MONEY AND BANKING

(THEORY AND PRACTICE)

BLOCKS: I-IV

Dr. B.R.AMBEDKAR OPEN UNIVERSITY

Hyderabad

1995

COURSE TEAM

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PREFACE

This book deals with the topics in Money and Banking (Theory and Practice) included in the syllabus for the Second Year of the B.Com., course offered by the Andhra Pradesh Open University. These topics generally cover the "core" area of the subject to be studied in the Second Year of the Three Year Degree Course in Commerce (B.Com.,). The syllabus for the sake of convenience is divided into Blocks, each of which comprises a number of units. Each Block generally covers a specific area of the subject. The units are prepared by specialists in accordance with a format so designed as to enable the student to read and understand them without much difficulty. Each unit begins with a statement of its objectives followed by contents and has at its end questions intended to test the student's comprehension of its subject matter. Technical terms with which the student may not generally be familiar are given at the end of each unit under the head, "Glossary".

As we all know, Money plays an important role in economic life. It facilitates many economic activities like production, trade, public finance, etc. The economies would not have been developed without the use of money.

Banks occupy a pivotal position in the economy of any country. They help in the development of commerce and trade by mobilising deposits and advancing loans to the industrial sector. Banks have become indispensable to the modern business world as they provide various services to business-men as also the general public. It is for this reason that 'Money and Banking' forms an important subject of study in the B. Com., course.

The course material of this paper is divided into three sections. The first section deals with Money, Functions of Money and Theories of Money. The second section explains different topics related to Banking (theory). This section discusses such important aspects as Commercial Banking, Central Banking, Indian Banking and the Reserve Bank of India. The last section covers in general the Law and Practice of Banking and in particular, the Banker-Customer relationship, Types of Accounts, Negotiable Instruments taking into account the latest trends and changes in the Law and Practice of Banking in India.

The University hopes that this material will help the student to get acquainted with the principal issues concerning Money and Banking.

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SECTION-A : MONEY

BLOCK-I : MONEY AND ITS ROLE

UNIT-1 : CHARACTERISTICS AND FUNCTIONS OF MONEY

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1.0 AIMS AND OBJECTIVES

In this Unit, we introduce you the Barter system, explain the evolution of Money and concentrate on kinds, characterstics and various functions of money.

By the end of this unit, you should be able to :

* mention the inconveniences of the barter system;
* explain how the 'money' is invented and what are the different stages in the evolution of 'money';
* expalin the meaning of the term money and define it;
* explain the different kinds of money; and
* describe the characterstics and functions of money.

1.1 INTRODUCTION

Money is an important invention of man. It is the centre around which the economic science is built. Money has made possible rapid economic progress. Mankind is so accustomed to its use that it does not think of dospensing with it. In fact, the present day economy is discribed as 'money' economy. It has facilitated the realisation of the advantages of division of labour, introduction of large scale production of goods and services and extention of various forms of business and financial transactions. It is not an exaggeration to say that the present economic development of most of the countries would not have been possible without the use of money.

This unit explains different aspects of money and the functions it performs.

1.2 THE BARTER SYSTEM AND ITS INCONVENIENCES

But the case of money is only a subsequent development. In the beginning, man tried to get the goods he did not produce but which were essential for his existance from others on barter system. Some men produced certain goods in quantities which exceded their consumption. Thus one man having surplus of one commodity-say rice-and needing antoher-say vegetables-searched for a person who required rice and had surplus vegetables to offer for rice. This act of direct exchange of one commodity for another without the meditation of money is called barter. Thus, barter is direct exchange of goods for goods.

This simle process might have worked well when transactions were few. A number of difficulties arose with the increase in economic activities. These are explained below.

i) Lack of double coincidence of wants

Barter is inconvenient and time-consuming as it requiresdouble coincidence of wants.A person who wants to exchange his goods for other goods has to find out another person Who has what he wants, and who at the same time is willing to take what the other man offers. For example, let's say there is a person who has cloth over and above his requirements but wants rice. He must search for a person who can take his cloth and give him rice though there may be a person ready to part with rice he may not require cloth. So this transaction cannot take place due to the lack of double coincedence of wants.

ii) Lack of common measure of value

The value of each commodity in terms of every other commodity entering exchange is to be computed under the barter system. The absence of any common unit interms of which the values of different goods and services could be measured and expressed is a serious short-comming of the barter system.At one time,cloth may have to be measured in terms of grain, at another time, in terms of shoes, and so on. As there are innumerable varieties of goods, different in quality and size, it is difficult to measure the value of one in terms of the other. Consequently,in barter economy, the modern facilities of life resulting from specialisation cannot be provided to mankind. It is very difficult to compute the net worth of an individual or business due to lack of a common unit under this system.

iii) Indivisibility of certain goods

Also there are certain goods, which are more valuable, but which cannot be divided if a man wants a small quantity of rice but had only a cow or horse to exchange, what should he do?

iv) Difficulty in the exchange of services

It is all the more difficult, when services are to be exchanged. The story is told of a French singer who gave performances on an island and was paid in terms of pigs, goats, apples, bananas, etc. The pigs and goats ate up the fruits and other eatables and the singer had to give many more performances to earn food for the pigs and goats.

v) Difficulty in storing value

There is a further difficulty in the baarter system,where the commodities cannot be preserved for a long time,because,they perish or lose value.

Thus, we see that, although in primitive times, the barter system worked out satisfactorily it became ineffective with the growth in size of the economy.

vi) Difficulty in transporting exchanged goods:

The goods exchanged in Barter system have also problem of transporting from one place to another.

CHECK YOUR PROGRESS - 1

- State the inconveniences of barter system.

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1.3 THE INVENTION OF MONEY

In fact, money deserves to be ranked high among the outstanding inventions in the entire history of mankind. The problem of expressing the value of each article in terms of all others is solved; the values of all commodities are expressed in terms of single commodity, i.e., money.

To overcome the disadvantages of barter, money was invented. Money was first used as an unit of account or measureof value in terms of which the value of all other things was measured.

A person who has an article to exchange sells it for money and with the money got he purchases the goods he wants. Money has facilitated exchange and made possible the present complex economic organisation based on division of labour and specialisation.

As already mentioned it would be no exaggeration to say that economic progress of the present day dimension would not have been possible without money. "Money is one of the most fundamental of all man's inventions. Every branch of knowledge has its fundamental discovery. In mechanics it is the wheel, in science the fire, in politics the vote. Similarly, in Economics, in the whole of man's social existence money is the essential invention on which all the rest is based".

1.4 EVOLITION OF MONEY

Different stages in the evolution of money are explained below:

i) Commodity Money

Primitive money took the form of commodity money. The particular commodity chosen as money depended upon various factors like the location of the community; climate; cultural and economic development of the community, etc. For example the communites living by the sea-shore chose shells or fish-hooks as medium of exchange. The cow, sheep and goat were used as units of account and media of exchange for a long time over a large area. But the "animal-money" has its own serious disadvantages.

Following is a classification of the commodities used as money at different times and in different societies.

1. Consumer goods such as rice, tea, salt, fish, fruits, tobacco, cloth, etc.
2. Capital goods such as knives, bullets, weapons, etc.
3. Tokens, scraps, furs, etc.
4. Metals such as gold, silver, iron, copper, brass, bronze.

ii) Metallic Money

Of the above commodities, metals came to be used almost universally and exclusively. The history of metals as money goes back probably to 300 B.C. There are a number of qualities that have tended to make precious metals the most desirable form of commodity money. Jevons has classified these in order of their importance: cognizability, utility, profitability, durability, indestructability, stability and homogenity.

Metallic money reached its highest form with the invention and perfection of the art of coinage. In the evolution of coinage, the following stages can be distinguished:

i) **The first stage :** Different shapes or sizes were given to articles which were by nature uniform in physical character.

ii) **The second stage :** Metals were used in the form of small in gots. These had to be weighed in order to ascertain their value.

iii) **The third stage :** Merchants put their marks on metal pieces.

iv) **The fourth stage :** Introduction of the milled edge. This enabled any one to find out at a glance, whether the coin had been clipped or interfered with in any way. Further, the coin was covered over with designs making it impossible to rub off any portion of the metal.

v) **The fifth and final stage :** This stage is the emergence of government as the sole authority for minting coins.

As between gold and silver,silver was used as money for a comparatively longer period in the past. The reason was that gold was too valuable and could not be used for small transactions such as the purchase of bread or salt. Hovever gold was also used as universally accepted money with the gradual discovery of new gold mines. Coins of smaller denominations were made with silver or copper or bronze to facilitate transactions of smaller value.

iii) Paper Money

After the metallic stage came paper money. Merchants started carrying papers showing their title to metallic money due to the difficulty of carrying gold or silver coins. In course of time, these pieces of paper came to be regarded as money and ultimately came under the control of Governments and central Banks. To begin with, paper money was a mere substitute for metallic money. In several countries notes were declared by law to be convertible into gold of a certain weight and fineness. Later, paper money ceased to be convertible.

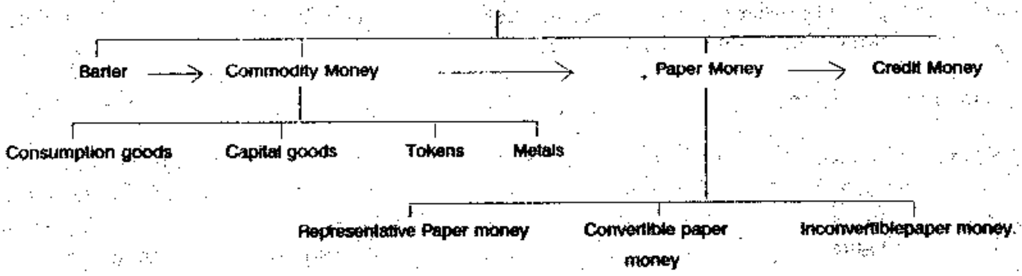
At this point you may wonder how paper, which has no intrinsic value, is accepted as money. The answer is that any article can **serve as money if it is generally accepted as money by everyone in the community.** Paper money, though it lacks intrinsic value, possesses the two essential qualities necessary for money. It has general acceptance; and, since the supply of paper can be restricted, it has also the quality of scarcity.

iv) Credit money

The latest stage in the evolution of money is **credit** money or **bank** money. This money predominates in the total volume of money in circulation. Credit money refers to bank deposits kept by people with banks which they can withdraw at any time they like through an instrument known as the Cheque. This money changes from person to person in the form of cheques, drafts, etc. Most of the transactions in business and industry today are settled through bank money.

The evolutiaon and development of money can be summarised in the following chart.

EVOLUTION AND DEVELOPMENT OF MONEY



CHECK YOUR PROGRESS - 2

What are the different stages in the evolution of money?

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1.5 MEANING AND DEFINATION OF MONEY

Having discussed the invention and evolution of money we now turn to explain the meaning and defination of the term 'money'. It is difficult to define the term 'money' comprehensively. In simple terms, it is stated that money is what money does". This is no definition because we have to ask again: what is it that money does? Anything which performs the functions of money can be called money. In that sense, coins, cheques and bills are money.

Crowther defines money as anything that is generally acceptable as a means of exchange and at the same time acts as a measure and as a store of value".

Robertson also defines it as "anything which is widely accepted in payment for goods or in discharge of other kinds of business obligation".

Keynes defines money as "money is that by the delivery of which debt-contracts and price-contracts are discharged and in the shape of which general purchasing power is held". Thus, general acceptability is the necessay condition for money.

The truth is that any complete definition of money should embrace all the essential functions which money performs in the country. Money must be something that performs all the three important functions of: medium of exchange, standard of value and store of value.

1.6 KINDS OF MONEY

we now briefly explain the different kinds of money

i) Common money and bank money

Common money which is otherwise known as legal tender money forms the basis for bank money. Legal tender money is the money which is backed by law.

Now-a-days most of the payments are by means of cheques drawn against current and savings deposits held in banks. These cheques are called bank money. Demand deposits act as medium of exchange, they serve as a store of value. Bank deposits against which cheques are drawn are simply acknowledgements of private debts expressed in terms of Money-of-account. They are not money but claims against money.

ii) Commodity Money

Commodity money is composed of actual units of some freely obtainable, nonmonopolised commodity chosen as money. Commodity money is also termed as full bodied money because the real or commodity value of the money material and its face value do not differ. In other words, its real value is equal to its face value. That's why it may also be called **standard** money.

Along with standard money (also known as full bodied money) token money also existed side by side. We may define token money as the money 'whose value is materially greater than the stuff of which it is composed'. The face value of token coin is greater than its real value.

iii) Representative Money

Representative money may be made either of cheap metal or convertible paper 'money'. The important thing to remember is that representative money is valued not for its own sake but for the sake of the commodity money which it represents. These notes were earlier backed by 100% metallic reserves possessed by the central bank of the country.

iv) Managed Money

In course of time, the demand for money increased owing to the great increase in population and the volume of business transactions.The supply of money could not be increased to meet the demand if 100% reserves were to be kept. This led to the reduction in the proportion of gold reserves in relation to the notes issued. This did not affect the convertibility of notes into gold as all notes issued were not presented for conversion at any single point of time. Under this type of arrangement the supply of money was managed so as to correspond to business conditions.

v) Fiat Money

FIAT money has absolute elasticity, and can be managed according to the requirement of trade and business.The three salient features of fiat money are:

1. It has little or no value as a commodity:
2. It is non-redeemable into any commodity whose value is equal or near-equal to its face or legal value; and
3. Its purchasing power is not kept at par with that of gold or silver in which it might have been formerly convertible.

1.7 CHARACTERISTICS OF GOOD MONEY

The follwing are essential Characteristics of 'good money':

i) Cognizability

The common man must be able to recognise money easily and quickly. If paddy is to act as money, it is not possible for a person lacking knowledge of paddy to identify the quality as there are hundreds of varieties of paddy. But gold is recognised by all men whether they are educated or uneducated. It is to meet this requirement of cognizability that currency notes are printed in different sizes, colours and with distinct designs.

ii) Utility and value

Money is that which is widely accepted. General acceptability is fulfilled if an article is useful and valuable. Value can be attributed to a commodity through scarcity. A commodity should have not only utility but also scarcity. Commodity and metals have utility unlike paper. Paper becomes worthless if it is declared illegal. Metals satisfy the qualities of utility and value and also other qualities while commodities satisfy only the quality of utility. Thus, metals are preferred to other forms of money. However, value can be attributed to paper also by giving legal protection and creating scarcity.

iii) Portability

Material used for money should be easily carried with us. Bulk commodities like bricks, cows, iron, etc., cannot be easily carrieed. Metals like gold, Silver can be easily carried in small quantities. But metals are also sometimes bulky if carried in large quantities. Paper money is the most highly portable money which can be carried in pockets.

iv) Divisibility

The material chosen as money should be capable of being divided. In this division, it should not lose its value. Gold and silver have this character. The value of gold and silver can be determined on the basis of the weight of each piece. Thus every metal possesses this character. Some goods do not posses this character. For example, cow. If we divided a cow into picces the original material itself is wasted. So many commodities cannot be used as money. But in the case of paper, it can be divided by converting it into lower value currencies.

v) Indestructibility

The material used for money must be durable and indestructible. This quality is essential if money is to satisfactorily discharge the functions of store of value and standard of deferred payments. But commodities like vegetables, cows, etc., are not durable, whereas metals are highly durable Paper is no doubt; perishable but it can be replaced with expense.

vi) Stability

The value of material used as money should not frequently change. Instability leads to unacceptability by people in the community. Paper money can also be made stable, but in times of war, its stability is lost. Metallic supply is under nature's control while paper supply is under man's control which is ever changing. So precious metals are more stable in their values.

vii) Homogeneity

Homogeneity means that the substance shall be uniform in quality. One coin should not be superior to another. Both paper and metals satisfy this condition.

1.8 FUNCTIONS OF MONEY

Money performs certain important functrions which can be grouped into the following three categories.

1. Primary functions,
2. Secondary function,and
3. Contingent functions.

1.8.1 PRIMARY FUNCTIONS

Under this category are included the most important functions which money must perform in every country.

1. **Medium of Exchange :** By acting as the medium of exchange, money has become universal commodity, i.e., an intermediary against which all goods are exchanged. As Crowther remarks "money has become the first broker". It bridges the gap between two parties to a transaction that exists in a barter economy owing to frequent lack of double coincidence of wants. Thus the use of money facilitates sale and purchase of goods and services.

2. **Standard of Value or Measure of Value :** Whenever a commodity serves as a medium of exchange, it is natural to express values, make contracts and keep accounts in terms that. "Money is the vehicle of our thoughts, prices, and worth". The monetary unit, which is used by all as a medium of exchange, furnishes a common measures of the heterogeneous values of goods and services.

It must, however, be remembered that money does not provide a measuring stick of prices in the same that many physical units do. Money itself possesses no absolute value. The price merely expresses a ratio in terms of money-the value not measured by but expressed in money. Hence some writers propose to abandon entirely the expression - "Standard of value" and prefer to use "Measuring of Value".

1.8.2 SECONDARY FUNCTIONS

1. **Standard of deferred Payments:** Money not only serves as a standard in immediate transactions, but payments due in futute are also expressed in terms of the moneytary unit.

Money associates the present with the future,and for this association to be satiscactorily performed, there must be a reasonable degree of stability in its value.

The importance of this function having greatly increased in recent times, much of the modern policy has centred around the efforts to achieve a more adequate standard of deferred payments.

2. **Store of Value :** Money acts par excellence as a store of value or general purchasing power in disposable form. A satisfactory medium of exchange must be stable in value and this characteristic permits money to serve as a means of storing up value for indefinite periods. To-day the individual merely keeps on hand the amounts of money he needs and invests the balance for the sake of a return. But in times of economic uncertaintly, money tends to act as a store of value in a greater degree.

3. **Guarantor of solvency :** The function of money as a guarantor of solvency, though considered as an additional function, is related to the function of money as a store of value. The holding of a certain proportion of the assets in the form of liquid money on the part of individuals, banks, companies, etc., will prevent the seizure of their properties by their creditors They are said to be solvent, hovever rich they might be, only when they meet their obligatiaons as they fall due.

4. **Transfer of Value :** Secondary function of money relates to its use as a medium of transfer of value. Though money value is easily and quickly transferred from one person and place to another, it does not involve any difficulty to transfer one crore of rupees, from one place to another through the device of cheque, draft, etc.

1.8.3 CONTINGENT FUNCTIONS

Prof. Kinley speaks of the contingent functions which arise from the charcteristics of the stages of economic life. They are four in number.

1. The distribution of national income;
2. The equalisation of marginal utility in expenditure:
3. Furnishing of a basis for credit system; and
4. Imparting of a general form to capital.

1. Distribution of National Income: Money facilitates the distribution of national income between factor-owners. In the absence of money, the distribution of the joint product, which in many cases is indivisible among various claimants would have been impossible. By facilitating the distribution of national product, money has made economic progress possible.

2. Equalisation of Marginal Utility in Expenditure: In modern times, every commodity is procured through the medium of money. Scince money is the only commodity which can be distributed among the competing uses in different quantities, a consumer applies the principle of maximum satisfaction by purchasing quantities of various goods with a given amount of money. Through the use of money, producers are also enabled to maximise their returns by substituting one factor for another at the margin.

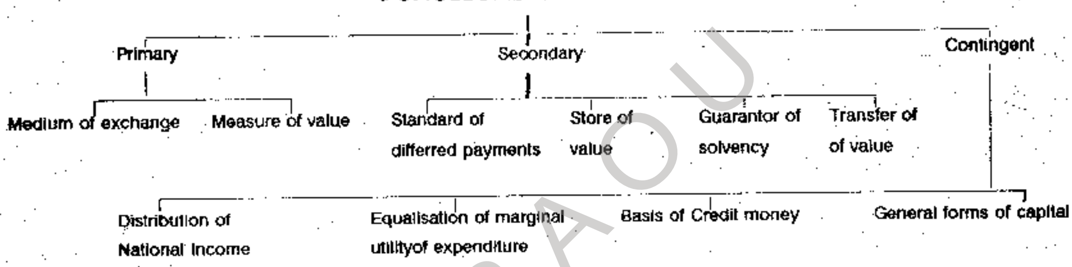
3. Basis for Credit System: Money is the basis of 'credit money' which plays an important role in the development of modern economic system. It is a cash reserve to ensure solvency and guarantee the payment of credit transactions.

4. General form of Capital: Finally modern business utilises money to give a liquid form to capital. By keeping the wealth in cash- balance we impart liquidity to it, because it can be readily converted into any form at any time.

Clearly the so called contingent functions of money are merely the advantages that acrue to society from using money as a medium of exchange and the measure of value.

These functions of money can be summarised in the following chart:

FUNCTIONS OF MONEY



CHECK YOUR PROGRESS - 3

What is money? List out its functions.

1.9 SUMMING UP

Before inventing money, the barter system was in practice. Barter is the direct exchange of goods for goods. Barter system had a number of difficulties, such as lack of double coincidence of wants, lack of common measure of value, indivisibility of certain goods, difficulty in storing value, etc. To overcome these disadvantages of barter, money was invented. Primitive money took the form of commodity money. After commodity money, metal was used as money with the invention of the art of coinage. After the metallic stage came paper money. The latest stage in the evolution of money is credit money.

Money can be simply defined as anything which is generally acceptable as medium of exchange. There are diffirent kinds of money, viz., common money, bank money, representative money, fiat money, etc. Good money should have certain characteritics like cognizability, portability, Divisibility, indestructibility, stability, etc.

Money performs certain important functions viz., primary functions, secondary functions and contingent functions. Primary functions include basic functions, i.e., medium of exchange and standard of value. Under secondary functions, money acts as standard of defferred payments, store of value, guarantor of solvency and transfer of value. Contigent functions of money include the distribution of social income, the equalisation of marginal utility in expenditure, basis for credit-system and imparting of a general form to capital.

1.10 CHECK YOUR PROGRESS; MODEL ANSWERS

1. i) Lack of double coincidence of wants
   ii) Lack of common measure of value
   iii) Indivisibility of certain goods
   iv) Difficulty in the exchanged of services
   v) Difficulty in storing value.
   vi) Difficulty in transporting exchange goods.

2. i) Commodity money
   ii) Metallic Money
   iii) Paper Money
   iv) Credit Money

3. Money may be defined as anything which is generally accepted and used as a medium of exchange as well as a measure of value.Its functions are:

a) primary functions
   i) Medium of exchange
   ii) Measure of value

b) Secondary functions
   i) Standard of deferred payments
   ii) Store of value
   iii) Guatantor of solvency
   iv) Transfer of value

c) Contingent functions
   i) Distribution of social income
   ii) Equalisation of marginal utility in expenditure
   iii) Basis for credit system
   iv) Imparting of a general form to capital.

1.11 MODEL EXAMINATION QUESTIONS

A. ESSAY QUESTIONS

Answer the following in about 30 lines each:

1. What do you understand by the term 'Barter system'? Expalin the inconveniences of barter system.
2. Describe the stages in the evolution of money.
3. Define money. Explain the various kinds of money?
4. List out the characteristics of good money.
5. Expalin the functions of money.

B. SHORT QUESTIONS

Answer the following in about 15 lines each:

6. Expalin the process involved in Barter system.
7. What are the inconveniences of barter system.
8. What are the stages in evolution of money ?
9. What do you mean by money ?
10. What are the primary functions of money ?
11. What are the different kinds of money?

1.12 RECOMMENDED BOOKS

1. Crowther.G : An out line of Money
2. Jingan M.L. : Money, Banking and Indernational Trade
3. Sundaram KPM : Money, Banking, Trade & Finance
4. Vaish M.C. : Money, Banking and International Trade.

1.13 GLOSSARY

Bank Money : Bank Deposits against which cheques can be issued.

Barter : Exchange of goods for without the use of money.

Fiat Money : Money which has absolute elasticity

Legal Tender Money : currency and coins issued by a central bankand government.

Managed Money : Money issued with less than 100% metallic reserves.

Representative Money : Money issued with 100% mettalic reserves.

UNIT-2 : MONEY ECONOMY

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2.4 Merits and Demerits of Money Economy

 2.4.1 Merits

 2.4.2 Demerits

2.5 Summing Up

2.6 Check Your Progress : Model Answers

2.7 Model Examination Questions

2.8 Recommended Books

2.9 Glossary

2.1 AIMS AND OBJECTIVES

This unit aims at explaining the classical and modern view point about the role of money in an economy and discussing the features of money economy and merits and demerits there of.

At the end of this unit, you should be able to:

* Distinguish the modern view from that of classical view about the role of money in an economy;
* Identify the features of money economy; and
* List out the merits and demerits of money economy

2.1 INTRODUCTION

An economy in which the transactions are settled through the medium of money is known as money economy. In this economy, the economic behaviour of individuals and institutions is largely influenced by money. The influence of money is found not only in the production of goods and services but also in their consumption. While each producer tries to maximise profits, each consumer tries to maximise his satisfaction in the best possible manner. However, the influence of money on the economy is subject to controversy among the economists. In this connection, it is relevant to discuss the views of classical and modern economists on the role of money in an economy.

2.2 CLASSICAL AND MODERN VIEWS ON THE ROLE OF MONEY IN AN ECONOMY

Now, we discuss the classical and modern views on the role of money in the economy.

2.2.1 CLASSICAL VIEW

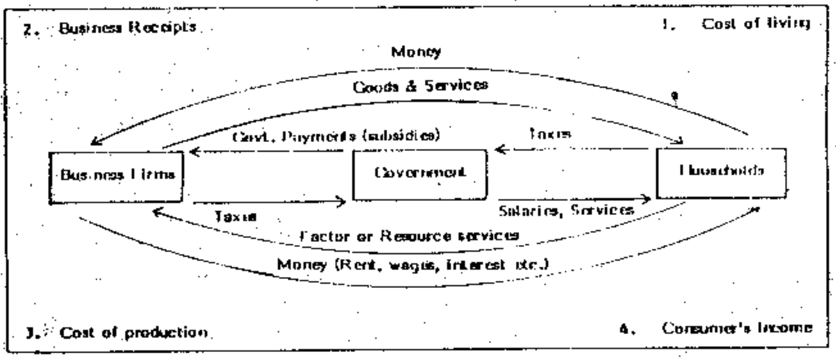
The classical economists felt that the real sector of the economy remained separate from the monetary economy. Consequently, changes in money supply influenced only the absolute price level without any influence on aggregate employment and output. Thus classical economists view that money is a passive factor in the economic system.

2.2.2 MODERN VIEW : CIRCULAR FLOW OF MONEY

In contrast to the classical view, modern economists hold the view that money has an important role in influencing the functioning of the economy by affecting the aggregate output and employment. Modern economists give more value to money in their economic planning as changes in money supply exert their influence on the functioning of the economic system. In their view, if money is out of order, it has its effects on the smooth functioning of the economy in one way or the other. Increase in the flow of money results in increase in aggregate output, employment and increase in prices. As against this, decline in aggregate spending results in decline in purchasing power, prices, output, and employment in the economy. This does not mean that monetary economy creates resources if these are lacking in the country. Monetary economy cannot bridge the gap in the natural resources or the scarcity of capital goods or the backwardness of technology. But an appropriate policy of monetary economy when planned and managed properly may act as a catalist to increase and maintain the actual rate of production nearer to the productive capacity of the country. In the same way, monetary policy is only one of the factors influencing the distribution of income and wealth among the members of a country. The modern economists' view becomes more clear when we study circular flow of money in an economy which explains the influence of money on economic activities like production, employment and distribution.

Circular Flow of Money in an Economy

People pursue different occupations and hold different economic positions. In their dual role as producers and consumers, they operate multifarious operations causing continuous flow of money in the form of receipts and payments. Money spent by the consumers for the purpose of purchasing various goods and services is received bu the retailers which in turn is sent to wholesalers, who pass it on to producers. A part of this flow is directed to the exchequer in the form of taxes. The manufacturers use the money proceeds to pay for the factory services, raw materials, technology, and to employees in the form of wages and salaries. In other words, money flows back to household sector in the form of payments made for rendering factor services in the form of wages and salaries, interest, rent, profit, remuneration, etc. A portion of incomes of the households may be diverted to the government in the form of taxes. Much of this amount generated from business and household sectors also flows back in the form of subsidies, various payments made by the government including the salaries to its employees. Thus the bulk of the money remains active in a continuous circular flow. The circular flow of money in the economy should remain undisturbed for the smooth functioning of the economic activity is subjected to chaos. The following diagram shows flow of money in the economy.



This diagram shows the flow of money from households to business firms in return for the purchase of goods and services and the flow of money from business firms to households in return for factor services. This diagram also shows the flow of money from households and business firms to government in the form of taxes and from government to households in the form of payments to factor services and to business in the form of subsidies.

During the process of completing the circle, the money flow takes on the forms of consumers' cost of living, business receipts, cost of production, and consumers' incomes. Consumers' cost of living are business receipts from the point of view of business frims. Similarly aggregrate costs of production and aggregrate costs of production and aggregate consumers incomes are the same thing viewed from two defferent angles.

Thus this circular flow of money shows clearly the role of money in an economy particularly its influence on production, distribution, consumption and employment as opined by the economists.

CHECK YOUR PROGRESS - 1

Expalin in brief the modern view on the role of money in an economy.

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2.3 FEATURES OF MONEY ECONOMY

An important feature of money economy as already mentioned above, is that money is used freely and widely in settlement of transactions. In other words money acts as a medium of exchange in respect of all transactions. All accounts are maintained in monetary units in this type of economy. Another important feature of money economy is that individuals and institutions store the values in terms of monetary units. Further all deferred payments are discharged through money.

Commercial banks are assigned an important role in money economies. They create bank money based on legal tender money. Bank money plays a wider role in settling the business transactions compared to that of legal tender money. Besides commercial banks there is also a central bank in the money economy. The central bank, through its monetary policy, influences the volume of money i.e., legal tender money and bank money and consequent price level.

In a money economy monetary forces, in addition to real forces (like productive resources, organisation, technology) influence the volume and pattern of production, the prices and distribution of real income among the different sections of the community. For example, an expansion or contraction of money supply may result in expansion or contraction of business and economic activity. If the central bank of the country does not take due care, an expansion of money and credit may result in inflationary conditions in the country and vice versa. In fact the role of money will be increased with the expansion of production and distribution. Consequently the money authorities will play a significant role in such situations. Monetary authorities manipualte the supply of money in order to stabilise prices, maximise output and to bring full employment.

2.4 MERITS AND DEMERITS OF MONEY ECONOMY

Pigou rightly remarked "in the modern world, industry is closely enfolded in a garment of money". It is no small wonder then that many have regarded the history of the money economy as marking the history of civilisation. But money economy has its own merits and demerits.

2.4.1 MERITS

i) To the Consumer : The one great merit of money economy is that it enables man as consumer to maximise his satisfaction. He can make the purchases exactly in the proportion which suits him best, since money has generalised purachasing power. In a moneyless economy he would come to have more of some commodities and less of others and thus be deprived of the greatest amount of actual enjoyment. Money helps the consumers to express their wishes and preferences for goods and services. Further, in money economy, production is adjusted to the wishes of the consumers. The producers come to know what people want and how much they want through the price mechanism. Then producers adjust their production accordingly. Consequently, the country's limited productive resources are allocated in the best possible manner. It is a different matter if any individual fails to maximise his satisfaction through his inability to judge the relative amounts enjoyment (yielded by different ways of spending). But the existence of money economy is fundamental, if a given volume of production is to maximise individual's satisfaction.

ii) To the Producer : The second great advantage of money is that it enables man as producer to concentrate on production and add effecively to the flow of goods and services which constitute the real income of society. The specialisation and division of labour on which our economic structure is founded would be impossible if every man has to spend a large part of his time and energy in bartering his goods. As Edia has remarked "money is to keep the machinery of production going at full capacity and in proper balance." Further, capital, which is the life-blood of industry can come into existence only in a money economy.

A producer can maximise his profit by allocating his income among the various factors of production. This task is facilitated by money. Borrowing and lending are the two essential functions of financial institutions, which accelerate the progress of the producers. Money facilitates this task as it functions as a store of value. In the barter system there would be many rates of interest and there are numerous commodities with different qualities. Uniform price for uniform service is facilitated by money. Further capital formation is possible in a money economy as it can be accumulated through savings. Capital which can be mobile develops the productive resources of different parts of the country, including backward areas.

iii) Further money facilitates the making of loans and payments in advances of all kinds. Even before the finished products are sold in the market,the workmen engaged on the production must be enabled to live and money facilitates arrangements being made for this. The making of advances by one kind of business man to another is also rendered much easier by the existence of money.

2.4.2 DEMERITS

However, money economy is not entirely free of defects. Some of the important demerits are expalined below.

i) Perversion of Social Ideals : In order to go deeper into human behaviour, one must brush aside the "money surface of things". The failure to do so has led to the perversion of social ideals. As Davenport has well expressed: "Money valuations pervade all our thinking. Cheapness is proved to be synonymous with ugliness, richness with beauty, elegance with expensiveness". The influence of money on ethical standards is well brought out by St. Paul "the love of money is the root of all evils".

ii) Money Illusion : Because money is the economic unit of measurment, and because economic values are expressed in terms of money, there is a widespread tendency to regard the value of money as constant and to attribute all changes in prices to causes affecting the real supply of and real demand for goods. This is precisely where the illusion lies. It is common for working-men to have a mistaken feeling of economic betterment when money wages rise,even though there is more than proprtionate rise in the prices of goods. The same illusion is more during the period of falling prices. Most working men fail to see that a proportionate decrease in money wages with a fall in prices does not necessarily result in a lowering of their economic welfare. As Bernstein has pertinently remarked: "the money illusion is the source of many economic fallacies and the cause of many economic difficulties".

iii) Instability of the value of Money : This is the greatest drawback of money.

The fluctuating value of money causes great social injustice,as it affects different classes in society differently. For instance, the violent fall in the value of money between 1914 and 1920 led in England, to a great and arbitrary redistribution of incomes,not only between differnt social and industrial classes, but between different persons in the same class.

Any violent or prolonged instability in the value of money affects not only the distribution but also the creation of real wealth. It threatens to undermine the basis of contract and business expectation on which our economic order is built up.

Having considered the merits and denerits of money economy, we may conclude this lesson with Robertson's view who aptly summarized the role of money in an economy: " Money which is a source of so many blessings to mankind, become also, unless we control it, a source of peril and confusion".

CHECK YOUR PROGRESS - 2

List out the merits of money economy.

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CHECK YOUR PROGRESS - 3

List out the demerits of money economy.

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2.5 SUMMING UP

Money influences economic activities largely in the economy. The classical and modern economists differ in their opinion on the influence of money. Classical economists view that money is a passive factor and it does not influence either the aggregate employment or out-put in the economy. In contrast to this, modern economists view that money palys an important role in the economy by influenceing both the aggregate output and employment. In the economy, money circulates continuously and it can be used as a weapon for the smooth functioning of the economy.

Money economy is one in which money is used freely and widely in the settlement of transactions. Commercial banks play an important role in money economy by creating money, with which the business transactions are settled. Money economy has both merits and demerits of its own. It helps the consumer to maximise his satiscaction and the producer to maximise his profit. The demerits of money economy include perversion of social ideals, money illusion, instability of the value of money etc.

2.6 CHECK YOUR PROGRESS: MODEL ANSWERS

1. Money plays an [illegible] role in an economy. It affects both the aggregate output and employment. Any [illegible] in money flow leads to an increase in aggregate output, employment and prices and vice versa. Money flows continuously in an economy and this circular flow of money influences [illegible] distribution, consumption and employment.

2. i) It helps the consumer in maximising his satisfaction.
   ii) It facilitates the [illegible] and division of labour in production process.
   iii) It facilitates the [illegible] payments of all kinds.

3. i) Perversion of social ideals
   ii) Money illusion
   iii) Instability of the value of money

2.7 MODEL EXAMINATION QUESTIONS

A. ESSAY QUESTIONS

Answer the following in [illegible] lines each:

1. Distinguish the [illegible] and classical view on the role of money in an economy.
2. What are the distinguishing features of money economy ?
3. What is money [illegible] ? Discuss its merits and demerits.

B. SHORT QUESTIONS

Answer the following in about 15 lines each:

4. What is the significance of money economy?
5. Explain the classical view about the role of money in an economy.
6. Expalin the modern view about the role of money in an economy.
7. Explain circular flow of money in an economy.
8. What are the advantages of money economy to the producer ?

2.8 RECOMMENDED BOOKS

1. Crowther G : An Outline of Money
2. Jingan M.L. : Money, Banking and International Trade.
3. Sundaram KPM : Money, Banking, Trade and Finance
4. Vaish M.C. : Money, Banking and International Trade.

2.9 GLOSSARY

Bank Money	:	Bank Deposits against which cheques can be issued.
Money Economy	:	Economy in which money is used freely and widely in settlement of transactions.

UNIT-3 : MONEY IN CAPITALIST AND SOCIALIST ECONOMIC SYSTEMS

Contents

3.0 Aims and objectives

3.1 Introduction

3.2 The significance of Money

3.3 Role of Money in a Capitalist Economic System

3.3.1 Adjustment Between production and consumption

3.3.2 Price Mechanism and Flow of Factors of production

3.3.3 Adverse Effects of Money in Capitalist Economy

3.4 Role of Money in a Socialist Economic System

3.5 Summing up

3.6 Check your Progress : Model Answers

3.7 Model Examination Questions

3.8 Recommended Books

3.9 Glossary

3.0 AIMS AND OBJECTIVES

This unit aims at explaining the significance of money and its role in capitalist and socialist economic systems. When you have finished this unit, You will be able to :

* recognise the significance of money ; and
* describe the role of money in capitalistic and socialist economic systems.

3.1 INTRODUCTION

Money occupies a central place in modern economies. Every individual and institution uses money daily in settling business and personal transactions. Money is used as a unit of valuation and accounting. Money has become an important instrument mainly because it facilitates exchange. Thus any commodity or service can be exchanged for money and vice versa. Further all incomes are received in the form of money. The role of money varies depending upon the nature of economic system. This unit explains its role both in capitalist and socialist economic systems.

3.2 THE SIGNIFICANCE OF MONEY

The significance of money is evident from the functions it performs. The significance of money has increased in the modern days due to the following factors.

i) Most of the debts in the modern economy are settled with the help of money

ii) All incomes are received in the form of money

iii) Wealth (at least partly) can be held in the form of money

iv) Money is a generalised purchasing power or a claim over any other thing. In other words, we obtain goods and services with the help of money

The significance of money in the economy can be studied under the following heads:

i) In Production : The significance of money lies in the fact that it enables the producer to concentrate his attention on his main job. Further, the division of labour in modern industrial production has been possible only because of money. These advantages have helped the producer to maximise the output of his industry. Thus money has made possible large scale and massive production in our days.

ii) In Trade : All the difficulties in the exchange of goods under the barter system were removed with the invention of money. Money Facilitated easy and quick exchange of goods and services. Prices are determined, measured and expressed in terms of money. Thus moneyhas been the basis for price-mechanism.

iii) In Consumption: The great accomplishment of money is that it enables the consumer to generalise his purchasing power by giving him a claim over a variety of goods and services. Under the barter system the consumer would not have derived maximum satisfaction as it would have been impossible for him to get the goods he wanted. But money, due to its generalised purchasing power has enabled the consumer to derive maximum satisfaction by equalising the marginal utilities of expenditure.

iv) In Public Finance . Most of the modern Governaments are welfare states. As such they carry on all economic activities. The policies deviced and implemented by the Government [illegible] impossible in the absence of money. Money has enabled the Governments to [illegible] recourse to deficit financing. The Government activities have come to be expanded with the discovery of money. Further, money helps in achieving economic stability.

As already mentioned, the transactions in an economy are coo[illegible]ough the medium of exchange. Infact possession of money determines one's own eco[illegible] and even political status. Thus money is a [illegible] dynamic force affecting economic [illegible] political activities in an economy. But the actual extent [illegible] of money [illegible] upon the nature of the economic sytem-capi[illegible] or socialistic.

3.3 ROLE OF MONEY IN CAPITALIST ECONOMIC SYSTEM

A brief introduction about the characteristics of the capitalistic economic system will enable us to understand the role of money more clearly. The characteristic feature of this society is economic freedom. It means that any person can engage in any type of activity he likes. He can dispose of his wealth and property in whatever way he desires. He can utilise his money for production, consumption, savings as he pleases. He can undertake a production activity of his choice or interest. He can consume whatever he wants. He also free to save any part of his income for the future. To sum up, all individulas exercise their economic choice without having any reference to other individuals in the economy.

Generally, some authority will exist to plan,direct and control production in the different sectors of an economy. But in capitalist economies, such authorities do not exist. Government does not enter either in production or consumption or in fixing the remuneration for various factors of production. In such a situation, one may wonder as to how the economic activity is initiated and regualated. But practice shows that this type of economic system operates smoothly and perfectly. Goods are produced according to their demand in the market. Economic resources flow into different production channels with the help of an unseen hand. You may wonder as to how the co-ordination takes place between the utilisation of resources and consumption needs of the public. Another question which you would like to ask may be: how are all the goods produced being consumed or how does the limited quantity of goods produced satisfy the unlimited wants of the people? The answer for all these questions and doubts is MONEY. In other words, money plays a prominent role in all these economic activies. This is explained below:

3.3.1 ADJUSTMENT BETWEEN PRODUCTION AND CONSUMPTION

The central aim of all production activities in capitalist economy is to make profit. Producers undertake the production of only those commodities which will yield profit in their opinion. Price of a commodity includes cost of production, distribution and certain amount of profit. In other words producers produce those commodities which are demanded by consumers. Thus consumers are able to order the production by purchasing the goods at the price which leaves profit to the producer. In other words, consumers discourage the production of those goods which are not desired by them by refusing to purchase them. Thus consumers direct and control the production mechasnism. Economic Sovereignity rests with consumers in a capitalistic economy. Hence the consumer is referred to as the king. The pattern and level of production is influenced according to his wishes. Here the term consumer does not mean a single consumer but the body of all the consumers in a country. Just as the political sovereignity rests with all people, economic sovereignity rests with all consumers.

3.3.2 PRICE MECHANISM AND FLOW OF FACTORS OF PRODUCTION

Producers who decide upon production of certain commodities compete among themselves to attract the factors of production. Prices of goods, services and factors of production are determined by supply and demand for the same. Hence factors of production move to those areas where highest prices are offered to them. Thus the price mechanism determines the flow of factors of production and thereby the production activity. Pricing mechanism also enable the distribution of limited quantities of goods among consumers whose demands are more than the supply. The pricing mechanism also influences the decision of the consumers to save and spend. In this case the rate of interest performs this function.

Thus the pricing process determines various economic activities like :

a) the types and quantities of commodities to be produced;

b) the types and quantities of commodities to be consumed;

c) the flow of factors of production into various spheres of productive activities;

d) the adjustment between demand for and supply of various goods and services;and

e) equality between demand for and supply of money.

Hence money is indispensable in the capitalist economy. This is because there is no supreme economic authority which directs and controls the economic process. It is the price which regulates the entire economic activity under capitalistic system.

Note the significance of money in this economic system. The difficulities of the barter system are eliminated through money. The exchange of goods and services has been facilitated. The purchasing power has been generalised. Goods can be exchanged for money and money can be exchanged for goods. Thus we can purchase any commodity with money and we can sell any commodity in terms of money. Money facilitates division of labour. The complex economic activities of the modern world are mostly due to the existence of money. Money has enabled man to become an entrepreneur or producer to concentrate on production,flow of goods and services which maximise gross national product of a country. Today the producer is able to spendless time in securing raw materials,spare parts,employees, land and other resources of production only because of the existence of money. But under the barter system he had to spend not only much of his time securing the agents of production but also face difficulties in the process of production. Massive industrialisation in modern economy has become possible and successful only because of money.

The banking system in capuitalist economy is completely built upon money,with money and for the production of money. The raw- material is money. With this raw-material, more money is produced. Thus money is indispensable for the production of development money and capital markets.

Money also plays an important role in the determination of uniform rates of interest. Fixing up of uniform prices in respect of some class of goods has become possible with the introduction of money. Fixation of uniform prices for uniform service has also been possible with the introduction of money. Thus loans find their ideal expression in money and it is the monetary economy alone in which it is possible to express the price of loanable funds in the form of an interest rate.

Economic freedom can be preserved with the use of money. Economic development is not posssible without the use of money. Consumers can purchase and consume the products they like with the help of money under this type of economic system. The production system is altered and adjusted to the choice of consumers. Shift in consumers preference is responded to by a change in price and a change in production schedule. All this adjustment is due to the use of money. Thus credit goes to money for the operation, expansion and development of an economy under capitalist system.

3.3.3 ADVERSE EFFECTS OF MONEY IN CAPITALIST ECONOMY.

Though money has a crucial role to play,its role leads to certain undesirable effects."Money which is a source of so many blessings to mankind becomes, unless you can control it, a source of peril and confusion." Thus money does not remain a wise instrument facilitating exchange but becomes an active force influencing prices, price level, volume of production, expansion of trade, increase in consumption and distribution of wealth. The demand for goods and services is influenced by the quantity of money and the rate of money circulation. In other words, the quantity and flow of money affects the price level. The frequent change in price level, particularly rise in prices, affects the purchasing power of the cosumers. In addition, money may flow into unproductive, non-priority and undesirable channels of the economy. This effect has far reaching economic, social and political consequences. This shows the need for the management of money. Effective monetary management brings the desirable socio-economic returns to the country. "Money is a powerful factor that is liable to stimulate or hinder economic and cultural progress. Intelligent and progressive application of the monetary system tends to result in fuller utilisation of natural resources and of technological inventions leading to a higher standard of living. On the other hand, a narrow and rigid application of the monetary system is apt to handicap progress. And the misuse of facilities provided by the monetary system is apt to lead to grave set backs through the destructive consequences of a runaway inflation or even of a relatively moderate but persistent creeping inflation".

In the capitalist economic system money is one of the sources of cyclical expansion or contraction of the level of economic activity. In this economic system either all the savers may not be the investors or all investors may not be savers. Thus savings may exceed investment or investment may exceed savings. While the first situation may result in expansion,the second situation results in contraction. These changes become the basis for business cycles-the chronic feature of capitalist economy. Thus money is responsible for economic fluctuations. In addition, money is also responsible for concentration of economic power in the hands of few individuals which becomes the root cause for the exploitation of the working class. Production may not be undertaken to fulfil the needs of all members of the society. But it may be undertaken to meet the desires of the rich people. Further money may become responsible for all corrupt and anti-social activities. As Ruskin stated "the devil of money has come to possess their souls. No religion or philosophy seems to have the power of driving it out". Thus money plays not only a useful role in the capitalist economic system, but it also creates undesirable consequences.

However we can minimise the adverse effects of money through effective management and control. Money is to be controlled by whom and for whom it was created. In other words, money should remain the servant of man, but it should not become his Master.

CHECK YOUR PROGRESS - 1

How does money play a prominent role in a capitalist economy ?

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CHECK YOUR PROGRESS - 2

List out the adverse effects of money in a capitalist economy.

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3.4 ROLE OF MONEY IN A SOCIALIST ECONOMIC SYSTEM

In a Socialist Economy the entire economic activity is planned and executed by the Government and its agencies. So we may think that the use of money can be dispensed with alltogether. Karl Marx, the great inspirer of Socialist Economies, regarded money as being responsible for the exploitation of workers by capitalists. So he desired an economic system free from the evils of money economy. The communists who came to power in Russia after the October revolution of 1917 resorted to direct controls and free distribution of goods in their endeavour to aboilish the use of money. They thought that by taking recourse to direct controls they could regulate the economy in which money would have no place. However the mistake was soon realised and they recognised that the role of money is essential. Lenin frankly stated in october 1921, that money was essential, to attain perfection in communism. Inspite of intensive planning, U.S.S.R. has retained the use of money.

Production and distribution in socialist economies are controlled by the government. The price system in this economic system is governed by the government. So the influence of money on the price system is limited. Though the price system is given subordinate position in guiding production, distribution, consumption, the socialist economic system depends on money as a means of payments and receipts and as a standard of value. With the experience of U.S.S.R., it can be stated that the use of money cannot be dispensed with in a socialist economy.

Though the Government in communist economies controls and directs production, the central planning authority faces the problem of choice. It cannot order the production of unlimited quantities in view of limited resources. Here the question of priority comes in. This involves comparison of the relative usefulness of different factors of production in different fields of employment. This comparison is made possible only with the help of a monetary unit and commercial accounting.

The distribution of goods among the consumers is another problem in the absence of money. The relative requirements of consumers are to be determined arbitrarily. Arbitrary allocation of goods among different consumers provokes criticism and resentment among the people. The problem can be solved through evolving a pricing system with the role of money. Thus the price system determines the distribution of money, income and thereby the distribution of real income. Money also plays its role in economic planning.

From the above discussion, we conclude that money plays an important role through the distribution of income and the price system. It is indispensible even in a socialist economy though the degree of its role varies from a capitalist economy.

3.5 SUMMING UP

Money is significant in the economy as it facilitates many economic activities like production, trade, consumption and public finance. The role of money varies depending on the nature of the economic system.

In the capitalist economic system, all the individuals have economic freedom. The economic activity takes place without the interference of the Government. In such economies money plays a prominent role and regulates the entire economic activity by means of price mechanism. It also plays an important role in fixation of uniform price in respect of some class of goods and services.

Though money plays a crucial role in capitalist economies, its role may lead to certain undesirable effects like flow of money into unproductive and undesirable channels, cylical changes in the level of economic activity, concentration of economic power in the few hands, etc.

Unlike in a capitalist economy, all the economic activities like production, distribution etc., are well planned and executed by the Government in a socialist economy. As such the influence of money on price systems is limited. But, still money is used as a means of payments and receipts and as a standard of value. It is also useful in the selection of limited resources in the production process.

3.6 CHECK YOUR PROGRESS : MODEL ANSWERS

1. i) Money adjusts production with consumption

   ii) It regulates the entire economic activity with the means of price mechanism.

   iii) It eliminates Iconveniences of the barter ;

   iv) It is the basis for the banking system and capital markets; and

   v) It helps in determining the uniform rates of interest and in fixing up of uniform prices for some class of goods and services.

2. i) The quantity and flow of money leads to frequent changes in price level;

   ii) Flow of money into unproductive and non priority channel of the economy.

   iii) It becomes a source of cyclical changes in the economic activity.

   iv) It may lead to concentration of economic power in the few hands; and

   v) It may become responsible for current and anti-social activities.

3.7 MODEL EXAMINATION QUESTIONS

A. ESSAY QUESTIONS

Answer the following in about 30 lines each:

1. Explain the role of money in a capitalistic economic system.
2. Compare and contrast the role of money in capitalist and socialist economic systems.
3. Describe the role of money in a socialist economic system.

B. SHORT QUESTIONS

Answer the following in about 15 lines each:

4. Explain the significance of money in the economy.
5. Describe the role of money in adjusting production with consumption in capitalist economic system
6. What are the adverse effects of money in a capitalist economic system ?
7. Explain the impact of money on the concentration of economic power.

3.8 RECOMMENDED BOOKS

1. Crowther.G.	:	An Outline of Money
2. Culbertson John.M.	:	Money and Banking
3. Jhingan M.L.	:	Money, Banking and International Trade
4. Sundaram KPM	:	Money, Baking and International Trade.
5. Vaish M.C.	:	Monetary Theory.

3.9 GLOSSARY

Capitalist Economic System	:	An economic system where private ownership of real capital is permitted.
Socialist Economic System	:	An economic system in which the entire economic activity is planned and controlled by government agencies.

BLOCK-II: VALUE OF MONEY

UNIT-4 : DEMAND FOR AND SUPPLY OF MONEY

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4.2 Demand for Money
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  4.2.2 Demand for Money under Static and Dynamic Conditions
4.3 Motives for Holding Money
  4.3.1 Transactions Motive
  4.3.2 Precautionary Motive
  4.3.3 Speculative Motive
  4.3.4 Deflationary Motive
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4.5 Supply of Money
  4.5.1 Components of Supply of Money
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4.0 AIMS AND OBJECTIVES

This unit aims to explain the demand for and supply of money and different issues relating there to.

At the end of this unit, you should be able to:

* explain the demand for money and distiguish between transactions demand and asset demand for money;
* describe the different motives holding money;
* explain the supply of money and its conponents;

* identify the agencies creating money; and

* explain the elasticity of demand for and supply of money.

4.1 INTRODUCTION

Demand for and supply of money are the important aspects relating to the value of money. As we all know money is mainly used as the medium of exchange. It is held by the people for different motives. The supply of money is nothing but the total volume of money held by the people in the country. Different agencies by creating money influence the supply of money. In this unit; the details of these aspects are dealt with.

4.2 DEMAND FOR MONEY

Demand for money is different from the demand for commodities. Commodities and services are required by people because they satisfy their wants. But money by itself is valueless and does not possess utility to satisfy human wants directly. While commodities are demanded for thier utility, money is demanded for the service it renders i.e., facilitating exchange of commodities and providing store of value. Accordingly, economists have evolved two concepts to explain the demand for money, namely a) medium of exchange concept and b) the store of value concept. These are also referred to as 'transactions demand' for money and 'asset demand' for money.

4.2.1 TRANSACTIONS DEMAND AND ASSET DEMAND FOR MONEY

People demand money basically to carry on their day-to-day transactions and to settle their business affairs. Ahin H. Hamer says that, "transactions motive relates to the need for cash for the current transactions of personal and business exchanges". The volume of transactions in a country and the demand for money for this purpose depend on the size of the national income, interval at which income is paid out to people, the stages of payment and the extent of credit transactions.

The asset demand for money means demand for money of households, firms and the government at a particular period of time, to keep in the form of cash balancee as distinct from other assets. Money can be stored as a form of wealth or asset and can be conveniently converted into other forms of wealth. Since money serves as a store of value, it is demanded for its own sake. The demand for money to be kept as cash balance depends on various subjective motives like transactions motive, speculative motive and deflationary motive. Keynes called the 'asset demand' for money as 'liquidity preference'. The basic differences between transactions demand for money and asset demand for money are- i) in the case of the former, demand for money arises over a period of time and it is based on assumptions of static conditions and ii)in the latter case, demand for money is at a point of time and relates to dynamic conditions.

4.2.2 DEMAND FOR MONEY UNDER STATIC AND DYNAMIC CONDITIONS

Under static conditions, there are no changes in the economy. The demand for money is a stable or constant function of the size of national income. It changes in direct proportion to changes in the size of national income. An increase in national income will bring about a proportionate increase in the consumer demand for money.

Under dynamic conditions,changes of all kinds occur in the economy and these changes are often uncertain and cannot be forecast. As such,there is no constant relationship between demand for money and national income. Demand for money as a percentage of national income may vary disproportionately. For example, during periods of general prosperity, pepole's expenditure on consumer goods and investment would increase and as such the community's demand for money, would decline. The reverse phenomenon holds good during the period of falling prices or rising value of money.

Under dynamic economic conditions,the demand for money is influenced by factors such as the pattern of payment of income,nature and pattern of expenditure and organisation of credit.

4.3 MOTIVES FOR HOLDING MONEY

The Cambridge economists have given three important reasons for holding money (or demanding money). They are transactions motive, precautionary motive and speculative motive. A brief account of these motives is given in the following paragraphs.

4.3.1 TRANSACTIONS MOTIVE

The transactions motive of holding money has emphasised by Irving Fisher. It refers to the demand for money for the conduct of day-to-day transactions. Since most of the people settle their transactions with money, they carry some cash with them.

Expenditure is continuous because wants arise continuously and have to be met. On the other hand,a person's income is periodic- once a week/fort nightly/monthly. So the individul's income and expenditure do not balance in the short period. Further the longer the interval between income and expenditure the greater the quantity of money to be held by the people.

In the case of an individual,the amount of money required to be held for transactions purpose depends on the size of his income, nature of his transactions and the time gap between receipt of income and expenditure. The total amount of money required in an economy for transactions purpose depends upon the level of national income, employment and general price level. For example,if employment and output rise, the total quantity of money needed to handle transactions too will rise. Thus the quantity of money held for transactions purpose varies in direct proportion to the quantity of transactions taking place in a given period. There is a direct relationship between the amount of money held for transactions purpose and the size of national income. For instance, the increase in economic activity will increase the number of transactions. So the amount of cash held to meet transactions varies with the level of economic activity. Similarly the amount of money held for transactions purpose varies directly with the size of national income.

This type of demand for money is fairly stable and predictable. Rarely is it subject to sudden and violent shifts. Keynes was of the opinion on that transactions demand for money is 'income elastic' but not interest inelastic'. Income elastic means that increase in income will be followed by some increase in transactions demand for money. So income elasticity will be more than zero, but less than one. By interest inelastic we mean that the transactions demand for cash is not depend on the rate of interest. That is cash required for current transactions is not related to the rate of interest. However, if the interest is fairly high individuals may tend to reduce their transactions demand for money. It is therefore appropriate to say that at high rates of interst, demand for cash for transactions is interest elastic. On the otherhand at medium and low rates of interest, demand for cash for transactions is interest inelastic.

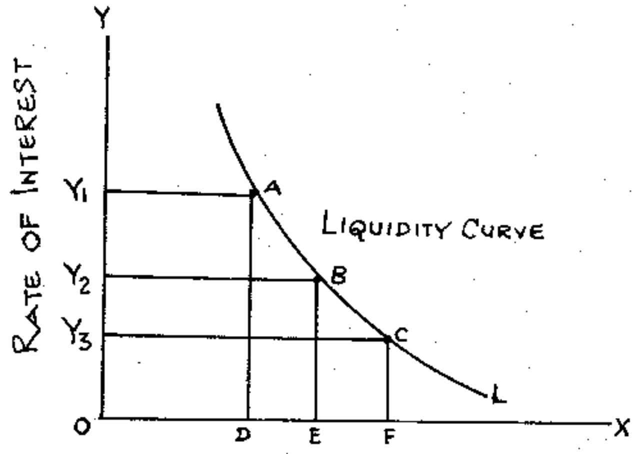
4.3.2 PRECAUTIONARY MOTIVE

Inadequacy of money may create difficulties to individuals or business firms keep such difficulties , individual and business firms additional sums of money on hand to ensure protection in the event of an emergency. This is called precautionary motive for holding money. The quantity of money required under precautionary differs from individual to individual and from one business firm to another. It largely depends on the nature of the business, access to credit market convertibility securities into money in the event of an emergency etc.

4.3.3 SPECULATIVE MOTIVE

People and institutions speculates about the future level of prices of all types of assets and securities in order to make profit or avoid losses. Keynes defines speculative motives as the desires of people to earn profit by knowing the market situation much earlier than what the future will bring forth. The quantity of money people would like to hold for speculative purposes depends upon factors like the present rate prevalent in stock exchange.

It has been mentioned in the foregoing pages that demand for money for speculative puposes depends upon the rate of interest. Other things being equal,the higher the rate of interest, the less will be the demand for cash. That is to say, the liquidity preference for speculative purposes is a negative function of the rate of interest. This can be explained with the help of the following diagram.



Speculative Demand for Money

The 'L' curve in the above diagram is the liquidity curve. It is sloping downwards from left to right. This indicates that there is an inverse relationship between speculative demand for money and rate of interest. The lower the rate of interest, the greater will be the desire of people to hold money for speculative purposes and vice versa. At lower interest rates, people would prefer to hold money rather than to buy securities. In the above diagram at point'A' the rate of interest is higher at 'r1' and hence the demand for money 'D' is lower. At point 'c' the demand for money is higher (F) because the rate of interest is lower 'r3'. Thus there is an inverse relationship between the rate of interest and the speculative demand for money.

There are three more motives for holding money. They are a) inflationary motive: b) business expansion motive and c) convenience motive. These motives are discussed below.

4.3.4 DEFLATIONARY MOTIVE

Holding money for this purpose arises when there is a general tendency for all prices to decline. When prices decline both producers and Consumers have a tendency to postpone their purchases. For instance,manufacturers will postpone their purchase of raw materials when they anticipate fall in prices of raw materials and other stores. Consumers may have a tendency to postpone their purchases under conditions of falling prices. Thus instead of purchasing goods people will tend to hold larger quantities of money. The opposite tendency prevails where there is an inflationary rise in prices. The volume of money held for deflationary motive is determined by variations in prices.

4.3.5 BUSINESS EXPANSION MOTIVE

This refers to the motive of business houses in accumulating and holding money in order to finance their expansion programmes. In the case of individuals also a similar motive applies because they hold some money to purchase expensive durable consumer goods and to acquire other assets like house etc.

4.3.6 CONVENIENCE MOTIVE

This implies that the holding of money is the most convenient way of keeping one's savings. Since adequate knowledge is required to buy securities and it involves risk,some people have a tendency to keep money intact. It is more in the case of low income groups. They are not interested in capital gains. They would rather prefer to hold their savings in money than in any other form.

CHECK YOUR PROGRESS - 1

List out the important reasons for holding money as per the Cambridge economists.

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4.4 ELASTICITY OF DEMAND FOR MONEY

A clear understanding of the concept of elasticity of demand is necessary before discussing elasticity of demand for money. The elasticity of demand for a commodity is the ratio of **change in demand** to the ratio of **change in price**. It is the response of demand to a change in price. The elasticity of demands for a commodity may be **unity** (=1) or more than unity or less than unity. It is unity if a change in price causes a proportinate change in demend . If the variation in demnd is more than the proportionate change in price, the elasticity of demands more than one and vice-versa.

Just as the demand for a commodity depends upon its price so also the demand for money depends on its value. The response of demamd for money to changes in value of money is known as the elasiticity of demand for money. The elasticity of demand for money is ratio of change in demand for money to a given change in its value. It may be represented as

$$\text{Elasticity of demand for money: } = \frac{(\text{Percentage change in demand for money})}{(\text{percentage change in the value of money})}$$

It is to be understood that value of money is the **reciprocal of the general price level.** In other words, it rises in the same proportion as the fall in price level and vice versa. A fall in the value of money (i.e., rise in price level requires a large quantity of money for transactions and for liquidity purposes. A fall in the value of money causes the demand for money to rise and vice versa.

According to classical economists the elasticity of demand for money is always unity. It means a change in value of money causes an exact change in its demand in inverse proportion. For example,if the value of money falls by 15 per cent (due to rise inprice level by 15 per cent, the demand for money expands by the same proportion. A decline in the value of money by 15 percent implies that the community requires a proportionately large amount of money to caarry out the volume of transactions a before. Supposing that the general price level falls by 15 Percent money rises by 15 per cent and demand for money falls by 15 per cent.

The elasticity of demand for money may be analysed in a slightly modified way. If the total demand for money is always equal to the total supply of money, the elasticity is unity. The classical economists contention was that the total amount of money demanded by the community must always be equal to the total quantity of money in existence or the volume of money supply. If the supply of money increases causing a proprtionate rise in prices, then the money held by the community will increase in the same proportion as the rise in prices. Thus according to classical economists, the demand for money has unit elasticity since it is equal to the supply of money.

The classical analysis of the demand for money is now considered to be defective on the following grouds:

Firstly, the classical version is based on the assumption that total output of goods and services in the economy remains constant even when supply of goods services will increase whenever there is an increase inthe supply of money changes. However,modern economists are of the view that the supply of money and prices.

Secondly,the classical theory was developed on the assumption that demand for money as a cash balance will move in the same proportion as the change in the price level. This assumption failed to take into account that proportion of money which people hold with them as an asset. So the total demand for money is determined by changes in the price level and asset demand for money.

4.5 SUPPLY OF MONEY

The supply of money refers to the total quantity of money held by the people at a particular point of time in the country. The term 'total quantity of money refers to the total amount of money in circulation. In this context quantity of money includes the amount of money held by individuals and business houses and exclude money held by the Government in treasuries and money lying with commercial banks and the central bank of the country.

4.5.1 COMPONENTS OF SUPPLY OF MONEY

The supply of money in spendable form consists of two important componets namely a) currency component and b) deposits component. Currency component consists of coins and currecny notes, used by commercial banks,which are in circulation. Deposit component consists of bank deposits with the commercial banks. While the former is regulated by the government and the central bank, the latter is regulated by the banking system.

Here it is pertinent to know the distinction between currency money and deposit money. Currency money is legal tendermoney because it has genral acceptability and is used in all transactions and settlement of debts. It is also called common money or ordinary money.

Bank money or deposit money consists of demand deposits of people with the commercial banks. Cheques are issued against this deposit money. However a cheque by itself does not command general acceptability as a medium of exchange. But it is accepted as an instrument for settlement of debts.

The concept of supply of money does not include certain items. So for a clear understanding of the term 'supply of money', it is necessary to know the items which are excluded from its purview. They are firstly, the coins and currency notes cash held by commercial banks are excluded because they constitute the basis of deposit money of the public. Secondly, the stock of monetary gold with the Central bank is also excluded from the concept of money supply. It is because gold forms the basis of international monetary system and it is not allowed for circulation within the country. Thirdly,the cash held by the Government and the Central bank is excluded. The reason is that it constitutes the reserves on which the demand deposits of the public are supported.

The proportion of currency money and deposit money in the total money supply depends upon factors like the state economic development of a country,the banking habits of the people, the level of incomes of the people,the nature and custom of business and trade and level of prices.

In advanced countries the number of transactions is very large and medium of exchange is mostly cheques and drafts because of well developed banking systems. These countries have people with high literacy rate, high level of income, and high banking habits. On the otterhand, in developing countries, the banking system is not so developed and banking habits are restricted to a small group of people. Most of the people are illiterate and do not make use of banking facilities. Therefore, in a developing country the proportion of currency to total quantity of money usually will be very high. But in advanced countries, the proportion of bank money to total money supply will be high. The income levels of people and economic status also influence the percentage of money components. For example, it is assumed that the rich people usually make use of bank money while the poor use mostly coins and currency. In a country with the vast majority of people having a low level of income, the ratio of currency to aggregate money supply will be low.

The stage of economic development of the country also determines the proportion of currency and bank money to total money supply. As an underdeveloped country gradually progress in various sectors and as national income and per capita income rises over a period of time, the ratio of currency to aggregate income will decline and ratio of deposit money will increase.

4.5.2 NATURE OF BANK DEPOSITS IN A DEVELOPING ECONOMY

The normal trend in a developing economy is that with an increase in national income, there is an increase in the money supply. At the same time, the proportion of deposit money in the total supply of money also increases. Besides, with the economic growth, the supply of money will become more elastic and the proportion of bank deposits will naturally increase. Nevertheless in a developing economy, it is possible to have a situation in which the proportion of bank deposits may decline even though there is an increase in the national income. This may happen due to the following reasons :

1. It is quite possible that banking facilities might be limited in the early stages of economic development. As a result, bank deposits may lag behind the growth of national income.

2. If the economic development is coupled with rapid increase in prices, the monetary authority may resort to the policy of restricting currency as well as bank deposits.

3. Sometimes, currency expansion may be much larger than the expansion of bank deposits. This may result in a decline in the proportion of bank deposits to the total money supply.

4. In the early stages of economic development when the banking system is not well expanded, people may not have banking habits. They may prefer to hold money in the form of currency rather than bank deposits. Obviously the national income and the volume of money held by the people may increase without there being a proportionate increase in the bank deposits.

4.6 AGENCIES CREATING MONEY

There are three main agencies to create money supply in an economy. They are 1) Commercial Banks 2) Central Bank and 3) the Government.

4.6.1 COMMERCIAL BANKS

Commercial banks have the power to create bank money or deposits. There are two ways of doing it. Firstly, the customers keep their money in the form of deposits. These primary deposits form cash for the banks. Secondly, commercial banks make loans and advances to different parties. Whenever a bank lends money, the customer is allowed to withdraw the sum by means of cheques. Thus, though loans, deposits are created. Such demand which are created at the initiative of the commercial banks are known as derivative deposits.

Derivative deposits involve exchange of claims i.e., borrowers supply to the bank their I.O.U's and receive instead, I.O.U's, of the bank. It is to be noted that while the debt of the customers is not generally acceptable as money, the debt of the commercial banks is acceptable as money. Therefore, in the modern economy, bank deposits are significant. They constitute money and influence the level of economic activity in the country. More bank loans means more investments more production and trade.

The following are some of the factors which influence the volume of bank deposits created by the commercial banks-1) the quantity of cash available with the banks 2) the ratio of cash to bank deposits 3) the willingness of borrowers to borrow funds from the commercial banks and 4) the control of the Central bank over the commercial banks. It is pertinent to note that the money supply is not influenced by time deposits because these deposits are not subject to cheques and not used as means of payment. They constitute the savings of the people.

4.6.2 CENTRAL BANK

The Central bank affects the money supply in an economy in two ways. Firstly, it issues currency notes and mints small coins. Secondly, it has the power to regulate the volume of loans and advances made by the commercial banks.

As already mentioned, the ability of commercial banks to create deposits will depend upon the cash these banks keep with them. The larger the cash balance, the more will be the loans and advances the banks can issue. Consequently, more will be the volume of deposit expansion. In order to increase the cash balance of commercial banks, the Central bank may purchase securities from market and pay cash to these banks or lend them additional funds. It may also reduce the reserve ratio with the help of any law or legislation and thus enable them to have surplus cash resources. The Central bank may also use direct controls called Selective Credit Controls to instruct commercial banks not to give loans to particular parties or may impose ceiling on loan component. Thus the Central bank controls the volume of money supply in the economy.

4.6.3 GOVERNMENT

The Government too plays an important role in the supply of money in a country. The taxes collected by the government from the public will reduce the volume of money with the people. On the other hand, government's expenditure increases the supply of money in the country. When the income from taxation and borrowings are inadequate to meet it's expenditure, the Government may create money through deficit financing. The normal procedure of creating money is for the Government to provide its own securities to the Central bank and collect equal amount of I.O.U's from the latter. The Government utilises these funds to pay its creditors. The ultimate effect is that the volume of cash with the public and the banking sysytem increases. The Government can also increase the supply of money through borrowings from commercial banks against its own securities. In such a case, commercial banks will create demand deposits in the name of the government. Thus the supply of money in a country can be increased. Also if the commercial banks expand their lending operations and increase bank deposits, if the central bank pumps in more money into circulation or influences commercial banks to expand credit, and if the government borrows from the Central bank and the commercial banks and creates expansion of common money as well as deposits, the supply of money in a country can be increased.

The components of money supply, namely, currency and deposits are vital for monetary management. The Central bank and the Government create the currency component while the deposit component is created by the commercial banks, subject to the rules of the Central bank.

It is not possible to issue currency in a short period due to certain statutory restrictions. So the currency component is generally inelastic. On the other hand, supply of bank money is easy and therefore it is elastic. If monetary authorities intend to change the money supply it is easier to manage the deposit component than the currency component. In a predominantly agriculture country like India, the currency component is higher than deposit component. Consequently monetary management is difficult.

CHECK YOUR PROGRESS - 2

How is money supply created in an economy?

4.7 ELASTICITY OF MONEY SUPPLY

Since money serves as a medium of exchange and of payments, there exists a direct relationship between the level of production and volume of trade on the one side and supply of money on the other. So any change in the level of production and trade will have to be accompanied by an equal change in the volume of money supply. If this does not happen, the price may either go up or go down. For example, if an increase in the volume of trade is accompanied by a smaller increase in the supply of money, the prices will go up. On the other hand, if supply of money is increasing at a greater rate than the increase in the supply of goods, there will be a decline in the price level. A change in the supply of money according to change in the volume of trade is known as elasticity of money supply. The monetary elasticity directly depends upon the ability of the Central bank or the monetary authority in the country to change the volume of money. Any shortage in the supply of money results in tight money conditions and it can be removed by the Central bank by pumping in more money into the economy.

On the other hand, if the supply of money is more than the demand for the same, the Central bank can remove the excess money by applying the technique of open market operations and other measures.

4.8 SUMMING UP

Money has two types of demand viz., transactions demand and asset demand. The former is related to the medium of exchange function of money and the latter to the function of store of value. Under static conditions the demand for money is constant and is directly changes in proportionate to the changes in the national income. But under dynamic conditions the demand for money will not change in proportionate to the changes in the national income.

Money is held for different reasons viz., transactions motive, precautionary motive, speculative motive, deflationary motive, business expansion motive and convenience motive. The elasticity of demand for money is the ratio of change in demand for money to the change in the value of money. As per the classical economists the demand for money is unity as the demand for money is equal to the supply of money.

The supply of money refers to the total volume of money held by the people in the country. It consists of two components, viz., currency component and deposits component. The proportion of these components depends upon certain factors like state of economic development of a country, the banking habits of the people, etc., Usually in a developing country the proportion if currency to the total money supply will be high. Where as in a developed country the proportion of deposit money to the total volume of money will be high.

The three important agencies which create or influence the money supply are : Commercial banks, the Central bank and the government.

Elasticity of money supply refers to the change in the supply of money according to the changes in the volume of trade. It is the monetary authority which changes the volume of money in the country.

4.9 CHECK YOUR PROGRESS : MODEL ANSWERS

1. The three important motives for the holding money are i) Transactions motive; ii) Precautionary motive; and iii) Speculative motive.

2. Money is created by the three agencies in the following ways:

   i) Commercial Banks : They create bank money or demand deposits. They create demand deposits in two ways. In the first way, primary deposits are created when the customers deposit money in the bank. Secondly, derivative deposits are created when commercial banks make loans and advances to the different parties.

   ii) The Central Bank : The Central Bank influences the money supply in two ways. Firstly, being the supreme monetary authority, it has the power to issue currency notes and mint small coins. Secondly, it has certain powers to influence the volume of loans and advances made by the commercial banks.

   iii) The Government : The Government too influences the supply in a country by the collection of taxes and borrowings from the public on one hand and by the Government expenditure on the other.

4.10 MODEL EXAMINATION QUESTIONS

A. ESSAY QUESTIONS

Answer the following in about 30 lines each:

1. What is 'demand for money' Explain the different motives for holding money.
2. Discuss the role of various agencies in the creation of money supply.
3. What is supply of money? Explain the components of supply of money.

B. SHORT QUESTIONS

Answer the following in about 15 lines each:

4. Distinguish transactions demand for money from asset demand for money.
5. Explain the demand for money under static and dynamic conditions.
6. Explain the concepts of elasticity of demand for money and elasticity of supply of money.
7. Describe the nature of deposits in a developing economy?
8. Explain the speculative motive for money with the help of liquidity curve.

4.11 RECOMMENDED BOOKS

1. Crowther.G : An Outline of Money
2. Culbertson John.M. : Money and Banking
3. Jhingon M.L. : Money, Banking and International Trade.
4. Sundaram K.P.M. : Money, Banking and International Trade.
5. Vaish M.C. : Money, Banking and International Trade.

4.12 GLOSSARY

Elasticity of demand for money : Ratio of change in demand for money to a given change in its value

Elasticity of money supply : A change in the supply of money according to the changes in the volume of trade.

Liquidity preference : The extent to which investors prefer to keep their assets liquid (i.e., in the form of money)

National Income : The total money value of all goods and services produced in a country during a specified period, generally one year.

Supply of money : The total volume of money held by the people in a country.

UNIT-5 : THEORIES OF VALUE OF MONEY

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5.0 AIMS AND OBJECTIVES

This unit aims at discussing the different theories of value of money.

After reading this unit, you will be able to:

- explain the relationship between the quantity of money and the value of money,
- discuss the two versions of the quantity theory of money,
- distinguish between the cash-transactions version and the cash balances version, and
- Explain the Income and Expenditure Theory of the value of money.

5.1 INTRODUCTION

By value of money, we mean the purchasing power of money over goods and services within a country. Generally, the value of money does not remain constant. Sometimes it rises and sometimes it falls. There is an inverse relation between the value of money and the price level. When the price level rises, the value of money falls, and vice versa. The various versions of

5.3.1 ASSUMPTIONS OF FISHER'S THEORY

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

1. (V) and (T) are independent variables. They are not influenced by changes in the quantity of money (M) or the price level (P). Velocity of circulation (V) depends upon the availability of goods to be bought and sold, the rate of turnover and the quantity of money people would like to hold. On the other hand, the volume of goods and services (T) depends on natural resources, production, transport, etc.

2. (P) is a passive factor. Neither does it change by itself nor does it cause any change in other factors. But it is affected by other factors in the equation.

3. Fisher's theory holds good in the long run. In the short run with changes in supply of money (M) there can be a change in other variables also i.e., changes in (P), changes in (V) and changes in (T), But when the short period transactions are over, (V) and (T) will become normal and therefore, a change in (M) will be followed by a change in (P).

4. Fisher also assumed that conditions of full employment exist in the country. Full employment implies that no idle resources are available to increase the production of goods and services. This assumption of full employment is implicit in another assumption that the volume of goods and services (T) is constant and relatively fixed. Thus the quantity equation of Fisher can be understood as follows:

a) (P) The price level is determined by three factors (M), (V) and (T).

b) Changes in (V) and (T) can be ignored in the long run and (P) does not change by itself.

c) A change in (M) is followed by an equivalent change in (P).

5.3.2 CRITICISM OF FISHER'S THEORY

The quantity theory of money as embodied in the equation formulated by Fisher has been subjected to the following criticism.

1. Fisher's equation is based on highly unrealistic assumption. He assumes (V) and (T) are independent variables and as such are not affected by changes in money (M). But in practice, changes in quantity of money bring about immediate changes in velocity of circulation (V) and also the quantity of output (T).

2. Pigou points out that (V) varies with the volume of trade and prices. (V) is also affected by changes and expected changes in the volume of money. Fisher assumes that the price level (P) is passive and is dependent upon changes in M. This is baseless. As a matter of fact, each one of the elements in this equation influence the other and is influenced by the other elements and there is no passive element at all.

3. The equation of exchange does not throw any light upon what factors determine the value of money. It merely states an identity. When the community is considered as consumers, their total spending is equal to the total volume of money held by them, multiplied by the velocity of money. From the view point of the community as producers, total expenditure is equal to the volume of trade multipled by the price at which transactions take place. Thus the equation merely splits up expenditure into two different parts namely MV and PT. This equation is a mere truism and is of no use as a tool of economic analysis.

4. The quantity theory does not deal with the general purchasing power of money. It deals only with some kinds of transactions which relate to purchase of goods and services meant for cosumption and form a part of the total volume of transactions. Thus Fisher's equation gives us the value of money in terms of a unit of transaction but not in terms of a composite unit of consumption goods and services.

5. Another shortcoming of Fisher's quantity theory is that it fails to explain the channel by which an increase in (M) produces an increase in money expenditure. It does not explain how money enters into circulation, raises demand and pushes up prices.

6. It is wrong to assume always that increased spending does not raise the real output but raises prices only. If increased spending occurs during the period of depression which is characterised by mass unemployment of labour, output will expand substantially without much increase in prices. Spending (MV) may not rise in proportion to M because 'V' falls. Price may not rise in proportion to spending because output 'Q' rises.

7. The quantity theory does not explain trade cycles. During the period of depression, an increase in the supply of money fails to raise the price level. Depression takes place not because of lack of money but because of lack of incomes. In a period of depression businessmen are pessimists. They do not take loans even if banks are prepared to lend on easy terms.

8. According to Keynes the theory holds good only in those countries in which there is the existence of employed resources of men and materials. Any increase in the quantity of money may increase the quantity of output without effecting the price level.

It is evident that Fisher's theory lays emphasis on the supply of money but slurs over demand. The Cambridge economists tried to rectify this mistake by placing equal emphasis on the demand for and supply of money.

CHECK YOUR PROGRESS - 1

List out the assumptions of Fisher's Theory.

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5.4 QUANTITY THEORY OF MONEY: CASH BALANCES APPROACH

The main propelling force behind developing the cash balance approach was to integrate the theory of money with the theory of value. Since the Cambridge economists did much to formulate and develop this equation, it is known as the Cambridge equation. Alfred Marshall, A.C. Pigou, J.M. Keynes and D.M. Robertson who belonged to the Cambridge University contributed to the development of cash balance version of the Quantity Theory of Money.

According to the Cambridge version, the value of money (or the price level) depends upon the demand for money. This approach depends upon the demand for and supply of money as obtaining at a particular moment (instead of obtaining during a particular period of time).

Demand for money is not only for the purpose of transactions but also for the purpose of storing up value. The demand for money which shows the determination of people to retain the power to purchase certain volume of commodities, services and property rights, largely depends upon the liquidity preference of people. It increases when people decide to keep more money in cash and this results in a decline in the velocity of money.

The advocates of cash balance version of the quantity theory generally give three reasons as to why people would like to hold cash with themselves.

(i) People hold cash in order to buy goods and services to carry on their day-to-day transactions.

(ii) They keep cash to protect themselves from unforeseen contingency.(This is known as precautionary motive)

(iii) They keep cash for speculative purposes.

It is assumed that at any given time, the public can hold a certain amount of cash balance sufficient to purchase a given volume of goods and services which may be considered a fraction of the national income. The proportion of the cash balance that the business firms and the public may wish to hold at anytime may be one-tenth or one-twelfth of the national income.

5.4.1 MARSHALL'S QUANTITY EQUATION

The cash balance version of quantity theory of money is explained by Marshall in the following statements:

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

According to Marshall, people in a country hold certain portion of their annual income in the form of currency or ready purchasing power and certain other fraction in the form of property or wealth. Therefore, the total amount of money demanded by the people is related to their annual income and the amount of their property.

The quantity equation of Marshall is: $M = PKY$

Where, M stands for quantity of money of the people

P represents the price level.

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

Y stands for the real income

The following illustration helps us to understand the equation more clearly. Supposing at a particular time, people normally have a cash balance to buy one-tenth of the annual income of the community. But at present they want to have cash balance of one-sixth of the national income. It means they want to hold more cash with themselves. This is possible only when the public reduces their expenditure on goods and services. Thus demand for large cash holdings means lesser demand for goods and services and decline in their prices.

If the people like to hold less cash balance with themselves, they will spend more on goods and services. As a result the price level will go up. Thus according to cash balance version of the quantity theory, the value of money depends upon the demand for money to be kept as cash.

Marshall's equation contains the asset and wealth components. The demand for money was functionally related only to the level of money income.

5.4.2 PIGOU'S QUANTITY EQUATION

Starting with the quantity theory of money, Pigou has observed that 'an increase in the supply of legal tender ought, always, since the elasticity of demand for legal tender is equal to unity, to raise prices, in the proportion in which the supply is increased'. The unit elasticity of demand for money simply means that if the purchasing power of money (1/p) is doubled its demand is halved and vice versa.

Pigou's quantity equation is: $P = \frac{KR}{M}$

Where, P = purchasing power of money

M = Money with the public

R = National income or total resources of the community, and

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

Pigou's equation says that the value of money (P) is equal to the amount of goods and services which people want to buy (KR) divided by the amount of cash balance with them.

It is to be noted that there is a lot of difference between Fisher's and Pigou's equations in respect of the use of the symbols P and M. In Pigou's equation 'P' stands for purchasing power which means the increase of price level. Symbol M x M is used as denominator in Pigou's equation while in Fisher's equation it is used as the numerator.

In terms of Price level Pigou's equation is:

$\frac{1}{P} = \frac{M}{KR}$ in which $\frac{1}{P}$ is Price level

But all peopled do not hold cash in the form of legal tender, some of them hold part of it in the form of bank deposits also. Hence, the equation was enlarged as follows:

$$P = \frac{KR}{M} [C+H(1-c)]$$

Where 'C' stands for the proportion of cash which people hold in the form of legal tender money, 'H' represents the percentage of cash which is kept in the form of bank deposit, (1-C) stands for bank deposits. If the total amount of money in the community is assumed as 1, part of it is held by the public as cash ,(viz., C) and the balance (viz. 1-C) is held by the public as deposits with the bank. The entire deposits of bank are not kept as cash but only a portion of it is kept as cash and this is represented by 'H'. Therefore, [C+H(1-C)] represents the total amount of cash in the country at a particular time.

5.4.3 ROBERTSON'S QUANTITY EQUATION

Robertson, another leading member of the Cambridge school of econiomists, gave the following equation:

$M = PKT$ (or) $P = \frac{M}{KT}$

Where, P= represents price level (the reserve value of money)

T= total amount of goods and services

K= the fractional part of T over which people wish to keep cash

Robertson's equation is the same as that of Pigou's with only minor difference. This is preferred to that of Pigou because of its easy comparability with that of Fisher.

5.4.4 KEYNES'S QUANTITY EQUATION

Keynes's cash balance equation refers only to consumption goods. According to him people hold money to buy or to represent only consumer goods and services. His equation is as follows:

$$n = pk$$

or

$$p = \frac{n}{k}$$

Where n is cash held by general public

p is price level of consumption goods

k is the portion of consumption goods over which cash (n) is kept.

Keynes stresses that people are interested in the value of money with regard to consumption goods only. Since he is studying the value of money in a restricted sense, Keynes used small letters and not capital letters in his equation.

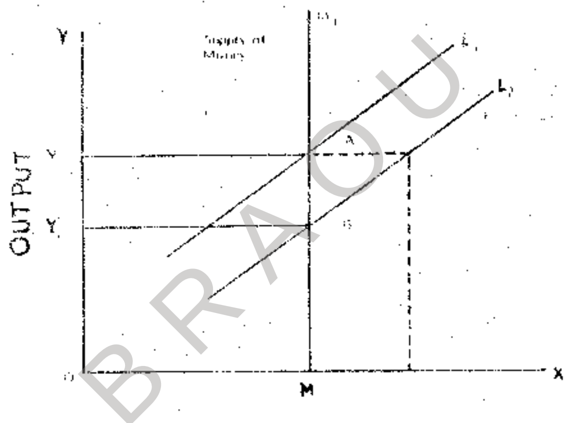
The equation is $n = p(k + rk^1)$,

in which k refers to consumption goods over which bank deposits are kept and represents the proportion of cash resources kept by banks against bank deposits.

5.4.5 AN ASSESSMENT OF THE CASH-BALANCE APPROACH

The cash balance version of Quantity theory has the merit of relating the value of money (in price level) to changes in demand for money. Changes in people's intention for keeping cash balance are represented by K. If people demand more money (rise in K) they have to spend less on goods and services (because the supply of money at any time is fixed). Decline in demand for goods and services leads to fall in prices. Conversely, if people desire to hold less cash (fall in k) their demand for goods and services will rise and as a result the price level will rise.

This can be explained with the help of the following diagram:



DEMAND FOR AND SUPPLY OF MONEY

MM_1 shows the supply of money: it is fixed at a particular point of time determined by the monetary authorities and hence it is fixed. L_1 stands for the demand for money. Output Y_1 is determined at a point wahere the demand for money is equal to the supply of money. When the demand for money to hold increases, the L_1 curve shifts to L_2 and a new equilibrium is established with a lower output, Y_2. In other words the Cambridge equation shows that:

i) Increased demand for money to hold means decreased demand for goods which will result in decreased income and output.

ii) Decreased demand for money to hold means increased demand for goods which will result in increased income, output and prices. Thus the cash balance equation attempts to offer explanation for the occurance of business cycles. However, it has been subjected to the following criticism.

1. All the Cambridge economists have emphasised the purchasing power of money in terms of consumption goods. The most important shortcoming of these arguments is that the value of

money or purchasing power of money cannot be artificialy limited only to consumption goods. The fact that money is used to buy many other goods is lost sight of.

2. Though the cash balance equation does attempt to explain changes in the level of economic activity, its attempt is hardly adequate. No direct reference to this has been made. (However, at a later stage, Keynes pointed out the need for economic activity to create purchasing power).

3. The cash-balance version does not take into account such variables as income, savings and investment which vitally influence changes in price level.

4. The cash balance equation neglects the asset demand for money. The equation does not emphasise the role of interest rate in determining the demand for cash balance. Consequently, the equation remains separate from the whole corpus of the monetary theory dealing with the rate of interest.

5. In this equation, cash balances of all groups of people have been jumped together. In fact different people's cash balances are subjected to different behaviour patterns.

5.5 COMPARISON BETWEEN CASH-TRANSACTIONS VERSION AND CASH-BALANCES VERSION

1. While the cash-transactions version emphasises the value of money over a period of time by incorporating the velocity of money (V), the cash-balance equation explains the value of money at a point of time by including the concept of demand for cash balance (K).

2. According to Robertson the two equations are different observations of the same phenomenon. The cash transactions equation is concerned with money as a flow while the cash balance equation is concerned with money as a stock or store of value.

3. While the cash-transactions equation stresses the transactions velocity of money (V) the cash balance equation emphasises demand for cash balance (K).

4. The American version of the quantity theory of money hardly explains how changes in the volume of money brings about alterations in the price level. The Cambridge version says that changes in the desire of people to hold money may bring about change in the price level even without any change in the total volume of money.

5. The Cambridge equation emphasises the demand for and supply of money. Thus it ensures interaction of monetary theory with the general theory of demand and supply. This is missing in the cash transactions version.

5.6 SHORTCOMINGS AND MERITS OF THE QUANTITY THEORY OF MONEY

Defects of Quantity Theory of Money

1. The quantity theory of money was subjected to severe criticism during the early thirties of this century. During the period of the great depression 1929-33, the prices declined steeply and unemployment prevailed all over the world. Attempts of monetary authorities to check the fall in prices through increasing the quantity of money proved to be ineffective. It became clear that price level was not a function of money supply alone but a number of non-monetary factors also influenced prices. For example, during war (war economy) the prices increase and the number of transations increase. As a result, more money is required. Monetary authorities may respond to it through pumping more money into the economy.

2. The quantity theory says that change in the quantity of money is the cause and change in prices in the effect. Keynes pointed out that this was not so: change in supply of money is

not the cause of change in prices level. According to him, the factors primarily responsible are change in income and expenditure and change in the relation between savings and investments. The quantity of money is a secondary factor when compared to the volume of expenditure.

3. The quantity theory of money has been useful in formulating monetary policies. The theory is based on the assumption that there is a direct relatioship between the quantity of money and price level. Though true, this may not hold good at all times: because prices are also influenced by other factors like weather and the size of harvest, inventions, foreign trade, Government spending, wages, taxes, etc.

Merits of the Quantity Theory

1. Inspite of the above defects, this theory has been used as the basis to evolve monetary policies and make decisions pertaining to the control of prices. The monetary authorities control and regulate prices through either increase or decrease of the quantity of money in the economuy. Techniques like bank rate, open market operations, etc., are based on the assumption that a larger volume of money in circulation will lead to higher prices.

2. The quantity theory assumes that the velocity of circulation of money, the quantity of bank deposits, issue of the currency by the Government, improvement in industrial development, etc., are the determinants of price level. In considering the effect of any one of these factors on price level, it is necessary to determine the effect of other factors which may influence or out-weight the particular factor influencing the prices.

3. Milton Friedman contends that no adequate exercise was given to test the validity of the quantity theory during the great depression. According to him there should have been due expansion of money or of credit or of both to fight out the adverse effects of depression. He believes that the present inflationary rise in prices in many parts of the world is due to expansion in money supply i.e., much in excess of expansion in real income.

CHECK YOUR PROGRESS - 2

Mention the defects of quantity theory of money.

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5.7 THE INCOME AND EXPENDITURE THEORY

The income and expenditure approach to the value of money was developed as a protest against the quantity theory of money. The income theory emphasises that changes in the supply of money can influence the price level of aggregate real income and consequently in its components namely, 'aggregate consumption' and 'investment'. The theory focuses attention on the flow of income creation, consumption, savings and investment as the ultimate causes for changes in the price level or the value of money. Though many economists were associated with the development of this theory, it was J.M. Keynes who gave a systematic and complete analysais of the income theory in his famous book, "General Theory of Employment, Interest and Money".

The total volume of income and eaxpenditure of the people in the economy is visualised as a continuous flow or steam. The theory assumes that the total volume of income generated in one period automatically becomes expenditure for the next period. Then the level of income and expenditure, the level of business activity, the level of prices, etc., will be stable and constant. In Keynesian language, expenditure means effective demand and more expenditure means more income. For example, expansion in the volume of expenditure i.e., effective demand, results in expansion of income of the community which in turn leads to further expansion of expenditure and so on. Naturally, economic activity expands as production, employment and trade rises. Consequently prices also rise. If the economic activity contracts, the prices decline. Thus the value of money, change in the price level is not isolated but is a part of general change in the economy. These changes are the result of changes in the level of income and expenditure in the economy.

Savings and Investment

The two basic factors that bring about a change in the level of income and expenditure are the level of savings and investment. Savings form a part of the income produced in an economy. An increase in savings leads to a fall in the consumption expenditure, which in its turn results in fall in effective demand. On the other hand, reduction in savings ultimately brings about a rise in effective demand.

Investment means expenditure on new capital goods. The larger the volume of investments the higher will be the volume of expenditure. So, if what is taken out of the total income (savings) is matched by what is added to the income stream (investment) the level of income and expenditure in the economy will be constant.

If savings are more than investment, the volume of expenditure is reduced. It results in reduction of income and expenditure. The level of business activity and prices will decline. On the other hand, if savings are less than investment, the volume of expenditure is increased and it leads to expansion of income and increase in the level of business activity and prices. These changes in the relationship between savings and investment of the community bring about: (a) change in the levels of income and expenditure, and (b) changes in the price level.

5.7.1 REVISION OF THE QUANTITY THEORY OF MONEY BY KEYNES

According to Keynes, prices are determined indirectly through the influence of a chain of events. A change in the quantity of money may lead to a change in the rate of interest, a change in the volume of investment, a change in employment, income, and output, a change in the cost of production and finally a change in the prices of goods and services. Keynes gave up the assumption of full employment which was made in the old quantity theory of money. He says that 'as long as there is unemployment, employment will change in the same proportion as the quantity of money changes'; on the other hand, when there is full employment prices will change in the same proportion as the quantity of money.

KEYNESIAN EQUATION

In brief the income theory of price involves an analysais of income and aggregate demand and costs and aggregate supply. According to the income theory, prices are determined by (1) money income, and (2) by real income.

$$P = \frac{Y}{O}$$

Where, P is the general level of prices

Y stands for money outlay

O represents the physical volume of goods and services produced

When money outlay rises more rapidly than output (O), prices will rise. If on the other hand, output increases more rapidly than the money outlay, prices may fall. Thus prices of consumer goods depend not on the quantity of money but on the income. It is the income that determines prices.

Keynes criticised the classical approach which regarded money as neutral and has no influence on the economy's real equilibruim - equilibrium of relative prices, interest rate and output. The classical theory was a theory of stationary equilibrium while Keynes was concerned with developing a theory of economy in which changing views about the future influence the present situation.

In this general theory Keynes has developed a reformed quantity theory of money integrating the theory of price with the general theory of value and output. He assumes that there will be constant returns on fixed wage unit as long as unemployment is present. Under this situation, an increase in the quantity of money will not raise prices so long as there is any unemployment. But after full employment is reached, wage units and prices will increase in the same proportion in which the effective demand increases (as a consequence of increase in the quantity of money.) It therefore, follows that the aggregate supply is perfectly elastic so long as there is unemployment and perfectly inelastic as soon as full employment is reached. The aggregate effective demand changes in the same proportion as the quantity of money. So keynesian quantity theory of money can be stated as follows: as long as there is unemployment, employment will change in the same proportion as the quantity of money changes, and where there is full employment, prices will change in the same proportion as the quantity of money.

5.7.2 ASSUMPTIONS OF THE REVISED THEORY

Obviously, this reformulated quantity theory of money is based on a number of simplifying assumptions. The following possible complications will, in fact, influence the events and upset the operational importance of the theory.

1. The aggregate effective demand will not change in the same proportion in which the quantity of money will change.
2. Since resources are not homogeneous, diminishing returns will result as employment increases.
3. Since resources lack perfect substitutability, the supply of some commodities will become inelastic while there are still unemployed resources available for the production of other goods.
4. The wage-unit will rise before full employment has been reached in the economy.
5. The factor rewards entering into marginal cost of production will not change in the same proportion.

Due to the above mentioned complicating factors, the increase in the effective demand brought about by the increase in the quantity of money will, generally speaking, spend itself partly in increasing the quantity of employment and partly in raising the level of prices in the economy.

5.8 SUMMING UP

The quantity theory of money states that the value of money depends upon the supply or quantity of money. If the quantity of money increases, the value of money decreases and vice versa. There are two versions of the quantity theory of money, viz., cash transactions approach and cash balance Approach.

The cash transactions equation (Fishers' equation) considers only one function of money, i.e., Medium of exchange. As per this equation, the total volume of money during a given period of time will be equal to the total value of goods and services. This equation is based on some assumptions like 'V'and 'T' are independent variables, 'P' is a passsive factor, prevalence of full employment, etc. But this theory was criticised on the ground [illegible] is based on unrealistic assumptions.

According to the Cash Balance Approach, the value of money depends upon the demend for money to be kept as cash. This approach takes into account the store of value function of money. the Cambridge economists like Alfred Marshall, Pigou, Robertson. Keynes contributed to the development of cash banances approach. This approach has the merit of relating value of money to changes in demand for money. However, the cash balances version was also subjected to some criticism.

The quantity theory of money has both merits and demerits of its own. The income and expenditure theory was developed as a protest against the quantity theory of money. According to this theory the changes in the price level or the changes in the value of money are brought about by changes in the levels of income and expenditure of the country. In the reformulated quantity theory of money, keynes has removed the assumption of full employment and integrated the theory of money with the general theory of value and output.

5.9 CHECH YOUR PROGRESS: MODEL ANSWERS

1. i) 'V' and 'T' are independent variables and are unaffected by change in money (M).
   ii) 'P' is a passive factor
   iii) Fisher assumes a long period of time
   iv) Existence of full employment in the country.

2. i) The change in the volume of money supply is not the only cause of changes in the price level.
   ii) According to the quantity theory change in the quantity of money is the cause and change in prices is the effect. But keynes has shown that both of them are the effects of some important causes, like change in income and expenditure and change in the relation between saving and investment.
   iii) It has not been useful as a guide to monetary policy or the prices are influenced by many factors rather than quantity of money only.

5.10 MODEL EXAMINATION QUESTIONS

A. ESSAY QUESTIONS

Answer the following in about 30 lines each:

1. State and explain Fisher's Equation of Exchange.
2. Distinguish between the cash balances approach and cash transactions approach to the quantity theory of money.
3. Critially examine the cash transactions equation. Briefly discuss the factors that determine the value of money.
4. Briefly explain the Cambridge equation of the quantity theory of money.
5. Bring out the speciality of the income and expenditure theory of Keynes.
6. Critically examine the quantity theory of money.

B. SHORT QUESTIONS

Answer the following in about 15 lines each:

7. Under what assumptions will MV be equal to PT ?
8. Explain the relationship between the quantity of money and the value of money.

9. List out the assumptions of Keynsian Income and Expenditure Theory.
10. Describe the Cambridge equation of exchange.
11. State Keynsian equation of Income and Expenditure.
12. Explain Pigou's Quantity Equation.
13. Explain Robertson's Quantity Equation.

5.11 RECOMMENDED BOOKS

1. Crowther. G.	:	An Outline of Money.
2. Culbertson John. M.	:	Money and Banking
3. Jhingon M.L.	:	Money, Banking and International Trade.
4. Sundaram K.P.M.	:	Money, Banking and International Trade.
5. Vaish M.C.	:	Money, Banking and International Trade.
6. Vaish M.C.	:	Monetary Theory.

5.12 GLOSSARY

Full Employment : An economic situation where unemployment is at a minimum and the number of unemployed is no greater than the number of vacancies.

Purchasing Power : The quantity of goods and services a unit of money can buy.

Velocity of Circulation of Money : The average number of times each unit of money is used during a period.

UNIT-6 : INFLATION AND DEFLATION

Contents

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6.0 AIMS AND OBJECTIVES

In this Unit we explain the economic situation under inflation and deflation and its impact on various sections of people.

After reading this unit, you should be able to:

* explain the meaning of inflation and theories of inflation;
* describe different types of inflation;
* discuss the causes for and effects of inflation;
* list out the measures to control inflation;
* discuss inflationary gap ;
* explain, what is deflation and what is deflationary gap;
* discuss the effects of deflation and the measures to control deflation; and
* distiguish between disinflation and reflation.

effective demand. Increased effective demand without a corresponding rise in the supply of goods and services leads to rise in price level.

Cost-push inflation occurs when prices rise due to an increase in cost of produciton. The reason is that prices of various factors of production increase. This situation arises as a result of either wage-push or profit-push factors.

iii) Open or Suppressed Inflation: Open inflation refers to a situation where prices rise without any interruption. The Government does not take measures to stop the rising prices. On the contrary, suppressed inflation is one where the Government attempts to check the rising prices through price ceilings, rationing, etc. During suppressed inflation, private holdings of cash, bank deposits, etc., increase. While prices do not rise in the controlled sector, they increase disproportionately in the uncontrolled sector.

iv) Creeping, Walking, Running and Galloping Inflation: The above classification is made on the basis of the extent to which prices rise. Inflation is said to be creeping, when price rise is very low, say 2 to 3% a year. Walking inflation refers to a situation, when prices rise gradually at the rate of 3 to 5 per cent a year. Running inflation occurs when prices rise by more than 10% yearly. The most severe form of inflation is 'Galloping' or 'Hyper-inflation' in which prices tend to rise by more than 16%. During the post First World War period, Hyper- inflation was experienced by Germany and the situation was so severe that a cart load of notes had to be carried to buy a cup of coffee. Similarly in France, a basket load of currency had to be carried to buy a loaf of bread.

v) Comprehensive and Sporadic Inflation: Depending on the coverage and scope, inflation is divided into two categories: (1.) Comprehensive inflation and (2). Sporadic inflation. Comprehensive inflation refers to a situation when every sector of the economy experiences inflationary pressures. Sporadic inflation is a situation when inflation occurs only in certain sectors. It is sectoral in nature. For example, increase in prices of food grains due to failure of crops or rise in prices of fertilisers, etc.

vi) Wage-Induced and Deficit-Induced Inflation: Wage-Induced inflation is a situation where prices rise on account of increase in money-wage. Increase in money wages would lead to increase in cost of production without a corresponding increase in output. This leads to a further rise in prices. Money-wage has a tendency to increase whenever prices rise.

Deficit-induced inflation occurs when Government resorts to deficit financing. Government resorts to deficit financing when it is unable to meet expenditure through taxation. This increases the total money supply or purchasing power of the people. The result is rising prices.

6.5 CAUSES OF INFLATION

According to Kenneth, K. Kuriharan, inflationary pressures arise from both the demand side and the supply side. The term **demand** is understood here as demand for money income, and **supply** means available output on which the money income is spent. The factors that cause inflation are discussed below:

i) Demand Factors: Increase in money income may be caused by factors such as (1) Increase in the total money supply in the economy (2) Increase in the amount of disposable income (3) Expansion of Bank credit, (4) Increased consumer expenditure and business outlay.

ii) Supply Factors: Inflation is also caused by factors affecting supply side. For instance when there is shortage of raw material, equipment and machinery, etc., the output of goods and services may not increase corresponding to an increase in money income. As explained earlier, there will not be any increase in the general price level inspite of increase in money income, if there are unemployed persons in the economy. But inflation will set in if money income continues to increase even after full empolyment level is reached.

The Role of Speculation: Speculation too plays a significant part in aggravating inflation. When prices are expected to increase the consumers will purchase more goods; this will lead to rise in prices. In the stock exchanges and produce markets, speculation of price rise accentuates inflationary pressures.

CHECK YOUR PROGRESS - I

List out the causes for inflation

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6.6 EFFECTS OF INFLATION

The effects of inflation are not uniform on all groups of people in the economy. For the purpose of analysis of the impact of inflation all people can be divided into the following major groups.

1. Debtors and Creditors : While debtors as a group are benefitted inflation, the creditors sustain loss. When a person borrows money before the rise in price level and repays at a later date when prices have risen, the purchasing power of money repaid will be less. The creditor loses because the value of money is less than at the time of lending.

2. Investors : Persons who invest in equities are benefitted by inflation. During the period of inflation equity dividends increase due to increased corporate earnings. So equity investors are benefitted.

On the other hand inflation affects adversely those who invest in fixed interest yielding bonds. They get the same increase but less purchasing power.

3. Business Community : Manufacturers, entrepreneurs, businessmen stand to gain during inflation. Businessmen sell the commodities at higher prices and earn windfall profits. The entrepreneurs earn huge profits as the rise prices will be more than the rise in the cost of production.

4. Wages and Salaries : Workers and salaried sections are adversely affected by inflation since wages/salaries do not rise in proportion to rise in prices. Their purchasing power will be relatively less and workers tend to lose. So trade unions bargain with employers for rise in wages.

5. The Rentier Class : People of fixed income groups like pensioners, annuity holders, those living on past savings, etc., suffer the most on account of inflation. Erosion in thier real incomes reduces their standard of living.

6. Farmers : Farmers are benefitted during inflation because of two reasons. Firstly, the prices of farm products increase and secondly, the increase in cost of production is less than the rise in prices. This is more so in the case of farmers who produce food grains. Further in the capacity of debtors they pay back less purchasing power to the creditors. Thus inflation gives double benefit to the farmers.

7. Consumers : Inflation affects consumers very badly. Rise in prices reduces private consumption through reduction in the purchasing power of the people. Thus consumers have to lead a low standard of life during inflation.

Kenneth K. Kuriharan summarises the effects of inflation thus : inflation redistributes wealth and income in such way as to hurt the consumer, creditors, small investors and low and fixed income groups and benefits the businessmen, debtors and farmers.

6.7 CONTROL OF INFLATION

In view of the adverse effects of inflation on the economy in general and on certain groups of people in particular, it is to be controlled by all possible measures. The anti-inflationary measures include (1). monetary measures (2). fiscal measures and (3). other measures.

i) Monetary Measures : According to some economists, inflation is a monetary phenomenon i.e., caused by monetary factors. Milton Friedman is one of the modern economists who advocate monetary measures to control inflation.

Anti-inflationary monetary measures include the Central Banking operation of restricting credit, etc. Some popular measures used by the Central Bank are bank rate policy, open market operations, variable reserve ratio and selective credit control. However, it is to be noted that monetary policy can successfully control inflation only when it is caused by excess supply of money (increased volume of money).

ii) Fiscal Measures : Fiscal measures relate to the government policy in respect of public expenditure and taxation. Keynes advocated Fiscal policy as instrument of checking inflation. According to him, if the inflation is due to excessive aggregate demand over the full employment level, it can be controlled reducing aggregate demand. The aggregate demand can be reduced by way of increasing the rate of taxes, introducing new taxes and reducing the public expenditure. However, it is difficult for the government to curtail certain types of expenditure like expenditure on construction of roads, education, medical and health, etc., which are essential for the development of the people. So it is not possible to reduce such expenditure altogether. However, some unproductive items of expenditure can be reduced to control inflation. Increase in rates of taxes and the introduction of new taxes may reduce consumption and thus bring down pressure on aggregate demand. Increased taxes on the rich people will be much more effective in checking inflation. Taxes on commodities reduce the expenditure of people and hence their demand. Fiscal measures are considered to be more effective than monetary measures to control inflation. However, it should not adversely affect productive investment and result in greater unemployment.

iii) Other Measures : The Government may try to increase output and thereby control inflation. For instance, in a country like India where inflation is due to shortage of agricultural production, inflation can be controlled by increasing agricultural output.

Where inflation is due to speculative activiites, the government may try to restrict such activities. For example, in India, the government has curbed the evils of speculation by taking over the distribution of essential commodities through consumers cooperatives.

If the price rise is confined only to certain commodities the government may try to restrict such activites.

If the inflation is on account of increase in labour cost government can control it by wage-freeze.

6.8 INFLATIONARY GAP

The concept of '*Inflationary gap*' was originated by J.M. Keynes. According to him the inflationary gap for the economy refers to "An excess of anticipated expenditure over available output at the base prices". Keynes brought this concept to emphasise the strategic significance of flow of money influencing the general price level and to indicate the primary importance of fiscal measures in wiping out the inflationary gap.

The aggregate demand for goods and services i.e., total expenditure is derived from three sources: (i) Private consumption expenditure (C) (ii) Private investment (I) and (iii). Government expenditure (G). Thus the total anticipated expenditure is: C+I+G.

The available output to meet the demand for goods and services is a function of employment and the level of technology at a given time. Inflationary gap occurs when there is an excess of demand over available supply. The following illustration makes this concept clear.

First, let us take the demand side: during war period Government's expenditure on Armed Forces increases. This results in an increase in the volume of money. Increased income in the community will lead to increased consumption expenditure and investment. Thus there is an increase in the total expenditure (the total demand).

The net disposable income of the community which constitutes aggregate demand for goods and services may be estimated as under.

1. National income during the given year, say, Rs. 20,000 crores.
2. Tax paid to the government say, rs. 5,000 crores.
3. Gross disposable income: 1-2 = Rs. 15,000 crores.
4. Savings by the community at 10% of the income; Rs. 1,500 crores.
5. The net disposable income with the community (by subtracting the figure at 4 from the figure at 3)

It is net disposable income with the community that determines the aggregate demand of the community for goods and services.

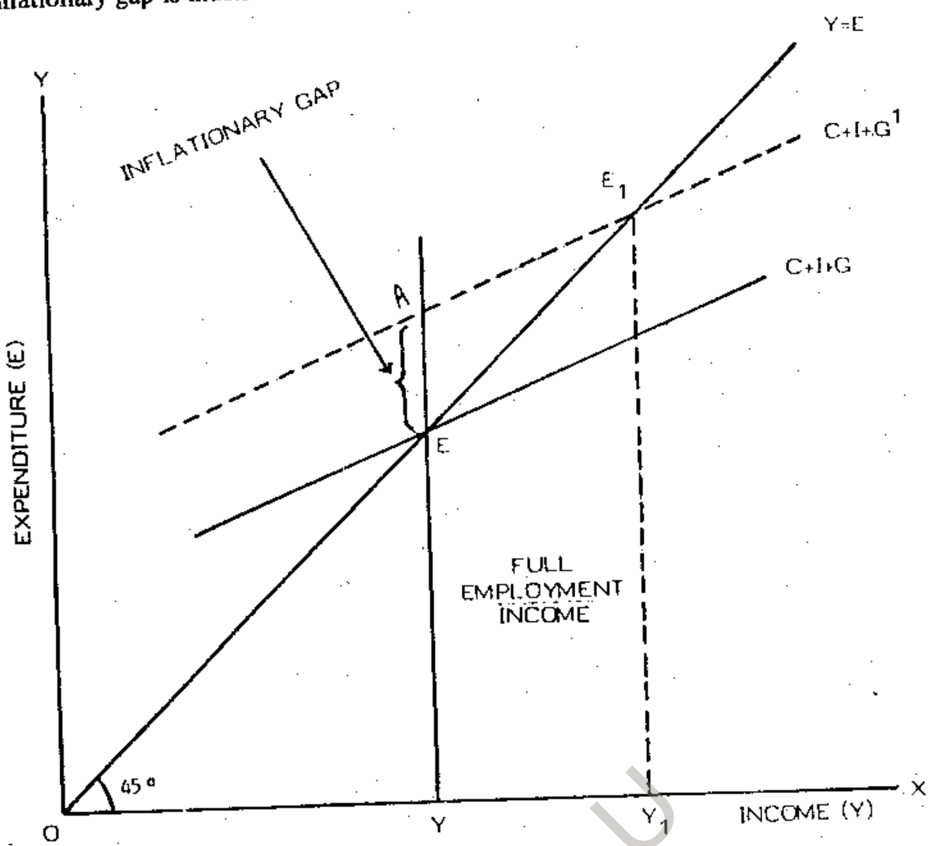
Let us now discuss the supply side:

The aggregate supply comes from the Gross National Product. A part of it is spent by the Government for war purposes. Therefore, the available output for the community's consumption is less than the gross national output. For example:

	Rupees in Crores
National Product	20,000
Appropriated for future purpose	8,000
Available for consumption	12,000

Thus, although net disposable income the community would like to spend is Rs.13,500 crores, the available output for civilian consumption is Rs.12,000 crores. The inflationary gap is Rs.1,500 crores.(13500–12000=1500). So long as the amount of disposable income with the people and the volume of goods and services available for them are the same, there will be price stability. The inflationary gap will be visible when the amount of disposable income is more than the quantity of goods and services available for consumption.

Inflationary gap is illustrated in the following diagram:



OY = Volume of output (income)

YE = Full Employment Demand

YA = New Demand

AE = Inflationary Gap

The horizontal axis represents the voulme of income and the vertical axis represents the voulme of expenditure (C+I+G). The 45° line is the equilibrium line. At point E, the economy is in equilibrium because at that point the supply of goods and services (or real income OY) is equal to demand for them (reflected by total expenditure YE). Therefore OY may be regarded as equilibrium income as well as full employment income at current prices.

OY = Volume of output (income)

YE = Full employment demand

YA = New demand

AE = Inflationary gap

Suppose, the Government has to increase its expenditure for development purposes, by an additional amount equal to EA then the new total expenditure is shifted upwards. The dotted line represents 'C+I+G^1. Then a new situtation arises. The real output (or income) remains constant at OY but the monetary demand for this output is not YE but YA. Thus, there is excess of demand equal to EA. Therefore, EA represents inflationary gap which is responsible for pushing up the price level.

Wiping out the Inflationary Gap : As explained already, inflationary gap starts with additional expenditure by the Government. Through economy in Government expenditure, the excess of aggregate demand can be reduced. But this is not always possible because Government has to spend for economic development or, during war time, to sustain the war effort. The following are some of methods to eliminate the inflationary gap.

(i). An increase in voluntary saving by the community will reduce effective demand.

(ii). The government may use the tax system to move up the surplus purchasing power with the people.

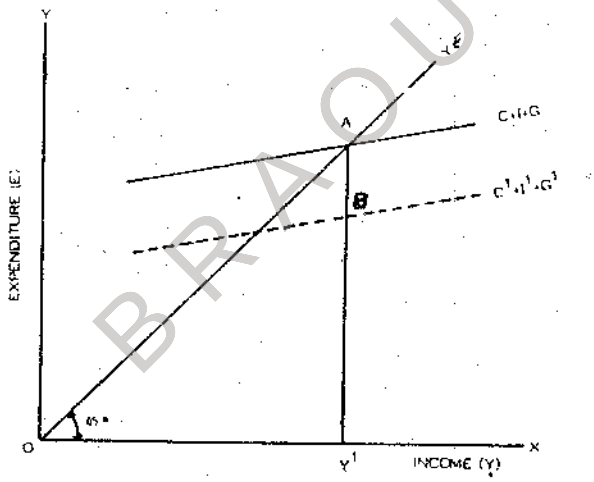
(iii). The output of goods and services may be increased so as to absorb the excess demand.

The inflationary gap is used statistically to measure the pressure of infaltion. It enables monetary authorities to adopt proper anti-inflationary policies.

6.9 DEFLATION

Deflation is an economic situation during which period the prices are falling or the value of money is rising. In the words of Pigou "deflation is that state of falling prices, which occurs at the time when the output of goods and services increases more rapidly that the volume of money income of the economy". But modern economists do not completely link inflation with the decrease in money supply. Crowther is of the opinion that "deflation is that state of the economy where the value of money is rising i.e., prices are falling.

Deflationary Gap : Deflationary gap is the opposite of inflationary gap. If the volume of goods and services is larger than the aggregate demand of them, a deflationary gap will arise. Under such circumstances, the C+I+G curve is pushed downwards. The decline in demand may be because of reduction in Government expenditure, a decline in private investment, and a fall in private consumption. This can be shown in the following diagram:



In the above diagram:

OX = Volume of Real Income available for the community

Y^1A = Original Full Employment Demand

Y^1B = New Demand

AB = Deflationary Gap

To wipe out the deflationary gap the government can increase public expenditure. The expenditure of the community can be raised through reduction in taxes. If C+I+G is raised to the original level, the deflationary gap will disappear.

The concept of deflationary gap has some policy implications. To remove the deflationary gap the government has to increase aggregate demand to that of full employment level. To attain this objective, the government can reduce the rate of taxation (so that private consumption or expenditure can increase) and by increasing the public expenditure.

6.10 EFFECTS OF DEFLATION

The effects of deflation on production, business, employment and the distribution of income are discussed below:

1. **Debtors and Creditors :** During the period of falling prices, the creditors gain and debtors lose. The debtors have to pay back more purchasing power to the creditor. The demand for consumption goods increase and also the burden of indebtedness goes up.

2. **Investors :** Deflation is beneficial to those who have invested in the fixed income yielding assets. Their income remains the same though the prices have fallen. Falling prices increase the purchasing power of money in the hands of investors. However, investment in equities brings less income by way of dividends because the corporate earnings decline. Investors in equities are adversely affected by deflation.

3. **Production :** Production and trade are adversely affected by deflation. Profits of entrepreneurs are reduced because of falling prices. Entrepreneurs tend to reduce their investment and that results in unemployment. Declining profits adversely affect the marginal efficiency of capital.

4. **Working Class :** Deflation benefits wage and salary earners. Their purchasing power of money is increased. But the evil of deflation is unemployment. Some of the workers are forced to remain umemployed.

5. **The Rentier Class :** Pensioners, annuity holders and the fixed income groups are benefitted by deflation, because of falling prices.

6. **Consumers :** Consumers are largely benefitted because they will be able to buy more goods and services with the same money income. But the unemployed persons have to suffer a lot.

The choice between inflation and deflation is like the choice between two evils but the lesser evil is inflation: It has got a favourable effect on employment and output. In the case of the underdeveloped countries, mild inflation is advocated as one of the policy measures of development. But it has to be carefully noted that inflation does not cross its limit.

CHECK YOUR PROGRESS - 2

List out different classes of the society which are benefitted by Deflation.

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6.11 CONTROL OF DEFLATION

Measures to be taken for controlling deflation are explained below:

i) Monetary Measures : The monetary measures to combat deflation refer to central banking operations of expansion of credit. It may use various weapons like the bank rate, open market operations, variable reserve ratios and selective credit controls. These measures will be effective only when deflation occurs due to shortage of money supply. When deflation is due to non-monetary factors, the monetary measures will not be effective in controlling it.

ii) Fiscal Measures : Fiscal measures to control deflation include the Government's increasing public expenditure and reducing the rate of taxation. The increased expenditure adds to aggregate demand and thus results in increased employment, output and prices. It is better if the government increases its expenditure by deficit financing. By lowering the rate of taxation, the aggregate demand can be increased through increase of private consumption.

6.12 DISINFLATION, REFLATION AND STAGFLATION

Disinflation is the process of curbing inflation. It can also be considered as a policy of deflation. As people did not like using the term deflation after 1930s, a new term 'disinflation' was brought into vogue. It is a deliberate action taken by the Government during inflation to bring about the general fall in the price level. According to J.L. Hanson, disinflation is a mild form of deflation - a policy adopted to check inflation by restricting demand.

Reflation is a cure for deflation. When prices fall to a very large extent, it is desirable that there should be gradual rise in the price level. The Government has to take step to control deflation when it has reached the other extreme. Such action on the part of the Government is described as reflation. Cole defines reflation as "inflation deliberately undertaken to relieve depression". According to H.E. Evitt, "if, after a period of deliberate deflation, it becomes apparent that a fall in prices and wages has been caused to an extent which is having serious effects on industry and trade....some resort to inflationary principles must be made. However, such a process does not result in inflation as such, but is merely retracing steps taken too far in the wrong direction, it is known as 'reflation' so as to absolve it of any inflationary taint."

Stagflation is a phenomenon where the economy experiences stagation as well as inflation. It is a situation when recession is accompanied by a high rate of inflation. It is, therefore, also called 'inflationary recession'. The main casue of stagflation is excessive demand in commodity markets, which leads to price rise, and at the same time the demand for labour is dificient, which creates unemployment in the economy.

6.13 SUMMING UP

Generally inflation refers to a rise in price level or fall in the value of money. It may result from an increase in the volume of money as compared to the supply of goods. There are two theories of inflation, namely, quantity theory approach and excess demand approach. As per the first approach the main cause of inflation is an increase in the quantity of money and as per the second approach the excess demand over supply of goods and services is the root cause of inflation. There are different types of inflation, like money inflation and price inflation, demand - pull and cost-push inflation, open and suppressed inflation, creeping, walking, running and galloping inflation, etc. Inflation arises because of two factors viz., demand factors and supply factors.

Inflation affects different people differently. Consumers, creditors, small investors, workers and salaried sections and fixed income groups are adversely affected, whereas businessmen, debtors and farmers are benefitted by inflation. Becasue of its adverse effects, inflation has to be controlled. Measures to control inflation are grouped into monetary measures, fiscal measures and other measures.

Inflationary gap occurs when there is an excess of demand over available supply of goods and services. It may be wiped out by increasing taxation and inducing savings.

Deflation is the stage of falling prices. Deflation also has its effects on different sections of the society, like debtors and creditors, investors, working class, rentier class, consumers, etc. The measures to control deflation can be classified into monetary measures and fiscal measures. There are three more concepts namely, dis-inflation, reflation and stagflation. Disinflation is the process of curbing inflation, whereas reflation is a cure for deflation. The term 'stagflation' refers to the situation where the economy experiences stagnation as well as inflation.

6.15 CHECK YOUR PROGRESS: MODEL ANSWERS

1. i) **Demand Factors :** The upward shift in demand may be caused by (a) an increase in money supply; (b) increase in the disposable income of the people; (c) Increase in the consumer expenditure; (d) expansion of bank credit, etc.

   ii) **Supply Factors :** The downward shift in supply may be caused by, (a) Shortage of raw material, equipment etc., (b) increase in exports reducing the availability of goods for domestic consumption and (c) Hoarding of goods by traders in anticipation of further rise in prices, etc.

2. Creditors, investors of fixed income yielding assests, working class, fixed income groups, consumers, etc.

6.16 MODEL EXAMINATION QUESTIONS

A. Essay Questions

Answer the following in about 30 lines each:

1. Define inflation and discuss its effects. How for can monetary measures control inflation?
2. Enumerate the consequences of inflation.
3. Explain the causes, and remedies of inflation.
4. Discuss the effects of deflation.Suggest remedies.
5. Distinguish between inflation, deflation, reflation and disinflation.
6. Between the inflation and deflation, which is worse? Comment.
7. What is inflationary gap? Suggest measures to eliminate it.

B. Short Questions

Answer the following in about 15 lines each:

1. Distinguish between cost-push and demand pull inflation.
2. Explain the concept 'inflationary gap' with a diagram.
3. Explain the meaning and consequences of deflation.
4. Describe the non-monetary causes of inflation.
5. What is a deflationary gap?
6. Explain the causes for inflationary gap.
7. Briefly explain different types of inflation.
8. Distinguish between disinflation and reflation.

6.17 RECOMMENDED BOOK

1. Crowther G. : An Outline of Money.
2. Culbertson John M. : Money and Banking
3. Jhingon M.L. : Money, Banking and International Trade
4. Srivastava S.K. : Monetary Economics in Theory and Practice
5. Sundaram K.P.M. : Money Economics in Theory and Practice
6. Vaish M.C. : Monetary Theory
7. Vaish M.C. : Money, Banking and International Trade

6.18 GLOSSARY

Deflation : A decline in the general price level of goods and services.

Deflationary Gap : Excess of goods and services over aggregate demand for them.

Disinflation : It is a process of curbing inflation.

Fiscal Policies : The Government's policy either to increase or decrease taxation to stimulate or check consumer demand.

Inflationary Gap : An excess of anticipated expenditure over the available output at base prices.

Inflation : An increase in the general price level of goods and services.

Money Wages : Wages paid in terms of cash or its equivalent.

Real Wages : Wages paid in terms of goods and services.

Stagflation : A phenomenon where the economy experiences both staganation and inflation.

Trade Cycle : The tendency of business activity to fluctuate regularly between boom and depression. During the downswing of the cycle there are falling prices, fall in production and increase in unemployment. During the upswing there are rising prices, expansion of production and decreasing unemployment.

Wage Freeze : An attempt to hold wages at their existing level for a period of time.

UNIT-7: MEASUREMENT OF VALUE OF MONEY

Contents

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7.1 Introduction
7.2 Concept of the Value of Money
7.3 Measurement of Changes in the Value of Money-Index Numbers
7.4 Essential Factors for the Construction of Index Numbers
7.5 Construction of Index Numbers
7.6 Difficulties in Construction of Index Numbers
7.7 Utility of Index Numbers
7.8 Kinds of Index Numbers
7.9 Summing Up
7.10 Check Your Progress: Model Answers
7.11 Model Examination Questions
7.12 Recommended Books
7.13 Glossary

7.0 AIMS AND OBJECTIVES

In this unit we have explained the concept of value of money, measurement of the changes in the value of money with the help of index numbers, uses and kinds of index numbers.

By the end of this unit, you will be able to:

* explain the concept of value of money;
* explain the measurement of changes in value of money;
* list out the steps involved in the construction of index numbers;
* identify the difficulties in the construction of index numbers; and
* discuss the various types of index numbers and their usefulness.

7.1 INTRODUCTION

Generally, the price level varies from time to time, which leads to fluctuations in the value of money. As we have seen in the last unit, changes in the value of money may affect different sections of the society either favourably or adversely.

Index numbers of prices are used for measuring the changes in the value of money. This unit explains the different aspects of the index numbers.

7.2 CONCEPT OF VALUE OF MONEY

The value of money means the amount of goods and services it can buy. It indicates the purchasing power of money. In other words, the value of rupee is measured in terms of the amount of goods and services it can command. For example, if a kilo of wheat costs Rs. 2/- (two rupees) 10 rupees can buy 5 kilos of wheat. If the price of wheat is increased to Rs.4

per kilo, then Rs.10 can buy only 2.5 kilos of wheat. Thus money buys more quantity of goods and services when their prices are low and vice-versa. The value of money depends upon the price-level.

There is an inverse relationship between the price-level and the value of money. When the price-level increases the value of money decreases. Similarly, when the price-level falls, the value of money increases.

Since the number of goods and services produced in a country is very large, it is not easy to express the value of money in terms of each and every commodity. So an average of all prices is calculated and this average is called the general price-level. The inverse relationship between the value of money and price level is given by the following formula:

Vm. $= \frac{1}{P}$; Where Vm. stands for the value of money and P stands for the price-level.

7.3 MEASUREMENT OF CHANGES IN THE VALUE OF MONEY-INDEX NUMBER

Money serves as the yardstick for the measurement of the value of each and every commodity exchanged for it. But how to measure the value of money? The value of money can be measured in terms of what the unit of money can purchase. In other words, the purchasing power of money indicates the value of money. To know the purchasing power of money, it is necessary to know the price- level. This is calculated through the statistical device called Index Number of Prices. Since the value of money is inversely related to the price level, changes in the value of money can be known by comparing the price levels of different periods. Such a comparison is done through index numbers. Lester V. Chandler defines the index number of prices as follows. " The index number of prices is a figure showing the height of average prices at one time relative to their highest at some other time that is taken as the base period. The index number of prices can also be defined as a number calculated by a statistical device to estimate the relative variations in the magnitude of a phenomenon from time to time and from place to place".

7.4 ESSENTIAL FACTORS FOR THE CONSTRUCTION OF INDEX NUMBERS

The index number of prices is a statistical device covering the changes in the prices of the commodities. The following factors enter into its computation.

1. The Choice of a Base Year : The first step in the construction of index numbers is the selection of a base year. The changes in the price level are always measured with reference to the base period. It is therefore necessary that the base year should be a nominal year, i.e., a year of normal economic activity. It should be a year of comparitive price stability. It is better if the base year is a near rather than a remote year because it reflects the real price changes. Sometimes the previous year is taken as the base year for the construction of index numbers. Such index numbers are termed *chain index numbers.*

The base year should be an year of normal economic activity, usually it will be a prominent year in some manner. For example, a pre-war or pre-depression year may be selected for comparison of future changes in prices.

2. Choice of Commodities : To obtain accurate results of price changes, the right type of commodities should be chosen for constructing an index number. It is difficult to include all types of commodities since there are hundreds of thousands of commodities in the world. The kind of commodities which have to be included for computation of index number of prices will depend upon the purpose of the index numbers. To show the value of money in general it is necessary to include as many important goods as possible. But, if the purpose is to find out the value of money to a worker it is necessary to take the retail prices of those goods which enter into his consumption.

3. Collection of Data : The collection of data should be comprehensive, accurate and systematic. The questionnaire, designed for the collection of data should facilitate to get comparable, representative, adequate and accurate data. Representative data means that it should include all important commodities and their prices. Comparative prices taken should be the representative of the whole group. The data should cover the same set of goods over the years in order to ensure comparability. As far as possible the data should be collected through a competent authority. The data should be adequate so that an acceptable index number of prices may be constructed. For instance, the index number of agricultural prices cannot be calculated only with the prices of rice. It is necessary to include prices of wheat, jowar, bajra and so on.

4. Choice of Index Numbers : The choice of index number is the essential requirement in the construction of index numbers. It determines the chain of commodities and the collection of price data.

There are many types of index numbers of prices such as general purpose index numbers, the wholesale price index numbers, the retail price index numbers and so on.

If the problem before us is to study the standard of living of a worker, we have to select the cost of living index numbers. The results will be accurate if the choice of index numbers is correct.

5. Choice of Weightage : The commodities included in the computation of index numbers should be given proper importance or weightage. For instance, some commodities are far more important than others and a larger proportion of the income of the people may be spent on them than others. For example, wheat is more important than fruits or sugar. A large number of people buy and spend a large proportion of their income on wheat than on sugar or fruits. In order to give different articles their due importance in the calculation of averages, the weightage to be given to each commodity is to be estimated. This can be expressed as a proportion of the total value of commodities. Supposing the total value of all goods is Rs. 100 crores and suppose all goods are given a total weightage of 100; if the production of rice is worth Rs. 15 crores, rice will be alloted a weightage of 15. If the production of wheat is Rs. 5 crores wheat will be given a weightage of 5 and so on.

6. Choice of Average : Many types of averages are used for construction of index numbers: arithmatical average, geometric average, harmonic average, etc. The most commonly used method is the single arithematical average in which the aggregates of prices of all items is divided by the number of items. The other type of average commonly used is the geometric average.

CHECK YOUR PROGRESS - 1

List out the steps involved in the construction of Index Numbers.

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7.5 CONSTRUCTION OF INDEX NUMBERS

The index number of prices can be constructed in the following way. Let us suppose that in a country only three comodities are produced, viz., wheat, cloth and fish; and their prices in the year-I (the year which we take as the base year. i.e., the year with which we can measure the prices of the commodities of the other years) are Rs. 5 per kg of Wheat: Rs. 4 per metre of cloth and Rs. 3 per kg. of fish. These prices of the base year can be considered as equivalent to 100 and with reference to the base year the prices of other years can be compared. Let us further suppose that during the year-II the prices of these commodities change in the following manner.

Wheat Rs. 10 per Kg.

Cloth Rs. 4 per Metre.

Fish Rs. 9 per Kg.

This means that in the year-II the price of wheat per kg. has doubled, the price of cloth per metre has remained constant and the price of fish has increased by three times. In this case, the construction of Index Numbers will be as follows:

Price Relatives (Year - I Base Year)

Commodity	Year-I	Year-II
	Price per Unit	Price Relatives
1. Wheat	Rs. 5=100	Rs. 10=200
2 .Cloth	Rs. 4=100	Rs. 4=100
3. Fish	Rs. 3=100	Rs. 9=300
Total	300	600
Average	300÷3=100	600÷3=200

$$\text{Price relative} = \frac{\text{Price of the commodity for current year}}{\text{price of the commodity for base year}} \times 100$$

The average price relative for the year-I is 100 and for the year-II is 200. It means over the period the price-level has doubled. The value of money is reduced to one half. Thus the index number of the prices indicate as to how over a period, prices have risen or fallen. With the rise in the price-level, the value of money will fall correspondingly. This is the simplest way of measuring the changes in the price-level through the construction of an Index Number of prices. The index number of prices reflects the price-movement over the years and the consequent changes in the value of money.

Weighted Index Numbers : The simple arithematic average of prices gives equal importance to all commodities and therefore it fails to depict the correct situation. While constructing index numbers for particular purposes, all goods are not of equal importance. In the budget of an industrial labourer, foodgrains are more important than sugar and as such while constructing the workers' cost of living index, due weightage should be given to foodgrains. Weights reflect the relative importance attached to different commodities. We get the weighted index numbers by multiplying the price-relatives by appropriate weights as shown below

In the previous example, suppose the weights are given as wheat: 5; Cloth= 3; Fish = 2; then the weighted Index Number can be calculated as shown below:

Commodity	Year-I	Year-II
	Price Relative x Weight	Price Relative x Weight
1. Wheat	100 x 5=500	200 x 5=1000
2. Cloth	100 x 3=300	100 x 3=300
3. Fish	100 x 2=200	300 x 2=600
Total	(10) 1000	(10) 1900
Average	1000÷10=100	1900÷10=190

This means that wheat is five times important, cloth three times and fish two times. The result is, over the years, the prices have risen by 90%. The satistician has to carefully study the problem and give appropriate weights to the commodities to arrive at the correct result.

7.6 DIFFICULTIES IN THE CALCULATION OF INDEX NUMBERS

There are some difficulties in the calculation of index numbers. While some of them can be solved, others have remained unsolved. The following are some of the difficulties.

1. **Collection of Data :** One of the difficult tasks in the computation of index numbers is with regard to the collection of adequate, representative and continuous data. In this connection, it may be noted that satisfactory figures are available for commodities dealt with in the wholesale market, whereas data are inadequate in the case of retail prices. As such the index numbers of wholesale pices are more accurate than the index numbers of retail prices. Sir Dennis Robertson states that "It is not always easy to get accurate figures of prices except for certain staple commodities sold wholesale". He further contends that the prices we are comparing may not be exactly of the same commodities.

2. **Difficulties in the Choice of the Base Year and the Commodities :** The base year should be a normal year with relative price stability. Further the commodities selected and their prices should be in accordance with the type of index numbers that are required to be computed. For instance, for the construction of the cost of living index numbers of industrial workers we should choose accurately the goods consumed by them. With regard to the computation of the retail price index numbers, only goods traded in retail market and their prices are to be taken into consideration.

A certain amount of arbitrariness is involved in the matter of deciding as to which base year has to be taken; what commodities are to be included and what kind of weightage is to be given to them.

3. **Selection of Averages :** The choice of the right type of average is another problem of index numbers. But generally the arithematical averages are made use of for computation of index numbers.

4. **Changes in the Quality of Commodities :** The consumer price index fails to take into consideration the quality changes and the consequent better service. Another drawback of the consumer price index numbers is that they do not take into consideration the introduction of new goods which may be close substitutes for the older and higher price commodities. There

may be a change affecting the purchasing decisions of consumers. For instance, the income of the people may change or distribution of income between different classes might change. Another difficulty is that the technological changes might reduce the prices of certain goods and consequently people may buy more of them.

5. Technical Difficulty : If the base year is reversed we do not get the same result but a different one. This is a mathematical problem. Some of the above difficulties which limit the utility of index numbers have been rectified. Marshall's system of chain index is a device by which new goods are introduced and old ones are dropped. This facilitates comparison of index numbers of successive years. Further, the technical difficulties such as non-comparability of the index numbers when the base year is reversed have been solved by means of reversal tests.

CHECK YOUR PROGRESS - 2

.. Spell out the difficulties you come across while calculating index numbers.

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7.7 UTILITY OF INDEX NUMBERS

Index numbers have the following uses.

1. Studies Economic Phenomenon: Most of the economic phenomena like national income and output can be studied through index numbers. Index numbers can also be computed to measure the changes in wages over the years, changes in imports and exports, etc., Index numbers are very useful in the study of post depression situation or to reveal the progress achieved through economic planning over a period of time.

2. Measures Changes in the Value of Money : A study of the purchasing powaer of money is important on various grounds. Stability in the purchasing power of money is the fundamental condition to stabilise the economic set up of the country. Hence in all the countries steps ae taken to keep the purchasing power of money stable within certain limits. To achieve this objective, it is necessary to measure the changes in the purchasing power of money through the index numbers of prices

Every country prepares different sectional index numbers such as index numbers of wholesale prices, retail prices, profits, etc. Each index number has its own use and significance.

3. Helps Consumer to know the Value of Money : The consumer price index shows the price changes of consumption goods. It also indicates the changes in the standard of living of the consumers because of changes in the price level. These index numbers reveal as to whether the consumers are better off or worse off because of the price changes.

The wholesale price index numbers indicate the general price level in a country and throws light on the value of money. The retail price index number which is commonly called the working class cost of living index is used to measure the value of money in terms of consumptin goods sought by the working class. In most cases the wages are related to this index in such a way that whenever there is a rise in the cost of living index numbers, the wages also go up. Thus, with the help of the cost of living index numbers, it is possible to study the changes in the level of real wages of labourers.

4. Compares Purchasing Power of Two Currencies : The purchasing power theory says that the external value of a currency depends upon its internal purchasng power. Naturally for calculating the rate of exchange by this method the index number of prices will be of great relevance under the inconvertible paper currencies. The external value of a currency tends to be determined by its internal purchasing powaer or the price level in the country.

7.8 KINDS OF INDEX NUMBERS

Index numbers are of different types. They are discussed in the following paragraphs:

i) General Purpose Index Numbers : The chief objective of general purpose index numbers is to measure the general purchasing power of money. It is computed by combining the weighted average of many different index numbers such as wholesale prices, retail prices, wages, profits, interest, etc. This index measures the value of money in the most general sense. Many people consider such index numbers as a useless hotch-potch without the real significance. The different index numbers may be in different directions and their average will not properly represent the general trend.

ii) Index Number of Wholesale Prices : The purpose of index number of wholesale prices is to measure the value of money with reference to those important and sensitive goods which are traded in wholesale markets. The commodities which enter into this type of index numbers include important foodstuffs, raw materials, semi-finished goods and manufactures. For all practical purpose, this index number is used to represent the general purachasing power of money.

iii) Index Number of Retail Prices : The purpose of retail price index numbers is to measure the value of money with reference to the final consumption of goods which are traded in the retail market. The difficulty in computation of this number is that retail prices may not be available for the same goods and for continuous periods.

iv) Index Numbers of Consumption Goods : These numbers take into account final consumption goods and services which consumers buy. The purpose of this index numbers is to measure the changes in the value of money to the consumer. This is the most significant and useful type of index number. But it is difficult to construct becaue it has to include so many goods and services.

v) Index Number of Wages : Many countries construct index number of wages to show the changes in wages over a period of time. Besides, index number of wages is helpful in calculating the real wage of labourers. This is obtained by comparing the money wage with the working class cost of living index numbers.

7.9 SUMMING UP

Purchasing power of money over goods and services is called as the value of money. Index number is a statistical device to measure the changes in the value of money. The steps involved in the construction of index numbers are, selection of base year, choosing of commodities, collecting the prices data, estimation of weights, selecting an appropriate average, etc. The difficulties in calculating index numbers include, collection of data, selection of base year, commodities, and averages, etc. Index numbers serve some purposes like studying the economic phenomenon, comparing the purchasing power of currencies of two countries, etc. There are some kinds of index numbers like general purpose index numbers, whole sale price index numbers, retail price index numbers, index numbers of wages, and index numbers of consumption goods.

5.3 QUANTITY THEORY OF MONEY-CASH TRANSACTIONS VERSION

The cash-transactions equation of the quantity theory of money was developed by the American economist Irving Fisher. It is known as Fisher's equation.

This equation considers that money has only one use, i.e. to facilitate buying and selling of goods and services. Therefore, the total volume of money in a country will be equal to the total value of all goods and services during a given period of time. Fisher puts this equation as under:

Total Quantity of Money during a given period (MV) = Total value of Goods and Services during a given period (PT)

(i.e) $MV = PT$ or $P = \frac{MV}{T}$

Where, M represents the quantity of money.

V represents velocity of circulation of money and

T represents volume of all goods and services transacted.

Thus according to him, the total quantity of money in a country during a given period of time is the same as the total supply money. The total value of all goods and services is the same as the total demand for money.

For better understanding of the equation of Fisher, the concepts of supply of money (MV) and demand for money (PT) are explained in the following paragraphs.

The Supply of Money (MV)

The supply or quantity of money in a country is comprised of two variables namely quantity of cash (M) and the velocity of circulation of that cash (V). The total quantity of money which is with the public (M) in the form of cash and bank deposits. It is to be noted that the cash does not remain idle but it is put in circulation. Therefore, to find out the total supply of money in a country during a period of time, it is necessary to take into account both the quantity of money and the velocity of money circulation of that money.

Demand for Money (PT)

Money is required to buy goods and services. So the total demand for money is the same as the total value of goods and services purchased. The total value of goods and services bought and sold during a given period of time can be obtained by taking the volume of goods and services transacted (T) and multiplying it by the average price of its goods and services (P) i.e. P x T or PT. Fisher's equation is as follows:

The total volume of money = The total value of all goods and services

MV = PT

The equation can also be written as $P = \frac{MV}{T}$

The equation shows that the general level of prices (P) tends to vary directly with the quantity of money (M) and its velocity of circulation (V) and inversely with the quantum of exchange (T).

5.3.1 ASSUMPTIONS OF FISHER'S THEORY

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

1. (V) and (T) are independent variables. They are not influenced by changes in the quantity of money (M) or the price level (P). Velocity of circulation (V) depends upon the availability of goods to be bought and sold, the rate of turnover and the quantity of money people would like to hold. On the other hand, the volume of goods and services (T) depends on natural resources, production, transport, etc.

2. (P) is a passive factor. Neither does it change by itself nor does it cause any change in other factors. But it is affected by other factors in the equation.

3. Fisher's theory holds good in the long run. In the short run with changes in supply of money (M) there can be a change in other variables also i.e., changes in (P), changes in (V) and changes in (T), But when the short period transactions are over, (V) and (T) will become normal and therefore, a change in (M) will be followed by a change in (P).

4. Fisher also assumed that conditions of full employment exist in the country. Full employment implies that no idle resources are available to increase the production of goods and services. This assumption of full employment is implicit in another assumption that the volume of goods and services (T) is constant and relatively fixed. Thus the quantity equation of Fisher can be understood as follows:

a) (P) The price level is determined by three factors (M), (V) and (T);

b) Changes in (V) and (T) can be ignored in the long run and (P) does not change by itself.

c) A change in (M) is followed by an equivalent change in (P).

5.3.2 CRITICISM OF FISHER'S THEORY

The quantity theory of money as embodied in the equation formulated by Fisher has been subjected to the following criticism.

1. Fisher's equation is based on highly unrealistic assumption. He assumes (V) and (T) are independent variables and as such are not affected by changes in money (M). But in practice, changes in quantity of money bring about immediate changes in velocity of circulation (V) and also the quantity of output (T).

2. Pigou points out that (V) varies with the volume of trade and prices. (V) is also affected by changes and expected changes in the volume of money. Fisher assumes that the price level (P) is passive and is dependent upon changes in M. This is baseless. As a matter of fact, each one of the elements in this equation influence the other and is influenced by the other elements and there is no passive element at all.

3. The equation of exchange does not throw any light upon what factors determine the value of money. It merely states an identity. When the community is considered as consumers, their total spending is equal to the total volume of money held by them, multiplied by the velocity of money. From the view point of the community as producers, total expenditure is equal to the volume of trade multipled by the price at which transactions take place. Thus the equation merely splits up expenditure into two different parts namely MV and PT. This equation is a mere truism and is of no use as a tool of economic analysis.

4. The quantity theory does not deal with the general purchasing power of money. It deals only with some kinds of transactions which relate to purchase of goods and services meant for cosumption and form a part of the total volume of transactions. Thus Fisher's equation gives us the value of money in terms of a unit of transaction but not in terms of a composite unit of consumption goods and services.

In the above diagram price and employment are measured along the Y axis and quantity of money on X axis. CD is the line of full employment on which P is the point of full employment. There is no doubt that inflation is accompanied by some rise in prices but every rise in price does not indicate inflation. There is some inflation upto the point P and the line AP measures partial inflation. It is because upto P, increase in money supply was accompanied by increasing employment opportunities. It is beyond the point P, inflation sets in.

The term **inflation**, as understoood by Keynes, can be applied to an underdeveloped economy like India where there is mounting unemployment and unutilised resources. Due to several constraints like limited capital, machinery, lack of transport, inadequate technical know-how, ect., rise in price level may not lead to increased output even though the country may not have reached a stage of full employment.

6.3 APPROACHES TO UNDERSTAND INFLATION

There are two approaches to understand inflation, which are explained below:

6.3.1 QUANTITY THEORY APPROACH

This approach is mainly based on the quantity theory of money. The advocates of the quantity theory of money contended that an increase of the quantity of money is the root cause of inflation. Milton Friedman and others stated that inflation is purely a monetary phenomenon. This theory is defective because it fails to explain adequately the concept of hyper-inflation and inflation in economies which are characterised by depression and unemployment.

6.3.2 EXCESS DEMAND APPROACH

Swedish and Cambridge economists like Wicksell, Bent, Hansen and Keynes and Pigou have contributed significantly to the Excess Demand Approach. According to them the root cause of inflation is the excess demand over supply of goods and services. Just as the price of a commodity is determined by the demand for and supply of that commodity so also the general price-level is determined by the aggregate demand for and supply of all goods. Excess demand results in rising prices and leads to inflation. Excess demand arises either due to upward shift in demand or downward shift in supply. The factors responsible for upward shift in demand are growing public and private expenditure, reduction in taxation, etc. Similarly, shortage of supply, increase in exports, hoarding of commodities, etc. are some of the factors causing downward shift in supply. Excess demand occurs during periods of war, during the course of economic planning, technological progress, etc.

6.4 TYPES OF INFLATION

There are different types of inflation. We now describe each briefly.

i) Money Inflation and Price Inflation: Money inflation occurs in the initial stages. During this stage, expansion in money supply leads to a sharp rise in the price level. Price-inflation is the next stage when a rapid rise in demand leads to an enormous increase in the money supply. In this stage prices rise rapidly and money supply lags behind.

ii) Demand-Pull and Cost-Push Inflation: Demand - pull inflation takes place when price rises owing to excess of aggregate demand over the existing supply of goods and services. It may be caused by an increase in the volume of money. As a result, money income of various factors of production will increase leading to an increase in effective demand. Increased effective demand leads to further rise in prices.

Demand-pull inflation also occurs under another situation. When marginal efficiency of capital increases, investment expenditure will automatically increase resulting in an increase in effective demand. Increased effective demand without a corresponding rise in the supply of goods and services leads to rise in price level.

Cost-push inflation occurs when prices rise due to an increase in cost of produciton. The reason is that prices of various factors of production increase. This situation arises as a result of either wage-push or profit-push factors.

iii) Open or Suppressed Inflation: Open inflation refers to a situation where prices rise without any interruption. The Government does not take measures to stop the rising prices. On the contrary, suppressed inflation is one where the Government attempts to check the rising prices through price ceilings, rationing, etc. During suppressed inflation, private holdings of cash, bank deposits, etc., increase. While prices do not rise in the controlled sector, they increase disproportionately in the uncontrolled sector.

iv) Creeping, Walking, Running and Galloping Inflation: The above classification is made on the basis of the extent to which prices rise. Inflation is said to be creeping, when price rise is very low, say 2 to 3% a year. Walking inflation refers to a situation, when prices rise gradually at the rate of 3 to 5 per cent a year. Running inflation occurs when prices rise by more than 10% yearly. The most severe form of inflation is 'Galloping' or 'Hyper-inflation' in which prices tend to rise by more than 16%. During the post First World War period, Hyper- inflation was experienced by Germany and the situation was so severe that a cart load of notes had to be carried to buy a cup of coffee. Similarly in France, a basket load of currency had to be carried to buy a loaf of bread.

v) Comprehensive and Sporadic Inflation: Depending on the coverage and scope, inflation is divided into two categories: (1.) Comprehensive inflation and (2). Sporadic inflation. Comprehensive inflation refers to a situation when every sector of the economy experiences inflationary pressures. Sporadic inflation is a situation when inflation occurs only in certain sectors. It is sectoral in nature. For example, increase in prices of food grains due to failure of crops or rise in prices of fertilisers, etc.

vi) Wage-Induced and Deficit-Induced Inflation: Wage-Induced inflation is a situation where prices rise on account of increase in money-wage. Increase in money wages would lead to increase in cost of production without a corresponding increase in output. This leads to a further rise in prices. Money-wage has a tendency to increase whenever prices rise.

Deficit-induced inflation occurs when Government resorts to deficit financing. Government resorts to deficit financing when it is unable to meet expenditure through taxation. This increases the total money supply or purchasing power of the people. The result is rising prices.

6.5 CAUSES OF INFLATION

According to Kenneth, K. Kuriharan, inflationary pressures arise from both the demand side and the supply side. The term **demand** is understood here as demand for money income, and **supply** means available output on which the money income is spent. The factors that cause inflation are discussed below:

i) Demand Factors: Increase in money income may be caused by factors such as (1) Increase in the total money supply in the economy (2) Increase in the amount of disposable income (3) Expansion of Bank credit, (4) Increased consumer expenditure and business outlay.

ii) Supply Factors: Inflation is also caused by factors affecting supply side. For instance when there is shortage of raw material, equipment and machinery, etc., the output of goods and services may not increase corresponding to an increase in money income. As explained earlier, there will not be any increase in the general price level inspite of increase in money income, if there are unemployed persons in the economy. But inflation will set in if money income continues to increase even after full empolyment level is reached.

SECTION-B :
BANKING (THEORY)

BLOCK - III : COMMERCIAL BANKING

UNIT-8 : FUNCTIONS OF COMMERCIAL BANKS

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8.0 AIMS AND OBJECTIVES

This unit intends to explain the origin and types of banks, functions of Commercial Banks and their significance in an economy.

After reading this Unit, you should be in a position to :

* explain the origin of banks
* discuss the functions of Commercial Banks;
* describe the role of Commercial Banks in the economic growth; and
* explain different types of banks.

8.1 INTRODUCTION

Commercial Banks play a significiant role in the economic development of a country. They perform a wide variety of functions. In this unit, we will deal with the functions performed by Commercial Banks and show how banks play a significant role in the economic development of nations.

8.2 BANKING IN ANCIENT, MEDIEVAL AND MODERN PERIODS

The word "Bank", is supposed to be derived from the German word "Bane" which means 'a joint stock firm', Some believe that the word is derived from 'banco' or 'banque' which means 'a bench'. In Greece and Rome, money lenders were called 'benchers' as they used to keep their coins on the bench for the purpose of changing one kind of money into another. Banking in the medieval period was mostly connected with money changing business. The merchants, goldsmiths and money lenders can be regarded as the ancestors of present day bankers. Goldsmiths used to hold considerable stocks of valuable metals. They used to receive and issue receipts as claims against the stocks held by them. They became prominent in England during the seventeenth century. Even in the ancient and medieval periods they used to accept deposits of precious metals from the public for safe keeping. With the passage of time they offered some interest on deposits to attract more deposits. They used to charge higher rates of interest by lending these deposits to make profits. Thus right from ancient times, banking was a bulsiness activity and was carried on by some members of the society.

Earliest of all the banking institutions was the Bank of Venice founded in 1157. Thus the first banking institution came into existance in Italy. The bank of Bercelona was established in 1401 and the Bank of Genoa in 1407. The Bank of Venice and the Bank of Genoa could survive only till the end of the 18th century. In 1609 the Bank of Amsterdam and in 1690 the Bank of Hamburg were established. The Lombards of Italy who migrated to England and other parts of Europe were mainly responsible for the planning and development of modern banking. Lombard Sreet in London represents the locality where the Lombards settled. During the reign of Queen Eligebeth 1., goldsmiths, merchants, private money lenders and money exchangers came into prominence. With the seizure of large gold boards from the London merchants in 1640 by King Charles 1, the merchants were scared to keep their surplus funds with them. Their surplus funds were deposited with goldsmiths who were doing the modern commercial banking operations. The goldsmiths' business suffered greatly during the reign of Charles II, who imposed several restrictions on the business of goldsmiths and ordered them to deposit their funds in the 'Exchequer'. The business of goldsmiths was finally ruined when the king closed the 'Exchequer' without making any repayment. The role of goldsmiths was replaced by a large number of private bankers. Though in 1694, the Bank of England came into existence, the growth of joint stock commercial banking was actually started with the passage of the Banking Act of1833 in England. Thus in the 19th century, the seeds were sown for growth of the modern joint stock commercial banking in different countries.

In India our ancient Hindu scriptures provide ample testimony to the existence of money lending activities. Even during the periods of he Ramayana and the Mahabharata, the money lending activities are carried on. Many references to money lending operations are made in Manu's Smrithi, Dharma Sastras and Arthasastra. The Vaishyas of the Hindu Community were mostly responsible for undertaking these activities. Others were called by different names like Sresties, Kausambi, Avanti, Seths etc. During the Mughal period in the 12th century, Multanis and Shroffs were undertaking banking activities to finance internal trade and commerce. Before the advent of the British traders into India, during the 17th century, the indigenous bankers and money lenders acted as bankers. These indigenous bankers have been called by different names such as: Mahajans, Seths, Sahukars, Shroffs etc. Until the fall of the Mughal Emperors and Nawabs during the 18th century, indigenous bankers flourished well by controlling the banking activities. After the entry of foreign traders into India and the establishment of the East India Company, Indigenous bankers suffered greatly due to severe competition from the banks set up by the East India Company on modern lines. The first bank came into existence in 1688 in the province of Madras as a Government institution. In 1724 another bank was set up in Bombay. In Madras also another bank was started later on the same lines. Modern banking business on Western lines was mostly developed during the beginning of the 18th century, when the employees of the East India Company started commercial banks with the name of "Agency houses". A large number of "British Agency Houses" came up in Calcutta and Bombay. The first bank called the Bank of Hindustan was established in 1770 in India. Due to the famine of 1788 and its effects, the bank could not function well and was closed in 1791. The Bengal Bank which was started in 1786 was also dissolved in 1791. Due to the mushroom growth of banks and agency houses, there were frequent bank failures. Hence it became necessary to codify the rules and regulations for a systematic development of banking in India. Consequently the Companies Act was passed in 1833 to control their activities. Subsequently, the system of Agency houses disappeared creating a big void in banking activity.

In India, three presidency banks were started with the financial participation of the Government. The first of its kind was the Bank of Bengal which was set up in 1806 with the contribution of capital by the Government. The Bank of Bombay and the Bank of Madras were started in 1840 and 1843 respectively. The Government subscribed Rs. 3 lakhs to each bank.

8.3.2 SUBSIDIARY FUNCTIONS

Apart from the above main functions, banks perform a large number of other functions.

i) Agency Services

Banks act as agents of their customers. Banks collect and pay cheques, drafts, bills, etc. On behalf of their customers they pay insurance premium, subscriptions, rents, income-tax, etc., by debiting the customers' Accounts as per specific instructions given. They also buy and sell shares and securities on behalf of the customers. They provide information about different ways and means of productive and safe investment of customers'funds. Sometimes bankers may also act as brokers for selling or purchasing securities on behalf of their clients for which they get some commission. Banks transfer the funds of their customers from one place to another by drafts or free mail or telegraphic transfers. In certain complicated matters, banks not only advise the customers but also act as their trustees, executors and attorneys. On behalf of the customers, banks may collect dividend and interest warrants and credit them to their account.

ii) General Utility Services

Generally banks provide locker facilities for the safe keeping of valuables, jewellery documents, etc., at a nominal charge. To ensure maximum security they provide double-key lockers. Thus banks act as custodian of valuables. They issue drafts, travellers' cheques, etc., for the benefit of the people to enable them to transfer their funds safely from place to place. Banks provide travellers' cheques free of charge. Sometimes banks act as a referee to the financial standing and credit worthiness of customers. When people take loans from any financial institution or other parties they are required to provide refernces to their bankers in which they maintain their accounts so that their credit worthiness and financial stability can be verified by the prospective creditors. When new companies are not able to mobilise capital for investment, banks may provide underwriting facility by purchasing the new issue of shares and securities of the company. Banks collect information relating to business, trade and general econmic conditions in the country and publish monthly or quarterly journals which are very useful and informative to the public. Banks may also deal in foreign exchange. They collect foreign exchange and make payments in the local currency. They also finance foreign trade of a country and discount the bills of exchange of the exporters. Bankers also help the importers by accepting the bills drawn by foreign exporters. Banks issue letters of credit to help the traders and businessmen to obtain credit at distant places. Thus banks perform a large number of subsidiary services which are very useful to the people in general and customers in particular.

CHECK YOUR PROGRESS - 1

What is a bank? List out its functions.

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8.4 SIGNIFICANCE OF COMMERCIAL BANKS IN AND ECONOMY

Commercial banks play an important role in the economic growth of a country. They are not only the warehouses of a country's wealth but are also the reservoirs of the country's resources to speed up the process of growth. The economic history of the developed industrial world bears ample testimony to the fact that commercial banking contributed much to their industrial resvolution.

i) Promote Capital Formation

A well organised banking system helps in pooling the small savings from the public. They encourage the habit of thrift and saving among the public. When all the small and scattered savings of the people which would have remained idle are combined together, they become a sizeable amount which can be utilised for productive purposes.

Thus the idle resources are mobilised and funnelled into productive channels. Saving is essential for capital formation. A high rate of saving and investment constitutes capital formation. Economic growth depends upon the diversion of resources from consumption to investment or production which facilitates higher rate of capital formation. They provide safety and security to the savings of the people. Thus on one hand banks help the people to get some income by way of interest on their savings and on the other hand banks help the country to mobilise more resources for raising the rate of investment in the country.

ii) Assist Business, Trade and Industry

Banks help the development of business, trade and industry in the country. They provide the liquid capital which is the life blood of commercial and industrial activities. They grant loans and advances to traders, industrialists and manufacturers to increase the real national income of the country. By means of cheques, promissory notes, bills of exchange, etc., banks provide adequate credit to encourage commercial and industrial expansion. In India they extend credit facilities only to the right type of traders, businessmen and industrialists in accordance with the objectives of our planned economic development. The commercial banks route the surplus funds of the community into productive channels. With the help of the banks, the financial resources of the community may be put to optimum use. Bank credit helps entrepreneurs to increase their productive capacity. New methods and techniques of production, with the help of more credit facilities, would help in the optimum utilisation of existing idle capacity in the country. With large scale production and specialisation, the real national income of a country increases.

iii) Provide Finance for Priority Sectors

Commercial banks divert their investmenyt towards the priority sector. In India, agriculture, small scale industries, self employment schemes and export promotion industries get more credit facilities from commercial banks as they are included in the list of priority sector.

iv) Reduce Regional and Economic Inequalities

Banks promote balanced regional development by minimising regional disparities in development. A country promotes balanced growth by proper distribution of investible funds among the backward and less developed regions of the country. By establishing a large number of branches in rural or semi-urban areas, uniform development of different regions can be achieved. Not only the regional disparities but the economic inequalities among the people also can be bridged to some extent. For example, the Reserve Bank of India provides credit at low rates of interest to the small traders, marginal farmers, self-employed people, etc., under the differential rates of interest policy. The people are encouraged to improve their economic position with the help of cheap credit provided by the commercial banks.

v) Economic Activity

The interest rate in the economy affect the level of economic activity. Higher interest rates may discourage investment and economic activity and lower interest rates may encourage higher investment and economic activities. The organised banking system under the control of the central bank regulates fluctuations in economic activity by manipulating the interest rates in the economy. To maintain stable economic growth banks may raise the interest rates when there is overinvestment in the economy. To stimulate investment, interest rates may be reduced. Thus banks help to maintain equality between savings and investment to avoid fluctuations in the economic activity and maintain stable growth.

vi) Monetise Debt

By providing discount facilities and granting loans, commercial banks monetise debts. Banks buy the debts of other persons. Demand deposits are created in exchange of debts. When banks discount bills of exchange they create deposits on the debts of other persons. The drawee's debt is monetised by the bank when the drawer gets the bill discounted.

Thus commercial banks play a vital role in the process of economic growth of a country. Banks help in accelerating the economic activity by increasing employment opportunities and the incomes of the people. The huge resources necessary for the planned economic development of various countries are supplemented by the financial resources of the banking sector to achieve the goals of economic development.

8.5 TYPES OF BANKS

With the passage of time, several types of banks have come into existence performing different specialised functions. Based upon the functions performed by them, banks may be classified into different types.

i) Commercial Banks

They are joint stock banks which accept different kinds of deposits from the public and grant short term loans. Their main aim is to provide security of funds to the depositors and make profits for their shareholders. As their deposits are mainly for short periods, they cannot lend money for long periods. They mainly finance business and trade for short periods to meet their day-to-day transactions. They may provide finance in the form of cash credits or overdrafts or loans. They also provide finance by discounting bills of exchange.

ii) Industrial Banks

These banks are also called investment banks. They provide long term finance to industries ranging over a few decades. They finance long term projects and developmental plans. They receive long term deposits from the public. They may also raise funds by the issue of shares and debentures. They specialise in the undertake industrial finance. They may purchase the new issue of shares, debentures and securities of new enterprises. They may also provide underwriting facilities. unlike commercial banks, these industrial banks do not exist in all countries. In some countries, commercial banks under the mixed banking saystem are undertaking both commercial banking and industrial banking functions. They meet the long term capital requirements of industrial concerns. They also promote new industrial units. They provide not only financial assistance but also technical and managerial guidance for efficient working of industries. In the developed world, especially in Germany and America, these banks are assuming increasing importance.

iii) Agricultural Banks

The Commercial and Industrial Banks are not able to meet the financial requirements of agriculture. Agriculture requires both short term and long term finance. Short period loans are provided by Co-operative banks while long term loans are provided by land mortgage banks, Farmers requires short term finance to buy seeds, fertilisers, implements, etc. They require long term finance to make permanent improvement on their land like digging wells or purchasing farm machinery and equipment of a permanent nature. They provide long term loans against the security of land. As the loans are given mainly for development purpose, these banks are called as "Land Development Banks". These banks may borrow funds from Government. They may also raise capital by issuing bonds and debentures. They have become prominent in India and other countries like Germany and Japan.

iv) Co-operative Banks

These banks are formed to supply credit to members on easy terms. They do not aim at profit in their operations. They attract deposits from the farmers and promote thrift by offering slightly higher rates of interest than commercial banks. They provide credit facilities to needy farmers and small scale industrial units. In India we have State Co-operative Banks at the state level, supplying Co-operativse credit through central Co- operative Banks at the district level. In India Co-operative banks are assuming an important role in providing agricultural finance. They protect the farmers from the clutches of the money lenders by supplying cheap credit.

v) Exchange Banks

They specialise in financing the import and export trade of the country. They purchase bills from exporters and sell them to importers. Exchange banks discount these bills of exchange to promote foreign trade. They may open many branches in different countries and settle the foreign trade transactions between traders of different countries. They may also undertake the usual banking operations. They provide remittance facilities and trade information to their clients. In recent years, commercial banks have also entered this field by opening their branches in foreign countries.

vi) Savings Banks

These banks collect small and scattered savings of the low and middle income group people. These banks aim at promoting thrift among the low income people who otherwise would have spent the money for unproductive purposes. These banks receive small amounts of deposits and withdrawals are restricted. Banks offer minimum interest on these deposits.

vii) Central Banks

They Central bank controls the entire banking system in the country. It operates the currency and credit system in the country. It acts as an agent and adviser to the Government and works in the best interests of the nation without any profit motive in its operations.

8.6 Summing up

The banking activity is not something new to the modern period. Even in ancient and medieval periods also, there was some kind of lending activity. However, over a period of time it has undergone drastic changes leading to the emergence of commercial banks. These commercial banks have come to perform a wide variety of functions to meet the changing requirements of the public. They may be broadly classified into primary functions and subsidiary functions. The former includes mainly the acceptance of different kinds of deposits from the public viz, fixed deposits, current account deposits and savings deposits and granting of loans and advances. The latter includes a wide variety of services classified as agency services and general utility services. Under the agency services, the banks collect and pay cheques, drafts, bills, etc., on behalf of the customers. They also pay insurance premium, subscriptions, rents and income-tax and collect dividend, interest etc., on behalf of the customers. Under general utility services, they provide locker facilities for the safe keeping of valuables, jewellery, documents, etc. They issue drafts and travellers cheques to facilitate transfer of customers' funds safely from place to place. At times, they also act as referees to the financial standing and credit worthiness of customers.

Naturally with the performance of the above functions, the commercial banks have come to play a significant role in the economic development of a country. They are not only the warehouses of the country's wealth but also the reservoirs of the country's resources to speed up the process of growth. They help in accelerating the economic activity by increasing employment opportunities and the incomes of the people. The huge resources necessary for the planned economic development of various countries are supplemented by the financial resources of the banking sector to achieve the goals of economic development. With the passage of time, several types of banks have come into existence performing different specialised functions. They are commercial banks, industrial banks, agricultural banks, co- operative banks, exchange banks, savings banks, central banks and indigenous banks.

8.7 CHECK YOUR PROGRESS: MODEL ANSWERS

1. A Bank is an institution whose business is primarily to hold deposits and make loans and investments with the object of getting profits.

   Functions of Commercial Banks include:

a) Primary Functions:
   - i) Receiving deposits from the public,
   - ii) Making loans and advances.

b) Subsidiary Functions:
   - i) Agency services like collecting and paying cheques, bills of exchange, drafts, etc., on consumers behalf and buying and selling of shares, debentures, securities etc. for its customers.
   - ii) Miscellaneous functions like providing lockers to the customers for keeping jewellery, valuable documents, etc., issuing various forms of credit instruments such as drafts, travellors' cheques etc., issuing letters of credit and acting as a referee to its customers, etc.

8.8 MODEL EXAMINATION QUESTIONS

A. ESSAY QUESTIONS

Answer the following in about 30 lines each:

1. Define the term 'Banking'. Describe the functions of a Commercial Bank.
2. Discuss the role of Commercial Banks in a modern economy.
3. Explain different types of Banks.
4. Describe the evolution of Commercial Banks.

B. SHORT QUESTIONS

Answer the following in about 15 lines each:

1. Briefly explain different types of deposits.
2. How Banks act as agents of their customers?
3. Distinguish between Commercial Banks and industrial Banks.
4. Write a note on :
   - i) Co-operative Banks, and
   - ii) Exchange Banks

8.9 RECOMMENDED BOOKS

1. Sayers R.S. : Modern Banking
2. Sundaram K.P.M. : Money, Banking & International Trade
3. Vaish M.C. : Money, Bamking & International Trade
4. Jhingan M.L. : Money, Banking & International Trade

8.10 GLOSSARY

Bank : Establishment for keeping money and valuables safely and the money being paid out on the customers order

Cheque : Written order (usually on a printed form) to a bank to pay.

Commercial Banks : Joint stock banks which accept different kinds of deposits from the public and grant short term loans.

Exchange Banks : Banks that specialise in financing foreign trade through the sale and purchase of exchange bills.

Fixed Deposits : Deposits repayable after a certain period of time.

UNIT-9 : COMMERCIAL BANKS AND CREATION OF CREDIT

Contents

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9.0 AIMS AND OBJECTIVES

In this unit, we have explained you the process of credit creation by commercial banks and significance of bank credit.

By the end of this unit, you will be able to:

* distinguish between primary and derived deposits;
* describe the process of credit creation;
* explain the multiple expansion of credit;
* list out the limitations on credit creation; and
* explain the significance of bank credit in the economy.

9.1 INTRODUCTION

The term, 'Credit' is derived from the Latin word 'Credo' which simply means belief or trust. In the modern commercial world, credit refers to the faith or confidence of the creditor in the capacity of the debtor to fulfil his promise to pay some amount in a certain period of time. The creation of credit or deposits is one of the important functions of commercial banks. By creating credit, commercial banks play an important role in determining the level of economic activity in an economy. This unit explains how commercial banks createa credit.

9.2 PRIMARY AND DERIVED DEPOSITS

One of the most important functions of a commercial bank is to create credit. Commercial banks create credit on the basis of their deposits and loans. These deposits mainly depend upon the banking habits of the people. The initiative for making deposits comes from the customers. In order to attract more deposits from the public, banks offer different rates of interest on various types of deposits. By mobilising more deposits the banker will be able to create more credit. When an individual deposits money with a bank, th bank credit his account with the amount of his deposit. Similarly when a customer deposits cheques, drafts or bills for collection, the banker, on realisation of the amount, credits the account of the customer. All these types of deposits are called **primary deposits**. If people decide to keep more money with the banks, the volume of primry deposits may be more. All these deposits are not kept idle with the bank in the form of idle cash holdings. These primary deposits are used by commercial banks to create some additioal deposits. As these additional deposits are created from the primary deposits they are called **derived deposits**.

Eminent economists like Sayers and Halm have expressed the view that commercial banks do create credit in the process of their operations. But economists like Walter Leaf and Edwin Cannan do not agree with this view. According to them, banks do not create credit in the economy. However, as we know the commercial banks in course of their operations, on the basis of their confidence in their customers, extend credit in several ways.

9.3 PROCESS OF CREDIT CREATION

Let us study now the process of credit creation, the different methods adopted therefor and the limitations faced by the bankers in this direction.

i) Granting Loans

"Loans create deposits". When a bank grants a loan to its customer it does not generally pay cash as the borrower may not require it immediately. It credits the individual's account with the amount of the loan. Thus without receiving any cash or cheque or draft or any other credit instrument from the customer, the banker creates an additional deposit simply by granting a loan to the customer. The banker supplies a pass book and a cheque book. The banker allows him to withdraw the deposit from his account as and when the customer likes. Thus by granting loans banks create additional deposits. Hence, it is rightly said that 'deposits are the children of loans'

ii) Discounting Bills of Exchange

Derived deposits are created when a bank discounts a bill of exchange. The bank does not pay cash. It credits the account of the customer with the amount equal to the value of the discounted bill. In this case also the bank creates a deposit without receiving any cash.

iii) Purchasing Securities

When a banker purchases Government bonds and securities from a customer it will credit the customer's account with the value of the security. In this instance also, the banker creates a deposit without receiving cash.

It is clear from the above description that the commercial banks create additional or derived deposits which will add to the total supply of money or the purchasing power of the community.

CHECK YOUR PROGRESS - 1

What do you mean by Bank Credit?

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9.4 MULTIPLE EXPANSION OF CREDIT

The banker receives deposits from the public. The banker pays interest on these deposits. He cannot afford to keep the deposits idle. Therefore he lends them to the needy people and institutions at higher rates of interest to make some profit. But how much can he lend is an important aspect of credit creation. Generally the bankers know by experience that a part of the deposits can be lent as all customers do not withdraw all their deposits at the same time. Some people may withdraw money from the bank, while others may deposit new money. The new deposits and withdrawals of every day may tend to be equal in such a way that the money held by a bank may not change substantially over a short period.

It is generally believed that banks cannot lend more than their deposits. But in reality, banks can lend much more than what they receive as deposits. According to R.S. Sayers, an authority on modern banking, banks are not only purveyors of money but also manufacturers of money. Let us try to understand the significance of this statement. In all the countries where the banking habit is developed, people feel it secure to keep their money with the banks. They prefer to make payments by cheques as they find it more convenient and methodical. Moreover a cheque is a proof of payment. Everyday the banker receives cash and pays cash across the counter. The receipts may balance the payments in day-to-day transactions. The total deposits of the bank may not decrease. The banker knows by experience that he need not keep the entire money that he received. All customers do not withdraw cash from the bank. Some customers may draw cheques in favour of their creditors. Those creditors may deposit these cheques with the same bank or with some other bank. They may not withdraw cash. Even if they withdraw cash from one bank they may deposit the same with another bank. Thus people in general may not wish to keep a large part of their money with them as it involves risk. When people receive cheques from their debtors they may deposit the cheques into their account. The banker simply debits one account and credits another account when debtor and creditor maintain their accounts in the same bank. Even if they have accounts in two different banks through the clearing house the claims can be realised by debiting the account of the debtor's bank and crediting the account of creditor's bank. Thus money may not actually flow out of the bank, but transactions may take place by book adjustments. Hence the banker maintains only a fraction of his total deposits in the form of cash to meet the claims if customers and inter-bank claims. The remaining balance is used for the purpose of credit creation. He need not restrict the total volume of credit upto the amount of this balance. He can lend much more than that. Let us study a concrete example to understand the extent to which the commercial banks can create credit. Let us assume that a customer deposits an amount of Rs.400 in his account in bank A. All this amount of Rs.400 cannot be lent to other persons. A part of it must be kept with the bank as the depositor may withdraw some amount. The amount of money kept by a banker against the deposit is called the liquidity ratio of the bank. For example, let us assume that the bank maintains 20% as the liquidity ratio. Then the bank has to prepare its balance sheet in the following manner as far as this transaction is concerned.

Balance Sheet of Bank 'A'

Liabilities	Rs.	Assets	Rs
Deposits	400	Cash	400
	400		400

Out of this Rs. 400, the bank has to keep 20% as cash under the liquidity ratio. The remaining balance may be used for the purpose of granting a loan. That is Rs. 80 is kept with the bank as cash and the remaining balance of Rs. 320 may be given as loan to a person named 'X' Then the balance sheet of bank A will be written as follows:

Balance Sheet of Bank 'A

Liabilities	Rs.	Assets	Rs.
Deposits	400	Cash	80
		Loan to Mr.'X'.	320
	400		400

Bank. A may grant a loan to 'X' and credit his account with the amount of his loan. 'X' may issue a cheque to one of his creditors 'Y' who may be having his account in bank 'B' After obtaining the cheque from 'X', 'Y' may not withdraw cash from bank 'A',. He may deposit the cheque with the bank 'B' in which he operates his account. Bank 'B' realises the amount from bank 'A' . Cash is kept with the banks. Only book adjustments are made by debiting the bank 'A' account and crediting Bank 'B' account through the clearing house. Thus money is with banks and not withdrawn by individuals. Then this transaction is entered in the balance sheet of bank 'B' as follows.

Balance Sheet of Bank 'B'

Liabilities	Rs.	Assets	Rs.
Deposits	320	Cash	320
	320		320

Out of this amount of Rs. 320/- the banker' B may retain 20% or Rs. 64 as cash to maintain liquidity and the remaining balance of Rs. 256 may be used for granting a loan or discounting a bill of exchange or purchasing a security from another individual 'Z'. If the amount of Rs. 256 is used for discounting a bill of exchange, this transaction is entered in the balance sheet of bank 'B' in the following manner.

Balance Sheet of Bank 'B'

Liabilities	Rs.	Assets	Rs.
Deposits	320	Cash	64
		Bills discounted	256
	320		320

The creditors or drawers of the bill may issue a cheque to their creditors who may deposit the cheque with bank 'C'. Then this transaction can be entered in the balance sheet bank 'C' as follows.

Balance Sheet of Bank 'C'

Liabilities	Rs.	Assets	Rs.
Deposit	256	Cash	256
	256		256

Out of this Rs. 256, the bank 'C' has to retain 20% or Rs. 51.20 and the remaining balance of Rs. 204-80 may be used for granting loan to some other person who may be having his account in bank 'D'. Then this transaction is written as follows.

Balance Sheet of Bank 'D'

Liabilities	Rs.	Assets	Rs.
Deposit	256	Cash	51.20
		loan	204.80
	256		256.00

Thus the process gets repeated in the banking system by creating new loans and new deposits till the original deposit of Rs. 400 is completely used. When we take the total amounts of deposits created by all the banks with the original deposit of Rs. 400, it will be equal to Rs. 2000 including the original deposit. It means the banking system could create or manufacture additional deposits or derived deposits of Rs. 1600 with a primary deposit of Rs. 400.

In the same way even though Rs. 1600 crores are granted as loans against Rs. 400 crores of original deposits, people do not withdraw all the amounts in the form of cash. Only 1/5th or 20% is withdrawn in the form of cash and the rest of the transactions are settled mostly by cheque, drafts, etc. Hence the cash balance of the commercial banks acts as the foundation or basis for the creation of the entire superstructure of credit. Out of Rs. 400 crores of deposits people may withdraw 20% of deposits or Rs. 80 crores which the banks maintain to meet the claims of these people having Rs. 400 crores as deposits . It means the remaining Rs. 320 crores will remain with the banks as idle cash balances. In order to convert these idle balances, into active balances, the banking system as a whole will lend to the extent of Rs. 1600 crores. These loans are granted on paper by book adjustment, as we have seen earlier. Actual cash is not paid to the individuals. They may require cash only to the extent of 20% of the total loans of Rs. 1600 crores granted which is equal to Rs. 320 crores. Thus these idle balances of Rs. 320 crores lying idle with the banks will become active when Rs. 1600 crores of deposits will answer the claims of derived deposit holders to the tune of Rs.1600 crores as they require only about 20% or 1/5th of the total derived deposits. 80 crores of rupees cash held by banks will answer the claims of primary deposit holders to the tune of Rs. 400 crores. Thus banks may pay interest on some part of the total primary deposits of Rs. 400 crores which are in the form of fixed and savings deposits but they collect a higher rate of interest on their loans and advances to the tune of Rs. 1600 crores. The difference in the rates of interest is the main source of profit to the banker. If the liquidity ratio is less, the bankers can create more credit and get more profits. With the same amount of Rs. 400 crores of primary deposits, banks can creat Rs. 4000 crores total deposits if the liquidity ratio is reduced from 20% to 10% .Thus by lowering the liquidity ratio, banks may create more quantity of credit. Hence it can be rightly stated that one rupee deposit creates 4 rupees credit or Rs. 400/- deposit creates Rs. 1600 additional deposits with 20% liquidity ratio. It is evident from the above that banks can lend much more than what they receive as deposits by this mechanism of credit creation. Similarly if we assume the total deposits as Rs. 400 crores, the banking system retains Rs. 80 crores as cash when the liquidity ratio is 20% and the remaining balance of Rs. 320 crores are used for creating additional deposits of Rs .1600 crores in the deposit credit ratio of 1:4 Including the original deposit the total deposits would grow from Rs. 400 crores. to Rs. 2000 crores. Hence R.S. Sayers rightly termed the commercial banks as the manufacturers of credit. The process is known as multiple expansion of deposits or creation of credit.

9.5 DEPOSIT MULTIPLIER

The amount of credit created by the banking system as a whole depends upon the liquidity ratio or percentage of cash to be kept by the banks against their deposits. This percentage will determine the **Deposit Multiplier**. With the following formula, the deposit multiplier can be calculated. $K = \frac{1}{r}$ in which K = deposit multiplier, r = percentage of cash reserves to deposits. If the percentage cash reserve ratio is 20% then the deposit multiplier will be $\frac{1}{\frac{20}{100}}$ or $\frac{1}{\frac{1}{5}}$ or 5 times. It is $25\frac{1}{\frac{1}{4}}$ or 4 times. If the percentage cash reserve is lowered to 10% the deposit multiplier is $\frac{1}{\frac{10}{100}}$ or $\frac{1}{\frac{1}{10}}$ or 10 times. Thus it is evident that the lower the rate of cash reserve, the higher will be the deposit multiplier. By multiplying the additional deposits with the deposit multiplier one will be able to calculate the amount of additional or derived deposits that would be created by the entire banking system as a whole with a given amount of increased deposits. Just as there is multiple expansion of credit there would be multiple contraction of credit when cash is withdrawn from the banks. Hence Crowther rightly said: "the bank's cash is the levy with which the whole gigantic system is manipulated".

9.6 LIMITATIONS ON CREDIT CREATION

Though the deposit multiplier indicates the maximum extent of credit that can be created by the banking system as a whole, banks face certain limitations to credit expansion. Credit creation depends upon the cash to be held by the commercial banks. The percentage of cash reserves of commercial banks is determined by the central bank. For example, in India the Reserve Bank of India determines the Statutory Liquidit Ratio and Net Liquidity Ratio (NLR) of the commercial banks. If the reserve ratio is increased by the Central banks, the capacity of commercial banks to create credit will decrease.

The banking habits of the people will also affect the total volume of credit. If people develop banking habits and deposits more money with the banks and carry on their day to day transactions with cheques, drafts and other credit instruments, banks would be in a position to create more credit. But if people do not have much faith in the banking system and prefer to keep cash with them and withdraw their deposits from the banks, the volume of credit would be reduced. The Commercial banks are also required to keep a certain prescribed percentage of total deposits with the Central bank under the cash reserve ratio. For example, the Reserve Bank of India can increase this ratio from the minimum of 3% to 15% on which the central bank does not pay any interest to the commercial banks. By increasing this ratio, the credit creating capacity of the commercial banks can be reduced.

Thepower of the commercial banks to create credit depends upon the availability of good securities and bills of exchange in the market. If good securities are not available or if genuine bills of exchange are not presented, banks may not be able to expand credit. If the economic conditions are good and prosperous, the business people and traders come forward to make more investment with a view to making more profits. In such prosperous boom periods, banks may lend more. But during periods of depression when the economic activity is at a low level, banks may not come forward to expand credit.

If the monetary policy of the central bank is anti-inflationary, the commercial bank's credit creating capacity will decrease. Quantitative and qualitative credit control weapons are used by the central bank to control the total volume of credit in the economy.

Criticism

Edwin Cannan, an economist, and Walter Leaf, a practical banker, are of the opinion that banks donot have much power to create credit as people withdraw cash from the banks. They may not keep their cash with the bank for a long time. Dr. Cannan compares the bank with that of a cloak room in which 100 umbrellas are deposited every day when the members visit a night club. The in-charge of the cloak room knows by experience that not more than 20 umbrellas are demanded during club hours. Hence he can give 80 umbrellas to the needy persons and collect some rent during the night and get some income. By any stretch of imagination can we say that the cloak room incharge created 80 umbrellas? Certainly not. Just as he cannot rent out more than 80 umbrellas, banks also cannot lend more than what they receive as deposits. This argument may be true only when it is applied to a single bank. But in respect of the entire banking system banks can create much more credit than the deposits they receive.

CHECK YOUR PROGRESS - 2

List out the limitations on credit creation.

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9.7 SIGNIFICANCE OF BANK CREDIT

Bank credit refers to the loans and advances granted by the banks. It is an important source of investment to exploit the available resources in a country. When credit is productively invested, the total employment and incomes of the people will also increase. During periods of depression more credit is created to stimulate the economic activity so that the economy may move into the phase of recovery and prosperity. Thus the total production and consumption of goods and services in a country can increase with the additional investment made available by bank credit, industrialists, traders and businessmen generally rely on bank credit, to promote and expand their enterprises. As credit increases consumption of goods and services, there will be encouragement for the development of large scale enterprises in a modern capitalistic economy. Credit plays a pivotal role in the corporate form of business organisation which issues shares, bonds securities, etc. Institutions like commercial banks, insurance companies and other financial institutions deal with these issues in creating credit. Credit enables the state to meet its expenditure over and above its revenue. Above all, credit is very important in an economy as it provides a convenient and economical medium of exchange in addition to other types of money. As changes in the quantity of credit lead to changes in the total money supply, it renders the monetary system of the country elastic. While explaining the importance of capital, J.S. Mill writes".... though credit is but a transfer of capital from hand to hand it is generally and naturally a transfer to hands more competent to employ the capital more effectively in production". Credit has aasumed such an important role that it is very difficult for us to imagine the functioning of a modern economy without credit.

9.8 SUMMING UP

The basis for credit creation is deposits and loans of commercial banks. Deposits arise in two ways: a) When people actually deposit their cash in commercial banks (primary deposits); b) when banks sanction loans to the public (Derivative Deosits). The derivative deposits are created from primary deposits. Commercial banks create credit by creating derived deposits. These deposits are created in different ways, like by granting loans to the public, by discounting bills of exchange of customers and by purchasing Government bonds and securities. The banker allows the customer to withdraw the deposit from his account by way of cheque as and when he requires.

The banks by their experience know that all depositors do not withdraw their deposits at the same time and hence, they need not maintain 100 per cent of deposits as reserves. They maintain only a fraction of their deposits in the form of cash and the remaining balance is used for the purpose of credit creation. The amount withdrawn from one bank will appear as primary deposit in another bank and that bank also create derived deposit from that primary deposit and so on. This is how the banking system creates credit in the country. The amount of credit created by the banking system depends mainly on the percentages of cash to be kept by them againsat their deposits. The lower the amount to be kept in the banks as reserve, the higher would be the credit creation & vice-versa. The credit creation by commercial banks is subject to certain liamitations like, cash reserve ratio of commercial banks, banking habits of the people, availability of collateral securities, monetary policy of the central bank, etc. The money created by banks plays an important role in the economy in determining the level and direction of economic activities, the level of production and employment, etc.

9.9 CHECK YOUR PROGRESS: MODEL ANSWERS

1. Loans and advances granted by commercial banks.

2. The limitations on credit creation by Commercial Banks are:

    i) The percentage of cash reserves of Commercial banks against their deposits;

ii) Banking habits of the people;

iii) The percentage of total deposits with the central bank;

iv) Availability of collateral securities;

v) Willingness of the people to borrow; and

vi) Monetary policy of the Central Bank.

9.10 MODEL EXAMINATION QUESTIONS

A. ESSAY QUESTIONS

Answer the following in about 30 lines each:

1. Distinguish between primary and derived deposits. How do banks create derived deposits?
2. 'Loans create Deposits' - Discuss.
3. Can the commercial bank lend more than what they receive as deposits from the Public ? explain.
4. "Bankers are not merely traders in money but in an important sense manufacturers of money". In the light of this statement explain how and to what extent commercial banks create credit.

B. SHORT QUESTIONS

Answer the following in about 15 lines each:

1. How derived deposits are created ?
2. Explain multiple expansion of credit.
3. List out the limitations on credit creation.
4. Explain the significance of bank credit.
5. How do you arrive 'Deposit Multiplier'?
6. Explain the process of credit creation by commercial banks.
7. Explain the criticism levelled by Walter Leaf against credit creation by commercial banks.

9.11 RECOMMENDED BOOKS

1. Crowther G. : 'An outline of Money'
2. Sayers R.S. : 'Modern Banking'
3. Jhingan M.L : Money, Banking and International Trade.
4. Sundaram KPM : Money, Banking and International Trade.
5. Vaish M.C., : Money, Banking and International Trade.

9.12 GLOSSARY

Credit : Faith or confidence of the creditor in the capacity of the debtor to fulfil his promise to pay a certain amount.

Credit Creation : The power of commercial banks to expand deposits through expanding their loans and advances.

Derived Deposits : Deposits created by commercial banks from primary deposits by granting loans to the public.

Overdraft : Refers to an amount of money by which a bank account is overdrawn.

10.2.3 THE PRINCIPLE OF PROFITABILITY

Banks' are influenced by the principle of profitability. The aim of investment is to make profit. As the very name implies commercial banks are mainly commercial in their banking activities. They cannot afford to keep funds idle. After mobilising the deposits, banks have to invest them in profitable ventures with adequate security. The banks lend some portion of their funds to get constant and regular return. All the investments of the banker may not be profitable. A profitable investment is one which yields some income to the bank. Loans and advances, investment in securities, money at call and short notice shown on the assets side of a balance sheet represent profitable investments. Cash reserves held by a bank and the dead stocks represent non-profitable investment. Cash reserves held by a bank and the dead stocks represent non-profitable investments. Land, building, furniture, stationary etc., represent the dead stocks. They may not directly yield any income. But they are essential for the functioning of the banking system.

10.3 CONFLICTING NATURE OF THESE PRINCIPLES

Even though the rate of return is high, loans may not be granted unless the bank is satisfied with the security. Thus safety and profitability may not go together in all types of investment. Hence the banker should strike a balance between the two. Similarly when banks maintain high liquidity, their profitability may fall. If the banker prefers to lend more, the liquidity ratio of the bank may fall below the required level. The bank may have to face shortage of funds and may not be able to meet the demand from customers. It may lose the confidence of the depositors and may have to face a run on the Bank. Thus it looks as though prinicipal of liquidity and profitability are conflicting and contradictory. Liquidity principle cannot be discarded onthe ground of profitability. Similarly security principle can not be set aside on the ground of profitability. Hence a prudent banker has to take wise decisions relating to the diversion of investment into various productive channels keeping in view the three important guiding principles, of liquidity, security and profitability. In view of the coinflicting nature of these principles, a wise banker must frame his investment policy by striking a balance between profitability on the one hand and liquidity and solvency on the other.

CHECK YOUR PROGRESS-1

List out the guiding principles of investment policy of a bank. Briefly explain the conflicting nature of these principles.

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10.4 FACTORS INFLUENCING LIQUIDITY OF BANKS

Every bank maintains cash balances and other liquid assets to meet the claims of customers. The ratio between the liquid assets and the total deposits of the banks is called liqidity ratio. This is determined by several factors.

i) Legal Requirements

The Central bank of the country any prescribe a certain minimum liquidity ratio applicable to all commercial banks. This is called statutory liquidity ratio. At present in India commercial

Ba nks are required to maintain 35% of total deposits in the forms of cash and other liquid assets. This ratio is precribed by the Central Bank from time to time in accordance with the changes in economic conditions of the contry. All Countries do not maintain an uniform ratio. For example in England it is 8% while in U.S.A. it is 10%.

ii) Banking Habits and Conditions

The liquidity ratio of a bank is mostly influenced by the banking habits of the people. If the people are in the habit of keeping money in the banks in the form of deposits and make payments by way of cheques, less cash may be withdrawn from the banks. Hence the liquidity ratio may be less. On the other hand, if people withdraw cash from the bank and do not use the cheques in the course of their day-to-day transactions, banks may have to maintain a higher liquidity ratio. In developed countries like U.K. and U.S.A. people make use of credit instruments like cheques, drafts, etc. in most of their transactions. Hence the liquidity ratio in those countries may be much less compared to underdeveloped countries. Similary even within a country, in rural areas where the banking habit is not much developed, banks may have to maintain a higher liquidity ratio compared to the developed urban areas.

iii) Structure of the Banking system

The structure of the banking system also influences liquidity. If large number of branches are functioning under each head office of a bank, each bank may function with less cash reserves as they can borrow from its main office in case of any need.

iv) Nature of Money Market

If the money market is well developed in a country with a large number of banking and other financial institutions, the liquidity ratio may be kept at a low level. Possibilties to borrow from others will be more when the money market is well developed. Banks may borrow not only from other banks but also from the Central Bank.

v) Size of Deposits

If the number of deposits is large, banks may function with samll cash reserves. The withdrwals of some depositors may be made good by receipts from other customers. When there are a small number of depositors each having a huge amount of deposits, banks may have to keep more cash reserves to meet their claims.

vi) Nature of Deposits

The nature of the accountsalso determines the liquidity. If the bank maintains more current accounts, the funds may be withdrawn by the depositors at any time without notice. Hence banks have to maintain more cash reserves. On the other hand if banks have huge funds in fixed deposit account, liquidity may be less.

vii) Busy Periods

During a certrain busy season like the harvesting period there may be more withdrawals from the banks. Hence the liquidity ratio may be high during such periods.

viii) Economic Conditions

The general economic conditions in the countries also influence the cash reserves of commercial banks. In a period of rising prices and inflation business conditions may be prosperous. A small cash reserve may be sufficient to meet the withdrawals.

ix) Nature of Advances and Investments

If the banks have invested a major portion of their funds in short period loans and in other liquid assets which can be converted into cash easily, the liquidity ratio may be less.

10.5 BALANCE SHEET OF A COMMERCIAL BANK-STRUCTURE OF ASSETS AND LIABILITIES

The balance sheet of a commercial bank is a statement showing its financial position on a particular date. It consists of assets and liabilites. Generally assets are shown on the right side and liabilities are shown on the left side of the balance sheet. Usually this statement is prepared at the end of every financial year. There is no uniformity in presenting the balance sheet among the various countries. But all balance sheets reflect their business transactions. Let us examine the structure of assets and liabilities of a commercial bank. The main headings of the balance sheet of a commercial bank are given below:

Balance Sheet of a Commercial Bank

Liabilities	Assests
1. Share Capital Authorised Capital Issued Capital Subscribed Capital Paid-up Capital.	1. Cash in hand
	2. Cash with other Banks
	3. Money at call and short notice receivable.
	4. Investments.
2. Reserve Fund and other reserves.	5. Advances
3. Deposits and other accounts.	6. Bills receivable being bills for collection as per contra.
4. Borrowings from other Banks or Agents.	
5. Bills payable	7. Constituents; Liabilities for acceptance, endorsements and other obligations per contra.
6. Bills for collection being bills receivable as per contra.	
7. Other Liabillities;	8. Premises less depreciation.
8. Acceptances, Endorsements and other obligations as per contra.	9. Furniture and fixtures less depreciation.
	10. Other assets including silver.
9. Profit & Loss Account.	11. Non- Banking assets acquired in satisfactio of claims.
10. Contingent Liabilities described in the B/S.	12. Profit and loss.

10.5.1 LIABILITIES

The liablities represent others' claims on bank. Let us discuss these claims in detail.

Capital

It is the paid-up capital that actually brings funds to the bank. Paid-up capital represents the amount of capital already paid by the shareholders. Authorised capital represents the maximum amount of capital which a company can raise by way of shares. Issued capital is that part of the authorised capitall which is issued to the public for subscription. The subscribed capital is the actual subscribed by the public.

Reserve Fund

This fund is created by transfering a portion of the accumulated profits of the bank. In India 20% of a bank's annual profits must be transferred to the reserve fund so long as it is not equal to the paid-up capital. In the event of any unexpected losses, the bank is permitted to draw upon these reserves. These reserves belong to the shareholders. Only in the event of liquidation of the bank, the capital and reserves will be repaid to the shareholders. Generally a bank with a high reserve fund enjoys more confidence. It acts as an additional security to the customers. The reserve fund is invested in first class Government securities which yield regular income to the bank.

Deposits

Deposits are of various types like fixed, demand and savings deposits which we have discussed earlier. Generally deposits form the largest item on the liabilities side. Increased deposits not only provide more liquidity but also reflect the increased confidence of the public in the working of the bank. Both the primary and secondary deposits form a major portion of the total liabilities of a bank.

Borrowing from others

In addition to these deposits, the banks may also borrow funds from other banks or finanical institutions in times of need. The commercial banks may also borrow from the central bank by rediscounting its bills of exchange. All these borrowings form a part of the total liabilities of the bank.

Bills Payable

The bills payable will shown on the liabilities side. These bills are payable to the customers to facilitate remittance of funds. Bills of exchange accepted or endorsed by the bank on behalf of the customers will appear on the liabilities side as the banks have to make payments. They also appear on the assets side as the bank has to get these payments from the customers.

Bills for Collection

On behalf of customers banks collect bills. cheques, drafts, etc. After collection they become the liabilities of the bank. They are treated as liabilities as the bank has to pay the proceeds to the customers.

Other Liabilities

Under this item, other liabilities like gratuity or pension to the employees unexpired discounts, insurance fund, unclaimed dividends, branch aujustments. etc., are shbown separately.

Acceptances, Endorsements and other Obligations

The banks accept or endorse the bills of exchange on behalf of their customers. It means guarantee the payment of bills at maturuty. These obligations fall on the liablilities side e banks have to make the payment on maturity.

Account

he bank is payable to the shareholders. Hence it is also shown on

provision for these liabilities in its balance sheet. These are own in advance. For example, liabilities may occur when banks en on behalf of customers.

he liabilities side of the balance sheet let us turn to assets side

10.5.2 ASSETS

The assets of the bank are shown in the balance sheet on the basis of their liquidity. Following are the various items that appear on the assets side.

Cash

Cash is the most liquid form of assets. Hence it appears first in the list of assets. A bank has to maintain sufficient liquidity to meet the claims of customers. Cash is the first line of defence against depositors. Though cash is not an earning assets, to avoid any risky situation it maintains sufficient cash balances to meet the customers' demands. Further, a commerial bank has to maintain a minimum percentage of cash against the total deposits to satisfy the requirements of law.

Cash with other Banks

Banks also keep a certain percentage of their total deposits with the central bank and with other commercial banks for the purpose of inter-bank clearance adjustments. Small banks may keep their funds with bigger banks for the purpose of safety as well as clearance. Commercial banks maintaining cash reserves with the Central bank have more prestige in the eyes of the customers.

Money at call and short Notice

Short period loans which are repayable to the bank on demand or at short notice are included under this category. These are regarded as a second line of defence against depositors. these loans are highly liquid as they can be converted into cash in a short period of time. These loans are given for a maximum period of fifteen days and the bank can recall them at short notice. These loans carry a nominal rate of interest.

Investment

Banks invest their funds to maximise their profits. The different types of investments are shown separately on the assets side of the balance sheet. Banks mostly invest in Government securities. The fixed interest yielding sicurities are called gilt edged securities. As there are no risks of loss, banks prefer investment in Government bonds and securities. The investment made by banks in non-Government securities is also shown separately in the balance sheet. These short term investments of banks are regarded as secondary reserves.

Loans and Advances

Banks generally give short term loans and advances which yield high income. Loans and advances, cash credits, overdrafts, etc, are the forms in which banks create additional purchasin power in the economy. These loans and advances are given against tangible securities offere the customers. A Bank also lends on the personal security of the borrowers to fulfill its obligations in helping the economically poor people.

Bills Receivable

Bills of exchange will appear on both sides of the balance she of exchange on hehalf of the customers. As these bills receive the assets side. As commercial banks sell these assets easily th These bills of exchange may be rediscounted by the Central B to the central Bank they become more liquid.

Acceptances and endorsement

These items refer to the obligations which the banker customers. They represent the total dues of a bank's custom appear on both sides of the balance sheet.

Premises and Furniture

Land, building, furniture, fixtures and other properties form a part of the total assets of a bank. These are called 'Dead Stock' and are shown at their depreciated value in the balance sheet. Usually these assets are undervalued. This undervaluation is the source of the secret reserves of the bank. In the event of failure of the bank, these assets may come to the rescue of the bank to keep up its public confidence and solvency.

Other Assets

The interest accrued on investments, silver, income-tax paid in advance, rent recoverable, etc., are included under this item. These items are shown separately under different headings.

Non-Banking Assets

In the course of their business, banks may acquire certain assets in settlement of claims. Under the Banking Regulation Act of 1949 banks must dispose off such assets wthin a period of seven years from the date of their acquisition.

CHECK YOUR PROGRESS - 2

Identify the items on the asset side of balance sheet of a Commercial bank on the basis of liquidity.

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10.6 SUMMING UP

Commerial banks follw three important principles while framing their investment policy, viz., principle of security, principle of liquidity and principle of profitability. These three principles are opposed to each other. In view of the conflicting nature commerial bank should follw a wide investment policy by striking a judicious balance between profitabilty on the one hand and liquidity and safety on the other. Liquidity is the capacity of a bank to produce cash on demand. It depends on various factors like legal requierements, banking habits of the people, structure of the banking system, nature of money market, nature and size of deposits, economic conditions in the country, etc.

The balance sheet of a commercial bank shows its financial position at the end of financial year. The liabilities of the bank are the items which are to be paid by the bank-either to its share holders or the depositors. They include share capital, reserve fund, deposits, borrowings, from others, Bills payable, profit and loss account, contingent liabilities, etc. The asset side reflects the distributions of the bank funds on different types of assets. The assets are shown in the balance sheet on their liquidity basis. They are cash in hand cash with other banks, money at call and short notice, investments, loans and advances, bills receivables, acceptance

10.7 CHECK YOUR PROGRESS: MODEL ANSWERS

1. The important principles of investment policy of a bank are ; i) Principle of security, ii) Principle of liquidity; and iii) Principle of profitability.

These principles are conflicting to each other. If the bank seeks high profit, it may have to sacrifice some safety and liquidity. Or if it seeks more safety and liquidity, it may have to give up some profitability. Hence, a prudent banker will follow his investment policy by striking a judicious balance between profitability on one hand and liquidity and safety on the other hand.

2. The items that appear on the asssets side of the balance sheet of a commercial bank on the basis of their liquidity are ; cash in hand, cash with other banks; money at call and short notice; investments, loans and advances; Bills receivables; acceptances and endorsements; premises and furniture, other assets, non-banking assets and profit and loss.

10.8 MODEL EXAMINATION QUESTIONS

A. ESSAY QUESTIONS

Answer the following in about 30 lines each:

1. What are the aims of the commercial banks' investments policy? How can these be achieved?
2. Explain the meaning of 'liquidity of bank assets' and the factors influencing the liquidity of commercial banks
3. Explain the balance sheet of a commercial bank. Analyse the various items in it.
4. Explain the principles guiding the investment policy of commercial banks.

B. SHORT QUESTIONS

Answer the following in about 15 lines each:

1. Explain the importance of liquidity of commercial banks.
2. Analyse the asset structure of a commercial bank with the help of an illustration.
3. Explain any five important items of liabilities side of a bank.
4. Write short notes on the following;
   a. Money at call and short notice
   b. Acceptances and endorsements.
5. What are the factors standing in the way of maximising the profitability of commercial banks?
6. Explain the conflicting nature of principles of investment policy of bank.

10.9 RECOMMENDED BOOKS

1. Basu S.K. : Fundamentals of Banking; Theory and Practice

2. Basu S.K. : A survey of contemporary Banking Trends

3. Jhingan M.L. : Money, Banking and International Trade

4. Sayers R.S. : Modern Banking

5. Sundaram KPM : Money, Banking and International Trade.

6. Vaish M.C. : Money, Banking and International Trade.

10.10 GLOSSARY

Asset	: Anything owned by person or company, etc. that has money value and which can be sold to pay debts.
Balance Sheet of a Bank	: The statement of assets and liabilities of banking company.
Liquidity	: The capacity of a commercial bank to produce cash on demand by custormers.
Luquidity Ratio	: The ratio between the liquid assets and the total deposits of a bank.

UNIT -11 : STRUCTURE OF BANKING SYSTEMS

Contents

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11.0 AIMS AND OBJECTIVES

The aim of this unit is to describe the different structures of commercial banking organisations.

After reading this unit, You will be able to:

* explain Branch banking system and its advantages and disadvantages;
* describe unit banking system and its advantages and disadvantages;
* distinguish between branch banking system and unit banking system;
* describe the mixed banking system; and
* explain the systems of Group Banking,Chain Banking and Correspondent Banking.

11.1 INTRODUCTION

The structure of banking system differs from country to country. Due to differences in economic, political and social conditions, different systems have come into existence in accordance with the traditions and conventions of the people in various countries. Broadly, speaking we can classify these systems into two types as Branch Banking and Unit Banking. Besides these two, other banking systems like Group Banking, Chain banking, Correspondent banking and Mixed banking have also come into existence. We discuss below these different forms of bank organisations.

11.2 BRANCH BANKING

Branch banking is a system in which each bank operates its banking activities as a single entity having one Board of Directors and one group of share holders. Each bank will have a large network of branches spread all over the country. The large sized banks may have branches in foreign countries also.

The smaller banks may operate with a small number of branches located only in a few areas of the country. This system of banking is very popular in countries like England, Canada, Australia, India, Pakistan, South Africa etc. All the branches under this system carry on their functions in accordance with the policies and directions of the head office from time to time. Usually the head office is located in an important place or large city. The credit of starting the branch banking system goes to England. It is also called "Localised Banking". In the early stages of banking development in England,banks were functioning with very few or no branches. In course of time, the small banks were merged with big banks. In England, the bulk of the banking business is carried on by the big five banks, which are called the "Big Five". Their names are Midland, Westminister,Barclays, Lloyds and the National Provincial Bank. About three-fourths of the entire banking operations are controlled by these five banks whose branches are spread over all parts of England. Similarly in India, banks like the State Bank of India, Central Bank of India, The Bank of India, Punjab National bank,The Bank of Baroda and the United Commerial bank share a large part of the total banking operations in the country. Now let us study the advantages and disadvantages of branch banking system which is very popular in most of the countries of the world.

11.2.1 ADVANTAGES

The branch banking system has many advantages. They are discussed below.

i) More Deposits : Under this system branches of a bank are spread over a wide area in the country. Hence banks may be able to mobilise more deposits from every nook and corner of the country. These branches in rural areas may promote the habit of thrift and saving among the rural masses. As this system of banking covers a wide geographical area, there are more possibilities of mobilising huge deposits. Even the rural savings can find way into the banking sector. In some places a bank may mobilise more savings and in other places may not succeed in receiving more deposits. But on the whole the volume of deposits is likely to be more under the branch banking system.

ii) Greater Public Confidence : As huge financial resources are mobilised with a large number of branches,banks enjoy much public confidence even during periods of depression and low level of economic activity. Even if there is a run on one branch funds from other branches of the same bank can be transferred to meet heavy withdrawals during any period. Thus the system has an inherent advantage to work as a shock absorber in the event of any crisis of confidence in banking. The image of the bank in the eyes of the people will be enhanced as the balance sheet of the bank shows the total deposits of all the branches running into a huge amount. This attracts the attention of the public who may deposit their funds on their own accord even without any publicity by the bank.

iii) Economy in Reserves : Under this system, banks may carry on their day-to-day activities with a small cash reserve. Idle cash reserves kept by Commercial Banks can be minimised as they can draw cash from head office or other branches of the bank when withdrawals are heavy during any busy season. Hence the possibilities of bankruptcy can be relegated to the background. Each branch can maintain only small liquid reserves to meet the requirements of customers. Hence the bank will be in a position to expand credit to a larger extent. The financial resources are economically used as the idle cash balances with each branch can be reduced to the minimum.

iv) No Duplication of Work : Each branch need not spend on advertisement as the head office will look after that work. All the routine work like publication of weekly reports, supply of equipment, recruitment of staff, etc. are attended to by the head office. Thus duplication of work is avoided.

v) Proper Use of Funds : This system enjoys the economies of large scale operations as all funds of the entire bank are pooled together . These funds can be moved from some branches where there is a surplus to other branches where there is shortage. Thus funds can put to optimum use.

vi) Diversification of Deposits : Under this system the prosperity of any bank is not dependent on any region or industry as the funds of banks are diversified over a wide area covering different industries and sectors. Even if any industry or region is under financial stress, the bank need not be afraid as the finances of the entire bank can be used to meet any situation. Once the bank is established and becomes popular deposits flow into the bank from all directions.

vii) Low Cost of Operations : Customers get more benefits and facilities at low cost due to the economies of large scale banking operations. Through scientific management of the banking operations , by adopting the principle of division of labour and innovative banking, it is quite possible to reduce the costs of operations with specialised and expertise staff. New methods and techniques are adopted to improve and expand banking business at low cost.

viii) Loans and Advances made on Merit : Loans are granted only after proper investigation without fear or favour. Local influence does not play any important role in granting any loan as the bank is guided by the three principles of character, capacity and capital of the prospective borrower. He can throw the burden of refusal of a loan to the head office in case of influential applicants from doubtful characters.

ix) Greater Efficiency in Management : All the branches of a commercial bank are controlled by the head office and the head offices of various banks are under the direct influence and control of the Central Bank. On the basis of information provided by the head offices of various banks, the Central Bank will be in a position to formulate policies, rules and regulations from time to time. There will be more effective control of the Central Bank on the functioining of the entire banking system. There will be greater efficiency in management. Most efficient and able people with expertise in banking may be recruited with proper selection.

x) Better Prospects of Promotion and Employment : There will be more prospects of promotion under this system as the number of branches increase from time to time with the progress of the bank. Under this system with the growth of deposits and volume of credit,the banking industry develops faster. It provides more employment opportunities directly and indirectly. When people get jobs in the banks,they are directly employed. When banks are in a better position to give more loans to different sectors and sections of people,there will be a fillip in the production of goods and services. Thus more employment opportunities are created with the help of finances provided by banks.

xi) Minimisation of Regional Disparities : These finances are invested in utilising the resources of our country. The entire banking system can help the Government to achieve the objectives of planned economic growth by promoting the habits of thrift and saving. As funds can be transferred from one branch to another branch,the backward areas can be improved to reduce regional disparities. Under this system, it is easy and more convenient for the Government to have more control and supervision on the banking system.

xii) Increase in Banking Facilities : In the abscence of branch banking system perhaps number of small regions or villages would not have had the opportunity of enjoying banking facilities. Branch banking system makes it possible to locate or establish a branch in a small town or village.

xiii) Remittance Facilities : Under this system as a bank will have a large number of branches at different places, customers may find it very convenient to transfer their funds from one place to another by means of drafts, telegraphic transfers and travellers' cheques. Money need not be transferred from one branch to another. The branches make the necessary book adjustments as all branches belong to the same bank though they are operating at different places.

xiv) Uniformity in Interest Rates : As the funds can flow from one area to another area depending up on the demand for money it is possible to bring about equality in interest rates.

In view of these numerous advantages bank failures are very rare under the system of branch banking.

11.2.2 DISADVANTAGES

Though there are many advantages of branch banking it has some disadvantages also. These are discussed as under.

i) Fear of Monopoly : The system of branch banking may lead to concentration of economic power in the hands of a few executives of the bank at the top level. The head office will have the direct contact with the Central Bank but not with the branches. These branches are controlled by the head office. A handful of high bank officials control the entire banking operations of the bank spread over a wide area. They may be guided by their selfish motives and corner the huge finances of the bank by channelising them into those sectors or industries in which they have their personal interest. The bank officers may be more interested in sanctioning huge loans to a small number of people like big business magnets in whom they are interested. They may ignore the needs of thousands of small businessmen. Moreover these monopolists may use their position as a stepping stone for aquiring political power and may divert the funds of the bank to fulfil their selfish ends. Hence there is an inherent danger of creating Monopoly power which acts as a constant threat to the progress of the community.

ii) Red-Tapism and Delay : Branch banking suffers from the evils of Bureaucracy. There is likely to be much red-tapism and delay in taking decisions as the branches have to refer important matters to the head office. The branch managers may not be given the freedom to take quick decisions. For example, branch banks may not be allowed to sanction big loans without the prior permisssion from the head office. Delay in decision making may be due to lack of sufficient authority on the part of branch managers.

iii) Difficulties of Management : The head office may face more difficulties in efficient management and control of a large number of branches functioning at different regions. Undue expansion of the bank by opening new branches may create more problems of mis-managemnet and lack of co-ordination. When new branches are opened there will be more expenditure for the bank towards establishments and maintenance. There is no guarantee that the business of the bank would increase with more branches. Hence the new branches may reduce the profit of the bank. Due to mismanagement, lack of adequate control on all the branches there may be bank failures. This may spread as a contagious disease leading to a disaster of the banking system. People may lose their confidence in the entire banking system shaking the entire banking organisation.

iv) Unnecessary Competition: When several banks open their branches in the same region there will be unnecessary and unhealthy competition which may lead to wastage of advertisement and consequent losses.

v) Inadequate Knowledge of Local Needs: A manager of a bank is appointed by the head office. These managers are not allowed to stay for a long period of at one place and are transferred to other places. Hence in the period of their short stay they may not be able to acquaint themselves with the local conditions and special needs of the people in that area.

vi) Defective Lending Policy: The managers may not be able to judge the credit worthiness of the borrower properly,as they may not be allowed to stay for a long period in one area. Hence funds may flow into the hands of the people of doubtful character who may not properly repay their loans taken from the bank.

vii) No Personal touch: Under branch banking the banker-customer relationship may not be harmonious as it is not possible for the banker to identify a large number of customers. There is lack of personal touch and contact between the banker and customer. If the manager does not know the local language,it will be an additional disadvantage to speak with all types of customers for improving his contacts with them.

viii) Neglect of Local Area: The funds of a local area are not used for development of the same region as all deposits ares pooled together by the head office. The investment policies are not framed by the branch offices in accordance with their local conditions. The policies are formulated by the head office and the branches have to simply follow them scrupulously. Similarly,the local people may not be able to secure employment in the branch as the recruitment is done by the head office or any central agency.

ix) More Trade Union Activity: Under branch banking system in view of very large number of employees there are more possibilities of emergence of Trade Unions among the bank employees. The employee-employer relationship may not be harmonious due to some differences between the workers and management. This may lead to more strikes and lock-outs causing wastage of several man-days of work.

x) Lack of Adequate Supervision and Responsibility: As the employees are large in number they may not feel any individual responsibility. They may not fully involve and identify themselves with the bank to work most efficiently as the supervision may not be very effective. Consequently the profits of the banks may be reduced considerably.

CHECK YOUR PROGRESS - 1

List out the merits of branch banking.

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CHECK YOUR YOUR PROGRESS - 2

List out the demerits of branch banking.

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11.3 UNIT BANKING

Under Unit Banking system, each bank operates as a single entity without any branches. It is also known as localised banking or open system of banking. The U.S.A. is regarded as the house of the Unit banking system as it was predominant in that country until the II World War period. Since that period there has been a decline in the importance of Unit Banking which is the product of free enterprise and rugged individualism. Under this system each bank works independently with its Board of Directors and management. The operations of the bank are strictly limited to a certain area. In a few cases the bank may be permitted to open a branch which has to limit its activities within a strictly limited area. The banking operations are carried through a single office. Thus,the area of operation is less and size of the bank is small. The unit banks are linked together by a system of correspondent banks for the purpose of easy remittance facilities and transfer of funds from place to place.

UNIT - 14 : CENTRAL BANK AND CREDIT CONTROL

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14.0 AIMS AND OBJECTIVES

The aim of this unit is to explain the various methods with which the Central Bank controls the credit created by Commercial Banks.

By the end of this unit, you will be able to:

* explain the need for credit control; and
* describe the different methods used by the Central Bank to control the credit created by commercial banks

14.1 INTRODUCTION.

In modern days, the credit created by commercial banks constitutes a major portion in the total money supply in the country . It is possible for commercial banks either to intensify inflationary pressure by expanding credit or to contribute to deflationary situation by contracting credit. Thus,it is clear that there should be some authority which controls the credit creation of commercial banks. It is the central bank which controls the credit creation of commercial banks. It follows various methods for controlling the credit creation. This unit first explains the need for the control of credit creation and later concentrates on the various methods of controlling it.

14.2 NEED FOR CREDIT CONTROL

For all practical purposes, credit plays the same role in the economy as that of money. Changes in the volume of credit bring about similar changes in the price level. Money creates credit and credit creates money. Commercial banks create credit in the economy. In their anxiety to make more profits the commercial banks may create excess credit, which may cause incalculable damage to the economy. Hence the need for credit control is felt on the following grounds:

i) **Inflation:** If the total volume of credit is not kept within safe limits excess credit may create inflation in the economy. All the credit created by commercial banks may not be used productively. A portion of credit may be spent extravagantly and unproductively without resulting in increased production of goods and services of equal value. Consequently, prices may tend to rise creating inflationary situation. On the other hand if the total volume of credit is inadequate to meet the requirements of trade and business there may be a decline in the economic activity and prices may tend to fall. Hence the monetary authority should make efforts to bring about equilibrium between the total supply and demand for credit, so that inflation can be avoided.

ii) **Speculataive Activities:** Credit may create unhealthy growth of business and industry. It may encourage more speculative activity which may discourage productive activities. Hoarding and black marketing activities may increase if credit is not restricted to productive uses.

iii) **Difference between the Poor and Rich:** Credit makes the rich richer and the poor poorer. Credit creates two classes of people in the society-creditors and debtors. The debtors may be forced to borrow at high rates of interest. Rising prices and higher interest rates may accentuate this phenomena unless the volume of credit is regulated according to the needs of the economy.

iv) **Trade Cycles:** The economic debacle of 1920-21 was caused due to unsound credit conditions. Uncontrolled expansion of credit against security was one of the causes of great depression that occured between 1929 and 33. Thus history is full of instances to show that uncontrolled expansion of credit can harm the interests of society.

It is evident from the above discussions that uncontrolled expansion of credit may make or mar the economic progress of a country. Hence to maintain a stable economy, the volume of credit created in the economy must be controlled. In all countries, the central banks are entrusted with the task of regulating the total volume of credit for the smooth functioning of the economy.

14.3 METHODS OF CREDIT CONTROL

There are several methods by which the central banks control the total volume of credit. These methods are broadly divided into two groups.

i) Quantitative or General Credit Control

ii) Qualitative or Selective Credit Control.

Let us study each one of them in great detail.

14.3.1 QUANTITATIVE OR GENERAL CREDIT CONTROL

The aim of the quantitative credit control is to regulate the total volume of credit created by the commercial banks. These are used mainly for expansion or contraction of the total quantity of credit in the economy. They are not much concerned with the purposes for which the credit is used. The commercial banks depend upon their reserves to expand or contract the volume of their credit. The instruments of quantitative credit control effect the cash reserves and thereby loanable funds of the commercial banks. Hence these are indirect controls which bring about changes in the volume of excess reserves of commercial banks so that the capacity of the commercial banks to create credit can be altered. These methods deal with the volume and cost of bank credit in general, without reference to any particular field of economic activity. Quantitative methods include bank rate policy, open market operations and the variation of the cash reserves. Let us deal with them in detail.

i) Bank Rate or Rediscount Rate

Bank rate is the rate at which the central bank rediscounts the bills of exchange or grant loans against approved securities to commercial banks. Section 49 of the Reserve Bank of India

Firstly we explain three Principles a then concentrate on factors influencing liquidity of bank. At the end of the Unit, various items of the commercial banks' balance sheet are also described.

10.2 GUIDING PRINCIPLES OF COMMERCIAL BANKS' INVESTMENT POLICY

The commercial banks' earning capacity depends upon their investment policies. The investment policy of a bank should aim at managing its assets and liabilities in order to seek some optimum combination of profit, liquidity and safety. Thus generally the investment policy of commercial bank is influenced by three importnt Principles. They are : Security, liquidity and profitabiliyty. Now, we explain these Principles.

10.2.1 THE PRINCIPLE OF SECURITY

The most important principle is the safety of security of fnds. As the banks act as custodians and trustees of depositors, their interrests must be safeguarded at any cost. The banks should not choose risky investment though they may yield more profit. As the banks deal with others money, they must be very careful while granting loans and advances or else they may not be able to recover them. The funds of the bank should not be locked up for a long time. Hence Commercial banks tend to invest in short term securities. If the banks are influenced only by large security considerations they may not advance a large portion of their funds and may not earn much profit. On the other hand, if the Commercial banks are very greed and lend more funds without looking into the security aspect, they may have to face several risks of loss. If the bank lends heavily to one individual or group of individuals, it may or may not be able to recover the money safely unless the enterprise is in a position to repay the loan. Hence it must lend to as large a number of persons as possible so that the loss of income by bad debts may be compensated by proper recoveries from safe investment. Similarly, banks should not invest all the funds in one place as there is a danger of natural calamities like floods, famines, etc., causing untold damage and misery to the people of that area. If the people of that area have taken a high portion of the funds of a bank, the bank's finacial position would be endangered. When the funds are diversified and invested in different places, lossesat one place may be compensated by gains in other places.

10.2.2 THE PRINCIPLE OF LIQUIDITY

Liquidity is another important guiding principle of investment. Liquidity refers to the ability of banks to pay cash aganst deposits. A bank receives deposits from the public in different forms. A portion of these deposits may be withdrawn by the depositors with or without any notice. The banker can enjoy the confidence of the public only when he pays the depositors on demand. Hence a wise banker must keep adequate cash or liquid assets to meet this demand. The liquid assets-deposit ratio is called liquidity ratio. The banks must keep a certain percentage of their total deposits liquid or in near liquid form, to meet the claims of customers and inter-bank claims. Liquid assets refer to those assets that can be converted into cash easily. The liquidity of any asset depends upon the ease with which it can be shifted on to other banks or the Central Bank before maturity in case of need. This is referred to as shiftability of an asset. If the assets of a bank are mostly shiftable, they increase the liquidity of the bank. The Central Bank prescribes certain rules and regulations when commercial banks want to shift their assets to the central bank. Generally commercial banks tend to invest their funds in Government securities so that as and when they are hard pressed for liquid cash they can easily sell the Government securities in the market. The investment of bank funds in easily saleable securities or debentures will increase the liquidity of commercial banks. In case of any need, the bank can sell the security and realise the money without any loss. When commercial banks maintain a high percentage of liquidity, the funds of the bank are immobilised without contributing any income to the bank.

10.2.3 THE PRINCIPLE OF PROFITABILITY

Banks' are influenced by the principle of profitability. The aim of investment is to make profit. As the very name implies commercial banks are mainly commercial in their banking activities. They cannot afford to keep funds idle. After mobilising the deposits, banks have to invest them in profitable ventures with adequate security. The banks lend some portion of their funds to get constant and regular return. All the investments of the banker may not be profitable. A profitable investment is one which yields some income to the bank. Loans and advances, investment in securities, money at call and short notice shown on the assets side of a balance sheet represent profitable investments. Cash reserves held by a bank and the dead stocks represent non-profitable investment. Cash reserves held by a bank and the dead stocks represent non-profitable investments. Land, building, furniture, stationary etc., represent the dead stocks. They may not directly yield any income. But they are essential for the functioning of the banking system.

10.3 CONFLICTING NATURE OF THESE PRINCIPLES

Even though the rate of return is high, loans may not be granted unless the bank is satisfied with the security. Thus safety and profitability may not go together in all types of investment. Hence the banker should strike a balance between the two. Similarly when banks maintain high liquidity, their profitability may fall. If the banker prefers to lend more, the liquidity ratio of the bank may fall below the required level. The bank may have to face shortage of funds and may not be able to meet the demand from customers. It may lose the confidence of the depositors and may have to face a run on the Bank. Thus it looks as though prinicipal of liquidity and profitability are conflicting and contradictory. Liquidity principle cannot be discarded onthe ground of profitability. Similarly security principle can not be set aside on the ground of profitability. Hence a prudent banker has to take wise decisions relating to the diversion of investment into various productive channels keeping in view the three important guiding principles, of liquidity, security and profitability. In view of the coinflicting natûre of these principles, a wise banker must frame his investment policy by striking a balance between profitability on the one hand and liquidity and solvency on the other.

CHECK YOUR PROGRESS-1

List out the guiding principles of investment policy of a bank. Briefly explain the conflicting nature of these principles.

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10.4 FACTORS INFLUENCING LIQUIDITY OF BANKS

Every bank maintains cash balances and other liquid assets to meet the claims of customers. The ratio between the liquid assets and the total deposits of the banks is called liqidity ratio. This is determined by several factors.

i) Legal Requirements

The Central bank of the country any prescribe a certain minimum liquidity ratio applicable to all commercial banks. This is called statutory liquidity ratio. At present in India commercial

11.3.1 ADVANTAGES

The Unit banks,being independent and one-office banks, have the following merits;

i) More Attention to Local Needs: As the operations of the bank are confined to a limited area the bank can serve the local needs of the people in the specified area. The resources of the bank are first used for the development of the local area and then the surplus funds are invested in Government Securities. Thus the resources of the bank are used for the upliftment of the local area but not transferred to other areas on any considerations of profit. Since the bank officers and other staff members of a unit bank are recruited from the same area,employment opportunities for local people are created. Moreover the bank people of the same locality are fully acquainted with the local needs of the area for providing funds for development. The special problems of the area for providing funds for development. The special problems of the area can be better served by attending to the needs of the individual enterprises of the community through quick decision making.

ii) Efficient Credit Policy: As banker and customer belong to the same area,the character and credit-worthiness of the customers are well understood by the bankers before they grant loans and advances. Hence the funds of the bank may not flow into wrong hands.

iv) Happy Customer-Banker Relationship: As the banker and people are from the same locality the harmony and understanding between them would be more to help in the speedy development of the area. The banker may be able to identify the customer of the bank easily. This promotes the happy relationship between the customer and the banker.

iv) More Harmony between Employees and Employers: As the bank is a small unit there may not be any problem of management supervision and control. As the number of workers is small within a bank the employee-employer relationship is likely to be more happy and harmonious. The scope for strikes and lock-outs is less as any dispute between the workers and the management can be solved by direct discussions.

v) Efficiency in Management and Supervision : Cases of fraud, irregularities, mismanagement and irresponsibility may be minimised as the scale of operations is small. Wastages and diseconomies of large scale operations can be eliminated.

vi) No Scope for Monopoly : This system does not help in the formation of monopoly and concentration of economic power in the hands of a few individuals as there is a large number of small independent banks.

11.3.2 DISADVANTAGES

Despite these advantages,unit banking possesses certain disadvantages.

i) Inability to Face Crisis : Unit banks being small in size may not be able to face adversity. During the great depression between 1929-1933, a large number of Unit Banks in USA could not survive. In the event of any run on the bank it may not be able to meet the sudden rush of deposit withdrawals. The funds of the bank are mostly invested in the same locality. In the event of natural calamities like floods or famine or droughts occurring in that area the bank may land in financial crisis.

ii) Inefficient Management : As the size of the bank is small and its operations are restricted to a limited area, the bank may not afford to use the services of well trained personnel and most modern methods and techniques of banking. Thus funds may be mismanaged. In the absence of many avenues of employment of funds in the same locality the banks may hold more liquid cash without earning any income. The scale of operations being small the establishment costs may be more and the profits may be less.

BLOCK-IV : CENTRAL BANKING

UNIT-12 : FUNCTIONS OF THE CENTRAL BANK

Contents

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12.2 Establishment of Central Banks

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12.0 AIMS AND OBJECTIVES

The aims of this unit are to describe the functions of a Central Bank in an economy and explain the distinction between Central Ibanking and Commercial banking. After going through this unit, you will be able to :

* define the Central bank and explain the principles of Central banking;
* Explain the functions of a Central bank; and
* distinguish between Central banking and Commercial banking.

12.1 INTRODUCTION

In almost every country, there is one bank which is the apex of the banking system. It regulates and controls the whole monetary system in the country. It plays an active role in implementing the Government's monetary policy in the country. The functions of such a bank are discussed in this unit, besides explaining the differences between Central banking and Commercial banking.

12.2 ESTABLISHMENT OF CENTRAL BANKS

The Central Bank of any country, as the very name implies, occupies the central position in the entire banking system of the country. Almost every country in the world has its central bank as the apex banking institution controlling the activities of the money market. Central banking in its modern sense is only of recent origin, although some central banks were established in the 17th and 18th centuries. The oldest central bank is the Riks Bank of Sweden which was established in 1656. The central bank of England is the Bank of England established in 1694 by an Act of parliament. England is considered to be the home of central banking as the Bank of England was the first to perform the fundamental functions of a modern central bank. Many countries in Europe, Asia and Africa established their central banks during 19th century. The Bank of France was set up in 1800, the Bank of Netherlands in 1814, the National Bank of Denmark in 1818, the National Bank of Belgium in 1850, the Bank of Spain in 1856, the State Bank of Russia in 1860, the Reichs Bank in Germany in 1875, the Bank of Japan in 1882 and the Bank of Italy in 1893. By the end of the 19th century, almost all countries in Europe had established their central banks to control their monetary systems. Java, Persia, Servia, Turkey, Portugal, Rumania, Bulgaria, Egypt, Algeria also established their central banks in the 19th century. In the U.S.A. the central bank is represented by the Federal Reserve system which was established in 1913. In India, the Reserve Bank of India came into existence in 1935 as the central bank of our country. The Bank of Canada was established as late as 1934. During the post-World War I period, the spirit of Nationalism gave much encouragement for the development of central banking in the world. The International Financial Conference held at Brussels in 1920 encouraged all countries without a Central Bank, to establish such banks in their countries in the interests of world co-operation and stability of monetary and banking systems. The establishment of the International Monetary Fund (IMF) in 1944 gave further fillip to the growth of central banks in the new Afro-Asian and Latin American countries. Today there is hardly any independent country without a Central Bank. These banks were originally started as private joint stock banks, providing finance to the government. The changes in economic, political and social conditions have enhanced the status of central banks as the arch pillars of their country's monetary and fiscal framework.

12.3 DEFINITION OF CENTRAL BANK

Let us acquaint ourselves with some of the definitions of central bank to understand its varied functions. In the statute of the Bank of International Settlements, a central bank is defined as "the bank in any country to which has been entrusted the duty of regulating the volume of currency and credit in that country'. According to Kisch and Elkin, a central bank is that bank the duty of which maibtenance of stability of the monetary standard which involves the control of the monetary circulation". In his famous book' Central Banking' M.H. Dekock defined central bank in a lengthy manner. According to him, a central bank is a bank which constitutes the apex of the monetary and banking structure of its country and which performs several functions in the national economic interest. According to Kent, it is an institution which is charged with the responsibility of managing the expansion and contraction of the volume of the money in the interest of general public welfare. R.S. Sayers in his book "Modern Banking" pointed out that the business of a central bank as distinguished from a commercial bank is to cntrol the commercial banks in such a way as to promote the general monetary policy of the state. From the various definitions, owe can conclude that the central bank is the highest banking institution in any country entrusted with the task of controlling and regulating the monetary and banking system in the country to serve the best interests of the nation.

12.4 OBJECTIVES OF CENTRAL BANKS

The Central bank is guided by the spirit of national welfare. Public welfare is its primary consideration and profit motive is secondary. It does not mean that it should suffer losses while working in the national interest. Unlike commercial banks, the central banks do not invite deposits from the public. Another important principle of the central bank is that it should help in the process of economic development of the country by maintaining financial and monetary stability in the country. The central bank should be free from all political influences so that it can pursue a suitable policy conducive to economic development. Though there can be good co-operation and harmony between the central bank and Government in their functioning, the central bank should not be influenced by the ideologies of the political parties in power.

12.5 FUNCTIONS OF CENTRAL BANKS

Central Banks in all countries perform the following functions in spite of differences in social, political and economic systems. These functions are described as traditional functions of the central bank. Let us now describe each one of these functions briefly.

12.5.1 MONOPOLY OF NOTE ISSUE

In every country the Central Bank enjoys the monopoly of note issue. No other bank in the country is authorised to issue notes. The central banks were originally called banks of issue until the beginning of the twentieth century. In a few countries even now central banks do not enjoy monopoly power in the issue of notes. There are several benefits in centralising the note issue function. The Central Bank enjoys much prestige and public confidence due to this prerogative of note issue. Uniformity in note issue can be achieved with a single central authority. The Central Bank will have direct control on commercial banks which have direct contact with different sections of people. The commercial banks can assess the requirements of finance in the various activities of country. On the basis of this information, the Central Bank can bring about required changes in the quantity of currency in the country. The required elasticity is provided by the central bank by regulating the supply of money. Different systems of note issue have been adopted by the central banks based upon the principles of elasticity and security.

12.5.2 BANKER, AGENT AND ADVISER TO THE GOVERNMENT

Another important function of a Central Bank is to act as the banker, agent and adviser to the Government. In all the countries of the world the central bank functions as the banker and fiscal agent to the Government of the country. Just as the commercial banks perform several services to its customers, the central bank performs several services to the Government. As the fiscal agent of the Government it collects the cheques and drafts on behalf of the Government and credits them to Government account. Not only does it maintain Government account; it also transfers funds from place to place and from one account to another account. The Central bank maintains the income and expenditure accounts of the Government for the entire country free of charge. It does not pay interest on the deposits of the Government. On the other hand, Government may pay some amount towards the cost of performing these services or may keep minimum cash balances with the central bank. Due to the close relationship between the public finance and monetary affairs, the Central Bank acts as banker to the Government.

The Central Bank performs enormous services to the Government as its agent, as a commercial bank does to its customers. But in performing these services, unlike commercial banks, the Central Bank is mainly guided by the nation's welfare motive and not by a profit motive. As a banker of the Government it manages public debt and Government accounts. When people pay taxes the supply of money in circulation decreases. When Government spends money on civil defence and development projects in the country the supply of money expands. The Central Bank as agent and adviser of the Government will take suitable monetary steps to regulate the supply of money to stabilise the price level. On all matters relating to money and finance, the expert advice of the central bank is sought by the Government to formulate monetary and fiscal Bpolicies. It plays as important role in advising the Government in the preparation of the budget. It floats the loans and receives subscriptions on behalf of the Government. Issue and redemption of Treasury bills. bonds, securities etc., are undertaken by the central bank. Due to the increasing importance of deficit financing in the planned economic development of underdeveloped countries the central banks and Government have to maintain perfect co-operation and co-ordination in all monetary and fiscal matters to maintain growth with social justice.

12.5.3 BANKER'S BANK

In all the countries the central banks act as the banker of all other banks. All other banks are required to keep a certain percentage of their deposits as cash reserve with the central bank, either by law or by custom. In England, the Bank of England enjoys this privilege as "a matter of tradition". In U.S.A. and India, banks are required to keep a certain percentage of their total deposit liabilities statutorily. In U.S.A. banks maintain 3 to 13 per cent of their total deposits while in India banks keep 3 to 15 percent of their total deposits as cash reserve with the central bank as required by law. Thus the cash reserves are centralised in the central bank which is a source of great strength, power and prestige to the banking system of the country. When all the reserves of the commercial banks are pooled together in the central bank, they can be used for meeting any financial crisis. These reserves provide more liquidity and stability to the banking system. These reserves are used by the central bank to clear inter-bank claims through the clearing house. During a slack season, clommercial banks may opt to keep more reserves with the central bank while in a busy season they may withdraw their surplus cash reserves to meet the claims of the customers. These reserves are very helpful in settling payment between one bank and another bank as this is done by the central bank by crediting the account of one bank and debiting the account of the other. Thus the central bank acts as the custodian of the cash reserves of all other banks, safeguarding and protecting the interests of the nation in general and customers in particular. The central bank can divert these reserves to places where there is greater need. The benefits of the centralised cash reserves can be realised by the banking system by more co-operation and understanding between the central bank and other banks in the country.

Commercial banks get various benefits from the central bank. The central bank gives financial help to commercial banks in times of need. They also get rediscounting facility from the central bank. Thus Central Bank acts as the **'lender of last resort'**. As the leader of the entire money market, the central bank formulates the policy for the effective and efficient working of all the banks in the country. Hence the commercial banks look up to the central bank for guidance and direction in the event of any monetary and financial problems.

Further, the central bank acts also as a clearing house. The function of central clearance and settlement was originally started by the bank of England in the middle of the 19th century. Later other countries adopted this practice. This system enables the central bank to know the liquidity position of each bank. It also enables the central bank to take corrective measures relating to the control of the total volume of credit created by commercial banks.

12.5.4 CUSTODIAN OF NATION'S RESERVES

Gold and foreign exchange reserves are maintained by the central banks in all countries. The central bank is required by law to maintain a minimum reserve against its note issue. The reserves are maintained by all central banks to meet deficits in balance of payments and maintain the external value of its currency. The foreign exchange reserves are maintained to avoid fluctuations in exchange rate. For this purpose it has to sell or buy foreign currencies in the exchange market. It is the responsibility of the central bank to maintain stable exchange rates. Foreign exchange reserves help the central banks to maintain stable external values of the currency. As the bank of issue, the central bank also takes the responsibility of maintaining stable internal value of the currency. For this purpose under the gold standard system., the central banks used to maintain cent percent gold reserves against the total currency. After the abolition of the gold standard system, many central banks maintain both gold and foreign exchange as a reserve against the note issue. The Central Bank holds some cash reserves of commercial banks statutorily. For meeting these reserve liabilities of the commercial banks, central banks maintain a reserve. A central bank is required to maintain certain minimum reserve against its currency. For example in India, at present, the Reserve Bank is required to maintain a Rs.200 crores worth of reserves consisting of a minimum of Rs. 115 crores of gold and Rs. 85 crores worth of foreign securities against its note issue and deposit liabilities. This amount of reserve is immobilised in the central bank and cannot be used for meeting any international transactions. Only the additional foreign exchange reserves can be used to avoid fluctuations in exchange rates. Thus the central bank aims at stabilising the external value of the currency, besides providing safety to note issue and protecting the interests of the depositors by being the custodian of the nation's reserves.

12.5.5 CONTROLLER OF CREDIT

The control of credit is the most important function of a central bank in the context of the present day economic unrest in most of the countries of the world. Wide fluctuations in the value of money are caused mainly due to unwarranted expansion in the supply of money and credit in the economy. The commercial banks create credit where as the central bank controls credit in the economy. The central bank influences economic activity in the country by discouraging expansion of unproductive and undesirable credit. With the help of the various techniques of credit control, the central bank controls the expansion and contraction of credit to stabilise the price level. We shall study these methods of credit control at great length in the following unit.

CHECK YOUR PROGRESS - I

List out the functions of a Central Bank.

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12.6 SIMILARITIES AND DIFFERENCES BETWEEN CENTRAL BANKING AND COMMERCIAL BANKING

Though Central banking is different from commercial banking, there are some similarities between these two. They are;

SIMILARITIES

i) Money dealings : The Central Bank as well as the commercial banks are monetary institutions dealing in money. The money created by the Central Bank is legal tender but the money created by commercial banks is called credit money or bank money.

ii) Credit Creation : By rediscounting the bills of commercial banks credit may be created by Central Banks where as commercial banks create credit on the basis of their primary deposits.

iii) Lending Policies : Both institutions do not lend against immovable properties, lest their liquid funds may be reduced. Hence they are not in favour of long term loans. They lend mostly for short periods to maintain high liquidity.

Though there are certain similarities the Central Bank is an institution which is entirely different from commercial banks as could be observed from the following:

DIFFERENCES

i) Ownership : The Central Bank is generally owned by the State while the commercial banks may be owned by private individuals as shareholders.

ii) Right to Note-Issue : Though at one time commercial banks had the right to issue notes, at present note issue is the monopoly of the Central bank in all countries. As an agent, adviser and banker, the Central Bank is closely connected with the Government.

iii) Profit Motive : The Central Bank is not a profit making institution. Profit is secondary and service to the people and the nation is its primary objective. On the other hand the commercial bank naturally aims at securing maximum profits. The funds of the Commercial Banks are invested even in risky enterprises to earn maximum profits. But the Central Bank works in the broad national interest with a view to achieve stable economic growth.

iv) Relationship with Government : Usually the Central Bank and the Government will have a close relationship as the top officials of the Central Banks are nominated by the Government. As the Commercial banks are privately owned institutions, Government generally does not interfere in the working of the commercial banks. As a matter of fact there is no direct relationship between the government and the Commercial Banks.

v) Foreign Exchange Transactions : The Central Bank maintains the foreign exchange reserves of the country. One of its functions is to maintain stable exchange rates. The commercial banks may also deal in foreign exchange, but do not act as custodians of foreign exchange reserves. They have nothing to do ewith the maintenance of foreign exchange rates.

vi) Position in the Money Market : The Central Bank is the apex monetary institution in any country. All the commercial banks in a country are controlled by the Central Bank. The Central Bank acts as the bankers' bank by controlling some portion of the funds of Commercial Banks. It is their guardian and lender of last resort. It will only help the Commercial banks rather than compete with them.

Though there are similarities and differences between the functioning of Central Banks and the Commercial banks, the success of a Central Bank depends mostly on the whole hearted support and co-operation of the Commercial banks. The Commercial bank's activities are controlled and regulated by the Central Bank to achieve co-ordination and avoid any competition in the healthy and smooth working of the monetary system in the country.

CHECK YOUR PROGRESS - 2

Explain, how Central Banking differs from commercial banking.

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12.7 SUMMING UP

Central bank is the apex monetary authority in the country. As the leader of the money market it supervises, controls and regulates the activities of commercial banks and other financial institutions. It helps in the process of economic development by pursuing a suitable monetary policy.Central banks perform certain important functions, like issuing currency, acting as banker, agent and adviser to the Government, acting as bankers' bank, maintaining nation's reserves and controlling credit creation by commercial banks.

Though there are a few similarities, central banking differs from commercial banking in terms of certain aspects like ownership, note issue, profit motive, relationship with the Government, transactions of foreign exchange, etc.

12.8 CHECK YOUR PROGRESS: MODEL ANSWERS

1. Central bank performs various functions in an economy. They are:
   i) Issue of currency;
   ii) Acting as banker, agent and adviser to the Government;
   iii) Acting as banker's bank;
   iv) Maintaining gold and foreign exchange reserves, and
   v) controlling the credit creation of commercial banks.

2. Points of difference between Central banking and Commercial banking are:
   i) The central bank is owned by the government, while commercial banks may be owned by private individuals.
   ii) Central banks have the right to issue currency notes, while commercial banks do not enjoy such rights.
   iii) Central banks do not aim at profits, whereas commercial banks aim at securing maximum profits;
   iv) There is direct relationship between the Government and Central bank whereas the direct relationship will not exist between the Government and commercial bank.
   v) Central banks act as custodian of foreign exchange reserves, whereas commercial banks do not act.
   vi) Central banks are the apex institutions in the money market, whereas commercial banks are controlled and regulated by central banks.

12.9 MODEL EXAMINATION QUESTIONS

A) ESSAY QUESTIONS

Answer the following in about 30 lines each:

1. Define a central bank and explain the functions of a Central Bank
2. Compare Commercial Banking with Central Banking.

B) SHORT QUESTIONS

Answer the following in about 15 lines each:

1. What is a central bank? How does it differ from commercial banks.
2. Write short notes on:
   i) Clearing house and
   ii) Lender of Last Resort.
3. Write short notes on:
   i) Monopoly of note issue; and
   ii) Banker's bank.
4. Explain the objectives of Central Banks.

UNIT-13: PRINCIPLES AND SYSTEMS OF NOTE ISSUE

Contents

13.0 Aims and Objectives
13.1 Introduction
13.2 Principles of Note Issue
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13.2.2 Banking Principle
13.3 Regulation of Note Issue
13.4 Systems of Note Issue
13.4.1 Fixed Fiduciary System
13.4.2 Maximum Fiduciary System
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13.4.4 Minimum Reserve System
13.5 Summing Up
13.6 Check Your Progress : Model Answers
13.7 Model Examination Questions
13.8 Recommended Books
13.9 Glossary

13.0 AIMS AND OBJECTIVES

This unit aims at explaining the principles and systems of note issue.

After going through this unit, you will be able to :

* **explain the** principles of note issue;
* **discuss the** arguments for and against the control of note issue by the Government;
* **describe the** various systems of note issue; and
* **discuss** the case for single note issue system.

13.1 INTRODUCTION

A good paper currency system should possess certain important qualities. It should be economical, elastic and should command public confidence. The note issue system is based on certain principles. This unit discusses such principles and different methods of note issue adopted from time to time by the various countries.

13.2 PRINCIPLES OF NOTE ISSUE

In different countries different principles are followed for the issue of notes. All these principles aim at securing uniformity and elasticity to the entire currency system. The monetary authorities must be in a position to bring about changes in the volume of currency to suit the requirement of trade and business. Let us study the principles of note issue in detail.

There are two principles of note issue.

12.10 RECOMMENDED BOOKS

1. De Kock M.H.	:	Central Banking
2. Sayers R.S.	:	Modern Banking
3. Shaw W.A.	:	Theory and Principles of central banking
4. Sundaram K.P.M.	:	Money, Banking and International Trade.
5. Vaish M.C.	:	Money, Banking and International Trade.

12.11 GLOSSARY

Central Bank : The bank that controls the volume of currency and credit in any country.

Clearing House : An agency through which the inter bank indebtedness is cleared. Usually the Central bank acts a clearing house for member banks.

Lender of Last Resort : When the Commercial banks and other finance houses want to borrow short-term loans and cannot borrow enough from one another as money market is short of cash, they come in the last resort to the central bank. So central bank is called the lender of the last resort.

Money market : A market for the purchase and sale of liquid assets especially bills of exchange, Treasury bills and other securities that are due to be redeemed within a short time.

13.2.1 CURRENCY PRINCIPLE

According to this principle, the currency in a country should be backed up by cent percent metallic reserve i.e., either gold or silver. According to this principle every monetary authority should acquire gold to issue an equivalent amount of currency so that the Government can command the greatest confidence of the people. Government will be in a position to provide gold for currency when all the members want to convert their currency into gold. When this principle is adopted, the expansion of currency is limited by the availability of gold reserves to the monetary authority. This principle has the following merits and demerits.

Merits

i) Security: It provides complete security to the currency system as the currency is backed up by cent percent gold. When currency authorities adopt this principle there is no danger of over issue of currency.

ii) Public Confidence: As paper notes are convertible into metallic coins, people will have more faith and confidence in the monetary system when this principle is adopted.

Demerits

i) Lack of Elasticity: A monetary system based upon this principle sacrifices the quality of elasticity, which is very essential for the present day growing economies.

ii) Lack of Economy: A monetary system based upon the currency principle is a costly system. It is most uneconmical as every note issued should be backed up by cent percent gold or silver. It leads to wastage of precious metals as they are kept as an idle reserve against currency without being used for more profitable and productive purposes.

iii) Difficult to put into Practice: A monetary system based upon this principle may not be able to expand its currency if the available gold and silver mines are exhausted. All countries do not possess equal quantity of mineral resources. Some countries may be endowed with rich mineral resources while other countries may face acute scarcity. In such countries where there is scarcity of these metals, monetary authorities may find it difficult to adopt this principle.

13.2.2 BANKING PRINCIPLE

According to this there is no need to keep cent percent metallic reserve against the note issue. This principle assumes that all people do not wish to convert their currency into gold at the same time. At any time only a few people may desire to convert currency into gold. Hence it will be sufficient if the government holds a fractional reserve. This principle is derived from the practice of creating more credit with less cash reserves by commercial banks. A monetary system based upon this principle believes that the responsibility of varying the supply of currency in the country should be left in the hands of an independent authority like the Central Bank. According to this principle, the question of how much quantity of money is to be created in the economy should be left entirely to the discretion of the banking system.

This principle has the following merits and demerits.

Merits

i) Elasticity: When this principle is adopted, the currency system becomes elastic and responsive to the changing needs of trade and business.

ii) Economical: A monetary system based upon this principle does not require cent percent metallic reserves. Hence it proves to be more economical. The principle gives some degree of freedom to the monetary authority to adjust the supply of money in accordance with the changing needs of the economy.

Demerits

i) Risk of Over-Issue: A monetary system based upon this principle may expand the currency even beyond the safe limits as cent percent metallic reserve need not be maintained against the note issue. Over-issue of notes may create inflation in the economy. Hence it does not provide much security.

ii) Less Public Confidence: A monetary system based upon this principle may not enjoy much public confidence as it does not provide full metallic backing for the entire currency.

13.3 REGULATION OF NOTE ISSUE

In every country laws have been passed for the issue of currency and its regulation. If note issue is not properly controlled the economy may be subjected to violent price fluctuations which may adversely affect the total output, income and employment in the economy. The total volume of currency should be properly adjusted to the requirements of trade and business in any country. Some economists are of the opinion that the Central Bank in any country should have the right to issue and regulate the volume of currency. Some others held the view that the state should have the power to regulate the note issue. Let us discuss the various shades of opinions on this aspect.

Arguments In Favour Of State Control

i) It is argued that the state has more prestige and enjoys the confidence of the people more than any other institution to regulate the note issue.

ii) The advocates of State Control on note issue contend that when Government issues the notes and regulates the volume of currency, there will be more security to the note issue as all the assets of the Government will back the entire currency. Issue and regulation of currency by government will ensure easy convertability of currency.

iii) It is pointed out that the Government will have the machinery and organisation at every level to estimate the needs of the total volume of currency. Therefore, it must have the power to expand or contract the total volume of currency in circulation to suit the needs of trade and business.

iv) Source of Profit: It is argued that the issue of currency and its regulation will be a source of profit to the state. These profits are used by the Government in the larger interest of the country.

v) Defacto Authority: Though Central Banks are vested with the authority to issue and regulate the total volume of currency, Government exercises great influence in framing the general economic policy in the country. Hence it would be better if Government regulates the issue of notes.

vi) Legislative Powers: Government enjoys the legislative power to pass the rules and regulations for effective and efficient working of the monetary system. During periods of emergency and economic crisis, government should have the regulating authority to correct any disequlibrium in the economy.

Arguments Against the Issue and Control of Notes by Government.

i) Political Considerations: It is pointed out that politica considerations play a dominant role in all matters of economic policy when Government regulates the supply of currency in circulation. Hence effective monetary policy may not be followed under the state control of note issue.

ii) Inflation: Under the pressures of heavy deficit budgets, irresponsible governments may indulge in over issue of notes causing irreparable damage to the economy. Issue of currency in excess of demand creates inflation. If the power of regulating the volume of currency is in the hands of Government it may not be possible to prevent the Government from abusing this power.

iii) Inadequate Knowledge of Trade and Business: The State, with all its heavy burden of administration, may not be in a position to develop intimate knowledge of trade and business. Hence it may not be able to assess the actual requirements of money. Trade, industry and business sectors may have to suffer if the volume of currency is not adjusted to the requirements.

iv) Red-tapism: Government departments are characterised with their inordinate delay in decision making and its execution. Hence it may not be possible for the Government to bring about quick changes in the total currency according to the changing economic conditions. Delay causes much damage to the stability of the economic system.

v) Inefficiency: Highly placed government officials who are well experienced in dealing with political and administrative problems may not possess the technical knowledge required to deal with monetary and financial problems.

vi) Historical Evidence: History is full of instances to show that Government lost the faith and confidence of the public when government notes were depreciated.

In view of the above considerations in all countries of the world, the power of regulating the volume of money is vested in the hands of a non-political institution like the Central Bank.

13.4 SYSTEMS OF NOTE ISSUE

Based upon the principles of note issue different systems of note issue have been adopted by various countries.

13.4.1 FIXED FIDUCIARY SYSTEM

Under this system, the Central Bank is given authority to issue currency upto a certain amount without the backing of gold. This limit is fixed by Government statutorily. This uncovered or fiduciary portion has to be covered by Government Securities. Beyond this limit there should be cent percent gold backing against the issue of currency. This system is based upon currency principle with the aim of providing convertibility of notes. This system was adopted for the first time by England under the Bank Charter Act (1844), which authorised the Bank of England to issue notes upto £ 14 million. This limit was changed from time to time. In 1939 the limit was changed to £ 530 million. This system was introduced by Japan, Norway, Finland and also Italy. In India this system was introduced in 1861 with a Fiduciary issue of Rs.4 Crores which was enhanced to Rs. 120 Crores in 1920. This system was considered inelastic as the quantity of money in circulation was not connected with the needs of the community. It is expensive as every unit of currency is to be backed up by gold. As the fixed limit was changed by the Government it has lost its significance. This system, no doubt works as a brake on unnecessary expansion of currency by irresponsible Governments. This system is also called partial fiduciary system.

13.4.2 MAXIMUM FIDUCIARY SYSTEM

Under the maximum fiduciary system, the maximum limit upto which the Central Bank can issue notes without any gold backing is fixed by the Government. Upto this limit, the Central Bank can vary the amount of money in circulation according to the needs of trade and business in the economy. Above the ceiling limit, the issue of currency must be backed up by cent percent gold reserves. England introduced this system in 1939 and fixed the maximum fiduciary limit at £ 580 million. This was increased to £ 1450 in 1946. Between 1870 and 1928 this system was adopted in France with the Fiduciary limit of 59431 million Francs. Japan adopted this system in 1941. This system has also been adopted in Finland, Norway and Russia. J.M. Keynes considered this as the best system since the law of the land controls the volume of note issue. As the system dispenses with gold reserve against note issue there is the danger of over issue and revision of the ceiling limit by Government as and when the Government requires additional resources.

13.4.3 PROPORTIONAL RESERVE SYSTEM

Under this system a certain percentage of the total currency issued should have gold backing. The rest is covered by Government securities. This percentage is not rigidly fixed and can be changed with the consent of the Government. The proportional reserve generally varies between 25 and 40 percent of the total note issue. This system was first adopted in Germany in 1875 and was followed by India in 1927 with some modifications. This was adopted by U.S.A. and France in 1928. Australia, Canada, New Zealand, Belgium, Holland, Switzerland and Argentina also adopted this system. This system was in vogue in India upto 1956 with 40 percent gold backing. The balance of 60 percent was backed up by rupee securities. According to the provisions of Reserve Bank of India Act the value of gold reserve should never be less than Rs.40 crores. This was described as **percentage deposit system** in India. In U.S.A. it was adopted with 40 percent while in Australia, Canada, Yaugoslavia and Argentina it was adopted with only 25 percent gold reserves. This system is economical as large amounts of gold are not locked up as reserve against currency. It is elastic as supply of currency can be easily increased. The system provides security to a great extent as the currency is backed up by gold reserves upto a certain percentage. The system may not provide full convertibility as all currency is not backed up by cent percent gold. Moreover currency contraction should take place with any loss of gold reserves. This may create deflationary tendency in the economy with disastrous consequences. Under this system if the Central Bank maintains only the minimum reserve it may not adopt convertibility as the gold reserves cannot be used for exchange against currency.

13.4.4 MINIMUM RESERVE SYSTEM

Under this system the monetary authority should maintain a minimum reserve of gold or foreign securities or both against currency as prescribed by law. At any cost the monetary authority shall maintain the quantity of stipulated reserve. Any currency issued beyond this limit need not be covered by any reserve. Usually the monetary authorities decide the amount of currency to be issued in accordance with the needs of the country and interests of the economy. In 1956 this system was introduced in India. Under this system the Reserve Bank of India should maintain a minimum reserve of Rs.115 crores in gold and foreign securities of Rs.400 crores. Subsequently in 1957 this limit was drastically reduced to a total reserve of Rs.200 crores of which the value of gold shall be not less than Rs.115 crores. The remainng balance should be covered by foreign securities. Under this system the monetary authority can provide adequate funds for developmental purposes. The system provides much elasticity and economy. The monetary authority can issue any amount of currency without any increase in the gold or foreign exchange reserves. This system can easily meet the situations arising out of banking crisis. But the system is not very secure as irresponsible Governments may indulge in unwarranted expansion of currency landing the economy in the grip of inflation.

Any system of note issue should be guided by the accepted canons of uniformity, elasticity, and security to provide a strong and stable monetary value for the currency. During the 19th Century the main objective of the monetary authorities in several countries was to provide convertibility of currency by maintaining metallic backing. In view of the growing needs of a vast number of countries, during the present century currency notes are accepted on their own merit without any metallic backing.

CHECK YOUR PROGRESS - 1

Briefly explain the monetary system followed in our country.

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13.5 SUMMING UP

The systems of note issue are based on two principles, viz., currency principle and banking principle. According to the first principle, the monetary authority is required to keep metal in reserves for the total value of notes issued by it and according to the second principle, the paper notes are issued without full backing of the metallic reserves. A monetary system based on banking principle is economical and elastic when compared to currency principle. The paper currency system is not automatic and hence it has to be managed. The total volume of currency has to be adjusted to the requirements of trade and business in the country. Otherwise it may adversely affect the economic activities in the country. The power of regulating the volume of money is vested in the central bank. Over the years different countries have evolved various methods of note issue. They are i) Fixed Fiduciary system, ii) Maximum Fiduciary system. iii) Proportional Reserve System and iv) Minimum Reserve System Our country is following the Minimum Reserve System.

13.6 CHECK YOUR PROGRESS : MODEL ANSWERS

1. Our country is following the Minimum Reserve system of note issue. Under this system, the Central Bank is authorised to issue notes to any extent, but it must keep a statutory minimum reserve of gold and foreign securities. Accordingly, in our country, the Reserve Bank of India is required to keep a minimum reserve of Rs.200 crores. Of this, Rs.115 crores should be kept in gold and the remaining Rs.85 crores in foreign securities. This system is very useful to developing countries like India, as it is elastic and economical.

13.7 MODEL EXAMINATION QUESTIONS

A. ESSAY QUESTIONS

Answer the following in about 30 lines each:

1. **Explain** the various systems of Note Issue. Which is the best system ?
2. **What** are the principles of note issue ? Describe them.
3. **Describe** the arguments for and against the control of note issue by the Government.

B. SHORT QUESTIONS

Answer the following in about 15 lines each :

1. Distinguish between Fixed Fiduciary System and the proportional Reserve System of note issue.
2. Briefly explain the system of note issue that is followed in our country.
3. Explain the principles of note issue.
4. Explain the Maximum Fiduciary System of note issue.

13.8 RECOMMENDED BOOKS

1. Basu S.K. : A Review of Current Banking Theory and Practice'
2. De Kock M.C. : 'Central Banking'
3. Jhingan M.L. : 'Money, Banking and International Trade'
4. Sayers, R.S. : 'Modern Banking'
5. Sundaram KPM : 'Money, Banking and International Trade'
6. Vaish M.C. : Money, Banking and International Trade

13.9 GLOSSARY

Currency principle of Note Issue : According to this principle, currency notes must be issued with cent percent backing of gold.

Monopoly of Note Issue : The Central bank which has right to issue notes.

Bussiness Cycle : Ups and downs in an economic activity. These are referred to as Booms and Depressions.

UNIT - 14 : CENTRAL BANK AND CREDIT CONTROL

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14.0 AIMS AND OBJECTIVES

The aim of this unit is to explain the various methods with which the Central Bank controls the credit created by Commercial Banks.

By the end of this unit, you will be able to:

* explain the need for credit control; and
* describe the different methods used by the Central Bank to control the credit created by commercial banks

14.1 INTRODUCTION.

In modern days, the credit created by commercial banks constitutes a major portion in the total money supply in the country . It is possible for commercial banks either to intensify inflationary pressure by expanding credit or to contribute to deflationary situation by contracting credit. Thus,it is clear that there should be some authority which controls the credit creation of commercial banks. It is the central bank which controls the credit creation of commercial banks. It follows various methods for controlling the credit creation. This unit first explains the need for the control of credit creation and later concentrates on the various methods of controlling it.

14.2 NEED FOR CREDIT CONTROL

For all practical purposes, credit plays, the same role in the economy as that of money. Changes in the volume of credit bring about similar changes in the price level. Money creates credit and credit creates money. Commercial banks create credit in the economy. In their anxiety to make more profits the commercial banks may create excess credit, which may cause incalculable damage to the economy. Hence the need for credit control is felt on the following grounds:

i) Inflation: If the total volume of credit is not kept within safe limits excess credit may create inflation in the economy. All the credit created by commercial banks may not be used productively. A portion of credit may be spent extravagantly and unproductively without resulting in increased production of goods and services of equal value. Consequently, prices may tend to rise creating inflationary situation. On the other hand if the total volume of credit is inadequate to meet the requirements of trade and business there may be a decline in the economic activity and prices may tend to fall. Hence the monetary authority should make efforts to bring about equilibrium between the total supply and demand for credit, so that inflation can be avoided.

ii) Speculataive Activities: Credit may create unhealthy growth of business and industry. It may encourage more speculative activity which may discourage productive activities. Hoarding and black marketing activities may increase if credit is not restricted to productive uses.

iii) Difference between the Poor and Rich: Credit makes the rich richer and the poor poorer. Credit creates two classes of people in the society-creditors and debtors. The debtors may be forced to borrow at high rates of interest. Rising prices and higher interest rates may accentuate this phenomena unless the volume of credit is regulated according to the needs of the economy.

iv) Trade Cycles: The economic debacle of 1920-21 was caused due to unsound credit conditions. Uncontrolled expansion of credit against security was one of the causes of great depression that occured between 1929 and 33. Thus history is full of instances to show that uncontrolled expansion of credit can harm the interests of society.

It is evident from the above discussions that uncontrolled expansion of credit may make or mar the economic progress of a country. Hence to maintain a stable economy, the volume of credit created in the economy must be controlled. In all countries, the central banks are entrusted with the task of regulating the total volume of credit for the smooth functioning of the economy.

14.3 METHODS OF CREDIT CONTROL

There are several methods by which the central banks control the total volume of credit. These methods are broadly divided into two groups.

i) Quantitative or General Credit Control

ii) Qualitative or Selective Credit Control.

Let us study each one of them in great detail.

14.3.1 QUANTITATIVE OR GENERAL CREDIT CONTROL

The aim of the quantitative credit control is to regulate the total volume of credit created by the commercial banks. These are used mainly for expansion or contraction of the total quantity of credit in the economy. They are not much concerned with the purposes for which the credit is used. The commercial banks depend upon their reserves to expand or contract the volume of their credit. The instruments of quantitative credit control effect the cash reserves and thereby loanable funds of the commercial banks. Hence these are indirect controls which bring about changes in the volume of excess reserves of commercial banks so that the capacity of the commercial banks to create credit can be altered. These methods deal with the volume and cost of bank credit in general, without reference to any particular field of economic activity. Quantitative methods include bank rate policy, open market operations and the variation of the cash reserves. Let us deal with them in detail.

i) Bank Rate or Rediscount Rate

Bank rate is the rate at which the central bank rediscounts the bills of exchange or grant loans against approved securities to commercial banks. Section 49 of the Reserve Bank of India

Act defines bank rates as "the standard rate at which it is prepared to buy or rediscount bills of exchange or other commercial paper eligible for purchase under this Act". In the olden days the rate of interest of the Bank of England was referred to as bank rate. In some countries it is called discount rate or rediscount rate. The terms and conditions relating to the grant of loans or discount of bills by the central bank constitutes bank rate policy. When the surplus cash balances of a commercial bank are completely lent or used and the cash balances have fallen to the minimum legal requirements or tend to fall below this minimum limit, the commercial bank may borrow or discount its bills from the central bank. The interest rate at which the central bank grants loans or rediscounts the bills of exchange of commercial banks is called the bank rate. These bills which are presented by commercial banks to the central bank are already discounted by commercial banks, when customers have presented them. As these discounted bills are rediscounted by the central bank the rate at which they are rediscounted is called rediscount rate.

Assumptions of Bank Rate Policy

The bank rate policy becomes more successful and effective when the following assumptions are satisfied.

i) It is assumed that there is a close relationship between bank rate and market rates in the economy. It means that any change in bank rate is accompanied by corresponding changes in the market rates in the same direction.

ii) It is further assumed that the money market is highly developed so that the volume of credit created by commercial banks can be controlled by bringing about immediate changes in market rates as and when the bank rate is changed.

iii) It is also assumed that banks have sufficient eligible bills and securities and have no prejudice to discount their bills with the central bank. The existence of a well developed short term funds market helps the working of bank rate effectively.

iv) It is assumed that the economy is highly flexible with an elastic economic structure. It means that the level of economic activity can be easily adjusted to the changes in the volume of credit caused due to changes in bank rate. Unless the businessmen and traders respond to changes in the market rates of interest the desired results may not be achieved.

v) The commercial banks do not possess any surplus cash reserves with them, so they act in accordance with the needs of the desired situation.

Let us now discuss the working of bank rate in the economy. For understanding this aspect, we must be very clear about the distinction and relationship between market rates and bank rate. Market rates include the deposit rates and lending rates of commercial banks along with the inter-bank call rates. Changes in bank rate are followed by corresponding changes in market rates. Fall in bank rate is accompanied by a fall in market rates. Let us suppose that there are inflationary conditions in the economy due to excess quantity of credit in the economy. In order to control the price rise, the central bank may raise the bank rate. The market rates will also be raised. The higher deposit rate of commercial banks may attract more deposits of money from the public. Higher lending rates may discourage fresh borrowing as borrowing becomes more costly. Those who have already taken loans from the bank may prefer to liquidate their stocks in order to repay their loans. Credit is tightened. Consequently the volume of credit may decrease. There may be a fall in business activity, incomes, and demand for goods, bringing down the price level. In a period of deflation, a reduction in bank rate may create the opposite effect to stabilise the price level. Thus the central bank influences the level of economic activity and price level by manipulating the bank rate in accordance with the requirements of the economy.

Limitations of Bank Rate Policy

The Bank rate policy has certain limitations. They are discussed below:

i) Bank rate policy may be successful in a developed economy where the majority of the above assumptions can be fulfilled. But in underdeveloped economies, the banking systems may not succeed as there may not be a close relationship between changes in the bank rate and market rates. The economy may be highly rigid but not flexible so as to allow frequent changes in wages, prices and incomes of the people. Changes in the bank rate may not be followed by corresponding changes in the market rates. The market rates may not be uniform throughout the money market to bring about desired changes in prices and incomes. Moreover changes in the rate of interest may not have much bearing on entrepreneurial activity as they are guided mostly by profits. There is no direct relationship between interest rates and the volume of investment as assumed by the bank rate policy. The degree of development of the economy influences the volume of investible funds to be raised rather than the rates of interest in the economy.

ii) In under-developed countries commercial banks do not posses many eligible bills of exchange to get them rediscounted by the central bank. Moreover in recent times commercial banks have acquired large liquid funds to make their financial position very strong and sound. They may not find it necessary to approach the central bank, for any financial assistance irrespective of changes in the bank rate.

iii) The bank rate policy may not be very effective during periods of depression. The Bank rate is reduced to allow the market rates to fall so that investment may increase at lower rates of interest. But this may not happen as entrepreneurs and businessmen are not induced to invest more due to declining rate of profits and prices.

iv). Banks may not have complete control over the entire volume of investment as there are several other non-banking financial intermediaries. Any increase in the interest charges of bank may not have much impact on the total volume of bank credit if the interest rates are still higher in the non-banking sector.

v) A rise in the bank rate may harm the interests of productive investment as the policy does not make any distinction between productive and unproductive credit. As bank credit becomes costlier, even productive credit may be discouraged.

vi) During a period of inflation the central bank may raise the bank rate as an anti-inflationary measure. Along with the bank rate, the market rates may also be increased. Rise in interest rates may attract short term foreign funds into the country. As it leads to expansion of the supply of money in circulation, prices may begin to rise. Thus the working of the bank rate policy may be disturbed due to the inflow of short term foreign funds.

In the advanced countries the money markets are highly organised and their economies are inter-dependent. The short term funds do not flow in and out due to changes in the bank rate. Hence within the country, the total supply of money in circulation could be changed by bringing about changes in the bank rate. There are no external influences on the economic activity of these independent economies in the advanced countries. Hence the bank rate policy is more effectively used in the advanced countries.

ii) Open Market Operations

Open market operations refer to the sale and purchase of Government and other approved securities by the central bank on its own initiative in the money market. Along with the central bank and commercial banks the other institutions like Financial intermediaries, Public Corporations, Public Agencies, Insurance Companies, investment Trusts, Development Banks, Industrial Finance Corporations, etc, will participate in these operations to control the supply of total bank credit in the economy. The credit creating capacity of commercial banks can be increased or decreased through these operations by influencing the cash balances of the commercial banks. The central bank may sell or purchase government securities or other public securities or banker's acceptances. Usually the central bank does not deal in private securities. These operations are undertaken by the central bank to maintain a stable price level and economic activity. These operations have a direct and immediate effect on the volume of money and credit. This method of credit control assumes the existance of a good market for securities as securities are considered the more important and decisive part of the whole money market. It is also assumed that the commercial banks maintain minimum cash reserves so that sale or purchase of securities can bring about desired changes in their cash balances and their capacity to create credit.

Let us study the process through which these operations are carried out. In times of inflation the quantity of currency and credit circulating in the economy may be more. The cenral bank may consider this situation as harmful. To maintain a stable price level the central bank sells the securities to the commercial banks and the public. When banks and private individuals purchase these securities they make the payments. People may withdraw their deposits from commercial banks to make payments to the central Bank. Money moves into the vaults of the central bank. As the deposits of the commercial banks are reduced, their credit-creating capacity is also reduced. A reduction in the quantity of money and credit in the economy may bring down the average price level. Thus by selling securities, the central bank exercises control on inflation. During periods of deflation the central bank buys the securities in the market to increase the cash reserves of commercial banks for expansion of credit in the economy.

Limitations

The limitations of open market operations are explained below:

i) Open market operations may not be very successful and effective if people and banks do not have the habit of purchasing and selling the Government securities in the money market.

ii) The commercial banks may not expand or contract their credit in accordance with the changes in their cash reserves. Under unfavourable economic and political conditions even business people and traders may not come forward to make use of credit for investments. Hence the increased cash reserves of the commercial banks may not increase the volume of bank credit.

iii) The commercial banks may sell the securities to offset the reduction of cash reserves due to open market operations. Then their cash reserve position may not be altered significantly. Sometimes the commercial banks may get their bills rediscounted by the central bank to maintain their credit-creating capacity. In such a case the central bank's open market operations may not be very effetive.

iv) When the central bank sells the securities and if the commercial banks and public do not purchase the securities it is very difficult for the central bank to reduce the cash reserves and credit-creating capacity of the commercial banks.

v) If the commercial banks possess large cash balances even after purchasing the securities from the central bank it may still have sufficient reserve to expand credit.

vi) Unless there is a close connection between changes in the quantity of money and credit in circulation, open market operations may not be successful in maintaining a stable price level. In practice we find no such relation between the two. Irrespective of any change in the quantity of money in circulation, commercial banks may contract or expand the volume of credit in accordance with the needs of business and trade. Unless the velocity of circulation of money remains constant, open market operations may not be effective.

Inspite of these limitations open market operations are considered to be more effective than the bank rate policy as thay have a direct and immediate effect on the quantity of money, credit, interest rates and prices of securities in the economy.

iii) Variable Cash Rreserve Ratio

The percentage of cash deposits which the commercial banks maintain with the central bank is called the reserve ratio. Commercial banks are compelled to maintain this minimun reserve either by law or by custom. In England the commercial banks maintain about 3% of their total deposits with the bank of England as a matter of custom. In India the commercial banks maintain 3% of their total deposits with Reserve Bank of India as a matter of law. This ratio can be changed by the central bank depending upon the economic situation in the country. In India the minimum reserve ratio can be increased from 3% to 15% of the total deposits of the commercial banks. By increasing the cash reserve ratio the cash reserves of the commercial banks are directly reduced. Hence their credit-creating capacity is curtailed. This is done during periods of inflation. In a period of deflation the central bank reduces this ratio to enable the commercial banks to expand credit.

Limitaitons

Variable cash Reserve Ratio has certain limitations. They are explained below:

i) When the reserve ratio is increased and if the commercial banks prefer to work with less cash balances without contracting their volume of credit this method may not be effective. Moreover if the commercial banks possess a large cash balance, a small increase in the reserve ratio may not reduce their credit-creating capacity substantially. During periods of depression even though the central bank reduces the cash reserve ratio, commercial banks may not be able to expand credit if there is no demand for bank funds.

ii) As this reserve ratio is uniformly applied in the case of all commercial banks, the small banks may find it difficult to manage with reduced cash balances whenever the reserve ratio is incresed.

iii) When the reserve ratio is increased by the central banks, the commercial banks may sell their securities in the market. When these securities are sold on a large scale, their prices may fall and the rates of interest may rise.

iv) This method creates much scope for uncertainty as the central bank can suddenly change the reserve ratio. To meet unexpected changes in the reserve ratio, the commercial banks may have to keep idle cash balances with them. Thus a portion of the resources of the banks will remain unutilised. As the commercial banks do not get any interest on the reserves kept with the central bank, this method imposes a great financial burden on the commercial banks.

CHECK YOUR PROGRESS - 1

What do you mean by bank rate? List out the assumptions of bank rate policy.

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14.3.2 QUALITATIVE OR SELECTIVE CREDIT CONTROL

Qualitative Credit Control refers to all those measures taken by the Central Bank to direct the flow of credit in certain selected desirable channels and prevent its flow into undesirable spheres. These measures distinguish between productive and unproductive credit. They restrict the credit to productive purposes discouraging the flow of credit into unwanted sectors. These measures affect the demand for and supply of bank credit. Hence both borrowers and lenders are affected. Unlike general credit controls, qualitative credit controls are discriminatory in nature and attempt to draw a distinction between essential and non-essential uses to which credit is used. These measures do not affect indiscriminately all the sections of the economy.

Priority sectors are given importance in the allocation of available credit in the economy. These measures have become more prominent during and after the Second World War . Let us study the main types of selective credit control in detail.

i) Moral Suasion

Suasion means persuasion. The Central Bank persuades the Commercial Banks to adopt the general monetary policy under this measure. In a period of inflation, the Central Bank may persuade the Commercial Banks to restrict their credit for essential and productive purposes. It may use its moral influence and persuade the Commercial Banks not to apply for further accommodation. It may request the Commercial Banks not to extend credit for speculative purposes. Though this method has no threat or legal sanction behind it, it may have a restraining influence. The Bank of England, the Reserve Bank of India along with a large number of other Central Banks have used this method with a high degree of success. The success or otherwise of this measure mainly depends upon the degree of co-operation between the Central Bank and the banking system. The prestige, position and authority of the central bank will determine the degree of success of this measure to a great extent.

ii) Direct Action

When the commercial banks do not act in conformity with the declared policy of the central bank, direct action may be taken on the commercial banks by the central banks. Direct action may be in the form of refusal to provide financial accommodation to the erring banks. The central bank may also refuse to provide rediscounting facility at bank rate to those banks who do not follow the prescribed rules. It may charge penal rate of interest. If a commercial bank fails to maintain the required cash reserves or liquidity, the central bank may refuse to extend financial help to the defaulting bank. Direct action carries some amount of coercion or force. Hence it may produce adverse psychological relations. It tends to vitiate the cordial and peaceful atmosphere in the banking system if it is used on a large number of banks.

iii) Rationing of Credit

Credit rationing is a method by which the central bank will fix maximum limits on loans and advances. Credit rationing may take different forms. A ceiling limit may be fixed on the total amount of credit to the economy or on the total amount of credit by way of rediscounting facility to any individual bank. The Central bank may also fix maximum limits on specific type of credit to a particular sector or total amount of credit to a sector. The Central Bank may also fix the maximum limits on its financial accommodation to each and every bank affiliated to it. If the maximum limit is fixed on the total amount of credit to the entire economy it is a quantitative measure but if it is for a specific purpose or sector it is a qualitative measure. The question of rationing credit, arises only when the demand for financial accommodation by commercial banks exceeds its supply. If the commercial banks have surplus cash balances there is no need for rationing as banks may not require any financial help. But when the banks are in real trouble and require assistance even beyond a certain limit the central bank as lender of last resort may have to comply with the genuine requests of commercial banks especially in a period of financial crisis.

iv) Margin Requirements

The differnce between the loan value and the markert value of securities offered by borrowers is known as "margin". Commercial banks do not give loan to the full value of the security pledged by borrowers: loan is given only upto a certain percentage of value of the security pledged. This percentage of loan is determined by the margin. For example if the margin is prescribed as 40% loan can be sanctioned only upto 60% of the value of the security. During periods of inflation, the central bank may enhance the margin to discourge credit for speculative activity. This method helps in diverting credit from speculative activities to areas of productive investment. In order to control black marketing and hoarding activities in essential commodities like food-grains, oilseeds, sugar, etc., Reserve Bank of India has been adopting this method frequently in our country.

v) Regulation of Consumer Credit

Most of the durable consumer goods like Television, Refrigerators, Motor Vehicles, etc., are purchased on instalment credit system in Western countries. A certain proportion of the value of the durable consumer goods is paid by the consumer and the remaining balance is financed by banks which can be repaid by the consumer in some instalments. Whenever the durable consumer goods are in scarcity, banks tighten the rules of the credit. Whenever the goods are available in plenty, banks liberalise their credit instalment schemes. Thus the volume of consumer credt for the purchase of durable consumer goods can be controlled by the commercial banks to avoid fluctations in economic activity and maintain stable prices. This method was first adopted in 1941 by the Federal Reserve system of USA and is now followed by many developed and underdeveloped countries.

vi) Publicity

Publicity relating to the working of the banking system tries to eliminate unhealthy trends. Through publicity, banks may come to know what they should do and what they should not do in their banking process. Weekly statements and monthly reviews of credit and functioning of the banking system provides a good source of information to bring about uniformity in credit policies of the commercial banks. This method is widely used successfully in developed countries. But in underdeveloped countries due to widespread illiteracy people may not properly understand or appreciate the spirit with which the Central Bank may publish the information.

Limitations of Selective Credit Control

The limitations of selective credit control are explained below:

i) Selective Credit Control techniques influence the credit created by Commercial banks. But a large number of non-banking financial institutions, money lenders, indigenious bankers, etc. creating a sizeable portion of the total credit in the economy, do not come under the purview of the central bank policies. Hence the desired goals of monetary policy may not be achieved through these measures.

ii) Selective credit controls aim at discouraging unproductive credit. But the commercial banks may not be able to ensure that the loans granted by them are used for productive purposes by the borrowers. Moreover it is a problem for the commercial banks to distinguish between the productive and unproductive credit. The profit motive of commerical banks may encourage them to grant unproductive loans which may be shown as productive through manipulation of accounts. The central bank may not be able to scrutinize such cases to take direct action.

iii) Under this policy there are no restrictions on clean credit. Hence margin requirements may be set aside by borrowers by securing clean loans.

iv) If the rise in prices of goods is mainly due to their scarcity in the market these measures may not be of much use to control the price rise.

v) These controls may come to operations when Commercial Banks create excess credit. Hence these measures may be taken after sufficient damage has already been done to the economy.

vi) Under the unit banking system these measures may not be as effective as they are under the branch banking system.

vii) The selective credit controls can be used successfully only when there is no interference from the Government on political considerations. Many a time, we find the policies of the Central Bank are made subservient to the policies of the Government.

Superiority of Selective Credit Control

While quantitative credit controls affect the total volume of the credit in the economy, qualitative credit controls affect credit only in certain sectors or areas of economic activity. As they control the purposes for which the bank credit is used these selective credit controls help in maintaining balanced growth of the economy. Productive credit can be used for the development of backward sectors and regions of the country. Selective credit controls discriminate in facour of productive uses of credit while quantitative credit controls do not make any such discrimination. The general credit controls are used only to regulate the total quantity of credit but not its quality. The traditional weapons cannot be employed to channelise credit into those lines where credit can be used most productively.

CHECK YOUR PROGRESS - 2

list out selective methods adopted by the central bank to control credit creation of commercial banks.

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14.4 SUMMING UP

In order to maintain stability in the economy the credit creation of commercial banks has to be controlled. In very country the central bank controls the credit. The Central Bank uses various methods to control it . These methods are broadly grouped into quantitative and qualitative methods. Quantitative methods include Bank Rate, Open Market Operations and Variable Cash Reserve Ratio. By changing the bank rate, by participating in the selling and purchasing of government and other approved securities in the money market and by changing the cash reserve ratio of commercial banks, the central bank would control the credit creation of commercial banks. The qualitative methods include the moral suasion, direct action, rationing of credit, regulation of margin requirments, regulation of consumer credit and publicity regarding the working of banking system. The qualitative methods are considered to be superior to quantitative methods because of their selectiveness.

14.5 CHECK YOUR PROGRESS: MODEL ANSWERS

1. The bank rate or the discount rate is the rate fixed by the central bank at which it rediscounts bills of exchange and government securities held by the commercial banks. The Central Bank uses the bank rate policy as an instrument to control credit. The efficacy of the bank rate policy depends on certain assumptions. They are:

i) Existence of a close relationship between bank rate and market rates of interest in the economy.

ii) Existence of highly developed money market.

iii) Availability of eligible bills and securities to the commercial banks.

iv) Flexibility in the economy.

v) Keeping of minimum reserves by the commercial banks, etc.

2. i) Moral suasion by the central bank;
   ii) Direct action on commercial banks;
   iii) Rationing of credit;
   iv) Regulation of margin requirements;
   v) Regulation of consumer credit; and
   vi) Publicity regarding the working of banks.

14.6 MODEL EXAMINATION QUESTIONS

A. ESSAY QUESTIONS

Answer the following in about 30 lines each:

1. Briefly discuss the weapons of credit control employed by the central bank.
2. Describe the different methods of selective credit control. Why have selective credit controls become more important than the quantitative credit controls?
3. Discuss the efficiency of general credit control methods adopted by the central bank.
4. What is Variable Cash Reserve Ratio? Explain its importance in controlling the credit.
5. Discuss the efficiency of general credit control methods adopted by the centrol Bank.

B. SHORT QUESTIONS

Answer the following in about 15 lines each:

1. Distinguish between the quantitative and qualitative methods of credit control.
2. Explain the bank rate policy as a method of credit control.
3. How is credit controlled through open market operations?
4. Explain the need for regulating the credit?
5. Write notes on: i) Moral Suasion, ii) Credit Rationing, and iii) Direct Action.

14.7 RECOMMENDED BOOKS

1. Basu S.K. : 'A Review of Current Banking Theory and Practice
2. De Kock M.H. : Central Banking
3. Jhingan M.L : Money, Banking and International Trade
4. Sayers R.S. : Modern Banking
5. Sundaram KPM : Money, Banking and International Trade
6. Vaish M.C. : Money, Banking and International Trade

14.8 GLOSSARY

Bank Rate : A rate at which the Central Banks rediscount the bills of exchange of commercial banks.

Boom : Prosperity period during which the economic activity expands.

Business Cycle : Ups and Downs in an economic activity. These are referred to as Booms and Depressions.

Bill of Exchange	:	A negotiable instrument and legal document of debt.
Cash Reserve Ratio	:	Refers to the proportion of deposits which commercial banks have to keep as a reserve with the Central Bank.
Dear Money Policy	:	The policy of the central bank by which the bank rate and other interest rates are kept at a high level.
Security	:	Any valuable given as a pledge for the repayment of a loan or the fulfilment of a promise or undertaking.

UNIT-15 : MONEY MARKETS AND ROLE OF CENTRAL BANKS

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15.0 AIMS AND OBJECTIVES

The aim of this unit is to introduce you to the Money Market and how the central bank functions in developed and under-developed money markets.

After going through this unit, you will be able to :

* explain the meaning of money market and its composition ;
* describe the characteristics of developed and under-developed money markets;
* explain the significance of money market in economic developmenti;
* explain the role of central banks in developed and under-developed money markets; and
* list out the objectives of monetary policy.

15.1 INTRODUCTION

A money market is a market for short-term loans. The money markets may be either developed or under developed. The central bank plays an important role in the money markets. This unit explains in detail the characteristics of both developed and under-developed money markets and the role of central bank therein.

15.2 MONEY MARKET: DEFINITION AND COMPOSITION

The term money market refers to a market in which short term funds are borrowed and lent. The money market does not deal in cash or money, but in trade bills, promissory notes and Government paper which are drawn for a short period. In other words, the money market is a place where short term funds are bought and sold.

The funds are borrowed in this market for a period ranging from a day to six months, against various types of credit instruments such as bills of exchange, banker's acceptance, etc.

According to Madden and Nadder, "Money Market is a mechanism through which short term funds are loaned and borrowed and through which a large part of financial transactions of a particular country are cleared".

Each nation has its own money market. But only two money markets are internationally known. They are the London Money Market and the New York Money Market. The main parties dealing in the London Money Market are the discount houses, the Bank of England and the Commercial Banks. The component parts of the New York Money Market are the Federal Reserve System, the United States Treasury, the banks, the foreign banks, stock and commodity exchanges, insurance companies, discount houses, etc.

Having understood the meaning of money market, it is desirable to know the distinction between the money market and the capital market. While the money market is a market for short term funds, the capital market refers to a market for long term funds. Sometimes, the same institution discharges both the functions. However, there are some specialized institutions dealing only in long term finances and others dealing only in short-term funds.

COMPOSITION

The money market is heterogeneous in character. It is composed of several sub-markets each one of which deals in different types of short-term credit. The following are some of the important constituents of the money market.

i) The Call Money Market

The Call Money Market is a market for extremely short period loans. These loans are popularly known as 'Call Loans' as they can be called back at any time or at a very short notice. These loans are given for a few days normally not exceeding seven days. But more often, they are lent for day to day or overnight only. The call loans do not require collateral securities. They possess high liquidity. These loans are often availed of by brokers and dealers in stock exchange.

The Call Money Market is composed of commercial banks and stock exchange brokers and dealers. While the commercial banks act as lenders, the stock exchange brokers and dealers act as borrowers.

ii) Acceptance market

The Acceptance Market refers to the market for banker's acceptances which arise out of trader transactions (both home and foreign transactions.) Raymond P. Kent has described a Banker's Acceptance as 'a draft drawn by an individual or a firm upon a bank and accepted by the bank whereby it is ordered to pay to the order of a designated party or to the bearer a certain sum of money at a specified time in future'. It should be noted that a Banker's Acceptance is different from a cheque. The former is payable at a future date whereas the latter is payable on demand. The banker's acceptances are mainly used for financing the movement of goods in international trade. They are also used for domestic shipment and storage of goods. The bankers' acceptance can be easily sold and discounted in the acceptance market. In the London Money Market, there are specialised firms dealing in bankers' acceptance. They are known as Acceptance Houses.

iii) The Bill Market

The Bill Market is also an important segment of the money market. The 'Bill Market' or the Discount Market' refers to the market in which short dated bills are bought and sold. This market often deals in such short dated papers as bills of exchange and treasury bills. These bills of exchange are discounted by the commercial banks to lend money to the customers and re-discounted by the central bank to grant financial accommodation to the commercial banks in the country. The bills are normally of 91 days duration.

The money market is generally composed of the following institutions:

1. The commercial banks,
2. The acceptance houses and bill brokers,
3. Non-bank financial institutions, and
4. The Central Bank.

The Commercial banks are the prominent group of operators in the money market. They provide short-term funds for business and industrial concerns. These banks also offer call money loans to bill brokers and dealers in the Stock Exchange Market. They also provide short term funds by discounting bills of exchange or any other eligible commercial paper.

The acceptance houses and the bill brokers are the main institutions dealing in the bill market. These houses specialise in acceptance and guaranteeingf trade bills. In the London Money Market the acceptance houses perform a very useful role as merchant 'bankers'. The bill brokers also participate in buying and selling the bills drawn on acceptance houses.

Non-banking financial institutions like insurance companies and business corporations also take part in the transactions of the money market with their short-term investible funds.

The Central Bank of a nation occupies a pivotal position in the money market and it is regarded as the guardian of the money market.

15.3 CHARACTERISTICS OF DEVELOPED AND UNDER-DEVELOPED MONEY MARKETS

i) Existence of a Centraal Bank

In the developed money market there will be a Central Bank at the top of the entire banking system to control the activities of the various constituents of the money market. It acts as the leader of the money market. It maintains the reserves of commercial banks. It helps them when they are in need of financial accommodation. It provides rediscounting facilities to the commercial banks. It permits the sub-markets to convert their near money assets into cash to increase their liquidity position. In a developed money market the central bank will be in a position to guide, lead and control the sub-markets to achieve the desired goals of monetary policy. It undertakes open market operations to maintain a stable price level. As the lender of last resort the central bank comes to the rescue of commercial banks during periods of financial crisis. Just as a ship cannot sail properly without a rudder, a well developed money market cannot function properly without an efficient and powerful central bank. In under-developed money markets the central banks may not exist, even if they exist they may not be very powerful and strong to control the constituents of the money market.

ii) A Developed, Well Organised and Integrated Banking System

The commercial banks are most important constituents of the money market. In a developed money market there will be a well organised and well co-ordinated banking system. Due to good co-ordination and integration, there will be a more economical use of cash in the banking system. The commercial banks which form the "nucl.us of the whole money market" may adopt lower cash reserve ratios uniformly as a measure of economy. As they occupy an important position, commercial banks serve as a link among the various segments in the money market. The commercial banks may provide financial assistance to other institutions in the money market. The commercial banks in turn look to the Central Bank for financial accommodation. In an under-developed money market the commercial banks may not be well organised as that of a developed money market. It may not be well knit and well integrated. Some parts of the money market may not be under the effective control of the central bank.

iii) Existence of Specialised and Integrated Sub-markets

There are various types of sub-markets like Bill Market, Collateral market, Call Market, Acceptance Market, etc. Each of them undertakes specialised transactions in the money market. According to Sen "the larger the number of sub-markets, the broader and more developed will be the structure of the money market". These sub markets concentrate on a particular type of activity like providing short term loans or discounting bills, etc. This is to avoid duplication and bring about more co- operation and co-ordination in conducting various types of transactions in the money market. In each sub-market there will be a large number of borrowers and lenders of money or near money. There will be good competition between them. This competition helps the money market to employ its liquid funds to the maximum extent. As there is close relationship among all sub-markets, any action in one sector of the market will have its reflection on the other sectors. For example, changes in the bank rate will be immediately accompanied by changes in the market rates. Thus in a developed money market, the various sub-markets will respond to any action taken by the central bank in the right direction. The developed money market is highly sensitive not only to domestic events but also to international influences. For example, when the central bank in a country raises its bank rate, short term funds from other countries may flow into that country. In an underdeveloped money market the various sub-markets are not well developed properly. The central bank may not have full control on all the sub-markets. In under-developed money markets, there may not be a large number of sub-markets and specialised institutions. They may not have close relationship between one sub-market and the other, the various sub-markets may not respond properly to the actions of the central bank.

iv) Availability of Proper Credit Instruments

Along with a powerful and strong central bank, in a developed money market, there will be adequate and proper credit instruments like trade bills, treasury bills, short dated government bonds, promissory notes, bills of exchange, etc. The larger the number of financial instruments, the higher will be the degree of development of the money market. Various types of bills and securities are available to all the segments of the developed money market. The number of dealers and brokers who are prepared to deal in these bills and securities will be sufficiently large, so as to create a healthy competition. A well developed bill market is an essential feature of a developed money market. With the help of efficient and experienced dealers and brokers, it is possible to bring about a proper allocation of bonds and securities for proper functioning of the money market. Absence of sufficient number of dealers will not create the needed competitive spirit to all constituents of the money market. In an under-developed money market we do not find adequate number of dealers to deal in credit instruments. Moreover the credit instruments also may fall short of the requirements.

v) Adequate Resources and Perfect Mobility of Funds

A developed money market consisting of several sub-markets will have adequate funds to deal in various types of short term financial transactions conducted in the money market. As there is a large variety of financial instruments each sub-market specialised in dealing with a certain type of transaction will have adequte funds. If the funds available in one market are in plenty, they flow into other markets. Due to this reasonable mobility of funds between one sub-market and the other, the interest rates tend to move in the same direction. When funds move from one market to another market it is possible to bring about uniformity in interest rates. One of the important features of a developed money market is that it provides cheap facilities for the remittance of funds from one place to another. Perfect mobility of funds will help the money market to bring about a well co-ordinated and well integrated interest structure in the economy. The disparities in interest rates in each sub-market can be reduced through this interest rate co-ordination. The central bank exercises better control on money market with co- ordinated interest rate structure. Any changes in the bank rate are accompanied by corresponding changes in the market rates in a developed money market. If the resources available within a country are not adequate the developed money market can attract funds from other countries. In countries like the U.S.A. and the U.K. the developed money markets could mobilise foreign funds by means of foreign trade. In underdeveloped money markets domestic funds may not be available adequately. They may not be able to attract foreign funds due to their poor economic conditions and lack of adequate political stability.

The money market requires all the above features for its development. Along with these features it should enjoy the confidence and faith of dealers and brokers in particular and people in general. In the absence of any discrimination a developed money market can attract huge foreign funds. The development of foreign trade improves the bill market, and the industrial development brings about the development of stock market. Thus several other factors in addition to the above features help the developed money market to bring about a well integrated and organised monetary structure in the economy. The absence of any of these characteristics will make a market an under developed money market. Taking into account all the above features London and New York are undoubtedly the most important financial centres in the world. Though the New York money market is developed it could not retain its pre-eminent position due to dollar crisis and floating exchange rates since 1973.

CHECK YOUR PROGRESS - I

List out the characteristics of under-developed money markets.

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15.4 IMPORTANCE OF A DEVELOPED MONEY MARKET

Money markets may be either developed or underdeveloped. So far, we discussed in detail the features of developed and undeveloped money markets. Here we explain how a developed money market helps in the economic development of a country.

A well developed money market is an essential condition of the economic development. The following points bring out the significance of the money market in economic development.

Firstly, the money market is of great help to trade and industry. This is a mechanism through which surplus funds are pooled together to meet the working capital requirements of trade and industry. The money market provides for discounting and rediscounting of bills of exchangae to finance trade and industry. The acceptance markets and discount markets provide finances for industrial transactions.

Secondly, the money market provides a profitable asset for the short-term funds of the commercial banks. The loans to the Call Money Market and the Bill Market are highly secure and liquid.

Thirdly, the money market is of great help to the central bank of the country. The short-term rates of interest in the money market are the indicators of the monetary and banking conditions in the country and help the central bank in the formation of its policy. The central bank can easily influence the different sections of the money market. In the words of Professor Sen " the more organised a money market the greater is the smoothness with which the central bank can excercise control over the banking system".

Lastly, the money market renders signal service to the Government. The Government gets short term funds from the money market through sale of treasury bills. In the absence of the money market the government would have been obliged to obtain funds either by borrowing from the cental bank or by issue of currency notes. Both these measures are harmful to the economy because they intensify the inflationary situation in the economy.

15.5 ROLE OF THE CENTRAL BANK IN A DEVELOPED MONEY MARKET

As the leader of the money market, the central bank occupies an important position in the smooth functioning of the entire economy. The Central Bank is the note issuing authority. At the same time it also controls the flow of currency and credit in the economy. In a developed money market the various sub-markets quickly respond to central bank policies. The organised money market is highly sensitive as any action taken in one sector quickly percolates to other sectors. Hence the central bank formulates the monetary policy keeping in view the prevailing economic conditions in the money market from time to time. As the various segments of the money market quickly respond, the central bank can take timely action through its monetary policy. As the various sub-markets are highly integrated and coordinated, the central bank exercises direct control over the entire monetary system and enforces its polices on all the various segments for their faithful implementation. These segments are not only competitive but also complementary. Hence the central bank need not operate in all segments of a developed money market. It can operate only in the most sensitive sub-markets. As the working of one sub-market is influenced by the other sub-markets actions of the central bank in one market are easily reflected in all other sub-markets. For example, a rise in interest rates in one sub-market may bring about a corresponding rise in interest rates in all sub-markets. thus in a developed money market the central bank influences one segment in the money maket. Its impact may be felt in other sub-markets immediately. The central bank can curb the inflationary trend in the economy by means of open market operations. The surplus cash reserves of commercial banks are reduced when the central bank sells securities to commercial banks during inflationary situations in the economy. To counteract deflationary situations the central bank purchases securities to increase the cash balances of the commercial banks. In this way the central bank influences the total volume of credit and level of business activity in the country.

The central bank serves the business and industrial sector by meeting their working capital requirements with the help of the bill market, which is one of the most important components of a developed money market. It provides rediscounting facilities to the commercial banks At the same time the central bank is in a position to issue fresh currency. This currency is withdrawn when the bills are repaid. In a developed money market the central bank operates the quantitative and qualitative credit controls effectively and efficiently to regulate the volume and quality of credit. By its direct control over the available funds in the money market the central bank influences the market rates of interest. Due to a rise in the bank rate the central bank attracts huge short term funds from other countries and allow its exchange rate to move in favour of its country. If the central bank decreases its bank rate, funds may flow out of the country seeking a higher return. Consequently, the exchange rate may turn unfavourable to its country. In a developed money market, changes in the bank rate are reflected through changes in other interest rates prevailing in the market. As the commercial banks are dependent on the central bank changes in bank rate influence the market rates in the country. But constant movement of funds from one country to another may disturb the smooth functioning of the money market and may jeopardize the effective control of the central bank over the money market. Hence it is said that the more organised a money market, the greater is the smoothness with which the central bank can exercise control over the banking system.

15.6 ROLE THE CENTRAL BANK IN AN UNDER-DEVELOPED MONEY MARKET

The central banks have to play a more important role in the under-developed money markets of developing countries than in the organised markets of developed countries in which the banking system as a whole is well developed and integrated. In less developed countries where people do not have sufficient faith in the banking system, they may not deposit their surplus money with the banks as the banking habit is not well developed. Hence the money market is not well organised and the central bank plays a more positive and dynamic role in the development of an efficient monetary system. In the underdeveloped money markets the central bank is mainly concerned with the control of total volume of credit. Further, the central bank has to shoulder additional responsibilities to bring about growth with social justice. For this purpose, it has to perform several promotional and developmental functions through various types of sub-markets. Besides providing credit to the agricultural sector through the commercial or co-operative sector it has to meet the short term credit requirements of trade and industry. Hence it has to develop the bill market, acceptance market, etc. to provide short term working capital to meet the credit needs of the business sector.

In an underdeveloped money market the central bank has to play a significant role in the development of money and capital markets. Commercial banks which provide the most important link among all the various segments of the money market must be developed to provide more banking facilities to the people and dealers in various sub-markets. According to R.S. Sayers, in an underdeveloped money market in view of inadequate development of a well knit banking system the central bank must be allowed to take up the ordinary banking facilities to the community besides the usual traditional functions. The central bank must extend all facilities to all regions of the country by formulating liberal policies. As the under developed money market suffers from dearth of capital the central bank with its note issuing power should supplement the commercial banking facilities and provide a viable link for a more integrated banking structure. It does not mean that the central bank should compete with commercial banks. But it should undertake commercial banking functions on a limited scale so that it can easily assess the total requirements of credit by different sub-markets and bring about co-ordination among all the segments of the money market. To fill up the gaps in the credit structure, the central bank can encourage the establishment of new banks or provide subsidy to the newly established commercial banks. The central bank may also provide liberal rediscounting facilities to provide more liquidity to the commercial banks. For the efficient working of the monetary system, the central bank may establish staff training colleges to provide needed technical knowledge to the persons employed in the different sub-markets. The central bank has to develop the bill market which is a good source of short term funds. By controlling the bill market the central bank may be able to bring the unorganised sections of the money market like money lenders and indigenous bankers under its effective supervision and control. Inspite of all the difficulties in underdeveloped money markets the central banks are making rapid strides to achieve a well integrated banking structure. Nationalisation of central bank facilitates proper control and direction of currency and credit policies in an underdeveloped market. The various segments of the money market will be well knit to function as a strong and sound monetary system.

15.7 OBJECTIVES OF MONETARY POLICY

Central bank plays its role in the money market with the help of a policy, known as monetary policy. The objectives of this policy are discussed below:

The economic policy of any country can be divided into monetary policy and fiscal policy. In a narrow sense monetary policy refers to the credit control policy of a central bank but in a broad sense it refers to all monetary and non-monetary measures taken by the banking system to influence the cost and supply of money. Monetary policy refers to all monetary and non-monetary decisions and measures that affect the monetary system. The quantitative and qualitative credit controls which were already discussed are the instruments of monetary policy. Following are the important objectives of monetary policy (a) To achieve internal price stability (b) To maintain stable exchange rates (c) To control or eliminate trade cycles (d) To maintain full employment, and (e) To achieve a high level of economic growth.The central bank employs its credit instruments to achieve these objectives.

The supply of money in a country consists of the total legal tender money and the quantity of credit money created by commercial banks. The central bank issues the notes and the credit is created by the commercial banks. The central bank operates the credit control measures to maintain a stable price level. Until the downfall of the gold standard system the stability; of the exachange rate was considered to be the most important objective of monetary policy. The disequilibrium in the balance of payments was automatically adjusted due to the inflow and outflow of gold. Due to these movements of gold the currency and credit in the economy was automatically expanded or contracted to maintain a stable price level. After the downfall of the gold standard mechanism, maintenance of internal price stability is given more importance than the exchange rate. This internal price level affects the volume of imports and exports. Consequently there may be a change in the balance of payments in situations which may bring about changes in the exchange rate. Hence the volume of credit is controlled to maintain stable prices to avoid any changes in the exchange rates. The monetary policy aims at avoiding fluctuations in business activity. During a period of boom, production, consumption, saving, investment, demand for goods, etc., will be high and in a period of depression the level of economic activity will be at a low level with high unemployment. Monetary policy aims at eliminating trade cycles by means of expansion or contraction of credit. The credit control policy seeks to promote and maintain high levels of employment and economic growth.The banking system provides additional finances to exploit the available idle resources in a country so that the rate of growth of the economy can be accentuated.

CHECK YOUR PROGRESS - 2

Mention the important objectives of monetary policy.

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15.8 SUMMING UP

A money market is a market in which short-term funds are borrowed and lent. Different sub-markets constitute the money market. They are, call money market, acceptance market, bill market and collateral loan market. The money market consists of various financial institutions like commercial banks, savings banks, insurance companies, acceptance houses, discount houses etc., and above all the central bank of the country.

The money markets may be either developed or under-developed. Developed money markets are characterised by the existence of a powerful central bank, existence of integrated banking system, existence of integrated sub-markets, availability of proper credit instruments and perfect mobility of funds. On the other hand, weak central bank, under developed banking system, not well integrated sub-markets, inadequate number of dealers in credit instruments and imperfect mobility of funds are the charcteristics of under developed money markets.

The central bank plays an important role in the money market. In a developed money market as the sub-markets are well integrated, the central bank operates only in the sensitive sub-markets which in turn affect the other sub-markets. In such markets the central bank can operate credit control methods effectively. The central banks play a more significant role in the under-developed money markets as compared to developed money markets. It has a great responsibility in achieving the growth with social justice, developing the commercial banks, co-ordinating all the segments of money market, etc. It controls the credit in the economy with the help of monetary policy. The objectives of monetary policy are to achieve internal price stability, maintain stable exchange rates, achieve a high level of economic growth, etc.

15.9 CHECK YOUR PROGRESS : MODEL ANSWERS

1. **The characteristics of under-developed money market are:**
   i) Existence of a central bank without adequate capacity to influence and control the sub-markets,
   ii) Lack of fully developed banking systems,
   iii) Absence of sufficient short term credit instruments as waell as dealers,
   iv) Existence of disintegrated sub-markjets,
   v) Absence of adequate resources, etc,
2. The important objectives of monetary policy are:
   i) To achieve internal price stability,
   ii) to maintain stable exchange rates,
   iii) to maintain the level of full employment,
   iv) to achieve a high level of economic growth, etc.

15.10 MODEL EXAMINATION QUESTIONS

A) ESSAY QUESTIONS

Answer the following in about 30 lines each:

1. What is Money market? Describe the important characteristics of a developed money market.
2. Discuss the importance of a developed money market in the economic development.
3. Explain the role of Central Bank in a developed money market.
4. Describe the different objectives of monetary policy.
5. Distinguish between developed and undeveloped money markets, and describe the role of central bank in the developed money marke

B) SHORT QUESTIONS.

Answer the following in about 15 lines each:

1. Distinguish between developed and under-developed money markets.
2. explain the role of central bank in an under-developed money market.
3. Write notes on:
   i) Sub-markets, and
   ii) unorganised sections of the money market.
4. List out the characteristics of undeveloped money markets.

15.11 RECOMMENDED BOOKS

1. De Kock M.H : Central Banking
2. Jhingan M.L. : Money, Banking and International Trade
3. Sayers R.S. : Modern Banking
4. Sen S.N : Central Banking in Under-developed Money markets
5. Sundaram K.P.M. : Money, Banking and International Trade

15.12 GLOSSARY

Acceptance Houses : Specialised agencies who are experts in accepting home and foreign trade bills as they are fully aware of the financial position of the drawers of bills.

Call Money Market : Market for extremely short period loans.

Capital Market : The market for medium and long term loans.

Money Market : The market for short-term loans.

Under the mixed banking system deposit banking and investment banking are combined together. Commercial banks can participate in the programmes of industrial and economic development of the country by providing industrial finance. They may grant long term loans or subscribe to the shares and debentures of industrial units. Commercial banks provide their expert guidence to the industrial units in which they have invested their capital. Banks may also underwrite the new issue of shares and debentures under this system.

The surplus funds of the commercial banks can be productively invested by providing long term industrial finance. On the other hand,commercial banks may face difficulties by granting loans and advances to the industries during a period of depression. During a period of depression the prices of shares and securities may fall and the bank may incur losses. Due to inefficiency if the industrial unit incurs losses, its credit banker also suffers losses. Several banks collapsed in Germany, Japan and France during the great depression period after 1929. Moreover it is not safe to freeze the finances of the bank in a few industrial units. The liquidity position of the commercial banks is more important in maintaining sound commercial banking instead of risking their capital in meeting long term needs of industries.

11.5 GROUP BANKING, CHAIN BANKING AND CORRESPONDENT BANKING

In addition to the systems explained above, certain other systems have also come into existence. These are explained below.

Group Banking : Under the group banking, system two or more banks are directly or indirectly controlled by an Association, Trust or Corporation. In this system there will be centralised management and control of all banking units by a holding company. When a big bank wants to become more powerful it begins to acqurre over a large number of small banks. Before the Great Depression this system of group banking was popular. But due to a large number of bank failures this system lost its importance.

Chain Banking : Under this system two or more banks are owned and controlled by one person or group of persons. The chain banking system was popular in U.S.A. till the twenties of this century. This system collapsed during the great depression period due to a large number of bank failures.

Correspondent Banking : Under this system a bank in a small town or village will be connected with another bank in the city as its corespondent bank. It is a system under which the various Unit banks are linked together for easy transfer of funds from place to place. The small banks in towns will hold deposits with the city bank which is called Correspondent bank. The city bank also will hold the deposits of the bank in a small town. This small bank is called Respondent bank. This system is very popular in U.S.A. The correspondent banking system provides a machinery for the smooth functioning of Unit Banking system in U.S.A.

11.6 SUMMING UP

Commercial banks differ in their structure from one country to another. There are two principal banking systems such as branch banking and unit banking. Under branch banking system,each bank operates its banking activities with a number of branches in differnt parts of the country. This system has both advantages and disadvantages of its own. The main advantages are mobilisation of deposits, making loans and advances depending on the merit of the case, diversification of deposits,operating the banks at low cost, proper distribution of capital, efficiency in management, etc. The demerits of the system are: red-tapism and delay,lack of knowledge of of local needs, using the funds of one locality in another locality,creation of monopoly power etc., Although the unit banking system has certain advantages it is not free from certain shortcomings. They are; inability to face cricis, inefficiency in management, less mobility of capital, inability to reduce regional imbalances,unhealthy competition, etc. Because of these shortcomings,the branch banking system is regarded as superior to unit banking system.

The mixed banking system is one in which the commercial banks advance both short-term and long-term loans to commerce and industry. Apart from these banking systems, there are other banking systems, like group banking,chain banking and correspondent banking.

11.7 CHECK YOUR PROGRESS - MODEL ANSWERS

1. The advantages of branch banking system are

   i) Mobilisation of savings
   ii) Diversification of deposits
   iii) Making loans and advances on merit.
   iv) Proper use of funds
   v) Minimisation of regional disparities
   vi) Efficiency in management
   vii) Economy in working, etc.

2. i) Fear of monopoly
   ii) Red-tapism and delay
   iii) Inadequate knowledge of local needs
   iv) Defective lending policy
   v) Neglect of local area
   vi) Lack of adequate supervision and responsibility

3. Yes, in view of shortcomings of unit banking, the branch banking is regarded as superior to it. The demerits of unit banking are:

   i) Limited financial resources
   ii) Less mobility of capital
   iii) Unnecessary competition among banks
   iv) Inability to reduce regional imbalances
   v) Inefficient management

11.8 MODEL EXAMINATION QUESTIONS

A) ESSAY QUESTIONS:

Answer the following in about 30 lines each:

1. Compare the merits and demerits of branch and unit banking. Which system would you recommend to our country?
2. What is mixed banking ? Discuss the merits and demerits of this system.
3. What is branch banking? Explain the advantages of branch banking over unit banking.

B) SHORT QUESTIONS:

Answer the following in about 15 lines each:

1. Is branch banking superior to unit banking? Explain.
2. Distinguish between unit banking and branch banking.

3. Explain the limitations of unit **banking system**
4. Point out the merits of unit banking

   Write short notes on:

   i) Chain banking,

   ii) Group banking and

   iii) Correspondent banking
5. Briefly explain about Deposit banking

11.9 RECOMMENDED BOOKS

1. Beckhart B.	: Banking Systems
2. Sayers R.S.	: Modern Banking
3. Basu S.K.	: Fundamentals of banking
4. Sundaram K.P.M.	: Money, Banking & International Trade
5. Jinghan M.L.	: Money, Banking & International Trade
6. Vaish M.C.	: Money, Banking & International Trade

11.10 GLOSSARY

Branch Banking	: A system of banking in which each bank operates with a net work of branches spread all over the country.
Chain Banking	: The system of banking in which two or more banks are owned and controlled by one or a group of persons.
Correspondent Banking	: A system of banking in which a bank in a small town or village is connected with another bank in the city as its correspondent bank.
Deposit Banking	: A system of banking in which banks receive deposits from public and lend them for short periods.
Group Banking	: A banking system in which two or more banks are directly or indirectly controlled by an Association, Trust or Corporation.
Mixed Banking	: A banking system in which commercial banks make short term loans as well as long term loans to commerce and Industry.
Unit Banking	: A system of banking in which each bank operates as a single entity without any branches.

BLOCK-IV : CENTRAL BANKING

UNIT-12 : FUNCTIONS OF THE CENTRAL BANK

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12.0 Aims and Objectives
12.1 Introduction
12.2 Establishment of Central Banks
12.3 Definition of Central Bank
12.4 Objectives of Central Banks
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12.5.1 Monopoly of Note Issue
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12.5.3 Banker's Bank
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12.5.5 Controller of Credit
12.6 Similarities and Differences between Central Banking and Commercial Banking
12.7 Summing Up
12.8 Check your progress - Model Answers
12.9 Model Examination Questions
12.10 Recommended Books
12.11 Glossary

12.0 AIMS AND OBJECTIVES

The aims of this unit are to describe the functions of a Central Bank in an economy and explain the distinction between Central Ibanking and Commercial banking. After going through this unit, you will be able to :

* define the Central bank and explain the principles of Central banking;
* Explain the functions of a Central bank; and
* distinguish between Central banking and Commercial banking.

12.1 INTRODUCTION

In almost every country, there is one bank which is the apex of the banking system. It regulates and controls the whole monetary system in the country. It plays an active role in implementing the Government's monetary policy in the country. The functions of such a bank are discussed in this unit, besides explaining the differences between Central banking and Commercial banking.

12.2 ESTABLISHMENT OF CENTRAL BANKS

The Central Bank of any country, as the very name implies, occupies the central position in the entire banking system of the country. Almost every country in the world has its central bank as the apex banking institution controlling the activities of the money market. Central banking

MONEY AND BANKING
THEORY AND PRACTICE

MONEY AND BANKING

(THEORY AND PRACTICE)

BLOCKS: V - IX

Dr. B.R. AMBEDKAR OPEN UNIVERSITY,
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PREFACE

This book deals with the topics in Money and Banking (Theory and Practice) included in the syllabus for the Second Year of the B.Com., course offered by the Andhra Pradesh Open University. These topics generally cover the "core" area of the subject to be studied in the Second Year of the Three Year Degree Course in Commerce (B.Com.,). The syllabus for the sake of convenience is divided into Blocks, each of which comprises a number of units. Each Block generally covers a specific area of the subject. The units are prepared by specialists in accordance with a format so designed as to enable the student to read and understand them without much difficulty. Each unit begins with a statement of its objectives followed by contents and has at its end questions intended to test the student's comprehension of its subject matter. Technical terms with which the student may not generally be familiar are given at the end of each unit under the head, "Glossary".

As we all know, Money plays an important role in economic life. It facilitates many economic activities like production, trade, public finance, etc. The economies would not have been developed without the use of money.

Banks occupy a pivotal position in the economy of any country. They help in the development of commerce and trade by mobilising deposits and advancing loans to the industrial sector. Banks have become indispensable to the modern business world as they provide various services to business-men as also the general public. It is for this reason that 'Money and Banking ' forms an important subject of study in the B. Com., course.

The course material of this paper is divided into three sections. The first section deals with Money, Functions of Money and Theories of Money. The second section explains different topics related to Banking (theory). This section discusses such important aspects as Commercial Banking, Central Banking, Indian Banking and the Reserve Bank of India. The last section covers in general the Law and Practice of Banking and in particular, the Banker-Customer relationship, Types of Accounts, Negotiable Instruments taking into account the latest trends and changes in the Law and Practice of Banking in India.

The University hopes that this material will help the student to get acquainted with the principal issues concerning Money and Banking.

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BLOCK - V : INDIAN BANKING

UNIT-16 : INDIAN MONEY MARKET

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16.4 RBI and the Indian Money Market

16.5 Indigenous Bankers

16.6 Defects of the Indigenous Bankers

16.7 Indigenous Bankers and the Reserve Bank of India

16.8 Indigenous Bankers and the Banking Commission

16.9 Summing Up

16.10 Check Your Progress

16.11 Model Examination Questions

16.12 Recommended Books

16.13 Glossary

16.0 AIMS AND OBJECTIVES

The aim of this unit is to introduce the Indian Money Market and explain its features. After going through this unit, you will be in a position to :

- describe the Indian Money market and its features;
- discuss the role played by the RBI in removing the defects of the Indian Money Market;
- explain the indigenous bankers and their methods of lending;
- list out the defects of indigenous banks;
- explain the steps taken to bring the indigenous banks under the influence of the RBI.

16.1 INTRODUCTION

In the previous unit we have explained the developed and undeveloped money markets and the role of Central Bank therein in general.

This unit explains the Indian money market and indigenous bankers in the Indian money market. At the end of the unit, the various efforts made to integrate the indigenous bankers are also discussed.

16.2 THE INDIAN MONEY MARKET

The Indian money market is not a single homogeneous entity. It is broadly divided into organised and unorganised sectors with divergence in the structure of interest rates. The organised sector is comprised of the Reserve Bank of India, the State Bank of India group, the public sector commercial banks, the Exchange Banks and the Central and State Industrial Corporations and the State Cooperative Banks.

The unorganised sector is comprised of the indigeneous bankers, money lenders, etc. The Reserve Bank of India (RBI) has a close link with the money market. It occupies a pivotal position in the money market and controls the flow of currency and credit in this market.

The operation of the Indian money market may be divided into three parts namely i) The Call-Money Market ii) The Collateral Loan Market, and iii) The Bill Market.

i) The Call Money market

In India the Call Money Market refers to the lending and borrowing of money for a very short period by the Indian commercial banks from each other. Borrowing in the call money market does not require any collateral securities. The operations of the Indian call money market are mainly confined to cities like Bombay and Calcutta, and to some extent, to Madras. The total funds borrowed and lent vary from day to day and do not exceed Rs.70 Crores. The main operators of the call money market in India are the Indian commercial banks and some of the exchange banks. The S.B.I does not participate in operation of the call money market. Exchange banks like the Grindlays Bank and the First National City Bank of New York are the major participants of the call money market. The call money market in India has remained underdeveloped. There are wide variations in the rates of interest charged in Bombay and Calcutta markets. The Indian Call Money Market experiences two seasons i) Slack season (May- October) and ii). The busy season (Nov.-April).

ii) The Collateral Loan market

Another important constituent of the Indian money market is the Collateral Money market.

In this market loans are offered in three forms : i) Loans ii) Overdrafts and iii) Cash Credit. The loans are given against collateral securities such as government bonds, shares of First Class Companies and Agricultural and Manufactured commodities which are easily marketable and do not vary much in price. A major part of the assets of the scheduled commercial banks consists of these collateral loans.

iii) The Bill market

In India, the Bill Market was established in 1952. The Indian commercial banks and the foreign banks discount the bills of exchange and other eligible commercial paper of the approved parties. All the bills - internal and foreign and short dated government securities of 90 days duration are dealt with by the bill market.

There are very few bill markets in India. Even though the R.B.I. has announced special facilities to encourage bill markets not much progress has been achieved in this respect. Since the major internal trade of the country consists mainly of agricultural goods, there is a paucity of internal bills. Therefore, the bill market in India mainly exists for foreign traded goods and short dated government securities. Efforts are being constantly made by the monetary authorities to develop a good bill market in our country.

16.3 FEATURES OF INDIAN MONEY MARKET

i) Lack of Integration

One o: the most important defects of the Indian money market is its division into different segments disconnected with each other. In the past, the relations between various members of the money-market were not cordial. But with the setting up of the R.B.I. in 1935, and with the passing of Banking Regulation Act in 1949, conditions have been greatly improved. The R.B.I. treats all the components of the money market equally as regards licencing, opening of branches, share capital, types of loans and advance to be given, etc. The R.B.I. is fully effective in the organised sector of the money-market. Both the commercial and cooperative banks have to rely more and more on the rediscounting and borrowing facilities provided by the Reserve Bank of India.

ii) Existence of Indigenous Bankers

The presence of indigenous bankers is an important weakness of the Indian money market. The indigenous bankers follow their own rules of banking and finance and do not submit to the control of the Reserve Bank. The attempts of the Reserve Bank to bring the indigenous bankers under its control have been in vain. However, most of the indigenous bankers are being covered under the organised money market through getting rediscounting facilities from the latter.

iii) Differences in Money Rates of Interest

Another major shortcoming in the Indian money market is with regard to differential rates of interest. The basic reason for the existence of divergent rates of interest was the immobility of funds from one section of the money market to the other. But this defect has been more or less removed now. At present different money rates of interest promptly adjust themselves to changes in the bank rates.

iv) Differences in Interest Rates in Defferent Centres

Disparity in money rates of interest in different regions including Bombay and Calcutta was another important drawback of the Indian money market. Differential interest rates in different centres led to fluctuations in the prices of securities. Inspite of the existence of R.B.I. these differences continued to persist even today. However, the Reserve Bank has rationalised and changed the system of remittance of funds between different parts of the country and thereby paved the way for equalising money rates all over the country.

v) Seasonal Stringencies of the Money Markeat

The Indian money market experiences seasonal monetary stringencies during the crop or busy season (Nov-June). There is a greater demand for funds in the money market and as a result the market experiences paucity of funds. On the other hand, in the slack season (July-October) funds lie idle. This leads to wide variations in money rates and the rates vary from 1% in the slack season to 15% in the busy season.

vi) Absence of Well Developed Bill Market

The Indian money market does not have a waell developed bill market in which short term bills could be bought and sold. A well organised bill market is essential for the smooth working of the credit system. It is also necessary to link up the various credit agencies to the central bank of the country. One of the most important reasons for the absence of the bill market has been the practice of financing foreign trade by foreign exchange banks to discount bills of exchange in the London Bill Market or hold them till maturity. The R.B.I. introduced in 1952 a Bill Market Scheme which was not really a market for bills but a system to enable commercial banks to borrow from R.B.I. But in 1970 the R.B.I. introduced a paper bill market which is known as the New Bill Market, in which short term trade bills are bought and sold. To establish a well developed money market in India there is a need to integrate the various components of the money market through a suitable monetary policy. The R.B.I. should develop the bill market and open Discount Houses.

16.4 R.B.I AND THE INDIAN MONEY MARKET

The above discussion has revealed the role played by the R.B.I in removing some of the defects of the Indian money market. It has been able to remove the differences between different sections of the Indian money market. The distinction between the Indian and foreign joint stock banks has been wiped out. The variations in the rates of interest which existed in different places and at different times have been mitigated. A considerable reduction has been brought about in monetary stringencies through open market operations and bill market schemes.

However, many loopholes have remained unplugged. The absence of the Bill market limits the ability of the Reserve Bank to withdraw surplus from the money market by discounting of bills. The inadequate development of the money market poses problems for some banks because they do not keep fixed ratios between their cash reserves and deposits. The indigenous bankers still occupy an important place in the money market and they are yet to be integrated with the rest of the money market.

16.5 INDIGENOUS BANKERS

The indigenous banking system dates back to the very ancient times. The indigenous bankers occupy a very important place in the Indian financial system. They have been variously called as shroffs, sahukars, mahajans, chettiars, kothiwals, sarafs, etc. They vary in their size from petty money lenders to substantial shroffs, whose business sometimes exceeds that of some of the scheduled banks. The indigenous bankers provide finances to the internal trade of the country by means of Hundis. They may be grouped into three categories Viz. i) Those who do banking business only ii) those who carry on trade and banking business, and iii) those who are principally traders but utilise their surplus funds in banking business also. A large section of indigenous bankers belongs to the second category.

The Indian Central Banking Enquiry Committee has defined an indigenous banker or bank as "an individual or private firm receiving deposits and dealing in Hundis or lending money". According to this committee, the indigenous banker was different from a money lender in as much as the primary function of money lender was to lend money and not to undertake any banking business. The committee is of the opinion that the acceptance of deposits is a necessary condition for calling any one as indigenous banker. But in practice, many indigenous bankers do not accept deposits. Hence,this condition cannot be considered as an essential prerequisite for calling a person as indigenous banker.

The indigenous banking is mostly confined to certain castes such as Vaishyas who include Jains, Marwaris and Chettiars. The Vaishyas and Jains are spread all over the country. The Marwaris operate in Rajasthan, Bombay and Calcutta. The operation of chettiars is mostly confined to Madras. Many of these indigenous bankers have offices and branches in several parts of the country and in several trade centres like Bombay, Calcutta and Madras.

The indigenous bankers generally act independently of each other. But some of them are organised as guilds of ancient origin. The guilds discuss matters of common interest and settle disputes among their members and function as insolvency courts. In recent times indigenous bankers have formed into associations such as Shroffs' Association in Bombay, the Marwari Chamber of Commerce, the Bankers' Association in Delhi etc. These Associations have been functioning usually in bringing together indigenous bankers in different parts of the country. However, a bulk of them are still left unorganised.

The indigenous bankers do not have a formal and systematic banking education. They receive practical training in their own style and form and acquire experience in due course. Their establishments are small and economical and their accounts are simple and accurate. They do not maintain separate accounts for banking and trade. Since they know the family background of the borrowers, they do not insist any security and also have an idea of their credit-worthiness. Their methods of business are extremely simple, acceptable and are readily available to rural people.

The bankers operate their banking business with their own money. But they also receive deposits from the public and pay interest. The rate of interest depends upon factors like the principal amount, the duration of deposit, the market conditions and personal relations. But the volume of deposits received by indigenous bankers has been declining in recent years due to an increase in competition from the Co-operative Banks and Joint- Stock Banks. Generally the indigenous Bankers do not permit withdrawals by cheque but in cash only.They obtain resources by borrowing from others. In cities, they get accomodation from the State Bank and

Joint-Stock Banks on demand of promissory notes, drawn by approved bankers or discounting Hundis endorsed by them. They generally deal with agriculturists and small traders. However they do not establish direct contact with agriculturists. They finance the agriculturists through local money lenders and traders, with whom the indigenous bankers maintain contacts.

Methods of Lending

Although their methods of doing business are outdated, indigenous bankers occupy a very important place among the various financial agencies which extend financial assistance to trade and industry. One of the usual methods of lending money is on written demand promissory notes. In the case of large loans they insist on sureties. The secured method of lending is to demand a receipt signed by the borrower acknowledging the loan and stating the rate of interest. Another method of lending is against bonds written out on stamped legal forms which state all the conditions of loan including rate of interest. The fourth method of lending is through getting the signature of the borrower on the affixed stamps in the books of the banker. The conditions of lending are settled orally. The fifth method of lending money is by the mortgage of land, house or any other property. Finally the indigenous bankers also finance their customer by borrowing and discounting Hundis.

The Hundis are called the indigenous bills of exchange. They are of two types - Darshani and Muddati. They are similar to Demand and Usance bills of exchange. Darshani Hundis are used for remittance of funds from one place to another whereas the Muddati Hundis are employed for financing trade or for mutual accommodation.

Relation between Indigeneous Bankers and Joint-Stock Banks

The indigenous bankers depend principally on their own funds. They have very little contact with the organised sector of the money market. However, when they are hard pressed for money during busy seasons they re-discount Hundis with the Joint-Stock Banks.They also borrow from the Joint-Stock Banks and the State Banks against the demand promissory notes and signed by one or two bankers and one merchant. However, the Joint-Stock Banks and the State Bank lend money up to a certain limit and only to those indigenous bankers who are on their approved lists.

The indigenous bankers are made to act as a link between the Joint-Stock Banks and the traders. They advance money to the merchants and draw Hundis on them. These Hundis are easily rediscounted by the Joint-Stock Banks because they bear the signature of the indigeneous Banker. Such endorsement is necessary before the Hundis can be rediscounted by the State Banks because the State Bank of India Act stipulates that no Hundi can be discounted unless it is endorsed by two independent persons.

16.6 DEFECTS OF THE INDIGENEOUS BANKERS

The indigenous bankers are not properly organised. They are conservative and jealous of each other. There is no co-ordination between them. They lack initiative and adopt antiquated methods of business. They do not undertake the business of large scale deposits which is the fundamental feature of organised banking. As a result, they are not able to mobilise the small savings of the rural people. By and large, they deal in Hundis and finance them with cash. They charge a very high rate of interest. It was observed by some experts that the rate of interest charged by the indigenous bankers ranged from 25% to 100%..

There are some defects in their method of operation. They combine banking business with private trading activities and rarely keep separate accounts for these two types of activities. Neither do they publish their accounts nor subject them to audit.

They conduct their operations as independent units and are unwilling to come under the control of the Reserve Bank of India. They are partly responsible for blocking the development of the fully organised money market in India.

Only a small portion of the loan extended by the indigenous banker is for the purpose of effecting improvements on loan. The bulk of the loan is for payment of interest or for the liquidation of old debts. So, their system of lending activity is considered detrimental to the borrowers. The indigenous bankers do not care for repayment of the principal amount as long as they recover the interest regularly. Thus enables them to have a perpetual hold on the borrowers.

Inspite of the above defects, it must be admitted that the indigenous bankers play a very important role in the money market of the country. The Shroff Committee estimated that about 75% to 90% of the total internal trade is being financed by indigenous bankers.

Some people feel that much of the criticism levelled against the indigenous bankers cannot be adequately substantiated. They are of the opinion that the indigenous bankers have distinguished the loan into short term and long term. They do not lend money for long term purposes except on security of the property.

It is to be noted that agriculture, trade, commerce, crafts and cottage industries own their existence, and continuance to the credit supplied by indigenous bankers. Inspite of the operation of a large number of Joint-Stock Banks, indigenous bankers have remained to play significant role in providing finance to agriculture, trade and small scale industries.

However, indigenous bankers are not governed by rigid rules and regulations. The traders can secure loans more easily from indigenous banks than they can from Joint-Stock Banks.

CHECK YOUR PROGRESS - 1

List out the defects of indigenous bankers in India.

....

....

....

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....

16.7 INDIGENOUS BANKERS AND THE RESERVE BANK OF INDIA

Though indigenous banks have been playing a prominent role in the country from time immemoral, they have remained outside the control of the organised banking system. The Central Banking Enquiry Committee (1931) emphasised the necessity of unifying the two sectors of the Indian money market. It recommended that the indigenous bankers should be brought into direct relation with Reserves Bank of India. The Committee also felt that indigenous bankers should be encouraged to provide the banking facility to areas where there is no bank at present and to serve the population whose requirements are not generally catered to by the Joint-Stock Banks or Co-operative Banks. Since the inception of the Resesrve Bank of India in 1935, efforts have been made repeatedly to bring indigenous bankers under its control. In 1937 the Reserve Bank prepared a draft scheme for the direct linking of indigenous bankers. The salient features of the scheme are as follows:

i) the indigenous bankers should confine themselves to the banking business proper. They should give up their trading and commission business within a reasonable time.

ii) They should maintain proper books of account in a recognised manner and should get the books of account audited by qualified auditors.

iii) They should switch over to the western type of accounting and banking.

iv) They should submit periodical reports of their accounts and activities to the Reserve Bank of India.

v) They should develop the deposit side of their banking activity.

vi) They should have a minimum working capital.

vii) The ambiguous system of Hundis should be given up. It must become a negotiable instrument.

viii) The indigenous bankers should play the role of a discount house as in London.

ix) They should subject themselves to supervision and control by the Reserve Bank. The Reserve Bank of India should have the right to regulate the business of the indigenous bankers on banking lines. In return, the Reserve Bank of India should be obliged to offer or extend to the indigenous banker, facilities available to scheduled banks.

The indigenous bankers refused to accept the above conditions. They were unwilling to separate the banking business from other business activities. They also disagreed with the suggestions of accepting deposits. They further argued that the facility provided by the Reserve Bank of India was inadequate to compensate their loss in banking business. In 1954 the Shroff Committee examined the problems of linking indigenous bankers with the Reserve Bank of India. The Committee also recommended that the R.B.I. should encourage the Hundis of the indigenous bankers. In 1961 the All India Shroff Committee made a plea for a direct link between the R.B.I. and the indigenous bankers.

16.8. INDIGENOUS BANKERS AND THE BANKING COMMISSION

The Banking Commission 1972 has attempted an evaluation of the utility of the indigenous banking system. The commisson confined itself to the urban areas with sizeable banking activity and to the indigenous bankers who are close to the organised money market. According to the Commission, indigenous bankers cater to the needs of numerous borrowers engaged in small and medium sized trade and industry. They are sought after because of their flexibility, absence of formalities and promptness. Some important sectors of indigenous bankers provide commercial banks with a useful money market instrument i.e., Hundis. The Hundis possess a high degree of liquidity and give a good yield. However, the Commission felt that the indigenous banking system might be abused. It examined the scope of institutionalising the operation of the indigenous bankers. The Commission also made certain recommendations with a view to disciplining the activities of indigenous bankers in their financial and social aspects.

The Commission felt that the indigenous bankers could be controlled through the commercial banks. The R.B.I. should exercise some indirect influence over the indigenous bankers through the commercial banks by laying down certain guidelines for the latter to deal with the former. The Commission felt that indigenous bankers should fulfill the following recommendations if they wanted to qualify for the discounting facility with the commercial banks.

i) They should not be engaged in any trading activity.

ii) They should put in their "own capital" of not less than rupees one lakh. The discounting facility will be fixed as a given multiple of own funds.

iii) They should maintain regular books of account and get them audited annually.

iv) They should submit to the R.B.I. a statement of business in a prescribed form annually.

v) They should not borrow from more than one bank.

vi) They should be members of an association.

The Commission has taken note of the fact that many attempts of the indigenous bankers to forge a link with the R.B.I. had failed in the past. It has observed that a direct link is neither necessary nor practicable. Hence it has suggested an indirect control through commercial banks.

It has made the following recommendations to ensure that the indigenous bankers become more useful to the nation.

i) The R.B.I should indicate the type of Hundis eligible for discounting and the quantum of Hundis to be allowaed in business transactions of indigenous bankers.

ii) The commercial banks should call for regular returns from indigenous bankers and undertake a systematic analysis of their financial statements.

iii) The commercial banks should try to satisfy themselves, at least at random, about the proper use of credit sanctioned by them to the indigenous bankers.

iv) There should be some understanding between the commercial banks and the indigenous bankers regarding the rates of interest to be charged by the indigenous bankers from their customers.

v) The indigenous Bankers should be encouraged to get themselves incorporated in the organised sector and a code of conduct be evolved for the operation. Bankers indulging in malpractices should not be allowed any further banking accommodation.

vi) It is necessary to codify the practices and usages pertaining to all indigenous negotiable instruments like the Hundis and bring such instruments under the framework of codified laws.

vii) Some of the indigenous bankers who come under the category of money lenders i.e., those who do not accept deposits from the public, should be regulated by a central legislation.

It is to be noted that the Banking Commission has repeated all the suggestions that have been made since 1935. The Commission seems to have deliberately ignored the fact that the indigenous bankers have been refusing the terms offered by the R.B.I. for proper integration. It is said that the Commission made these recommendations in the hope that, with the passage of time, the indigenous bankers would change their minds.

Thus, all the Commissions that have been appointed after the establishment of the R.B.I. have realised that the indigenous bankers play very useful role in the development of the country. If they are linked with the R.B.I. the entire financial system in the country will get strengthened. The Commission rightly pointed out that some of the efficient indigenous bankers could effectively function as the acceptance houses or discount houses like those that are present in London and meet the growing needs of a developing economy.

16.9 SUMMING UP

The Indian money market can be broadly divided into organised and unorganisaed sectors. The organised sector includes commercial banks, exchange banks, RBI, etc. Whereas unorganised sector comprises of indigenous banks, money lenders, etc. The Indian money market is characterised by the features of under-developed money markets like, lack of integration among its different segments, presence of indigenous bankers, prevalence of different rates of interest, seasonal stringencies and presence of undeveloped bill market. Thus many defects exist in Indian money market inspite of the efforts by the RBI to remove them.

An important defect of the Indian money market is the presence of indigenous bankers. They provide finance to the internal trade of the country by means of Hundis. Majority of them carry both trading and banking business. They operate mainly with their own funds and generally deal with agriculturalists and small traders. They follow simple and easy methods of lending like lending money on promissory notes, against bonds written on stamped legal forms, by the mortgage of properties, etc. They also approach the joint stock companies for getting financial assistance in busy seasons by re-discounting Hundis.

The indigenous bankers have many defects like inability to mobilise the small savings of the rural people, charging high rates of interest, combining banking business with private trading activities, etc.

In spite of their significant role in the country, the indigenous bankers remained outside the control of the organised banking system. The RBI also made certain efforts to bring the indigenous bankers under its control. For this purpose it also prepared a scheme. But the indigenous bankers had not accepted this scheme and did not separate the banking business from the private trading business. The banking commission felt that the indigenous bankers may be indirectly controlled by the RBI through commercial banks.

16.10 CHECK YOUR PROGRESS : MODEL ANSWERS

1. The defects of the indigenous bankers are:

   i) lack of co-ordination among them,

   ii) inability to mobilise savings of the rural people,

   iii) charging high rates of interest on the loans,

   iv) combining banking business with private trading activities,

   v) granting loans for unproductive purposes, etc.

16.11 MODEL EXAMINATION QUESTIONS

A. ESSAY QUESTIONS

Answer the following in about 30 lines each:

1. Describe the characteristics of Indian money market.
2. Examine the deficiencies of the Indian money market. Suggest measures to make the Indian money market a developed one.
3. Discuss the role of indigenous bankers in the Indian money market. Offer some measures to link these with the organised sector of the money market.
4. Explain the defects of the indigenous banking system. How do you rectify them?
5. Explain briefly the steps taken to bring the indigenous bankers under the influence of the Reserve Bank of India.

B. SHORT QUESTIONS.

Answer the following in about 30 lines each:

1. Describe the different parts of the Indian Money Market.
2. Discuss the role of the Reserve Bank of India in the organisation of the money market.
3. List out the characteristics of Indian money market.
4. Discuss the suggestions of the Banking commission to promote indigenous bankers in India.
5. List out the defects of Indigenous bankers.

16.12 RECOMMENDED BOOKS

1. Muranjan S.K. : Modern Banking in India.

2. Panandikar G.S. : Banking in India

3. Sayers R.S. : Modern Banking

16.15 GLOSSARY

Bill Market : A market in which short term bills are bought and sold.

Call Money Market : A market for extremely short period loans.

UNIT-17 : STRUCTURE AND GROWTH OF MODERN BANKING IN INDIA

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17.0 AIMS AND OBJECTIVES

This unit aims at discussing various types of banks in India, their nature and functional relationship. It also attempts to analyse the changing scene of banking in India with special emphasis on the statutory regulations and the recommendations of expert study groups.

After going through this unit, we expect you to be able to :

- classify the commecial banks and explain their nature;
- analyse the growth of banking in India;
- describe the emergence of public sector banking in India;
- describe the Lead Bank Scheme; and
- explain the schemes of Deposit Insurance and Credit Gurantee.

17.1 INTRODUCTION

Indian banking today has made a parallel advances with national aspirations. A banking system which was mainly colonial in nature till independence and confined credit activity to commerce and export houses, soon refashioned itself to meet the financial requirements of manufacturing industries also. It has all the requisites of a developed organisation, except that its volume and velocity are small. It is true that it does not possess some auxiliary institutions like the discount and issue houses, savings banks, investment trusts and investment banks.

This unit explains the nature of various types of banks in India and the changes that have taken place in the Indian banking scene.

17.2 CLASSIFICATION OF COMMERCIAL BANKS

The commercial banks in India can be classified as (i) Scheduled Banks (ii) Non-Scheduled Banks (iii) Licenced and Unlicenced Banks (iv) Foreign Banks (v) Merchant Banks or Banks of Deposits.

i) Scheduled Banks

According to section 42(B), a scheduled bank is one which has been included in the second schedule of the Reserve Bank of India Act, 1934. To be eligible for such inclusion, the aspirant commercial bank has to be financially and economically sound, and satisfy the following conditions:

a) Capital and Reserves

It should have a paid up capital and reserves of an aggregate value of not less than Rs. 5 lakhs. The expression 'value' means the real or exchangeable value and not the nominal value which may be shown in the books of the bank concerned. In common parlance, it is called 'networth' - realisable tangible and intangible assets minus outside liabilities. The Act further provides that in case there is a difference of opinion between the officials of the Reserve Bank of India and those of the bank concerned in assessment of the values of various assets and liabilities, it is the Reserve Bank's valuation that will prevail.

b) Operations not Detrimental to Depositors

The banks' affairs should not be conducted in a manner detrimental to the interests of its present or future depositors. A bank will be said to be working against the interests of the depositors when the management is acting dishonestly or doing anything which is not in consonance with sound banking principles or practices.

c) A Company or Other Notified Institution

The bank must be a company as defined in Sec.3 of the Companies Act, 1956 or an institution notified by the central government in this behalf or corporation or company incorporated under any law in force in any place outside India. Thus the Banking Regulations Act prevents any sole trader or partnership firm from carrying on banking business.

Whether the above conditions are fulfilled or not shall be ascertained after an inspection of the bank's books and accounts. Only when these conditions are fulfilled, the RBI may direct the inclusion of the bank in the second schedule. A bank wahich had been scheduled, but later fails to comply with any of the conditions described above or goes into liquidation will cease to carry on banking business.

Status of Scheduled Banks

Scheduled banks in India are just like the member banks of the Federal Reserve System of the United States of America. The scheduled banks in India comprise nationalised banks, the State Bank of India and its seven associates, all the foreign banks and the State Co-operative Banks and the 74 other Indian banks. These are eligible for certain facilities and are subject to certain oblig ıtions. The privileges to which they are entitled are as follows:

a) Remittance facilities by bank draft, mail or telegraphic transfers through offices of the Reserve Bank of India and its agencies free of charge and or at concessional rates of 1/64% or 1/32% with a minimum of Rs.1/-.

b) Advances under various sub-sections of Section 17, and an emergency advance under Section 18 of the Reserve Bank of India Act: This facility is allowed on a purely temporary basis because the maximum period for which it could be availed is 90 days. These advances are almost taken for general banking purposes. Section 18 provides for extension of facilities to meet abnormal requirements of scheduled banks. This would be done when the Reserve Bank feels that a situation has arisen where a scheduled bank, due to a lack of such advances, would cause a serious dislocation of trade, commerce and industry. These advances may be granted against such varied securities as mortgage, sub-mortgage of immovable properties, hypothecation of goods, pledge and sub-pledge of shares of joint stock companies, etc. Apart from these privileges, the scheduled banks bear the following obligations.

a) They have to maintain an average daily balance with the Reserve Bank, the amount of which shall not be less than 5% of the demand and time liabilities, b) They are required to submit periodical returns under Section 42(2) of Reserve Bank Act and Sections 10,18,20,23 to 27 etc., of Banking Regulations Act.

Scheduled Co-operative Banks

For the first time in 1965, the provisions of the Banking Companies Act were extended to certain co-operative societies also. Accordingly all those State Co-operative Banks, Central Co-operative Banks, and Primary Non-agricultural Credit Societies which have a paid up capital and reserves of not less than one lakh rupees have been brought within the regulatory provisions of the Reserve Bank. Consequently the name of the Banking Companies Act was changed into Banking Regulations Act.

(ii) Non-Scheduled Banks

The non-scheduled banks are those which have not been included in the second schedule of the Reserve Bank of India Act. The reasons might be that their paid up capital and reserves do not aggregate Rs.5 lakhs, or the affairs are being conducted in a manner which is prejudicial to the interests of the depositors. Generally, the non-scheduled banks are small institutions which restrict their activities to local areas.

These banks are not eligible for all the privileges of Scheduled banks. Yet there is no exemption for them so far as the maintenance of their daily cash reserves in concerned. They are permitted to keep the cash balances with them, but some of them voluntarily maintain the balances with the Reserve Bank of India. These banks are also eligible for concessional remittance facilities provided they have been included in the "approved list" under the scheme of Reserve Bank of India. For such an inclusion, the non-scheduled bank must be a company registered under the Companies Act and it must be transacting banking business in India. A non-scheduled bank is not entitled to the credit facility of the Reserve Bank.

(iii) Licenced and Unlicenced Banks

The commercial banks in the country are also divided on the basis of licences to carry on the banking business. The provisions for licensing are contained in Section 22 of the Banking Regulations Act. The provisions are designed to ensure the continuance and growth of only such banking companies as are run on sound lines. Those banks whose functioning is unsound should be weeded out and an indiscriminate floating of new banking companies should be discouraged. However, the provision for licensing has been used by the Reserve Bank as a method for improving the working of individual banks rather than as mere restrictive measures. The conditions which a banking company has to fulfill before becoming eligible to carry on banking business are set out in sub-section (3) of Sec.22 of the Act. These conditions are as follows:

a) Capacity to pay the depositors

The capacity to pay the present or future depositors is a basic condition for the grant of license. As such, the banking company is required to maintain liquid and other realisable assets in the banks on the basis of which officers of the Reserve Bank can form an opinion about its solvency. Further the affairs of the company are not to be conducted in a manner detrimental to the interests of its present or future depositors.

b) No discrimination Abroad

If a banking company is incorporated outside India, the Government or law of that country should not discriminate in any way against such companies. Further, such a foreign banking company must comply with all the provisions of the Act in India. If a company, at any time, fails to comply with any of the above provisions, the company ceases to carry on banking business in India and the Reserve Bank may cancel the licence granted to such a banking company.

iv) Foreign Banks

The commercial banks are further divided into Indian and foreign banks, depending on whether they have been incorporated under the Companies Act in India or outside. The banks having their incorporation abroad are now referred to as foreign banks. Until 1950, they were called foreign exchanage banks since they alone transacted most of the import and export financing business of this country.

v) Merchant Banks or Banks of Deposits

The business of merchant bank is to render advisory services to entrepreneurs in setting up new industrial ventures, acting as issue houses, organising and extending finance, etc. It does not open an account for any member of the public and does not ordinarily issue cheque books to its customers. In U.K. and other western countries merchant banks have been operating for the last 100 years. In India separate merchant banks do not exist. However, foreign banks have been handling this business through a separate division for quite some time. The lead was taken by the National and Grindlays Bank. Later other foreign and Indian banks have set up their merchant banking divisions.

CHECK YOUR PROGRESS - 1

List out the different types of banks.

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17.3 GROWTH OF BANKING IN INDIA

Banks constitute an important segment of the financial infrastructure in any country. The economic history of many countries reveals that economic development and the growth of financial infrastructure go hand in hand. Without the growth of the financial infrastructure, there can be no development. In a majority of the countries including India, industrialisation and the development of banking have been almost simultaneous. But one peculiar feature of the development of banking in India was that it was started by business houses and was closely associated with such houses. For example, the Central Bank of India was associated with the house of Tatas, United Commercial Bank with the house of Birlas, the Indian Bank with the Rajahs of Chettinad, Punjab National Bank with Jains, etc. One of the reasons that prompted nationalisation as to break such associations. The banks in India merely acted as depositors of community savings and lent such savings to needy investors who were acceptable to them according to certain criteria. They were mainly guided by the objectives of profit maximisation. These business houses have established their banks in developed regions and developed sectors.

They did precious little to take the banking system to areas in the interior. Further, they did little to develop banking along new lines of investment and production.

When India took to economic planning immediately after independence, attention had to be paid to the financial system. Without this, the pattern of savings and investment could not be made to maximize the growth rate of the national income and bring about an equitable distribution of such income. The planners made a systematic study of their functioning which revealed the following features: 1) Although banking had been functioning in this country for over a century, its area of operation was confined to port towns and urban centres. Rural and interior areas of the country were practically neglected. Such a state of affairs facilitated the undesirable flow of funds from rural to urban areas and from undeveloped states to comparatively developed states. 2) The banks finance mostly, the wholesale trader and large and medium scale industry. They had neglected the most important sectors of the Indian economy namely agriculture, small scale industries and retail trade which contribute over three-fifths of the national income. 3) The bank credit was mostly security-oriented and there was no watch over large borrowal accounts. Banks did not pay attention to the real purpose of the borrower; or actual end use of the money. Consequently banks did not promote growth with stability and social justice. The small farmers, retail traders, small industrialists etc., who could not offer adequate security were neglected by the banking sector. 4) Banks were mostly in the hands of big industrial houses and a substantial part of the credit was given to units under their control and on preferential terms. This resulted in the concentration of economic power. 5) There were regional disparities in the distribution of bank credit. 6) There was no mechanism in commercial banks to ensure a close watch over the large borrowal accounts. Bank credit was misused for hoarding and speculation. Sometimes there was diversion of credit.

The RBI, as leader of the commercial banks tried from time to time to impose some discipline through credit controls, inspection, licensing policy etc. Steps were also taken to open branches in unbanked centres, diversion of credit from trade to industry, provision of finance to small industries, preferential terms for exports credit and several other methods in order to overcome some of the deficiencies discussed above. These measures did not yield the desired results because of the conflict between social benefit and private profits. As a result the Government introduced a scheme of "Social Control of Banking" in 1967. It was later given a legal framework under the Banking Laws Amendment Act, 1968.

Social Control of Banks

Social control denotes a level of regulation either through policy measures or through legislature enactments for the achievement of certain desired ends. Social control mainly aimed at reducing the influence of property interest, professionalising the management of the banks, etc.

The salient features of the scheme are 1) the setting up of a national Credit Council to bring about a re-orientation in the lending policies of the banks, 2) the appointment of non-industrialists, as full time chairmen of all banks, having deposits of Rs.25 crores or more, with the previous approval of the Reserve Bank, 3) Prohibition of all advances and guarantees by bankers to directors and consumers in which they are interested, 4) setting up of a training institute at highest level to improve technical expertise of banks' executives and instilling a sense of independence and integrity into the banking profession.

17.4 THE BANKING COMMISSION

The Government of India appointed the Banking Commission in February 1969 under the chairmanship of Sri R.G. Saraya. The terms of reference were related to the improvement of the structure of commercial banks, their geographical and commercial coverage, improvement and modernisation of operation methods, management policies, cost and capital structure, recruitment of personnel and review of existing legislations. The recommendations on which the government took a final decision are summerised below:

i) Banks, operating methods and procedures: The two recommendations which were not accepted by the government of India relate to the establishment of a common inspection agency, for all banks and for the banking system. But all the recommendations pertaining to operational methods and procedures were accepted.

ii) Specialised Institutions: The government did not accept the recommendation for the establishment of a separate merchant banking institution. The recommendation for the setting up of a specialised institution for consumer credit was also not accepted by the government. The government accepted the findings of the Commission that there was no need for a specialised savings bank or a specialised discount house.

Based on the recommendations of the Commission the Government accepted certain reforms. For example, the Commission recommended that legal provision should be made to protect all individuals who maintained accounts with banks in current, savings or fixed deposits and also for the safe custody of articles/lockers. Suitable amendments have been made to the Banking Regulations Act to give effect to the above recommendations.

17.5 THE EMERGENCE OF PUBLIC SECTOR BANKS

The concept of the state sector in banking is not new to India. A number of such banks were started in the princely states of Mysore, Travancore, Sourashtra etc. But a real beginning was made with the enactment of the S.B.I. Act 1955 which recommended that the business and staff of the imperial bank be transferred to the State Bank of India. When the Act came into force in July 1955, roughly one-third of the total banking deposits aand one-third of the total bank offices were with the S.B.I. and its subsidiaries. With the nationalisation of the 14 major banks, roughly 85% of the Indian Banking in terms of deposits and bank offices came under the state sector. Another 6 banks were nationalised subsequently on April 15, 1980. There are now 20 public sector banks besides the State Bank of India and its subsidiaries covering nearly 90% of the total banking business in India. In 1969 the basis for the nationalisation of banks was that the banks should have more than Rs.50 crores of deposits. In 1980 banks having more than Rs.200 crores of deposits were selected for nationalisation. The main consideration for nationalisation of banks in the second phase was to speed up the implementation of the 20 point economic programme by raising the share of the priority sector advances in the total banking credit and ensuring, effective control over the implementation of the credit policy in the banking system.

17.6 THE LEAD BANK SCHEME

Suggestions for the development of credit and banking in the country on the basis of the area development approach were first made by the Gadgil Study Group of the National Credit Council. The main idea behind this was that depending on their field of operation and location, each commercial bank should be assigned a particular area where it could act as a pace-setter in providing credit and banking facilities. The group suggested that the unit of area to be adopted for this purpose would be a district. All the districts in the country excepting in metropolitan areas and a couple of union territories have been allotted for the development of the public sector and private sector banks. A lead bank has to assess the resources and potential for expansion of branches and diversification of credit facilities in the district allotted to it. It acts as a consortium leader, to invoke the co-operation of other banks. It has to keep in close touch and maintain a liaison with other development agencies particularly the State Government so that bankable schemes may be evolved and taken up for financing by commercial banks for the economic development of the particular district.

17.7 DEPOSIT INSURANCE & CREDIT GUARANTEE CORPORATION

The Deposit Insurance Scheme was started with a view to give a measure of protection to depositors, particularly the small depositors, from the risk of loss of their savings arising from bank failures. Such a measure is intended to infuse confidence in the minds of people and facilitates the promotion of the banking habit and the banking system. For this purpose the Deposit Insurance Corporation was set up by an Act of the Parliament in 1962. In the wake of social control measures initiated in 1968 followed by the nationalisation of banks, the banks were expected to ensure an increased flow of credit to small borrowers, who found it difficult to have access to institutional credit. The Deposit Insurance Scheme ensures automatic coverage of deposits of all commercial banks in India. A similar coverage is also extended to deposits of Co-operative Banks in certain states. The coverage was initially provided for Rs.1,500 per depositor per bank, and has since been raised gradually to Rs.30,000. Under this scheme, 75% of the total depositors and 99% of the accounts have been covered so far.

With a view to giving an impetus to the commercial banks for the extension of liberal credit to small borrowers, a Credit Guarantee Scheme covering bank loans given to borrowers was considered necessary. For this purpose, the Credit Guarantee Corporation of India was set up on 14th January 1971. It is an agency to provide a simple but wide ranging system of guarantee for loans granted by credit institutions to small and needy borrowers.

CHECK YOUR PROGRESS - 2

List out the various schemes started in India in the banking sector.

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17.8 SUMMING UP

Commercial banks can be clasasified into various kinds like Scheduled Banks, Non-Scheduled Banks, Foreign Banks, etc. A scheduled bank is one which is included in the second schedule of the Reserve Bank of India Act, 1934. To be included in this schedule, a bank has to fulfil certain conditions. These banks are eligible for certain facilities provided by the Reserve Bank of India (RBI) and are also responsible to certain obligations. The banks which are not included in this schedule are nonscheduled banks. Based on the licences to carry on the banking business banks are classified into licenced and unlicenced. Depending on their incorporation in India and outside, banks are divided into Indian and foreign banks. The banks which render advisary services to the enterpreneurs, under writting the issues, etc., are called the merchant banks.

The banking in India was first started by business houses with the profit maximisation motive. Being privately managed, these banks had many deficiences and could not promote the economic growth with social justice. In spite of the efforts of the R.B.I. the deficiencies could not be removed. Then the Government introduced a scheme of social control of banking in 1967 for regulating the banks. The banking commission which was appointed by the Government in 1969 had recommended on various aspects, like operating methods and procedures, etc., Certain recommendations had been incorporated in the Banking Regulating Act. With the enactment of SBI Act in 1955, the public sector banking has emerged in India. Later 14 banks in 1969 and 6 in 1980 were nationalised.

Based on the suggestions of the Gadgil Study Group, the lead Bank Scheme was started. Under this scheme, each commercial bank is assigned a prticular area in which it acts as a pace setter in providing credit and banking facilities. With a view to giving protection to depositors the Deposit Insurance Scheme was started in 1962 and for providing guarantee to the small borrowers for the loans granted by banks, the Credit Guarantee Scheme was started in 1971.

17.9 CHECK YOUR PROGRESS : MODEL ANSWERS

1. Scheduled Banks, Non-scheduled Banks, Licenced and unlicenced Banks, Foreign Banks, and Merchant Banks.

2. Different schemes started in the India banking sector are:

   i) Social control over commercial banks scheme

   ii) The Lead Bank Scheme

   iii) The Deposit Insurance Scheme

   iv) Credit Guarantee Scheme

17.10 MODEL EXAMINATION QUESTIONS

A. ESSAY QUESTIONS:

Answer the following in about 30 lines each.

1. Explain the structural changes that have been brought about in Indian banking in recent years. Do you think that such changes have been useful to trade, commerce and industry?

2. Discuss the merits of the Credit Guarantee Scheme and Deposit Insurance Scheme.

3. Briefly analyse the growth of banking in India since independence.

4. Explain the classification of commercial banks.

B. SHORT QUESTIONS

Answer the following in about 15 lines each:

1. Examine the emergence of public sector banking in India.

2. Write down on the following:

   i) Deposit Insurance Scheme, and

   ii) Credit Gurantee Scheme

3. Explain what is meant by "Scheduled Banks"

4. What are the functions of merchant banks ?

5. List out the terms of reference of the Banking commission. What are the two recommendations which were not accepted by the Government.

17.11 RECOMMENDED BOOKS

Joshi N.C.	: Indian Banking
Muranjan S.K.	: Modern Banking in India
Panandikar S.G.	: Banking in India
Reserve Bank of India	: Report on Currency and Banking

17.12 GLOSSARY

Lead Bank Scheme : It is a scheme in which each bank is expected to provide financial leadership to other banks and financial institutions located in the district alloted to it.

Non-Scheduled Banks : Banks which are not included in the second schedule of the RBI Act. These banks are usually small in size and restrict their activities to local areas.

Scheduled Banks : Banks which are included in the second schedule of the RBI Act.

UNIT-18 : NATIONALISATION OF COMMERCIAL BANKS

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18.7 Model Examination Questions

18.8 Recommended Books

18.9 Glossary

19.0 AIMS AND OBJECTIVES

The aims of this unit are to explain the causes of nationalisation of commercial banks in India and to review the progress made by them after nationalisation.

At the end of this unit, we expect you to be able to:

- explain the social control over banks;
- describe the causes for the nationalisation of commercial banks; and
- analyse the progress made by the commercial banks after nationalisation.

18.1 INTRODUCTION

Opinion was crystallised in favour of nationalisation as far as Centaral Banks are concerned. But there are diverse opinions in case of nationalisation of commercial banks. The supporters of nationalisation of commercial banks state that nationalised commercial banks would function more effectively than those under private management. But the critics of nationalisation state that the evils like red-tapism and bureaucracy, that are associated with Government Departments would percolate into commercial banks.

On the one hand it is argued that the highest degree of cooperation and coordination between the central bank and commercial banks can be possible only when both of them are brought under Government control. Those who are against nationalisation on the other hand state that nationlisation of commercial banks should be the last but not the first step for this purpose.

The supporters of nationalisation of commercial banks put forth their argument that legal tender money and bank money should be under the control of the state. They further argue that all fields of production including commercial banks should be brought under the state control where socialism is accepted as a desirable form of economic organisation of a country.

This unit explains the nationalisation of commercial banks in India and their progress after nationalisation.

18.2 SOCIAL CONTROL OVER BANKS IN INDIA

There has been a demand for a long time from the leftist sections for nationalisation of commercial banks in India. It is pointed out that Indian Commercial Banks neglected agriculture, small industry, exports and the interests of weaker sections of the society. They provided finance mainly to business, commerce and that too, to rich people. Over the three Five Year Plans, bank credit to industry increased from 1479.2% during the Third Five Year Plan. Agricultural sector acccounted for only 2.1% of the total bank credit in March 1967 as against 64.3% in the case of industry and 19.4% in the case of commerce. Thus it is clear that commercial banks were unable to finance agriculture and small industry. The Fourth Five Year Plan was agricultural oriented and the agricultural sector required huge national resources. In this connection, the cooperative banks which were entrusted with the task of providing agricultural finance failed in discharging their responsibilities. Against this background, Government was thinking of nationlising the Indian commercial banks.

Mr. Morarji Desai the then Deputy Prime Minister, made a statement in Lok Sabha on December 14, 1967 imposing social control over banks. The objective of social control was to prevent monopolistic trend, concentration of economic power, misdirection of resources and to make banking system serve our socio-economic objectives. Thus the basic goal in imposing social control was to achieve the social ends that nationalisation could secure without taking over the banks into public ownership.

Consequenty National Credit Council was set-up on 22-12-1967 to assess perodically available resources of credit and to ensure its equitalble and purposeful distribution among the several sectors by keeping national economic development in view. This council assessed the demand for bank credit, determined priority for the grant of loans, coordinated lending and investment policies of commercial and cooperative Banks.

Another step in this direction was the enactment of the Banking Laws (Amendment) Act of 1968. This Act provides for reconstitution of Board of Directors with majority of the directors from among non-industrialists and persons from agriculture, cooperatives, economists, accountants, lawyers, etc.

18.3 NATIONALISTION OF COMMERCIAL BANKS IN INDIA

The working of social control during the short period did not contribute to the attainment of its goals. The lending policies did not show any phenomenal change. The crisis of planning was deepened. The Prime Minister felt that only public ownership of banks would contribute to the most effective mobilisation and development of natural resources and their utilisation for productive purposes in accordance with our plans amd priorities. The then Prime Minister Mrs. Indira Gandhi, after assuming the finance portfolio in a dramatic manner, announced the nationalisation of 14 major scheduled commercial banks on July 19, 1969. An ordinance was promulgated on the night of July 19, nationalising 14 leading scheduled banks each having deposits of Rs.50 crores and more. Consequently the Banking Companies (Acquisition and Transfer of Undertakings) Act of 1970 was passed. The 14 Nationalised Banks are Allahabad Bank, Bank of Baroda, Bank of India, Bank of Maharastra, Canara Bank, Central Bank of India, Dena Bank, Indian Bank, Indian Overseas Bank, Punjab National Bank, Syndicate Bank, United Bank of India, United Commercial Bank and Union Bank of India.

Nationalisation was considered necessary for the achievement of the objectives of social control, (1) Removal of control by a few. (ii) Provision of adequate credit for agriculture, small industry and exports, (iii) Giving of professional bent to bank management (iv) Encouragement of new classes of entrepreneur, (v) Provision for adequate training as well as reasonable terms of service for bank staff, etc.

Later the Government nationalised six more commercial banks on 15th April,1980 viz. (1) Andhra bank (2) Corporation Bank (3) New Bank of India (4) Oriental Bank of Commerce (5) Punjab and Sind Bank (6) Vijaya Bank.

CHECK YOUR PROGRESS - 1

List out objectives of nationalisation of commercial banks in India.

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18.4 PROGRESS OF COMMERCIAL BANKS AFTER NATIONALISATION

Nationalisation of banks changed the complexion and dimension of commercial banking in India. It helped to hasten the pace of geographical and functional diversification. The new dimensions placed varying responsibilities on the shoulders of commercial banks such as expansion of branch offices in unbanked and remote rural areas on a massive scale, meeting the credit requirements of export sector, agricultural sector, small scale sector, cottage and rural industries, self-employed persons, artisans, weaker sections of the society, small traders and other persons of small means. This progress is discussed under the following heads:

i) Branch Expansion

Branch expansion programme of commercial banks is very significant for fulfilling the socio-economic goals particularly balanced development of various parts of the country. Impressive progress of commercial banks in increasing their branch net work and diversifying their activities has brought about a wider, special and functional spread of banking facilities in the country. After nationalisation the traditional concentration of banks in and around urban centres has turned in favour of a wide dispersal of branches in semi-urban, rural, backward and unbanked areas.

Nationalised banks launched a massive branch expansion programme for which there is no parallel in banking in any country. Growth of branch offices is shown in the following table.

	June 1968		June 1983	
	Number of bank branches	% to total	Number of bank branches	% to total
Rural	1,832	22.2	22,618	53.8
Semi-urban	3,322	40.2	9,036	21.5
Urban	1,447	17.5	5,575	13.3
Metropolitan	1,661	20.1	4,787	11.4
Total	8,262	100.0	42,016	100.0

During the 14 years of nationalisation (Upto June,1983) banks opened a record number of 33,754 branches of which 21,117 were in rural areas. The national average per bank office which was 65,000 at the end of June, 1969 declined to 17,500 by June, 1982. However, a lot of effort is still to be made in this direction by opening more and more number of branches in rural and unbanked areas.

ii) Deposit Mobilasation

Another area of progress of banks is acceleration of deposit mobilisation. Alongside the geographical expansion, functional diversification took place. Consequent upon the massive efforts taken by banks, deposits increased from Rs. 4,646 crores (in June 1969) to Rs. 53,566 crores (in June, 1983). Deposit mobilisation efforts by banks still fall short of the needs of the present economic environment. There is vast scope for mobilising deposits from different sections of the economy, particularly in the rural areas. Most of the deposit mobilisation schemes are now tailored to the convenience and preference of urban depositor, neglecting potential rural depositor. The banks have to tailor the scheme to match the convenience, preference and the needs of the rural depositor to be able to exploit the untapped rural savings. Besides this, in a vast country like ours, the requirements and preferences of various groups of people in different areas undergo periodic changes. The banks have to change their schemes in the light of every emerging situation.

The success of any deposit mobilisation scheme would very much depend upon the personalised services of the staff of rural branches. Integration with the rural community, participation in local activities and development of personal relations by the bank staff will enable the bank to tap the rural savings. But the present bank staff with an urban cult and little knowledge about rural areas is unable to deal with the customer properly. The banks should give preference to rural orientation in their recruitment policies.

iii) Agricultural finance

Commercial banks entered upon undertaking agricultural finance in the year 1967-68 almost from scratch. But emphasis was laid on agricultural finance only after nationalisation of commercial banks in the country. Several measures were taken to bridge the credit lacuna in agricultural sector viz., Lead Bank Scheme, Area Approach, Differential Interest Rate Scheme, Village Adoption Scheme, financing through Cooperatives, Small Farmers Development Agency, Marginal Farmers and Agricultural labourers Agency, Organisation of Farmers, Service Societies, setting up of Agricultural Finance Corporation, sponsoring Regional Rural Banks etc. As a result loans granted by commercial banks to agricultural sector increased from Rs,162.33 crores (by the end of June, 1969) to Rs. 5,269 crores (by the end of March, 1983). Increased bank advances to priority sectors are as follows.

Rs. in crores

	June 1969	June 1981	March 1983
1. Agriculture	162	4,041	5,269
2. Small Scale Industries	251	3,515	4,480
3. Road & Water Transport Operators	5.5	820	–
4. Retail Trade and Small Business	19	752	–
5. Professional and Self Employed	2	220	–
6. Education	0.8	12.6	–

But habitual defaulters had been financed to reach the credit targets. The commercial banks are tempted to take the easy course of lending to well-to-do farmers instead of catering to the needs of the marginal and small farmers and thus adversely affected the object of nationalisation. It is not enough just to spread the branches to rural areas. What is needed is a change in the attitude of the banks towards the agriculturists and a total involvement of the banks in the agricultural economy with a determination to help in overcoming the agricultural problems.

What is significant here is to improve the quality of service and bring the agriculturists into the fold and then to guide small and marginal farmers in the utilisation of credit. Besides the above impediments in agricultural finance, the staff of commercial bank branches in rural areas are not keen on doing the filed work. Even agricultural graduates prefer to be posted in cities and urban centres.

iv) Small Scale Industry

Small Scale Industries play a pivotal role in our economy as they contribute to balanced development of different regions. Commercial banks have been financing Small Scale Industries basing on the guidelines of the Reserve Bank of India which stipulate three categories of small scale units viz., (a) artisans and village cottage industries, (b) small industries in the tiny sector, and (c) large size small scale units. Commercial banks, financial assistance to small scale industries increased from Rs. 251.10 crores (June 1969) to Rs. 4,480 crores (March, 1983).

There are some problems in increasing the financial assistance to small industries such as absence of accepted accounting procedure, incomplete feasibility reports, etc. Most of these problems cannot be solved until Bankers adopt a constructive attitude which would facilitate the attainment of the social objecives of bank nationalisation. So the bankers have to consider the technical soundness, commercial feasibility, financial profitability, managerial competence and socio-economic viability of the project rather than emphasising on security and procedural formalities. Another problem is that bankers are not familiar with the technical aspects and technology of the industries on the basis of which they are asked to provide finance. Bankers may have to depend upon various technical agencies in addition to employing technical experts in financing small scale industries.

Commercial banks are also facing problems such as absence of awareness and confidence on the part of rural and cottage industialists and artisans in the country-side regarding the establishment of industries and their unorganised nature. In addition, rural industrialists experience problems relating to absence of continuous supply of raw materials and potential market facilities. Hence banks have to help the industrilists in setting up of the units, in securing raw material and in finding out marketing facilities in addition to providing required finance in right time on favourable terms and conditions.

The chronic problem associated with financing of small industrial units is that of their growing sickness. Consequently the banker is facing the problems like mounting overdues and poor recoveries. The efforts adopted by bankers in this direction did not prove effective. It is essential that bankers evolve a system of monitoring the accounts to check sickness at incipient stage and for taking prompt action. The bankers may also adopt the measures like revamping of management of the units, offering concessions such as lowering of interest rate and reduction in margin, rescheduling of repayment of loans and the like.

v) Self-Employment

Banks have also been helping self-employed persons as a part of their priority sector lending. Bank advances to self-employed persons increased from Rs.2 crores (June 1969) to Rs. 220 crores (June, 1981). To help the self employed or an entrepreneur, the bankers have to spend a little more time outside their offices trying to acquaint themselves with the small enterpreneurs and assessing their financial needs. This movement should gather momentum and reach out to the entrepreneurs in all walks of life and take care of their variety of financial and non-financial needs including management of the project. But the young unemployed seeking help under this scheme and enterpreneurs have been facing a variety of problems due to commercial and unsympathetic attitude of bankers. Bankers in order to help the disappionted young unemployed have to give up their time consuming procedural formalities, liberalise the terms and conditions to solving their problems sympathetically with realistic and practical approach. Bankers should also provide right quantum of finance in right time besides helping with non-financial services like specialist advice, nursing the projects, etc.

vi) Assistance to Area Priority Sectors

a) Transport Operators

Under the scheme , a loan may be given to an individual or an association (not more than six individuals) owning and normally operating by himself or themselves a transport vehicle hired for carrying goods or passengers. The definition of transport vehicle also includes Rickshaws, Carts, Boats, Steamers and Launches. The loan may be granted upto Rs.1 lakh for meeting expenses relating to repairs, taxes, overhaul of the vehicle. Bank advances to road and water transport operators incresed from Rs. 5.5 crores in June 1969 to Rs. 820 crores in June, 1981.

b) Retail Trade and Small Business

Individuals, firms or cooperative societies engaged mainly in trading activities other than in fertilizers and with an annual turnover not exceeding rupees one lakh are eligible for loans under this scheme. Loans granted by banks under this scheme incresed from Rs.19 crores (June,1969) to Rs.752 crores (June 1981)

c) Assistance to Education

Banks have also been rendering their financial assistance for the spreading of education on priority basis. Banks, financial assistance to education boosted up from Rs. 0.8 crore to Rs. 12.6 crores from June, 1969 to June, 1981.

The commercial banks have to strive further with all sincerity to achieve the objecives for which they have been nationalised.

18.5 SUMMING UP

The Indian Commercial Banking system had not played its proper role in the planned economic development of the country. Small industrial and business units were ignored. The commercial banks could not finance the agricultural sector adequately. Small business units, exports units, etc had been continuously ignored. To over come this situation, the Social Control over commercial banks was introduced. As this social control could not attain its objectives, the Government has gone for nationalising the commercial banks. So far 20 banks (14 in 1969 and 6 in 1980) were nationalised in India. The main objective of nationalisation of Commmercial Banks was to mobilise and utilise the financial resources for productive puposes in accordance the plan priorities. After nationalisation, commercial banks achieved a very good progress in terms of branch expansion, resource mobilisation, provision of finace for agriculture and priority sectors, etc.

18.6 CHECK YOUR PROGRESS : MODEL ANSWERS

1. i) to remove the ownership and control of banks in a few hands

   ii) to mobilise resources

   iii) to provide adequate credit for agriculture, small industries

   iv) to professionalise the banks, managements

   v) to utilise the resources in accordance with the social objecives of the Five-Year Plans

   vi) to provide reasonable terms of service to the bank staff.

18.7 MODEL EXAMINATION QUESTIONS

A. ESSAY QUESTIONS

Answer the following in about 30 lines each:

1. Explain the progress made by nationalised commercial banks in India.
2. What are the causes of nationalisation of commercial banks in India?

B. SHORT QUESTIONS

Answer the following in about 15 lines each:

1. Explain the objectives of social control over banks.
2. Explain the progress of branch expansion of commercial banks.
3. Explain the problems faced by commercial banks in financing small scale industries.
4. What are the arguments for nationalisation of commercial banks ?
5. Explain the assistance of commercial banks to the priority sectors.

18.8 RECOMMENDED BOOKS

1. Johsi N.C. : Indian Banking
2. Panandekar S.G. : Banking in India

18.9 GLOSSARY

Nationalisation : It is a process by which the Government assumes control of organisations operating in the private sector.

UNIT-19 : STATE BANK OF INDIA

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19.1 Introduction
19.2 Establishment of State Bank of India
19.3 Objectives and Functions
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19.5 Summing Up
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19.0 AIMS AND OBJECTIVES

This unit attempts to explain the establishment, management, functions and progress of the State Bank of India (SBI).

At the end of this unit, you will be able to :

- explain the establishment of State Bank of India;
- explain the functions and objectives of the Bank; and
- analyse the progress of the Bank in different fields.

19.1 INTRODUCTION

In India the public sector banking emerged with the establishment of State Bank of India. It was established by nationalising the Imperial Bank of India. State Bank of India with its subsidaries is playing a significant role in the planned development of our country. This unit explains the establishment, functions and significant achievements of State Bank of India in detail.

19.2 ESTABLISHMENT OF STATE BANK OF INDIA

The Imperial Bank of India was instituted by the amalgamation of the three presidency banks of Bombay, Calcutta and Madras in 1921. It was governed by the Imperial Bank of India Act, 1920 which was amended in 1934. It occupied a pivotal position in the banking industry by virtue of its large resources, business and branches. Out of the total deposits of all scheduled banks by the end of 1954 the share of Imperial Bank was 24.5 per cent.

Before the establishment of Reserve Bank of India (RBI), Imperial Bank acted as the banker to the government, custodian of government funds, bankers' bank, clearing house, etc. Although there was a change in the status and working of the Imperial Bank after the establishment of Reserve Bank of India in 1935, it did not lose its prestige as it acted as an agent where the latter had no branches.

Government was thinking of nationalising the Imperial Bank from 1947 itself. The Rural Banking Enquiry Committee, however, expressed against nationalising the Imperial Bank and recommended certain measures of control over the bank. But the Government took the historic decision of nationalising the Imperial Bank on 20th December, 1954 on the basis of the recommendations of the Committee on All India Rural Credit Survey appointed by the R.B.I. An important recommendation of the committee relates to the setting up of "State Bank of India as one strong, integrated, state partnered commercial banking institution with an effective machinery of branches spread over the whole country for stimulating banking development by providing vastly extended remittance facilities for cooperative and other banks and followaed a policy which would be in effective consonance with the national policies adopted by Government without departing from the principle of sound business." The Government accepted the recommendation and established the State Bank of India on 1st July 1955 by nationalising Imperial Bank of India. The State Bank of India (subsidiary banks) Act was passed in September 1959 and in course of time 8 major State associated banks were amalgamated with the main Bank or its subsidiaries. They are: Bank of Saurastra, Bank of Patiala, Bank of Bikaner, Bank of Jaipur, Bank of Rajasthan, Bank of Indore, Bank of Baroda, Bank of Mysore. State Bank of Hyderabad and the Travancore Bank.

19.3 OBJECTIVES AND FUNCTIONS

The important functions and objectives of the Bank are explained below:

i) Functions of the Bank

The functions of the bank are specified in Section 33 of the Act. Important among them are:

1. To act as an agent of the Reserve Bank of India at all places in India where the State Bank has a branch but there is no branch of the Banking Department of the Reserve Bank to pay, receive, collect and remit money, bullion, and securities on behalf of the Government of India and transacat any other business which the Reserve Bank may entrust to it from time to time.

2. To advance and lend money and to open cash credits upon the security of stocks, title to goods, shares and debetures.

3. To sell and realize the proceeds of sale of any promissory notes, debentures, stock receipts, bonds, stocks, shares, securities of goods or documents of title which have been deposited with or pledged, hypothecated, assigned or transferred to the State Bank as security for such advances, loans or credit which are held by the State Bank or over which the State Bank is entitled to any lien or charge in respect of any loan, advance, credit or claim of the State Bank and which have not been redeemed in due time.

4. To draw, accept, discount, buy and sell bills of exchange and other negotiable instruments.

5. To invest funds of the State Bank in any of the securities and to convert the same into money when need arises to do so.

6. To issue demand drafts, to affect telegraphic transfers and other kinds of remittances made payable at its own offices, to purchase drafts, telegraphic transfers and other remittances, to make, issue and circulate letters of credit to the bearer on demand.

7. To buy and sell silver and gold.

8. To receive deposits and keep cash accounts.

9. To receive all kinds of bonds, scripts, title deeds or valuables on deposit or for safe custody.

10. To sell and realize all property, whether movable or immovable, which may come into the possession of the State Bank in satisfaction of its claims and to hold any right, title or interest in any property which may be the State Bank's security for any loan or advance.

11. To act as agent of any cooperative bank which is registered under any law in force.

12. To underwrite issues of any stocks, shares, debentures or other securities in which the State Bank is authorised to invest its funds under clause (5) above.

13. To transact pecuniary agency business on commission.

14. To administer whether jointly with other persons or alone estates for any purpose whether as executor, trustee or otherwise.

15. To draw bills of exchange and grant letters of credit payable out of India.

16. To buy bills of exchange payable out of India at any usance not exceeding 15 months in the case of bills relating to the financing of seasonal agricultural operations or six months in other cases.

17. To borrow money for the purpose of the business of the State Bank, to give security for money so borrowed by pledging assets or otherwise.

18. To advance or lend money to or to open cash credit in favour of any company having rupee share capital or any cooperative society registered under any law in force, for the purpose of averting the winding up of the company or society or where any such company is being wound up for the purpose of facilitating such winding up for any period upon the security of the assets of such company or society.

19. With the approval of the Reserve Bank, to subscribe, to buy, acquire, hold and sell any shares in the capital of any banking company and to form and conduct any such banking institutions, a subsidary of the State Bank or in any other manner.

20. To subsidise from time to time the pension funds referred to in section 8 if necessary.,

21. To do any other kind of business which the Central Government in consultation with the Reserve Bank and on the recommendations of the Central Board, may authorise.

22. To perform functions entrusted to or required of the State Bank by this Act or by any other law in force for the time being.

23. Generally, to do all such matters and things as may be incidental or subsidiary to the transacting of the various kinds of business, including foreign exchange business, herein specified.

ii) Objectives

The main objective in nationalising the Imperial Bank was to spread banking facilities through the establishment of a large network of branches over the country. According to the State Bank of India Act, the bank had a statutory obligation to open 400 new branches in the rural, semi-urban, and unbanked areas during the First Five Years of its exaistence or such extended period as may be permitted by the bank. The motto behind this expansion is to serve the unbanked areas of the country. In this connection, the bank created a special fund known as the "Integration and Development Fund". This fund is created with the dividends due to R.B.I., the contributions of the R.B.I. and Central Government. The fund will be utilised for meeting the losses in excess of such yearly sum as may be agreed upon between R.B.I. and S.B.I. and attributable to the additional branches established in pursuance of the provisions of the the State Bank of India Act and such other losses or expenditure as may be approved by the Central Government in consulation with R.B.I.

S.B.I was expected to operate its activities in conformity with the broad economic policies of the Government. Another important objective of the Bank is to promote the agriculture finance and to solve the problems of the existing system of agricultural finance. In addition the bank aims at providing special facilities for the training of the personnel of the bank and imparting knowledge on cooperative principles.

The bank is expected to help the Reserve Bank in its credit policies and check any monetary disequilibrium that is likely to develop in the money market.

CHECK YOUR PROGRESS - 1

List out the objectives of State Bank of India.

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19.4 PROGRESS OF THE BANK

At the time of establishment of S.B.I., two responsibilities were placed on its shoulders. Firstly, the State Bank has to ensure smooth transformation from profit seeking commercial banking to a truly national institution to serve the cause of the country. Secondly, it was required to undertake such developmental activities which do not normally include in the business of commercial banks. S.B.I. made a commendable progress during the 29 years from its inception in different spheres of the economy. There was phenomenal change in the aptitude and outlook of the bank towards the nation at large. It has become a pioneer in the entire banking industry. It has also developed itself as a model bank to all other commercial banks in the country in contributing to the attainment of socio-economic goals of the country. The significant achievements of the S.B.I. can be summarised in the areas of branch expansion, deposit mobilisation, advances to priority sector like agriculture, small scale industries, export finance, establishment of merchant banking division, innovative banking, etc.

i) Branch expansion

The objective of the bank during the days of its establishment was to open 400 branches within 5 years of its establishment. The bank achieved this object well in time. Since then it has been opening its offices in rural areas, semi-urban, unbanked and under-banked areas. The number of branches in India increased from 466 at the end of June, 1955 to 3,072 in 1974. Further this number increased to 6,434 by the end of June, 1983. Total number of branches of associated banks were 3,057 by the end of June, 1983.

ii) Deposit Mobilisation

The State Bank of India has formulated several innovative schemes for deposit mobilisation. Further its vast branch network is an added advantage for accelerating the deposit mobilisation by the bank. The bank's aggregate deposits increased from Rs.188 crores in June, 1955 to Rs. 2,237 crores by the end of 1973. A substantial amount of these deposits were mobilised from rural and semi-urban areas. These deposits further increased to Rs. 13,541 crores by the end of October, 1983. Out of this, term deposits amounted to Rs.10,799 crores. This reveals that time deposits form a significant portion of the total deposits of the bank. Aggregate deposits of the associated banks stood at Rs. 3,452 crores by the end of October, 1983.

iii) Advances

The Bank's total advances increased from Rs.99 crores at the end of 1955 to Rs.1,582 crores at the end of December, 1973. The bank's share in the total credit of all scheduled commercial banks stood at 23(excluding investment in Government securities) increased to Rs. 11,825 crores by the end of November, 1983. The share of advances of S.B.I. and its associates forms 31.84advances of all scheduled commercial banks by the end of November, 1983.

The Bank has been the major institution providng finance for short-term and medium-term for the agriculture, small scale industries medium and large industries, weaker sections of the society, etc. Normally commercial banks do not enter into medium-term financing but S.B.I. was allowed to provide medium-term finance to industries. Certain industries like, Iron and Steel, Engineering, and Fertilisers and Chemicals got major credit finances from the Bank.

iv) Export Finance

The Bank's role in the field of export promotion includes export financing, exploring and developing new markets for Indian exports, both traditional and non-traditional. The Bank maintains an information service for its customers on export possibilities of various commodities. The Bank also circulates information to the Indian exporters and importers. The Bank also established the International division in Bombay in 1970. This division seeks to bring together the Indian exporters and foreign importers by means of the information supplied to them. The Bank also assists in securing loans in foreign currency.

v) Lead Bank Scheme

Under this Scheme, 90 districts were allotted to the State Bank and its subsidiaries and detailed survey reports were completed about almost all the districts. The State Bank group has been allotted 208 centres in its 69 lead districts and 224 centres in the lead districts of other banks. The State Bank group conducted action oriented studies of a much smaller and more manageable area to enable it to draw up a specification plan for meeting credit needs of various economic activities in the area. The Bank has also taken up various studies in all the community development blocks in the lead districts alloted to it.

vi) Small Scale Industries

A scheme for financing small scale industries was formulated by the State Bank immediately after its inception. The scope of the Bank's scheme was extended in 1960 to cover the grant of term loans for purchase of fixed assets. In addition the bank decided to go out to the prospective borrowers through a system of surveys in coordination with the state governments so as to overcome the psychological inertia on the part of small scale industrialists and meet their entire credit requirements. Thus it offers a package of credit covering the entire requirements of the borrower at liberalised terms and conditions.

Specialised and competent staff were appointed in those branches where small scale financing is largae. At these branches a local working group comprisng representatives of the Small Industries Service Institute, Cooperative Banks and the National Small Industries Corporation is in operation. Coordination committees are formed at the local head offices, with the representatives of state level agencies or departments.

The Bank also introduced the Entrepreneurs Scheme in 1967. Under this scheme importance is given to the competent entrepreneur and technical feasibility and economic viability of the project. The Bank also introduced Rural Industries Project in 1969 to help small artisans. The Bank is also actively associated with the half-a-million job programme sponsored by the Government for the educated unemployed. The Bank started implementing the recommendations of its study team from 1975 on all aspects of small industry financing which aimed at improving the qualitative aspects of financing, implementing and nursing the programmes.

Bank's assistance to small scale industries increased from Rs.10 lakhs at the end of 1956 to Rs.251 crores at the end of 1973. This amount further boosted up to Rs.1490 crores (including that of associate banks) by the end of June, 1983. By the end of June, 1983, the total number of small scale units benefitted by the S.B.I. and its associate banks are 3,61,536 and 1,40,651 respectively.

vii) Agricultural Finance

The Bank grants direct advances to farmers for all agricultural activities, with a view to boosting up agricultural output. The bank mainly considers the progress of the farmers and the economic viability of the sachemes.

The Bank introduced the schemes for small farmers and farm graduates in 1969. The first scheme is designed to help the small farmers in making their farm viable by providing loans and advances. Loans are granted on the basis of group borrowing. In this scheme the Bank primarily insists upon group guarantee without insisting upon any other security. The Farm Graduate Scheme seeks to extend credit to technically qualified personnel particularly graduates in Agriculture, Dairy Science, Agricultural Engineering, etc.

The Bank's strategy for financing agricultural sector was reviewed during 1971. The Bank decided shift from scattered lending to intensification of the area approach. An important feature of the strategy was to select intensive centre. Preference was given to backward areas. Agricultural Development Branches (ADB) were set up at such centres. Total direct assistance of the S.B.I. group to agriculture increased from Rs. 176 crores to Rs. 1634 crores by June, 1983. Similarly, indirect finance provided by the Bank increased from Rs. 65 crores to Rs. 386 crores by June 1983. Total number of beneficiaries were 47,18,226 and 72,304 under direct and indirect financing respectively by June, 1983.

viii) Agricultural Development Branches

The Bank has opened agricultural development branches at selected centres in the entire country in order to provide credit to farmers intensively. These branches were opened in backward and underdeveloped areas particularly in S.F.D.A./M.F.A.L.A. districts, and also in areas covered under special agricultural development programmes formulated by the State Government. By the year 1977 the Bank's group had opened 314 agricultural development branches. These branches provide credit to agriculturists in about 100 villages by way of crop loans, investment loans and also to meet other needs. Finance is also provided for allied activities to agriculture like dairy and poultry in order to provide a subsidiary means to the farmers. Finance is also provided for the construction of godowns, transport facilities and marketing of crops, etc.

ix) Village Adoption Scheme

Village Adoption Scheme was formulataed by the State Bank. This scheme is mainly implemented in rural and semi-urban areas. According to this scheme, a branch adopts a few villages for intensive and integrataed financing to farmers for meeting various requirements. All the villagers in these adopted villages are to be financed by the bank for their various requirements. A system of group guarantees has been instituted in case of non-viable farmers. The Bank also provides finance for allied activities in order to raise the incomes of small farmers.

x) Financing of Primary Agricultural Credit Societies

In addition to providing direct finance to farmers the Bank also provides finance indirectly through primary credit societies.

xi) Financing Land Mortgage Banks

The bank's assistance to land mortgage banks is of three types viz.,

1. Subscription to the debentures issued by the central land mortgage banks;
2. Granting advances on the security of such debentures; and
3. provision of interim financing accomodation to central land mortgage banks against Government guarantee.

xii) Small Business Finance

The Bank has formulataed its policies for meeting the credit needs of the small borrower engaged in other economic activities such as distribution, transport etc. Loans granted by the Bank's group to small businessmen increased from Rs. 32 crores to Rs. 630 crores by June, 1983.

xiii) Employment-Oriented Lending

The Bank was the first to formulate employment-oriented lendng scheme to finance on concessional terms to technically qualified or experienced persons to set up small industrial units. Similar scheme was also extended to Agricultural Graduates. This decision was taken in 1971 to lend to promote employment opportunities. The schemes such as Entrepreneur Scheme, Farm Graduate Scheme and Scheme relating to Agro - Service Centres were implemented more vigorously. New schemes were devised for doctors, dentists, engineers and other graduates. Initially, the emphasis was laid on self-employment. In due course, the policy was modified to cover self-employment/additional employment on account of expansion and removal of under/partial employment.

xiv) Differential Interest Rate Sacheme

This scheme was introduced in August, 1972. Bank's advances under this scheme increased from Rs.3.9 crores to Rs.124 crores during December 1973 to June 1983. This scheme results in the generation of gainful economic activities. Loan is granted on reasonable terms and conditions under this scheme. Total beneficiaries under this scheme were 14.37 lakhs by the end of June,1983.

xv) Merchant Banking Division

State Bank set up the merchant banking division in 1972 and the division was properly organised in June, 1972. This division in addition to serving the clients, helps the small and medium entrepreneurs who wish to set up industrial enterprises and enter the capital market for the first time. This division assisted technocrats and new entrepreneurs who did not know how to deal with financial planning, capital structure, public issues, etc.

xvi) Innovative Banking

Banks like other institutions have to strive to respond effectively to the changing needs of the society. The State Bank in recent years initiated measures to generate a proper climate within the organization for social responsiveness. The measures are intended to a) bring to bear social orientation on the part of Bank's employees in operating situations, b) encourage the staff to develop operating units at local institutions,and c) persuade and support the employees for a greater political involvement in community affairs.

Thus, the State Bank of India has taken up a number of innovative schemes and it has also been continuing this task with a view to contribute to the socio-economic welfare of the members of the country.

19.5 SUMMING UP

State Bank of India was started in 1955 by nationalising the Imperial Bank of India. Besides acting as the agent of RBI, it performs all the commercial banking functions, viz., receiving deposits, advancing and lending, making investments and so on. Apart from these normal functions, it also underwrites the issue of shares, debentures or other securities and subscribes, acquires and sells shares in the capital of any banking company with the approval of RBI. Thus, it has wide range of functions to perform. The important objectives of the bank are to expand branches to serve the unbanked areas, to operate its activities in conformity with the economic policies of the Government, etc.

The bank had made a significant progress in different spheres of the economy. The bank's achievements in different areas include branch expansion, deposit mobilisation, advancing to priority sectors like agriculture, small-scale industries, exports, etc. In addition, the bank also had taken up merchant banking business and many innovative schemes in banking.

19.6 CHECK YOUR PROGRESS MODEL ANSWERS

1. The important objectives of Statae Bank of India are:

   i) Branch expansion to provide banking facilities in unbanked areas of the country.

   ii) To operate its activities in conformity with the economic policies of the Government.

   iii) To promote agricultural finance.

   iv) To help the RBI in implemeting its credit policies.

19.7 MODEL EXAMINATION QUESTIONS

A ESSAY QUESTIONS

Answer the following in about 30 lines each:

1. Describe the progress made by State Bank of India.
2. Explain the important objectives and functions of State Bank of India.

B SHORT QUESTIONS

Answer the following in about 15 lines each:

1. Explain the causes of nationalisation of Imperial Bank of India.
2. Explain the establishment of State Bank of India.
3. Mention the objectives of State Bank of India.
5. Explain the progress made by State Bank of India in the agricultural finance.
7. What is Village Adoption Scheme ?
8. Explain the assistance of State Bank of India to small scale industries.

19.8 RECOMMENDED BOOKS

1. Joshi N.C.	: Modern Banking
2. Panandekar S.G.	: Banking in India
3. R.B.I	: Report on Currency and Banking.
4. State Bank of India	: Annual Reports

19.9 GLOSSARY

Lead Bank Scheme : It is a scheme in which each bank is expected to provide financial leadearship to the other banks and financial institutions located in the district alloted to it.

Village Adoption Scheme : It is a scheme in which a branch adopts a few villages for intensive and integrated financing to farmers.

UNIT-20 : EXCHANGE BANKS IN INDIA

Contents

20.0 Aims and Objectives
20.1 Introduction
20.2 Functions of Exchange Banks
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20.0 AIMS AND OBJECTIVES

This unit aims at explaining the working of exchange banks in India and the measures for improving their performance.

After going through this unit, you will be able to :

- explain the functions of exchange banks;
- discuss the criticism against the working of exchange banks;
- mention the measures suggested to improve the performance of exchange banks;
- explain the Export-Import Bank of India.

20.1 INTRODUCTION

Exchange banks are those banks, which provide finance to foreign trade and which have their head offices located outside India, i.e., in foreign countries. These exchange banks have an important place in the Indian money market. There are 13 exchange banks in India by the end of May, 1980 viz., i) Algemne Bank of Netherland; ii) Bank of America; iii) Bank of Tokyo; iv) Banque National de Paris v) Butix Bank of the Middle East; vi) Chartered Bank; vii) First City National Bank; viii) Grindlays Bank; ix) Hongkong Bank; x) Mitsui Bank; xi) Sonali Bank; xii) American Express International Banking Corporation; and xiii) the Emirates Commercial Bank. They have 130 branches in India. Their deposits in India stood at about Rs.900 crores and credit advanced by them was Rs.750 crores by the end of 1976. This shows that most part of our foreign trade was largely depended on these foreign banks. According to Reserve Bank's survey, nearly 80 per cent of the foreign trade was financed by exchange banks.

Indian Banks and Foreign Exchange Business

Indian commercial banks are not able to participate in India's foreign trade to large extent. The reasons for the limited participation as pointed out by the Central Banking Enquiry Committee are:

i) Severe competition from the big foreign banks, which have long establishment and larger capital resources;

ii) Lack of adequate number of branches of Indian Joint Stock Banks in London and such other significant financial centres.

iii) Non-availability of competent staff for Indian Banks.

iv) Lack of liquid resources and absence of suitable monetary conditions of our economy.

This unit explains the functions of exchange banks, criticism against the working of these banks and measures to improve their position. Later it is also attempted to describe the Export-Import Bank of India.

20.2 FUNCTIONS OF EXCHANGE BANKS

The important functions of exchange banks is to finance export and import transactions. This is explained below.

i) Export Transactions

When an Indian sells goods to a foreigner (say to a Britisher) the Indian exporter usually insists on having a credit opened by the foreign importer through a bank of London. When the credit is opened, the Indian exporter is advised by the branch or correspondent in India of the London bank which has made the arrangement. Now the exporter draws a bill of exchange, usually drawn for a period of 90 days after sight and negotiates it with his banker in India. The negotiating bank sends it to the bank which has established the credit. The bill is presented for acceptance. The exchange bank generally does not hold such a bill till maturity. It is discounted in the London Money Market with the endorsement for the exchange bank concerned.

ii) Import Transactions

When an Indian imports goods from a foreign country, the negotiating bank sends the bill to its office in India for presentation to the importer for acceptance in the case of a D/A bill or payments in the case of a D/P bill. In the case of D/A bills the documents accompanying the bills are handed over against acceptance. While in the case of D/P bills the documents are not handed over except on payment of the amount of the bill immediately. Generally India's export trade is financed by the exchange bank on D/A term while the import trade on D/P terms.

iii) Other Financial Operations Relating to Foreign Trade

a) Exchange banks also finance foreign trade by financing movement of goods from Indian ports to foreign ports and from foreign ports to Indian ports.

b) They also finance for the movement of goods from ports to the interior towns and from interior town to the ports.

iv) Commercial Banking Functions

a) They give loans and advances to businessmen for doing internal trade.

b) They provide trade information to their businessmen and they also act as the referees.

c) The exchange banks discount all types of Hundies and Bills belonging to the businessmen.

d) They act as agents to the businessmen.

e) The exchange bank being a commercial bank accepts deposits from public.

f) Exchange banks provide industrial finance also.

CHECK YOUR PROGRESS - 1

List out the functions of Exchange Banks.

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20.3 COMPLAINTS AGAINST EXCHANGE BANKS

The working of the exchanage banks has been severely criticised within the country. These complaints may be broadly grouped under two heads viz., the complaints made by the Indian joint stock banks and the complaints made by the Indian Clientele of these banks.

1. According to the Indian Joint Stock banks these exchange banks which are controlled by foreign interests enter into unfair competition with them by monopolising the foreign trade.

2. Exchange banks extend their operations into the field of internal trade by establishing the branches in important industrial centres of the country.

3. In addition to the complaints made by the Indian Banks there are a number of complaints raised by Indian clients. Important among the criticisms raised by them are:

   i) the differential treatment of financing the export trade of India by D/A bills and the import trade by D/P bills; and

   ii) the discriminating treatment by foreign banks between Indian firms and foreign firms. For example they follow different margin rates and interest rates in between the Indian firms and foreign firms.

4. The exchange banks frequently insist that business should be given to foreign shipping companies, insurance companies etc., before giving accommodation to Indian firms.

5. The exchange banks provide foreign trade information to the foreign companies in India. The Indian owned companies are not provided with such information.

6. Indians are not given preference in the selection of personnel.

7. Whenever the foreign exchange banks run into losses there will be no claim on the assets of these banks by Indian depositors.

8. The exchange banks impose too many restrictions on Indians without imposing the same on foreigners.

20.4 SUGGESTIONS FOR IMPROVEMENT

Whatever the criticisms levelled against the working of the exchange banks may be, we should not forget the contribution made by them for the growth of India's foreign trade. In view of this, certain suggestions have been made to improve the position of the exchange banks and for this certain restrictions were also imposed by the Reserve Bank of India.

1. The differential treatment of financing the export trade of India by D/A bills and the import trade by D/P bills should be given up.

2. The margin requirement of 10 to 15 per cent which the exchange banks require from Indian firms for opening confirmed letter of credit (Which is not applicable to foreign firms) should be waived with.

3. In the same way the benefit of lower rate of interest should also be applied to Indian firms on par with foreign firms.

4. Exchange banks should not insist that business should be given to foreign shipping companies, etc., before giving accomodation to Indian firms.

5. The Reserve Bank of India should have a more effective control over the exchange banks.

6. Exchange banks have to get licences from Reservse Bank of India for operating in the country and opening of the new branches in the country.

7. The exchange banks are to be inspected regularly by the Reserve Bank.

8. At the time of granting a licence to exchange banks Reserve Bank should satisfy itself regarding the government and the law of the country.

9. An exchange bank incorporated outside India is required to have an aggregate value of paid up capital and reserve of at least Rs.15 lakhs.

10. The exchange bank is required to keep deposits with the Reserve Bank an amount of not less than Rs.20 lakhs, either in cash or in unencumbered securities.

11. They should not be allowed to acquire any controlling interest in any Indian Bank as this will lead to the encroachment of the exchange banks in the international trade.

12. 20% of the profits of the exchange banks from the business are to be required to deposit with the Reserve Bank.

13. Exchange banks should be prohibited from undertaking trustee business in India.

14. Restrictions should be placed on the aggregate volume of deposits which were raised and used by the exchange banks.

15. The exchange banks should be compelled to register with rupee capital so that Indians can acquire shares in them and thereby increase their participation in foreign exchange business.

16. The first charge on the amount deposited with Reserve Bank would be that of the Indian depositors and creditors of that bank.

17. The granting of commercial privilege should be based on the principle of reciprocity.

18. A purely Indian exchange bank with the co-operation of the Indian Joint Stock banks should be established on the initiative of the Government to transact the foreign trade business.

Foreign Exchange Banks And Nationalisation

At the time of the nationalisation of 14 major commercial banks in July 1969, there was also a demand for nationalisation of foreign exchange banks . But they were not nationalised. The reasons shown by Government are:

1. existence of legal restrictions;
2. opposition for foreign countries; and
3. special nature of activities and services of foreign exchange banks - they are confined mostly to foreign trade.

In view of the problems associated with the functions of foreign exchange banks, it is desirable that India should not continue to depend upon foreign exchange banks for the provision of foreign exchange facilities. On this basis certain measures were taken for export promotion.

1. The Industrial Development Bank of India has been participating in giving term finance and guarantee facilities to industrial concerns, both public and private.
2. The refinance facility was provided by the Reserve Bank of India to export contracts.
3. The Risk Insurance Corporation was set up in 1951.
4. Export Credit Guarantee Corporation was set up with effect from 1964.
5. The "International Division" was established by the State Bank of India.
6. The most important step is the establishment of Export-Import Bank of India.

20.5 EXPORT-IMPORT BANK OF INDIA

Among the long standing demands of the representatives of trade and industry, most significant and worth-while one is for an Export-Import Bank (EXIM Bank) for India. In recent years there has been much discussion on the need for a single and specialised institution to cater exclusively to the needs of foreign trade. Several official committees and trade organisations have time and again favoured setting up of such an institution.

The Joshi Committee on Export Credit and Finance (1967) had expressed itself in favour of an institution which could provide the required services to foreign trade and which could eventually evolve itself into an EXIM bank. Later, the Indian Institute of Foreign Trade (IIFT) after a detailed study had recommended to the government on the possibility, desirability and feasibility of setting up of an EXIM bank for India on lines of the EXIM bank of U.S.A. and the EXIM bank of Japan.

In the promotion of exports particularly capital goods, provision of credit facilities plays a dominant role. The competitive strength in the present international market is mainly influenced by the terms and conditions of payents. The financial resources at the disposal of the Indian Financial Institutions engaged in providing export credit are inadequate.

Before 1969 commercial banks offered finance to the exporters on a priority basis and at concessional rates. But since nationalisation in 1969 they have been mostly preoccupied with the socio-economic development of the country. At this juncture it was too much to ask them to provide credit to the export sector on a large scale.

The financial requirements aside, the exporters also require other services like insurance, guarantee, market information, acceptance etc., which have been met all along by the Export Credit and Guarantee Corporation (ECGC) and the IDBI. Consequently, the exporter had to approach a number of agencies resulting in unnecessary paper work which was time consuming process to complete single transaction. Besides this, due to the preoccupation of the existing institutions, they were unable to meet all the requirements of the Indian exporter.

In view of these shortcomings of the then existing system of financing foreign trade, a number of committees favoured a single and specialised export financing agency which may be termed as the EXIM bank of India to provide necessary banking and non-banking services to meet the requirements of India's Foreign trade.

Lack of co-ordination among the institutions with varying degrees of organisational set up continues to be an obstacle for reaching higher export targets. The problem of finance for exporters cannot be tackled with a fragmented approach and needs a well co-ordinated and comprehensive plan. Therefore, the Government in 1981 thought that it was an opportune time to form a much stronger and resourceful organisation to meet the timely needs of the exporters in an effective manner.

Consequently The Export-Import Bank of India was established on January 1, 1982, as a statutory corporation, wholly owned by the Union Government.

Objectives

The main objectives of the Exim-Bank are:

(i) to ensure an integrated and co-ordinated approach to solve the problems of exporters, providing special attention to capital goods and project exports, joint ventures and export of technical services and international merchant banking;

(ii) to extend buyer's credit and lines of credit; and

(iii) to tap domestic and overseas markets for resources for undertaking developmental and financing activities in the area of exports.

Promotional Activities

The promotional activities of the bank are as follows:

i) Planning, promoting and developing exports and imports;

ii) Providing technical, administrative and managerial assistance for promotion, managemen and expansion of exports; and

iii) Undertaking market and investment surveys and techno-economic studies related to development of exports of goods and services.

Export Promotion Schemes

The Bank mainly give term credit for export of goods and services on deferred terms. The Bank started its lending operations on March 1, 1982. It has introduced a variety of schemes for the promotion of exports of engineering capital goods, technology and consultancy services. It offers financial assistace of flexible and responsive credit terms to enable Indian exporters to compete in international markets. It also operates schemes for financial assistance to overseas buyers for the purchase of engineering goods (known as buyer's credit) and to Indian promoters towards their equity contribution in joint ventures abroad.

Resources

The authorised capital of the Bank is Rs.200 crores which can be increased to Rs.500 crores. The paid-up capital is Rs. 75 crores. The Government of India has given a long-term loan of Rs. 20 crores. The Bank is authorised to borrow from the Government of India and Reserve Bank and can also raise resources in domestic and international markets.

Operations

Since commencing operations from March 1, 1982 till June 30, 1982, the Bank has extended assistance to the tune of Rs.133 crores consisting of Rs.24 crores medium and long-term loans; guarantees amounting to Rs.32 crores and rediscounting of export bills aggregating to Rs.77 crores. During the same period, the Bank cleared 99 bids valued at more than Rs. 3,700 crores in respect of construction contracts, turn key projects and supplies which would involve the total commitment of Rs.852 crores for the Bank.

20.6 SUMMING UP

Exchange banks are those banks which are specialised in financing foreign trade. The main function of exchange banks is to finance foreign trade transactions. In addition, exchange banks also undertake the commercial banking business, such as the acceptance of deposits, granting of loans and advances.

In India the working of exchange banks was subject to a lot of criticism. According to the Indian joint stock companies, the exchange banks have more or less monopolised the finanacing of India's foreign trade, and they are competing with the Indian banks in financing the International Trade. The Indian clients have criticised that the exchange banks are discriminating between Indian firms and foreign firms in their assistance. Certain suggestions were made to improve the position of exchange banks, such as giving up the differential treatment in financing foreign trade, non-insistance of giving the business to foreign shipping companies, having effective control by RBI over the exchange banks, etc. In India various committees have recommended a single and specialised export financing agency to overcome the defects in the system of financing foreign trade. Accordingly, the Government of India have established the Export-Import Bank of India in 1982 to provide necessary banking and non-banking services to the foreign trade of our country. The bank undertakes many activities for promoting foreign trade. It has introduced various schemes to promote exports of our country.

20.7 CHECK YOUR PROGRESS: MODEL ANSWERS

1. The functions of exchange banks are:

   i) Financing export trade,

   ii) Financing import trade,

   iii) Financing other operations relating to foreign trade,

   iv) Undertaking Commercial banking functions, such as acceptance of deposits, granting of loans and advances, etc.

20.8 MODEL EXAMINATION QUESTIONS

A. ESSAY QUESTIONS

Answer the following in about 30 lines each:

1. What are the criticisms levelled against the working of exchange banks in India ? Suggest measures to improve their performance.

2. Explain the objectives and significance of Export-Import Bank of India.

B. SHORT QUESTIONS

Answer the following in about 15 lines each:

1. Explain the export promotion schemes of EXIM Bank of India.

2. What are the commercial banking functions performed by exchange banks ?

3. What are the financial functions of exchangae banks relating to foreign trade ?

4. What do you understand by exchange banks ?
5. How the Indian exporters were helped before 1982 ?
6. Mention the measures taken for export promotion in India.
7. What are the reasons for limited participation of Indian Commercial Banks in the foreign trade ?

20.9 RECOMMENDED BOOKS

1. Joshi N.C.	: 'Indian Banking '
2. Panandekar S.G.	: 'Banking in India'
3. RBI	: 'Report on Currency and Banking '

20.10 GLOSSARY

Exchange Banks	: The banks that specialise in financing foreign trade. In India they are called foreign exchange banks since, they are incorporated outside India.

UNIT-21: CO-OPERATIVE BANKS

Contents

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21.1 Introduction
21.2 Origin and Growth of Co-operative Movement in India
21.3 The Co-operative Credit Structure
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21.3.2 Central Co-operative Banks
21.3.3 State Co-operative Banks
21.4 The Co-operative Banks and the Reserve Bank of India
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21.6 The Land Development Banks
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21.6.3 Working of Land Development Banks
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21.0 AIMS AND OBJECTIVES

The aim of this unit is to explain the Co-operative Banks and Land Development Banks and their working.

By the end of this unit, we expect you to be able to :

- describe the Co-operative Credit Structure;
- explain the functions of Co-operative Banks;
- visualise the future of Co-operative Banks;
- describe the Land Development Banks and their structure;
- examine the working of Land Development Banks.

21.1 INTRODUCTION

Lack of adequate and cheap sources of finance has been one of the reasons for the depressed condition of Indian agriculture. Since independence, many steps have been taken to remove some of the weaknesses so as to increase the credit facilities necessary for the rural sector. The co-operatives have been assigned a special place in the process of restructuring the rural sector. The Reserve Bank of India and State Bank of India have been given a special role to play in this field. Since 1969 the nationalised banks also have entered the rural credit field in a big way. The Agricultural Refinance and Development Corporation was set up in July 1963 to provide finances for various projects in the rural areas.

The commercial banks and co-operative banks are two wings of the organised banking structure of any country. The operations of the commercial banks are mostly confined to the organised industrial and commercial sector, while the co-operative banks are primarily engaged in providing credit facilities to the agricultural sector.

The State and Central Co-operative Banks provide financial assistance to agriculture through Primary Co-operative Societies. The Co-operative Urban Banks cater to the needs of artisans, petty traders and businessmen. These institutions together constitute the Co-operative Banking System. Besides, there are land development banks which provide long term credit for agriculture. As a matter of fact the land development banks do not strictly fall within the scope of the legal definition of banking. However, they are organised as an integral part of the co-operative banking system, because they play a vital role in the development of agricultural and allied activities.

This unit explains the working of these banks in detail.

21.2 THE ORIGIN AND GROWTH OF CO-OPERATIVE MOVEMENT IN INDIA

Before discussing the functions of co-operative banks it is essential to examine, in brief, the origin and growth of the co-operative movement in India. The evolution of co-operative movement in India may be traced back to the beginning of this century. The movement was started with the objective of providing finances to agriculturists at lower rates of interest and thus relieve them from the clutches of the village money lenders. The Co-operative Societies Act, 1904 provides for the formation of the co-operative credit societies. Under the Act a number of small primary credit societies were started in several parts of the country. But they could not mobilise the resources consistent with the growing demand of members for loans. Consequently, the new Act called the Co-operative Societies Act, 1912 was passed. It provided for the establishment of Central Co-operative Banks with headquarters in urban centres. The Co-operative Central Banks were formed by the unions of primary credit societies and individuals and industrial units. The main functions of these banks are:

i) to pool the surplus resources, if any, of the member socities.

ii) to raise deposits from the public.

iii) to use the resources for lending to the needy societies to meet their growing requirements.

iv) to provide the managerial skills required in the management of banking business ; and

v) to supervise and guide the affiliated societies.

In 1914 the Government appointed the Maclagon Committee on co-operative credit to examine the progress in the co-operative movement in India and to make appropriate recommendations for its improvement. This committee recommended the establishment of state level federations of Central Co-operative Banks called the State Co-operative Banks. These banks function as the leaders of the Co-operative credit structure for the whole state. Thus every state has established a State Co-operative Bank to function as the Apex Bank of the co-operative sector.

21.3 THE CO-OPERATIVE CREDIT STRUCTURE

As explained above the Co-operative Banking in India has come to be developed with a three tier system with the State Co- operative Banks at the state level; the Central Co-operative Banks at the intermediate level located at the district headquarters; and primary credit societies at the base level which cover small towns and villages.

The primary credit societies lend money to villagers at lower rates of interest. They supplement their funds by borrowing from the Central Co-operative Bank either directly or through the banking unions where such unions exist. The banking unions or federations of primary co-operative societies act as a link between the primary societies and the central co-operative banks. The Central Co-operative Banks get their funds from the Apex Banks or Reserve Bank or Commercial banks. The Apex Banks i.e., the State Co-operative Banks obtain funds through share capital, deposits and loans from commercial banks, RBI and the Government. This three - tier system of co- operative banks has been found to be an ideal set up in India to cater to the credit needs of the rural poor. It has the advantage of decentralisation by operating through the small units at the base and involving the local leadership. The bigger units at the higher level can command the status required to mobilise resources, extend necessary credit support and affect recovery of dues.

21.3.1 PRIMARY CREDIT SOCIETIES

The primary co-operative society is an organisation of persons living in a particular locality. It can be started with ten or more persons normally belonging to a village. The membership is open to all those residing in that locality or village, irrespective of their status.

Each member contributes to the share capital of the society. The sale price of each share is generally nominal so as to enable even the poorest farmer to become a member. The liability of each member is unlimited, that is each member is fully responsible for the entire society, in the event of its faliure. This makes it obligatory on all members to know each other well. The principle of unlimited liability is a check on the activities of the borrowers and the purpose for which loans are borrowed from the society and their utilisation. The society is managed by an honorary secretary and a president assisted by the Board of Directors. All these officials are elected from among the members on the principle of one man one vote.

The society gets its funds from share capital, reserve fund, deposits, loans from members and non-members, funds from Central and State Co-operative Banks. The loans given are for a short period for carrying on agricultural operations, and the rate of interest is fixed (about 6%). Dividends are not declared and profits are generally used for the welfare and development of the village.

The number of primary co-operative societies has declined from 1.08 lakhs in 1951-52 to 0.95 lakhs in 1980-81. This was due to reorganisation of these societies. However, the membership has increased from 4.8 lakhs in 1951-52 to 54.14 lakhs in 1980-81 i.e., a growth of more than ten times during a period of about three decades. There was also a phenomenal increase in the loans due from the members. During 1951-52 to 1980-81, the loans due from members, increased from Rs.34 crores to Rs.2,912 crores. Inspite of this impressive progress the primary societies have continued to remain as the weakest organ within the co-operative banking structure. The reasons are as follows:

i). They could not extend adequate financial assistance to the farmers and this led to the dependence of farmers on money lenders for short-term loans.

ii). Since the resources of these societies are meagre, they were unable to meet even the basic needs of the members.

iii). There was an alarming increase in the rate of over dues of the members. The study team on over-dues of co-operative credit institutions found that the over-dues of the members of the primary societies exceeded their own funds and deposits put together. The over-dues of the societies were of the order of Rs. 972 crores at the end of 1981 (June) constituting 44% of outstandings.

21.3.2 CENTRAL CO-OPERATIVE BANKS

The central co-operative banks are federations of primary credit societies in a specified area, normally; a district. They are usually located in the district headquarters or prominent towns in the district. These banks can have some private individuals also as members. Such banks are called mixed type central banks. These banks are based strictly on co-operative principles while the mixed banks do not strictly adhere to such principles. However, the mixed type banks have an advantage of getting funds from private individuals also. But the disadvantage is that the private individuals use the funds for trading purposes and thereby vitiate the purpose of loan which is agricultural credit. These banks obtain their funds from the sources such as share capital, reserves, deposit from public, and loans from the State Co-operative Banks. They also borrow from R.B.I. and commercial banks. Besides, the deposits of the primary credit societies form another source of funds for the Central Banks.

The main function of the central co-operative banks is to finance the primary credit societies and thereby enable the latter to extend financial assistance to the persons in rural areas. These banks play a useful role in attracting funds from the general public and using them for agricultural purposes. They also recover surplus funds of the primary credit societies and make them available for other needy societies. In addition to these functions, the central co-operative banks carry on commercial activities such as acceptance of deposits, giving loans and advances against security of first class gilt-edged securities, fixed deposits, gold, documents of the goods, collection of their bills, cheques and hundis, receiving of valuables from customers for safe custody, etc.

During 1951-52 to 1980-81 there has been a reduction in the total central co-operative banks, from 509 to 337. This was due to the merger of weaker banks with stronger banks but the share capital and loans have increased steadily. All the central co-operative banks put together had share capital and reserves of Rs.591 crores and deposits of Rs.1968 in 1980-81. The total loans issued was to the tune of Rs.3,020 crores. The loans outstanding were Rs.2,591 crores in 1980-81 as against Rs.36 crores in 1951-52.

21.3.3 STATE CO-OPERATIVE BANKS

The State Co-operative banks, also known as Apex Banks form the highest financial institution in the entire co-operative credit structure. The state co-operative bank may be pure or a mixed bank. It is said to be pure if it is a federation of Central Co-operative Banks. It is a mixed bank if its members consist of both the central co-operative banks and individual share holders. The State Co-operative banks finance, co-ordinate and control the working of the central banks. They serve as a link between the Reserve Bank of India and the general money market on the one hand and the Central Co-operative Banks and primary co-operatives on the other.

There is no co-operative bank at the all-India level. But there is an Indian Co-operative Banks Association which co-ordinates the activities of the various state co-operative banks and renders its services to all the member banks. The agricultural credit department of the Reserve Bank of India maintains a close contact waith state co-operative banks. It collects and publishes very useful information regarding the co-operative movement in India.

The State co-operative bank derives its funds from its share capital and deposits. It receives current and fixed deposits from the members as well as the general public, the local boards, the municipalities, etc. It obtains loans from commercial banks and the Reserve Bank of India. A certain portion of the working capital is provided by the State Government.

The state co-operative bank acts as a balancing centre between various central banks in the state. The central banks are prohibited from dealing with each other directly. The excess funds of the central banks are directed to other needy central banks through the state co-operative bank. It has no contact with the primary credit societies. The central banks act as intermediaries between the state co-operative bank and primary credit societies.

The following table shows the progress of state co-operative banks in India during 1951-52 to 1980-81.

	1951-52 1980-81
Number	16 26
Own funds (Rs. in crores)	7.65 290
Deposits (Rs. in crores	21 1,140
Loans & overdrafts (Rs. in crores)	201,791

The above table reveals that there is a noticeable progress in respect of state co-operative banks in the country. The bank's own funds increased significantly during this period. Similarly the total deposits increased from Rs.21 crores in 1951- 52 to Rs. 1,140 crores in 1980-81.

CHECK YOUR PROGRESS - 1

Mention the sources of finance to Central Co-operative Banks.

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CHECK YOUR PROGRESS - 2

List out the three levels of Co-operative Banking in India.

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21.4 THE CO-OPERATIVE BANKS AND THE RESERVE BANK OF INDIA

In recent years the relationship between the cooperative banks and the Reserve Bank of India has been strenghtened. Co-operative banks can get direct accommmodation from the Reserve Bank by discounting agricultural and other eligible bills at concessional rates of interest. The regulatory powers of the Reserve Bank of India have been extended to the co-operative banks, through the enactment of the banking Laws (application to co-operative societies) Act 1965. Further, certain provisions of the RBI and Banking Regulation Act, 1949 extended to the State, Central and primary co-operative banks, have brought them under the direct control of the R.B.I. Consequent upon the amendment of the R.B.I. Act, the State Co-operative Banks have secured the status of scheduled banks. The extension of control by the Reserve Bank of India has enabled the State Co-operative Banks to enjoy the facility of tive banks to enjoy the facility of deposit insurance. The state co-operative banks can obtain refinance from the RBI for short-term and medium-term agricultural requirements of the small-scale and cottage industry within the co-operative sector. The R.B.I. extends the short-term and medium term loans at concessional rates of interest. By the end of 1980-81 the R.B.I. had sanctioned credit facilities to the tune of Rs.798 crores for seasonal and agricultural operations.

With a view to placing the infrastructure of agricultural credit under a separate national level bank, the National Bank for Agriculture and Rural Develoment "(NABARD)" has been established in 1982. It has become the apex of the agricultural credit structure at the national level, taking over the role of refinancing from the RBI.

21.5 THE FUTURE OF CO-OPERATIVE BANKS

The rural debt and investment survey by the R.B.I. in 1961-62 revealed that co-operatives provided 15 per cent of the agricultural credit. By the end of 1980-81 the agricultural credit provided by co-operatives was estimated at 1/3 of the requirement of the agricultural sector. Thus co-operatives became the largest single institutional agency for financing agriculture.

In recent years co-operatives have changed their banking policies to suit to the changing conditions on the agricultural front. Mechanisation of agriculture and modernisation techniques like high yieldig varieties of seeds, intensive irrigation facilities, multiple croping etc., have necessitated more credit for agricultural purposes. In the chanaging environment, co- operatives have to play a vital role in meeting the credit requirements of small and medium farmers. It is in this context that we should consider whether the existing three tier co- operative credit structure will be able to meet the needs of the farmers or any structural reforms are called for. Since the primary credit societies are in direct contact with the farmers, it is necessary to strengthen such societies. It is recognised that credit should be integrated with the supply of inputs and promotional and technical guidance and other services to the farmers.

The concept of a farmer service society has been evolved on the basis of the recommendations of the National Commission on Agriculture. When the nature and scope of the functions of the primary societies are enlarged it is appropriate that they should be viable units and should be managed by qualified and competent people. A step in this direction may be the amalgamation of some units so that they can discharge all these functions effectively.

The Three-tier system of co-operative credit institution was criticised on the ground that the cost of meeting credit is high and that there are many avoidable procedural delays. The primary socities cannot be dispensed with because of their close rapport with the farmers. The Apex organisation is needed in order to provide access to the money market and the Reserve Bank of India. In view of this it is only the Central Co-operative Banks that can be replaced by the branches of the State co-operative banks. The Reserve Bank appointed a study team for Kerala in 1973 to report on the need for the elimination of the central banks. The study team reported that if the central banks did not attain the requird level of performance within a period five years, they should be merged with the state co-operative banks. This practice was to be extended to the central co-operative banks in other states as well.

21.6 THE LAND DEVELOPMENT BANKS

Agriculturists need long-term loans to affect permanent improvements in their lands, such as the purchase of costly agricultural machinery etc., besides short-term and medium-term loans to carry on agricultural operations. The primary credit societies provide only short term and medium-term loans. In order to meet the long - term credit requirements of the agriculturists, the establishment of a separate institution has become necessary. The Land Development Banks (or land mortgage banks) were reorganised for the purpose of providing long-term credit to agriculturists. The first Land Development Bank was started in 1920 in Punjab, followed by one in Tamil Nadu in 1925. In the light of the experience gained in Punjab and Tamil Nadu, other states established land development banks. But the progress of the land development banks was observed to be very dis-satisfactory. These banks came to occupy an important place by providing long-term credit during the Second Five Year Plan. It was during the Second Five

Year Plan that the land development banks got the needed impetus. By the end of the Second Five Year Plan, all the states in the country had established Land Development Banks.

21.6.1 STRUCTURE OF LAND DEVELOPMENT BANKS (LDBs)

Land Development Banks may be federal or unitary in their structure. The federal type consists of one Central Land Development Bank and a number of primary land development banks. The unitary type consist of a number of Central Land Development Banks with branches spread over different areas. Under the federal system the Central Land Development Banks collect funds through the issue of debentures and pass them on to the primary land development banks, which in turn, finance the agriculturists. The central institution does not have direct contact with the customers.

The land development banks which are organised on co-operative lines do not aim at making a profit. Their main objective is to lend money at low rates of interest to farmers.

In some states there are branches of central land development banks or central co-operative banks which act as agents of central land development banks for financing individual members. In Madhya Pradesh, the state co-operative bank functions, as a central land development bank. In Andhra Pradesh, Maharashtra, and Kerala, there are a number of central land development banks and efforts are being made to integrate them into one unified bank for each state.

While the organisation of central land development banks is the same throughout the country except in Madhya Pradesh, there is a considerable diversity in the organisation below that level. For example, in states like A.P., Tamil Nadu and Karnataka, the units of operation at the Taluk level are primary land development banks. They advance loans to individual agriculturists from funds provided by the Central Land Development Bank. These primary land development banks are affiliated to the Central Land Development Banks.

However, in Andhra Pradesh these banks were merged with Co- operative Banks under the **'Single Window Co-operative Credit Delivery System'**. Under this system the Primary Credit Societies provide all types of loans, i.e., short-term, medium term and long-term, to the member-farmers.

21.6.2 FINANCES OF LAND DEVELOPMENT BANKS

The Land Development Banks derive funds from the share capital, resesrves and debentures. Debentures are the most important source. The debentures are issued for 20-25 years by Central Land Development Bank and carry a fixed rate of interest.

The banks issue two types of debentures: (i) ordinary debentures, and ii) rural debentures. In the case of the latter the period varies between 7 and 15 years. The banks create a regular sinking fund to repay debentures. The debentures are generally guaranteed by the state government regarding payment of interest and principal. These debentures are subscribed by the public, the co-operative banks, the LIC, etc.

21.6.3 WORKING OF LAND DEVELOPMENT BANKS

The land development banks grant loans on the security of agaraicultural property. Since the period of loans runs to 20- 30 years, the rules with regard to security are very rigid. The loans are granted against the first mortage of agricultural property. Generally the loan is given to the extent of 50the value of the property mortgaged. However, the maximum amount of loan given to an individual is limited to Rs.10,000 Rs.15,000. While granting a loan, the banks take into account not only the value of securities but also the integrity of the borrower and his repaying capacity.

The land development banks grant loans to farmers for a variety of reasons like improvement of land, liquidation of prior debts, purchase of costly machinery, sinking of wells, installation of pump sets, etc. Until recently, the farmers were taking loans from the land development banks mostly for the liquidation of earlier loans. Now there is a change and the loan is utilised for the purposes of production. Tlhe Reserve Bank of India has also insisted that the loans should be given for productive purposes only. However, the farmers today are engaged in a number of subsidiary activities which also contribute towards economic development. Keeping in view the changing trends, the land development banks are now providing finances to non-traditional activities such as dairy farming, poultry farming, piggery, sheep-rearing, sericulture, gobar gas plants, rural godowns, wesrehouses, market yards, etc.

21.6.4 CRITICISM LEVELLED AGAINST LAND DEVELOPMENT BANKS

One of the main criticisms againt Land Development Banks is that the rate of interest charged is generally very high, sometimes 10% or even more. This, however, is not a valid argument because the rate of interest of these banks depends upon the cost incurred by them to obtain funds from outside agencies.

It is pointed out that the banks abnormally delay the sanctioning of loans, sometimes for periods over a year. This redtapism is partly due to lapses on the part of the farmers and the illiteracy of the agriculturists. Incomplete loan applications, improper addresses etc., may also be cited as reasons for the delay in sanctioning loans.

The cumbersome procedure and overly rigid rules of banks are oftendistressing to farmers and force them to resort to money lenders for financial assistance. This drawback can be overcome by educating agriculturists and by creataing an atmosphere in which they can fully appreciate the difficulties of banks.

It is also pointed out that instalments are fixed without regard to the repaying capacity of loanees. Rescheduling of advances are not made even in genuine cases of deafault arising from natural calamities such as droughts and floods.

The banks do not have expert and competent technical staff to properly assess the value of the land and go into the technicalities involved in sanctioning loans. It is true that the managerial, organisational and procedural improvements in the banks are urgently called for.

Judged from the point of view of overdues, the performance of land development banks has been very disappointing. Overdues have been mounting during the past few years. The absence of effective supervision, the inability of banks to make a correct estimate of the cost of a project, etc., have been listed as the basic reasons for huge defaults.

CHECK YOUR PROGRESS - 3

List out the main objective of Land Development Banks. And give their structure.

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21.7 THE LAND DEVELOPMENT BANKS AND THE RESERVE BANK OF INDIA.

The Reserve Bank of India provides long-term credit for agriculture by purchasing the debentures of land development banks. The Reserve Bank of India has recognised the debentures of land development banks fully guaranteed by the state government in respect of repayment of intaerest and principal. The long duration debentures of 12-15 years issued by the land development banks are taken by the Reserve Bank of India. The contribution of the Reserve Bank of India is around 8-15 percent of the total amount of debentures issued by the land development banks. The Reserve Bank purchases these debentures at lower rates of interest. The total involvement of the Reserve Bank of India in the ordinary and rural debentures floated by land development banks was Rs.6.90 crores and Rs.6.04 crores respectively as on 30th June, 1981.

During the Sixth Plan period (1980-85) land development banks are expected to reach the target of Rs.2,300 crores of loans to agriculturists. The most important single purpose of this provision is to develop minor irrigation. Besides, the banks are to take up diversified lending for other equally important purposes, some of which are subsidiary to agriculture. With the launching of the integrated rural development programmes, the emphasis will be not only on raising production but also on helping the farmers to supplement their income by taking up other subsidary occupations.

21.8 SUMMING UP

In India the Co-operative movement was started with the objective of providing finances to agriculturists at lower rates of interest and thereby relieving them from the clutches of money lenders. The Co-operative banking which provides short-term and medium term agricultural credit has a three-tier structure. The three-tier is formed by primary credit societies at base organised at village level, Central Co-operative Banks at district level and State Co-operative Banks at state level. The Primary Societies mainly get funds from Central Banks and lend to the members. The Central Co-operatives Banks are federations of primary societies and their main function is to finance the primary credit societies. The main source of funds for these banks are loans from the State Co-operative Banks, share capital and deposits. The State Co-operative banks, being at the apex level, finance, co-ordinate and control the working of the Central Co-operative Banks. These banks mainly derive funds from its share capital, deposits and loans (refinance) from the RBI. The RBI has the regulatory powers over the Co-operative Banks in the country.

The Land Development Banks were established to meet the long term credit requirements of the agriculturists. These banks derive funds from the share capital, reserves and debentures and grant long-term loans for a variety of purposes like, improvement of land, sinking of wells, installation of pumpsets, etc. The RBI provides long term credit to these banks by purchasing their debentures. There is also some criticism on these banks. The important grounds on which they were criticised are : delay in the sanction of loans, lack of expert and technical staff and high overdues.

21.9 CHECK YOUR PROGRESS : MODEL ANSWERS

1. The sources of finance for Central Co-operative Banks are : share capital, reserves, deposits from the public, deposits from the primary societies, loans from the state co-operative banks and borrowaings from the RBI and commercial banks.
2. The three-tier structure of Co-operative banking in India consists of :

   i) state Co-operative Banks at the State level (apex level),

   ii) Central Co-operative Banks at the district level (intermediary level), and

iii) Primary Credit Societies at the Village level (base level).

3. The function of land development banks is to provide long term loans to the farme rs at low rates of interest. Their structure may be federal or unitary. The federal type consists of one central land development bank and a number of primary land development banks. The unitary type consists of a number of central land development banks with the branches spread over different areas.

21.10 MODEL EXAMINATION QUESTIONS

A. ESSAY QUESTIONS

Answer the following in about 30 lines each:

1. Discuss the existing Co-operative Credit Structure. What suggestions would you offer to make it more effective?
2. Explain the role of Land Development Banks in providing long term credit to agriculturists. Offer some suggestions to improve their working in the light of the criticism levelled against them.
3. Bring out the significance of Co-operative Credit in agricultural development. What measures have been taken by the RBI to strengthen the Co-operative Credit System ?

B. SHORT QUESTIONS

Answer the following in about 15 lines each:

1. The Primary Credit Societies are the nerve centres in the Co- operative Credit Structure. Explain.
2. What future do you visualise for the co-operatives in India.
3. How does the RBI help the Land Development Banks in providing credit to the agriculturists.
4. Explain the structure of Land Development Banks.
5. Do you think that the Co-operative Central Banks form an unnecessary link in the three-tier system? Briefly substantiate your view point.

21.11 RECOMMENDED BOOKS

1. Choubey B.N. : Principles and Practice of Co-operative Banking in India.
2. Laud G.M. : Co-operative Banking in India.
3. Nakkiran S. : Co-operative Banking in India.

21.12 GLOSSARY

Land Development Banks : The Co-operative Banks which provide long term credit to agriculturists.

Primary Credit Society : The Co-operative organisation at the base level of the co-operative credit structure which provide short-term and medium term credit to agriculturists.

'Single Window Co-operative Credit Delivery System' : It is a system in which the Primary Agricultural Co-operative Society will provide all types of loans (short-term, medium-term and long-term loans) and other services to its member-farmers.

UNIT-22 : REGIONAL RURAL BANKS

Contents

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22.3 Capital Structure
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22.0 AIMS AND OBJECTIVES

This unit aims at explaining the establishment of Regional Rural Banks (RRBs) and different aspects relating to there of.

After going through this unit, you will be able to :

- describe the establishment of RRBs;
- explain the capital structure;
- list out the objectives and characteristics of RRBs;
- describe the credit policy of RRBs;
- evaluate the performance of RRBS; and
- discuss the problems faced by RRBS.

22.1 INTRODUCTION

The rural sector is the backbone of our economy because nearly 70 per cent of our population lives in villages. Rural income, derived mainly from agriculture, plays a significant role in the national income. Agriculture needs huge finances for its development and modernisation. The planning policy of the Indian Government has been to develop and resconstruct villages, but the lack of credit is one of the main problems of rural resconstruction.

The foundation of the institutional credit structure in rural India was laid with the organisation of co-operative credit societies. The co-operative credit structure, could not keep pace with the growing demand for institutional credit with the rise in demand for agricultural credit. Commercial banks were, therefore, inducted into the field of agricultural credit under the policy of 'social control over banks' in 1968, and the subsequent nationalisation of 14 major commercial banks in 1969 carried the process further. Rural branches of commercial banks expanded greatly after nationalisation. As against 1,833 branches in the rural areas in June, 1969 there were as many as 6,697 branches in March, 1975. Direct lending from commercial banks to agriculture which was Rs.54 crores in June, 1969 rose to Rs.540 crores by December, 1974. This increase in the direct lending of commercial banks to agriculture was commendable. But a long distance has still to be travelled and there is much more to be achieved. Thus the need for the establishment of another agency to provide credit for rural development was experienced.

In this unit we first explain you the establishment, capital structure, management, objectives, characteristics and credit policy of RRBs. Later their performance is described and problems are discussed.

22.2 ESTABLISHMENT OF REGIONAL RURAL BANKS

The Government of India set up a committee under the chairmanship of Shri M. Narasimham to examine the issue of establishing a new agency to provide credit in the rural areas.

The Committee observed that commercial banks had two major difficulties in serving the rural population namely (a) their high cost structure in operating in the rural areas, and (b) their attitudinal character. Therefore there was a need for an institution which could combine the local knowledge and familiarity of rural problems, which the co-operatives possess with the degree of business organisation, ability to mobilise deposits, access to money markets and a modernised outlook, which the commercial banks have. The committee was of the view that the existing institutional credit agencies, as they were structured, would not be able to fill the regional and functional gaps in the rural credit institutional system within a reasonable period of time even with such adaptation, recognition and restructuring as they be incorporated. It is against this background that the committee suggested the establishment of Government owned regionally based and rurally oriented banks to supplement and not supplant, the existing institutional credit agencies.

The committee suggested that in selected areas where (i) neither the co-operative nor commearcial banks have been able to make much impact, (ii) there is considerable scope for mobilising deposits, and (iii) meaningful rural development has to be effected, a few rural banks may be set up initially. It considered that about 50 per cent of the business of regional rural banks (RRBs) should consist of small loans and that they should also extend finance for rural industry and trade. The committee also recommended that one of the more important objectives of the rural banks should be to attempt effective coverage of small and marginal farmers, landless labourers, rural artisans, etc.

The recommendations of the Narasimham committee were accepted by the Government of India. Accordingly, the Regional Rural Banks Ordinance of 1975 was promulgated by the President of India on the 26th September, 1975 which was subsequently replaced by the Regional Rural Banks Act of 1976. Consequently, RRBs were established by the Government from October 2, 1975.

22.3 CAPITAL STRUCTURE

The authorised capital of each RRB shall be rupees one crore, which the Central Government may increase or decrease in consultation with Reserve Bank of India and the sponsoring banks, subject to a minimum of Rs.25 lakhs. The issued capital of each RRB shall be Rs.25 lakhs, of which 50 percent shall be subscribed by the Central Government, 15 percent by the concerned State Government and 35 percent by the sponsoring bank. There is a provision for an increasae in issued capital by the Board of Directors of the RRB after consultation with the Reserve Bank and the sponsoring bank and with the prior approval of the Central Government. The shares of RRB shall be treated as trustee securities for the purposes of Section 20 of the Indian

Trusts Act, 1882, and shall be treated as approved securities for the purpose of the Banking Regulation Act of 1949.

22.4 OBJECTIVES

The main objectives of RRBs have been to-

i) help the development of agricultural and other rural activities through providing credit and other facilities, particularly to small and marginal farmers, agricultural labourers, artisans and small entrepreneurs, in reasonable time and at reaasonable terms;

ii) provide alternative sources of credit to the rural poor to free them from the clutches of money-lenders;

iii) meet the growing needs of the rural poor and backward sections of society;

iv) provide employment opportunities and develop entrepreneurship; and

v) combine the business goals of the rural areas with social obligations.

CHECK YOUR PROGRESS - 1

Mention the main objectives of RRBs.

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22.5 LOCATION

The location for RRBs is to be decided upon very carefully. Certain norms have been set up for this purpose:

1. The area should be a relatively backward or tribal area.
2. The new bank is to be established where co-operative banks are not active.
3. There should be no branch of the commercial bank in the area.
4. The area should have the potential for providing a break through in development.

22.6 CHARACTERISTICS

The chief characteristics of RRBs are as follows:

1. RRBs grant loans and advances, particularly to small and marginal farmers, agricultural labourers, rural artisans, small entrepreneurs and persons of small means engaged in trade and commerce and other productive activities in the area of operation.
2. They have a limited geographical coverage.
3. They charge a lower interest on advances than the prevailing lending rates of co-operative societies in the area and also pay an interest of 0.5 per cent more on deposits.

4. The salary structure is lower than that of commercial bank employees and is at par with that of the employees of the State Government concerned.

5. They get assistance from the Reserve Bank of India.

6. RRBs are permitted to lend 1 crore for every Rs.15 lakhs of their own deposits.

22.7 CONCESSIONS TO RRBs

The RBI has been offering some concessions and exemptions to the RRBs as against the scheduled commercial banks. They are: i) reduction of cash reserve ratio from 6% to 3%, and ii) exemption of deposit of 10% of incremental demand and time liabilities.

The RRBs have been availing the refinance facility offered by the RBI under the refinance scheme initiated on October 1, 1976. During the year 1980-81, refinance limits aggregating Rs.119.64 crores were sanctioned to 52 RRBs and the amounts outstanding against these limits at the end of June, 1981 totalled Rs.111.4 crores. For the year 1981-82 limits aggregating Rs.135.92 crores have been sanctioned to 66 RRBs. Reserve Bank of India enables those RRBs whose deposits are more than Rs.5 crores at the end of March, 1981 not only to achieve the main objective of widening the credit coverage of weaker sections of society but also to earn more income by refinance facility.

22.8 CREDIT POLICY OF RRBs

The credit policy of the RRBs including the terms, conditions, requirements of security and legal formalities, have been liberalised. It is no longer necessary to mortgage property or deposit title deeds. There is no need for a borrower to produce a 'no encumbrance' certificate or obtain legal opinion in this resgard. All that the bank insists upon is a group guarantee, consisting of three borrowers. The borrower is also exempted from stamp duty.

The bank has dispensed with all these time consuming formalities, as it intends to help small borrowers. The bank has minimised the need for the borrower to visit its branch more than once for the grant of a loan. The banker selects the borrower in the village itself. (In the case of commercial or co-operative banks, the borrower has to make a number of visits to the bank). The bank grants the loan only to borrowers who produce a 'no dues' Certificate from other Government or public sector institutions to avoid duplication of granting loans.

RRBs were directed to charge interest at the rate of 9 per cent on specified loans granted to primary societies and Farmers Service Societies (FSS) with effect from March 1,1979. This was reduced to 8 per cent in the same month in respect of term loans to small farmers for minor irrigation land development and other diversified purposes.

22.9 EVALUATION OF PERFORMANCE

The performance of RRBs is evaluated under the following heads:

i) Number of Banks

The scheme of setting up of RRBs was started in October, 1975 with only five RRBs but later the number had increased to 11 by March 12, 1976. During the following year (upto June, 1977) as many as 48 RRBs had been set up. In pursuance of the new economic policy of the Government of India, which laid down that the scheme of RRBs should be revived, 29 RRBs were set up during the year 1980-81. The total number of RRBs instituted by the end of June, 1981 were 102 covering 172 districts spread over 18 states. At the end of June, 1983, there were 142 RRBs covering 247 districts. The programme under the Sixth Five Year Plan is to increase the number of RRBs to 170 covering about 270 districts by March 1985. The performance of this scheme in the establishment of number of RRBs is significant compared to that of other financial agencies in the country.

ii) Deposits

Deposits per RRB (on an average) increasaed significantly from Rs.3.32 lakhs in 1975 to Rs.88.74 lakhs in 1978. They further increased to Rs.172.38 lakhs in 1979.

On the whole, deposits of all RRBs increased from Rs.20 lakhs in 1975 to Rs.756 lakhs in 1976 and they continuously increased to Rs.9,826 lakhs in 1979. Further deposits of 132 reporting RRBs aggregated to Rs.518 corres by the end of June, 1983 as against Rs.381 crores by the end of June, 1982 in respect of 114 RRBs.

iii) Advances

Total advances granted by all RRBs rose significantly from Rs.10 lakhs in 1975 to Rs.747 lakhs in 1976 probably due to a significant rise in number of banks and their branches. Advances further continuously boosted upto Rs.17,306 lakhs in 1979. Consequently the credit deposit ratio increased from 50 percent in 1975 to 176.12 per cent in 1979. This credit deposit ratio of RRBs is much higher than that of commercial banks. Total advances of 132 reporting RRBs aggregated to Rs.624 crores by the end of June, 1983 as against Rs.466 crores by the end of June, 1982 in respect of 114 RRBs.

Small and marginal farmers and agricultural labourers received a major share in the total advances sanctioned by RRBs as the share of this category of borrowers in total advances varied between 61 percent and 65 percent. The share of rural artisans and others in total advances varied between 32 per cent and 35 per cent and the share of indirect advances in total advances ranged between 3 and 6 per cent during 1977 and 1979. The share of the weaker sections in total credit was raised to 91 per cent by the end of June, 1982.

iv) Implementation of the 20-Point Programme

Since RRBs have been specially established to cater to the credit needs of the weaker sections who form the main beneficiaries under the New 20-Point Programme, their entire lending is towards purposes is dentified under the programme. Even so, they have been specifically advised to involve themselves more vigorously in the implementation of various schemes under the Programme.

v) Refinance Facilities from NABARD

With the formation of the National Bank for Agriculture and Rural Development (NABARD on July 12, 1982, the RRBs commenced availment of the short-term refinance facility from NABARD (earlier it was from RBI as per the scheme introduced in October, 1976). During 1982-83 (June-June) limits aggregating Rs.227 crores were sanctioned to 97 RRBs. The amount drawn against these limits, and remaining outstanding at the end of June, 1983, was Rs.189 crores. In the previous year, refinance was sanctioned to 82 RRBs to the tune of Rs.177 crores against which availment was to the extent of Rs.162 crores. RRBs made further progress in availing long term refinance from NABARD (earlier from ARDC). At the end of June, 1983, 458 schemes were sanctioned involving a NABARD commitment of Rs.177 crores.

With its establishment, NABARD assumed the responsibility for laying down policies for RRBs, overseeing their operations and attending to the problems faced by them. All work relating to the establishment of RRBs, administration of refinance scheme, formulation of appropriate operational policies for RRBs, monitoring their performance, and the statutory inspection of RRBs is undertaken by NABARD.

Due to their inability to prepare bankable schemes conforming to the technical and other norms prescribed for the purpose. RRBs had not been making adequate use of long-term refinance facilities available earlier from Agricultural Refinance and Development Corporation (ARDC). In order to equip them with essential technical staff, NABARD has decided to provide them with assistance from its R and D fund for the employment of these technical personnel.

vi) Insured Status

Regional rural banks are registered as insured banks with the Deposit Insurance Corporation. All the deposits, upto Rs.20,000 per depositor in the same right and capacity in each bank, are, accordingly, insured with Deposit Insurance Corporation of India, thus providing protection to the depositors.

vii) Refinance Scheme for Regional Rural Banks

Regional rural banks shall be entitled to the facility of loans and advances under a scheme which came into force from 1st October, 1976. The total refinance limit for each regional rural bank is fixed on the basis of the prescribed formula at 15:50:35, indicating the proportion of regional rural bank deposits, the Reserve Bank of India refinance and the sponsoring bank's advances respectively in the aggregate lending programme of each regional rural bank. At present the refinance is provided at 2 per cent below the bank rate, i.e., 8 per cent per annum.

22.11 PROBLEMS

The problems faced by RRBS are discussed below:

i) Overdues

The main problem of RRBs is mounting overdues. The position of overdues in relation to demands raised in respect of all the RRBs is not available. At the end of December, 1982, the overdues of all the RRBs amounted to Rs.128 crores which formed 22.2 per cent of their total outstanding amount of Rs.577 crores. Overdues in the case of 40 RRBs which completed six years or more worked out to 24 per ceant. On the assumption that the amount of demand raised would be about half of the total loan outstanding, the recovery percentage would work out between 50 per cent and 55 per cent only. The position is likely to deteriorate in the years to come. It is necessary that the RRBs take special measures to reduce the overdues.

ii) Mounting Losses

Of the 107 RRBs, 42 RRBs incurred losses during the year 1981. What is more disturbing is that 11 RRBs which had completed five years or more at the end of 1981 had also shown losses. In the case of a few RRBs, the amount of accumulated losses had far exceeded the total amount of their paid-up capital. Such RRBs will find it extremely difficult to wriggle out of the situation. It is gathered that during 1982, a large number of RRBs have incurred losses.

This situation is likely to further worsen on account of : (a) increase in overhead expenses consequent upon the revision of staff salaries and allowances; (b) reduction in margin available to the RRBs on account of upward revision in interest rates on deposits with effect from 21st October, 1982, and reduction in lending rates with effect from 1st April, 1983; (c) revision of Reserve Bank of India's refinance scheme in terms of which the RRBs established earlier are required to provide a larger contribution out of their own resources toward their lending programmes; and (d) modification of the Deposit Insurance and Credit Guarantee Corporation Scheme requiring the RRBs set up in the previous four years or more to pay the usual guarantee fee, etc. This aspect has to be examined in detail and immediate steps taken to make the RRBs viable.

iv) Longer Gestation Period

On an analysis of the available data, it is observed that in the case of the RRBs set up after July, 1978, the gestation period has been longer as compared to the RRBs set up earlier. RRBs set up upto June 1977 had, on an average, recorded outstanding loans of over Rs.1.5 crores after two years of their establishment. However, in the case of RRBs set up in 1978 and afterwards, the outstanding loans, after two years of their establishment, were less than Rs. 1 crore. This appears to have resulted from (a) the selection of areas having insufficient potential in subsequent cases, and (b) the lack of enthusiasm on the part of concerned agencies in providing guidance and support to the more recent RRBs.

iv) Limited Channels of Investment

The RRBS have limited channels of investment, as compared to the commercial banks. Their lending is confined primarily to the weaker sections, and they earn interest ranging from 10 per cent to 11.5 per cent. On the surplus funds deposited by them in the current account with their sponsor banks,they get interest at 9 percent per annum, though, on deposits at call for over 60 days, they get interest at 11.5 per cent. On the other hand, they have to pay interest at 11 percent on term deposits maturing after five years or more. Thus, they lose heavily on such deposits after providing for overheads. The authorities should consider enlarging the scope of the lending activities of RRBs to other than small and marginal farmers. Suitable safeguards should, however, be taken to see that it is not at the cost of financing their target groups such as tractor and minor irrigation projects. This should be done particularly in such areas where the scope for lending to the presently defined target group of RRBs is limited.

v) Control and Monitoring

The general superintendence, direction and management of affairs and business of RRBs rest with their Board of Directors, consisting of nominees of Government of India, State Governments and the sponsor banks. The supervision and monitoring of the RRBs is done by NABARD and regulatory functions are looked after by the Reserve Bank of India. Decisions on broad policies regarding organisational matters, loaning policies, etc., are taken by the Steering Committee on RRBs, in many cases in consultation with the Government of India. State Level Co-ordination Committees (SLCCs) have also been formed to have a uniformity in approach to the different RRBs. Decisions in staff matters are taken by the Government of India on the recommendations of the SLCCs. In the matter of initial staff support training facilities, and refinance upto the prescribed extent, the RRBs depend upon the sponsor banks. The role of the sponsor banks and their responsibility in the development of RRBs have not been spelt out, but, in general, they are expected to provide general counselling and support to their RRBs and oversee their activities so that they are in a position to realise the goals. There is a feeling amongst the RRBs that they are being "controlled" by many agencies and dicisions on vital matters take a long time. It is desirable that roles of all the concerned agencies are clearly spelt out. Owing to the increase in the number of RRBs and nature of the problems faced by them, there is a need for a central agency to look after all issues related to them.

vi) Staff Resources

It has been observed that the extent and quality of staff support provided by the sponsor bank is inadequate particularly in the initial stages. Officers deputed by the sponsor bank may not always be the best available to hold administrative positions in the RRBs. The staff recruited by the RRBs are generally inexperienced and the training imparted to them particularly on the job training is not sufficient to prepare them to hold managerial positions independently. In the light of the nature of the work a Chairman of the RRB has to attend to the present incumbents, particularly those belonging to the middle management grade, are not capable of shouldering the responsibility placed on them. They lack the experience and maturity required for heading the RRB. It is necessary that the RRBs are headed by senior and competent officials.

In many States, the staff turnover of RRBs is quite high. They treat RRBs as a stepping stone for other services or as a stop-gap arrangement as long as they do not get employment elsewhere. In the absence of any promotion policy for officers, the RRBs have not been able to build up a suitable care of their own to attend to control functions at their administrative offices or look after bigger branches. Of late, unions in RRBs have raised demands for parity in salary, allowances and other monetary benefits with commercial banks. In the absence of a proper dialogue with RRB unions, resentment and frustration among the RRBs staff is growing. The Government of India/NABARD should discuss these issues with the unions and decide if they are feasible within the broad framework of RRBs. It may, however, not be possible for the RRBs to pay to their staff salaries and allowances at par with the commercial banks, for their viability would be geopardised by it.

vii) Other Problems

RRBs have been facing some problems in mobilisng deposits, for which they offer a high rate of interest. The banks are facing embarrassment from the potential depositors, mostly farmers owning more than five acres as they are not served by the banks.

Due to the liberalisation of the terms and conditions there are many villagers seeking loans. The problem that the branches of the RRBs are facing now is that they are unable to refuse help to the villagers.

Another problem is the lack of adequate infrastructural facilities in rural areas.

Review Committee's View

The Review Committee appointed by the Reserve Bank of India has come out strongly in favour of continuing the RRBs. The Comnmittee has pointed out that the agricultural credit of the commercial banks has not helped to bridge the geographical gap in the availability of credit not covered by co-operatives. The support of this Committee for RRBs can be seen from the following statement: "The superiority of RRBs as an agency of rural credit over the rural branches of commercial banks is derived from its low cost of operation, its simplicity and low profile, local participation in management, familiarity of the local staff, and the close association of district level agriculture and rural development agencies".

CHECK YOUR PROGRESS - 2

List out the problems faced by RRBs.

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22.12 SUMMING UP

The Co-operatives and Commercial banks could not meet the growing need for the institutional credit in the rural areas. To meet this demand the RRBs were established on the recommendation of Narasimham Committee. The capital of these banks is subscribed by the Central Government (50 per cent), the State Government concerned (15 per cent) and the sponsoring bank (35 per cent).

The main objective of RRBs is to provide credit and other facilities, especially to the small and marginal farmers, agricultural labourers and small entrepreneurs in the rural areas. These banks are generally located in the backward areas. They get financial assistance from the RBI and provide loans at lower rates of interest than co-operative societies. These banks are also availing certain concessions provided by the RBI. These banks grant loans on liberalised terms and conditions. It is not necessary on the part of the borrowers either to mortgage property or deposit title deeds.

The RRBs made a significant progress in terms of expansion of branches, mobilisation of deposits granting of loans, availing refinance facility from the NABARD, etc. These are facing certain problems. The important of them are, increasing overdues, limited channels of investment and lack of experienced staff.

22.13 CHECK YOUR PROGRESS : MODEL ANSWERS

1. i) to develop the rural economy by providng credit for the purpose of developing agriculture and allied activities, credit and other facilities particularly to small and marginal farmers, agricultural labourers, artisans and small entrepreneurers.

   ii) to meet growing needs of the rural poor and backward sections of the society.

   iii) to provide employment opportunities and develop entrepreneurship.

2. The problems faced by RRBs are :

   i) increase in overdues

   ii) accumulation of losses

   iii) limited channels of investment

   iv) control by many agencies

   v) lack of experienced staff.

22.14 MODEL EXAMINATION QUESTIONS

A. ESSAY QUESTIONS

Answer the following in about 30 lines each:

1. Describe the establishment and progress of Regional Rural Banks.
2. Discuss the main problems faced by Regional Rural Banks. Suggest measures to minimise them.

B. SHORT QUESTIONS

Answer the following in about 15 lines each:

1. How is the credit policy of Regional Rural Banks liberalised?
2. Explain the capital structure of Regional Rural Banks
3. What are the objectives of Regional Rural Banks ?
4. What are the recommendations made by the Narasimham Committee
5. List out the characteristics of Regional Rural Banks.
6. Explain the factors that influence the location of a branch of RRB.

22.15 RECOMMENDED BOOKS

Desai S.S.M. : Rural Banking in India

Panandekar S.G. : Banking in India

Joshi N.C. : Indian Banking

22.16 GLOSSARY

Regional Rural Banks : The Banks which are established with the objective of extending credit and other banking facilities, especially to the small and marginal farmers in the rural areas.

Sponsoring Bank : The public Sector bank which sponsers a Regional Rural Bank.

UNIT-23 : LEAD BANK AND OTHER ALLIED SCHEMES

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23.1 Introduction
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23.7 Summing Up
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23.9 Model Examination Questions
23.10 Recommended Books
23.11 Glossary

23.0 AIMS AND OBJECTIVES

The purpose of this unit is to discuss the concept, functions and progress of Lead Bank Scheme and other allied schemes.

By the end of this unit, you will be able to:

- explain the Lead Bank Scheme;
- identify the functions of Lead Bank;
- describe the progress of Lead Bank Scheme;
- explain the Small Farmers' Development Agency;
- list out the objectives of Marginal Farmers' and Agricultural Labourers, Agencies and Farmers' Service Societies; and
- describe the Differential Interest Scheme.

23.1 INTRODUCTION

With the intension of extending banking facilities to rural areas, the Lead Bank Scheme was introduced. And different schemes were formulated with the object of helping the small farmers and weaker sections of the society. These schemes are explained in this unit.

23.2 LEAD BANK SCHEME

A study group under the Chairmanship of Prof. D.R. Gadgil was appointed by the National Credit Council to report on "the organisational framework for the implementation of social objectives'. This group has recommended the 'area approach method' in the preparation of plans and programmes for the development of banking and credit structure. Under this area approach method the Reserve Bank of India introduced the 'Lead Bank Scheme' in December, 1967. Major territorial and functional gaps were identified by the study group. It also identified uneven spread of banking offices and banking business in different states and population groups with pronounced urban orientation. This study group also observed the flow of resources from rural to urban areas and from small population centres to large population centres. The study group also observed the flow of resources from rural to urban areas and from small population centres to large population centres. The study group pointed out uneven distribution of credit to certain types of borrowers. Hence the study group suggested that local condition should be taken into consideration in preparing plans for the extension of credit and banking facilities. Thus the study group recommended the adoption of the area approach method for the formulation of plans and programmes for the development of banking structure. Further it recommended that particular districts should be assigned to banks which may act as pace-setters for providing integrated banking facilities.

The Reserve Bank of India in August, 1969 appointed a Committee of bankers with Sri Nariman as Chairman 'to evolve a coordinated programme for ensuring the setting up of adequate banking facilities in the un-banked districts of the country'. The Nariman Committee recommended that the banks should be allotted specific districts where they would take the lead in surveying the potential of banking development in extending branches and expanding credit facilities. Reserve Bank of India formulated the Lead Bank Scheme basing on these principles. All the districts in the country have been allocated to the State Bank of India and its subsidiaries and to 14 Nationalised Commercial Banks and three private sector banks. Greater Bombay, Calcutta, Madras, Delhi, Chandigarh and Goa were not covered under this Scheme. In other words, almost the entire India except the above cities were covered by the Lead Bank Scheme.

Functions of Lead Bank

1) To survey the resources and potential for banking development in the district concerned.

2) To survey the number of industrial and commercial units and other establishments and farms, which don't have banking accounts or which depend primarily on money lenders.

3) To examine the facilities for the marketing of agricultural and industrial production, storage and warehousing facilities and linking of credit with marketing in the district.

4) To study the facilities for the stocking of fertilisers and other agricultural inputs and for the repair and servicing of equipment.

5) To recruit and train staff, who would offer advice to small borrowers and farmers and who would follow up and inspect the use of loans.

6) To assist other primary lending agencies.

7) To maintain contracts and liaison with the Government and Quasi-Government agencies.

8) To act as consortium leader and invite the cooperation of other banks operating in the district in mobilising deposits, locating actual and potential credit needs and catering for them.

Progress of the Lead Bank Scheme

The first phase of the programme consists of the completion of surveys for the identification of centres which have a potential for bank operations, and the opening of bank branches. Such surveys have been completed in almost all the districts.

In the second phase, area development programmes have to be formulated and implemented. Banks have so far prepared district credit plans for 377 districts. Those plans were launched in 359 districts by 30th June, 1978. The work relating to the preparation of credit plans for the remaining five districts was expected to be completed by 31st March, 1978.

On 20th December, 1979 the Lead Banks were advised by the Reserve Bank of India to terminate the then existing credit plans, and to prepare fresh plans for the period January, 1980

- December, 1982 along with the annual action plans for 1980. To ensure uniformity in the coverage of the second round of the credit plans, detailed guidelines were issued by the Reserve Bank to all the Lead Banks. Upto June, 1980 the District Credit Plans in respect of 357 out of 397 districts were prepared. As per the information received from all the head offices of Lead Banks, District Credit Plans have been launched in all the districts for the period 1983-85.

Working Group to Review the Working of Lead Bank Scheme

A working group to review the working of Lead Bank Scheme was set up in November, 1981. Some of the important things to be referred to by the group are:

1) To review the preparation and implementation of district credit plans and to suggest improvements for proper and effective coordination of activities among the various organisations participating.

2) To review the role of the 'Lad Banks' and to suggest measures to make them more effective and also to suggest measures to improve the organisational set up of Lead and Non-Lead Banks at the district and other levels.

3) To examine the role of the District Consultative Committee and Standing Committees and make suggestions for their more effective functioning.

The working group submitted its recommendations, which were accepted by Reserve Bank of India with minor modifications. Important among them are:

1. Reconstitution of the District Consultative Committee and Standing Committee for effective work.
2. Construction of the District Level Review Committee.
3. Appointment of separate district co-ordinators in Non-Lead districts.

CHECK YOUR PROGRESS -1

Identify the important functions of Lead Bank.

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23.3 SMALL FARMERS' DEVELOPMENT AGENCY (SFDA)

The All-India Rural Credit Review Committee (1969) recommended the establishment of the Small Farmers' Development Agency(SFDA). The main objective in establishing such an agency is to help those cultivators who have small yet potential, economically viable holdings. The small farmers have always been neglected by the unorganised as well as the organised sector of banking. Therefore, the establishment of the SFDA is a significant development in the field of rural finance, for it forms an important link in the chain of organised financial institutions through which money flows into the rural sector of the Indian economy.

SFDAs have been established in 46 selected districts, on a pilot basis. These agencies:

(a) identify small but potentially viable farmers in their areas;

(b) find out the problems of such farmers; and

(c) provide such farmers with institutional credit and inputs, and help them to improv their production capacity.

The SFDAs help potentially viable farmers in their areas in such a way that they achiev viability in 3 to 4 years. The schemes of these agencies are mostly production and cred oriented. Every SFDA is supposed to assist about 50,000 potentially viable farmers in irrigatio land-levelling, soil conservation, storage, marketing and customers' service facilities. For th 25 per cent of the assistance is in the form of a subsidy, the balance is a loan, mainly from cc operative credit institutions.

23.4 MARGINAL FARMERS' AND AGRICULTURAL LABAOURERS' AGENCIES (MFALA)

The Marginal Farmers' and Agricultural Labourers' Agencies have been established t help sub-marginal farmers and agricultural labourers. Marginal farmers with holdings of up t one hectare and agricultural labourers who earn more than 50 percent of their income fron agriculture, receive subsidised credit support for agriculture and subsidiary occupations unde this scheme. This subsidised-credit support is given for dairy-farming, poultry, fishery, piggery horticulture, etc. The MFAL schemes are based mainly in favour of employment and subsidiar occupations.

23.5 FARMERS' SERVICE SOCIETIES(FSS)

The National Commission on Agriculture (NCA), in its interim report in 1971, pointed ou that the problem of agriculture credit was primarily the problem of providing credit into variou agricultural inputs and services. To convert this idea into actual practice, the NCA said that;

(a) the integrated credit service should be available to small and marginal farmers and agricultural labourers, and

(b) the organisation should cover not only a complete range of agricultural activities but ancillary occupations and artisans, and offer various types of service to the agricultural sector.

In accordance with these suggestions, some Farmers' Service Societies have been organised in a few SFDA and MFAL areas by the commercial banks from 1973-74.

The basic objectives of the scheme of FSS are to offer the small farmers a full package of services and technical guidance instead of mere credit. By the end of June, 1976 there were 311 Farmers' Service Societies. Their number increased to 396 in March, 1977 out of which 181 were sponsored by commercial banks and 130 by co-operatives.

23.6 DIFFERENTIAL INTEREST RATES (DIR) SCHEME

For a long time, it was felt that lower interest rates should be charged for certain sectors of the economy which need financial assistance but cannot get it from banks because of higher interest rate. The Reserve Bank of India appointed a committee under the chairmanship of Dr.R.K. Hazari to examine the question of differential interest rates. The terms of reference of the committee were:

(i) to review the scope and extent to which differential interest rates were already being charged by banks from borrowers in each sector;

(ii) to determine the criteria for identifying the borrowers who may be granted the benefit of lower interest rates in each sector;

(iii) to indicate the range of the differential rates that may be allowed in each sector; and

(iv) to examine if any other concessions should be granted either in lieu of or in addition to lower interest rates.

On the recommendations of this Committee (which submitted its report in May, 1971), the Government announced in March, 1972, its decision to charge 4 per cent interest to low income group persons. The Reserve Bank laid down certain criteria for eligibility for loans at differential rates under the scheme. The eligible sectors include scheduled tribe, scheduled castes and others engaged on a modest scale, in agriculture and other allied activities; people occupied in the collection, or elementary processing of forest produce; people collecting fodder in difficult areas and selling it to farmers and traders; people physically engaged on a modest scale in rural and cottage industries and vocations; students going for higher education on merit; physically handicapped persons pursuing a gainful occupation; and orphanages and women's homes where saleable goods are made and where there is no adequate and dependable source of finance. A person to be eligible for a loan under this scheme should not have a family income of more than Rs.3,000 per annum if he is a resident in an urban or semi-urban area or Rs.2,000 per annum if he is a resident in a rural area. In addition, he should not have land exceeding one acre if irrigated and 2.5 acres if unirrigated.

Term-loan and working capital would be granted in accordance with the specific requirements of the borrower. In 1973, the ceiling for working capital loans to any single borrower was raised from Rs.500 to Rs.1,500 and for term-loans form Rs.2,500 to Rs.5,000. The assets purchased with the loan may be hypothecated to the bank. Group guarantee may also be accepted in cases of loans to homogeneous groups of borrowers. Each loan is coverd under the Credit Guarantee Scheme and the guarantee fee is met by the banks up to March, 1981. The number of borrowed accounts and the amounts of loan outstanding under DIR scheme was 26.69 lakhs and Rs.225 crores respectively at the end of June, 1981.

23.7 SUMMING UP

The Reserve Bank of India formulated the Lead Bank Scheme in 1969. All the districts in the country except certain cities were covered under the scheme. The Banks under this scheme are expected to play the lead role in the districts concerned. The lead banks have certain important functions to perform like to survey the resources for the banking development, to examine the facilities for the marketing of agricultural and industrial production, to maintain liaison with the government agencies, etc. The scheme achieved the progress in identifying the centres for opening branches and in preparing the credit plans.

The various schemes of Small Farmers' Development Agency, Marginal Farmers' and Agricultural Labourers' Agencies, Farmers' Service Societies, and Differential Interest Rates Scheme were formulated with the object of helping the small farmers and weaker sections of the society.

23.8 CHECK YOUR PROGRESS : MODEL ANSWERS

1. The important functions of lead bank are:

   i) To survey the resources for banking development.

   ii) To survey the concerns which depend primarily on money lenders.

   iii) To examine the marketing facilities for agricultural and industrial production.

   iv) To study the stocking facilities for fertilisers and other agricultural inputs.

v) To maintain liaison with the Government agencies.

vi) To act as a leader for other financial institutions in various aspects.

23.9 MODEL EXAMINATION QUESTIONS

A) ESSAY QUESTIONS

Answer the following in about 30 lines each:

1. Explain the different schemes formulated with the object of helping the small farmers and weaker sections effectively.

2. Describe the functions and progress of Lead Bank Scheme.

B SHORT QUESTIONS

Answer the following in about 15 lines each:

1. What are the functions of a Lead Bank ?

2. Explain the Scheme of Small Farmers' Development Agency.

3. What is the Differential Interest Rates Scheme ?

4. Write short notes on:

   i) Marginal Farmers' and Agricultural Labourers' Agencies; and

   ii) Farmers' Service Societies.

5. Explain the Lead Bank Scheme.

23.10 RECOMMENDED BOOKS

1. Joshi N.C. : Indian Banking

2. Muranjan S.K. : Modern Banking in India

3. Reserve Bank of India : Reports on Currency and Banking.

23.11 GLOSSARY

Lead Bank : The bank which is expected under the Lead Bank Scheme to provide financial leadership to the other banks and financial institutions located in the district allotted to it.

BLOCK-VI : RESERVE BANK OF INDIA

UNIT-24: CONSTITUTION AND FUNCTIONS OF RESERVE BANK OF INDIA

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- 24.3.6 Assistance to Agricultural and Industrial sectors

24.4 Summing Up

24.5 Check Your Progress : Model Answers

24.6 Model Examination Questions

24.7 Recommended Books

24.8 Glossary

24.0 AIMS AND OBJECTIVES

This unit aims at discussing the establishment and functions of the Reserve Bank of India (RBI).

After going through this unit, we expect you to be able to:

- explain the need for the establishment of the RBI;
- discuss the functions performed by the RBI.

24.1 INTRODUCTION

A major landmark in the evolution of central banking in India was the amalgamation of the three Presidency Banks of Bombay, Bengal and Madras to form the Imperial Bank of India in 1921. Though it performed two important central banking functions, it was the banker to the Government and to some extent, the bankers' bank, it was not a central bank. The other central banking functions were performed by the Government only. As a result of this unsatisfactory arrangement, demands were made for a full-fledged central bank. Attempts in this direction took a definite shape when a Bill was introduced in January, 1927 in the Indian Legislative Assembly to establish a gold standard currency for British India and constitute the Reserve Bank of India. It was the recommendation of the Hilton Young Commission that a central bank to be called Reserve Bank of India should be established in India and that it should take over the central banking functions that the Imperial Bank had been performing so far. However, the Bill introduced for this purpose was abandoned on account of disagreement between the Government and the Assembly. Again in 1931, the Central Banking Enquiry Committee recommended the establishment of the Reserve Bank for developing banking facilities and for bringing about rapid economic development in India. Moreover, the White Paper on Indian Constitutional Reforms, reiterated the importance of a Reserve Bank free from political influence. Accordingly, a fresh bill was introduced in the Legislative Assembly in 1933 which was duly passed by the Assembly and became an Act on 6th March, 1934. The Reserve Bank of India commenced its operations from 1st April, 1935.

This unit attempts to discuss the objectives behind the establishment of RBI besides describing its functions in detail.

24.2 NEED FOR THE ESTABLISHMENT

The preamble of Reserve Bank of India Act states that the object of establishing the Reserve Bank was 'to regulate the issue of Bank notes and the keeping of reserve with a view to securing monetary stability in British India and generally to operate the currency and credit system of the country to its advantage'. The financial system of India before the establishment of the Reserve Bank, had been utterly inadequate mainly because of the dual control of currency by the Government and of credit by the Imperial Bank. The separation of these two functions was found to be defective from the point of view of the economic development of the country. The Hilton Young Commission pointed out 'the inherent weakness of a system in which the control of currency and credit is in the hands of two distinct authorities whose policies may be widely divergent and in which currency and banking services are controlled and managed separately from one another'. Under these circumstances the need was felt for the establishment of a central bank performing both these functions. A central bank was also found necessary to achieve monetary stability - internal and external - as it has the right to issue currency notes and the authority to adopt a credit policy suitable for the country.

Secondly, the White Paper on Indian Constitutional Reforms made a condition that the Reserve Bank should be established if the responsibility at the centre were to be transferred from British to the Indians. It was stated in support of this that "no room should be left for doubts as to the ability of India to maintain her financial stability and credit, both at home and abroad'.

Thirdly, the inadequacy of the Imperial Bank of India in controlling the money market was patent, because of the lack of confidence of other joint-stock banks on the Imperial Bank. The success of a central banking institution depends on the confidence which it inspires in the member banks and the influence which it exercises on them. But the Imperial Bank, which was acting as the central bank, was for all practical purposes, a commercial bank competing with other joint stock banks. So these banks were naturally reluctant to approach the Imperial Bank for any help. Under these circumstances it was decided to establish a Reserve Bank with the object of disacharging purely central banking functions and thereby making a fresh start in the field of Indian central banking.

Fourthly, a central bank was found necessary to remove the structural instability of the banking system. Without a central bank each commercial bank has to maintain enough cash reserves to ensure its own liquidity position. This multiple reserve system under which each bank is required to keep huge cash reserves is highly disadvantageous when compared to a single reserve system. The centralised reserves could be used for helping the particular bank that is facing financial difficulties. It is quite unlikely that deposits from all the banks will be withdrawn at the same time. A single reserve system is definitely more efficient, economical, mobile and elastic. It is only by establishing a central bank, that a multiple reserve system can effectively be replaced by a single reserve system.

Lastly, a central bank was found necessary in order to follow an appropriate credit policy. Since the central bank has the sole authority to issue notes, it can exercise control over the basis for the creation of credit. As a banker's bank, a central bank has control over the cash reserves of commercial banks and hence can influence their power to create credit. Further, a central bank is armed with various weapons of credit control through which it can control the credit situation in the country.

It is for achieving all the above objectives, that the Reserve Bank of India was brought into existence.

24.3 FUNCTIONS

The Reserve Bank performs all the functions of a central bank. Its main function is to regulate the monetary mechanism comprising of the currency, banking and credit systems of the country. The Bank is given complete monopoly right for the issue of notes and has wide powers over the other commercial banks. Another important function of the Bank is to conduct the banking and financial operations of the Government. The Bank is also responsible for maintaining the external value of the rupee. Apart from the traditional central banking functions, the Reserve Bank is expected to take an active part in the economic development of the country. The Bank is playing an important role in the promotion of institutional finance for agriculture and industry. Let us now discuss in detail the various functions of the Reserve Bank.

24.3.1 ISSUE OF NOTES

The Reserve Bank of India has the monopoly right for the issue of notes in the country. This right is conferred upon the Bank by Section 22 of the Reserve Bank of India Act. The Bank issues on its own account, bank notes of the denominations of Rs.2 and above. It also issues on behalf of the Central Government one rupee notes, one rupee coins and other subsidiary coins. Notes issued by the Reserve Bank are called the bank notes while the one rupee notes of the Central Government are called currency notes.

As in the case of the Bank of England, the Reserve Bank maintains two departments, viz., the issue Department and the Banking Department. The note-issue function is performed by the issue Department, and Banking Department looks after the general banking business. The assets of the Issue Department which back the note-issue are kept distinct from those of the Banking Department. According to Section 33 of the Reserve Bank of India Act, the assets of the Issue Department against which bank notes are issued should consist of gold coin and bullion, foreign securities, rupee coins, Government of India securities and such bills of exchange and promissory notes payable in India and as are eligible for purchase by the bank. The original Act of 1934 provided for the proportional reserves of gold and foreign securities against note issue. Under the Act, not less than 2/5th of the total note issue was required to be covered by gold coin, gold bullion or foreign securities. There was a further condition that the value of the gold coin and gold bullion was not to fall below Rs.40 crores. However, in order to finance the Second Five Year Plan, a change in the currency reserve position was brought about by the Reserves Bank of India Amendment Act of 1959. This Amendment Act provided for two changes in the monetary system. One was the revaluation of gold reserves held by the Reserve Bank from the original price of Rs.21.24 per tola to Rs.62.50 per tola, which was the rupee equivalent of the price of one tola of gold agreed to by the International Monetary Fund. The second was a shift from the proportionate to the minimum reserve system with regard to the issue of currency.

Along with the revaluation of gold, the minimum reserve to be held in gold was fixed at Rs.115 crores, instead of Rs.40 crores. According to the second change, there would be no limit to the volume of currency that could be issued by the Reserve Bank provided it maintained a minimum of Rs.115 crores of gold and Rs.400 crores of foreign exchange. There was a further provision in the Amendment Act of 1956 that the foreign exchange could be allowed to fall below Rs.400 crores upto a limit of Rs.300 crores, under certain conditions, and with the previous sanction of the Government of India.

The minimum was again reduced in October, 1957, when the Act was further amended. It was decided that the aggregate value of gold coin, gold bullion and foreign securities held in the issue Departmnent of the Bank should not at any time be less than Rs.200 crores, of which the value of gold coin and gold bullion, should at no time, be less than Rs.115 crores. The balance of Rs.85 crores may be in the form of foreign securities. The net effect of the amendment, therefore, is that while the provision about the gold reserve remains unaltered, the effective minimum limit for foreign securities will, in future, be Rs.85 crores. Provision has also been made, as in other countries, for the suspension of the requirement regarding reserves of foreign exchange to meet unforeseen contingencies. The Reserve Bank (second Amendment) Act, 1957 empowers the Reserve Bank to dispense with the entire holding of foreign securities with the previous sanction of the Central Government. These amendments are in line with current thinking about foreign exchange reserves. It is now universally accepted that the main purpose of foreign exchange reserves is to enable the country to tide over an unfavourable turn in the balance of payment and the strength of the currency depends more on the soundness of the Government of the country than on the value of its gold and foreign exchange reserves. The general trend of central banking legislation in many countries has been to delink foreign reserves from note-issue. As such, the amendment regarding the reduction or complete elimination of the reserves need not arouse any suspicion with regard to the soundness of our currency.

24.3.2 BANKER TO THE GOVERNMENT

The Reserve Bank acts as the banker to the Central and State Governments in the country. Under sections 20, 21 and 21 A of the Reserve Bank of India Act, the Reserve Bank is charged with the duty of acting as a banker to the Government. It is entrusted with the banking business of the Government of India free of charge. Accordingly it undertakes to accept money on behalf of the Central Government, to make payments on its behalf and to carry out its exchange remittance and other banking operations, including the management of the public debt and the issue of new loans and Treasury bills. In terms of Section 21-A the Reserve Bank performs similar functions on behalf of the State Government by virtue of the agreements entered into with them.

i) Agreement with Central Government

The terms and conditions on which the Bank acts as banker to the Central and State Governments have been set out in the separatae agreements which the Bank has entered into with the Governments. As per the agreement, the Bank transacts the general banking business of the Central Government. For this purpose, the Bank keeps such books of account as the Government may desire. The Bank is not entitled to any remuneration for conducting ordinary banking operations on behalf of the Government. It is given the advantage of keeping the Government cash balances free of interest. The Bank manages the public debt and the issue of new loans and Treasury Bills of the Central Government. For the management of the public debt, the bank is entitled to charge half-yearly, a commission at the rate of Rs. 2,000 per crore per annum on the amount of the public debt outstanding at the close of the half year for which the charge is made. In places where the Reserve Bank has no branch or office, it has appointed agents for transacting Government business. Under the Reserve Bank of India Act, the Bank is obliged to appoint the State Bank of India as its sole agent at places where the Bank has no branch or office but where the State Bank has a branch.

The Act also requires the Bank to maintain currency chests of its Issue Department at places prescribed by the Government and to keep the chests supplied with sufficient notes and coins. The Treasury or the agency, where such a chest is kept is permitted to withdraw funds from the chest when its payments on a day exceed its own balances. If there is a surplus, the same is deposited in the Chest. The bank is required to provide reasonable remittance facilities to the public at the places where the currency chests are maintained.

The Bank is also obliged, under the Agreement, to remit, on the account of the Government between India and London, such accounts as may be required from time to time, at the prevailing market rate, for telegraphic transfers.

ii) Agreement with State Governments

Since the inauguration of provincial Autonomy in 1937, the Reserve Bank has entered into separate agreements with the State Governments setting out the terms and conditions on which the Bank would transact the banking business of the State Government concerned, manage their public debt and issue new loans. The Reserve Bank now acts as the banker to all the State Governments in India.

The State Governments are required to keep a specified minimum balance with the Reserve Bank. The minimum balances have been revised on a number of occasions. At present they range from Rs.5 lakhs to Rs.85 lakhs for various States. In the case of the Central Government while the agreement does not stipulate any minimum balance to be maintained, the balances are usually not less than Rs.50 crores. The State Governments are required to meet any temporary deficits in their minimum balances either by issuing their own Treasury bills, or by obtaining Ways and Means advances from the Bank.

iii) Issue of Loans and Treasury Bills

The Reserve Bank manages public debt and is responsible for the issue of loans on behalf of the Central and State Governments. On account of its close contact with, and intimate knowledge of, the financial markets the Reserve Bank is in a position to advise the Governments on the quantum, timing and terms of the new loans. In order to carry out the loans operations on the Government securities market, and to obtain the best possible terms for the Government concerned, the Bank coordinates the borrowing programmes of the Central and the State Governments and thereby eliminates unhealthy competition between the different Governments of the country.

The Reserve Bank sells treasury bills whenever necessary on behalf of the Central Government. They are sold by tender at weekly auctions. These bills have a currency of 91 days. The sale of such bills provides short term finance to Government and also helps to absorb any excess liquidity in the money market. The procedure for the issue of treasury bills is that the amount of bills offered, and the dates on which the tender payments are to be made, are notified by the Bank through a press communique. Though any member of the public could apply for the purchase of these bills, usually only banks submit tenders for the purchase of these bills. Applications for treasury bills have to be made for a minimum amount of Rs.25,000 or a multiple thereof. Tenders quoting the lowest rate of discount are generally accepted in full. The balance, if any, is alotted to those who quote the next best rates. The results of the auction are announced through a press communique along with the notice of the next weekly auction. Sucessful applicants are required to make the payment on the third day following the issue of the press communique. On maturity, these bills are repaid at the office or branch from which they are issued.

Apart from the bills sold on tender, the Reserve Bank also issues adhoc treasury bills to the State Governments, semi- government departments and foreign central banks. These bills also have a currency of 91 days. This procedure would enable the State Governments to obtain funds to meet their needs, whether or not weekly auctions are held. This also eliminates the undesirable competition of State Governments, with the regular investors, such as banks and insurance companies for the limited supplies of Treasury bills at the weekly auctions. At present there are no public auctions. Instead of inviting tenders every week for specified sums, treasury bills are now available throughout the week at a rate announced from time to time. This change has been made since 1965 mainly to facilitate investment by commercial banks to add to their resources.

iv) Ways and Means Advances

In pursuance of Section 17(5) of the Reserve Bank of India Act, the Reserve Bank is authorised to make, to the central and State Governments, ways and means advances which are repayable not later than 3 months from the date of making the advances. The Act does not specify the rate of interest to be charged or the maximum amount of the advance. These matters are regulated by the respective agreements entered into between the Bank and the Central and State Governments.

Since 1954-55, the Central Government has increasingly resorted to the Reserve Bank for accommodation to meet its growing needs to finance the development expenditure under the Five Year Plans. This has taken the form of sales of ad hoc treasury bills to the Bank rather than ways and means advances. In recent years the State Governments have been resorting to short-term borrowings from the Reserve Bank in two ways. First, loans are taken under ways and means advances. These advances are made without collateral securities and are provided upto certain limits prescribed by the Bank. At present, these limits are fixed at thrice the level of the minimum balances that the State Governments are required to maintain with the Reserve Bank and such advances are called the normal ways and means advances. Secondly, special ways and means advances against the pledge of Central Government securities are also provided. The Bank also grants additional advances beyond these limits, in special cases. Both normal and special ways and means advances are granted at one per cent below the bank rate.

v) Adviser to Government

The Bank's advice is often sought by the Central and State Governments on various financial and economic matters. The Bank's advice is sought on certain aspects of the formulation of the country's Five Year Plans such as the financing pattern, mobilisation of resources and institutional arrangements with regard to banking and credit matters. The bank also renders advice on matters of international finance. The Bank has a large research and statistical organisation through which it keeps in close touch with the current economic and financial developments both in India and abroad. The Bank keeps the Government informed of developments in the financial markets periodically.

24.3.3 CONTROL OF CREDIT

Since economic expansion in our country is sought to be achieved without jeopardising price stability and exchange equilibrium, proper control is to be exercised on bank credit which is mainly responsible for inflationary pressures. The Reserve Bank, therefore, is vested with the usual powers available to central banks to control credit. These include bank rate, open market operations and variable reserve requirements and also some selective credit controls. The recent monetary policy of Reserve Bank shows that it has taken a serious view of the rising price levels and the key note of the policy has been to exercise both a general and selective restraint on credit. We may discuss here the various instruments used by Reserve Bank of India to control credit only in brief as they are dealt with in detail under the monetary policy of Reserve Bank of India.

i) Bank Rate

The Bank rate is the rate at which the Reserve Bank of India rediscounts certain specified bills. By manipulating the bank rates, the Reserve Bank can regulate the Bank credit and control inflation. The manipulation of bank rate allows the Reserve Bank to regulate the aggregate bank credit by affecting the cost of borrowing as well as the total supply of bank credit. The bank rate has been changed by Reserve Bank several times to regulate the credit granted by commercial banks. This can be seen from the following:

Changes in Bank Rate

With effect from	Bank Rate (in %)
November, 1935	3.0
November 15, 1951	3.5
May 16, 1957	4.0
January 3, 1963	4.5
September 6, 1964	5.0
February 17, 1965	6.0
March 2, 1968	5.0
January 9, 1971	6.0
May 30, 1973	7.0
July 23, 1974	9.0
July 17, 1981	10.0

It is understandable that since the inception of the Reserve Bank of India, the bank rate has been gradually increased to curb the inflationary pressures created by the expansion of credit by commercial banks. One point to be noted is that the bank rate has not been very successful. This may be due to the disorganised nature of money market.

i) Open market Operations

Open market operations consist of selling ansd buying of eligible securities by the Reserve Bank in the open market to effect a change in the volume of money in circulation. Prior to the Second World War, the extent of the Bank's open market operations was negligible. In the post war period the Bank purchased securities with a view to providing funds to the banking system and expediting credit. The Bank's purchases were particularly heavy during 1948-49 and 1950-51. The sales of the securities were particularly heavy from 1964-65 to 1968-69. Broadly speaking, the Reserve Bank has not used its open market operations as a means of credit control, primarily in order to facilitate Government borrowings.

iii) Variation of the Reserve Ratios of Commercial Banks

The Bank rate policy and the open market operations have only limited use in India because of the peculiarities in the institutional and structural framework of our banking system. By changing the minimum cash reserves required to be maintained by the scheduled banks with the Reserve Bank, it is possible to control credit in an effective manner. As per the amendment of the Reserve Bank of India Act in 1962, scheduled banks were required to keep with the Reserve Bank 3 per cent of the total demand and time liabilities. This rate could be raised by the Reserve Bank upto 15 per cent. This instrument was used for the first time in 1960. The cash reserve ratio was raised from 3 to 5 per cent with effect from June 19, 1973 and after undergoing some fluctuations, it was fixed at 7 per cent with effect from 11th June, 1982.

iv) Selective Credit Controls

By and large, selective credit controls are employed for the purpose of controlling inflationary tendencies which appear owing to an increase in the total money in circulation through an over expansion of bank credit. In India, these measures are intended to prevent the anti-social use of credit, which is associated with the speculative hoarding of stocks of strategic commodities like foodgrains etc. The selective credit controls used by Reserve Bank include prescribing minimum margins for lending against specific securities; stipulating discriminatory rates of interest on certain types of advances and fixing ceiling limits on the amount of credit for certain purposes.

Apart from the above methods of credit control, the Reserve Bank has also made use of moral suasion for controlling credit. Moral suasion implies persuasion of commercial banks to follow certain lines of policies, impressing upon them the need to do so. Either by holding meetings or by circular letters, the Governor of the Reserve Bank persuades the banks to follow a particular line of action. There is no element of compulsion in this persuasion and hence the success of this policy largely depends on the willing co-operation extended by the commercial banks.

24.3.4 BANKERS' BANK AND LENDER OF LAST RESORT

The banks may be scheduled banks or non-scheduled banks. A scheduled bank is one which is included in the second schedule to the Reserve Bank of India Act. Every scheduled bank is required to keep with the Reserve Bank a cash balance of not less than three per cent of its total demand and time liabilities. The Reserve Bank has the power to increase the cash reserves upto 15 per cent of the demand and time liabilities. These balances are kept with the Reserve Bank not with a view to ensure the safety of the funds of the depositors, but to enable the Reserve Bank to exercise control over the credit that may be created by the commercial banks. It is, however, to be admitted that this purpose has not been fully achieved due to the fact that the statutory cash reserves are too small compared to the total resources of the banks.

Every scheduled bank is further required to submit, to the Reserve Bank, every Friday a return containing such details as i) the amount of its demand and time liabilities and its borrowings from banks in India, ii) the total amount of legal tender notes and coins held by it in Indiia iii) the balance held by it at the Reserve Bank; iv) the balances held by it at other banks in current accounts and the money at call and short notice; v) the investments in Central and State Government securities including treasury bills and treasury deposit receipts; vi) the amount of advances in India; and vii) the bills purchased and discounted in India. Under the Banking Regulations Act, 1949, the Reserve Bank has the power to give any direction to commercial banks and the latter are required to comply with such directions.

A scheduled bank can obtain financial assistance from the Reserve Bank either in the form of rediscouting of eligible bills or in the form of loans and advances against eligible securities. The type of bills that are accepted for rediscount and the types of securities accepted for the purpose of granting loans are specified in the Act. Commercial banks cannot obtain financial accommodation from the Reserve Bank as a matter of routine. Apart from the nature of the security, the Reserve Bank considers a number of other factors before extending financial help. It examines whether the bank concerned offers excessive rates of interest in order to attract deposits from the public, whether it availed of all the other sources of financial accommodation in the money market, and whether it has been over-trading and extending credit for speculative purposes or indulging in unsecured business to any undesirable extent. To ensure that the funds provided by the Reserve Bank are not misused in any manner, the Reserve Bank may call for any information from the bank concerned and impose any condition that it may deem necessary. The Reserve Bank has the discretion to refuse the required assistance without assigning any reason. Normally any scheduled bank which is conducting its affairs properly and which is able to offer the necessary securities can always depend upon the Reserve Bank for financial accommodation during a period of emergency. Hence the Reserve Bank is called not only the banker's bank but also **the lender of last resort.**

The Reserve Bank is authorised to make loans and advances to scheduled banks, State Co-operative Banks and State Financial Corporations, repayable on demand or on the expiry of fixed periods not exceeding 90 days against the security of: i) stocks, funds and securities (other than immovable property); ii) gold or silver documents of title to gold or silver; iii) such bills of exchange and promissory notes as are eligible for purchase or rediscount by the Reserve Bank or as are fully guaranteed as to the repayment of the principal and payment of interest by a State Government; iv) promissory notes of any scheduled bank or State co-operative bank supported by documents of title to goods, such goods having been transferred, assigned or pledged to any such bank as security for the advance made for bonafide commercial or trade transactions or for the purpose of financing seasonal agricultural operations or the marketing of crops. Where the loans and advances are made against the security of bills of exchange and promissory notes arising out of any transaction relating to the export of goods from India, the maturity date is extended to 180 days. If the Reserve Bank is of the opinion that a special occasion has arisen, it may waive the usual rules of eligibility regarding the securities. This relaxation of the rules of eligibility helps the Reserve Bank to discharge its function as the 'Banker's Bank' and the 'Lender of Last Resort' more effectively.

The Reserve Bank acts as the clearing house for the settlement of balances between the comercial banks which keep their surplus funds with it. In the absence of this facility each Commercial bank has to enter a separate clearance and settlement transaction with other banks individually. " he process of effecting a settlement between banks in the books of the Reserve Bank of India is a comparatively simple operation and therefore, it is possible to economise in terms of money as well as time. This function of the Reserve Bank of India thus is likely to strengthen the banking system of the country.

24.3.5 CUSTODIAN OF FOREIGN EXCHANGE RESERVES

The Reserve Bank of India has the responsibility to maintain the official rate of exchange. According to the Reserve Bank of India Act of 1934, the Bank was required to buy and sell terling at fixed rates - any amount of sterling in lots of not less than Rs.10,000. After India ecame a member of the International Monetary Fund, the Reserve Bank of India assumed the esponsibility of maintaining fixed exchange rates with all, other member-countries of the IMF. he Reserve Bank of India buys and sells foreign exchanage from authorised persons at rates f exchange fixed by the Government. For example, it sells sterling at 5.7940 per Rs.100 and uys sterling at 5.8880 per Rs.100. Besides maintaining the rate of exchange of the rupees, the RBI holds India's reserves of international currencies. Finally, the Reserve Bank administers the exchange controls of the country.

24.3.6 ASSISTANCE TO AGRICULTURAL AND INDUSTRIAL SECTORS

In this connection, mention may also be made of the role played by the Reserve Bank of India in financing the agricultural and industrial sectors in India. The backwardness of agriculture in India is due to lack of adequate credit facilities to the agriculturist. It is rightly said that the agriculturist is born in debt, lives in debt and dies in debt. The task of financing agriculture has received the particular attention of the Reserve Bank right from its inception. The Bank has recognised the need for expanding and co-ordinating the credit facilities to the agricultural sector. Under the Reserve Bank of India Act, the Reserve Bank is charged with the responsibility of making its resources available to agriculture within certain limits. In order to look after this function, the Bank maintains an Agricultural Credit Department. The Reserve Bank has also been alive to the need for industrial development in the economic growth of the country. The Reserve Bank and the central Government have established a few institutions for the supply of long-term finance to industries.

It is clear from the above that apart from the traditional central banking functions, the RBI also performs certain non- monetary functions like the promotion of sound banking in India. While the monetary functions like control of credit, issue of notes etc., are significant as they regulate the volume of money and credit in the country, the non-monetary functions are equally important in the context of India's economic backwardness.

CHECK YOUR PROGRESS - 1

Mention the functions of RBI as the Banker to the Government.

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24.4 SUMMING UP

The Reserve Bank of India was established in 1935 for performing the central banking functions in the country. The main objective for its establishment was to regulate the issue of bank notes in the country with a view to securing monetary stability.

The Reserve Bank of India performs all the functions of a Central Bank which were explained earlier in the 12th unit. They include issuing of the currency notes in the country, acting as the banker to the Government, controlling the credit creation of commercial banks, acting as the bankers' bank, maintaining the foreign exchange reserves and financing the agricultural and industrial sectors.

24.5 CHECK YOUR PROGRESS : MODEL ANSWERS

1. As the banker to the Government, the RBI performs certain functions. They are :

    i) Transacting the banking business of the Central and State Governments.

    ii) Issue of loans on behalf of the Governments,

    iii) Selling the Treasury Bills on behalf of the Central Government.

    iv) Giving ways and means advances to the Governments, and

    v) Advising the Governments on various financial and economic aspects.

24.5 MODEL EXAMINATION QUESTIONS

A. ESSAY QUESTIONS

Answer the following in about 30 lines each:

1. Discuss the various functions performed by the Reserve Bank of India.
2. Explain the procedure followed by the Reserve Bank of India for the issue of notes.
3. Examine the role of the Reserve Bank of India as banker to the government.
4. How do you justify the remark that the Reserve Bank of India is the "Bankers' Bank and Lender of Last Resort" ?
5. What are the various methods of credit control adopted by the Reserve Bank of India ?

B. SHORT QUESTIONS

Answer the following in about 15 lines each:

1. Explain the selective Credit control methods.
2. Discuss the need for the establishment of Reserve Bank of India.
3. What is the system of Note-Issue followed by the RBI ?
4. What do you understand by the term 'Lender of Last Resort'.
5. Write on the following:

    i) Bankers' Bank,

    ii) Bank Rate.

6. Explain the term 'Custodian of Foreign Exchange Reserves'.
7. Explain the following terms:

    i) Ways and Means Advances

    ii) Monopoly of Note-Issue

    iii) Currency Chests.

24.7 RECOMMENDED BOOKS

1.	Joshi N.C.	: Indian Banking
2.	The Reserve Bank of India	: History of Reserve Bank of India
3.	The Reserve Bank of India	: Functions and Working

24.8 GLOSSARY

Bank Rate : It is the standard rate at which the RBI is prepared to buy or re-discount bills of exchange or commercial papers eligible for purchase.

Gold Standard : A monetary system in which the value of each basic unit of a country's currency is fixed in terms of gold

Public Debts : These comprise the national debt, the debts of local government authorities and the debts of public corporations.

Treasury Bills : Short-term Government securities offered for sale as a means by which the Government can borrow money.

Ways and Means Advances : Temporary borrowings by the Governments from the RBI.

UNIT-25 : MONETARY POLICY

Contents

25.0 Aims and Objectives
25.1 Introduction
25.2 Objectives of Monetary Policy
25.3 Monetary Policy of Reserve Bank of India
25.3.1 Quantitative Methods of Credit Control
25.3.2 Qualitative or Selective Methods of Credit Control.
25.4 An Evaluation of the Monetary Policy of Reserve Bank of India
25.5 Summing Up
25.6 Check Your Progress : Model Answers
25.7 Model Examination Questions
25.8 Recommended Books
25.9 Glossary

25.0 AIMS AND OBJECTIVES

The aims of this unit are to discuss monetary policy and its objectives in general and those of the Reserve Bank of India in particular.

When you have finished this unit, you will be able to:

- explain the meaning of monetary policy;
- give the objectives of monetary policy;
- describe the credit control methods employed by the RBI;
- evaluate the monetary policy of RBI.

25.1 INTRODUCTION

As we know, it is the Central bank of a country which controls the credit creation of commercial banks. The policy followed by the central bank to control credit is known as monetary policy and it forms part of the economic policy of a country. It refers to the credit control measures adopted by the central bank of a country. It may be defined as "the management of the expansion and contraction of the volume of money in circulation for the explicit purpose of attaining a specific objective such as full employment". This unit explains the objectives of monetary policy and discusses the monetary policy of RBI in detail.

25.2 OBJECTIVES OF MONETARY POLICY

The traditional objectives of monetary policy were regarded as the maintenance of price and exchange stability-objectives symbolized by the institutional arrangement of gold standard. However, depending upon the economic conditions prevailing in the country, the objectives of monetary policy have undergone change. In the context of the developing countries,the objectives of monetary policy have obviously to be fitted into the broader and more compelling needs of furthering economic growth.

As such, a large number of objectives have been pursued among which the important ones are the following:

a) Maintenance of stable exchange rates
b) Maintainence of price level and control of trade cycles
c) Neutral money
d) Maintenance of full employment
e) Maintenance of balance of payments equilibrium
f) Assisting economic development

a) Maintenance of Stable Exchange Rates

This is the traditional objective of monetary policy when gold standard was followed. The reason for pursuing this objective of achieving the stability of exchange rates are:

i) a stable exchange rate was considered as an essential condition for the promotion of smooth international trade;

ii) fluctuations in exchange rates might lead to lack of confidence in a particular currency; and

iii) changes in foreign exchange rate might lead to certain upleasant effects like speculation in the foreign exchange market.

However, stabilisation of foreign exchange rate as an objective of monetary policy has been criticised as it aims at achieving through sacrificing price stability which is more important than exchange stability.

b) Maintenance of Price Level and Control of Trade Cycles

As long as gold standard existed, maintenance of a stable exchange rate remained the objective of monetary policy. However, after the suspension of gold standard, attention has been paid to the objective of stabilising the price level and trade cycles. It has been noticed that fluctuations in the price are always accompanied by fluctuations in the level of business activity.

Price instability and the fluctuations in business activity are disadvantageous. Certain problems of production and distribution would arise as a result of price instability. A rise in the price level, though it provides a stimulus to production, may develop into 'run away' inflation which destroys economic prosperity. It also leads to redistribution of wealth in favour of the rich, inflicting suffering on the poor. A fall in the price level on the other hand, would lead to business failures, unemployment and curtailment of production. Both are evils to be shunned and only stability in prices would assure stable prosperity with a neutral effect on distribution.

This objective is, criticised on the grounds that i) the concept of a stable price level is itself vague, as in a dynamic world it is difficult to determine a satisfactory price level; ii) it removes the incentive of increasing prices to industrialists and businesmen, with the result that production stagnates, and iii) it does not guarantee stability of business conditions.

c) Neutral Money

The concept of neutral money as an objective of monetary policy aims at eliminating the disturbing effects of changes in the quantity of money on prices. Accordingly, money should remain neutral or a passive factor with a function of facilitating exchange only. Neutral money policy is followed as an objective of monetary policy on the assumption that changes in the supply of money are responsible for the disturbances in the operations of the monetary system. Keeping the effect of changes in the supply of money neutral, whatever changes take place in the price level, they can be treated as resulting from the productive power of the economy. The changes in the productive power and consequent changes in the supply of goods would exert an influence on the price level in such a way that increase in the supply of goods would lead to a fall in the price level and a decrease in the supply of goods would result in a rise in the price level.

This objective of neutral money is criticised as (i) it is based upon the quantity theory of money which has many limitations of its own; (ii) it does not assure stable prices, and (iii) during depression the laissez faire principle (or the principle of neutral effect) of neutral money cannot hold good.

d) Maintenance of Full Employment

This objective of full employment aims at increasing the number of jobs to the maximum in consistence with the existing employment opporunities. This is to be achieved by increasing effective demand to the limit beyond which it would cause inflation. Full employment would seek to optimise the current utilisation of the capacity. In carrying out this objective, the monetary authorities are expected to correct the deficiency of demand and prevent exess over the available supply.

The actual increase in the volume of employment depends upon the size of the multiplier, that is, the number of times income increases in relation to given increase in investment expenditure. That is why, monetary policy of increasing money supply does not always succeed in the objective of increasing income, output and employment.

e) Maintenance of Balance of Payments Equilibrium

Another important objective of monetary policy is to secure balance in a country's external payment position. For achieving this objective, bank rate is used as a weapon. When a country is faced with an adverse balance of payments position, short-term interest rates in the country are increased through an increase in bank rate. As a result, the outflow of gold or depletion of foreign exchange reserves is arrested on the one hand, and a net inflow is attracted on the other. Further, it would increase saving, decrease spending, and result in a general fall in prices. The fall in prices would increase exports, decrease imports and would favourably affect the balance of payments position of the country. However, the success of the bank rate depends upon the extent to which it can attract short-term funds into the country, and sustain the confidence of investors abroad in the currency of the country concerned.

f) Assisting Economic Developement

This objective is more relevant in developing countries as they are poised for achieving accelerated economic development through fuller utilisation of the available material and human resources. Since capital scarcity is the major stumbling block in the economic progress of devoloping countries, the aim of monetary policy should be to promote savings and to create conditions favourable for the flow of foreign capital. The monetary policy while enabling the State to undertake investment on a large scale, also ensures the prevention of the excessive price rise resulting therefrom. Then it becomes possible to promote development with stability. The monetary policy also controls the flow of money supply to undesirable sectors in accordance with the planned programmes of economic development.

CHECK YOUR PROGRESS - 1

Mention the important objectives of monetary policy.

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25.3 MONETARY POLICY OF RESERVER BANK OF INDIA

The Reserve Bank of India started with a cheap money policy and had fixed a low bank rate of 3 percent which was raised to 3.5 percent in November, 1951. With the inauguration of planning, appropriate adjustments in the monetary policy to suit the pace and pattern of planned development were considered necessary. The monetary policy followed by the Reserve Bank of India since 1951 may broadly be termed as one of controlled expansion i.e., a policy of 'adequate financing of economic growth and at the same time ensuring reasonable price stability". Since the Indian economy has witnessed considerable inflation potential for inflation, particularly since 1972, the suitable monetary policy would be one of credit restraint without jeopardising the progress of productive sectors of the economy.

A wide range of powers have been conferred upon Reserve Bank of India to control the credit created by commercial banks, through the provisions of the Banking Regulations Act, 1949 and the Reserve Bank of India Act, 1934. Apart from excercising the statutory powers, the Bank also adopts informal methods of moral persuasion to impress upon the banks the need to control the credit.

With the expansion in money supply, as a result of deficit budgeting policy of the Government, bank deposits have grown in magnitude and consequently their credit capacity has increased considerably. The developmental financing in each successive Five Year Plan is increasing to create an inflationary impact. Under these circumstances, the Reserve Bank of India has felt that it is essential to employ more and more measures to control credit and thereby to curb inflation.

The methods of credit control employed by the Reserve Bank of India may be classified into i) Quantitative methods, and ii) Qualitative methods or selective methods. The quantitative methods of credit control include bank-rate policy, open market operations and variation of cash reserves. The qualitative or selective methods of credit control include the various directives issued by the Reserve Bank of India restricting the grant of credit to certain specified sectors of the economy.

The distinction between quantitative and qualitative methods of credit control is that, while the former influence the overall volume of bank credit, the latter influence the flow of credit to only specified sectors of the economy.

25.3.1 QUANTITATIVE METHODS OF CREDIT CONTROL

i) Bank Rate Policy

"Bank rate is the standard rate at which it (the Reserve Bank) is prepared to buy or rediscount bills of exchange or other commercial paper eligible for purchase under this Act." However, due to the paucity of bills of exchange and the consequent sluggishness in rediscounting of bills, the rate of interest charged by the Reserve Bank on advances made to banks has come to be known as bank-rate.

Scheduled banks had rarely approached the Reserve Bank for their credit needs till 1952 due to their traditional reluctance to approach the central bank for accommodation, and also due to the easy money conditions that prevailed through out that period. The bank rate therefore, could not be effective during this period. Since 1952, however, banks have started approaching the Reserve Bank for additional funds, perhaps to meet the increased demand for bank credit arising from accelerated economic development.

If bank rate is changed upwards or downwards, it effects the cost of credit available to the commercial banks from the Reserve Bank. An increase in bank rate would make Reserve Bank accommodation costlier to the commercial banks as a result of which they would be forced to raise the lending rates of the borrowers. This would discourage the borrowers from borrowing and consequently there would be contraction of bank credit. The reserve would be the process if the bank rate is lowered. In this context, it should be remembered that the bank rate is a pace setter for all other rates of interest in the money market, therefore, they move in the same direction as the bank rate moves.

For the first time, the bank rate was raised from 3 to 3.5% in November 1951, in order to bring under control the inflationary situation created as a result of the Korean War.

Since the commencement of the Second Five Year Plan, the Reserve Bank has used this weapon time and again. Bank rate was raised five times from 3 to 3.5% in November,1951; from 3.5%to 4% in May 1957; from 4% to 4.5% in January, 1963; from 4.5% to 5.00% in September, 1964; and from 5% to 6% in Febuary, 1965. Bank rate was decreased for the first time from 6% to 5% March, 1968 to arrest the recession trends in the economy. Again in January,1971 it was raised from 5.00% to 6%.

According to Reserve Bank, the rise in prices is caused by production losses (particularly in the agriculture sector) and continued heavy budgetary deficits. With the increase in the liquidity of banks, the terms of lending have been relaxed and the borrowers have been encouraged to resort to excessive use of bank credit particularly for building up inventories. Expansion of credit is mainly the result of the faster rise in the production of some industries (such as sugar). Under these circumstances, the monetary measures taken by the Reserve Bank of India alone are not sufficient to produce any significant impact on the economy unless the need for fiscal measures, also Realising the need for fiscal measures, the Reserve Bank of India urged the Government to xecercise greater control over public expenditure. It is to be noted that a raise in the bank rate would lift up the entire structure of interest rates prevailing in the organised markets. The idea behind this is to reduce the demand for liquid resources which are reported to be generating pressures in the form of inventory building in the economy in the context of all-round shortages. When the prices are rising much faster than the rise in the interest rates, the cost of holding inventories is not burdensome for businessmen. Therefore, an increase in the bank rate introduced by the Reserve Bank of India to control the general price level is unlikely to achieve much success in that direction.

In respect if production losses, particularly in the agricultural sector, and supply constains, the measures taken by the Reserve Bank of India have been unsuccessful.

In the wake of the package of measures introduced by the central government to contain in inflation,the Reserve Bank raised the bank rate from 7% to 9% on 23rd July 1974, and from 9% to 10% in July 1981. Simultaneously, the minimum lending rate on advances of schedule banks was also raised from 11 to 12.5% except in the case of specially exempted categories. While the net liquidity ratio remains at 40% the maximum rate chargeable on borrowing from the Reserve Bank was raised from 15 to 18% thus making borrowings from the Bank costly.

Assessment of Bank Rate Policy in India

The governer of the Reserve Bank speaking at the 33rd Ordinary General Meeting of Indian Institute of Bankers, made the following observation on the efficacy of bank rate changes in India: "In India, the bank rate instrument is of relatively small significance so far as the movement of short-term funds is concerned. As regards the impact on domestic economy, it has to be noted that a large segment of fixed investment under Five Year Plans is undertaken in the publi sector. A rise in bank rate does not tend to reduce public investment which is governed primarily by the larger planning strategy. The fixed investment n the private sector too is not very much influenced by changes in the bank rate, through probably the effect is more pronounced than in the case of public sector investment". But he proceeded to observe that the usefulness of the weapon of the bank rate under Indian conditions is perhaps of the greater significance in its impact on inventory accumulation as a considerable amount of bank credit is utilised for that purpose. However, the efficacy of the bank rate in this sphere is largely conditioned by the general outlook or prospect regarding the future course of price, and the bank rate itself may not be expected to achieve significant result. Thus, in a planned economy which has a large public sector investment, and where Government have a battery of powers of direct regulations of investment, the efficacy of the bank rate changes is far less clear than it is in industrially advanced countries with a free economy. This is not to say that bank rate is totally irrelevant in Indian conditions. Its importance as a pace-setter to the other market rates of interest, both short-term and long-term cannot be over-emphasised.

ii) Open Market Operations

Deliberate and direct buying and selling of securities and bills in the money market by the central bank, on its own initiative, are called open-market operations. During times of inflation, the Reserve bank sells the securities in its possession, and as a result the cash reserves at the disposal of commercial banks deplete and restrict their capacity to grant credit. During depression, the Reserve Bank buys the securities, and the cash reserves at the disposal of commercial banks increase thus enabling them to expand credit.

The Reserve Bank of India is authorised to engage in the purchase and sale of securities of the Central Government or a State Government of any maturity or such securities of a Local Authority as may be specified in this behalf by the Central Government on the recommendations of the Central Board. The bank's open market operations, by and large, have been conducted in Central Government securities, and to a very limited extent in State Government securities.

Open market operations cannot be successful without an adequate volume of securities at the disposal of the Bank, and without the presence of a broad and active securities market. Since the Second World War, the volume and variety of securities in the Bank's portfolio increased as a result of the growth of public debt enabling the Bank to undertake open market operations on a large scale. This is also helped by the large scale Government borrowing undertaken to finance the development programmes under the Five-Year plans. The Indian financial markets, though they do not compare well with those in U.K. and the U.S.A., are sufficiently broad and active to enable the bank to buy and sell Government securities. The Reserve Bank itself has contributed much to the development of money and capital markets by helping to create a proper institutional framework and by assisting their further growth. The Government borrowing under the Five -Year Plans has further broadened the Government securities market.

As a matter of fact, open market operations in India have never taken the role of a full-fledged instrument of credit policy. Credit is sought to be restricted, more through other monetary measures including selective credit controls. The objective of open market operations has remained largely i) to assist the Government in its borrowing operations; ii) to maintain orderly conditions in the securities market; and iii) to assist commercial banks to overcome seasonal stringency instead of influencing the availability and cost of credit. However,the Bank's open market operations have been in line with the monetary policy.

Though the range of open market operations was low before the Second World War, in the post-war years, the Reserve Bank used the open market operations to provide the banks with additional cash reserves for carrying on the financing activities during busy seasons. These operations led to an inflationary situtation particularly after the Korean War. An unduly large credit expansion was observed in the 1950-51 busy season. Therefore, in November, 1951 apart from raising the bank rate, the Reserve Bank announced a change in the open market policy. It said that it would not buy Government securities to meet the seasonal requirements of scheduled banks. But, it would be prepared to make loans and advances at the bank rate against such securities. Since 1951, the bank's operations involved the purchase of one security against the sale of another as distinguished from outright purchase or sale. Whatever support was given was more or less of a 'discriminating' nature and of a temporary duration. This policy resulted in a considerable diminution in the scale of the Bank's open market operation as compared to that of the previous years. Since the middle of 1957, however, the emphasis has ben shifted to sale of securities. This became most pronounced from 1964-65 to 1 968-69 during which period the net sales were of the order of Rs. 320 crores. Since then however, the purchases c securities have exceeded the sales. To sum up, the open market policy of the Reserve Bank has been fairly successful since 1951 in supporting the general monetary policy.

iii) Variation of Cash Reserves

As the central bank is the custodian of the interests of the depositing public, it insists on commercial banks to maintain minimum cash reserves so that their liquidity and solvency are not affected. Changes in the reserve requirements affect the amount of reserves that commercial banks must hold as deposits with the Central Bank, and consequently the amounts available for granting credit.

Under the Reserve Bank of India Act, the scheduled banks are under an obligation to maintain with the Reserve Bank of India a statutory cash reserve of an amount equal to, and not less than 3 percent of their demand and time liabilities. The Reserve Bank is empowered to raise the percentage of the statutory reserve upto a maximum of 15 percent and also to require the banks to maintain additional cash reserves.

The Reserve Bank exercised the power to raise the statutory reserve requirement in two stages during the year 1973. One from 3 per cent to 5 per cent of Demand and Time Liabilities in June 1973, and the other from 5 per cent to 7 percent in September 1973. These steps were warranted as a credit squeeze device in view of the continuing imbalance in the economy between the aggregate supply and aggregate demand and the rapid increase in the liquidity of banks which led to the excessive use of bank credit by the borrowers. An estimate was made that, for one-per cent-point increase in the statutory cash reserve deposit, an amount of over Rs. 100 crores was impounded with the Reserve Bank and was not available for credit creation. Thus, with the four percentage point rise in the reserve deposit in 1973, Rs. 430 crores were sterilised for purposes of granting credit.

The Reserve Bank reduced the statutory reserve ratio during 1974 from 7 percent to 5 percent (with effect from 28th June) and from 5 per cent to 4.5 per cent (with effect from 14th December) and from 4.5 percent to 4 percent (with effect from 28th December). The reduction of reserve ratio was necessary to enable the banks to meet the essential needs during the busy season, keeping in view the trends in deposit growth and the estimated overall needs of credit. Again during 1976, the statutory reserve was raised to 5 percent (with effect from 4th September) and further to 6 percent (with effect from 13th November) in order to control the rising prices and to regulate the expansion of credit by commercial banks. It was raised in stages to 7.75 per cent in 1981 and again reduced in stages to 7 per cent (with effect from 11th June, 1982)

Though the Reserve bank's power to impose additional cash reserve was first exercised during 1960, effective use of this power was only made in 1977, when the banks were directed to make an additional statutory reserve equal to 10 per cent of the incremental deposit of each bank after 14th January. Subsequently, banks were required to deposit with the Reserve Bank in rupees. Fifty per cent of the net aggregate amount received by them after 1st June, 1978 was under the Non-Resident (External) Rupee Accounts and Foreign Currency (Non-Resident) Accounts Scheme. This stipulaion was made to neutralise the impact on money supply by the inflow of resources from abraod. It was withdrawn in June, 1979. The rates of interest paid on such deposits has been raised to 6.5 per cent with effect from 1st June, 1978.

In addition to the statutory reserve requirement, the Reserve bank may require the commercial banks to maintain liquid assets of an amount equal to and not less than 25 percent of their demand and time liabilities. This measure is intended to restrict the banks capacity to grant credit on the one hand, and to improve their liquidity position on the other. As a credit control device, this minimum liquidity ratio was increased in successive stages from 25 per cent in 1970 to 30 per cent in November, 1972 and to 32 per cent with effect from 8th December, 1973. Again, it was raised to 33 percent later on, and further increased to 34 percent with effect from 1st December, 1978. As a result of the increase in the liquidity ratio, the banks potential for credit expansion is greatly restricted.

25.3.2 QUALITATIVE OR SELECTIVE METHODS OF CREDIT CONTROL

Apart from the quantitative methods of credit control, the Reserve Bank has been operating selecive credit controls in respect of certain commodities, which have been 'sensitive' or in short supply. These controls are enforced with a view to discourage the use of bank finance for hoarding of such commodities so as to check a rise in their prices. Since the inauguration of the Second Five-Year Plan, the price trends have become a some-what disquieting. The rise in prices has been attributed to a number of factors such as the short-fall in production and supplies, the increase in demand due to changes in consumption patterns, larger money supply, and the hoarding of stocks by agriculturists and intermediaries. The money supply with the public and bank credit have been exhibiting an upward trend since 1966. In view of the rapidly worsening situation on the price front the Reserve Bank commenced using the selective measures of credit control. The Planning Commission has rightly observed that "Central Banking in planned economy can hardly be confined to the regulation of the over-all supply of credit to somewhat negative regulation of the flow of bank credit. It would have to take a direct and active role, firstly, in creating or helping to create the machinery needed for financing developmental activities all over the country and secondly in ensuring that the finance available flows into directions intended"

The Reserve bank's directives may relate to any/or all of the following:

a) the puposes for which advances may or may not be made,

b) the margins to be maintained in respect of secured advances,

c) the maximum amount of advances to any company, firm, individual, etc.,

d) the maximum amount upto which guarantees may be given by the banking company on behalf of any one company, firm, etc., and

e) the rate of interest and other terms and conditions on which advances and other financial accommodation may be given.

At present the selective credit controls, are exercised in respect of certain essential commodities like food grains, vanaspati, cotton yarn, sugar and oil seeds. The framework of selective credit controls consist of (a) prescribing minimum margin for lending against specific securities; (b) stipulating discriminatory rates of interest on certain types of advances; and (c) fixing ceiling limits on the amount of credit for certain purposes. All these techniques are adopted in India.

The selective control measures were used for the first time on 17th November,1956 when the Reserve Bank issued a directive to the scheduled banks to raise the existing margins in respect of loans against rice and paddy by an amount of not less than 10 percent of the value of the commodities. This was later extended to cover all foodgrains, pulses, sugr and cotton. In March, 1963 with a view to counteract the boom on stock exchanges, a minimum margin of 50 percent was fixed in respect of the advances against equity shares. Limits were also fixed on the maximum amounts which could be advanced by banks to any single borrower. In November 1965, the Reserve Bank introduced the Credit Authorisation Scheme under which banks are required to obtain the authorisation of the Reserve Bank before granting an advance of an amount of Rs. 1 crore or more to any single party.

Since January, 1970, the nationalised banks are required to obtain the Reserve Bank's prior approval for

i) buying shares or debentures of a joint stock comapny; or for underwriting their issue, where the investment exceeds Rs. 1 lakh.

ii) lowering rates of interest or margins in case of loans in excess of 10 lakhs;

iii) granting deferred payment guarantees; and

iv) granting accommodation in any form to any single party in excess of Rs.25 lakhs.

A characteristic feature of the operation of selective credit control measures is their flexibility. Such controls have often been amended, modified or withdrawn according to the changing requirements of demand for, and supply, of the essential commodities and the trends in economic situation. The technique of selective control has been sought to be perfected and refined as it passed through several phases of its evolution. Originally the directives related to the fixation and alteration of margin requirements. In June, 1957, however an important stage in the evolution of selective control was reached when, regulation of the aggregate level of advances came to be used.

Selective credit control directives have the effect of keeping the level of advances against the commodity concerned within limits or permitting a rational or marginal increase therein. The advances of central banks against commodities covered by selective credit controls declined as a proportion of the total bank credit from about 11 per cent in 1970, to about 6 to 7 per cent in 1973. During 1971 the selective credit controls were mainly operated in a manner which would have a deflationary impact on the economy. The same policy has been continued during 1972 also. During 1972-73 the credit policy of the bank again aimed at restricting the undue expansion of credit so as to contain the inflationary pressures in the economy. The minimum lending rate on advabces against commodities covered by selective credit controls was raised to 15 persent during 1974-75. In the subsequent year, there was reduction in the minimum margin requirements in respect of advances against a number of commodities. In 1977, the credit policy was liberalised particularly to assist the sugar and textile industries. Since the inflationary pressures continued to affect the economy, the policy of caution and restraint was continued up to 1980. A further credit sqeeze was imposed in 1981, and consequently restrictions were placed on non-food credit. However in 1982, credit was made available to vital sectors of the economy and also for exports.

The effecive application of these controls does not always ensure a favourable impact on the price situation. The obvious reason is that bank finance only forms a minor part of the total finance used in the trading of such seasonal commodities. In this connection, it is fruitful to quote the Reserve Bank itself: "The efficacy of the selective credit control should not be assessed mainly in terms of their positive influence on prices since the latter primarily depend on the availability of supply of the relavant commodities, relative to demand. The success of these controls is to be judged in a limited sphere, viz; their impact on the pressure of demand originating from bank credit in this sense, the measures should be deemed successful; but for their operation it is likely that price situation might have been some whatworse".

Moral Suasion

Apart from the above methods of credit control, the Reserve Bank has also been excercising moral suasion on banks. The banks are persuaded, either by holding meetings or by circular letters, to follow a particular line of action. It is customary to address letters to banks at the time of every slack season and the reductions asked for by the Governor relate mainly to seasonal commodities. In recent years as banking business has been progressively concentrated with a few institutions, the Reserve Bank's task in this regard has become easier. The fact that the leading banks are in the public sector makes this measure more effictive.

CHECK YOUR PROGRESS -2

Mention the credit control methods adopted by RBI.

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25.4 AN EVALUTION OF MONETARY POLICY OF RESERVE BANK OF INDIA

It can be understood from a detailed discussion of the various methods used by the Reserve Bank that its monetary policy has acquired a new vigour and dynamism. Since 1970-71 the major objective of monetary policy has been to control inflationary pressure.

First, the monetary policy is not given a major importance in the expansion and development of the economy. In a country like India, the major responsibility for stimulating the economy to attain the stage of self-sustained growth has to be assumed by the Government. To the extent that it depends upon bank finance, the Reserve bank should ensure that economic development is not hampered for want of adequate funds. However, it should be realised that monetary policy cannot be of much avail if it is not accompained by the adoption of suitable fiscal and economic policies by the Government.

Secondly, the various weapons and powers of the Reserve Bank have been successful in curbing inflationary pressures that have resulted from bank finance.

Thirdly, the monetary policy of the Reserve Bank of India has become ineffective because of the use of black money for hoarding and speculative purposes.

"Successful credit regulation is not merely a question of availability of instruments but also one of judgement with regard to timing and degree of restraint employed or relaxation allowed". If the various credit measures had been appropriately timed they would have achieved better results.

25.5 SUMMING UP

The central bank of a country takes certain measures to control the credit creation of commercial banks. The monetary policy refers to such measures. It has certain important objectives such as maintenance of stable exchange rates, stablising the price level and trade cycles, maintenance of full employment, assisting economic development, etc.

The Reserve Bank of India started with a cheap money policy. During the plan period it aimed at financing of economic growth and at the same time ensuring reasonable price stability. Under the present inflationary circumstances, the RBI employed certain methods of credit control. They are classified into quantitataive methods and qualitative methods. Quantitative methods include bank rate policy, open market operations and variation of cash reserves. The RBI attempted to control the credit by changing the bank rate, particiapating in open market operations and by changing the Cash Reserve Ratio of commercial banks. Apart from these methods the RBI is exercising certain selective methods of credit control, such as prescribing minimum margins for lending against specific securities fixing, ceiling limits on the amount of credit for certain purposes, moral suasion on commercial banks, etc. Thus the RBI used various methods to control inflationary pressure in the country.

25.6 CHECK YOUR PROGRESS : MODEL ANSWERS

1. i) to maintain stable exchange rates.
   ii) to stabilise price level.
   iii) to maintain full employment level.
   iv) to maintain equilibrium of balance of payments.
   v) to assert the planned economic development.

2. The RBI adopted various methods to control the credit creation of commercial banks and thereby inflationary pressures in the country. They are:

i) Quantitative Methods

a) Bank Rate Policy

b) Open Market Operations

c) Variation of Cash Reserves

ii) Qualitative Methods

a) Margin Requirements

b) Ceiling Limits

c) Discriminatory Rates of Interest

d) Moral Suasion.

25.7 MODEL EXAMINATION QUESTIONS

A. ESSAY QUESTIONS

Answer the following in about 30 lines each:

1. What do you understand by monetary policy and what are its objectives?

2. What should be the objectives of monetary policy in a developing economy like India?

3. Discuss the monetary policy followed by the Reserve Bank of India.

4. What instruments of monetary policy have been employed by the Reserve Bank of India, and to what extent have they been successful in achieving their objectives?

5. Analyse the role of bank-rate policy as a monetary instrument in India.

6. Make critical assessment of the monetary policy of the Reserve bank of India and point out the factors responsible for its ineffeciveness.

B. SHORT QUESTIONS

Answer the following in about 15 lines each:

1. Explain the objectives of monetary policy.

2. Distinguish between quantitative and qualitative methods of credit control.

3. Explain the Moral Suasion as a device of credit control.

4. Expla n the terms : i) Neutral Money, and ii) Statutory Reserve Ratio.

25.8 RECOMMENDED BOOKS

1. Joshi N.C. : Indian Banking

2. Reserve Bank of India : Functions and Working

25.9 GLOSSARY

Collateral Security	: Security taken by a bank in support of its lending to customers.
Full employment	: The level of employment at which every one (able and willing to work) is employed. The full employment level of economy indicates full capacity output,i.e., all resources are employed.
Laisser-faire Principle	: The doctrine stating that the state interference in industry and commerce should be kept to a minimum.
4. Neutral Money	: Money serving as a medium of exchange and unit of account, but does not affect the economy.
5. White Paper	: An official statement by Government on some matters of current economic or social interest, generally a basis for legislation.

SECTION - C :

BANKING - LAW AND PRACTICE

BLOCK-VII : BANKER AND CUSTOMER

UNIT-26 : BANKER-CUSTOMER RELATIONSHIP

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26.0 AIMS AND OBJECTIVES

The aims of this unit are to explain the nature of relationship between a banker and a customer and to examine the statutory and non-statutory provisions and customs governing such relations.

After readng this unit, we expect you to be able to:

- explain the meaning of the term 'banker and define it;
- explain the term 'customer' and define i.;
- describe the relationship of the banker, as an agent, a trustee, pledgee and bailee of the customer.

26.1 INTRODUCTION

The relationship between a banker and a customer is of great practical significance. It arises out of the contract made between the banker and customer involving obligations on both sides. The contract of debt is at the back of most of the dealings. The legal basis of relationship between banker and customer is of many dimensions. The various statutory requirements and protections hinge directly on this relationship. However, while examining the relationship between the two, it is logical to examine the terms 'banker' and' customer'.

This unit first explains the meaning of the terms 'banker' and 'customer' and later examines the relationship between these two.

26.2 BANKER-MEANING AND DEFINITION

Numerous definitions have been developed by economists about the term 'banker' but very few of them give a satisfactory meaning. According to A.C. Hart" a banker or a bank is a person or a company carrying on the business of receiving money and collection of drafts for customers subject to the obligation of honouring cheques drawn upon them from time to time by the customers to the extent of the amount available in their current account." The above definition requires the fulfilment of the following conditions for recognising a person or an institution as banker or a bank.

a) Acceptance of money on current account and the collection of cheques and drafts for customers.

b) Payment of cheques or orders drawn by customers which are essentially payable on demand. Of course, these instruments will be honoured to the extent the amount is available in the current account or upto the agreed overdraft limit.

c) Banking business must be the main business of such a person or a company. This view was held by Stafford Vs. Henry (1850). In this case one Mr. Labertouche had carried on varied business, part of which, at that time, was regarded as banking. But as it was not his main business, it was held that he was not a banker. According to Sir John Paget, no one is a banker (i) who does not take deposit accounts ; (ii) who does not take current accounts; (iii) who does not issue and pay cheques; and (iv) who does not collect cheques crossed or uncrossed for his customers.

The commonly used definition of a banker as a dealer in money and credit is not satisfactory. It is because there are many financial institutions other than banks which deal in money and credit. Eg. Money-lenders deal in money and credit, but they do not come under the category of banker. Similarly building societies receive deposits and they also provide credit, but they are not bankers. In both the cases, demand deposits against which cheques can be drawn by a customer are not kept.

26.3 CUSTOMER-MEANING AND DEFINITION

There is no statutory definition of customer. According to the classical view as expressed by Sir John Paget "to constitute a customer, there must be some recognisable course or habit of dealing in the nature of regular banking business ". That is, mere maintenance of an account is not enough unless:

i) there is a recognizable (i.e., acknowledged and established) course or habit of dealing between the customer and the banker, and

ii) the connection of these dealings is with some banking business.

According to him, a single transaction or the rendering of some service will not entitle a person to become a customer. It is the continuity and custom over a period of time that is necessary. To be a customer the person should be accustomed to visit the banker frequently.

Further, the dealings must be of a banking nature. That is the money should be deposited in the customer's account and withdrawals should be made against it. The receipt of money on loan and the obligation to repay on demand against cheques are the bases of banking business.

While there is no dispute as to the requirement of transactions being related to banking business, as far as the duration theory is concerned, it has not been supported by others. It was discarded as far back as 1914, consequent upon the judgement in Lank Broke Vs. Todd. It was held that the relation of banker and customer begins as soon as the first cheque paid in is accepted for collection and not merely when it is paid. One after another the courts have given a ruling that even a single transaction could give rise to banker-customer relationship. In the Commissioner of Taxation Vs. English, Scottish and Australian Bank Ltd., 1920, this point was made clear. The Privy Council held that "word customer signifies a relationship in which duration is not of essence". A person whose money has been accepted by the bank on the condition to undertake to honour cheques upto the amount standing to his credit, is, in the view of their Lordship, a customer of the bank in the sense of the statute, irrespective of whether his connection is of long or short standing. Therefore, from the strictly legal view point, continuity of dealings is not essential. When an account has been opened, frequency of transactions can very well be assumed.

According to Dr. Hart "a customer is one who has an account in a bank or for whom a banker habitually undertakes to act as such". This definition has been endorsed even by the Kerala High Court. It observed that "broadly speaking a customer is a person who has the habit of resorting to the same place or person to do business. So far as banking transactions are concerned, he is a person whose money has been accepted on the footing that the banker will honour upto the amount standing to his credit, irrespective of his connection being of short or long-standing". It is clear that a person becomes a customer irrespective of the fact whether his account has been operated upon for sometime or not.

The nature of dealings of the customer with the banker determines the status of the customer. The person who does not deal with the banker in regard to the essential functions of banker - accepting of the deposits and lending of money, but avails, any of the services rendered by the banker is not called the customer of the banker. For instance, a person without a bank account in his name may remit money through a bank draft, encash a cheque received by him from others or deposit his valuables in the safety lockers of the bank. Yet he is not called the customer of the bank because his dealings with the banker are not in regard to the essential functions of a banker. Such dealings are considered as casual dealings and are not in the nature of banking business. It is, therefore, clear that to constitute a customer, a person should have a bank account in his name by making necessary deposits of money and his dealings with a banker must be of the nature of banking business.

CHECK YOUR PROGRESS - 1

State meaning of the term 'customer'.

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26.4 RELATIONSHIP BETWEEN BANKER AND CUSTOMER

Having attempted to explain the terms 'banker' and 'customer', we may turn our attention to examine the relationship between a banker and a customer. It is examined under the following headings.

26.4.1 RELATIONSHIP AS DEBTOR AND CREDITOR

As soon as the customer opens an account in a bank, the banker assumes the position of a debtor. The money deposited by the customer with the banker may be made use of by the latter according to his discretion. The customer, however, has the right to demand his money back from the banker and the banker is under an obligation to repay the debt as and when he is required to do so.

A customer remains as a creditor of his banker so long as his account carries a credit balance but he never gets a charge over the assets of his debtor (banker) and remains as unsecured creditor of the banker.

The banker's relationship with the customer is exactly opposite under conditions of overdraft. As soon as the customer's account is overdrawn, the banker becomes the creditor. Since the loans and advances granted by the banker are usually secured by tangible assets of the borrower, the banker becomes a secured creditor of his customers.

Though the relationship between the banker and his customer is mainly that of a debtor and creditor, this relationship differs from similar relationships arising out of ordinary commercial debts in the following respects:

(a) The Creditor must Demand Payment: In case of commercial debt, the debtor pays the amount on the specified date or earlier or whenever demanded by the creditor as per the terms of the contract. But in the case of a deposit in the bank, the debtor (banker) need not repay the amount on his own accord. It is essential that the depositor (creditor) should make a demand for the payment of the amount in an appropriate manner. This difference is due to the fact that banker is not an ordinary debtor. He accepts the deposits with an additional obligation to honour his customers' cheques. If the banker returns the deposited amount on his own accord, some of the cheques sent by the depositor might be dishonoured and his reputation might be adversely affected. Moreovesr, as per the statutory definition of banking, the deposits are repayable on demand or otherwise. The depositor makes the deposit for his convenience and also with a motive to earn income. Hence, the depositor has to demand repayment of the deposited money.

(b) Proper Place and Time of Demand: The demand by a creditor must be made at the proper place and at the proper time. The depositor enters into a relationship with only that branch of the bank where an account is opened in his name. He must make the demand for repayment of the deposit only at that particular branch. Otherwise the banker is not bound to honour the cheques of the depositor. Nevertheless, on special request of the customer, the banker may arrange for repayment of the deposited money at some other branch. For example, in the case of bank drafts, travellers' cheques etc., the branch receiving the money undertakes the repayment of the money at a specified branch or at any branch of the bank.

In Indo-Allied Industries Ltd., Vs. Punjab National Bank Ltd., 1920, the Allahabad High Court held that in the absence of an express contract to the contrary there is as an implied contract with the customer who opened the account with the branch of the banking concern, which caused with it the duty of the bank to pay the customer only at the branch where the account was kept subject to instructions to transfer the account elsewhere. The court further held that if the obligation to transfer was frustrated by local legislation or government action of the country where the account was kept, the remaining implied obligation to pay at the branch where the account was kept, could not be substituted automatically by unconditional obligation of the principal to pay elsewhere by resorting to Section 226 of the Indian Contract Act.

In the above case the Indo-Allied Industries Ltd., had its accounts with the Rangoon branch of Punjab National Bank Ltd. On the liquidition of the former, the latter was informed about the appointment of the liquidator. The liquidator did not operate the accounts for two years and in the meanwhile the Rangoon branch was nationalised. The People's Bank Number 7, the successor of he Rangoon branch wanted to transfer the money to the liquidator in India but its request for tne same was rejected by the Burmese exchange control department. Thereafter, the bank treated the managing agent of the company, then residing at Rangoon as duly authorised to withdraw the amount and permitted him to do so. The liquidator sought to make the head office of the Punjab National Bank responsible for the payment made collusively and wrongfully because under Sec. 226 of the Indian Contract Act, the principal is responsible for agent's action on the contract. It is necessary that the demand for payment should be made during the banking hours only. If payment is made before or after the banking hours, the banker may become liable for the same.

(c) Demand must be in proper manner: As per the statutory definition of banking, deposits are withdrawn through cheque, drafts, etc. It implies that the demand to refund the deposited money should be made through a cheque, draft or an order as per the common usage amongst the bankers. It means that the demand should not be made verbally or through a telephonic message or in any such manner.

(d) Not Time Barred: The deposits with the bank do not become time barred on the expiry of three years in India and six years in U.K., as in the case of ordinary debts. The statute of limitation begins to run only when the amount becomes due i.e., the period of limitation is counted from the date when demand has been made either by drawing a cheque or writing a letter. (Joechinessons Vs. Swiss Bank Corporation 1921).

26.4.2 BANKER AS A TRUSTEE

In certain circumstances, the banker acts as a trustee of the customer. A trustee holds money or assets and performs certain functions for the benefit of some other person called the beneficiary. For instance, if the customer deposits any valuables with the banker for safe custody, the latter acts as a trustee of the customer. The customer continues to be the owner of the valuables deposited. The legal position of the banker as a trustee or as a debtor of the customer is different. In the capacity of a trustee, the money or the documents held by the banker are not treated as his own and are not available for distribution among his general creditors in the case of liquidation.

The banker's position either as a trustee or as a debtor is determined by the circumstances in each case. If he does something in the ordinary course of business without any specific direction from the customer, he acts as a debtor. In the case of money or bills etc., deposited with the bank for a specific purpose, the banker's position will be determined by ascertaining whether the amount was actually debited or credited to the customer's account or not. For example, if a cheque is sent for collection from another bank, the banker acts as trustee until the cheque is realised and credited to the customer's account. Once the amount thus realised is credited to the customer's the banker will be the debtor for the same amount. On the other hand, if the customer instructs his bank to purchase certain securities out of his deposits, but the bank fails in its business activity to make such purchases, the banker continues to be the debtor of his customer for the amount which was not withdrawn to carry out the specific instruction of the customer.

The relationship between the banker and the customer as a trustee and beneficiary depends upon the specific instructions given by the latter to the former regarding the purpose or use of money or documents entrusted to the banker. In the case between the New Bank of India Ltd. Vs. Pearelal (AIR 1962), the Supreme Court held that in the absence of other evidence, a person paying into the bank whether he is a constituent of the bank or not, may be presumed to have paid the money to be held as a banker ordinarily holds money of other constituents. If no specific instructions are given at the time of payment or thereafter and even if the moneys are held in Suspense Account, the bank does not thereby become a trustee of the amount paid. In other words, when a person dealing with a bank delivers money to a bank, the intention to create a relationship of creditor and debtor between him and the bank is presumed; unless this presumption is rebutted. For example, (i) When the money is paid to a bank with special instructions to retain the same pending further instructions or (ii) to pay the same to another person who has no account with the bank and the bank accepts the instructions and holds the money pending instructions from that other person or (iii) When instructions are given by the customer to his banker that a part of the amount lying in his account be forwarded to another bank to meet a bill to become due and payable by him and the amount is sent by the banker as directed, a trust results, and the presumption which ordinarily arises by reason of prepayment of money to the bank is rebutted.

In the above case, a customer deposited two sums of money at the Lahore branch of a bank for transmission to its Calcutta branch with instructions to await his directions regarding the opening of accounts for keeping the same in a fixed deposit or otherwise at a Calcutta branch. The customer did not give directions but the bank opened a fixed deposit account without his consent and was subsequently placed under a scheme of arrangement. The Supreme Court held that after the purpose for which the money was entrusted was carried, in the absence of further instructions, the bank did not cease to be a trustee and continued to hold the same for, or on behalf of the customer.

26.4.3 BANKER AS AN AGENT

The banker also acts as an agent of the customer and performs a number of agency functions for the convenience of his customers. For example, the banker buys or sells securities for his customer, collects cheques on behalf of the customer, makes payments of various dues for his customer. The nature and range of such agency functions have become wider and have assumed a lot of importance in modern banking. For instance, some banks have provided tax service departments to look after the tax problems of their customers.

The banker makes periodical payments to the customer's creditor on behalf of the latter. In this position the banker and customer relationship is governed by the law relating to the principal and an agent. The banker enjoys all the rights of an agent and in turn is subjected to all the obligations that flow from that agency.

CHECK YOUR PROGRESS - 2

When does the banker customer relationship as debtor and creditor become reversed ?

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26.4.4. BANKER AS A PLEDGEE

The banker acts as a pledgee of the customer in the following cases:

(i) Where the money is paid into the bank with his special instructions to retain the same pending further instructions the banker acts in the capacity of pledgee.

(ii) When the money is paid into the bank with instructions to pay over the same to another person who has no bank account and the bank accepts the instructions and holds the money pending instructions from that other person.

(iii) Where instructions are given by a customer to his banker that a part of the amount in his account, be forwarded to another bank to meet the bills that become due and the amount is sent by the banker as directed.

(iv) In respect of shares or goods held as collateral security, the position of the banker is that of a pledgee. As a pledgee the banker is entitled to dispose of the shares and appropriate the amount towards loan account in the case of default. If the banker is considered to be a trustee he will have no right to dispose of the trust property for his benefit.

26.4.5 BANKER AS A BAILEE

Where jewellery, valuables, stocks, bonds and debentures etc., are deposited for safe custody, the banker becomes the bailee and the depositor the bailor. Here all the stipulations regarding bailment come to apply in terms of section 148 of the Indian Contracts Act. But the point to be particularly noted is that when the banker takes charge of the customer's property in his strong room, he acts purely in the capacity of a custodian. In no case does he become an insurer of goods. He is only liable for negligence on his part and not for the goods being stolen or fradulently used by persons in his own employment. But it is to be examined whether the banker acting in such a way is a gratituous bailee, or bailee for reward. This has been a moot point for quite a long time. But it has been ultimatelly decided that a banker is a paid bailee and therefore, must safeguard the customer's articles by every means in his power. For this purpose he must provide the most effective appliances possible.

CHECK YOUR PROGRESS - 3

Mention the agency functions that a banker undertakes to perform as an agent of the customer.

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26.5 SUMMING UP

Mere dealer in money cannot be treated as a banker. It has to accept deposits on accounts, collect cheques and drafts for customers and pay cheques and orders drawn by customers. Its main business should be banking business. A person who has a bank account in his name and deals with the banker in regard to its essential functions shall be treated as a customer.

By opening an account with the bank a contractual relationship between the banker (debtor) and customer (creditor) established. But when the account is overdrawn the banker becomes creditor and the customer becomes debtor. The debtor-creditor relationsip between the banker and customer differs from the similar relationship of debtor and creditor of ordinary commercial debts in some respects. They are: the customer (creditor) must demand the payment at proper place and time and the customer must demand in a proper manner. The banker may also have the relationship with the customer as a trustee, an agent, a pledgee and a bailee.

26.6 CHECK YOUR PROGRESS : MODEL ANSWERS

1. A customer is a person who has a bank account in his name and whose dealings with the banker are of the nature of banking business.

2. As soon as the customer's account is overdrawn the banker - customer relationship as debtor and creditor is reversed. Then the banker becomes creditor and the customer becomes debtor.

3. As an agent of the customer, the banker undertakes to perform many functions such as :

   i) buying and selling securities on his behalf.

   ii) collection of cheques, drafts, dividends on his behalf.

   iii) making of payments of various dues on his behalf, etc.

26.7 MODEL EXAMINATION QUESTIONS

A. ESSAY QUESTIONS

Answer the following in about 30 lines each:

1. What do you understand by the term 'customer' of a bank ? what are the conditions necessary to treat a person as the customer of a,bank ?
2. Discuss the general features of the banker-customer relationship.
3. The banker-customer relationship is that of debtor and creditor. Explain this statement. What precuations should the customer keep in mind before demanding payment by the banker ?
4. What are the special features of banker-customer relationship?

B. SHORT QUESTIONS

Answer the following in about 15 lines each:

1. What do you mean by a banker ? How is he considered as the debtor of a customer ?
2. How does a banker act as an Agent and Trustee of a customer ?
3. When can a banker refuse payment to his customer ?
4. When does a banker act as a bailee and pledgee of a customer ?

26.8 RECOMMENDED BOOKS

1. Davar R.S. : Law and Practice of Banking
2. Shekar K.C. : Banking, Theory and Practice
3. Srivastava P.K. : Banking, Theory and Practice.
4. Tannan M.L. : Banking Law and Practice.

26.9 GLOSSARY

Bailee : A person who is entrusted with the possession of goods, documents, etc.

Pledgee : A person who keeps the property given on security until the debt or obligation is discharged and if it is not, may sell the property.

Trustee : An individual, a group of persons, a bank or an institution which holds money or other property on behalf of owners and performs certain functions for their welfare.

UNIT-27 : OBLIGATIONS AND RIGHTS OF A BANKER

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27.0 AIMS AND OBJECTIVES

The purpose of this unit is to discuss the statutory, apparent and implicit obligations of a banker towards his customer and the rights that the banker can exercise.

By the end of this unit, we expect you to be able to :

- explain the obligation of a banker to honour customer's cheques;
- discuss the obligations imposed on a banker, under a garnishee order;
- examine the liability of a banker in the case of wrongful dishonour of cheques;
- explain the obligation of a banker to maintain the secrecy of a customer's account;
- mention the proper occasions for disclosure of information about customer's account; and
- describe the rights of a banker.

27.1 INTRODUCTION

In the previous unit, we have explained the relationship between the banker and customer. This relationship imposes several obligations on the part of the banker towards his customer.

The banker also has certain rights to exercise. In this unit these obligations and rights are discussed at length.

27.2 OBLIGATION TO HONOUR CUSTOMER'S CHEQUES

The primary relationship between the customer and banker is that of a creditor and debtor and vice-versa. The special feature of the relationship imposes additional obligations on the banker. The obligations are discussed in the following paragraphs.

The duty of the banker is to repay the cheques of the customer who keeps the current account in the bank. This duty arises out of two implied stipulations between the parties. The first is that the banker will repay what he borrows from his customer provided the latter makes a properly written demand for repayment at the correct branch of the bank. The other is that the banker will not injure his customer's credit by refusing to pay his cheques except on reasonable and proper grounds. In India this obligation is imposed on a banker under Section 31 of the Negotiable Instruments Act, 1881 which provides that the "drawee of a cheque having sufficient funds of the drawer in his hands, properly applicable to the payment of such cheques, must pay the cheque when duly required to do so, and in default of such payment must compensate the drawer for any loss or damage caused by such default". Thus the banker is bound to honour the cheques of the customers provided the following conditions are fulfilled;

(i) There must be sufficient fund of the customer to pay his cheques. By sufficient funds we mean at least equal to the amount of the cheque presented. Otherwise the banker must necessarily dishonour the cheque issued by the customer. However, where the banker has agreed to the facility of overdraft to the customer, the banker is bound to honour the cheques upto the amount covered by the overdraft. If the customer has accounts with two or more branches of the same bank, he has no right to expect the banker to combine the accounts for the purpose of honouring the cheques. The banker however, has the privilege to combine the accounts for exercising his right of set-off (Mohammad Hussain Vs. Charted Bank 1965). It is held that cheques are generally payable at the branch where the account of the customer is kept and each branch of a bank is treated as a distinct entity for this purpose.

(ii) The funds must be properly applicable to the payment of the cheque. It is essential that the account on which a cheque is drawn must have sufficient funds. If some funds are earmarked by the customer for some specific purpose, such funds are not available for honouring the cheque. The depositor having a credit balance in his current account cannot draw a cheque on the basis of his fixed deposit with the banker as the latter is a deposit under a separate agreement for a specific period. It can only be withdrawn in the manner specified and not through a cheque. Sometimes an obligation also emerges out of the past practice followed by the banker. For example, if the banker has honoured the cheques of the customer on several occasions in the past without sufficient funds and later on requested the customer to make good the deficiency in his account, an implied arrangement to overdraw the account is presumed to exist.

(iii) The banker must be given reasonable time to honour the cheques. This means that the cheque, complete, and in order, must be presented to the banker at a proper time. Ordinarily a period of 6 months is considered sufficient within which a cheque must be presented for payment. After the expiry of 6 months from the date of the issue, a cheque becomes **stale** and will be dishonoured by the banker. A post-dated cheque is to be dishonoured by the banker because the order of the drawer becomes effective only on the date given in the cheque. The banker must have reasonable time for crediting funds before cheques can be drawn against them. The reasonable time depends upon the facts and circumstances of each case. When a customer presents the cheques even before the instruments deposited are collected, such cheques will be returned by the banker with a remark "ENC, meaning Effects Not Cleared".

(iv) There must be no legal ban preventing the payment of such cheques. For example, if a garnishee order is issued by the court attaching the funds in a particular account, the cheques drawn against such accounts must essentially be returned.

CHECK YOUR PROGRESS - 1

Mention the conditions to be fulfilled for the honour of cheques.

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27.3 GARNISHEE ORDER AND ITS APPLICATION

It is an order from the court obtained by a judgement creditor attaching the funds in the hands of the third party due to the judgement debtor. The obligation of a banker to honour his customer's cheques is extinguished on receipt of an order of the court. This is known as a **garnishee order**. It is issued under rule 46 of the Code of Civil Procedure, 1908. If the debtor fails to pay the debt due by him to his creditor, the latter may apply to the court for the issue of a garnishee order on his debtor banker. Such order attaches the debts, not secured by a negotiable instrument. It prohibits the creditor from recovering the debt and the debtor from making payments thereof. Thus the account of the customer with the banker becomes suspended and the banker is under an obligation not to make any payments from the account concerned after the receipt of the garnishee order. The creditor on whose request the order is issued is called the judgement creditor. The debtor whose money is frozen is called the judgement debtor and the banker who is the debtor of the judgement debtor is called a garnishee.

The garnishee order is issued in two parts. Firstly, the court directs, the banker to stop payment out of the account of judgement debtor. Such order is called 'Order Nisi'. It seeks explanation from the banker as to why the funds in the said account should not be utilised for meeting the judgement creditor's claims. The banker is prevented from paying the amount due to his customer on the date of receipt of the Order Nisi. The banker should immediately intimate the customer of this fact so that dishonour of his (customer's) cheques can be avoided. After the bank files the explanation, the court may issue the final order called "Order Absolute". According to this order the entire balance in the account or a specified amount attached will be handed over to the judgement creditor. On receipt of such order the banker is at an obligation to pay the garnished funds to the judgement creditor and his liability to the customer is discharged to that extent. The following points need to be noted in this connection:

i) The garnishee order may attach the entire amount of the judgement debtor with the banker irrespective of an amount due by the debtor to the creditor. As an alternative, the order may attach a specified amount only which is sufficient to meet the creditor's claims from the judgement debtor. In the first case the entire amount in the account of the customer of the bank is garnished or attached. If the banker pays any amount of such sum which is in excess of the amount of debt of the creditor plus cost of legal charges, he (the banker) will render himself liable for such payment. For example, the entire amount of Rs. 15,000 to the credit of the principal debtor is attached by the court and the debt owed by him to the creditor 'Y' (Rs.10,000). If the banker honours cheques of the customer 'X to the extent of Rs.6,000 and thus reduces the balance to Rs.9,000 he (the banker) will be liable for defying the order of the court. On the other hand if the banker dishonours all cheques subsequent to the receipt of the garnishee order, he will not be liable to the customer for dishonour of cheques.

In the second case, the amount specified by the order is attached and the amount in excess of that may be paid to the customer by the banker. Where the garnishee order attaches a specified amount, the usual practice is to transfer that amount to a Suspense Account and permit the customer to operate his account in respect of the balance.

ii) The garnishee order prohibits the banker from paying the debts due, or accuring due. 'Accruing due' refers to the debts which are not payable but an obligation for payment exists. If the account is overdrawn, the banker owes no money to the customer. As such, the court order ceases to be effective. That is to say, the customer's overdraft account is not attachable even though he has not drawn up to the permitted limit.

iii) The banker has the right to set-off any debt owed by the customer before the amount to which the garnishee order applies is determined. It is essential that the debt due from the customer is actual and not merely contingent.

iv) The garnishee order attaches the balance standing to the credit of the principal debtor at the time the order is served on the banker. The following points are to be noted in this connection.

a) The garnishee order does not apply to (i) the amount of cheques, drafts,bills etc., which have been sent by the customer, but remain uncleared at the time of receipt of the order, (ii) the sale proceeds of the customer's securities eg., stocks, shares, which are in the process of sales and, are not yet realised by the banker. In this respect the banker acts as an agent of customer and the amounts relating to collection of cheques and sale of securities are not debts due by the banker to the customer, untill they are actually received by the banker and credited to the customer's account

b) The garnishee order applies to the current balance at the time the order is served and it has no prospective operation. The amounts deposited to the customer's account after the garnishee order is served are not attached by the order.

c) The garnishee order is not effective on the payment already made by the banker before the order is served upon him. However, if a cheque is presented for payment and the money is not paid, and in the meanwhile the garnishee order is issued, the banker has to stop payment. Similarly if the customer directs the banker to transfer an amount in his account and the banker has already made some entries in his books of account to that effect, but an intimation of the same is yet to be sent to other account holder, and in the meanwhile, if the garnishee order is received by the banker, such transfer has no effect, and the garnishee order attaches the amount.

d) In the case of cheques presented to the paying banker through the clearing house, the effectiveness of the garnishee order depends upon the fact whether the time for returning the dishonoured cheque, to the collecting banker has expired or not. Every drawee bank is given a specified time within which it has to return the unpaid cheques, if any, to the collecting bank. If such time has not expired and in the meanwhile the bank receives a garnishee order, it may return the cheque dishonoured. But if the order is received after such time is over, the payment is deemed to have been made by the paying banker. The order shall not be applicable to such amount.

e) The garnishee order is not applicable to money held abroad by the judgement debtor and securities held in the safe custody of the banker.

f) The garnishee order may be served on the head office of the bank concerned and it will be treated as sufficient notice to all the branches. The head office is given the reasonable time to intimate the same to the branches. However, if the branch office makes payments before such intimation is received the garnishee order will not apply to such payment.

The garnishee order is applicable to the following accounts:

(i) Joint Account

In the case of a joint account, if only one of the customers is a judgement debtor, the joint account cannot be attached. But if both or all the joint account holders are joint judgement debtors in any legal proceedings the joint account can be attached.

(ii) Partnership Account

In the case of debts taken by the partnership firms , the personal accounts of the partners can also be attached in addition to the accounts in the name of the firm. It is because the liability of the partners is both joint and several.

If the partner is a judgement debtor only his individual account may be attached, and not that of the firm nor those of other partners.

(iii) Trust Accounts

An account opened in the name of a trustee in his personal capacity cannot be utilised for paying his personal liabilities. The banker should, therefore, inform the court that the account is a trust account. Further the bank should stop payment from the account and instruct the trustee.

(iv) Attachment Order issued by Income Tax Authorities

The account of the customer of a banker may be attached by the income tax authorities, if the former defaults in making payment of the tax due from him according to Section 226(3) of the Income Tax Act 1961. The order of the income tax officer may attach:

(a) any debt due and payable,

(b) debt due but not payable on the date of receipt of the notice,and

(c) any amount received subsequently. The balances lying in a joint account may also be attached even though the notice is issued on a single account.

After making payment as required under this section, the banker shall be fully discharged from his liability to the assessee to the extent of the amount so paid. But if he fails to make payment, he shall be deemed to be an assessee in default in respect of the amount specified in the notice. Further, proceedings may be taken against the banker for realisation of such amount. The banker should, therefore, comply with such orders.

CHECK YOUR PROGRESS - 2

What do you mean by 'Garnishee Order'.

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27.4 LIABILITY OF BANKER IN THE CASE OF WRONGFUL DISHONOUR OF CHEQUES

The banker has a statutory obligation to honour his customer's cheques unless there are some valid reasons to refuse payment. In case he dishonours cheques, intentionally or by mistake, he is liable to compensate the customer for the loss suffered by him. According to

h) Foreign Exchange Regulation Act, 1973

The banking companies dealing in foreign exchange business are designated as authorised dealers in foreign exchange. Section 43 of this Act authorises any officer of the Directorate of inforcement of RBI to inspect the books and accounts and other documents of such dealers and also examine them on oath.

i) Under the Industrial Developmnent Bank of India Act, 1964

Under Section 24 of this Act, the IDBI is empowered to collect credit information and other information from various nationalised banks, which is necessary for its efficient functioning.

27.5.2 DISCLOSURE PERMITTED BY PRACTICES AND USAGES

The practice and usages customary amongst bankers permit the disclosure of certain information under the following circumstances:

a) With the Express or Implied Consent of the Customer

The banker will be justified in disclosing any information relating to his customer's account with a letter of consent. The customer may instruct the banker to give some or all particulars of his account to others, eg. Auditors. Similarly where the customer has given the banker as the reference, the banker is fully justified in answering all such references. The consent of the customer may be expressed or implied. Expressed consent exists in cases where the customer directs the banker in writing to intimate the balance in his account or any other information to his agent, employer, or consultant. The banker would be justified in furnishing to such persons only the required information and no more.

b) Disclosure in Banker's Interest

The banker's act is justified when he discloses the state of account of a customer in his own interest, for example, if the banker has to recover the dues from the customer or the guarantor, disclosure of necessary facts to the guarantor or the solicitor becomes necessary and is quite justified.

c) Disclosure in the Public Interest

The banker who is aware of the fact that an account is kept by an anti-national or the customer is having dealings with an alien country, he must at once report the matter to the proper authorities.

d) Banker's Opinion

The last type of disclosure is that of answering credit enquiries from fellow bankers regarding the credit of the proposed guarantor, or of an acceptor of a bill under discount. Under such cases, the banker is obliged to answer the enquiries. This practice prevalent among bankers is referred to as 'Common Courtesy'. In such cases the banker must be extremely careful while answering the enquiries. If his report is too favourable, he may be charged with misrepresentation or negligence. On the other hand if it is too unsatisfactory, an action for libel may be brought up by the customer.

In a case Hedley Byrney & Company Ltd., Vs. Heller & Partners Ltd., Lord Morris observed that a banker of whom a reference was made was not expected to make a detailed enquiry and produce a well-balanced report. All that was expected was that he should answer honestly the questions put to him from what he knew from the books and the accounts before him.

27.5.3 PRACTICAL CONSIDERATIONS CONCERNING DISCLOSURE

The practical considerations to be kept in mind by the banker with regard to revealing any information about the customer's account are discussed below:

1. The banker should furnish only the required information and no more, when the disclosure is made at the instance of the customer.

2. The banker should avoid inadvertant disclosure. When amounts are disclosed to the customer the banker should see that others do not hear it. For this purpose the bank staff should be instructed not to shout the information across the counter.

3. If the banker has any doubt about the propriety of the disclosure it is better to obtain the express authority from the customer.

4. As far as possible information should not be conveyed on the phone unless the banker is sure of the customer's voice.

5. When information is conveyed through an agent for delivery to a customer, it should be in a properly sealed closed cover.

6. The banker should provide the required information honestly; without any bias or prejudice and should not misrepresent the facts deliberately. In such cases he incurs liability not only to his own customer but also to the enquirer.

7. The banker should give an authentic statement of the customer's account or his financial position without disclosing the actual figures. However, this general opinion should neither be too low nor too high.

27.5.4 CONSEQUENCE OF IMPROPER DISCLOSURE

1. Liability to the Customer : As stated already, the customer may sue the banker for breach of contract in case of excess disclosure or disclosure without authority. He may proceed for libel if he considers the information given by the banker defamatory.

2. Liability to Third Parties: This arises when the third party suffers loss when relying upon an opinion given by the banker fradulently. The banker is not liable where a careless or negligent reference is given unless there is some contractual or fiduciary relationship with the enquirer. The bankers are under no statutory duty required to exercise care in giving their replies, their duty being only to act honestly. Therefore, if the enquirer happens to be a customer of the same bank, it is advisable for the banker to add a suitable disclaimer to the reply so as to avoid liability.

27.6 BANKER'S RIGHTS

Banker's Rights are discussed under the following heads.

27.6.1 BANKER'S LIEN

A lien is a right to retain the property belonging to a debtor until he has dicharged the debt due to the retainer of the property. A lien is merely a right to retain and it is lost when the position is lost. It may be a particular lien or a general lien. A particular lien arises from a particular transaction connected with the propety subject to the lien. A general lien arises not merely out of a particular transaction, but for the general dealing between the two parties in respect of other transactions of similar character. The lien confers on the creditor the right to retain the goods and securities and not the right to sell them.

Particular lien is enjoyed by persons like tailors, goldsmiths, craftmen, etc. For example, the goldsmith can retain a Jewel until the making charges are paid. General lien is applicable in respect of all amounts due from the debtor to the creditor. But in the case of particular lien, the goods are retained for a particular debt only. Section 171 of Indian contract Act, 1881 confers, in the absence of a contract to the contrary, the right of general lien on the bankers who are authorised to retain the goods and securities banked to them

Special Features of Banker's Lien

i) The banker possesses the right of general lien on all goods and securities entrusted to him in his capacity as a banker and in the absence of a contract inconsistent with the right of lien. However, the banker cannot exercise his right of general lien in the following few cases:

a) if the goods and commodities have been entrusted to the banker as a trustee or as an agent of the customer; and

b) if there exists a contract, express or implied between the customer and banker and it is inconsistent with the right of banker's right of general lien. In other waords, if the goods and securities are entrusted to the banker for some specific purpose, he cannot have lien over them.

ii) The ordinary right of lien is a right merely to retain the position of goods till the loan is repaid. It does not confer on the creditor the right to sell the goods. In the case of pledge, the creditor enjoys the right of sale. The position in the case of a banker is as follows:

The banker's right of lien is more than a general lien. It confers on him the power to sell goods and securities in the case of default by the customer. The right of lien resembles a pledge and as such it is called an "implied pledge'. Thus the banker enjoys the privilege of a pledge and can dispose of the securities after giving proper notice to the customer.

iii) The right of lien is conferred upon the banker by the Indian Contract Act. No separate agreement or contract is necessary between the banker and the customer to exercise the right of lien. However, the banker takes the letter of lien from the customer mentioning that the goods are entrusted to the banker as security for the loan taken from the banker. The right of lien can be exercised on goods or other securities standing in the name of the borrower only and not jointly with others.

iv) The banker can exercise the right of lien on securities remaining in his possession after the payment of loan for which they were lodged by the customer. There is an implied assumption that the customer has offered the same security as a cover for any other advance outstanding as on that date or taken subsequently.

v) The right of lien can be exercised on goods or other securities standing in the name of the borrower only and not jointly with others. For example, if the securities are held in the joint names of two or more persons, the bank cannot exercise the right of general lien in respect of debt due from a single person.

Conditions to Exercise Right of Lien

The banker has to fulfil the following conditions before he can exercise the right of lien:

i) The property must come into his hands in his capacity as a banker.

ii) The goods or securities should not have been entrusted for a specific purpose inconsistent with the lien.

iii) The possession of the property must be lawfully obtained.

iv) There must be no agreement inconsistent with the lien.

v) Lien can be exercised only on goods and securities belonging to someone else. There can be no lien on fixed deposits since the ownership of the money is passed on to the banker. There can only be right of set-off in such a case.

Exceptions to the Right of Lien

The banker cannot exercise the right of lien in the following circumstances:

(i) Safe Custody Deposits: When a customer deposits valuables such as securities, documents, ornaments with the banker for safe custody, a contract inconsistent with the right of lien exists. In this case a banker is considered as a bailee or a trustee with the purpose to secure safe custody of the goods deposited with him. Therefore, he cannot exercise the right of lien over such valuables.

(ii) Documents Deposited for Special Purpose: If a customer sends a bill of exchange or any other document with specific instructions to utilise the proceeds for a specific purpose, the banker cannot exercise the right of lien. For example, if the customer directs the banker to collect the bill of exchange and utilise the proceeds of the same to honour the bill of exchange on his behalf, the amount so realised is exempted from the right of general lien.

If no specific purpose is mentioned by the customer, the banker can have lien on bills or cheques sent for collection.

(iii) Money Deposited for Specific Purpose: If the customer deposits the money or keeps aside a credit balance for a specific purpose, the banker cannot exercise the right of lien over such amounts.

(iv) Securities left with the Banker Negligently: The banker cannot exercise the right of lien on the documents or valuables left in his possession by the customer by mistake or by negligence.

(v)The banker cannnot exercise the right of lien over securities pledged with him for securing a loan, before such loan is actually granted to him.

(vi) The banker cannot exercise the right of general lien over the securities deposited by the customer as a trustee in respect of a personal loan. But if the banker is unaware of the fact that the securities do not belong to the customer, the banker's right of general lien is not affected.

(vii) The Banker possesses the right of set-off and not lien on the money deposited. The banker's right of lien extends over the goods and securities handed over to him. Money deposited with the bank and the credit balance in the account do not fall in to the category of goods and securities. Therefore, the banker cannot exercise the right of lien in respect of the money deposited with him.

CHECK YOUR PROGRESS - 3

Point out the important exceptions to the Right of Lien.

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27.6.2 RIGHT OF SET-OFF

It is a statutory right of a debtor to adjust an amount due to him from the creditor as against the amount payable to the creditor. For example, Rs.4,000 is payable by B to A, the creditor, and in turn owes Rs 1,000 to A. Then B is bound to pay Rs. 3,000 after adjusting Rs.1,000 due to him. This right is also available to the banker and permits him to adjust a debit balance in the customer's account with any balance standing to the customer's credit. Normally the banker gives due notice before exercising the right of set-off.

The right of set-off can be exercised only if the following conditions are satisfied.

1. The debts are certain and due on the date. In the absence of special agreement, the banker is not entitled to retain a customer's credit balance with the presumption that bills dicounted will be dishonoured.

2. In the case of a sole trader the account in his personal name and in the firm's name are deemed to be in the same right and hence the right of set-off can be exercised in either of the two accounts.

3. An account in the name of a person in his capacity as a guardian for a minor is not to be treated in the same right as his own account with the banker.

4. Funds held in trust account are deemed to be in different rights. If a customer opens a separate account with definite instructions as regards the purpose of such account the latter should not be deemed to be in the same right i.e., the right of set-off cannot be exercised.

5. The right can be exercised in respect of the debts due and not in respect of further debts or contingent debts. For example, the banker can set-off a credit balance in the account of a customer towards the payment of a bill which is already due, but not in respect of a bill which will mature in future.

6. The right may be exercised unless there is an agreement to the contrary. If there is an agreement expressed or implied, inconsistent with the right of set-off, the banker cannot exercise such right.

7. The banker may exercise his right at his discretion. For the purpose of exercising this right all the branches of the bank constitute one entity. The banker combines one or more accounts in the name of the same customer at more than one branch. However, the customer cannot compel the banker to exercise this right.

8. The banker can exercise the right of set-off before the garnishee order is initiated. In respect of funds belonging to the customer, the banker has the right to first exercise his right of set-off. Threafter, he can surrender only remainder amount to the judgement creditor under the garnishee order.

27.6.3 RIGHT TO CHARGE INTEREST, INCIDENTAL CHARGES, ETC.

The banker has an implied right to charge interest on the advances granted to the customer. Bankers usually follow the practice of debiting the customer's account periodically with the amount of interest due from the customer. The right to charge interest may be either express in agreement or a banking custom. The right to charge interest ceases on the death or on insolvency of the customer. Unless there is an agreement to the contrary the customer has to pay interest once in a quarter. Where it is not paid in cash it will be added to the principal and it amounts to compound interest. In the case between Konkalla Venkata Suryanarayana Vs. SBI 1975, the High Court of A.P. upheld the right of banker to charge compound interest with monthly interests as provided in the agreement.

Bank charges are avoided in the case of overdrafts, cash credits and current accounts, but not in the case of savings accounts.

27.7 SUMMING UP

A banker is under statutory obligation to honour the cheques drawn by the customer provided certain conditions are fulfilled such as sufficient balance in the account, presentation of the cheques within the reasonable time . When a court orders the banker, directing him to stop payment from the account of the customer, the obligation of the banker to honour the cheques is extinguished. This order is known as Garnishee Order'. It is issued in two parts, i.e., to stop the payment (Order Nisi), attach and handover the balance to the judgement creditor (Order Absolute). This order is applicable to Joint Acccounts, Partnership Accounts and Trust Accounts. If the banker dishonours his customer's cheques without valid reasons, he is liable to compensate the customer for the loss suffered by him. This loss includes monetary loss and reputation loss. The banker also has an obligation to maintain the secrecy of the customer's account. However the banker may disclose the information about his customer's account, when the Law requires such disclosure and when the practice and usage amongst the bankers permit such disclosure. For the improper disclosure of information the customer may sue the banker.

The banker has three important rights, such as general lien, right of set-off and right to charge interest, incidental charges, etc. A lien is a right to retain the property belonging to a debtor until the debts due to him have been paid. It may be a particular lien or general lien. The banker has a general lien on all the goods and securities entrusted to him in his capacity as a banker by his customer unless there is a contract inconsistent with the lien. The banker has to fulfil certain conditions before he can exercise the right of lien. The banker has a right to adjust a debit balance in the customer's account with the credit balance in his account. The banker also has an implied right to charge commission, interest or other charges for the various services rendered by him to his customer.

27.8 CHECK YOUR PROGRESS : MODEL ANSWERS

1. i) There must be sufficient funds in the customer's account.

   ii) The funds in the customer's account must be properly applicable to the payment of the cheque.

   iii) The cheque should be complete in all respects and is presented within a reasonable time.

   iv) There should be no legal direction not to pay from the account.

2. It is a court order to a bank prohibiting it from making any payment from the customer's account. It is issued in two parts. In the first part, the court directs the banker to stop payment from the customer's account (Order Nisi). In the second part, the court orders to attach and hand-over the balance to the judgement creditor.

3. i) Safe custody deposits

   ii) Deposits for a special purpose.

   iii) Documents or valuables left with banker by mistake.

   iv) Valuables pledged with the banker for securing a loan which was not granted.

27.9 MODEL EXAMINATION QUESTIONS

A. ESSAY QUESTIONS

Answer the following in about 30 lines each:

1. What do you mean by 'Garnishee Order'? What obligations are imposed on the banker under a garnishee order ? What are its limitations ?
2. Critically examine the liability of a banker for wrongful dishonour of the cheques of a customer.
3. Comment on a banker's obligations to maintain the secrecy of a cutomer's accounts.
4. Mention the precautions that a banker should take when requested to give his opinion about the credit standing of a customer.
5. Under what circumstances is a banker justified in disclosing the state of his customer's accounts ?
6. What is meant by banker's general lien ? Explain the exceptions to banker's right of lien.
7. Explain the banker's right to set-off.

B. SHORT QUESTIONS

Answer the following in about 15 lines each:

1. Explain the banker's right to charge interest, incidental charges, etc.
2. List out the conditions to exercise right of lien by a banker.
3. Describe the consequences of improper disclosure of information about the customer's account.
4. Explain the 'garnishee order'.
5. Discuss the banker's obligation to honour the customer's cheques.
6. Write on the following:
   i) Special Lien,
   ii) Garnishee Order,
   iii) Right of Set off.

27.10 RECOMMENDED BOOKS

1. Davar K.S.	:	Law and Practice of Banking
2. Srivastava P.K	:	Banking Theory and Practice
3. Sundaram K.P.M & Varsheney P.N.	:	Banking Law and Practice.
4. Tannan M.L.	:	Banking Law and Practice.

27.11 GLOSSARY

Garnishee Order : It is an order from the court obtained by a judgement creditor attaching the funds in the hands of the third party due to the judgement debtor.

Judgement Debtor : The customer of the bank whose moneys in the bank is attached by the garnishee order is called the judgement debtor.

Judgement Creditor : The person on whose request the court issues a garnishee order instructing the banker to pay/or not to pay, any money, from the particular customer's account is called a judgement creditor.

Lien : It is a right to retain property belonging to a debtor until he has discharged the debt due to the retainer of the property.

Order Nisi : An order issued by the court directing the banker to stop payment out of the account of a judgement debtor. It forms a part of the garnishee Order.

Right of Set-off : It is a statutory right of a debtor to adjust an amount due to him from the creditor as against the amount payable to the creditor.

Trust : A sum of money or other property held by an individual, a group of persons, a bank or other institution on behalf of another person, group or institution. The administrators of the trust are known as 'Trustees'.

BLOCK-VIII : TYPES OF ACCOUNTS AND CUSTOMERS

UNIT-28 : TYPES OF ACCOUNTS

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28.10 Check Your Progress : Model Answers
28.11 Model Examination Questions
28.12 Recommended Books
28.13 Glossary

28.0 AIMS AND OBJECTIVES

This unit attempts to explain the various types of accounts and analyse their distinct features. After reading this unit, you will be in a position to :

- explain the different aspects of fixed Deposit and Savings Bank Accounts;
- describe the Recurring Deposit Accounts;
- identify the characteristics of current, savings and fixed deposit accounts;
- mention the precautions that a banker should take in opening an account;
- describe the legal position of the banker in the case of wrong entries;
- explain the closing of a bank account.

28.1 INTRODUCTION

The Banker-customer relationship begins with the opening of an account. The bulk of the resources of a bank are raised from borrowings from the public which are referred to as deposits. In fact, acceptance of deposits from the public is one of the essential functions of a banker. The deposits are accepted by the banker from different sections of the people engaged in economic activities with different financial commitments. Accordingly the nature of banking facilities required by them would vary considerably. It is to meet the requirements of these people that the banks have introduced different types of accounts with various facilities and privileges. Traditionally, the banker used to accept three types of deposits viz, fixed deposits, savings deposits and current deposits. Of late, a few new types of accounts like recurring deposits, multi-purpose deposit schemes, super savings schemes, janata deposit schemes, insurance - linked savings deposits, pigmy deposit schemes etc., have also been introduced.

An attempt is made in this unit to discuss the banker's practices in relation to the opening and operation of different types of customer's accounts.

28.2 FIXED DEPOSIT ACCOUNTS

These deposits are made with the bank for a fixed period specified in advance and therefore, they are called fixed deposits or term deposits. On the expiry of a specified period like five or ten years, these deposits are repaid. Since the repayment of these deposits takes place after the specified period, the bank can make a profitable use of the amount in the meanwhile. This is the reason why a higher rate of interest is offered on such deposits.

i) Opening of a Fixed Deposit Account

For the purpose of opening a fixed deposit account, an application form is to be filled up in which the depositor has to state the amount of the deposit and also the period for which the deposit is to be made. His specimen signature is also required. A Fixed Deposit Receipt is issued to the depositor, acknowledging receipt of the sum of money specified therein, to be repaid at the expiry of the period mentioned therein along with interest at the specified rate.

ii) Payment of Interest

Interest is usually paid on the maturity of the deposit. However, at the request of the customer, the banks may pay interest quarterly or half-yearly also. The interest thus earned is paid to the depositor in cash or is credited to his savings account. Withdrawal of interest or the principal through cheques is not permitted. However when it is credited to his savings or current account, he may withdraw the same through cheques.

iii) Interest on Overdue Deposits

Generally on the expiry of the fixed period, interest ceases to accrue on the deposited amount. However, as per the directives of the Reserve Bank of India, banks can, at their discretion, allow interest on such deposits for the overdue period provided that (a) the deposit is renewed with effect from the date on which it matured for payment, and (b) the rate of interest allowed does not exceed the appropriate rate applicable to the period for which the deposit is proposed to be renewed, as ruling on the date of maturity of the deposit.

iv) Payment Before Due Date

If the customer so wishes, he can withdraw the amount of the fixed deposit before its maturity. But according to the directive of the Reserve Bank, if any deposit is repaid before the expiry of the specified period, the interest on such deposit is calculated as follows:

a) First, the rate of interest applicable for the deposit on the basis of the period for which it remained with the bank is determined.

b) Then the said rate is reduced by 2 percent.

But the penalty of reducing the interest rate by 2 per cent is not to be imposed by banks if it is repaid prematurely on the death of a depositor to the heirs or the legal representatives.

v) Advance against fixed Deposit

The depositor can take a loan from the bank against the security of the Fixed Deposit Receipt. The interest on such a loan is at least 2 per cent higher than the interest payable on the deposit, if the deposit stands in the name of the borrower and in case the deposit stands in the name of a person other than the borrower the rate of interest should be determined taking into consideration the purpose for which the advance is granted.

vi) Fixed Deposits in Joint Names

Fixed Deposit Accounts can be opened in the joint names of two or more persons payable to either or survivor. In such a case it becomes a joint debt owed by the bank to all the depositors. The banker, however, faces certain problems if a fixed deposit account is opened in the joint names.

If any one of the joint depositors demands the repayment of the fixed deposit before maturity, it is necessary for the banker to obtain the consent of the remaining depositors. The mandate 'payable to either or survivor' holds good only on the expiry of the period for which the deposit is made. Therefore a single depositor cannot take back the amount before maturity without the consent of others. Where a loan is sought by one of the joint depositors against the security of the Fixed Deposit Receipt (FDR) the banker has to get the loan application signed by other depositors or may insist on the production of a no objection letter from them. These may be held as surety.

In the event of the loss of the FDR, if any one of the joint depositors makes a request for the issue of a duplicate receipt, the banker should require that such a request is signed by all the depositors as there is a possibility of the FDR being in the possession of the other depositors. When the depositors report to the bank the loss or theft of a fixed deposit receipt and request it to issue a duplicate, the banker should take the following steps:

a) A letter signed by all the depositors informing the banker about the loss of the receipt and requesting him to issue a duplicate one should be obtained.

b) A duly stamped letter or indemnity must be obtained from the depositor/depositors to safeguard his own interest in case the original receipt is also presented for repayment.

c) A note to this effect should be made in the Fixed Deposit Ledger for future guidance.

The banker should be very careful in complying with the requests made by the depositors for changing the name in the receipt or making an addition or deletion thereto.

vii) Mode of Repayment of Fixed Deposits

The deposit receipt generally contains an undertaking by the banker to pay the amount only when it is duly discharged. Therefore, it is necessary to produce the receipt duly discharged at the time of repayment of the deposit. Where the deposit receipt has been lost, the banker cannot avoid the repayment but can ask for an indemnity with a proper security or guarantee from the customer.

The Government of India promulgated the Income Tax (Amendment) Ordinance in July, 1981 with the object of bringing 'benami' deposits with banks and companies into the tax net. According to this Ordinance which was subsequently replaced by an Enactment, banks are required to repay deposits by Account Payee Cheques or Account Payee bank drafts if the amounts of such deposits repayable together with interest is Rs.10,000 or more. This stipulation does not apply to savings and current account deposits, but only to fixed deposits. Banks are permitted to repay any deposit made by a person who has an account with it, by crediting it to the account of such a person.

28.3 SAVINGS BANK ACCOUNTS

Savings accounts are mainly meant for non-trading customers who have some potential for saving, and who do not have numerous transactions entering their account. Salaried people of the lower and middle income group, small traders and farmers mainly open such accounts. The need for keeping cash reserves against such deposits is comparatively larger vis-a-vis the fixed deposits but smaller as against the current deposits. With the extension of banking facilities during the last decade and the growth of the banking habit among the people, the savings deposits of all scheduled commercial banks have gone up substantially.

i) persons who can Open Savings Accounts

A savings account can be opened:

a) By a person on his/her own behalf.

b) By more than one person payable to any one or more of them or survivor or survivors.

c) By a guardian on behalf of a minor, in which case a declaration as to the date of birth of the minor should be obtained from the guardian.

d) By the minor himself/herself for reasonable amounts provided the minor produce satisfactory proof of his/her date of birth.

e) By one person for another person with the stipulation that the deposit can be withdrawn by the latter only on his or her attaining the majority or marriage or some other specified time.

f) By Secretaries, Treasurers, Managers or other officers of non-trading concerns such as schools, clubs, hospitals, religious and charitable institutions. However in these cases, the rules and by-laws governing such institutions and all other necessary information should be furnished to the bank when the account is opened.

g) Savings Bank Account in the name of trading concern (be it a proprietorship, firm or joint stock company) can be opened for placing their special funds such as provident fund, etc. But they cannot open savings bank accounts for conducting trade.

ii) Restrictions on Withdrawals

Banks impose a limit on the number of withdrawals that can be made by a customer within a given period. If the number of withdrawals exceeds the limit, some incidental or service charges will be levied by banks.

(iii) Restrictions on Deposits

A savings account can be opened with any amount subject to a minimum of Rs.5. This minimum balance should be maintained in the account. If for a continuous period of six months or more the account shows a balance less than the minimum that account may be closed. Some banks insist upon the customers to maintain a minimum balance of Rs.100 if the cheque facility is to be provided.

iv) payment of Interest

Interest is allowed at 5 per cent per annum on minimum monthly balance of Rs.10 and multiples thereof between the tenth and last day of each calendar month. It is calculated on a quarterly basis or at longer intervals. Scheduled commercial banks with deposits less than Rs.25 crores may, at their discretion, give an additional interest of 1/4 per cent. Regional Rural Banks may give an additional 1/2 per cent. The above rate of interest is payable irrespective of whether the cheque facility is extended or not.

v) Death of the Depositor

On the death of the depositor, the amount standing to his credit will be paid to such perosns as are legally entitled thereof on producing satisfactory proof like Succession Certificates, Probate Will or Letter of Administration granted by a competent court.

CHECK YOUR PROGRESS - 1

Point out differences between savings bank and current accounts with regard to i) type of customers ii) rate of interest and iii) withdrawals.

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28.4 RECURRING DEPOSIT OR CUMULATIVE DEPOSITS ACCOUNT

This is only a varient of the saving bank account introduced by banks in recent years. The idea behind this account is to inculcate the habit of savings among the people on a regular basis by offering an incentive in the form of a higher rate of interest. It stands favourable as compared to the rate of interest on the savings bank account. The deposits may be made in multiples of Rs.5 or 10, every month for a certain period. The period of recurring deposit varies from bank to bank.

The depositor is allowed to close the account before maturity, but is allowed a lesser rate of interest depending upon the period for which the deposit has run. These accounts are transferable from one branch to another without charge. Further the account can be opened by a person himself, by more than one person jointly, by a guardian in the name of a minor or even by a minor. The monthly instalments should be paid before the last working day of that month. The accumulated amount along with interest is payable after a month of the payment of the last instalment

28.5 CURRENT ACCOUNTS

A current account is a running account with amounts being paid into and drawn out of it continuously. It is the obligation of the banker to repay these deposits on demand. Therefore they are called demand deposits or demand liabilities. These accounts are generally opened by big businessmen, joint stock companies, public institutions etc., whose banking transactions are numerous and frequent. Some of the special characteristics of current accounts are discussed below:

a) A current account meets the convenience of the customers as they are relieved of the task of handling cash themselves and of assuming the risk inherent therein.

b) As these deposits are payable on demand, the banker has to maintain larger cash reserves than are needed in the case of fixed and savings deposits.

c) The operating cost of the account is also more as the banker undertakes to make payments and to collect the bills, drafts, cheques etc., any number of times daily. That is why banks do not pay any interest on credit balances in current accounts. On the other hand, a moderate charge is made to cover incidental expenses and to afford adequate remuneration for the labour involved in keeping the account.

d) A current account can be opened free of charge for firms or individuals known to the bank or introduced by bonafide clients. The minimum balance for opening an account is Rs.100 which is to be maintained in order to keep the account running.

e) The account can be overdrawn by special arrangement with the bank. Cheques drawn without such special arrangements are not only dishonoured but the bank also reserves to itself the right of closing such accounts without notice to the customer.

28.6. OPENING OF CURRENT AND SAVINGS ACCOUNTS

With the opening of an account, the banker comes into a relationship with the customers. This relation nip imposes several obligations on the banker and therefore, he must be very careful in opening an account in the name of a customer. The banker should take the following precautions:

a) The banker should ensure that the request for opening a savings or current account is made on the prescribed form of the bank. The applicant is required to furnish such particulars as his name, occupation, full address, specimen signature and the name and signature of a referee. He should give an undertaking to comply with the bank's rules in force from time to time.

b) Before opening the account, the banker must be able to verify the true identity of the customer. The banker thus reserves the right not to open an account in the name of a person whose true identity has not been established. The intending customer has to be introduced to the banker by a respectable person - either a customer of the same branch of the bank, or one who is known to the staff of the branch. This introduction takes place by signing on the application form itself along with full address.

It is necessary that the person introducing the applicant to the banker must himself be a respectable person, because the latter's opinion about the applicant should carry value. The banker should therefore, take reasonable care in accepting the introduction or reference from any person.

c) The intending customer has to give his specimen signature on a prescribed form for the purpose of bank's record. These signature-cards are preserved by the banker and the signature of the customer on the cheques is compared with his specimen signature before the payment is made. This procedure protects the banker against possible forgery.

28.7 OPERATION OF THE ACCOUNT

After an account is opened with the banker, the customer begins to operate it. The operation of the account involves the depositing of sums of money; and cheques and withdrawal of amounts from the bank. The various aspects of the operation of the account are discussed here.

An important feature of banking business is that every transaction is to be supported by a separate slip or document. The 'pay-in-slip' book contains slips with perforated counter-foils to be filled in by the customer at the time of depositing cash, cheques, drafts, bills, etc. After filling in all the necessary details on the foil and the counter-foil, the customer hands over the same together with the cash or cheque to the cashier, who acknowledges receipt of the same by signing the counter-foil along with the stamp of the bank and returns it to the customer. The slip retained by the bank is passed on to the clerk concerned for making necessary credit entries in the account of the customer.

The 'Cheque Book' contains blank forms of cheques which are used as an instrument to withdraw money from the bank. In the case of savings bank accounts a cheque book is provided to only those customers who undertake to maintain a minimum balance of Rs.100 to their credit. Customers without a minimum balance of Rs.100 may withdraw money from their savings bank account through a withdrawal form available from the bank. But in the latter case it is essential that the Pass Book must accompany the withdrawal form every time.

The 'Pass Book' is a small handy book issued by a banker to his customer to record all the transactions between them. In fact it is an authenticated copy of the customer's account in the books of the banker. The customer deposits the pass book periodically with the bank for the purpose of recording entries therein. A pass book is important to the customer as it enables him to know the entries made by the banker in his ledger account.

Though the pass book is considered as an authenticated record of the customer's account with the banker, there are differences of opinion regarding the validity of the entries made in the pass book. The banker may commit some errors in recording the entries in the pass book. The question therefore arises whether the pass book constitutes a conclusive proof of the accuracy of the entries made therein.

(i) Effect of wrong entries in favour of the customer

The account of a customer may sometimes wrongly show a larger credit balance than the actual balance as a result of incorrect entries on the debit side or credit side. Then the legal postion is as follows:

The pass book is written by the banker and hence the entries therein may form an evidence against the banker. The customer is rightly entitled to believe them as correct and to act on the basis of such entries. If the pass book shows a higher balance and the customer withdraws such balance treating it as his own and subsequently spends it, the banker shall not be entitled to recover such amount wrongly paid to the customer. However the customer has to prove that (i) he acted in such manner relying on the correctness of the balance shown in the pass book and had no knowledge of the mistakes therein, and (ii) he altered his position by spending the same.

There are also some exceptions to the above said principle of estoppel. If the customer regularly maintains his account books and the bank regularly sends him the pass book (or statement in lieu of the pass book), the customer cannot act on the basis of the above presumption. Though he is under no obligation to check the pass book (or the statement), in such circumstances, it is difficult to establish that he was ignorant about the mistakes in the pass book, because he regularly maintained the account books.

Banks now-a-days periodically issue to the customers confirmation slips, which give the balance in the account as on a given date. By putting his signature on the confirmation slip, the customer accepts and confirms such balance. The legal effect of a customer's signing the confirmation slip was considered by the Kerala High Court in Essa Ismal Vs. Indian Bank Ltd., (1965). The Court observed that "unless there is evidence to show that the practice or the custom indicated a stated or settled account, the customer is not precluded from questioning the debit entries in a pass book but, when confirmation slips are sent and signed by the customer, he will be bound by the debits made'.

ii) Effect of Wrong Entries in favour of the Banker

Sometimes an error made in the pass book may be favourable to the banker. The legal position in this regard is as follows:

a) The customer is entitled to get the mistake rectified as soon as he detects it. This right of the customer does not lapse even if he returns the pass book without raising objection regarding any entry or he remains silent after the receipt of the pass book because the customer is not bound to examine the pass book periodically and regularly. He is entitled to recover the amount wrongly debited to, or omitted to be credited to his account.

b) The right of the customer to get the mistake rectified is, however, subject to one limitation. If the customer acts in such a manner that the entries in the pass book render a settled account and the negligence of the customer in regard to the entries is proved., and consequently the position of the banker is changed to his disadvantage, the customer shall not be entitled to dispute the accuracy of any such entry.

28.8 CLOSING OF A BANK ACCOUNT

The relationship between a banker and his customer is a contractual one and therefore can be terminated by either of them by giving notice of their intention to the other party. However, through the operation of the law sometimes the banker is required to close the account. The following are the rights and obligations of a banker in this regard:

a) If a customer directs the banker in writing to close his account the banker is bound to comply with such direction without calling for the reasons.

b) If an account remains unoperated for a longer period, the banker may request the customer to withdraw the money and close the account or may transfer the balance to an "unclaimed deposit account'.

c) The banker can close the account of the customer, if he finds that the latter is no more a desirable customer in the sense of being convicted for forging cheques or bills or in the habit of issuing cheques without sufficient funds or fails to fulfil his commitment to pay back the loans or overdrafts, etc.

d) When the banker comes to know of the death of a customer, he must stop the operation of his account because the authority of the customer terminates as he dies.

e) If a banker receives a notice regarding the insanity of his customer, he is bound to stop payments from his account.

f) The relationship between the banker and his customer is also affected if the customer becomes insolvent. The credit balance of the customer is transferred to the Official Receiver of the insolvent customer.

g) On receipt of a Garnishee Order from the Court, the banker has to suspend payments from the account of the customer. If the order prohibits the payment of a specified sum from the account, the banker may honour the cheques to the extent of the balance amount.

h) When the banker has received a notice of assignment of the credit balance in the account of a customer to a third party, the banker is bound to pay the same amount to the said third party.

CHECK YOUR PROGRESS - 2

Mention the occasions when a banker Closes the account of his customer.

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28.9 SUMMING UP

With a view to meeting the requirements of different people, the banks have introduced different types of accounts. Important of them are fixed deposit accounts, savings bank accounts, recurring deposit accounts and current accounts. In the case of fixed deposit accounts, deposits are made for a specified period and are repaid on the expiry of such a period. A higher rate of interest is paid on these deposits. The depositor can take a loan from the bank against the fixed deposits. If the depositor wishes, he can withdraw the amount of the fixed deposit before the due date. In such a case the interest is reduced as a penalty. Savings bank accounts are mainly meant for non-trading customers who want to deposit their small savings in a bank, which they need to withdraw only occasionally. Banks impose certain restrictions on the right of the depositor to withdraw money from their accounts within a given period. The purpose of the recurring deposit accounts is to encourage people to save regularly and get a higher rate of interest compared to the interest rate on savings bank accounts. The current accounts are opened by the customers who have numerous banking transactions like business men. In the case of these accounts the customer is allowed to deposit or withdraw money as and when he likes. Generally no interest is allowed on these deposits.

The accounts are opened on request in a prescribed form of the bank. The intending customer has to be introduced to the bank generally by an account holder of the bank. After opening the accounts, the payments are made by the 'pay-in-slips' and withdrawals are made by cheques or withdrawal forms. All the transactions between the banker and customer are recorded in the Pass Book. If the entries are made wrongly, they may be either favourable to the customer or to the banker. In certain occasions the banker may close the accounts of his customers such as inoperation of the account for a longer period, death of the customer, insolvency of the customer.

28.10 CHECK YOUR PROGRESS : MODEL ANSWERS

1. i) Savings bank accounts are opened by non-trading cutomers who want to deposit their small savings in the bank, whereas the current accounts are opened by those who have a numerous and frequent banking transactions like businessmen.
   ii) Interest is allowed on the deposits in saving bank accounts whereas no interest is paid on the credit balances in current accounts.
   iii) Certain restrictions are imposed on the right of the customer to withdraw the money from the savings bank account within a specified period of time, whereas no such restrictions are there in the case of current accounts.
2. i) When the customer directs the banker to close his account.
   ii) When the account remains unoperated for a longer period.
   iii) When the banker finds that the customer is no more desirable as he involves in forgery, etc.
   iv) When the banker comes to know the death of the customer.
   v) When the customer becomes insolvent.

28.11 MODEL EXAMINATION QUESTIONS

A. ESSAY QUESTIONS

Answer the following in about 30 lines each:

1. Distinguish between current, savings and fixed deposit accounts.
2. Describe the circumstances in which a banker should close the account of his customer.
3. Explain the effect of wrong entries in the pass book.
4. Describe the different aspects of fixed deposit accounts.

B. SHORT QUESTIONS

Answer the following in about 15 lines each:

1. What is the main difference between fixed deposit account and current account ?
2. Explain the position of the banker if a fixed deposit account is opened in joint names.
3. Explain the mode of repayment of fixed deposits.
4. Discuss the precautions that a banker should take while opening the accounts.
5. What do you mean by savings bank accounts ? Who can open these accounts?
6. Explain the following:

i) Recurring Deposit Accounts;

ii) Fixed Deposit Receipt; and

iii) Savings Account.

28.12 RECOMMENDED BOOKS

1) Davar R.S. : Law and Practice of Banking

2. Srivastava P.K. : Banking Theory and Practice.

3) Sundaram K.P.M & Varshney P.N : Banking Theory, Law and Practice.

4. Tannan M.L. : Banking Law and Practice in India.

28.13 GLOSSARY

Cheque Book : It contains blank forms of cheques which are used as instruments to withdraw money from the bank.

Current Account : It is a running account with the amounts being paid into and drawn out of the account continuously.

Fixed Deposit : An amount deposited with the banker for a fixed period.

Fixed Deposit Receipt : It is an undertaking given by the banker to pay the amount when he receives a fixed deposit.

Joint Account : A joint account is an arrangement where an acount is opened with the banker in the name of two or more persons.

Official Receiver : A person appointed to administer the estates of bankrupt persons.

Pass Book : It is a small handy book issued by a banker to his customer in which the transactions between them are entered. It is a replica of the customer's account with the banker.

Pay-In-Slip Book : It contains slips with perforated counterfoils to be filled in by the customer at the time of depositing cash, cheques, drafts, bills, etc.

UNIT-29 : SPECIAL TYPES OF CUSTOMERS

Contents

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29.0 AIMS AND OBJECTIVES

This unit aims at discussing the special types of customers of a bank and the precautions which the banker should take in his dealings with them.

By the end of this unit, we expect you to be able to:

- mention the precautions to be taken by the banker in opening and conducting accounts in the names of minors and married women;
- explain how the banker deals with pardanashin women, lunatics and drunkards;
- state the steps to be taken by the banker in opening joint accounts;
- describe how the banker deals with the partnership firms and executors and administrators;
- mention the precautions to be taken by the banker in opening accounts in the case of trustees, local authorities, Joint Hidu Families, clubs, committees, and societies.

29.1 INTRODUCTION

The customers of the bank can be broadly classified into three categories: (a) individuals who are not businessmen (b) individuals and associations - trading and non-trading and (c) joint stock companies. In the case of individuals, the account may be opened for two or more persons in which case the account is called a joint account. Again all individuals are not alike. There are persons who can be customers only within a limited sense of the term because they suffer from one or other legal defect. Either they are not of the age of majority and sound mind or they are joint holders of an account or some artificial creatures of law. With these incapacitated customers, the opening of an account is permitted, but when it comes to the question of issuing advances, some technical difficulties do arise in varying measures. Therefore, the banker must take the necessary precautions in dealing with such customers in order to safeguard his own position. It is proposed to discuss the position of the banker with regard to these special types of customers and the precautions to be taken in dealing with them.

This unit discusses the position of customers and precuations to be taken in dealing with them.

29.2 MINORS

According to Section 3 of the Indian Majority Act, 1875, all persons below the age of eighteen are regarded as minors. However, when a guardian, is appointed by a court in respect of these persons, their minority extends to twenty one years. According to the Indian Contract Act, 1872 a minor is incompetent to contract and all agreements entered into by him are absolutely void excepting those for necessaries of life and for his benefit. Thus, a minor is not bound to repay any money borrowed by him. Further he is entitled to recover any securities pledged by him for the pupose of taking a loan. A minor can always plead infancy and not be estopped to do so even where he has procured a loan or entered into some other contract by falsely representing himself as a major.

There is nothing, however, to prevent a minor from opening an account. But in view of the legal incapacity, the banker has to take the following precautions in dealing with a minor.

(i) Usually minor accounts should be opened on the joint names of the natural guardian and the minor or else only in the name of his guardian. But there is no risk in operating an account solely with the minor so long as it shows a credit balance. The banker obtains a good discharge in respect of all payments made from such an account.

(ii) Normally, a minor should not be granted loans nor be allowed to overdraw as he cannot be held personally liable for any such loan during his minority. Even a guarantee given by a third party to secure the debt of a minor becomes invalid, because the debt itself against a minor cannot be legally enforced.

(iii) A minor is entitled to recover any securities pledged by him for the purpose of taking a loan. Therefore the position of the banker is in no way better in the cae of secured overdraft than in the case of the unsecured overdraft, since he cannot avail any security given by a minor to secure his account.

iv) A minor may draw, endorse or negotiate a cheque or a bill and pass on a good title to the holder. The holder can receive payment and enforce his rights under the instrument against any party, but not against the minor himself. The minor cannot be sued in respect of such a bill or cheque.

v) Ordinarily cheques should not be collected in the account of the minor, nor should a current account be opened in his favour.

CHECK YOUR PROGRESS - 1

Who is a minor ? Why should be a banker very careful in dealing with him ?

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29.3 MARRIED WOMEN

In the prevailing law, there is no incapacity attached to a married woman. She can open an account with a bank and operate it in her own name and on her own behalf. She can very well draw cheques and give valid discharge. But while granting an overdraft, the banker should carefully examine the nature of securities she can offer since she can generally bind her own separate estate, but not that of the husband except when she incurs debt:

i) with the consent and authority of the husband, or

ii) for the necessaries of life, in case the husband defaults in supplying them.

In these two cases only, she gets an implied authority to pledge her husband's credit. In all other circumstances, a loan can be recovered only out of the personal assets of the married woman. It is in the interests of the banker that the account of a married woman should be opened jointly with her husband with an "either or" clause so that the balance becomes payable to the survivor without any difficulty whatsover.

29.4 PARDANASHIN WOMEN

A pardanashin woman is one who observes strict veil and seclusion from any person, other than the members of her own family. The identity of such a woman is difficult to be ascertained and the person dealing with her may be charged with having obtained her consent by undue influence. The onus of proving that she gave her consent of her own free will lies on the contracting party. Ordinarily, therefore, it is not safe for a bank to open an account in the name of pardanashin woman and the banker should refuse to do so.

29.5 LUNATICS

A lunatic is a person who lacks the power of understanding and rational judgement and is unable to guage the effect of his actions upon his interests. Under Section 12 of the Indian Contract Act, 1872, lunatics are incompetent parties because of mental deficiency. But a lunatic is only temporarily mentally deranged unlike an idiot who is permanently insane. As such he can open an account and have operations during the period of sanity.

When a banker receives notice of a customer's lunacy or insanity, all operations on the account must be suspended until the receipt of an order of the court, or proof of the customer's recovery. He is, however, entitled to debit his lunatic-customer in respect of all cheques honoured by him before getting the notice. This right ceases as soon as the notice is received by him.

The banker's position is not safe if he stops the operation of an account by relying upon mere hearsay evidence of his customer's lunacy. He has to confirm such informtion before taking further steps.

When a person becomes insane, the court appoints a Receiver to take care of his property as long as he continues to be so. In such a case, the banker can honour the cheques issued under the authority of suh a Receiver. The funds of the customer must be handled according to the instructions given by the Receiver who is acting under the authority of the court.

29.6 DRUNKARDS OR INTOXICATED PERSONS

An intoxicated person is generally of sound mind and capable of understanding the implications of his contracts. It is during the stage of drunkenness that the law wants that others should not take advantage of his loss of understanding and reasoning.

In English Law, a contract by a drunken person is voidable and can be ratified by him when he is sober. In India, however, a contract by a drunken person is void and cannot be ratified. The onus of proving that the drunkard enjoyed the lucid interval at the time the contract was made lies always upon the party.

The position of an intoxicated person is almost similar to lunacy. It is, however, difficult to find out whether the person is so intoxicated as to be capable of understanding the nature and effect of a contract. Under such circumstances, if a customer tenders, when drunk, his own cheque over the counter and insists upon having cash for the same, the bank must honour such a cheque only in the presence of a witness and not otherwise.

29.7 JOINT ACCOUNT HOLDERS

A joint account is an arrangement where an account is opened in the names of two or more persons. It is necessary that all the joint account holders in whose name the account stands should sign the cheques. Sometimes, the parties may stipulate by agreement that any one of them may draw on the joint account without the consent or signatures of others. On the death of either party, the bank allows the survivor to draw the balance standing to the joint account.

Precautions

The banker should take the following precautions with regard to joint accounts:

(i) The application for opening a joint account has to be signed by all the parties who intend to open such an account.

(ii) The banker should get clear instructions in writing as to the operation of the account. The name of the person who operates the account and signs the cheques should be specified. In the absence of specific instructions, the cheques must be signed by all the joint account holders.

(iii) It is also to be stated to whom the balance due has to be paid in the event of the death of one or more of the joint parties. Legally speaking, the balance of the account belongs to the survivor or survivors. In spite of it, a written record of the intentions of the parties is always advisable.

(iv) If it is permitted that the parties can overdraw their account at any time, it is necessary for the banker to obtain the consent of all the joint account holders. He must also secure a joint and several promissory note signed by all the parties, so that they are not only liable jointly but also severally.

(v) If any one of the joint account holders dies or becomes bankrupt, the banker should stop all the operations immediately.

CHECK YOUR PROGRESS - 2

Mention the precautions that a banker should take with regard to joint accounts.

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29.8 PARTNERSHIP FIRMS

A partnership is the creation of a contract between persons. A banker should not open an account in the name of the partnership firm unless the application is made by one or more partners. Generally every partner enjoys an implied authority to open a bank account in the name of the firm except when he is expressly prohibited. However, he is not entitled to open the account in his own name. Before opening such an account, a clear mandate must be obtained from the partners containing such particulars as (i) the names of partners who are authorised to draw cheques, (ii) the names of partners who are entitled to borrow money on behalf of the firm; (iii) the names of the partners who have the power to overdraw, endorse, make or accept bills of exchange and promissory notes on behalf of the firm; and (iv) the names of the partners who have the power to mortgage or sell any property belonging to the firm.

Unless the bank is instructed not to honour the cheques drawn by any partner, the bank is justified in honouring such cheques. However, payment of such cheques can be countermanded by any one of the partners.

In the absence of an express agreement among the partners, no partner can sell or mortgage any immovable property belonging to the firm. But a managing partner can pledge its movable properties. In order to avoid these uncertainties, such powers must be clearly stated in the mandate.

On receiving a notice of the insolvency of the firm, the banker should immediately stop the operations of the account. If the balance is in credit it must be handed over to the Official Receiver and in the case of debit balance, the debt should be proved for obtaining the dividend from the Receiver.

If any partner becomes insolvent, the account must be closed when there is a debit balance and the debt should be proved before the Receiver. In the case of credit balance, the other partners may continue the account, but the bank should obtain a fresh mandate. Any cheques previously drawn by the insolvent partner can be paid on the confirmation of other partners.

In the event of the death of a partner, the other partners may continue to operate the account if that shows a credit balance, by giving a fresh mandate to the banker. If the balance is in debit, the account must be closed to determine the liability of the deceased's estate.

29.9 EXECUTORS AND ADMINISTRATORS

An 'executor' is a person named in the will to execute the will of a deceased person after his death. Where no one is named in the will or the person named in the will refuses to act, then the court appoints a person and such a person is called 'administrator'. The rights and responsibilities of executors and administrators are exactly the same except the mode of their appointment. Their job is to wind up the estate of a deceased and not to carry on business, unless authorised by the will. In such accounts, the banker should take the following precautions:

i) The banker should inspect the Probate or Letters of Administration appointing them as executors or administrators. Then he must note in a special register the directions which the deceased has given in his will as to the disposal of the property and other matters.

ii) On the production of the probate (or letter of administration), the executor/administrator should be allowed to close the deseased's account and transfer the balance to the executorship account.

iii) The banker should obtain a clear mandate from all the executors stating clearly the power of each executor to draw cheques on the joint account and to overdraw money on behalf of the executors.

iv) The borrowing by an executor is always in his personal capacity, and, if it is not authorised, the estate of the deceased cannot be made liable for such borrowings. Similarly, if the money is misapplied, no contribution can be sought from the deceased person's estate if the executor fails to repay the money which he has borrowed. Therefore, the bank should ensure in terms of will that the borrowing is authorised.

v) On the death, resignation, insolvency, or insanity of one of the executors, the banker can continue to operate the account. But if the account is overdrawn on the personal security of such an insolvent, the account must be closed in order to fix the responsibility of such person.

vi) In the absence of an express provision in the will or in the absence of the will, the business of the deceased must not be continued longer than is necessary for winding it up. If it is carried on beyond reasonable time, the executors are committing breach of trust to which the banker also will become a party.

vii) The executors may borrow to facilitate the administration of estate, viz., to pay of debts pending realisation of assets. In all such cases the liability of the executors is personal although they have the right to be indemnified from the deceased's estate. The banker can ask for a charge on the specific asset of the estate or the personal assets of the executors, to secure the debt.

29.10 TRUSTEES

Trustees are persons appointed to look after an estate generally of a deceased person. They administer some business property for the benefit of a person called he beneficiary. A trust is usually formed by means of a document called the "Trust-Deed". If an account in the names of persons acting as trustees is to be opened the banker should take the following precautions:

i) With regard to Trust accounts, the banker must not be a party to a breach of trust. The banker must not allow any transfers from the trust account to the private account of a trustee in which case he becomes liable for breach of trust.

ii) It is to be noted that trustees do not have individual powers. As such they should act together. Cheques are to be signed by all of them unless express power is given in the deed to any one of them to sign on behalf of others. However, countermanding of payment can be done by any one of them.

iii) Trustees in general have no implied authority to borrow money unless they are expressly authorised by the trust-deed. Therefore, the banker should grant loans to the trustees after thorough examination of the borrowing powers as given in the trust-deed.

iv) In the case of the death, insolvency or retirement of any one of the trustees, the powers of such trustee or trustees devolve on the surviving trustee or trustees unless the trust-deed requires otherwise. Therefore, on getting notice of such insolvency, death etc., the banker must refer to the trust-deed to find out whether the surviving trustee or trustees have the power to act. Otherwise he must stop all the operations on the account until the terms contained in the trust-deed are fulfilled.

29.11 JOINT STOCK COMPANIES

Now-a-days busines is largely organised in the form of joint stock companies. A joint stock company is an artificial person with the perpetual succession brought into existence under the Companies Act, 1956. Being a separate entity, it can enter into valid contracts on its own name. Before opening an account, the banker should examine the following aspects:

i) Examination of Documents

he banker should examine the important documents of the company like Certificate of Incorporation, Memorandum of Association, Articles of Association, Certificate of Commencement of Business, etc. The powers and the operational aspects of the company are mainly determined by these documents.

ii) Board's Resolution

Along with the application to open an account in the name of the company, the banker should obtain a copy of the resolution of Board of Directors in regard to the opening of the bank account. The resolution should specify clearly (a) the persons authorised to execute bank forms (b) the manner of operation of the account-how and by whom the bills, cheques etc., will be signed and endorsed, (c) the names of persons who will deposit the title deeds in case of equitable mortgage and in who will deposit the title deeds in case of equitable mortgage and in whose presence the seal of the company will be affixed to the documents.

iii) Borrowing Powers

A company cannot borrow unless allowed by its Memorandum. However, in case of a trading or banking company, such a power is implied, even though it is not mentioned in the Memorandum. But the Directors can borrow money (otherwise than on debentures) only by means of resolutions passed at meetings of the Board, though the Board may, in turn delegate such power to any committee of directors, Managing Director, Secretaries and Treasurers or the Manager of the company. Further, Section 293 (i) (d) of the Companies Act lays down that if the directors decide to borrow money (apart from temporary loans from the bankers) where the total borrowing will be in excess of the aggregate of the paid-up capital and free reserves of the company, the approval of the company in general meeting is necessary. The term "temporary loans" means loans repayable on demand or within six months from the date of loan, such as short-term cash credit arrangements, the discounting of bills and other short-term loans of a seasonal charcter, but does not include loans raised for financing capital expenditure. As such, the banker has to be extremely careful in sanctioning loans to limited companies and should observe the following precautions:

a) That the company borrows only for the purposes mentioned in the Memorandum of Association.

b) That the Board of Directors has met and passed a resolution for borrowing by a method other than the issue of debentures or debenture stock.

(c) That the Board of Directors has also passed a resolution to the effect that the existing company's borrowing as also the proposed borrowing are within the limits specified by the Companies Act, or else within the limits set by the share holders in the General Meeting.

iv) Registration of Charges

In a mortgage, the interest in a specified immovable property is transferred as a security for a debt. However, if immovable property is made security for payment of money to another without any transfer of interest in the propety, it is a charge. Section 125 lays down that the following mortgages and charges created by a company should be registered within 21 days of their creation in order to have them treated as secured debts in the case of winding up:

a) A mortgage or charge for the purpose of securing any issue of debentures;

b) A mortgage or charge on uncalled share capital of the company;

c) A mortgage or charge on any immovable property;

d) A charge on any book debts of the company;

e) A mortgage or charge on any immovable property not being pledged;

f) A floating charge on the undertaking or property of the company including stock in trade.

g) A charge on calls made but not paid;

h) A charge on a ship or any share in a ship;

i) A charage on good will, on a patent or licence under a patent, on a trade mark, or on a copyright or a licence under a copyright.

If any of the mortgages or charges are not registerd as aforesaid, they will be void against the liquidator appointed in the event of winding up as also against other creditors, and the money secured thereby becomes immediately payable. They will rank as unsecured debts. The banker, therefore, has to be watchful to see that the company gets the charges over the assets registered within the prescribed period, lest the debts are rendered unsecured.

v) Director's Personal Account

As in the case of other customers, while dealing with a company, the banker has to be careful that he treats the debts and credit in the company's account quite distinct from those in the personal accounts of directors. If the directors happen to maintain accounts in their own name with the same bank, the banker is under an obligation to ensure that the funds of the company are not credited to their personal accounts. Any negligence in this respect will make the banker liable for refund of money and will deprive him of the statutory protection under section 131 of the Negotiable Instruments Act.

29.12 LOCAL AUTHORITIES

A banker has to exercise utmost care while opening an account in the name of a local authority. He must study in detail the statute under which such authorities are established. In addition, he must take the following precautions.

i) He must examine the constitution of Local Authorities. They generally have a managing committee with a President, a Vice- President and a Treasurer.

ii) He must ascertain whether they are empowered to open a bank account. Some Authorities are prohibited from opening a bank account with a private bank. Even if they are authorised to open the account, only certain persons are authorised to open the account and not others. Generally, the Treasurer of the Authority is given powers to open a bank account and operate it according to the authority given to him. Therefore, the banker must ascertain the powers of the Treasurer. In no case should the account be opened in the name of the Treasurer. It must always be in the name of the Authority.

(iii) The banker must examine the borrowing powers of the Authority. The provisions of the Act are to be scrutinised by the banker to satisfy himself that the proper procedure is followed in granting any advance to such an Authority.

29.13 CLUBS, SCHOOLS, COMMITTEES, SOCEITIES, ETC

Clubs, societies, charitable and religious institutions, libraries, schools etc., not engaged in trading activities maintain their accounts with the banks. The following precautions should be taken by the banker in dealing with them:

(i) Before opening an account, the banker must see whether they are properly registered or not. After satisfying himself that they are properly registered, he must examine the by-laws of such associations or clubs. He must obtain a copy of the resolution of the managing committee appointing him as their banker.

(ii) A mandate must be obtained containing the necessary particulars relating to the method of operation of the account, the specimen signatures of the persons who are authorised to operate the account and to draw, accept, make and endorse bills and notes.

(iii) When the associations are unregistered, the banker must be very careful to safeguard his position. He must take a clear mandate from the managing committee of such association or club as regards the operation of the account.

iv) When an overdraft is granted to such an association or club, the banker must make some arrangement by which some one is made personally liable for the repayment of the same. Otherwise, he cannot recover the same from the Managing Committee since they are acting only in their representative capacity.

29.14 JOINT HINDU FAMILIES

A Joint Hindu Family consists of more than one male member possessing ancestral property and carrying on family business. The business is managed by the senior member of the family known as Karta and the other members are called coparceners. It is the Karta who has the power to borrow and pledge the property for the purpose of carrying on the business. His liability is unlimited whereas the liability of the coparceners is limited to their shares in the joint family estate. The banker should take the following precautions in opening an account of a Joint Hindu Family:

(i)The application to open the account must be signed by all the members. The account may be opened in the name of the Karta or in the name of the family business.

(ii) The banker should obtain a clear mandate as to the person empowered to draw cheques.

(iii) Although the Karta has the power to borrow, the banker should get the promissory note and instrument creating the charge signed by all the adult male members.

(iv) The banker should verify the purpose for which, the loan is taken. This is because if the Karta starts any new business, the liability of the coparceners ceases. But in the case of a joint family consisting of a father and sons the new business started by the father is deemed to be ancestral and thus the coparceners become liable for the debts incurred by the business to the extent of their shares in the family property.

29.15 SUMMING UP

A minor has no contractual capacity. Hence, if money is advanced to him by a bank not only is the amount unrecoverable, but any securities pledged by him will also have to be returned. As such the banker has to take certain precautions in dealing with them. While dealing with married woman, the banker should carefully examine the nature of security she offers since she can generally bind her own estate. As it is not safe to open account in the name of a pardanashin woman, the banker refuses to do so. On receiving notice of a customer's lunacy, the banker suspends the operation of the account. If a drunkard customer asks payment, the banker should see that the payment is witnessed. With regard to joint account the banker should see that all the parties have signed the application for opening a joint accounts and get clear instructions in writing as to the operation of the account. In the case of partnership fims, the banker should obtain the names of the partners who are authorised to draw cheques, the names of the partners who are entitled to borrow on behalf of the firm, etc. The banker should allow the executors administrators to close the deceased's account and transfer the balance to the executorship account and should be careful as the borrowings by him are in his personal capacity. In regard to trust accounts also he has to take certain precautions such as not allowing any transfers from the trust account to the private account of the trustee etc.,

Before opening an account in the name of a company, a banker has to examine certain aspects like documents of the company, resolution of the board, borrowing powers. In the case of local authorities the banker has to examine the constitution of the authority, borrowing powers, etc. With regard to the clubs, societies, etc., the banker has to see their registration, resolution of the managing committee as in the case of joint stock companies. In opening an account in the name of the Joint Hindu Family, the banker has to get the application for opening the account signed by all the members and should obtain a mandate as to the person authorised to draw cheques. Like this the banker has to take many precautions in dealing with its special type of customers.

29.16 CHECK YOUR PROGRESS:MODEL ANSWERS

1. Any person who is below the age of eighteen is regarded as a minor. Since he has no contractual capacity, the banker should be very careful in dealing with him. If money is advanced to him by a bank, not only is the amount unrecoverable, but any security pledged by him has also to be returned.

2. i) The application to open the joint account should be signed by all the parties.

   ii) The banker should get instructions in writing as to which members are entitled to draw cheques.

   iii) In the event of death of any of the parties, the banker should pay the balance to the survivor or survivors, where no special instructions are given to the banker.

   iv) In the event of insolvency or death of a joint account holder, the banker should immediately stop all the operations.

   v) The banker should obtain the consent of all the joint account holders if the parties are permitted to overdraw their account.

29.17 MODEL EXAMINATION QUESTIONS

A. ESSAY QUESTIONS

Answer the following in about 30 lines each:

1. Explain the precautions to be taken by a banker in opening and conducting accounts in the names of minors and married women.

2. What do you mean by a joint account ? What steps are to be taken by a banker in opening joint accounts ?

3. Discuss the procedure followed by a banker in opening an account in the name of a joint stock company.

4. Explain the precautions a banker should take while opening accounts of the following parties:

   i) Partnership firm;

   ii) Joint Hindu Family;

   iii) Joint Stock Company; and

   iv) A club or society.

B. SHORT QUESTIONS

Answer the following in about 15 lines each:

1. Explain the legal position of a minor in opening a bank account.

2. What precautions should a banker take in operating an account in the name of Karta ?

3. How does the banker deal with Pardanashin women, Lunatics and Drunkards ?

4. How does the banker deal with executors and administrators ?

29.18 RECOMMENDED BOOKS

1. Davar R.S. : Law and Practice of Banking
2. Srivastava P.K : Banking Theory and Practice
3. Sundaram K.P.M & Varshoney P.N : Banking Theory and Practice.
4. Tannan M.L. : Banking Law and Practice in India.

29.19 GLOSSARY

Administrator : He is a person appointed by the court to execute the will of a deceased person.

Executor : He is a person named in the will to execute the will of a deceased person.

Joint Account : A joint account is an arrangement where an account is opened with the banker in the names of two or more persons.

Joint Hindu Family : It consists of more than one male, possessing ancestral property and carrying on family business.

5. Official Receiver : A person appointed to administer the estates of bankrupt persons.

6. Pardanashin Woman : She is one who observes a strict veil and seclusion from people other than her own family member.

BLOCK-IX : NEGOTIABLE INSTRUMENTS

UNIT-30 : NEGOTIABLE INSTRUMENTS - KINDS AND FEATURES

Contents

30.0 Aims and Objectives
30.1 Introduction
30.2 Meaning and Definition of Negotiable Instruments
30.3 Salient Features of Negotiable Instruments
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30.7 Holder and Holder in Due Course
30.8 Payment in Due Course
30.9 Summing Up
30.10 Check Your Progress : Model Answers
30.11 Model Examination Questions
30.12 Recommended Books
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30.0 AIMS AND OBJECTIVES

The purpose of this unit is to explain the various kinds of negotiable instruments, their features and rights and obligations of the parties thereof.

After you have worked this unit, we expect you to be able to :

- define negotiable instruments and describe their features.
- define promissory note and discuss its features;
- describe the bill of exchange;
- explain the meaning and essentials of cheque;
- compare promissory note, bill of exchange and cheque;
- distinguish between holder and holder in due course.

30.1 INTRODUCTION

Negotiable instruments occupy a predominant place in modern business transactions. In fact, the development of business is greatly attributable to the use of negotiable instruments. These instruments have come to play a pivotal role in making payments and discharging business obligations. A negotiable instrument is a transferable document which satisfies certain conditions. These instruments are easily transferable from one person to another person and form an integral part of the modern business operations.

Promissor notes, bills of exchange and cheques are important negotiable instruments. A trader can issue any of these instruments in discharging his obligations. The Negotiable Instruments Act, 1881 contains the law relating to the negotiable instruments in India.

This unit first explains the meaning of negotiable instruments and their features and then describes different types of negotiable instruments and the parties thereto.

30.2 MEANING AND DEFINITION OF NEGOTIABLE INSTRUMENTS

"Negotiable Instrument" has not been defined in the Negotiable Instruments Act. But the Act, in section 13(1), stated that "a negotiable instrument means a promissory note, bill of exchange or cheque payable either to order or to the bearer". This section does not indicate the characteristics of a negotiable instrument, but merely states that a promissory note, a bill of exchange and a cheque are negotiable instruments. However, in actual practice, because of trade customs, many other instruments have been brought under the category of negotiable instruments and are accepted in business dealings as well as by the Courts in cases of disputes. Section 137 of the Transfer of Property Act states - "instruments which are for the time being, by law of custom, negotiable" emphasising thereby that the courts accept the instruments other than those specified in the Negotiable Instruments Act. Thus, the following are the important instruments of credit with the characteristics of negotiability.

(i) Promissory Notes

(ii) Bills of exchange

(iii) Cheques

(iv) Government securities

(v) Dividend warrants

(vi) Hundies

(vii) Bank Notes

(viii) Share warrants

(ix) Circular notes

(x) Bearer debentures

(xi) Exchange bills

The following are not negotiable instruments though they are freely transferable:

(i) Bills of lading

(ii) Post Office Orders

(iii) Share Certificates

(iv) I owe you (I.O. Us)

In the words of Thomas - "An instrument is negotiable when it is, by a legally recognised custom of trade or by law transferable by delivery or by endorsement and delivery, without notice to the party liable, in such a way that (a) the holder of it for the time being may see upon it in its own name, and (b) the property in it passes to a bonafide transferee for value free from any defect in the title of the person from whom he obtained it".

Thus a negotiable instrument is a document evidencing an obligation, which:

(i) is transferable by mere delivery,

(ii) such delivery operating to transfer all legal rights to the obligation evidenced, and

(iii) is free of any defects in the transferrer's title.

30.3 SALIENT FEATURES OF NEGOTIABLE INSTRUMENTS

The following are the salient features of negotiable instruments:

i) Transferability

An essential feature of negotiable instruments is that they are easily transferable from one person to another person. The ownership of property in the instrument can be transferred by mere delivery in the case of bearer instruments and by 'endorsement and delivery' in the case of order instruments.

ii) Absolute and Good Title of the Transferee

A negotiable instrument confers absolute and good title on the transferee who takes it in good faith, for value and without knowing the fact that the transferrer had a defective title thereto. The transferee of a negotiable instrument is known as a "holder in due course'. The significance of this characteristic is that a bonafied transferee is not affected by any defect of title on the part of the transferrer or of any of the previous holder of the instrument.

iii) Right of Action

The holder who is legally called the 'holder in due course' can sue in his own name. The holder of a negotiable instrument can realise the amount of the instrument from the party liable to pay thereon.

(v) No Notice is Necessary to the Debtor

There is no need to give to the debtor or other obligee liable on the instrument, notice of its transfer to ensure the payment only to the transferee.

CHECK YOUR PROGRESS - 1

List the salient features of negotiable instruments.

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30.4 PRESUMPTIONS OF NEGOTIABLE INSTRUMENTS

There are certain presumptions in regard to the negotiable instruments. The presumptions specified in sections 118, 119 and 120 of the Negotiable Instruments Act are listed below:

a) Every negotiable instrument is made for a consideration.

b) Every negotiable instrument is made on the date which it bears.

c) Every bill of exchange is accepted within a reasonable time after its date and before its maturity.

d) Every transfer of a negotiable instrument is made before its maturity.

e) The endorsements appearing upon a negotiable instrument are made in the order in which they appear thereon.

f) A lost promissory note or bill of exchange is duly stamped.

g) The holder of a negotiable instrument is a holder in due course provided that where the instrument has been obtained from its lawful owner, or from any person in lawful custody thereof, by means of an offence or fraud, or has been obtained from the maker or acceptor thereof by means of an offence or fraud, or for lawful consideration, the burden of proving that the holder is a holder in due course lies on him.

(h) In a suit upon an instrument which has been dishonoured, the court shall, on proof of the protest, presume the fact of dishonour, unless and until such fact is disproved.

(i) No maker of a promissory note, and no drawer of a bill of exchange or cheque, and no acceptor of a bill of exchange by a holder in due course be permitted to deny the validity of the instrument as originally made or drawn.

(j) No maker of a promissory note and no acceptor of a bill of exchange payable to order shall, in a suit thereon by a holder in due course, be permitted to deny the payee's capacity, at the date of the note or bills, to indorse the same.

(k) No endorser of a negotiable instrument, in a suit thereon by a subsequent holder, shall be permitted to deny the signature or capacity to contract of any prior party to the instrument.

30.5 PROMISSORY NOTE, BILL OF EXCHANGE AND CHEQUE

We shall now discuss the definitions and features of the promissory note, bill of exchange and cheque.

i) Promissory Note

A promissory note is defined, in Section 4 of the Negotiable Instruments Act, as "an instrument in writing (not being a bank note or a currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to, or to the order of a certain person, or to the bearer of the instrument".

Illustration

(I) Gopal signs an instrument stating, "I promise to pay Krishna or order Rs. 1000".

A promissory note, thus is drawn and signed by the debtor, who promises to pay the creditor a certain sum of money. An important point to be noted is that the words used must clearly bring out a promise to pay. The specimen of a promissory note is presented below.

Rs. 10,000/-
Hyderabad
July 15, 1990

Three months after date, I promise to pay Narayan or order a sum of Rupees Ten Thousand only for value received.

Stamp
Sd/-
Rama Rao

To
K.Narayan
Ram Nagar
Hyderabad

Salient Features of a Promissory Note

The salient features of a Promissory Note are:

(i) It must be in writing.

(ii) It must contain an express promise or clear undertaking to pay. An acknowledgement of a debt is not a promissory note. For example "I.O.U. Rs.500" is not a promissory note as it is simply an acknowledgement of debt. Similarly a mere receipt for money does not amount to a promissory note even though it contains the terms of repayment. As such, a document containing "I have taken from Mr. Raman rupees two thousand only. The amount is repayable after two years along with interest at the rate of 10 per cent per annum' is not a promissory note. This means that the promise to pay the money must be express and not tacit.

(iii) The promise to pay shall be unconditional. A promise tied with a condition is not a promissory note. For e.g. "I promise to pay 'A' Rs. 2,000, immediately after his marriage with B" is not a promissory note.

(iv) The promissory note shall contain an undertaking to pay the amount in money only. An instrument with a promise to pay something other than money or something in addition to money is not a promissory note. Moreover, the amount payable must be stated specifically.

(v) The debtor and payee of a promissory note must be certain specific persons. That is, the parties to the instrument should be defined clearly. A promissory note must be signed by the maker though it is written by the maker himself. If he is illiterate it is valid to have his thumb impression upon the note.

ii) Bill of Exchange

A bill of exchange is defined by Section 5 of the Negotiable Instruments Act as "an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument". A bill of exchange is a written acknowledgement of the debt, written by the creditor accepted by the debtor. The specimen of a bill of exchange is given below:

Rs. 5,000/-

Hyderabad

July 15, 1990.

Two months after date pay to Mr. X or order a sum of rupees five thousand only. Value received

To

Y

Abids

Hyderabad

Stamp

sd/-

'Z'

Parties to a Bill of Exchange

There are three parties to a bill of exchange.

i) Drawer: The 'drawer' is a person who draws a bill. He is like a 'maker' in the case of a promissory note. An important point to be noted is that the drawer must sign the bill, In the absence of the drawer's signature, the bill remains incomplete and cannot be issued.

ii) Drawee: The drawee is the person on whom the bill is drawn. He becomes the acceptor after he gives his assent to the order of the drawer by writing the word "accepted" right across the face of the bill with his signature and date. In this context, it may be added that the bill is void if the drawer's name is not mentioned.

iii) **Payee:** The payee is a person to whom or to whose order the money is, by the instrument, directed to be paid. The drawer may make the bill payable to himself or may name another peson in the bill to whom it has to be paid.

Salient Features of a Bill of Exchange

The following are the essential features of Bill of Exchange:

i) It must be in writing.

ii) It must contain an express order to pay.

iii) It must be signed by the drawer.

iv) It must be an unconditional order.

v) The parties to a bill of exchange viz, Drawer, Drawee and Payee must be specifically mentioned.

vi) The amount to be paid must be stated in terms of money.

vii) The amount must be payable on demand or after a definite period of time.

Types of Bills of Exchange

Bills of exchange may be divided into the following types:

(a) Inland and Foreign Bills

(b) Demand and Time Bills

(c) Trade and Accommodation Bills

(a) Inland and Foreign Bills

As per section 11, a bill of exchange shall be deemed to be an inland bill if:

(a) it is drawn in India and made payable in India, or

(b) it is drawn in India and drawn upon any person resident in India.

On the other hand, a bill of exchange is considered to be a foreign bill if it does not satisfy any of the two conditions stated in Section 11. In other words, a foreign bill of exchange is that which is drawn in one country and made payable in another country, or drawn upon a person resident in some other country. The following are the examples of foreign bills.

(i) The bills drawn in India on a person resident outside India and made payable outside India.

(ii) The bills drawn outside India and made payable either in or outside India.

(iii) The bills drawn outside India on persons residing in India.

(iv) The bills drawn outside India and made payable outside India.

Bills in Sets

The foreign bills are usually drawn in two or three sets and each copy is numbered and has a reference to others. The reason for drawing them in sets is that they can be sent by different mails or through different routes, to ensure that atleast one will reach its destination.

The rules relating to the bills in sets have been covered by section 132 and 133 of the Negotiable Instruments Act which are listed below:

(i) Bills of exchange may be drawn in parts, each part being numbered and containing a provision that it shall continue to be payable only so long as the others remain unpaid. All the parts together make a set but the whole set constitutes only one bill and is extinguished when one of the parts, as if a separate bill, would be extinguished.

(ii) The drawer of the bill should sign and deliver all the parts but the acceptance or endorsement is to be made or done only on one of the parts. When a person accepts or endorses different parts of the bill in favour of different persons, he and the subsequent endorsers of each part are liable on such part as if it were a separate bill.

(iii) As between holders in due course of different parts of the same sets, he who first acquired title to his part is entitled to the other parts and the money represented by the bill.

The specimens of bills in sets are given below.

The first would read as:

Washington,
15th July, 1990.

Sixty days after sight of this First of Exchange (Second and third of the same tenor and date unpaid) pay to the order of M/s. John Burton & Co., Bangalore, the sum of Rupees Two Thousand only. Value received.

Sd. Campbell & Com.

RS. 2000/-

To
M/s. V.Venkat & Co.,
Bangalore.

The second would read as:

Wshington,
15th July, 1990.

Sixty days after sight of this Second of Exchange (first and third of the same tenor and date unpaid) pay to the order of M/s. John Burton & Co., Bangalore, the sum of Rupees Two Thousand only. Value received.

Sd.Campbell & Com.

Rs.2000/-

To
M/s.V.Venkat & Co.,
Bangalore.

The third would read as:

Washington,
15th July, 1990.

Sixty days after sight of this Third of Exchange (first and second of the same tenor and date unpaid) pay to the order of M/s. John Burton & Co., Bangalore, the sum of Rupees Two Thousand only. Value received.

Sd. Campbell & Co..

Rs.2000/-

To
M/s. V.Venkat & Co.,
Bangalore.

(b) Demand and Time Bills

A bill which is payable at sight or upon its presentation is known as a demand bill. Demand bills are also called 'Sight Bills'. Demand bills need no acceptance. Cheques are also considered as demand bills because they are payable on demand.

A bill of exchange payable after date or after a fixed time is termed as a time bill. It may be payable either after date or after its maturity.

(c) Trade and Accommodation Bills

A Trade bill is a bill drawn, accepted or endorsed for consideration. A trade bill is a sequal to trade transactions.

Example : X sells goods on credit to Y. In this transaction, X is the creditor and Y is the debtor. If X draws a bill of exchange on Y, it is a trade bill. The cnsideration in the case of this bill is the worth of goods supplied by X to Y.

An accommodation bill is a bill drawn, accepted or endorsed without any consideration. The purpose of drawing and accepting accommodation bills is to provide funds to one or more parties.

Example : X who is in need of money for his business, draws a bill on Y and Y accepts the same without any consideration. This is known as an accommodation bill. In this case, X can discount the bill with a banker and realise the proceeds immediately. X will pay the amount to Y on or before the due date so as to enable him meet the bill.

Section 43 states that "a negotiable instrument made, drawn, accepted, endorsed or transferred without consideration or for a consideration, which fails, creates no obligation of payment between the parties to the transaction. But if any such party has transferred the instrument with or without endorsement to a holder for consideration, such holders and every subsequent holder deriving title from him may recover the amount due on such instrument from the transferrer for consideration or any prior party thereto". Two exceptions to Section 43 are :

(i) No party for whose accommodation a negotiable instrument has been made, drawn, accepted or endorsed can, if he has paid the amount thereof, recover thereon such amount from any person who became a party to such instrument for his accommodation.

(ii) No party to the instrument who has induced any other party to make draw, accept, endorse or transfer the same to him for a consideration which he has failed to pay or perform in full shall recover thereon an amount exceeding the value of the consideration (if any) which he has actually paid or performed.

According to Sec. 59, any person who in good faith and for consideration becomes the holder after the maturity of a bill of eaxchange drawn or accepted without consideration for the purpose of enabling some party thereto to raise money thereon may recover the amount of the bill from any prior party.

iii) Cheque

"A Cheque is a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand" (Sec.6). In other words, a cheque may be defined as an unconditional order in writing, addressed by one persn to another, the latter being a banker, signed by the person giving it, requiring the banker to pay on demand a certain amount of money to him or to the order of a specified person or to the bearer. A cheque is always drawn on a specified banker. Thus the drawee in case of a cheque is the banker. The cheques are always payable on demand. In fact, all cheques are bills of exchange but all bills of exchange are not cheques.

Parties to the Cheque

There are three parties to a cheque.

i) **Drawer** : The person drawing the cheque is known as the drawer.

ii) **Drawee Banker** : The banker on whom the cheque is drawn is called a drawee banker or the paying banker

iii) **Payee** : The person to whom the cheque drawn is payable is known as the payee.

However, in the case of self cheques i.e., drawn payable to self, the drawer and the payee are the same person.

A Specimen of a Cheque is seen below.

Code No. 51

STATE BANK OF HYDERABAD

No. SB/AI : 340257

Initials

LEDGER FOLIO

Pay to ....or Bearer

Rupees..

....

State
Bank
of
Hyderabad

Rs. /-

SB A/c. No............

Essentials of a Cheque

i) A cheque must be an instrument in writing. It must be in ink as cheques drawn in pencil can be easily altered.

ii) A cheque must contain an unconditional order. The order to a bank is expressed by the word "pay to" . An important point to be remembered is the time limit for the encashment of a cheque. At the foot of a cheque, we may find " This cheque is valid for six months from the date of issue'. However, such a provision does not make a conditional order. So far as the drawee banker is concerned, it ceases to be an effective instrument after expiry of the time limit. If the payee has not encashed a cheque before the expiry of the time limit, the payee should revalidate the cheque.

(iii) A cheque must be drawn on a specified bank only. It should not be drawn on any person.

(iv) The sum of money to be paid must be certain. In other words, a cheque must be an order to pay a specified sum of money only.

v) A cheque should be an order to pay specified amount of money on demand (Section 19).

Ante-Dated and Post-DAted Cheques

A cheque which bears a date before the date of issue is ante-dated and a cheque that bears a date later than the date of issue is post-dated. A post-dated cheque is not an instrument payable on demand, but when it is presented on or after the date given on it, the paying banker cannot refuse to honour it merely on the ground that it is a post-datead cheque. A post-dated cheque is as much a negotiable instrument as a cheque for which payment is due immediately on presentation and there is no authority for holding that a person in whose favour such a cheque is endorsed before the date of payment is not a holder in due course (Hajei Mohd. Haneef Saheb and Co. Vs. Abu Bucher and others 1956). Hence, a cheque can be dated with a date earlier or later than the one on which it is actually drawn. Thus, a cheque is not invalid for the reason that it is ante-dated or post-dated. The bank will honour a cheque if-

a) It is properly drawn and complete in all respects;

b) The customer has sufficient balance with the bank;

c) The signature of the customer on the cheque tallies with the specimen signature given to the bank; and

d) The bank has no doubt about the bonafide of the holder

CHECK YOUR PROGRESS - 2

List the main features of a Promissory note.

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CHECK YOUR PROGRESS - 3

Mention the parties of a bill of exchange and cheque.

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30.6. COMPARISON OF PROMISSORY NOTE, BILL OF EXCHANGE AND CHEQUE

The table given below gives a clear idea regarding the similarities and dissimilarities of different negotiable instruments - the promissory note, the bill of exchange and the cheque.

COMPARISON OF PROMISSORY NOTE, BILL OF EXCHANGE AND CHEQUE

Particulars	Promissory Note	Bill of Exchange	Cheque
1. Parties to the instrument	Two - Maker and Payee	Three - Drawer, Drawee and Payee	Three-drawer, Drawee and Payee
2. By whom drawn	One person	Any person	Customers of bank only
3. On whom drawn	None	Any person	The Bank
4. Nature of the instrument	Unconditional undertaking to pay	Unconditional order to pay	Unconditional order to pay
5 Time when payable	On demand or after a period of time	On demand or after a period of time	On demand
6. Acceptance	Not necessary	Necessary	Not necessary
7. Crossing	Cannot be crossed	Cannot be crossed	Can be crossed
8. Grace Days	3 days for usance promissory notes	3 days for usance bills	Not available. Always payable on demand
9. Provisions relating to accptance for honour, drawee in case of need, etc.,	Not applicable	Applicable	Not applicable
10. Counermanding payment	Not applicable	Once accepted cannot be countermanded	Can be countermanded at any time before payment
11. Drawing in sets	Cannot be drawn in sets.	Can be drawn in sets	Can be drawn in sets
12. Non- Presentment to make parties liable.	Non-Presentment discharges endorsers. Presentment is not necessary to make the drawer liable except where it is payable at a particular place.	Non-presentment where required discharges the drawer and endorsers.	delay in presentment does not discharge the drawer, unless the delay has caused a loss to him

30.7 HOLDER AND HOLDER IN DUE COURSE

HOLDER

Section 8 of the Negotiable Instruments Act defines 'holder' as "any person entitled in his own name to the possession thereof and to receive or recover the amount due thereon from the parties thereto". The following conditions are to be fulfilled if a person is to be called the holder of a negotiable instrument.

i) A holder must have the legal right to possess the instrument in his own name. Therefore, a person who acquires a cheque or will by theft, fraud or forged endorsement cannot acquire the legal title in his own name and hence cannot be a holder.

ii) The holder must be entitled to receive or recover the amount from the parties concerned, if necessary, even by filing a suit in his own name against them.

HOLDER IN DUE COURSE

According to Section 9, "Holder in due course means any person who for consideration, became the possessor of a promissory note, bill of exchange or cheque, if payable to bearer, or the payee or endorsee thereof if payable to order, before the amount mentioned in it became payable, and without having sufficient cause to believe that defect existed in the title of the person from whom he derived his title". The conditions given below are to be satisfied if a person is to be called a holder in due course:

i) The holder in due course must possess the instrument. In case of an order instrument, he must be its payee or endorsee i.e., his name must appear on the instrument.

ii) The instrument must be regular and complete in all respects.

iii) It must have been obtained for valuable consideration.

iv) The instrument must have been obtained before the amount mentioned therein becomes payable. However, it is not applicable to a cheque which is always payable on demand.

v) Another condition is that the instrument must have been obtained by the holder in due course without having sufficient cause to believe that any defect existed in the title of the transferrer.

Differences between Holder and Holder in Due Course

The following are the main differences between the holder and holder in due course:

i) While consideration is essential in the case of the holder in due course, it is not necessary in the case of a holder.

ii) While it is necessary for a holder in due course to posses the instrument before it becomes payable, in the case of a holder, neither actual possession nor any time limit within which it must be possessed is necessary.

iii) The most important difference is that while the holder in due course should obtain the possession of the instrument without having sufficient cause to believe that any defect existed in the title of the transferrer, this condition is not essential for a holder.

Rights of a Holder

The rights of the holder of a negotiable instrument are as follows:

i) He can convert an endorsement in blank into an endorsement in full.

ii) He can cross a cheque generally or specially with or without the words 'not negotiable',

iii) He can claim payment of the instrument and can sue in his own name for the recovery.

27.5.1 DISCLOSURE OF INFORMATION REQUIRED BY LAW

The banker is under a statutory obligatin to disclose the information relating to his customer's account when the law specifically required him to do so. He discloses the customer's accounts under the following circumstances:

a) Under Income Tax Act, 1961

According to Section 131, the tax authorities possess the same powers as are vested with the court under Code of Civil Procedure, 1908. The Income Tax authorities are empowered to enforce the attendance of any person including officers of banking companies and compel production of books of accounts and other documents. They may require any banker or officer of bank to furnish information in relation to such points or matters which they feel useful or relevant to any proceeding under the Act. The Income Tax authorities are thus empowered to call for necessary information from the banker for the purpose of assessment of the income of the bank's customers.

b) Under the Companies Act, 1956

When the Central Government appoints an inspector to investigate the affairs of any joint stock company (Sections 235 to 237 Companies Act,1956), it shall be the duty of all officers and other employees and agents of all companies (a) to produce the books and papers realting to the company, and (b) to give to the inspector all assistance in connection with the investigation, which are reasonable. Thus the banker is under an obligation to disclose all information regarding the company but not any other customer for the purpose of such investigation.

c) Under the Order of the Court

When the court orders the banker to disclose information relating to a customer's account, the banker is bound to do so. The Bankers Books Evidence Act, 1811 provided that a certified copy of the entries in the banker's books are treated as sufficient evidence and production of books of accounts in the court cannot be forced upon the banker. This is done to avoid inconvenience to the banker to appear before the court.

d) Under the Reserve Bank of India Act, 1934

The RBI collects credit information from banking companies and also furnishes consolidated credit information to any banking company. Therefore, every banking company is under a statutory obligation under Section 45 B of the RBI Act, 1934 to furnish such credit information. However the information supplied to the RBI by the banking companies will be kept confidential.

e) Under the Banking Regulation Act, 1949

Every banking company is required to submit returns annually on all such accunts in India which have not been operated for 10 years. Banks are required to give particulars of deposits standing to the credit of every such account.

f) Under the Gift Tax Act, 1958

Section 36 of this Act confers on the gift tax authorities powers similar to those of Income Tax Authorities under section 131 of Income Tax Act, 1961.

g) Disclosure to Police

The Criminal Procedure Code, Section 94 (3) requires the Banker to produce books of accounts before the police. The police officer conducting investigation is empowered to go through banker's books of accounts for the purpose of such investigation.

h) Foreign Exchange Regulation Act, 1973

The banking companies dealing in foreign exchange business are designated as authorised dealers in foreign exchange. Section 43 of this Act authorises any officer of the Directorate of inforcement of RBI to inspect the books and accounts and other documents of such dealers and also examine them on oath.

i) Under the Industrial Developmnent Bank of India Act, 1964

Under Section 24 of this Act, the IDBI is empowered to collect credit information and other information from various nationalised banks, which is necessary for its efficient functioning.

27.5.2 DISCLOSURE PERMITTED BY PRACTICES AND USAGES

The practice and usages customary amongst bankers permit the disclosure of certain information under the following circumstances:

a) With the Express or Implied Consent of the Customer

The banker will be justified in disclosing any information relating to his customer's account with a letter of consent. The customer may instruct the banker to give some or all particulars of his account to others, eg. Auditors. Similarly where the customer has given the banker as the reference, the banker is fully justified in answering all such references. The consent of the customer may be expressed or implied. Expressed consent exists in cases where the customer directs the banker in writing to intimate the balance in his account or any other information to his agent, employer, or consultant. The banker would be justified in furnishing to such persons only the required information and no more.

b) Disclosure in Banker's Interest

The banker's act is justified when he discloses the state of account of a customer in his own interest, for example, if the banker has to recover the dues from the customer or the guarantor, disclosure of necessary facts to the guarantor or the solicitor becomes necessary and is quite justified.

c) Disclosure in the Public Interest

The banker who is aware of the fact that an account is kept by an anti-national or the customer is having dealings with an alien country, he must at once report the matter to the proper authorities.

d) Banker's Opinion

The last type of disclosure is that of answering credit enquiries from fellow bankers regarding the credit of the proposed guarantor, or of an acceptor of a bill under discount. Under such cases, the banker is obliged to answer the enquiries. This practice prevalent among bankers is referred to as 'Common Courtesy'. In such cases the banker must be extremely careful while answering the enquiries. If his report is too favourable, he may be charged with misrepresentation or negligence. On the other hand if it is too unsatisfactory, an action for libel may be brought up by the customer.

In a case Hedley Byrney & Company Ltd., Vs. Heller & Partners Ltd., Lord Morris observed that a banker of whom a reference was made was not expected to make a detailed enquiry and produce a well-balanced report. All that was expected was that he should answer honestly the questions put to him from what he knew from the books and the accounts before him.

SECTION - C :

BANKING - LAW AND PRACTICE

iv) He may obtain a duplicate copy of a lost cheque.

Rights of a Holder in Due Course

Apart from the rights of a holder as discussed above, a holder in due course has the following additional privileges.

i) A holder in due course obtains a better title to the instrument irrespective of the fact whether the person from whom he has taken it has title to it or not.

ii) Every prior party to a negotiable instrument is liable thereon to a holder in due course until the instrument is duly satisfied. That is, a holder in due course can recover the amount of the instrument from any or all of the previous parties to the instrument.

iii) The rights of a holder in due course are not affected even though the instrument is originally 'inchoate' (i.e., incomplete) and the transferrer completed the instrument for a sum greater than what was intended by the maker or drawer.

iv) An acceptor of a bill of exchange drawn in a fictitious name and payable to the drawer's order is not relieved from liability to the holder in due course claiming under an endorsement by the same hand as the drawer's signature and purporting to be made by the drawer on the ground that such name is fictitious.

v) A person liable on a negotiable instrument cannot defend himself against a holder in due course on the ground that the instrument was lost or obtained from him by means of an offence or fraud or for an unlawful consideration.

vi) No maker of a promissory note and no drawer of a bill of exchange or cheque and no acceptor of a bill of exchange for the honour of the drawer shall, in a suit thereon by the holder in due course, be permitted to deny the validity of the instrument as originally made or drawn.

vii) No maker of a promissory note and no acceptor of a bill of exchange payable to order shall, in a suit thereon by a holder in due course, be permitted to deny the payee's capacity, at the date of the note or bill, to endorse the same.

viii) No endorser of a negotiable instrument shall in a suit thereon by a subsequent holder, be permitted to deny the signature or capacity to contract of any prior party to the instrument.

30.8 PAYMENT IN DUE COURSE

According to section 10, "Payment in due course means payment in accordance with the apparent tenor of the instrument in good faith and without negligence to any person in possession thereof under circumstances which do not afford a reasonable ground for believing that he is not entitled to receive payment of the amount therein mentioned".

From the above, the following essential features of the payment in due course are clear.

i) It is necessary that the payment should be made according to the true intentions of the parties thereto as are clear from the document.

ii) The banker should make the payment in good faith and without negligence.

iii) Payment should be made in circumstances which do not give any scope for suspicion about the title of the person possessing the instrument.

30.9 SUMMING UP

A negotiable instrument is easily tranferable from one person to another by mere delivery or by endorsement and delivery. On transfer it confers absolute and good title to the transferee. Certain presumptions regarding negotiable instruments are provided in the Negotiable Instruments Act, 1881, such as every negotiable instrument is made for a consideration, it is drawn on the date which it bears and its transfer is made before its maturity. The Negotiable Instruments Act mentions three negotiable instruments namely, promissory notes, bills of exchange and cheque. These instruments have certain features. The important features of a promissory note are, it must be in writing, the promise to pay money must be unconditional and it should be signed by the maker.

The bill of exchange has certain essential features such as it should contain an order to pay, the order should be unconditional and it should be signed by the drawer. The parties to the bill of exchange are drawer, drawee and payee. There are different types of bills of exchange. A cheque is an unconditional order by the customer in writing requiring the banker to pay on demand a certain amount of money. The parties to a cheque are drawer, drawee banker and payee.

The holder of a negotiable instrument is any person who is entitled in his own name to the possession of the instrument and to receive or recover the amount due on the instrument. A holder in due course is a person who receives a negotiable instrument for some consideration before its maturity, without any knowledge of the defective title of the transferrer. The holder in due course has certain privileges in addition to having the rights of a holder. Every prior party to the instrument is liable thereon to a holder in due course until the instrument is duly satisfied.

30.10 CHECK YOUR PROGRESS : MODEL ANSWERS

1. i) Easy tranferability
   ii) Absolute and good title of the tranferee
   iii) Holder's right to take action
   iv) No notice is necessary to the party liable on the instrument i.e., debtor.
2. A Promissory note must contain an express promise or clear undertaking to pay and such a promise should be an unconditional one.
3. i) Parties to a bill of exchange are: drawer, drawee and payeee.
   ii) parties to the cheque are drawer, drawee banker and payee.

30.11 MODEL EXAMINATION QUESTIONS

A. ESSAY QUESTIONS

Answer the following in about 30 lines each:

1. Define a negotiable instrument and describe its maini features.
2. Define a Bill of Exchange and point out in what respects it differs from a promissory note and a cheque.
3. Discuss the various types of Bills of Exchange.
4. What are the important presumptions of negotiable instruments as recognised by the Negotiable Instruments Act ?
5. Define a cheque and satat its main characteristics.
6. Distinguish between a holder and a holder in due course. Explain the privileges granted to a holder in due course under the Negotiable Instruments Act .

B. SHORT QUESTIONS

Answer the following in about 15 lines each:

1. Who is called the holder ? State his rights.

2. List out the features of the payment in due course.
3. Explain the following:
   i) Ante-dated cheque, and
   ii) Post-dated cheque.
4. Explain the Trade and Accommodation Bills.
5. What do you mean by Promissory note ? State its features.
6. Explain the following:
   i) Cheque
   ii) Holder
   (iii) Drawer, and (iv) Payee.

30.12 RECOMMENDED BOOKS

1. Avetar Sing : Negotiable Instruments
2. Davar R.S. & Ramachandra Rao B. : Law and Practice of Banking
3. Srivastava P.K. : Banking Theory and Practice
4. Tannan M.L. : Banking Law and Practice in India

30.13 GLOSSARY

Ante-Dated Cheque : If the drawer mentions a date earlier than to the date of writing the cheque, it is called an ante-dated cheque.

Cheque : It is a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand.

Endorsement : Signing on the back of the cheque by the maker or holder for the purpose of its negotiation.

Holder : Any person entitled in his own name to the possession of a promissory note, bill of exchange or cheque and to receive or recover the amount due thereon from the parties thereto.

Holder in Due Course : Any person who receives a promissory note, bill of exchange or cheque for some consideration without any knowledge of the defective title of the transferrer.

Negotiable Instrument : It is an instrument wahich can be passed on from one individual to another. Examples are promissory note, bill of exchange and cheque.

Payment in Due Course : It is the payment made by the banker in accordance with the apparent tenor of the instrument in good faith and without negligence.

Post-Dated Cheque : If the drawer mentions a date on the cheque, which is subsequent to the date on which it is drawn, it is called post-dated cheque.

UNIT-31 : ENDORSEMENT AND CROSSING OF CHEQUES

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31.8 Glossary

31.0 AIMS AND OBJECTIVES

The purpose of this unit is to discuss the various kinds of endorsement, their legal effects, different methods of crossing of cheques and their implications.

After going through this unit, you will be in a position to :

- define the term "endorsement";
- classify the endorsement into different kinds;
- explain the legal provisions regarding endorsement;
- mention the essentials of a valid endorsement;
- describe the different types of crossing;
- discuss the liability of the paying banker on crossed cheques;
- explain the significance of certain markings on cheques.

31.1 INTRODUCTION

An important characteristic of a negotiable instrument is its negotiability, i.e., it can be negotiated from one person to another. A cheque is an important negotiable instrument through which a large number of bank transactions take place. Generally, cheques are crossed with an intention to ensure that the payments are made to the right persons. This unit describes the endorsement and crossing of cheques and their different aspects.

31.2 ENDORSEMENT

The negotiation of the instrument can be done in two ways, i.e., by delivery and by endorsement and delivery. A negotiable instrument payable to bearer may be transferred by its mere delivery. The delivery may be actual or constructive. Whereas an instrument payable to order (i.e., payable to a specified person) is transferred by endorsement and delivery thereof. Both these acts are essential to transfer an instrument payable to order.

Definition of Endorsement

Section 15 defines endorsement is as the act which is performed, "when the maker or holder of a negotiable instrument signs the same, otherwise than as such maker, for the purpose of negotiation, on the back or face thereof or on a slip of paper annexed thereto, or so signs for the same purpose a stamped paper intended to be completed as a negotiable instrument, he is said to have endorsed the same and is called the endorser".

It is clear that endorsement signed by the maker or a holder on the negotiable instrument for the purpose of negotiation. It is essential that the intention of signing the instrument must be negotiation. Otherwise it will not constitute an endorsement. The person who signs the instrument with the purpose of negotiation is called the 'endorser' and the person in whose favour the instrument is transferred is called the endorsee'. The endorser may sign either on the face or on the back of the negotiable instrument but according to the common usage, endorsements are usually made on the back of the instrument. If the space on the back is insufficient for this purpose, a slip of paper, (known as 'allonge') may be attached thereto for the purpose of recording the endorsement.

31.2.1 KINDS OF ENDORSEMENTS

According to the Negotiable Instruments Act, endorsements are of the following kinds:

i) Endorsement in Blank

An endorsement is said to be 'in blank' if the endorser puts his signature only on the instrument and does not write the name of anyone to whom or to whose order the payment is to be made. Mere signature converts an order instrument into a bearer one and so long as it remains so, it can be transferred by delivery alone. For example, where a cheque is payable to X or order , and if X merely signs on its back, such an endorsement is called endorsement in blank.

ii) Endorsement in Full

When an endorser, in addition to putting his signature, mentions the name of the person to whom or to whose order the payment is to be made, such an endorsement is called endorsement in full. The effect of full endorsement is that further endorsement can be made only by the endorsee. If in the above illustration, X adds the words 'pay to Y' or 'pay to Y or order' such an endorsement is called endorsement in full. The instrument will then be payable to Y or his order and will necessitate endorsement by Y for its further negotiation.

iii) Conditional Endorsement

It is negotiation which takes place on the happening of a stated event and not otherwise. According to section 52, " if the endorser of a negotiable instrument, by express words in the endorsement, makes his liability or the right of the endorsee receive the amount due thereon depending on the happening of a specified event, although such event may never happen, such endorsement is called conditional endorsement". For example, "Pay X if he returns from Delhi." Thus X gets the right to receive payment only on the happening of the particular event, i.e., if he returns from Delhi.

iv) Restrictive Endorsement

The endorsement may, by express words, restrict or exclude the right to negotiate or may merely constitute the endorsee an agent to endorse the instrument or to receive its contents for the endorser or for some other specified person. Such an endorsement seeks to put an end to the principal characteristic of a negotiable instrument and seals its further negotiability. If X signs in any of the following ways on a negotiable instrument and makes it payable to Y, the right of Y to further transfer it for value is immediately lost.

(a) Pay to Y only

(b) Pay the contents to Y only

(c) Pay Y for my use or on my account

(d) Pay Y for the account of Z.

v) Endorsement 'Sans Recourse'

'Sans recourse' means without recourse or reference. An endorser of a negotiable instrument may, by express words in the endorsement, exclude his own liability thereon. For example, Y endorses a cheque as follows :

(a) Pay to X or order at his own risk

(b) Pay to X without recourse to me

Here Y will not be liable to X or any of the subsequent endorsees in case the bank dishonours the cheque.

vi) Facultative Endorsement

It is an endorsement where the endorser waives some right to which he is entitled. For example, the endorsee is liable to give notice of dishonour to the endorser, and normally failure to give this notice will absolve the endorser from his liability. But the endorser may expressly write, "Pay to Y or order, Notice of Dishonour waived". By such an endorsement, the endorser remains liable for non-payment, even if no notice is served because of his own express surrendering of the right to receive notice.

31.2.2 LEGAL PROVISIONS REGARDING ENDORSEMENT

The following provisions are contained in the Act as regards endorsements :

i) Effect of Endorsement

The significance of an endorsement lies in imparting transferability to a bill. Section 50 provides : "the endorsement of a negotiable instrument followed by delivery transfers to the endorsee the property therein with the right of further negotiation". However, it is open to the endorser or endorsee to make the instrument restrictive by adding some words to that effect.

ii) Endorse.

The endorsement may be made only by the maker or holder of the instrument and none else. In the case of a bill or cheque drawn payable to order, the holder will be the payee or endorsee and it is he who can endorse it. But where a bill is payable to the order of two or more payees or endorsees who are not partners, all of them must endorse it unless the one endorsing it has authority to endorse it for the others. A stranger, however, cannot endorse a negotiable instrument nor does he by signing on the instrument become liable as an endorser.

iii) Time

According to sectuion 60, a negotiable instrument may be negotiated until its payment has been made by the banker, drawee or acceptor at or after maturity but not thereafter.

(iv) Endorsement for a part of the amount

The instrument must be endorsed for its entire amount. Section 56 provides that 'no writing on a negotiable instrument is valid for the purpose of negotiation if such writing purports to transfer only a part of the amount appearing to be due on the instrument". Thus an endorsenment for a part of the amount of the instrument is invalid. But where an instrument has already been partly paid, it could be negotiated for the balance, if a note to that effect is given on the instrument.

v) In case of Death

The legal representative of a deceased person cannot nagotiate by delivery only, a promissory note, bill of exchange or cheque payable to order and endorsed by the deceased but not delivered.

vi) Chronology

Unless the contrary is proved, it is presumed under Section 118 that the endorsements appearing upon a negotiable instrument were made in the order in which they appear thereon. It means that the endorsement which appears on an instrument first is presumed to have been made earlier to the second one.

31.2.3 REQUISITES OF A VALID ENDORSEMENT

An endorsement must be regular and valid in order to be effective. The following rules are usually followed in this regard :

i) Signature

The signature on the instrument for the purpose of endorsement must be that of the endorser or any other person who is duly authorised to endorse it on his behalf. If a cheque is payable to two persons, both of them should sign their names in their own handwriting. If the endorser signs in block letters or gives only his surname, it will not make a valid endorsement.

ii) Spelling

The endorser or his duly authorised agent entitled to sign on his behalf must put his signature in the same way as his name appears on the document. If his name is misspelt or his designation has been given incorrectly, he should sign the instrument in the same manner as given in the instrument,

iii) No addition or omission of initial of the name

An initial of name should neither be added nor omitted from the name of the payee or endorsee as given in the cheque.

iv) Prefixes and Suffises to be Excluded

Prefixes and suffixes to the names of the payee, or endorsee need not be included in the endorsement. For example, the words "Mr., Mrs., Shri, Shrimathi, General, Major, Dr." etc., need not be given by the endorser.

CHECK YOUR PROGRESS-1

How is a negotiable instrument transferred ?

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CHECK YOUR PROGRESS-2

List out the different kinds of endorsement.

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31.3 CROSSING OF CHEQUES

A cheque is an unconditional order, drawn on a specified banker and is always payable on demand. At times an open cheque payable across the bank's counter leads itself to fraud and forgery by unscrupulous persons causing loss either to the bank or to the customer. To avoid such risks, or atleast to detect payments made to wrong persons, the drawer may give a direction to the paying banker through certain words marked on the cheque itself, which constitute 'crossing'. Crossing is an instruction given to the paying banker to pay the amount of the cheque through a banker only and not directly to the person presenting it at the counter. A cheque bearing such an instruction is called a 'crossed cheque', others without such crossing are 'open cheques' which may be encashed at the counter of the paying banker. The crossing on a cheque is intended to ensure that its payment is made to the right payee.

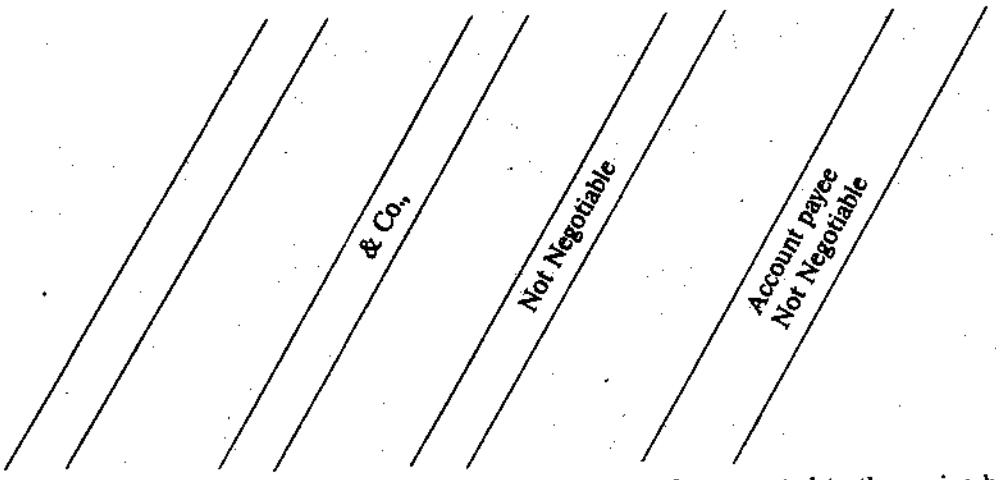
31.3.1 TYPES OF CROSSING

Crossing on cheques are of two types - general crossing and special crossing governed by sections 123 to 131 of the Negotiable Instruments Act.

i) General Crossing

According to Section 123, "Where a cheque bears across its face an addition of the words 'and company' or any abbreviation thereof, between two parallel transverse lines, or two parallel transverse lines simply, either with or without the words 'not negotiable', that addition shall be deemed a crossing, and the cheque shall be deemed to be crossed generally".

It is to be noted from the above that the drawing of two parallel transverse lines on the face of the cheque constitutes "general crossing". The lines must be (i) on the face of the cheque (ii) parallel to each other and (iii) in cross direction (i.e., transverse). Inclusion of the words 'and company' is immaterial and of no special consequence. Examples of general crossing are given below :

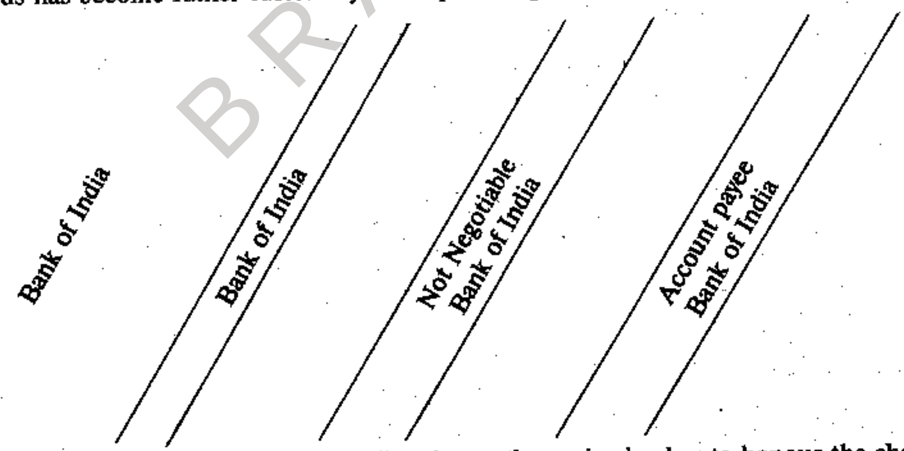


The effect of a general crossing is that the cheque must be presented to the paying banker through any other banker and not by the payee himself at the counter. The collecting banker credits the proceeds to the account of the payee or the holder of the cheque. The latter may thereafter withdraw the money.

ii) Special Crossing

According to Section 124, "Where a cheque bears across its face an addition of the name of a banker, either with or without the words not negotiable, that addition shall be deemed a crossing and the cheque shall be deemed to be crossed specially and to be crossed to the banker.

The addition of the name of a banker across the face of a cheque constitutes 'special crossing'. Drawing of two parallel lines on the face of the cheque is not essential in case of special crossing. Special crossing differs from general crossing because in case of the former inclusion of the name of a banker is essential whereas in general crossing the drawing of two parallel transverse lines is a must. It should be noted that in addition to these minimum statutory requirements for the two types of crossing, additional words or lines may also be included, for example in the case of special crossing, the name of a banker may be written within two parallel transverse lines or with the words 'and company' or 'Account Payee Only' or 'not negotiable'. The inclusion of these words has become rather customary. Examples of special crossing are given below :



The special crossing on the cheque is a direction to the paying banker to honour the cheque only when it is presented through the bank mentioned in the crossing and through no other bank. The cheque crossed specially thus becomes more safe than the generally crossed one.

31.3.2 PERSONS WHO CAN CROSS A CHEQUE

Crossing is an instruction or a direction to the paying banker. Obviously, the drawer of a cheque is competent to cross it generally or specially. Section 125, however, permits the following persons also to cross the cheques :

i) The holder of a cheque may cross it generally or specially if it is uncrossed; or may cross it specially if it is crossed generally or may add words 'not negotiable' in case of both the types of crossing.

ii) The banker to whom the cheque is crossed specially may again cross it specially to another banker for collection.

It is to be noted that a general crossing may be converted into a special crossing by a holder by adding the name of a banker to make the payment of the cheque more safe. But the reverse is not possible, i.e., a holder cannot convert a special crossing cheque into a general crossing one because such alteration amounts to a material alteration and needs confirmation by the drawer.

31.3.3 LIABILITY OF THE PAYING BANKER ON CROSSED CHEQUES

Clarifying the position of a paying banker, section 126 lays down, "where a cheque is crossed generally, the banker on whom it is drawn shall not pay it otherwise that to a banker and where a cheque is crossed specially, the banker on whom it is crossed, shall not pay it otherwise than to the banker to whom it is crossed, or his agent for collection". Therefore, so long as the banker pays a crossed cheque in due course in the above manner, he incurs no liability even to the true owner. Crossing is a material part of a cheque and the bank cannot afford to disregard it. The faliure to observe crossing will certainly render the bank liable; the payment will be inconsistent with the direction contained in the crossing. Section 129 states: 'Any banker paying a cheque crossed generally otherwise than to the banker to whom the same is crossed, or his agent for collection, being a banker shall be liable to the true owner of the cheque for any loss he may sustain owing to the cheque having been so paid".

i) Liability to the True owner of the Cheque

Generally, the paying banker is not responsible to the payee or the holder of a cheque, as there is no contract between the two. However, if the paying banker makes payment of a crossed cheque in contravention of the direction of the drawer as conveyed through the crossing, the banker shall be liable to the true owner of the cheque. If a crossed cheque is lost by the true owner and its finder gets its payment at the counter of the paying banker, the true owner is entitled to recover the amount of the cheque from the person who received its payment from the bank. Whatever is the loss suffered by the true owner or are the expenses incurred by him have to be reimbursed by the banker.

ii) Liability to the Drawer

If the banker fails to make payment of a crossed cheque in accordance with Section 126, the payment is not deemed to be made as per the mandate of the customer. The banker cannot debit his customer's account with the amount of such cheque, if the payment is made to a wrong person. Further, the paying banker shall lose the statutory protection granted to him under Section 128, since such payment is not deemed to be payment in due course.

CHECK YOUR PROGRESS-3

Give the meaning of the term 'crossing of a cheque'. How is it done?

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2. List out the features of the payment in due course.
3. Explain the following:
   i) Ante-dated cheque, and
   ii) Post-dated cheque.
4. Explain the Trade and Accommodation Bills.
5. What do you mean by Promissory note ? State its features.
6. Explain the following:
   i) Cheque
   ii) Holder
   (iii) Drawer, and (iv) Payee.

30.12 RECOMMENDED BOOKS

1. Avetar Sing : Negotiable Instruments
2. Davar R.S. & Ramachandra Rao B. : Law and Practice of Banking
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4. Tannan M.L. : Banking Law and Practice in India

30.13 GLOSSARY

Ante-Dated Cheque : If the drawer mentions a date earlier than to the date of writing the cheque, it is called an ante-dated cheque.

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UNIT-31 : ENDORSEMENT AND CROSSING OF CHEQUES

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31.0 AIMS AND OBJECTIVES

The purpose of this unit is to discuss the various kinds of endorsement, their legal effects, different methods of crossing of cheques and their implications.

After going through this unit, you will be in a position to :

- define the term "endorsement";
- classify the endorsement into different kinds;
- explain the legal provisions regarding endorsement;
- mention the essentials of a valid endorsement;
- describe the different types of crossing;
- discuss the liability of the paying banker on crossed cheques;
- explain the significance of certain markings on cheques.

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An important characteristic of a negotiable instrument is its negotiability, i.e., it can be negotiated from one person to another. A cheque is an important negotiable instrument through which a large number of bank transactions take place. Generally, cheques are crossed with an intention to ensure that the payments are made to the right persons. This unit describes the endorsement and crossing of cheques and their different aspects.

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Definition of Endorsement

Section 15 defines endorsement is as the act which is performed, "when the maker or holder of a negotiable instrument signs the same, otherwise than as such maker, for the purpose of negotiation, on the back or face thereof or on a slip of paper annexed thereto, or so signs for the same purpose a stamped paper intended to be completed as a negotiable instrument, he is said to have endorsed the same and is called the endorser".

It is clear that endorsement signed by the maker or a holder on the negotiable instrument for the purpose of negotiation. It is essential that the intention of signing the instrument must be negotiation. Otherwise it will not constitute an endorsement. The person who signs the instrument with the purpose of negotiation is called the 'endorser' and the person in whose favour the instrument is transferred is called the endorsee'. The endorser may sign either on the face or on the back of the negotiable instrument but according to the common usage, endorsements are usually made on the back of the instrument. If the space on the back is insufficient for this purpose, a slip of paper, (known as 'allonge') may be attached thereto for the purpose of recording the endorsement.

31.2.1 KINDS OF ENDORSEMENTS

According to the Negotiable Instruments Act, endorsements are of the following kinds:

i) Endorsement in Blank

An endorsement is said to be 'in blank' if the endorser puts his signature only on the instrument and does not write the name of anyone to whom or to whose order the payment is to be made. Mere signature converts an order instrument into a bearer one and so long as it remains so, it can be transferred by delivery alone. For example, where a cheque is payable to X or order , and if X merely signs on its back, such an endorsement is called endorsement in blank.

ii) Endorsement in Full

When an endorser, in addition to putting his signature, mentions the name of the person to whom or to whose order the payment is to be made, such an endorsement is called endorsement in full. The effect of full endorsement is that further endorsement can be made only by the endorsee. If in the above illustration, X adds the words 'pay to Y' or 'pay to Y or order' such an endorsement is called endorsement in full. The instrument will then be payable to Y or his order and will necessitate endorsement by Y for its further negotiation.

iii) Conditional Endorsement

It is negotiation which takes place on the happening of a stated event and not otherwise. According to section 52, " if the endorser of a negotiable instrument, by express words in the endorsement, makes his liability or the right of the endorsee receive the amount due thereon depending on the happening of a specified event, although such event may never happen, such endorsement is called conditional endorsement". For example, "Pay X if he returns from Delhi." Thus X gets the right to receive payment only on the happening of the particular event, i.e., if he returns from Delhi.

iv) Restrictive Endorsement

The endorsement may, by express words, restrict or exclude the right to negotiate or may merely constitute the endorsee an agent to endorse the instrument or to receive its contents for the endorser or for some other specified person. Such an endorsement seeks to put an end to the principal characteristic of a negotiable instrument and seals its further negotiability. If X signs in any of the following ways on a negotiable instrument and makes it payable to Y, the right of Y to further transfer it for value is immediately lost.

(a) Pay to Y only

(b) Pay the contents to Y only

(c) Pay Y for my use or on my account

(d) Pay Y for the account of Z.

v) Endorsement 'Sans Recourse'

'Sans recourse' means without recourse or reference. An endorser of a negotiable instrument may, by express words in the endorsement, exclude his own liability thereon. For example, Y endorses a cheque as follows :

(a) Pay to X or order at his own risk

(b) Pay to X without recourse to me

Here Y will not be liable to X or any of the subsequent endorsees in case the bank dishonours the cheque.

vi) Facultative Endorsement

It is an endorsement where the endorser waives some right to which he is entitled. For example, the endorsee is liable to give notice of dishonour to the endorser, and normally faliure to give this notice will absolve the endorser from his liability. But the endorser may expressly write, "Pay to Y or order, Notice of Dishonour waived". By such an endorsement, the endorser remains liable for non-payment, even if no notice is served because of his own express surrendering of the right to receive notice.

31.2.2 LEGAL PROVISIONS REGARDING ENDORSEMENT

The following provisions are contained in the Act as regards endorsements :

i) Effect of Endorsement

The significance of an endorsement lies in imparting transferability to a bill. Section 50 provides : "the endorsement of a negotiable instrument followed by delivery transfers to the endorsee the property therein with the right of further negotiation". However, it is open to the endorser or endorsee to make the instrument restrictive by adding some words to that effect.

ii) Endorse.

The endorsement may be made only by the maker or holder of the instrument and none else. In the case of a bill or cheque drawn payable to order, the holder will be the payee or endorsee and it is he who can endorse it. But where a bill is payable to the order of two or more payees or endorsees who are not partners, all of them must endorse it unless the one endorsing it has authority to endorse it for the others. A stranger, however, cannot endorse a negotiable instrument nor does he by signing on the instrument become liable as an endorser.

iii) Time

According to sectuion 60, a negotiable instrument may be negotiated until its payment has been made by the banker, drawee or acceptor at or after maturity but not thereafter.

(iv) Endorsement for a part of the amount

The instrument must be endorsed for its entire amount. Section 56 provides that 'no writing on a negotiable instrument is valid for the purpose of negotiation if such writing purports to transfer only a part of the amount appearing to be due on the instrument". Thus an endorsenment for a part of the amount of the instrument is invalid. But where an instrument has already been partly paid, it could be negotiated for the balance, if a note to that effect is given on the instrument.

v) In case of Death

The legal representative of a deceased person cannot nagotiate by delivery only, a promissory note, bill of exchange or cheque payable to order and endorsed by the deceased but not delivered.

vi) Chronology

Unless the contrary is proved, it is presumed under Section 118 that the endorsements appearing upon a negotiable instrument were made in the order in which they appear thereon. It means that the endorsement which appears on an instrument first is presumed to have been made earlier to the second one.

31.2.3 REQUISITES OF A VALID ENDORSEMENT

An endorsement must be regular and valid in order to be effective. The following rules are usually followed in this regard :

i) Signature

The signature on the instrument for the purpose of endorsement must be that of the endorser or any other person who is duly authorised to endorse it on his behalf. If a cheque is payable to two persons, both of them should sign their names in their own handwriting. If the endorser signs in block letters or gives only his surname, it will not make a valid endorsement.

ii) Spelling

The endorser or his duly authorised agent entitled to sign on his behalf must put his signature in the same way as his name appears on the document. If his name is misspelt or his designation has been given incorrectly, he should sign the instrument in the same manner as given in the instrument,

iii) No addition or omission of initial of the name

An initial of name should neither be added nor omitted from the name of the payee or endorsee as given in the cheque.

iv) Prefixes and Suffises to be Excluded

Prefixes and suffixes to the names of the payee, or endorsee need not be included in the endorsement. For example, the words "Mr., Mrs., Shri, Shrimathi, General, Major, Dr." etc., need not be given by the endorser.

CHECK YOUR PROGRESS-1

How is a negotiable instrument transferred ?

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CHECK YOUR PROGRESS-2

List out the different kinds of endorsement.

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31.3 CROSSING OF CHEQUES

A cheque is an unconditional order, drawn on a specified banker and is always payable on demand. At times an open cheque payable across the bank's counter leads itself to fraud and forgery by unscrupulous persons causing loss either to the bank or to the customer. To avoid such risks, or atleast to detect payments made to wrong persons, the drawer may give a direction to the paying banker through certain words marked on the cheque itself, which constitute 'crossing'. Crossing is an instruction given to the paying banker to pay the amount of the cheque through a banker only and not directly to the person presenting it at the counter. A cheque bearing such an instruction is called a 'crossed cheque', others without such crossing are 'open cheques' which may be encashed at the counter of the paying banker. The crossing on a cheque is intended to ensure that its payment is made to the right payee.

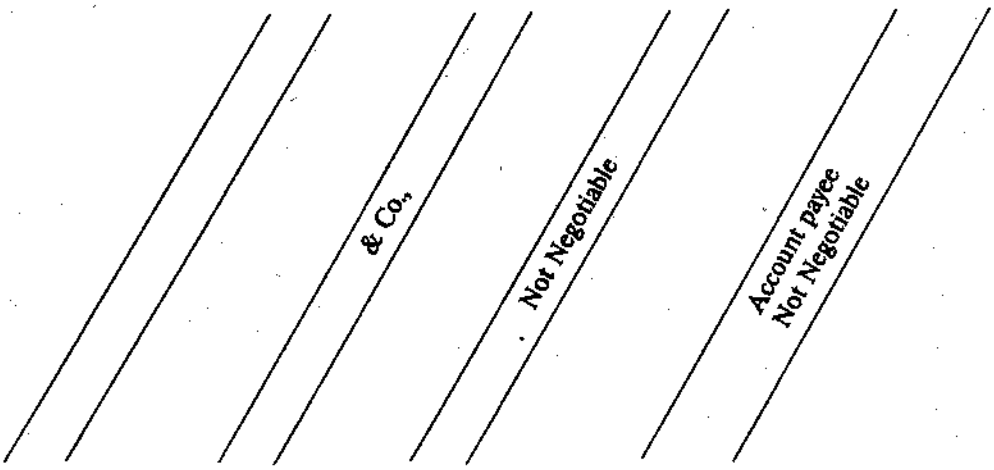
31.3.1 TYPES OF CROSSING

Crossing on cheques are of two types - general crossing and special crossing governed by sections 123 to 131 of the Negotiable Instruments Act.

i) General Crossing

According to Section 123, "Where a cheque bears across its face an addition of the words 'and company' or any abbreviation thereof, between two parallel transverse lines, or two parallel transverse lines simply, either with or without the words 'not negotiable', that addition shall be deemed a crossing, and the cheque shall be deemed to be crossed generally".

It is to be noted from the above that the drawing of two parallel transverse lines on the face of the cheque constitutes "general crossing". The lines must be (i) on the face of the cheque (ii) parallel to each other and (iii) in cross direction (i.e., transverse). Inclusion of the words 'and company' is immaterial and of no special consequence. Examples of general crossing are given below :

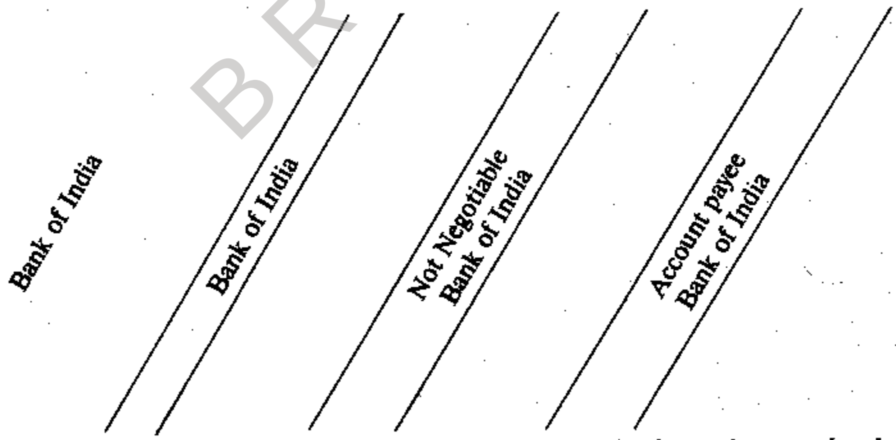


The effect of a general crossing is that the cheque must be presented to the paying banker through any other banker and not by the payee himself at the counter. The collecting banker credits the proceeds to the account of the payee or the holder of the cheque. The latter may thereafter withdraw the money.

ii) Special Crossing

According to Section 124, "Where a cheque bears across its face an addition of the name of a banker, either with or without the words not negotiable, that addition shall be deemed a crossing and the cheque shall be deemed to be crossed specially and to be crossed to the banker.

The addition of the name of a banker across the face of a cheque constitutes 'special crossing'. Drawing of two parallel lines on the face of the cheque is not essential in case of special crossing. Special crossing differs from general crossing because in case of the former inclusion of the name of a banker is essential whereas in general crossing the drawing of two parallel transverse lines is a must. It should be noted that in addition to these minimum statutory requirements for the two types of crossing, additional words or lines may also be included, for example in the case of special crossing, the name of a banker may be written within two parallel transverse lines or with the words 'and company' or 'Account Payee Only' or 'not negotiable'. The inclusion of these words has become rather customary. Examples of special crossing are given below :



The special crossing on the cheque is a direction to the paying banker to honour the cheque only when it is presented through the bank mentioned in the crossing and through no other bank. The cheque crossed specially thus becomes more safe than the generally crossed one.

31.3.2 PERSONS WHO CAN CROSS A CHEQUE

Crossing is an instruction or a direction to the paying banker. Obviously, the drawer of a cheque is competent to cross it generally or specially. Section 125, however, permits the following persons also to cross the cheques :

i) The holder of a cheque may cross it generally or specially if it is uncrossed; or may cross it specially if it is crossed generally or may add words 'not negotiable' in case of both the types of crossing.

ii) The banker to whom the cheque is crossed specially may again cross it specially to another banker for collection.

It is to be noted that a general crossing may be converted into a special crossing by a holder by adding the name of a banker to make the payment of the cheque more safe. But the reverse is not possible, i.e., a holder cannot convert a special crossing cheque into a general crossing one because such alteration amounts to a material alteration and needs confirmation by the drawer.

31.3.3 LIABILITY OF THE PAYING BANKER ON CROSSED CHEQUES

Clarifying the position of a paying banker, section 126 lays down, "where a cheque is crossed generally, the banker on whom it is drawn shall not pay it otherwise that to a banker and where a cheque is crossed specially, the banker on whom it is crossed, shall not pay it otherwise than to the banker to whom it is crossed, or his agent for collection". Therefore, so long as the banker pays a crossed cheque in due course in the above manner, he incurs no liability even to the true owner. Crossing is a material part of a cheque and the bank cannot afford to disregard it. The faliure to observe crossing will certainly render the bank liable; the payment will be inconsistent with the direction contained in the crossing. Section 129 states: 'Any banker paying a cheque crossed generally otherwise than to the banker to whom the same is crossed, or his agent for collection, being a banker shall be liable to the true owner of the cheque for any loss he may sustain owing to the cheque having been so paid".

i) Liability to the True owner of the Cheque

Generally, the paying banker is not responsible to the payee or the holder of a cheque, as there is no contract between the two. However, if the paying banker makes payment of a crossed cheque in contravention of the direction of the drawer as conveyed through the crossing, the banker shall be liable to the true owner of the cheque. If a crossed cheque is lost by the true owner and its finder gets its payment at the counter of the paying banker, the true owner is entitled to recover the amount of the cheque from the person who received its payment from the bank. Whatever is the loss suffered by the true owner or are the expenses incurred by him have to be reimbursed by the banker.

ii) Liability to the Drawer

If the banker fails to make payment of a crossed cheque in accordance with Section 126, the payment is not deemed to be made as per the mandate of the customer. The banker cannot debit his customer's account with the amount of such cheque, if the payment is made to a wrong person. Further, the paying banker shall lose the statutory protection granted to him under Section 128, since such payment is not deemed to be payment in due course.

CHECK YOUR PROGRESS-3

Give the meaning of the term 'crossing of a cheque'. How is it done?

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CHECK YOUR PROGRESS - 4

How does special crossing differ from general crossing?

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31.3.4 SIGNIFICANCE OF CERTAIN MARKINGS

It is important to know the significance of certain markings on the cheque.

i) Not negotiable

At times, the words 'Not Negotiable' are added in general or special crossing of the cheques. The effect of these words in terms of section 130 is that the transferee cannot acquire a better right in cheque than is possessed by the transferer himself. If the transferer has a defective title, the transferee cannot have a better title. It does not impede transferability but impedes only negotiability, i.e., the transferer cannot transfer a better right, but only his own title whether defective or good. In the absence of the words 'not-negotiable' in the crossing of a cheque, if a person receives a cheque in good faith, for proper value and in a proper form, he obtains a good title eventhough the title of the transferer is defective.

ii) Account Payee

The addition of words like 'Account Payee', "Account Payee only" or some variants thereof like "Payee's A/c", "Account XY" etc., imply a direction to the collecting banker that he should credit the account of the payee with the amount of the cheque and should not pay cash for it at the counter. It is an indication that the receiving bank should pay the amount into the bank which keeps the account of the specified payee, and nowhere else. If the amount of the cheque bearing such crossing is credited to an account other than that of the named payee, the collecting banker loses his statutory protection on the ground of negligence.

iii) Double Crossing

Double crossing consists in specially crossing a cheque twice, i.e. the names of two banks are mentioned either within or without the transverse lines. The payment of such cheques is prohibited except in one case. Section 197 states "where a cheque is crossed specially to more than one banker, except when crossed to an agent for the purpose of collection, the banker on whom it is drawn shall refuse payment". Thus, before paying a cheque, the banker must ensure that it does not bear two special crossings, with the sole exception where the first banker is the agent of the second.

iv) Opening of Crossing

Cancellation of crossing on a cheque is called opening of the crossing. The cheque thereafter becomes an open cheque. Only the drawer of the cheque is entitled to open the crossing of the cheque by writing the words "pay cash" and cancelling the crossing along with his full signature.

The paying banker must be very careful in ascertaining the validity or genuineness of the drawer's signature opening the crossing. If the drawer's signature on the cheque is forged by the holder in order to open the crossing and the payment is obtained at the counter the banker will remain liable to the true owner of the cheque.

31.4. SUMMING UP

A negotiable instrument can be transferred either by delivery (in case it is payable to bearer) or by endorsement and delivery (in case it is payable to the order). Endorsement is done when the maker or holder signs on the negotiable instrument for the purpose of negotiation. The person who signs on the instrument ia known as the 'endorser' and the person in whose favour the instrument is endorsed is known as the endorsee. There are different kinds of endorsement, such as, blank endorsement, full endorsement, conditional endorsement, restrictive endorsement, etc. The Negotiable Instruments Act contains certain provisions regarding endordement. To be valid the endorsement should be signed by the endorser or his duly authorised agent in the same way his name appears on the document. Cheques are crossed for the purpose of ensuring the payments made to the right payees. A cheque may be crossed generally or specially. A generally, crossed cheque bears two parallel lines with or without the words 'not negotiable'. The addition of the name of a banker across the face of a cheque constitutes 'special crossing'. When a crossed cheque is paid as against to the direction of the drawer as conveyed through the crossing, the banker shall be liable to the true owner of the cheque. And when the payment of a crossed cheque is made to the wrong person, the banker cannot debit the drawer's account with such amount. When certain markings are made on the cheques, the paying banker should take care of them.

31.5. CHECK YOUR PROGRESS : MODEL ANSWERS

1. A negotiable instrument is transferred in two ways. They are : (i) By delivery : A negotiable instrument payabe to bearer may be transferred by its mere delivery, and (ii) By endorsement and delivery : when a negotiable instrument is payable to order, it is transferred by endorsement and its delivery.

2. i) Blank endorsement, ii) Full endorsement, iii) Conditional endorsement iv) Restrictive endorsement, v) 'Sans Recourse' endorsement, and vi) Facultative endorsement.

3. Crossing is an instruction to the paying banker to pay the amount of the cheque through a banker only but not directly to the person presenting it at the counter. It is done by drawing two parallel inverse lines accross the face of the cheque. Such a cheque is known as crossed cheque. A cheque may be crossed generally or specially.

4. In the case of general crossing the drawing of two parallel lines across the face of the cheque is a must. whereas in the case of special crossing inclusion of the name of the banker is essential, either with or without the words "Not negotiable".

31.6 MODEL EXAMINATION QUESTIONS

A) ESSAY QUESTIONS

Answer the following in about 30 lines each:

1. What is endorsement ? Describe the essentials of a valid endorsement.
2. Explain and illustrate different kinds of endorsement.
3. What are the different types of crossing of cheques? Explain the significance of each type of crossing.

B) SHORT QUESTIONS

Answer the following in about 15 lines each:

1. Distinguish between general crossing and special crossing.

2. What do you mean by 'Not Negotiable Crossing' ?
3. What is crossing of a cheque ? Who can cross the cheques ?
4. Explain the liability of the paying banker on crossed cheques.
5. Explain the terms : i) Double crossing, ii) opening of crossing, iii) Account payee.
6. Explain 'Sans Recourse' endorsement and 'Facultative' endorsement.

31.7 RECOMMENDED BOOKS

1. Avatar Singh : Negotiable Instruments
2. Srivastava P.K. : Banking Theory and Practice
3. Sundaram K.P.M.& Varshney P.N. : Banking Theory, Law & Practice.
4. Tannan M.L : Banking Law & Practice in India.

31.8 GLOSSARY

Crossing : It is an instruction given to the paying banker to pay the amount of the cheque through a banker only and not directly to the person presenting it at the counter.

Endorsement : Signing on the back of the cheque by the maker or holder for the purpose of its negotiation.

Unit 32 : PAYMENT OF CHEQUES

Contents

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32. Statutory Protection to the Paying Banker
32.4 Circumstances leading to Refusal of Payment
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32.7 Check Your Progress: Model Answers
32.8 Model Examintation Questions
32.9 Recommended Books
32.10 Glossary

32.0 AIMS AND OBJECTIVEW

The purpose of this unit is to discuss the precautions to be taken by the banker in the payment of chques, the statutory protection avilable to him and his liabilities.

When you have finished this unit, you will be able to :

- explain the precautions to be taken by the paying bankrer;
- describe the statutory protection provided to the paying banker;
- describe the circumstances when the banker can refuse the payment;
- identify the suitable replies to be made by the banker for dishonouring cheques.

32.1 INTRODUCTION

A statutory responsibility has been cast upon the banker to honour the cheques issued by the customer. This obligation of the banker is of curical importance. A cheque, no doubt, is a negotiable instrument, but more important, it is a mandate of the customer which the banker is required to carry out. It is a written order by which the customer requires his banker (drawee) to refund the money deposited with him. The refund may be made either to the drawer (customer) himself or to some third party (payee). It is this repayment to third parties which gives rise to certain legal problems. If the banker honours the ceques carelessly and negligently in a manner inconsistent with the instructions of the drawer. he will be subject to heavy liablity. The banker, apart fórm losing the money so paid becomes liable to pay damages or compensation to his customerand also to the true owner of the cheques as provided for in the Negotiable Instruments Act. Further, a failure on the part of the banker to comply with the statut‹ ry obligation to made payment of his customer's cheques, so long as he possesses sufficient funds to the credit of the latter without sufficient reasons, makes him liable under section 31 to compensate the drawer for any loss or damage caused by such default. Therefore, the paying banker should be very careful in the discharge of his duties.

This unit describes the precautions to be taken by the banker while making payment, statutory protection provided to the paying banker by the Negotiable Instgruments Act, and other related aspects.

32.2 PRECAUTIONS TO BE TAKEN BY THE PAYING BANKER

The paying banker shoulsd ensure that the cheque is regular in all aspects and should take the following precautions while making payment of his customer's cheques.

i) Proper form of the Cheque

The Negotiable Instruments Act defines a cheque but does not prescribe its form. As such, the banker cannot dishonour a cheque drawn on a piece of paper provided it carries an unconditional order to the banker and fulfils other requisites of a cheque. Though the law has not prescribed any particular format for a cheque, it is ususal for the banks to get their own cheque books printed. This makes it essential that the cheque forms issued by the banker be used by the customers though the banker may honour a chque drawn otherwise at his discretion.

Drawing of cheques on the printed forms issued by a banker is convenient to the customer as he has to simply fill in the blanks. The counterfoils of the cheques are useful for him to know the payments made and to trace out a particular payment

It is also easy for the customer to countermand the payment of a particular cheque, as he can issue instrucitons to the banker referring to the serial number of the cheque.

Where cheques are drawn on printed forms whose serials have been noted by the banker the chances of forgery are greatly minimised.

Cheque Drawn on a Form Issued to Another Person

In case a cheque is drawn on a cheque form issued by the banker to someone other than the drawer, the banker is not justified in refusing payment and the cheque does not become invalid simply because it was not issued to the drawer. The only safeguard that the bank has to observe is to ensure that there is no forgery of customer's signature and that it pays in due course to the holder of the instrument in good faith and with out notice that his title to it is defective.

(ii) Date of the Cheque

The date of the cheque is important because the mandate of the customer to the banker given in the cheque becomes legally effective from the date mentioned therein. The drawer of a cheque fills in the date before the cheque is issued, but if he has not done so , the instrument does not become invalid. The payee of the cheque or any subsequent holder thereto may fill in the date. But if an undated cheque is presented for payment the banker must refuse its payment. However, the date should be complete in respect to the number of the day, the month and the year.

Stale Cheques

Literally a stale cheque is an overdue cheque, one that is presented long after it was drawn. The generally accepted banking custom is to treat a cheque as stale after six months of its issue. It is usual for the banker to return such a cheque with the remark out of date and if pressed for payment ask for the drawer's confirmation. This practice whereby a cheque is regarded as stale after six months has no statutory sanction in India.

post-Dated Cheques

If the drawer (or any holder) mentions a date on the cheque, which is subsequent to the date on which it is drawn, it is called a post-dated cheque. Such a cheque becomes effective only from the date mentioned therin. The banker should, therefore, not make payment of their post-dated cheque before the date mentioned therin, otherwise, he will be liable as follows:

a) If the drawer instructs the banker, before the date mentioned in the cheque, not to make payment of the post-dated cheque, the banker cannot debit his account with the amount of the cheque. In case the banker had honoured the cheque before the receipt of the countermand order, such payment is deemd as payment made without the authority of the drawer.

b) If, as a consequence of payment of a post-dated cheque by the banker, any other cheque issued by the drawer is dishonoured on the ground of insufficiency of funds, the drawer will be entitled to claim damages for its dishonour.

c) If the customer dies, becomes insolvent or insane after the banker has made the pament but before the date mentioned in the cheque, the amount cannot be debited to the customer's account because the latter's mandate becomes ineffective on the occurrence of any of these events.

d) Payment of a post-dated cheque before the date of the cheque is not considered as pament in due course. The banker therfore. cannot avail of the statutory protection under Section 85.

iii) Amount of the Cheque

The amount of the cheque must be specefic sum and written on the instrument. It should be clearly stated both in words and figures. In case the two amounts differ, section 18 provides that the amount in words shall be the amount undertaken or ordered to be paid. The banker may, therefore, pay the amount written in words without incurring liability for the same. However, in practice the banker returns such a cheque with the remark "amount in words and figures differ" . If the amount is expressed in words only, the banker must pay the cheque but if the amount is written in fugures only, it should be sent back to the drawer for necessary entry.

Sufficient Funds: The question of payment of the cheque arises only when the balance to the credit of the customer is sufficient. Unless arrangments have been made in advance for overdrawing the account, the banker is under no obligation to honour the cheque with inadequate funds in the account of the drawer. This is important because a cheque has to be paid in full and never in part. The minimum balance required to be maintained in a current accont or savings account is deemed as available for honouring the cheques.

iv) Chronological Order of Payment

When several cheques drawn on an account are presented for payment on the same day, the banker generally follows the rule of making payment of the cheque in the chronological order of their recipt.

The banker may sometimes face a situation when a number of cheques are presented simultaneously for payment, or are received by one mail or through the same clearing but the funds avilable in the account of the customer are insufficient to pay all them. There are two view points in such a situation. The banker may treat all the cheques as constituting one demand and hence dishnour all of them for shortage of funds. But it would not be fair in the interests of the customer because the dishonour of all the cheques will affects his reputation greatly while funds are sufficient to honour at least a few of them. It appears better if he honours as many cheques as possible till the credit alance is not exhausted. In practice a cheque for a bigger amount is paid first in such a situation but if a cheque for a smaller amount is payable to the tax autorities etc., it may be honoured first.

v) Mutilated Cheques

It is a cheque which has been torn into pieces but pasted afterwards. hether such a cheque should be paid or not will depend upon the available evidence, the surrounding circumstances and the extent of legibility of the material facts. If a cheque is accidentally torn in the hands of the payee before presentation, the banker can pay it after obtaining confirmation from the drawer or else getting the collecting banks guarantee. If the banker has sufficient proof that the drawer wanted to cancel a particular cheque by tearing it into pieces, he has no course open but to return it.

vi) Material Alterations

A cheque contains a mandate of the customer to his banker to pay a specified sum of money to the bearer or the person mentoned therein or to his order. Any alteration or correction therein must be confirmed by the drawer's full signature in order to be valid. The paying banker should exercise care to ensure that payment is not made on cheques bearing an alteration, praticularly a material alteration without confirmation by the drawer.

Material alterations are those which change the business effect of an instrument and cause it to speak a language differnt from what it originallay spoke. Such an alteration changes the legal identity or whole character of the instrument either in its terms or in the legal relation of the parties. The alterations with regard to the following are material alterations:

a) Date of the cheque

b) Place of payment

c) Amount of the cheque

d) Names of the parties or the relationship between them or affecting their legal status.

e) Legal character (substitution of the work 'bearer' in place of 'Order' in the cheque

A material alteration makes a material or signification change in the mandate given in the cheque. If an addition or alteration does not affect the mandate of the drawer or the position of the parties materially, it will not be called a materially, it will not be called material alteration.

According to section 87, "any material alteration of a negotiable instrument renders the same void as against anyone who is a party thereto at the time of making such alteration and does not consent thereto, unless it was made in order to carry out the common intention of the original parties. Any such alteration, if made by an endorsee, discharges his endorser from all liability to him in respect of the consideration thereof", However, even if the alteration is material, it will not vitiate the instrament if 1

a) it is made before the actual issue of the instrument:

b) it is made merely to correct a mistake or to make the instrument what it was originally intended to be : or

c) it is made with the consent of all the parties to the instrument, the consent being expressed to implied, prior to the alteration or thereafter.

Burden of Proof

The burden of proof that a particular material alteration falls within the above exception, and hence does not vitiate the instrument lies upon the party which claims it to be so. It is for the plaintiff to satisfy the court that the alterations if any were made subsequent to the issue of the instrument and not at the time of issue. The party which wants to enforce the instrument has to accept the onus of proving that he has not been negligent.

Banker's Position in Material Alterations

The paying banker's position with regard to material alterations, between drawing and presentation, should be examined under two headings.

a) **Where the alteration is apparent :** If the banker pays a cheque which has been materially altered without the drawer's consent, he does so at his own risk unless the customer's authority to the alteration has been obtained. As such, where there is a material alteration which is apparent, the paying banker should insist upon proper authentication by the drawer. As a rule, he should not generally accept authentication by mere initials but call for the full signature of the drawer since he may not be familiar with the drawer's initials, which in all probability are more prone to forgery.

b) Where alteration is not apparent: When an alteration is fraudulently made, naturally without the consent of the parties to the instrument, but which does not appear to have been so altered, the paying banker is protected in terms of Section 89. The two conditions for granting such protection however are:

i) There is nothing on the face of the instrument to indicate that it was materially altered. That the alteration has been so cleverly or skillfully done that he would not have, with any amount of reasonable care and scrutiny detected it out.

ii) The payment has been made in due course, i.e., the banker has paid to the holder of the cheque in good faith and wothout notice that his title to the cheque is defective.

Once these two conditions are satisfied, even if the material alterations have been fraudulently affected, the paying banker can debit the drawer's account and obtain a valid discharge.

vii) Forgery of Drawer's Signature

The paying banker should be careful to verify whether the cheque bears the genuine signature of the drawer after comparing the same with his specimen signature. If the signature on the cheque differs from the specimen signature of the drawer or is a forged one, the banker must refuse payment of the cheque because a cheque with forged signature of the drawer gives no mandate to the banker to make any payment. Payment of chque with the forged signature of the drawer is deemed as payment without the authority of the customer and hence a breach of the implied contract between banker and his customer. The paying banker cannot enjoy protection under the law. The banker cannot debit his customer's account with the amount of the cheque bearing the forged signature of the drawer and has to suffer the loss himsel[illegible] banker bears this liability even if the signature of the drawer is cleverly forged and it is diffiicult to detect it inspite of a resonable degree of care and secutiry. The banker is not obsolved of his liability on a forged cheque, even if the customer is negligent in keeping the cheque book under lock and key as reaquired by the rules of the bank.

The customer, however, is under an obligation to the banker in this regard. The customer, should not be negligent in observing the necessary precautions to save the banker from the losses which may arise because of his own acts. It is essential that in drawing and encashment of cheques, the neglect of the customer must be intimately connected with the transaction itself, and be the proximate cause of the loss.

a) When a banker is in doubt about the signature of the drawer he seeks the confirmation of the drawer. The customer expressly represents that the signature is his own. Later on. the customer will be estopped from denying the validiy of his signature on the cheque. Similarly if the signature of the customer on the cheque differs form his specimen signature, but he writes to the banker about his issuing a chaque bearing a differnt signature of his, such intimation will amount to confirmation of his signature on the cheque.

b) If the customer comes to know or has resonable ground to believe that a cheque with his forged signature is going to be presented for payment, he is undr duty to inform the banker immediately to avoid loss to the banker. In such a case, he is estopped from denying the validity of he cheque.

c) Sometimes such estoppel arises from the silence on the part of the customer. If the customer fails to inform the banker that his signature on a cheque has been forged, and the banker loses his right of action against the forger, the customer is estopped form denying the genuineness of his signature.

In case of joint accounts, both or all the signatures on the cheques must be genuine. If one of the signatures is a forged one, the banker should not make payment. If one of the joint account holders forgets to get the signatgure of the other one, and the banker makes payment of the cheque, he will be liable to the other one.

viii) Payment of Cheques During Banking Hours

According to section 65, a cheque must be presented to the paying banker for payment within the banking hours. Banking hours mean the period of time when a bank transacts banking business with the public. Such hours are fixed by the banks and customers are notifed of them by a general notice. The banker should made paymernt of the cheques presented to him during the banking hours only. Actual payment might be make after the banking hours if it could not be dealt with within the banking hours.

If the banker pays a cheque presented to him after the banking hours, he incurs a grave risk. In fact, the amount of such cheque cannot be debited to the drawer's account till the opening of the bank on the next day. If, in the meantime, the drawer countermands payment of such a cheque, the banker cannot debit such amount to his customer's account. Similarly, when a Garnishee Order is served in the banker restraining him from making payment out of the drawer's account, it implies that the death of the customer or his insolvency makes the payment of the cheque invalid.

CHECK YOUR PROGRESS-1

State the meaning of a stale cheque. Is the payment made on a stale cheque?

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CHECK YOUR PROGRESS-2

Mention the different forms of material alterations.

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32.3 STATUTORY PROTECTION TO THE PAYING BANKER

The paying banker is always under a duty to satisfy himself that he pays money with his customer's authority and to the true owner. If the money is paid to a wrong person, under a forged or unauthorised endorsment, this amounts to a breach of duty and the banker thereby becomes liable to make good the loss to the drawer. Available routine procedure in a bank, however, hardly gives an opportunty for the investigation of endorsements, except as to their outward regularity. If the banker begins to make intensive inquiries about the title of the presentor, much expenditure of time and money would be involved, destroying in this process the "demand character " of the chreque. The law, therefore, has tried to come to the rescue of the busy banker and provided him a good "quittance" on the fulfilment of crtiain conditions which are summarised in the familiar expression of payment in due course. Since the provisions in respect of statutory protection to the paying banker are a little elaborate, it is advisable to discuss them under approptiate headings.

i) Protection in case of Order Cheques

In case of an order cheque, section 85 (1) provides statutory protcetion to the paying banker as : "where a chque payable to order purports to be endorsed by or on behalf of the payee, the drawee is discharged by payment in due course". This section seeks to provide protection to the paying banker in case of forged endorsments. After insertion of section 16 (2), this protection is available in respect of other endorsments also, because the banker is not expected to verify the signatures of each and every endorser. The two conditions for granting statutory protection to the paying banker are as follows:

a) Endorsement must be regular: It is essential that the endorsements are regular though not necessarily genuine or valid. There is a difference between the regularity of endorsemrnt and its validity or genuineness. If a cheque payable to certain persons is endorsed under the signature bearing the same name and in the same spelling as that of the payee or the endorsee, the endorsement is said to be regular. Apparently, it appears as the payee or the last endorsee. A valid endorsment is that endorsement which has been made by the person who is the true owner of the cheque or has the necessaary authority to sign on behalf of the payee. To avail of the statutory protection, the banker must ascertain that the endorsement is regular. He need not verify its validity.

b) Payment must be made in due course: Section 10 defines a payment in due course as payment in accordance with the apparent tenor of the instrument in good faith and without negligence to any person in possession thereof under circumstances which do not afford a reasonable ground for believing that he is not entitled to recive payment of the amount mentioned therein". It is, therefore, essential that the banker pays the cheque in good faith and without negligence. Otherwise statutory protection cannot be granted to the paying banker.

Effect of statutory protection

The statutory protection is available to the banker in the case of forged signatures of the endorser and not that of the drawer. When the statutory protection is availed of , not only is the drawee banker discharged from his liability, but the drawer is also discharged from responsibility.

ii) Protection in the case of Bearer Cheques

Section 85 (2) provides protection to the paying banker in respect of bearer cheques as follows :

Where a cheque is originally expressed to be payable to bearer, the drawee is discharged by payment in due course to the bearer thereof notwithstanding any endorsment whether in full or in blank appearing thereon, and notwithstanding that any such endorsement purports to restrict of exclude further negotiation".

This Section implies that a cheque originally issued as a bearer cheque always retains its bearer character irrespective of the fact that it bears endorsement in full or in blank or whether any endorsement restricts further negotiation or not. Thus, the banker is not required to verify the regularity of the endorsements on bearer cheques even in case, payment of an uncrossed bearer cheque to the bearer in due course. If such a cheque is stolen and the banker makes its payment without the knowledge of such theft, he will be dicharged of his obligation and will be protected under Section 85(2).

iii) Protection in case of Cross Cheques

The whole purpose of crossing is to prevent anyone but the payee from cashing a cheque. The drawee bank must not pay it except through another bank in the case of general crossing, and the prescribed bank where the crossing is special. If the banker ignores the directions conveyed by the types of crossing while paying, he cannot debit the customers account with the amount of the cheque and will not otherwise be held liable for any loss which the true owner sustains as a result of this payment. But if the payment is made according to the directions conveyed in the crossings, the law gives a measure of protection to protect the paying banker Section 128 of the Negotiable Instruments Act provides that, "where the banker on whom a crossed cheque is drawn has paid the same in due course, the banker paying the cheque and (in case, such cheque has come to the hands of the payee) the drawer thereof, shall respectively be entiled to the same rights and be placed, in the same position in all respects, as they would respectively be entitled to and placed in if the amount of the cheque had been paid to and received by the true owner thereof".

The banker making payment of a crossed cheqe is thus given protection under Section 128, if he makes the payment after fulfilling the following two requirments.

a) He has made payment in due course i.e., in good faith and without negligence and according to the apparent tenor of the cheque, and

b) The payment has been made in accordance with the requirement of the crossing (under Section 126), i.e., through any banker in case of general crossing, and through the specified banker in case of special crosing. In this connection the following points are worthy of note:

i) If a crossed cheque is dishonoured, the crossing is not deemed to be cancelled by such dishonour. Therefore, if such a cheque is represented for payment, the paying banker cannot ignore it.

ii) If a cheque is crossed specially to more than one banker, the banker on whom it is drawn shall refuse payment except when crossed to an agent for the purpose of collection.

..us if the crossing appears to be altered in some manner, no protection would be available

32.4 CIRCUMSTANCES LEADING TO REFUSAL OF PAYMENT

The following are the circumstances in which the statutory duty of a banker to honour his customer's cheuqe is terminated, i. e., payment can be refused

a) Countermand of payment: Countermand is stopping the payment of a cheque by the customer. It is withdrawal of his own mandate. Countermand, therefore, revokes the binding character of any mandate which has not been fully acted upon at the time when it is served. The need for such a stop payment order arises usually when a cheque is stolen or lost or some dispute has cropped up between the drawer and the payee after the issue. Once a countermand is communicated to the banker and he comes to know of it, he must not make payment of that cheque. After an effevtive countermand, if he makes payment, he is liable for any damage suffured by the customer as a result thereof. Some of the important points in the context of countermand are listed below which the paying banker must take due note of :

i) The countermand comes into operation as soon as it comes to the concious knowledge of the banker. The banker is under duty to give immediate attention to it and stop payment.

ii) Non-obedience of the stop payment instrucions exposes the banker to an action for damages, for which there is obviously no safety clause.

iii) The countermand can be effected by means by which the intention of the coustomer to withhold payment is made known to banker. But it has been held that it is too dangerous to stop payment by an oral communication or by a telegram. If there is a telephonic or telegraphic message to this effecxt. this must be soon after confirmed by a letter.

iv) The countermand notice must be unambigous and it must clearly mention the serial number of the cheque whose payemnt has to be stopped. Mere name of the payee, the amount and its date of issue might in certain cases create confusion. If the banker after responable and honestly reading the instruction pays the praticular cheque, he will not be held liable for any loss which the custoner may then be put to . At the same time wherever the banker feels a lack of clarity in the instrucitons, he is expected to seek elucidations lest there is wrongful dishonour.

v) The countermand instrucitons must be sent to the branch of the bank where the account is being maintained, because it is here that it is going to be acted upon. A notice of the stopping of cheque at one branch, of bank does not imply a notice to the other branches. But if a countermand has been recieved by a wrong branch. it should take steps to make it effective at the right branch .

vi) When a stopped cheque has been paid, the customer's account will normally have to be recredited, and the banker cannot escape this liability even if it was paid by inadvertance.

vii) Where two or more persons are authorised to sign cheques, whether severally or jointly, as joint holders of the account or as authorised agents on behalf of an account holder, bankers generally act on stop payment instructions issued by one of them, whether the cheque is signed by him or not.

viii) A stop payment order once issued may be cancelled as well by the drawer, and then the cheque becomes payable by the banker. But it is always advisable for the banker to get the cancellation instructions by the same person(s) who issued the stop order. This is perticularly important in cases where the countermand is made by two or more persons holding an account.

b) Death of the Drawer: On receipt of reliable information about the death of the customer, the banker must stop payment of the cheques signed by him because the order of the customer to the banker ceases to operate on the occurence of his death . The following points must be observed:

i) The time of receipt of notice or information by the banker about the death of the customer and not the time of death itself is important fot the banker. Payment made between the time of death and the receipt of its news by the banker may rightly be debited to the customer's account.

ii) The bankor should not rely on rumours and must ascertain the news about the customer's death reliably.

iii) If an agent, who has signed a cheque on behalf of his principal dies, the payment of such a cheque is not to be stopped because the agent himself was not the drawer. Similarly, if a person who signs in his official capacity such as the principal of a college, director of an institure or secretary of club dies, the account of the college, insture or club shall not become inoperative and the cheques draws on such accounts should not be dishonoured on this ground .

iv) The account of the deceased custmor shall remain inoperative until a succession certificate is produced by his legal representative or a probate of the will or a latter of Administration is received. The banker must ensure that the debt due from the bank is covered in the succession certificate. The banker must insist on the presentation of succession certificate in such cases otherwise he may incur same risk.

c) Insolvency of the Drawer: Another case when the banker's authority to pay third party cheques gets terminated is on the insolvency of the customer. On a customer being adjudicated as insolvent, the law begins to operate and all his properties properties vest in the Official Assignee or the Receiver for the benefit of his creditors. Naturally the bank account of the cusotmer as well is vested with the Offical Assignee/Receiver and payment on all cheques drawn by him either before or after the date of such petition should be stopped. But the cheques paid before the date of adjudication order shall be considered to have been properly paid, if the banker had no notice of the insolvency petition and the transactions were otherwise bonafied.

Likewise, in the case of a company customer, the payment of cheques should be stopped till a reviever is appointed.

d) Insanity of the Customer: The banker is bound not to honour his custemer's cheques on reipt of notice that the latter has become absolutely insane or of unsound mind. But so long as the customer acts rationally and excercises his understanding independently, his cheques should not be refused. The banker should have confirmed the information about the insanity of the customer from reliable sources before he refuses payment on this basis.

e) Notice of Assignement of Credit Balance: The credit balance in the account of a customer may be assigned (or transferred) by him to another person under Section 130 of the Transfer of Property Act 1882. On receipt of a notice of such assigment, the banker must stop payment of the cheques drawn by the assignor, as the latter ceases to be the owner of such funds.

f) Garnishee Order: A banker is bound to comply with the order issued by the court restraining him from paying the money from a customer's account. He must refuse payment of the cheques presented after the receipt of a Garnishe Order or any other order of the Court attaching the customer's money.

g) Breach of Trust: If the banker comes to know that the customer who is operating a trust account, contemplates using the funds of the trust account in breach of trust, the banker must stop payment of the cheques drawn on such account.

h) Defective Title of the Party : If any person presenting a cheque has defective title to the cheque and the banker is aware of this fact, he can refuse to honour such a cheque without any risk, because if he makes payment of the cheque to such person, it will not be made in good faith and the payment will not be deemed as payment in due course

i) The bank is justified in fefusing payment of the cheques in the following circumstances also.

a) If the cheque is a post dated cheque, or a stale cheque.

b) If the cheque is drawn on another branch of the same bank.

c) If the cheque contains an apparent material alteration which is not properly authenticated by the drawer.

f) If the signature of the drawer is a forged one or does not tally with his specimen signature.

e) If the funds of the customer in his hand are not sufficient or are not properly applicable to the payment of such a cheque.

CHECK YOUR PROGRESS - 3

List the circumstances in which the banker refuses the payment of cheques.

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3.2.5 BANKER AND DISHONOURED CHEQUES

When a banker dihonours a cheque he has to give a reason for dishonouring the cheque. All the banks have printed slips containing various reasons for dishonouring a cheque. The relevant reason in a given case is tick- marked on the slip and the slip is enclosed with the cheque. This slip is called the "return memo". The following are some examples of causes for the issue of a "return memo".

i) Refer to Darwer: When the funds in the account of the drawer are insufficient to meet the cheque. the bankes uses the words refer to drawer.

ii) Not Arranged For : This phrase is used when the payment of the cheque would result in an overdraft which has not been approved or the amount of overdraft will exceed the approved limit.

iii) Exceeds Arrangements : A banker ticks this remark where the overdraft which might be created as a result of paying this cheque would exceed the overall limt sanctioned to the party.

iv) Effects Not Cleared, Please present Again: When the drawer has sent cheques drafts, etc., for collection but the same have not yet been realised and the balance in the drawer's account is insufficient to meet the cheque, this reason is given for dishonouring the cheque.

v) Full Cover Not Received: Such a remark points up that either the customer has not deposited enough funds in his account to meet this particular cheque, or has failed to provide sufficient security to cover the overdraft which is likely to be created after paying the cheque.

vi) Irregularly Drawn Requires Confirmation: Wherever the cheques are drawn in an unusal or ambiguous manner, or which give some indication that they have been tampered with, such a remark is put.

Bankers liability in case his reply is inappropriate : The banker must take utmost care in giving a suitable reply to dishonoured cheque. He must give a reply which is most appropriate in the circumstances of the case. If the banker states a reason which is not appropriate and which injires the reputation of the drawer unnecessarily, the drawer is entitled to claim damages from the banker.

CHECK YOUR PROGRESS - 4

When does the banker give the following replies ?

i) Refer to Drawer; and ii) Exceeds arrangements, on dishonouring the cheques.

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32.6 SUMMING UP

It is the duty of the banker to pay cheques properly drawn by his customer, provided the customer has sufficient funds in his account A banker's position in regard to payment of cheques is full of risks. He has to take various precautions while making payment on the cheques drawn by his customers. He has to see that proper cheque formsare used, date is properly filled in, the amount is written in words and figures, mateiral alterations are confirmed by the drawer's signature, signature of the drawer is genuine and the cheque is presented within the banking hours. The Act provides the statutory protection to the paying banker. This protection may be in the case of order cheques and bearer cheuqes.

However the banker may refuse payment on cheques in certain cases like, countermanding of payment by the customer, receipt of Garnishee Order, death of the customer, etc. For dishonouring a cheque, the banker should give an apprppriate reply.

32.7 CHECK YOUR PROGRESS : MODEL ANSWERS

1. A cheque which is presented for payment after six months of its issue is known as stale cheque. The banker will not pay on such a cheque and retuens it with a remark out of date.

2. i)Alteration of date, ii) Alteration of place of payment, iii) Alteration of amount, iv) Alteration of the word 'bearer' in place or 'order', v) Alteration of crossing.

3. i) The countermanding of payment by the customer ii) In case of death of customer, iii) In case of insanity of customer. v) on recipt of a Garnishee Order: v) On receipt of a garnishee order; vii)In case of defective title of the person presenting the cheque; vii) In case the cheque is stale; viii) Material alterations not properly authenticated by the drawer, etc.

4. i) When the funds in the drawer's accont are not suffieicent to meet the pament of cheque.

   ii) when the overdraft created as a result of paying the cheque would exceed he overall limit sanctioned to the drawer.

32.8 MODEL EXAMINATION QUESTINS

ESSAY QUESTIONS

Answer the following in about 30 lines each:

1. Explain he precautions to be taken by a banker in making payment of a chque.
2. What is meant by the term paying banker?

   State briefly his duties and responsibilities in regard to honouring a cheque.
3. What is meant by material alteration in cheques? Give examples of such alterations.
4. Describe the circumstances in which a banker is justified in refusing payment of chequres.
5. State and explain the protection offered by the Negotiable Instrumrents Act, 1881, to the paying banker.

B. SHORT QUESTIONS

Answer the following in about 15 lines each:

1. Discuss the effects of payment against a cheque containing a forged signature.
2. what are the risks involved if a banker honours a post-dateed cheque?
3. Explain the following terms :

   i) Stale cheque; ii)Multilated cheque.

4) Explain the banker's position in material alterations.
5) What is return memo? Give some examples of replies which the banker makes for dishonouring cheques.

32.9 RECOMMENDED BOOKS

1. Avetar singh : Negotiable Instruments

2. Davar R.S & Ramachandra rao B. : Law and Practic and Banking

32.10 GLOSSARY

Material Alteration	: A change in the name, date or amount of the cheque etc, that causes it to speak different language from what it originally spoke.
Mutilated Cheque	: A cheque that is torn into two or more pieces.
Stale Cheque	: If a cheque is not presented for payment within a period of six months, it becomes a stale cheque.

UNIT - 33 : COLLECTION OF CHEQUES

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33.0 AIMS AND OBJECTIVES

The purpose of this unit is to explain the precautions to be taken by the banker in collecting cheques, the statutory protection to him and his liabilities.

After reading this unit, we expect you to be able to :

- describe the position of the collectiong banker;
- explain the statutory protection provided to the collecting banker;
- discuss the duties of the collecting banker towards his customer.

33.1 INTRODUCTION

One of the important services rendered by a banker is collection of cheques, bills of exchange and other instruments on behalf of a custmer. When a customer receives a cheque drawn on any bank, he may either receive its payment personally or through his agent from the drawee bank or send it to his banker for collection from the drawee bank. In the latter case the banker deputed to collect the amount of a cheque from the drawee bank is called the 'collecting banker'. The banker credits the account of the customer with the amount after its realisation.

Though the banker is not under legal obligation to collect his customer's cheques, collection of cheques has now become an important function of the banker.

This unit explains in detail the position of the collecting banker, his statutory protection and duties.

33.2 THE POSITION OF THE COLLECTING BANKER

A collecting banker while collecting the cheques of the customer acts as either a holder for value or an agent of the customer. Thus the legal position of the collecting banker depends upon the capacity in which he collects the cheques. While the statutory protection is extended to him in the latter capcity it is denied to him if he collects in the former capacity.

i) As a Holder for Value

A holder for value is one who holds a bill for which the value has, at some time, been given though not necessarily by the holder himself. In the context of banking business, the term arises when the banker who is collecting the proceeds of a cheque has himself given value. This happens when the banker credits the amount of the cheque and allows the customer to draw against it or otherwise pays the amount thereof to the customer before the proceeds are actually realized from the drawee bank. This facility is given to the customer since some time lag is always involved between the presentation of the cheque and the time when the proceeds can be made available for drawing.

The collecting banker becomes the holder for value in the following ways :

a) by lending further on the strength of the cheque.

b) by paying on order the amount of the cheque or part of it in cash or in account before it is cleared.

c) by agreeing either then or earlier or as a course of business, that a customer may draw before the cheque is cleared.

d) by accepting the cheque in avowed reduction of an existing over draft, and

e) by giving cash over the counter for the cheque at the time it is paid in for collection.

Here as holder for value, the banker is in the position of any other such holder of a negotiable instrument. Automatically he becomes a holder in due course entitled to sue the [illegible]st parties liable on such cheques in his own name. Likewise, he incurs liability as well. but one endorsement is proved to be forged, he will be liable to the true owner of the cheque. But he shall have the right to recover the money from the last endorser, i.e., his own customer. If the customer is unable to pay, the banker will himself bear the loss.

ii) As an Agent

A collecting banker acts as an agent of the customer if he credits the latter's account with the amount of the cheque only after the amount is actully realised from the drawee banker. Then only the customer is entitled to draw the amount from his account. For acting as an agent, the banker collects some commission from the customer. The collecting banker however, does not possess a greater title to the cheque than the customer. As long as the title of the customer is good, the banker incurs no risk.

Conversion by the collecting banker

A banker is charged for having wrongfully converted cheques to which his customer had no title or had a defective title. Conversion means wrongful or unlawful interference with another person's property which is not consistent with the owner's right of possession. Property includes negotiable instruments also. So the banker is charged for conversion if he collects cheques for a customer who has no title or a defective title to the instrument. A righful owner of the goods can revover the same from anyone who takes it without his authority and in whose hands it can be traced. The banker cannot escape from this liability when he acts as an agent to his customer for the collection of cheques.

Liability of the Collecting Banker in the case of its agent

Generally the collecting banker collects the amount of the cheque from the paying banker through its branch at the place of the paying bank. But in some cases the collecting bank may not have his branch at the place of paying banker. In such a case, the collecting banker appoints another bank having a branch at that place as its agent for collection. The status of such agent banker is a sub-agent and the liability of the collecting banker in this respect was decided by the Bombay High Court in the Punjab National Bank Ltd. Vs. Ishwarbhai Lalbhai patel & Co.

The Bombay High Court stated that in the case of a properly appointed sub-agent, the agent is responsible to the principal for acts of the sub-agent, while in the case of a substitute agent i.e., a person named by the agent holding an express or implied authority to act for the principal in the business of agency, the principal is responsible.

CHECK YOUR PROGRESS - 1

Give meaning of the term 'collecting banker'. How does he act?

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CHECK YOUR PROGRESS-2

Mention the liability of the collecting banker in the case of conversion.

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33.3 STATUTORY PROTECTION TO THE COLLECTING BANKER

The collecting banker should take due precautions in order to avoid the risk of conversion involved therein. But it is difficult task for the collecting banker to judge the validity of his customer's title particulary when he has to collect a large number of cheques continously in the ordinary course of his business. The Negotiable Instruments Act provides statutory protection to the collection banker in order to minimise the risks of conversion inherent in the case of collction of cheques by the banker. The protection is:"a banker who has, in good faith and without negligence required payment for a customer of a cheque crossed generally or specially to himself shall not, in case the title to the cheque proves defective, incur any liablility to the true owner of the cheque by reason only of having received such payment". It is clear that certain conditions are to be fulfilled if the statutory protection is to be enjoyed by the collecting banker. These conditions are as follows;

i) The Cheque must be a Crossed Cheque

It is only in respect of crossed cheques that the collecting banker enjoys a certain amount of protection. To be entitled to protection, the cheques have to be crossed generally or specially before they reach his hands. If a certain cheque was not crossed at the time it was paid into the bank, it cannot secure prtection by itself crossing it later. It may be noted that it is a common practice among bankers to cross cheques received by them with a rubber stamp of the collecting banker, but this does not help. In collecting an open cheque, the bank can be held liable for conversion and as such answerable to the true owner for the value, if the customer had no title or a defective title thereto.

ii) The Payment must be Received for Customer

The banker will be protected only when he collects the cheque on his customer's behalf. A customer is one who has an account with the banker and has dealings of banking business. In other words protection will not be available, if the banker collects the cheque of a non-customer. in addition, the banker will be protected statutorily when he collects the cheque as an agent of the customer and not as its holder for value.

iii) Payment must be Received in Good Faith and without Negligence

The cardinal condition for the protection to be available to a collecting bank is that he should have acted in good faith and without negligence. If the exercise of due care has been found wanting in collecting, he loses the benefit of section 131. This obligation of due care is imposed on the collecting banker to safeguard the interest of the true owner. What is due care and deligence is a question of fact, and has to be interpreted in the light of the facts of the case and its surrounding circumstances. In general, the amount of care expected from the banker is as much as a reasonable man would have exercised to protect himself and others against fraud. A practice habitually followed by banks is not a criterion for the exercise of proper care.

In this context, it is necessary to understand the meaning of negligence with the help of some examples.

(a) Collecting Third Party Cheques

If a bank collects cheques for agents and other third parties and pays the same fraudulently or without authority to their accounts, it shall be liable to compensate the true owner loss or damage which he sustains thereby. Cases of this kind occur when, an office bearer or employee of an institution known to be such or appearing to be such from the terms of the cheque pays in the same to his own private account, and the bank credits the proceeds thereof. The bank should take care not to collect each and every cheque which has been endorsed in favour of the agents and office bearers of associations organisations. Wherever the banker supects foul play, the client should be put on enquiry.

(b) Not Taking Cognizance of "Not Negotiable" Crossings

'Not negotiable' crossing though does not impede transferability of the cheque, certainly impedes negotiability. The transferrer fails to pass a better title than what he himself has and these words serve as a warning to the holder that he takes that instrument subject to the defects of title in its transferrer. As such wherever there is such a crossing, the banker should be careful in ascertaining the title of the previous parties, lest he is charged of conversion of money. But the collecting banker does not lose his protection unless guilty of negligence.

C) Carelessness in Account Payee Crossing

This crossing puts upon the bank the duty of making of a careful and satisfactory inquiery before collecting the cheques in favour of a person other than the payee named therein. Failure to observe this precaution depreves the banker of the staturory protection. In Bevan vs. National Bank (1906) it was held that the words "account payee" were a direction to the receiving bank that the drawer desired to pay the particular cheque into the bank which kept the account of the payee. To disregard a direction of that kind was prima facie negligence.

(d) Absence of Proper Enquiries

In many cases, the collecting banker cannot afford to be satisfied about the genuineness of the transaction merely by what appears on the face and, of course, on the back of a cheque He may have to make enquiries about the cheque and the underlying transaction in order to protect himself against a possible charge of negligence. What type of enquiry is to be made, or is justified or appropriate, depends upon the facts of each case. Some factors that need to be borne in mind by the banker are :

i) The amount of the cheque

ii) The history of the account in which the cheque is paid in

iii) The antecedents of the customer

iv) The relationship between the customer and the drawer/payee, etc.

(e) Omission to Detect Irregular Endorsements

The necessary inquiries may relate, not only to authority put in and collect the cheques, but also in endorsing them. If the banker is found negligent in verfying the regularity of endorsements on the cheques collected by him, he will lose the protection avilable under section 131. The common irregularities with regard to endorsements which a banker may disregard at his risk are:

i) Failure to see that the endorser signed in the same manner and with the same spellings (no matter incorrect) as they appear on the instrument in the name of the payee or endorsee.

ii) Failure to verify the authenticity of the authority of the person who signs per procuration.

iii) Failure to verify the signatures where two or more endorsements are there on the instrument in the same hand writing.

f) Opening of Accounts

Failure to obtain proper introduction in opening an account for a new customer or to follow up a reference given by such customer would also amount to negligence, disentitling the banker from claiming protection aginst a charge of conversion. It is, therefore, not only the neglignece in the process of collecting cheques but also at the time of opening the account for the customer that the banker collecting be deprived of the statutory protection.

CHECK YOUR PROGRESS - 3

List the conditions to be fulfilled by the collecting banker for enjoying the statutory protection.

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33.4 DUTIES OF THE COLLECTING BANKER

The collecting banker is responsible to the customer for his acts of omission or mistakes as he acts as an agent to his customer. The duties of a collecting banker towards his customer are as follows :

i) Presenting cheques for payment

The collecting banker is under an obligaion to present the cheques to the drawee bank within reasonable time.

According to the law and judicial pronouncements, this reasonable time would be :

a) Presenting the cheque within one day after the receipt there of whether the cheque is drawn on a bank in the same place, i.e., the collecting and drawee banks are locally situated.

b) Forwarding or presenting it on the day following the receipt thereof where the cheque is drawn on bank in another town. That is where the collecting and drawee banks are at defferent places, cheques should be presented/forwarded by the collecting bank on the day after their receipt.

Sections 72 and 84 lay down the consequences of nonpresentation of a cheque before the drawee bank within a reasonable period of time. If a cheque is presented with undue delay and in the meanwhile the drawer of the cheque suffers damage, the drawer is discharged to the extent of such damage.

According to Section 84(1) "Where a cheque is not presented for payment within a reasonable time of its issue and the drawer or person on whose account it is drawn had the right, at the time when presentation ought to have been made, as between himself and the banker, to have the cheque paid and suffers actual damage through the delay, he is discharged to the extent of such damage, that is to say, to the extent to which such drawer or person is a creditor of the banker to the larger amount than he would have been if such cheque had been paid". The reasonable time for this purpose shall be determined having regard to :

ii) the nature of the instrument,

ii) the usage of trade and of bankers, and

iii) the facts of the particular case.

When the drawer of the cheque is so discharged, the holder of the cheque shall be the creditor of the banker to the extent of such discharge and shall be entitled to recover the amount from him under Section 84(3).

i) Serving Notice of dishonour

In case of dishonour of the cheques presented for collection, the collecting banker is required to give due notice of dishonour to the customer. The bank generally conveys the notice of dishonour by returning the cheque to the customer which is deemed as sufficient notice of dishonour, if the customer has endorsed it. As an agent for collection if the banker serves such notice to the customer it wuld be taken that he has performed his duty, and it is for the customer to give notice to the other parties. Where the collecting banker is not the agent but a holder for value, he will have to undertake the additional responsibility. He is required to give notice of dishonour to all the parties to the cheque so as to make all or any of them liable for the payment of the amount of the cheque. If he stops with giving notice to the customer only, he may not be able to proceed against any party other than the customer. An omission to give notice will discharge all the parties secondarily liable i.e., endorsers and the drawer in the case of an ordinary bill of exchange and he himself will become resposible to his customer for any loss sustained as consequence of such omission.

However, there is no prescribed form for sending the notice, and it is usual to return the cheque to the customer with note indicating the reason for dishonouring it. Regarding the time for giving notice of dishonour, section 96 provides that the collecting banker is entitled to the same time to give notice to his principal as if he were the holder giving notice of dishonour.

33.5 SAUMMING UP

A banker while collecting the cheques of his customer acts as either a holder for value or an agent of the customer. The banker becomes a holder for the value when he credits the amount of the cheque and allows the customer to draw against the cheque before its proceeds are actually realised from the drawee bank. When the banker acts as an agent of the customer, he allows the customer to draw the amount, after the amount is actually realised from the drawee banker. In such a case the banker does not possess a greater title to the cheque than the customer. The banker is charged for the wrongful conversion of cheques to which his customer has no title or had a defective title. The collecting banker is provided with statutory protection to minimise such a risk of conversion. This protection is available only if the cheque is crossed, collection is made on behalf of the customer and the banker is acted in good faith and without negligence. The collecting banker has also certain duties like presenting of cheques for payment within reasonable time and serving notice of dishonour to the customer.

33.6 CHECK YOUR PROGRESS : MODEL ANSWERS

1. Collecting banker is a banker who is deputed by the customer to collect the amount of a cheque from the drawee bank. The collecting banker acts either as a holder for value or an agent of the customer.
2. When the collecting banker has converted cheques to which his customer had no title or had a defective title, he (the banker) may be held liable to pay the money to the true owner of the cheque.
3. i) The cheque must be a crossed one.
   ii) The collection of cheque must be made on behalf of the customer.
   iii) The banker must have acted in good faith and without negligence.

33.7 MODEL EXAMINATION QUESTIONS

A. ESAY QUESTIONS

Answer the following in about 30 lines each:

1. Explain the term 'collecting banker'. What are his duties and responsibilities in collecting the customers, cheques ?
2. Enumerate the conditions which must be satisfied before statutory protection is available to a collecting banker in India.
3. What constitutes negligence on the part of a collecting banker ? Explain its legal consequences.

B) SHORT QUESATIONS

Answer the following in about 15 lines each:

1. What is conversion ? Explain the liability of the collecting banker in the case of conversion.
2. What is the position of a collecting banker as a holder for value ?
3. Explain the liability of the collecting banker in respect of its agent appointed for collection.
4. Explain the following: i) Collecting Banker, ii) Conversion.

33.8 RECOMMENDED BOOKS

1. Avetar Sing : Negotiable Instruments
2. Davar R.S. & Ramachandra Rao B : Law and Practice of Banking
3. Srivatsava P.K. : Banking Theory & Practice.
4. Tannan M.L. : Banking Law & Practice in India.

33.9 GLOSSARY

Collecting Banker : A banker who collects cheques of his customer from the drawee bank.

Conversion : It means the collection of the amount of the cheque by the banker on behalf of a customer who has no title to it.

ANDHRA PRADESH OPEN UNIVERSITY

B.COM. II YEAR

COMMERCE - GROUP - C: PAPER - II

MONEY AND BANKING (THEORY AND PRACTICE)

COURSE STRUCTURE

SECTION - A : MONEY

BLOCK - I	:	**MONEY AND ITS ROLE**
Unit -1	:	Characteristics and Functions of Money
Unit - 2	:	Money Economy
Unit - 3	:	Money in Capitalist and Socialist Economic Systems
BLOCK - II	:	**VALUE OF MONEY**
Unit - 4	:	Demand for and Supply of Money
Unit - 5	:	Theories of Value of Money
Unit - 6	:	Inflation and Deflation
Unit - 7	:	Measurement of Value of Money

SECTION - B : BANKING:THEORY

BLOCK - III	:	**COMMERCIAL BANKING**
Unit - 8	:	Functions of Commercial Banks
Unit - 9	:	Commercial Banks and Creation of Credit
Unit -10	:	Investment Policy and Asset Structure of Commercial Banks
Unit - 11	:	Structure of Banking systems
BLOCK - IV	:	**CENTRAL BANKING**
Unit - 12	:	Functions of the Central Bank
Unit - 13	:	Principles and Systems of Note Issue
Unit - 14	:	Central Bank and Credit Control
Unit - 15	:	Money Markets and Role of Central Banks
BLOCK - V	:	**INDIAN BANKING**
Unit - 16	:	Indian Money Market
Unit - 17	:	Structure and Growth of Modern Banking in India
Unit - 18	:	Nationalisation of Commercial Banks
Unit - 19	:	State Bank of India
Unit - 20	:	Exchange Banks in India
Unit - 21	:	Co - Operative Banks
Unit - 22	:	Regional Rural Banks
Unit - 23	:	Lead Bank and other Allied Schemes

BLOCK - VI : RESERVE BANK OF INDIA

Unit - 24 : Constitution Functions Reserve Bank of India

Unit - 25 : Money Policy

SECTION - C : BANKING : LAW AND PRACTICE

BLOCK - VII : BANKER AND CUSTOMER

Unit - 26 : Banker - Customer Relationship

Unit - 27 : Obligatons and Rights of Banker

BLOCK - VIII : TYPES OF ACCOUNTS AND CUSTOMERS

Unit - 28 : Types of Accounts

Unit - 29 : Special Types of Customers

BLOCK - IX : NEGOTIABLE INSTRUMENTS

Unit - 30 : Negotiable Instruments - Kinds - Features

Unit - 31 : Endoresement and Crossing of Cheques

Unit - 32 : Payment of cheques

Unit - 33 : Collection of Cheques

3. Sundaram K.P.M. & Varshney P.N : Bankinbg Theory Law and Practice

4. Tannan M.L : Banking Law & Practice in India

FACULTY OF COMMERCE

B.COM. II YEAR (3 YEAR DEGREE COURSE) EXAMINATION

MODEL EXAMINATION QUESTION PAPER

MONEY & BANKING

GROUP - C : PAPER - II

Time : 3 hours

Max. Marks : 100

Min. Marks: 35

Part - A : Essay Questions

(Marks 4 x 15 = 60)

Answer any four questions of the following

Each question carries 15 marks

Answer the following in about 30 lines each

1. Explain the functions money.
2. What are the cosequences of inflation? Explain the measures to control inflation.
3. Explain the functions of Commercial Banks.
4. Briefly describe the weapons of credit control employed by the Central Bank.
5. Explain the progress made by commercial banks after nationalisation.
6. Explain the liability of a banker for wrongful dishonour of customer's cheques.
7. Distinguish between current, savings and fixed deposit accounts.
8. Define a negotiable instrument and describe its main features.

Part - B : Short Questions

(Marks 5 x 8 = 40)

Answer any 5 questions of the following

Each question carries 8 marks

Answer the following is about 15 lines each

9. Explain the circular flow of money in an economy
10. Explain the speculative demand for money with the help of limidity curve.
11. Explain the principles guiding the instrument policy of commercial banks.
12. Write short notes on :
    i) Monopoly of Note Issue
    ii) Banker's Bank
13. List out the characteristics of Indian Money Market
14. Distinguish between Quantatitive and Qualitative methods of credit control.
15. Explain the Note- issue system followed by RBI.
16. When can a banker refuse payment to his customer?
17. Explain the legal position of a minor in opening a bank account.
18. Distinguish between general crossing and special crossing.

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UNDERGRADUATE COURSES-II YEAR

SUBJECT : COMMERCE

COURSE : MONEY AND BANKING

ASSIGNMENT - I

N.B.

1. Do not copy the answer from any book.
2. As far as possible try to answer the question independently in your own words.
3. If it is necessary to quote from any source mention the source from which you are quoting.
4. Use your own foolscap paper for writing the assignments.
5. Leave sufficient margin for the comments of the evaluator.
6. Completion of this assignment normally should not take more than two hours.

PART - A : ESSAY QUESTIONS

I. Answer the following questions in about 30 lines each.

1. What is money? Explain its functions.
2. Critically examine Fisher's equation of exchange.
3. What is meant by liquidity of bank assets? What factors influence the liquidity of banks?

PART-B : SHORT QUESTIONS

II. Answer the following questions in about 15 lines each.

1. Explain the circular flow of Money in an economy.
2. Discuss the effects of inflation.
3. Explain the limitations of Unit Banking System.

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UNDERGRADUATE COURSES - II YEAR

SUBJECT : COMMERCE

COURSE : MONEY AND BANKING

ASSIGNMENT - II

N.B.

1. Do not copy the answer from any book.
2. As far as possible try to answer the question independently in your own words.
3. If it is necessary to quote from any source mention the source from which you are quoting.
4. Use your own foolscap paper for writing the assignments.
5. Leave sufficient margin for the comoments of the evaluator.
6. Completion of this assignment normally should not take more than two hours.

PART - A : ESSAY QUESTIONS

I. Answer the following questions in about 30 lines each.

1. Examine the deficiencies of the Indian Money Market. What measures do you suggest to make the Indian Money Market a developed one?
2. Explain the progress made by commercial banks after nationalisation.
3. What are the objectives and functions of Regional Rural Banks?

PART - B : SHORT QUESTIONS

II. Answer the following questions in about 15 lines each.

1. Explain the principles of note issue.
2. Describe the role of central bank in undeveloped money market.
3. Explain the Lead Bank Scheme.

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UNDERGRADUATE COURSES - II YEAR

SUBJECT : COMMERCE

COURSE : MONEY AND BANKING

ASSIGNMENT - III

N.B.

1. Do not copy the answer from any book.
2. As far as possible try to answer the question independently in your own words.
3. If it is necessary to quote from any source mention the source from which you are quoting
4. Use your own foolscap paper for writing the assignments.
5. Leave sufficient margin for the comments of the evaluator.
6. Completion of this assignment normally should not take more than two hours.

PART - A : ESSAY QUESTIONS

[illegible]wer the following questions in about 30 lines each.

1. What are the various functions performed by the Reserve Bank of India.
2. Discuss the general features of banker-customer relationship.
3. Define a "Bill of Exchange" and point out in what respects it differs from a promissory note and a cheque.

PART - B : SHORT QUESTIONS

II. Answer the following questions in about 15 lines each.

1. Explain the salient features of a promissory note.
2. Distinguish between special crossing and general crossing.
3. When can a banker refuse payment to his customer?