setup in 1991, and Credit Analysis and Research (CARE) Ltd., setup in 1993 provide credit rating services to the corporate sector.

Credit rating promotes investors interests by providing them information on assessed comparative risk of investment in the listed securities of different companies. It also helps companies to raise funds more easily and at relatively cheaper rate if their credit rating is high.

(v) Stock Holding Corporation of India (SHCIL) Ltd., setup in 1988, with the objective of introducing a book entry system for transfer of shares and other type of scrips thereby avoiding the voluminous paper work involved and thus reducing delays in transfers.

7.9 Role and Importance of Capital Market In India:-

Capital market has a crucial significance to capital formation. For a speedy economic development adequate capital formation is necessary. The significance of capital market in economic development is explained below:-

Mobilisation Of Savings And Acceleration Of Capital Formation:-

In developing countries like India the importance of capital market is self-evident. In this market, various types of securities help to mobilise savings from various sectors of population. The twin features of reasonable return and liquidity in stock exchange are definite incentives to the people to invest in securities. This accelerates the capital formation in the country.

Raising Long - Term Capital:-

The existence of a stock exchange enables companies to raise permanent capital. The investors cannot commit their funds for a permanent period but companies require funds permanently. The stock exchange resolves this dash of interests by offering an opportunity to investors to buy or sell their securities, while permanent capital with the company remains unaffected.

Promotion of Industrial Growth:-

The stock exchange is a central market through which resources are transferred to the industrial sector of the economy. The existence of such an institution encourages people to invest in productive channels. Thus it stimulates industrial growth and economic development of the country by mobilising funds for investment in the corporate securities.

Ready and Continuous Market:-

The stock exchange provides a central convenient place where buyers and sellers can easily purchase and sell securities. Easy marketability makes investment in securities more liquid as compared to other assets.

Technical Assistance:-

An important shortage faced by entrepreneurs in developing countries is technical assistance. By offering advisory services relating to preparation of feasibility reports, identifying growth potential and training entrepreneurs in project management, the financial intermediaries in capital market play an important role.

Reliable Guide to Performance:-

The capital market serves as a reliable guide to the performance and financial position of corporates, and thereby promotes efficiency.

Proper Channelisation of Funds:-

The prevailing market price of a security and relative yield are the guiding factors for the people to channelise their funds in a particular company. This ensures effective utilisation of funds in the public interest.

Provision of Variety of Services:-

The financial institutions functioning in the capital market provide a variety of services such as grant of long term and medium term loans to entrepreneurs, provision of underwriting facilities, assistance in promotion of companies, participation in equity capital, giving expert advice etc.

Development of Backward Areas:-

Capital Markets provide funds for projects in backward areas. This facilitates economic development of backward areas. Long term funds are also provided for development projects in backward and rural areas.

Foreign Capital:-

Capital markets makes possible to generate foreign capital. Indian firms are able to generate capital funds from overseas markets by way of bonds and other securities. Government has liberalised Foreign Direct Investment (FDI) in the country. This not only brings in foreign capital but also foreign technology which is important for economic development of the country.

Easy Liquidity:-

With the help of secondary market investors can sell off their holdings and convert them into liquid cash. Commercial banks also allow investors to withdraw their deposits, as and when they are in need of funds.

Revival of Sick Units:-

The Commercial and Financial Institutions provide timely financial assistance to viable sick units to overcome their industrial sickness. To help the weak units to overcome their financial industrial sickness banks and FIs may write off a part of their loan.

7.10 Growth of Indian Capital Market:

7.10.1 Indian Capital Market before Independence:

Indian capital market was hardly existent in the pre-independence times. Agriculture was the mainstay of economy but there was hardly any long term lending to agricultural sector. Similarly the growth of industrial securities market was very much hampered since there were very few companies and the number of securities traded in the stock exchanges was even smaller.

Indian capital market was dominated by gilt-edged market for government and semi-government securities. Individual investors were very few in numbers and that too were limited to the affluent classes in the urban and rural areas. Last but not the least, there were no specialised intermediaries and agencies to mobilise the savings of the public and channelise them to investment.

7.10.2 Indian Capital Market after Independence:

Since independence, the Indian capital market has made widespread growth in all the areas as reflected by increased volume of savings and investments. In 1951, the number of joint stock companies (which is a very important indicator of the growth of capital market) was 28,500 both public limited and private limited companies with a paid up capital of Rs. 775 crore, which in 1990 stood at 50,000 companies with a paid up capital of Rs. 20,000 crore. The rate of growth of investment has been phenomenal in recent years, in keeping with the accelerated tempo of development of the Indian economy under the impetus of the five year plans.

7.10.3 Developments in Capital Market Since 1991

The government has taken several measures to develop capital market in post-reform period, with which the capital market reached new heights. Some of the important measures are:

1) Securities and Exchange Board Of India (SEBI):-

SEBI became operational since 1992. It was set with necessary powers to regulate the activities connected with marketing of securities and investments in the stock exchanges, merchant banking, portfolio management, stock brokers and others in India. The objective of SEBI is to protect the interest of investors in primary and secondary stock markets in the country.

2) National Stock Exchange (NSE):-

The setting up to NSE is a landmark in Indian capital markets. At present, NSE is the largest stock market in the country. Trading on NSE can be done throughout the country through the network of satellite terminals. NSE has introduced inter-regional clearing facilities.

3) Dematerialization of Shares:-

Demat of shares has been introduced in all the shares traded on the secondary stock markets as well as those issued to the public in the primary markets. Even bonds and debentures are allowed in demat form. The advantage of demat trade is that it involves Paperless trading.

4) Screen Based Trading:-

The Indian stock exchanges were modernised in 90s, with Computerised Screen Based Trading System (SBTS), It cuts down time, cost, risk of error and fraud and there by leads to improved operational efficiency. The trading system also provides complete online market information through various inquiry facilities.

5) Investor Protection:-

The Central Government notified the establishment of Investor Education and Protection Fund (IEPF) with effect from 1st Oct. 2001: The IEPF shall be credited with amounts in unpaid dividend accounts of companies, application moneys received by companies for allotment of any securities and due for refund, matured deposits and debentures with companies and interest accrued there on, if they have remained unclaimed and unpaid for a period of seven years from the due date of payment. The IEPF will be utilized for promotion of awareness amongst investors and protection of their interests.

6) Rolling Settlement:-

Rolling settlement is an important measure to enhance the efficiency and integrity of the securities market. Under rolling settlement all trades executed on a trading day (T) are settled after certain days (N). This is called T + N rolling settlement. Since April 1, 2002 trades are settled' under T + 3 rolling settlement. In April 2003, the trading cycle has been reduced to T + 2 days. The shortening of trading cycle has reduced undue speculation on stock markets.

7) The Clearing Corporation of India Limited (CCIL):-

The CCIL was registered in 2001, under the Companies Act, 1956 with the State Bank of India as the Chief Promoter. The CCIL clears all transactions in government securities and repos and also Rupee / US $ forex spot and forward deals All trades in government securities below Rs. 20 crores would be mandatorily settled through CCIL, white those above Rs. 20 crores would have the option for settlement through the RBI or CCIL.

8) The National Securities Clearing Corporation Limited (NSCL):-

The NSCL was set up in 1996. It has started guaranteeing all trades in NSE since July 1996. The NSCL is responsible for post-trade activities of NSE. It has put in place a comprehensive risk management system, which is constantly monitored and upgraded to pre-expect market failures.

9) Trading In Central Government Securities:-

In order to encourage wider participation of all classes of investors, including retail investors, across the country, trading in government securities has been introduced from January 2003. Trading in government securities can be carried out through a nationwide, anonymous, order-driver, screen-based trading system of stock exchanges in the same way in which trading takes place in equities.

10) Credit Rating Agencies:-

Various credit rating agencies such as Credit Rating Information services of India Ltd. (CRISIL – 1988), Investment Information and credit Rating Agency of India Ltd. (ICRA – 1991), etc. were set up to meet the emerging needs of capital market. They also help merchant bankers, brokers, regulatory authorities, etc. in discharging their functions related to debt issues.

11) Accessing Global Funds Market:-

Indian companies are allowed to access global finance market and benefit from the lower cost of funds. They have been permitted to raise resources through issue of American Depository Receipts (ADRs), Global Depository Receipts (GDRs), Foreign Currency Convertible Bonds (FCCBs) and External Commercial Borrowings (ECBs). Further Indian financial system is opened up for investments of foreign funds through Non-Resident Indians (NRIs), Foreign Institutional investors (FIIs), and Overseas Corporate Bodies (OCBs).

12) Mutual Funds:-

Mutual Funds are an important avenue through which households participate in the securities market. As an investment intermediary, mutual funds offer a variety of services / advantages to small investors. SEBI has the authority to lay down guidelines and supervise and regulate the working of mutual funds.

13) Internet Trading:-

Trading on stock exchanges is allowed through internet, investors can place orders with registered stock brokers through internet. This enables the stock brokers to execute the orders at a greater pace.

14) Buy Back Of Shares:-

Since 1999, companies are allowed to buy back of shares. Through buy back, promoters reduce the floating equity stock in market. Buy back of shares help companies to overcome the problem of hostile takeover by rival firms and others.

15) Derivatives Trading:-

Derivatives trading in equities started in June 2000. At present, there are four equity derivative products in India Stock Futures, Stock Options, Index Futures, Index Options. Derivative trading is permitted on two stock exchanges in India i.e. NSE and BSE. At present in India, derivatives market turnover is more than cash market.

16) PAN Made Mandatory:-

In order to strengthen the “Know your client" norms and to have sound audit trail of transactions in securities market, PAN has been made mandatory with effect from January 1, 2007.

EXERCISE 7.2

Q1. What are the factor influencing capital markets?

Q2. Explain the constituents of Indian capital market?

7.11 Summary

Capital market deals with medium term and long term funds. It refers to all facilities and the institutional arrangements for borrowing and lending term funds (medium term and long term). The demand for long term funds comes from private business corporations, public corporations and the government. The supply of funds comes largely from individual and institutional investors, banks and special industrial financial institutions and Government. Globalisation and financial liberalisation in India have ushered in a battery of changes in the financial architecture of the economy, as a result of which the resultant gain of the global integration of domestic and foreign financial markets has thrown open new opportunities but at the same time exposed the financial system to significant risks. While the capital market reforms are impressive, there are still areas that present major problems. The long term debt and corporate debt market presents the biggest problems. As a result of which, many large Indian companies look to foreign capital markets for longer term debt and equity.

7.12 Glossary

1. **Capital market** refers to the institutional arrangements for facilitating borrowing and lending of long term funds.

2. **Shares;** It is a portion of capital which is divided among number of people. It is a unit of ownership interest in a corporation and offered for sale.

3**. A debenture** is an acknowledgement of the debt of the Company. It is a long term debt instrument yielding a fixed rate of interest issued by a company.

4. **Primary Market;** It is also called New Issue Market. It is the market where securities are issued for the first time. These securities are never traded before elsewhere.

5. Secondary Market refers to a market where securities are traded after being initially offered to the public in the primary market and/or listed on the Stock Exchange.

6. **Stock exchange** is an organized market for buying and selling corporate and other securities. In Stock exchange, securities are purchased and sold out as per certain well-defined rules and regulations.

7.13 Answers to Self Check Exercises

Exercise 7.1

Answer 1. Refer to section 7.3.

Answer 2. Refer to section 7.4.2.

Exercise 7.2

Answer 1. Refer to section 7.7.

Answer 2. Refer to section 7.8.

7.14 Suggested Readings

1. Hajela, T.N., (2009) Money and Banking, Ane Books Pvt Ltd., New Delhi.

2. Sundharam KPM, Banking: Theory, Law and Practice, Sultan Chand and Sons, New Delhi.

3. M.R. Baye, D.W. Jansen (1996), Money, Banking and Financial Markets, AITBS (Indian ed.)

4. K.C. Sekhar: Banking – Theory and Practice, Vikas Publishing House, New Delhi.

5. S.B. Gupta, Monetary Economics, S. Chand Publications, New Delhi.

6. M. L. Seth, Monetary Economics, Vikas Publications, New Delhi

7. R. R. Paul, Money, Banking & International Trade, Kalyani Publications, Ludhiana.

7.15 Terminal Questions

Q1. Discuss the Role and scope of a well developed capital market in the growth process of an economy.

LESSON 8

COMMERCIAL BANKING-I

STRUCTURE

8.0 Objectives

After studying this lesson you will be able to:

- Define bank
- Classify the bank on the basis of ownership
- Categorize the bank on the basis of function
- Sort the bank on the basis of domicile

8.1 Introduction

We know people earn money to meet their day to day expenses on food, clothing, education of children, etc. They also need money to meet future expenses on marriage, higher education of children housing building and social functions. These are heavy expenses, which can be met if some money is saved out of the present income. With this practice, savings were available for use whenever needed, but it also involved the risk of loss by theft, robbery and other accidents.

Thus, people were in need of a place where money could be saved safely and would be available when required. Banks are such places where people can deposit their savings with the assurance that they will be able to with draw money from the deposits whenever required.

8.2 Meaning of Banking

Bank is a lawful organization which accepts deposits that can be withdrawn on demand. It also tends money to individuals and business houses that need it.

8.3 Definitions of Bank

Indian Banking Companies Act - “Banking Company is one which transacts the business of banking which means the accepting for the purpose of lending or investment of deposits money from the public repayable on demand or otherwise and withdrawable by cheque, draft, and order or otherwise". .

Dictionary meaning of the Word 'Bank' -The oxford dictionary defines a bank as "an establishment for custody of money received from or on behalf of its customers. It's essential duty is to pay their drafts on it. its profits arises from the use of the money left employed by them".

The Webster's Dictionary Defines a bank as "an institution which trades in money, establishment for the deposit, custody and issue of money, as also for making loans and discounts and facilitating the transmission of remittances from one place to another".

According to Crowther, a bank "collects money from those who have it to spare or those who are saving it out of their incomes, and it lends this money to those who require it."

The above definitions of bank reveal that bank is a Business institution which deals in money and use of money. Thus a proper and scientific definition of the bank should include various functions performed by a bank in a proper manner. We can say that any person, institution, company or enterprise can be a bank. The business of a bank consists of acceptance of deposits, withdrawals of deposits, Making loans and advances, investments on account of which credit is exacted by banks.

8.4 Types of Banks

There are various types of banks which operate in our country to meet the financial requirements of different categories of people engaged in agriculture, business, profession etc. Banks can be classified into various types on the basis of their functions, ownership, domicile, etc.

8.4.1. Classification on the Basis of functions

8.4.1.1 Central Bank:

A central bank functions as the apex controlling institution in the banking and financial system of the country. It functions as the controller of credit, banker's bank and also enjoys the monopoly of issuing currency on behalf of the government. A central bank is usually control and quite often owned, by the government of a country. The Reserve Bank of India (RBI) is such a bank within an India.

8.4.1.2 Commercial Banks

It operates for profit. It accepts deposits from the general public and extends loans to the households, the firms and the government. The essential characteristics of commercial banking are as follows: - **a**. Acceptance of deposits from public - For the purpose of lending or investment -Repayable on demand or lending or investment. **b**. Withdrawal by means of an instrument, whether a cheque or otherwise. **c**. Another distinguish feature of commercial bank is that a large part of their deposits are demand deposits withdrawable and transferable by cheque.

8.4.1.3 Industrial Banks:

Industrial banks also known as investment banks mainly meet the medium term and long term financial needs of the industries. The main functions of Industrial banks are:

a. They accept long term deposits

b. They grant long term loans to industrialists to enable them to purchase land, construct factory buildings, purchase heavy buildings, etc.

c. They help sell or underwrite the debentures and shares of industrial firms.

d. They can also provide information about the general economic position of the economy:

Example: Industrial Development bank of India (IDBI); Industrial Finance Corporation of India (IFCI); State Finance Corporations (SFC)

Industrial Development Bank of India (IDBI)

The IDBI was established on July 1, 1964 under an Act of Parliament. It was set up as the central coordinating agency, leader of development banks and principal financing institution for industrial finance in the country. Originally, IDBI was a wholly owned subsidiary of RBI. But it was delinked from RBI w.e.f. Feb. 16, 1976.

IDBI is an apex institution to co-ordinate, supplement and integrate the activities of all existing specialised financial institutions. It is a refinancing and re-discounting institution operating in the capital market to refinance term loans and export credits. It is in charge of conducting techno-economic studies. It was expected to fulfil the needs of rapid industrialisation. The IDBI is empowered to finance all types of concerns engaged or to be engaged in the manufacture or processing of goods, mining, transport, generation and distribution of power etc., both in the public and private sectors.

Industrial finance Corporation of India (IFCI)

The IFCI is the first Development Financial Institution in India. It is a pioneer in development banking in India. It was established in 1948 under an Act of Parliament. The main objective of IFCI is to render financial assistance to large scale industrial units, particularly at a time when the ordinary banks are not forth coming to assist these concerns.

Its activities include project financing, financial services, merchant banking and investment. Till 1993, IFCI continued to be Developmental Financial Institution. After 1993, it was changed from a statutory corporation to a company under the Indian Companies Act, 1956 and was named as IFCI Ltd with effect from October 1999.

Industrial Credit and Investment Corporation of India (ICICI)

ICICI was set up in 1955 as a public limited company. It was to be a private sector development bank in so far as there was no participation by the Government in its share capital. It is a diversified long term financial institution and provides a comprehensive range of financial products and services including project and equipment financing, underwriting and direct subscription to capital issues, leasing, deferred credit, trusteeship and custodial services, advisory services and business consultancy.

The main objective of the ICICI was to meet the needs of the industry for long term funds in the private sector. Apart from this the Industrial Reconstruction Corporation of India (IRCI) established in 1971 with the main objective of revival and rehabilitation of viable sick units and was converted in to the Industrial Reconstruction Bank of India (IRBI) in 1985 with more powers. Development banks have been established at the state level too. At present in India, 18 State Financial

Corporation's (SFCs) and 26 State Industrial investment/Development Corporations (SIDCs) are functioning to look over the development banking in respective areas /states.

8.4.1.4 Agricultural Banks

Agricultural credit needs are different from those of Industry and Trade. The Agriculturists require:

a. Short term credit to buy seeds, fertilizers and other inputs.

b. Long Term credit to purchase land, to make permanent improvements on land, to purchase agricultural machinery and equipment, etc

c. In India Agricultural Finance is generally provided by co-operative institutions. Agricultural co-operatives provide short-term loans and Land Development banks provide Long term credit to the agriculturists.

8.4.1.5 Specialized Banks:

These banks are established and controlled under the special act of parliament. These banks have got the special status. One of the major bank is 'National Bank for Agricultural and Rural development' (NABARD) established in 1982, as an apex institution in the field of agricultural and other economic activities in rural areas. In 1990 a special bank named small industries development Bank of India (SIDBI) was established. It was the subsidiary of Industrial development Bank of India. This bank was established for providing loan facilities, discounting and rediscounting of bills, direct assistance and leasing facility.

Export Import Bank of India (EXIM Bank):

The Export-Import (EXIM) Bank of India is the principal financial institution in India for coordinating the working of institutions engaged in financing export and import trade. It is a statutory corporation wholly owned by the Government of India. It was established on January 1, 1982 for the purpose of financing, facilitating and promoting foreign trade of India.

This specialized bank grants loans to exporters and importers and also provides information about the international market. It also gives guidance about the opportunities for export or import, the risks involved in it and the competition to be faced, etc.

The main functions of the EXIM Bank are as follows:

(i) Financing of exports and imports of goods and services, not only of India but also of the third world countries;

(ii) Financing of exports and imports of machinery and equipment on lease basis;

(iii) Financing of joint ventures in foreign countries;

(iv) Providing loans to Indian parties to enable them to contribute to the share capital of joint ventures in foreign countries;

(v) To undertake limited merchant banking functions such as underwriting of stocks, shares, bonds or debentures of Indian companies engaged in export or import; and

(vi) To provide technical, administrative and financial assistance to parties in connection with export and import.

Small Industries Development Bank of India

This specialized bank grant loan to those who want to establish a small-scale business unit or industry. Small Industries Development Bank of India (SIDBI) was established in October 1989 and commenced its operation from April 1990 with its Head Office at Lucknow as a development bank, exclusively for the small scale industries. It is a central government undertaking. The prime aim of SIDBI is to promote and develop small industries by providing them the valuable factor of production finance. Many institutions and commercial banks supply finance, both long-term and short-term, to small entrepreneurs. SIDBI coordinates the work of all of them.

Functions of Small Industries Development Bank of India (SIDBI):

(i) Initiates steps for technology adoption, technology exchange, transfer and upgradation and modernisation of existing units.

(ii) SIDBI participates in the equity type of loans on soft terms, term loan, working capital both in rupee and foreign currencies, venture capital support, and different forms of resource support to banks and other institutions.

(iii) SIDBI facilitates timely flow of credit for both term loans and working capital to SSI in collaboration with commercial banks.

(iv) SIDBI enlarges marketing capabilities of the products of SSIs in both domestic and international markets.

(v) SIDB1 directly discounts and rediscounts bills with a view to encourage bills culture and helping the SSI units to realise their sale proceeds of capital goods / equipments and components etc.

(vi) SIDBI promotes employment oriented industries especially in semi-urban areas to create more employment opportunities so that rural-urban migration of people can be checked.

8.4.1.6 Exchange Banks:

Exchange banks Deal in foreign exchange and specialize in financing foreign Trade. They facilitate international payments through the sale and purchase of bills of exchange and thus play an important role in promoting foreign trade.

8.4.1.7 Savings Bank

Savings Banks: The main Purpose of saving banks is to promote saving habits among the general public and mobilize their small savings. In India, postal saving banks do this job. They open accounts and issue postal cash certificates.

8.4.1.8 World Bank

World Bank: World Bank refers to an institution which provides financial assistance to the member countries of the world. After the world wide depression and World War II, two institutions were founded in 1944, a) International Monetary Fund (IMF), b) International Bank of Reconstruction and development (IBRD) or popularly known as the World Bank. While the IMF was established to provide short-term loans to overcome the balance payments difficulties, the World Bank aimed at providing long term loans for the purpose of (a) reconstructing the war damaged economies and (b) developing the less developed economies.

8.4.2 Classification on the Basis of Ownership:

On the basis of ownership, banks can be classified into three categories:

8.4.2.1.Public Sector Banks: These are owned and controlled by the government. In India, the nationalized banks and the regional rural banks come under these categories.

8.4.2.2.Private Sector Banks: These banks are owned by the private individuals or corporations and not by the government or co- operative societies.

8.4.2.3.Co-operative Banks: Cooperative banks are operated on the co-operative lines. In India, co-operative credit institutions are organized under the co-operative society's law and play an important role in meeting the financial needs in the rural areas.

8.4.3 Classification on the basis of Domicile

On the basis of domicile, the banks are divided in to two categories:

8.4.3.1.Domestic banks: These are registered and incorporated within the country.

8.4.3.1.Foreign banks: These are foreign in origin and have their head offices in the country of origin.

8.4.4.Scheduled and Non-scheduled Banks

8.4.4.1. A Scheduled Bank

A Scheduled Bank is that which has been included in the Second Schedule of the Reserve Bank of India Act, 1934 and fulfils the three conditions: It has paid-up capital and reserves of at least of Rs. 5 lakhs. It ensures the reserve bank that its operations are not detrimental to the interest of the depositor. It is a corporation or a cooperative society and not a partnership for single owner firm.

8.4.4.2 Non-Scheduled Banks

The banks which are not included in the Second schedule of the Reserve Bank of India Act are non-scheduled banks.

Exercise 8.1

Q1. Define Bank.

Q2. Classify the banks on the basis of functions.

8.5. Summary

A bank can play a useful role in promoting the economic development of any country' economy. Banks tending and investment activities lead to changes in the quantity of money in circulation which in turn influence the nature and quality of production. Therefore, banks have been rightly crowned as 'the nerve'

Center of all economic activity. And also play important role in day to day life of every consumer who consumes the banking sector activities.

8.6. Glossary

1. Bank is a lawful organization which accepts deposits that can be withdrawn on demand.

2. Exchange banks Deal in foreign exchange and specialize in financing foreign Trade.

3. Savings Banks: The main Purpose of saving banks is to promote saving habits among the general public and mobilize their small savings.

4. World Bank: World Bank refers to an institution which provides financial assistance to the member countries of the world.

5. Public Sector Banks: These are owned and controlled by the government.

6. Private Sector Banks: These banks are owned by the private individuals or corporations and not by the government or co- operative societies.

7. Co-operative Banks: Cooperative banks are operated on the co-operative lines.

8.7. Answers to Self-Check Exercises

Exercise 8.1

Answer 1. Refer to section 8.3.

Answer 2. Refer to section 8.4.1.

8.8. Suggested Readings

1. Hajela, T.N., (2009) Money and Banking, Ane Books Pvt Ltd., New Delhi.

2. Sundharam KPM, Banking: Theory, Law and Practice, Sultan Chand and Sons, New Delhi.

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7. R. R. Paul, Money, Banking & International Trade, Kalyani Publications, Ludhiana.

8.9. Terminal Questions

Q1. What is a bank? On what basis the banks are classified, explain in detail.

LESSON 9
COMMERCIAL BANKING-II

STRUCTURE

9.0 Objectives

After studying this lesson you will be able to;

- Define commercial banks
- List the features of commercial banks
- Identify the primary functions of bank
- Recognize the secondary and innovative functions of banks

9.1 Introduction

The Banks which perform all kinds of banking business and generally finance trade and commerce are called commercial banks. Since, their deposits are for a short period, these banks normally advance short term loans to businessmen and traders and avoid medium and long term and long term lending. However, recently Commercial banks have also extended their areas of operation to medium term and long term finance.

9.2 Meaning of Commercial Banks

Commercial Banks is financial Institution that accepts deposits for the purpose of lending. In other words, commercial Banks provide services such as accepting deposits, giving business loans and also allow for variety of deposit accounts. They collect money from those who have it to spare and lend to those who require it. Commercial Bank is a banker to the general public. Commercial Banks registered under Indian companies Act, 1936 and are also governed by the Indian Banking Regulation Act, 1949.

9.3 Definitions

Various definitions of a bank have been given by various authors. Some important definitions of a bank listed below.

According to the Indian Companies (Regulation) Act, 1949, “the accepting, for the purpose of lending or Investment, of deposits of money from public, repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise.”

According to Prof. Kinley, “A bank is an establishment which makes to individuals such advances of money as may be required and safety made, and to which individuals entrust money when not required by them for use.”

According to John Paget, “Nobody can be a banker who does not (i) take deposit accounts (ii) take current accounts, (iii) issue and pay cheques, and (iv) Collect cheques- crossed and uncrossed for its customers.”

Prof Sayer defines the terms bank and banking clearly. He defines banks as “an institution whose debts (bank deposits) are widely accepted in settlement of other people’s debts to each other.” According to him, “ordinary banking business consists cash for bank deposits and bank deposits for cash, transferring bank deposits from one person or corporation to another; giving bank deposits in exchange for bills exchange, government bonds the secured promises of business man to repay and so forth”.

In short, we can say that banks are not merely traders in money but also in an important sense manufacturer of money.

9.4 Features of Commercial of Banks

1. A commercial bank is a financial intermediary.
2. Its central objective is commercial that is, profit making.
3. It takes money from a surplus unit by paying a low rate of interest and lends the same fund to a deficit unit at a higher rate of interest and thus makes profit.
4. It is said to be a dealer in credit.
5. It may be organized privately or by the Government.

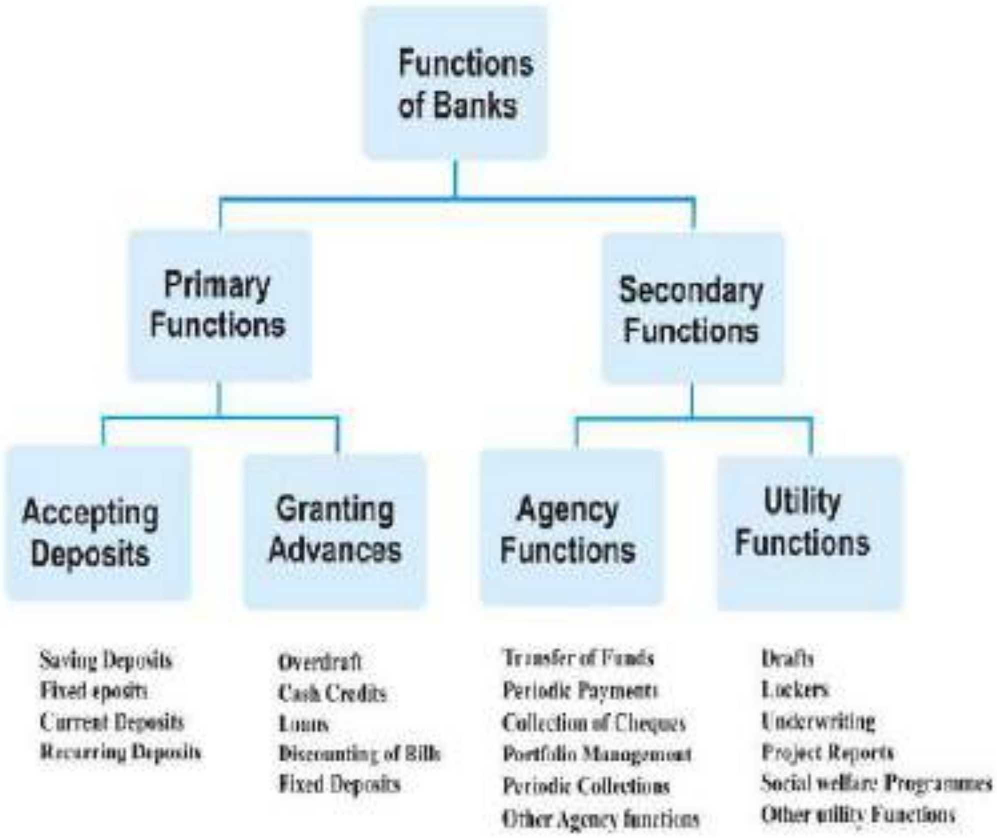
9.5 Functions of Commercial Banks

9.5.1. Primary Functions:

1. Accepting of deposits The following are the types of deposits:

a) Current deposits account: They are, generally opened by trading and industrial concerns, public authorities, etc. Current accounts are active or running accounts which are continuously in operation. Customers can deposit any amount of money and any number of times and there is no restriction on the number of withdrawals. Current deposits are repayable on demand. It is for this reason, they are also called demand deposits or demand liabilities. So, banks are required to keep the major portion of the current deposits in liquid form. Generally no interest is allowed on current deposits.

b) Fixed deposit account: They are opened by small investors who do not want invest their money in risky industrial securities, but wish to deposit their money in banks and earn good and steady income. No introduction is necessary for opening the fixed deposit accounts, as they are not operated by cheques. Fixed amounts are deposited by customers for fixed periods at fixed rate of interest. The fixed deposits can be withdrawn, not on demand, but only after the expiry of fixed periods. It is for this reason known as time deposits.



c) Savings deposit account: They are opened by middle and low income groups who wish to save a part of their current incomes for their future needs and earn fair interest on their deposits. Customers can deposit any amount of money and any number of times. There are restrictions on the number as well as the amount of withdrawals from these accounts.

d) Recurring deposit: It is meant for people who have regular monthly incomes. They are intended to encourage the habit of saving among the depositors on a regular basis. The depositor deposits a fixed sum of money every month for an agreed period, and at the end of the specified period, he gets back the amount deposited together with the interest accrued thereon.

2. Forms of advances

a) Loans: The banker advances a lump sum for a certain period at an agreed rate of interest. The entire amount is credited to loan a/c, interest is charged on entire amount whether the borrower withdraws in full or part. The loan may be repaid in instalments or at the expiry of a certain period. The loan may be made with or without security. Loan may be a demand loan or a terms loan. Demand loan is payable on demand, it is for meeting the working capital needs of the borrower. Term loans may be medium term or long term loan.

i. Medium term loans are granted for a period of one year to 5 years for the purchase of vehicles, tools and equipments.

ii. Long term loans are granted for a period of more than 5 years for capital expenditure such as purchase of land, building, new machinery etc.

b) Cash credit: This a permanent arrangement by which the customer is allowed to borrow money up-to a certain limit, here the borrower withdraws the money as and which he requires and interest is charged only on the amount actually withdrawn. Cash credit arrangements are usually against pledge or hypothecation of goods. Cash credits are the most favourite mode of borrowing by large commercial and industrial concerns.

c) Overdrafts: Overdraft is an arrangement between a banker and his customer by which the latter is allowed to withdraw over and above his credit balance in the current account up-to on agreed limit. This is only a temporary accommodation/arrangements usually granted against securities. Interest is charged on the amount overdrawn.

d) Bills discounted and purchased: While the traders opt for credit transaction the debtors accepts the bill drawn upon him to pay certain sum money on certain specified date by the credit-BOE. The banker discounts the BOE and credits the customer a/c, here the banker receives the interest in advance. Sometimes banks purchase the bill instead discounting them. But in almost all cases the bank holds the bill only as a security for the advance.

3. Creation of credit: Credit creation is an important function of commercial banks. When a commercial bank advances a loan to its customers, liquid cash will not be lent. Instead it opens an account in the borrower's name and credits his account with the amount of loan. Such a deposit is indeed credit creation .and this deposit is called secondary or derivative deposit. Thus credit creation helps to increase the money supply so as to promote economic development in the country.

4. Use of cheque system: Commercial banks perform the unique function of issuing and collecting cheques. Deposits can be withdrawn with the help of a cheque as it is a negotiable instrument. It can be transferred easily from one person to another. It becomes the most developed credit instrument. In modem business world the use of cheques to settle debts is found to be more convenient form than the use of liquid cash.

5. Remittance of funds: Banks help their customers in transferring funds from one place to another by issuing bank drafts, mail transfers, and telegraphic transfers and electronics transfers on nominal commission charges.

9.5.2 Secondary Functions

The secondary functions of a modern banker may be classified into: 1. Agency functions 2. Miscellaneous functions /General utility functions.

1. Agency functions: The banker acts as an agent to his customers.

i) Payment and collection of dividends, salaries, pensions, telephone bills, insurance premium etc...: Customers can leave standing instructions with the banker for various periodic payments ensuring the regular payments and avoiding the trouble of performing it themselves.

ii) Purchase and sales of securities: They simply perform the function of a broker and undertake the purchase and sale of various securities like shares, stocks, debentures etc., on behalf of their customers.

iii) Acting as executor, administrator and trustee: An executor is a person appointed by a testator by a will to execute his will. When no will is prepared by the testator or when no executor is named in the will or when the executor named in the will is not available or willing to act as such, the court appoints a person called as administrator. A trustee is a person who is entrusted with some property by the settler of the trust for the benefit of another person called the beneficiary. A modern bank serves as a trustee of its customer.

iv) Acting as attorney: An attorney is a person appointed by another person by a power of attorney to act on his behalf. As an attorney of a customer, the banker is empowered to sign transfer forms in respect of sales and purchases of securities made by him on behalf of his customers.

2. Miscellaneous functions:

i) Safe custody of valuables: There are 2 ways through which a banker ensures safety of its customer's valuables.

a. By accepting valuable for safe custody-

b. By hiring out safe deposit lockers to the customers.

ii) Letter of credit: Letter of credit assumes great importance in international trade. Letter of credit assures payment to an exporter soon after he parts with the goods and enables the importer to make payment only after he receives the goods or the document title to goods. Thus, letters of credit facilitate foreign trade.

iii) Traveller’s Cheques: A traveller’s cheque can be purchased by anyone, are issued in different denominations. No commission is charged on the sale of traveller’s cheque, the purchaser has to deposit the money in the issuing bank equivalent to the amount of traveller’s cheque, at the time of purchase as well as at the time of encashment he has to sign in the cheque. There is no expiry period, refundable, issued in single name only and not in joint names, clubs, Societies etc.

iv) Merchant Banking: It covers a wide range of activities such as management of customer’s services, portfolio management, credit syndication, counselling, assisting companies in matters relating to restructuring, amalgations, mergers and take over etc., preparation of project reports, project counselling, corporate counselling, issue management, pre-investment and feasibility.

v) Dealing in foreign exchange business: It includes, export finance, forward contract, issue of solvency certificates, banks get trade information and disseminate.

vii) Leasing Finance: The banking laws (Amendment) act, 198, enables commercial banks to carry on equipment leasing business and set up subsidiaries for carrying on such business.

viii) Factoring: Factoring is a ‘continuing arrangement between a financial institution say, a commercial bank (called the factor) and the business concern (called the customer) selling goods and services to trade customers in which the factor purchases the book debts of his client and immediately pay the client either the full value or a substantial part of the book debts, and thereafter collects the book debts from the debtors of the client on the due dates.

ix) Housing Finance

x) Tax Consultancy: Banks advices on income tax and other taxes, preparing customers annual statements, claiming allowances file appeals etc.,

xi) Underwriting of securities: Every modem banker underwrite the shares and debentures of trading companies. He also underwrites the securities of government and semi government institutions.

xii) Credit cards: Credit cards are issued to customers having current saving stock. It enables a customer to purchase the goods and services up-to a certain limit without making immediate payment.

Xiii) Gift cheques: The purchaser of the cheque need not be an account holder, it has no negotiability and its payment is made only to the payee, gifted on occasions such as wedding, birthday etc.,

xiv) Consultancy Function: The consultancy service covers technical, financial, managerial and economic aspects. This service is provided small scale industries.

xv) Teller System: Under this system, the teller is authorized to receive cash and make payments up-to limited amounts without reference to the ledger balance or the specimen signature. Now it is automated teller system.

9.5.3 Innovative Functions

The adoptions of Information and Communication technology enable banks to provide many innovative services to the customers such as;

1. ATM services

Automated Teller Machine (ATM) is an electronic telecommunications device that enables the clients of banks to perform financial transactions by using a plastic card. Automated Teller Machines are established by banks to enable its customers to have anytime money. It is used to withdraw money, check balance, transfer funds, get mini statement, make payments etc. It is available at 24 hours a day and 7 days a week.

2. Debit card and credit card facility

Debit card is an electronic card issued by a bank which allows bank clients access to their account to withdraw cash or pay for goods and services. It can be used in ATMs, Point of Sale terminals, e-commerce sites etc. Debit card removes the need for cheques as it immediately transfers money from the client's account to the business account. Credit card is a card issued by a financial institution giving the holder an option to borrow funds, usually at point of sale. Credit cards charge interest and are primarily used for short term financing.

3. Tele-banking:

Telephone banking is a service provided by a bank or other financial institution that enables customers to perform financial transactions over the telephone, without the need to visit a bank branch or automated teller machine.

4. Internet Banking:

Online banking (or Internet banking or E-banking) is a facility that allows customers of a financial institution to conduct financial transactions on a secured website operated by the institution. To access a financial institution's online banking facility, a customer must register with the institution for the service, and set up some password for customer verification. Online banking can be used to check balances, transfer money, shop online, pay bills etc.

5. Bancassurance:

It means the delivery of insurance products through banking channels. It can be done by making an arrangement in which a bank and an insurance company form a partnership so that the insurance company can sell its products to the bank's client base. Banks can earn additional revenue by selling the insurance products, while insurance companies are able to expand their customer base without having to expand their sales forces.

6. Mobile Banking

Mobile banking is a system that allows customers of a financial institution to conduct a number of financial transactions through a mobile device such as a mobile phone or personal digital assistant. It allows the customers to bank anytime anywhere through their mobile phone. Customers can access their banking information and make transactions on Savings Accounts, Demat Accounts, Loan Accounts and Credit Cards at absolutely no cost.

7. Electronic Clearing Services:

It is a mode of electronic funds transfer from one bank account to another bank account using the services of a Clearing House. This is normally for bulk transfers from one account to many accounts or vice-versa. This can be used both for making payments like distribution of dividend, interest, salary, pension, etc. by institutions or for collection of amounts for purposes such as payments to utility companies like telephone, electricity, or charges such as house tax, water tax etc.

8. Electronic Fund Transfer/National Electronic Fund Transfer (NEFT): National Electronic Funds Transfer (NEFT) is a nation-wide payment system facilitating one-to-one funds transfer. Under this Scheme, individuals, firms and corporate can electronically transfer funds from any bank branch to any individual, firm or corporate having an account with any other bank branch in the country participating in the Scheme. In NEFT, the funds are transferred based on a deferred net settlement in which there are 11 settlements in week days and 5 settlements in Saturdays.

9. Real Time Gross Settlement System (RTGS): It can be defined as the continuous (real-time) settlement of funds transfers individually on an order by order basis. 'Real Time' means the processing of instructions at the time they are received rather than at some later time. It is the fastest possible money transfer system in the country.

Exercise 9.1

Q1. State which of the following statements are True and which are false. Write ‘T’ for True and ‘F’ for a False statement:

(a) Loans and advances are both granted by banks to customers for a long period of time.

(b) Banks keep our jewellery and important documents safe with them.

(c) Banks grant loans to students for their studies at reasonable interest rate.

(d) Discounting of bills is done by banks free of cost.

(e) Through overdraft, a customer can withdraw more money than the amount in his/her bank account.

Q2. Match the statement in column A with the word(s) / terms in column B:

Column A	Column B
(a) The banking facility that helps us to make payments out of our bank account without actually carrying money with us.	(i) ATM
(b) The banking facility enabling us to deposit or withdraw cash 24 hours a day.	(ii) Phone Banking
(c) The facility that helps us to perform banking transactions over the Internet.	(iii) Credit Card
(d) We can get information about the balance in our bank account over the mobile phone using this facility	(iv) Debit Card
(e) The facility that enables us to make payment for purchase of goods by taking credit from the bank	(v) Net Banking

9.6 Summary

Bank act as payment agents by conducting checking or current accounts for customer, paying cheque drawn by customers on the bank, and collecting cheque deposited to customers current accounts. Banks also enable customer payments via other payment methods such as automated teller machine (ATM), Telegraphic Transfer etc. Banks borrow money by accepting funds deposited on current accounts, by accepting term deposits, and by issuing debt securities such as banknotes and bonds. Banks lend money by making advances to customers on current accounts, by making instalment loans and by investing in marketable debt securities and other forms of money lending.

Banks also provide almost all payment services and a bank account is considered indispensable by most businesses, individuals and governments.

9.7. Glossary

1. ATM services; Automated Teller Machine (ATM) is an electronic telecommunications device that enables the clients of banks to perform financial transactions by using a plastic card. Automated Teller Machines are established by banks to enable its customers to have anytime money.

2. Mobile Banking; Mobile banking is a system that allows customers of a financial institution to conduct a number of financial transactions through a mobile device such as a mobile phone or personal digital assistant. It allows the customers to bank anytime anywhere through their mobile phone.

3. Real Time Gross Settlement System (RTGS): It can be defined as the continuous (real-time) settlement of funds transfers individually on an order by order basis. 'Real Time' means the processing of instructions at the time they are received rather than at some later time. It is the fastest possible money transfer system in the country.

4. Electronic Fund Transfer/National Electronic Fund Transfer (NEFT): National Electronic Funds Transfer (NEFT) is a nation-wide payment system facilitating one-to-one funds transfer. Under this Scheme, individuals, firms and corporate can electronically transfer funds from any bank branch to any individual, firm or corporate having an account with any other bank branch in the country participating in the Scheme.

9.8. Answers to Self Check Exercises

Exercise 9.1

Q1. (a) F, (b) T, (c) T, (d) F, (e) T

Q2. (a) (iv), (b) (i), (c) (v), (d) (ii), (e) (iii)

9.9. Suggested Readings

1. Hajela, T.N., (2009) Money and Banking, Ane Books Pvt Ltd., New Delhi.

2. Sundharam KPM, Banking: Theory, Law and Practice, Sultan Chand and Sons, New Delhi.

3. M.R. Baye, D.W. Jansen (1996), Money, Banking and Financial Markets, AITBS (Indian ed.)

4. K.C. Sekhar: Banking – Theory and Practice, Vikas Publishing House, New Delhi.

5. S.B. Gupta, Monetary Economics, S. Chand Publications, New Delhi.

6. M. L. Seth, Monetary Economics, Vikas Publications, New Delhi

7. R. R. Paul, Money, Banking & International Trade, Kalyani Publications, Ludhiana.

9.10. Terminal Questions

Q1. What is meant by Central Bank? Explain the primary functions of a commercial bank.

Q2. Write a note on innovative function of commercial banks.

LESSON 10
CREDIT CREATION

STRUCTURE

10.0 Objectives

After studying this lesson you will be able to:

- Recognize the basis of credit creation
- Explain the process of credit creation
- Elucidate the limitations of the bank
- List the asset and liabilities of bank.

10.1 Introduction

An important function performed by the commercial banks is the creation of credit. The process of banking must be considered in terms of monetary flows, that is, continuous depositing and withdrawal of cash from the bank. It is only this activity which has enabled the bank to manufacture money. Therefore the banks are not only the purveyors of money but manufacturers of money.

10.2 Meaning of Credit Creation

Banks, unlike other financial institutions, have a peculiar ability to create credit i.e., to expand their demand deposits as a multiple of their cash reserves. This is because of the fact that demand deposits of the banks serve as the principal medium of exchange, and in this way, the banks manage the payment system of the country. In short multiple expansion of deposits is called credit creation.

When a bank extends loans it is not directly paid to the borrower, but is only credited to his account and a cheque book is given. Thus every bank loan creates an equivalent amount of derivative deposit. By using this deposit, banker can again extend loan to some other parties after keeping a specified amount as reserve. Thus with a little cash in hand the banks can create additional purchasing power to a considerable

Credit can be created by a single bank or by more than one banker. When it is created bymore than one banker, it is called multiple credit creation.

10.3 Basis of Credit Creation

The basis of credit money is the bank deposits. The bank deposits are of two kinds viz.,

(1) Primary deposits and (2) Derivative deposits

1. Primary Deposits: Primary deposits arise or formed when cash or cheque is deposited by customers. When a person deposits money or cheque, the bank will credit his account. The customer is free to withdraw the amount whenever he wants by cheques. These deposits are called “primary deposits” or “cash deposits.” It is out of these primary deposits that the bank makes loans and advances to its customers. The initiative is taken by the customers themselves. In this case, the role of the bank is passive. So these deposits are also called “passive deposits.” These deposits merely convert currency money into deposit money. They do not create money. They do not make any net addition to the stock of money. In other words, there is no increase in the supply of money.

2. Derivative Deposits: Bank deposits also arise when a loan is granted or when a bank discounts a bill or purchase government securities. Deposits which arise on account of granting loan or purchase of assets by a bank are called “derivative deposits.” Since the bank play an active role in the creation of such deposits, they are also known as “active deposits.” When the banker sanctions a loan to a customer, a deposit account is opened in the name of the customer and the sum is credited to his account. The bank does not pay him cash. The customer is free to withdraw the amount whenever he wants by cheques. Thus the banker lends money in the form of deposit credit. The creation of a derivative deposit does result in a net increase in the total supply of money in the economy, Hartly Withers says “every loan creates a deposit.” It may also be said “loans make deposits” or “loans create deposits.” It is rightly said that “deposits are the children of loans, and credit is the creation of bank clerk’s pen.”

Granting a loan is not the only method of creating deposit or credit. Deposits also arise when a bank discounts a bill or purchase government securities. When the bank buys government securities, it does not pay the purchase price at once in cash. It simply credits the account of the government with the purchase price. The government is free to withdraw the amount whenever it wants by cheque. Similarly, when a bank purchase a bill of exchange or discounts a bill of exchange, the proceeds of the bill of exchange is credited to the account of the seller and promises to pay the amount whenever he wants. Thus asset acquired by a bank creates an equivalent bank deposit. It is perfectly correct to state that “bank loans create deposits.” The derivate deposits are regarded as bank money or credit. Thus the power of commercial banks to expand deposits through loans, advances and investments is known as “credit creation.”

Thus, credit creation implies multiplication of bank deposits. Credit creation may be defined as “the expansion of bank deposits through the process of more loans and advances and investments.”

10.4 Process of Credit Creation

An important aspect of the credit creating function of the commercial banks is the process of multiple-expansion of credit. The banking system as a whole can create credit which is several times more than the original increase in the deposits of a bank. This process is called the multiple-expansion or multiple-creation of credit. Similarly, if there is withdrawal from any one bank, it leads to the process of multiple-contraction of credit. The process of multiple credit-expansions can be illustrated by assuming

(a) The existence of a number of banks, A, B, C etc., each with different sets of depositors

(b) Every bank has to keep 10% of cash reserves, according to law, and,

(c) A new deposit of Rs. 1,000 has been made with bank A to start with.

Suppose, a person deposits Rs. 1,000 cash in Bank A. As a result, the deposits of bank A increase by Rs. 1,000 and cash also increases by Rs. 1,000. The balance sheet of the bank is as follows:

Balance Sheet of Bank A

Liabilities	Rs.	Assets	Rs.
New deposit	1,000	New Cash	1,000
Total	1,000		1,000

Under the double entry system, the amount of Rs. 1,000 is shown on both sides.

The deposit of Rs. 1,000 is a liability for the bank and it is also an asset to the bank. Bank A has to keep only 10% cash reserve, i.e., Rs. 100 against its new deposit and it has a surplus of Rs. 900 which it can profitably employ in the assets like loans. Suppose bank A gives a loan to X, who uses the amount to pay off his creditors. After the loan has been made and the amount so withdrawn by X to pay off his creditors, the balance sheet of bank A will be as follows:

Balance Sheet of Bank A

Liabilities	Rs.	Assets	Rs.
Deposit	1,000	New Cash Loan to X	100 900
Total	1,000		1,000

Suppose X purchase goods of the value of Rs. 900 from Y and pay cash. Y deposits the amount with Bank B. The deposits of Bank B now increase by Rs. 900 and its cash also increases by Rs. 900. After keeping a cash reserve of Rs. 90, Bank B is free to lend the balance of Rs. 810 to anyone. Suppose bank B lends Rs. 810 to Z, who uses the amount to pay off his creditors. The balance sheet of bank B will be as follows:

Balance Sheet of Bank B

Liabilities	Rs.	Assets	Rs.
Deposit	900	Cash Loan to Z	90 810
Total	900		900

Suppose Z purchases goods of the value of Rs. 810 from S and pays the amount. S deposits the amount of Rs. 810 in bank C. Bank C now keeps 10% as reserve (Rs. 81) and lends Rs. 729 to a merchant. The balance sheet of bank C will be as follows:

Balance Sheet of Bank C

Liabilities	Rs.	Assets	Rs.
Deposit	810	Cash	81
		Loan	729
Total	810		810

Thus looking at the banking system as a whole, the position will be as follow:

Name of bank	Deposits Rs.	Cash reserve Rs.	Loan Rs.
Bank A	1,000	100	900
Bank B	900	90	810
Bank C	810	81	729
Total	2,710	271	2,439

It is clear from the above that out of the initial primary deposit, bank advanced Rs. 900 as a loan. It formed the primary deposit of bank B, which in turn advanced Rs. 810 as loan. This sum again formed, the primary deposit of bank C, which in turn advanced Rs. 729 as loan. Thus the initial primary deposit of Rs. 1,000 resulted in bank credit of Rs. 2439 in three banks. There will be many banks in the country and the above process of credit expansion will come to an end when no bank has an excess reserve to lend. In the above example, there will be 10 fold increases in credit because the cash ratio is 10%. The total volume of credit created in the banking system depends on the cash ratio. If the cash ratio is 10% there will be 10 fold increase. If it is 20%, there will be 5 fold increases. When the banking system receives an additional primary deposit, there will be multiple expansion of credit. When the banking system loses cash, there will be multiple contraction of credit.

The extent to which the banks can create credit together could be found with the help of the credit multiplier formula. The formula is:

$$K = \frac{1}{r}$$

Where K is the credit multiplier, and r, the required reserves. If the reserve ratio is 10% the size of credit multiplier will be:

$$K = \frac{1}{r} = \frac{1}{0.1} = 10$$

It means that the banking system can create credit together which is ten times more than the original increase in the deposits. It should be noted here that the size of credit multiplier is inversely related to the percentage of cash reserves the banks have to maintain. If the reserve ratio increases, the size of credit multiplier is reduced and if the reserve ratio is reduced, the size of credit multiplier will increase.

Leaf and Cannon Criticism

Walter Leaf and Edwin Cannon objected to the theory of credit creation. According to them, the commercial bank cannot lend anything more than what it receives as cash from deposits. But the contention of Leaf and Cannon that banks cannot create credit is wrong due to the following reasons:

(a) A single bank may not be able to create derivative deposits in excess of its cash reserves. But the banking system as a whole can do what a single bank cannot do.

(b) As Crowther points out that the total net deposits of commercial banks are for in excess of their cash reserves. It means they can create credit.

10.5 Limitation on Credit Creation

The commercial banks do not have unlimited power of credit creation. Their power to create credit is limited by the following factors:

1. Amount of Cash: The power to create credit depends on the cash received by banks. If banks receive more cash, they can create more credit. If they receive less cash they can create less credit. Cash supply is controlled by the central bank of the country.

2. Cash Reserve Ratio: All deposits cannot be used for credit creation. Banks must keep certain percentage of deposits in cash as reserve. The volume of bank credit depends also on the cash reserve ratio the banks have to keep. If the cash reserve ratio is increased, the volume of credit that the banks can create will fall. If the cash reserve ratio is lowered, the bank credit will increase. The Central Bank has the power to prescribe and change the cash reserve ratio to be kept by the commercial banks. Thus the central bank can change the volume of credit by changing the cash reserve ratio.

3. Banking Habits of the People: The loan advanced to a customer should again come back into banks as primary deposit. Then only there can be multiple expansions. This will happen only when the banking habit among the people is well developed. They should keep their money in the banks as deposits and use cheques for the settlement of transactions.

4. Nature of Business Conditions in the Economy: Credit creation will depend upon the nature of business conditions. Credit creation will be large during a period of prosperity, while it will be smaller during a depression. During periods of prosperity, there will be more demand for loans and advances for investment purposes. Many people approach banks for loans and advances. Hence, the volume of bank credit will be high. During periods of business depression, the amount of loans and advances will be small because businessmen and industrialists may not come to borrow. Hence the volume of bank credit will be low.

5. Leakages in Credit-Creation: There may be some leakages in the process of credit creation. The funds may not flow smoothly from one bank to another. Some people may keep a portion of their amount as idle cash.

6. Sound Securities: A bank creates credit in the process of acquiring sound and profitable assets, like bills, and government securities. If people cannot offer sound securities, a bank cannot create credit. Crowther says "a bank cannot create money out of thin air. It transmutes other forms of wealth into money."

7. Liquidity Preference: If people desire to hold more cash, the power of banks to create credit is reduced.

8. Monetary Policy of the Central Bank: The extent of credit creation will largely depend upon the monetary policy of the Central Bank of the country. The Central Bank has the power to influence the volume of money in circulation and through this it can influence the volume of credit created by the banks. The Central Bank has also certain powerful weapons, like the bank rate, open market operations with the help of which it can exercise control on the expansion and contraction of credit by the commercial bank.

Thus, the ability of the bank to create credit is subject to various limitations. Still, one should not undermine the importance of the function of credit creation of the banks. This function has far-reaching effect on the working of the economy, especially on the business activity. Bank credit is the oil which lubricates the wheels of the business machine.

The balance sheet of a commercial bank is a statement of its assets and liabilities. Assets are what others owe the bank, and what the bank owes others constitutes its liabilities. The business of a bank is reflected in its balance sheet and hence its financial position as well. The balance sheet is issued usually at the end of every financial year of the bank.

The balance sheet of the bank comprises of two sides; the assets side and the liabilities side. It is customary to record liabilities on the left side and assets on the right side. The following is the Performa of a balance sheet of the bank.

Balance Sheet of the Bank

Liabilities	Assets
1. Capital	1. Cash
a. Authorised capital	a. Cash on hand
b. Issued capital	b. Cash with central bank and other banks
c. Subscribed capital	
d. Paid-up-capital	
2. Reserve fund	2. Money at call and short notice
3. Deposits	3. Bills discounted
4. Borrowings from other banks	4. Bills for collection
5. Bills payable	5. Investments
6. Acceptances and endorsements	6. Loans and advances
7. Contingent liabilities	7. Acceptances and endorsement
8. Profit and loss account	8. Fixed assets
9. Bills for collection	

10.6 Liabilities of the Bank

Liabilities are those items on account of which the bank is liable to pay others. They denote other's claims on the bank. Now we have to analyze the various items on the liabilities side.

1. Capital: The bank has to raise capital before commencing its business. Authorised capital is the maximum capital up to which the bank is empowered to raise capital by the Memorandum of Association. Generally, the entire authorised capital is not raised from the public. That part of authorised capital which is issued in the form of shares for public subscription is called the issued capital. Subscribed capital represents that part of issued capital which is actually subscribed by the public. Finally, paid-up capital is that part of the subscribed capital which the subscribers are actually called upon to pay.

2. Reserve Fund: Reserve fund is the accumulated undistributed profits of the bank. The bank maintains reserve fund to tide over any crisis. But, it belongs to the shareholders and hence a liability on the bank. In India, the commercial bank is required by law to transfer 20 per cent of its annual profits to the Reserve fund.

3. Deposits: The deposits of the public like demand deposits, savings deposits and fixed deposits constitute an important item on the liabilities side of the balance sheet. The success of any banking business depends to a large extent upon the degree of confidence it can instill in the minds of the depositors. The bank can never afford to forget the claims of the depositors. Hence, the bank should always have enough cash to honour the obligations of the depositors.

4. Borrowings from Other Banks: Under this head, the bank shows those loans it has taken from other banks. The bank takes loans from other banks, especially the central bank, in certain extraordinary circumstances.

5. Bills Payable: These include the unpaid bank drafts and telegraphic transfers issued by the bank. These drafts and telegraphic transfers are paid to the holders thereof by the bank's branches, agents and correspondents who are reimbursed by the bank.

6. Acceptances and Endorsements: This item appears as a contra item on both the sides of the balance sheet. It represents the liability of the bank in respect of bills accepted or endorsed on behalf of its customers and also letters of credit issued and guarantees given on their behalf. For rendering this service, a commission is charged and the customers to whom this service is extended are liable to the bank for full payment of the bills. Hence, this item is shown on both sides of the balance sheet.

7. Contingent Liabilities: Contingent liabilities comprise of those liabilities which are not known in advance and are unforeseeable. Every bank makes some provision for contingent liabilities.

8. Profit and Loss Account: The profit earned by the bank in the course of the year is shown under this head. Since the profit is payable to the shareholders it represents a liability on the bank.

9. Bills for Collection: This item also appears on both the sides of the balance sheet. It consists of drafts and hundies drawn by sellers of goods on their customers and are sent to the bank for collection, against delivery documents like railway receipt, bill of lading, etc., attached thereto. All such bills in hand at the date of the balance sheet are shown on both the sides of the balance sheet because they form an asset of the bank, since the bank will receive payment in due course, it is also a liability because the bank will have to account for them to its customers.

10.7 Assets of the Bank

According to Crowther, the assets side of the balance sheet is more complicated and interesting. Assets are the claims of the bank on others. In the distribution of its assets, the bank is governed by certain well defined principles. These principles constitute the principles of the investment policy of the bank or the principles underlying the distribution of the assets of the bank. The most important guiding principles of the distribution of assets of the bank are liquidity, profitability and safety or security. In fact, the various items on the assets side are distributed according to the descending order of liquidity and the ascending order of profitability.

The various items on the assets side are.

1. Cash: Here we can distinguish cash on hand from cash with central bank and other banks cash on hand refers to cash in the vaults of the bank. It constitutes the most liquid asset which can be immediately used to meet the obligations of the depositors. Cash on hand is called the first line of defense to the bank.

In addition to cash on hand, the bank also keeps some money with the central bank or other commercial banks. This represents the second line of defense to the bank.

2. Money at Call and Short Notice: Money at call and short notice includes loans to the brokers in the stock market, dealers in the discount market and to other banks. These loans could be quickly converted into cash and without loss, as and when the bank requires. At the same time, this item yields income to the bank. The significance of money at call and short notice is that it is used by the banks to effect desirable adjustments in the balance sheet. This process is called 'Window Dressing'. This item constitutes the 'third line of defense' to the bank.

3. Bills Discounted: The commercial banks invest in short term bills consisting of bills of exchange and treasury bills which are self-liquidating in character. These short term bills are highly negotiable and they satisfy the twin objectives of liquidity and profitability. If a commercial bank requires additional funds, it can easily rediscount the bills in the bill market and it can also rediscount the bills with the central bank.

4. Bills for Collection: As mentioned earlier, this item appears on both sides of the balance sheet.

5. Investments: This item includes the total amount of the profit yielding assets of the bank. The bank invests a part of its funds in government and non-government securities.

6. Loans and Advances: Loans and advances constitute the most profitable asset to the bank. The very survival of the bank depends upon the extent of income it can earn by advancing loans. But, this item is the least liquid asset as well. The bank earns quite a sizeable interest from the loans and advances it gives to the private individuals and commercial firms.

7. Acceptances and Endorsements: As discussed earlier, this item appears as a contra item on both sides of the balance sheet.

8. Fixed Assets: Fixed assets include building, furniture and other property owned by the bank. This item includes the total volume of the movable and immovable property of the bank. Fixed assets are referred to as 'dead stocks'. The bank generally undervalues this item deliberately in the balance sheet. The intention here is to build up secret reserves which can be used at times of crisis.

Balance sheet of a bank acts as a mirror of its policies, operations and achievements. The liabilities indicate the sources of its funds; the assets are the various kinds of debts incurred by a bank to its customers. Thus, the balance sheet is a complete picture of the size and nature of operations of a bank.

Exercise 10.1

Q1. A bank received a deposit of Rs. 200. It gave a loan of Rs.180 to a borrower. What is the cash reserve ratio?

Q2. In the above question find out the amount of (a) primary deposit, (b) secondary deposit and (c) total deposit?

Q3. What are the assets of banks?

10.8 Summary

In this chapter we have studied the main function of bank i.e., credit creation. In the second section of the chapter we have studied the process of credit creation. In the last two section we have studied the Asset and liabilities of the bank.

10.9 Glossary

1. Credit Creation: Banks, unlike other financial institutions, have a peculiar ability to create credit i.e., to expand their demand deposits as a multiple of their cash reserves. This is because of the fact that demand deposits of the banks serve as the principal medium of exchange, and in this way, the banks manage the payment system of the country. In short multiple expansions of deposits is called credit creation.

2. Primary Deposits: Primary deposits arise or formed when cash orcheque is deposited by customers. When a person deposits money or cheque, the bank will credit his account. The customer is free to withdraw the amount whenever he wants by cheques. These deposits are called "primary deposits" or "cash deposits."

3. **Derivative Deposits:** Bank deposits also arise when a loan is granted or when a bank discounts a bill or purchase government securities. Deposits which arise on account of granting loan or purchase of assets by a bank are called "derivative deposits."

4. Liabilities are those items on account of which the bank is liable to pay others. They denote other's claims on the bank.

5. Assets are the claims of the bank on others. In the distribution of its assets, the bank is governed by certain well defined principles. These principles constitute the principles of the investment policy of the bank or the principles underlying the distribution of the assets of the bank.

10.10 Answers to Self-Check Exercises

Exercise 10.1

Answer 1. 10 percent

Answer 2. (a) Rs.200 (b) Rs.180 (c) Rs.380

Answer 3. Refer to section 5.7.

10.11. Suggested Readings

1. Hajela, T.N., (2009) Money and Banking, Ane Books Pvt Ltd., New Delhi.

2. Sundharam KPM, Banking: Theory, Law and Practice, Sultan Chand and Sons, New Delhi.

3. M.R. Baye, D.W. Jansen (1996), Money, Banking and Financial Markets, AITBS (Indian ed.)

4. K.C. Sekhar: Banking – Theory and Practice, Vikas Publishing House, New Delhi.

5. S.B. Gupta, Monetary Economics, S. Chand Publications, New Delhi.

6. M. L. Seth, Monetary Economics, Vikas Publications, New Delhi

7. R. R. Paul, Money, Banking & International Trade, Kalyani Publications, Ludhiana.

10.12. Terminal Questions

Q1.What is credit? How does a bank create credit?

Q2. What are the asset and liabilities of a bank?

LESSON 11
COMMERCIAL BANKING IN INDIA

STRUCTURE

11.0 objectives

After studying this lesson you will be able to:

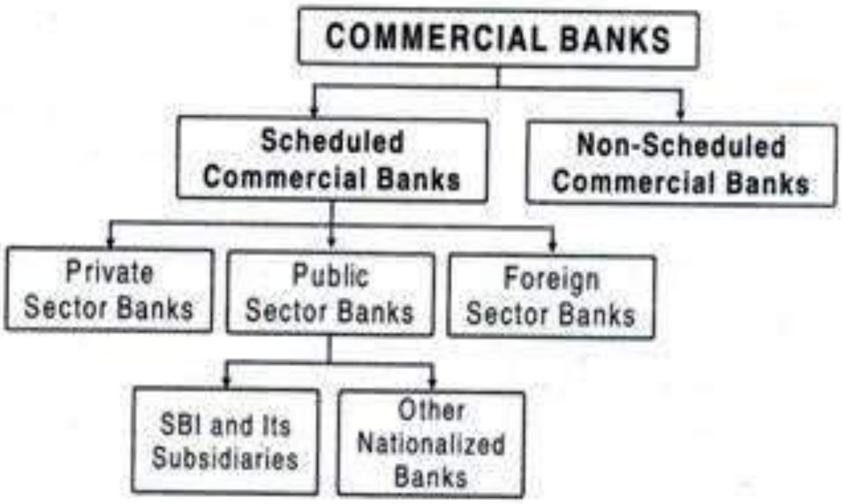
- Identify the structure of commercial bank in India
- List the objectives for Nationalization of Banks in India
- Explain the reforms in banking sector

11.1 Introduction

After independence the Government of India (GOI) adopted planned economic development for the country (India). Accordingly, five year plans came into existence since 1951. This economic planning basically aimed at social ownership of the means of production. However, commercial banks were in the private sector those days. In 1950-51 there were 430 commercial banks. The Government of India had some social objectives of planning. These commercial banks failed helping the government in attaining these objectives. Thus, the government decided to nationalize 14 major commercial banks on 19th July, 1969. All commercial banks with a deposit base over Rs.50 crores were nationalized. It was considered that banks were controlled by business houses and thus failed in catering to the credit needs of poor sections such as cottage industry, village industry, farmers, craft men, etc. The second dose of nationalization came in April 1980 when banks were nationalized.

11.2 Commercial Banks in India

The commercial banks can be broadly classified under two heads:



11.2.1. Scheduled Banks:

Scheduled Banks refer to those banks which have been included in the Second Schedule of Reserve Bank of India Act, 1934.

In India, scheduled commercial banks are of three types:

1. Public sector banks
2. Private Banks
3. Foreign banks

Currently, there are 88 scheduled commercial banks, including 28 public sector banks, 29 private banks and 31 foreign banks.

11.2.1.1 Public sector banks

These are banks where majority stake is held by the Government of India or Reserve Bank of India. In 2012, the largest public sector bank is the State Bank of India. This consists of 14 banks which are nationalized in the year 1969 and 6 banks which are nationalized in the year 1980.

- Allahabad Bank
- Andhra Bank
- Bank of Baroda
- Bank of India
- Bank of Maharashtra
- Canara Bank
- Central Bank of India
- Corporation Bank
- Dena Bank
- Indian Bank
- Indian Overseas Bank
- Oriental Bank of Commerce

- Punjab & Sind Bank
- Punjab National Bank
- Syndicate Bank
- UCO Bank
- Union Bank of India
- United Bank of India
- Vijaya Bank
- State bank and its associates

11.2.1.2 Private Banks

Private Banks are banks that the majority of share capital is held by private individuals. In Private sector small scheduled commercial banks and newly established banks with a network of 8,965 branches are operating. To encourage competitive efficiency, the setting up of new private bank is now encouraged. Examples of old private sector banks are:

- Bank of Rajasthan
- Catholic Syrian Bank
- Dhanalakshmi Bank
- Federal Bank
- ING Vysya Bank
- Karnataka Bank
- Karur Vysya Bank
- Lakshmi Vilas Bank
- Lord Krishna Bank
- South Indian Bank
- Tamilnadu Mercantile Bank
- Examples on new generation private sector banks are:
- Bank of Punjab
- Centurion Bank
- HDFC Bank
- ICICI Bank
- IDBI Bank Ltd.
- IndusInd Bank
- Kotak Mahindra Bank
- UTI Bank
- Yes Bank

11.2.1.3 Foreign Banks

Foreign banks are registered and have their headquarters in a foreign country but operate their branches in India. Apart from financing of foreign trade, these banks have performed all functions of commercial banks and they have an advantage over Indian banks because of their vast resources and superior management. At the end of September, 2010, 34 foreign banks were operating in India.

Examples of foreign bank functioning in India are:

- ABM Amro Bank
- Bank of America

- Bank of Bahrain & Kuwait
- Bank of Ceylon
- Barclays Bank
- BNP Paribas
- Ceylon Bank
- Citibank
- Hongkong & Shanghai Banking Corporation.(HSBC)
- JP Morgan Chase Bank
- Sonali Bank
- Standard Chartered Bank

11.2.2. Non-Scheduled Banks:

Non-Scheduled banks refer to those banks which are not included in the Second Schedule of Reserve Bank of India Act, 1934.

11.3 Nationalization of Bank

Bank Nationalization in India Indian Banking history can be traced to 19th century. During the colonial era many Indian banks were founded either by the Presley States or by wealthy individuals. The primary aim of most of the banks was to cater financial needs of trade and industry in that locality. During this period the banking services became the privilege of big business firms and wealthy individuals. Masses were denied easy credit and banking services. Agriculture and rural small scale industries did not have access to credit facilities and banking services. They depended on village money lenders and other private financiers to fund their activities. These local financial prodders exploited the rural population by charging enormous interest rates and harsh repayment conditions. Nationalization of banks in India by then Indian Prime Minister Indira Gandhi wrote a new chapter in Indian Banking history. The nationalized banks in India were compelled to focus on rural and agricultural sectors as a part of their social responsibility. Their resources were utilized to empower farmers and agricultural laborers in order to free them from the clutches of money lenders. Nationalization of banks in India was done in two phases. The first phase of nationalization started in 1955 when the erstwhile Imperial Bank of India became State Bank of India with an Act of parliament. During 1959, seven subsidiaries were nationalized and associated with State Bank of India one by one. This heralded a new beginning in Indian banking system. The State Bank group became the largest bank in India serving 90 million customers with a network of over 9000 branches in nook and corners of the country. The second phase of nationalization started in 1969 with the nationalization of 14 major commercial banks in India. In 1980, 6 more commercial banks were nationalized and became public sector banks. After this period the Public Sector Undertaking banks expanded their reach and grew in leaps and bounds. The nationalized banks in India expanded their branches and spread their activities across the country. The PSU banks introduced new schemes and programs to cater all sections of the society. Thus the nationalization of Banks in India helped the masses to avail banking services at affordable cost.

11.3.1 Objectives behind Nationalisation of Banks in India

The nationalisation of commercial banks took place with an aim to achieve following major objectives.

1. **Social Welfare:** It was the need of the hour to direct the funds for the needy and required sectors of the Indian economy. Sector such as agriculture, small and village industries were in need of funds for their expansion and further economic development.

2. **Controlling Private Monopolies:** Prior to nationalization many banks were controlled by private business houses and corporate families. It was necessary to check these monopolies in order to ensure a smooth supply of credit to socially desirable sections.

3. **Expansion of Banking:** In a large country like India the numbers of banks existing those days were certainly inadequate. It was necessary to spread banking across the country. It could be done through expanding banking network (by opening new bank branches) in the un-banked areas.

4. **Reducing Regional Imbalance:** In a country like India where we have a urban-rural divide; it was necessary for banks to go in the rural areas where the banking facilities were not available. In order to reduce this regional imbalance Nationalisation was justified.

5. **Priority Sector Lending:** In India, the agriculture sector and its allied activities were the largest contributor to the national income. Thus these were labeled as the priority sectors. But unfortunately they were deprived of their due share in the credit. Nationalisation was urgently needed for catering funds to them.

6. **Developing Banking Habits:** In India more than 70% population used to stay in rural areas. It was necessary to develop the banking habit among such a large population.

11.3.2 Advantages of Nationalization of Commercial Banks

Some of the advantages of Nationalization of Commercial Banks are as follows:

1. To Check on Creation of Industrial Monopoly: Before nationalization of commercial banks credit was concentrated to few hands and this formed Industrial Monopoly. No person except big Industrialist could get loan and advances. This neglected the other smaller industrialist. So, commercial banks were nationalized to curb the monopolizing tendencies.

2. Credit Facility to Priority Sector: Agriculture sector is backbone of India. This sector was neglected at that time. There was no credit facility available to agriculture sector before nationalization.

3. Reduction of Regional Imbalance: Regional imbalances had existed in India for a long time in area of banking facilities. After nationalization, branches opened in backward states like Assam, Bihar, Uttar Pradesh than in developed states like Gujarat, Tamil Nadu etc. These banks reduced the Regional Imbalances.

4. Collection of Saving: Before the Nationalization, the banks did not attract more saving from public. Because people did not trust banking system. But After nationalization of commercial Banks, the deposits were increased. Because public believed in public sector Bank then private sector Banks.

5. To check on Black Money: In order to avoid income tax, people kept money with banks. For the solution of this problem the banks were nationalized.

6. Economic Growth: Before nationalization of banks, economy of country was not growing due to antisocial practices, speculation and hoarding. The country's economy suffered badly. In order to solve this problem banks were nationalized.

7. Export Promotion: Commercial Banks also promotes export. Because there is need to promote export for earn Foreign exchange. So, Banks give Finance to Exporter at concessional rates.

8. Credit Card Facility: Credit card facility is provided by these Banks which has made our life easy. People can buy necessary things through credit card an make payment later on.

9. Promote Small Scale Industry: Nationalized commercial Banks encouraged small scale Industry by granting Loans. These bank grant short term and long term loan to purchase machinery and equipment.

11.3.3 Disadvantages of Nationalization of Commercial Banks

1. Low performance: The biggest problem of nationalized banks has been their low performance. Banks are required to keep minimum capital to risk asset ratio which known as capital adequacy ratio. It should be 9%.Most of public sector banks had negative ratio. Only four banks maintained ratio during 1999-2000.

2. Favouritism: Another limitation of commercial banks was favouritism in granting loan. They harass certain small industrialist and same time banks grant loan to big industrialist on easy terms and conditions. They follow the policy of partiality which affected the trust of client in banks working.

3. Unbalanced Distribution of Credit: In initial years, Agriculture sector got priority and other sector were neglected. Bank do not advance loan to weaker section such as labourers, worker and small trader due to lack of security.

4. Financial Crisis: After nationalization, some banks were operating under losses .This is because banks advance loan without adequate security. Banks grant non performing loans which interest has not been received for 180 days. The recovery of loan was poor which lead to losses. This is main reason for failure of banks.

5. Political Interference: Another limitation of nationalized commercial banks was increasing the political interference in granting loans, appointment of banks personnel, opening of new branches etc.

6. Inadequate Facilities: Nationalized commercial banks have failed to provide adequate facilities and services to population living in rural and sub urban area. Banks failed to mobilize rural deposit.

6.4 Commercial Banks and Economic Development

Commercial banks are considered not merely as dealers in money but also the leaders in economic development. They are not only the store houses of the country's wealth but also the reservoirs of resources necessary for economic development. They play an important role in the economic development of a country. A well-developed banking system is essential for the economic development of a country. The "Industrial Revolution" in Europe in the 19th century would not have been possible without a sound system of commercial banking. In case of developing countries like India, the commercial banks are considered to be the backbone of the economy. Commercial banks can contribute to a country's economic development in the following ways:

1. Accelerating the Rate of Capital Formation: Capital formation is the most important determinant of economic development. The basic problem of a developing economy is slow rate of capital formation. Banks promote capital formation. They encourage the habit of saving among people. They mobilise idle resources for production purposes. Economic development depends upon the diversion of economic resources from consumption to capital formation. Banks help in this direction by encouraging saving and mobilising them for productive uses.

2. Provision of Finance and Credit: Commercial banks are a very important source of finance and credit for industry and trade. Credit is a pillar of development. Credit lubricates all commerce and trade. Banks become the nerve centre of all commerce and trade. Banks are instruments for developing internal as well as external trade.

3**. Monetisation of Economy:** An underdeveloped economy is characterised by the existence of a large non-monetised sector. The existence of this non-monetised sector is a hindrance in the economic development of the country. The banks, by opening branches in rural and backward areas can promote the process of monetisation (conversion of debt into money) in the economy.

4. Innovations: Innovations are an essential prerequisite for economic development. These innovations are mostly financed by bank credit in the developed countries. But in underdeveloped countries, entrepreneurs hesitate to invest in new ventures and undertake innovations largely due to lack of funds. Facilities of bank loans enable the entrepreneurs to step up their investment on innovational activities, adopt new methods of production and increase productive capacity of the economy.

5. Implementation of Monetary Policy: Economic development need an appropriate monetary policy. But a well-developed banking is a necessary pre-condition for the effective implementation of the monetary policy. Control and regulation of credit by the monetary authority is not possible without the active co-operation of the banking system in the country.

6. Encouragement to Right Type of Industries: Banks generally provide financial resources to the right type of industries to secure the necessary material, machines and other inputs. In this way they influence the nature and volume of industrial production.

7. Development of Agriculture: Underdeveloped economies are primarily agricultural economies. Majority of the population in these economies live in rural areas. Therefore, economic development in these economies requires the development of agriculture and small scale industries in rural areas. So far banks in underdeveloped countries have been paying more attention to trade and commerce and have almost neglected agriculture and industry. Banks must provide loans to agriculture for development and modernisation of agriculture. In recent years, the State Bank of India and other commercial banks are granting short term, medium-term and long-term loans to agriculture and small-scale industries.

8. Regional Development: Banks can also play an important role in achieving balanced development in different regions of the country. They transfer surplus capital from the developed regions to the less developed regions, where it is scarce and most needed. This reallocation of funds between regions will promote economic development in underdeveloped areas of the country.

9. Promote Industrial Development: Industrial development needs finance. In some countries, commercial banks encouraged industrial development by granting long-term loans also. Loan or credit is a pillar to development. In underdeveloped countries like India, commercial banks are granting short-term and medium-term loans to industries. They are also underwriting the issue of shares and debentures by industrial concerns. This helps industrial concerns to secure adequate capital for their establishment, expansion and modernisation. Commercial banks are also helping manufacturers to secure machinery and equipment from foreign countries under installment system by guaranteeing deferred payments. Thus, banks promote or encourage industrial development.

10. Promote Commercial Virtues: The businessmen are more afraid of a banker than a preacher. The businessmen should have certain business qualities like industry, forethought, honesty and punctuality. These qualities are called "commercial virtues" which are essential for rapid economic progress. The banker is in a better position to promote commercial virtues. Banks are called "public conservators of commercial virtues."

11. Fulfillment of Socio-economic Objectives: In recent years, commercial banks, particularly in developing countries, have been called upon to help achieve certain socio-economic objectives laid down by the state. For example, nationalised bank in India have framed special innovative schemes of credit to help small agriculturists, self-employed persons and retailers through loans and advances at concessional rates of interest. Banking is thus used to achieve the national policy objectives of reducing inequalities of income and wealth, removal of poverty and elimination of unemployment in the country.

Thus, banks in a developing country have to play a dynamic role. Economic development places heavy demand on the resources and ingenuity of the banking system. It has to respond to the multifarious economic needs of a developing country. Traditional views and methods may have to be discarded. "An Institution, such as the banking system, which touches and should touch the lives of millions, has necessarily to be inspired by a larger social purpose and has to sub serve national priorities and objectives." A well-developed banking system provides a firm and durable foundation for the economic development of the country.

11.5 Banking Sector Reforms in India:

Indian financial system, especially the banking industry has experienced a process of significant structural transformations in the last few decades. Banking today is re-defined and reengineered with the development of sophisticated instruments and innovations in market practices. The financial sector reforms introduced as an integral part of the new economic reforms initiated in 1991 have touched upon almost all aspects of the banking sector. For a few decades preceding the onset of banking and financial sector reforms in India, banks operated in an environment that was heavily regulated and characterised by sufficient barriers to entry which protected them against much competition. The main thrust of the financial sector reforms has been the creation of a strong, efficient, and stable financial structure for the economy with greater element of market discipline in the context of liberalisation.

In August 1991, the Government appointed a Committee under the Chairmanship of Shri. M. Narasimham (Popularly known as Narasimham Committee I) to examine all the aspects relating to the structure, organisation, functions and procedures of the financial system in the context of liberalisation of banking practices. The aim of this Committee was to bring 'operational flexibility' and 'functional autonomy' so as to enhance efficiency, productivity and profitability of the banks. The Committee submitted its report in November, 1991. Shri. M. Narasimham chaired another committee on banking sector reforms which submitted its report in April, 1998. This committee is known as Narasimham Committee II which focused on bringing about structural changes so as to strengthen the foundations of Indian banking system.

The broad objectives of the financial sector reforms contain two major thrusts, namely:

(1) The thrust towards liberalisation which seeks to reduce direct controls over banks and other financial market participants, and
(2) The thrust towards stronger regulation of the financial sector. The approach towards financial sector reforms in India is based on the following principles:

1. Cautious and appropriate sequencing of reforms measures.
2. Introduction of the norms that are mutually reinforcing.
3. Introduction of complementary reforms across monetary, fiscal and external sectors.
4. Development of financial institutions.
5. Development of more transparent and efficient financial markets.

Considering the situation, it can be observed that the main objective of Indian banking sector reforms was 'to promote a diversified, efficient and competitive financial system with the ultimate goal of improving the allocative efficiency of resources through operational flexibility, improved financial viability and institutional strengthening.' The major highlights Indian financial sector reforms are listed below:

1. Interest rate liberalisation and disbanding of administered interest rates.
2. Enhancing the role of market forces by making sharp reduction in pre-emption through reserve requirements.
3. Conveying operational autonomy to public sector banks with focus on competition enhancing measures.
4. Market determined pricing for Government securities.
5. Enhanced transparency and disclosure norms to facilitate market discipline.
6. Introduction of pure inter-bank call money market.
7. Auction-based repos and reverse repos for short term liquidity management.
8. Facilitation of improved payments and settlement mechanism.
9. Requirement of significant advancements in dematerialisation and markets for securitized assets.

10. Establishment of uniform prudential norms of regulation and supervision.

11. Introduction and phased implementation of international best practices on risk-weighted capital adequacy requirements, accounting, income recognition, provision and exposure.
12. Suitable measures to strengthen risk management through recognition of different components of risk.
13. Application of market-to-market principle for investment portfolio and limits on deployment of funds in sensitive areas.
14. 'Know Your Customer (KYC)' and 'Anti Money Laundering' guidelines. India adopted Basel I guidelines in 1999 while Basel II guidelines were implemented in phases by 2009. The Basel III capital regulations have been implemented in India from April 1,2013 in phases and will be fully implemented as on March 31, 2018. The performance of the Indian economy is one of the strongest drivers for the banking industry's growth and vice versa.

A boost in the banking industry is expected from the rising per capita income in India, which along with a growth in the earning population of the country will lead to a higher number of people utilising banking services. A World Bank Survey conducted in 2011 revealed that only 35 per cent of all adults in India had a bank account with a formal banking institution, while this figure stood at 21 per cent in the poorest income quantile. This represents a massive opening that financial institutions in the country can leverage upon for future growth.

Further, the policies of the Reserve Bank have prioritized 'financial Inclusion' which broadens the resource base of the financial system by developing a banking culture among the hitherto financially excluded Indian population. Concerted efforts were initiated by the Government and RBI to promote 'financial inclusion' as one of the important national objectives of the country. Sustained government support and a careful re-evaluation of existing business strategies can set the stage for Indian banks to become bigger and stronger, thereby setting the stage for expansions into a global consumer base.

Exercise 11.1

1. Write a note on Nationalization of banks in India.
2. Discuss the structure of commercial banks in India.

11.6 Summary

Commercial banks play a very significant role in development of Indian banking system. No country can progress without organized baking system. Commercial banks also promote economic development and social welfare activities in India. These banks provide loan and advances to priority sectors.

11.7.Glossary

1. **Public sector banks:** These are banks where majority stake is held by the Government of India or Reserve Bank of India.

2. **Private Banks** are banks that the majority of share capital is held by private individuals.

3. **Foreign banks** are registered and have their headquarters in a foreign country but operate their branches in India.

4. **Non-Scheduled Banks:** Non-Scheduled banks refer to those banks which are not included in the Second Schedule of Reserve Bank of India Act, 1934.

5. **Scheduled Banks:** Scheduled Banks refer to those banks which have been included in the Second Schedule of Reserve Bank of India Act, 1934.

11.8 Answers to Self-Check Exercises

Exercise 6.1

Answer 1. Refer to section 11.3.

Answer 2. Refer to section 11.2.

11.9. Suggested Readings

1. Hajela, T.N., (2009) Money and Banking, Ane Books Pvt Ltd., New Delhi.

2. Sundharam KPM, Banking: Theory, Law and Practice, Sultan Chand and Sons, New Delhi.

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7. R. R. Paul, Money, Banking & International Trade, Kalyani Publications, Ludhiana.

11.10. Terminal Questions

Q1. Define Commercial banks. Discuss the advantages and disadvantages of nationalization of commercial banks.

Q2. Write a note on Reform on banking sector.

LESSON 12
CENTRAL BANKING

STRUCTURE

12.0 Objectives

After studying this lesson you will be able to

- Understand what central banking is;
- Know about the organisation of RBI;
- Point out various functions of RBI;
- Know about various objectives of RBI;
- Understand what is credit control;
- Understand the qualitative methods of credit control;
- Understand the quantitative methods of credit control.

12.1 Introduction

Central Bank is an apex financial institution of a country. It is needed to regulate and control the monetary system of an economy. The need for a central bank in India was felt during 18th century. The earliest attempts to set up a central bank dates back to 1773 when Warren Hastings recommended to establish the “General Bank of Bengal and Bihar” as Central Bank of India. In 1913 Lord Keynes also recommended to set up a Central Bank. Later on in 1921, by amalgamating three presidency Banks (Presidency Bank of Bengal, Presidency Bank of Madras and Presidency Bank of Bombay), Imperial Bank of India was set up.

Though Imperial Bank of India performed certain central banking function, but the right of Note issue was not given to Imperial Bank of India and Government of India performed the function of credit control. The establishment of a Central Bank that would issue notes and at the same time function as banker to the Government was recommended in 1926 by the Royal Commission in India Currency and Finance (known as the Hilton Young Commission). In 1931, Central Banking inquiry committee also recommended for setting up of a Central Bank in India.

In 1933, the “Round Table Conference” also suggested to set up a Central Bank free from political influence. As a result of all these recommendations and suggestions, a fresh bill was passed by the assembly on December 22, 1933 and got Governor General Ascent on March 6, 1934. Thus the Reserve Bank of India started working since, 1st April, 1935 in accordance with the provision of the Reserve Bank of India Act, 1934.

The pattern of central banking in India was based on the Bank of England. England has a highly developed banking system in which the functioning of the central bank as a banker’s bank and their regulation of money supply set the pattern. The central bank’s function as ‘lender of last resort’ was on the condition that the banks maintain stable cash ratios as prescribed from time to time. The effective functioning of the British model depends on an active securities market where open market operations can be conducted at the discount rate. The effectiveness of open market operations however depends on the member bank’s dependence on the central bank and the influence it wields on interest rates. Later models, especially those in developing countries showed that central banks play an advisory role and render technical services in the field of foreign exchange, foster the growth of a sound financial system and act as a banker to government.

12.2 Central Bank

The central bank of the country is the Reserve Bank of India (RBI). It was established in April 1935 with a share capital of Rs. 5 crores on the basis of the recommendations of the Hilton Young Commission. The share capital was divided into shares of Rs. 100 each fully paid which was entirely owned by private shareholders in the beginning. The Government held shares of nominal value of Rs. 2,20,000.

12.2.1 Meaning

Reserve Bank of India is the central bank of the country which was nationalised in the year 1949. It is an apex institution which has been guiding, monitoring, regulating, controlling and promoting the destiny of IFS since its inception. It is oldest among the central banks in the developing countries. The Central Bank differs from other financial institutions. First, it differs in that it is controlled by the people who are more or less closely connected with other organs of government. Second, it does not exist to secure the maximum profit, which is the principal aim of a commercial bank. Third, the central bank must have a special relation with the commercial banks whereby it may influence the operations of these institutions in the implementation of the government’s economic policy. The Reserve Bank of India Act, 1934 was commenced on April 1, 1935. The Act, 1934 (II of 1934) provides the statutory basis of the functioning of the Bank. The Bank was constituted for the need of following:

- To regulate the issue of banknotes
- To maintain reserves with a view to securing monetary stability and
- To operate the credit and currency system of the country to its advantage.

12.2.2 Preamble

The Preamble of the Reserve Bank of India describes the basic functions of the Reserve Bank as:

" ..to regulate the issue of Bank Notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage."

12.2.3 Management

The Reserve Bank's affairs are governed by a central board of directors. The board is appointed by the Government of India in keeping with the Reserve Bank of India Act. The organization structure of RBI consists of a Central Board and Local Board.

12.2.3.1 Central Board: The general supervision and control of the bank's affairs is vested in the Central Board of Directors which consists of 20 member team including a Governor, 4 Deputy Governors and 15 Directors (of which 4 are from local boards, and one is a finance secretary of Central Government). All these persons are appointed or nominated by Central Govt. The chairman of the Board and its Chief Executive authority is the Governor. Governors and Deputy Governors hold office for such a period as fixed by Central Government not exceeding 5 years and are eligible for reappointment. Directors hold office for 4 years and their retirement is by rotation.

As a matter of practical convenience, the Board has delegated some of its functions to a committee called the Committee of the Central Board. It meets once in a week, generally Wednesdays. There are sub committees to assist committees such as building committee and staff sub-committee.

12.2.3.2 Local Board: For each regional areas of the country viz., Western, Eastern, Northern and Southern, there is a Local Board with head quarters at Bombay, Calcutta, New Delhi and Madras. Local boards consist of 5 members each appointed by the Central Government. The functions of the local boards are to advise the central board on local matters and to represent territorial and economic interests of local cooperative and indigenous banks; advice on such matters that may generally be referred to them and perform such duties as the Central Board may delegate to them.

12.2.3.3 Departments

The Central office of the RBI, located at Mumbai is divided into several specialized departments. The main departments are:

1. Issue Department: - It arranges for the issue and distribution of currency notes among the different centres of the country.

2. Banking Department: - It deals with Government transactions and maintains the cash reserves of the commercial banks.

3. Department of Banking development:- It is concerned with the development of banking facilities in the unbanked and rural areas in the country.

4. Department of Banking operations: - This department supervises and controls the working of the banking institutions in the country.

5. Non-Banking Companies Department: - It regulates the activities of non-banking financial companies existing in the country.

6. Agricultural credit Department: - This department studies the problems connected with the agricultural credit in the country.

7. Industrial finance Department: - It is concerned with the provision of finance to the industrial units in the country.

8. Exchange control Department: - The entire business of sale and purchase of foreign exchange is conducted by this department.

9. Legal Department: - The main function of this department is to give legal advices to the other departments of RBI.

10. Department of Research and Statistics: - This department is concerned with conducting research on problems relating to money, credit, finance, production etc.

12.3 Objectives of RBI

Prior to the establishment of the Reserve Bank, the Indian financial system was totally inadequate on account of the inherent weakness of the dual control of currency by the Central Government and of credit by the Imperial Bank of India.

The Preamble to the Reserve Bank of India Act, 1934 spells out the objectives of the Reserve Bank as: “to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage.”

The important objectives are:

1. To act as Monetary Authority: Formulates implements and monitors the monetary policy to maintain price stability and ensuring adequate flow of credit to productive sectors.

2. To Regulate and supervise the financial system of the country: It prescribes broad parameters of banking operations within which the country's banking and financial system functions. It helps to maintain public confidence in the system, protect depositors' interest and provide cost-effective banking services to the public.

3. To Manage the Exchange Control: Manages the Foreign Exchange Management Act, 1999 to facilitate external trade and payment and promote orderly development and maintenance of foreign exchange market in India.

4. To issue currency: Issues and exchanges or destroys currency and coins not fit for circulation to give the public adequate quantity of supplies of currency notes and coins and in good quality.

5. To undertake developmental role: RBI performs a wide range of promotional functions to support national objectives.

6. To undertake related Functions by acting as:

- Banker to the Government: performs merchant banking function for the central and the state governments; also acts as their banker.
- Banker to banks: maintains banking accounts of all scheduled banks.
- Owner and operator of the depository (SGL-Subsidiary General Ledger account) and exchange (NDS) Negotiated Dealing System is an electronic platform for facilitating dealing in Government Securities and Money Market Instruments that will facilitate electronic submission of bids/application for government bonds.

To sum up the objectives include:

1. To manage the monetary and credit system of the country.

2. To stabilizes internal and external value of rupee.

3. For balanced and systematic development of banking in the country.

4. For the development of organized money market in the country.

5. For facilitating proper arrangement of agriculture finance and be in successful for maintaining financial stability and credit in agricultural sector.

6. For proper arrangement of industrial finance.

7. For proper management of public debts.

8. To establish monetary relations with other countries of the world and international financial institutions.

9. For centralization of cash reserves of commercial banks.

10. To maintain balance between the demand and supply of currency.

11. To regulate the financial policy and develop banking facilities throughout the country.

12. To remain free from political influence while making financial decisions

13. To assist the planned process of development of the Indian economy. Besides the traditional central banking functions, with the launching of the five-year plans in the country, the Reserve Bank of India has been moving ahead in performing a host of developmental and promotional functions, which are normally beyond the purview of a traditional Central Bank.

Exercise 12.1

1. What do you mean by "Central Banking". Explain in detail.

2. Discuss the organisation of Reserve Bank of India?

3. Discuss various objectives of Reserve Bank of India?

12.4 Functions of RBI

RBI performs various traditional banking function as well as promotional and developmental measures to meet the dynamic requirements of the country. Main functions of RBI can be broadly classified into three. These are

I. Monetary functions or Central banking functions

II. Supervisory functions

III. Promotional and Developmental functions.

12.4.1 Monetary Functions

A. Issue of currency notes

B. Acting as banker to the Government

C. Serving as banker of other banks

D. Controlling credit

E. Controlling foreign exchange operations

A. Issue of currency notes: -

Under Section 22 of the Reserve Bank of India Act of 1934, the Reserve Bank of India is given the monopoly of note issue. Now RBI is the sole authority for the issue of currency notes of all denominations except one rupee notes and coins in the country. One rupee notes and coins are issued by Ministry of Finance of GOI. The RBI has a separate department called the Issue Department for the issue of currency notes. Since 1956 system of Note Issue changed from Proportional Reserve System to minimum reserve system. Under Proportional reserve system of note issue, not less than 40% of the total volume of notes issue by the RBI was to be covered by gold coins, bullion and foreign securities. But under the Minimum reserve system of note issue, RBI is required to maintain a minimum reserve of gold or foreign securities or both against the notes issued. No maximum limit is fixed on the volume of notes. RBI maintains gold and foreign exchange reserves of Rs.200 crores of which 115 crores is in gold & balance in foreign securities, Govt. of India securities, eligible commercial bills, Pro-notes of NABARD for any loans etc.

This change from Proportional Reserve system to Minimum Reserve system is made because of two major reasons. Firstly, the planned economic development of the country called for an increased supply of money, which could not be had under the proportional reserve system. Secondly, the foreign exchange held as reserve by the Reserve bank had to be released for financing the five year plans. In short, this was to enable the expanding currency requirements of the economy.

B. Acting as Banker to government: -

The Reserve bank act as a banker to the Central and State Governments. As a banker to the Government RBI acts in three capacities, viz., (a) as a banker,(b) as a financial agent, and (c) as a financial advisor (a) As a banker: - RBI renders the following services

1. Accepts deposits from the Central and State Government.

2. Collects money on behalf of Government.

3. Makes payments on behalf of the Government, in accordance with their instructions.

4. Arranges for the transfer of funds from one place to another on behalf of the Governments

5. Makes arrangements for the supply of foreign exchange to the Central and State Governments.

6. It maintains currency chests with treasuries and other agencies in places prescribed by the Government of India. These chests are supplied with sufficient currency notes to meet the requirements for the transactions of the Government.

7. Short term advances are granted to Central and State Governments for a period not exceeding three months. These advances are granted up to a certain limit without any collateral securities.

8. In times of emergencies like war, extraordinary loans are also granted to the Governments by the RBI.

(b) As a financial agent: - The services given are

1. Acts as an agent of the Central and State Governments in the matter of floatation of loans. On account of Reserve Bank's intimate knowledge of the financial markets, it is able to obtain the best possible terms for the Government in this matter. Further by coordinating the borrowing programmers of the various Governments, it is able to minimize the adverse effects of Government borrowings on the money and securities market.

2. On behalf of Central Government RBI sells treasury bills of 90 days maturity at weekly auctions and secures short-term finance for the Central Government. Apart from that RBI also sells adhoc treasury bills of 90 day's maturity to the State Governments, Semi-Government Departments and foreign central banks on behalf of the Central Government.

3. RBI manages and keeps the accounts of the public debts of the Central and State Governments. It arranges for the payment of interest and principal amount on the public debt on the due dates.

4. As an agent RBI also represents Government of India in the International institutions like the IMF, the IBRD etc.

The Reserve Bank is agent of Central Government and of all State Governments in India except for that of Jammu and Kashmir and Sikkim.

(c) As a Financial Adviser: - renders following services

1. It advices the Central and State Government on all financial and economic matters such as the floating of loans, agricultural and industrial finance etc.

2. Advice on matters of International finance is also given to Central Government.

3. It collects the recent information on current economic and financial developments in India and abroad, with the help of its Research and Statistics Department and keeps Government informed periodically.

Banker's bank: -

RBI acts as banker to Scheduled banks. Scheduled Banks include commercial banks, foreign exchange banks, public sector banks, state co-operative banks and the regional rural banks. As a bankers' bank it renders the following services:

1. It holds a part of the cash balances of the commercial banks:- Every commercial bank in India is required to keep with the Reserve Bank a cash balance of not less than 6% of its demand and time liabilities. This rate can be increased up to 20%. The two main purposes of maintaining cash reserve by commercial banks are as follows. Firstly to protect the interest of the depositors, secondly to enable the Reserve Bank to accommodate the commercial banks on times of difficulties and thirdly the Reserve Bank can control the credit created by the commercial banks by varying the statutory cash reserve requirements.

2. It acts as the clearing house: - By acting as clearing house the Reserve bank helps the member banks in the settlement of the mutual indebtedness without physical transfer of cash.

3. It provides cheap remittance facilities to the commercial banks

4. It provides financial accommodation to the commercial banks: - At times of financial crisis the RBI is the lender of last resort for the commercial banks. Financial assistance is given by The Reserve bank either by rediscounting eligible bills or by granting loans against approved securities.

D. Control of Credit: -

RBI undertakes the responsibility of controlling credit in order to ensure internal price stability and promote sufficient credit for the economic growth of the country. Price stability is essential for economic development. To control credit, RBI makes use of both quantitative and qualitative weapons by virtue of the powers given to it by Reserve Bank of India Act of 1934 and the Indian Banking Regulation Act of 1949.

These weapons are listed below.

(a) Quantitative weapons

1. Bank rate policy:

Bank rate is the lending rate of central bank. It is the official minimum rate at which central bank of a country rediscounts the eligible bills of exchange of the commercial banks and other financial institutions or grants short term loans to them. By increasing bank rate, RBI can make bank credit costlier.

2. Open Market Operations:

RBI Act authorizes the RBI to engage in the purchase of securities of central and State Government and such other securities as specified by Central Govt. But by and large, its open market operations are confined to Central Government Securities and to a very limited extend to State Government Securities. RBI uses this weapon to offset the seasonal fluctuations in money market. When there is an excessive supply of money, RBI sells the securities in the open market. In that way RBI is able to withdraw the excess money from circulation. But when there is shortage of money supply in the market, it purchases securities from the open market and as a result, more money is arrived at for circulation

3. Variable Cash reserve ratio:

Under the RBI Act of 1934, every scheduled and non- scheduled bank is required to maintain a fixed percentage of total time and demand liabilities as cash reserve with RBI. It is called statutory Cash Reserve Ratio (CRR). An increase in CRR reduces lending capacity of the bank and a decrease in CRR increases the lending capacity. RBI can prescribe a CRR ranging up to 15% which is at present 4% (as on Jan ’2014).

4. Variable Statutory Liquidity Ratio;

According to sec 24 of BRA 1949, every commercial bank is required to maintain a certain percentage of its total deposits in liquid assets such as cash in hand, excess reserve with RBI, balances with other banks, gold and approved Government and other securities. This proportion of liquid assets to total deposits is called SLR. BRA empowers RBI to fix the SLR up to 40%. The variation of the SLR is intended to reduce the lendable funds in the hands of the commercial banks and to check the expansion of bank credit. An increase in SLR will decrease the lendable funds in the hands of commercial banks and vice versa. Present rate of SLR is 23%. (As on Jan ’2014).

5. Repo Rate and Reverse Repo Rate;

Repo rate is the rate at which RBI lends to commercial banks generally against government securities. Reduction in Repo rate helps the commercial banks to get money at a cheaper rate and increase in Repo rate discourages the commercial banks to get money as the rate increases and becomes expensive. Reverse Repo rate is the rate at which RBI borrows money from the commercial banks. The increase in the Repo rate will increase the cost of borrowing and lending of the banks which will discourage the public to borrow money and will encourage them to deposit. As the rates are high the availability of credit and demand decreases resulting to decrease in inflation. This increase in Repo Rate and Reverse Repo Rate is a symbol of tightening of the policy. As of October 2013, the repo rate is 7.75 % and reverse repo rate is 6.75%. On January 28, 2014, RBI raised repo rate by 25 basis points to 8.00 %.

b. Selective credit controls (Qualitative weapons)

1. Credit Ceiling

In this operation RBI issues prior information or direction that loans to the commercial banks will be given up to a certain limit. In this case commercial bank will be tight in advancing loans to the public. They will allocate loans to limited sectors. Few example of ceiling are agriculture sector advances, priority sector lending.

2. Credit Authorization Scheme

Credit Authorization Scheme was introduced in November, 1965 when P C Bhattacharya was the chairman of RBI. Under this instrument of credit the commercial banks are required to obtain the RBI's prior authorization for sanctioning any fresh credit beyond the authorized limits.

3. Moral Suasion

Moral Suasion is just as a request by the RBI to the commercial banks to follow a particular line of action. RBI may request commercial banks not to give loans for unproductive purpose which does not add to economic growth but increases inflation.

4. Regulation of margin requirements

Margin refers to the difference between loan amount and the market value of collateral placed to raise the loan. RBI fixes a lower margin to borrowers whose need is urgent. For e.g. if RBI believes that farmers should be financed urgently, RBI would direct to lower the margin requirement on agricultural commodities. RBI has used this weapon for a number of times.

5. Issuing of directives

BRA empowers RBI to issue directives to banks and banks are bound to comply with such directives. RBI directives may relate to:

- Purpose for which advance may or may not be made
- Margins requirement
- Maximum amount of loan that can be sanctioned to any company, firm or individual
- Rate of interest and other terms and conditions on which loans may be given

E. Control of foreign Exchange operations

One of the central banking functions of the RBI is the control of foreign exchange operations. For the control of foreign exchange business, the RBI has set up a separate department called the Exchange Control Department in September, 1939. This Department has been granted wide powers to regulate the foreign exchange business of the country. As the central bank of India, it is the responsibility of the RBI to maintain the external value of the Indian rupee stable. India being member of the IMF, the RBI is required to maintain stable exchange rates between the Indian rupee and the currencies of all other member countries of the I.M.F.

Besides maintaining stable exchange rates, RBI also acts as the custodian of the foreign exchange reserves of the country. The foreign exchange reserves of the country held by RBI includes Euro, U.S. dollars, Japanese yen etc RBI also acts as the administrator of exchange control. It ensures that the foreign exchange reserves of the country are utilized only for approved purposes and the limited foreign exchange reserves of the country are conserved for the future.

12.4.2. Supervisory Functions

RBI has been given several supervisory powers over the different banking institutions in the country. The supervisory functions relate to licensing and establishment, branch expansion, liquidity of assets, amalgamation, reconstruction and liquidation of commercial banks and cooperative banks

12.4.3. Promotional and Developmental Functions

RBI is also performing promotional and developmental functions. These functions includes the following

a) Provision of Agricultural Credit:

For the promotion of agricultural credit RBI has set up a separate department called the Agricultural Credit Department. It. has also set up two funds namely –

1. The National Agricultural Credit (Long term operations) and

2. The National Agricultural credit (stabilization) fund for facilitating Long term, Medium term and Short term finance for agricultural purposes.

b) Provision for Industrial finance:

RBI has played a very significant role in the field of industrial finance by helping the setting up of a number of public sector industrial finance corporations that provide short term, medium term, and long term finance for industrial purpose. These industrial finance corporations include

1. Industrial finance Corporation of India (IFCI),
2. State Finance Corporations (SFC), Industrial Development Bank of India (IDBI),
3. Industrial Reconstruction Corporation of India (IRCI),
4. Refinance Corporation of India, and
5. Unit Trust of India (UTI)

Besides the above RBI also renders the Credit Guarantee Scheme which intends to give protection to banks against possible losses in respect of their advances to small scale industrial units.

c.) Development of Bill Market:

A bill market is a place where short term bill of 3 month duration are generally discounted or rediscounted. RBI plays a very important role in the promotion of Bill Market as a well-developed bill market is essential for the smooth functioning of the credit system.

d.) Collection and publication of statistics on financial and economic matters:

These functions of RBI are extremely useful to the Government in knowing and solving the various economic problems. They are also of immense help to financial institutions, business and industry and for general public.

e.) Miscellaneous functions:

RBI has established training centres for staff for its own staff and other banks. Bankers' training college Mumbai, National Institute of Bank Management Mumbai, Staff Training College Madras, and College of Agricultural Banking at Pune are the institutions run by RBI.

Exercise 12.2

1. What do you mean by "Credit Control"? Explain in detail.
2. Write short note on following:

a) Bank Rate

b) Open Market Operations

c) Credit Rationing

12.5 Summary

The Central Bank is the apex monetary institution in the money market which acts as the monetary authority of the country, and serves as the government bank as well as the banker's bank. It undertakes the major financial operations of the government; by its conduct of these operations and by other means, it influences the behaviour of financial institutions to ensure that they support the economic policy of the government. The primary focus of the RBI in conduct of money market operations is on ensuring that the liquidity and short term interest rates are maintained at levels consistent with the monetary policy objectives of maintaining price stability, ensuring adequate flow of credit to productive sectors of the economy and bringing about orderly conditions in the foreign exchange market.

12.6 Glossary

1. **Central Bank** is an apex financial institution of a country. It is needed to regulate and control the monetary system of an economy.
2. **Bank rate** is the lending rate of central bank. It is the official minimum rate at which central bank of a country rediscounts the eligible bills of exchange of the commercial banks and other financial institutions or grants short term loans to them.
3. **Statutory Liquidity Ratio;** every commercial bank is required to maintain a certain percentage of its total deposits in liquid assets such as cash in hand, excess reserve with RBI, balances with other banks, gold and approved

Government and other securities. This proportion of liquid assets to total deposits is called Statutory Liquidity Ratio.

4. **Repo rate** is the rate at which RBI lends to commercial banks generally against government securities.
5. **Reverse Repo rate** is the rate at which RBI borrows money from the commercial banks.
6. **Moral Suasion** is just as a request by the RBI to the commercial banks to follow a particular line of action.
7. **Margin** refers to the difference between loan amount and the market value of collateral placed to raise the loan.

12.7 Answers to Self Check Exercises

Exercise 12.1

Answer 1. Refer to section 12.3.

Answer 2. Refer to section 12.4.1 and 12.4.2.

Exercise 12.2

Answer 1. Refer to section 12.3.

Answer 2. Refer to section 12.4.1 and 12.4.2.

12.8 Suggested Readings

1. Hajela, T.N., (2009) Money and Banking, Ane Books Pvt Ltd., New Delhi.

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12.9 Terminal Questions

Q1. “Central Bank is an apex financial institution of the country”. Elaborate.

Q2. What are the various methods of credit control by RBI?

LESSON 13
MONETARY POLICY

STRUCTURE

13.0 Objectives

After studying this lesson you will be able to

- Define monetary policy
- State the objectives of monetary policy
- List and explain the various instruments of monetary policy
- Identify the limitations of monetary policy

13.1 Introduction

In the economic literature, there seems to be near unanimity that monetary policy is a powerful instrument for improving the macro-economic position of a country. Monetary policy has been considered to be an important organ of economic policy. Hence, the objectives of monetary policy by and large coincide with the objectives of the overall economic policy. The three major objectives of economic policy in India have been growth, social justice and price stability. Though it is widely recognised that the objective of price stability is one that can be pursued most effectively by monetary policy, in practice, the monetary policy has contributed significantly to the attainment of other objectives as well. However, the successful design and implementation of monetary policy depends upon the prevailing economic situation and structural factors such as the proportion of currency in money supply, size of the public debt, size of the non monetised sector in the economy etc.

Since monetary policy influences the ultimate objectives through its instruments, the problem of identifying targets assumes relevance. A monetary policy target whether intermediate or final, carries important signals to the markets, conveys the monetary policy stance in unambiguous terms and helps anchoring inflationary expectations in the economy. Traditionally, money supply, bank credit and interest rates were considered as monetary policy targets. But in recent times, for aiming at intermediate target, viz, broad money, the overacting target has been reserve money, particularly the bank reserves, while the supplementary operating target is the short term interest rate. Again, against, the backdrop of the desired objectives of the monetary policy, it would be necessary to examine an array of instruments. The various major instruments of monetary policy are open market operation, statutory liquidity ratio, cash reserve ratio, bank rate policy, interest rate policy, refinancing facilities and money market measures.

13.2 Monetary Policy

Monetary policy is the process by which monetary authority of a country, generally a central bank controls the supply of money in the economy by exercising its control over interest rates in order to maintain price stability and achieve high economic growth. In India, the central monetary authority is the Reserve Bank of India (RBI). It is so designed as to maintain the price stability in the economy

Monetary policy can be either expansionary or contractionary. Under an expansionary policy the total supply of money are increased in the economy more rapidly than usual, and under contractionary policy the money supply expands more slowly than usual or even shrinks. Expansionary policy is traditionally used to reduce unemployment in a recession by lowering interest rates in the hope that easy credit will encourage the entrepreneurs to begin new enterprise or expand their existing businesses. Contractionary policy is intended to slow inflation in order to avoid the resulting distortions and deterioration of asset values.

13.2.1 Definition

1. According to Prof. Harry Johnson, "A policy employing the central banks control of the supply of money as an instrument for achieving the objectives of general economic policy is a monetary policy."
2. According to A.G. Hart, "A policy which influences the public stock of money substitute of public demand for such assets of both that is policy which influences public liquidity position is known as a monetary policy."

From both these definitions, it is clear that a monetary policy is related to the availability and cost of money supply in the economy in order to attain certain broad objectives. The Central Bank of a nation keeps control on the supply of money to attain the objectives of its monetary policy.

13.3 Objectives of the monetary policy

The objectives of a monetary policy in India are similar to the objectives of its five year plans. In a nutshell planning in India aims at growth, stability and social justice. The objectives of the monetary policy of India, as stated by RBI, is:

1. **Price Stability:** It implies promoting economic development with considerable emphasis on price stability. The centre of focus is to facilitate the environment which is favorable to the architecture that enables the developmental projects to run swiftly while also maintaining reasonable price stability. All the economics suffer from inflation and deflation. It can also be called as Price Instability. Both are harmful to the economy. Thus, the monetary policy having an objective of price stability tries to keep the value of money stable. It helps in reducing the income and wealth inequalities. When

the economy suffers from recession the monetary policy should be an 'easy money policy' but when there is inflationary situation there should be a 'dear money policy'.

2. **Rapid Economic Growth:** It is the most important objective of a monetary policy. The monetary policy can influence economic growth by controlling real interest rate and its resultant impact on the investment. If the RBI opts for a cheap or easy credit policy by reducing interest rates, the investment level in the economy can be encouraged. This increased investment can speed up economic growth. Faster economic growth is possible if the monetary policy succeeds in maintaining income and price stability.

3. **Controlled Expansion of Bank Credit:** One of the important functions of RBI is the controlled expansion of bank credit and money supply with special attention to seasonal requirement for credit without affecting the output.

4. **Exchange Rate Stability:** Exchange rate is the price of a home currency expressed in terms of any foreign currency. If this exchange rate is very volatile leading to frequent ups and downs in the exchange rate, the international community might lose confidence in our economy. The monetary policy aims at maintaining the relative stability in the exchange rate. The RBI by altering the foreign exchange reserves tries to influence the demand for foreign exchange and tries to maintain the exchange rate stability

5. **Balance of Payments (BOP) Equilibrium:** Many developing countries like India suffer from the Disequilibrium in the BOP. The Reserve Bank of India through its monetary policy tries to maintain equilibrium in the balance of payments. The BOP has two aspects i.e. the 'BOP Surplus' and the 'BOP Deficit'. The former reflects an excess money supply in the domestic economy, while the later stands for stringency of money. If the monetary policy succeeds in maintaining monetary equilibrium, then the BOP equilibrium can be achieved.

6. **Equal Income Distribution:** Many economists used to justify the role of the fiscal policy in maintaining economic equality. However in recent years economists have given the opinion that the monetary policy can help and play a supplementary role in attaining an economic equality. Monetary policy can make special provisions for the neglect supply such as agriculture, small-scale industries, village industries, etc. and provide them with cheaper credit for longer term. This can prove fruitful for these sectors to come up. Thus in recent period, monetary policy can help in reducing economic inequalities among different sections of society.

7. **Neutrality of Money:** Economist such as Wicksteed, Robertson has always considered money as a passive factor. According to them, money should play only a role of medium of exchange and not more than that. Therefore, the monetary policy should regulate the supply of money. The change in money supply creates monetary disequilibrium. Thus monetary policy has to regulate the supply of money and neutralize the effect of money expansion. However this objective of a monetary policy is always criticized on the ground that if money supply is kept constant then it would be difficult to attain price stability.

8. **Full Employment:** The concept of full employment was much discussed after Keynes's publication of the "General Theory" in 1936. It refers to absence of involuntary unemployment. In simple words 'Full Employment' stands for a situation in which everybody who wants jobs get jobs. However it does not mean that there is Zero unemployment. In that senses the full employment is never full. Monetary policy can be used for achieving full employment. If the monetary policy is expansionary then credit supply can be encouraged. It could help in creating more jobs in different sector of the economy.
9. **Promotion of Fixed Investment:** The aim here is to increase the productivity of investment by restraining non-essential fixed investment.
10. **Promotion of Exports and Food Procurement Operations:** Monetary policy pays special attention in order to boost exports and facilitate the trade. It is an independent objective of monetary policy.
11. **Desired Distribution of Credit:** Monetary authority has control over the decisions regarding the allocation of credit to priority sector and small borrowers. This policy decides over the specified percentage of credit that is to be allocated to priority sector and small borrowers.
12. **Equitable Distribution of Credit:** The policy of Reserve Bank aims equitable distribution to all sectors of the economy and all social and economic class of people.
13. **To Promote Efficiency:** It is another essential aspect where the central banks pay a lot of attention. It tries to increase the efficiency in the financial system and tries to incorporate structural changes such as deregulating interest rates, ease operational constraints in the credit delivery system, to introduce new money market instruments etc.
14. **Reducing the Rigidity:** RBI tries to bring about the flexibilities in the operations which provide a considerable autonomy. It encourages more competitive environment and diversification. It maintains its control over financial system whenever and wherever necessary to maintain the discipline and prudence in operations of the financial system.

13.4 Instruments of Monetary policy

Instruments of Monetary operations involve monetary techniques which operate on monetary magnitudes such as money supply, interest rates and availability of credit aimed to maintain Price Stability, Stable exchange rate, Healthy Balance of Payment, Financial stability, Economic growth etc. RBI, the apex institute of India which monitors and regulates the monetary policy of the country stabilizes the price by controlling Inflation.RBI takes into account the following monetary policies:

The instruments of monetary policy and control can be classified into two:-

13.4.1 Quantitative weapons (Indirect Instruments)

Quantitative methods or weapons are those which control total volume or size of credit in the country without any reference to the purpose for which it is used. They affect indiscriminately all sections of the economy. Important quantitative weapons are:

a. Bank rate policy

b. Open market operations

c. Variable Cash Reserve Ratio (CRR)

d. Variable Statutory Liquidity Ratio (SLR)

e. Liquidity Adjustment Facility (LAF) includes Repo rate and Reverse Repo rate

f. Marginal Standing Facility (MSF)

The details review of the quantitative methods of monetary policy are discussed here under.

a. Bank rate policy: - Section 49 of RBI Act, 1934 defines the bank rate as "the standard rate at which the Reserve Bank is prepared to buy or rediscount bills of exchange or other commercial papers eligible for purchase under the Act". Thus bank rate is the minimum rate at which the RBI is ready to rediscount eligible bills of exchange or other commercial papers presented to it by the commercial banks or grant loans to the commercial banks against approved securities. By manipulating the bank rate the RBI can control the bank credit and the general price level of the country. By raising the bank rate, it can make the bank credit costlier and thereby cause contraction of bank credit. By lowering the bank rate, on the other hand, it can make the bank credit cheaper and thereby cause contraction of bank credit.

Though the bank rate policy of RBI has had some effects on some occasions, on a whole, it has not been very effective. The ineffectiveness of bank rate in controlling credit is due to the following factors.

- A major portion of credit requirements is met by indigenous bankers, who are not under the control of RBI.
- Lack of co-ordination between various sectors of money market: There is a wide disparity of interest rates in Indian money market.
- Market rate of interest does not change in same proportion of bank rate.
- There is scarcity of eligible bills in Indian money market and rediscounting is not so popular in India.
- Banks are left with large deposits even after meeting the minimum statutory reserves. So they did not feel the necessity of seeking financial assistance from RBI.

b. Open Market Operations (OMO): - An open market operation is an instrument of monetary policy which involves buying or selling of government securities from or to the public and banks. This mechanism influences the reserve position of the banks, yield on government securities and cost of bank credit. The RBI sells government securities to contract the flow of credit and buys government securities to increase credit flow. Open market operation makes bank rate policy effective and maintains stability in government securities market.

Apart from outright purchase and sales of securities, RBI also involves in the Switch operations i.e., purchase of one type of securities against the sales of another type of securities. The main objectives of open market operations are:

Objectives of OMO

- To facilitate borrowing of funds by the govt. from the public.
- To maintain the prices of Government Securities stable. When there is a fall, RBI purchases them to raise their prices.

- To offset the seasonal changes in the supply of money in money market.
- To support the bank rate policy.
- To control credit.

c. Variable Cash Reserve Ratio (CRR): - Cash Reserve Ratio is a certain percentage of bank deposits which banks are required to keep with RBI in the form of reserves or balances .Higher the CRR with the RBI lower will be the liquidity in the system and vice-versa.RBI is empowered to vary CRR between 15 percent and 3 percent. But as per the suggestion by the Narshimham committee Report the CRR was reduced from 15% in the 1990 to 5 percent in 2002. As of October 2013, the CRR is 4.00 percent. Though the RBI was empowered to make use of the weapon of variable cash reserve ratio as early as 1951, the RBI made use of this weapon only since March,1960.

d. Variable Statutory Liquidity ratio (SLR): - The current SLR is 23%.According to sec 24 of BRA 1949, every commercial bank is required to maintain a certain percentage of its total deposits in liquid assets such as cash in hand, excess reserve with RBI, balances with other banks, gold and approved Government and other securities. This proportion of liquid assets to total deposits is called SLR. BRA empowers RBI to fix the SLR up to 40%. The variation of the SLR is intended to reduce the lendable funds in the hands of the commercial banks and to check the expansion of bank credit. An increase in SLR will decrease the lendable funds in the hands of commercial banks and vice versa. Present rate of SLR is 23%. (as on jan'2014)

e. Liquidity Adjustment Facility (LAF) includes Repo rare and Reverse Repo: - LAF consists of daily infusion or absorption of liquidity on a repurchase basis ,through repo (liquidity injection) and reverse repo (liquidity absorption) auction operations through government securities as collateral securities.

- Repo rate is the rate at which RBI lends to commercial banks generally against government securities. Reduction in Repo rate helps the commercial banks to get money at a cheaper rate and increase in Repo rate discourages the commercial banks to get money as the rate increases and becomes expensive.
- Reverse Repo rate is the rate at which RBI borrows money from the commercial banks. The increase in the Repo rate will increase the cost of borrowing and lending of the banks which will discourage the public to borrow money and will encourage them to deposit. As the rates are high the availability of credit and demand decreases resulting to decrease in inflation This increase in Repo Rate and Reverse Repo Rate is a symbol of tightening of the policy. As of October 2013, the repo rate is 7.75 % and reverse repo rate is 6.75%. On January 28, 2014, RBI raised repo rate by 25 basis points to 8.00 %.

f. Marginal Standing Facility: - This was instituted under which the scheduled commercial banks can borrow over night at their discretion up-to one percent of their respective NDTL at 100 basis points above the repo rate to provide a safety valve against unanticipated liquidity shocks

13.4.2 Qualitative weapons (Direct Instruments)

Qualitative weapons are those which regulate the quality of credit i.e., uses to which credit is put. They are concerned with the encouragement of credit to productive uses, and discouragement of credit to non essential activities. The main qualitative credit control weapons are:

a. Regulation of margin requirements

b. Regulation of consumer credit

c. Issuing of Directives

d. Rationing of credit

e. Credit authorisation scheme f. Moral suasion

g. Direct action

The detailed explanations of the major qualitative methods are given here under.

a. Regulation of margin requirement: - Margin refers to the difference between loan amount and the market value of collateral placed to raise the loan. RBI fixes a lower margin to borrowers whose need is urgent. For e.g. if RBI believes that farmers should be financed urgently, RBI would direct to lower the margin requirement on agricultural commodities. RBI has used this weapon for a number of times.

b. Issuing of Directives: - Under section 21,of the BRA of 1949, RBI is empowered to issue directives to any particular bank or to the entire banking system and the banks are bound to comply with the directives issued to them. RBI directives can be in regard to:

- Purpose for which advance may or may not be made
- Margins requirement
- Maximum amount of loan that can be sanctioned to any company, firm or person.
- Rate of interest and other terms and conditions on which loans may be given

c. Credit Ceiling: - In this operation RBI issues prior information or direction that loans to the commercial banks will be given up to a certain limit. In this case commercial bank will be tight in advancing loans to the public. They will allocate loans to limited sectors. Few example of ceiling are agriculture sector advances, priority sector lending.

d. Credit Authorization Scheme: - Credit Authorization Scheme was introduced in November, 1965 when P C Bhattacharya was the chairman of RBI. Under this instrument of credit the commercial banks are required to obtain the RBI's prior authorization for sanctioning any fresh credit beyond the authorized limits.

e. Moral Suasion: - Moral Suasion is just as a request by the RBI to the commercial banks to follow a particular line of action. RBI may request commercial banks not to give loans for unproductive purpose which does not add to economic growth but increases inflation.

f. Direct Action: - This method is rarely used by RBI. But it is adopted when all other measures fail. It implies refusal of RBI to extend rediscounting facilities to banks which follows unsound banking practices and such other measures.

13.5 Limitations of Monetary Policy with Reference to India

The following are the main limitations of the monetary policy adopted by the Reserve Bank:

1. Restricted Scope of Monetary Policy in Economic Development: In reality the monetary policy has been assigned only a minor role in the process of economic development. The monetary policy is not given any predominant role in the process of economic development. The role assigned to the Reserve Bank is minor indeed. The Reserve Bank in expected to see that the process of economic development should not be hindered for want of availability of adequate funds.

2. Limited Role in Controlling Prices: The monetary policy of Reserve bank has played only a limited role in controlling the inflationary pressure. It has not succeeded in achieving the objective of growth with stability. The former Governor of Reserve Bank, I.G. Patel states,' the role of monetary policy in combating inflation is strictly limited and that monetary policy can be effective only if it is a part of an overall framework of policy which includes not only fiscal and foreign exchange policy but also what is described as an income policy'. In India, however, the monetary policy of the Reserve Bank is not appropriately integrated with fiscal, foreign exchange and income policies.

3. Unfavourable Banking Habits: An important limitation of the monetary policy is unfavourable banking habits of Indian masses. People in India prefer to make use of cash rather than cheque. This means that a major portion of the cash generally continues to circulate in the economy without returning to the banks in the form of deposits. This reduces the credit creation capacity of the banks. Moreover in India there is predominance of currency in the money supply. This hampers the credit creating capacity of the banks. Due to high proportion of currency in money supply, banks have to face the problem of large withdrawals of currency every time they create credit. Fortunately, the recent trend is increasing deposit ratio in money supply. It is expected to make money policy more effective.

4. Underdeveloped Money Market: Another limitation of monetary policy in India is underdeveloped money market. The weak money market limits the coverage, as also the efficient working of the monetary policy. The money market comprises of the parts, the organised money market and unorganised money market. The money policy works only in organised money market. It fails to achieve the desired results in unorganised money market.

5. Existence of Black Money: The existence of black money in the economy limits the working of the monetary policy. The black money is not recorded since the borrowers and lenders keep their transactions secret. Consequently the supply and demand of money also not remain as desired by the monetary policy. In the words of V. Pandit, 'Black money is rightly regarded as a threat to the official money credit policy mechanism to manage demand and price in several sectors of the economy.

6. Conflicting Objectives: An important limitation of monetary policy arises from its conflicting objectives. To achieve the objective of economic development the monetary policy is to be expansionary but contrary to it to achieve the objective of price stability a curb on inflation can be realised by contracting the money supply. The monetary policy generally fails to achieve a proper coordination between these two objectives.

7. Influence of Non-Monetary Factors: An important limitation of monetary policy is its ignorance of non-monetary factors. The monetary policy can never be the primary factor in controlling inflation originating in real factors, deficit financing and foreign exchange resources.

The Reserve Bank has no control over deficit financing. It cannot regulate the deficit financing, which affects money supply considerably.

8. Limitations of Monetary Instruments: An important limitation of monetary policy is related to the inherent limitations in the various instruments of credit control. There are limitations regarding frequent and sharp changes in the bank rate, as these are supposed to conflict with the development objectives. Most bank rates are virtually fixed and mutually unrelated so that the scope for adjustment is very limited.

The margin requirements have tended to be so high for most of time due to prolonged inflation, that the scope for further increase in them is limited. The CRR and SLR have also been fixed very high locking most of the funds in low yielding assets. These limitations of monetary instruments hamper the smooth working of monetary policy.

9. Not Proper Implementation of the Monetary Policy: Successful application of monetary policy is not merely a question of availability of instruments of credit control. It is also a question of judgement with regard to timing and the degree of restraint employed or relaxation allowed. However, past experience shows that Reserve Bank’s credit restrictions have always fallen short of the required extent of restraint. The Bank has adopted a hesitant attitude in the field of monetary control. In short, the monetary policy of the Reserve Bank suffers from many limitations. It requires improvements in many directions

Exercise 13.1

Q1. Identify the appropriate targets of monetary policy in Indian situation.

Q2. What are the various direct and indirect instruments of monetary control?

13.6 Summary

The financial sector in India is still in a state of transition because of ongoing reforms and the growing integration between different segments. No doubt, the degree of operational freedom of the Reserve Bank has been enhanced with the elimination of the central government’s automatic access to RBI credit. However, a major constraint in the conduct of monetary policy is the inadequate depth and liquidity in the secondary market for government securities and money market instruments. Therefore, Reserve Bank relies on the Cash Reserve Ratio as an important operating instrument. Thus, it has been the endeavour of the Reserve Bank to develop both depth and liquidity in money and government securities markets through institutional measures so that, eventually, the dependence on the CRR is reduced.

13.7 Glossary

1. Cash Reserve Ratio (CRR): The cash reserve ratio refers to the cash which banks have to maintain with the Reserve Bank of India as a certain percentage of their demand and time liabilities. Under the provision of the Reserve Bank of India act, the scheduled commercial banks were required to maintain with the Reserve Bank every week a minimum of average daily cash reserve equivalent to three per cent of their demand and time liabilities as an outstanding as on the Friday of the previous week.

2. **Statutory Liquidity Ratio (SLR):** The Ratio of liquidity assets to demand and time liabilities in India is known as the statutory liquidity ratio. The main objectives for maintaining the SLR are as follows. SLR is maintained in order to control the expansion of the bank credit; by changing the level of SLR, RBI can increase or

decrease bank credit expansion; SLR ensures the solvency of commercial banks; by determining SLR, RBI in a way compels the commercial banks to invest in government securities and government bonds. The RBI can increase the SLR to contain inflation, suck liquidity in the market to tighten the measures to safeguard the customer's money.

3. Reserve Money : Reserve money represents those liabilities of the central bank and the government, that are deemed to be eligible as reserves to be held by banks for the purpose of the deposit money creation in a system, where the fractional reserve ratio governs the creation of deposit money. Accordingly, reserve money in India is the sum total of currency with Reserve Bank, public, banker's deposit with RBI, which are liabilities of the RBI to the non bank sector and hence equivalent to currency with public. The main sources of reserve money in India are the assets acquired by the RBI; and by government's currency liabilities to the public. Reserve Money = Net RBI Credit to Government + RBI Credit to Banks + RBI Credit to Commercial Sector + Net Foreign Exchange Assets of RBI + Government's Currency Liabilities to the Public (–) less Net Non-Monetary Liabilities of RBI.

13.8 Answers to Self Check Exercises

Exercise 10.1

Answer 1. Refer to section 13.3.

Answer 2. Refer to section 13.4.

13.9 Suggested Readings

1. Hajela, T.N., (2009) Money and Banking, Ane Books Pvt Ltd., New Delhi.

2. Sundharam KPM, Banking: Theory, Law and Practice, Sultan Chand and Sons, New Delhi.

3. M.R. Baye, D.W. Jansen (1996), Money, Banking and Financial Markets, AITBS (Indian ed.)

4. K.C. Sekhar: Banking – Theory and Practice, Vikas Publishing House, New Delhi.

5. S.B. Gupta, Monetary Economics, S. Chand Publications, New Delhi.

6. M. L. Seth, Monetary Economics, Vikas Publications, New Delhi

7. R. R. Paul, Money, Banking & International Trade, Kalyani Publications, Ludhiana.

13.10 Terminal Questions

Q1. Describe the objectives and indicators of monetary policy in an economy? Also explain the operational procedure of the monetary policy in India.