ECONOMICS

MONEY, BANKING AND INTERNATIONAL TRADE

DR. B.R. AMBEDKAR OPEN UNIVERSITY
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COURSE TEAM

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INTRODUCTION TO THE COURSE

It is not a truism but a fact that Money is what makes the world move, although it is not a measure of it. The bank, being the principal agency today for money transactions, necessarily plays a crucial role in trade and commerce. With the countries of the world becoming increasingly economically interdependent, international trade and commerce have assumed an added importance, involving the balancing of exports with imports which raises such problems as 'Balance of Payments'. The course titled "Money, Banking and International Trade" discusses the functions of money and of banks in mobilising the country's resources for a variety of purposes and activities, both national and international, involving money transactions. It considers the theory and practice concerned with money and banking as exemplified in both internal and international trade. It pays particular attention to the various theories of international trade and its financing which have emerged as a result of the complex arrangements and agreements governing it, with special reference to India.

The syllabus is divided into 3 blocks. The Block-I discusses the concepts, evolution, functions and importance of money. It also explains theories of value of money and inflation and also supply of money. The Block-II deals with the commercial and central banking and then goes on explaining Indian experiences relating to Indian banking system, Reserve Bank of India, Money Market, Capital market, Cooperative banks and regional rural banks. The last Block explains the theories of international trade and issues pertaining to it such as terms of trade, balance of trade, balance of payments, exchange rates, international institutions. Indian experience is also dealt with.

This book deals with topics in Money, Banking and International Trade included in the syllabus for the Third Year of the Undergraduate course offered by the Dr. B.R. Ambedkar Open University. These topics cover the specialized area of the subject to be studied in the Third Year of the 3 year Degree Course. 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. 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 synopsis followed by an objective and has at its end assignments to the students comprehension.

The University hopes that this material will help the student acquainted with the principal issues concerning Money, Banking and International Trade.

BLOCK - I
MONEY

Important concepts pertaining to money are discussed in this block. Evolution, functions and importance of money are also dealt with. It also enables you to learn theories of value of money and inflation and also supply of money.

This block consists of the following units :

Unit-1 : Concept of Money-Meaning and components of Money Supply

Unit-2 : Functions and Importance of Money

Unit-3 : Value of Money - Measurement - Index Numbers

Unit-4 : Theories of Value of Money: Fisher, Cambridge and Friedman

Unit-5 : Supply of Money in India

Unit-6 : Inflation Theory and Indian Evidence

UNIT-1: CONCEPT OF MONEY-MEANING AND COMPONENTS OF MONEY SUPPLY

Contents

1.0 AIMS AND OBJECTIVES

The purpose of this unit is to explain the concept of money and to give an idea of components of money supply.

After reading the unit, you will be able to

* examine the Barter System,
* [illegible] of money,
* analyse the characteristics of money, and
* describe the components of money supply.

1.1 INTRODUCTION: ECONOMIC ACTIVITY - NEED FOR EXCHANGE

Now a days every economy is considered as Money economy. A monetary economy is one in which money is widely used and accepted as a medium of exchange. The development of money is an epitome of the history of civilization. The economic activity consists of wants-efforts-and satisfaction i.e., to satisfy wants every individual has to depend upon others. In the process of inter-dependence one can produce only one or two goods in which he has skills, resources and for the rest he has to depend on others who specialise the production of the other goods. In the primitive society wants are simple and goods are exchanged for goods in a village where caste system decided the economic activity. This was known as barter system.

1.2 BARTER SYSTEM

Barter means direct exchange of goods for goods. Money is not used in the exchange process. As explained earlier the economic activity consists of exchange of goods and services between people to satisfy their wants. As civilization changed, wants increased, man experienced some inconvenience in his daily life :

Gradually the economic progress influenced civilization of man and civilization directed the process of production and exchange. Then the process of barter gave way to the process of money exchange i.e., goods and services are exchanged for money and thus money exchange came into existence. It involves a continuous flow of money payments between the two major classes of economic process viz., producers of goods and consumers of goods. This is explained as circular flow of Money which is discussed in detail in the following unit.

The money is a blood stream of every day economic life. The introduction of money facilitated the introduction of division of labour and production on large scale with its advantages. In the market mechanism money and credit have replaced the barter system. The inconveniences of barter system further promoted the prominence of money.

1.3 INCONVENIENCES OF BARTER SYSTEM

The inconveniences of barter system can be explained as follows :

1.3.1 LACK OF DOUBLE COINCIDENCE OF WANTS

Satisfaction of wants require exchange of goods for goods or goods for services in the barter system. Wants differ, tastes differ and as such the goods required for transaction differ. There is need for double coincidence of wants. It is necessary for a person who wishes to trade his goods or services to find some other person, who is not only willing to buy his goods or services but also possesses that good which the former wants. For example a person who has cloth to exchange need rice. He must search for a person who can take his cloth and give him rice at that particular point of time. If the person having rice does not require cloth of the other the exchange of goods will not take place. This is known as lack of double coincidence of wants.

It involves time factor also. It takes much longer time to find someone who is ready to buy what the seller wants to sell and who also is able to pay in terms of what the seller needs.

1.3.2 LACK OF COMMON MEASURE OF VALUE

In the process of want satisfaction there are innumerable varieties of goods differing in quality and size. It is difficult to measure the value of one in terms of the other. Every transaction involves valuation of goods. For example one kg. of sugar may be valued in terms of wheat i.e. 3 kg. of wheat. It is possible only when the goods are few to be exchanged for. But when there are large number of goods the problem is to determined exchange value in terms of many number of other goods and services i.e., common measure of value. In the absence of common measure of value, it is difficult to fix exchange values. In the case of a man who can exchange only his services it is very difficult to remember the exchange values in terms of all other services and all other goods he requires. It is also difficult to exchange his services simultaneously for all other goods and service, he requires at a point of time.

1.3.3 INDIVISIBILITY OF GOODS

Indivisibility of certain goods makes the barter system inoperative. There are goods of different in sizes different in durability and hence in value. In the process of exchange it is necessary to divide the commodity into units and sub-units. For example rice, cloth can be divided and sub-divided but in the case of animals it cannot be done. For example a part of a horse cannot be exchanged for a kg. of rice. Then the exchange cannot take place.

1.3.4 DIFFICULTY IN STORING WEALTH

It is common that one has to store a part of his wealth for future needs. When the wealth is in the form of goods and services it is difficult to store it, since most of the food items cannot be stored beyond one year. Similarly services cannot be stored. In the case of animals, wealth it is perishable. Only wealth in the form of permanent assets can be stored. All cannot have such wealth. Those having other kinds of wealth cannot store it.

1.3.5 DIFFICULTY IN MAKING DEFERRED PAYMENTS

It is not possible to make just payments involving future contracts under the barter system. In daily life it is necessary to defer the payments in certain cases. Then the two parties of the barter may have the problems of

a) the quality of the goods or services to be repaid,

b) the specific commodity to be used for repayment,

c) valuation of the same commodity at different times as there is risk of increase or decrease in value of over a time.

1.3.6 LACK OF SPECIALISATION

The present day production involves specialisation as a person cannot produce all goods and services. In the barter system a high degree of specialisation is difficult to achieve. In the words of Coulborm "Barter is only tolerable, then in very simple circumstances . . . . . But as soon as division of labour develops to a considerable extent money becomes necessary to facilitate exchange."

1.4 MEANING OF MONEY

Money as a medium of exchange, does not require coincidence of wants. Goods and services can be exchanged for money and with that money again goods and services can be purchased. Value of any commodity or service can easily be measured in terms of money. There is no necessity to divide the goods and the value of good can be paid in term of money. Wealth in the form of money can be stored for any length of time. The process of deferred payments becomes easy and the principle of specialisation can be effectively implemented. Thus, with money people can overcome the difficulties of barter.

The meaning of money becomes clear if various definitions are discussed since there is no unanimity over the definition of money among the economists. It means there is no clarity over the concept. Different economists hold different opinions on the most appropriate definition of money. In this connection it is proper to quote Harrod.

According to Harrod, money cannot be defined like a physical substance. It does not have any fixed physical properties for all time to come. It is a social phenomenon, and many of its current features depend on what people think it is ought to be". There are four schools of thought over the meaning of money. These four schools of thought include both concrete and abstract money in the definition of money.

a) Traditional view :

In the traditional school, Seligmen, Walker Hicks, Howbray, Keynes and Crouther need mention. In simple terms, Seligman stressed general acceptability." Walker, Hicks Newly, Hansbray lay stress of its functions. But Crouther clearly states that "anything that is generally acceptable as a means of exchange". It implies three important functions, as a medium of exchange, as a measure of value and as a store value.

b) The Quality theory view :

Prof. Milton Friedman and his followers defined money as "currency plus total comm ial bank deposits adjusted". This approach pointed out the function of store value.

c) The Redcliff Committee view :

According to its report money is the total amount of credit available in the economy. It takes a wider view of money. According to this the velocity of circulation of money is meaningless.

d) The Gurley & Shaw view :

Gurley and Shaw go a step forward in describing a close substitutes for money. According to this commercial banks are the most important financial intermediaries. The other are savings and loan associations like life insurance companies, savings banks, provident funds, government leading agencies etc.

The traditional view exclude near money from the definition where as the others considered those assets which possess attributes of satisfying one or more criteria of identical behaviour in performing the functions of money. Thus money is what money does. It includes currency, or hard money and demand deposits of commercial banks which are withdrawable on demand.

In India the Reserve Bank adopted two definitions of money, the narrow definition and the border definition. The narrow definition covered currency held by the public. Thus demand deposits of the banking sector and other deposits with the R B I. The other deposits include demand deposits of the semi-government institutions, demand deposits of foreign governments and other central banks as also some deposits of the IMF and the World Bank.

The broader definition of money is aggregate monetary resources and includes the time deposits of the banks as well.

From April, 1977 the RBI adopted four alternative definitions of money M1, M2, M3 and M4.

M1 = is the currency held by the Public and Currency held by the non-govt. sector, demand deposit (net of inter bank deposit) held by the public and other deposits of RBI.

M2 = M1 + saving deposits with post office saving banks.

M3 = M1 but does not include savings deposits with post office savings banks. Instead it includes net time deposit with the bank.

M4 = M3 but also total deposits (instead of only the savings deposits) of the post office savings organisations. Savings, time and post office recurring deposits and post office cumulative deposits.

Recently another concept of "High Powered Money" is being used. This includes the currency held by the public and the banks and other deposits of the RBI.

As explained above the meaning of money is gradually changing from time to time.

1.5 CLASSIFICATION OF MONEY

Money is classified on the basis of commodity used and on the basis of liquidity. On the basis of commodity used the classification is (i) Metallic Money (ii) Paper Money. On the basis of liquidity, money can be classified as (i) Actual Money (ii) Near Money.

Metallic money is further classified as (a) Standard Money (b) Token Money (c) Subsidiary Money.

Paper money is further classified as :
a) Representative Paper Money
b) Convertible Paper Money
c) Inconvertible Paper Money
d) Fiat Money and
e) Bank Money or Credit Money.

Therefore the types of money can be explained as follows :

1. *Standard Money :* It is also known as full-bodied money. In the begining gold and silver were used. These coins are made of a well-defined weight and fineness. The face value of the standard money equals the intrinsic or metallic value. Between 1835-1893 the Indian rupee coin was made of silver.

2. *Token Money :* It is made of inferior and higher metals such as copper, nickel etc. It is used for making smaller payments. It is subsidiary for the standard money. Its intensic value is less than the face value. The rupee coin in circulation in India is a token coin. If it is melted, its metal will not be sold worth one rupee.

3. *Subsidiary money :* It is made of lighter metals used for low-value coins. This money is used to make smaller payments i.e., exchange of low-priced goods and services. All coins of the denominations for 1 np. to 25 np. in India are subsidiary money.

4. *Representative Money :* This is one kind of Paper Money started in China, the use of paper money gradually spread to other countries. In India use of paper for money started in the 19th century.

Representative Paper Money is fully backed by gold and silver reserves. If the gold and silver was to be used there may be wear and tear, resulting in wastage of metal. To avoid this waste paper money is used to the full extent of its value. Metals reserves are maintained by the issuing authority.

5. *Convertible Paper Money :* The paper money issued is convertible into standard coins at the option of the holder. Under this, system the people are given gold and silver in exchange for paper currency for making payments abroad. This system has become absolute these days.

6. *Inconvertible Paper Money :* The paper notes issued by the G O I during the second world war were an example of inconvertible paper money. It is a kind of forced loan obtained from the public.

Under this system, the issuing authority keeps no metallic reserves behind paper currency - nor does the issuing authority guarantee the convertibility of paper notes into coins or metals notes issued by the central banks of all countries represents inconvertible paper money. They are also known as fiduciary money.

7. *Fiat Money :* This is also known as emergency currency. It is an extraordinary type of money and is issued under special circumstances. This is only a variety of inconvertible paper money. No reserves of any type are kept behind fiat money. It is issued in limited quantities. Presently all inconvertible paper money is fiat money and there is practically no difference between the two.

8. *Actual Money :* This money in circulation. It consists of legal tender money such as coins, token coins and paper money and bank money or bank deposits.

9. *Near Money :* It consists of treasury bills, bonds, debentures etc. This money is not liquid. Near Money has to be first converted into actual money before it can be utilised to buy goods, and services from the market.

10. *Money of Account and Money Proper :* There is other classification given by Keynes like *Money-of-account and Money-Proper. Money of account* is that in which debts and prices of general purchasing power are expressed. *Money proper* is the actual money in which contracts or debts are settled such as Indian rupee. There is no difference between money-proper and money of account when the account within a country are maintained in money proper.

The classification of money is not of much practical relevance. In India the relevant aspect is high powered money. i.e., state money plus other deposits with the central bank and deposit mor f the banking system. The metallic content of the government currency is in very small proportid total currency supply in the country. Credit money occupies an important place. The credit struc ierc of a modern money economy is based upon a very narrow base consisting of government curre The reserves of gold and foreign exchange are used to meet the foreign obligations.

11. *Legal tender money and non-legal tender money :* Legal tender money is that which the state and the people accept as the means of payment in discharge of debts. All notes and coins issued by the government and the central bank of a country are compulsory legal tender in that country. It is further classified as limited legal tender money i.e., 1 paisa to 25 paise in India unlimited legal tender money is 50 paise to 1 rupee and all paper notes in India. Unlimited means people have to accept payments in unlimited quantities in notes and these coins.

Non legal tender money is otherwise known as optional money. Bank money in the form of cheques and bills of exchange, promissory notes are examples. People are not bound to accept this money.

1.6 CHARACTERISTICS OF MONEY

The definitions and the classifications of money discussed above help us to identify the following characteristics of money.

1.6.1 COGNIZABILITY

Cognizability means that the common man in the country must be able to recognize money easily and quickly. Towards this purpose currency notes are printed in different sizes, colours and with distinct designs.

1.6.2 UTILITY & VALUE

It must be accepted in general as a medium of exchange and this general acceptability occurs only where the commodity used as money is useful and has value. The value of any commodity depends upon utility and scarcity. Metals are preferred to other forms of money. However value can be attributed to paper also by giving legal protection and creating scarcity.

1.6.3 PORTABILITY

Material used for money should be easily carried with people. Metals like gold and silver can be easily carried in small quantities. Paper Money is the most highly portable.

1.6.4 DIVISIBILITY

The material chosen as money should be capable of being divided. In this division it should not loose its value. Gold and silver have this character. The value of these metals can be determined on the basis of the weight of each piece. In the case of paper it can be divided by converting it into lower value currencies.

1.6.5 INDESTRUCTABILITY

The material must be durable. This is essential if money is to satisfy the needs of exchange and storing. Even the function of deferred payments can easily be carried on only when the material used as money is indestructable. Metals are highly durable. Paper is Perishable but can be easily replaced with little expense.

1.6.6 STABILITY

The material used as money should not be changed frequently. It creates confussion in the minds of the public and leads to non acceptance. The value of the metal used must also be stable. Previous metals are more stable in their value. Paper money can also be made stable, but in times of war its stability is lost.

1.6.7 HOMOGENEITY

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

1.7 COMPONENTS OF MONEY

According to the definitions given earlier in this lesson, the components of money supply are

i. Currency with the public,
ii. Other deposits of the RBI,
iii. Demand deposits of the Banks, which cover the cooperative banks also,
iv. Time deposits of the banks,

v. Savings deposits of the post offices and
vi. time deposits of the post office.

According to the traditional view, the money supply consists of

i. Currency money or legal tender i.e., coins or currency notes.
ii. Bank money - Chequable demand deposits - with commercial banks.

According to the modern view or expanded approach money supply consists of

i. Coins
ii. Currency notes
iii. banks demand deposits
iv. time deposits with banks
v. Financial assets such as deposits with non-banking financial intermediaries like the Unit Trust, post office, savings banks
vi. Bills - Treasury and exchange bills
vii. Bonds and equities

Keeping the liquidity in view the Reserve Bank of India considered the following assets as aggregate money supply.

i. Currency (C)
ii. Demand deposits of Banks (DD)
iii. Other deposits of the RBI (OD)
iv. Post office saving deposit
v. Time deposits of banks and
vi. Time deposits of Post offices

In recent years the RBI has adopted four measures of money stock on a descending order of the liquidity criteria.

i. M_1
ii. M_2
iii. M_3 &
iv. M_4

M_1 = (a) Currency notes and coins with the public (Cash on hand of all banks is excluded)

(b) Demand deposits with all commercial banks and cooperative banks (Inter bank deposits are excluded)

(c) Other deposits held with the RBI (Balance in account No. 1 of the IMF the RBI employees person Provident Fund and guarantee funds and adhoc liability items are excluded).

This is equal to the traditional view of money supply with the public.

M_2 = (a) M_1

(b) Savings deposits with P.O. Savings Banks

M_3 = (a) M_1

(b) Time deposits of all commercial and cooperative banks (Inter bank time deposits are excluded).

M_4 = (a) M_3

(b) Trial deposits with the P.O. Savings Organisation (NSCS are excluded).

From the point of view of monetary management M_1 signifies a flow, where as M_3 refers to stock.

The following table gives an idea of money supply in India at different points of time.

Table - 1 : **Money Stock in India** (Rs. in Crores)

Year	M_1	M_2	M_3	M_4
1970-71	7,321	8,311	10,958	12,142
1978-79	21,858	23,634	39,867	44,555
1981-82	24,896	27,237	62,551	69,961

RBI Bulletins

The money and banking statistics gives some detailed components of money.

Table - 2 : **Components of Money Supply** (Rs. in Crores)

	Dec' 88	Dec' 89
Currency with the public	35,417	43,492
Demand deposit with banks	30,048	32,981
Time deposit with banks	1,24,244	1,41,120
Other deposits with RBI	418	566
M_3		
Net bank credit to Government	96,800	1,13,693
Net bank credit to commercial sector	1,22,345	1,40,207
Foreign exchange assets	4,536	3,789

Source : Hindu publication, March 15, 1990.

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Check Your Memory :

i) Which of the following is an essential characteristic of barter economy
   a) goods exchanged against goods
   b) simple and smooth system
   c) lack of civilization
   d) inconvenience

ii) Invention of money is the outcome of
   a) Peoples reasoning power
   b) the banking system
   c) difficulties of barter
   d) none of the above

iii) Value of a commodity expressed in terms of _____ is price

iv) Money is _____

v) Match the following :

A	B
1. Standard Money	1. Paper Money
2. Token Money	2. Inferior metals
3. Representative Money	3. Treasury bills and bonds
4. Near Money	4. Full bodies money

1.8 MODEL EXAMINATION QUESTIONS

A) Answer the following questions in 30 lines each.

i) What do you mean by Barter? Explain the inconveniences of Barter?

ii) Define money. What are its characteristics?

B) Answer the following question in about 15 lines each.

1) What are the components of money?

2) Explain the need for exchange.

3) Answer the following concepts.
   a) High powered money
   b) M_4

UNIT-2 : FUNCTIONS AND IMPORTANCE OF MONEY

Contents

2.0 AIMS AND OBJECTIVES

The purpose of this unit is to explain the functions of money and importance and role of money in different economic systems.

After reading the unit, you will be able to

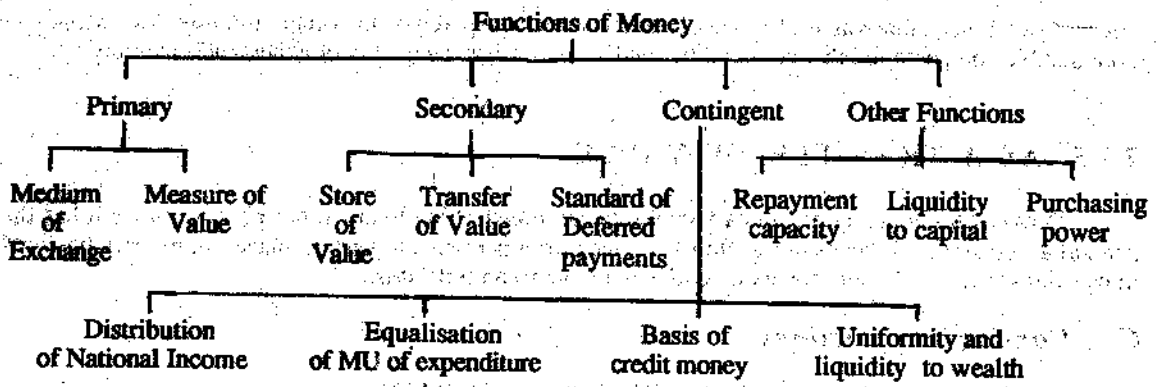
* describe the functions of money,
* analyse the classicals & modern views on money,
* depict the circular flow of income, and
* explain the role of money in different economic systems.

2.1 INTRODUCTION

The meaning of money, classification of money, characteristics of money components of money are studied in unit one. It is clear that Money is defined in terms of its functions and its nature. Therefore, from the meaning of money the main functions can be derived. In addition to that, secondary, contingent and other functions are also given in this lesson.

2.2 FUNCTIONS OF MONEY

The following chart gives a clear idea of the functions at a glance.



Let us discuss them in detail

A. Primary Functions

2.2.1 MEDIUM OF EXCHANGE

Exchange refers to sale of goods and services for money and money thus received is again spent on goods and services required by that seller. In such a way money is used for sale and purchase of goods and services. The value of any commodity expressed in terms of money is price. Price is paid in terms of money. In this way all exchanges take place in terms of money. It is on this account that money is referred to as medium of exchange. By serving as a medium of exchange money removes the need for double coincidence of wants and other inconveniences of barter. Further it facilitated trade. Its uniformity facilitates acceptability as a means of payment and general acceptability - generates public confidence. Its durability confers on money its role of purchasing power in money, its portability is desired for the convenience of making transaction and its divisibility facilitates the smooth operation of small and big transactions.

2.2.2 MEASURE OF VALUE

Money is the common denominator which determines the rate of exchange between goods and services which are priced in terms of money. There can be no pricing process without a measure of value. Since all values are expressed in terms of money, it is easy to determine the rate of exchange between various types of goods and services in the community and it is possible to compare the relative values. Money as a means of value also facilitates accounting and provides basis for calculation of profit and loss and costing.

B. Secondary Functions

2.2.3 STORE OF VALUE

Generally there may be a time gap between the receipt of the income i.e., weekly, monthly or yearly. Therefore, the income received today is to be used for daily necessaries till the next receipt of income. It means that income is to be stored in the form of money to fulfil daily objections. Money acts as a bridge from the present to the future i.e., an efficient store of value. It is a convenient means of keeping any income which is surplus to immediate spending needs and it can be exchanged for the required goods and services at any time in the future. This function can be secured by any valuable asset. One can store value for the future by holding short term promissory notes, bonds, mortgage, prefered stocks household furniture, houses, land or any other kind of valuable goods. The above forms of assets yield some regular income to the owner in the form of indirect profits or rent.

2.2.4 STANDARD OF DEFERRED PAYMENTS

In day to day life some individuals depend upon credit. When the present income is not sufficient to meet the needs one has to borrow from the other or any financial agency on the condition of repayment after some time. This is known as deferred payment or postponed payment. All debts are taken in money. This facilitated the modern business transactions on large scale. Money is a suitable standard of

deferred payments, suite value of money is stable when compared to the other commodities. Money is more durable compared to other commodities and as money has the quality of general acceptability.

2.2.5 AS A TRANSFER OF VALUE

Person who holds money in cash or assets can transfer that to any other person. Since it has the general acceptability, it keeps in transferring values from person and place to place. In modern business transactions transfer of value is very essential and money can fulfil this.

C. Contingent functions

2.2.6 DISTRIBUTION OF NATIONAL INCOME

The market value of goods and services produced in a year in a country is national income. It is distributed to the factors of production in the form of rent wages interest and profit. i.e., .the price of each commodity consist of the above four remunerations to the factors. Money is a medium of exchange facilitated the division of value of a commodity into parts. Thus it caused economic progress also.

2.2.7 EQUALISING MARGINAL UTILITIES OF EXPENDITURE

A rational consumer tries to maximise his satisfaction with his limited income by optimum distribution of his income on unlimited wants. In this process he compares the marginal utility obtained from goods and services to the respective prices. As long as the marginal utility is greater than the prices, he goes on purchasing it till it becomes equal to price. This is well explained by the principle of equi-marginal utility. This comparison of utility with price becomes possible only when money is used as a medium of exchange it is not possible with any other commodity.

2.2.8 BASIS OF CREDIT MONEY

The people who save money i.e., present income - present consumption, deposits it in banks. The commercial banks on the basis of these deposits create credit. This credit money is like blood stream in the business field. If money is not there, the business transactions would not have been possible.

2.2.9 UNIFORMITY AND LIQUIDITY TO WEALTH

Liquidity means keeping cash on hand. Only when wealth is kept in the form of money it has ready convertiblity. It it is kept in any other form it takes time to convert into cash at times of emergency. Then it imparts uniformity and liquidity to different forms of wealth.

D. Other Functions

2.2.10 REPAYMENT CAPACITY

In order to maintain the repayment capacity every firm has to keep some amount of liquid money in its asset. So it safeguards its repayment capacity.

2.2.11 LIQUID TO CAPITAL

Money is the basis for capital formation. Capital means a part of the wealth which is used for further production of wealth. It is essential to keep capital in a liquid form for a variety of motives.

2.2.12 PURCHASING POWER

Money as a medium of exchange is purchase power. Purchasing power stored in terms of money can be put to any use. Money income remaining same, purchasing power varies with changes in prices of goods and services.

A comprehensive idea of various functions of money is given. All the above functions are inter-related.

2.3 IMPORTANCE OF MONEY

There are divergent views between classicals and modern economists about the role and importance of Money.

2.3.1 CLASSICAL VIEW

For classicals money was useful only as a technical device which over come the difficulties of barter in effecting exchanges. It has little effect on the operation of an economy. Money is the veil behind which the action of real forces is concealed. Behind the veil the says law operates i.e., supply creates its own demanded - when a producer produces a commodity he creates a demand for other commodities which he would purchase with his own commodity. Money is used only to express prices of goods in the market i.e., exchange ratio between real goods and services in absolute terms - but it will not effect the economic activity in any way. It is a passive factor. Even if there were some monetary disorders it was an exception and in the long run the supply of money ought to adjust to the demanded for money. Classical view thus pertains to long run whereas the modern economist after keyness concerned with short run.

2.3.2 MODERN VIEW

In the short period money is powerful and it promotes or hinder the economic activity. It has power to regulate the general economic activity contribute to wealth and welfare and accomplish general socio-economic reforms. An increase in money supply may lead to greater employment. If the increase is greater than the real output prices increase and this change alter the distribution of income in the society. The followers of keyness also advocate that it can be kept as liquid as set i.e., hoarding. Hoarding and dishoarding have serious implications resulting in economic fluctuations. Thus it is not a passive factor and not a simple technical device. According to Chandler "Money is sterile in that by itself it can produce nothing useful, but it has a very high indirect productivity owning to its ability to facilitate exchange and specialisation.

A brief idea of importance of money is given in the introductory unit. The functions of money in this unit further made it clear that money is the beginning and the end of all the economic activity. Thus money occupies a central position in the modern economy. It helps the consumer to equalise marginal utilities from diverse commodities. It facilitates specialisation and introduction of division of labour in the production process - thus gives scope to Producer to minimise cost of production and maximise profits. It is the medium of exchange which results in expansion of trade not only eternally and internationally. It is the unit of accounting and budgeting and as such the distribution of income among the factors become easy. In a welfare state, government is also very much involved in the economic process. All this is explained in the circular flow of income.

The operation of the circular flow depends upon the economic system which a country adopts. There are three types of economic system - capitalist, socialist and mixed. It is relevant here to discuss the importance of money in these system.

2.3.3 CIRCULAR FLOW OF INCOME

The influence of money on the economy is well explained by the circular flow of income.

The above flow clearly explain the importance of money. The Households with an objective of satisfying their wants gets into economic activity in the form of factor services i.e., as owner of raw material, as capitalists as entrepreneurs and as workers. The remunerations they get for the factor contribution are rent, interest, profit and wages respectively. Thus in the first stage money flows from firms to households. In the second stage the households spend their income on goods and services to satisfy their wants - thus it flows into goods market. Out of this income by firms some money is spent on goods and services by the owners of firms to satisfy their wants and some money is saved and reinvested on factor services. The goods market and factor market are the two main channels through which the money flows :

CIRCULAR FLOW CHART

If the government sector is taken into consideration the channels of flow widens. Government as a producer purchases factor services and make payments to the public, as a consumer purchases goods & services for improving the standard of living of the people. Its activities are better known by the annual budget. It is the field of public finance. It consists of revenue and expenditure of the government. The sources of revenue are taxes, fees, fines and borrowings. In these forms the money flows into the treasury from the public. In the case of public sector units in the form of prices of goods also money flows to government. The revenue thus received. Government spends under different heads of public utility services like schools, hospitals, providing justice and maintenance of law and order. In addition to this, it pays interest, wages, and rent also. In this way the importance of money can be understood by the flow of money between government, household and firms sectors. The savings in the Household sector also flow to firms in the form of bank deposits and credit creation by the banks.

2.4 ROLE OF MONEY IN A CAPITALIST ECONOMY

The features of capitalist economy are Right to property, law of inheritance and free play of market forces. Therefore, any activity is taken up with profit motive. The price mechanism or the market mechanism guides production. The market mechanism means, that price of any commodity or service is determined by interaction between demand for and supplyof goods or services. Price determines what goods are to be produced and to what extent. There is no government interference in the fields of production, exchange and distribution. Price mechanism constitutes, use of money as the value of any commodity expressed in terms of money is price.

The producer tries to maximise his profits and therefore is guided by prices of goods in the market. The commodities which have high prices are generally produced as high price reflects shortage of supply when compared to demand. The production pattern thus selected, direct the use of natural resources and human resources - Therefore, money is the determining force.

The consumer's freedom gives scope for selection of goods for consumption. With a view to maximise his satisfaction the consumers compares the marginal utility of goods with respective prices. Thus money is the instrument by which the consumer tries to maximise his satisfaction.

The price mechanism determines the distribution of national income among the factors of production as the price of a commodity consists of raw material cost, capital cost and labour cost. The remaining part is appropriated as profit.

The price mechanism again helps the individual to arrive at correct decisions regarding savings and spending in the form of interest rate. Interest is the price of capital. It regulates investment and it establishes an interrelation - ship among the various types of markets in a capitalist economy. Therefore, money is so vital for the functioning of capitalist economy.

2.5 ROLE OF MONEY IN A SOCIALIST ECONOMY

The socialist economy is a controlled economy. State regulates every economic activity i.e., production and distribution through planning authority. Karl Marx opposed the use of money since it is responsible for the exploitation of labour by the capitalists. But in practice it was realised that without money economy could not function. In Soviet Russia the planning is an essential process and in that process economic calculations are essential - these calculations are possible only when the money is used as unit. The Supreme Economic Council in the Soviet Union prepares two types of plans - physical plans and financial plans. The physical plans are prepared in terms of physical resource while financial plans are prepared, in terms of monetary resources. Salaries and wages are paid in money and they can spend within the limitation stipulated by the government. In the socialists economy also optimum utilisation of scarce resources is inevitable and money helps in this connection. As money is the basis of economic calculations - its use is inevitable but it is not the master as in the case of capitalist economy but only a servant. It is the planning body that determines allocation of resources and the pattern of production. Therefore money occupies only a secondary place.

2.6 ROLE OF MONEY IN A MIXED ECONOMY

The Mixed economy is evolved to get out of the evils of capitalist and socialist economics and utilise the advantages of both the systems. In an uncontrolled capitalist economy - the profit motive production pattern results in concentration of wealth and ignoring the needs of the common man. On the other hand controlled and centralised socialist economy suffer with inefficiency and result in wastage of real and financial resources. In the mixed economy private sector and public sectors participate in production. The public sector is expected to control the essential channels of production and distribution. It is expected to work for a set of objectives i.e., providing public utility services, reducing inequalities in income distribution, reducing regional disparities and gradual increase in the standard of living of the common man. The private sector function on market mechanism but its actions are regulated by the government through its monetary policy, fiscal policy and industrial policy. The monetary policy, given such an importance indicates the role of money. The best example of mixed economy is India. In India establishment of socialistic pattern of society through democratic socialism is the objective. The process of five year plans is the main instrument. Investment is the main variable to achieve economic development. Investment is influenced by the rate of interest. Rate of interest is part of monetary policy. Economic fluctuations occur due to changes in money supply. Economy can be lifted up from the depression by increasing the supply of money and adopting cheap money policy. The inflation can be controlled by adopting controls and increasing the rate of interest.

2.7 SUMMING UP

Regarding the importance of money the classical considered it as neutral between ends. It is only a technical device but for the modern economists it is blood stream of the economy. Its importances varies from capitalist economy to socialist economy and from it to mixed economy. It has much importance in capitalist and mixed economics than in socialist economy. It s functions are varied managing from Primary functions of using as a medium of exchange to a miscellaneous functions of using it as liquidity to capital. When such is the importance of money, it is necessary to measure the changes in value of Money.

Dr. M.S.S. Somayajulu

Check Your Progress :

i) Market mechanism constitutes :
   a) change in supply
   b) change in demand
   c) use of money
   d) none of the above

ii) The Primary functions of money is
   a) Transfer of value
   b) distribution of national income
   c) liquidity to capital
   d) Medium of exchange.

iii) The circular flow of money is between _____ and _____

iv) Measure of value is _____ functions of Money.

v) Match the following :

a)	Store value	a)	Primary functions
b)	Basis for credit Money	b)	Secondary functions
c)	Repayments capacity	c)	Contingent functions
d)	Medium of exchange	d)	Other functions

2.8 MODEL EXAMINATION QUESTIONS

I. Write your answers in 30 lines each.

1. Explain the importance of money in every day economic life
2. What are the various functions of money?
3. Explain the role of money in capitalist & socialist economies.

II. Write your answers in 15 lines each.

1. Explain circular flow of money.
2. Analyse importance of money in mixed economy.

UNIT-3 : VALUE OF MONEY - MEASUREMENT AND INDEX NUMBERS

Contents

3.0 AIMS AND OBJECTIVES

The purpose of this unit is to explain the concepts and determinants of value of money and the construction of index numbers.

After reading the unit, you will be able to,

* Explain the meaning and determinants of value of money,
* analyse the concepts and aspects of index numbers, and
* critically examine the construction of price index.

3.1 INTRODUCTION

In daily life of a man exchange process occupies an important place. Except in a primitive society, exchange takes place with the means of money, i.e., goods and services are exchanged for money and with that money again goods and services are purchased. The value of goods and services expressed in terms of money is known as price. In a capitalist economy market mechanism directs the production. Market mechanism is nothing but price changes due to changes in the supply of and demand for goods. Price changes influence every aspect of the working of an economy and therefore, it is but natural that the study of meaning and determination of value of money is of much relevance in Monetary economics.

3.2 CONCEPT OF VALUE OF MONEY

As in the case of goods, the value of money can also be discussed in terms of "value-in-use" and 'Value-in-exchange'. Value-in-use refers to the utility aspect whereas the value in exchange refers to the scarcity aspect.

3.2.1 VALUE-IN-USE

In the case of full bodied money the value of money would be equal to the value of the material of which money consists. This reasoning can be extended to cover even that type of paper currency which is convertible into bullion at pre-determined rates. For example, in the case of gold coins standard or gold bullion standard, the use value of a standard monetary unit would be the use value of the quantity of gold into which it can be converted. In this sense the use of money depend upon the uses to which it can be put as also on its other qualities in terms of durability and so on. The use of money even when it has no intrinsic value, depends on ability to act as store of value and be of convenience to the economic units in implementing their economic decisions.

3.2.2 VALUE-IN-EXCHANGE

The second aspect of value of money is "Value-in-exchange". It is, in a sense, the reciprocal of the prices of goods and services. The value of money measures the amount of goods and services which it can buy. Obviously the purchasing power of money depends upon the level of prices of the goods and services to be purchased. Thus the lower the price level, the greater would be the purchasing power of money and the higher the level of prices the lower would be the purchasing power. Thus the purchasing power or the value of money inversely is related with the price level. To express symbolically.

$$V_m = \frac{1}{P}$$

Where, V_m stands for the value of money and P stands for the price level.

3.3 DETERMINANTS OF MONEY VALUE

According to Crowther, the phrase "Value of money without qualification does not make any sense because there are innumerable values of money depending on the uses to which money is put to. To overcome this difficulty and to give preciseness to the concept of the value of money he suggests three standards :

i) Whole sale value of money
ii) Retail value of money or the consumption standard
iii) labour value of money

3.3.1 WHOLE SALE VALUE OF MONEY

According to this the value of money is expressed in terms of all those goods that are transacted in whole sale markets. This is measured through the wholesale price index.

3.3.2 RETAIL VALUE OF MONEY OR THE CONSUMPTION STANDARD

According to the consumption standard, the value of money is expressed in terms of the prices of consumption goods an services which are ordinarily bought by an average family for the purpose of consumption. As these transactions take place in detail market this is also known as retail value of money.

The problems in measuring the value of money in retail terms are that, firstly what goods are to be considered as consumption patterns differ from family to family. Secondly, in retail market different prices are charged for the same goods and services.

3.3.3 THE LABOUR VALUE OF MONEY

In this process the rate of wage payable to worker for a day's work is taken into account and the value of money is measured. Here also the problem is that the labour is not homogeneous and that the labourers differ in skills, efficiently and regularity of work.

The above three standards help us only to measure the value of money arbitrarily. However the absolute value of money cannot be worked out as it involves comparison of the values of all commodities in the economy that are exchanged against money. It becomes impracticable owing to the great variety and complexity of modern business transactions. Further the absolute value of money is not of much importance to any body. It is important only in relative sense i.e., for comparing its value at one time with its value at another. This will give an idea of changes in value of money over a period of time and this is necessary if the minimum standards of life are to be provided to the workers. If the uniform standard of living is to be maintained the real incomes of the people are to be kept constant, if not to be increased. The real income can be kept constant only when the fall in value of money is to be compensated by increase in money incomes. The changes in value of money or the changes in general price level can be know by statistical device i.e., index number.

3.4 CONCEPT OF INDEX NUMBERS

The tool of index number provide us a good deal of practical guidance. It reveals the relative movements of different variables in the economy. Index numbers may be defined as a series of figures by which changes in the size of economic phenomenon are measured from time to time. There may be production, import and export index numbers like index numbers. But the relevant one for us is price index number. Price index numbers are constructed to measure the behaviour of various kinds of price averages. The most commonly used indices. are :

i) the general level of prices of all goods, services & securities sold for money
ii) Retail prices of consumer goods
iii) Wholesale prices
iv) the cost of living

3.4.1 THE PRICE INDEX

The price index number help us to measure the changes in value of money over a period of time. Generally the change in prices of goods and services is not uniform. If the prices of some goods and services are falling, those of others may be rising. The proportions of these changes also are not same. The prices of some goods may not change, the prices of some goods may rise while the prices of some others goods may fall.

A price index would measure the average changes in prices of a group of goods and services. It is often expressed as a percentage showing the average level of prices in one period compared with the average prices in another period.

3.5 ASPECTS IN THE CONSTRUCTION OF INDEX NUMBERS.

The construction of index number is based on the following aspects.

1. Purpose
2. Selection of commodities
3. Source of data
4. Base priced.
5. Averaging
6. Weightage
7. Formula

3.5.1 PURPOSE

According to Heberler, the price level cannot be independent of the purpose in mind and for each purpose a separate index number is to be constructed. Among the many types of indices, the more important are (a) the retail price index (b) the wholesale price index and (c) the general price index. If the

purpose of index number is to know the changes in real and money incomes of workers, the retail price index is to be constructed. If the purpose is to study the changes in money for a businessman, the wholesale price index is to be constructed. Government and research institutes compile a special type of index number for the purpose in hand. Based on the purpose the data is collected and compiled.

Thus the purpose for which the index number is to be constructed is to be clear at the first stage.

3.5.2 SELECTION OF COMMODITIES

Selection of number and kinds of items to be included in the price index is an important part. The choice of goods will depend upon the purpose of the index. the number of items should not be too small and too large. It is essential that the items chosen should be the most representative ones.. For example, if the price index is to be worked out for the workers, food items, cloth, kerosene, fuel are to be taken into account. In food and cloth also the particular types that are generally used by workers are to be considered but not luxury items. Similarly the charges in air fare, prices of refrigerators are not relevant.

3.5.3 SOURCE OF DATA

When once the purpose and the goods are decided, the next stage consists of collection of data. The data necessary for the construction of the index number should be accurate, comparable, representative and adequate. The information should be for the same types of goods and services for different periods. The problem in collection of data arise particularly in the case of goods distributed in public distribution system, in the case of goods for which govt. adopts dual price system and so on. Generally market quotations are often obtained in the form of bid and asked price form journals, newspapers as the source of data influences the importance of index number very much.

3.5.4 SELECTION OF BASE YEAR

The base year may be defined as that year, the average price level of which is to be compared with the average price level of other years. The year should be normal. The years in which there are natural calamities like floods, drought, should not be considered. Similarly the years of war should not be considered. The price during the base year should be more or less stable. In this connection also either the period of depression or the period of boom may not be taken. Further period should not be either very recent or remote.

3.5.5 AVERAGING

Since index numbers are averages, the problem is to select an approximate average. The two important averages are the arithmetic mean and Geometric mean. The arithmetic means is the simpler. The geometric mean is more accurate. However, the average prices should be reduced to price relatives (percentages) either on the basis of the fixed based method or the chain base method. The choice between these depends upon the nature of data and other factors. Suppose the base year in 1939 and all prices in that year have been collected. We want to calculate an index number for 1970. We make, therefore, a second list of prices in 1970 of the same commodities. With a view to have them in the same from we express them as percentage of the 1939 prices putting the prices in 1929 and 100. For example if the price of sugar is Rs... 50/- quintal in 1939 and if it rises to 150 p. q sugar in 1970 will be expressed as 300. Thus we must work the average of all the 2970 price prices and that will give us the index number for 1070.

3.5.6 WEIGHTAGE

In the simple index number the items included in the list are of equal importance. It serves no purpose since the goods differ in their importance. For example food is more important than cloth. Food or clothing are more important that shelter i.e., house. Therefore, to construct an accurate index number, it is essential to give separate weight, to each item depending upon its importance. When rice is given weight 3, the cloth may be given 2, the house may be given 1. Indices where weights are attached to each items according to its importance are known as weighted numbers. the weights are determined with reference to the relative amounts of income spent on commodities by consumers. Weights may be given in terms of value or quantity.

3.5.7 FORMULA

A number of formulas have been devised to construct an index number. But the selection of an appropriate formula depends upon the availability of data and the purpose. No single formula may be used for all types of index numbers.

3.6 CONSTRUCTION OF PRICE INDEX

3.6.1 SIMPLE PRICE INDEX

In the beginning it is better to work out a simple price index - then from it weighted price index can be constructed. To construct the simple price index, compute the price relatives and average them. Add the relatives and divide them by the number of items.

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

$$\text{or} = \frac{P_1}{P_2} \times 100$$

In the following table the commodities selected are rice, wheat, cloth, sugar and fuel col. 1 in the table. The base year is 1970. The prices in the base year are shown in col.2 (P_0). For comparison the year selected is 1980. Prices in 1980 are given in col.4. (P_1). The price relatives are shown in col.5.

$$\left(\frac{P_0}{P_1} \times 100\right)$$

Table

	Commodiues		Price in 1970 (P_0)	Index No. in the base year	Price in 1980 (P_1)	Price Relatives $\frac{P_0}{P_1} \times 100$
	(1)		(2)	(3)	(4)	(5)
1.	Rice	Per Kg.	3	100	5	$\frac{3}{5} \times 100 = 60$
2.	Wheat	Per Kg.	2	100	4	$\frac{2}{34} \times 100 = 50$
3.	Cloth	Per Meter	12	100	8	$\frac{12}{18} \times 100 = 80$
4.	Sugar	Per Kg.	4	100	8	$\frac{4}{8} \times 100 = 50$
5.	Fuel	Per quintal	200	100	450	$\frac{200}{500} \times 100 = 40$
					E.I. =	280

Index number of current year = $\frac{\Sigma I}{N}$

where Σ (sign) denotes the sum of

I stands for the price relatives

N stands for the number of items

Thus Index no. of 1980 = $\frac{280}{65}$ = 56

LIST OF LIVING SIMPLE INDEX NO FOR COMPUTATION OF INDEX NUMBERS

	Commodity		Price in 1970 (Base year) (P_0)	Price in 1980 (current year) (P_1)	Price Relative $\frac{P_0}{P_1} \times 100$
1.	Rice	Per Kg.	4	6	$\frac{6}{4} \times 100 = 150$
2.	Wheat	per Kg.	2	4	$\frac{4}{2} \times 100 = 200$
3.	Cloth	per meter	20	35	$\frac{35}{20} \times 100 = 175$
4.	Sugar	per Kg.	5	8	$\frac{8}{5} \times 100 = 160$
5.	Fuel	per quintal	70	140	$\frac{140}{70} \times 100 = 200$
					El 885

Index no. of the current year = $\frac{885}{5}$ = 177

The proceeding table shows that 1970 is the base period and 1980 is the year which the price index has been constructed on the basis of price relatives. The Index of wholesale prices in 1980 comes to 177. This means that the price level rise by 77 percent in 1980 over 1970.

3.6.2 WEIGHTED PRICE INDEX

Taking the above example, weighted price index can also be worked out. As already pointed out weightage is assigned to each one. Rice 5, wheat 4, cloth 2, sugar 1, fuel 3. The following table given the weighted price index.

Commodity	Weighted (W)	Price in 1970 (Rs.)	Price in 1980 (Rs.)	Price Relatives (R)	W x R
1. Rice	5	4	6	150	750
2. Wheat	4	2	4	200	800
3. Cloth	2	20	35	175	350
4. Fuel	3	70	140	200	600
5. Sugar	1	5	8	160	160
	E 15				EWR = 2660

Using arithmetic mean, the weighted price index in 1980 = $\frac{EWR}{E} = \frac{2660}{15} = 177.3$

In the above example the weighted price index shows an increase of 77.3% in the price level in 1980 over 1970.

3.7 DIFFICULTIES IN THE CONSTRUCTION

There are certain difficulties in constructing the Index numbers. They are both of conceptual and practical.

3.7.1 CONCEPTUAL DIFFICULTIES

1. The index numbers are intended to measure the value of money. The concept, value of money, itself is vague. It is simply defined as reciprocal of general price level. But the concept of general price level is not scientific. This is because the general price level must include all items. As it is not possible to include all items, it cannot be called as general price level. To avoid this problem sectional price levels are considered to work out the price index but they reflect different changes in the value of money.

2. With price indices the value of money cannot be measured accurately since the price of certain commodities may fall while of other commodities may rise. Prices of some commodities may remain constant. Therefore a rise or fall in general price level does not reflect the above variations.

3. Generally changes in value of money are worked out with wholesale prices. But the wholesale prices have no relevance to the common man. His living standards are influenced by retail prices and the retail prices vary between places at that particular point of time.

3.7.2 PRACTICAL DIFFICULTIES

1. It is difficult to select the base year. The difficulty is that no year is fully normal. Certain abnormal things do happen in every year. Further the base year charges from time to time.

2. The second difficulty is selection of representative commodities. Consumption patterns of different categories of people or even different people in the same category varies. The quality of the commodities may change in the year of inquiry from what it was in the base year. Under these circumstance it becomes meaningless to include old quality commodities in the price index number. Hence there is considerable difficulty in the choice of representative goods.

3. There are difficulties in getting the statistical information, since there may not be any records. This is a great problem in developing economics.

4. The determination of weights also is a problem as there are no hard and fast rules for assigning weights.

5. The use of different averages yields different results from the same statistical data. There are several kinds of averages such as arithmetic average, geometrical average mean, medium, mode etc. which method is to be employed is the problem.

Inspite of the above problems there are some advantages of index numbers. They are now widely used to assess the cost of living, index, to analyse markets for goods and services, to measure changes in Industrial production to evaluate internal and external trade and to formulate economic policies.

The cost of living is an important tool. It helps to calculate the change in real incomes, it helps to strike balance in wage negotiations and it is the basis for increasing money wages.

In consumer price index weights are given and these weightages govern the market for such commodities like food, clothing, fuel and lighting, house rent etc.

It is necessary to know the changes in Industrial production from time to time so that its contribution to National income is known and necessary measures can be taken on that basis.

The foreign trade position of a country can be assessed on the basis of its export and import indices. These indices reveal whether the external trade of the country is increasing or decreasing.

On the basis of above uses the economic policies are formulated from time to time.

3.8 SUMMING UP

The money has no use value but only an exchange value. Inspite of it the changes in value of money effects the whole economy. Therefore it is necessary to know how the value money changes. In this connection the importance of index number is discussed - but the theoretical aspects of change in value of money gives a clear idea of different schools of thought from time to time.

- Dr. M.S.S. Somayajulu

Check Your Progress :

i) The value of money means
   a) it storing value
   b) its purchasing power
   c) its commanding power
   d) its exchange utility

ii) The value of money varies with price level :
   a) in the direct proportion
   b) in the increase proportion
   c) in the same proportion
   d) none of the above

iii) When the wholesale price index increase in a year the _____ value of money _____.

iv) The main difficulty in the measurement of the charges in value of money is _____.

v) Measure the changes in the value of money from the following data.

Year	1975	1976	1977	1978
Wholesale Pice Index	100	90	130	200

3.9 MODEL EXAMINATION QUESTIONS

I. **Answer the following question in 30 lines each.**

1. Explain the concepts of value of money.
   What are the determinants of value of money?
2. What is price index? What are the aspects to be considered in constructing the index numbers?
3. How are the simple and weighted price index constructed?

II. **Answer the following question in 15 lines each.**

1. Explain the following concepts
   (a) Value-in-use (b) Value-in-exchange
2. What is simple price index? How do you construct it?
3. What is weighted price index? Explain the procedure of its construction.
4. List the major difficulties in constructing the index numbers.

UNIT - 4 : THEORIES OF VALUE OF MONEY

Contents

4.0 AIMS AND OBJECTIVES

The purpose of this unit is to explain the different views relating to changes in the value of money.

After reading the unit, you will be able to

* describe the transactions approach of quantity theory of money,
* explain the cash balances approach of quantity theory of money,
* analyse the Keynesian equation of income theory of money, and
* discuss the Milton Friedman's restatement of quantity theory of money.

4.1 INTRODUCTION

In the previous unit the concept of "value of money" is defined and the process of measurement through the statistical tool of index number is also discussed. It is generally accepted that the value of money is just the reciprocal of the general price level, i.e., purchasing power of money over goods and services within a country. The relation between value of money and the price level is an inverse one. The theories of value of money discussed in this unit are a step forward as they explain the cases of changes in the value of money.

4.2 THEORIES OF VALUE OF MONEY

We can broadly classify the quantity theories into (a) transaction approach (b) cash balance approach (c) income approach based on the main functions of money as a medium of exchange and as a store value. In 1956 the traditional quantity theory has been restated. The income theory of the value of money, on the other hand integrates the money changes with levels of output, employment and income.

The first approach of the Quantity Theory of Money (Transaction approach) was propounded by Devanzetti, elaborated by John Loke, David Hume and so on, but was closely associated with the name of Irving Fisher. By his propagation this approach was popular in the U.S.A. as Fisher's Equation.

The second approach of the Quantity Theory of Money QTM (cash balance approach) originated by Petty, Locks Cantallem and Adam Smith was later on developed by Marshall, Pigou, Keynes and

Robertson. The Cambridge economists made this approach popular. The restatement in the U.K. of the QTM was done by the Modern Economist, Milton Fieldman.

The third approach, the income theory has roots with Manddevalli, Thomas Tooke, elaborated by Aftalion, but closely associated with the name of JM Keynes.. Therefore, the quantity theory of Money has :

i)	Transaction approach	-	Fisher's equation
ii)	Cash balance approach	-	Cambridge equation
iii)	Income approach	-	Restatement of Quantity Theory of Money
iv)	Modern approach	-	Restatement of Quantity Theory of Money

4.3 QUANTITY THEORY OF MONEY - TRANSACTION APPROACH - FISHER'S EQUATION

The Quantity Theory of Money derives its name from the fact that it bases the explanation of the determination of the value of money and variation, there on to the quantity of money in relation to the level of economic activity. Even the need for money influences the value of money.

4.3.1 THE THEORY

In the transaction approach the quantity of money is the main determinent of the price level or the value of money. Any change in Quantity of Money produces an exactly proportionate change in the price level. According to Fisher "other things remaining unchanged, as the quantity of money in circulation increases the price level also increases in direct proportion and the value of money decreases and vice verse". If the quantity of money is doubled the price level will also double itself and the value of money will be one half. Fisher explained the inverse relationship between the supply of money and the value of money in the following equation.

$$PT + MV + M'V'$$

In the above equation PT indicates the demand side of money and $MV + M\ V'$ indicates the supply side of money. To know the value of money the general price level is to be known and the general price level can be ascertained by the following equation

$$P_C = \frac{MV + M'V'}{T}$$

Where :

P = Price level, or I/P the value of money,

M = Quantity of legal tender money,

V = the velocity of circulation of money,

M' = the quantity of credit money,

V' = the velocity of credit money,

T = volume of goods and services exchanged for money.

In the beginning only MV have been considered but later on due to the importance of credit money in transaction $M'V'$ also have been taken into account.

Irving Fisher in his book "The purchasing Power of Money" gave the above identity, i.e., the total money value of purchases equals to total money value of sales. In a money economy all exchange transactions involves payments in terms of money (M). The related turnover of money against all goods and services sold or exchanged is described as the velocity or circulation.

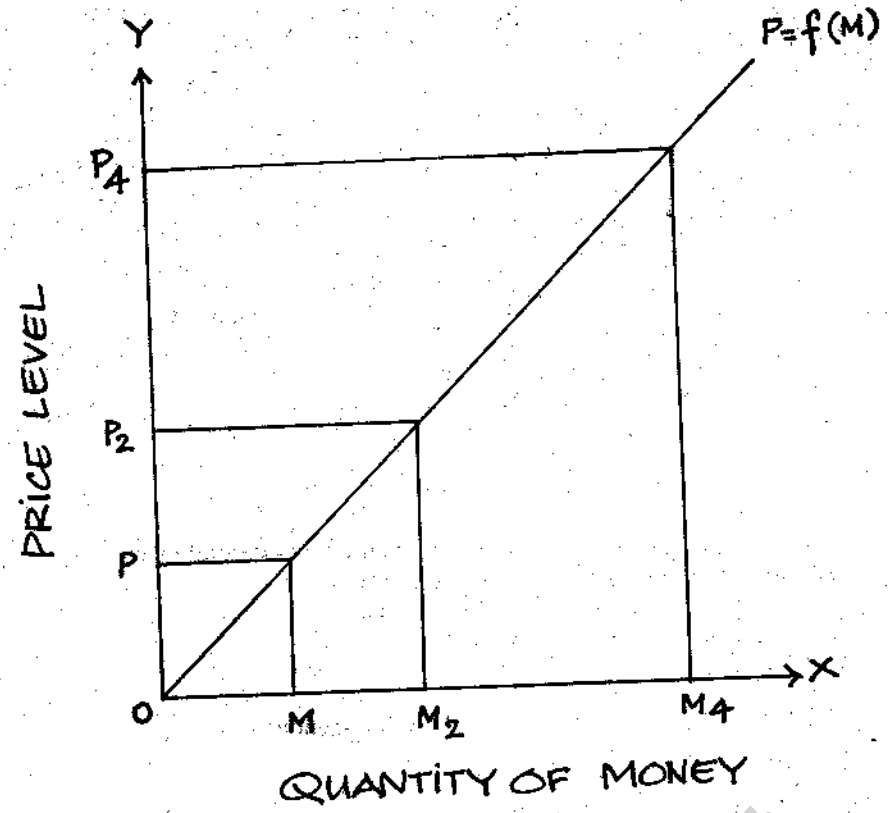


Fig. - 4.1 : Relationship between Money Supply Price Level

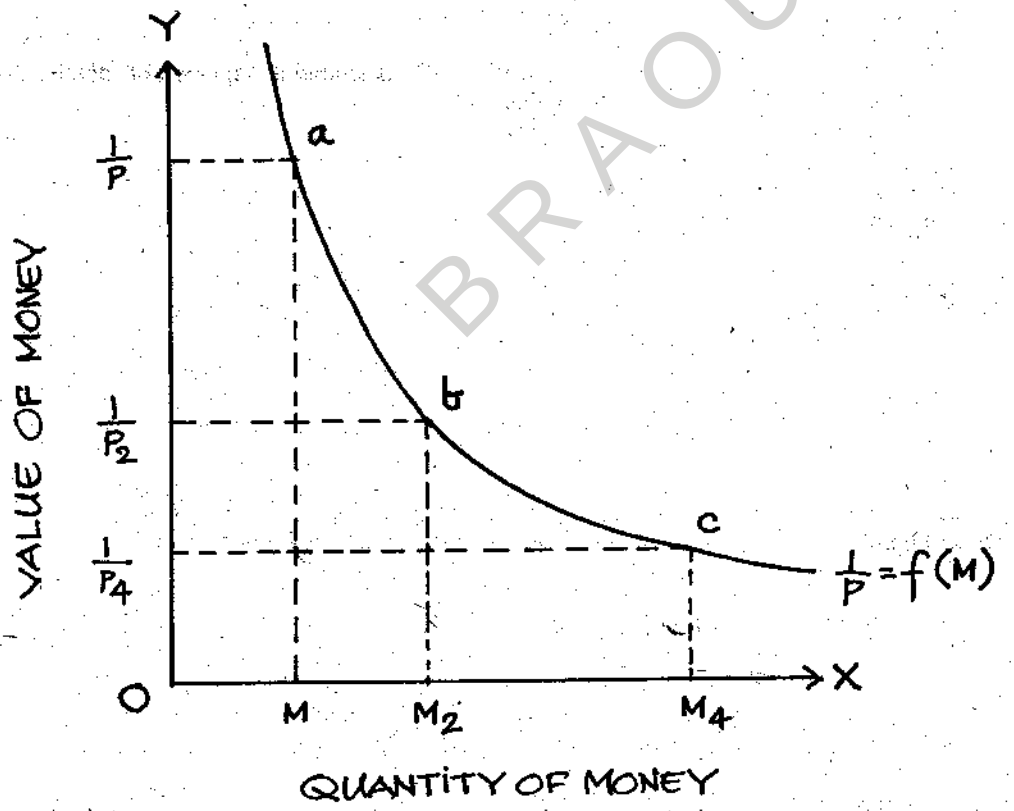


Fig. - 4.2 : Quantity Theory of Money

Fisher points out the price level (P) varies directly the quantity of money (M + M') considered under certain assumptions, i.e., T and V + V' remaining constant. The implication is that if M and M' are double while V V' and T remaining constant, P is also doubled but the value of money (1/P) is reduced to half. The theory can be well understood by the following diagram.

4.3.2 DIAGRAMMATIC EXPLANATION

In a diagram 4.1 the relationship between Money supply and the Price level is shown. The money supply is given on 0-X axis and price level is shown as 0-Y axis. If money supply increase from OM to OM_2 i.e., doubled the price level is also doubled i.e., moves from OP to OP_2 or if M increased to M_4 and price level moves to P_4. Thus P varies exactly in the same proportion as quantity of money. In diagram 4.2 the value of money to which the theory is given is shown. On 0-X axis the quantity of money is shown but on an O-Y axis, the reciprocal of Price level i.e., (1/P) is shown. The slope of the curve indicates the fall in value of money. When money supply is OM the Value of Money is $1/P_4$ i.e., lesser the quantity of money more would be the value of money where quantity of money gradually increases to PM_2 and OM_4 the value of money.

4.3.3 ASSUMPTIONS OF THE THEORY

1. 'P' the price level is a passive factor that is P is influenced by the other factors.
2. The supply of Money is exogenously determined and constant.
   Further the proportion of M' to M also remain constant.
3. Existence of full employment in the economy and therefore
4. T, i.e., volume of goods and services (Transactions) also remain constant and independent of MV and M' V'
5. The demand for money is proportional to the value of transactions,
6. The theory is applicable in the long run.

4.3.4 CRITICISM OF THE THEORY

The implication of the Fisher's Equation is very simple but is subjected to severe criticism.

1. Fisher's equation MV = PT or MV + M'V' = PT is simply an equation of identity that is the quantity of M must always be equal to the volume of transactions. It is a truism but does not explain how the increase in Quantity of Money influences the price level. In fact the Quantity of Money influences the price level through many variables like rate of interest, investment, employment and output and then the price level. when these variables are considered the price level may or may not vary. in the exact proportion to Quantity of Money.

2. 'P' is not passive factor as assured by Fisher. P is influenced by the changes in employment and output, and on the other hand P influences profits, investment and the business activity.

3. The assumption of constancy of V also is not correct. Whenever there is change in M, it immediately effects the velocity. For example in a canteen the demand for coffee is not influenced by the changes in the number of cups. Given the demand for coffee the change in number of cups influences the number of times that a cup is washed and used but not the demand.

4. The assumption of full employment is not relevant in the real situation. There is always tendency towards full employment therefore change in Quantity of Money influences level of employment and output.

5. Given the above possibility T does not remain constant. The volume of transactions i.e., goods and services also change whenever there is change in Quantity of Money.

6. Keynes points out as long as there is unemployment every increase in money supply would lead to an increase in output until the economy reaches full employment.

7. There is technical inconsistency i.e., multiplying two non-comparable factors MV. M refers to money at point of time where as V refers to the velocity of circulation over a period of time.

8. In the Fisher's equation, the human element is missing. Fisher establishes mechanical relationship between Quantity of Money and prices but ignored the habits and customs of the people. The decisions of consumers and producers are influenced by the savings and investments.

9. The quantity theory of money as given by Fisher is one sided since it considered only the supply aspect of Money and its influences on the price level taking the demand for money is given and constant. In fact the demand factors are also important i.e., store value of money is ignored which is an important component to total demand for money.

10. Fisher considered that all transactions take place on cash payment. In real business the credit sales plays an important role. When once it is accepted, demand may take place even without change in quantity of money.

11. Fisher also ignored the government involvement i.e., ignored the role of taxation in Price determination. The price of a commodity is influenced by indirect takes like customs, excise and sale stages in the market.

12. The quality theory of money relates to long run. But according to Keynes in the long run we are all dead. In reality some times violent and far-reaching changes take place in the short run.

Conclusions :

It is evident from the above criticism that the QTM is imaginary, defective and misleading. According to Keynes. it is also incomplete. There is no direct and proportional relationship between the Quantity of Money and the price level and therefore it has little significance for framing policies. However the theory has its value as a simple expository device. The theory is used to achieve stability in price level. the banking operations like Open Market Operations, Bank rate policy and important tools in monetary policy and the basis for these is Quantity Theory of Money.

4.4 QUANTITY THEORY OF MONEY

4.4.1 THE THEORY

The Cambridge Economists extended the general theory of value to money also. According to these economists namely, Marshall, Pigou, Robertson and Keynes, the value of money at any point of time is determined by equilibrium between the demand and supply of money. The supply of money in this approach at a particular moment comprises all the cash and bank deposits subject to withdrawal by cheques. Thus the supply of money is a stock rather than stock and flow. It means the Cambridge Economists ignored the velocity aspect of Money. Changes either in supply or in demand influence the value of Money. The demand for money, in the cash balance approach is different from that of transaction approach. The demand for money in this consists demand from individuals and business firms both for meeting expected and unexpected expenditure. Most of the individuals keep certain definite portion of their income in the form of ready cash. Likewise commercial firms too keep certain cash balances to meet their day to day business requirements. Thus the total demand for money consists of quantity of money which is held by private individuals, commercial firms, and the government to meet their day to day requirements. This constitutes a certain proportion of its annual real national income. This is considered as "store value" function of Money. The store value is otherwise known as liquidity preferences of the people. This liquidity preference is with transaction motive and precautionary motive but not with speculative motive.

Out of the real income, the people prefer to keep certain proportion in the liquid form rather than in the form of other assets. In fact they can buy property, shares of Joint stock companies, can build up stock inventory or he can deposit his funds in the bank. Out of all these forms, ready liquidity rest with cash kept on hand. It takes time to convert into cash if it is kept in other forms of assets.

According to Cambridge economists, the higher the liquidity preference of the people, the greater the demand for money and vice versa. The liquidity thus exerts its influences on the demand for money. Given the supply of money, the value of money varies directly and the price level inversely with the demand for money. An increase in the level for money means smaller for money. An increase in the level for money means smaller demand for goods and services because the people can have larger cash

balances only by cutting down their expenditure on goods sources services. Consequently the price level will fall but the value of money will rise. Converse will be the case with fall in demand for money. This relationship is well given by the economists in different equations as shown below.

4.4.2 THE EQUATIONS

1. Marshall equation
   (i) $M = KY$
   (ii) $P = \frac{KY}{M}$

2. Pigou Equation
   (i) $P = \frac{KR}{M}$
   (ii) $P = \frac{KR}{M} (C + h (1-c))$

3. Robertson Equation
   $P = \frac{M}{KT}$

4. Keynes Equation
   (i) $n = pk$
   (ii) $p = \frac{n}{k}$
   (iii) $p = \frac{n}{k + rk'}$

4.4.3 EXPLANATION

1. According to Marshall 'K' has more important influence on P than M. 'K' is the fractfon of their total money income (Y) which people desire to hold in money in the form of ready purchasing power, M is the total quantity of money. Y is the money income and P is the price level. It means the quantity of money (M) remains same if K increase (cash balance) the expenditure on goods and service decrease, prices decrease, value of Money increase even if the money supply (M) is constant. Thus K plays an important role in determining the value of money.

2. pigou expanded the scope of K in his equation. According to him K the nroportion of income kept on hand, is further divided into two parts - the first part is held in the form o_ legal tender and the second part is kept in the banks as deposits to be withdrawn whenever required. Therefore, the legal tender kept on hand and a part of the cash withdrawn from the bank deposits at any point of time influence the price level and value of money. In his equation R is the total resource, K is the proportion of these resources which the community keep in the form of titles and P is the price per unit of these titles in terms of wheat, C is the proportion of his titles to legal tender which the representative men choose to keep in actual legal tender, h denotes the proportion of actual legal tender that bankers keep against the bank balance held by their customers (1-c) is the remaining part of in the form of bank balance P is not the price level but the value or purchasing power of money. The following numerical example gives a clear idea of the Pigou's equation.

Pigou's version can be illustrated with the help of a numerical example. In his equation K, C and H is less than one for example 1/10th, 1/4 and 8% respectively.

R is 10,000 tons of wheat
M is equal to Rs.. 10 lakhs

Then $P = \frac{\frac{1}{10} \times 10.000}{10.00.000}$ tonnes = Kg.. of what = 1 Re.

When extended for m is considered, against each rupee of money balances the public and banks held 1/4th $\frac{8}{100}\left[1-\frac{1}{4}\right]=\frac{31}{100}$ rupee or 31 paise so that against a total of Rs.. 10,00,000 of money balance, the actual legal tender =

$10,00,000 \times \frac{31}{100} = 3,10,000$. This is the value of M.

$$P = \frac{\frac{1}{10} \times 10.000}{3.10.000} \quad \frac{1}{4}+\frac{8}{100}\left(1-\frac{1}{4}\right) \text{ tonnes}$$

$$= \frac{1}{310} \times \frac{31}{100} \times 1000 \text{ kg.} = 1 \text{ Kg.. as before}$$

3. In Keynes equation assuming K, K' and 'r' to remain constant, the conclusion is that 'n' and 'p' rise and fall together. The proportion between 'k' and K' depends on the banking arrangements of the public white their absolute value would depend upon the hearts of the people. The value of 'r' would depend upon the reserve practices of Banking system. As long as these values remain constant a direct relation between the quantity of money (n) and the price level (p) holds. In the long run k, K' and 'r' may not remain constant or independent of the changes in 'n'. A change in 'n' influence k, K' and 'r'. Then 'n' may not exist its full proportionate effect on P.

4. In Robertson's equation 'p' changes directly as 'M' and inversely as K or T. There is close similarity between Fisher's equation and Robertson equation except the fundamental difference that Fisher's equation and Robertson equation except the fundamental difference that Fishers' equation consider money as medium of exchange while that of Robertson equation as store value.

4.4.4 CRITICISM OF CAMBRIDGE EQUATION

1. The cash balance approach is not adequate to explain the price behaviour in a dynamic society since it assumes uniform unitary elasticity of demand for money. In a dynamic society the demand for money is always greater than unity.

2. The demand for money as given in the Cambridge equation is not comprehensive. It ignored the speculative demand for money which is very prominent in the real society.

3. The Cambridge equation also assumes K and T given in a dynamic set up, neither K nor T could be assumed constant.

4. This theory ignores the role of rate of interest which is a causative factor for price changes. The rate of interest influences price level via the level of investment and output.

5. In the economy the price level is also influenced by level of income, savings and investment. This theory overlooked then.

6. The theory explained the purchasing power in terms of real income i.e., consumption goods (wheat). But the investment goods also are equally important. Therefore it is wrong and illogical to ignore these goods.

7. More than real income, the monetary and business habits of the people as well as political conditions prevailing in the country also determine the value of K. It is narrow to consider that only real income determines K.

8. 'R' represents the real income in the country. It represents all the goods and services produced in the country, it is very difficult to have an accurate measurement of the real income.

4.4.5 SUPERIORITY OF THE CASH BALANCE APPROACH

Inspite of the above defects in the cash balance approach, it is considered superior to that of Transaction Approach because of the following reasons.

1. The Fisher's equation is mechanical in the sense that it establishes a truism that MV = PT. But the Cambridge equation is realistic since it considers the human motives also in determining the price level.

2. The transaction approach considered only changes in supply of money influence the price level given the demand - where as the cash balance approach considered that changes either in supply or demand influence the price level.

3. The transaction approach ignored the level of income as determinent factor of price level where as the cash balance considered level of income also.

4. The role of K in the cash balance approach is more significant in determining the price level than the role of M in Transaction Approach even if M is constant the changes in K comes changes in demand for goods and services and prices.

5. Apart from all the above, the cash balance has provided the foundation for the building up of the Keynesian Liquidity Preference theory of interest. It is part of the general theory of income, employment and output. It also focuses attention on the limitation of the monetary authority to control the business cycles through the uses of Monetary weapon also.

4.5 COMPARISON BETWEEN TRANSACTIONS AND CASH BALANCES APPROACHES

	Transaction Approach	*Cash Balance Approach*
1.	Explain the value of money over a period of time by incorporating the velocity of (V)	Explain the value of Money at a point of time by including the concept of demand for cash balance (K)
2.	Money is considered as a flow (MV) as medium of exchange in transactions.	Money is considered as stock - store value - i.e., cash balance (K)
3.	Do not explain how changes in Money supply influence the change in price level.	Changes in K influence the Price level via the changes in demand for goods and services even if there is no change, in M.
4.	Considers only changes in Money supply influences prices taking the demand as given.	Considers that changes in both supply and demand in money influence the price.
5.	'P' is concerned with the prices of everything which enters into transactions that is settled with money.	P is concerned with only the prices of those goods which form part of country's real income i.e., consumption goods.
6.	Explain equilibrium between (MV = PT) Money supply and demand for money which is a truism.	The K which is an important factor to explain price changes is not mechanical but involves human element i.e., transaction or precautionary motives of the people.

4.6 INCOME THEORY OF MONEY-KEYNESIAN EQUATION

The income theory was gradually developed by Tooke, Wicksell and Aftalion and formally by Keynes. According to this theory, it changes incomes rather than changes in money supply which causes changes in the aggregate demand. When income, increase aggregate demand for goods and services increases. People spend more and the price level rises. On the contrary when income falls, aggregate demand falls. People spend less and the price level falls. Therefore, changes in the price level depend upon the volume of expenditure in the economy. The level of income is influenced by volume of savings and investment in the economy. Thus changes in the price level or volume of money are caused by the income and expenditure of the community or by volume of savings and investment.

The important macro variables are income, consumption and savings. The income is the market value of goods and services in a country in a year. It can also be explained as the total of money payments to the factors of production (Y). In a given time the total income is always equal to total expenditure (Y=E). The income in this years is the source of expenditure in the next year. The people save some income. The savings is the residual after meeting the consumption needs of the individual. Therefore Y = C + S. Whatever that is saved is invested in the economy. Therefore, Y + C + I. Then savings is equal to investment (S = I). Investment means addition to the existing stock of capital.

The theory asserts that the aggregate demand for goods and services is determined by the size of the money income of the community. An increase in money income of the commity implies larger purchasing power in the hands of the people who will spend it on buying larger quantities of goods and services than before. If production cannot be increased due to internal bottlenecks, the aggregate demand will rise the price level. If the production is greater in proportion than aggregate demand the money income will have no effect on price level. This income theory can be explained with the following equation.

$$p = \frac{Y}{0}$$

P represents general price level, Y represents money income and, 0 represents total output of goods and services.

In his general theory, Keynes has developed a referred 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 and fixed wage unit as long as unemployment is present. Under this situation, an increase in the quantity of money will not rise 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.

4.6.1 ASSUMPTIONS 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 source 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.

6. 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, spread itself partly in increasing the quantity of employment and partly in rising the level of prices in the economy.

4.7 RESTATEMENT OF QUANTITY OF MONEY - MILTON FRIEDMAN

The quantity theory of money - A restatement published in 1956 set down a particular model of quantity theory of money. According to Friedman, the analysis of the demand for money on the part of the ultimate wealth-owning units is formally identical with that of the demand for any durable consumer good. The demand for money depends upon three factors.

a) the total wealth to be held in various forms,

b) the price and return on this form of wealth and alternate forms,

c) the tests and preferences of the wealth owning units.

Thus money is an asset or capital good. Wealth includes all sources of income or consumable services. Income is the average expected yield on wealth during its life time. Wealth can be held in five different forms.

a) Money (M)

b) Bonds (B)

c) Equities (E)

d) Physical non-human goods (G) and

e) Human capital (H)

Wealth owners apportion their wealth among its various forms in such a way as to maximise utility form them. The cost of holding various forms of wealth is measured by the rate of interest that can be earned on such assets as bonds, equities etc., and the rate of change in their prices. People hold more wealth when the rate of interest decrease or prices of such assets increase and vice versa. Money also yields real return in the form of convenience, security etc., to the holder which is measured in general price level (P).

When the price level falls the rate of return on money is positive because the value of money increases and when the price level rises, it is negative because of the fall in the value of money. Thus the price level P is an important variable in the demand for money function of Friedman. In the case of human wealth it is difficult to measure because the conversion of human into non-human wealth or the reverse is subject to institutional constituents.

Variable other than income may effect the utility attached to the services of money. There variables are the tastes and preferences of wealth holders. They also determine the demand function for money along with other form of wealth. Such variables are noted as u thus the demand function for money for an individual wealth holder

$$M = f\left(Y, P, rb, re, \frac{1}{P}, \frac{dP}{dt}, W, u\right) \quad \ldots\ldots \quad 1$$

$$\frac{M}{P} = f\left(\frac{Y}{P}, rb, re\ \frac{1}{P}, \frac{dP}{dt}, w, u\right) \quad \ldots\ldots \quad 2$$

The supply of money is independent of the demand for money. The supply of money is unstable due to the actions of monetary authorities. On the other hand the demand for money is stable.

M = total stock of money

Y = total permanent income

P = the price level

rb = the yield on bonds

re = the yield on equities

$\frac{1}{P}, \frac{dP}{dt}$ = the expected rate of change of prices of goods

W = the ratio of non-human to human wealth

u = tastes and preferences and all other relevant variables.

Money which people want to hold in cash or bank deposits is related in a fixed way to their permanent income. If central bank increases the supply of money by purchasing securities, people who sell securities will find that their holdings of money have increased in relation to their permanent income. They will spend their excess holdings of money partly on assets and partly on consumer goods and services. This expenditure will reduce their money balances and at the same time raises the national income. On the contrary, a reduction in the money supply by selling securities on the part of the central bank will reduce the holdings, of many of the buyers of securities in rotation to their permanent income. They will therefore raise their money holdings partly by selling their assets and partly by reducing their consumption expenditure on goods and services. This will tend to reduce the national income. Thus an both counts, the demand for money remain stable. According to Friedman, a change in the supply of money causes a proportionate change in the price level or income or in both if the economy is operating at less than full employment level, an increase in the supply of money will rise output and employment with a rise in total expenditure. But this is possible in the short run.

4.8 SUMMING UP

The value of money changes in the same proportion of money supply according to the transaction approach as given by Fisher. This is based on the main function of money as medium of exchange. The Cambridge economists, taking the secondary function of money as store value they explained that value of money changes according to the proportion of income which the people prefer to keep on hand. On the other hand Keynes integrated the value of money with levels of output employment and income. Milton Freidmen, modern economists restated the theory by explaining the alternatives to keep money and how it influence the value of money. However the changes in supply and demand for money influences the value of money in the conclusion. Then what are the factors that determine the supply of money and demand for money in the economy. In India how supply of Money changed from time to time is an important question.

- **Dr. M.S.S. Somayajulu**

Check Your Progress :

I. 1. Fisher's quantity theory of Money in terms of equation of exchange is criticised.
   a) being merely a mathematical truism
   b) a less than full employment phenomenon
   c) locally unsound,
   d) non of the above,

   2. The Cambridge economists explained the value of money based on
   a) medium of exchange function,
   b) standard of defenced payments functions
   c) store value function
   d) liquidity to capital function

II. Answer in five lines
   1. Velocity of Money
   2. Money illusion

III. Existence of full employment is the main assumption of _____ theory of Money.

IV. The value of money is explained in terms of real income by _____ (Economist).

V. Match the following :

1. Robertson	(i)	$P = \frac{KR}{M}$
2. Pigou	(ii)	$P = \frac{M}{KT}$
3. Keynes	(iii)	$P = \frac{KR}{M}(c + h(1 - c)$
4. Marshall	(iv)	$P = \frac{n}{K}$

4.9 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. Critically discuss the quantity theory of money given by Fisher.
2. What is the Milton Friedman's approach in his restatement of quantity theory of money?

II. Answer the following questions in about 15 lines each.

1. Explain the cash balance approach as given by Pigou?
2. What is real balance equation?

UNIT-5 : SUPPLY OF MONEY IN INDIA

Contents

5.0 AIMS AND OBJECTIVES

The purpose of this lesson is to explain the concept of supply of money and how it changed from time to time in India.

After reading the unit, you will be able to

* explain views on supply of money, and
* analyse factors influencing the supply of money.

5.1 INTRODUCTION

Much is discussed in the previous units about the definition, importance and the value of money. The value of money is determined by the equilibrium between demand and supply of money. Theoritically some economists discussed the variations in demand for money given the supply. Some others discussed the variations in supply of money given the demand for money. In this unit the supply of money and the relevant factors are discussed.

5.2 CONCEPT OF SUPPLY OF MONEY

The supply of money is meant the total stock of domestic means of payments which is held by the public. Public implies individuals business firms state and local government bodies. Money held by central government, Treasurey, Central Bank and Commercial Bank are not taken into account as they are money creating agencies. The money supply is the stock of money in circulation - therefore it is a stock as well as flow concept. When 'M' is viewed at a point of time it is stock, when viewed over a period of time it is flow concept. Similar to the supply of a commodity here also stock of money is different from supply of Money. The supply of money or the volume of money in circulation refers to the volume of money held by the people in the country i.e., stock means the money which is held by commercial banks as cash reserves and with the central bank. The money stock held by the central bank in non-disposable form is not regarded as money supply in the economy. The definition of money supply is gradually widened.

(a) Traditional approach

(b) Monetarist approach

(c) Gurley or Shaw approach

(d) Liquidity approach

(e) Reserve Bank of India approach

The traditional approach stressed the medium of exchange function of money and according to it, money supply is defined as currency with the public and demand deposits with commercial banks. Demand deposits are current accounts of depositors in a commercial bank. They are the liquid form of money because depositors can drawn cheques for any amount lying in their account and the bank has to make immediate payment on demand. Demand with deposits bank plus currency with the public are together denoted as (M1).

The Monetarist approach is developed by Prof. Friedman taking functions of store value of Money. According to him literally the number of dollars people are carrying around in their pockets, the number of dollars they have to their credit at banks in the form of demand deposits and also commercial banks such deposits. Such deposits earn a fixed rate of interest varying with the time period for which the amount is deposited. The supply of money according to Friedman's approach is indicated by M2 in America and M3 in Britain and India.

In the Gurley and Shaw approach the money supply consists of M2 plus deposits of savings banks, building surities loan associating and deposits of other credit and financial institutions like equity share and the units of Unit Trust of India.

In the fourth stage, the Redcliff committee offered a new line of thinking which is more wider one. It holds that money supply is just a part of the wider structure of liquidity that is relevant to the spending decisions of the people which in turn is determined by the general liquidity of the economy. It further observed that money supply in modern economy cannot be successfully measured emprically as the degree of liquidity of different constituents of money supply are varying in nature and are relative in time variation.

5.3 SUPPLY OF MONEY IN INDIA

Based on the liquidity approach to money, the RBI considered the supply of money as currency (c) Demand deposits (DD) other deposits of the RBI (OD) Post office savings deposits. Time deposits of banks and time deposits of post offices. In recent years, it has adopted four means of money stock M1, M2, M3 and M4.

M1 = (a) currency notes and coins with the public
+ (b) Demand deposits with commercial and cooperative banks (inter bank deposits are excluded).
+ (c) other deposits held with the RBI.

M1 is the same as traditional view of money supply with the public.

M2 = (a) M1
+ (b) Savings deposits with P.O. savings banks

M3 = (a) M1
+ (b) Time deposits of all commercial and co-operative banks
(inter bank time deposits are excluded)

M4 = (a) M3
+ (b) Total deposits with P.O. Savings Bank Origin (N.S.Cs are excluded)

In India according RBI Report on Currency and Finance,Money supply with the public is as follows (Rs. crores)

Table : Money Supply (in crores Rs.)

		1960-61	1970--71	1977-78
I.	Currency with the Public (a + b = c - d)	2098	4367	8665
(a)	notes in circulation	1942	4069	8559
(b)	circulation of rupee coins	142	247	353
(c)	circulation of small coins	71	137	238
(d)	cash in hand with banks	57	186	485
II.	Deposit money with the public (i) + (ii)	770	2954	9419
(i)	Net demand deposits	757	2910	9349
(ii)	Other deposits with RBI	13	44	70
Money supply with the public		2868	7321	18084

5.4 DETERMINANTS OF MONEY SUPPLY

a) The size of the monetary base

b) Community's choice regarding cash and credit proportions in holding money and

c) The cash reserve ratio.

5.4.1 SIZE OF THE MONETARY BASE

Monetary base refers to the supply of funds available for use either as cash or as central bank reserves. Money supply varies directly in relation to the changes in their base. It consists of monetary gold stock, reserves assets such as government securities, bonds and bullion etc., with the central bank and amount of central bank credit outstandings.

The monetary gold stock in an economy is determined by

a) the stock of gold accumulated in the past,

b) the net addition made to monetary gold stock from the current domestic production of gold and

c) the imports and exports of gold

The reserve assets of the central bank determines the note issue

d) the central bank credit in the form of loans and investment tends to uplift the reserve funds of the commercial banks.

However, the relative importance of the above differs depending upon the monetary system,. Under the gold standard the gold stock is more importance convertible paper standard gold has no relevance. At present monetary base is determined by the currency and the central bank credit.

5.4.2 COMMUNITY CHOICE

It refers to the habits of the people to deposit their income in the bank. A rupee in hand worth rupee only. But if the same is deposited in a bank it performs the function of rupees. If the business people prefer to make payment in the form of cheques there will be larger volume of money. Further in an economy with high degree of monetisation people would demand more money. If the exchange takes place through barter, money supply cannot be more.

5.4.3 THE CASH RESERVE RATIO

The commercial banks create credit on the basis of deposits. The reserve ratio is the proportion of money that may be kept as reserve given the deposit. For example if the reserve ratio is 20% and if the deposit is 1000, Rs. 200/- is kept by banks as reserve. The rest of Rs. 800/- is used to give credit i.e., creation of demand deposits. Therefore, higher the reserve requirement lower will be the credit creation and vice versa. However the credit creation of commercial banks is influenced by (a) the amount of cash with the banking system (b) cash - reserve ratio (c) external draw, (d) willingness of customers to borrow (e) supply of collateral security (f) banking habits and banking system and monetary policy of the central bank.

Money supply function can be thus expressed as :

MS = (f) (l, dr, tr, i,Y)

Ms = supply of money

l = the quantity of total legal tenders possessed by the banks

dr, tr, the cash reserve ratios for demand deposits and time deposits.

i, the rate of interest

Y, the level of national incomes

The monetary base is now a days explained as High Powered money. High powered money is the sum of commercial bank reserves and currency held by the public. The use of H P money consists of the demand of Commercial Banks for the legal limit or required reserves with the central bank and excess reserves and the demand of the public for currency. Thus high powered money H = C + RR + ER, C = currency, RR = Reserve Requirement, ER = Excess reserves.

The relation between the money supply and high powered money is M = mH

H is the high powered money

'm' is the money multiplier.

The size of the money multiplies is determined by the currency ratio of the public, the required reserve ratio at the commercial bank and the excess reserve ratio of commercial banks.

The lower these ratios are, the larger the monetary multiplier. ff 'm' is fairly stable the central bank can manipulate the money supply (M) by manipulating (H). The central bank can do so by open market operations. But the stability of 'm' depends upon the stability of the current ratio and the reserve ratios RRr and ERr.

5.5 SUMMING UP

The supply of money is viewed both as a stock concept and flow concept, it means that the stock of domestic means of payment which is held by the public and its circulation. The factors that influence the supply of money are the size of the monetary base, the community's choice and the cash reserve ratio. In India the money supply is explained in terms of M1, M2, M3, and M4. It increased from time to time. The increase in supply of money is considered as responsible for inflation in India – what is inflation and what are its effects have to be analysed from the Indian economy point of view.

Dr. M.S.S. Somayajulu

Check Up Your Memory :

(i) Money supply is
(a) stock concept
(b) a flow concept
(c) both a stock and a flow concept
(d) none of the above

(ii) Velocity of circulation of money is measured

(iii) _____ are not considered as money supply

5.6 MODEL EXAMINATION QUESTIONS

I Answer in 30 lines each.

1. Explain the factors influencing money supply.
2. What are the various components of money supply in India?

II Answer in 15 lines each.

1. Explain traditional view of money supply.
2. List the factors determining the velocity of money.

UNIT-6 : INFLATION THEORY AND INDIAN EVIDENCE

Contents

6.0 AIMS AND OBJECTIVES

The purpose of this unit is to explain the concept of inflation and its effects with emperical evidence in India.

After reading the unit, you will be able to,

* explain the meaning and types of inflation,
* analyse the causes of inflation,
* describe the effects of inflation on different aspects of the economy,
* discuss the measures to control inflation,
* identify the important concepts pertaining to inflation, and
* examine the measures taken in India to control inflation.

6.1 INTRODUCTION

In the economic literature, inflation is a term which frightens every one and which has become a common feature in the world. Every one, either in government or outside, either producers or consumers, either rich or poor talk of controlling inflation and inspite of it, it not only exists but also spreads. The risk of inflation cannot be dismissed as a figment of imagination or as a matter of little consequence inflationary process often takes its toll. Apart from economic disruption, it can also be a major source of political and social unrest. A detailed discussion of the meaning, causes, effects and measures necessary to control it will help to understand the seriousness of the term.

6.2 MEANING OF INFLATION

Different economists defined inflation in different ways as it appears to each one of them. Inflation is understood by more people as a substantial and rapid general increase in the level of prices and consequent deterioration in the value of money over a period time. Some important definitions are :

Prof. Crouther : "Inflation is a state in which the value of money is falling i.e., prices are rising".

Prof. Hawtray : "Inflation is the issue of too much currency".

Kemmer : "Inflation is as toh much currency in relation to the physical volume of business being done."

Prof. Coulborn : "Inflation is too much money chasing far few goods".

Prof. Goldmeiser: "Inflation occurs when the volume of money actively hidding for good and services increases faster than the available supply of goods.

Keynes distinguishes between partial inflation and full inflation. The rise in price level upto full employment level is partial one since the price rise induces increase in output also. When economy reaches full employment, the price rise may not cause an increase in production. It is called full inflation. Generally the price rise in developing economics is called partial inflation. Therefore, these are explained as stages of inflation - Partial inflation is the first stage and full inflation is the second stage. The essence of all the definitions is the rise in price level or fall in the value of money.

6.3 TYPES OF INFLATION

Inflation is differentiated on many grounds -

a) Based on the rate of increase in price level these are
(1) creeping (2) walking (3) running and (4) galloping

b) According to the factors which influence money supply and demand for goods and services
(1) excessive (2) cost (3) deficit and (4) flight

c) Under the creterion of time
(1) wartime (2) post war and (3) peacetime

d) From the coverage or scope point of view
(1) comprehensive and (2) sporadic

e) According to governments reaction to the prevelance of inflation
(1) open and (2) repressed

f) Profit inflation

g) On the basis of factors pertaining to the balance of payments :
(1) export boom (2) import-price-hike and (3) key-currency

a. 1) *Creeping Inflation* : According to Kent, Creeping inflation means rise in price level by not more than three percent a year.

2) *Walking Inflation* means the rise in price level three to four percent per annum.

3) *Running Inflation* is the price rise by ten percent per year.

4) *Galloping Inflation* refers to price rise fits and starts. It is also called hyper inflation as it may be even hundred percent.

b. 1) *Excessive Inflation* is the price rise due to excess of money supply in relation to the availability of real goods and service.

2) *Cost Inflation* refers to the situation when prices rise due to increase in factor prices. It occurs when money incomes of factors expand more than real productivity.

3) *Deficit Inflation* is the result of government resorting to definet budget. During planning era government launches upon heavy investment. The production of consumption goods fails to keep pace with the increased money expenditure.

cost of production increase due to wage increase or profit motivated. A part of the supply curve, shifts upwards i.e., S to S1 and from S1 to S2. As a result new equilibrium price occur i.e., P' and P". It reflects the rise in prices from OP to OP' and OP" given the constant demand at DD. If however, the government or monetary authority is committed to maintain full employment there will be more public spreading or more credit expansion causing the price level to rise much more such as from P to P"' and P""

6.4.3 MIXED DEMAND PULL AND COST PUSH INFLATION

Some economists do not accept this dichotomy that inflation is either demand pull or cost push. They hold that the actual inflationary process contains some elements of both. In fact excess demand and cost push forces operate simultaneously and interdependently in an inflationary process. This inflation is mixed demand pull or cost push when price level changes reflect upward shifts in both aggregate demand and supply functions. In fact an inflationary process may begin with either excess demand or wage push. The time in each case may be different. In demand pull inflation price increases may proceed wage increases while it may be the other way round in the case of cost push inflation. So price increases may start with either of the two forces, but the inflationary process cannot be sustained in the absence of the other forces.

6.4.4 THE STRUCTURAL INFLATION

The demand pull and cost push inflation are generally attributed to developed countries where the full employment exists. In the case of developing economies the reason for price rise may be mostly structural deficiencies. According to Mydral and Streeten the underdeveloped or developing countries like India suffer with structural imbalances due to market imperfections and stagnancy as may be caused by a dual nature of the economy with high fragmentation. As such scarcity in some sectors may cause under utilisation of the productive capacity of the economy and create the problem of sectoral inflation more serious than a general price rise. The main bottlenecks in a developing economy are :

1) Market imperfections
2) Capital bottleneck
3) Food bottleneck
4) Entrepreneurial bottleneck
5) Infrastructural bottleneck
6) Foreign exchange bottleneck
7) Resource gap

Due to these bottlenecks the aggregate supply is always less than the aggregate demand and causes price rise.

6.5 EFFECTS OF INFLATION

Inflation, the rising trend of general price level effects every one in the economy with different intensities. If economy is taken as a whole the inflation effects production, distribution and the balance of payments. If different sections of the community are considered the inflation effects, Debtors and creditors, salaried persons wage earners, fixed income groups, equity holders, businessman and agriculturists.

6.5.1 ON PRODUCTION

According to Keynes, Price rise upto full employment level creates incentives to invest and earn profits. When the economy reaches full employment stage, the effects are disastrous.

a) it creates mal adjustments in production and disrupts the working of the price system.
b) capital accumulation is hindered by uncontrolled inflation, the country's savings potentiality decreases.

c) speculation increases the cost of genuine productive activity.

d) Hoarding and black marketing takes place.

e) it changes the pattern of production. The resources are diverted from production of essential goods to non essentials.

Thus production on undesirable lines result and it breaks down the economic system.

6.5.2 ON DISTRIBUTION

Income distribution due to inflation may tilt in favour of rich. Wide income disparities arise since the income of all factors will not increase in the same proportion. Profits increase because there is a lag between a rise in prices and rise in the cost of production.

6.5.3 ON GOVERNMENT

Government gains under inflation for rising wages and profits spread an illusion of prosperity within the country. As money incomes of the people increase government collects that in the form of taxes on incomes or commodities. So the revenue of the government increase during inflation. Moreover the real burden of the public debt decrease when prices are rising. Though the government also has to spend more on its projects and on administration, the gains are greater than the loss.

6.5.4 ON BALANCE OF PAYMENTS

Inflation adversely affects the balance of payments position when prices of goods increase rapidly in the country than in other countries, the goods cannot compete with other country's goods in the foreign markets. This tends to increase imports and reduce exports. The result is unfavourable balance of payments.

6.5.5 ON DIFFERENT SECTIONS OF PEOPLE

Debtors & Creditors : During inflation debtors gain and creditors lose. The debtors return in the same amount after some period by which time the value of money falls due to price rise. Creditors loose because they get some amount with less value of money.

Salaried persons : The real income of the salaried people fall because of price rise. Though there is increase in D.A. or pay from time to time this increase is always less proportionate to the increase in price level - The result is increase in money incomes but fall in real incomes.

Wage earnes : The effect of inflation on wage earness depend upon the strength of Trade unions and the speed with which their wages adjust to rising prices. If the Trade unions are strong they may get equal increase in money income when compared to price rise. If they are weak they incur loss due to fall in real incomes.

Freed income groups : Like pensioners, recipients of interest and rent, lose because they receive fixed payments while the value of money continues to fall with rising prices.

Equity Holders : Person who hold shares or stocks of companies which do not carry a fixed rate of interest, gain during inflation. As profits of companies increase dividends on equities also increase at a faster rate than prices.

Agriculturists : Among agriculturists there are landlords, peasant proprietors and landless agricultural workers. Landlord lose during rising prices because they get fixed rents.

Peasants and proprietors who own and cultivate their farms gain. Prices of farm products increase more than the cost of production. For prices of inputs and land revenue do not arise to the some extent as the rise in the prices of farm products.

The landlords agricultural workers are hit hard by rising prices. Their wages are not raised by the farm owners because trade union is absent among them.

6.6 MEASURES TO CONTROL INFLATION

The measures to control inflation consists of those controlling excess demand and those which promote production to fill the gap in supply of goods and services this is so since price rise is due to pulls in demand or push in the costs. To control demand there are monetary measures, Fiscal measures and other measures.

A. DEMAND SIDE MEASURES :

6.6.1. Monetary Measures

Aim at reducing the money supply and the consequential fall in demand. The weapons under monetary measures are (a) Bank Rate (b) Open Market Operations and (c) Variable Reserve Ratio. The other measures are (d) demonstration and (e) issue of new currency.

a) *Bank Rate :* is the rate of interest charged by the Central bank on the loans taken by commercial banks. At the time of inflation, it rises the bank rate which ultimately leads to rise in the interest rate charged by the commercial banks on the loan to business men. As a result, the loans already taken will be repaid and the new loans are restricted. Thus the money circulation is cut down, the demand for goods fall, prices fall.

b) *Open Market Operations :* means the central bank purchasing and selling bonds. At the time of inflation the central bank prefers to sell bonds, so that the excess money available with the public goes to central bank and as a result the money circulation, demand for goods and prices of goods are lowered.

c) *Variable Reserve Ratio :* It is the ratio that Commercial Banks have to keep out of their deposits, in the central bank. During the inflation the Central Bank increase the ratio that is to be kept in it. Then the scope of giving loans by the commercial banks is restricted and money circulations falls, demand falls, prices fall.

d) *Demonetisation :* Of currency of higher demoninations. Such a measure is usually adopted when there is abundance of black money in the country. But this measures reflect the inability of the government to control inflation by their measures. So generally this is not used frequently.

e) The extreme monetary measure i*issue of new currency*y in place of old currency. Under this system one new note is exchanged for a number of notes of the old currency. The value of bank deposits is also fixed accordingly. Such a measure is adopted when there is an excessive issue of notes and there hyper inflation in the country. This measure is inequitable as it hurts the small depositors the most.

6.6.2 FISCAL MEASURES

Relate to budgetary changes from time to time with regard to the public revenue or public expenditure. The principal fiscal measures are (a) Taxes (b) Reduction in public expenditure (c) cutting down personal consumption expenditure (d) promoting savings and (e) avoiding deficit financing.

a) *Taxes :* Personal income tax, estate duty gift tax which are direct in nature reduce the disposable income in the public. Then the demand for goods fall and prices fall.

b) ***Reduction in public expenditure*** **:** Causes restricted flow of incomes to the public. At low levels of income the demand for goods is low and prices may continue at low level.

c) *Domestic personal consumption* : Can be cut down by improving heavy indirect taxes like excise, sales taxes. These taxes, when imposed discourage unnecessary consumption and demand for goods. In this connection, it is necessary that increase in this taxes should not be so high that they discourage savings, investment and production.

d) *Promoting Saving* : Savings in the public may be promoted by proper incentives for savings in personal income tax, corporate tax. If necessary the government may adopt the policy of forced savings like compulsory deposits schemes etc. It can also float public loans on condition of repayment after some time. All these restrict the money supply and demand for goods and services.

e) Now a days in developing economics government adopt the policy of *deficit financing* to fill the gap between the proposed developmental expenditure and the public revenue. The deficit financing itself may not be inflationary, but when it is spent on long gestation projects and on building the infrastructure facilities it leads to inflation. Therefore, it would be proper to avoid deficit financing at the time of inflation.

6.6.3 OTHER MEASURES

Consists of direct controls on prices and rationing of scarce goods. Price controls mean a ceiling on the price of goods - then the prices are not allowed to increase.

Rationing divert the consumption from those commodities whose supply is scarce and demand needs to be restricted for some special reasons. But these have the scope of limited application.

B. SUPPLY SIDE MEASURES

On the supply side, i.e., to increase the supply of goods to meet the demand, it consists of using raw materials for such products for which there is heavy demand. The export and import duties may also suitably be changed to improve the supply of scare goods in the country and to avoid exporting the raw materials and essential goods for other countries so that equilibrium can be achieved between the demand and supply within the country.

The policy of rationalisation of industries help reducing the coasts of production and improving the efficiency.

Thus it is necessary for the government to adopt the Monetary, fiscal and other measures on demand side complementary to the efforts to increase the production and minimising the costs of production in the country.

6.7 IMPORTANT CONCEPTS ON THE LITERATURE OF INFLATION

There are some important concepts in the economic literature connected with inflation.

They are :

a) inflationery gap
b) Phillips curve
c) stagflation

6.7.1 INFLATIONARY GAP

This is an important concept explained by Keynes in his pamphlet "How to pay for the war" in 1940. Keynes defined the inflationary gap as an excess of public expenditure over the available output at pre-inflation or base prices. It implies that inflation occures mainly because of excess of expenditure

over income at the full employment level. The larger the aggregate expenditure the larger the gap and the more rapid the inflation. The concept of inflation any gap is used by Keynes just only to show the main determinants that cause an inflationery rise of prices.

In the following table and diagram this concept is explained :

		Rs.	
1.	Gross National Income at current prices	250 cr.	
2.	Taxes	60 cr.	
3.	Disporable increase	190 cr.	
4.	GNP at pre-inflation prices	200 cr.	
5.	Govt. expenditure	80 cr.	
6.	Output available for consumption at pre-inflation prices	120 cr.	
	Inflationary gap is (3-6)	190 cr. - 70 cr.	120 cr.

If the disposable income i.e., Rs. 190 cr. is not spent and a part of it say Rs. 38 cr. (20%) is saved - then the demand would be equal to 152 cr. - in that case the inflationery gap would be (152-120) Rs. 32 crores.

In the following diagram: on OX axis income and on OY axis expenditure are shown.

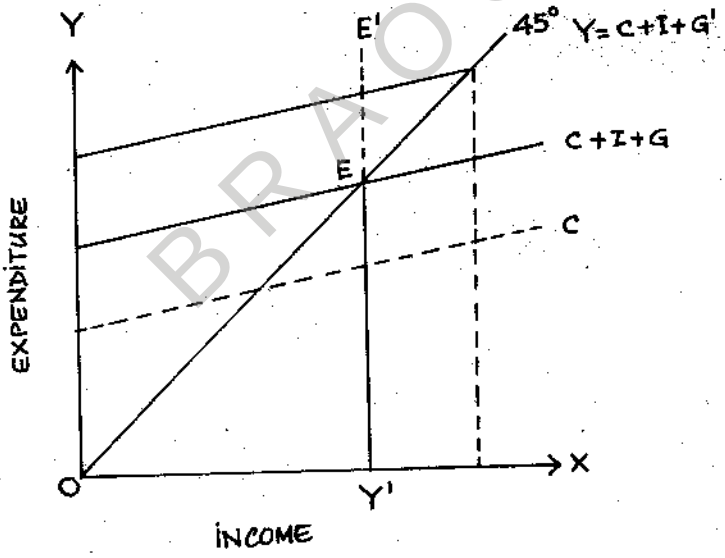


Fig. - 6.3 : Inflationary Gap

YF is the full employment level of income which is arrived at be equality of aggregate consumption and aggregate investment (C + I + G).

45° line represent total supply of goods at point E.

Due to the reasons explained, there may by excess demand. It may be due to more government expenditure etc. Then the C + I + G curve shifts upwards i.e., C + I + G' - As a result the new equilibrium point would be E'. It means though the supply of goods remain constant at YF the expenditure would be E'Y'. Then the inflationary gap is EE'.

The concept of inflationary gap is continued on the grounds that it assumes full employment it applies only to the goods market ignoring the factor market and that the concept is used as flow of present income and expenditure, but the prices rise apply to goods produced in the past and so on. However, this concept has some statistical importance.

6.7.2 PHILLIPS CURVE

The technique of Phillips curve is used to explain the relationship between the rate of unemployment and the rate of money wages. A.W. Phillips explained this based on the emperical evidence in U K. According to him there is inverse relationship between the two, i.e., when the unemployment is high the rate of increase in money wage rate is low. On the contrary, when unemployment is low the rate of increase in money wage rate is high. The reasons are :

a) when the demand for labour is high and there are very few unemployed the employer prefers to pay higher wage rates.

b) In a period of rising business activity when unemployment falls with increasing demand for labour, the employees will bid up wages.

c) The charge in cost of living as indicated by the rate of change of retail prices. If increase in demand for labour and employment is followed by proportionate increase in labour productivity the prices will not rise. If the rate of increase in money wage rates is higher than the growth rate of labour productivity, prices will rise.

The Phillips, curve relates, percentage change in money wages on the vertical axis with percentage of labour force unemployed on the horizontal axis.

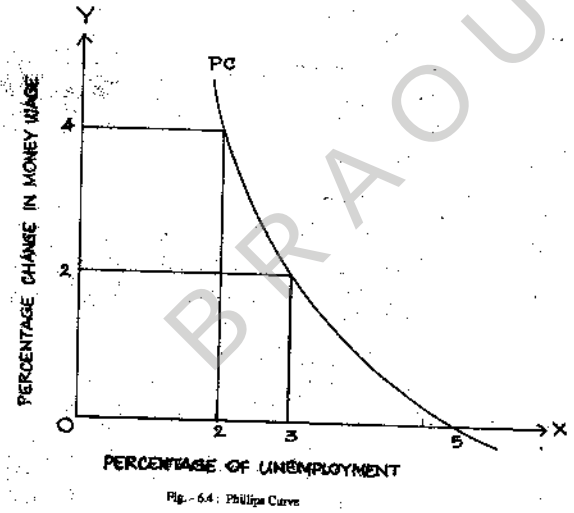


Fig. - 6.4 : Phillips Curve

PC is the phillips curve. It is convex to the origin. It means the percentage change in money wages rise with decrease in the unemployment rate.

For example when unemployment rate is 3% i.e., ON the percentage change in wage rate is 2. The growth rate of money wages is OM. If the rate of unemployment comes down to 2% from 3%, the rate of growth of money wages increase from 2% to 4%. If the rate of unemployment is 5% the rate of growth of money wages is zero. Thus Phillips curve explain the reverse relationship between the rate of unemployment and rate of growth of money wages.

The phillips curve is also subjected to criticism on the grounds that it applies to short run. According to Friedman there is no trade off between inflation and unemployment.

6.7.3 STAGFLATION

Stagflation is a situation in which the economy experiences stagnation or unemployment along with a high rate of inflation. It is otherwise called as inflationary necession. The concept is coined in 1970 combining stagnation "Stag" plus inflation ("flation").

The cause for stagflation is restriction in the aggregate supply. When aggregate supply is reduced there is a fall in output and employment and the price level rises. A reduction in aggregate supply may be due to a restriction in labour supply. The restriction in labour supply in turn may be by a rise in money wages on account of strong unions or by a rise in the legal minimum wage rate, or by increased tax rates which reduce work effort on the part of workers. When age rise, firms are forced to reduce production or employment. Consequently there is a fall in real income and consumer expenditure. Since the decline in consumption will be less than the fall in real income, there will be excess demand in the commodity market which will push up the prices.

Another reason for fall in aggregate supply is the increase in indirect taxes by central, state and local governments. When indirect takes are increased they raise costs or prices and reduce output and employment. Moreover, when the government increases taxes, it leads to the transfer of real purchasing power from the people to the government. As a result aggregate demand falls and output and employment adversely affected. If however, the government increases its expenditure equal to the increase in tax revenue it would raise the price level further due to increase in additional demand.

The measures to come out of stagflation are

1. To keep the minimum wages constant,
2. To follow tax based income policies,
3. Limiting the increase in money wages with productivity increase,
4. To reduce personal and business taxes because they tend to reduce labour costs and raise demand for labour.

6.8 INFLATION IN INDIA - MEASURES TAKEN SINCE INDEPENDENCE

India is a developing economy. If adopted the policy of planning to achieve economic development. In a mixed economy the objective is to establish socialistic pattern of society. Seven five year plans have been completed and the eighth plan is to start. Therefore it is appropriate to discuss the inflationary situation in India. Generally the wholesale price index and the consumer price index are used to measure the inflation.

In India, inflation started in the second five year plan when long run, heavy industries stategy of Economic development commenced.

During the First Plan i.e., 1951-52 to 55-56 there was price stability. In fact the WPI for all commodities decreased by 17% during that period. In terms of CPI taking the base year 1949 = 100 it declined from 101 to 96 in 1956.

In the second plan period i.e., 1955-56 to 1960-61 the WPI increase from 92.5 to 124.9. Similarly all India working class CPI increased from 96 to 124 (CPI 1949 = 100). The annual compound inflation rate was 5.3%.

During the third plan i.e., 61-62 to 65-66 the inflation rate was accelerated i.e., the annual componed inflation rate was 6.5. The WPI (1952-53 = 100) rose from 125.1 in 61-62 to 165.1 in 65-66 i.e., 32.2 increase.

The the index number of prices have been revised with a new based year of 1961-62 in order to have a meaningful comparison later.

During the three year period of annual plans there was recession with severe inflation. The compound annual rate was 7.8% by 1969-70 (WPI 61-62 = 100) stood at 172.

In the Fourth Five Year Plan 69-70 to 73-74 the inflation rate was 9%. The WPI rose from 172 in 69-70 to 254 in 73-74 i.e., 47% per cent increase.

The years 1973-74 and 1974-75 witnessed 40% price rise. This severity caused imposition of emergency and taking up the drastic measures to control inflation. As a result the price index temporarily declined by 6.4%. When emergency was lifted there was political change and India again experienced severe inflation. Even the Janatha Government could not control it. During the period of two years the WPI, went up from 182.1 to 191.1. But from 78-79 to 79-80 the price rise was 21%. Gradually the prices rose and the value of rupee fell down to the extent of 13 paise in recent times.

PRICE TRENDS IN INDIA 1970-71 TO 1979-80

Year	Wholesale Price Index-all commodities	Annual Plan Changes in Percentage (Rate of Inflation)
(1)	(2)	(3)
1970-71	10.0	–
1971-72	108.2	+ 8.2
1972-73	121.5	+ 12.2
1973-74	158.0	+ 30.0
1974-75	173.9	+ 10.0
1975-76	162.6	- 6.4
1976-77	182.1	+ 11.9
1977-78	182.7	+ 0.3
1978-79	191.1	+ 4.5
1979-80	232.0	+ 21.4
1980-81	270.7	+ 16.7
1981-82	277.1	+ 2.4
Dec. '82	287.1	+ 2.4
1986-87	376.8	+ 3.6

Source : Government of India - Economic Survey 1982-83

6.9 CAUSES FOR INFLATION IN INDIA

The causes can be classified into Monetary and Non-Monetary factors. Among the monetary factors, the significant are :

i) Over expansion of money supply
ii) Expansion of bank credit
iii) Deficit Financing
iv) Increase in Public Expenditure
v) Huge investment on infrastructure and long gestation projects
vi) Black Money

Among the non-monetary the important are :

i) Population growth
ii) National calamities
iii) Hoarding and Spectative activities
iv) Industrial Import Content
v) Under utilisation of production capacity

The measures taken to control inflation in India are :

i) Monetary Policy
ii) Fiscal Policy
iii) Direct Controls
iv) Miscellaneous Measures

The Reserve Bank of India adopted bank rate policy, open market operations and manipulation of reserve requirements.

In the case of fiscal policy, Government emphasised on taxation, public borrowings and changes in public expenditure.

The Direct Controls consists of price controls, rationing and strengthening of public distribution. In respect of miscellaneous measures, the measures consist of increasing production of necessaries, control of wages, checking the growth of population growth, import of essential goods etc.

Inspite of the measures taken, the effect is quite insignificant. Because of various reasons, the policies indicated above could not be implemented effectively - hence the inflationary trend has become an integral part of the development process.

- Dr. M.S.S. Somayajulu

Check Your Progress :

1. Inflation means too much money chasing _____ goods.
2. The price rise in developing economies is called _____ inflation.
3. Galloping inflation refers to the situation of _____ pure wise.
4. Inflationary gap is explained by _____ (Economist).
5. Phillips curve establish relationship between _____

6.12 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in 30 lines.

1. Explain the causes of inflation duly stressing the Demand Pull and Cost Push Inflation.
2. What are the factors responsible for inflation in India - Explain the measures taken to control it.

II. Answer the following questions in 15 lines.

1. Inflationary Gap
2. Phillips Curve
3. Monetary Policy and Inflation
4. Effects of Inflation

GLOSSARY (Units : 1-6)

Bank Money	:	Bank Deposits against which cheques can be issued.
Barter	:	Exchange of goods for goods without the use of money.
Capitalist Economic System	:	An economic system where private ownership of real capital is permitted.
Equilibrium Price	:	Equilibrium price is one where the quantity demanded of a commodity is exactly equal to the quantity supplied.
Fiat Money	:	Money which has absolute elasticity.
Fiscal Employment	:	The Government's policy either to increase or decrease taxation to stimulate or check consumers, demand.
Full Employment	:	An economic situation where unemployment is at a minimum and the number of unemployed is no greater than the number of vacancies.
Inelastic Demand	:	Where a considerable rise or fall in the price of a commodity has little effect on the quantity demanded.
Legal Tender Money	:	Currency and coins issued by a central bank and Government.
Liquidity Preference	:	The extent to which investors prefer to keep their assets liquid (i.e., in the form of money)
Managed Money	:	Money issued with less than 100% metallic reserves.
Marginal Efficiency of Capital	:	The relation between the prospective yield of one more unit of a type of capital and the cost of producing that unit.
Money Wages	:	Wages paid in terms of cash.
National Income	:	The total money value of all goods and services produced in a country during a specified period, generally one year.
Purchasing Power	:	The quantity of goods and services a unit of money can buy.
Real Wages	:	Money issued with 100% metallic reserves.
Socialist Economic System	:	An economic system in which the entire economic activity is planned and controlled by Government agencies.
Velocity of Circulation of Money	:	The average number of times each unit of money is used during a period.
Wage Freeze	:	An attempt to hold wages at their existing level for a period of time.

SUGGESTED READINGS

1. John. M. Culbeston : Money and Banking
2. Kulkarni ABN & Kalkundrikar AB : Money, Banking, Trade & Finance
3. Sanyasaiah K & Ranganadhachari AV : Money, Banking, International Trade
4. Srivastava SK : Monetary Economics in Theory and Practice
5. Sundaram KPM : Money, Banking and International Trade
6. Vaish, MC : Monetary Theory
7. Vaish, MC : Money, Banking & International Trade
8. Thingan : Monetary Theory
9. M.L. Seth : Monetary Theory
10. H.L. Bhatia : Monetary Theory
11. D.M. Mithani : Monetary Theory and Growth

BLOCK - II
BANKING

This block deals with the commercial and central banking. It explains the Indian experience pertaining to banking sector such as Indian banking system, RBI, money market capital makret, co-operative banks and regional rural banks.

This Block contains the following 12 units.

UNIT - 7 : CONCEPT AND ROLE OF BANKING

Contents

7.0 AIMS AND OBJECTIVES

The purpose of this unit is to explain how commercial banks have come into existence and how they came to occupy an indispensable place in the modern economies all over the world. This unit also explains different types of banks.

After studying this unit, you will be able to understand :

* how banks started their business of accepting deposits and lending banks
* how banks started playing a predominant role in the economic development of a country
* what are the different types of banks.

7.1 INTRODUCTION

Banks have become part and parcel of modern day living. But what is a bank? Bank is an institution which deals with money. Bank may be compared to a lake. From one side lot of money will be flowing into it in the form of deposits and from another side lot of money will be flowing out of it in the form of loans. Every day many people go to a bank to deposit their savings and many more to get some money from the bank. In one word, bank is a market where money is sold and money is purchased.

Banks function by attracting deposits from the general public. People prefer to keep their money in a bank than at any other place because they are certain theat their money is safe in a bank. This confidence of the people in a bank make them to go to a bank and deposit their hard earned savings in it. This confidence of the people in a bank is the basic prerequisite for the successful functioning of any bank. With he deposits of the general public, the bank strength its business of lending money to the needy. So a bank deals with other peoples, money and makes lot of profit in the process. The secret of their business is they pay less interest on deposits but collect higher interest on the loans they advance.

7.2 ORIGIN OF BANKS

The word "Bank" is supposed to be derived from the German word "Banc" 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 goldsmiths. 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 business activity and was carried on by some members of the society.

Even during the Vedic and Epic eras, banking activity was carried on by the "Vaish" community. In the ancient times, in addition to money changing, the bankers used to float loans for the Government.

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 Street in London represents the locality where the Lombards settled. During the reign of Queen Elizebeth-I, goldsmiths, merchants, private money lenders and money exchangers came into prominence. With the seizure of large gold hoards from the London merchants in 1640 by King Charles-I, 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 of 1833 in England. Thus in the 19th century, the seeds were shown for growth of the modern joint stock commercial banking in different countries.

7.3 ORIGIN OF BANKS IN INDIA

In India our ancient Hindu scriptures provide ample testimony to the existence of money lending activities. Even during the period of the Ramayana and the Mahabharata the money lending activities were carried o... Many references to money lending operations are made in Manu's Smrithi, Dharma Sastras and Arthsasthra. 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 "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.

In 1921 these three Presidency banks were amalgated and the "Imperial Bank of India" came into existence. This bank was nationalised in 1955 and was renamed as "State Bank of India". The "Oudh Commercial Bank" which came into existence in 1881 was the first Indian Bank. The 'Punjab National Bank' and the 'People's Bank' were established in 1894 and 1901 respectively. The "Swadeshi" movement in 1905 gave good encouragement for floating several banks. The Bank of India in 1906, the Bank of Baroda in 1909, the Central Bank of India in 1911, the Indian Bank in 1907 were some of the important banks that were started immediately after the Swadeshi movement. After the first world war, several banks were started but could not survive. The failure of one bank caused the failure of other banks with a capital and reserve of over Rs. 5 lakhs. By 1945 this number increased to 144. The participation of our country in 1947 further affected the working of our commercial banks. At the time of our Independence in 1947 there were 648 commercial banks working with 4,819 branch offices in India. In order to develop banking on sound, systematic and scientific lines a comprehensive act called Banking Regulation Act was passed in 1949.

7.4 ROLE OF BANKING

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 revolution.

i. Banks 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 sizable amount which can be utilised for productive purposes. Thus the idle resources are mobilised and funnelled into productive channels. Savings 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 facilities 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. Banks Promote 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. Banks Provide Finance for Priority Sectors

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

iv. Reduction of 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. Banks Influence Interest Rates

The interest rate in the economy affects 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 over-investment 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. Banks 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.

vii. Banks create credit and help in business expansion

Expansion of bank credit provides funds to entrepreneurs for investment under condition of unemployment it will push up production in the country. But under conditions of full employment expansion of bank credit will have the effect of inflationary pressure. On the other hand a decline in bank credit will result in decline in production, employment, sales and prices. From the point of view of an underdeveloped economy the expansion of bank credit offering more financial resources to industries is one of the contributory causes for rapid economic development.

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.

7.5 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 each credits or overdrafts or loans. They also provide finance by discounting bills of exchange.

ii. Industrial Banks

The 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 and 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 system 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 require 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

The banks are formed to supply credit to members on easy terms. The 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-operative 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 open many branches in different countries and settle the foreign exchange 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

The 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 interest of the nation without any profit motive in its operations.

viii. Indigenous Banks

These form part of an unorganised money market. They lend money for short periods and charge very high rates of interest. They lend money to small traders, farmers, businessmen, etc., against securities. The Indian Central Banking Enquiry Committee defined an indigenous banker or bank as an individual or private firm receiving deposits and dealing in hundies or lending money. They maintain vernacular system of accounts and do not maintain any audited accounts.

7.6 CONCLUSION / SUMMARY

The basic prerequisite for a bank is to command the absolute confidence of the people. People should feel that their money is safe in a bank. They can get it back whenever they need it. More than the rate of interest, it is this confidence of the people that makes a bank to do business successfully. The fact that one should know about a bank is that it deals with other peoples' money.

Bank play a pivotal role in the economic development of a nation by providing capital formation by promoting business,trade and industry and by reducing regional and economic inequalities. One annot imagine the rapid ecohomic development of an underdeveloped country without a dynamic and well coordinated banking system in that country.

Revised by - **Dr. Mallaiah**

7.7 SUGGESTED BOOKS

1. R.S. Sayers : Modern Banking, VI Edition, Chapters 1 and 2.
2. S.K. Basu : A Survey of Contemporary Banking Trends, Part-II, Chapter II.
3. K.P.M. Sundaram : Money, Banking,Trade and Finance, 13th Edition, Part-II, Chapter I.

7.8 MODEL EXAMINATION QUESTIONS

I. Answer the following in about 30 lines.

1. Describe the evolution of Commercial Banks.
2. Explain clearly the role of Commercial Banking in a modern economy.
3. Describe the different types of banks.

II. Answer the following in about 15 lines.

1. Industrial banks and Agricultural banks.
2. Co-operative banks, Exchange banks and Indigenous banks.

UNIT-8: COMMERCIAL BANKS: FUNCTIONS, PRINCIPLES AND CREDIT CREATION

Contents

8.0 AIMS AND OBJECTIVES

The purpose of this unit is to make you understand the functioning of a commercial bank and how it creates credit, how it provides finances to different sections of people and different sectors of an economy.

After a careful study of this unit, you will be in a position to understand -

* the main functions of a commercial banks
* how banks not only deal with money but also manufacture money in the form of credit
* significance of credit creation
* limitations on credit creation.

8.1 INTRODUCTION

The primary function of a commercial bank is to accept deposits from the general public. People prefer to keep their money in a bank because they consider bank as the safest place to do so. This confidence of the people is responsible for a bank to run its business. So accepting deposits and then advancing loans with the help of these deposits are the main functions of a bank. Every banker, by experience knows that only a few of them would come to the bank to withdraw their deposits. If he can keep a small proportion of these deposits with him in the form of cash, that is sufficient to meet the cash needs of those few depositors who came to a bank to withdraw their deposits. The remaining part of the deposits will be made use of by the banker to advance loans to different sections of the people. By this process, a banker will be in a position not only to help himself out also the economy as a whole. This is how a banker creates credit and distributes among the borrower. Thus a bank is an intermediary between depositers and borrowers.

8.2 FUNCTIONS OF COMMERCIAL BANKS

Let us now study in detail the various functions performed by commercial banks. We can broadly devide the functions into two categories :

1. ***Primary or fundamental functions*** : These functions are generally performed by all commercial banks. These include the receipts of deposits and lending of money.

2. ***Subsidiary Functions*** : These functions vary from bank to bank depending upon the Government policy towards banking.

Primary Functions : All commercial banks perform the following functions.

8.2.1 RECEIPT OF DEPOSITS

A commercial bank accepts different kinds of deposits from the public. This is the most important function of a commercial bank. Deposits are of three types.

(a) *Fixed Deposits* : These are deposits repayable after a certain period of time. The rate of interest depends upon the length of the period. The longer the period of deposit, the higher is the rate of interest on fixed deposits. As banks are free to use these deposits during a special period, they grant attractive rates of interest besides providing security of funds. Fixed deposits are also known as time liabilities of the bank. Generally, withdrawal of fixed deposit before the expiry of the specific period is not allowed. However, banks may permit the depositors to withdraw the amount in certain cases after making a reduction in the rate of interest payable on the deposit. Banks advance money on the security of fixed deposits. When bank receives fixed deposits, they issue fixed deposit receipts (FDR) to the depositors. The amount deposited, the rate of interest allowed on the deposit, the date of maturity, withdrawal etc., are mentioned in the receipts. These receipts are not negotiable instruments. Hence they cannot be used like cheques, drafts, bills, etc. The holder of a fixed deposit is not regarded as a customer of a bank as he cannot operate the account from time to time like current account or savings bank account.

(b) *Current Account Deposits* : Deposits on current account are called demand deposits. The depositors are free to operate the account several times. Hence no interest is paid on this account by the banker. As these are repayable on demand without any restrictions, these deposits are also called demand liabilities. Cheques are generally used for withdrawing money from this account. Mostly businessmen make use of this facility as they can avoid the risk of keeping or carrying money with them and issue cheques instead of cash. Generally banks charge some amount as incidental charges for meeting the expenses of maintaining this account.

(c) *Savings Deposits* : Savings deposits are those on which banks place some restrictions on their withdrawal. The interest on these deposits is calculated on the minimum balance maintained during a specified period of each month. Generally the interest rate is very low. Savings deposits are of two types. In the case of ordinary savings deposits, the minimum balance to be maintained is fixed at a low level. For example it is fixed at Rs.100/- by our commercial banks. The depositor does not enjoy the use of cheque facility. He can withdraw money from his account by means of withdrawal forms provided by the bank. In the case of special savings account the banker insists on a minimum amount of balance, i.e., Rs. 250/- to be maintained in the account. The depositor is given the facility of withdrawing money by means of cheques.

In addition to these types of deposits, some commercial banks may receive deposits under the name of thrift deposits, recurring deposits, Kiddy bank deposits, etc. Some fixed amount is deposited at regular periodical intervals in the case of recurring deposits. The amount is accumulated at compound rate of interest. After the expiry of a specified period of time the accumulated principal amount along with the interest is paid to the depositer.

8.2.2 GRANTING LOANS AND ADVANCES

Banks use their surplus funds to grant loans and advances to businessmen and traders against the personal security of the borrowers or against the documents of title to goods, collaterals and marketable securities. Some times, loans are given against the personal security of the borrower with or without surety, depending upon the credit worthiness of the borrower. Mostly banks lend a major portion of their funds for short periods as they receive more deposits for short periods. Commercial banks prefer to finance trade and commerce which require short term funds. Moreover traders and business people may offer higher rates of interest on short term loans. Generally banks lend in four ways, namely, direct loans, over-drafts, cash credits and by discounting bills. The current account holders are given the facility of overdraft by which they are allowed to overdraw their account upto a certain limits fixed by the bank. Interest is charged only on the amount withdrawn but not on the entire amount of overdraft facility. The period of overdraft facility is decided by mutual agreement of the customers and the banker. Bankers do not insist on any security against overdraft facility. Under the facility of cash credit a customer is allowed to borrow money from the bank upto a certain limit against the security of bonds, shares, promissory notes etc.

Discounting a bill of exchange is yet another important method of lending by commercial banks. Goods are sold generally on basis of exchange or Hundies. These are drawn by the seller of goods. The Purchaser puts his signature after accepting the conditions and terms of payment in due course (usually 90 days are fixed as the maximum period with a grace period of 3 days). In the mean time if the seller wants to get money he can get it discounted by his bank. The bill of exchange is a negotiable instrument and can be transferred from person to person. It is a legal document of debt and the debtor cannot deny the debt. Not only the bank but also the buyer and seller of goods get the benefit by using bills of exchange. The banker gets profit by way of discount. The purchaser of goods get the goods without making any payment. The seller gets the money by getting the bill discounted by his bank.

In the process of lending, commercial banks create additional deposits called derived deposits. In the next few pages, we shall discuss this aspect in detail.

Subsidiary Functions

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

8.2.3 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 customer's 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.

8.2.4 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 acts 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 references 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

economic 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.

8.3 PRINCIPLES OF BANKING

Share capital and customers' deposits constitute a major portion of the total capital of a commercial bank. The bank has to use this capital, by properly and productively investing it. This is called the investment policy of commercial banks. A prudent banker invests his funds so as to maximise profits to shareholders, while providing adequate liquidity and security to depositors at the same time. There are no hard and fast rules for investment of funds. As economic conditions differ from country to country, the investment policy is not uniform in all countries. Moreover the nature of funds also may differ from locality to locality. If long term deposits are received, funds may be invested by granting long term loans. Hence local conditions also influence investment policy. But generally the investment policy of a commercial bank is influenced by three important principles. They are: liquidity, profitability and security.

8.3.1 THE PRINCIPLE OF SECURITY

The most important principle is the safety or security of funds. As the banks act as custodians and trustees of depositors, their interests must be safeguarded at any cost. The banks should not choose risky investments 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 greedy 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 loss of income by bad debts may be compensated by proper recoveries from safe investments. 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 financial position would be endangered. When the funds are diversified and invested in different places, losses at one place may be compensated by gains in other places.

8.3.2 THE PRINCIPLE OF LIQUIDITY

Liquidity is another important guiding principle of investment. Liquidity refers to the ability of banks to pay cash against deposit. 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 in 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 bank.

8.3.3 THE PRINCIPLE OF PROFITABILITY

Banks are influenced by the principle of profitably. 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. Al 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 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.

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 bellow 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 the principle of liquidity and profitability are conflicting and contradictory. Liquidity principle cannot be discarded on the ground of profitability. Similarly security principle cannot 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 conflicting 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.

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 bank is called liquidity ratio. This is determined by several factors.

i. Legal Requirements

The Central bank of of the country may prescribe a certain minimum liquidity ratio applicable to all commercial banks. This is called statutory liquidity ratio. At present in India Commercial Banks are required to maintain 35% of total deposits in the forms of cash and other liquid assets. This ratio is prescribed by the Central Bank from time to time in accordance with the changes in economic conditions of the country. All countries do not maintain any 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 or 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 ration in those countries may be much less compared to underdeveloped countries. Similarly 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 a 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. Possibilities 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 small cash reserves. The withdrawals 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 deposit, banks may have to keep more cash reserves to meet their claims.

vi. Nature of Deposits

The nature of the account also 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 certain 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 country also influence the cash reserves of commercial banks. In a period of rising pricing and inflation, business conditions may be prosperous. A small cash reserve may be sufficient to meet the withdrawals.

ix. Nature of Advance 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.

8.4 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 liabilities. 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.

8.4.1 LIABILITIES

The liabilities 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 capital which is issued to the public for subscription. The subscribed capital is the actual capital subscribed by the public.

Balance Sheet of a Commercial Bank

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

Reserve Fund : This fund is created by transfering a portion of the accumulated profits of the bank. In India 20% of a bank's 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 the 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.

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

Bills Payable : The bills payable will be 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 of 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 adjustments, etc., are shown separately.

Acceptances, Endorsements and other Obligations : The banks accept or endorse the bills of exchange on behalf of their customers. It means they guarantee the payment of bills at maturity. These obligations fall on the liabilities side because banks have to make the payment of maturity.

Profit and Loss Account : The profit earned by the bank is payable to the shareholders. Hence it is also shown on the liabilities side.

Contingent Liabilities : Every bank makes some provision for these liabilities in its balance sheet. These are unforeseeable as they are not known in advance. For example, liabilities may occur when banks have to meet the guarantees given on behalf of customers.

Having discussed briefly the liabilities side of the balance sheet let us turn to assets side of the banks.

8.4.2 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 an asset. 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 life of defence against depositors. Though cash is not an earning asset, to avoid any risky situation it maintains sufficient cash balance to meet the customers' demands. Further, a commercial 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 like 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.

Investments : 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 securities are called gilt edged securities. As there are no risks of loss, banks prefer investment in Government bond 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 purchasing power in the economy. These loans and advances are given against tangible securities offered by the customers. A bank also lend on the personal security of the borrowers to fulfill its social obligations in helping the economically poor people.

Bills Receivable : Bills of exchange will appear on both sides of the balance sheet. Banks discount the bills of exchange on behalf of the customers. As these bills receive payments they are shown on the assets side. As commercial banks sell these assets easily they are regarded as liquid assets. These bills of exchange may be rediscounted by the Central Bank. If the bills can be shifted to the Central Bank they become more liquid.

Acceptances and Endorsements : These items refer to the obligations which the banker has accepted on behalf of the customers. They represent the total dues of a bank's customers which it has accepted. They 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 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 of such assets within a period of seven years from the date of their acquisition.

8.5 PROCESS OF CREATION OF CREDIT BY COMMERCIAL BANKS

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.

8.5.1 PRIMARY AND SECONDARY 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, the bank credits 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, credit 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 primary 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 additional deposits. As these additional deposits are created from the primary deposits, they are called **derived deposits**.

8.5.2 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.

A. Granting Loans

"Loans create deposits". When a bank grants a loan to its customer it does not generally pay each 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 simple 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".

B. 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. Thus the bank's deposits increase equal to the value of the discounted bill. In this case also the bank creates a deposit without receiving any cash.

C. Purchasing Securities

When a banker purchases Government bonds and securities from a customer it will credit the customer's accounts 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.

8.5.3 MULTIPLE EXPANSION OF CREDIT OR EXTENT OF CREDIT CREATION

The bank 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 be 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 surveyors 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 debts 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 f 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 (20%) 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 debting 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' which is as follows :

Balance Sheet of Bank 'B'

Liabilities	Rs.	Assets	Rs.
Deposit	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.
Deposit	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 of bank 'C' as follows :

Balance Sheet of Bank 'C'

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. 2,000 including the original deposit. It means the banking system could create or manufacture additional deposits or **derived deposits** of Rs. 1,600 with a primary deposit of Rs. 400.

In the same way, eventhough Rs. 1,600 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. 1,600 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. 1,600 crores granted which is equal to Rs. 320 crores. Thus these idle balance of Rs. 320 crores lying idle with the banks will become active when Rs. 1,600 crores of rupees deposits will answer the claims of derived deposit holders to the tune of Rs. 1,600 crores as they require only about 20% or 1/5th of the total derived deposits. Rs. 80 crores of 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 but they collect a higher rate of 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. 1,600 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 create Rs. 4,000 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 create 4 rupees credit or Rs. 400/- deposit creates Rs. 1,600 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. 1,600 crores in the deposit credit ratio of 1:4. Including the original deposit the total deposits would grow from Rs. 400 crores to Rs. 2,000 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.

8.5.4 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 $\frac{1}{20/100}$ or $\frac{1}{1/5}$ or 5 times. If it is 25%

deposit multiplier will be equal $\frac{1}{25/100}$ or $\frac{1}{1/4}$ or 4 times. If the percentage cash reserve is lowered to 10% the deposit multiplier is $\frac{1}{10/100}$ or $\frac{1}{1/10}$ 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"

8.6 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 Liquidity Ratio and Net Liquidity Ratio (NLR) of the commercial banks. If the reserve ratio is increased by the Central Bank, 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 transaction 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 case 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.

The power 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 held 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 banks' 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 do not 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 incharge 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.

8.7 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 capitalists 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 enable 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 assumed such an important role that it is very difficult for us to imagine the functioning of a modern economy without credit.

8.8 CONCLUSION / SUMMARY

Accepting deposits, granting loans and discounting bills are the main functions of a commercial banks. In addition to these functions, banks also perform some agency services like collecting pay cheques, drafts and bills on behalf of their customers. They also perform some general utility services like providing locker facilities for safe keeping of valuables, jewellery and documents at a nominal charge.

Liquidity, profitability and security are the three main principles of banking. Though these principles sometimes clash with each other, an experienced banker know how to bring about a harmonious balance particularly between liquidity and profitability. A banker must give top priority to the principle of security because it is this principle which keeps the confidence of the people in a bank intact. If this confidance of the people about the safety of their money in a bank is shaken or gets disturbed, no bank can survive.

Banks are in a position to grant more loans than the deposits they have at their command. This capacity of the commercial banks is known as process of credit creation. This theory of credit creation by commercial banks is based on the assumption in that the loan granted by one bank leads to an increase in the deposits of another bank. This assumption is realistic in the modern economies because there are a very good number of banks and these banks are in a position to influence one another. If this assumption is only imaginary the theory of credit creation by commercial banks goes to pieces.

The credit created by commercial banks helps to bring a rapid economic development of a country by providing finances to agriculture, industry, etc. But too much credit creation generates inflationary pressures in the economy. Hence credit creation should always under effective control by centrally bank.

Revised by - **Dr. Mallaiah**

8.9 SUGGESTED BOOKS

1. R.S.Sayers : Modern Banking, VI Edition, Chapters 1, 2 & 8.
2. Manning Dacey : British Banking Mechanism, Chapters 2 & 8.
3. K.P.M.Sundaram: Money, Banking, Trade and Finance, Part - II, Chapters 2 & 3.

8.10 MODEL EXAMINATION QUESTIONS

I. Answer the following in about 30 lines.

1. Distinguish between Primary and Secondary deposits. How do banks create secondary deposits?
2. What are the main functions of commercial banks?
3. "Loans create deposits" Discuss.
4. Explain the main banking principles.
5. Why a balance sheet of a bank always balances?

II Answer the following in about 15 lines.

1. Explain how a banker strikes a balance between liquidity and profitability.
2. What are the main assets and liabilities of a commercial banks?
3. What are the limitations on credit creation?
4. What are the advantages of credit creation?

UNIT -- 9 : INDIAN BANKING SYSTEM

Contents

9.0 AIMS AND OBJECTIVES

The purpose of this unit is to explain the nature and growth of Indian Banking System and the different constituents of Indian money market and recent trends in Indian banking system.

After studying this unit you will be able to understand :

* Nature of Indian Money Market and its defects
* Indigenous bankers and their importance in Indian money market and the defect of Indigenous bankers.
* Nature and growth of Indian Commercial Banks.
* Circumstances which led to the nationalisation of Indian Commercial banks and the progress made by commercial banks after nationalisation.

9.1 INTRODUCTION

Bank is a plan where transactions in money take place. So all the banks put together may be called money market. Before analysing the Indian banking system, we have to understand the basic features of Indian Money Market.

Indian money is characterised by its dychotomy -- that is, on one side we have a highly organised and modern banking system and on the other we have a crude and an unorganised sector in the form of indigenous bankers. The organised sector comprises of all the commercial banks. All the big commercial banks were nationalised in 1969. After nationalisation there were far reaching changes in the growth, composition and policies of Indian commercial banks.

9.2 MONEY MARKET

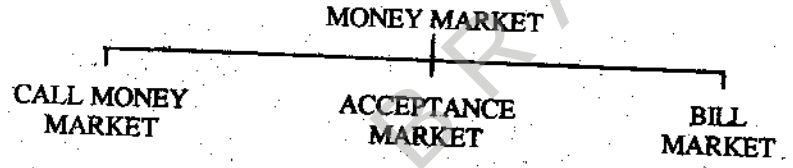
The term money market refers to a market in which short term funds are borrowed and lent. The money market does not deal in cash or money, but in trade bills, promissory notes and government paper which are drawn for a short period. In other words, the money market is a place where short term funds are bought and sold. According to Madden and Nadder " Money market is a mechanism through which a short term funds are loaned and borrowed and through which a large part of financial transactions of a particular country are cleared". A more satisfactory and convincing definition of money market is offered by Prof. Crowther. He says that "the money market is the collection name given to various firms and institutions that deal in the various grades of near-money". Short term bills are known as 'near-money". Thus it is clear from the above definitions that money market is a reservoir of short term funds are accumulated and made available to those who need financial accomodation for a short period. 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.

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 ar 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.

At this stage it is desirable to know the distinction between the money market and the capital market. While the money 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 specialised institutions dealing only in long term finances and others dealing only in short-term funds.

9.3 COMPOSITION OF THE MONEY MARKET

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 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 from 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 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 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 the London money market, there are specialised firms dealing in banker's acceptance. They are known as Acceptance Houses.

9.4 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 brought 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 accomodation to the commercial banks in the country. The bills are normally of 91 days duration. All the discounting and re-discounting is undertaken in this market.

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 guaranteeing of 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. It controls and guides the institutions working in the money market. Therefore, the performance of the Central Bank in a country is ultimately dependent upon the character and composition of the money market.

9.5 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 Co-operative Banks.

The unorganised sector is comprised of the indigineous 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 1) The Call-Money Market, 2) The Collateral Loan Market and 3) 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 vide variations in the rates of interest charged in Bombay and Calcutta markets. The Indian call money market experiences two seasons. 1. Slack season (May-October) and 2. 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 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 beings constantly made by the monetary authorities to develop a good bill market in our country.

9.5 FEATURES OF INDIAN MONEY MARKET

i. Lack of Integration

One of 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 advances to be given, etc. The R.B.I. is fully effective in the organised sector of the money-market. Both the commercial and co-operative banks have to rely more and more on the re-discounting 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 do not submit to the control of the Reserve Bank. 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 short coming 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 Different 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 Market

The Indian money market experiences seasonal monetary strigencies 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 well 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.

9.6 R.B.I. AND THE INDIAN MONEY MARKET

The earlier 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 posses 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.

9.7 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. (1) Those who do banking business only (2) those who carry on trade and banking business and (3) those who are principle 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 under-take any banking business. The committee is of the opinion that the acceptance of deposits is a necessary condition for calling any one an indigenous banker. But in practice, many indigenous bankers do not accept deposits. Hence, this condition cannot be considered as an essential prerequiste for calling a person an 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 branches are managed by their agents, known as Munims or Gumastas who are known for their honesty, industry and efficiency. They submit periodical returns and reports to the head office and get instructions from them from time to time.

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.

There is no proper co-operation between various classes of indigenous bankers and they are united only by strong communal feelings.

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.

These 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.

The volume of deposits received by indigenous bankers have 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 accommodation from the State Bank and Joint-Stock Banks on demand of promissory notes, drawn by approved bankers or discounting Hundies 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 surities. 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 Indigenous 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 upto 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 indigenous 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.

9.8 DEFECTS OF THE INDIGENOUS 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 land. 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 indigeneous bankers do not care for repayment of the principal amount as long as they recover the interest regularly. This 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 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 owe 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 a 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.

9.9 INDIGENOUS BANKS AND THE RESERVE BANK OF INDIA

Though indigenous banks have been playing a prominent role in the country from time immemorial, 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 Reserve 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 Reserve 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 :

1) The indigenous bankers should confine themselves to the banking business properly. They should give up their trading and commission business within a reasonable time.

2) They should maintain proper books of account in a recognised manner and should get the books of account audited by qualified auditors.

3) They should switch over to the western type of accounting and banking.

4) The should submit periodical reports of their accounts and activities to the Reserve Bank of India.

5) They should develop the deposit side of their banking activity.

6) They shoud have a minimum working capital.

7) The ambiguous system of Hundis should be given up. It must become a negotiable instrument.

8) The indigenous bankers should play the role of a discount house as in London.

9) 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 banker refused to accept the above conditions. They were unwilling to separate the banking business from other business activities. They also disagreed with the 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.

9.10 INDIAN COMMERCIAL BANKS

Indian banking today has made a parallel advance with national aspirations. A system which was mainly colonial in nature till independence and confined credit activity to commerce and export houses, soon refashioned itself and began 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. But in certain respects the Indian money market is more highly developed than its counterparts in many other countries, excepting U.K. and U.S.A. However, in India, indigenous bankers and money lenders still occupy an important place. They are still financing about 50% of the internal trade and agriculture.

1. Classification of Commercial Banks

The Commercial Banks at present can be classified as (i) Scheduled Banks (ii) Non-Scheduled Banks (iii) Licenced and Unlicenced Banks (iv) Foreign Banks (v) Merchant Banks and 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 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 are not being conducted or not likely to 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 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 R.B.I. may direct the inclusion of the bank in the second schedule. A bank which had been scheduled, but later fails to comply with any of the conditions described above or goes into liquidation will have to cease to carry on banking business.

ii) 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 reserve of not less than one lakh rupees have been brought within the regulatory provisions of the R.B.I. Consequently name of the Banking Companies Act was changed into Banking Regulation Act.

(i) 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 14 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 obligations. 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 in 90 days. These almost taken for general banking purpose. Section 18 provides for facilities to meet abnormal requirements of scheduled banks. This would be 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, he scheduled banks bear the following obligations.

(i) 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. (ii) 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.

(ii) Status of 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 sized institutions which restrict the 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 reserve is 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-Schedule 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 licencing 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 a 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 incorporate 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 exchange 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 division.

9.11 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, indusrialisation 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 was to break up such associations. The banks in India merely acted as depositors of community savings and let such savings to needy investors who were acceptable to them according the 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 financed 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 borowers 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 this 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. As regards the sources of mobilisation, an illustrationwill give some idea about the tardy progress made by the Indian banks. The RBI, as leader of the commercial banks tried from time to time to impose some discipline through credit controls, inspection licencing 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 frame work 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 professionalisng 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-oreintation in the lending policies of the banks. (2) the appointment of non-industrialists, as full time chairmen of banks, having deposits of Rs.25 crores or more, with the previous approval of the Reserve Bank. (3) to prohibit all advances and guarantees by bankers to director 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.

1. 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, requirement of personnel and review of existing legislations. The recommendations on which the government took a final decision are summerised below :

i) *Bank's operating method 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 Commissioner 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.

2. The Emergence of Public Sector Banking

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, Saurastra 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 and one-third of the total bank officers 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 officers came under the state sector. Another 6 banks namely the Andhra Bank, the Corporation Bank, the Vijaya Bank, the New Bank of India, the Oriental Bank of Commerce, and the Punjab and Sind Bank 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 20 point 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.

2. The Lead Bank Scheme -- An Area Approach

Sugggestion 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 alloted 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 alloted 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.

3. 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 saving 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 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.

9.12 NATIONALISATION OF BANKS

Opinion was crystallised in favour of nationalisation as far as Central 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 function more effectively than those under private management. But the critics of nationalisation state that the evils that are associated with Government departments also percolate into commercial banks. These evils are generally described as red-tapism and rigidity.

On the other 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 nationalisation of commercial banks should be the last but not the first step for this purpose.

The suporters 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.

1. 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, the bank credit to

industry increased from 14% during the First Five Year Plan to 79.2% during the Third Five Year Plan. Agricultural sector accounted 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 nationalising 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 secure without taking over the banks into public ownership.

Consequently National Credit Council was set-up on 22.13.1967 to assess periodically the available resources of credit and to ensure its equitable 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, co-ordinated lending and investment policies of commercial and co-operative 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.

2. Nationalisation 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 and utilisation for productive purposes in accordance with our plans and 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 Rs.50 crores and more. Consequently the Banking Companies (Acquisition and Transfer of Undertakings) Act of 1970 was passed. The 14 nationalised Banks are Alahabad Bank, Bank of Baroda, Bank of India, Bank of Maharashtra, 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: i) 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 and 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.

9.13 PROGRESS OF COMMERCIAL BANKS AFTER NATIONALISATION

Nationalisation of banks in July 1969 changed the complexion and dimensions 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, cottage and rural industries, self-employed persons, artisans, weaker sections of the society, small traders and other persons of small means.

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 network 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.

Table -1 : Branch expansion of nationalised banks

	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	17.6	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 Mobilisation

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 the the potential rural depositor. The banks have to tailor the scheme to match convenience, preferences and the needs of the rural depositor to be able to exploit the untapped rural savings. Besides this, in a vast country like ours, 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 top 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 Co-operatives, 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 :

Table - 2 : Bank Advances to Priority Sectors (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 caterings 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 field 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 can't be solved until bankers adopt a constructive attitude which would facilitate the attainment of the social objectives of bank nationalisation. So the bankers have to consider the technical soundness, commercial feasibility, financial profitabilitie, 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 industrialists and artisans in the country-side regarding the establishment of industries and their unorganised nature. In addition, rural industrialists experience problem relating to absence of continuous supply of raw materials and potential market facilities. Hence banks have to help

the industrialists in setting up of the units, in securing raw materials 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, re-scheduling of repayment of loans and the like.

v. Self-Employment

Banks have also been helping self-employed persons as 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 entrepreneurs 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 entrepreneurs have been facing a variety of problems due to commercial and unsympathetic attitude of bankers. Bankers in order to help the disappointed young unemployed have to give up their time consuming procedural formalities, liberalise the terms and conditions in addition 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 increased from Rs. 5.5 crores in June 1969 to Rs. 820 crores in June, 1981.

b) Retail Trade and Small Business

Individuals, firms or co-operative societies engaged mainly in trading acitivites other than in fertilizers and with annual turnover not exceeding Rupees one lakh are eligible for loans under this scheme. Loans granted by banks under this scheme increased 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 during June, 1969 to June, 1981.

The Commercial banks have to strive further with all sincerity to achieve the objectives for which they have been nationalised.

9.14 SUMMARY / CONCLUSION

Indian money market shows many features of an undeveloped money market. There is a vast unorganised sector in form of indigenous banks. Reserve Bank of India introduced many reforms in the field of undigenous banks to bring them into manistream of modern banking system. Reserve Bank of India had also introduced schemes like Lead Banks to tap the rural deposits and to provide financial assistance to rural sector.

Revolutionary changes were first Indian banking system after 14 major commercial banks were nationalised in 1969. Bank branches are now being opened in many rural areas. Small Scale Industries, agriculture, rural artisans, and many other weaker sections of the society are provided credit facilities after commercial banks were nationalised.

Revised by - **K. Sateesh Reddy**

9.15 SUGGESTED BOOKS

1. S.R.K. Rao : The Indian Money Market, Chapters I, III, IV and XI

2. K.P.M. Sundaram : Money, Banking, Trade and Finance Part V and Chapter - II

9.16 MODEL EXAMINATION QUESTIONS

I. Answer the following in 30 lines.

1. Examine the role of indigenous bankers in Indian money market and suggest measures to link them up with organised sector of money market.
2. What are the main features of Indian money market.
3. Why did Government of India nationalise resort to nationalisation of leading banks in 1969? What are changes that were brought in the banking system after the nationalisation.

II. Answer the following in 15 lines.

1. What are the main constituenty of money market.
2. Critically examine the lead Bank Scheme in India.
3. Explain the problems faced by commercial banks in financing the small scale industries.

UNIT-10 : CENTRAL BANKING - PRINCIPLES & FUNCTIONS

Contents

10.0 AIMS AND OBJECTIVES

The unit explains the necessity of a Central Bank and principles, functions and role of the Central Bank.

After reading the unit, you will be able to

* discuss the principles of Central Bank,
* analyse the functions of the Central Bank,
* describe the role of Central Banks in developed and developing money markets and
* distinguish between central banking and commercial banking.

10.1 INTRODUCTION

The Central Bank of any country, as the very name implies, occupies the central position to 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 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 Netherland's 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 Finance Conference held at Brussels in 1920 encouraged all countries without a central bank, to establish such banks in their countries in the interest of world co-operation and stability of monetary and banking systems. The establishment of the International Monetary Fund (I.M.F.) in 1944 gave further fillip to

the growth of central banks in the new Afro-Asia 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.

10.2 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 essential duty of which is maintenance of stability of the monetary standard which involves the control of the monetary circulation". According to M.H. Dekock 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, pointed out that the business of a central bank as distinguished from a commercial bank is to control the commercial banks in such a way as to promote the general monetary policy of the state. From the various definitions, we 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.

10.3 PRINCIPLES OF CENTRAL BANKING

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.

10.4 FUNCTIONS OF CENTRAL BANKS

Central Banks in all countries perform the following functions inspite of differences in social, political and economic systems. These functions are described as traditional functions of the central bank.

10.4.1 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 prerotative 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 contract 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.

10.4.2 BANKER, AGENT AND ADVISER TO THE GOVERNMENT

Another important function of a central bank is to act as the banker, agent and adviser to 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 accounts; 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 change. 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. Cut in performing these services, unlike commercial banks, the central bank is mainly guided by the nation's welfare motive ant 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 people pay taxes the supply of money in circulation decreases. When Government it manages public debt and Government accounts. 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 policies. It plays an important role in advising the Government in the preparation of the budget. It floats the loans and receipts 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.

10.4.3 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 traditions". 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 percent 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, commercial 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 a 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. 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 upto 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. 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.

10.4.4. 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 take 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 and gold and Rs.85 crores worth of foreign securities against its note issue and deposit liabilities. This amount of reserves is immobilised in the central bank and cannot be used for meeting any international transaction. 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.

10.4.5 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 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 whereas 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 lesson.

Check Your Progress -- I

1. What is Clearing House ?

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10.5 ROLE OF THE CENTRAL BANK IN DEVELOPED & DEVELOPING MONEY MARKETS

As a 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.

10.5.1 ROLE OF THE CENTRAL BANK IN A DEVELOPED MONEY MARKET

In a developed money market the various sub-markets quickly respond to central bank policies. The organised money market is highly sensitives 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 co-ordinated the central bank exercised direct control over the entire monetary system and enforces its policies 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, arise 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 market. 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 siphoned off 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 more organised a money market, the greater is the smoothness with which the central bank can exercise control over the banking system.

10.5.2 ROLE OF 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 under-developed 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 under-developed 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 extent 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 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 facilities 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.

10.6 RELATIONSHIP BETWEEN CENTRAL BANKING AND COMMERCIAL BANKING

10.6.1 SIMILARITIES

i. *Both Deal in Money :* 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. *Both Create Credit :* By rediscounting the bills of commercial banks credit may be created by central banks whereas commercial banks create credit on the basis of primary deposits.

iii. *Both do not lend against Immovable Property :* 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.

10.6.2 DISSIMILARITIES

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:

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 bank 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 with the maintenance of foreign exchange rates/

vi. *Their 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 difference 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. Hence 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.

10.7 SUMMARY / CONCLUSION

Central bank is the apex banking institution controlling the activities of the money market in a country. The main principles of the central bank include national welfare, maintaining financial and monetary stability, etc. The major functions are monopoly on note issue, banker and advisor to the Government, banker to the banks, custodian of nation's reserves and controller of credit.

The central banks have to play important role in developed money markets. Their role in underdeveloped money markets should be positive and dynamic in the development of an efficient monetary system. They have a few similarities with commercial banks like dealing in money and creating credit. But in many aspects like note issue, profit motive, foreign exchange transactions, etc, the central banks have major differences with commercial banks.

Revised by - K. Sateesh Reddy

10.8 SUGGESTED BOOKS

1. De Kock M.H. : Central Banking
2. Shaw W.A. : Theory and Principles of Central Banking
3. San S.N. : Central Banking in Underdeveloped Money Markets

10.9 MODEL EXAMINATION QUESTION

I. Answer the following questions in about 30 lines each.

1. What are the functions of a Central Bank?
2. Give an account of the growth of Central Bank.
3. Compare Commercial Banking with Central Banking.

II. Answer the following questions in about 15 lines each.

1. How does the Central Bank control the Commercial Banks in serving as a Bankers' Bank?
2. What is Central Bank? What are its principles.

UNIT-11 : RESERVE BANK OF INDIA - FUNCTIONS AND WORKING

Contents

11.0 AIMS AND OBJECTIVES

The purpose of this unit is to analyse the circumstance that led to the establishment of the Reserve Bank of India and to examine its various functions.

After reading the unit you will be able to --

* discuss the necessity of the Reserve Bank of India and,
* explain the functions of the Reserve Bank of India.

11.1 INTRODUCTION - NEED FOR ESTABLISHING R.B.I.

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.

The object of establishing the Reserve Bank was to regulated the issue of Bank notes and 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 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. 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 credit policy suitable for the country.

State Governments. It advises them regarding the amount and time of floating such loans. The Reserve Bank also sells Treasury bills whenever deemed necessary on behalf of the Central Government by tender at the weekly auctions. To provide short-term investment facilities to the State Governments, semi-government bodies and foreign central banks, the Reserve Bank also issues *adhoc* Treasury bills. All these bills have a currency of 91 days. It also makes ways and means advances to the central and state governments.repayable within 3 months from the date of making such advances. The central government often seeks Bank's advice on matters relating to the floatation of new loans, investment of funds, agricultural credit, co-operation, industrial credit, financial aspects of planning and development etc. There is naturally a close liasion between the Governor of the Reserve Bank and the Finance Ministry of the Central Government. The Reserve Bank acts as a government banker and all accounts are being adjusted in it.

11.2.3 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 rate, 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 borrowings as well as the total supply of credit. The bank rate has been changed by Reserve Bank several times to regulate the credit granted by commercial banks. It increased from 3% in November 1935 to 10% in July 1981 and further to 11% in July 1991.

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.

ii. Open Market Operations

Open market operations consist of selling and buying of eligible securities by the Reserve Bank in the open market to affect a change in the volume of money in circulation. Prior to Second World War, the extent of 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, primary 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 used in India because of the peculiarities in the institutional and structural frame work 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 percent of the total Demand and Time Liabilities. This rate could be raised by the Reserve Bank upto 15 percent. This instrument was used for the first time in 1960. The cash reserve ratio was raised from 3 to 5 percent with effect from June 16, 1973 and after undergoing some fluctuations, it was fixed at 7 percent with effect from 11th June, 1982. However, from 1983 it was continuously raised. In one year i.e., 1988, it was increased two times. Over the past 3 years it remain unchanged at 11%.

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 the 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 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.

11.2.4 BANKER'S 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 percent of its total Demand and Time Liabilities. The Reserve Bank has the power to increase the cash reserves upto 15 percent 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 they 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 India; 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 deposit receipts; vi) the amount of advances in India; and vii) the bills purchased and discounted in India. 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 rediscounting of eligible bills or in the form of loans and advances against eligible securities. The type 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.

11.2.5 CUSTODIAN OF FOREIGN EXCHANGE RESERVES

The Reserve Bank of India has the responsibility to maintain the official rate of exchange. After India became a member of the International Monetary Fund, the Reserve Bank of India assumed the responsibility of maintaining fixed exchange rates with all other member-countries of the IMF. The Reserve Bank of India buys and sells foreign exchange from authorised persons at rates of exchange fixed by the Government. Besides maintaining the rate of exchange of the rupee, the RBI holds India's reserves of international currencies. Finally, the Reserve Bank administers the exchange controls of the country.

11.2.6 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. With the setting up of the National Bank for Agricultural and Rural Development (NABARD) on July 12, 1982 the major functions of the Agricultural Credit Department of the Reserve Bank were taken over by the former. 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.

11.2.7 DEVELOPMENTAL AND PROMOTIONAL FUNCTIONS

Now the Reserve Bank performs many developmental and promotional functions, which were earlier considered outside the purview of the central banks. Now, Reserve Bank attempts to mobilise savings through banks and other financial institutions for productive purposes. It is trying to reduce the dependence of the people on indigenous bankers and money lenders. The Reserve Bank with the objective of providing security to depositors took initiative to establish the Deposit Insurance Corporation of India in 1962. In order to mobilise savings, it played an active role in the establishment of the Unit Trust of India (UTI) in 1964.

11.3 SUMMARY / CONCLUSIONS

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.

Revised by - K. Sateesh Reddy

11.4 SUGGESTED BOOKS

1. Suraj B. Gupta : Monetary Economics -- Institutions, Theory and Policy (Chs. 4 & 19)
2. Reserve Bank of India. : Functions and Working of the Reserve Bank of India, 1983
3. Bhatter and Sheo Kessan : The Reserve Bank of India and its Functions

11.5 MODEL EXAMINATION QUESTIONS

I. Answer the following in about 30 lines.

1. What are the various functions performed by Reserve Bank of India?
2. Examine the role of the RBI as banker to the banks and to the Government.
3. What are the various methods of credit control adopted by the RBI?

II. Answer the following in about 15 lines.

1. What is the system of Note-Issue followed by Reserve Bank of India?
2. Give a brief account of the circumstances that led to the formation of the Reserve Bank of India.

UNIT-12: MONETARY POLICY: OBJECTIVES AND INSTRUMENTS (WITH SPECIAL REFERENCE TO INDIA)

Contents

12.0 AIMS AND OBJECTIVES

The purpose of this unit is to explain the objectives and instruments of monetary policy in general and explain credit controls followed in India in particular.

After reading the unit, you will be able to

* analyse the necessity of controlling the credit,
* explain the meaning and objectives of monetary policy,
* discuss the monetary policy followed by R.B.I.,
* describe the instruments of monetary policy,
* critically examine the quantitative methods of credit control,
* discuss the different methods of selective credit control, and
* distinguish between general and selective credit controls.

12.1 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.

12.1.1 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.

12.1.2 SPECULATIVE 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.

12.1.3 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.

12.1.4 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 1933. Thus history is full if instances to show that uncontrolled expansion of credit can harm the interest 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 total volume of credit for the smooth functioning of the economy.

12.2 MEANING AND OBJECTIVE OF MONETARY POLICY

The policy followed by a central bank to control credit is known as monetary policy and it forms part of the economic policy 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". The traditional objective 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 objectives have been pursued among which the important ones are the following --

a) Maintenance of stable exchange rates
b) Maintenance 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

Let us discuss these objectives in some detail.

12.2.1 MAINTENANCE OF STABLE EXCHANGE RATES

This is the traditional objective of monetary policy when gold standard was followed. The reasons 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 unpleasant effects like speculation in the foreign exchange market.

However, stabilisation of foreign exchange rates 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.

12.2.2 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 level 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, however, 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 businessmen, with the result that production stagnates and (iii) it does not guarantee stability of business conditions.

12.2.3 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 takes place in the price level, they can be treated as resulting from the changes in 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 an increase in the supply of goods would lead to a fall in the price level and a decrease in the supply of goods would 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.

12.2.4 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 opportunities. 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 excess 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.

12.2.5 MAINTENANCE OF BALANCE OF PAYMENTS EQUILIBRIUM

Another important objective of monetary policy is to secure balance in a country's external payments 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 in the country. However, the success of the bank rate depends upon the extent to which it can attract short-term funs into the country, and sustain the confidence of investors abroad in the currency of the country concerned.

12.2.6 ASSISTING ECONOMIC DEVELOPMENT

This objective is more relevant in developing countries as they are poised for achieving accelerated economic development through full utilisation of the available material and human resources. Since capital scarcity is the major stumbling block in the economic progress of developing 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.

12.3 MONETARY POLICY OF RESERVE 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 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, 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. Apart from exercising 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 creating capacity has increased considerably. The developmental financing in each successive Five Year Plan is increasing to create an inflationary impart. 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.

12.4 METHODS OF CREDIT CONTROL

The methods of credit control employed by central banks 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 central bank 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 the bank credit, the latter influence the flow of credit to only specified sectors of the economy.

12.4.1 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.

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.

12.4.2 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.

Check your progress -- 1

1. What is the necessity of a central bank to control the credit?

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2. What do you mean by monetary policy?

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3. List the major objectives of monetary policy.

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4. What are the methods of credit control and what is the major distinction between the two?

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5. What is the objective of neutral money policy?

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12.5 QUANTITATIVE CREDIT CONTROL

Quantitative credit control refers to all those measures taken by the central bank to regulate the total quantity of credit created by the commercial banks. The purpose of these measures is to expand or contract the total volume of credit in the country. There are three major quantitative methods, viz., Bank Rate Policy, Open Market Operations and the Variation of Cash Reserves. Let us deal with them in detail.

12.5.1 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. Reserve Bank of India Act defines bank rate 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 of 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 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.

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. Hawtrey and J.M.Keynes have expressed different view in this regard. Let us study these two approaches.

Theories of Bank Rate

Hawtrey's Approach : In his two books, 'Art of Central Banking' and ' A Century of Bank Rate' Hawtrey explains the way in which the bank rate influences the economic activity by bringing about changes in employment, investment, incomes and prices. Hawtrey emphasises the influence of bank rate on short term rate of interest and the demand of dealers for holding stocks of goods. According to him rise in the bank rate followed by a rise in the market rates will increase the cost of holding the stock of goods as these stocks are financed by short term loans. Hence businessmen prefer to sell away the stocks of goods to pay off their standing loans from banks. Businessmen may tend to sell their stocks rather than to purchase them. As a result, producers may have to curtail their production due to a fall in demand. Investment, employment and incomes may fall along with the demand for goods. Fall in demand for consumer goods accompanied by a corresponding fall in demand for capital goods may create deflationary conditions in the economy. Thus contrary situation of inflation created when the bank rate is lowered. Thus according to Hawtrey, changes in bank rate operate in the economy through changes in the short term rates of interest. Hawtrey assumed that the amount of interest changes form an important factor in holding the stocks of goods by businessmen. He also assumed that the businessmen are very sensitive to changes in short term rates of interest. In reality this may not be true. Interest charges may form minute part of the total cost of holding stocks of goods. Moreover businessmen and producers are guided mostly by prospective demand for their goods rather than charges in short term rates of interest.

Keynes Approach : n his book 'Treatise on Money' Keynes emphasises the influence of bank rate changes on the long term rates of interest. According to him changes in production, employment and prices are brought about thorough changes in long term rates of interest which will affect the demand of businessmen for fixed capital goods. He holds the view that the demand for capital goods like machinery depends upon the long term rates of interest. If the rate of profit is constant, a rise in long term rates of interest may reduce the profits and discourage long term investment. Decrease in investment may reduce the volume of credit, production, employment, incomes, demand for goods, etc., creating a deflationary situation. A contrary situation may be created with a fall in bank rate and a corresponding fall in long term rates of interest. Thus, according to Keynes a higher bank rate may increase the long term rates of interest and decrease the level of economic activity. A fall in bank rate may bring down the long term rates of interest and increase the level of economic activity. Keynes assumed that the demand for capital goods is elastic and changes in interest changes will effect the volume of business and trade. In reality it is not true. The demand for capital goods like machinery depends upon the prospective demand for consumer goods rather than changes in long term rates of interest. Moreover businessmen are guided by several technical factors while expanding or contracting the volume of production rather than the changes interest charges as they form a small proportion in the total cost.

Both Hawtrey and Keynes have explained the two different aspects of the same problem. When bank rate changes, both short term and long term interest rates may change and ultimately the level of economic activity may be influenced.

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 brining 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 banking 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. It is also assumed that commercial banks do not possess any surplus cash reserves with them, so they act in accordance with the needs of the desired situation.

Limitations of Bank Rate Policy

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 rigidbut not flexible so as toallow frequent changes in wages, price and incomes of the people. Changes in the bank rate 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 possess 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 independent. 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.

Bank Rate Policy in India

Scheduled banks had rarely approached the Reserve Bank for their credit needs till 1952 due to their traditional reluctance to approach the central bank of accommodation, and also due to the easy money conditions that prevailed through out that 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.

For the first time, the bank rate was raised from 2 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% in September, 1964; and from 5% to 6% in February, 1965. Bank rate was decreased for the first time from 6% to 5% in March, 1968 to arrest the recession trends in the economy. Again in January, 1971 it was raised from 5% to 6%.

According to the Reserve Bank, the rise in prices is caused by production losses (particularly in the agricultural 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 prices particularly of raw materials and a substantial increase particularly of raw materials and a substantial increase in the production of some industries (such as sugar). Under these circumstances, the monetary measure taken by the Reserve Bank of India alone are not sufficient to produce any significant impact on the economy unless they are accompanies by the necessary fiscal measures also. Realising the need for fiscal measures, the Reserve Bank of India urged the Government to exercise greater control over public expenditure. It is to be noted that a rise 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 of production losses, particularly in the agricultural sector, and supply constraints, 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 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 scheduled 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 borrowings from the Reserve Bank was raised from 15 to 18% thus making borrowings from the Bank costly.

12.5.2 OPEN MARKET OPERATIONS

Open Market Operations refer to the sale and purchase of Government and other approved securities by the central bank and commercial 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 existence 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 charges 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 central 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

i. Open market operations may not be very successful and effective if the people and banks do not have habit of 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 effective.

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 they have a direct and immediate effect on the quantity of money credit-interest, rates, and prices of securities in the economy.

Open Market Operations in India

As a matter of fact, open market operations in India have never taken the role of 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 and during busy seasons. These operations led to an inflationary situation 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 been shifted to sale of securities. This became most pronounced from 1964-65 to 1968-69, during which period the net sales were of the order of Rs.320 crores. Since then, however, the purchases of 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.

12.5.3 VARIABLE CASH RESERVE RATIO

The percentage of cash deposits which commercial banks maintain with the central bank is called the reserve ratio. Commercial banks are compelled to maintain this minimum reserve either by law or by custom. In England the commercial banks maintain about 3% of their total deposit 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 deposit 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.

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.

Limitations

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 posses 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 increased.

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 my 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 reserve kept with the central bank, this method imposes a great financial burden on the commercial banks.

Variable Cash Reserve Ratio in India

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 per cent in September, 1973. These steps were warranted as a credit squeeze device in view of the continuing imbalance in the economy between 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-percent 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 per cent to 5 per cent (with effect from 28th June) and from 5 percent to 4.5 percent (with effect from 14th December) and from 4.5% to 4% (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 estimate 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 percent in 1981 and again reduced in stages to 7 percent (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 percent 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 stipulation was made to neutralise the impact on money supply by the inflow of resources from abroad. It was withdrawn in June, 1979. The rates of interest paid on such deposits has been raised to 6.5 percent 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 per cent 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 per cent later on, and further increased to 34 per cent 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.

Check your progress -- 2

1. What is Bank Rate?

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2. What do Open Market Operations refer?

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3. What is Cash Reserve Ratio?

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12.6 QUALITATIVE CREDIT CONTROL

12.6.1 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 purpose. 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.

12.6.2 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.

12.6.3 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 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 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 lastresort may have to comply with the genuine requests of commercial banks especially in a period of financial crisis.

12.6.4 MARGIN REQUIREMENTS

The difference between the loan value and the market 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 pledge. 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 discourage credit for speculative activity. The 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, oil seeds sugar, etc. Reserve Bank of India has been adopting this method, frequently, in our country.

12.6.6 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 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 credit for the purchase of durable consumer goods can be controlled by the commercial banks to avoid fluctuations in economic activity and maintain stable prices. This method was adopted in 1941 by the Federal Reserve system of USA and is now followed by many developed and underdeveloped countries.

12.6.6 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. Cut 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.

12.7 LIMITATIONS OF SELECTIVE CREDIT CONTROL

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 sizeable portion of the total credit in the economy, 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 discourage 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 banks to distinguish between productive and unproductive credit. The profit motive of commercial 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 restriction on clean credit. Hence margin requirements may be set aside 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 consideration. Many a time, we find the policies of the Central Bank are made subservient to the policies of the Government.

12.8 QUALITATIVE METHODS OF CREDIT CONTROL IN INDIA

Apart from the quantitative methods of credit control, the Reserve Bank has been operating selective 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 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 from 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 purposes 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, etc. and
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 margins 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 amount of not less than 10 per cent of the value of the commodities. This was later extended to cover all foodgrains, pulses, sugar and cotton. In March, 1963 with a view to counteract the boom on stock exchange, 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 company; 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 if 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 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 advances against commodities covered by selective credit controls was raised to 15 percent 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 upto 1980. A further credit squeeze was imposed in 1981, and consequently restrictions were placed on on-food credit. However in 1982, credit was made available to vital sectors of the economy and also for exports.

The effective 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 relevant 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 the price situation might have been some-what worse".

Apart from the above methods of credit control, the Reserve Bank has also been exercising *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 effective.

12.9 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 favour 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.

12.10 AN EVALUATION OF MONETARY POLICY

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 much avail if it is not accompanied 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.

Revised by - K. Sateesh Reddy

12.11 SUGGESTED BOOKS

1. K.N.Raj : The Monetary Policy of the Reserve Bank of India
2. G.P.Gupta : Reserve Bank and Monetary Management
3. The R.B.I. : Review of the working of the Monetary System
4. The R.B.I. : Report on Currency and Finance, 1977-78 and 1986-87

12.12 MODEL EXAMINATION QUESTIONS

I. **Answer the following questions in about 30 lines each.**

1. Briefly describe the weapons of credit control employed by the Central Bank.
2. Describe the different methods of selective credit control. Why have selection credit controls become more important than the quantitative credit controls?
3. Compare the views of Keynes and Hawtrey regarding the economic consequence of variations in the Bank Rate.
4. What is meant by monetary policy? What are its objectives?

5. What instruments of monetary policy have been employed by the Reserve Bank of India, and to what extent they have been successful in achieving their objectives ?
6. Analyse the role of bank-rate policy as a monetary instrument with special reference to India.
7. Make critical assessment of the monetary policy of the Reserve Bank of India and point out the factors responsible for its ineffectiveness.

II: Answer the following questions in about 15 lines each.

1. Explain the need for credit control.
2. What are the major objectives of monetary policy?
3. What is 'reserve ratio'? What is its significance in controlling credit ?
4. Discuss the monetary policy followed by R.B.I.
5. What are open market operations? What are its limitations?
6. Explain the following selective methods of credit control

   (a) Moral sausion (b) Margin requirements
7. What are the limitations of qualitative credit controls? How effective are they in India?

UNIT-13 : MONEY MARKET IN DEVELOPED AND DEVELOPING COUNTRIES

Contents

13.0 AIMS AND OBJECTIVES

The purpose of this unit is to explain the concept of money market, its importance and functions. We also learn how a developed money market in a developed country differs from the money market of an underdeveloped country.

After reading this unit you will be able to explain :

* the meaning of money market,
* difference between money market and capital market,
* functions and sectors of money market, and
* what is a developed market and how it differs from an unorganised money market in a developing economy.

13.1 INTRODUCTION : MEANING OF MARKET

In general English 'market' means a place where sellers and buyers meet to exchange goods. But in Economics, 'market' does not refer to a place where exchange of commodities takes place. It refers to the contact between sellers and buyers of one commodity or service. Thus we have wheat market, gold market or labour market and so on. The sellers and the buyers of wheat who stay at different places, but maintain contact through some means of communication such as letters, phone, telex etc., will constitute a market. In this way we have different markets - foreign exchange market, commodity markets, labour market, share market, bill market, money market, capital market etc.

13.2 MEANING OF MONEY MARKET

Let us learn about money market. Money market refers to the demand for and supply of short term loans. In other words, it refers to the totality of financial institutions which deal with short term funds in the economy. Those who are willing to lend and those who are willing to borrow short term funds put together we will get what we call money market. If a loan is to be repaid within 15 months, it is called short term loan. Individuals and institutions and such others lend and borrow money/ funds even for a day, a week, a month for various purposes and not necessarily for longer periods extending for a year or so. The borrowers in the money market are generally merchants, traders, brokers, manufacturers, speculators and even government institutions. The lenders in the money market, on the other hand, are commercial banks, insurance companies, non-bank financial concerns and the Central Bank of the country. Thus money market consists of all institutions engaged in the operation of short period finances. The Central Bank, the commercial banks, discount houses, bill brokers, acceptance houses etc., are the institutions which constitute a money market. In this way it represents short term requirements of the economy. As noted above the money market does not refer to a particular place where money is borrowed and lent by the parties concerned. It is not necessary for the borrowers and lenders to establish personal contact with each other at some definite place. They may carry on negotiations though mail or telephone.

13.3 MONEY MARKET AND CAPITAL MARKET

The term Money Market may be distinguished from the term Capital Market. The Money Market deals only with short term finances, whereas the capital market deals with long term funds. Though the functions of the two markets are different, yet they may be closely related with each other. In fact there may be some short of over lapping between the two markets. The financial institutions, atleast some of them may be common to both the markets. In other words, such institutions may be dealing with both short term as well as long term finances.

13.4 CONSTITUENTS OF MONEY MARKET

The following are the constituents of the Money Market.

13.4.1 CENTRAL BANK

The Central Bank is the Principal institution in a Money Market. It supplies short period loans to other members of the Money Market and the government. It issues credit instruments like bank notes. Bank notes constitute the bulk of purchasing power of the country. The Central Bank also controls the credit activities of other commercial banks. Hence a Central Bank exercises great influence in the Money Market of any country.

13.4.2 COMMERCIAL BANKS

These are the most important institutions working in the Money Market. They take short period loans from the public in the shape of deposits and give short period loans to the people who need them. These banks supply credit to the traders and manufacturers.

13.4.3 DISCOUNT HOUSES

In all advances countries loans are granted by discounting bills. This is a convenient way of advancing loans for a short period. There are institutions called discount houses. Their main business is to purchase bills. They also take short period loans from the commercial banks for carrying on this discount operations.

13.4.4 BILL BROKERS

These institutions work as agents. They bring together the sellers and buyers of the bills and get commission for their services. Sometimes, they also directly discount the bills.

13.4.5 ACCEPTANCE HOUSES

Acceptance house accept bills on behalf of their customers. These institutions play an important part in international trade. The foreign importers make credit arrangements with the acceptance houses and exporters draw bills on the foreign importers. Bills accepted by these institutions can be readily discounted in the Money Market. Before the bills fall due, the acceptance houses collect the bill amount from the importers and meet the bills. They charge commission for their services from the importers.

13.4.6 NON-BANKING FINANCIAL INSTITUTIONS

Insurance companies and business corporations having surplus short term investible funds also lend to the borrowers in the Money Market.

13.5 FUNCTIONS OF MONEY MARKET

Money Market performs the following functions :

1) The Money Market pools together the surplus funds of the public. 2) It makes such funds available to trade, commerce and industries for short periods. 3) It offers credit facilities for various purposes. 4) It forms a reservoir from which the funds can be drawn in times of need. 5) It supplied short period funds to the government for their temporary needs. 6) Some Money Markets provide short period funds for foreign government also. The Money Market serves as a medium through which the Central Bank of the country exercises control on the creation of credit. 7) Some times a good Money Market helps the smooth working of the Central Bank.

The functions of the Money Market are virtually the same in all the countries. But the institutions, instruments and modes of operation are different in different Money Markets.

Check Your Progress - I

1. What is Money Market? How does it differ from Capital Market?

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2. What are the functions of Money Market?

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13.6 SECTORS OF THE MONEY MARKET OR SUB-MARKETS OF THE MONEY MARKET

There are different types of short term credit transactions in the Money Market. For each type of credit transaction there is a different specialised sub-market in the Money Market. The various types of specialised sub-markets are :

13.6.1 CALL MONEY MARKET

This market deals with extremely short period loans. Here loans are given for a day, overnight, or upto a maximum of 7 days to brokers and dealers on stock exchanges by commercial banks without any collateral securities. These loans are called Call Loans, because they can be called back by lending bank concerned at any time it deems it necessary.

The call Money Market in India refers mostly to the inter-bank Call money market. The surplus banks in this market lend to the needy banks.

13.6.2 COLLATERAL LOAN MARKET

It deals only with collateral loans that is, loans backed up by securities, stocks and bonds etc., where the borrower repays the loan, the collateral is returned; if the borrower fails to repay it becomes the property of the lender. The borrowers in the collateral market are mostly brokers and dealers in stocks and shares and these loans are mostly advanced by commercial banks to private parties. Some times even the smaller commercial banks may obtain collateral loans from the bigger banks in emergencies.

13.6.3 BILL MARKET OR DISCOUNT MARKET

This market deals with short period commercial papers and specialises in the purchase and sale of various types of commercial bills like bills of exchange, treasury bills etc. The bill of exchange covers some commercial transactions between the two parties namely the buyer and the seller of the goods. Treasury bill is a short term government security usually of the duration of three months sold by the Central bank on behalf of the government.

13.6.4 ACCEPTANCE MARKET

This market deals with bankers' acceptance and an acceptance market is one where bankers' acceptances are discounted. A banker's acceptance may be referred as a draft drawn by a business firm upon a bank and accepted by it whereby it is required to pay to the order of specified party or to the bearer a certain specified sum of money at a specified date in the future. These bankers' acceptance arise out of commercial transactions both within the country and as well abroad.

13.7 CHARACTERISTICS OF A DEVELOPED MONEY MARKET OR FEATURES OF A MONEY MARKET IN A DEVELOPED ECONOMY

Money Markets are of two types organised money markets and unorganised money markets. Briefly stated, an organised Money Market is one wherein the Central Bank is able to control credit effectively along with the operations of different monetary institutions that make it. Generally in a developed economy like England the Money Market also will be fully developed and well organised, unlike in an underdeveloped or developing economy. In a less developed or developed or unorganised. The features or the characteristics of a well organised money market that exists in a developed economy are explained below :

13.7.1 DEVELOPED AND INTEGRATED BANKING SYSTEM

The banking system in a developed country is not only well developed but is also well coordinated and well integrated. In a developed country commercial banks in the banking system mostly deal in short term loans because their deposits are of a short term variety. The other constituents of the Money Market are also well linked with commercial banks as well as with the Central Bank.

13.7.2 AN APEX CENTRAL BANK

In the developed Money Market, there is always a Central Bank at the top. It is generally a very strong and powerful bank exercising effective control on the various constituents of the Money Market. This bank is the ultimate reservoir of all types of funds whether short term, medium term or long term. In fact it is the lender of the last resort. The other member banks borrow from the Central Bank in times of need or in emergencies.

13.7.3 EXISTENCE OF AN INTEGRATED INTEREST STRUCTURE

The different rates of interest that prevail in the market are properly integrated with each other. Any change in the Central Bank rate of the country produces proportional changes in the interest rate in the market. It is through this well integrated and coordinated interest structure that the Central Bank exercises control on the functions of the market.

13.7.4 EXISTENCE OF SUB-MARKETS

In a developed economy the money market is characterised by the existence of specialised central markets such as bill market, call market, collateral market etc. There are various types of short term financial transactions conducted in the Money Market. Each of these transactions is covered by a specialised market.

13.7.5 PROPER COORDINATION AMONG SECTORAL MARKETS

The Sectoral markets in a developed economy do not look at cross purposes. There will be good deal of coordination and integration in their activities.

13.7.6 RESPONSIVENESS

The developed Money Market in an advanced economy is highly sensitive to national and international events, both in the economic as well as the political fields. It is the sensitivity which is the hall mark of a well organised money market in a developed economy.

13.7.7 EXISTENCE OF FINANCIAL INSTRUMENTS

Another feature is the availability of a large variety of financial instruments like Promissory notes,

bills of exchange treasury bills, short dated government bonds etc. The larger the number of financial instruments prevalent in the market, the more highly developed the market is.

13.7.8 CHEAP REMITTANCE FACILITIES

In a developed Money Market facility exists to send money from one place to another and also from one institution to another at a low cost. As a matter fact, these cheap remittance facilities are essential for the smooth and efficient working of the Money Market.

13.7.9 ELASTIC MONEY SUPPLY

The Central Bank must be able to put more money into circulation or withdraw money from circulation according to the conditions of demand. In a developed country, the Central Bank can put money into or withdraw money from the market, through rediscount operations.

So far we have indicated the features of a developed money market that exists in an advanced country. The abscence of the above characteristics in a Money Market is an indication of its under developed character. Invariably in an under developed economy, the Money Market also will be unorganised or under-developed not presenting those features. We can cite Indian Money Market as an example of less organised Money Market in a developing economy.

Check Your Progress - II

1. What are the sot markets of a money market ?

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2. What are the features of a developed money market ?

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13.8 MONEY MARKET IN A DEVELOPING ECONOMY

As stated earlier, in a developing economy the money market presents all the features of an unorganised money. It is but natural for the money market to be underdeveloped as the economy is not fully developed. Always well organised money markets are associated with developed economies. Effective and efficient monetary management is not possible in developing economy. The Central Bank will not be in a position to control credit and the operations of the constituents of the money market. As such money markets' contribution to country's economic development gets reduced. If, for example the Central Bank is able to control inflation that takes place during the process of development, the rate of growth can be speeded up. The following are the features of an unorganised money market of a developing economy.

13.8.1 LOOSE IN STRUCTURE

The structure of an unorganised money market will be loose. There will not be contracts between the units or the constituents. These operations are not homogeneous or identical they do not perform the some functions. Some of the components or parts of the money market remain outside the reach of the Central Bank (Example money lenders and indigenous bankers in Indian Money Market). The Central Bank policies will not reach them or touch them. As a result the Central Bank's leadership becomes nominal.

13.8.2 DIFFERENT RATES OF INTEREST

There will be wide divergence in the rates of interest. There will be no relation between the bank rate and the market rate. The market rate has little to do with bank rate. They differ widely. Even the market will not be uniform. They differ from place to place, from institution to institution and sometimes borrower to borrower. As a result the bank rate policy can hardly be successful in an unorganised money market.

13.8.3 UNEVEN DEVELOPMENT OF COMPONENTS

All the component parts of the money market are not evenly and properly developed. There will not be well developed bill market and also short term loan market. Capital market, that is, market for long term loans remains underdeveloped. There will be no clear cut distinction between long term and short term loan markets. In these poor countries money market will not be properly equipped because of the abscence or partial development of any component part. In such a money market the development will be one sided. Bill market or acceptance houses may be altogether absent.

13.8.4 STRUCTURAL INSTABILITY

In unorganised money markets bank failures take place because of lack of stability in the bank structure and this shakes the public confidence in banking system. This affects the growth of banking and banking habit on the part of the people. Commercial banks will not be able to create and disburse credit in the economy. People place confidence only in legal tender money created by the Central Bank in the form of notes and coins. Cheque system will not be popular and as a result, trade becomes dull.

13.8.5 THE MONEY MARKET WILL NOT BE ELASTIC

In an unorganised money market the Central Bank finds it difficult to adjust the supply of currency according to its demand. As a result there will be seasonal stringency. The rates of interest vary from season to season.

13.8.6 INEFFECTIVE CENTRAL BANK

In a developing economy where the money market is not well organised, the Central Bank cannot effectively enforce its credit policies. Methods of credit control such as Bank rate policy, open market operations adopted by the Central Bank, cannot achieve the objective for which they are used. In such a market, methods and instruments of monetary management may not be fully successful.

13.9 SUMMING UP

Market for short term funds is known as Money Market and it differs from Capital Market which is a market for long term funds. The Money Market is composed of certain institutions like Central Bank, Commercial Banks, discount houses etc; and performs a number of functions by serving as a link between lenders and borrowers of short term funds. A number of sub-markets integrated and coordinated Money Market. Finally Money Market in a developed economy presents certain features which are absent in the Money Market of a developing economy.

- Dr. K. Changal Rao

13.10 SUGGESTED BOOKS

1. D.M. Mithani - Currency and Banking
2. K.P.M. Sundaram - Money, Banking and International Trade
3. A.V. Ranganadhachary and R.R. Paul - Currency and Banking

13.11 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. What is a Money Market ? Explain its constituents?
2. Briefly describe the sub-market of Money Market?
3. What are the characteristics of a developed Money Market?
4. What are the features of a Money Market in a developing Economy?

II. Answer the following questions in about 15 lines each.

1. How does a Money Market differ from a Capital Market?
2. What are the functions of a Money Market?
3. Explain a) Call Money Market and b) Bill Market?

UNIT-14: MONEY MARKET AND CAPITAL MARKET IN INDIA

Contents

14.0 AIMS AND OBJECTIVES

In the previous lesson we learnt about money market in developed and developing countries. In this unit the purpose of our study is to know all about Indian money market and capital market - their composition, nature, organisation, functions etc.

After reading this unit you will be able to explain :

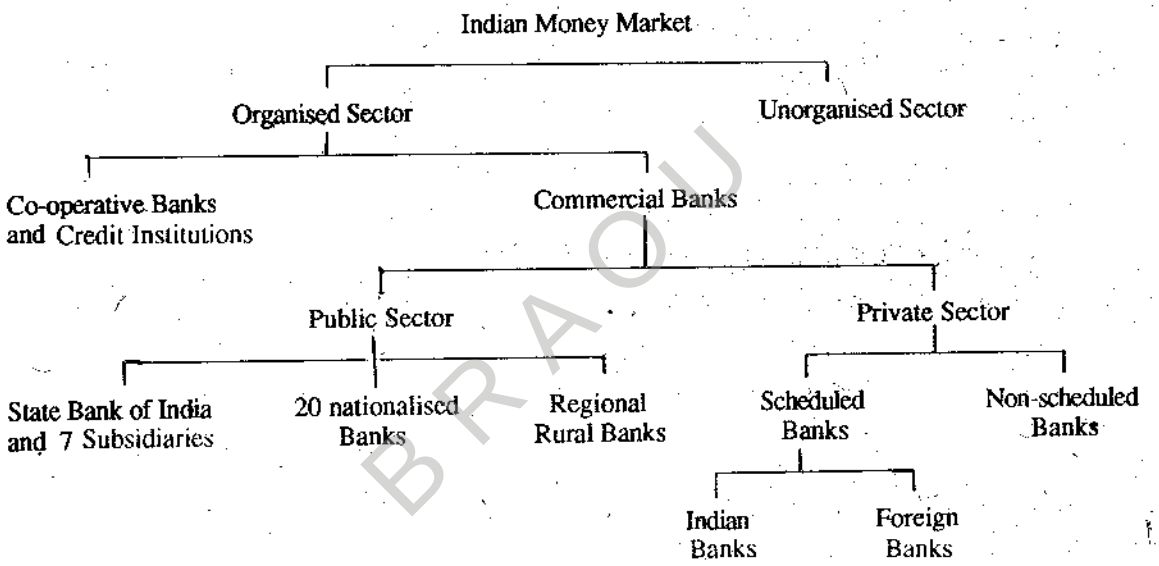
* the nature, composition, constituents and deficiencies in the Indian money market,
* Indian capital market - its composition, and growth before and after Independence,
* difference between capital market and money market and their interdependence, and
* role of Stock Exchanges in capital market.

14.1 INDIAN MONEY MARKET

In a developing economy, the Indian money market presents all the features of a less developed or unorganised money market. It is devided into two parts or sectors. a) Organised money market which is fully developed and also known as modern sector and 2) unorganised sector. This dichotomy (division) indicates lack of integration and coordination. The Components (parts,of the organised sector are - the Reserve Bank of India, the State Bank of India and its associated banks, nationalised banks private banks, co-operative banks, foreign exchange banks and in the unorganised sector are included indigenous bankers, money lenders (known by different names, marwadies, Sahukars, Mahajans, Seths, Saraffs, Chethiars and who do money lending business in rural and semi-urban areas), Chit funds, loan offices, nidhis etc. The leader of the Indian Money Market namely the Reserve Bank of India has no control over this part of the money market and its control is confined only to the organised sector.

14.2 STRUCTURE AND COMPONENTS OF INDIAN MONEY MARKET

Structurally, Indian Money Market is divided (as noted above), into organised sector and unorganised sector and each one made up of different constituents. The structure and components are shown in the chart below and a details description of their functions are given elsewhere in this book :



14.3 CHARACTERISTICS OF THE INDIAN MONEY MARKET

The Indian Money Market which is not well organised and is not closely knit has the following features :

Dichotomy : Division of the market into two sectors, organised and unorganised with little or no contact and co-operation between them is the most striking characteristic. On account of this, lack of integration between these sectors, there is a wide variation in interest rates current in these two sectors.

Existence of Semi-government Financial Institutions : In addition to the big commercial banks there are a number of semi-government financial institutions to be found in the organised sector of the Indian money market. These institutions provide mostly long term credit to industries.

Absence of a Developed Bill Market : Despite the sustained efforts made by the Reserve Bank during the past several years it has not been possible to develop a bill market in the country. In fact this is the biggest obstacle in the development of the money market in India.

No Control on Unorganised Sector : The indigenous bankers have been given virtually complete freedom to carryon the business in any manner they like. No distinction is being observed between short term and long term loans. In the unorganised sector itself there is a multiplicity of interest rates.

Absence of Discount Houses : The main reason for this is the almost complete lack of commercial bills in the Indian market.

Existence of Inter Bank Market : An important feature of the Indian money market is the existence of the inter banks market in the country. In other words the different constituents of the money market i.e., banks can borrow from each other in times of need.

14.4 DIFFERENTIATION BETWEEN ORGANISED AND UNORGANISED SECTORS

The unorganised sector of the Indian money market may be differentiated from the organised sector as under :

Blending of Money Lending and Trading : The unorganised agencies of the money market such as money lenders and indigenous bankers conduct mixed business of money lending and trading.

Informality : Money lenders and indigenous bankers have informal dealings with their borrowers.

Simplicity : They keep their accounts in a very simple and indigenous form in the vernacular language.

Flexibility : Their loan operations are flexible in nature. They give loans for all purposes and new loans to the borrowers even before the repayment of the old loans.

Personal Contacts with the Borrowers : Further their business depends on personal contacts with the borrowers.

Secrecy of Business : The financial transactions of the money lenders and indigenous bankers remain a secret affair. In fine, it is the method of working rather than in the nature of business that indigenous agencies like money lenders and indigenous bankers stand in marked contract with modern institutions of money market.

14.5 SUB-MARKETS IN INDIAN MONEY MARKET

In the Indian Money Market there are certain submarkets like the call money market, the collateral loan money market and the bill market, which are integral to the main market and through which the constituents of the market operate as lenders and borrowers of short term loans or funds. The composition and functions of these submarkets are explained below.

14.5.1 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 India 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 money market experiences two seasons. 1. Slack Season (May - October) and 2. The Busy Season (Nov. - April).

14.5.2 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 the assets of the scheduled commercial banks consists of these collateral loans.

14.5.3 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 RBI 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.

Check Your Progress - I

1. What are the components of the Indian money market?

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2. What are the sub markets in the Indian money market?

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14.6 DEFECTS IN THE INDIAN MONEY MARKET

The Indian Money Market, being the market of a developing country is not a fully developed or well organised money market. It has defects, suffers from certain deficiencies and drawbacks. They are as follows :

Dichotomy and Lack of Coordination : The division or dichotomy of the Indian Money Market into organised and unorganised sectors indicates lack of integration and coordination among different units or sectors in the money market. The organised sector units of modern well organised and scientifically operating financial institutions with the RBI at the apex, scheduled and non-scheduled commercial banks in the private as well as in the public sectors, foreign banks, post office savings banks and corporative banks. The unorganised sectors comprises the widely scattered, indigenous bankers, money lenders, chit funds etc., unorganised part lacks scientific organisation being unorthodox in approach, stagnant and ill-organised. Thus it is characterised as unbalanced and loose, its sub components having no ties with the another.

Different Interest Rates and Policies : Due to lack of homogenity in the composition of the Indian money market, there is wide divergence not only in the structure of interest rates, but also in the lending policies of the different financial institutions. Money lenders especially charge exorbitant rates of interest and lend mainly for unproductive purposes.

Inadequate Control by the RBI : The Central Bank of India - namely the RBI which the supreme monetary authority in the country has no adequate control over the policies and functioning of the unorganised part of the money market, which is quite large in size and plays a significant role in rural finance.

Inelastic and Unstable : The Indian Money Market is inelastic - it cannot adjust money supply as per its demand and is not stable due to lack of effective control by the RBI. Instability due to bank failures may check people's confidence. Inelasticity and instability stand in way of rapid economic development of the country.

Underdeveloped Bill Market : The bill market which is an important constituent of the organised part of the money market, is also underdeveloped in India. As compared to advanced countries, there is a great paucity of sound and first class commercial bills of exchange in our country. Indian traders resort to hundies, rather than draw bills of exchange. Further there is a lack of standardisation in drawing of bills and hundies in India.

Again the banking habit is not much developed in our country. So cash transactions are more popular than credit transactions. As a consequence of all these conditions, no adequate supply of bills can take place.

Absence of Banker's Acceptance : There is no development of bankers' acceptance credit by the banks in India.

Inadequate Banking Facilities : India is a vast country which is partly served by banking institutions. They are grossly inadequate in number and coverage. This led to the domination of private individuals like money lenders, indigenous bankers, etc. These people combing money lending and trading activities and work with meagre funds. Their financial resources are inadequate with insufficient to meet the demand.

14.7 RESERVE BANK AND INDIAN MONEY MARKET

The Reserve Bank of India has taken various measures to improve the existing defects and to develop a sound money market in the country. Important among them are :

i) Through the introduction of two schemes, one in 1952 and the other in 1970, the Reserve Bank has been making efforts to develop a sound bill market and to encourage the use of bills in the banking system. The variety of bills eligible for use has also been enlarged.

ii) A number of measures have been taken to improve the functioning of the indigenous banks. These measures include: a) their registration; b) keeping and auditing of accounts; c) providing financial accomodation through banks; etc.

iii) The Reserve Bank is fully effective in the organised sector of the money market and has evolved procedures and conventions to integrate and coordinate the different components of money market. Due to the efforts of the Reserve Bank, there is now much more coordination in the organised sector than that in the unorganised sector or that between organised and unorganised sectors.

iv) The difference between various sections of the money market have been considerably reduced. With the enactment of the Banking Regulation Act, 1949, all banks in the country have been given equal treatment by the Reserve Bank as regards licensing, opening of branches, share capital, the type of loans to be given, etc.

v) In order to develop a sound money market, the Reserve Bank of India has taken measures to amalgamate and merge banks into a few strong banks and given encouragement to the expansion of banking facilities in the country.

vi) The Reserve Bank of India has been able to reduce considerably the differences in the interest rates between different sections as well as different centres of the money market. Now the interest rate structure of the country is much more sensitive to changes in the bank rate.

Thus, the Reserve Bank of India has succeeded to a great extent in improving the Indian money market and removing some of its serious defects. But, there are certain difficulties faced by the Reserve Bank in controlling the money market :

i) The absence of bill market restricts the Reserve Bank's ability to withdraw surplus funds from the money market by disposing of bills.

ii) The existence of indigenous bankers is the major hurdle in the way of integrating the money market.

iii) Inadequate development of call money market is another difficulty in controlling the money market. The banks do not maintain fixed ratios between their cash reserves and deposits and the Reserve Bank has to undertake large open market operations to influence the policy of the banks.

14.8 VAGHUL COMMITTEE FOR THE DEVELOPMENT OF INDIAN MONEY MARKET

For developing the money market, it is felt necessary by the Reserve Bank to have a comprehensive review of the money market. As such, the Governor of the Reserve Bank of India appointed in September, 1986, a Working Group on the Money Market, under the chairmanship of Shri M. Vaghul. The Working Group submitted its Report on January 13, 1987.

14.8.1 MAJOR RECOMMENDATIONS

The Report makes a number of observations and recommendations. There are as follows :

1. The present interest rate ceiling on the call money fixed by the Indian Banks Association should be abolished. The call money rates should be freely determined by the market forces.

2. The Call money market should strictly be an inter-bank market.

3. The interest rate on inter-bank term deposits should be determined by the market forces.

4. A genuine bill culture is to be developed by taking a number of positive measures pertaining to interest rates and legislative amendments.

5. The government should make payments for all credit purchases in the form of bills.

6. The maximum discount rate on bills should not exceed an equivalent effective interest rate of 16%.

7. Further rediscounting by the institutions should be freely permitted.

8. The interest rate on short-term commercial papers should be freely determined by the market forces.

9. There should be no restrictions on the participants in the commercial paper market.

10. To develop an active secondary market in 182 days' Treasury Bills, let there be a large number of participants who will bid regularly in the auctions; then, there can develop a portfolio of varying maturities.

11. By April, 1987, a Treasury Bill Refinance Facility should be introduced. The refinance rate should be at least 1.5 percentage points higher than the prevailing Treasury Bill rate.

12. The Finance House of India is an autonomous public limited company should be established to deal in short-term money market instruments. It should be jointly formed by the Reserve Bank, the public sector banks and the financial institutions.

13. Each new instrument introduced in the money market should have been approved by the Reserve Bank.

14. The stamp duty on bills must be abolished.

14.8.2 FOLLOWUP ACTION BY THE RBI

During 1987, the Reserve Bank of India has taken the following measures to implement the recommendations of the Working Group :

i. With a view to make bill financing attractive to the borrowers, from April 1, 1987, the effective interest rate on bill discounting for categories subject to the maximum lending rate has been fixed at a rate one percentage point lower than the maximum lending rate.

ii. In order to attract additional funds into rediscount market the ceiling on the bill rediscounting rate has been raised from 11.5% to 12.5%.

iii) Access to bill rediscounting market has been increased by selectively increasing the number of participants in the market.

iv) Measures taken to promote bill financing include:
a) only 75% of the eligible receivables of all parties subject to the Credit Authorisation Scheme would be taken into account for financing with effect from April 1, 1988; b) banks have been given the discretion to sanction additional adhoc inland bill limits to all parties subject of CAS; and c) all parties subject to CAS have been required to attain a ratio of bill acceptance to credit purchases of 25% by April, 1988.

v) In order to provide greater liquidity to banks' holding of 182 days Treasury Bill, a '182 Days Treasury Bill' Refinance facility has been introduced.

vi) A decision has been taken to set up Finance House jointly by the Reserve Bank of India, public sector banks and the financial institutions.

All these recommendations are worth considering.

It is heartening to note that following the recommendation of the Vaghul Committee, the Reserve Bank of India has set up the Discount and Finance House of India Limited (DFHI), in April 1988, with a view to provide liquidity to money market instruments.

Check Your Progress - II

1. What are the measures adopted by the Reserve Bank of India to improve Indian money market?

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2. Briefly state the major recommendations of Vaghul Committee.

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14.9 NECESSITY OF CAPITAL MARKET OR NEED FOR LONG TERM FINANCE

Finance is the life blood of industry. Industry requires finance to carry on its productive activity. In the absence of adequate industrial finance no industrial development is possible. Industrial finance implies the provision of finance for the organisation of production activity by various types of industries. It is absolutely essential that industries should get sufficient finance for their development and expansion.

Broadly speaking industries require two types of finance or capital - Short Term and Long Term. An industrial enterprise requires short term finance for the purchase of raw materials, for the payment of wages, and for meeting other day to day requirements. Such short term finance is also known as Working Capital. Long term finance is needed for purchasing land, constructing finance is also necessary for extension or expansion, reorganisation, renovation and modernisation programmes. Long term finance is also known as "Block" or "Fixed" Capital. Such long term finance involves a period of 5 years and above.

For an industry there are two types of sources of finance viz., internal and external. An enterprise may finance its industrial production through internal sources. The depreciation fund, Reserve Fund, and retained profits are examples of internal sources of finance. External finance is raised from external sources which are out-side the business - that is from Capital Market.

14.10 CAPITAL MARKET: MEANING & COMPONENTS IN INDIAN CAPITAL MARKET

Capital Market is the market for long term funds, just as the "Money Market" for short term funds. It refers to all facilities and the institutional arrangements for the borrowing and loaning of term funds. It is a vehicle through which long term finance is channelised for various needs of industries,

commerce, Government and local needs. According to W.H. Husband and J.C. Dokerbay "the Capital Market is used to designate activities in long term credit which is characterised mainly by securities of investment type." But the term Capital Market conveys a wider meaning in view of its varied functions. Livington remarked that in a developing economy it is the business of the Capital Market to facilitate the movement of the stream of command over capital to the point of highest yield. By so doing it marks control over resources to pass into the hands of those who can employ them most efficiently, thereby increasing Productive Capacity and swelling the national dividend. Arun K. Datta Gupta writes that "the Capital Market is complex of institution investment and practices which establish link between the demand for and supply of different types of Capital funds"

It should be noted that it does not deal in Capital goods but is concerned with the raising of money capital. In our country the demand for long term money capital comes predominantly from private sector manufacturing industries and from the government largely for the purpose of economic development and to a very small extent from agriculture. The supply of funds for Capital Market comes largely from individual savers, corporate savings, banks, specialised financing agencies and the government. Among institutions (a) commercial banks are important investors but are largely interested in government securities and to a small extent in debentures. (b) The LIC is of growing importance in the Capital Market through its major interest is still in government securities. (c) Provident funds constitute a major media of savings but their investments too are mostly in government securities. (d) Specialised institution set up since independence namely the Industrial Finance Corporation of India, the Industrial Credit and Investment Corporation. of India, the State Finance Corporation, the Industrial Development Bank of India, the Unit Trust of India - all these aim at providing long term capital market is also composed of those who demand funds (borrowers) and those who supply funds (lenders).

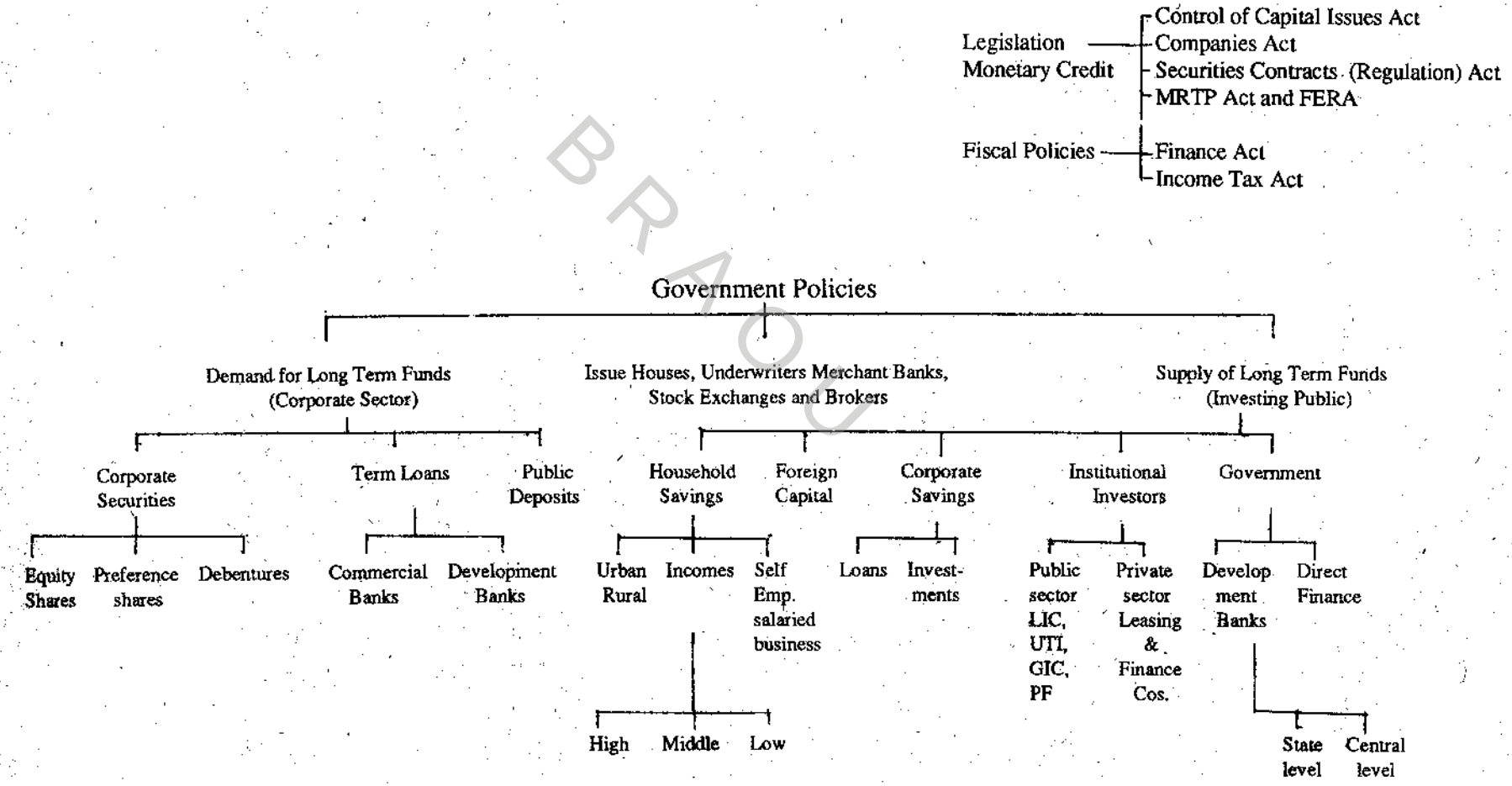
An ideal Capital Market attempts to provide adequate Capital at reasonable rate of return for any business or industrial proposition which offers a prospective yield high enough to make borrowing worth while. The expansion of the corporate enterprise since the beginning of Planning in 1951 has necessiated the development of the Capital Market in India. An efficient Capital Market is an essential prerequisite of economic development and the development of Capital Market in a country is dependent upon the availability of savings, institutions to bring the investor and business activity together for mutual interests, regulation of investment etc.

14.11 MONEY MARKET AND CAPITAL MARKET - A COMPARISON

The distinction between "Capital Market" and "Money Market" is significant. Funds are required for short periods or for long periods. Capital Market refers to the market for long term funds while Money Market refers to the market for short term funds. Capital Market itself may be divided into two types viz., the market for old capital and market for new capital. The market for old capital is known as the Stock exchange and it deals with the transactions of shares and debentures of old and established companies. The market for new capital is the market in which stocks and shares of new companies are bought and sold. Though we can clearly distinguigh the money market and capital markets, many writers use the term "Money Market" to include both the long term Capital Market and the short term money market proper.

There is, however, a close relationship between the Money Market and Capital Market. For one thing, the Capital Market depends upon the Money Market for finance. This is particularly true of the old Capital Market. For another, the same institution deals both in the money market as well as in the Capital Market. For example the commercial banks in India lend funds both for short periods as well as for long periods. Again the Money Market and Capital Market are interdependent. For instance, a relative rise in the rate of interest in the money market may increase the demand in the Capital Market

DIAGRAM SHOWING STRUCTURAL FRAMEWORK OF CAPITAL MARKET IN INDIA



and a relative increase in the yield in the Capital Market will increase the demand in the Money Market. Thus, the two markets are intimately related to each other and make writers speak of the inner or money market proper and the outer market which includes the Capital Market also.

14.12 CLASSIFICATION OF INDIAN CAPITAL MARKET

The Capital Market in India may be classified into two categories viz., organised and unorganised. In the organised sector of the Capital Market demand for long term Capital comes from corporate enterprises, Government and Semi-government institutions requiring funds for various development activities. The sources of supply of funds comprise individual investors, corporate and institutional investors, like banks, investment trusts, life insurance companies, finance corporations, Government and institutional financing agencies. On the other hand the unorganised sector of the Capital Market consists of indigenous bankers in towns, and Money lenders in rural areas and there is no close contact between its different constituent. This sector is more or less cut off from the organised sector, and the supply of funds at their disposal falls short of the requirements made on them. Mostly these bodies finance consumption rather than production and the rates of interest charged by them are exorbitant.

14.13 INDIAN CAPITAL MARKET BEFORE INDEPENDENCE

The Capital Market in India was not properly developed before Independence. In the first place, agriculture was the main occupation but there was very little of organised term lending to the agricultural sector. Secondly, the growth of the securities market was very much hampered since most of the English enterprises in India looked to the London market rather than to the Indian Capital Market. Thirdly, the total number of companies was small and the number of securities traded on stock exchanges was still smaller. A large part of the Capital Market consisted of the gilt edged market for government and semi-government securities. Fourthly, individual investors were very few limited to the rich classes in the urban and rural areas. Besides, the government had placed many institutions for the institutional savers such as banks and insurance companies and naturally they had to prefer government securities and to a small extent only debentures. Fifthly, the managing system performed to some extent the functioning of promotion, issue and underwriting of new capital issues and these prevented the development of specialised issue houses, so common in western countries. Finally, there were no specialised intermediaries and agencies to mobilise the savings of the public and channelising them to investment. Such institutions were started only after Independence.

Check Your Progress - III

1. How is the Capital Market of India composed ?

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2. How are the money and Capital Markets inter dependent?

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14.14 INDIAN CAPITAL MARKET AFTER INDEPENDENCE

The need for an orderly and well developed Capital Market was felt with the launching of five year plans to Usher in rapid economic development. Development - more so industrial development hinges upon the supply of enormous funds for investment purposes. Hence the Government of India took a number of measures to develop further the Capital Market in India.

14.15 GROWTH OF CAPITAL MARKET IN INDIA SINCE INDEPENDENCE

Till recently India suffered for want of adequate institutional frame work. However, years after Independence measures have been taken to bring about a moderately well balanced structural development in the Indian Capital Market. Some of the noteworthy developments are reviewed hereunder.

1. The Government of India took pains to institute elaborate legislative measures to safeguard the interests of the investors. These measures have helped to boost confidence in the investors minds and reduce the trouble of promoters in promoting investments. The Companies Act, 1956 intends to establish an integrated relationship between the promoters investors and the corporate management. The structural alternations it has made in the matter of prospectus, allotment of shares, terms and conditions of flotation of shares etc. have enabled a marked rise in the market for investment in joint stock companies.

The capital issues control order was promulgated for the first the time on 17th May, 1943 to check inflation. The Capital issues (Control) Act, 1947 and its amendment in 1956 have as their objective the securing of a balanced investment of the country's resources in industry, agriculture and social services.

The securities contracts (Regulation) Act, 1956 is to regulate the activities of stock exchanges. Under the Act, only those stock exchanges that are recognised by the Central Government are permitted to carry on the business and the government empowered itself with the light to derecognise a stock exchange in the interests of trade and/or public. The Act also laid down certain provisions for listing of securities so as to eliminate the scope for manipulations. The Act intends to give a fillup to the confidence of the public and this create a healthy and strong investment market.

The Insurance Act, 1938 together with the Life Insurance Corporation Act, 1956, as also the provident Fund Act and Rules 1957 have been designated to remove the evils of the misuse of the funds and discourage concentration of capital.

The Deposit Insurance Scheme, 1956 offers insurance against funds deposited in the commercial banks at specified levels and at specific rates. This is a positive measure to encourage savings habit in the public. The Monopolies and Restrictive Trade Practices Act, 1969 ensures that there is no concentration of economic power.

2. Since independence, particularly after the beginning of the era of planning, various institutions have come up to meet the long term requirements of the development programmes of the country. A beginning was made in 1948 with the setting up of the Industrial Finance Corporation of India. Now, almost every state in the country has a state Financial Corporation besides these we have Industrial Credit and Investment Corporation. of India and the Industrial Development Bank of India. The Life Insurance Corporation of India and the Unit Trust of India have also been showing increasingly active interest in strengthening the Capital Market.

3. Commercial Banks have also been contribution indirectly to the growth of Capital Market in India not only by granting of more advances against shares and debentures, but also making available to finance corporation through purchasing of shares, debentures etc.

4. Underwriting activity is continuously on the rise in India. All financial institutions including the commercial banks have been given great impetus to this activity.

5. Certain incentives are provided to encourage the savings and investment in shares. Tax exemption is given up to certain amount of income derived from investments in UTI or shares in Indian Companies, small approved rural debentures etc. Exemptions are applicable even to wealth tax over investments made.

6. Trails are under current constantly for the integration of organised and unorganised sectors of the Capital Market. The attempts to coordinate both the segments of the investment market i.e., Capital Market and Money Market, are progressing steadily.

7. With a view to quicken the disposal of application for fresh capital issues by the controller of Capital Issues certain guides were issued and this led to an end of a long and delayed processing of application for the issue of such shares by the Controller of Capital Issues due to inadequate information provided by the applicant largely owing to the absence of any codified guidelines on this important aspect.

14.16 STOCK EXCHANGE AND CAPITAL MARKET

The Stock Exchange is the market where stocks, shares and other securities are bought and sold. It is the market where the owners may dispose of their securities as and when they like. It is an "essential concomitant of the capitalistic system of economy, indispensable for the proper functioning of corporate enterprise".

In a modern capitalist economy, almost all commodities even the smalles, are produced on a large scale; and large-scale production implies large amounts of capital. The joint stock company - or the corporate form the organisation - is ideally suited to secure large amounts of capital from all those who have surplus funds. The joint stock company issues stocks and bonds and enables those who have surplus funds to employ them profitably in either of them according to their convenience and temperament. An investor who puts his savings in a company by buying its securities cannot get the amount back from the company. The only way the capital invested in stocks and shares of a joint stock company may be realised by its owner is through the sale of those stocks and shares to others. The stock market or exchange is a place where long-term commitments or investments are bought and sold. For the existence of capitalist system of economy and for the smooth functioning of the corporate form of organisation, the stock exchange is, therefore, an essential institution.

14.16.1 CHARACTERISTICS OF STOCK EXCHANGE

Whatever may be the differences in constitution, organisation and functions between stock exchanges in different part of the world, there are certain common characteristic features of stock exchanges all over the world.

The stock exchange is a voluntary association; either it is a private club or a private or public limited company. Rarely it is operated under government control. The stock exchange itself conducts no business but merely provides facilities to its members to transact business and regulates their operations. It attempts to maintain and promote high standards of commercial honour and business morality and integrity among its members. It constantly endeavours to safeguard the interests of both its own members and of the general public.

Every organised stock exchange is managed by a governing committee or managing committee composed of elected members. The managing committee exercises rigid control over the members through the disciplinary powers granted to it by its constitution, and its control covers activities relating directly or indirectly to the dealings on the floor of the stock exchange. It deals also with the manner and the method of dealings with customers. Penalties such as expulsion, suspension or fine according to the nature of offence and gravity may be meted out by the managing committee to the erring members.

Membership of a stock exchange involves great responsibility both to fellow members and to clients. Therefore, every organised stock exchange has strict rules governing the admission of new members. If a stock exchange is of the nature of a private club, a person is admitted to the membership after he has been recommended by a certain number of older members and elected by the managing committee. In the case of company exchanges, members have to acquire a share of the company either from the Board of Directors or from an outgoing member.

14.16.2 CONTROL OF STOCK EXCHANGE IN INDIA

The immediate circumstance which led to the Indian Government's interest in stock exchange reform was the spectacular post-war boom in indian Stock exchanges during 1945 and 1946. Dr. P.J. Thomas was asked to undertake a comprehensive study on the subject. Dr. Thomas make many useful recommendations for the reform of the Indian stock exchanges. Two more committees followed - one of which was presided over by A.D. Gorwala - and ultimately the Securities Contract (Regulation) Act was passed in 1956 based mainly on A.D. Gorwala Committee's report. Some of the important provisions of this Act are summarised below.

Recognition : Only stock exchanges recognised by the Central Government are allowed to functions. According to the Act, seven exchanges have been recognised so far by the Government. A stock exchange is recognised only if the Government is satisfied on three points :

a) The rules and by-laws of the stock exchange applying for recognition will ensure protection of depositers and fair dealings in general;

b) It is in the interest of the trade and also in the interest of public; and

c) The applicant stock exchange is willing to accept and abide by conditions and rules imposed by the Central Government.

Powers of the Central Government : The Central Government has been vested with powers to control the working of every stock exchange in the country. The Government has the power to prescribe the qualifications for members of stock exchanges, the maintenance of accounts by members, the representation of the Government on stock exchanges, and so on. The Government has also the extreme powers of superseding the governing body of a stock exchange, and appointing any person or persons to exercise all the power and perform the duties of the governing body, and can also withdraw recognition granted to a stock exchange. Besides, the Government has also the power to suspend its business for a period of seven days (extendable to longer periods) if considered essential in the public interest.

14.17 OUTLOOK

The Indian Capital Market is now fairly well developed to make much needed resources available for bolder economic planning in the economy. Besides institutional planning, we need enterprise and thrift to achieve economic growth. The limit to financial resources is never an absolute one; it is related to the quantity of effort that is brought to bear on implementation of projects; on enlarging their surpluses and on preventing through fiscal and other measures of leakages of resources and to consumption or non priority investment so what is needed from the long term interest of the country is the right kind of effort to explore the resources.

14.18 SUMMING UP

Money Market and Capital Market which are interdependent are necessary for smooth functioning and orderly growth of the Economy. Money Market in India composed of certain sub-markets like Call Money Market, Bill Market etc., is divided in to Organised and Unorganised sectors presents all the features of a developing market. Reserve Bank of India took various steps to integrate the market by bringing into its fold the components that lie outside its purview and its efforts are fairly well rewarded when short term funds are made available by the Money Market to meet their working capital needs, industries further need long term finance. This is met from Capital Market. Strictly speaking Capital Market did not develop much before we got Independence as there was little effort for development. The real beginning was made with the establishment of IFCI in 1948. Since then it is fast developing. A wide variety of financial institutions have come up to cater to the needs of industrial development.

Alongwith these institutions Stock Exchanges, which are integral for corporate growth, have also grown in number and size. Nevertheless, Indian Capital Market has to go a long way to become fully developed and well organised.

- Dr. K. Changal Rao

14.19 SUGGESTED BOOKS

1. S.C. Kuchhal : Industrial Economy of India
2. Das and Sivaiah : Indian Industrial Economy
3. K.P.M. Sundaram : Money Banking and International Trade

14.20 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in 30 lines each.

1. What are the features of the Indian Money Market?
2. Briefly describe the sub-markets in the Indian Money Market.
3. What are the defects in the Indian Money Market?
4. What are the measures adopted by the R.B.I. to develop Indian Money Market?
5. What are the major recommendations made by the Vaghul Committee?
6. What is Capital Market? How does it differ from Money Market?
7. Trace the growth of the Indian Capital Market since 1947.

II. Answer the following questions in 15 lines each

1. How is the Indian Money Market divided?
2. What are the components of the Indian Money Market?
3. What are the features of the Unorganised sector of the Indian Money Market compared to Organised Sector?
4. Distinguish between Call Money Market and Bill Market.
5. What are the terms of reference of Vaghul Committee?
6. Why do industries need long term capital?
7. What are the government policies that influence the Indian Capital Market?
8. How is the Capital Market India classified?
9. What were the reasons for the slow growth of Capital Market in India before 1947?
10. What is the purpose of the Securities Contract (Regulation) Act, 1956?
11. What is a Stock Exchange? Explain its role in the Capital Market?

UNIT-15 : BANK NATIONALISATION AND ADVANCES TO PRIORITY SECTORS

Contents

15.1 AIMS AND OBJECTIVES

This lesson explains the causes that led to nationalisation of 14 scheduled banks in 1969. Progress after nationalisation, both quantitatively and qualitatively, and strides especially in the fields of priority sector are presented, ofcourse with evaluation.

After reading the unit, you will be able to

* analyse the conditions of banks before nationalisation of banks in 1969,
* explain the causes and reasons for nationalisation of banks,
* progress and achievements in the modern banking system due to nationalisation of banks, and
* discuss the changes in the allocation of advances to the priority sector after 1969.

15.1 INTRODUCTION TO NATIONALISATION OF COMMERCIAL BANKS

Commercial Banks are important in carrying out monetary policies in any economy. In India money market commercial banks play vital role in mobilising and distributing deposits and credit. Efficiency of the banks, coordination among banks promotes rapid growth. Regulation and control over commercial banks is increasing to meet the ends in India. Reserve Bank of India was nationalised on 1st January, 1949 to initiate the process of development and to manage monetary sector. Later it was felt that our economy can make rapid progress, with the nationalisation of commercial banks.

Nationalisation means bringing the unit or bank under the control of public sector or government by transferring the ownership and management.

Left political parties, socialists and left congressmen were advocating for the nationalisation to promote growth and welfare. Nationalisation of commercial banks along with development of public sector, they argued, will be more effective rather than leaving the banking system to the private sector. Protogonists of capitalism plead the prominence of private sector, as they feel that it promotes competition and efficiency regarding optimal utilisation of resources. During 1991 global changes, and domestic crisis, heralded the resurgence of privatisation (it) not in banking sector, but industry sector and other areas.

Chronologically if we observe the changes that took place in India since independence, we will be able to peruse the performance of banking system in general and commercial banks in particular.

After the nationalisation of Reserve Bank of India in 1949, Imperial Bank of India was nationalised on July 1st, 1955 and was called State Bank of India. As a consequence of State Bank of India (subsidiary Banks) Act of September, 1959 eight more banks were integrated with State Bank to become subsidiaries of State Bank. On July 19th, 1969 nationalisation of 14 major commercial banks took place. In 1969 all the schedule banks having Rs. 50 crores and more of deposits were nationalised. Once again on 15-4-1980 the commercial banks possessing Rs.200 crores and more of demand and time liabilities were nationalised, they were 6 in number.

According to R.S.Sayers the reasons for results of nationalisation of Banks are as follows.

1. Wasteful competition will be eliminated and efficient functioning will be promoted.
2. High degree of cooperation and coordination can be secured and integration will be realised.
3. Monetisation and creation of credit money will be according to the guidelines of central bank, rather than for making profits.
4. Transition from capitalism to socialism can smoothly take place through nationalisation.

Apart from the above mentioned reasons, nationalisation may be done to strengthen banking system, to eliminate concentration of economic power, to promote productivity, welfare, efficiency, development and so on.

15.2 CONDITIONS ON THE EVE OF SOCIAL CONTROL AND NATIONALISATION OF COMMERCIAL BANKS

There was a sea-change in the composition of commercial banks after independence. The conditions that prevailed in 1960's induced the government to impose social control in 1967. Two years later economic, political and social factors led to nationalisation of major commercial banks. After independence the following changes took place.

Table 15.1

Commercial Banks and Indicators Before 1969

Year	1951	1956	1969
Number of Scheduled Banks	92		71
Number of Non-scheduled Banks	474		14
Total Banks	566		85
Total No. of Branches	4,151		8,262
Deposits (in Rs. Crores)	909		10,635
Population Per Office		98,000	60,000
No. of employees		79,000	2,20,000

Non-scheduled banks were amalgamated into big banks and income part of scheduled banks; even there was reorganisation of Scheduled banks after 1950. This fact is reflected in Table 15.1. Total number of banks (not their branches) was 85 in 1969 against 566 in 1951. Despite, the net work of banking system was improved, this is indicated by their number of branches and deposits.

Branches have shown a growth of about hundred percent during 1951-1969. In the same period deposits increased from Rs.909 crores to Rs.10,635 crores. On an average one bank was available for 98,000 population in 1956. Due to rapid increase in bank branches, each bank was available for every 60,000 population.

In June 1969, rural areas had a share of 22.4% of total bank branches, though rural population was 80% in the country's population.

In the year of 1951, bank advances were Rs. 584.6 crores against Rs. 3,064.4 crores in 1968. Priority sector like agriculture received small proportion of advances. Agriculture had a share of meagre 0.3% of total advances in 1968, compared to 2.1% in 1951. Industry shares were 67.5% and 33.5%, respectively. Personal and professional loans' share decreased from 7.3% of advances in 1951 to 3.7% in 1968.

Deposit Insurance Corporation Bill of 1961 gave guarantee to the depositors and banking regulation acts strengthened functioning of banking system. Need for the reorganisation of rural credit widened branch net work. Yet, commercial banks could not fulfil the requirements.

Commercial banks were mainly concerned with the maximisation of profits. Because of that, many (new) branches were opened in urban and metropolitan areas rather than in rural areas. Priority sector like agriculture, self employment and personal loan sector were neglected. Concentration of economic power increased. Not only the bankers could control many resources, their directors were granting advances to their relatives and interested persons. Large scale industries, big industrial houses were getting major portion of bank advances. Small scale industries, the potential sector of employment, could get the advances to the extent of 8.3% of total bank advances in 1969. Regional imbalances were increased, rural areas were neglected, rates of interest were not uniform, regulations could not channalise credit in the right directions. Alternative sources of credit were not available to the required evel. With this backdrop social control and nationalisation became imminent in our economy.

15.3 SOCIAL CONTROL IN INDIA

Indian government was not ready to nationalise commercial banks, after the establishment of State Bank of India and its subsidiaries. Many felt that the objectives can be achieved with the imposition of control over commercial banks rather than nationalisation them. It can save government from paying compensation. The fear of socialisation can be allayed due to social control. It avoids red tapism and continues to achieve efficiency due to competition both from public sector banks as well as private sector banks.

Social control over commercial banks was announced in Lok Sabha on December 14, 1967 by the then Deputy Prime Minister, Mr. Morarji Desai. According to this, banks have to follow the directions, advices of the government or its agency to meet the social objectives. Purpose of social control was prevent concentration of economic power, promote credit and to avoid malallocation and misdirection of credit.

Government has undertaken two measures to implement social control (1) establishment of National Credit Council and (2) enactment of banking legislations like Banking Laws Ammendment Act, 1968.

National Credit Council is an advisory body. It was set up on 22-12-1967 to assess credit requirement and its allocation among different sectors. This will determine requirements of priority sectors like agriculture, small scale industries etc. It helps in optimising the use of financial resources by coordinating the credit and investment policies. Priorities for the grant of loans will be determined by it. Finance Minister is the Chairman, and Governor of the R.B.I. is the Vice Chairman, the other 23 members will be officials and representatives from different sectors.

Banking Laws (Amendment) Act of 1968 provided changes in the constitution of the board of directors of any bank. Majority of directors ought to be from nonindustrialistsbut should be those having experience and knowledge in different fields. As per this act Reserve Bank can remove chairman of any bank. R.B.I. has powers to issue directives to banks regarding the quantity and purpose of the advances.

Without permission of RBI, no bank can grant a loan, of Rs. 1 crore or above. Act of 1968 gave additional power to RBI and erring banks can be taken over by government if they do not heed the directives.

Even before realising the results of social control government nationalised major commercial banks.

The impact of 1965 war, failure of harvests, industrial recession led to the deepening of crisis in India, both the real and monetary sectors.

Social control made the directors to find out the ways of evasion. Board of directors had no cohesion.

As the alternative sources of credit were limited, even under the conditions of social control commercial banks didn't change their lending policies.

15.4 CAUSES AND CASE FOR NATIONALISATION

For early realisation of objectives of social control nationalisation of big banks was only the alternative. Social control takes a longer period of trial, with less certainity and more misunderstandings.

Following are the causes of nationalisation:

1. To Realise the objectives of social control quickly, certainly and correctly, political party, especially that in power was determined to nationalise commercial banks.

2. Commercial banks were owned and controlled by few share holders in numbers. It led to concentration of economic power. To reduce such centralisation and concentration of power, nationalisation was necessary. Hence unproportional concentration of economic power is the cause of nationalisation. Concentration of wealth is another cause.

3. Failure of the commercial banks to open new branches in rural and backward regions to mobilise resources.

4. Disappointing performance in advancing loans to priority sectors, needy people, and underdeveloped areas.

5. Resources of the banks were utilised by the directors of banks to promote their personal interests.

6. Advances were reaching large industrial and business houses at the cost of small business units.

7. Rural development was neglected.

8. Funds were misutilised, as the loans were advanced for speculative, and unproductive uses. Credit for undesirable activities led to nationalisation.

9. Violation of priorities emphasised in plans.

10. Lack of coordination between different organs of money markets.

11. Profit motive dominated the banking system, ignoring welfare of all in general, weaker sections in particular.

12. Window dressing of commercial banks. Accounts were manipulated on the dates of submitting accounts to the RBI.

13. lack of co-ordination and wasteful competition.

In 1969, Indira Gandhi, the then Prime Minister, strongly pleaded the case for nationalisation. She said that it was meant for early realisation of social control objectives. They were :

a) Removal of control by a few,

b) provision of adequate credit to priority sectors,

c) providing professional bent to management,

d) encouragement of new classes of enterpreneurs,

e) provision of adequate training as well as terms of services for bank staff, and

f) to satisfy legitimate aspiration of weaker sections.

From the economy's point of view and from employee's side it was welcomed as it accomplishes the goals of social within the frame work of our Constitution.

15.5 NATIONALISATION OF COMMERCIAL BANKS

Nationalisation of 14 leading scheduled banks was announced by Mrs. Indira Gandhi on July 19th, 1969. Banks with Rs. 50 crore and more deposits were nationalised by promulgating ordinance on the day mentioned. This measure provides for payment of Rs. 87-30 crores as compensation, either in cash or in government securities. Banks incorporated outside were excluded from its ambit. The banks nationalised in 1969 were

1. Allahabad Bank, 2. Bank of Baroda, 3. Bank of India, 4. Bank of Maharashtra,
5. Canara Bank, 6. Central Bank of India, 7. Dena Bank, 8. Indian Bank,
9. Indian Overseas Bank, 10. Punjab National Bank, 11. Syndicate Bank, 12. Union Bank of India,
13. United Bank of India, 14. United - Commercial Bank.

Government brought 6 more scheduled banks under nationalisation net on 15.4.1980. They were (1) Andhra Bank, (2) Corporation Bank, (3) New Bank of India, (4) Oriental Bank of Commerce, (5) Punjab and Sindh Bank, and (6) Vijaya Bank.

These 20 nationalised banks worked along with State Bank of India and its subsidiaries in carrying out the programmes envisaged by the government. Even distribution of credit, purpose-wise geographically and income status wise was necessary according to the study group of National Credit Council in 1969. This was accomplished by nationalised banks.

Check Your Progress :

1. What is meant by social control?

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2. The number banks nationalised in 1969 was _____ .

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3. What are the causes of nationalisation of banks ?

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15.6 NATIONALISATION AND PROGRESS OF BANKS

Progress of commercial banks is an index of economic growth. Progress of commercial banks was noteworthy especially after nationalisation. It had horizontal, vertical and multi facet expansion through expansion in the number of branches, increase in deposits and advances.

Out of 8,262 branches of all commercial banks, nationalised banks including SBI and its subsidiaries accounted for 7,015 bank branches in June 1969. Deposits mobilised by scheduled commercial banks were Rs. 3897 crores, the advances amounted to Rs.3,034 crores in 1969.

Number of branches were increased to 53,269 in June, 1989 with deposits of Rs. 1,31,016 crores and advances of Rs.83,715 crores. During the same period share of priority sectors in the bank credit increased from 14.6% of total credit in June 1969, to 44% in June, 1988. At present about 90% of credit is controlled by nationalised commercial banks.

Simply expansion of deposits do not reveal the real progress as national income also increased. Deposits as percentage of Gross National Product (GNP) expressed give a meaningful index of progress. Such deposit, GNP ratio was 27.4% in 1980-81 and became 33% in 1985-86.

15.6.1 BRANCH EXPANSION

Branch expansion was extensive and rapid after nationalisation. Lead bank scheme, worked through nationalised and other banks, made rapid progress in creating banking facilities.

As a result of Gadgil area approach, Nariman, the chairman of Committee of Bankers in 1969 gave shape to head bank system. Districts or areas will be allotted to a particular bank and that bank will be responsible for the development of area. Nationalisation paved the way for smooth functioning of this lead bank system to implement phased programme (after surveys) with coordination and cooperation of other banks and institutions.

Numerical expansion of branch banking and increase in rural banks is given in Table 15.2.

It can be understood that between 1969 and 1986 all nationalised banks (including SBI and subsidiaries) and Regional Rural Bank branches increased by 700 percent; percentage of rural banks was 64% out of increased branches during the 17 years period mentioned above.

Table 15.2

Branch Expansion of Public Sector & Other Commercial Banks

Bank	No. of Branch Offices as on 30.6.1969	30.6.1986	Increase in No. of Branches	Increase in Number of Offices in Rural Area
A) State Bank of India and subsidiaries	2,462	10,815	8,353	4,072
B) 14 Nationalised Banks (in 1969)	4,134	21,694	17,560	9,486
C) Regional Rural Banks	-	12,729	12,729	11,742
D) 6 (Six) Nationalised Banks (in 1980)	419	3,554	3,135	1,481
A+B+C+D Total	7,015	48,792	41,777	26,781
E) Other Indian Scheduled Commercial Banks	900	4,298	3,398	1,149
F) Foreign Banks	130	136	6	1
G) Non-Scheduled Banks	217	39	-	-
Total of All Commercial Banks	8,262	53,265	47,003	27,886

It can be known that increase in the number of branches in rural areas is much faster than in non-rural areas. It is due to the policy of the government and implementation by the regulated and nationalised banks. During 1986 all the 20 nationalised banks made a profit of Rs. 150 crores. Central Bank of India, Bank of Baroda accounted for Rs.44 crores, i.e., about 30% of profits. But as the profits are ploughed back into developmental activities by nationalised banks, at aggregate level it may not matter much, but shows the efficiency of banks at micro level.

Branch opening in rural and unbanked areas is increased rapidly. Share of bank branches in rural areas has increased to 52% in 1982, compared to 22% in 1969. Regional imbalances are reduced after nationalisation.

15.6.2 GROWTH OF DEPOSITS

Aggregate bank deposits were Rs. 5,906 crores in 1970, they increased to Rs. 1,00,964 crores in 1986 (December). Due to mobilisation of resources both from urban and rural areas, deposits are growing considerably, to steer economic development. Maharashtra leads all other states in deposit mobilisation performance.

15.6.3. GROWTH OF BANK ADVANCES AND CREDITS

Lending activity really increased at a greater speed as loans are sanctioned with liberal conditions of surity and guarantees. Even on personal and group surities loans are advanced. Hitherto neglected regions, sectors, trades, persons are getting the credit facilities at low possible rates of interests. Commercial banks' (including nationalised) credit amounted to Rs. 4,684 crores in 1970-71 and it was Rs. 60,551 in December 1986. Though recoveries of demands have improved from 51% to 56% in between 1984 and 1986 it is not satisfactory.

15.7 PRIORITY SECTORS AND THEIR ADVANCES

The sectors which were neglected before were given priority while advancing loans to them. Such sectors are agriculture, small scale industries, retail trade, self employment, education etc.

Due to establishment of the Credit Guarantee Corporation of India (Jan. 1971), refinance facilities from RBI, differential interest rates, and other corporations, priority sectors are getting more loans. More loans with easy repayment facilities, with facilities of low rate of interests have enormously increased productive activity.

Table 15.3

Advances to Different Sectors by Public Sector Banks

Sector	June 1969		June 1984	
	No. of A/cs. (in Thousands)	Amount outstanding (Rs. in Crores)	No. of A/cs. (in Thousands)	Amount outstanding (Rs. in Crores)
Agriculture	164	162.3	13,317	6,429
Small Scale Industry	51	251.0	1,306	5,549
Retail Trade and Small Business	33	19.3	2,962	1,201
Professional and Self Employed Persons	8	1.9	1,317	427
Education & Housing	1	0.8	215	79
Total Priority Sector	260	440.9	19,836	15,432

Table 15.3 shows the allocation of advances to different priority sectors. Priority sectors had a share of 14.6 percent of total advances given by all public sector banks in 1969. It has improved to the level of 43.6% in 1984. Priority sector received Rs. 15,432 crores in 1984 against the advances of Rs. 440 in 1969.

Agricultural sector gets advances from many agencies. Though it is receiving increasing advances, we should see that they reach small and marginal farmers. Rural development has to be promoted by giving necessary attention to priority sectors. Agriculture occupies 42% of share out of advances to priority sector in 1984.

Small scale industries are getting about 40% of loans advanced to priority sector. As it is labour intensive and high output capital ratio sector, every care has to be taken in advancing loans from the period of establishment to the marketing of the products.

Self employment is an area where enterpreneurs look for the assistance from technical and financial institutions. Scheduled public sector banks can improve their level of income at individual level and can make them efficient at national level. For this liberalisation of terms and procedural formalities are one hand and cheap credit policy on the other hand are necessary. These objectives are getting fulfilled by nationalised banks. It accounts for 8% of advances to priority sector.

By advancing loans to retail traders, small businessmen and transport operators, purchasing power has been improved by the banks. Including educational loans (which promotes skills), loans advanced are Rs. 500 crores in 1984.

Various facets of economic activity are covered by the nationalised banks to improve conditions of the people in the country at rapid rate.

Bank credit to the export sector increased from Rs.270 crores to Rs. 1,799 crores in between June, 1969 and March, 1982.

15.8 SUMMARY, EVALUATION AND CONCLUSION

Nationalisation of banks took place in 1969 and 1980. Before that, imperial bank was nationalised in 1955. Nationalisation of 20 major commercial banks was done with the objective of realising the objectives of social control rapidly. To promote growth and welfare in the economy, and to provide social justice and balanced development, nationalisation was felt imminent. Post nationalisation showed encouraging results in branch expansion, deposit mobilisation, credit extension with multi-dimensional ramifications.

Nationalisation had its demerits also, though there was rationale for its implementation. Evaluation has shown that it led to bureaucratisation of the banking system. Lack of initiative, lack of perception, scanty managerial skills and lack of their application caused inordinate delays. Red tapism ruled the roost.

Branch expansion was tardy, especially in the later phase of planning. Unviable banking units, overdues in the banks, misappropriation of funds are adversly affecting the confidence on banking activity.

Political pressures are rising in the selection of personal appointment of directors, and in the working of the nationalised banks. Recent experience of waiving loans upto Rs. 10,000 has vitiated the atmosphere and many felt that it was an unnecessary gesture.

Trade unions of the employees are taking unproportional grip over the banks and the danger of paralysing the economic activity due to their strike is (peeping and) striking.

Uneconomic branches, lack of motivation, overdues increase are casing doubts on the achievement of progress.

Inequalities of income is not reduced, concentration of wealth has increased and social control objectives are partially fulfilled.

R.K.Sinha, chairman of Estimate Committee of Lok Sabha expressed disappointment at the failures of the nationalised banks.

Agriculture sector could receive only 17.6% of scheduled banks' advances in 1985. Credit available to that sector was insufficient. Even the credit requirements of the sector, areas and weaker sections are not worked out properly.

Reports of Era Seziyan Committee (1983, 1984) say that public sector has negligence of maintaining of public accounts. In 1982, the number of fraud cases were 2,065 involving Rs. 19.53 crores according to Seziyan report.

It can be concluded that nationalisation was helpful in implementing the social objectives. Yet improvements in the functioning both at quantitative and qualitative level are expected from the public sector banks, as they are the promoters of growth in monetary sector.

- Sri G.V. Ranga Rao

15.9 SUGGESTED BOOKS

1. Sanyasaiah and Ranganadha Chari : "Money Banking and International Trade "
2. K.P.M. Sundaram : "Banking Theory, Law and Practice"

3. Ruddar Datt and KPM Sundaram : "Indian Economy"
4. Misra and Puri : "Indian Economy"

15.10 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in 30 lines each.

1. Explain the nationalisation of banks in India and what is the rationale behind it.
2. Elucidate the role of nationalised banks, and their progress after 1969.

II. Answer the following questions in 15 lines each.

1. What is social control? Why was it imposed?
2. What are priority sectors? What is share in credit advances?
3. What are the causes of nationalisation?

UNIT-16 : CO-OPERATIVE BANKING

Contents

16.0 AIMS AND OBJECTIVES

The unit aims to examine the role of co-operative credit in assisting the rural sector in general and small farmers in particulars. It also examine the role played by the land development banks.

After reading the unit, you will be able to

* explain the structure of co-operative credit system,
* analyse the three tier system followed in Indian co-operative structure,
* discuss the structure of land development banks, and
* examine the working of land development banks.

16.1 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 restructing 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 finance 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.

16.2 THE CO-OPERATIVE CREDIT STRUCTURE

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.

16.2.1 ORIGIN & 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 this century. The movement was started with the objective of providing finances to agriculturists at lower rates 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.

16.2.2 MAJOR FUNCTIONS OF CO-OPERATIVE BANKS

The main functions of these banks are :

i. to pool the surplus-resources, if any, of the member societies.
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.

16.2.3 THREE TIER IN CO-OPERATIVE BANKING

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.

Thus 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.

16.3 THREE TIERS

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 Bank 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.

16.3.1 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 failure. 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 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 :

1. 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.

2. Since the resources of these societies are meagre they were unable to meet even the basic needs of the members.

3. 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 overdues 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 outstanding.

16.3.2 CENTRAL CO-OPERATIVE BANKS

The central co-operative banks are federations of primary credit societies in 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, where the membership of more banks is confined to co-operative organisation only. 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, deposits 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 from another source of funds for the Central Banks.

The main function of the central 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 banker 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 crores 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.

16.3.3 STATE CO-OPERATIVE BANKS

The State Co-operative banks, also know 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 bank and individual shareholders. 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 with 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)	20	1,791

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 to Rs. 1,140 crores in 1980-81.

16.4 THE CO-OPERATIVE BANKS AND THE RESERVE BANK OF INDIA

In recent years the relationship between the co-operative banks and the Reserve Bank of India has been strengthened. Co-operative banks can get direct accomodation 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 co-operative bank. The State, Central and primary co-operative banks, have brought them under the direct control of the R.B.I. 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 deposit insurance. The state co-operative banks can obtain refinance from the R.B.I. 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.

16.5 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 yielding varieties of seeds, intensive irrigation facilities, multiple cropping etc., have necessiated more credit for agricultural purposes. In the changing 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 grounds that the cost of meeting credit is high and that there are many avoidable procedural delays. The primary societies cannot be dispensed with because of their close report 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. 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 required level of performance within a period of 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.

Check Your Progress - I

1. What are the three tiers in the co-operative credit structure?

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2. What are the major weaknesses of co-operative credit societies?

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16.6 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.

16.6.1 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.

16.6.2 FINANCES OF LAND DEVELOPMENT BANKS

The Land Development Banks derive funds from the share capital, reserves 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: (1) Ordinary debentures and 2) 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 principle. These debentures are subscribed by the public, the co-operative banks, the LIC etc.

16.6.3 WORKING OF LAND DEVELOPMENT BANKS

The land development banks grant loans on the security of agricultural 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 mortgage of agricultural property. Generally, the loan is given to the extent of 50% of the value of the property mortgaged. However, the maximum amount of loan given to an individual is limited to Rs. 10,000 to 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. The 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 diary farming, poultry farming, piggery, sheep-rearing sericulture, gobar gas plants, rural godowns, warehouse, market yards etc.

16.6.4 CRITICISM LEVELLED AGAINST LAND DEVELOPMENT BANKS

One of the main criticism against 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 often distressing to farmers and force them to resort to money lenders for financial assistance. This drawback can be overcome by educating agriculturists and by creating 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 default arising from natural calamities such as draughts 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 has 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.

16.6.5 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 interest 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. This is done with an intention to enable the land development banks to give loans to the rural investors at correspondingly 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 subsidiary occupations.

16.7 SUMMING UP

Indian agriculture essentially requires cheap resource of finance. The co-operative banks are established primarily to provide credit facilities to the agricultural sector. Indian co-operative structure consists of three-tiers, namely, primary credit societies, central co-operative banks and State Co-operative banks. This unit concentrates on the co-operative credit system followed in India. At the end, land development banks are analysed critically.

Revised by - **K. Sateesh Reddy**

16.8 SUGGESTED BOOKS

1. R.B.I. : Review of the Co-operative Movement in India
2. Samiuddin and Mahfoozur Rahman : Co-operative Sector in India
3. M.C.Vaish : Monetary Theory

16.9 MODEL EXAMINATION QUESTIONS

I. **Answer the following questions in 30 lines each.**

1. Discuss the existing co-operative credit structure. What suggestions would you offer to make it more effective?
2. Do you think that the Co-operative central banks form an unnecessary link in the three-tier system? Substantiate your view point.

3. Bring out the significance of Co-operative Credit in the development of agriculture. What measures have been taken by the RBI to strengthen the co-operative credit System?
4. 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.

II. Answer the following questions in 15 lines each.

1. "The primary credit societies are the nerve centres in the co-operative credit structure" system?
2. What future do you visualise for the co-operatives in India?
3. How does the Reserve Bank of India help the Land Development Banks in providing credit to agriculturists?
4. Explain the structure of Land Development Banks.

UNIT-17 : REGIONAL RURAL BANKS

Contents

17.0 AIMS AND OBJECTIVES

The purpose of this unit is to deal with the need for the establishment of Regional Rural Banks; their capital, objectives, characteristics, credit policies, performance, problems and recommendations made by different Committees appointed to study the working of RRBs and make suggestions.

After reading the unit you will be able to explain,

* the factors that led to establishment of RRBs,
* special features and working of RRBs,
* financial assistance rendered to the weaker sections in the rural economy, and
* steps to be taken to improve the working of RRBs.

17.1 INTRODUCTION

The rural sector is the backbone of our economy because many people live in (nearly 70 per cent of our population) villages. According to 1981 census, proportion of rural population to total population was 76.69 per cent and that of village population 23.61 per cent. Rural incomes, derived mainly from agriculture, play 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 reconstruct villages, but lack of credit is one of the main problems of rural reconstruction.

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. (In 1980 six more commercial banks were nationalised). 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 6,667 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 and the Government of India set up a Committee to examine the issue under the Chairmanship of Shri M. Narasimham. The Committee was asked to examine, in detail, the issues involved in the establishment of 'new rural banks' as subsidiaries of the public sector banks to deal with the problem of rural finance. The working committee submitted its report on July 30, 1975.

17.2 NARASIMHAM COMMITTEE

The Committee observed that the commercial banks and 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 adoption, 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 suppliment and not supplant, the existing institutional credit agencies.

The Committee suggested that in selected areas where (i) neither the co-operative nor commercial 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 performance of these banks should be judged primarily by their success in the coverage of such categories of borrowers towards meaningful productive activity and recovery of their advances, rather than by the profits they make.

17.3 ESTABLISHMENT OF REGIONAL RURAL BANKS

The recommendations of the Narasimham Group RRBs were established by the Government from 2nd October, 1975. The Regional Rural Banks were to be set up mainly with a view to developing the

rural economy by providing, for the purpose of development of agriculture, trade, commerce, industry and other productive activities in the rural areas, credit and other facilities, particularly to the small and marginal farmers, agricultural labourers, artisans and small entrepreneurs, and for matters connected there with and incidental thereto.

Check Your Progress - I

1. How are the credit needs of the rural people served by the cooperatives and commercial banks?

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2. What was the need for starting Regional Rural Banks?

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17.4 CAPITAL STRUCTURE

The authorised capital of each RRB shall be rupees one crore, which the Central Government may increase or decrease in consultation with the 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% shall be subscribed by the Central Government, 15 per cent by the concerned State Government and 35 per cent by the sponsoring bank.

17.5 OBJECTIVES AND FUNCTIONS

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 enterpreneurs, in reasonable time and at reasonable 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 enterpreneurship; and

v) combine the business goals of the rural areas with social obligations.

17.6 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.

17.7 CHARACTERISTICS OF RRBs

1) RRBs grant loans and advances, particularly to small and marginal farmers, agricultural labourers, rural artisans, small enterpreneurs 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 part 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 Rs. 1 crore for every Rs. 15 lakhs of their own deposits.

17.8 DIFFERENCES BETWEEN RRBs AND SCHEDULED COMMERCIAL BANKS

The Regional Rural Banks are also scheduled banks.

The RRB, however, differs from a scheduled commercial bank in the following respects:

1) The RRB is deemed to be a cooperative society for the purposes of Income-Tax Act, 1961.

2) The area of operations of the RRB is limited to a specified region relating to one or more districts in the concerned state.

3) The RRB grants loans and advances only to the small and marginal farmers, agricultural labourers, rural artisans and small entrepreneurs or small traders.

4) The RRB charges interest rates as adopted by the cooperative societies in the State.

5) The interest paid by the RRB on its term deposits may be 1/2 per cent more than that is paid by the commercial banks.

6) If an RRB crosses the limit of 100 branches, it has to seek Reserve Bank's permission before going beyond 100 branches.

7) The RRB is a sponsored bank. It is sponsored by a scheduled commercial bank.

17.9 CONCESSIONS

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. 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 way of higher margin in using their deposit resources, by continuing the same refinance facility.

17.10 CREDIT POLICY

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 regard. 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.

Check Your Progress - II

1) What are the objectives and functions of RRBs.

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2) How RRBs differ from Commercial Banks.

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3) What are the special features of RRBs.

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4) Outline the Credit Policy of the RRBs.

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17.11 EVALUATION OF PERFORMANCE

17.11.1 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. 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 was to increase the number of Regional Banks to 170 covering 270 districts by March, 1985.

By the end of March, 1985, there were 183 RRBs established in the country, covering 322 districts spread over 23 states. U.P. claims to have the largest number of RRBs totalling 38. Bihar ranks second with 22 RRBs while Maharashtra has so far only 8 RRBs. On June 30, 1987, there were 196 RRBs, covering 350 districts. By March 1990, there were 196 RRBs covering 370 districts in the country with 14,650 branches. The total deposits with RRBs amounted to Rs. 4,150 crores and advances came to Rs. 3,560 crores. On December 31, 1986 there were 12,838 branches of the RRBs. In view of the state-wise offices of RRBs, it has been observed that U.P. claims to have the largest number of branches amounting to 2,787. Bihar stands second with 1,775 branches, M.P. third with 1440 branches and Andhra Pradesh fourth with 1,010 branches. Thus, nearly 55 per cent of the total branches of the RRBs are concentrated in these four states alone. Karnataka, Orissa, Rajasthan and West Bengal have between 700 and 1000 RRB branches. Maharashtra has only 10 RRBs with 456 branches. Gujarat has 9 RRBs with 307 branches. The performance of this scheme in the establishment of number of RRBs is significant compared to that of other financial agencies in the country.

17.11.2 DEPOSITS

Deposits per RRB (on an average) increased 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 crores by the end of June, 1983 as against Rs. 381 crores by the end of June, 1982 in respect of 114 RRBs.

17.11.3 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 per cent in 1975 to 176.12 per cent in 1979. This credit deposits 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.

In December 1989, 196 reporting RRBs have aggregate deposits of Rs. 3,644 crores and advances of Rs. 3,155 crores. Over 92 per cent of the total advances are made by the RRBs to the weaker sections. Their advances under IRDP during 1986 amounted to Rs. 200 crores relating to 7,84,145 accounts. Purpose-wise advances at the end of March, 1990 are given below.

Table : Purpose-wise Advances to RRBs
(At the End of March, 1990)

Purpose	Amount (Rs. in Crores)
1. Short-Term Crop Loans	620
2. Term Loans For Agricultural Activities	700
3. Allied Activities	570
4. Rural Artisans, Village and Cottage Industries	280
5. Retail Trade, Self-Employed, Etc.	1,020
6. Consumption Loans	30
7. Other purposes	280
8. Indirect Advances	50
Total	3,550

Source : RBI, Report on Currency and Finance, 1989-90, Vol. I., P. No. 179.

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 per cent and 65 per cent. The share of rural artisans and others in total advances varied between 61 per cent and 65 per cent. The share of rural artisans and others in total advances varied between 32% & 35% and the share of indirect advances in total advances ranged between three and six 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, 1983.

17.11.4 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). During 1982-83 (July-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.

In December 1986, the RRBs obtained refinance amounting to Rs. 246.9 crores from the sponsor banks. They borrowed Rs. 226.9 crores of short-term loans and Rs. 80.3 crores of medium-term loans from the NABARD.

17.11.5 OTHER DEVELOPMENTS

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.

17.12 MAJOR PROBLEMS FACED BY RRBs

The RRBs, in most cases, seemingly have a mixed record of 'successes' on some fronts and 'failures' on some others in their business and attainment of goals. Their failure in achieving their targets may be attributed to several problems they encounter in practice. Following Professor Chairman Wadhva, we may pin-point some of the major problems faced by the RRBs as under.

17.12.1 OVERDUES

The main problem of RRBs is mounting overdues. The position of overdues in relation to demand raised in respect of all the RRBs is not available. At the end of December, 1982, the overdues of all the RRBs amount 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 cent. 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 measure to reduce the overdues.

17.12.2 PROFITABILITY

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 have 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, alarge number of RRBs have incurred losses. The trend is continuing.

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 subsequently reduction in lending rates with effect from 21st April, 1982; (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 towards 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.

17.12.3 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 in - 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.

17.12.4 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 per cent 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 11.5 per cent. On the other hand, they have to pay interest at 11 per cent on term deposits maturing after 5 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.

17.12.5 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 decisions 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.

17.12.6 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 cadre of their own to attend to control functions at their administrative offices or look after bigger branches. Of late, unions in RRB have raised demands for parity in salary, allowances and other monetary benefits with commercial banks. In the absence of a proper dialogue with RRBs unions, resentiment and frustration among the RRB 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 jeopardised by it.

17.12.7 HASTE AND LACK OF COORDINATION IN BRANCH EXPANSION

Haste in branch expansion programme in many cases has resulted in lopsidedness due to lack of co-ordination. In several cases, it could not be ensured that the branches of the RRBs are opened at centres where no commercial or cooperative banking facilities were provided.

17.12.8 DIFFICULTIES IN DEPOSIT MOBILISATION

The RRBs encountered a number of practical difficulties in deposit mobilisation. On account of their restrictive lending policy which excludes richer sections of the village society, these potential depositors show least interest in depositing their money with these banks.

17.12.9 CONSTRAINTS IN DEPOSIT MOBILISATION

The RRBs exclude the richer sections of the village society in providing direct financial assistance. These sections have potential savings to deposit. But, they are least interested in depositing them with the RRBs in view of the restrictive credit policy of these banks. Further, state and local governments and their agencies also have not cooperated much by maintaining their deposit accounts with RRBs.

In short, the RRBs have failed to mobilise deposits as per the target set.

17.12.10 SLOW PROGRESS IN LENDING ACTIVITY

The RRBs pace of growth in loan business is slow. For this the following reasons may be given: i) There have been limited scope for direct lending by RRBs in their fields of operations; ii) It is always difficult to identify the potential small borrowers and the bank staff have been required to make special and sincere efforts in this regard; iii) Most of the small borrowers do not like the bank formalities and prefer to borrow from the informal/indigenous sources of finance, such as money lenders; iv) The anomalies in the Differential Interest Rate (DIR) Scheme also posed a special problem to the RRBs. While the RRBs charge 14 per cent interest, the commercial banks charge only 4 per cent under the DIR Scheme in rural areas. Thus, no borrower would go to RRBs or co-operative societies in the area when a loan from the commercial bank is available under the DIR Scheme; v) There is no effective link between the RRBs and PACs and the farmers service societies; vi) There is lack of coordination between officials of the district credit planning committees and the RRBs.

17.12.11 URBAN-ORIENTATION OF STAFF

A crucial practical difficulty experienced in their working by the RRBs is the urban orientation of their staff which is rarely inclined to serve in rural areas. There is no true local involvement of the bank staff in the villages where they serve.

17.12.12 PROCEDURAL RIGIDITIES

The RRBs follow the procedures of the scheduled commercial banks in the matter of deposits and advancing loans which are highly complicated and time-consuming from villagers' point of view. The rural borrowers always appreciate informal ways and simple procedures as have been followed by the money lenders and the indigenous bankers.

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.

17.12.13 CONCLUDING REMARKS

Despite these problems, the RRBs have been trying their level best to achieve their social objectives. They have succeeded in projecting their image of 'small man's bank'. They are, in fact, development banks of the rural poor. They have been trying to fill regional and functional gaps in rural finance in our country.

17.13 SUGGESTIONS FOR REORGANISATION AND IMPROVEMENT IN THE WORKING OF RRBs

The RRBs have, indeed, made a good beginning in the direction of the objective of promoting rural development with redistributive justice.

It is, however, necessary to reorganise their structure and improve their working. Professor Chairman Wadhva makes the following important suggestions:

1) The unique role of RRBs in providing credit facilities to weaker sections in the villages must be preserved. The RRBs should exist as rural banks of the rural poor.

2) The RRBs may be permitted to lend up to 25 per cent of their total advances to the richer sections of the village society.

3) There is an urgent need to create a more hospitable rural environment for the RRBs. The hostile attitude of PACS towards RRBs must change.

4) The State Government should also take keen interest in the growth of RRBs.

5) There should be a clearly demarcated planning for the scope of the activities of RRBs, cooperatives and commercial banks in the rural areas.

6) Participation of local people in the equity share capital of the RRBs should be allowed and encouraged.

7) Local staff may be appointed, as far as possible, in the RRBs.

8) Co-operative societies may be allowed to sponsor or co-sponsor with commercial banks in the establishment of the RRBs.

9) The RRBs should be linked with PACS and farmers' service societies (FSS).

10) When the RRBs assist PACS, the latter must ensure that a minimum percentage of their lendings should go to the weaker sections.

11) The RRBs should be strongly linked with the sponsoring scheduled commercial banks and the Reserve Bank of India.

12) Co-ordination between district level development planning and district level credit planning is also required in order to chart out the specific role of the RRBs as a development agency of the rural area.

13) A uniform pattern of interest rate structure should be devised for the rural financial agencies.

14) The RRBs must strengthen effective credit administration by way of credit appraisal, monitoring the progress of loans and their efficient recovery.

15) The credit policy of the RRBs should be based on the group approach of financing rural activities.

16) The RRBs may initiate certain new insurable policies like deposit-linked cattle and other animals insurance policy, crop insurance policy or life insurance policy for the rural depositors.

17) The RRBs should increase their consumption loans to the villagers and weaker sections.

18) The RRBs may also provide marketing guidance and consultancy services to the villagers.

19) The RRBs may relax their procedures for lending and make them easy for the village borrowers.

20) The RRBs should be permitted to provide full range of banking services, such as remittances and other utility/agency services, which would help a lot in developing banking habit among the villagers.

21) The image of RRBs should be improved. They should not be identified as 'second class' banks or an extension of the urban-oriented commercial banks. They must develop their own identity.

22) The RRBs should be encouraged to form their separate associations at state and national levels. These associations may coordinate training and research activities of their member banks and publish newsletters or journals, etc.

17.14 DANTWALA COMMITTEE'S REPORT ON RRBs

In June, 1977 the Reserve Bank of India appointed a Committee to review the working of RRBs. It was headed by Professor M.L. Dantwala. It is, therefore, called the Dantwala Committee. The Committee submitted its Report to the Reserve Bank of India in February, 1978.

The following terms of reference were assigned to the Committee :

1. To evaluate the performance of the RRBs in view of the objectives set out for them;

2. To spell out the precise role of the RRBs in the rural credit structure.

3. To make recommendations on the scope, methods and procedures of functioning of the RRBs and other related matters.

The Dantwala Committee conducted a detailed study of the working of 12 selected RRBs, namely: 1) Tungabhadra Gramin Bank; 2) Bhojpur Rohtas Gramin Bank; 3) Champaran Kshetriya Gramin Bank; 4) Kshetriya Gramin Bank, Hoshangabad and Raisen; 5) Jaipur Nagaur Aanchalik Gramin Bank; 6) Korapur Panchabati Bramin Bank; 7) Prathama Bank; 8) Haryana Kshetriya Gramin Bank; 9) Gorakhpur Kshetriya Gramin Bank; 10) North Malabar Gramin Bank; 11) Nagarjuna Gramina Bank; and 12) Mallabhum Gramin Bank.

The Dantwala Committee (or the Review Committee) has come out strongly in favour of continuing RRBs. The Committee 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 cooperatives. The support of this committee for RRBs can be seem 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."

It observed that the performance of these RRBs was good in general in fulfulling the objectives set out for them.

The following are the major findings and recommendations of the Dantwala Committee :

1. The RRBs with some modifications in their organisation and function can become a very useful in the totality of the rural credit structure. The RRBs can make a substantial contribution to improving the quality and quantity of credit flows to the rural areas by becoming an integral part of the rural credit structure.

2. The Committee, however, did not favour the proposal of converting selected PACS into rural banks. It suggested that of providing rural credit in a more efficient manner.

3. The RRBs should function at the the intermediate level. It should progressively fill the 'credit gap' in the rural sector.

4. The RRBs are superior to the rural branches of commercial banks in supplying rural credit, because of their lower cost of operation, simplicity, low profile, local participation in management and close connections with their clients and rural development authorities. The Committee, therefore, opines that the commercial banks should prefer to meet the credit requirements of the rural areas through the RRBs.

5. The jurisdiction of a RRB should be confined to one district.

6. The Committee recommended the following scheme of composing the share capital of the RRBs.

1) Sponsoring Bank : 40 per cent
2) RBI : : 25 per cent
3) State Government : 15 per cent
4) Local Participation : 20 per cent

7. The RRBs should be allowed to provide full banking facilities in the areas of their operation.

8. Forms and procedures of the RRBs should be further simplified.

9. The RBI should ensure uniformity in the interest rate policy on part with all rural financial agencies in the organised sector of the money market.

10. The RRBs should be adequately recruit technical Staff.

11. Sponsoring banks should provide training to the staff of the RRBs.

17.15 SUMMING UP

The Regional Rural Banks started functioning from October 2, 1975. These were started under 20 points Economic Programme to fillup the gap in the sources of institutional finance needed for agricultural and rural development. The main purpose of these banks is to make finance available for productive and developmental purposes to the weaker sections of the rural economy namely; small farmers, marginal farmers, agricultural and other labourers, artisans and others who are economically weak. The operations of these banks are generally limited to one district and rarely to two districts; (Nagarjuna Grameena Bank covers two districts - Khammam and Nalgonda). Its network of branches spread through out the district with local people who know the local needs as its employees, these banks are expected to go a long way in serving credit needs of the rural masses. These Regional Rural Banks have been mainly concerned to combine the strong points of both cooperative and commercial banks avoiding completely the defects of both. Thus Rural Banks have originated from the base and rural touch of the cooperatives and the organisational efficiency and financial strength of the commercial banking system. To conclude, these banks with their branches in many districts are serving well the rural poor, notwithstanding the fact that they suffer from certain limitations and deficiencies.

Revised by - K. Sateesh Reddy

17.16 SUGGESTED BOOKS

1. D.M. Mithani : Currency and Banking
2. K.P.M. Sundaram : Money, Banking and International Trade
3. A.B.N. Kulkarni and A.B. Kalkundrikar : Money, Banking, Trade and Finance.

17.17 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. Explain the objectives and working of RRBs.
2. Comment on the superiority of RRBs over other financial institutions in rural areas.
3. Review the progress of the RRBs since their establishment.
4. What are the major problems faced by the RRBs?
5. What are the suggestion you make for reorganisation and improvement in the working of RRBs?
6. Mention some of the important findings and recommendations of the Dantwala Committee.

II. Answer the following questions in about 15 lines each.

1. What are the recommendations made by the Narasimham Committee?
2. What are the functions of the Regional Rural Banks?
3. How are the RRBs differ from Commercial Banks?
4. What are the characteristics of the RRBs?
5. Explain the problem of 'overdues' with respect to RRBs.
6. Write a note on the credit policy of the RRBs.
7. How RRBs facilitate implementation of 20 points Economic Programme?
8. What is the assistance extended to RRBs by the NABARD?

UNIT-18 : RESERVE BANK OF INDIA AND AGRICULTURAL FINANCE POLICY AND INSTITUTIONS

Contents

18.0 AIMS AND OBJECTIVES

The purpose of this unit is to deal with the part played by the Reserve Bank of India in providing various types of assistance including credit to agriculture through its agencies.

After reading the unit, you will be able to know

* role of R.B.I. in providing agricultural credit facilities,
* system of Integrated Rural Credit,
* types of credit facilities, and
* assistance of State Bank of India, Commercial Banks, Regional Rural Banks and NABARD to agriculture.

18.1 INTRODUCTION

Finance is an essential requirement for every productive activity and agriculture is no exception. In India, agriculture is in a backward condition. It is perhaps due to the shortage of adequate financial resources which prevent agriculturists from effecting improvements in cultivation. The existing institutions of credit are not capable of meeting the financial needs adequately. It was for this reason that the R.B.I. assumed the responsibility of providing more credit through various institutions.

18.2 RESERVE BANK OF INDIA - AGRICULTURAL CREDIT

18.2.1 RESERVE BANK'S ROLE BEFORE 1954

Since its inception in 1935, the RBI has been playing an important role in providing credit to agriculture and in strengthening credit institutions, in particular primary co-operative credit societies and land development i.e., Agricultural Credit Department. Its main functions are:

1. To maintain expert staff to study all questions of agricultural credit and be available for consultation by the Central and State Government, provincial State Co-operative Banks and other Banking Organisations.

2. To co-ordinate the operation of the Bank in connection with agricultural credit with those of provincial co-operative banks and other institutions engaged in the supply of agricultural credit.

But till 1949 when the RBI was nationalised, the role of RBI in rural finance was very insignificant. In 1949-50 the State Co-operative Banks borrowed only Rs. 2.7 crores from the RBI. This was due to the absence of good rediscountable bills with State Co-operative Banks and existence of only two State Co-operative Banks (in Maharashtra and Tamilnadu).

18.2.2 RESERVE BANK'S ROLE AFTER 1954 - INTEGRATED RURAL CREDIT

After the publication of the All India Rural Credit Survey Committee Report in 1954, the activities of the RBI have increased. It recommended integrated rural credit scheme. This scheme was based on three fundamental principles viz., (i) The State should participate in the co-operative at all levels.

2) There should be full co-ordination between credit and other economic activities such as agriculture, marketing, processing etc.,

3) The co-operative movement should be run by adequately trained and efficient personnel who are fully aware of as well as responsible to the needs of the farmers.

The State should participate in the co-operative movement financially as well as otherwise. The co-operative societies are supposed to help the farmer not alone in credit requirements but also advice and direction in better cultivation, the supply of seeds and fertilizers, marketing of their produce and soon. To take advantage of this scheme, the primary co-operative society should become a multipurpose society.

The Government accepted most of the recommendations of the Committee and has given effect to them. The State Bank of India has been charged with the development of rural and Co-operative Banking. It would pay special attention to the needs of co-operative institutions connected with credit, marketing and processing. Further, the Co-operative Development and Ware housing board was set up in 1956 and the Central Warehousing Corporation in 1957.

The Reserve Bank of India was asked to create two separate funds. The first was called the National Agricultural Credit (Long Term Operations) Fund with an initial contribution of Rs. 5 crores. From this fund, the Reserve Bank was to grant long term loans to the State Government to enable them to participate in the share capital of the co-operative societies. The other fund was called the National Agricultural (Stabilisation) Fund to which Rs. 1 crore was to be allotted annually to grant medium term loans to State Co-operative Books.

18.2.3 RESERVE BANK - SHORT TERM CREDIT

The Reserve Bank provides short term credit to State Co-operative Banks financing seasonal agricultural operations and marketing of crops at the concessional rate of 2 per cent below the bank rate.

In 1950-51, the Reserve Bank of India sanctioned short term credit to the extent of Rs. 7.6 crores only. But in 1981-82 this amount had increased to Rs. 1090 crores. The credit limits are at the concessional rate of interest of 3 per cent below the bank rate. Besides, the Reserve Bank sanctions loans to meet the working capital of co-operative sugar factories, Apex marketing Societies for purchase, stocking and distribution of chemical fertilizers.

18.2.4 RESERVE BANK - MEDIUM TERM CREDIT

These loans are given for a period of 3 to 5 years. The purposes are reclamation of land, bunding and other land improvements necessary for the cultivation of crops, the maintenance of small irrigation works and the purchase of machinery, livestock etc., In 1954-55, the amount sanctioned to medium term loans was Rs. 27 lakhs. This has been increased to Rs. 110 crores in 1981-82. Medium term loans are also given to agriculturists for purchase of shares in Co-operative Sugar Factories. The Bank converted short term loans into medium term loans in areas affected by scarcity.

18.2.5 RESERVE BANK - LONG TERM CREDIT

In regard to long term finance to agriculture, the Reserve Bank (a) subscribes to the debentures of Central Land Development Banks (b) it gives loans to Agricultural Refinance and Development Corporation and (c) it grants loans to State Governments to enable them to subscribe to the share capital of co-operative credit institutions. The Reserve Bank has given an undertaking that it would subscribe to debentures by Central Land Development Banks upto 20 per cent of the total value or the short fall in the public subscription whichever is less.

The Reserve Bank normally sanctions loans for 12 years (though it can lend upto 20 years according to the Act) to the State Governments to enable them to contribute to the share capital of the State and Central Co-operative Banks and large sized primary societies being made out of National Agricultural Credit (Long Term Operations) Fund established in 1956. Loans amounting to Rs. 212 crores were sanctioned during 1981-82.

18.2.6 RESERVE BANK'S HELP TO WEAKER SECTIONS

Besides strengthening the structure of institutional finance and augmenting the credit going to agricultural sector, the Reserve Bank has also adopted special means to help the weaker sections of rural population and to reduce the imbalance in the regional distribution of available finance. For example (medium term loans) to Central Co-operative Banks deposits, provided these funds are used for financing small and marginal farmers identified by small farmers and agricultural labourers (MFAL) agency. Further, the Bank allowed advances to be used for the purchase of bullocks by farmers of SFDA areas. Again, the primary agricultural credit societies have been permitted to advance five year medium-term loans in excess of certain minimum to individual members for purchase of power tillers without mortgage of land. Further, both tenants and share croppers belonging to weaker sections have been made eligible for long term finance. The Reserve Bank provided softening conditions of repayment of loans by farmers in areas of scarcity or famine conditions. The Reserve Bank decided to direct more funds into states where per hectare outstandings are relatively low with the aim to bring a more balanced distribution of investment finance.

18.3 RESERVE BANK - OTHER INSTITUTIONS

18.3.1 RESERVE BANK - STATE BANK OF INDIA

The Government nationalised the Imperial Bank on 20th December, 1954 on the recommendation of All India Rural Credit Survey appointed by RBI. The Government later established the State Bank of India on July 1, 1955. This bank was expected to operate its activities in confirmity with the broad economic policies of the Government. Further State Bank of India has been directed to promote agricultural finance and to solve the problems of the existing system of agricultural finance. The activities of the Bank comprise of

(a) *General assistance :* It provides liberalised remittance facilities to State and Central Co-operative Banks.

(b) *Loan to Co-operative Banks :* The State Bank have also been granting short term credit facilities to the State and Central Co-operative Banks against Government securities at a concessional rate of interest i.e., half per cent below the usual rate of advance.

(c) *Assistance to Land Development Banks :* State Bank subscribes to the debentures floated by Central Land Development Banks from time to time. It grants temporary financial accomodation against Government guarantee.

(d) The State Bank of India has introduced the village adoption scheme to meet the total credit needs of all farmers and artisans in the village.

(e) State Bank group has been extending assistance for agricultural development through its special agricultural development branches (ADB).

Since the Reserve Bank cannot directly grant credit facilities to the agriculturists, the State Bank of India has been directed to meet the needs of the farmers. The State Bank of India is participating in all schemes of lending to rural areas formulated by the Government and the Reserve Bank of India.

18.3.2 RESERVE BANK - COMMERCIAL BANKS

The Reserve Bank of India circulated among all Commercial Banks 'guidelines for financing of agriculture by Commercial Banks' in December, 1970. These were prepared on the basis of a study of the credit planning cell of the Reserve Bank of India.

As such the contribution of commercial banks to agricultural credit, reached Rs. 10,666 crores in 1987; constituting 19% of the total bank credit. This needs to be stepped up further with the opening of more rural branches to mobilise deposits. These banks should provide more money for marketing of agricultural products.

The rural variant of Commercial Banks, namely the Regional Rural Banks has also expanded much. Their number of offices stood at more than 13,500 in 1988. The area approach to the problems of agricultural finance i.e., financing agriculture through an intensive programme of area development was taken up in right earnest.

Thus the commercial banks are making some headway with their contributions to agricultural finance.

18.3.3 RESERVE BANK - REGIONAL RURAL BANKS

The Reserve Bank felt that the Regional Rural Banks have a significant role to play in the financing of the rural sector. The R.B.I. has suggested the setting up Regional Rural Banks in areas where Co-operatives were rather weak and where the need for such agencies were rather weak and where the need for such agencies was felt. The Reserve Bank of India has also suggested joint sponsorship of RRBs by apex Co-operative banks to develop closer linkage.

The Regional Rural Banks have been able to achieve the main objective of helping the weaker sections in the rural areas by providing credit to suit their requirements. This indeed is the finding of the steering committee constituted by the Reserve Bank.

The RRBs have been actively participating in programmes designed to provide credit assistance to identified beneficiaries under the new 20 point Programme, Integrated Rural Development Programme and other special programmes of the scheduled castes and scheduled tribes.

18.3.4 RESERVE BANK - NATIONAL BANK FOR AGRICULTURE AND RURAL DEVELOPMENT (NABARD)

It was on the recommendations of the Sivaraman Committee, the most important development in the field of rural credit in recent years is the setting up of the National Bank for Agriculture and Rural Development (NABARD) on 12th July, 1982. It has replaced for merging in itself the Agricultural Refinance and Development Corporation and two credit related constituents of the Reserve Bank of India viz., Agricultural Credit Department and the Rural Planning and Credit Cell. It is an all India refinancing agency for providing undivided attention, forceful direction and pointed focus, to the credit problems of the rural sector. The NABARD's Head Office is in Bombay and with 16 regional offices throughout the country.

The NABARD is to have share capital of Rs.100 crores to start with (contributed equally by the Reserve Bank and the Government of India). The amount of its authorised capital has been raised from Rs.500 crores to Rs.1000 crores.

Functions :

The main functions of NABARD are

1. It has the objective of promoting the health and strength of the credit institutions i.e., Co-operatives, Commercial Banks and Regional Rural Banks.

2. It has the authority of directing, inspecting and supervising credit flows in agricultural and rural development.

3. It provides short term credit (upto 18 months) to State Co-operative Banks for seasonal operations (crop loans), marketing of crops, purchse and distribution of fertilizers and working capital requirements of co-operative sugar factories.

4. It provides medium term credit (18 months to 7 years) to State Co-operative Banks and RRB s for approved agricultural purposes, purchase of shares of processing societies and conversion of short term crop loans into medium term loans in areas affected by national calamities.

5. It provides medium and long term credit (not exceeding 25 years) for investments in agriculture under schematic lending to State Co-operative Banks, Land Development Banks, RRBs and Commercial Banks.

6. It provides long term loans to State Governments (not exceeding 20 years) for contribution to share capital of co-operative credit institutions.

7. It maintains a research and development fund to be used to promote research in agribulture and rural development.

Performance of NABARD :

It should be remembered that the NABARD is an apex institution and does not deal directly with farmers and other rural people. It grants assistance to them through Co-operative Banks, Commercial Banks, RRBs etc.

1. The NABARD sanctioned short term credit amounting to Rs.2,807 crores in 1989-90 for financing seasonal agricultural operations (at 3 per cent below Bank rate). It also granted short term credit of Rs.450 crores during 1989-90 for purposes other than seasonal agricultural operations.

2. It sanctioned medium term loans to the extent of Rs. 16 crores during the year 1989 for approved agricultural purposes.

3. In regard to long term assistance, it sanctioned 9,211 schemes in 1989-90 to the extent of Rs. 2,039 crores. The total number of schemes sanctioned upto march, 1990 stood at 78,863 and disbursements amounting to Rs.12,407 crores. Most of the schemes belong to minor irrigation (29,749 out of 78,863).

4. It has pursued a policy of developing and promoting agricultural investments in less developed areas and/or underbanked states.

5. The NABARD provided credit to the non-farm sector viz., Small Scale Industries, Cottage & Village Industries etc. For meeing their working capital requirements. The short term credit is provided for financing production and marketing activities of Co-operative Sugar Mills, Handloom Weavers Societies and 22 broad groups of recognised Cottage and Small Scale Industries, Industrial Co-operatives and Weavers and rural artism Co-operations.

6. The NABARD sanctioned financial assistance to 76 Regional Rural Banks from its Research and Development fund for setting/strengthening their Technical, Monitoring and Evaluation Cells (TME).

Khusro Committee's Recommendatins on NABARD :

The Khusro Committee pointed out the refinance function has attracted relatively more attention than other functions of the NABARD over the years. It stressed the need to enlarge its activities much beyond those of refinance. The following are its recommendations :

1. NABARD should undertake an effective role in institutional development, particularly with regard to Co-operative.

2. NABARD should resort to direct lending under special circumstances in the interest of regional/sectoral development.

3. NABARD will have to raise resources from the market in the coming years on an increasing scale.

4. The inspection functions of the NABARD is not integrated with refinace and institutional development function. It should redefine the purpose and objectives of inspections to facilitate such integration.

The scope of the operations of NABARD is large indeed. It has to emerge as a strong development Bank for rural regeneration. It should concentrate more on the building up of the Co-operatives. It has to promote research in agricutlure and rural Development to formulate and design projects and programmes to send the requirements of different areas and to cover special activities.

18.4 SUMMARY AND CONCLUSIONS

To sum up the Reserve Bank is playing an increasingly important role in rural finance. As for its performance, it has been quite good. It promoted credit institutions on sound lines and substantially contributed in argumenting their resources. Besides supplying of credit to agricultural development it also ensured the social objectives of helping the poorer sections of population and of reducing regional disparities in the distribution of funds.

There is increasing reliance of co-operative Banks on the Reserve Bank. The proportion of finance from Reserve Bank to Co-operative Banks is about 10 percent of the working funds of the later. In the case of some States it is over 90 per cent. It is an indication of the weakness of the co-operative system of finance.

Efforts must be made to strengthen the co-operative credit institutions in mobilisation of untapped rural deposits. The Reserve Bank as such is doing its best and can continue to play a prominent part in helping the rural sector at large.

- Dr. K. Prasad Rao

18.5 SUGGESTED BOOKS

1. Ruddar Datt K.P.M.Sundaram : Indian Economy
2. A.U.Agrawal : Indian Economy
3. S.K.Ray : Indian Economy

18.6 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. Explain the part played by Reserve Bank of India in financing agriculture.
2. Explain the various measures taken by the Reserve Bank of India in strengthening Co-operative Credit Structure.

II. Answer the following in about 15 lines each

1. Integrated rural credit
2. Commercial Banks -- Agricultural Credit
3. NABARD activities.

GLOSSARY (Units : 7-18)

Accelerator	:	The ratio between the changes in demand for consumer goods and capital goods.
Acceptance	:	When a bill is accepted by the drawee, it is called acceptance.
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.
Agricultural Banks	:	Banks that meet the long term and short term financial requirements of agriculturists to a considerable extent.
Asset	:	Anything owned by a person or company etc., that has money value and which can be sold pay debts.
Balance sheet of a Bank	:	The statement of assets and liabilities of a banking company.
Balanced growth	:	Refers to uniform rate of growth in an economy.
Bank	:	Establishment for keeping money and valuables safely and the money being paid out on the customer's orders.
Bank rate	:	It is the standard rate at which the Reserve Bank is prepared to buy or rediscount bills of exchange or other commercial papers eligible for purchase.
Bill of exchange	:	It is a negotiable instrument and a legal document of debt.
Boom	:	Prosperity period during which the economic activity expands.
Branch Banking System	:	A system in which each bank operates with a net work of branches spread all over the country.
Business cycle	:	Ups and downs in an economic activity. These are referred to as Booms and Depressions.
Capital	:	Wealth that may be used for the production of more wealth.
Call Money Market	:	Market for extremely short period loans.
Capital Market	:	The market for medium and long term loans.
Cash-Reserve Ratio	:	Refers to the proportion of deposits which commercial banks to keep as a reserve with a Central Bank.
Central Bank	:	The bank that controls the volume of currency and credit in any country.
Chain Banking	:	The system of banking in which two or more banks are owned and controlled by one or a group of persons.
Cheap Money	:	Credit money is made available at low rate of interest.

Cheque	:	Written order (usually in a printed form) to a bank to pay money.
Collateral Security	:	Security taken by a bank in support of its lending to customers.
Commercial Banks	:	Joint stock banks which accept different kinds of deposits from the public and grant short term loans.
Correspondent Banking	:	A system in which a bank in a small town or village is connected with another bank in the city as its correspondent bank.
Credit	:	Faith or confidence of the credit in the capacity of the debtor to fulfil his promise to pay a certain amount.
Dear Money Policy	:	The policy of the Central Bank by which the bank rate and other interest rates are kept at a high level.
Deposit Banking	:	A system of banking in which banks receive deposits from the public and lend them for short periods.
Fixed Deposits	:	Deposits payable after a certain period of time.
Foreign Exchange Banks	:	Banks that specialize in financing foreign trade through the same and purchase of exchange bills.
Full Employment	:	The level of employment at which every one (able and willing to work) is employed. The full employment level of the economy indicates full capacity output i.e., all resources are employed.
Gold Standard	:	A monetary system in which the value of each basic unit of a country's currency is fixed in terms of gold.
Group Banking	:	A banking system in which two or more banks are directly or indirectly controlled by an Association.
Hoarding	:	Carefully saved and guarded store of money.
Hundi	:	An internal bill of exchange.
Laissez-faire principle	:	The doctrine stating that the State interference in industry and commerce should be kept to a minimum.
Legal Tender	:	Form of money which must be accepted if offered in payment.
Liquidation	:	Payment or settlement (debts) of an unsuccessful business company by dividing up its property to pay debts.
Mixed Banking	:	A banking system in which commercial banks make short term as well as long term loans to Commerce, Trade and Industry.
Money	:	Metallic coins and printed notes with values stamped on them.
Negotiable Instrument	:	That which can be changed into cash or passed from persons to persons instead of cash.
Neutral Money	:	Money service as a medium of exchange and unit of account but does not affect the economy.

Overdraft	:	Refers to an amount of money by which a bank account is over drawn.
Public Debts	:	These comprise the National debt, the debts of local government authorities and the debts of public corporations.
Security	:	Any valuable given as a pledge for the repayment of a loan or the fulfilment of a promise or undertaking.
Treasury Bills	:	Short Term Government Securities offered.
Unit Banking	:	A system in which each bank operates as a single unity without any branches.
Value of Money	:	Purchasing power of money.
Ways and Means Advances	:	Temporary borrowings by the Government from RBI.
White Paper	:	An official statement by Government on some matters of current economic or social interest generally a basis for legislation.

SUGGESTED READINGS

1. K.P.M. Sundaram & P.N. Varshney : Banking: Theory, Law & Practice
2. K.C. Shekar : Banking Theory & Practice
3. K. Sanyasaiah & A.V. Ranganadhachari : Money, Banking, International Trade and Public Finance
4. Reserve Bank of India : History of Reserve Bank of India
5. Basu A.K. : Fundamentals of Banking Theory
6. Bredford F.A. : Money and Banking
7. Chandler L.V. : The Economics of Money and Banking
8. Crowther G. : An Outline of Money
9. Kent R.P. : Money and Banking
10. De Koch M.H. : Central Banking
11. Halm George N. : Economics of Money and Banking
12. Hawtrey R.G. : The Art of Central Banking
13. Sayers R.S. : Modern Banking
14. San S.N. : Central Banking in Underdeveloped Money Markets
15. Shaw W.A. : Theory and Principles of Central Banking
16. Vera Smith : Rational of Central Banking

BLOCK - III : INTERNATIONAL TRADE

This block deals with necessity of having trade with other countries and theories relating to international trade. It also deals with the problems and issues relating to international trade such as terms of trade, balance of trade, balance of payments, exchange rates and devaluation. It explains the international monetary institutions such as World Bank and IMF. In the end, foreign trade and payments problems pertaining to India are explained

This Block consists of the following 7 Units :

Unit - 19 : Need for A Separate Theory of International Trade

Unit - 20 : Theories of International Trade

Unit - 21 : Terms of Trade and Gains from Trade

Unit - 22 : Balance of Payments

Unit - 23 : Exchange Rates

Unit - 24 : International Monetary System

Unit - 25 : India's Foreign Trade and Payments

UNIT-19 : NEED FOR A SEPARATE THEORY OF INTERNATIONAL TRADE

Contents

19.0 AIMS AND OBJECTIVES

The aim of this unit is to explain the concepts of internal and international trade and to analyse the basis of international trade.

After reading the unit you will be able to

* discuss some basic concepts relating to international trade,
* explain the difference between internal and international trade, and
* examine the basis of international trade and also its advantages and disadvantages.

19.1 INTRODUCTION

The term 'Trade' generally means exchange of goods among people. Trade is of two types namely internal or domestic trade and external or international trade. Internal or domestic trade means exchange of goods between people within the given geographical boundaries of a nation or region. On the other hand external or international trade, is exchange of goods between different countries.

19.2 INTERNAL TRADE AND INTERNATIONAL TRADE

It should be noted that the difference between interregional trade and international trade is only one of degree and not of kind. The fundamental principles in both cases and the same international trade like interregional trade is the result of division of labour. In internal or interregional trade, people specialize in producing goods in which they have a comparative advantage., the same thing happens in international trade. In the words of Prof. Haberler, "strictly speaking, it is neither possible nor essential to draw a sharp distinction between the problems of foreign and domestic trade. If we examine the alleged pecularities of foreign trade, we find that we are dealing with differences in degree rather than with such basic difference of a qualitative nature as would warrant sharp theoretical divisions."

There are nevertheless, general differences between internal and foreign trade which necessitates the formulation of a separate theory of international trade. Some of these differences are practical, some pedagogic. Perhaps the most obvious justification for a seperate study arises from the barriers between countries which prevent completely free movement of goods, persons and capital. These barriers may be political, social or linguistic, as well as economic which takes the form of custom duties, direct trade

restrictions or exchange controls. Such trade barriers are rarely important, enough to impede the flow of trade within a country, but to the extent that they are important between countries they give rise to a number of problems which form part of the study of international Economics.

Secondly, difference between internal and international trade arises because trade within the country is conducted in terms of a single currency. But in the case of international trade, it is found that every country has its own currency since the nationals of each country execute their transactions whether domestic or foreign in their national currency, this raises the problem of foreign exchange; i.e., of converting international payments and receipts from one currency into another. But these specific problems of converting currencies does not arise in internal trade.

The third distinguishing characteristic of international trade arises from the fact that the existence of political boundaries carries with it controls and regulations of international trade and payments, in the form of customs duties, exchange control, foreign trade monopolies and so forth, which do not generally exist in the domestic trade area.

Another factor perhaps the most significant one which distinguishes international from internal economic transaction is that at any point in time, over all economic conditions and policies are likely to differ much more markedly between countries than within a country. For instance if two or more regions form part of the same country it is likely that similar broad economic policies will be followed in all areas and is unlikely the Central Government to follow a policy of expansion involving low interest rates in one region while pursuing a policy of contraction in another involving high interest rates.

Further in case of international transactions Governments always intervene and try to maintain a balance between exports & imports or at least minimise the bad effects of a deficit. Henry Sidqwick correctly remarked that it is only in the case of foreign trade that the investigation of the conditions of favourable interchange excite practical interest, because it is only in the case that there has been a serious questions of governmental interference with a view to making the interchange more favourable. But in the case of internal trade such problems do not arise as at the national level.

Another distinguishing feature of internal trade lies in the existence of greater geographical distances and the consequent increases in the transport costs. According to Henry Sidqwick, the fact of distance which renders international exchange costly, necessitates a special theory for the determination of international values. For instance transport costs become an important input in the case of international trade, while these can be ignored in internal trade. Not only goods have to be transported over longer distances but distinct problems of packing, insurance, banking and freight which are generally absent in the case of domestic trade, require special attention in the case of international trade.

Finally, inter regional trade differs from international trade in that trade between different regions in the same country is amount members of the same group, where as trade between countries in between different cohesive units. In the words of Friedrich List "Domestic trade is among us international trade is between us and them".

To sum up the differences between international and interregional trade arise from factor immobility, different currencies, different national policies, seperate markets, politically different units and economic nationalism. All these causes give rise to a separate theory of international trade.

19.3 BASIS OF TRADE

Given its special features as described above it would be possible now to explain the basis of international trade. The fundamental basis of trade whether internal or international is that all different regions within a country and different countries are not equally efficient in the production of all goods. It is therefore advantageous for each region and each country to specialize in the production of goods in which it is specially suited and in exchange obtain those goods in which it is less suited to produce. Now a very important question arises why does a country specialize in the production of certain commodities?

First, differences in geographical factors like climate, availability of national and manpower resources constitute the natural basis of specialisation of trade. Given its peculiar geographical and other natural conditions a country can produce certain goods more efficiently than others e.g., Arab countries have a natural advantage in the production of petroleum products and Afghanistan in dry fruits. Australia and North America possess vast areas of fertile land which enable them to produce wheat and other crops efficiently. So also tropical climate is found more suitable for the production of rubber, tobacco, cotton, tea and coffee than temperate regions. Therefore geographical differences is one of the important basis of trade.

Secondly, differences in skills, techniques of production and labour force also create a basis for specialisation and trade. Countries with abundance of labour might be able to use labour intensive techniques efficiently, countries like Switzerland having skilled workers would specialise in the production of goods requiring such skills. Likewise countries endorsed with abundance of capital might be able to use capital intensive techniques, efficiently.

Thirdly, differences in tastes, preferences and incomes may give rise to differences in demand conditions and thus trade between nations. A rich country with high consumption standards needs a wider variety of goods than a poor country and therefore its dependence on other countries for both exports and imports would be high.

Fourthly, differences in the level of development of different countries create a basis for trade. Under developed countries will at first have to import machines and technical know-how from industrialised countries. After they achieve industrial development they may be in a position to export capital goods to other countries.

Fifthly, it must be emphasised that some of the countries are producing and exporting certain commodities mainly because of historical reasons. For e.g., production of jute, tea and rubber in India was started on the initiative of the British rulers in the 19th century at the cost of other goods.

In short, differences in relative prices between countries is the basis of international trade. The reason for the basis of international trade. The reason for the cheapness of one commodity and dearness of another relatively at home than abroad may be due to the differences in either the supply conditions or the demand conditions in the two countries. It may be noted that the classical economists, however stressed only differences in the supply conditions at home and abroad as the basis of international trade and the lacuna of the classical theory was filled up Heckscher and Ohlin who stressed that differences in the relative prices will depend upon differences in the demand for and the supply of the commodity of the commodity in the two regions.

19.4 ADVANTAGES OF TRADE

Nations trade with each other because they benefit from it. Other motives may be involved of course, but the basic motivation for international trade is that of gain. A country need not produce all the goods which it requires, it will produce only those in which it has a natural and imperative advantage and it will import commodities in which it has a comparative disadvantage. When every country follows this principle, goods are produced more efficiently and countries gain from trade. Thus international trade provides maximum scope for the optimum exploitation and allocation of world's scarce resources.

International trade widens the scope for division of labour and specialization by widening the market. Trade expands the market beyond the frontiers of a country; with increasing scope for division of labour and specialization will further increase efficiency and reduce costs of production. This would lead to a more efficient and fuller utilisation of a country's resources. Further by ensuring free competition, international trade reduces the dangers of monopolistic exploitation of consumers because goods and services are produced at lowest per unit cost and price is not higher than the average cost of production. Thus trade increases units of production and consumption, real income and national well being of all the participating countries.

Trade enables a country to sell goods in which it has excess production and buy goods which it cannot produce at all or produce inefficiently because of national and other factors. For example countries like Japan without any oil resources can buy the same from other countries for its domestic requirements. So also the unprecedented prosperity enjoyed by some nations would have been impossible

but for the ready world demand. To illustrate this point it can be noted that the development of OPEC countries would not have taken place but for international trade. The vast petrol reserves of these countries would have remained unexploited making them the worlds poorest desert countries.

Likewise a country can acquire knowledge of new techniques of production and new goods through trade. International trade provides maximum scope for a country to sell her products in those would markets where she can get the best prices for her products and buy essential raw materials and other consumer goods from the cheapest sources of supply. Consequently, trade enables a country to enjoy maximum advantage both as a consumer and as a producer. So also an underdeveloped country can use trade as a means or as an engine of growth. It enables the underdeveloped countries to import capital goods and essential raw materials which are required for their economic development. It also enables these countries to import the technical know-how, managerial talents, entrepreneurship etc., from the developed countries at the most competitive terms. Trade changes the quality of the people in under developed countries teaches them to consume new things and to use old things in new ways. More important than these advantages of material benefit are the advantages of international trade which may go a long way in promoting greater independence, co-operation and peace among nations. Thus international trade is a pre-requisite of international economic co-operation and brotherhood.

19.5 DISADVANTAGES OF TRADE

Trade instead of being a source of gain may become a source of some undesirable effects and exploitation international trade inflict losses on those home industries whose products are displayed by imports. The classic example of India during the 19th century could be cited wherein the indigenous handloom industry was destroyed because of cheap imports of mill made clothes from England. Several third world countries of Africa, Asia and Latin America have also had similar bitter experience.

There is also the danger of trade becoming an obstacle to development. A country may not think of its long term development if imported goods are available at low prices. Its dependence on other countries may increase which in times of war will prove dangerous. Further, a country which establishes industries for promoting exports will suffer when other countries do not buy its products. This contributes to instability and uncertainity in the country. Finally trade may produce a demonstration effect whereby foreign consumption habits are imitated blindly by local population. This would destort the saving and investment patters of a country and create artificial demand for imported foods. Thus foreign trade is not an unmixed blessings. It many advantages must be balanced against its disadvantages, otherwise a country instead of benefitting from foreign trade may actually suffer irrepairable losses.

19.6 SUMMARY

In this unit, we have discussed the distinction between internal and international trade, the basis of trade and advantages and disadvantages of trade.

Prof. Tippa Reddy & Dr. N. Vijaya

19.7 SUGGESTED BOOKS

1. Bo Sodersten : International Economics
2. David Young : International Economics
3. Enke & Salera : International Economics

19.8 MODEL EXAMINATION QUESTIONS

I. Answer the following in about 30 lines each.

1. What are the fundamental reasons for international trade?
2. Explain the need for a seperate theory on international trade.

II. Answer the following in about 15 lines each.

1. How does international trade differ from internal trade?
2. What are the advantages of international trade?
3. Discuss the demerits of international trade.

UNIT-20 : THEORIES OF INTERNATIONAL TRADE

Contents

20.0 AIMS AND OBJECTIVES

This unit aims to examine the classical and modern theories of trade.

After reading the unit, you will be able to

* discuss the classical theories of international trade, and
* explain the Heckscher-Ohlin theory.

20.1 INTRODUCTION

Theories of trade seek to explain the pattern of trade of countries trading with one another. They explain why a country exports certain commodities and imports others. In this unit, we explain classical and modern theories of trade.

20.2 THE CLASSICAL THEORY OF TRADE

The classical theory as developed by Torrens, Adam Smith and Ricardo explain that trade between nations is based on international division of labour. Differences in climate, natural resource and skills are the basis of division of labour. Given its climate, natural resources and skills are the basis of division of labour. Given its climate and natural resources, a country can produce certain goods more efficiently, i.e., at a lower cost, than other countries. Therefore, it will specialise in the production of such commodities and import other commodities from foreign countries.

20.2.1 ASSUMPTIONS

The classical theory of international trade is based on the following main assumptions :

1. There is perfect mobility of factors of production like labour and capital within a country. But between countries these factors are assumed to be immobile.
2. Costs are measured terms of labour units used in the production of goods. The classical economists developed the labour theory of value according to which relative prices would be determined by labour costs.
3. Production is governed by the law of constant returns. Costs per unit will remain constant whether production is on a large or a small scale.

4. Techniques of production are given. There is zero technical progress.
5. All the factors of production are given in supply. There is full employment of resources. Factors of production are homogeneous.
6. It is assumed that there there are conditions of perfect competition within a country and free and unrestricted trade between countries.
7. Costs of transport between countries are supposed to be nil.
8. Tastes and preferences of consumers are assumed to be similar in all the countries.

20.2.2 THEORY OF ABSOLUTE ADVANTAGE

Adam Smith developed the theory of Absolute advantage to explain the basis of trade. Given its natural resources and skills, a country produces certain commodities more efficiently than others. For example, India and Brazil, specialized in two commodities, wheat and sugar. Their cost conditions may be worked out as here under :

TABLE - 1

	Wheat	Sugar
India :	10 labour hours	20 labour hours
Brazil :	20 ,, ,,	10 ,, ,,

It is clear that India required only 10 labour hours to produce a quintal of wheat while Brazil requires 20 Labour hours to produce the same. In respect of sugar, Brazil required 10 labour hours while India needs 20 labour hours. India has an absolute advantage in the production of wheat and Brazil in the production of sugar. Trade will benefit both the countries if India specialises in the production of wheat, Brazil in the production of sugar exporting their respective products of each other. Suppose in each of them there are 30 labour hours worth of resources; in the absence of trade they may be utilised to produce one quintal of wheat or sugar in which case the total world production of wheat and sugar would be 2 quintals each. With specialisation India would devote all its resources to the production of wheat and thus produce 3 quintals of it. Similarly, Brazil will will be able to produce 3 quintals of sugar. It can be seen that with the same resources, production levels in both the countries increase because of specialisation and trade.

20.2.3 THEORY OF COMPARATIVE ADVANTAGE

David Ricdardo extended the classical theory of trade further to show that even in the absence of absolute differences in costs, international trade is possible and beneficial to all the countries. His theory is called the theory is of comparative advantage. In the example cited by him there are two countries Portugal and England, and two commodities - Cloth and Wine.

TABLE - 2

	Cloth	Wine
Portugal	90 Labour hours	80 Labour hours
England	100 ,, ,,	120 ,, ,,

England requires more of labour hours than Portugal to produce a given unit of cloth or wine. Portugal has absolute advantage over England in the production of both the commoditics. It means that according to Adam Smith's theory, specialisation and trade are not possible. However, Ricardo proves that specialisation is still possible in each of these countries. Though Portugal can produce both wine & cloth with less of labour cost than England, it has comparatively greater advantage in the production of wine (80 labour hours) than in that of cloth (90 labour hours). Similarly, though England has absolute disadvantage in both wine and cloth, its disadvantage is comparatively less in the

case of cloth (100 labour hours) than in that of wine (120 Labour hours). According to Ricado, it would be to the advantage of both the countries if Portugal specialises in the production of wine and England in the production of cloth. Portugal will export its surplus wine to England and import cloth from it.

The main difference between the theories of Adam Smith and Ricardo is that in the former, the respective costs of production of the two countries are compared, while in the latter comparisons are made between commodities within the same country. Within Portugal wine is produced with greater efficiency than cloth. It will devote all its resources to the production of wine and will exchange its surplus wine for cloth from England. Similarly, within England cloth is produced more efficiently than wine. Specialisation based on comparative advantage leads to greater efficiency in the utilisation of resources in each country. Thus both the countries gain from trade. In the absence of trade Portugal will produce cloth and wine. According to their labour costs, a unit of wine (80 labour hours) would be equal in value to 0.9 units of cloth. In England one unit of wine (120 labour units) would be equal to 1.2 units of cloth. When trade begins, Portugal will produce only wine and for every unit of surplus wine it would get upto 1.2 units of cloth from England. Thus, Portugal is able to buy cloth cheap; for every unit of wine exchange it would get 1.2 units of cloth instead of 0.9 units.

Similarly, England will produce cloth and wine in the absence of trade; one unit of cloth (100 labour hours) would be exchanged for 0.8 units of wine. With trade it will produce only cloth and exchange a unit of surplus cloth for upto 1.1 units of wine. Thus, for every unit of cloth it would get from Portugal 1.1 units of wine instead of 0.8 units in the absence of trade.

Ricardo's theory of comparative advantage has been modernised by Haberler. He has abandoned the labour theory of value and introduced in its place the concept of opportunity costs. This includes all the factors of production. Ricardo's theory is based on the assumption of constant returns. Haberler extended it to cover increasing and diminishing returns also. Further, the classical theory ignores demand conditions and concentrates only on production costs as an explanation of trade. Haberler has introduced social indifference curves to represent demand conditions. In this way the Ricardian theory has been sufficiently modified. In spite of this, it may be noted that there is no change in the basic conclusions of the theory of comparative advantage. The essence of the theory has remained intact.

20.2.4 LIMITATIONS OF THE CLASSICAL THEORY

The classical theory of international trade has been criticised on various grounds. First, the theory is static in character as it assumes that the supply of factors of production and techniques of production are given and constant. Actually there is always change in techniques of production and new resources are being continuously discovered. Similarly, some resources are being exhausted because of continuous use. As a result of all these factors, production conditions would change, new commodities and techniques would be introduced; the existing comparative advantage would change. Secondly, the theory does not explain why costs of production for a given commodity differ from country to country. It only states that it is generally so because of differences in climate and other geographical conditions. No economic explanation is given of differences in costs. Thirdly, the assumption of full employment is unrealistic. In underdeveloped countries there is under-utilisation of natural and man-power resources under these conditions it is not possible to talk about comparative advantage. Further, industrially developed countries and backward countries would have different cost conditions. If this theory is accepted, it would mean that underdeveloped countries would permanently be exporters of primary goods while industrialised countries permanently be exporters of primary goods while industrialised countries will be permanent exporters of finished goods. Tastes and preferences of population in underdeveloped countries would differ from those of developed countries. Forthly, the assumptions of perfect competition and free trade are also seen to be unrealistic. Actually conditions of monopoly, government restrictions on imports and exports are quite common.

20.3 THE MODERN THEORY OF INTERNATIONAL TRADE

The modern theory is also called 'factor endowments theory' or Heckscher-Ohlin theory of trade. As noted above, the classical theory does not provide a scientific explanation of the basis of comparative advantage . The modern theory explains cost differences in terms of availability of factors of production in each country. Certain countries have abundance of labour in relation to capital. Other countries may

have relatively more of capital than labour. Similarly, certain commodities are produced by labour intensive techniques while others are produced by capital intensive techniques. According to this theory, a country exports those commodities which use its relatively abundant factor more intensively and imports those cymmodities which use its relatively scarce factor more intensively.

20.3.1 ASSUMPTIONS

The theory is based on a number of assumptions. **First,** for the sale of convenience, it is assumed that there are only two countries, two commodities and two factors of production. Labour and capital are the only two factors of production taken into consideration. They are homogeneous all over the world. **Secondly,** for ahy give commodity example, wheat is production is the same in all the countries. For example, wheat is produced with an identical technique in every country. But for different commodities the techniques differ. For wheat and tractors there will be different techniques, but wheat may be produced by a labour intensive technique while tractors are produced by capital intensive techniques. **Thirdly,** ountries differ from one another according to the relative abundance or scarcity of labour and capital. Some countries may be labour abundant like India, while other may be capital abundant like the U.S.A. Scarcity or abundance are measured in relative terms. **Fourthly,** production is subject to conditions of constant returns to scale. It means that if all the inputs are doubled, the output also will be doubled. If only one factor is changed and others kept constant, there may be diminishing or increasing or constant returns. **Fifthly,** it is assumed that the supply of factors of production is given and that they are fully employed. **Sixthly,** there is complete mobility of factors within the country and immobility between the countries. **Seventhly,** there is perfect competition in the commodities and factor markets. Factors of production are paid according to their marginal productivities.

The theory is illustrated with examples based on two countries, two commodities and two factors of production. Suppose there are two countries—India and the U.S.A—and two commodities Paddy and tractors. Paddy is produced by labour intensive techniques and tractors by capital intensive techniques. There are only two factors of production - Labour and capital. Let us assume that India is a labour abundant country and the USA capital abundant. As India has abundance of labour in relation to capital, labour would be cheaper than capital and wage rates. Therefore, India will produce paddy, which is a labour intensive commodity at a lower cost than tractors. Similarly in the USA, capital is cheaper than labour. It will produce tractors, which is capital intensive, at a lower cost than paddy.

It is natural that a country exports commodities which it can produce at a lower cost and import those which it can only produce at a higher cost. India has a comparative advantage in the production of paddy because it requires more of labour than capital and labour is cheaper India than in the USA. In other words, India exports paddy as it uses its abundant factor more intensively, and would import tractors as they use its scarce factor, i.e., capital, more intensively.

Since the USA is a capital abundant country and it can produce more tractors- a capital - intensive commodity cheaply than paddy. As it is already known, paddy is a labour intensive good and the USA has labour scarcity.

Given the above mentioned conditions, specialisation and trade are possible between India and the USA. India will specialise in paddy and export its surplus to the USA in exchange for tractors. The USA will specialise in tractors and export surplus tractors to India for importing paddy. Trade between these two countries will expand till factor prices, i.e., wage rates and interest rates in the respective countries equalise. When trade starts, wage rates in India are lower than in the USA. The interest rates are higher in India than in the USA. As trade expands and India increases the production of paddy, the demand for labour increases and the demand for capital decreases. This means that wage rates will rise and interest rates will fall. The opposite will be the case with the USA. As it increases the production of tractors, the demand for capital would rise more than that of labour. Rates of interest would rise and wage rates would fall. Thus trade will bring about an equilisation of the respective wage rates in these countries. Similarly, interest rates would be equalised. It should be remembered that at this point trade will not come to a halt; only its further growth will be halted.

20.3.2 LIMITATIONS

From the discussion set fourth above it can be seen that the modern theory offers a more scientific explanation of cost differences than the classical theory. But it must be emphasised that it is equally static and unrealistic in its assumptions. The assumptions of given resources, techniques and assumptions of given tastes and preferences and conditions of perfect competition. The modern theory suffers from the assumption of identical techniques all over the world for a given commodity. It can be seen that cloth can be produced by different techniques like handlooms, powerlooms and mechanised mills. As against this, the theory assumes that cloth is produced by only one technique which is the same in every country. Because of its static character, the theory cannot explain satisfactorily the pattern of trade between developed and underdeveloped countries, Leontief tested this theory for the USA. It is generally belived that the USA is capital rich and labour scarce country. Therefore, its exports should be capital-intensive and imports labour-intensive. Leontief found that the American exports and imports were just contrary to this. Its exports were labour-intensive and imports capital-intensive. These strange results are described as 'Leontief's paradox'.

20.4 SUMMING UP

Our study of the classical and modern theories has shown that none of these explains satisfactorily trade as it actually takes place. It is so mainly because a country's exports and imports are determined by a number of factors like historical conditions, government policy, the state of its development, international political situation as well as its geographical conditions and factor endowments.

Prof. Tippa Reddy

20.5 SUGGESTED BOOKS

1. Bo Sodersten : International Economics
2. David Young : International Economics
3. Enke & Salern : International Economics

20.6 MODEL EXAMINATION QUESTIONS

I. Answer the following in about 30 lines each.

1. Explain Ricardo's theory of comparative advantage.
2. Examine the modern theory of trade.

II. Answer the following in about 15 lines each.

1. Explain Adam Smith's theory of Absolute Advantage.
2. What are the assumptions of the classical theory of trade.
3. Explain the main assumptions of the Hecksher-Ohlin theory.
4. What is meant by 'Leontief's paradox'?
5. Explain a country's pattern of trade in the light of the factor endowments theory.

UNIT-21 : TERMS OF TRADE AND GAINS FROM TRADE

Contents

21.0 AIMS AND OBJECTIVES

The aim of this unit is to describe different concepts relating to terms of trade and its measurement.

After reading the unit, you will be able to

* explain the meaning of terms of trade,
* introduce different concepts of terms of trade
* recognise different factors affecting terms of trade, and
* identify the difficulties in the measurement of terms of trade.

21.1 INTRODUCTION

In the earlier two units, we have learnt the necessity to have a seperate theory of international trade and also classified and modern theories of international trade. In this unit, let us try to analyse different concepts of terms of trade and identify the different influencing factors of terms of trade. We have to keep in mind one thing that is, the concept of terms of trade in this unit pertains to international trade but not to agricultural and interest sectors.

21.2 MEANING OF TERMS OF TRADE

The concept terms of trade is perhaps the most widely need concept in international trade by policy makers. When trade takes place between two open economies, certain goods are offered for sale by both the countries. The physical exchange ratio at which goods are exchanged for each other is often termed as terms of trade. In other words by terms of trade, we mean the terms at which two countries trade with each other. It indicates the quantities of goods bought and sold and the price at which they are traded. It refers to the value of a country's exports which have to be given in exchange for its imports. It indicates the rates at which a country exchanges its own goods for that of another. Since many commodities are exported and imported simultaneously from both the sides we can no longer use physical quantities such as kilograms of rice, or metres of cloth or tonnes of iron etc. But we can use as a measure the ratio between the index of export prices and the index of import prices. This can be expressed in the form of an equation as

$$\text{Terms of Trade} = \frac{\text{Price of imports}}{\text{Price of exports}}$$

It may be noted that the ratio of export and import prices is nothing but the 'cost ratio' which is the ratio of factor cost of production involved. Thus terms of trade is an indication of the intervention of many forces like price, wage, productivity etc., governing the economic relations and welfare of the countries engaged in trade.

21.3 CONCEPTS OF TERMS OF TRADE

Several concepts of terms of trade have been given by different writers. These several concepts have been classified by Meier under three broad groups.

I. These terms of trade that relate to the real ratio of international exchange between commodities. In this group are discussed
   a) Net Barter terms of trade
   b) Gross Barter terms of trade
   c) Income terms of trade

II. Those terms of trade that relate to the interchange between productive resources. In this group we have the
   A) Single factoral terms of trade and the
   B) Double factoral terms of trade

III. Those terms of trade that interpret the gains from grade in terms of utility analysis. In this group we have
   A) Real cost terms of trade, and the
   B) Utility terms of trade

The above mentioned different concepts of terms of trade are explained below.

21.3.1 NET BARTER OR COMMODITY TERMS OF TRADE

Frank William Tanssig introduced the concept of the act barter or commodity terms of trade, popularly called 'the commodity terms of trade' is the ratio between import prices and export prices and can be writtern as

$$N = \frac{PX}{PM}$$

Where N stands for Net barter terms of trade.
PX stands for price of export commodity.
PM stands for the prices of import commodity.

If PX rises, PM remaining the same, the net barter terms of trade will rise indicating an improvement in the nation's trading position because it will be receiving a higher price per unit for its exports and paying no more per unit for its imports. On the other hand if PM rises, then the net barter terms of trade will fall and the terms of trade is said to be deteriorating.

When this concept of net barter terms of trade is applied to more than one export and import commodity we use the export and import price indicates instead of using the price of particular export and import goods.

When we want to compare the changes in terms of trade between two periods, the following ratio is applied

$$\frac{PX_1}{PM_1} = \frac{PX_0}{PM_0}$$

where subscripts '1' and '0' stand for current and base year respectively. In the base year, the price index numbers of exports and imports i.e., PXo & PMo will always be 100, so that the terms of trade will be

$$\frac{100}{100} = 1$$

Now, if in the current year, the export price index is 130 and the import price index is 100, then the terms of trade will be $\frac{130}{100}$ i.e., 1.3. The net barter terms of trade of 1.3 in the current year shows a rise over the base year's net barter terms of trade 1 indicating an improvement of 30 per cent. It follows that if export prices rise relatively to import prices, the terms of trade rise or become favourable to the country and if import prices rise relatively to export prices, the terms of trade will fall or become unfavourable to the country.

It may be noted that the net barter terms of trade concentrates exclusively on relative price movements. Ignoring other important factors of a nation's trade like the change in the volume and composition of exports and imports, changes in the quality of exports and imports. An improvement in the productivity of land, labour or capital in export industries so that the nations imports are paid for at a lower real cost. It has been pointed out by J.S. Mill that if export prices fall due to fall in costs of production of the export commodities, it might not involve and reductions in the amount of gain derived by a country from her foreign trade though it would result in a movement unfavourable to the country of the commodity terms of trade. Hence it has been now generally recognised that it is a misleading index of gain from trade.

21.3.2 GROSS BARTER TERMS OF TRADE

The gross barter terms of trade is the ratio of the total physical quantity of imports to the total physical quantity of exports of a country, the higher is this ratio the more favourable are gross barter terms of trade. The gross barter terms of trade can be expressed as

$$Gt = \frac{QM}{QX}$$

When Gt stands for the gross barter terms of trade, QM stands for the total quantity of imports and QX for the total quantity of exports. For comparing changes in the gross barter terms of trade between two time periods, we use the index numbers of the quantities of exports and imports in the two time periods instead of the quantities alone. The ratio is than expressed as

$$Gt = \frac{QM_1}{QX_1} \quad \frac{QX_0}{QM_0}$$

Where the terms QX and QM stand for the index quantity of exports and imports of the country and the subscripts 0 and 1 stand for the base year and the given current year respectively. Let us suppose that the index of total imports and total exports in the base year 1970 is 100 and that in 1990 the export index rises to 140 while the import index rises to 190. In this situation the gross barter terms of trade will be equal to $\frac{190}{140} \times \frac{100}{100} = 1.35$. It means that there is an improvement of 35 per cent in the gross barter terms of trade of the country in 1990 compared with the base year 1970. Conversely if the import index rises to 120 and the export index rises to 130 in 1990. The gross barter terms of trade become unfavourable for the country because for a given bundle of exports the country receives 8 per cent. $\frac{120}{130} \times \frac{100}{100} = 0.92$. Less imports in 1990 than she did in 1970. Consequently the country suffers a relative loss from international trade.

It may be noted that the concept of the gross barter terms of trade as an index of the measurement of gains from trade will be misleading, because even if the gross barter terms of trade are unfavourable there will be gain from international trade if the factor productivity in the export sector has increased and as a consequence the cost of production per unit of export output has decreased. Further more; the gross barter terms of trade do not reflect the capital movements and their effects on the economy of the country.

Tanssig's purpose in introducing this concept is to correct the commodity or 'net barter' terms of trade. The net barter terms of trade are relevant only when nothing enters into the trade between countries, except sales and purchases of visible and invisible goods. The gross barter terms of trade corrects the net barter terms of trade for unilateral transactions, or unrequired, exports or imports such as tribute, gifts, immigrants remittances etc.

21.3.3 INCOME TERMS OF TRADE

The income terms of trade is the ratio of the total value of exports divided by the price index of import and can be written as

$$It = \frac{PX}{PM} QX$$

Where I denotes income terms of trade
PX denotes price of exports
PM denotes price of imports
QX denotes quantity of exports

The purpose of this index is to show clearly the three variables that influence a country's ability to buy foreign goods; are its export prices, export quantum and import prices. A rise in it indicates that the country can obtain a larger volume of imports from the sale of its exports. It is significant that according to the directions and magnitude of the changes in PX and QX, the changes in income terms of trade and net barter terms of trade may be in opposite directions. If for example with unchanged import prices, export prices have fallen but export quantities have increased by a greater percentage then the fall in the export prices, then the income terms of trade will improve despite a deterioration in the net barter terms of trade.

It may be noted that both net and gross barter terms of trade measure only the surplus or deficit of exports over imports but fail to take into account the effect of over all changes in the volume of exports on the real income in the country while the income terms of trade takes this into account.

21.3.4 SINGLE FACTORAL TERMS OF TRADE

Jacob Viner developed the 'Single Factoral' terms of trade. It is the ratio of the export price index and the import price index adjusted for changes in productivity of country's factors of production engaged in the production of export commodities. Single factoral terms of trade can be expressed as

$$St = \frac{PX}{PM} \times ZX$$

Where St denotes single factoral terms of trade $\frac{PX}{PM}$ is the net barter terms of trade and ZX denotes the index of factor productivity in exports.

The single factoral terms of trade removes the shortcomings of the net barter terms of trade as a measure of gain from trade. Let us assume that export price falls by 10 per cent but export cost has fallen by 20 per cent in this situation, the single factoral terms of trade will be $\frac{90}{100} \times 120 = 108$. Thus the single factoral terms of trade for the country has improved by 8 per cent and the country is

clearly better off even though the net barter terms of trade have deteriorated by 10 per cent. It is so because the fall in the export price index is more than compensated by the increase in the factor productivity in the export sector. In this context the use of the single factoral terms of trade is considered to be more logical and rational than the commodity terms of trade. For instance when economic development takes place, the new techniques of production are introduced which reduce the cost of production per unit of output, consequently the use of the commodity terms of trade as a measure of gain for the country from international trade is apt to be misleading.

However, the concept of single factoral terms of trade also suffer from the shortcoming that it does not take into consideration the potential domestic cost of production of imports. To overcome this weakness, Jacob Viner developed another index known as the 'double factoral' terms of trade.

21.3.5 DOUBLE FACTORAL TERMS OF TRADE

The concept of double factoral terms of trade takes into account the productivity of factors of production entering into the production of country's exports as well as the productivity of foreign factors of production producing country's imports. The concept of double factoral terms of trade can be expressed as

$$D_t = \frac{PX}{PM} \times \frac{ZX}{ZM}$$

Where Dt represents double factoral terms of trade. ZM is the index of factor productivity in imports. ZX is the index of factor productivity in exports. PX and PM denotes price indicates of exports and imports. If the factor productivity of exports increases by 20 per cent while the factor productivity of imports increases by 30 per cent, than the single factoral terms of trade which were favourable will become unfavourable. Consequently, the concept of double factoral terms of trade is more scientific and logical index than the concept of the single factoral terms of trade.

However in practice it may be noted that both the concepts of single factoral and double factoral terms of trade have little practical utility due to the difficulties involved in the measurement of changes in factor productivity because it is almost impossible to define operationally and to measure statistically the concept of a 'unit of productive factor' and, therefore, that of a productive index.

21.3.6 REAL COST TERMS OF TRADE

The real cost terms of trade are obtained by multiplying the single factoral terms of trade with the index of the amount of disutility like pain irksomeness etc., per unit of the productive resources employed in producing the exports. The real cost terms of trade can be expressed as

$$R_T = S_T \cdot R_X = \frac{PX}{PM} \cdot ZX \cdot RX$$

Where R_T denotes the real cost terms of trade and R_X stand for the index of the amount of disutility suffered per unit of productive resources employed in promoting exports. The terms PX . PM & ZX have the same meaning as in the formula of the single factor terms of trade.

The real cost terms of trade is a better measure of the real economic welfare achieved by a country from international trade. It however, ignores the real cost involved in production of imports. To overcome this defect the concept of the utility terms of trade has been introduced by Jacob Viner.

21.3.7 UTILITY TERMS OF TRADE

The utility terms of trade are obtained by multiplying the real cost terms of trade with the index of the relative desirability or utility of imports as compared to the goods that could have been produced for domestic consumption with those factors of production which are now used in the production of export goods (UM). The utility terms of trade may be written as

$$T_n = Tr \cdot UM = \frac{PX}{PM} ZX \cdot RX \cdot UM$$

It may be noted that the concepts of the 'real cost' terms of trade and the 'utility' terms of trade refer to the subjective costs (disutility) whose measurement is not feasible. Hence these concepts are of no practical use in real life. In practical life; the concept of the commodity terms of trade is generally employed to measure the gain from international trade.

21.4 FACTORS AFFECTING TERMS OF TRADE

The terms of trade of a country are determined by the relative intensities of its import demand and export demand compared with those of the other country. In the other words the terms of trade depend upon :

a) Elasticity of demand for imports by the country concerned.
b) Elasticity of demand for its exports by the foreign country
c) Elasticity of supply of its exports
d) Elasticity of supply of its imports

These four kinds of elasticity known as 'reciprocal demand elasticity' determine the terms of trade of a country and variations in the terms of trade of a country are brought about by variations in the reciprocal demand elasticity. The reciprocal demand elasticity is determined by the relative intensity of demand elasticity is determined by the relative intensity of demand which in run depends upon several factors such as population growth, nature of goods imported and exported, Government's trade policy, taxes and capacity to import etc. Any change in any one or all of these factors will cause a change in relative intensity of demand of a country which in turn will effect its terms of trade. The major factors affecting the terms of trade of a country are :

a) Shifts in the demand for exports or imports
b) Tariffs
c) Devaluation
d) Availability of Substitutes
e) Economic growth

21.4.1 SHIFTS IN THE DEMAND FOR EXPORTS / IMPORTS & TERMS OF TRADE

Other things remaining the same, if the demand for imports of a country increases the prices of imports relative to those of exports will increase, consequently, the terms of trade of the country will deteriorate in as much as for a given quantity of imports the country will have to give away a larger quantity of exports. Similarly if the demand for the exports of the country increases, the prices of her exports relative to the prices of her imports will increase and the commodity terms of trade of the country will improve.

21.4.2 TARIFFS AND TERMS OF TRADE

A country may levy an import tariff in order to improve her terms of trade. The terms of trade become favourable to the tariff-imposing country. However, the specific effects of a tariff depend on the elasticities of the offer curve. A tariff shall improve the terms of trade for the tariff imposing country if the elasticity of the other country's offer curve is greater than unity and less than infinity. Further more, the effect of an import tariff may be either nullified or more than nullified if the other country retalities by imposing an equal or more than equal amount of tariff or her imports.

21.4.3 DEVALUATION AND TERMS OF TRADE

If the elasticities of supply of exports and imports are large in proportion to the elasticities of demand for exports and imports, devaluation of a country's currency will worsen its terms of trade and revaluation will improve its terms of trade. If the elasticities of supply of exports and imports are equal to the elasticities of demand for exports and imports so the the product of the supply elasticities equal the product of the demand elasticities, the terms of trade will remain unchanged consequent upon currency devaluation. In other words the terms of trade will diteriorate, remain unchanged and improve as a result of devaluation. If

1) SX . SM > DX . DM
2) SX . SM = DX . DM, and
3) SX . SM < DX . DM

21.4.4 IMPORT SUBSTITUTES & TERMS OF TRADE

If close substitutes of import goods (import substitutes) are available in large quantity in the country, the terms of trade will be unfavourable for the exporting country. In the absence of availability of close substitutes the bargaining power of the exporting country will be strong, consequently the terms of trade will be favourable for the exporting country.

21.4.5 ECONOMIC GROWTH AND TERMS OF TRADE

Economic growth of a country means an increase in its gross national product or in other words increase in income per head over time. Economic growth may occur due to increase in the supply of the factors of production and technological improvements allowing the production of larger aggregate output with the quick quantity of resources. Due to economic growth, the income elasticity of demand for imports every change so also the domestic production of otherwise importables may also increase. The effect is described as income elasticity of demand and the latter effect is called income elasticity of supply. The net effort of growth on terms of trade will depend on the relative strength of the supply and demand effect. For instance if the income elasticity of demand is greater than unity, but that of supply is less than unity, then terms of trade will deteriorate as there will be a net rise in the demand for the importables. Conversely, when the income elasticity of demand is less than unity, but that of supply is greater than unity, the terms of trade will improve because there will be a net fall in the demand for importables.

21.5 TERMS OF TRADE AS AN INDEX OF GAIN FROM TRADE

The terms of trade are of great economic significance to a country since they determine the gain that accrues to a country from international trade. If terms of trade move in a country's favour it will increase grains from its international trade and raise in it the level of incomes. It will be quite the reverse in a country for whom the terms of trade become adverse. Economists regard a rise in the prices of country's exports relative to the prices of imports as a favourable movement of terms of trade indicating an increase in the total gain from trade, if import prices rises relatively to export prices the terms of trade will fall or became unfavourable to the country and a decrease in total gain from trade. If the citizens of country A are desperately anxious to buy a good Y from country B, but the citizens of country B are for same reason less anxious to buy goods X from country A, then the greater part of the gain from trade accrues to country B. The ratio at which the goods exchange, that is the terms of trade are more favourable to B than to A. J.S. Mill showed the importance of demand conditions in determining the terms of trade between countries. He did not pay the same attention, however, to the question of supply. This was left to Marshall who argued that the terms of trade of a country are influenced not only by demand, but also by the ability of a country to adjust supplies of its own products to the demands of foreign markets. It was in order to draw out the importance of both demand and supply elasticities that Marshall developed the device of the 'offer curve'.

21.6 DIFFICULTIES IN THE MEASUREMENT OF TERMS OF TRADE

Even though the concept is terms of trade is of great economic significance there are same practical difficulties involved in the measurement of term of trade.

Firstly, to measure the relative change in prices index numbers of export and import prices are utilised. For the constructions of index numbers, selection of some suitable base year is of vital importance. The particular base year chosen should be a normal year judged from various considerations. A base year which is normal from all considerations is however, very rate to come across in real life. Secondly index numbers of import and export prices makes no allowance for changes in the quality of goods traded or for the changes in the composition of goods entering into international trade. Thirdly the time lay between exports and imports also poses a problem in the exact measurement of the terms of trade. If a country's exports when the terms of trade are favourable because of lower prices of imports (export prices remaining constant) and imports when the terms of trade are favourable because of lower prices of imports (prices of exports remaining constant) her actual terms of trade remain constant although the in indices show an improvement in her terms of trade.

The concepts real and utility terms of trade refer to the subjective costs (disutility) whose measurement is not possible consequently these concepts are of no practical significance.

Check Your Progress :

1. What are terms of trade?

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2. Explain the concept of utility terms of trade.

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3. Define income terms of trade and mention its significance.

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4. Explain the real cost terms of trade.

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21.7 SUMMARY AND CONCLUSIONS

This unit has focussed on different concepts pertaining to terms of trade. We have also dealt with the factors which influence the terms of trade such as shifts in the demand for exports and imports, tariffs, devaluation, import substitutes and economic growth. Terms of trade can be regarded as an index of gains from trade. There are some practical difficulties involved in the measurement of terms of trade. We have analysed them in the last part of the unit.

- **Dr. N. Vijaya**

21.8 SUGGESTED BOOKS

1. Bo Soderstein : International Economics
2. David Young : International Economics
3. Enke Salera : International Economics

21.9 MODEL EXAMINATION QUESTIONS

I. Answer the following in about 30 lines each.

1. What do you understand by 'Terms of Trade'. How are they determined.
2. Explain the concept of terms of trade and examine the difficulties in measuring them.

II. Answer the following in about 15 lines each.

1. Bring out the relationship between terms of trade and gains from international trade.
2. Explain the differences between Net and Gross Barter terms of trade.
3. Distinguish between the single and double factoral terms of trade.

UNIT-22 : BALANCE OF PAYMENTS

Contents

22.0 AIMS AND OBJECTIVES

It explains various aspects of the balance of payments of a country, the basic concepts of balance of trade and balance of payments, current and capital accounts, the difference between accounting balance and equilibrium and disequilibrium in balance of payments and the nature, causes and remedies for conditions of disequilibrium.

After reading the unit, you will be able to

* distinguish between balance of payments and balance of trade,
* explain the statement of balance of payments,
* describe the concepts of equilibrium and disequilibrium in balance of payments, and
* analyse the methods of correcting disequilibrium in balance of payments.

22.1 INTRODUCTION

In this unit, we will learn the concepts relating to balance of payments. The statement of balance of payments is explained. You will also know how the disequilibrium in balance of payment, be rectified.

22.2 BALANCE OF PAYMENTS - BALANCE OF TRADE

The balance of payments may be defined as a systematic record of all economic transactions which take place during a given period between residents - individuals, institutions and government bodies - of a country and those of the rest of the world. It is common knowledge that the residents of a country buy goods and services from other countries. They may visit foreign countries as tourists or students and they may use foreign insurance, banking or transport services for various purposes. All these transactions inteal payments to foreigners. In the same way, the residents of a country may sell goods and services to foreign residents. They may offer them insurance, banking and transport services. Residents of foreign countries may visit this country for various purposes. Residents of foreign

countries may visit this country for various purposes. In the case of all these transactions, the residents receive payments from the rest of the world. Economic transactions would result in payments or receipts of money. A record of all such payments and receipts between a country and the rest of the world during a given period is called balance of payments. Table-I presents Balance of Payments statement of country 'X'. Balance of Payments statement of country. Payments to foreigners are debit items and receipts from them are credit items.

Table - I

Balance of Payments Statement of country 'X'

Credits (+)	Rs. Crores		Debits	Rs. Crores
Current Account				
1. Exports of merchandise	1000	4.	Imports of merchandise	1500
2. Exports of services		5.	Imports of services	
a) Insurance & Banking	100		a) Insurance & Banking	20
b) Transport services	50		b) Transport services	20
c) Tourism	30		c) Tourism	10
d) Interest on loans, etc. Dividend	100		d) Interest on loans; and dividend	40
3. Unrequired receipts : Gifts, etc.	20	6.	Unrequired payments : Gifts etc.	10
Total	+ 1300		Total	— 1600
Current Account Balance	— 300			
Capital Account				
7. Long term & short term loans	300	9.	Long term and short term loans	50
8. Decrease in gold & foreign exchange reserves	100	10.	Increase in gold and foreign reserves	50
Total	+ 400		Total	— 100
Capital Account Balance	= — 300			
Total balance	+ 1700			— 1700

Depending on the nature of transactions, it is possible to classify them into different types. First, the relation of exports to imports of merchandise (i.e., goods) is described as the balance of trade. It is a record of payments and receipts on account of imports and exports of goods. Since one can actually see the movement of goods from one country to the other, it is called visible trade or commodity trade. Items 1 and 4 represent these transactions. Secondly, buying foreign services like those of banking, insurance, shipping, etc., or selling our banking, insurance and shipping services to foreigners are recorded in 'invisible trade or balance'. Payment of interest on loans taken from foreign residents and dividend on shares owned by foreign investors are included in the invisible balance. Similarly, receipts of interest on loans to foreigners and dividends on foreign shares are a part of this account. Though we do not see the movement of goods between countries, we can observe payments and receipts on account of these transactions. They are, therefore, called invisible items of trade. Items 2 and 5 give the details of such transactions.

Unrequired receipts refer to gifts and donations received from the rest of the world. These receipts are not earned by any sale or transfer of goods or services. They are one sided or unilateral transactions. Compare them with exports where payments are received because of sale of goods or services. Similarly, a country may give gifts or donate funds to foreign countries for some reasons or other. For example, several countries are giving free gifts of foodgrains and medicines to victims of famine in Ethiopia. They are called unrequired payments. Items 3 and 6 represent such receipts and payments.

Items 7 & 9 in Table I refer to long-term and short term loans. When a country receives these loans, they are shown as a credit item, though a loan involves liabilities. It is to be understood that a country sells or exports its bonds (promissory note) to foreigners for receiving the loan amount. A country which advances the loan is importing a foreign country's bond (promissory note) for which it is paying money. Such transactions are shown as debit items.

Changes in official gold and foreign exchange reserves have a special significance. If a country loses gold or foreign exchange reserves, it is understood that it is exporting them. It is shown as a credit item. Similarly, if it receives gold or foreign exchange reserves from other countries, it is understood that it is importing them. Therefore it is shown as a debit item. In Table I, items 8 and 10 represent such transactions.

Check Your Progress - 1

1. What is meant by balance of trade?

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2. What is balance of payments?

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22.3 CURRENT AND CAPITAL ACCOUNTS

As shown in Table I, all transactions are classified into Current Account and Capital Account. Current Account covers transactions such as exports and imports of goods and services which relate to the current year's national income. In other words, such payments or receipts do not create any future claims over foreigners nor cancel the existing claims. They are also referred to as autonomous transactions. As against this, capital account covers transactions which create or cancel claims over foreigners. When a country borrows from other countries, it has to pay interest on the loan every year and repay the loan after some years. It means the other countries have acquired a claim over it. When a country gives loans to others, it buys claims over others. It is customary to call capital account transactions compensatory or adjustment transactions'.

It may be observed that Table I presents balance of payments accounts in the double entry book keeping form. It is based on the principle that all payments must balance or be equal to all receipts. This will be the case whether there is a deficit or a surplus. This can be explained easily with the help of an example. Suppose an individual has purchased goods and services worth Rs. 10,000 during a year. It means that he has made payments worth Rs. 10,000, whatever be his income. Suppose further that his income is only Rs. 8,000. He has a deficit of Rs. 2,000. He must have either borrowed Rs. 2,000 from some one, or sold his assets worth that much or he must have used his past savings. To make up this deficit he must have adopted one of these methods or some combination of them. The opposite will be the case if he has a surplus.

22.4 ACCOUNTING BALANCE

Similarly, in the case of a country's balance of payments, there will always be a balance between total credits and debits. Such a balance is called accounting balance. Table I shows that on the current account, country X has receipts of Rs. 1300 crores and payments of Rs. 1600 crores, resulting in a deficit of Rs. 300 crores. It means that exports are less than imports to that extent. Country X has borrowed long term or short term capital and also reduced its gold and foreign reserves. In this way, the current account deficit of Rs. 300 crores is made up by a capital account surplus of the same value. A country with surplus on its current account would offset it by a deficit on capital account. With this surplus, it will either give loans to a deficit country or accumulate its currency or buy gold with it. That is how the surplus is disposed of. The sum of credit items would equal the sum of debit items.

Accounting balance is an essential property of double entry book-keeping method. A country may have a deficit or surplus in its balance of payments. According to Table I, country X has an unfavourable balance or deficit in its balance of payments. It is financing this deficit partly by selling its gold reserves and partly by borrowing from other countries. If a country has a surplus, it means that it has a favourable balance of payments. Its surplus is utilised for buying gold or foreign currency or for giving loans to a deficit country.

Check Your Progress - 2

1. What is current account?

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2. What is capital account?

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3. Explain accounting balance.

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When deficit or surplus occurs continuously over a long period, it is called **secular disequilibrium**. A country with an ambitious programme of industrialisation might be forced to import more than its exports for 5 or 10 years or even more. After it is developed industrially, its capacity to export would increase. For example, India continues to have deficit in its balance of payments for the past 30 years because of its industrial development plans. Disequilibrium has continued over this period.

Structural disequilibrium prevails when tastes and preferences of people change or techniques of production are modernised. If adjustments are made for all these changes, disequilibrium conditions disappear.

If deficit or surplus in balance of payments continues for a long time in spite of government measures to correct it, such a situation is described as **fundamental disequilibrium**. If a country suffers from fundamental disequilibrium, it has to consider drastic measures like devaluation and exchange control.

22.8 CAUSES OF DISEQUILIBRIUM

In the light of the foregoing discussion on the nature of disequilibrium, we can describe briefly the main causes of disequilibrium. **First**, seasonal or cyclical fluctuations may cause changes in imports and exports and thereby cause disequilibrium. **Secondly**, there may be changes in demand for a country's exports due to changes in tastes and preferences or techniques of production in foreign countries. There may be competition from other countries for our exports. **Thirdly**, a country might increase its imports for the purpose of economic development and thus cause deficit in its balance of payments. **Fourthly**, inflation and excessive expenditure by the government may also lead to decline in exports and increase in imports thereby widening the gap between them. Increasing prices would attract foreign goods i.e., lead to higher imports. Similarly, higher expenditure may step up the demand for imports.

When a country suffers from a deficit in balance of payments it has to pay for the deficit either by selling gold or use past savings of foreign exchange or borrow from other countries. Any of these policies cannot be used for long. There is a limit to the amount of gold or foreign exchange reserves which it can have in its possession. When it losses these reserves it will become bankrupt and lose prestige in the world market. Similarly, there is a limit to the amount of loans which it can raise and bear the burden of interest and repayment. Therefore, it is natural that some corrective measures are adopted.

22.9 METHODS OF CORRECTING DISEQUILIBRIUM IN BALANCE OF PAYMENTS

According to the classical economists, any disequilibrium in balance of payments is corrected automatically without any corrective measures by the government. If a country has deficit, it will lose gold reserves to that extent. Decline in gold reserves would cause a fall in the supply of money and there by a decline in prices. Lower prices would increase exports and reduce imports. Thus deficit would automatically disappear. In the same way a surplus country would receive gold reserves in payment for its excess exports. This would result in a higher supply of money and a higher price-level which would cause its imports to rise and exports to fall. Thus, its surplus would disappear.

It must be noted that such an automatic adjustment is possible only when a) the supply of money is based completely on gold reserves; b) prices are flexible according to changes in supply of money, and c) change in prices lead to changes in demand and supply of exports and imports. It is clear that such conditions do not prevail any where in the real world. Therefore such an automatic adjustment is not possible. When there is a deficit in the balance of payments, government has immediately to introduce corrective measures. It has to take steps to increase exports or reduce imports or both. If this is not possible, it would try to control the foreign exchange market by various methods. It may also have resort to devaluation when all other measures fail.

Since deficit is a more serious problem than surplus, we will now discuss some of the methods of correcting the deficit in balance of payments.

22.9.1 DEFLATION

It is a policy whereby the government reduces the supply of money and the price-level. Through open market operations or by raising the bank rate, the Central Bank tries to bring down the price-level. Lower prices will increase the demand for exports and imports would be discouraged as foreigners would not prefer to sell their goods where prices are low. Further, higher interest rates would attract foreign capital. The combined effect of these measures would be to reduce the deficit in balance of payments.

It has been said that the policy of deflation is a remedy which aggravates the disease instead of curing it. Higher interest rates and lower supply of money would lead to fall in investment, production and employment levels. The deficit will be wiped out by creating unemployment. So, it is not popular method of correcting deficit.

22.9.2 DEPRECIATION

It means decline in the external value of a country's currency. Suppose the exchange rate between the dollar is Rs. 10 = $1. Suppose India's imports are larger than its exports. Its demand for dollars is higher than the supply. The price of dollar in terms of rupees would rise. Suppose it becomes Rs. 15 = $1. Then the American importers will get for the same dollar Rs. 15/- worth of goods instead of Rs. 10/- which they would have for before the change in the exchange rate. This will boost up India's exports and reduce its imports.

But depreciation is not a suitable method of correcting deficit. Frequent changes in the exchange rate will adversely affect foreign trade. It may also cause speculation about exchange rates. There is also no certainly that change in prices will influence their demand and supply of exports and imports.

22.9.3 DEVALUATION

When the goverament officially reduces the external value of its currency it is called devaluation. When the government of India announces that the dollar-rupee exchange rate is changed from Rs. 10 = $1 to Rs. 15 = $1, it means that the rupee has been devalued in relation to the dollar. This will make Indian exports cheaper and imports costlier. Demand for Indian exports will rise while demand for Indian imports will fall. As a result, India's deficit will be wiped out.

Devaluation will be successful only if certain conditions are fulfilled. The price elasticity of demand for exports and imports must be very high; otherwise, devaluation will not lead to higher exports and lower imports. Further, it should be possible for the country in question to increase the production and supply of goods for export. If there are any obstacle to raising production, the effect of devaluation would be lost. Again, since devaluation tries to raise a country's exports and reduce its imports, it will have an adverse effect upon foreign countries. After all a country's exports are imports of another country. When a country tries to reduce its imports, other countries will retaliate with similar policies. If every country resorts to devaluation, no country can benefit from it.

22.9.4 EXCHANGE CONTROL

Under this measure the government acquires monopoly power and controls the supply and demand for foreign exchange. All foreign exchange earned by exporters is to be sold to the government at the official exchange rate. If any one wants to import goods from abroad, he has to apply to the government for foreign exchange. The government provides foreign exchange to importers according to its own priorities. There is no free market in foreign exchange. The exchange rate is fixed by the government and it does not change, whatever be the demand and supply conditions. By strictly regulating the supply and demand for foreign exchange, the government sees to it that exports equal imports.

India has been following this method for the past 30 years. But it must said that this policy leads to black-marketing in foreign exchange, smuggling and corruption. The exchange control measures should be supported by other measures to increase exports.

22.9.5 IMPORT - CONTROL

Another method of correcting the imbalance in balance of payments is to restrict imports by levying heavy import duties or by fixing quotes for them or even by completely banning them, when tariff duties are raised imports become costly and their demand falls. Sometimes, the govt. announces quotes to be imported for each commodity. Imports above this quota are not permitted. The effect of these measures would be to cut down imports to the desired level and also protect domestic industries against foreign competition.

22.9.6 EXPORT - PROMOTION

A country with an adverse balance of payments may try to raise its exports by various measures in order to reduce the gap between exports and imports. The government may provide tax incentives and other benefits and prizes to promote exports. In recent times greater importance is being given to export— promotion than to import control. This is because it is not easy to reduce imports beyond a certain point. If imports of essential raw materials and machinery are restricted, it will have a negative impact on the economy. So it is suggested that export promotion is a better policy than import control, since it increases production and employment levels in the country.

As discussed above, there are various methods of correcting the disequilibrium in balance of payments. Their effectiveness depends upon a number of condition. Given the conditions prevailing in it, a country may adopt any of the above mentioned measures or some combination of them to restore the equilibrium in its balance of payments.

22.10 SUMMARY / CONCLUSION

Balance of payments shows the systematic record of all transactions between residents and those of the rest of the world. Whereas balance of trade shows the record of payments and receipts on account of imports and exports of goods. The statement of balance of payments is useful in explaining a country's external strength and the value of its currency.

It is desirable to have equilibrium in the balance of payments position. We have to consists 3 to 5 years for analysing it. But generally, disequilibrium situation prevails for many countries for various reasons. There are many ways in correcting this disequilibrium.

Prof. Tippa Reddy

22.11 SUGGESTED BOOKS

1. Bo Sodersten : International Economics
2. David Young : International Economics
3. Enke & Salera : International Economics

22.12 MODEL EXAMINATION QUESTIONS

I. Answer the following in about 30 lines each.

1. Show how a country's balance of payments statements is prepared. Explain its main features.
2. Discuss briefly how disequilibrium in balance of payments is corrected.

II. Answer the following in about 15 lines each.

1. Explain the difference between balance of trade and balance of payments.
2. Explain the usefulness of balance of payments accounts for economic analysis.
3. Define exchange control. How is it useful to the correcting of the adverse balance of payments?
4. Explain the conditions under which devaluation will be effective.
5. What is the difference between cyclical and secular disequilibrium in the balance of payments?

UNIT-23 : EXCHANGE RATES

Contents

23.0 AIMS AND OBJECTIVES

It discusses the determination of exchange rates under different currency standards like the Gold standard, Paper Currency standard and Managed Flexible standard, the relative merits and demerits of flexible, fixed and managed exchange rate systems, and the main objectives and functioning of the International Monetary Fund (IMF) with reference to exchange rates and international liquidity.

After reading the unit, you will be able to

* explain exchange rates under gold and paper currency standards,
* analyse the balance of payments theory of exchange rate,
* describe advantages & disadvantages of fixed & flexible exchange rates, and
* discuss the functioning of IMF with reference to exchange rates.

23.1 INTRODUCTION

The market which deals in the purchase and sale of foreign currencies is called foreign exchange market. The currencies that used as medium of exchange for settling international payments are called foreign exchange. Without such currencies international trade would be like barter where exports are exchanged directly for imports. As is well known, barter system leads to all sorts of inconveniences and inhibits trade. With foreign exchange, it would be easy to quote the prices of exports and imports in terms of foreign currencies domestic currency, imports are paid for in these currencies. It can be seen that exporters earn foreign exchange which is converted into domestic currency. Similarly, whenever foreign goods are imported, we buy foreign currency with domestic currency in order to make payment for imports.

23.2 EXCHANGE RATE

The amount of domestic currency paid for a unit of foreign currency is called *exchange rate*. If a sum of Rs. 20/- has to be paid for a US dollar, then the exchange rate between the rupee and US dollar is Rs. 20 = $1. It is the rupee price of one US dollar. Like the price of any commodity which is expressed in terms of rupees, it is also a price of a unit of foreign currency. For each and every country's currency, there will be a price expressed in rupees. Exporters of goods receive payment in

foreign currency. If an Indian businessman exports goods to America, he will receive American dollars in payments for them. He will convert them into rupees at the prevailing exchange rate. Similarly, when an Indian imports goods from America, he has to pay for them in dollars. He buys dollars by paying rupees in the Indian foreign exchange market in this way, exports create supply of foreign currency and imports create demand for it.

If there is a free foreign exchange market without any government interference, the exchange rate like, the price of any commodity, would be determined by supply and demand for foreign exchange. The supply of foreign currency is created by exports. At higher prices exports will be higher and, the therefore supply will be higher. The supply curve will be sloping upwards to the right. The demand for foreign currency is created by the demand for imported goods. If the price of foreign currency is created by the demand for imported goods. If the price of foreign currency is higher, the demand for imported goods. If the price of foreign currency is higher, the demand for it and imports would be lower and vice versa. The demand curve will be sloping downwards to the right. When the demand and supply are equal, we get equilibrium rate of exchange. The exchange rate will fluctuate with fluctuations in demand and supply, i.e., imports and exports. At higher exchange rates, imports will fall while exports will be higher. At lower exchange rate imports will rise and exports will fall.

The exchange rates are determined differently under different currency systems and foreign exchange markets. Under the gold Standard, exchange rates are fixed rigidly. They do not change whatever be the changes in demand and supply. Under Inconvertible Paper Currency Standard, exchange rates change freely with changes in the price-levels of the trading partners. In the case of free foreign exchange markets, demand and supply determined the exchange rate. As these conditions change, the exchange rate also changes. In both these cases, the exchange rates are flexible. Finally exchange rates may be determined by the government of the country concerned. It will be raised or lowered according to the conditions laid down by the IMF. This system is called Managed Flexible Exchange Rates System.

23.3 EXCHANGE RATE UNDER THE GOLD STANDARD

The Gold standard refers to the system where the value of the basic unit of currency is defined in terms of gold. The government will be prepared to convert gold into currency and currency into gold at this price. There will be no restrictions on the export and import of gold. The supply of money is based on gold reserves. If gold reserves increase the supply of money will also increase and vice versa.

Suppose India and the USA are on the gold standard. In India, the govt. has announced that the price of one gram of gold is Rs. 100/- and in USA it is fixed at $ 5. The exchange rate between the rupee and dollar is determined as here under :

1 gram of gold	=	Rs. 100 in India
,, ,,	=	$. 5 in USA
∴ Rs. 100	=	$. 5
(1 gram)		(1 gram)
i.e., Rs. 20	=	$. 1
(0.2 gram)		(0.2 gram).

The gold value of Rs. 20/- is the same as that of $1. The exchange rate between these currencies (Rs. 20 = $1) is called 'mint parity'.

Since there is free convertibility of currency into gold in both the countries and also free movement of gold between them, the exchange rate will remain more or less fixed. It will change within a narrow range set by the cost of transporting gold from one country to the other. Suppose the cost of transporting gold from one country to the other. Suppose the cost of transporting a gram of gold from India to USA is Rs. 10/- and for 0.2 gram, it would be Rs. 2/-. Whatever the nature of balance of payments, the exchange rate will not rise above Rs. 22/- (Rs. 20 + 2) and will not fall below Rs.18/- (Rs. 20 - 2). The highest price (Rs. 22/-) is called 'upper limit' or 'gold export point'. The lowest price is called lower limit' or 'gold import point'. Suppose, India has a deficit in balance

of payments, i.e., its imports are higher than is exports. The demand for dollars would be higher than their supply. Therefore, the price of dollars might rise above the mint par rate of Rs. 20 = $ 1. But it cannot rise beyond Rs. 22 = $ 1. If it is (suppose) Rs. 25 = $1, people would not pay this price. They would prefer to buy gold at the rate of Rs. 100/- a gram from the government and export it to America by spending Rs. 10/- on transport. In America, they will exchange one gram of gold for $ 5. In this way they can buy any amount of dollars. They have spent in all Rs. 110 (Rs. 100 + 10) for $ 5, i.e., Rs. 22 = $1. This is called gold export point. If the exchange rate is above this point, importers would export gold to America and buy as many dollars as they want at $1 = Rs. 22.

Similarly, suppose India has a surplus in balance of payments, i.e., its exports are larger than its imports. The supply of foreign currency would be higher than its demand. So the exchange rate would fall. But it cannot fall below the rate of Rs. 18 = $ 1. Suppose the actual rate is Rs. 15 = $1, no one would sell dollars at this rate. Instead, the Indian exporters who have earned dollars would prefer to take them to America and buy gold from the American government at the rate of $5 per gram. They will bring it to India by spending Rs. 10/- on transport. In India they will convert gold into rupees at the rate of Rs. 100/- a gram. Thus, they would get in all for $5 an amount of Rs. 90/- (Rs. 100 - 10), i.e., $1 = Rs. 18/-. They can sell or convert any amount of dollars into rupees at this rate. This is called 'gold-import point'. If the exchange rate is below this level, they will freely import gold, and buy rupees at $1 = Rs. 18/-.

As seen above, a deficit country would lose or export gold and a surplus country would receive or import gold leaving the exchange rate to fluctuate within a narrow range. Adjustment in the balance of payments would be brought about by changes in prices rather than in exchange rates. A deficit country loses gold, which would result in decline in the supply of money and, therefore, decline in price-level. As prices decline, exports may rise and imports may fall, thus wiping out the deficit. In a similar way, a surplus country would receive gold which would cause the supply of money and price level to rise. Higher price level would cause exports to fall and imports to rise, thereby removing the surplus.

The system of fixed exchange rates under the Gold Standard was in operation in different countries of the world till the end of the First World War. Under this system, governments do not have any control over their own currencies and exchange rates. Moreover, a surplus country would suffer from the problem of inflation and a deficit country from deflation. Price-stability would be sacrified for the sake of exchange stability. As the problem of price-instability and scarcity of gold came up, it was found difficult to stick to the Gold Standard. Further, as the First World War broke out, governments wanted greater control over the supply of money and exports and imports, and exchange rates were changed to suit the interests of the country in question. Thus the system of Gold Standard and fixed exchange rates came to an end.

23.4 EXCHANGE RATES UNDER PAPER CURRENCY STANDARD

After the break-down of the Gold Standard, the system of Paper Currency Standard has come to be adopted. Under this system is currency is not supported by gold reserves, and its supply is freely regulated by government policy. Exchange rates change frequently with changes in the domestic purchasing power of currencies. In this context, a new theory was developed for the determination of exchange rates. Gustav Cassel formulated the **'Purchasing Power Theory'** explain the determination of exchange rates under the Inconvertible Paper Currency Standard.

According to this theory the exchange rate between two inconvertible currencies is determined on the basis of their respective purchasing power. Suppose India and England are on the Paper Standard. Suppose further that in India a quintal of sugar costs Rs. 500/- whereas in England the same costs £ 25. It means Rs. 500/- have the same purchasing power as £ 25. Then :

$$\underset{\text{(one quintal of sugar)}}{\text{Rs. 500}} = \underset{\text{(one quintal of sugar)}}{25}$$

$$\therefore \text{ Rs. } 20 = £\ 1.$$

This rate is called 'Purchasing Power Parity' as Rs. 20/- in India and £1 in England have the same purchasing power. The exchange rate will change if the price-level changes in these countries. Suppose,

in India there is inflation and a quintal of sugar costs Rs. 1000/- while in England prices are constant, the new exchange rate would be :

Rs. 1000 = £25
Rs. 40 = £ 1

If prices change in both the countries, the ratio of change in prices will determine the new exchange rate. The price index in each country will indicate the extent of change in prices, i.e., the purchasing power which will indicate the new exchange rate. It can be known with the help of a formula.

$$\text{New Exchange rate} = \text{Old exchange rate} \times \frac{\text{Price index in India}}{\text{Price index in England}}$$

If current price index in India is 400 and in England 200, the new rate would be :

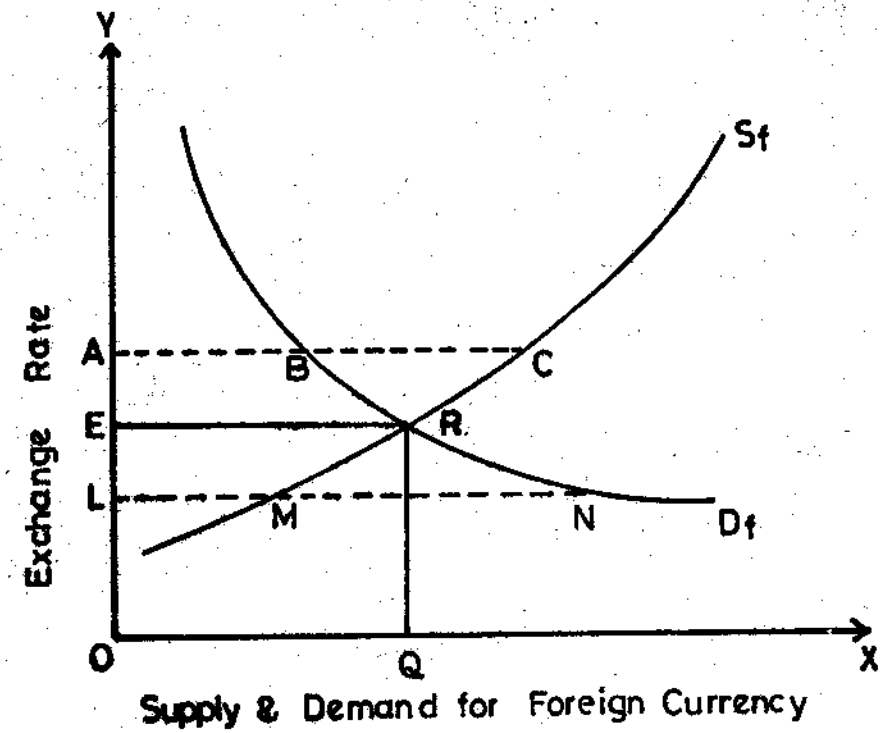
$$= 20 \times \frac{400}{200} = 40$$

23.4.1 CRITICISM

After the First World War, when the exchange rates were changing wildly, the Purchasing Power Party theory was helpful in explaining the causes for such changes. But it could not explain how the old exchange rate itself was determined. The theory has been criticised for various reasons. **First,** it is said that there is no clear connection between purchasing power and exchange rates. The purchasing power of a currency is expressed in terms of all the goods and services marketed in the country, whereas exchange rate applies only to goods which enter the foreign market. Of the several goods a country produces, only a few enter foreign trade. **Secondly,** the theory states that whenever the purchasing power changes, it causes exchange rates to change. But it is also true that the exchange rate may change independently and it may cause domestic prices, i.e., purchasing power, to change. So the causation is two sided. **Thirdly,** the theory ignores the role of supply and demand in determining exchange rates. It is common knowledge that when imports and exports are not equal, there will be a pressure on the exchange rate. **Fourthly,** here is the problem of index numbers. An index number of prices is constructed on the basis the prices of various types of goods produced in a country. There is a base year for it. These goods will not be the same in India and in England. There are many goods which are not common to these countries. Moreover, the base year may be different for different price indices. As a result of all these, it may not be possible to compare the index numbers or purchasing power of different currencies. **Finally,** speculation about changes in exchange rates and capital movements between countries might cause changes in exchange rates without reference to changes in purchasing power. Therefore, the theory has not found favour with economists and policy makers.

23.5 BALANCE OF PAYMENTS THEORY OF EXCHANGE RATE

According to this theory the exchange rate is determined by the supply and demand for foreign exchange. A glance at the balance of payments statement of any country reveals that all the credit items indicate the demand for foreign exchange. The debit items indicate the demand for foreign exchange. The credit items include exports of goods and services, gifts and donations from foreigners and inflow of capital funds. All these items earn foreign exchange for a country. Like the supply schedule of any commodity, the supply schedule of foreign exchange is a function of price, i.e., exchange rate. If the exchange rate is higher, the exports would increase and they will produce a greater supply of foreign exchange. At lower exchange rates, the supply will be less. The supply curve, as shown in Figure 1, would be sloping upwards to the right.



Supply & Demand for Foreign Currency

It must be emphasised that the supply of foreign exchange is created by the demand for Indian exports from foreigners.

The demand schedule depends on the exchange rate. The Indian demand for foreign goods creates the demand for foreign exchange. If the exchange rate is high, foreign goods will become costlier and the demand for them will decrease. When the exchange rate falls, foreign goods will be cheaper and their demand will be higher. Thus, the demand curve as shown in the diagram slopes downwards to the right. In Figure—1, X-axis measures supply and demand for foreign exchange. Y-axis measures the exchange rate. Df is demand curve and Sf is supply curve.

The point where the supply and demand curves intersect there will be the equilibrium rate of exchange. In the diagram, OE is the equilibrium rate of exchange, where supply and demand are equal. If a equilibrium rate of exchange, where supply and demand are equal. If a higher exchange rate preyails, viz., OA, demand will be less than supply, i.e., import will be less than exports, which will push the exchange rate downwards. At a lower exchange rate (OL) demand will be higher than supply forcing the exchange rate upwards. Ultimately, the equilibrium exchange rate will be restored.

Criticism

The balance of payments theory has been criticised on the following grounds. First, the theory assumed that tradé between countries is unrestricted and free. There is supposed to be no regulation of exports and imports. In the real world, there is no free trade. All kinds of controls are imposed on imports and exports, as a result of which the supply and demand schedules of foreign exchange become meaningless. Second, the theory is based on the assumption that demand and supply are not influenced by the exchange rate. It is generally observed that sometimes changes in exchange rate influence exports and imports and sometimes the other way round. Third, it is assumed that initially there is an equilibrium between supply and demand. This is an unrealistic assumption. Fourth, the theory ignores the effect of changes in the prices of exports and imports on their demand and supply and thus on exchange rates.

The balance of payments theory, however, is considered to be more satisfactory than others because it examines the demand and supply conditions of exports and imports and the inter relationship between them.

23.6 FIXED VERSUS FLEXIBLE EXCHANGE RATES

As discussed above, there are two kinds of exchange rate systems viz., fixed and flexible exchange rates. Fixed exchange rates occur under the Gold Standard. If there is any disequilibrium in balance of payments, its effect will not be felt on the exchange rates. Adjustment is done through changes in price-level and the subsequent changes in exports and imports. Free exports and imports of gold prevent fluctuations in exchange rates. Flexible exchange rates occur under paper currency standards. Any deficit or surplus in the balance of payments leads to changes in exchange rate through which the equilibrium is restored. If there is deficit, the exchange rate would rise and in case of surplus, it falls.

23.6.1 ADVANTAGES OF FIXED EXCHANGE RATE SYSTEM

The fixed and flexible exchange rate policies have their respective merits and disadvantages. In the case of fixed exchange rates, whatever be the situation of balance of payments, the exchange rate is unchanges. Fixed exchange rate provides confidence to exporters and importers. They are certain of the exchange rate and thus of their expected incomes. It has the advantage of preventing speculation about exchange rates. Often, speculation leads to instability and unnecessary movement of capital from one country to another. Fixed exchange rate policy allows exports and imports to adjust themselves each other without any government interference. Changes in relative prices automatically bring about an equilibrium in balance of payments. Fixed exchange rates provide confidence to foreign investors, because there would be no uncertainly regarding the value of their investment and income. Moreover, there is no scope for any arbitrary action by the State. Every government has to follow the rules of the game.

23.6.2 DISADVANTAGES OF FIXED EXCHANGE RATE SYSTEM

Fixed exchange rate system has certain disadvantages as well. Though exchange rates are stable, the price level changes frequently according to changes in the balance of payment. Surplus leads to inflation and deficit causes deflation. The government will not have any control over domestic price level and employment. There is also no certainty that the equilibrium will be restored through price changes. If the price elasticity of demand for exports and imports is not high, the equilibrium will not be restored easily. Similarly, if the economic situation is rigid and prices cannot be changed easily, the adjustment mechanism will not work. Further, if there is gold standard, there is the danger of gold exports and imports taking place due to deficit or surplus. The government may have to intervene to reduce the undesirable effects of disequilibrium in the balance of payments.

23.6.3 ADVANTAGES OF FLEXIBLE EXCHANGE RATE SYSTEM

The flexible exchange rates have their own advantages and disadvantages. Under this system the equilibrium rate of exchange can be determined in a simple manner. The foreign exchange market itself through the interplay of demand and supply forces determines the exchange rate. More important, any deficit or surplus in the balance of payments is corrected automatically without any changes in the domestic price-level or employment level. It is in fact very difficult to change the prices and production levels in any economy. Because of monopoly and trade unions; prices are difficult to change. The adjustment is done continuously through changes in exchange rates. The government also does not have to intervene in the foreign exchange market for any purpose. There will be no need to maintain any foreign reserves to prevent fluctuations in exchange rates. Thus, the flexible rates are supposed to be superior to the fixed rates policy.

23.6.4 DISADVANTAGES OF FLEXIBLE EXCHANGE RATE SYSTEM

The flexible exchange rate system has its own disadvantages. Adjustment in balance of payments may not be possible because of low elasticities of demand for exports and imports. Changing exchange rates may encourage speculation in foreign exchange. Most of the times, such speculation is harmful because it creates conditions of instability. This may also result in decline in international investment. Foreign trade and investment will become more risky on account of unstable exchange rates. There might in fact, be a decline in foreign trade and investment.

World experience of flexible exchange rates is not very encouraging. Canada was the first country to adopt flexible exchange rate policy. It resulted in higher speculation and decline in the volume of trade. In recent times West Germany and Japan have been following the policy of floating rates. It must be noted that actually the governments always interfere and regulate the foreign exchange market. Even under the Gold Standard, the governments used to intervene to prevent gold movements and to maintain stable exchange rates. Even in the case of flexible rates, the governments try to control undue changes in exchange rates and speculations. What we find most common in the real world is the management of exchange rates by the government. Both the fixed and flexible exchange rate policies have failed. Since the establishment of the International Monetary Fund, we are having the system of managed flexible exchange rate policy. This will be studied in the following section.

23.7 THE INTERNATIONAL MONETARY FUND (I.M.F.)

With the breakdown of the Gold Standard, the world market experienced conditions of instability and disorder. Every country was fixing its exchange rates arbitrarily, changing them whenever it liked and introducing all kinds of restrictions on foreign trade. There was a conference of 44 nations at Brettonwoods in America to discuss measures to save the world from this crisis. The conference decided to establish an international organisation known as the International Monetary Fund (IMF) to achieve its objectives.

23.7.1 OBJECTIVES

The IMF began its operations in 1947. Its character set forth its objectives. They are :

1) To promote international monetary cooperation through mutual consultation and collaboration among the member countries;

2) To promote international trade and thereby promote high levels of income and employment in all the countries;

3) To promote stable exchange rates and prevent competitive and arbitrary changes in exchange rates by member countries;

4) To work for a system of multilateral system of payments and removal of exchange controls; and

5) To help member nations to correct maladjustments in their balance of payments. Thus it will work for reducing the duration and size of disequilibrium in the balance of payments of its members.

The IMF is governed by a Board of Governors, an Executive Board and a Managing Director. It has its headquarters at Washington. The Fund has its own resources contributed by its members according to their specified quota.

Each member is given a quota which is revised from time to time. A member's voting rights are decided by the size of its quota. America has the biggest quota. At first 25 per cent of a member's quota was to be paid in gold or US dollars and the remaining in the country's own currency. Since 1978 the practice of maintaining gold reserves has been discontinued. Now the quota is to be maintained in terms of Special Drawing Rights which is IMF's own currency. In 1981, the IMF quotas were raised to SDR 61 billion and India's quota was fixed at SDR 1.7 billion.

23.7.2 EXCHANGE RATES AND THE IMF

When the IMF began its operations in 1947, it was laid down that member countries should announce the value of a unit of their currency in terms of gold or US dollars. The US dollar was treated as equivalent to gold because of the US government's commitment to convert dollar into gold for this purpose. Moreover, the US had vast reserves of gold to support its dollar as world currency. Since the value of every country's currency was defined in terms of gold or US dollar, cross exchange rate upto one per cent of its par value. If any member wanted to change its exchange rate beyond this

limit, it had to seek the approval of the IMF. The member had to convince the IMF that it was suffering from chronic and persistent disequilibrium in its balance of payments which could be corrected only by a big change in its exchange rate. The IMF would grant its permission after a careful study of the member's case. This was done to discourage unnecessary changes in exchange rates and to prevent competitive devaluations. It was thus a system of stable exchange rates which were allowed to be changed only in exceptional circumstances. Therefore, it was called Managed Flexibility Standard. It was neither completely flexible nor absolutely fixed.

In 1971 the American dollar was in difficulties since on account of deficit in its balance of payments, the US government gave up its commitment to covert US dollars into gold. The IMF was forced to change its policy on exchange rates. Member countries were allowed to change their exchange rates freely. Only some guidelines and suggestions were given to countries seeking its help. The practice of expressing exchange rates in terms of gold or US dollars was discontinued. The price of gold was raised because of oil crisis in 1974. The IMF introduced SDRs (Special Drawing Rights) as a new international paper currency. Initially, the valve of SDR was defined in terms of US dollar. Later on, with the introduction of floating exchange rates system, the value of the SDRs was delinked from the US dollar. Since 1981, the value of the SDRs is defined in terms of the average value of the five leading currencies of the world, viz., US dollar, German Mark, Japanese Yen, French and the British Pound. These five countries have the highest share in world trade. The value of the SDRs changes whenever the average value of the above mentioned package of currencies changes. It means that the IMF has switched over from stable exchange rates to floating exchange rates. It has also reduced the importance of gold in international transactions. It has sold much of its gold reserves through auctions in London and the money is being used to help the developing countries.

23.7.3 THE IMF AND INTERNATIONAL LIQUIDITY

With the change in the IMF's exchange rate policy there is also a change in other policies. Member countries are now free to change their exchange rates. But in reality the IMF tries to prevent unnecessary exchange rate changes by helping its members in times of difficulty. If a deficit country is provided with short-term loans of foreign exchange, it would not think of either changing its exchange rate or introducing exchange control measures. It would have enough of time to increase its exports or reduce imports or both. The IMF has since its inception been trying to help member countries with balance of payments problems by providing international liquidity. It is important to understand the meaning and importance of international liquidity and its relationship with exchange rates policy.

It is well known that exports pay for imports. If exports are less than imports, the difference between them has to be paid for in terms of gold or the currency of the country from which goods are imported or any currency that is acceptable to that country. Similarly, an export surplus country would receive the balance in the form of gold or its own currency or any other currency which is acceptable to it. International liquidity is defined as anything which is generally acceptable as a means of settling residual balances, and in which reserves are held. Gold, key currencies, i.e., currencies of big trading countries of stable value, and the currency issued by the IMF are used for international payments and thus constitute international liquidity.

The demand for international liquidity depends upon the nature of exchange rates. If there are flexible exchange rates, a country does not require any liquid assets. Adjustments are made through change in exchange rates. But if there are fixed exchange rates, the demand for liquidity will be larger. The higher the deficit, the larger will be the demand for liquidity, and vice versa. Similarly, the supply of international liquidity is created by additions to stocks of gold reserves, deficit of countries of key currencies and the capacity of IMF to create its own currency.

At first, gold was the only form of international liquidity. Later, the US dollar because of its gold backing became world currency. With the crisis of 1971, the USA withdraw its currency from the category of currencies. The oil crisis and the sudden rise in gold prices made it difficult for many poor countries to maintain gold reserves. The IMF was using the members quota as the basis for assisting deficit countries. A member's quota till recently consisted of gold and its currency reserves. Now, the quota is fitted in terms of SDRs. A country can borrow upto 450 per cent of its quota over a period of three years.

The IMF has been playing an important role in supplying international liquidity. Till 1967 it had no right to create its own currency. Its resources consisted of gold and US dollar reserves. These were not sufficient to help the member countries suffering from payments deficit. Therefore, in 1967 the IMF was empowered to create a new world currency called SDRs (Special Drawing Rights). It is a paper currency issued by the IMF without any backing of gold or other reserves. A deficit country can borrow SDRs to finance its deficit. Similarly, a surplus country can accumulate its surplus in the form of SDRs. In 1978 the SDRs became the official currency of the IMF and its value was delinked from gold and the US dollar. As seen above, the value of the SDRs is defined in terms of the average value of a package of five currencies. Whenever this average value changes, the value of the SDRs also changes. But the IMF is not free to increase the supply of the SDRs whenever it wants. Periodically, the IMF is permitted to increase the issue of SDRs upto a fixed limit. At first, the IMF was authorised to issue SDRs 9.3 billion, and in 1982 it was raised to SDRs 24.5 billion. This was done with the specific purpose of helping the developing countries whose trade deficit is growing steadily and thus their need for liquidity. The newly created SDRs are distributed among the member countries according to their respective quotas. The members are free to use them to finance their deficit or accumulate their surplus.

Check Your Progress - 1

1. Define 'rate of exchange'.

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2. What is mint parity?

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3. What is purchasing power parity?

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4. What is meant by gold standard?

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5. What is meant by international liquidity?

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23.8 SUMMARY / CONCLUSION

Thus, it is clear that the world has moved from the system of fixed exchange rates to that of floating exchange rates. It is also clear that the IMF is able to issue a world currency called SDRs which is distributed among its members. It is an important source of international liquidity. A member country can use its quota of SDRs or borrow from the IMF in times of deficit so that it need not think of devaluation or exchange control to correct its disequilibrium. In this way, the IMF is able to minimise the need for exchange rate changes and thereby promote stable exchange rates.

- Prof. Tippa Reddy

23.9 SUGGESTED BOOKS

1. Bo Sodersten : International Economics
2. David Young : International Economics
3. Enke & Salora : International Economics

23.10 MODEL EXAMINATION QUESTIONS

I. Answer the following in about 30 lines each.

1. Discuss the advantages and disadvantages of flexible exchange rates.
2. Critically examine the purchasing power parity theory.
3. Explain how the value of SDRs is determined. Discuss its importance as a source of international liquidity.

II. Answer the following in about 15 lines each.

1. How is the exchange rate determined under gold standard?
2. Explain how the equilibrium rate of exchange determined.
3. Explain the objectives of the IMF.

UNIT-24 : INTERNATIONAL MONETARY SYSTEM

Contents

24.0 AIMS AND OBJECTIVES

The aim of this unit is to explain the establishment of International Monetary Fund (IMF), the introduction of SDR and to explain European Monetary System.

After reading the unit, you will be able to

* discuss the Gold Standard System,
* describe the IMF,
* analyse the Dollar crisis and Jamica accord, and
* explain the European Monetary System.

24.1 INTRODUCTION

We have learnt theories of international trade and issues pertaining to it such as balance of trade, balance of payments, exchange rates, etc. In this unit, let us study international monetary system in detail. Creation of IMF and introduction of SDRs are also dealt with. Let us also discuss other issues relating to international monetary system, such as, dollar crisis, Jamica accord and European monetary system.

24.2 MEANING OF GOLD STANDARD

The system of fixed exchange rates under the gold standard was in operation in different countries of the world till the end of the first world war. By international gold standard it is meant as an international monetary standard where all participating countries have legally defined a unit of account (dollar, Sterling, Rupee etc.,) in terms of gold. External value of their currencies are fixed through the medium of gold purchases and sales of gold in unlimited quantity at officially fixed price which permits unrestricted gold flows into and out of the country. Thus under the gold standard, Governments do not have any control over their own currencies and exchange rates. Moreover a surplus country would suffer from the problem of inflation while a deficit country from deflation. Price stability in a gold standard would mean a sacrifice for the sake of exchange stability. As the problem of price instability and scarcity of gold mounted up, it was found extremely difficult to stick on to the gold standard, and also, since the

first World War broke out, Governments wanted to have greater control over the supply of money, exports and imports and exchange rates. These were changed accordingly to suit the interest of the country in question. Thus the system of gold standard and fixed exchange rates had come to an end.

With the abandoning of the gold standard in 1930's by the major countries of the world a vaccum was created in the field of international trade. The Great Depression had also created a havoc in the international monetary system. It was characterised by the trade and exchange war among countries with competitive depreciation of currencies and severe restrictions on imports of goods and exports of capital. The result was that the world trade and world economic growth suffered a lot. The world statesmen feared that these restrictive trade and payments practices would continue even after the war unless international efforts were made to create some effective International machinery whereby exchange stability could be guaranteed. Sharing such convictions, experts in United States and the United Kingdom prepared comprehensive plans for International monetary co-operation. The British proposal is known as 'Keynes Plan' and the American proposal being 'White Plan' after their principal authors Lord Keynes & Mr. White. The basic features of the two plans were fixed into a joint plan in 1944 at the United Nations Monetary and Financial Conference of 44 Nations held at Bretton Woods, New Hamp Shive in the U..S.A.' The Conference led to the establishment of the International Monetary Fund.

24.3 INTERNATIONAL MONETARY FUND

The creation of the International Monetary Fund popularly known as IMF is a landmork in the history of world economic cooperation. The I.M.F. began its operation in 1947 and its main objectives were

(1) to promote international monetary cooperation through mutual consultation and collaboration among the member countries;

2) To promote international trade and thereby promote high levels of income and employment in all the countries.

3) To promote stable exchange rates and permanent competitive and arbitrary changes in exchange rates by member countries;

4) To work for a system of multilateral system of payments and removal of exchange controls; and

5) To help member nations to correct mal-adjustments in their balance of payments.

Thus, to sum up under the Bretton Woods System the IMF was to supervise mainly on two pillars; the maintenance of stable exchange rates and a multilateral credit system. The members of the I.M.F. agreed to keep their exchange rates fixed at agreed par values and not to change them more than one per cent below or above parity, if any member wanted to change its exchange rate beyond that limit, it had to seek the approval of the International Monetary Fund. The member had to convince the IMF that it was suffering from chronic and persistent disequilibrium in its balance of payments which could be corrected only by a big change in its exchange rate. The IMF would grant its permission after a careful study of the members case. This was done primarily to discourage unnecessary changes in exchange rates and to prevent competitive devaluations. It was thus a system of stable exchange rates which were allowed to be changed only in exceptional circumstances. Therefore, it was called Managed Flexibility Standard. It was neither completely flexible nor absolutely fixed.

The second important aspect of the fund actively concerned is its arrangements for international liquidity. The Fund has its own resources contributed by its members according to their specified quota. Each member had some borrowing rights to help to meet temporary external deficits. The IMF was using the member quota as the basis for assisting deficit countries. A member's quota till recently consisted of gold and its currency reserves. Now, the quota is fixed in terms of Special Drawing Rights (SDRs). A country can borrow upto 450 per cent of its quota over a period of three years. Thus the credit system was infact envisaged as an important and integral part of the IMF system.

Since its operation in 1941, the IMF played a conservative role. In the late 1940's it stressed the necessity for adjustment in exchange rates and took a positive view of the devaluation but in 1950's

and in 1960s the fund did not try to work for any systematic use of exchange rates changes but it took the view that changes in major exchange rates were undesirable.

The IMF reinforced 3 main types of adjustment. A country could reduce its expenditure when confronted with a balance of payments deficit, it could try to rely on expenditure switching policies by devaluing and a third way was to increase the provision of world liquidity.

It may be noted that the Fund looked upon with disapproval of the exchange rate changes among industrial countries but when it came to less developed countries the fund tactily approved exchange rate changes.

During 1950's & '60s the IMF played quite a passive role. Part of the reason for the inactivity of the Fund during this period can be explained by the dominance of the United States which was the most important source of international liquidity. With the co-operation of a few other industrialised nations it could control and steer the development of the internrational system.

24.4 INTRODUCTION OF SDR

An important step towards revitalising the Fund was taken in 1967 and the IMF meeting in Rio de Javeiro when special drawing rights were introduced. Thus from relative obscurity the fund has emerged atleast potentially as an important supplier of international liquidity. A deficit country can borrow SDRs to finance its deficit. Similarly a surplus country can accumulate surplus in the form of SDRs.

Special drawing rights are often referred to as a 'paper gold'. It is a paper currency issued by IMF without any backing of gold or other reserves. Initially the value of SDR was defined in terms of gold content 0.888671 grams i.e., the same value as 1 US dolalr.

24.5 THE DOLLAR CRISIS

In 1971 the American dollar was in difficulties. There were two main causes for the crisis which confronted the American dollar namely internal and external causes. Internally the American economy had been confronted with a serious type of inflation for several years prior to 1971. As a result, the American prices had been rising at 4.2 per cent per annum. This rise in prices was also accompanied by large scale unemployment in the country production was dwindling year after year and the rate of growth was continuously falling down, and with the constant increases in American prices, the internal value of the dollar had gone down to a considerable extent.

The external value of the American dollar had also been deteriorating year after year prior to 1971 due to the unfavourable balance of payments. The main reason for the deficit was a rapid increase in the American imports from countries like West Germany and Japan because these goods were much cheaper than the American goods. At the same time American exports were rapidly declining due to the rapid rise in American prices. Yet another reason for the deficit in the American balance of payments had been due to the spending of vast sums of money on military operations in Vietnam and Korea. In August 1971, the crisis of the American Dollar had touched the peak level. To meet the situation, the then American President, Mr. Richard Nixon formally declared that the dollar was no longer even formally convertible into gold and hence the US Govt. gave up its commitment to convert US dollard into gold. But the gold price was not changed. It continued to remain at 35 dollars per ounce.

The objective of the new American Policy was to bring about an improvement in the internal and the external value of the Dollar and taking into account the adverse position in the internal and external spheres it should have devalued the dollar. But instead of devaluing the dollar, the American Govt. started pressurising the Govt. of West Germany and Japan into revaluing their currencies. These countries, however declined to oblige the American Government. On the contrary, they left their currencies free to find their own levels in the international exchange markets. The result was that the West German Mark and the Japanese Yen started moving upwards in the free exchange markets in relation to the American dollar. Thus, an era of fixed exchange rates initiated at Bretton Woods came to an end. The international monetary system, built up so assiduously at the Bretton Woods Conference broke down

in the middle of 1971; it means that the IMF has switched over from the stable exchange rates to floating exchange rates and it also reduced the importance of gold in international transactions.

Many statesmen in the leading industrialised countries disliked the flexible exchange rates system as it was influenced by controls and official interventions and they wanted to return to a system of fixed exchange rates. The strivings of the major industrialised countries towards a new system of stable exchange rates resulted in the SmithSonain realignment. The SmithSonain agreement also widened the permissible band of movements of the exchange rates to 2.25 per cent above or below the new paritius of central rates. Prior to this the exchange values of currencies could be varied only to the extent of 1 per cent under the rules of IMF. But despite this agreement the dollar was still not convertible into gold, so far as the foreign central banks were concerned.

Despite the above agreement, the international monetary crisis continued unabated. To bring about an improvement in the international monetary system the IMF appointed on 27th June, 1972 an adhoc committee of the Board of Directors. This committee consisted of 20 members who were represented with both the developed as well as the underdeveloped countries. After a two years period of consultations and deliberations, the committee of 20 was able to prepare the outlines of a new world monetary system which received the final sanction of the IMF on 23rd June, 1974. The new system was enforced with immediate effect. But it was, however, purely a temporary affair. The new system was to remain in force till a permanent system replaced it. Some of the important points of the system were gold stood demonetised under the new system. The place of gold in monetary reserves was to be taken by the SDRs in the member countries. Prior to 1974 the value of the SDRs was determined in terms of gold but on July 1st, 1974, the SDR was redefined as a 'basket' that consisted of sixteen various currencies.

The developing countries were given a new facility known as the 'Extended Facility' under which the loans from the IMF coud be for periods varying between 4 to 8 years, prior to this the developing countries could contract only short term loans from the IMF.

Another attractive feature of the new agrrement was the oil facility, by advancing oil loans to developing countries who found themselves unable to pay the higher oil prices out of their foreign exchange earnings.

24.6 THE JAMICA ACCORD

As said above the entire monetary system was purely a provisional system. Efforts in establishing a permanent monetary system were being persistently made by the Committee of 20. These efforts met with success at the Monetary Conference held at Kingston (Jamica) on 8th January, 1976. A new international monetary system was born on that historic day. The main features of the new system were as follows:

1) The exchange rates of the currencies of the member countries of the IMF had been left free to 'float' on the foreign exchange markets. Thus the world economy had adapted itself to the floating system of exchange rate.

2) One-Sixth of the gold stock of the IMF i.e., 25 million ounces of gold was sold in the open market at the ruling prices.

3) The paper gold or the Special Drawing Rights had been declared the principal reserve asset of the international monetary system.

4) The oil facility had been abolished under the new system.

In fact, the Jamaica Monetary Package was not a satisfactory reform from the point of view of developing countries. If anything, it had worsened the lack of equity in the distribution of international liquidity. By abolishing the official price of gold and letting it be sold at open market prices, the Jamica Package had given enormous benefits to the rich nations of the world which had held enormous quantities of gold. This huge injection of fresh liquidity had made it impossible to create new liquidity in the form of SDRs which would have benefitted the developing countries.

24.7 EUROPEAN MONETARY SYSTEM

As is well known the international foreign exchange market had been undergoing violent ups and downs since the first devaluation of the US dollar on August 15, 1971. This had its inevitable repurcussions on European currencies which suffered severe fluctuations in the post 1971 period. There was a virtual chaos in the European financial markets which adversely affected the prospects of economic growth in Western Europe. Therefore in 1972 the European Economic Community decided to limit the fluactuations of their currencies relative to each other to a smaller band. This arrangement was called 'the snake in the tunnel'. In meant that the EEC currencies were tied together and could only fluctuate with narrow limits with respect to one another but they could fluctuate with respect to other currencies within the limits given by the band proposal. It is to be noted that UK, Italy and Ireland did not take part in the joint float. France also left float in 1974 and Sweden in 1977 and Norway followed suit in December, 1978.

Strivings for European Monetary Co-opeation have, however continued. In March 1979, the European Monetary System (EMS) was created. At the centre of this new form of co-operation in the European currency unit (ECU) which is a basket currency of a unit of account made up by the major European currencies. One essential intention of the European Monetary System was to try to limit the internal exchange rate movements among the participating European currencies. Hence the members have agreed not to allow their currencies to deviate by more than 2.25 per cent from the central rates, defined as those prevailing when the scheme was introduced. To this extent, the EMS Scheme may be viewed as an attempt at reviving the Snake arrangement by trying to stabilise fluctuations in exchange rates. The scheme also aims to establish the European currency unit as an International reserve asset and to create a European Monetary Fund to support the scheme and help foster European cooperation in the International Monetary field.

On the other side, the oil crisis and the increase in oil prices profoundly affected the world economy. Many countries ran very heavy deficit in their Balance of Payments because of the increased oil prices. The problems created by the oil crisis did not disappear as no systematic international action was taken to confront the transfer problem it entailed. Since no international solution was possible the various nations had to deal with the problem as on individual basis as best as they could. And therefore many countries have devalued their currencies and a deep recession followed. The need for supervision of exchange rate has however been recognised. The possibilities for a clean float were quite small, instead various forms of co-operation and management took place and a system of managed floating have been evolving where the central banks will try to hold the fluctuations of exchange rate around some 'normal value'. The IMF has adjusted its actions and frame of reference to the system which was developed. The new system that has emerged will be less dependant on the dollar than was with the old Bretton Woods System, and the system of floating rates would have a more effective adjustment mechanism. Even at this state it is however clear that much has been and is being accomplished to improve the functioning of the international monetary system.

24.8 SUMMARY/CONCLUSIONS

So far, we have discussed the operation of gold standard system which was existing in different countries till 1930's. A vaccum was created in the field of international trade with the abandonment of gold standard. This gap was fixed up by the establishment of International Monetary Fund. An interest step that took place in 1967 is the introduction of Special Drawing Rights as an international liquidity. Due to dollar crisis and other exchange problems efforts were started to establish a permanent monetary system. These efforts met with success on 8th January, 1976 with the introduction of a new monetary system. European monetary system was also discussed in this unit.

- Dr. N. Vijaya

24.9 SUGGESTED BOOKS

1. Bo Soderstein : International Economics
2. David Young : International Economics
3. Enke & Sabera : International Economics

24.10 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. Explain the establishment of IMF. What are its objectives? Discuss its functioning.
2. Explain the European monetary system.

II. Answer the following questions in about 15 lines each.

1. What is gold standard system? Why was it abandoned?
2. What is dollar crisis?
3. What is Jamica accord? What are the main features of new international monetary system introduced in 1976?

UNIT - 25 : INDIA'S FOREIGN TRADE & PAYMENTS

Contents

25.0 AIMS AND OBJECTIVES

The purpose of this unit is to explain India's foreign trade, recent trends in exports & imports, and balance of payments position.

After reading the unit, you will be able to

* make out the recent trends in the composition and direction of trade, and
* explain the position of India's balance of payments.

25.1 INTRODUCTION

India's trade relations with different countries of the world have changed quite significantly during the last forty four years. Two factors could be attributed to these changes. The first one is the changing economic compulsions within the system and the resulting policy shifts therefrom. The second is the changes in political compulsions both within and outside the system and the changes following therefrom in our political relations with different countries. In this Chapter we shall examine the three facets of India's foreign trade, its value, its composition and its direction.

25.2 INDIA'S BALANCE OF TRADE POSITION

It is clear from the table-1 that the balance of trade has been adverse for India for most of the planning period. Excepting 1972-73 and 1976-77, when there were small surpluses amounting to Rs. 104 crores and Rs. 69 crores respectively, while in all other years there were deficits. What is matter of concern is the fact that during the eighties, the deficits touched astronomical heights and there is no respite in sight. Following the 'second oil price shock' of 1979-80, when the organisation of Petroleum Exporting Countries (OPEC) increased the crude oil price from around $ 13.00 per barrel to as high as $ 35.00 per barrel the trade deficit rose to Rs. 2,725 crores in 1979-80 and further to Rs. 5,383 crores in 1980-81 from a level of Rs. 1,085 crores in 1978-89. As in evident from table, the trade deficit rose to a record level of Rs. 8,763 crores in 1985-86. In 1989-90 it stood at Rs. 7,731 crores.

25.2.1 POSITION OF IMPORTS-REASONS

The most striking feature of trade is the large increases in its value. Both imports and exports have contributed to it. However, the contribution of imports is relatively larger resulting in huge trade deficits. A variety of factrors have contributed to this large rise in the value of imports. The most important factor has however, been the heavy imports of development goods, namely, capital goods and the maintenance goods for the same. This has been in pursuance of the objective of heavy industry-biased industrialisation initiated in the Second Plan. Quite often imports of foodgrains had to be resorted to on a significant scale largely to meet domestic shortages caused by floods and drought conditions. Another important factor has been the steep rise in the prices of import goods, in particular of petroleum and fertilizers since 1973-74. Devaluation of 1949 after a lag and that of 1966, also raised the rupee value of imports.

25.2.2 POSITION OF EXPORTS - REASONS FOR LOW GROWTH

There has also been a rise in the value of exports, although modest. Over the entire period since 1950-51, the rise has been a little more than 29 times. The growth too has been meagre and relatively small growth of exports. A lot of these causes originated in foreign countries in particular developed capitalist countries. Such developments as recessions abroad, protectionist barriers etc., errected by these countries restricted India's exports. The export of large many traditional items with low income and price elasticities also kept its value low, particularly in the earlier years. The earlier government's weak export-policy has also been responsible for this state of affairs. As for the recent modest increase in the value of exports is concerned one contributory factor has been the diversification of the economy. As a result non-traditional items like engineerings goods with high electrical (income-wise and price-wise) came to be exported to many countries. In fact, much of the later sharp increase is also due to these exports. Another important factor is the trade agreements with a number of countries in particular with the socialist countries and government's promotional efforts in recent years have also given a boost to exports.

25.2.3 OVERALL SITUATION

This total turnover i.e., (the value of imports plus the value of exports) has gone up by as much as 32 times over 1950-51. The growth has however, varied year to year. On the whole it has been low in the initial years and high in the value of trade. Despite the apparent fact of large increase in the value of trade, the picture is far from bright. Firstly, as a large part of the rise has been caused by an increase in imports, it conceals the fact of defecits in trade. Secondly, the rise however large, cannot be considered big enough for the country as it has taken place over a very small base, and it has happened over a period of four decades. Thirdly, a significant part of the rise is only in monetary terms, because of the large rise in the prices during this period. If we adjust it for the rise in price, the actual rise in volume/real trade will turn out to be much less. Fourthly, the increase in the total, as also in imports uncertainities. Fifthly, if one looks at the country's share in world exports, our performance would appear not so good. It has fallen over the years and now account for a meagre 0.5 per cent. Many developing countries have fared much better than India during eighties. These include China, Pakistan, Bangladesh, Sri Lanka, Barundi, Mauritania, Mali, Egypt, Thailand, Columbia, Malasia, Mexico, Turkey etc. Sixthly, inadequate availabilities of foreign exchange caused by a meagre rise in exports which means that the country does not earn thorough foreign exchanges to pay for the much-needed imports. Seventhly, the large functionaries in the terms of trade since 1950-51 and also frequent deterioration in the terms of trade which have also been sudden and sharp.

From the above discussion about the trends in the value of trade, it is obvious that which large imports have contributed to development, exports have not come up to the needs for foreign exchange, causing huge trade deficits. Besides these values have been much fluctuating with terms of trade often turning adverse suddenly and sharply. The picture on the whole is thus not satisfactory.

25.3 COMPOSITION OF TRADE

Another aspect of the trade of a country is its compositions. By composition of foreign trade of any country we imply the composition of exports and imports. An examination of the composition of foreign trade of a country enables us to analyse the progress of that country and the rate and speed of structural changes operating in it. For example, an industrialising country would be importing largely capital goods and exporting non-industrial products while the higly industrialised countries would be importing raw materials and goods in which they do not have comparative advantage and exporting largely industrial goods. Hence, we can safely conclude that the former group of countries are developing ones and the later group of countries are developed ones. It may also be mentioned that the speed with which a country changes its pattern of trade (leading to a percentage decline in imports of manufactured products and a percentage increase in the exports of such products) is sometimes taken by some economists on an indication of the pace of development in the country.

Before, the advent of planning in India, the main exports were primary goods like jute, tea, cotton, hides & skins, manganese ore, mica etc. while manufactured products constituted the bulk of imports. During the planning period, the process of industrialisation and economic development has induced a number of changes in the composition of foreign trade, as would be clear from the description below.

25.3.1 COMPOSITION OF IMPORTS

In 1947-48, the main items of imports in India in order of importance were : machinery of all kinds, oils (Vegetable, mineral and animal), grain, pulses and flour, cotton raw & waste vehical (excluding locomotives), cutlery, hardware implements & instruments, chemicals, drugs & medicines, dyes & colours; other yarns and textile fabrics, paper, paper board & stationary and metals other than iron and steel and manufactured. These imports together constituted more than 70 per cent of all imports.

The initiation of the planning process in the country in 1951-52, and more so the beginning of the Second Five Year Plan in 1956-57 introduced a programme of industrialisation with heavy emphasis on the development of capital goods & basic industries which brough about considerable change in the composition of imports. It became necessary to import capital equipment in large quantities. After some years maintenance imports' entered into the import structure of the country in a big way as spare parts, materials and machinery had to be imported in large quantitities to keep the equipment in working order. The composition of imports since 1960-61 is given in table-2.

In this table, imports of the country have been divided into two broad groups - bulk items & non-bulk items. Bulk items are further divided into (i) POL (Petroleum, Oil and Lubricants) and (ii) non-POL bulk items which include consumption goods, fertilizers & iron and steel. Non-bulk items are divided into capital goods, pearls, precious, semi-precious stones and other items. Capital goods are further divided into electrical & non-electrical machinery.

As is clear from this table, total imports in 1960-61 amounted to Rs. 1795 crores. Of this the largest share was of capital goods (Rs. 561 crores or 31.2 per cent). This was mainly due to the strategy of large scale industrialisation adopted in the second five year plan. The share of iron and steel in total imports was Rs. 193 crores (i.e., 10.8 per cent) and the share of POL was Rs. 109 crores i.e., 6.1 per cent.

The total import bill in 1970-71 amounted to Rs. 1634 crores of which the share of capital goods was Rs. 404 crores. The import expenditure on consumption goods amounted to Rs. 326 crores because of the requirements of building up buffer stocks of foodgrains. The decade of seventies saw a steep rise in import expenditure due to the substantial increase in oil prices. For instance, the price of oil was pushed up by OPEC from around $ 2.50 to $ 3.00 per barrel in the middle of 1973 to $ 11.65 per barrel in 1974 and around $ 13.00 per barrel in 1978 to around $ 35.00 per barrel in 1979. As a consequence of hikes in oil price in seventies, the order of importance of different imports which was on capital goods, consumption goods, iron and steel, petroleum oil and lubricants, fertilizers etc. in 1970-71 has changed in 1980-81, where POL imports occupied the first place followed by capital goods, consumption goods, iron and steel, fertilizers etc.

The decade of eighties witnessed important changes in the import policy of the government which was a major contributory factor to rising import expenditures in the eighties. Import bill rose substantially from Rs. 12,549 crores in 1980-81 to Rs. 17,134 crores in 1984-85 and further to Rs. 35,412 crores in 1989-90. Major items in India's import structure in 1989-90 were as follows: Capital goods accounting for an import expenditure of Rs. 8831 crores (25 per cent of total imports), petroleum oil & lubricants accounting for an import expenditure of Rs. 6274 crores (17.7 per cent), pearls, precious, semi-precious stones accounting for an import expenditure of Rs. 4242 crores (12 per cent), iron and steel accounting for an import expenditure of Rs. 2019 crores (5.7 per cent) & fertilizers accounting for an import expenditure of Rs. 1776 crores (5 per cent).

To sum up, the composition of Inda's import trade has undergone significant changes since Independence. The type of capital goods imported also reflect the capital intensive nature of the industries which are being established in the country and what is more significant is that in many items like bicycles, sewing machines, textile machinery, aluminium, caustic soda, newsprint, paper etc. Our dependence on imports have considerably declined and in certain items the almost elimination of manufactured consumer goods bears out the fact that many of these goods are being produced within the country.

25.3.2 COMPOSITION OF EXPORTS

The three most important commodities in India's export basket at the time of Independence were jute, tea and cotton textiles. Together they contributed more than 50 per cent of total earnings. During the start of the first five year plan, i.e., 1950-51, the share of these primary commodities in total export earnings was 38.5 per cent, 13.3 per cent and 8.3 per cent respectively which together constituted 60.1 per cent of total export earnings. While the share of manufactured goods was negligible, this pattern was basically due to underdeveloped nature of the economy. As the industrial structure of the country got strengthened and diversified, new commodities increased their share in total export earnings while the share of traditional primary goods continuously declined. To mention, while the combined share of jute, tea and cotton textile during the first decade of planning was around 47 to 48% it tumbled down to 31 per cent in 1970-71 and further to 9.7 per cent in 1989-90. As against this, the share of engineering goods which was meagre 2.1 per cent in 1960-61, went upto 12.9 per cent in 1970-71 and stood at 11.9 per cent in 1989-90. This changing export structure of the Indian economy clearly reflects the changing industrial base.

Another singificant feature to be noted is that the increases in exports have been quite broad based, specially in the last few years in the sphere of non-traditional items. While in respect of engineering goods, iron and steel, iron-ore chemical, sugar, the increases are really spectacular, other items have also expanded equally. Examples are cotton fabrics, leather and leather manufacturer, cashew kurnels, tobacco and oil cakes, coffee, fish and fish preparations etc. These facts clearly prove that Indian economy is not only becoming diversified, but that its different products are responding to the international requirements.

To sum up, the composition of India's export trade has undergone significant change since Independence considerable diversification is to be found in our exports. Many new/non-traditional items have become important. The items today number about fifty at the time of Independence and these items of exports are fast multiplying and are steadily gaining in importance.

25.4 DIRECTION OF TRADE

As a colony of Great Britain, India was an important trading partner of the commonwealth countries. As high as 70 per cent of the exports were diverted to this group of countries. Of the remaining 30 per cent, the share of West European countries had been 18 per cent and only about 12 per cent of its exports were diverted to the other nations of the world. As regards imports, the Commonwealth countries accounted for more than 80 per cent share. The remaining 20 per cent was distributed unevenly among three countries in Western Europe, the U.S.A., and Japan. This pattern continued for some years after Independence as well since India had not till then explored the possibilities of developing trade relations with other countries of the world. However, as political and diplomatic contacts developed the situation has changed very much since, and now after four decades of

planning, the trading relations exhibit marked changes. Particularly noteworthy is the expansion of trade (both exports and imports) with the socialist bloc countries especially USSR and the dependence on U.K. and its allies has considerably declined.

25.4.1 DIRECTION OF IMPORTS

In the year 1950-51, the share of the U.K. in India's imports was 20.8% and that of the U.S.A. was 18.3%. Within a decade, the picture started showing some changes. New trading partners like West Germany, Canada and USSR emerged. There was a change in the relative position of UK and USA, as well, with the latter pushing down the former to the second place. Excepting a year or two USA has coninuously maintained 1st position thereafter, the reason being that India has imported large scale quantities of capital goods, intermediate products and foodgrains (under P.L. 480 agreement) from USA. With the expansion of trading relating with Japan, West Germany and USSR, the dependence on UK declined from 20.8% in 1950-51 to 8.4% in 1989-90. On the other hand the share of Japan increased from 1.5% in 1950-51 to 8.0 per cent in 1989-90.

Another significant development in the expansion in trading relations with the socialist countries especially USSR is that imports from USSR were negligible in 1950-51. In 1960-61 they amounted to a meagre Rs. 16 crores, however, there often they increased rapidly as a result, share of USSR in India's imports increased from 1.4% in 1960-61 to 6.5% in 1970-71. During 1980-81 to 1983-84 USA occupied the first place in India's imports and USSR was second. In 1984-85 USSR occupied first place. The picture changed there after. In 1989-90 the order of importance of different countries in India's imports was as follows: USA share 12%, UK 8.4%, Japan 8%, West Germany 7.8%, Belgium share 7.6% and USSR 5.8%.

In recent years, OPEC (Organisation of Petroleum Exporting Countries) has emerged as a big source of imports an amount of the heavy expenditure being incurred by this country on imports of crude oil and petroleum products. For instance the share of OPEC in India's total imports rose from 7.6% in 1970-71 to 17.4% in 1985-86. However, because of the imports of petroleum and petroleum products in 1986-87, the share of OPEC in India's total imports fell to 9.7% and again increased to 13.3% in 1987-88, 13.4% in 1988-89 and further to 14.3% in 1989-90.

25.4.2 DIRECTION OF EXPORTS

Significant changes in the direction of exports have also occurred during the planning period. At the start of the Planning process in India in 1950-51, the share of U.K. in India's total exports was as high as 23.3 per cent. This came down substantially to 11.1 per cent in 1970-71 and 5.8 per cent in 1989-90. The second position in 1950-51 and 1960-61 was occupied by USA, its share in India's exports being 19.3% and 16.0% respectively. This indicates that India was dependent on UK and USA for 42.6% and 43% of its export earnings in 1950-51 and 1960-61 respectively. Other capitalist countries and socialist countries purchased Indian goods on a very small scale. However, after 1960-61, India's trading relations with these countries expanded at a very rapid pace. For instance USSR which purchased only Rs. 1 crore worth of goods from India in 1950-51 increased its purchases to Rs. 210 crore in 1970-71 and Rs. 2006 crores in 1985-86. Infact, during that year it occupied the first place in India's earnings. There after the position has changed and USA occupied the first position in 1986-87, 1987-88, 1988-89 and 1989-90 and USSR occupied 2nd place in all these years. The share of these countries in India's export in 1989-90 was as follows: USA 16.2 per cent, USSR 16.1 per cent, Japan 9.8%, West Germany 6.4 per cent and U.K. 5.8 per cent. As far as group of countries is concerned, the largest share of 55.9 of India's exports went to the OECD group in 1989-90. The East European group of countries accounted for 19.3% and the group of developing countries 15.6% of India's export earning in that year. To sum up India's exports have diversified to many countries over the years although a major proportion is concentrated in a few countries.

Inspite of India's increase in trade both in terms of value and volume (exports and imports) we cannot say that all is well with our foreign trade. There are already many adverse trends seen over the years like the India's percentage share in the world trade has been declining, adverse-rupee commodity ratio, increasing trade deficits, frequent and unfavourable terms of trade etc.

25.5 INDIA'S BALANCE OF PAYMENTS

When India became Independent it had a 'Sterling, balance of Rs. 1733 crores. This was the result of a sizable surplus or balance of trade with U.K. during the second world war period when U.K. had made large scale purchasing from India to meet its war requirements. The foreign exchange position of the country was therefore satisfactory. However, from the beginning of the planned era in 1950, India had faced the problem of deficit in its balance of payments. These deficits have risen from plan to plan and have been caused by many factors, largely associated with our planned efforts.

Taking the three year period 1948-49, 1949-50 and 1950-51 as a whole the deficit on current account stood at Rs. 260 crores and in capital account there was a substantial outflow of Rs. 324 crores in this period. Since the country had sufficient foreign exchange balances, the payment obligations were met without borrowing. Taking both current and capital accounts together the foreign exchange reserves were drawn by Rs. 583 crores. The country's deficit originated in the First Plan itself and continued rising unabated since then. During the first plan the deficits were small and were easily managed with little burden on the economy. However, the second plan period (with industrialisation under Mahalonobis strategy) witnessed large deficits almost ten times bigger than those in the previous plan. In the III, IV and V Five Year Plans, the deficits were about two to three times bigger than in the second plans. The sharp increase in deficits however, took place during the Sixth Plan and the Seventh Plan.

Table : Balance of Payments (Annual Average Deficits)

I Plan	II Plan	III Plan	Three Annual Plans	IV Plan	V Plan	VI Plan	VII Plan (1985-87)
32.5	344.7	615.0	1037.4	792.0	834.9	3062.0	3488.5

Source : Economic Surveys of Government of India

First Five Year Plan : The first five year plan was marked by a sharp increase in both imports and exports. The over all deficit in the balance of trade during the 1st plan was Rs. 541.9 or however, there was a surplus of Rs. 500.6 crores on the invisible account. The balance of payments situation was satisfactory as the deficit on current account was only Rs. 42.3 crores. The inflow of foreign capital won to the tune of Rs. 13.6 crores and draft on foreign exchange reserves was Rs. 127 crores.

Second Five Year Plan : Through out the second plan period, exports were stagnant and the value of imports was almost double the value of exports. As a result, the deficit in balance of trade was 2261.3 crores. The only positive feature was that receipts on invisible remained positive as in the first plan and as the overall deficit on current amount was reduced to Rs. 1646 crores. The inflow of foreign capital was of the order of Rs. 910.2 crores. The foreign exchange reserves were drawn down by Rs. 598.8 crores. It may be noted that the main cause of heavy deficits in balance of payments during the second plan was the development strategy adopted which necessitated large scale imports of capital equipment, machinery and technical know-how.

Third Five Year Plan : The average annual deficit in balance of payments (comprising deficit or current account and capital amount and errors) was Rs. 615 crores. A substantial part of the deficit was financed through foreign assistance. Loans amounted to an average of Rs. 535.7 crores per annum while grants averaged Rs. 29.3 crores per annum. Drawings from IMF (Gross) stood at an average of Rs. 48.8 crores per annum. Decline in foreign exchange reserves was Rs. 1.2 crores per annum.

Three Annual Plans : The total deficit in the balance of payments during the period of the three Annual Plans 1966-67 to 1968-69 stood at Rs. 3090.9 crores. This was financed totally from foreign assistance.

Fourth Five Year Plan : The total deficit in the fourth plan (comprising current account deficit and capital account deficit and errors & ommissions) stood at Rs. 3964.4 crores.

Fifth Five Year Plan : The import bill of India increased from Rs. 2729.3 crores in 1973-74 to Rs. 4156.9 crores in 1974-75 this was mainly due to the unprecedented rise in oil prices from $ 2.50 & 3.00 per barrel in the middle of 1973 to $ 11.65 per dollar in early 1974 - i.e., by four times. Despite the positive net receipts of Rs. 216.6 crores on invisible items. The country experienced a record deficit of Rs. 977.2 crores in the balance of trade in 1974-75 and the deficit on current account in this year amounted to Rs. 760.6 crores. Taking the Fifth Five Year Plan period as a whole, there was a surplus of Rs. 1403.7 crores on current account. Taking the current and capital account, the total deficit in balance of payments aggregated to Rs. 3010.4 crores. This was financed by foreign assistance in terms of loans & grants drawing from the IMF and foreign resources.

Sixth Five Year Plan : During each of the first four years of the Sixth plan there was a trade deficit of Rs. 6000 crores, however, in the last year of the plan i.e., 1984-85 the deficit rose to Rs. 6721.1 crores. The unexpected success in the country's offshore exploration activities helped India in curtailing its oil bill. In value terms the share of petroleum imports in total import expenditure declined from 42% in 1980-81 to 32% in 1984-85. However, non-oil imports continued to increase mainly as a result of import liberalisation policy on the other hand export growth was subdued.

Seventh Five Year Plan : The trade deficit in each of the first three years exceeded Rs. 9000 crores and in the 4th year (1988-89) touched the high level of Rs. 13,556 crores. The deficit on current account on a proportion of the Gross Domestic Product has gone up very sharply in recent years. This is evident from two key ratios namely the trade deficit and net earnings from invisibles (percentage of GDP) trade deficit which averaged 3.4 per cent of GDP during the sixth plan period increased to 3.7 per cent in 1985-86 and was 3.2 per cent in 1986-87. As for net earning from invisibles are concerned there was a sharp decline in them from an average of 2.1 per cent of GDP during the 6th plan to 1.4 per cent in 1985-86 and further to 1.2 per cent in 1986-87. In other words net invisibles financed on an average, more than 60 per cent of trade deficit during the 6th plan, they financed only 32 per cent of trade deficit during 1985-86 to 1988-89. As result of these trends the deficit in current account jumped substantially from an average of 1.3% of GDP during the Sixth Plan to 2.3 per cent in 1985-86 and 2 per cent in 1987-88. This is more than the targetted average of 1.6 per cent of GDP set for the Seventh Plan.

To sum up the balance of payments deficit continues to pose a very serious problem, especially with the increasing trade deficits on account of our imports exceeding our exports, reductions in private remittances coupled with a fall in the level of concessional aid. This situation no doubt has been causing much strain on the foreign exchange reserves and can lead to a further increase of our debt burden, it may also worsen in the years to come if the necessary time bound remedial and precautionary measures are not taken up.

25.6 SUMMARY & CONCLUSIONS

In short it can be said that India's foreign trade since Independence has undergone tremendous change in terms of value, composition and direction of trade. It is also obvious that India's Balance of Payments situation has been steadily worsening over years causing a serious balance of payments problem to the Indian economy.

- Dr. N. Vijaya

25.7 SUGGESTED BOOKS

1. Misra & Puri	:	Indian Economy (Chapters 44 & 45)
2. Michael P. Todaro	:	Economic Development in the Third World (Chapters 12-14)
3. J.S. Uppal	:	India's Economic Problems (Chapters 19 & 20)
4. Bo Soderstein	:	International Economics

25.8 MODEL EXAMINATION QUESTIONS

I. Answer the following in about 30 lines each.

1. What are the major trends in India's balance of trade during the last 15 years? Explain the causes for persistent deficit in India's balance of trade.
2. What is the composition of exports and imports in India's foreign trade?
3. Explain the pattern and direction of India's imports and exports.

II. Answer the following in about 15 lines each.

1. What is the position of India's balance of payments during the last 10 years?
2. Explain the low growth situation of India's exports.

Table - 25 : Value of Indias Foreigns Trade

An idea about the expansion in Indias Foreign trade can be had from the following table.

Year	Imports (Rs. Crores)	Exports (Rs. Crores)	Total valuc of Trade (Rs. Crores)	Balance of Trade (Rs. Crores)
1950-51	1,025	947	1,972	(-) 78
1960-61	1,795	1,040	2,835	(-) 775
1965-66	2,218	1,269	3,487	(-) (949)
1970-71	1,634	1,535	3,169	(-) (9x)
1972-73	1,867	1,971	3,838	(+) (104)
1975-76	5,265	4,043	9,308	(-) (1,222)
1976-77	5,074	5,143	10,217	(+) (69)
1980-81	12,549	6,711	19,260	- (5,838)
1981-82	13,608	7,806	21,414	- (5,802)
1982-83	14,293	8,803	23,096	- (5,490)
1983-84	15,831	9,771	25,602	- (6,000)
1984-85	17,135	11,744	28,879	- (5,391)
1985-86	19,658	10,895	30,553	- (8,765)
1986-87	20,096	12,452	32,553	- (7,644)
1987-88	22,244	15,674	37,918	- (6,570)
1988-89	28,194	20,302	48,496	- (7,892)
1989-90	35,412	27,681	63,093	- (7,731)

Note : Figures for 1989-90 are provisional.

Sources : (i) For 1950-51 figures, Commerce Annual Number, Table 6.8 (xvii), p.vi;
(ii) For 1960-61 and 1965-66 figures, Government of India, Economic Survey, 1974-75, Tables 6.6 and 6.7, pp 102.3;
(iii) For 1970-71 to 1976-77 figures, Economic Survey, 1980-81, Tables 6.6 and 6.7, pp. 119.21;
(iv) For 1980-81 to 1984-85 figures, Economic Survey, 1989-90, Table 7.2 and 7.3, pp. S-74 to s-77;
(v) For 1985-86 to 1989-90 figures, RBI, Report on Currency and Finance, 1989-90, Vol.I, Table X-1, p.337.

Table - 25 : COMPOSITION OF INDIAS IMPORTS (PLAIN SUBGROUPS)

(Rs. Crores)

Commodity Groups (1)	1960-61 (2)	1970-71 (3)	1980-81 (4)	1984-85 (5)	1989-90 (6)
I. BULK ITEMS	N.A.	825	8,739	10,039	14,239
1. POL	109	137	5,267	5,409	6,274
2. Non-POL bulk items	N.A.	688	3,472	4,630	7,965
a) Consumption goods	N.A.	326	901	1,389	914
b) Fertilizers	23	100	818	1,346	1,776
c) Iron & Steel	193	147	852	941	2,019
II. NON BULK ITEMS	N.A.	809	3,810	7,095	21,173
1. Capital goods	561	404	1,910	3,168	8,831
a) Electrical Machinery	90	70	260	663	1,922
b) Non-Electrical Machinery	320	258	1,089	1,995	3,532
2. Pearls, precious & semi precious stones	N.A.	25	417	1,032	4,242
3. Others	N.A.	380	1,483	2,895	8,100
Total	1,795	1,634	12,549	17,134	35,412

Source: For figures in col. (2) Government of India, Economy survey, 1972-73, Table 6.6 pp. 160-1.
For col. (3 to 6) RBI Report on Currency & Finance, 1989-90. Vol. I table x-5 p.349.

Table - 3 : Composition of Indian Exports

(Rs. Crores - Post Devaluation)

Commodity	1960-61	1970-71	1975-76	1978-79	1979-80	1985-86	1988-89	1989-90
1. Jute	213	190	248	167	336	262	250	298
2. Tea & Meat	195	148	237	341	368	626	599	905
3. Cotton fabricS	91	142	159	224	287	574	1,131	1,480
4. Iron ore	27	117	214	233	285	579	673	928
5. Leather & leather manufactures	39	80	201	328	486	770	1,490	1,951
6. Cashew kernels	30	57	96	80	118	225	277	368
7. Tobacco	25	33	98	116	113	170	128	175
8. Engineering goods*	22	198	477	819	772	954	2,322	3,284
9. Ready-made garments	-	29	-	421	460	1,067	2,098	3,224
10. Handicrafts of which	N.A.	73	224	957	832	1,881	5,195	6,285
Gems & jewellery	N.A.	45	123	714	519	1,503	4,399	5,296
11. Cofee	11	25	66	144	163	265	280	343
12. Mica	16	16	15	19	21	21	29	N.A.
13. Raw Cotton	14	14	39	16	75	68	28	128
14. Chemicals & allied products	5	29	84	148	198	498	1,534	2,158
15. Fish & fish preparations	7	31	127	226	253	409	633	687
16. Others	-	-	-	1,487	1,651	2,526	3,629	-
Total	1,040	1,535	4,036	5,726	6,418	10,895	20,295	27,681

* Engineering goods include machinery, transport equipment & metal manufactures including iron & steel.

Sources : (i) Govt. of India, Economics Survey, 1971-72, Table 6.7 pp. 140-41

(ii) Economic Survey, 1984-85, Table 6.6 pp 160-1.

(iii) Economic Survey, 1985-86, Table 6.7, pp 164-5., (iv) Economic Survey, 1989-90, Table 7.3, pp S-76 and S-77 V RBI, Report on Currency and Finance, 1989-90, Vol I, Tables X-3 and X-4, pp 340-2.

SYLLABUS

BLOCK-I : MONEY

Unit-1 : Concept of Money-Meaning and components of Money Supply

Unit-2 : Functions and Importance of Money

Unit-3 : Value of Money - Measurement - Index Numbers

Unit-4 : Theories of Value of Money: Fisher, Cambridge and Friedman

Unit-5 : Supply of Money in India

Unit-6 : Inflation Theory and Indian Evidence

BLOCK-II : BANKING

Unit-7 : Concept & Role of Banking

Unit-8 : Commercial Banks : Functions, Principles & Credit Creation

Unit-9 : Indian Banking System

Unit-10 : Central Banking - Principles & Functions

Unit-11 : Reserve Bank of India - Functions and Working

Unit-12 : Monetary Policy : Objectives and Instruments (With special reference to India)

Unit-13 : Money Market in Developed & Developing Countries

Unit-14 : Money Market and Capital Market in India

Unit-15 : Bank Nationalisation and Advances to Priority Sectors

Unit-16 : Cooperative Banking

Unit - 17 : Regional Rural Banks

Unit-18 : RBI and Agricultural Finance : Policy and Institutions

BLOCK - III : INTERNATIONAL TRADE

Unit-19 : Need for A Separate Theory of International Trade

Unit-20 : Theories of International Trade

Unit-21 : Terms of Trade and Gains from Trade

Unit-22 : Balance of Payments

Unit-23 : Exchange Rates

Unit-24 : International Monetary System

Unit-25 : India's Foreign Trade and Payments

Faculty of Social Sciences

B.A. III Year (3 YDC) Examination

ECONOMICS

Paper - IV : Money, Banking & International Trade

Time 3 hours] [Max. Marks 100
Min. Marks 35

Section - A (Marks 4 x 15 = 60)

* Answer any Four of the following Eight questions.
* Each question carries 15 marks
* Answer the following in about 30 lines each.

1. Explain the various functions of money.
2. Critically examine the quantity theory of money.
3. "Loans create deposits" - Discuss.
4. What are the functions of a Central Bank?
5. Briefly describe the weapons of credit control employed by the Reserve Bank of India.
6. Examine the modern theory of international trade.
7. Discuss the advantages and disadvantages of flexible exchange rates.
8. Discuss the objectives and effects of import-substitution policy in India.

Section - B (Marks 5 x 8 = 40)

* Answer any Five of the following Ten questions.
* Each question carries 8 marks.
* Answer the following in about 15 lines each.

9. What are the major determinants of money supply?
10. Explain the different types of money.
11. What are the motives of holding money?
12. What are the main constituents of money supply?
13. What is the system of note-issue followed by R.B.I.?
14. What are the major objectives of monetary policy?
15. Explain the structure of Land Development Banks.
16. Explain the difference between internal and international trade. What is the necessity of separate theory of international trade?
17. Explain the difference between balance of trade and balance of payments.
18. How is the exchange rate determined under gold standard?

Faculty of Social Sciences

B.A. III Year (3 YDC) Examination

ECONOMICS

Paper - IV : Money, Banking & International Trade

ASSIGNMENT NO. 1

N.B. :

1. Do not copy the answer directly from any of the books.
2. As far as possible try to answer the questions independently in your own words.
3. If it is necessary to quote from any source, give the correct reference.
4. Use your own foolscape pages for writing the assignment.
5. Leave sufficient margin for the comments of the evaluator.
6. Completion of this assignment normally should not take more than 2 (two) hours' time.

I. Answer the following questions in about 30 lines each.

1. Define money and explain various kinds of money.
2. Define inflation and discuss causes, effects and remedies of inflation.
3. State and explain Fisher's equation of exchange.

II. Answer the following questions in about 15 lines each.

1. Explain the inflationary gap.
2. Explain the transaction demand for money.
3. Explain the 'circular flow of money' in any economy.

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B.A. III Year (3 YDC) Examination

ECONOMICS

Paper - IV : Money, Banking & International Trade

ASSIGNMENT NO. 2

N.B. :

1. Do not copy the answer directly from any of the books.
2. As far as possible try to answer the questions independently in your own words.
3. If it is necessary to quote from any source, give the correct reference.
4. Use your own foolscape pages for writing the assignment.
5. Leave sufficient margin for the comments of the evaluator.
6. Completion of this assignment normally should not take more than 2 (two) hours' time.

I. Answer the following questions in about 30 lines each.

1. What are the main functions of commercial banks?
2. What are the major features of Indian money markets?
3. What are the various methods of credit control available to a Central Bank?

II. Answer the following questions in about 15 lines each.

1. What is social control? Why was it imposed?
2. What future do you visualise for the co-operatives in India?
3. Explain the scope and operations of NABARD towards agricultural credit.

Faculty of Social Sciences

B.A. III Year (3 YDC) Examination

ECONOMICS

Paper - IV : Money, Banking & International Trade

ASSIGNMENT NO. 3

N.B. :

1. Do not copy the answer directly from any of the books.
2. As far as possible try to answer the questions independently in your own words.
3. If it is necessary to quote from any source, give the correct reference.
4. Use your own foolscape pages for writing the assignment.
5. Leave sufficient margin for the comments of the evaluator.
6. Completion of this assignment normally should not take more than 2 (two) hours' time.

I. Answer the following questions in about 30 lines each.

1. Explain the classical theories of international trade.
2. Discuss how disequilibrium in balance of payments is corrected.
3. Critically examine the purchasing power parity theory.

II. Answer the following questions in about 15 lines each.

1. Explain the objectives of I.M.F.
2. Explain the export promotion policy.
3. Explain the difference between balance of trade and balance of payments.